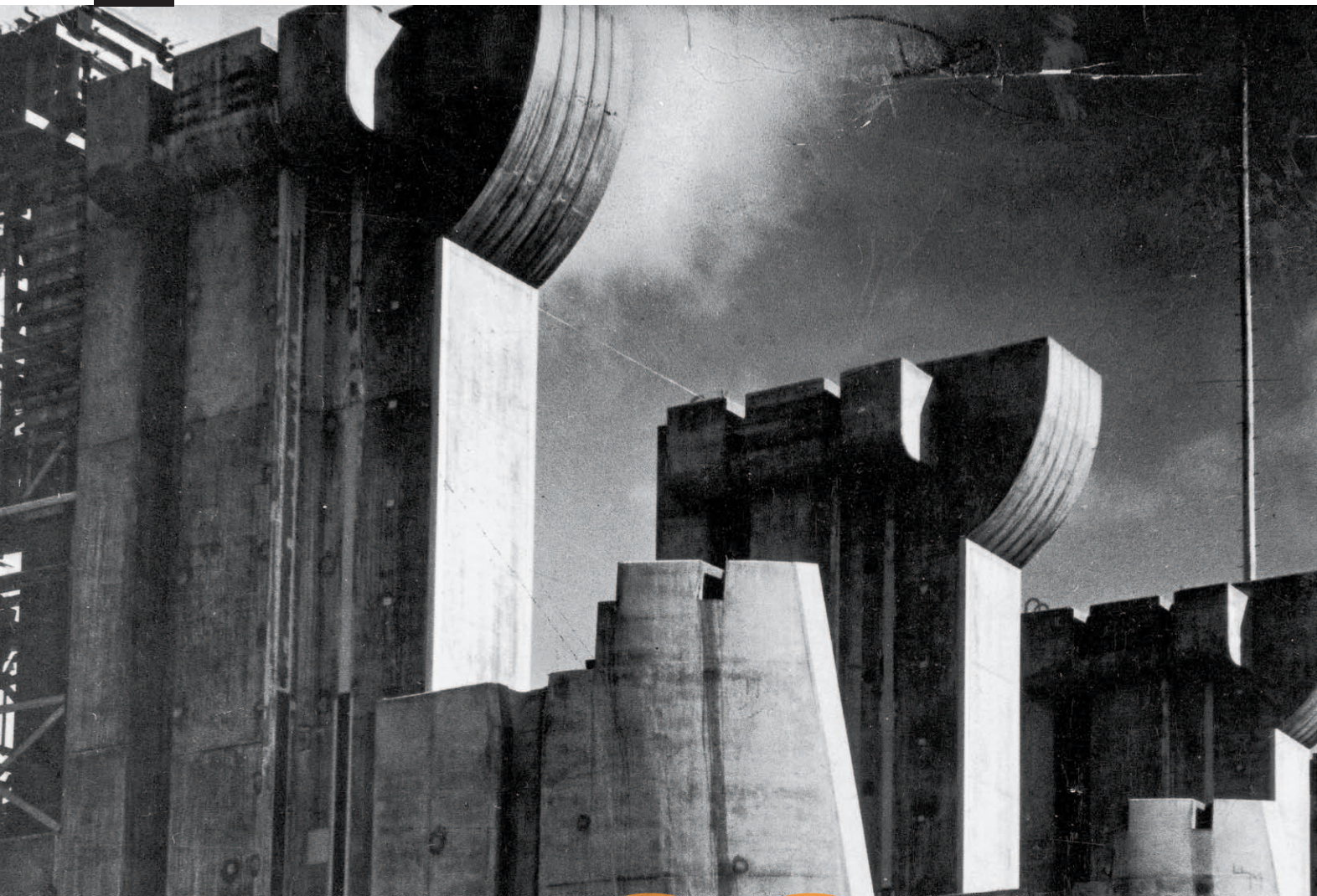




**THE LOOMING
CHALLENGE
TO U.S.
COMPETITIV**

PHOTOGRAPH Margaret Bourke-White/
Time & Life Pictures/Getty Images:
Fort Peck Dam, 1936

BY MICHAEL E. PORTER AND JAN W. RIVKIN

THE AMERICAN ECONOMY is clearly struggling to recover from a recession of unusual depth and duration, as we are reminded nearly every day. But the United States also faces a less visible but more fundamental challenge: a series of underlying structural changes that could permanently impair America's ability to maintain, much less raise, the living standards of its citizens. If government and business leaders react only to the downturn and fail to confront America's deeper challenge, they will revive an economy with weak long-term prospects.

During the past year, we have examined U.S. competitiveness with the help of a diverse group of scholars, business leaders from around the world, and the first-ever comprehensive survey of Harvard Business School alumni. Our research suggests that the U.S. faces serious challenges. Too often, America's leaders, in government and business, have acted in ways that neutralize the country's many strengths. However, the decline of U.S. competitiveness is far from inevitable. The United States remains the world's most productive large economy and its largest market for sophisticated goods and services, which stimulates innovation and acts as a magnet for investment.

To restore its competitiveness, America needs a long-term strategy. This will require numerous policy changes by government, which may seem unlikely with Washington gridlocked. However, many of the crucial steps can and must be carried out by states and regions, where many of the key drivers of competitiveness reside. More important, business leaders can and must play a far more proactive role in transforming competition and investing in local

communities rather than being passive victims of public policy or hostages of misguided shareholders.

WHAT IS COMPETITIVENESS?

America cannot address its economic prospects without a clear understanding of what we mean by competitiveness and how it shapes U.S. prosperity. The concept is widely misunderstood, with dangerous consequences for political discourse, policy, and corporate choices that are all too evident today.

The United States is a competitive location to the extent that companies operating in the U.S. are able to compete successfully in the global economy while supporting high and rising living standards for the average American. (We thank Richard Vietor and Matthew Weinzierl for helping to articulate this definition.) A competitive location produces prosperity for both companies and citizens.

Lower American wages do not boost U.S. competitiveness. Neither does a cheaper dollar. A weakened currency makes imports more expensive and discounts the price of American exports—in essence, it constitutes a national pay cut. Some steps that reduce firms' short-term costs, then, actually work against the true competitiveness of the United States.

Whether a nation is competitive hinges instead on its long-run productivity—that is, the value of goods and services produced per unit of human, capital, and natural resources. Only by improving their ability to transform inputs into valuable products and services can companies in a country prosper while supporting rising wages for citizens. Increasing productivity over the long run should be the central goal of economic policy. This requires a business environment that supports continual innovation in products, processes, and management.

Boosting productivity over the short run by firing workers, as many U.S. firms did at the onset of the Great Recession in 2008, is a reflection not of competitiveness but of weakness. An economy in which many working-age citizens cannot find or do not even seek jobs may appear to enjoy high productivity in the short run, but in fact it has underlying competitiveness problems. It is a nation's ability to generate high output per employable person—not per currently employed person—that reveals its true competitiveness.

Improving competitiveness is not the same as creating jobs. Policy makers can stimulate employment in the short run by artificially boosting demand in labor-intensive local industries not exposed to inter-

LOSING MARKET SHARE

The U.S. percentage of world exports fell across the board from 1999 to 2009, with steep drops in such key sectors as aerospace and communications equipment, and only a few bright spots.

AEROSPACE VEHICLES AND DEFENSE

–36
POINTS OF WORLD MARKET SHARE

INFORMATION TECHNOLOGY

–9

COMMUNICATIONS EQUIPMENT

–8

AUTOMOTIVE

–3

BIOPHARMACEUTICALS

–1

OIL AND GAS PRODUCTS

+1

FINANCIAL SERVICES

+8

SOURCE UN COMMODITY TRADE STATISTICS DATABASE AND IMF BOP STATISTICS

national competition, such as construction. Creating jobs without improving productivity, however, will not result in sustainable employment that raises the nation's standard of living. Rather than defining the sole goal as job creation, the U.S. must focus on becoming a more productive location, which will generate high-wage employment growth in America, attract foreign investment, and fuel sustainable growth in demand for local goods and services.

Government efforts to stimulate demand are also different from improving competitiveness. Governments commonly play an important role by temporarily increasing outlays to soften the impact of recessions. Such moves may hold up living standards and company performance in the short run, but they typically don't improve the fundamental drivers of productivity and therefore cannot improve living standards and company performance in the long run.

American competitiveness is important not only for firms based or founded in the U.S. but also for foreign firms that operate in the country. Foreign firms contribute to U.S. prosperity if they bring productive activities to the U.S. that provide jobs at attractive wages. U.S. affiliates of foreign firms accounted for nearly 5% of U.S. private employment in 2009.

Competitiveness is not a zero-sum game, in which one country can advance only if others lose. Long-term productivity—and, along with it, living standards—can improve in many countries. Global competition is not a fight for a fixed pool of demand; huge needs for improving living standards are waiting to be met around the world. Productivity improvements in one country create new demand for goods and services that firms in other countries can pursue. Greater productivity in, say, India can lead to higher wages and profits there, boosting demand for pharmaceuticals from New Jersey and software from Silicon Valley. Spreading innovation and productivity improvement allows global prosperity to grow.

Because the global economy is not a zero-sum game, the decline of American competitiveness is a problem not only for the U.S. The global economy will be diminished if its largest national economy is weak, ceases to be an engine of innovation, and loses its influence in shaping a fair and open global trading system.

DOES THE U.S. HAVE A COMPETITIVENESS PROBLEM?

It would be easy to blame America's current economic challenges on the severe cyclical downturn

IDEA IN BRIEF

THE UNITED STATES IS A COMPETITIVE LOCATION TO THE EXTENT THAT COMPANIES OPERATING IN THE U.S. ARE ABLE TO COMPETE SUCCESSFULLY IN THE GLOBAL ECONOMY WHILE SUPPORTING HIGH AND RISING LIVING STANDARDS FOR THE AVERAGE AMERICAN.

By this standard, U.S. competitiveness is in grave danger. The erosion of U.S. competitiveness began well before the Great Recession. The U.S. faces competition from a widening range of nations with lower wages and improving economic strategies. But a short-term focus in many businesses and political gridlock have prevented the U.S. from taking the steps needed to meet the challenge.

The U.S. retains core strengths in areas such as entrepreneurship and higher education. However, these are increasingly nullified by weaknesses in the tax code, fiscal policy, K-12 education, and other areas. To address its challenges, America needs a strategy and a consensus on direction. Government will play a crucial role, but business must lead the way.

we have experienced. Economic policy could then focus solely on measures to spur recovery, as it has, overwhelmingly, in the last three years.

To support the interpretation that America's problems are cyclical, not structural, one could point to the facts that labor productivity has held up in America and corporate profits hit record highs in 2010. Unfortunately, that snapshot masks deeper signs of an incipient competitiveness problem—one that began before the Great Recession and in some ways contributed to it. The problem shows up in a range of economic performance measures as well as in the trajectories of the underlying factors that drive competitiveness.

Productivity. America's long-run rate of growth in labor productivity was strong relative to that of other advanced economies in the late 1990s and early 2000s, but it began to trail off before the financial crisis. Productivity has been sustained since the crisis largely by rising unemployment and falling workforce participation, ominous signs for U.S. competitiveness.

Job creation. Even more unsettling is the country's job-creation picture. Long-term growth in private-sector employment has dipped to historically low levels, a trend that started well before the Great Recession. (See the exhibit "Disappearing Job Growth.") In industries exposed to international competition, job growth has virtually stopped.

Wages. American wages have been under pressure for more than a decade. In 2007, before the downturn, U.S. median household income stood below 1999 levels in real terms—and has fallen even more since. In the two decades prior to 2007, median income grew, but at an anemic annual rate of just 0.5%. Most affected have been middle- and lower-income workers, many of whom are more exposed to international competition today than ever before.

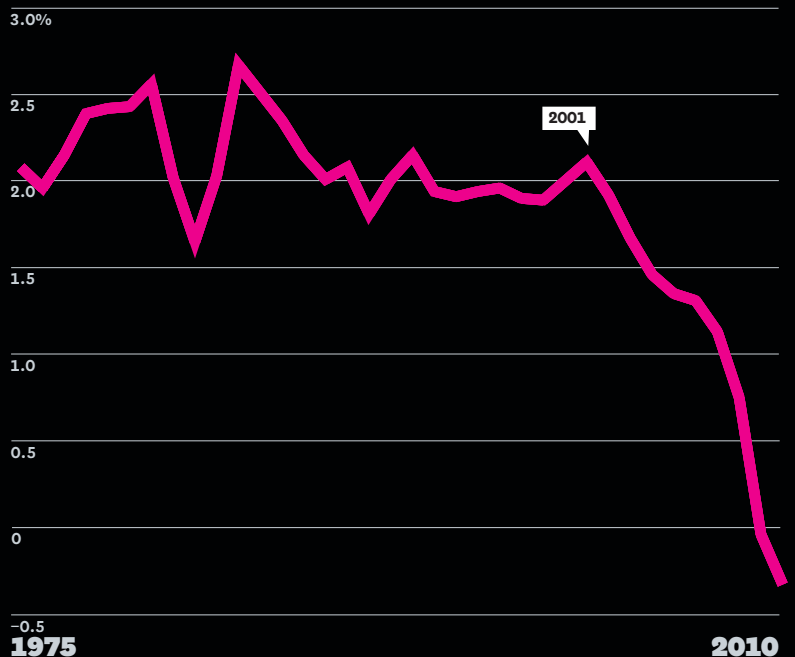
International trade and investment. The U.S. remains the world's largest recipient of foreign direct investment; however, growth in inbound FDI slowed

in recent years to rates lower than those of many other large advanced economies. And although U.S. exports rose during the past decade, America's share of world exports has declined substantially and in virtually all areas. Notably, Germany saw robust export share gains during the same period in many industry clusters, including some of its largest.

Outlook of managers. While the data are troubling, even more worrisome is the picture painted by managers on the front lines of international competition. We recently surveyed nearly 10,000 Harvard Business School alumni to assess the trajectory of the U.S. along the two dimensions that define competi-

DISAPPEARING JOB GROWTH

Rolling 10-year compound annual growth rate in number of U.S. private nonfarm employees



SOURCE: BUREAU OF LABOR STATISTICS

tiveness: the ability of U.S.-based firms to compete successfully in the global marketplace and the ability of firms in the U.S. to support high and rising living standards in America. The vast majority of respondents, 71%, foresaw a decline in U.S. competitiveness in the coming years. Respondents also reported that when the U.S. competes with other countries to host business activities, it loses two-thirds of the time.

CRACKS IN THE FOUNDATION

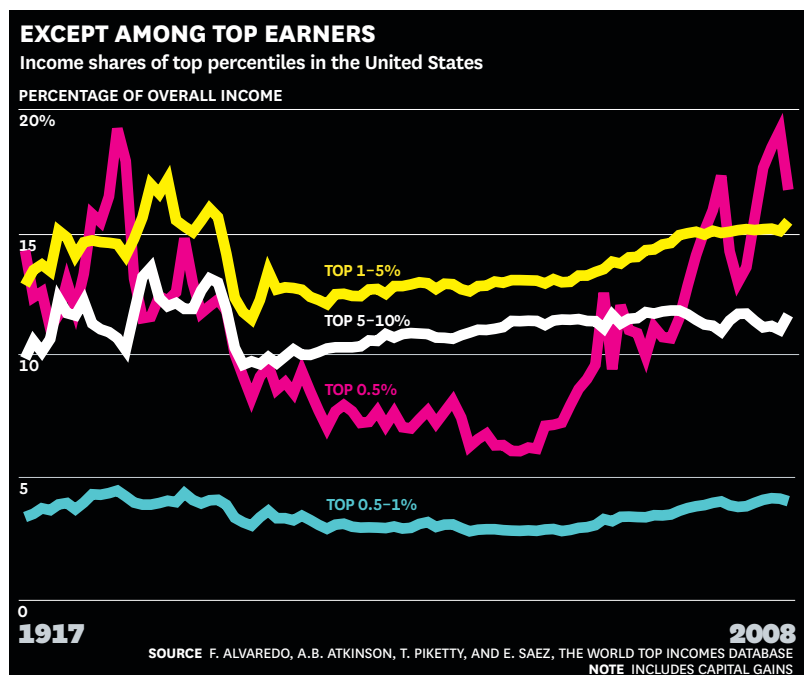
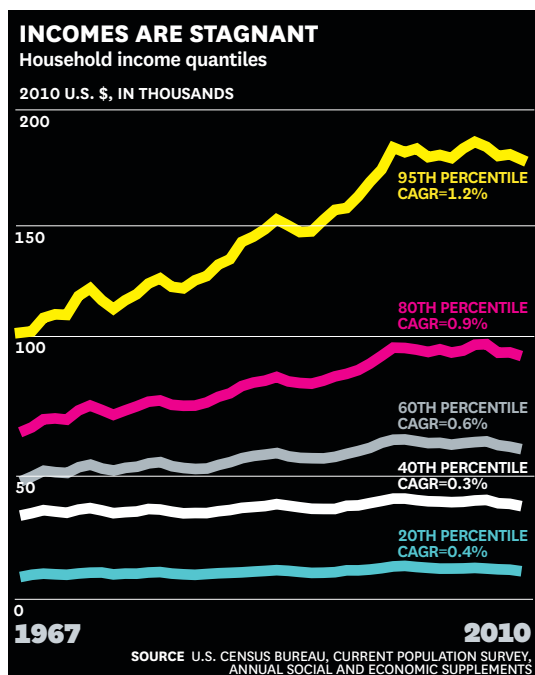
This erosion reflects troubling trends in many of the factors that underpin U.S. competitiveness. This set of factors, as identified in the work of Michael Porter, Mercedes Delgado, Christian Ketels, and Scott Stern, includes macro and micro components. From a macro perspective, a competitive nation requires sound monetary and fiscal policies (such as manageable government debt levels), strong human development (good health care and K-12 education systems), and effective political institutions (rule of law and effective law-making bodies).

Macro foundations create the potential for long-term productivity, but actual productivity depends on the microeconomic conditions that affect business itself. A competitive nation exhibits a sound business environment (including modern transport and communications infrastructure, high-quality research institutions, streamlined regulation, sophisticated local consumers, and effective capital markets)

as well as strong clusters of firms and supporting institutions in particular fields, such as information technology in Silicon Valley and energy in Houston. Competitive nations develop companies that adopt advanced operating and management practices. In a large country like the U.S., many of the most important drivers of competitiveness rest at the regional and local levels, not the national level. Though federal policies surely matter, microeconomic drivers tied to regions—such as roads, universities, pools of talent, and cluster specialization—are crucial.

Assessing the U.S. through this lens, we see significant cracks in its economic foundations, with particularly troubling deterioration in macro competitiveness. Problems include levels of government debt not seen since World War II; health care and primary education systems whose results are neither world-class nor reflective of the large sums spent on them; and a polarized and often paralyzed political system (especially at the federal level) that makes decisions only when facing a crisis. In micro competitiveness, eroding skills in the workplace, inadequate physical infrastructure, and rising regulatory complexity increasingly offset traditional strengths such as innovation and entrepreneurship.

Our HBS alumni survey provided an original and timely assessment of overall competitiveness and the strengths and weaknesses of the U.S. The findings were sobering. (See the chart “Evaluating





SEE ALSO For further discussion of how globalization has affected U.S. competitiveness, see “Shattering the Myths About U.S. Trade Policy,” page 149.

the U.S. Business Environment,” page 85.) Respondents perceived the United States as already weak and in decline with respect to a range of important factors: the complexity of the national tax code, the effectiveness of its political system, basic education, macroeconomic policies, and regulation. Some current American strengths, such as logistics and communications infrastructure and workforce skill levels, were seen as declining. America’s unique strengths in entrepreneurship, higher education, and management quality were intact, but these strengths must overcome growing weaknesses in many other areas.

Nearly two-thirds of survey respondents said that the U.S. business environment is falling behind that of emerging economies, while just 8% said that the U.S. is pulling ahead. Overall, the picture that emerges is an American economy that has some crucial strengths but is weakening, with problems especially visible in macro factors.

HOW DID AMERICA GET HERE?

To address America’s competitiveness problem, we must first understand the intricate and intertwined roots of the current predicament. They stem from changes in the world economy as well as failures within America itself.

Increasing global options. America’s troubles trace back, ironically, to the triumph of Western capitalism over traditional communism in the 1980s. Scores of countries that previously had closed economies, weak property rights, rampant corruption, unstable governments, and decrepit physical infrastructure quickly opened for business. Many of them pursued ambitious economic strategies to boost macro and micro competitiveness. Growing prosperity turned these countries into desirable markets, attracting foreign investment.

At the same time, technological improvements in communication, logistics, and IT made it possible to integrate more and more countries into global supply chains. Today it is feasible, and often profitable, to do business from anywhere to anywhere. In 1990, the 20 U.S.-headquartered companies with the largest asset bases outside the U.S. had 33% of their total assets abroad; today that figure is 58%. Whereas “multinational” used to evoke an image of a large, established corporation, today we see start-ups with global reach. As emerging economies have developed, the activities conducted there have shifted from the labor-intensive and low-tech to the capital- and knowledge-intensive.

AS COMPANIES HAVE BECOME GLOBAL, THEIR CONNECTIONS TO COMMUNITIES HAVE WEAKENED.

To a large extent, the proliferation of possible locations for company activities boosts global prosperity, allowing more effective specialization of resources and wider diffusion of innovation. This “rise of the rest” is potentially great news for the American economy, as prosperous emerging economies can be growth markets for U.S.-made goods, allies in supporting free and fair trade, and sources of innovation. However, as companies have become increasingly global, their connections to the communities where they operate, in America or elsewhere, have weakened.

Shortened time horizons in business and government. Even as managers’ geographic horizons have broadened, their time horizons appear to have shortened. Shareholder activism, stock-based incentives, and declining managerial tenure surely injected new, needed discipline into American business and had some positive effects. However, financial markets and executive compensation practices that reward quick fixes and focus attention on “this quarter’s numbers” can tempt managers to move business activities to whatever location offers the best deal today rather than make the sustained, location-specific investments required to boost long-run productivity. Of particular concern are declining investments in America in a skilled workforce, R&D and advanced manufacturing capabilities, local supplier networks, and local educational institutions—all needed to fuel productivity. The path of least resistance—and short-term gain—is to move, not improve.

In government, time horizons have also shortened. Leaders focus on the news cycle and the next election, not policies needed to strengthen America for the long term.

THE U.S. MUST REDOUBLE INVESTMENTS NEEDED TO MAKE AMERICAN WORKERS HIGHLY PRODUCTIVE.

Middle-class pressures, inequality, and unsustainable promises. Broadened geographic horizons and shortened time horizons challenge the U.S. to redeploy workers and boost their productivity as firms shift their locations. In principle, America can be better off when a low-value-added manufacturing task is moved from the Midwest to Brazil and Brazil's growth then creates demand for high-value-added U.S. products. But what becomes of the laid-off manufacturing worker in the Midwest, especially when America's competitive fundamentals are eroding?

The resulting pressures have fallen especially on middle-class workers in the sectors of the U.S. economy that face direct global competition. These "traded sectors" have seen virtually no job growth since 1990. Also, the long-standing link between wages and worker productivity has broken. (See the exhibit "The Gap Between Productivity and Wages," page 68.) Since the 1980s, U.S. wages have risen more slowly than productivity—they are now influenced by how American workers stack up against lower-paid workers elsewhere. It is not surprising, then, that lower- and middle-tier household incomes have stagnated.

At the upper end of the skill and income distribution, globalization has opened opportunities for individuals with unique talents to prosper on a global scale. At least partly as a result, compensation of highly skilled professionals and upper management has raced far ahead of that of average workers, and income has become more concentrated in the upper half of 1% of earners. (See the exhibits "Incomes Are Stagnant" and "Except Among Top Earners.")

How might society cope with these pressures on the middle class? The right response includes redou-

bling the human and technological investments required to make American workers highly productive. Instead, starting in the 1990s, America masked the problem of stagnating incomes in the middle class in several ways. First, there was a massive extension of credit, especially to buy homes and monetize home equity. This approach contributed to the housing and consumption boom but also the bust that culminated in the financial crisis of 2008–2009. Second, as the middle and lower classes were squeezed, the federal government expanded health care benefits, with severe fiscal consequences. Third, as manufacturing and other private-sector jobs disappeared, government employment expanded. From 1990 to 2010, the only major sectors of the U.S. economy that added more jobs than public administration were education and health services (which in fact include many government-funded employees) and professional and business services. Meanwhile, effective federal tax rates dropped, especially after 2001.

Hobbled government. Reductions in tax receipts, the stimulus spending necessitated by the financial crisis, and the rapid growth in health care outlays have conspired with other factors (two costly wars, a dysfunctional tax code that limits government revenue, the aging of the population) to leave the U.S. federal and state governments with soaring deficits and debts.

Consequently, government in the U.S. increasingly lacks the resources to invest in the building blocks of long-run productivity. Traditionally, governments have taken the lead in providing services and assets that pay off for society but offer low returns for any one company or individual. They usually play a central role in funding education and training, infrastructure such as highways, and R&D. In the U.S., however, such spending has been shrinking as a portion of total federal spending over the past few decades (though stimulus spending in 2010 provided an uptick). Federal and state budgets have shifted from investing in the future toward paying for the past.

Rebalancing the portfolio of government expenditures toward the future would be difficult in the most cooperative of political environments. Yet with the pressure on the middle class, we have seen the fraying of the center in U.S. politics. The current environment is among the most polarized in memory. In taking increasingly short-term views, politicians have made the business environment even more complicated and now seem willing to pit rich against poor and to court economic disaster in order

to advance their agendas. Witness, for instance, the brinksmanship that led the federal government to the edge of default in the summer of 2011 and triggered an historic downgrading of U.S. debt. The resulting uncertainty has made businesses hesitant to invest in America.

Vicious and virtuous cycles. The dynamics described here have reinforced one another in dangerous ways. For instance, inadequate investment in public goods makes the U.S. a less attractive place to do business, encouraging firms to invest abroad. The migration of business activity out of the U.S. and the accompanying loss of tax revenue make it harder for the government to invest adequately in public goods. As corporations relocate jobs and earn record profits while American wages stagnate, business as an institution faces rising skepticism in society. Politicians then find it harder to enact policies that support business in America, making it even more likely that firms will move elsewhere.

In contrast, China has tapped virtuous cycles. Given its policies and sheer size, it has become a serious challenge for the United States. China has used surpluses to fund productivity-improving investments that add to surpluses; its growing domestic market attracts multinational investments, which in turn boost domestic wages and spending power; and so on. China's economic strategy plays off the short-term focus of multinationals. To gain access to the Chinese market, for instance, some U.S. executives have been surprisingly willing to share technological insights with Chinese partners who may subsequently become able rivals.

At the same time, China is believed by many to have weakened its currency artificially, failed to protect intellectual property rights, and distorted markets through state-owned companies and in other ways. We do not view Chinese economic policies as sustainable or legitimate, but the country certainly has a strategy. In contrast, America lacks a coherent strategy, and as domestic difficulties have grown, the U.S. has withdrawn from leadership in advancing the global trading and investment system.

More than any single sign of loss of competitiveness, it is these reinforcing spirals, and our inability to break them, that make us worry about America's economic future.

A CALL FOR ACTION, NOT DESPAIR

We have painted an ominous picture of U.S. competitiveness. Yet we remain fundamentally optimis-

tic about America's economic future because the United States retains profound strengths that are very difficult to replicate. America's system of higher education and its entrepreneurial community continue to be the world's most powerful engine of innovation, on which productivity growth ultimately depends. The U.S. has an open, democratic society and a system of rewarding merit that attract much of the world's best talent. America's sophisticated markets and institutions foster intense rivalry, spurring companies to discover new routes to productivity. America's firms are among the most ably managed in the world, and its capital markets remain the most vibrant despite the financial crisis. American society is more prone, without sentiment, to let more productive firms and institutions drive out less productive ones, making the economy as a whole remarkably dynamic and resilient. In many ways, the core of the U.S. economy remains strong.

None of the dynamics we have described are inevitable. Nor are they dictated by unstoppable forces of nature or demographic trends. Rather, America's situation is the result of choices, and lack of choices, by policy makers and managers. The steps to reverse the loss of competitiveness are feasible, though they will require a new focus on facing reality and acting in the common interest.

Regional and local leaders, in both government and business, can take many of the steps needed to boost competitiveness without relying on Washington. Gridlock inside the Beltway does not have to become gridlock in America. Local civic leaders, including those in business, can and are beginning to spur many of the investments in individuals, infrastructure, innovation, and institutions needed to raise long-term productivity.

To address its challenges, however, America needs a strategy and a consensus on direction, not self-interested steps promoted by single-issue advocacy groups. The plan must ultimately engage government at all levels—local, state, and national—as well as labor. We believe that business must lead the way. By tackling problems in the business environment and their local communities, companies will not only contribute to American competitiveness; they will unleash some of their greatest opportunities to innovate and grow. ♥

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