

## EU competitiveness on a growth path

*In 2006 the overall competitiveness performance of the EU economy improved considerably. The European Competitiveness Report 2007 underlines the central role that productivity plays as a source for growth over the long term and examines the contribution of the various economic sectors in economic developments and the role of policies, especially those covered by the microeconomic pillar of the Lisbon strategy, in improving performance. Research and innovation as well as training and education policies have strong impacts on competitiveness. Economic reforms that enhance the general business environment and facilitate structural change and re-allocation of resources are also crucial. A major driver for increased economic efficiency is competition, either through trade openness, a reinforced Single Market, especially in services, continuous liberalisation of network industries or product market reform. Coordinated action in these areas on EU level produces superior benefits to acting alone.*

### 1. Overall competitiveness performance

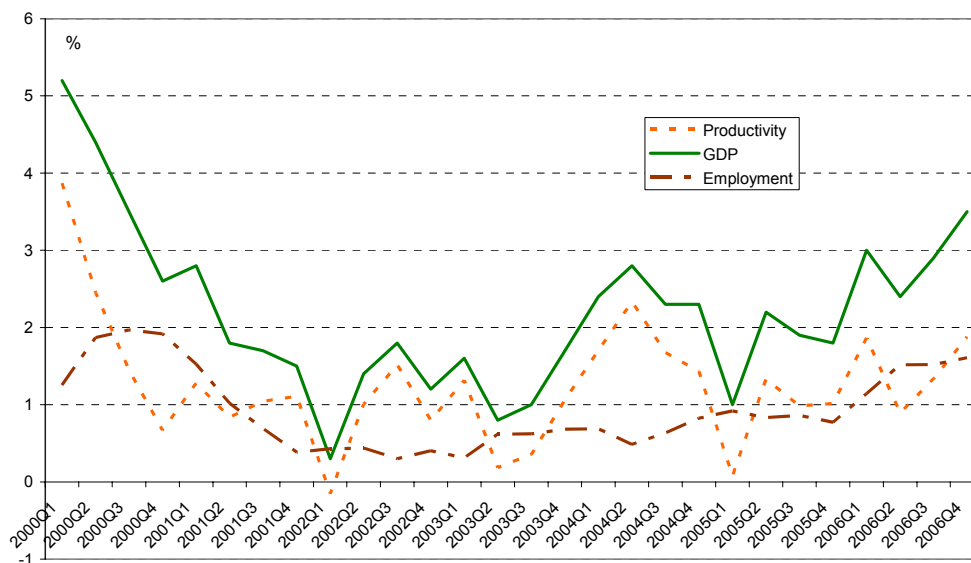
- **Widespread improvements** of the European economy can be observed in terms of productivity and employment growth;
- **New member states** and those with low productivity and per capita Gross Domestic Product (GDP) are catching up;
- The **EU-US productivity gap has started to diminish** with some indications that factors other than the favourable cycle are also at work;
- **Total Factor Productivity** is the main source of the productivity gap between the EU and the US.

The **strength of the economic recovery** in Europe is larger than was expected last year: the EU's real Gross Domestic Product (GDP) grew by 3.0% in 2006 - the highest growth rate since the year 2000. This improvement was supported by acceleration in both productivity and employment growth (see Graph 1).

Recent developments in the EU in comparison with the **United States**, confirm that the trend of ever increasing economic growth and productivity gap, which could be observed over the last decade, has come at a halt.

Countries with lower initial levels of labour productivity have achieved higher growth, whereas countries initially ranking at the top of productivity performance found it more difficult to maintain high growth rates.

**Graph 1: GDP, employment and productivity growth in the EU-27**



Note: Growth compared to the same quarter of the previous year.

Source : Eurostat 25/05/2007

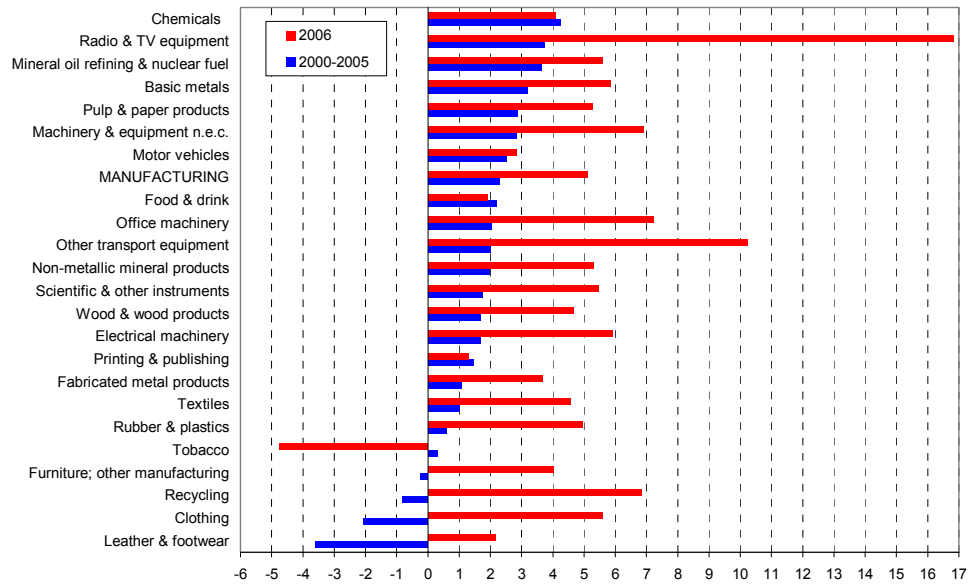
The enhanced productivity growth in 2006 is underpinned by stronger growth in total factor productivity. It is the part of productivity growth generated by intangible factors such as technical progress or organisational innovation instead of increased use of inputs, such as capital. This makes total factor productivity the most comprehensive measure of the efficiency of an economy.

In 2006 **labour productivity growth has accelerated considerably** (see graph 2).

The data confirm a general catching-up tendency for the total economy, including many service sectors. Apart from water transport (shipping), all industries with the highest rates of value added growth in the European Union relate to the **new information and communication technologies**, i.e. communication equipment, office machinery and computers, as well as telecommunications and computer related services.

The EU shows higher growth in selected areas of **high-tech manufacturing**, particularly pharmaceuticals, and the network industries, such as the sectors of electricity, gas and water supply, water transport, and telecommunications, which are apparently undergoing substantial restructuring processes.

**Graph 2: Labour productivity annual growth (%) in manufacturing sectors, 2000-2005\* and 2006**



Source: calculated with Eurostat data.

\* The figures represent the average annual growth rates between the productivity levels of the first and the last years

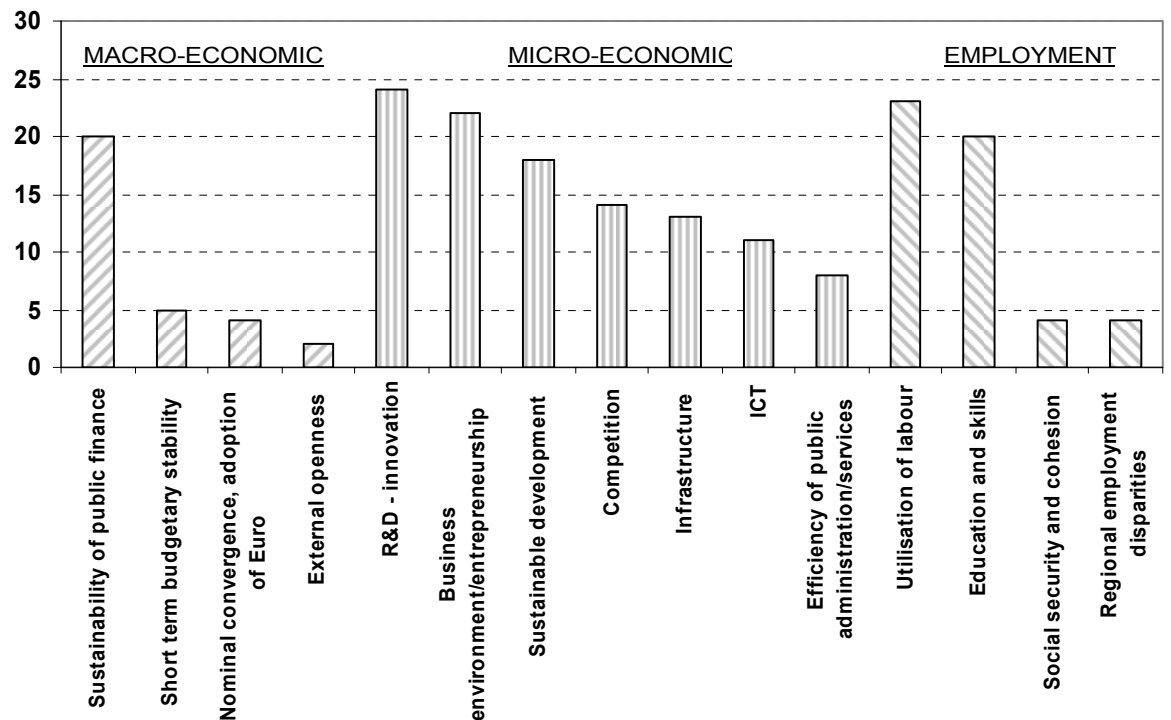
## 2. Drivers of competitiveness

### Microeconomic reforms contribute most to productivity growth in Europe:

- **Investment in ICT** brings high returns in terms of productivity when accompanied by appropriate organisational changes and investment in skills;
- **Competition** is an important driver of productivity and innovation;
- Stimulating **entrepreneurship** and enhancing conditions for SMEs have positive effect on productivity;
- By freeing resources **better regulation** and cutting red tape can contribute significantly to higher output and consumption;
- **Trade openness** and productivity go together;
- **Skill** upgrading becomes a crucial competitiveness factor.

Raising the long-term economic growth potential by increasing productivity growth is one of the fundamental objectives of the renewed Lisbon strategy and an important response to the challenges of globalisation, ageing, the rapid pace of technological progress and the need to combat climate change. The microeconomic policy pillar of the Lisbon strategy covers many of the policy areas most relevant to enhancing productivity.

**Graph 3: Key challenges as identified by the 25 Member States in their 2005 National Reform Programmes, by broad policy area**



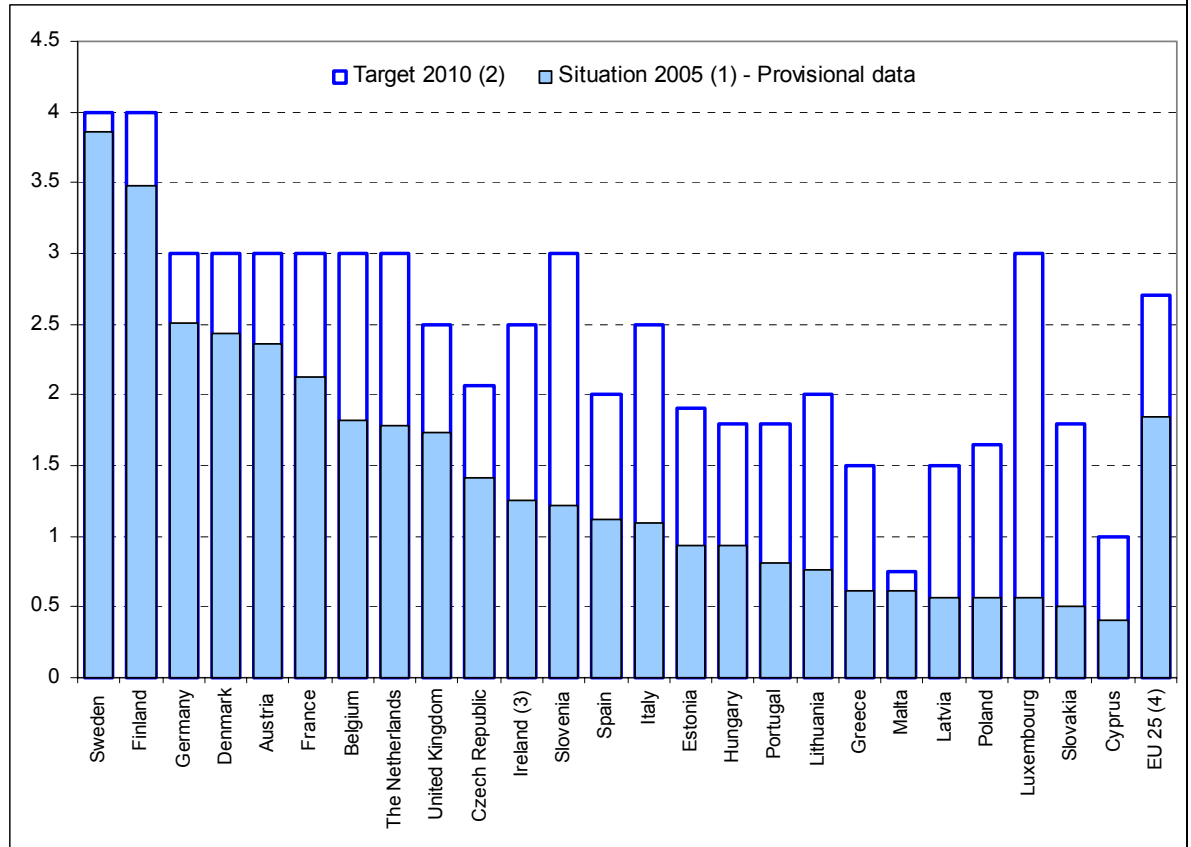
Source: Commission Annual Progress Report 2006.

### 2.1. Research & Development (R&D) and Innovation

The European Commission has estimated that the impact of reaching the European Union's R&D intensity target (3% of GDP) would lead to increases in total factor productivity of 0.8% and could boost real income by 3%. However, there is today a clear recognition that additional progress in this area will in part depend on better integrating the elements of the knowledge triangle: R&D, innovation and education and training. One of the challenges in reaching the European Union's R&D intensity target is how sufficient private R&D spending can be induced.

In particular for R&D some Member States still have a long way to go (see Graph 4).

**Graph 4: Gross domestic expenditure on R&D (GERD) as% of GDP - levels & targets**



**Notes:**

(1) IT, NL, RO, UK: 2004; AT, FI: 2006

(2) IE; PL, UK: R&D intensity targets for 2010 were estimated on the basis of data provided by these countries.

(3) IE: The target is 2.5% of GNP in 2013

(4) EU-27: The EU-27 R&D intensity for 2005 was estimated by DG Research.

The EU-27 R&D intensity for 2010 results from aggregation of the targets set by the Member States

(including estimated targets for IE, PL, and UK, but excluding BG)

(5) Member States have been ranked according to the current level of R&D intensity from left to right.

Source: Eurostat, Member States

**2.2. Internal Market and Competition Policy**

Despite considerable progress being made towards integration in goods markets, considerably fewer **service industries** yet benefit from a single EU-wide market. While services account for close to 70% of the EU-15 value added, they represent only some 20% of intra EU-15 trade. The Services Directive adopted in December 2006 has not been implemented yet. A Copenhagen Economics study calculated that even without the country-of-origin principle the service directive could create up to 600.000 extra jobs, while the welfare gains would be about 10% lower than those under the original proposal.

Furthermore, completing the single market for **financial services** will reduce the cost and improve the availability of financing for investment and innovation.

### **2.3. Small companies**

At the EU level loan guarantee schemes for Small and Medium-Sized Enterprises (SMEs) are provided at the order of € 1.1 billion under the new Competitiveness and Innovation Framework Programme (2007-13). This almost doubles the amount of yearly funding compared to the current situation. It is expected that this will result in a funding of €30 billion for SMEs.

In addition, the initiative JEREMIE ("Joint European Resources for Micro to Medium Enterprises") aims to provide improved access to finance for SMEs. It includes the supply of micro credit, venture capital, loan or guarantees and other forms of innovative financing.

### **2.4. Better Regulation**

The reducing of the level of product market regulation has an important bearing on economic performance. Facilitation of market entry or exit of firms has a positive impact on productivity and competitiveness. According to the European Commission a 25% reduction of administrative costs may bring a real GDP level increase of up to 1.5% - equivalent to some € 150 bn.

Smaller but not insignificant effects can also be expected from the reduction of corporate tax barriers and related compliance costs.

### **2.5. Trade openness**

Too often, globalisation is associated with job losses in sectors that lose out. The resulting social costs and anxiety are real and call for appropriate policy response. However, they should not lead to overlooking the strongly positive effects that openness and integration into world markets have on a country's economic performance. Openness to trade can play an important role in raising productivity growth. For instance, empirical analysis indicates that, on average, a 1% increase in the openness of the economy, as measured by the ratio of imports to value added, results in an increase of 0.6% in labour productivity in the following year.

### **2.6. Skills upgrading**

Skill upgrading becomes a crucial competitiveness factor by increasing the efficiency of labour input and by raising the capacity of firms to absorb new technologies. Efforts within the growth and jobs strategy to foster the accumulation of human capital support the increasing demand for skills. In particular, soft skills such as team working, learning, sharing and communicating as well as the ability to think in an interdisciplinary way will become crucial.

## **3. Future of manufacturing in Europe**

Manufacturing contributes directly to welfare and productivity growth and generates significant demand for research and high skilled services. The manufacturing industry with its related service sectors will remain a key pillar of the EU economy in the 21<sup>st</sup> century. Much will depend on the ability of European firms to capitalise on the opportunities represented by global challenges, such as ageing and climate change. Since Europe will need to address these challenges early on, there is a real opportunity for establishing lead market positions in products such as those linked to health care, convenience, leisure and entertainment and environmental technologies. The analysis confirms that the economic reforms discussed earlier are especially important for sectors exposed to trade, such as manufacturing, for maintaining their global position.

#### **4. Coordination matters**

Coordinated reforms are better reforms due to spill-over effects and complementarities between policies. For instance, roughly half of the potential increase of GDP generated by Member States' achievement of their R&D intensity targets would result from cross-border knowledge spill-over. Increasing skills and R&D raises real wages, which in turn should increase participation rates. Also, the reduction of administrative burdens, through lower mark-ups, has strong synergies with the employment target by helping to reduce equilibrium unemployment.

[More information](#)