Overview

George C. Lodge

The task of this panel is to describe the policy implications of what we have heard yesterday and today. Since there is some ambivalence and contradiction in what has been said, we are, I assume, free to choose the thoughts whose implications we trace.

Fred Bergsten said, and Bob Lawrence told me after his speech, that competition from Japan and other Asian countries, and even some European countries, was a significant factor in causing our economic devastation and contributed in an important way to our $60-billion to $100-billion trade deficit. Economic recovery, such as it may be, is no remedy for competitive failure. The remedy? Improve efficiency, said Lawrence and others: Lower prices, improve quality, lower wages, lower income. And as Jeff Sachs and Ray Marshall suggested, countries do this best which are good at developing a consensus between government, business, and labor about how the burdens of this austerity are to be shared. Thus, continued competitive pressure will force institutional — structural — changes with important implications for both public policy and business policy. (Larry Summers' view that such changes provide "no reason for public policy" was of course different.)

Much was said about industrial policy. Here I agree with George Eads and others that the choice is not to have one or not. The choice is a good one or a foolish one: coherence vs. ad hocery. Robert Kuttner put it well: "We commit industrial policy with a set of ideological blinders on that prevent us from doing it very well."

Proceeding from there, allow me to sketch broadly the changes which I see as happening and inevitable. I shall do this by analyzing three cherished myths and how reality is eroding those myths. We are tempted to follow the myths and to deny reality, a path without promise. In a sense this is a psychological or psycho-ideological problem. It requires us to inspect some basic assumptions.

Myth No. 1: free trade and comparative advantage

The myth: The comparative advantage of one nation over another in world competition derives from its natural resources, its labor, and its capital. An essentially static notion, this idea led many western economists to conclude, for example, that Japan at the end of World War II was a basket case and could develop only by making maximum use of its major resource, cheap labor.[1]

According to this idea, countries should produce what they can make most efficiently and trade for the rest. Trade occurs among numerous private companies in markets where prices are set by the laws of supply and demand. The task of government is to keep the avenues of trade free and open through multilateral agreements. In this way all economies will eventually grow and prosper, although some may need to suffer the short-run pain of adjustment to changes in comparative advantge.[2]

The reality: The static conception of comparative advantage, David Richardson implied, is no longer relevant. As my colleague Bruce Scott has pointed out: "Unwilling to accept the conventional Western idea that their role is to specialize in goods based on cheap labor . . . the East Asians have forged a dynamic theory of comparative advantage that allows them to allocate human and financial resources towards jobs with high value-added in growing industries and, for example, to succeed in steel despite a lack of both coal and iron."[3]

Through the use of systematic government policies, Japan has moved its economy from labor-intensive products such as textiles, to capital-intensive goods such as television sets and automobiles, into the advanced-technology sectors of electronics, semiconductors, and computers.[4] Many other countries are following the Japanese exam-

1. See Bruce Scott, "Can Industry Survive the Welfare State?" *Harvard Business Review,* September-October 1982.

2. John Zysman and Stephen S. Cohen, ***The Mercantilist Challenge to the Liberal International Trade Order,*** a study prepared for the Joint Economic Committee of the U.S. Congress, U.S. Government Printing Office, Washington, D.C. 1982, p. 4.

3. Scott, p. 72.

4. Zysman and Cohen, p. 9.

ple. Successful countries — that is, those who are able to formulate national goals and policies which achieve them — have learned how to ***create*** comparative advantage and design it to achieve a global strategy.

Under such circumstances the old premise of free trade is in many ways a delusion. "The assumption — half fact and half fiction — that governments are negotiating about the rules of trade, leaving the market to settle the outcomes, is increasingly less tenable," writes John Zysman and Stephen Cohen in a study prepared for the United States Congress.[5] Government, in fact, is concerned with outcomes. Countries are designing policies and institutions both to create advantage, that is achieve competitiveness, and to ease the costs of industrial transition within their borders. Both sets of activities fundamentally disrupt the traditional premise of free trade.

To echo David Richardson, countries, like companies, have portfolios of business or industries. Government policies are used to influence the mix in the portfolio as well as its structure: the development of new industries, the concentration of old, the redeployment of capital and labor out of declining and into growth sectors, the encouragement of research and development in carefully targeted areas, and more.[6] The United States is losing market share to those countries with effective competitive strategies.

The alternatives for America appear to be: to devise a competitive national strategy for itself, or to continue to resort to a variety of devices to protect its weakening industries from the strategies of others. Its attempts to change reality — that is, to force other countries to abandon their strategies and to play by the rules of free trade — have not worked, and it is unlikely that they will.

For example, the attempt to use U.S. countervailing duty laws to prevent European government from subsidizing their steel industries in 1982 evolved into a market-sharing agreement — hardly free trade. The legal action threatened a broad range of U.S. interests in Europe, ranging from the purchase of U.S. agricultural goods to nuclear policy versus the Soviet Union. These countervailing interests were sufficient to convert the enforcement of the laws into a negotiated agreement under which the Europeans promised to limit their steel exports to the U.S. to 5.4 percent of the market. If it is gov-

---

5. **Zysman and Cohen, p. 5.**
6. **Scott, p. 75.**

ernmentally negotiated shares which will determine the size and nature of the world steel industry, then a number of other decisions are naturally forced upon government about the nature and size of the U.S. industry, the costs of retrenchment, and the national interest concerning imports (presumably Mexican steel is preferable to Korean, at least until the Mexicans get their bank debts paid). And if steel is diminishing as a contributor to our economy, what takes its place? We are thus driven to examine the next myth having to do with what is government's proper function.

Myth No. 2: the role of government

The myth: As David Richardson again said, Americans have traditionally adhered to the concept of John Locke and his followers that government is a necessary evil: the less of it the better. Its purposes are best limited to protecting body and property and the enforcement of contracts. What there is of it should be checked, balanced, and separated. It should neither plan nor indeed even be coherent, and as many of its functions as possible should be decentralized. Implicitly, it should be responsive to interest groups and crises. "Because of the inherently antigovernment character of the American creed," writes Samuel Huntington, "government that is strong is illegitimate, government that is legitimate is weak."[7]

The reality: The results of efforts to diminish the role of government have been disappointing because of the global reality in which the United States finds itself requires a quite different conception of government — not more of it, but a different conception. As government policies bear ever more importantly on U.S. competitiveness, the government is being forced to a fuller consciousness of the myriad effects of what it does; if there is conflict and contradiction, it must choose priorities and work to create the consensus to implement its choices. Clearly the vast array of government transfer payments — subsidies and loans as well as its environmental, tax, and monetary policies — have a critical effect on savings, investment, and industry growth. The fact is that the pulls and thrusts of interest groups, augmented by crises of one sort or another, have created a very large and very interventionary government. Government, which traditionally eschewed making its interventions coherent because of

---

7. *American Politics: The Promise of Disharmony*, Cambndge, Mass., Harvard University Press, 1981, p. 39.

its allegiance to the traditional myth and aversion to anything called "planning," has now found it necessary to become more coherent — for budgetary reasons if for no other. President Reagan's centralization of regulatory authority in the Office of Management and Budget is a case in point. Although one cannot yet say that the United States as a whole has grasped the necessity of a strategy for competitiveness, it is quite clear that a number of leaders of business and labor have done so: They have perceived the new reality.

The myth of the limited state has produced a large, expensive, and incoherent government, but the government has not been without a strategy. That strategy, however, has been implicit, indeed intentionally so, given our creedal aversion to making it explicit. The goals of the strategy have been short-term consumer welfare, "a higher standard of living through subsidies to consumption," with a consequent erosion of investment and productivity. Meanwhile, other nations have shaped their strategy to raise the standard of living by encouraging savings, investment, and productivity.

In implementing its strategy, Zysman and Cohen have referred to the Japanese government's two roles: It is "a gatekeeper," controlling the links between the domestic and the international economy, and it is "the front office," promoting, guiding, and financing domestic firms to achieve rapid expansion and to gain increased shares of world markets.' As a gatekeeper, it controls what enters in the way of technology, capital, and foreign-based control. As a promoter, it force-feeds industries at the frontier of innovation and growth so as to.hasten their capacity to compete in the world. Japan produced only 160,000 cars in 1960. By 1970 they were producing 3.1 million cars, and ten years later it was more than 8 million a year.[9] This dramatic increase was made possible in part by the Japanese tax system, which allowed very rapid depreciation schedules, and by a credit policy that provided long-term debt at low interest rates.

The myth of the limited state has caused the United States to shun government credit allocation and to leave it to the supposedly free capital markets. But consider the reality. In 1981, the Council of Economic Advisers reported, $361 billion was raised in U.S. credit markets. Of this, $86.5 billion resulted from federal government

8. Zysman and Cohen, p. 13.

9. Zysman and Cohen, p. 17.

activity: loan guarantees to ailing giants in the steel, automotive, and other industries; housing loans and guarantees; and subsidies to farmers and the like. The council decried the fact that "increasingly political judgments, rather than marketplace judgments, have been responsible for allocating the supply of credit."[10] The council went on to suggest a formal "federal credit budget." Is this — should this be — the beginning of some coherent procedure whereby the federal government considers priorities for credit? The U.S. government cannot choose winners and losers, it is said. But does it not already do so, favoring the losers over the winners? Contemplating the national interest in world competition, could not one draw a useful distinction, for example, between the semiconductor industry and fast-food shops? The free market/limited state myth would say no; reality suggests a different answer.

The myth of limited government has produced a governmental organization in which not only the executive branch is separated from the legislative, but in which also the various agencies of the executive branch are disjointed. Trade policy, for example, is now made in countless places throughout Washington: Defense, Commerce, Treasury, Agriculture, Labor, the Senate, and the House. The office of the United States Trade Representative is theoretically designed to coordinate all trade policy, but it can only do this with strong presidential endorsement, which in 1983 was not present. Reality is forcing change in this fragmented structure, but it comes slowly. Meanwhile, our competitors proceed more deliberately.

Converting the American government into such a machine seems most unlikely, given the power — and indeed the value — of the old myth of the limited state. But reality appears to be forcing a permanent shift in the role of government. It is inconceivable that government could successfully undertake such a role without the close collaboration of business and labor, particularly big business, which is heavily engaged in world competition. Business, not government, has the competence necessary to compete successfully, but this competence is handicapped if it is not nourished and legitimized by government policies. That such a consensus can be developed was shown in the working of the advisory committee to the USTR in the 1979 trade negotiations.

---

10. *The Economic Report of the President,* transmitted to the Congress, February 1982, p. 94.

Myth No. 3: managers and managed

The myth: The old assumption is rooted in the ideas of property rights and contract: The owner is free to do with his business as he will, observing either short- or long-run considerations, and he can hire and fire his employees, who have an obligation to obey the contract of employment. At first the contract was individualistic, and the owners' right to fix the terms was constrained only by the market for labor. As managers replaced owners in large publicly held companies, their obligation was to maximize benefit to owners, as the managers and owners defined that benefit, generally in terms of earnings per share, often over the short run. With the rise of trade unions, the contract in many companies became both collective and adversarial, its terms set through bargaining.

The reality: Again, multiple erosion has occurred. The institutionalization of the stock market has meant that it is difficult for managers to obtain a true reading of the owners' wishes. They are frequently driven, therefore, to "play to the mercurial tics and prejudices of a small cadre of stock price influencers' shifting ideas of value rather than value itself," to use consultant John Schnapp's colorful language."

Furthermore, debtholders — banks and other financial institutions — have become more important in many cases than shareholders. And the various demands of government and the community in general have become more pressing.

Finally, a variety of factors have caused change in relationships between managers and managed. The heirarchical separation of managers and workers that tended to result from the old model has become costly. With rising levels of education, workers obtain greater fulfillment by being involved in the decisions affecting their work which had previously been made exclusively by management. The introduction of new technology proceeds more smoothly and efficiently if workers are informed and consulted before it is introduced and if they join in managing the new procedures.

In many unionized settings, the old concept of managerial prerogatives and adversarial relationships drove labor costs far above that of foreign competitors, causing industrial deterioration and unemployment. Many unions, most notably the United Automobile Workers

---

11. "Who for the Pedestal Now?" New York *Times*, **July 11, 1982**

and the Communication Workers of America, have recognized that restraint was necessary in order to save jobs. But they are unwilling to restrain their adversarial proclivities without a promise of participation in such management decisions as investment, allocation of profits, employment security (as Michael Wachter suggested), and even managerial salaries. Why should a worker take a pay cut if the profits gained thereby would be used to raise top management's salaries or to purchase an oil company or a savings and loan association?

In a wide variety of ways and for many reasons, therefore, the old notion of contract is being replaced by a new one of consensus. Managers and managed have mutualities of interest that are far greater than their conflicts. Both, at least theoretically, have an equal interest in competitiveness and in the company's ability to attract capital from whatever market — equity, debt, or government. This new fact has expressed itself in a variety of programs ranging from "quality of work life" and employee involvement in the auto industry to employee buy-outs. Some 16 percent of America's major companies in 1983 were estimated to be involved in such buy-outs. They were less expensive than shutdowns, since employees who owned the firm were prepared to sacrifice to make it competitive. Board membership in these new companies was generally shared by managers and workers. In fact, the separation implied by these old words was no longer appropriate.

The significance of these changes for managers and unions is radical and profound. The old bases of authority for each has been eroded; new ones are unclear. Some feel that the time has come to do away with unions altogether, their old adversarial mission having shown itself to be counter-productive. At the same time, thoughtful managers know that whatever the myth, their right to manage is in fact coming from those whom they manage. This is the wave of the future.

The competitiveness of American enterprise seems to depend on a quite new concept of corporate governance. From whence will the right and ability to manage derive in the 1980s and beyond: shareholders, debtholders, the managed, or the community, through government? How will the balance among these four sources be arranged? In Japan, shareholders are of little significance, and the relationships among banks, government, managers, and managed are carefully constructed for growth and competition. How will the United States respond? The debate on corporate governance in the

United States in 1983 seemed appropriate but remote from the problem as the old arguments proceeded about inside vs. outside directors, shareholder democracy, and the like.

I am not arguing that these changes in the traditional paradigm are good or even desirable. Each is fraught with problems. But I am saying that they are occurring and will continue to do so. Denying reality because of an affection for old myths is a form of psychosis which will solve nothing.