Facing New Realities

By Elmer W. Johnson

In the November/December 1988 issue, Yotaro Kobayashi, president of Fuji Xerox, discussed the international competitiveness of U.S. and Japanese industries. In this issue, the *Journal* carries remarks on the competitiveness of U.S. industry made by a former senior executive at a large U.S. corporation at the 5th JEF-Aspen U.S.-Japan Council.

Joseph Schumpeter, the famous economist, said that the very genius and essence of capitalism is its relentless process of "creative destruction." Yet, looking back on the period from the end of World War II to about 1973, it almost seemed that U.S. industry was exempt from Schumpeter's cruel law. Given the conditions of war-torn Europe and Japan, the U.S. quickly came to dominate trade in the free world.

By the mid-1960s, Kenneth Galbraith was confidently predicting that the era of market competition was coming to a close, to be superseded by a new age of technocratic oligopoly. Little did he foresee the unprecedented fierceness of competition that would characterize the coming period of global markets.

Like Galbraith, our largest corporations were caught with their pants down. Part of the explanation lies in the fact that in the 1970s corporate managers were diverted by an onslaught of legislation that would virtually transform the large U.S. corporation into a subcontractor of the federal government for the protection of a vast array of social interests. It is no wonder that we were caught unawares by changing world conditions.

A second part of the explanation undoubtedly concerns our sorry legacy of labor-management relations. During the long period of American dominance, in some industries at least, management resolved their periodic conflicts with alienated work forces by resort to expensive labor contracts whose cost could be passed on to the consumer in the form of higher prices. We were pricing ourselves out of the coming world markets.

Finally, during our long period of prosperity and stability, we developed corporate cultures and management styles that led to excessive bureaucratization and rigidity. The product often tended to become a detail as managers came to manage by numbers. As they pursued their quest for global efficiency and rationalization, they often lost touch with changing markets and changing technologies. They also forgot how to mobilize and unleash human resources.

By the early 1980s, corporate America knew it was in trouble. It turns out that Schumpeter was right after all and that the stability of the 1948–73 period was an aberration. For the last several years we have been urgently engaged in adjusting our large business organizations to three new realities. The first is the emergence of global markets. The second is the Japanese obsession with product quality and their development of a revolutionary new way of organizing and motivating the work force. The third is the technology explosion that required us to look anew at the independencies of product engineering and manufacturing processes, using the new tools of systems engineering and mathematical modeling, made possible by the modern computer.

American business has taken giant strides in meeting these new challenges, and I could be quite optimistic about the restoration of our full competitive vigor were it not for a fourth phenomenon on the domestic front: namely, the accelerating mania in our country for leveraged buy-outs of corporations of almost any size. There is no doubt that many takeovers of control of U.S. corporations have led to the reinvigoration of management. But the recent binge of buy-outs, acquisitions and stock repurchases has caused corporate debt levels to soar and greatly increase the fragility of the U.S. economy.

The debt of nonfinancial corporations has about doubled to nearly $2 trillion over the last six years, and we are removing stockholders' equity at a rate of $100 billion per year. The net interest payments of nonfinancial corporations now account for over half their aggregate pretax earnings. In the 1950s and 1960s, that ratio was 15%, and even in the 1970s it rose to only 30%.

What are the forces that are driving this process? One is the windfalls to be made by the executives and their backers. Another is the hundreds of millions of dollars in fees received by the bankers and lawyers who engineer these deals. Never have so many people become so wealthy for contributing so little.

Martin Lipton, whose New York law firm represented Kraft in connection with its initial rejection and ultimate acceptance of the takeover of Kraft by Philip Morris, had this to say: "The nation's in great jeopardy by everything that is going on. We are forcing an unlivable amount of leverage on American business. We are forcing every business to focus on short-term results, and we are depriving our future generations of research and development. One of these days, we're going to have a tremendous crash."

This is precisely my own view. I should point out that this phenomenon could not have developed as it did but for fundamental flaws in our tax system—a system that permits the deductibility of interest regardless of the thinness of stockholders' equity and that strongly discourages a long-term investor mentality. We in America are in danger of forgetting that business corporations are long-term institutions—partnerships between generations. It is only over a period of many years that we develop implicit compacts and relationships of mutual trust with customers, employees, communities and the public. It is only through this process that we create organizations whose people are highly productive and creative.

Before we in the U.S. point the finger at Japan or any other country as being responsible for our competitiveness problems, I believe it is important to first focus our attention on that part of the problem for which we alone are responsible.

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