RESEARCH & IDEAS

US Competitiveness at Risk

Published: September 20, 2012

America's declining global competitiveness—it ranks No. 7 this year in one respected survey—began long before the current recession took hold. Harvard Business School Professors ***Michael E. Porter*** *and Jan W. Rivkin discuss causes and possible solutions. From Harvard magazine.*

Editor's note: *When did America's declining global competitiveness begin? One starting spot might be 2008, the last year the country topped the World Economic Forum's list of most globally competitive nations. Four years later, the US has fallen to No. 7—The Netherlands and Germany moved ahead on the top 10 leaderboard this year.*

But the fact is, America has been slipping since the year 2000, long before the housing bubble burst and recession swept the country, say Harvard Business School Professors Michael E. Porter and Jan W. Rivkin. They detail the reasons for this failure—and what can be done to fix it—in the following interview, first published in Harvard *magazine's Can America Compete? report.*

> ***"That great American job machine started sputtering around 2000"***

Porter and Rivkin lead the School's U.S. Competitiveness Project, which collects expertise and research from HBS colleagues and from other institutions with the goal of creating strategies to reignite America's economic future in the global economy.

Porter is the Lawrence University Professor, and Rivkin the Rauner professor of business administration and head of HBS's strategy unit.

Harvard Magazine: What prompted you to begin this inquiry?

Michael Porter: There was a clear feeling at Harvard Business School that something different was happening in the US economy—this was not just a deep recession caused by the housing mortgage crisis and so forth. The recession is very real, but something more was going on. This project was born from that feeling, and the belief that the school could convene and analyze and understand in ways we had not taken full advantage of.

As Jan and I started looking at the data, a whole set of indicators validated disturbing trends that began well before the Great Recession.

Most obvious and most important is the job-creation machine. For decades, America has been unique among large advanced countries in generating large numbers of jobs steadily over time: roughly 2 percent job growth per year [on a rolling 10-year basis that smooths out short-term factors]. That great American job machine started sputtering around 2000. There's something structural here, because it started before the recent downturn. Moreover, we and others discovered that virtually all the net new jobs created over the last decade were in *local* businesses—government, healthcare, retailing—not exposed to international competition. That was a sign that the US was not doing well in businesses that have to compete internationally.

The data also showed what many had known—that wages started stagnating well over a decade ago. The participation of Americans in the workforce peaked in 1997, and workforce participation is critical to prosperity because the more people who work as a proportion of the total working-age population, the higher per capita income will be whatever the wage level. All of this is threatening the American dream, the idea that each generation will be better off than the previous one.

The question was, "Why did this happen?" What were the causes of the problems, and what could leaders do about them?

Jan Rivkin: By many current measures, America looks all right *today*: we have an enormously productive economy, high wages in absolute terms in many parts of the economy, a large share of exports and foreign direct investment [FDI]. But when you look at the trajectory over time—job growth rates, wage growth rates, changes in export or FDI share, particularly compared to emerging economies—the country looks much weaker. We should have been worried before the Great Recession.

Q: In the 1980s, Americans were concerned about the competitive challenge from Japan. Are current challenges different?

JR: Today, we've got a far more diverse set of global competitors with capabilities that span the full set of reasons that customers buy and companies relocate. We've got a US government that lacks the latitude to move that it had in the 1980s: large government debts and obligations facing the US now threaten to crowd out the investments in infrastructure, innovation, and individuals that we need to sustain long-run productivity growth.

MP: And business has become substantially more global. The typical US-based multinational corporation has a much higher percentage of its total activity outside the US today. Early in our work, we'd talk to business executives and they would say, "I can't just worry about America, I run a global company, we're not an American company anymore." The notion in business that this is our country and we own its challenges has diminished.

We believe that that corporate perception is ill-advised. It may be true that more of a company's activity is global, but that doesn't diminish the importance of US vitality to its vitality. The first reaction to globalization was often, "It's wonderful that we can relocate anywhere. If we have a skill shortage here in America, we can just go somewhere else. If we can get a better tax deal there, we'll go there." But that thinking is changing. One of the optimistic findings of this project is the enormous readiness of many in the business community to roll up their sleeves and do things in their communities and companies to make America more competitive.

JR: An important notion is what we call the "business commons" from which companies draw: a skilled workforce, an educated populace, vibrant local suppliers, basic rule of law, and so on. Historically, American businesses invested in these resources deeply, and that helped to build many of America's strengths.

Then, in a world of increasing geographic mobility, many businesses took that commons for granted in America. Interestingly, they actually invested in building the commons elsewhere because they realized its importance—but in the process, over a number of decades, the commons got run down in America. The good news is, we see a large number of business leaders who recognize the importance of reinvesting at this point.

Q: In this context, you advance an unusual definition of competitiveness. Is that really the fulcrum for your whole project?

JR: We define US competitiveness as the

COPYRIGHT 2012 PRESIDENT AND FELLOWS OF HARVARD COLLEGE

ability of firms in the US to succeed in the global marketplace while raising the living standards of the average American.

The second part of that definition is immensely important. Sometimes you hear people saying the US would be more competitive if only wages were lower or we had a cheaper dollar. But if we took a national pay cut in that fashion, we'd hardly applaud it as a great success of US competitiveness. To the contrary, that's an indicator that we have to choose between being able to sell our products to customers and paying our citizens well.

"The ultimate goal of national policy has to be long-term productivity growth"

A competitive economy does *both*. The only way you can do both is by satisfying customers, shareholders, *and* employees. You can do that only by raising productivity—being better at changing inputs into valuable outputs than the other guys. So the ultimate goal of national policy has to be long-term productivity growth.

That may sound obvious, but the rhetoric these days is all about jobs, jobs, jobs. It's easy to understand why: if you lack a job, it is all about jobs. But if you set out simply to create jobs for their own sake, you wind up investing in areas not where you're productive, but where you can create a lot of jobs quickly. Yes, we absolutely want jobs. But we want competitive jobs that can last in a demanding global economy.

MP: The sectors where you can generate the most jobs quickly tend to be in things like healthcare and construction—inherently local activities. But any economy is an interesting combination of what we call "traded businesses"—like manufacturing, sophisticated services, and tourism that are exposed to international competition—and local ones. For any large population there are a lot of local needs—food, housing, utilities—but ultimately the vitality of an economy is heavily determined by the traded part. That's where we find the opportunities for much higher productivity that can support high wages. You want to grow those areas where you can be highly productive and serve the *world* market. Where you can't be productive, you need to import. You want local needs to be met efficiently, but the ultimate wealth that feeds the local economy derives heavily from the traded economy.

Therefore, the US economy's inability to generate net new jobs in the traded sector for the last decade is deeply disturbing. Also, the ability to raise wages, particularly in the traded sector, is being capped by the enormous improvements going on in other countries. It used to be that the wages of US workers rose in line with domestic productivity, but the two became decoupled. Some attribute that to declining unionization. That may be part of it, but much has to do with the fact that employers can hire an equally skilled person in another location at a lower wage. Other countries have been improving their game with good skills compared to us and have better infrastructure in some cases than we do.

We believe the US retains its core strengths, but we have allowed ourselves to fail to progress rapidly enough to continue to justify our standards of living, at least during the recent decade.

JR: The things America is great at—higher education and entrepreneurial capacity and scientific and technical infrastructure—are very hard to replicate. The things that we're bad at now are largely the results of choices we made.

GE Healthcare employees assemble magnetic-resonance imaging machines in Beijing. In 2011, the highly global company moved its x-ray unit headquarters staff to China-a major, rapidly growing market.

Q: The US today seems to have trouble focusing on major policies in pursuit of overarching goals such as enhanced productivity. What does it mean for businesses and the government—in their own spheres and together—to be strategic and comprehensive in pursuit of making the US competitive again?

MP: The challenge of the whole issue of competitiveness and productivity is that it's influenced by a vast array of factors: schools, roads, regulatory complexity, almost everything matters—not just the traditional macroeconomic policies. If you don't have a good public-education system, for example, you lack the foundation for productivity. If you don't have people who are healthy and can afford good healthcare, you lack that foundation. If you don't have a governmental system that works effectively and delivers good public services, that's a drag on productivity.

The United States used to be a uniquely productive place to do business, and not only for entrepreneurship where we still have strengths. For example, we used to have amazingly efficient logistics. Because we've been so committed to open competition, we tended to have efficient producers and distributors throughout the economy. A lot of other countries were saddled with special interests and monopolies. We've been able to preserve the long-term strengths Jan just mentioned—we stay ahead in those areas.

But ironically, we've lost out on some things that seem more basic. For instance, do we have a regulatory environment that makes it easy to conduct business? The World Bank's "Doing Business" report ranks every country on the ease of doing business. Twenty years ago, the US would have been by far the easiest place. Now we're well down the list—not in the top 10. In other countries, I've participated in some government-established working groups dedicated to improving their rankings. Lately, the US just hasn't been improving the basics nearly as fast as some other countries.

It's a knotty problem because competitiveness is sort of *everybody's* agenda. That's one reason you have to be strategic: there are so many things to work on that if you don't have a clear sense of priorities and sequencing and a sustained effort, you don't make progress. Our single-issue focus lately works against us.

There's also a tremendous mismatch between the time horizons of politics and of competitiveness. Most things that matter for building competitiveness take a decade or *multiple* decades to improve. But we have a political system that's increasingly about today's news. This mismatch has probably gotten worse in the last 10 or 20 years. The politics of economic policy is never easy, but we used to be better at overcoming political differences.

JR: Two elements make building competitiveness vexing. The first, which Mike emphasized, is that there are so many related elements. The second is that the lag times involved are very long. Investments in improving K-12 education have an impact a decade, two decades, from now. That means you need to make sets of choices that are holistic and farsighted—and I think you can argue that in both public policy and on the business side, we have moved toward fragmentation and near-term thinking.

MP: It's particularly hard to pursue the agenda in the United States. This is a very large country, very spread out, very complex, there are 300-million-plus people—so it's just more difficult to think strategically and long term here as opposed to in South Korea or Singapore. China has had the luxury, or curse, of a high degree of centralization that makes long-term thinking much easier.

Q: One issue that is in businesses' purview is the research you've done on firms' location decisions. Could businesses be doing a better job of that?

MP: American businesses *should* be locating certain activities abroad because that makes them more competitive by enabling them to better penetrate international markets. In some cases, producing offshore also saves unnecessary costs of shipping goods to distant markets, or allows better adaptation of products to local circumstances. So globalization at one level has *enhanced* the competitiveness of US-based companies and will support their growth in the US.

"Today, the political support for business has become very polarized"

That said, our research revealed that offshoring and constructing global supply

COPYRIGHT 2012 PRESIDENT AND FELLOWS OF HARVARD COLLEGE

chains is really complicated—it is challenging to accurately figure out the total costs of locating in China or another country versus in the US We found that many activities should have gone offshore, but some probably should not. In making their location decisions, some managers failed to understand hidden costs of offshoring, such as indirect costs of hiring and retention, supervision, and intellectual-property protection.

We also identified some trends that are working in favor of the US for location decisions—some for reasons we should be unhappy about. For example, wages are rising much more rapidly in China and India than they are here. We want China's wages to go up—we just would like ours to go up faster, justified by our productivity. Also, the US dollar has depreciated.

Other trends favoring the US are unambiguously good news. For instance, it has become significantly more expensive to move goods, so if you want to tap America's market, the largest single market in the world by a considerable margin, you're more likely to produce here.

And you can add another wild card: the whole energy situation. The US suddenly has a potential surplus of energy through the production of oil and especially natural gas trapped in shale. This development is a potentially transformational asset, and major activities in chemicals and other industries can move back to the US because we now have low-cost energy.

JR: Mike described some issues that make location choices a hard problem for multinational corporations—particularly, hidden costs that don't appear until years in the future. A second difficulty is that there is a tendency to take a static view of the *US* environment. It's very easy to assume that the state of the business environment here is a given. In fact, businesses can *improve* the environments in which they operate—by investing in the local workforce, by mentoring local suppliers, and so on—but that's hard to include in your calculations correctly.

Q: You use the vivid phrase "Improve, not move" as a way of describing businesses' options.

MP: One of the myths about competitiveness is that it is driven mostly by government policy and that the solution to competitive problems is government action. The more we've gotten into this, the more we understand that *business* can influence many of these things that constrain US competitiveness without the president signing a new law. Businesses—both individually and collectively—can make major contributions by enhancing skills, improving the supplier base, and taking other steps.

JR: Just as it's an error to think government is the only solution, it's also an error to think government is exclusively the problem. You can trace some of the weaknesses in the US business environment right back to things that businesses have done in their narrow self-interest. How did we get such an incoherent, complex corporate tax code? Because the IRS wanted loopholes? No, because businesses pleaded for loopholes that benefited them.

MP: And legislators saw a great way to get campaign contributions.

Q: What reaction have you heard from the business community?

MP: Very little disagreement on the fundamental diagnosis. Most people feel in their gut that something is going wrong in our economy. When we're in the company of political leaders and public figures, there are often statements of optimism, of not wanting to bet against America—and we share this perspective. We think this is a fixable problem, that the US could make rapid improvements. It's going to take time, but we believe America is eminently capable of renewing its competitiveness.

We are discovering an increasing awareness in the business community: they have a role in American competitiveness. They want to do something constructive and be part of the solution. But one of the things that is different now from 30 years ago is the public perception of and attitude toward business. There's a lot of skepticism, and frankly, some of it is deserved.

JR: I've met very few business leaders who conclude, "There's no problem, and we'll just ride this one out." At the same time, I've met very few who feel the situation is so bad it can't be fixed.

Most people we've talked with feel we've got a real problem, it can be fixed, but it requires action. They're asking about the right steps to take. Even the leaders we see taking action are asking, "What more can we do?" There's a search for better answers.

MP: That said, there's an almost universal view that our federal political system is one of the greatest threats to our economic future—because of its inability to tackle some of these issues. There are some federal policies that a great majority of those in the private sector agree are necessary. They defy labels—they're not Republican or Democratic, not liberal or conservative policies.

Almost everybody agrees we've got to simplify the corporate tax code: statutory rates are too high, the code is riddled with loopholes, deductions need to be reduced. The right policy is to lower the rate substantially and end most deductions. That's a policy economic theory supports, and almost everybody in the private sector agrees with—though some will lose cherished deductions.

The US also has an unusual system of taxing our companies on foreign income, which has led to dozens of companies moving their corporate headquarters offshore and American companies holding more than a trillion dollars of cash abroad rather than repatriate it. Almost all agree that a better system would harmonize US practices with those of other leading countries.

On immigration reform, pretty much everybody agrees we need increased skilled immigration. And there are many other areas like these, yet the US can't seem to make any progress on them.

It's not that we haven't had partisan bickering in the past, but at the end of the day we came together and compromised on key policies for education, infrastructure, and support for science [see the conversation with David Moss]. America believed in business and entrepreneurship. Today, the political support for business has become very polarized. This is a key reason we're just not making progress on some of the fundamentals. WK

Reprinted by permission of *Harvard* magazine. Copyright ©2012 Harvard Magazine Inc. All rights reserved.