The Political Economy of Competitiveness

Richard N. Cooper

"Competitiveness" is an attribute widely desired, little understood. We need to spend a bit of time sorting out concepts. This need can be sharpened by the paradox of the United States, which stands second (after Finland) in the widely-cited index of competitiveness of the World Economic Forum, yet has a current account deficit with its trading partners of around $500 billion, five percent of US GDP, as a result of a large excess of imports over exports.

The dictionary defines "competitive" circularly as "able to attain the desired results in a competitive situation, "and by the latter it means "decided by competition, "which in turn is defined as "struggle or rivalry for supremacy." We are concerned here with economic or commercial competition, not sports events or beauty contests. We might speak of a business firm as being especially "competitive" if it is able to increase its share of the relevant market while maintaining its profits or, alternatively, to increase its profitability while maintaining its market share. The firm is competitive if it can profitably maintain its market share in the face of competition from other firms. Since we are interested in worldwide competitiveness, this competition from other firms must include foreign as well as domestic firms, whether in the world market or the domestic market.

Unfortunately this common-sense definition of "competitiveness" for a firm does not carry over comfortably to countries. While we can certainly identify "market shares" for countries in the world market for particular products, it is more difficult for the country as a whole. Share of world exports or share of gross world product is determined by the size of the country -- its population, labor force, and, importantly, productivity. "Profits" have no precise country analogue, unless we mean output per person or per person employed.

In speaking about national competitiveness, we could mean simply that the country contains many competitive firms, as defined above. But how many? How large de they need to be -- what fraction of national output? (Every country after all has a comparative advantage in <u>some</u> Product.) And do they need to be owned by nationals, or could they include foreign-owned firms operating in the country? Japan offers an example of a country with several dozen competitive firms, which are important, indeed crucial, for Japan's export performance; but much of Japan's domestic economy, by wide consensus, is uncompetitive by world standards.

Several attempts have been made to define "competitiveness" as applied to countries, and they all converge around output per capita or some close variant. For example, "competitiveness provides the basis for raising people's earnings in a non-inflationary way" (Europe's Competitiveness Advisory Group, June 1995); "the ability to produce goods and services that meet the test of international markets while citizens earn a standard of living that is both rising and sustainable over the long-run" (US Competitiveness Policy Council, 1992); "The only meaningful concept of competitiveness at the national level is national productivity" (Michael Porter, The Competitive Advantage of Nations, 1998).

Per capita income is closely related to productivity (which equals output per man-hour of input), which in turn determines standards of living in a country (including leisure).

The Geneva-based World Economic Forum has compiled a cross-country index of national competitiveness since 1996, published annually in its Global Competitiveness Report (Oxford University Press). More recently it has refined its work into two indices: one called the growth competitiveness index (GCI), another the Current Competitiveness Index (CCI, renamed in 2004 the Business Competitiveness Index). The first of these indices attempts to summarize a variety of factors that positively influence sustainable national growth in per capita income, over a period of roughly a decade. The second index attempts to summarize a variety of factors that are highly correlated with national labor productivity in the recent past. The GCI is based on three component indices, with equal weights, concerning macroeconomic conditions, institutional factors, and technological development. The CCI is based on measures of the quality of the local business environment and the quality of company operations and strategy. Some of the underlying components come from national data, much from surveys of businessmen run by WEF and others.

How can competitiveness be achieved at the national level? Labor productivity is determined by the techniques of production used, the average amount of capital available per worker, the skills of the workers, and the efficiency with which technology, capital, skilled and unskilled labor are combined, including of course marketing success and the business environment in which the economic units operate. Labor productivity can grow through improvements in any of these components. In practice all four factors are changing continually in growing countries, although their relative weights vary significantly from country to country and from time to time. The growing countries of East Asia, for instance, have relied much for their growth on high rates of investment -- large additions to capital per worker -- in recent decades. In contrast, recent growth in the United States has relied much less on increases in capital per worker (although complex issues of how best to measure “capital” complicate and may qualify this statement). Rather, US growth in recent years has come mainly from increased in “total factor productivity,” especially improvements in the use of capital, lumped into changing techniques of production and higher overall efficiency in the above list.

A key characteristic of the world economy -- especially the rich countries -- is that technological change has become institutionalized, in the sense that many educated and talented people are paid -- partly through salaries and bonuses, partly through advancement and promotions, partly through prizes and social prestige -- to think up new ideas. Many will be dead-ends, but many will be useful and some will be irresistible, in the sense that ten or twenty years from now millions of people will be using them. This stream of useful -- and profitable -- innovations is another dimension of competitiveness, as many people or firms around the world buy or license the innovations from the innovating country. Some of the innovations are new products or services; most however provide more efficient processes for producing familiar goods and services, hence increase measured productivity. (Introducing new products into productivity measures is problematic and involves various statistical compromises.)

Innovation often but not always involves extensive “investment” in research and development, and corresponding levels of skills in the labor force. But not always. When I was a child, a scooter -- a two-wheeled riding platform propelled with one foot -- was a common toy. It virtually disappeared for many decades. It has recently been re-introduced by a Taiwanese firm in a strong, folding modern design, and can now be widely observed in the United States. Here is an old idea updated with modern materials, an innovation that did not rely on the frontiers of science.

Innovations elsewhere can often be imitated at lower cost, and indeed this provides one of the major mechanisms for growth in developing countries today -- and historically for the United States, drawing on European ideas, and subsequently Japan, drawing on ideas from the United States and Europe. But imitation of innovations itself requires some economic creativity, since often new processes of production are required, which in turn require adaptations by management and labor, even when equipment is imported, especially if it is not.

This continual process of innovation, somewhere in the world if not at home, implies that both products and productive processes are subject to continual change, placing a premium on the ability of firms and of countries to adapt quickly to new opportunities and to changes in the structure of costs. Having advance information of what is likely to come of course facilitates such adaptation.

Competitiveness has a macro dimension and a micro dimension. The latter concerns how management gets the most out of its employees and how skillfully it markets its products. The former concerns factors external to the firm: interest rates, the exchange rate, the rate of inflation, tax rates and enforcement, wages and the availability of skills in the labor market, the general regulatory environment, and the efficacy of the procedures for settling disputes. A more depreciated currency can improve the international competitiveness of a country's firms, but it does so by reducing living standards of its citizens. It may also take pressure off firms to cut costs and improve efficiency, as President Park argued in South Korea during the 1970s.

Much attention has been paid to regulation of financial and labor markets, and the nature and efficacy of such regulation is indeed an important part of the environment in which firms operate. But William Lewis of McKinsey Global Institute has argued (in The Power of Productivity, 2004) that even more important is the regulation of product markets, to which too little attention has been paid. MGI's findings, in a series of sector-level studies in many countries, including Brazil, India, Russia, and South Korea among developing countries, are that a major impediment to local competition, hence to improvements in productivity, is regulations that inhibit or even prohibit entry of new firms, including foreign firms. He places great emphasis on the importance of retail trade in this regard, a sector that is too often neglected as technologically or conceptually uninteresting, because of its direct contact with consumers, its backward linkages to suppliers and manufacturers, and its economic size in all countries.

"Competitiveness" is universally valued and desired. No one, so far as I know, espouses an uncompetitive economy. But the policy actions required to bolster competitiveness are often controversial, so while everyone wants the objective, not everyone places such high value on it as to override other considerations, whether of a public or a personal character. Both ideology and interests may resist a government's taking the actions considered necessary to bolster competitiveness; and they do so either by challenging the connection between the proposed actions and the desired objective, or by asserting the priority of other objectives, such as equality of income distribution, over improved competitiveness.

Ideology, or more generally concept of the public good, is perhaps less important today than it was 20 and certainly 40 years ago, when Marxist views about how to manage an economy were widely regarded in rich and poor countries alike, with its emphasis on centralized planning and its suspicion of private ownership and of all forms of competition, including foreign trade. It may well be that Marxist planning could work in simple, largely agricultural societies -- although Soviet and Chinese experimentation with collectivization of agriculture suggests that it does not work well even then -- but modern industrial societies, with tens of thousands of products and where technical change is both possible and desirable, are impossible to run along Marxist lines. This is now widely recognized. A residual of Marxist thinking, however, can be found in proper concern for the well-being of the poorest and most disadvantaged members of society. One of the major challenges of all modern economies is to achieve the efficiency improvements that are continuously being made possible, while also assuring that no one is left seriously behind. It is an established fact that the best way to reduce poverty is to grow the economy -- higher average income tends to pull up all incomes over time -- but growth alone does not assure that all benefit.

More important than ideology in resisting change are the short-term interests of politically influential individuals or groups. Many influential people have a perceived and perhaps even a real interest in preserving the status quo, from which they have learned to benefit materially and in social status. Change, particularly reduction in resource-allocating authority of government officials, may seriously threaten the status quo -- indeed, that may be its purpose, with the aim of improving competitiveness. Many excuses will be advanced why the proposed change is undesirable -- among which will not be the admission that it reduces the authority and rewards of the officials or politicians making the objections.

Even the attainment of macroeconomic stability may be difficult, insofar as it involves serious discipline in framing the government's budgets. Government expenditures are often popular, at least with the direct beneficiaries, while taxes never are. This results in the politician's dilemma: how to appeal to the first group without alienating the tax-payers. The resolution of this dilemma too often has been resort to deficit financing, often at the central bank, resulting in chronic inflationary pressures. One does not have to espouse price stability -- indeed, I believe that would be unwise for many developing countries -- to wand a high degree of discipline both on government expenditures and on central bank financing of government.

The proper role of government is to create and maintain a stable macroeconomic environment, in which long-term business planning can take place, and to maintain the right balance in regulation and taxation -- which, contrary to what one sometimes hears in the United States, does not involve minimal regulation and taxation. Trust is an important part of any modern economy that involves commitments over time (that is, <u>all</u> modern economies). Trust needs to be fostered and reinforced by a system for settling commercial disputes that is seen to be fair minded (impartial) between the contending parties, even when one of the contending parties is government. That in turn requires laws, regulations, and supervision and enforcement of same. This is most obvious in the financial arena, where agents are handling large sums of the public's money, and where the temptations to misuse such funds is high absent a highly disciplined regulatory environment. But it also applies to health care, drugs, food, product and workplace safety, environmental degradation, and a host of other issues. "Optimal" government is not minimal government, but rather government that provides a clear framework for commercial transactions whenever such a framework is necessary for economic efficiency.

Taxation of course is necessary to provide for traditional public goods such as transport infrastructure and education, as well as financing the regulatory and dispute settlement arrangements. Serious failure of government in these regards results in a loss of competitiveness.

Confusion is sometimes made between strong government and pervasive government. Government should be strong in the tasks it undertakes, but it should undertake only those tasks that are really necessary -- that is, desirable activities that cannot be effectively provided without the intervention of government. The US Federal government is a strong government, but it is not pervasive in that many activities are left to state or local governments, or to the private sector. Many governments around the world are far more pervasive in their pretensions, but in fact are weak in execution – often the worst of both worlds, since economic agents then may have to operate outside the law to survive.

We can close by returning to the paradox posed at the outset: the United States ranks second in both the latest WEF competitiveness indices, down from first last year and second in early years, despite a huge current account deficit in its transactions with the rest of the world. How can this be? It is necessary first to recall that the foreign trade position of the United States is influenced by the state of the economy, both its growth and the exchange rate of the dollar. The dollar floats freely as far as the US government is concerned, except in unusual circumstances. The exchange rate of the dollar is influenced by the trade deficit, but even more by inflows of foreign capital into the United States; and of course the exchange rate influences the competitiveness of US products on the world market, and indeed even in the domestic market, given the low level of import protection for most products.

The US deficit is as large as it is because foreigners wanted to invest so heavily in the United States -- in direct investments, in stocks, bonds, and real estate. These investments were overwhelmingly private until a few years ago. Lately they have included public funds -- the by-product of exchange rate policies of other countries, particularly those in Asia -- but private investments continued large and seem again to be growing, as recovery of the US economy from the 2001-02 recession takes hold. Foreigners like the United States as a place to invest partly because of its large size, but partly also for all the reasons that lead to a high rank on the WEF competitiveness indices. It is a good place to do business, its growth prospects, while modest by comparison with some emerging markets, are excellent among the rich countries. Its productivity is high and growing at a nice rate. And that is what national competitiveness is all about.