Is the U.S. Losing Competitiveness?
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1. Symptoms of a Problem

In just four year's time, according to the International Monetary Fund, the U.S. economy is likely to be overtaken by China's, if gross domestic product (GDP) is calculated on the basis of purchasing power parity. For first time since the 1880s, the United States will no longer have the world's largest economy. Nor is that the only sign that the U.S. economy is suffering relative decline. The U.S. stock market was heavily outperformed by most emerging markets over the past ten years. The average annual return for American stocks was 0.5% between 2001 and 2011, compared with 11.4% for emerging market stocks. For ordinary Americans, as well as for international investors, the past decade has been deeply disappointing. Between 1999 and 2007 – the year when the financial crisis began – median household income fell in real terms. It has fallen further since then. According to the National Bureau of Economic Research, the recession caused by the financial crisis ended two years ago, but the economy still needs to create an additional 7 million jobs to get back to pre-recession levels, plus another 5 million to match the continued growth in the labor force. This, despite massive levels of monetary and fiscal stimulus that have, respectively, trebled the size of the Fed's balance sheet and nearly doubled the ration of federal debt to GDP.

To listen to some economists, you might think all the U.S. need do is to run even larger deficits for full employment to be restored. Yet only a part of America's problems today can be blamed on the cyclical consequences of the financial crisis. This is at root a structural crisis, symptoms of which were already apparent even before the crisis began. Indeed, it might be argued that the financial crisis occurred precisely because excessive leverage was being used by the household and financial sectors to compensate for the economy's underlying structural problems. However, the precise nature of these structural problems is not well understood.

The obvious culprit for relative decline is globalization, the process of worldwide economic integration through market reforms that began in the late 1970s. It is true that in U.S. industries exposed to international competition, employment growth has essentially stopped in recent years. It is also true that the growth in foreign direct investment in the United States has slowed in recent years to rates below those of other large advanced economies. The U.S. share of world exports has declined substantially. Many economists have concluded that the recent decline in U.S. manufacturing employment is mainly a result of increasing global competition. American workers, so the argument runs, simply cannot match the "China price" because labor costs are so much lower in emerging markets like China's.

Yet, according to recent estimates, only a small fraction of jobs lost between 2008 and 2010 were mass layoffs (50 or more jobs) attributable to relocations outside the United States. In practice, "offshoring" jobs generally turns out to save less money than companies expect. Despite mounting public disquiet about its effects, globalization has in fact played a relatively modest role in destroying manufacturing jobs and reducing median incomes.[1]

Another popular explanation for the U.S. economy's troubles is declining innovation. Recent reports by the Boston Consulting Group and the Information Technology and Innovation Foundation (ITIF) have suggested that, in terms of measures of innovation such as spending on research, patents and venture funding, the U.S. ranks not number 1 but, respectively, number 8 and number 6 in the world. In the ITIF rankings of forty countries according to how much each improved its innovation capacity from 1999 to 2009, the U.S. came in "dead last".[2] This analysis is hard to square with evidence that the principal driver of job losses in U.S. manufacturing has in fact been technological innovation.[3]

2. Defining Competitiveness

Traditionally, economists have tended to measure competitiveness rather narrowly. Defining the concept in terms of internationally comparable unit labor costs or even simply in terms of exchange rates, we appear to have nothing to worry about. In fact, since 1980 the U.S. has been one of the most successful countries in the Organization for Economic Cooperation and Development (OECD) when it comes to controlling unit labor costs. Average unit labor costs in the OECD have risen by 47 per cent over the past thirty years. In Germany the figure has been 107 per cent. The figure for the United States is just 15 per cent.[4] Similarly, the dollar has been weakening in real trade-weighted terms since around 2001, with only a temporary and (by the standards of the mid 1980s) modest rally in the worst phase of the global financial crisis, as investors opted for a "flight to safety". Partly for these reasons, U.S. exports have performed relatively well in the past decade – they have risen around 59 per cent in real terms – though admittedly not well enough to eliminate the large current account deficit.

Yet these approaches are indeed much too narrow. Competitiveness is about more than just the cost of labor or the exchange rate. Michael Porter and Jan Ravkin of Harvard Business School have recently published an illuminating study of U.S. competitiveness. This is how they define the term:

> 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. … 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. … Increasing productivity over the long run should be the central goal of economic policy. This

[1] Michael E. Porter and Jan W. Rivkin, "The Looming Challenge to U.S. Competitiveness",

[2] Fareed Zakaria, "The Future of Innovation: Can American Keep Pace?", *Time*, June 5, 2011.

[3] Adam Davidson, "Making it in America", *Atlantic Monthly* (Jan/Feb 2012)

[4] http://stats.oecd.org/.

> requires a business environment that supports continual innovation in products, processes, and management. Boosting productivity over the short run by firing workers … is a reflection not of competitiveness but of weakness.[5]

Competitiveness in this sense is determined by a matrix of seventeen different macroeconomic and microeconomic variables:

1. Macroeconomic policy: soundness of government budgetary, interest rate, and monetary policies
2. Effectiveness of the political system: ability of the government to pass **effective laws**
3. Protection of physical and **intellectual property rights** and **lack of corruption**
4. Efficiency of **legal framework: modest legal costs; swift adjudication**
5. **Complexity of the national tax code**
6. K-12 education system: universal access to high-quality education; curricula that prepare students for productive work
7. Logistics infrastructure
8. Communications infrastructure
9. High-quality universities
10. Context for entrepreneurship: availability of capital for high quality ideas; **ease of setting up new businesses**; lack of stigma for failure
11. Availability of skilled labor
12. Flexibility in hiring and firing of workers
13. Innovation infrastructure
14. Regulation: **Effective and predictable regulations** without unnecessary burden on firms
15. Strength of clusters: geographic concentrations of related firms
16. Quality of capital markets: ease of firm access to appropriate capital; capital allocated to most profitable investments
17. Sophistication of firm management and operations.[6]

I will have more to say later about the variables highlighted in bold.

3. Prosperity at Risk: The Harvard Business School Survey

Porter and Rivkin's recently published study of U.S. competitiveness, *Prosperity at Risk*, is based on an in-depth survey of nearly 10,000 Harvard Business School alumni. Its key findings are startling. No fewer than 71% said they expect U.S. competitiveness to decline over the next three years. During the year before the survey, more than 1,700 of the respondents had been personally involved in decisions about whether to place business activities and jobs in the U.S. or elsewhere. Of 607 instances of decisions on whether or not to offshore, "the U.S. retained the activity just 96 times (16%) and lost it in 511 cases (84%)". Moreover, "11% of activities reported by respondents to have been moved out of the U.S. in the past year – a total of 56 moves – consisted of 1,000 or more jobs. Of activities retained by the U.S., only five decisions (5%) involved 1,000 or more jobs; no activities moved to the U.S. involved 1,000 or more jobs; and only four decisions (3%) to locate newly established activities in the U.S. involved 1,000 or more jobs". Nor

[5] Porter and Rivkin, "Looming Challenge".

[6] Michael E. Porter, Mercedes Delgado, Christian Ketels, and Scott Stern, "Moving to a New Global Competitiveness Index," *Global Competitiveness Report 2008-09* (Davos, 2008).

were these low skill jobs that were going abroad. "42% of all decisions about potentially moving existing activities out of the U.S. involved research, development, and engineering activities."[7]

Asked to rank the reasons for declining U.S. competitiveness, the HBS alumni highlighted the following areas of weakness:

1. Effectiveness of [the] political system
2. The K-12 education system
3. The complexity of the tax code
4. Macroeconomic policy
5. Regulation
6. The efficiency of [the] legal framework.

Between two fifths and three quarters of those surveyed expected the U.S. to fall further behind in these six areas.[8]

These are of course survey data; they should not be confused with objective realities. The authors of the Harvard study themselves suggest another reason why these HBS alumni might be more ready than those of previous generations to move operations abroad: "Incentives 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."[9] It would have been rather surprising if the alumni themselves had expressed this view. Nevertheless, these findings are suggestive. If the six areas listed above are the sources of declining competitiveness in the minds of our best qualified business executives, we need to look more closely at the relationship between institutions and economic performance.

4. The Institutional Problem

The notion that the United States is suffering some kind of institutional loss of competitiveness is not peculiar to the Harvard Business School research cited above. A very similar conclusion can be reached from the World Economic Forum's annual Global Competitiveness Index, which has been calculated using the same (sophisticated) methods since 2004. In that period, the aggregate score for the U.S. has declined markedly (-7%), while those for China, Hong Kong and Germany – to name just three – have improved (by +14% in the case of China). Again, the problem appears to be institutional.

The WEF's Executive Opinion Survey produces a significant amount of the data that goes into the WEF Global Competitiveness Index. The table below selects 16 measures of the efficacy of government, focusing on aspects of the rule law ranging from the protection of private property rights to the policing of corruption and the control of organized crime. It is an astonishing yet scarcely acknowledged fact that on no fewer than 15 out of 15 different issues relating to property rights and governance, the United States now fares markedly worse than Hong Kong. Taiwan out-ranks the U.S. in 9 out of 15. Even mainland China does better in two dimensions. Indeed, the United States makes

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[7] Michael E. Porter and Jan W. Rivkin, *Prosperity at Risk: Findings of Harvard Business School's Survey on U.S. Competitiveness* (January 2012)

[8] Ibid., esp. p. 11.

[9] Porter and Rivkin, "Looming Challenge".

the global top 20 in only one area: investor protection, where it ranks 5th equal. On every other count, its reputation is shockingly bad.

Table: World Economic Forum Measures of the Effectiveness of the Rule of Law

Issue	*Top country*	*Top score*	*USA score*	*USA rank*	*Hong Kong rank*	*Taiwan rank*
Property rights protected	Finland	6.4	5.1	39	**6**	**14**
Anti-corruption	New Zealand	6.6	4.6	36	**10**	**34**
Politicians' ethics	Singapore	6.4	3.2	50	**22**	**27**
Anti-bribery	New Zealand	6.7	4.9	42	**11**	**34**
Independence of judiciary	New Zealand	6.7	4.9	36	**15**	44
No political favoritism	Sweden	5.8	3.3	50	**29**	**28**
Efficiency of law in private disputes	Singapore	6.3	4.5	36	**5**	44
Efficiency of law in disputes with government	Finland	5.7	4.2	39	**3**	**34**
Low costs of organized crime	Denmark	6.8	4.9	86	**28**	**45**
Reliability of police	Finland	6.7	5.6	30	**9**	32
Corporate ethics	Denmark	6.7	5.1	29	**15**	35
Financial auditing and reporting standards	South Africa	6.5	5.2	40	**12**	**30**
Corporate governance	Sweden	5.9	5.1	26	**31**	34
Protection of minority shareholders	Sweden	6.0	4.8	32	**24**	**25**
Investor protection	New Zealand	9.7	8.4	5=	**3**	60

Source: World Economic Forum
Note: In all but the last category the maximum possible score is 6. For investor protection it is 10.

Nor can the HBS and WEF studies be dismissed as outliers. We can find similar evidence in the following sources:

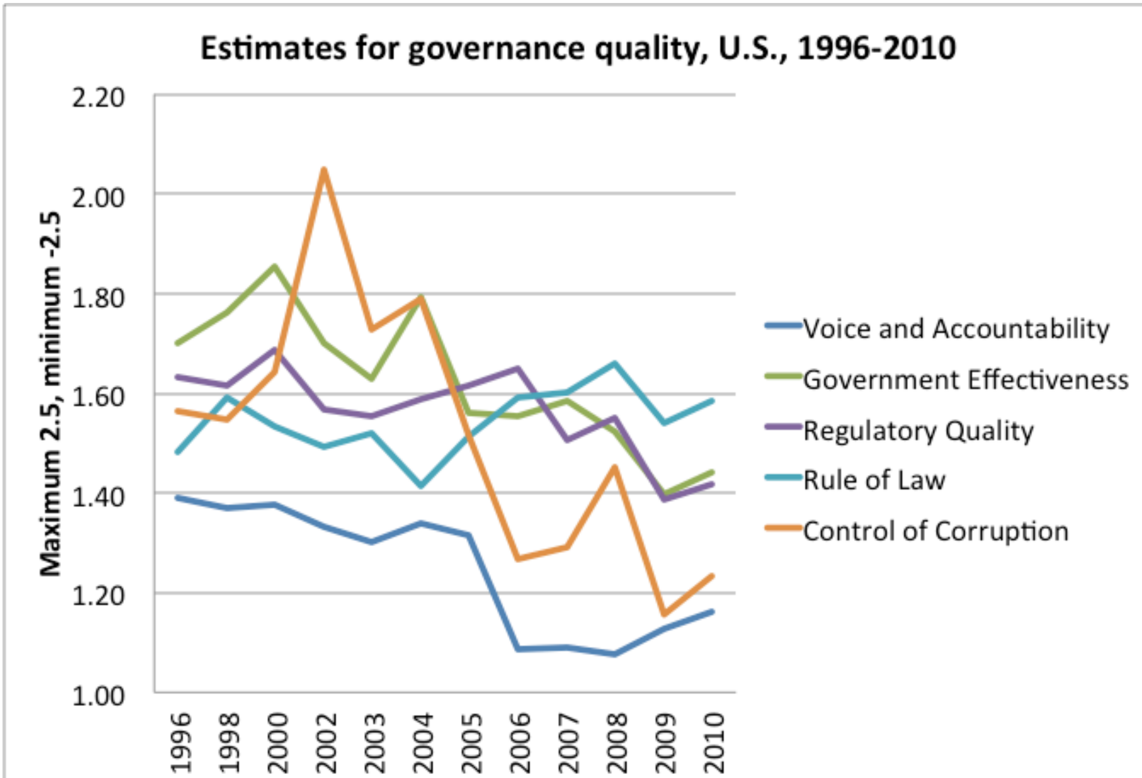
- The Heritage Foundation, Freedom Index
- The International Finance Corporation (IFC), Ease of Doing Business Index
- The World Justice Project Rule of Law Index
- The World Bank, Worldwide Governance Indicators.

In the Heritage Foundation's Freedom Index, the U.S. ranks ninth in the world in terms of economic freedom, a considerable distance behind Hong Kong and Singapore. The IFC rates the ease of doing business in a country in a number of different dimensions. In terms of the ease of paying taxes, the U.S. ranks 72nd. In terms of dealing with construction permits, it ranks 17th; registering a property 16th; resolving insolvency 15th, and starting a business 13th. The WJP's Rule of Law index ranks the U.S. 21st out of 66 in terms of access to civil justice; 20th for the effectiveness of criminal justice; 19th for fundamental rights; 17th for absence of corruption; 16th for the limiting of government powers; 15th for regulatory enforcement; 13th for order and security; and 12th for the openness of government.[10]

The most compelling evidence of all comes from the World Bank's indicators on World Governance. As the figure below shows, since 1996 the United States has suffered a decline in the quality of its governance in five different dimensions.

[10] World Justice Project, *Rule of Law Index 2011* (2011), p. 103.

Figure



Source: http://info.worldbank.org/governance/wgi/index.asp

Compared with Germany and Hong Kong, the U.S. is manifestly slipping behind in these areas (see appendix). This is a remarkable phenomenon it itself. Even more remarkable is that it is happening almost unnoticed by Americans.

5. The Six "Killer Apps"

Economists from Adam Smith to Douglass North and Hernando de Soto have seen the quality of institutions as a key determinant of economic performance. A recent book by Daron Acemoglu and James Robinson restates the case.[11] In my own work I have argued that the fundamental reasons why Western civilization pulled ahead of the rest of the world after around 1500 were institutional. The West, led after around 1900 by the United States, had six "killer applications" that the Rest lacked:[12]

1. Competition (economic and political)
2. The scientific method
3. The rule of law
4. Modern medicine
5. The consumer society

[11] Daron Acemoglu and James Robinson, *Why Nations Fail: The Origins of Power, Prosperity and Poverty* (New York, 2012).
[12] Niall Ferguson, *Civilization: The West and the Rest* (New York, 2011).

6. The work ethic.

But since around the late 1970s we have ceased to monopolize these things. Not only have non-Western countries, beginning with Japan, "downloaded" our institutional advantages; we have seemingly been intent on deleting them. As described above, we have lost competitiveness in general. Our scientific decline may now be an inevitable consequence of the low quality of U.S. high school education, as laid bare in the most recent (2009) OECD Program for International Student Assessment (PISA), which ranked American 15-year-olds 25th in math, 17th in reading, and 22nd in science among 34 surveyed countries. Chinese students took the tests for the first time in 2009 and came first in all three subject areas. More than 50% of China's students scored in the top two levels (out of six) in math, while less than 10% of U.S. students did. The gap in mathematical attainment between Chinese and U.S. teenagers is now as big as the gap between American and Albanian teenagers.[13]

Yet educational failure may itself be merely a symptom of a more profound institutional failure. Philip K. Howard of the non-profit organization Common Good cites as example of bad legislation the case of the special education law, enacted in 1975. This "was structured as an open-ended mandate, and soon spun out of control. Today, special ed consumes 20 percent of the total K-12 budget. Programs for gifted children get less than half of one percent, and pre-K education gets almost nothing [less than half of 1%]". Typically, the Government Accountability Office found 82 separate programs for teacher quality. Howard argues for a "legal spring cleaning" to clear away the accumulation of decades of obsolete legislation, as well as for mandatory sunset provisions in all future laws with budgetary impact.[14] He also highlights the related problem of regulation run amok.

- Under a recent federal directive, the number of health-care reimbursement categories will soon increase from 18,000 to 140,000, including 21 separate categories for "spacecraft accidents" and 12 for bee stings.
- There are over 140 million words of binding federal statutes and regulations, and states and municipalities add several billion more.
- The federal worker-safety laws now include some 4,000 rules.

To address the problem of an increasingly meddlesome bureaucracy implementing increasingly complicated regulations, Howard calls for a shift from "instruction manual" regulation, which is designed to cover every eventuality, to "results based" regulation, in which judgment is allowed to play its part – as used to be the case.[15]

6. Conclusion: Hot Spot Washington

The Economist Intelligence Unit has just published a new survey of global cities entitled *Hot Spots*.[16] Here at last is some good news about American competitiveness. Of the world's top 60 cities, 12 are in the U.S. Even more remarkable, Washington is ranked number 8.

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[13] OECD, PISA 2009 Results: What Students Know and Can Do (Paris, 2010).

[14] Philip K. Howard, "It's Time to Clean House", *Atlantic Monthly*, March 14, 2012.

[15] Philip K. Howard, "Results-Based Regulation: A Blueprint for Starting Over", *Common Good*, December 2, 2011.

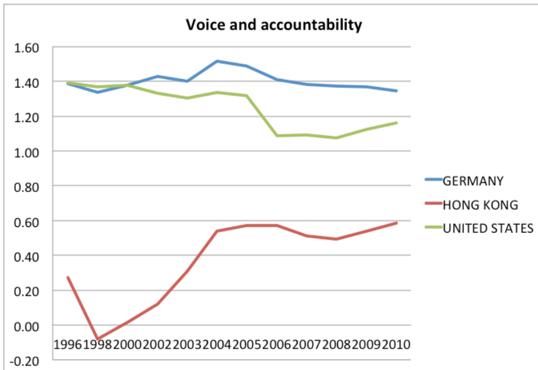
[16] EIU, *Hot Spots: Benchmarking Global City Competitiveness* (London, 2012).

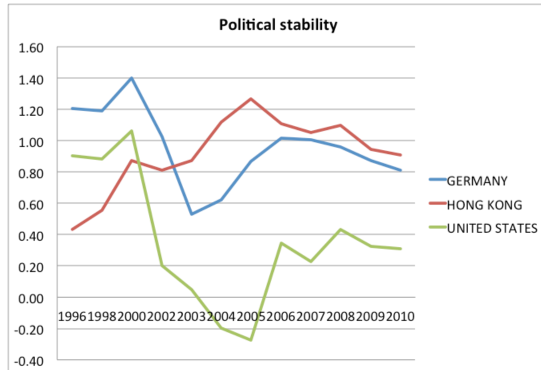
The nation's capital may be a competitive city by the EIU's criteria. But, to judge by the evidence presented here, Washington seems to be intent on rendering the rest of America uncompetitive in a highly troubling way. All discussions of declining U.S. competitiveness need to focus on a hitherto largely overlooked phenomenon: a measurable degeneration in the quality of this country's institutional framework. When executives complain about the effectiveness of [the] political system, the defects of K-12 education system, the complexity of the tax code, the inconsistency of macroeconomic policy, the burdens of regulation, and the inefficiency of [the] legal framework, they are not fantasizing or passing the buck. They are identifying real problems. In some respects, I might go so far as to call it the problem of "Soviet America". The United States was victorious in the Cold War. Yet, imperceptibly, certain traits we used to associate with the Communist enemy have been creeping into American life. Over-mighty bureaucracy, excessive regulation, a sham rule of law, corruption: these are dangerous tendencies, and economic stagnation is only one of their likely consequences. Other consequences we might expect include political decadence and geopolitical decline. At the very least, we are seeing here the emergence of a more European America – though European in the sense of Italy, not Germany.

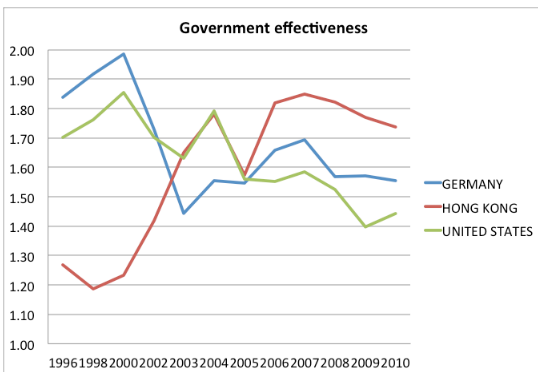
The late Mancur Olson used to argue that, over time, all political systems were likely to succumb to sclerosis, mainly because of the self-interested conduct of vested interests. Often it took an external shock like a lost war to wipe the slate clean and allow open institutions to be re-established.[17] It must fervently be hoped that the United States can avoid such a painful variety of reform. But that reform is urgently needed, to restore transparency and efficiency to our systems of legislation, regulation and justice, is surely beyond doubt.

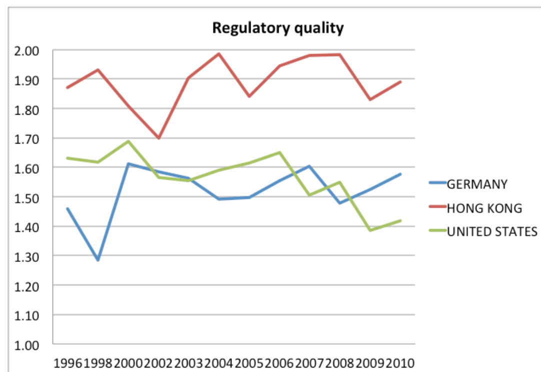
[17] Mancur Olson, *The Rise and Decline of Nations: Economic Growth, Stagflation, and Social Rigidities* (New Haven, 1982).

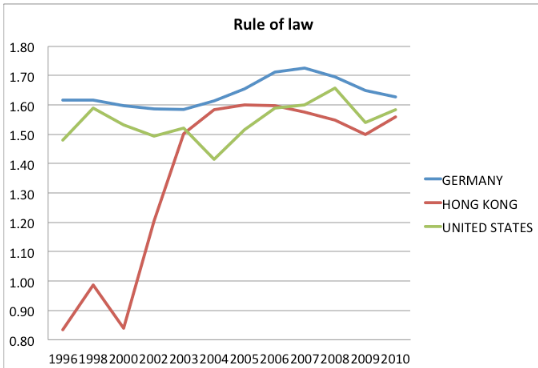
Appendix: U.S. Governance Quality in Comparative Perspective, 1996-2010

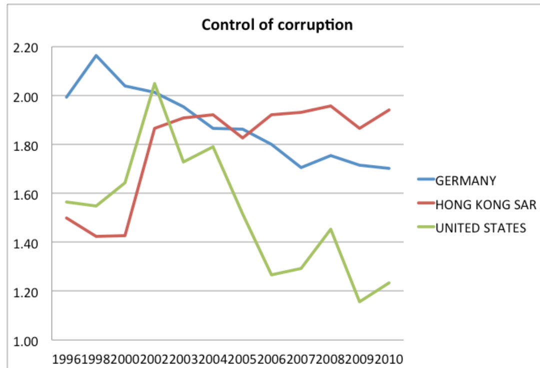












Source: www.govindicators.org