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COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 28.11.2008
COM(2008) 774 final

COMMUNICATION FROM THE COMMISSION

on the European Competitiveness Report 2008

[SEC(2008)2853]

1. INTRODUCTION

The EU is facing a changing international reality. Currently financial markets are in a severe crisis that has started to spill over to the real economy. Policy makers around the world are working to restore confidence in the financial system. In 2008, volatile commodity, food and energy prices and the weakening of the dollar against the euro have influenced economic developments. These developments underline the need for Europe to further enhance its adaptation capacity to external shocks by developing a knowledge-based economy and boosting competitiveness through continued commitment to the Growth and Jobs Strategy. European competitiveness is at the centre of analysis of the yearly competitiveness report of the Commission. Its main focus is on recent changes of the EU's productivity growth, which is the key driver of competitiveness in the long run. Besides this, the European Competitiveness Report 2008¹ analyses different factors that may have an impact on competitiveness, such as the openness in trade and FDI and corporate social responsibility (CSR) as well as the EU's recent proposal for a sustainable industrial policy. This year's report also studies in depth the competitiveness of the most important segment of our economy, the small and medium-sized enterprises (SMEs).

The 2008 Competitiveness Report shows a continued improvement of the European economy in terms of productivity and standards of living vis-à-vis the United States, although in 2007 Gross Domestic Product (GDP) per capita levels were still lower than the US by roughly a third. Both at macro and sector level, total factor productivity (TFP) is an important source of difference between the US and the EU. A number of factors, such as innovation, better institutional and business environment, improved managerial practices, and access to ICT explain the higher contribution of total factor productivity in the US compared to the EU countries. Intra-EU productivity differences are diminishing, new Member States are catching up and some of the richest EU Members States actually outperform the US.

2. OVERALL COMPETITIVENESS PERFORMANCE

Growth of the European economy continued in 2007

Economic growth in the EU continued to be strong in 2007, though a slowing down became visible especially in the fourth quarter (the EU's real GDP grew by 2.6%). This strong economic growth performance was supported by a high employment growth rate of about 1.7%. Labour productivity growth, which is typically more cyclical than employment growth, slightly weakened to 1.3% in 2007 (from 1.5% in 2006).

In terms of per capita income levels (i.e. GDP per capita) the EU is still lagging behind the US (EU-27=100, US=154.3). The reasons for this continued gap vary across EU Member States, although it is partly due to differences in hours worked per person. For some EU Member States (Belgium, France and Netherlands) this gap is fully explained by a lower number of hours worked, as their hourly labour productivity actually outweighs US levels. For the new Member States, lower GDP per capita levels are mainly due to lower labour productivity.

¹ European Competitiveness Report 2008 COM (2008)...

Table 1: Growth of real labour productivity per person employed & 2007 levels of GDP per person employed (ppe), GDP per hour worked (phw), and GDP per capita (pc)

	Average annual labour productivity growth per person employed			GDP ppe 2007 (EU-27=100)	GDP phw 2007 (EU-25=100) (*)	GDP pc 2007 (EU-27=100)
	1996-2001	2001-2006	2007			
Austria	1,6	1,4	1,4	120,4	107,9	127,7
Belgium	1,3	1,4	1,1	131,2	133,8	118,9
Bulgaria	2,4	3,3	3,3	35,6	34,6	37,9
Cyprus	2,6	0,2	1,1	84,7	73,9	91,6
Czech Republic	2,0	4,1	4,6	73,1	59,7	81,0
Denmark	1,4	1,7	0,0	107,1	112,3	124,0
Estonia	8,5	6,9	6,6	67,5	54,2	71,4
Finland	2,2	2,0	2,1	113,4	107,1	118,3
France	1,2	1,2	0,8	123,6	129,4	110,6
Germany	2,0	1,6	1,0	106,6	119,3	114,0
Greece	3,1	2,5	2,7	105,4	77,9	98,2
Hungary	3,2	4,0	1,5	74,8	60,3	64,1
Ireland	3,2	2,2	1,6	135,4	115,9	145,9
Italy	0,9	0,0	0,5	108,0	94,9	101,3
Latvia	6,0	6,7	6,6	53,6	45,3	57,9
Lithuania	7,2	5,9	6,7	60,2	51,5	59,8
Luxembourg	1,5	1,6	0,2	182,3	180,8	279,2
Malta	2,6	1,1	1,1	90,1	85,0	77,1
Netherlands	1,4	1,6	1,1	113,1	130,4	131,2
Poland	5,5	3,6	1,9	61,4	49,7	54,4
Portugal	1,8	0,6	1,7	68,4	62,2	73,6
Romania	0,9	6,9	4,7	40,5	N/A	40,2
Slovakia	3,8	5,0	8,1	76,6	69,1	68,3
Slovenia	4,0	3,6	3,3	85,7	79,3	90,1
Spain	0,2	0,5	0,8	102,5	99,6	104,1
Sweden	1,8	3,0	0,5	113,0	112,2	123,6
United Kingdom	1,9	1,6	2,3	110,8	107,4	117,8
EU-25	1,7	1,4	1,3	103,9	100,0	100,0
EU-27	1,7	1,4	1,3	100,0	N/A	N/A
US	1,8	2,1	1,0	142,0	128,4	154,3

Note: The relative levels of GDP per person employed, per hour worked and per capita have been calculated on the base of purchasing power standards.

(*) Data for Romania and EU-27 are not available (N/A), and number for the US refers to 2006

Source: AMECO (Annual macro-economic database of the European Commission's Directorate General for Economic and Financial Affairs), June 2008

Intra-EU productivity differences are diminishing

In 2007 (as well as in 2006) productivity growth in the EU-27 outperformed that of the US which is a positive development. However, the EU-27 productivity level is much lower than in the US as an employed person in the US contributes on average 42% more to GDP than his or her EU counterpart; the difference of productivity per hour worked is lower (28% in 2006; 2007 data not yet available for the US). Intra-EU differences are still substantial. Starting from very low levels of productivity in the immediate post-Communist years, the new Member States are catching up since they typically show faster growth in labour productivity. Facilitated by EU membership, the new Member States benefit from the adoption of advanced technologies and improved organisation and management.

Box: Growth and productivity – explanations of concepts

Economic growth can be decomposed into employment growth and growth in labour productivity. Employment growth may result from an increase in the population in a country ("demographic component") or from better labour market performance (including participation rates, unemployment rates and hours worked; this is the "labour market component").

Higher per capita income levels do not necessarily correspond to increased welfare levels. To the extent that these high income levels are achieved through intensive use of labour (relative to other countries), this implies less leisure per worker which should be counted as a welfare loss when leisure time is positively valued. Therefore, labour productivity per hour worked is a more direct indicator of efficiency than labour productivity per person employed, as hours worked per employee differ across countries.

A complementary productivity indicator is total factor productivity. TFP refers to the factors linking production and the combination of productive inputs. In other words, changes in production can be due to changes in factor inputs (say, capital or labour) but also due to other changes. This latter component, the unexplained residual, reflects a change in TFP. It is the part of the productivity growth generated by intangible factors such as technical progress or organisational innovation instead of increased use of inputs, such as capital. Among the policies most relevant to TFP growth are those designed to foster technological progress, organisational changes, labour mobility, increased investment in R&D, the use of ICT, competition and product market reforms. These policies are all at the heart of the microeconomic pillar of the Lisbon strategy, suggesting that it can contribute significantly to boosting TFP.

Structural labour productivity growth in the EU is lower than in the US

The annual average EU-15 growth rate of real GDP was around 0.8% lower than the US over the 1995-2006 period. A macroeconomic growth accounting exercise for this group reveals the strong and weak points in that period (see Annex):

- **EU strengths:** The EU-15 has made relative improvements compared to the US in the field of labour market participation. Moreover, the initial education of labour has also improved more in the EU-15².
- **EU weaknesses:** The lower growth rate in the EU-15 was mainly due to **less favourable demographic developments and lower growth of labour productivity**, the latter being caused mainly by underperforming total factor productivity developments and, to a lesser extent, less capital deepening.

The slower growth of labour productivity and in particular of total factor productivity may relate to EU's lower level of innovation performance, which is a key long term driver of productivity. Although measures of innovation performance show the EU is catching up with the US, the rate of this convergence appears to have slowed down.

² The results should be interpreted carefully, as the available data are not fully harmonised and the data on employment breakdown by educational attainment for the US are only available from 2001.

High variation across sectors in their contribution to EU labour productivity growth

A large part of the annual labour productivity growth rate in the whole economy over the period 1995-2005 (1.6%)³ is accounted for by a relatively low number of sectors. Setting aside non-market sectors, the highest six (out of 49) contributors, namely agriculture, retail trade, wholesale trade, post and telecommunication, inland transport, and financial intermediation, account for half of labour productivity growth over the period. This is the result of above average productivity growth rates combined with relatively high shares in the economy. Interestingly, the EU's performance in these sectors, relative to US, is mixed as in half of them (post and communications, inland transport and financial intermediation) the EU displays higher labour productivity growth. At the same time, the US largely outperforms the EU in retail trade.

3. DRIVERS OF COMPETITIVENESS

3.1. Trade openness and competitiveness

Openness in terms of trade or foreign direct investment (FDI) benefits the economy – there is massive empirical evidence that open economies are richer and more productive than closed ones: macroeconomic studies indicate that a 1 percentage point increase in the share of trade in GDP raises the level of income in the range of 0.9 to 3 percent. From a sectoral perspective, a positive and significant relation is found between trade openness levels (both export openness and import penetration) and labour productivity growth.

Exporters are more productive than non-exporters

Firms engaging in trade are substantially more productive than those that do not. Evidence using firm level data shows that the "export premium" (i.e. better performance by exporters) based on labour productivity in EU ranges from 3% to 10%. Two hypotheses are being used as explanation for the export productivity premium: self-selection hypothesis according to which the most productive firms self-select into export markets; and the more intuitive learning-by-exporting hypothesis according to which firms increase productivity through exporting. These two hypotheses are not mutually exclusive and most productive firms may self-select into exporting, but once firms have entered export markets productivity growth may receive a further boost. Empirical evidence supporting firm-level productivity gains via learning-by-exporting is, however, more mixed than the evidence showing that only the more productive firms self-select into exporting. Even if exporting has a mixed effect on firm-level productivity, it has a clear undisputed positive impact in aggregate productivity. Similar results can be found for importers that are also more productive than non-importers, and for firms engaged in foreign direct investment (FDI) that are more productive than both exporters and importers. Given the productivity gains associated with exports, imports and FDI activities, policies aimed at opening markets abroad, as well as open domestic markets are well placed.

³ The productivity (per hour worked) growth rate for the whole economy is calculated as the weighted average of sectoral growth rates, where weights are the sectors' shares in the total number of hours worked. This may differ from the growth rate presented by other sources. The source of data is the research database EUKLEMS (www.euklems.net).

The crucial role of the internal market

For EU countries the internal market has been of paramount importance when reaping the productivity gains from openness. Focusing on intra-EU trade, recent research confirms the important role of the internal market for productivity growth: it is estimated that average productivity would be reduced by 13% if bilateral trade within the EU was eliminated. Furthermore, it is also estimated that productivity can increase by 2% if trade costs within the EU are further reduced by 5%. These findings stress the importance of the Single Market, a common currency and eliminating border controls for doing business within the EU and underline the economic potential of further improvements of the functioning of the internal market.

A well developed internal market also plays an important role as it enables Europe to take the lead in setting benchmarks and bringing about convergence of rules worldwide. Finally, since decreasing trade costs in the past have been driven by lower transportation costs and tariffs, the emphasis on “softer” trade costs often linked to non-tariff barriers could benefit SMEs that particularly suffer from these kinds of barriers.

The importance of non-tariff-barriers

Trade costs (divided into transport costs, border costs including tariffs, currency and information costs, and retail and wholesale distribution costs) for developed countries might add up to a 170% ad-valorem tax equivalent. However, EU firms perceive that non-tariff barriers and lack of information (e.g. lack of knowledge on export markets) are more important than the traditional policy-based trade constraints of import tariffs and duties⁴. In addition EU firms also perceive internal market policies as very helpful for doing business abroad because of a common currency, common customs procedures at the EU external borders and Single Market legislation including harmonised technical standards⁵.

The EU's external competitiveness policies should therefore help to reduce behind-the-border costs. Information costs and non-tariff barriers in third countries are major trade impediments. **Policies directed to deepen integration with third countries, ideally by implementing policies aiming at removing behind-the-border barriers for goods and services trade and foreign direct investment and by enhancing international regulatory cooperation are in order here.** These policies can deal with reducing regulations heterogeneity, non-tariff barriers and standardising customs procedures. The Transatlantic Economic Council and regional and bilateral "deep free trade agreements" with some Asian countries pursue this approach. Particularly with some Asian countries with weak IPR protection systems, the EU should work towards an effective protection of innovations.

3.2. Economic performance and competitiveness: the role of SMEs' growth

Entrepreneurship and small and medium-sized enterprises (SMEs) are increasingly recognised as the main drivers of the EU's economic performance since they are engines of structural change, innovation and employment growth. Encouraging the growth potential of SMEs is

⁴ Although these results hold generally for all broad sectors of activity considered in the analysis, for particular sectors and countries import tariffs are still major trade barriers for European firms exporting abroad.

⁵ Based on estimations using "Observatory of European SMEs" survey, Flash Eurobarometer Series no. 196.

one of the primary objectives of the Small Business Act (SBA) which is a key element in the EU's Growth and Jobs Strategy⁶.

The effect of business structure and dynamics on productivity and differences between the EU and the US

Using sector and country data it can be shown that while a strong SME presence in itself is not a guarantor of a strong labour productivity or value added growth, the entrepreneurial climate triggered by a strong SME presence can contribute to generate the business dynamics and the development of high-growth firms in a sector/country which are positively associated with labour productivity, employment and value added growth.

At a more aggregate level there is evidence that both entry and exit contribute to overall productivity growth. Comparison of these contributions across the Atlantic reveals that the contribution of entry to aggregate productivity growth is on average slightly higher in Europe but the contribution of exit is much lower than in the US.

A comparison between the EU and the US also reveals important differences in business structure and business dynamics. The main differences are that (i) in the US successful new firms expand more rapidly compared with the EU; (ii) entrants in the US enter at a smaller size and display a higher dispersion of productivity levels than in Europe; and (iii) in the US the more productive firms have a stronger tendency to increase their market shares than in the EU after some years. As a result American firms are on average larger than European firms and firm size distribution in the US displays a substantially smaller firm and employment share of micro enterprises (1-9 employees). Entry and exit rates as well as survival rates are largely comparable across the EU countries and the US though some sources suggest that entry rates are more similar than exit rates, which tend to be lower in the EU than in the US. Taken together, these findings suggest that the market environment is more competitive in the US and favours greater market experimentation. In addition, the evidence indicates that relative to the US, barriers to growth pose the biggest problem for a business in the EU.

Rapidly growing firms exist in every economic sector and in every country in the EU

Employment in new firms is crucial for total employment growth and is of at least the same importance as the net job contribution of continuing (high growth) firms. Contrary to popular belief, recent evidence shows that rapidly growing firms are found in every sector of economic activity and in every country. **This implies that high-growth firms are not only, or even primarily, high tech firms. They manifest the firms' entrepreneurial alertness and ability to exploit opportunities on the market.** Nevertheless, evidence also points to the relative weakness of the EU in high-tech sectors. In the US many more new R&D-intensive firms, (often labelled "New Technology-based firms" or NTBFs) were able to develop, grow rapidly and become key economic players. This phenomenon allows the US economy to orient itself towards new promising sectors with more flexibility than the EU.

There is evidence that industrial countries close to the technological frontier provide stronger incentives for entrepreneurial innovation, while firms in other countries will typically pursue a catch-up strategy based on investments for growth. Within the EU-15, high-growth firms are

⁶ Commission Communication "Think Small First - A Small Business Act for Europe" – COM(2008)394

characterised by above-average innovativeness, whereas in the new Member States their innovation inputs and outputs are closer to average.

4. IMPACT OF IMPORTANT EU POLICIES ON COMPETITIVENESS

4.1. Sustainable Industrial Policy

To keep Europe competitive in the increasingly challenging international environment and to further environmental goals by constraining the carbon footprint, the EU is promoting change toward a low-carbon and resource-efficient economy. In order to achieve this objective, the European Commission proposed a range of Community-wide measures among which: the 3rd Internal Energy Market package and the Climate action and renewable energy package⁷ in January 2008 which are currently discussed in Council and Parliament. Its ambition is to reach a significant reduction of the EU's greenhouse gas emissions (depending on the international situation, 20% or 30% as compared to 1990 levels) and an increase of the share of renewable energy in the EU's overall energy consumption to 20% by 2020, without compromising the EU's competitiveness.

The shift towards a low-carbon economy represents a real potential in growing markets for "environmentally friendly" products. It also creates opportunities for the competitiveness of this sector on international markets. European industry has already made significant advances in improving its energy and resource efficiency and is at the leading edge in key industries⁸. However, barriers still hold back the market penetration of such products and technologies. One such barrier results from consumers often not being aware of the existence of these products or being discouraged by their higher initial prices despite longer-term subsequent savings.

Evidence shows that increased market penetration of energy and resource efficient products and technologies entails very significant potential benefits for both the economy and the environment. To unleash such potential the Commission has recently adopted an Action Plan on Sustainable Consumption and Production and Sustainable Industrial Policy that sets out a harmonised, integrated and dynamic framework aimed at improving the energy and environmental performance of products⁹. The framework proposed aims at improving the overall environmental performance of products throughout their life-cycle, promoting and stimulating the demand for better products and technologies and helping consumers to make better choices through a more coherent and simplified labelling. As such they should contribute to the strengthening of the EU competitiveness.

4.2. Corporate Social Responsibility

When re-launching the Lisbon Strategy in 2005, the Commission stated that Corporate Social Responsibility (CSR)¹⁰ "can play a key role in contributing to sustainable development while

⁷ COM(2008)30 final, COM(2008)13 final, COM(2008)16 final, COM(2008)17 final, COM(2008)18 final and COM(2008)19 final.

⁸ Wind energy, for which EU companies have 60% of the world market share, is a case in point. Solar energy is another example.

⁹ COM(2008)397.

¹⁰ CSR is a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis.

enhancing Europe's innovative potential and competitiveness"¹¹. The importance of CSR cannot be overestimated, not least since one lesson from the current financial crisis is that socially responsible entrepreneurs and CEOs are of utmost importance for the wellbeing of our societies.

CSR has a positive impact on firms' competitiveness

An overview of the effects of CSR on six different determinants of competitiveness at firm level - cost structure, human resources, customer perspective, innovation, risk and reputation management, and financial performance - shows that it can have a positive impact on competitiveness. The strongest evidence of a positive impact of CSR on competitiveness appears to be in the cases of human resources, risk and reputation management and innovation. The reputation of a company in terms of CSR becomes increasingly important for the chances to be successful in recruiting staff on highly competitive labour markets.

The evidence suggests an important positive relationship between CSR and competitiveness via human resource management, although for some companies the additional costs of CSR might initially outweigh the benefits. CSR is an essential component of risk and reputation management for many companies, and becomes increasingly important as enterprises are exposed to greater public scrutiny. Dealing with CSR issues such as transparency, human rights, and supply-chain requirements from a risk management perspective have led some companies to discover additional positive impacts of CSR.

Certain aspects of CSR, such as the creation of employee-friendly work-places, can enhance a firm's capacity for innovation. The positive relationship between CSR and innovation is strengthened by the fact that innovation is increasingly a collaborative exercise, and by the trend towards the generation of new business value from innovations that address societal problems.

The relationship between CSR and competitiveness appears to be getting stronger

Many of the factors affecting the business case of CSR are themselves dynamic and are intensifying, such as employee expectations, consumer awareness, trends in private and public procurement, the nature of innovation processes, and the importance that financial markets attribute to social and environmental issues. Business interest in CSR is increasingly based on opportunities for new value creation and not just on value protection through risk and reputation management.

The strength of the business case of CSR in any given enterprise is still dependent on its competitive positioning. For some companies, exceeding social and environmental legal requirements might generate costs that undermine competitiveness. However, for an increasing number of enterprises in a growing number of industries, CSR is becoming a competitive necessity. Moreover, to be a competitive differentiator, CSR needs to be part of a core business strategy. Enterprises in which CSR remains a peripheral concern, mainly confined to public relations functions, are likely to miss opportunities for competitiveness gains.

¹¹ Communication to the Spring European Council "Working together for growth and jobs. A new start for the Lisbon Strategy", COM(2005)24.

5. POLICY IMPLICATIONS

This year's Competitiveness Report has important policy implications: well designed and implemented policies in some specific areas such as trade, innovation and entrepreneurship or energy can contribute to strengthening the competitiveness of the EU economy.

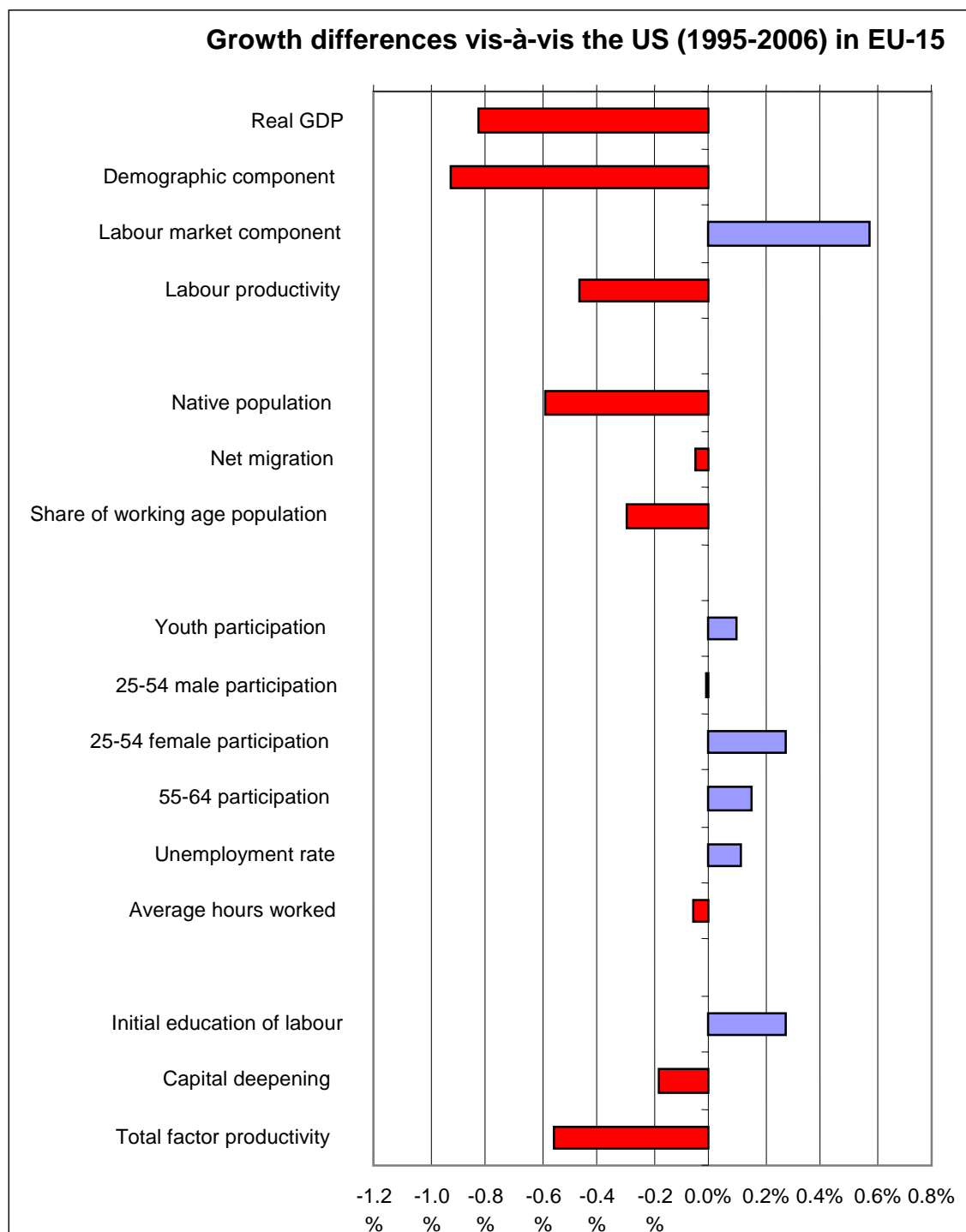
The analysis of this year's Report has shown that the priorities and policy recommendations of the 2008-2010 cycle of the EU's Growth and Jobs Strategy remain highly relevant. The EU has to further boost innovation, the uptake of ICT and the competition in retail and product markets. The Small Business Act, if implemented at all levels, will improve the business environment and promote entrepreneurship. It will foster entrepreneurial experimentation and the overall business climate in the EU.

Concerning the external dimension of competitiveness, trade policies should target the reduction of behind-the-border costs, namely international regulatory co-operation and policies aimed at reducing non-tariff barriers and customs procedures. This can contribute to significant productivity gains for the EU economy.

Early action in the field of sustainable production can lead to first mover advantages and can bring very significant potential benefits for both the economy and the environment. The recently adopted Action Plan on Sustainable Consumption and Production and Sustainable Industrial Policy is an important step towards a competitive low-carbon economy.

Finally, this year's Competitiveness Report has pointed to a positive link between competitiveness and Corporate Social Responsibility. The Commission will continue to provide political impetus and the practical support to all stakeholders engaged in CSR.

Annex: Growth decomposition in the EU-15 vis-a-vis the US (1995-2006)



Source: Moure, G. (2008), "What Drives Income Differentials, Underutilisation of Labour and Economic Growth in Europe? A Detailed GDP Accounting Exercise", Manuscript, Free University of Brussels.