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To the U.S.-China Economic and Security Review Commission
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Mr. Chairman and members of the Committee:

Thank you for the opportunity to take part in this hearing. The subjects that we are to discuss today are the ones with which I have been involved in one way or another for much of my working life. For almost 20 years I was the head of the research effort of a major international corporation (IBM), and had the opportunity to see firsthand the transformation of an Asian nation (Japan) from being relatively undeveloped technologically and economically to having a major worldwide impact in computers, semiconductors, electronics and automobiles. For the next 18 years I was the head of a major foundation (Alfred P. Sloan Foundation), deeply interested in science, technology, and economics. In addition, through most of my working life I have been an individual researcher in the areas of applied mathematics and economics. Today I am a Research Professor at New York University's Stern School of Business.

While the transformation of Japan in the 1970's and 1980's shows the possibility of rapid economic development in a nation that was relatively undeveloped, what we are seeing in China – the situation with which we are concerned today – is markedly different from the Japanese model. The Japanese government successfully fostered economic and technological growth with government-sponsored efforts to develop Japanese technology and Japanese companies within Japan, often testing these companies in the restricted Japanese market and then, when they deemed these companies competitive, helped them on a path to worldwide markets. During this time, U.S. corporations often struggled against significant obstacles to have major facilities in Japan or to gain Japanese market share.

The Chinese government on the other hand, has chosen a different path. To develop the industries it deems important for China, it will sometimes subsidize wholly Chinese companies. It will sometimes also subsidize American- or partly American-owned companies. In this way, China can make it profitable for these companies to develop production facilities in China and, more recently, to expand R&D as well. The result is to create in China, and as part of the Chinese GDP, facilities that access and practice the most current methodology and R&D. Often the output of these facilities goes to the U.S. market. There, with the effect of subsidy, low labor costs, or up-to-date methodology – or all three – they can often outcompete U.S. firms actually working in the United States.

The result is that U.S. companies are contributing to the development of China and simultaneously contributing to the loss of jobs and destruction of industries in the United States. Nevertheless, they are doing these things in the pursuit of the widely accepted corporate goal of maximizing profits.

[1] The views expressed here are solely my own and do not represent the views of any of these organizations.

We must therefore realize that in the modern globalizing world, the interests of many of our global corporations and the interests of the nation have diverged.

To put these developments into perspective a bit of history helps.

A Historical View

For a very long time most of the work of the world was done on farms or in small shops. An individual could learn the printing trade or shoe making and graduate to his own shop; a family could run a farm. In both cases an individual or very small groups of people could grow crops or make shoes that could be sold to others and thus have the money to supply what was not made at home.

But today the goods we consume cannot be made at home; they are complex and require large organizations to create them. You cannot manufacture a car in your garage; it takes a large-scale organization to do it. The food you eat is not produced by a family on a nearby farm, but is made by large organizations on highly mechanized farms with machinery produced by other large organizations. The food itself then travels on highly organized transportation networks to get to huge outlets, where nearby you can pick up a refrigerator made by another large organization or a television set that no individual or small group could ever build.

The same is true of services: there is no way to build your own telephone service. And even medicine, one of the last strongholds of the individual practitioner, is rapidly agglomerating into large-scale enterprises.

A person must now be part of an organization that makes or distributes the complex goods and services that people buy today. Being part of an organization is what people must do to earn a living and support themselves and their families. *The fundamental social role of corporations and other businesses is to enable people to participate in the production of the goods and services that are consumed in the modern world; this is what enables people to earn a share of the value produced for themselves and their families.*

The Divergence of the Profit Motive and the Fundamental Role

As I mentioned above, globalization has now made it possible for U.S. global corporations to pursue their profits by building capabilities abroad. *Instead of investing alongside U.S. workers and using their investment and R&D to increase their productivity, corporations today can produce goods and services abroad using low-cost labor, and import those goods and services into the United States.* But in creating their profits this way, they are building up the GDP of other countries while breaking their once-tight links with America's own GDP.

Economists will sometimes argue that this development of capabilities abroad is good for the U.S. economy as a whole. For one thing, we get cheaper goods. That is certainly true, but it is also true that if we lose our superior capabilities in many areas and are less competitive, we have less to trade for those goods, so that eventually the cheaper goods become expensive in real terms. I do not intend to repeat today the arguments that are spelled out in the book on global trade and its consequences that I co-authored with Professor Will Baumol.

I would like to point out, however, that the view that the industrial development in your trading partner can be harmful to your total GDP is not new. There is a long history of well-known economists making that observation, most recently Paul Samuelson.[2] What Professor Baumol and I have added to that long history in our book *Global Trade and Conflicting National Interests* is the realization that the benefits of your trading partner's economic development occur in the early stages of its development, and as your partner becomes more fully industrialized and is no longer confined to low value-added industries, further development is harmful to your GDP.

This result, which we derive rigorously from the most standard economic models, corresponds to the intuitive notion that we do well when we lose low-wage jobs and not well when we start losing high-wage or high-tech jobs. We are losing high-wage and high tech jobs today; this conforms to the notion that we have reached the point of conflict between corporate and country goals.

Aligning Country and Company

As we have seen above, China has a national strategy aimed at the rapid increase of its GDP. As part of that strategy the country aligns corporate goals with national goals. China has made it profitable for foreign (often U.S.) corporations to create high value-added jobs in China. They do this by offering tax and other incentives that make it *profitable* for corporations to locate high value-added jobs in China. They are exploiting the fact that the capabilities of today's global corporations are available to the bidder who offers the highest profit.

We need to consider a U.S. national economic strategy that includes incentives for companies to have high value-added jobs in the United States. If we want high value-added jobs, let us reward our companies for producing such jobs – whether they do that through R&D and advanced technology, or by just plain American ingenuity applied in any setting whatsoever.

The Asian countries have done this often by individual deals with individual companies. We lack the tradition, the knowledge and the inclination in the U.S. government to do that. An approach that is better suited to U.S. capabilities would be to use the corporate income tax. We have already used the corporate income tax to spur R&D, so why not apply it to directly reward what we are aiming at - high value-added jobs.

For example, the corporate tax rate could be scaled by the value that is added per full-time employee, by the workers of corporations operating in the United States. A company with high value-add per U.S. employee would get a low rate, a company with low value-add per U.S. employee would get a high rate. This tax could be made revenue-neutral by having a high tax rate for unproductive companies balance a low (or even negative) tax rate for productive companies. Depending on the rates, it could be as strong or as weak an incentive as desired. This is quite doable, as value-add is measurable. Indeed, it is measured today in Europe as the basis for the value-added tax.

This would be a tax aimed at results not means. It would not be for big companies particularly or for small. It would not be for high-tech or low tech. It would be very American, anyone whose company, large or small, has high value add per person would benefit; those who are unproductive would see their profits heavily taxed. It would be an incentive to find new and better ways to do things in every industry.

[2] See References 1-6.

Critics of this or any change may say that our national economic strategy is, in fact, to leave markets alone and take whatever those markets produce. They may also suggest that this is the best possible economic strategy. But “free market” is not a single, simple concept. Do we mean free markets with or without anti-trust laws? With or without child-labor laws? Do we want financial markets with virtually no supervision? Different restrictions and policies will produce different results all coming from “free markets”; as will different tax policies or special loans for special industries, and so on and so on. After the recent debacles perhaps it is time to think seriously about what kind of free markets we really want.

Controlling our own Destiny – the Need for Balanced Trade

If we were alone in the world, we could adopt whatever internal policies we wanted, for example the tax mentioned above to encourage productivity; companies who wanted to produce in the United States would have no choice but to conform. But we are not alone in this globalizing world. And today many companies have found it advantageous to move production and R&D abroad. Driven by foreign subsidies and underpriced currencies so many companies have done this that we have a huge and unsustainable balance-of-payments deficit.

China in particular is loaning us the money to buy their underpriced goods with all the destructive effects that go with that. This had been a major contributor to the imbalance of trade, which is not a sustainable path for this or any nation. We are in effect living beyond our means, importing more value than we export, consuming more value than we create. Warren Bufffet, in a *Fortune* article[3], accurately compared us to a rich family living beyond its means by steadily selling off pieces of the family estate.

If we change our tax structure to reward those who create value here in the United States there would also be nothing to prevent U.S. companies from leaving the country, and continuing to send in goods and services from abroad, thus continuing the imbalance of trade and further weakening the productive capabilities of the country.

On the other hand, if trade is balanced, the value of goods imported is matched to the value of goods exported from the country; those exported goods and services are provided by corporations that produce in the United States and comply with the U.S. standard of what a corporation should be. *Balanced trade is therefore necessary if we are to control our own economic destiny*.

It is worth mentioning that balanced trade is one of the standard conditions of an economic equilibrium, although it gets less press than another condition, known as “comparative advantage”. With balanced trade, trade can get sorted out. Companies that are in the United States and conform to its policies balancing by their exports whatever is imported. But if we do nothing to rebalance trade we are at the mercy of the mercantilist policies of foreign countries whose policies can flood us with their goods, create increasing indebtedness, and destroy our industries.

That is why balancing trade is essential for controlling our own economic destiny.

[3] Reference 11

Balancing Trade

There is, of course, a long list of approaches to balancing trade, ranging from jawboning to tariffs. I do not attempt to list them here. But I do want to single out one simple approach advanced and advocated by Warren Buffet that could really make a difference. It is well described in his 2003 article in *Fortune*[4]. This approach, in contrast to import quotas or tariffs aimed at imports from particular countries, creates a free market in import certificates. It would balance trade and would give us control over our own economic destiny.

Since the import certificate approach is a major departure from the past it should be introduced gradually. But we should take this approach seriously. In fact, a bill based on the Buffet approach was introduced in the Senate in a past Congress by Senators Dorgan and Feingold. This approach has also been the subject of a careful study by the Economic Policy Institute, which resulted in an endorsement.

Conclusion

We need to change our system and better align the goals of corporations and the aspirations of the people of our country. This is not an idle dream; it has happened before. The growth we had in America in the decades after WWII and before 1970 was both rapid and well distributed. Americans of almost every stripe benefited.

To improve our situation today we must realign the interests of global corporations with those of the country. Just the realization that the goals of our country and of major corporations are no longer aligned is an important first step. That realization has consequences of its own. For example, it should affect the way that Congress should listen to the advice it gets from global corporations.

However, if we are clear on the necessity of aligning country and company we will find ways to do it. We have given a few examples of changes that could push in that direction. If we look in that direction we will find more and better ways to do this.

In addition, in a globalizing world where nations pursue their own interests with mercantilist policies, we must balance trade if we are to control our own destiny. Fortunately, there is at least one way to do that: the Buffet proposal.

We might well ask: Can we change the fundamental motivations of our corporations, whether through taxation or other means? In this connection it is interesting to hear the remarks of two recent General Electric CEO’s.

On the subject of government incentives, the present-day CEO, Jeffrey Immelt, recently stated[5]:

If the U.S. government "…wants to fix the trade deficit, it's got to be pushed…GE wants to be an exporter. We want to be a good citizen. Do we want to make a lot of money? Sure we

[4] Reference 11
[5] See Interview in Reference 10

do. But I think at the end of the day we've got to have a tax system or a set of incentives that promote what the government wants to do."

His predecessor, Jack Welch, the G.E. chief executive who ushered in the reign of shareholder value maximization a quarter-century ago, told the *Financial Times* in March[6] that "shareholder value is the dumbest idea in the world."

Both are starting to sound a little bit like their distinguished G.E. predecessor, Reginald Jones, who argued in the 1970's that corporate leaders must balance shareholder concerns against the interests of employees, American industry, and the nation – a view that was endorsed by the Business Roundtable in 1981

Perhaps the time has come to move in that direction.

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