ENHANCING EUROPEAN COMPETITIVENESS

FIRST REPORT TO THE PRESIDENT OF THE COMMISSION THE PRIME MINISTERS AND HEADS OF STATE

THE COMPETITIVENESS ADVISORY GROUP

June 1995

I. COMPETITIVENESS AND THE EUROPEAN ECONOMY

I. 1 The challenge

Fifty years on from political and economic reconstruction after the Second World War, Europe appears an odd mix of huge resource potential, on the one hand, and relative decline in the ability to exploit this potential, on the other.

During the 1950s and 1960s, Europe had an excellent record in rebuilding productive capacity, employment and productivity growth, raising standards of living in a non-inflationary environment, structural change, reducing the technological gap with American front-runners. The most important achievement of these two decades was the creation of the European Community. Disruption in the 1970s has been followed over the last fifteen years by painful - though largely successful - efforts to restore macroeconomic discipline and convergence. Economic and financial integration has progressed. Restructuring of productive capacity has got underway. But, at the same time, Europe has increasingly been unable to provide an adequate number of new jobs and prevent a dramatic increase in unemployment. It has not been decisive enough in the correction of profound regional imbalances or of worsening economic performance.

The big challenge Europe faces is therefore to reverse relative decline. In an increasingly global economy, protectionist strategies offer no solution. In its first Report, the Competitiveness Advisory Group (CAG) wishes to convey to politicians, labour leaders, business community, and indeed to all our citizens, a sense of urgency. We must beware the danger of shifting from investment- and innovation-driven growth to wealth-driven decline.

National specificities in economies, reflecting different historical and cultural roots, have to be acknowledged, but now there is growing awareness that the different strands of capitalism move closer together, rather than further apart. Dichotomies between individualism versus managed consensus, competition versus cooperation, free market versus social welfare policies, seem too simplistic. The need is to orchestrate broad consensus in favour of a European model, in which market mechanisms are promoted and, at the same time, are integrated by policies respecting the social dimension of all economic activity. The danger of a dual society, a widening gap between the very rich and the very poor, is real. On the whole, European countries have always attributed a high value to social cohesion and solidarity. In this context, the basic role of the State is not as entrepreneur, rather as guide: a modest but efficient regulator and redistributor.

This Report of the Competitiveness Advisory Group rests on our shared conviction that urgent action is imperative if we are to move forward and restate Europe's leading role in the global economy.

The Group proposes the definition of an Action Plan for which this Report indicates the priorities and objectives considered most relevant. The Action Plan would constitute the operational phase of the initiative that the Commission has already taken in submitting a programme on industrial competitiveness to national governments.

I. 2 The significance of competitiveness

Competitiveness is at times perceived as something of an obsession, undermining national cultures, displacing jobs, dividing peoples, encouraging social dumping by low-wage countries on more advanced nations. Far from all this, to the CAG competitiveness must be seen in its true light. Competitiveness implies elements of productivity, efficiency, profitability. But it is not an end in itself or a target. It is a powerful means to achieve rising standards of living and increasing social welfare - a tool for achieving targets. Globally, by increasing productivity and efficiency in the context of international specialisation, competitiveness provides the basis for raising peoples' earnings in a non-inflationary way. It increases value added and growth potential, stimulating not only resource-saving innovation, but investment to expand capacity and to create jobs as well. Economic competition is thus the ally, not the enemy, of social dialogue.

For the CAG therefore, competitiveness is not a zero-sum game. There is a positive-sum - both for national factors of production and for our trade partners. The drive to competitiveness should not lead to short-termism, but rather encourage benchmarking strategies to develop new technological opportunities and so to maximise long-term profitability and capital accumulation. And this while providing the means to enable society to become more responsive to the needs of its citizens.

Huge investment is badly needed if Europe is to mobilise and valorise its resources. In infrastructure, certainly - but more than this: competitiveness stems from, and at the same time, helps strengthen human capital potential. A country's, or region's, competitiveness crucially depends on its ability to invest in intangibles - knowledge, skills, creativity - thus creating the bases for better quality jobs. These non basic factors of production tend to attract - and to stabilise - economic activity and employment. The competitiveness game for Europe, as for other advanced regions of the world, mainly revolves around the ability to accumulate and improve human capital.

I. 3 Exploit our potential

European countries are facing recurrent obstacles in translating growth into job opportunities: both higher quality employment and lower unemployment. Due to a number of factors including low average female participation rates, discouraged job search among the young and the long-term unemployed, as well as certain structural features of the labour market, European employment ratios are distinctly below potential, even taking into account demographic variables. Decoupling of recovery of output and improvement in the labour market is a symptom of malaise.

As stressed by the White Paper on *Growth, Competitiveness and Employment*, as well as by the *Guidelines for the Social Dialogue*, unemployment in Europe must be fought through actions that foster competitiveness and sustainable economic development.

Without better educated and motivated citizens, we shall experience mounting difficulties in promoting technology diffusion, incremental innovation, dematerialisation of processes and consumer tastes, the hybridisation of new highly pervasive technologies into traditional production. Industrial and tertiary activities are more and more suppliers of knowledge incorporated in goods and services, less and less generators of purely material products and routines. Sound systems of primary and secondary education are a pre-condition for developing the necessary "humanware" as well as for fighting social exclusion.

In many parts of Europe, networks of small and highly specialised suppliers of intermediate and final goods, drawing their early roots from crafts and skills and a tightly-knit human and social environment, provide a healthy reservoir of intermediate users and producers. By building on this historical and cultural diversity, they can often represent one of our most important sources of competitive advantage.

I. 4 Where we are now

As an international competitor, Europe reveals geo-political and institutional characteristics that can be seen as structural disadvantages: institutional fragmentation and market segmentation causing inefficiency and lost opportunities for pan-European competition and economies of scale; costly and inefficient infrastructures; limited geographic labour mobility compared to America and Japan, due to linguistic and cultural barriers as well as to different national labour market regulations. Many of these structural disadvantages are being attacked by Single Market rules. The main issue is how far - and how fast - national governments will respect their commitment to rapid implementation of these new rules.

During the last decade several indicators have pointed to a significant loss of relative performance by European manufacturing and the service sector vis-à-vis major Asian and American competitors. In drawing such comparisons, the need is to avoid oversimplification. Profound differences between Member States, between regions and between different industrial sectors cannot properly be accounted for in aggregate indicators. Furthermore, many comparable indicators are affected by strong cyclical components and by recurrent currency gyrations affecting real exchange rates. Data are less ambiguous if we look beyond the traditional aggregate indicators to the performance of individual sectors and, even more, that of enterprises. However, various aggregate indicators of underlying performance in manufacturing industry since the beginning of the last decade reveal clear signs of European loss in relative performance, especially compared to Japan but in some respects also to the United States (Graphs 1-4). Slow growth in output is accompanied by a decline in employment, and by sluggish gains in productivity.

Real wages rose less than productivity, as in the USA but unlike Japan. The USA, however, was able to create millions of jobs. These were even manufacturing jobs during the 1980s, then mostly in services (reservations remain, however, about the quality of some of these new jobs). Japan, at least until very recently, had a record of near full employment.

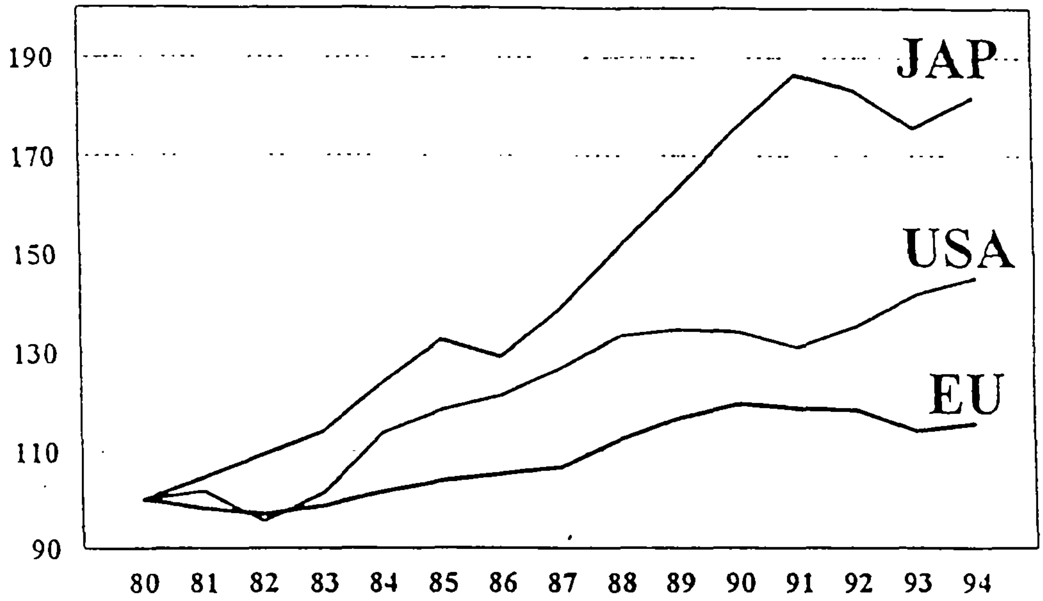
The European trend in real investment in manufacturing was roughly in line with that in the USA. It was much below Japan. These figures conceal, however, significant differences between the Member States.

Causes of the slower accumulation of capital per worker here in Europe may include the higher real cost of capital for business investment relative to real wages, as well as the higher initial weighting of capital-intensive industries suffering over-capacity. Another plausible and somewhat related explanation lies in a phase of restructuring aimed at achieving a more efficient, if smaller, industrial base, with a greater share of fixed investment devoted to net reduction in obsolete capacity. This may reflect a healthy strategy of modernisation but, at the same time, it could give rise to capacity constraints during cyclical recoveries.

Graph 1

Output in manufacturing, 1980 = 100

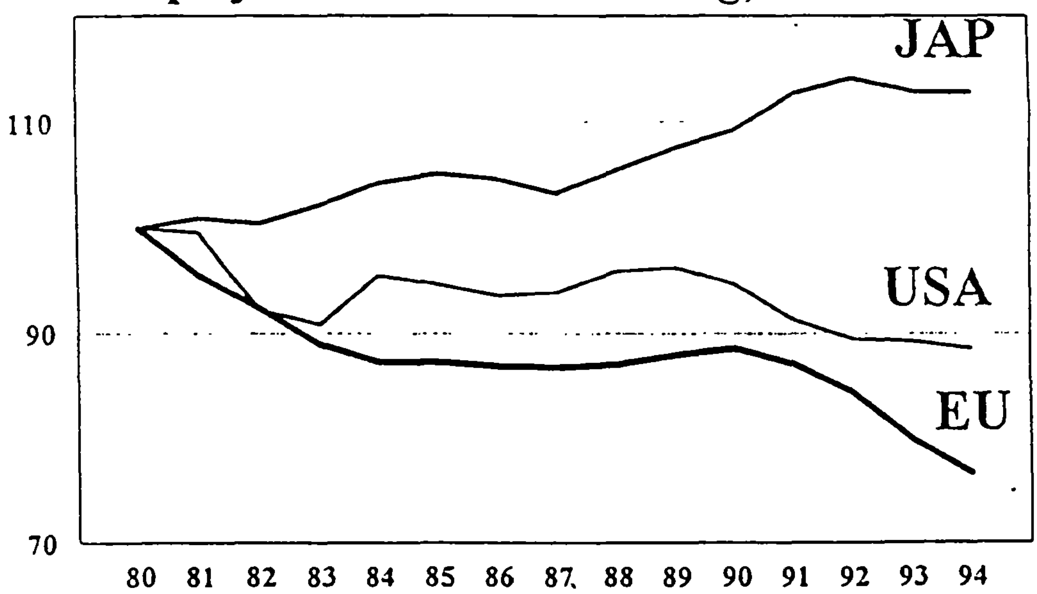
(gross value added at 1985 prices)



Source : European Commission

Graph 2

Employment in manufacturing, 1980 = 100

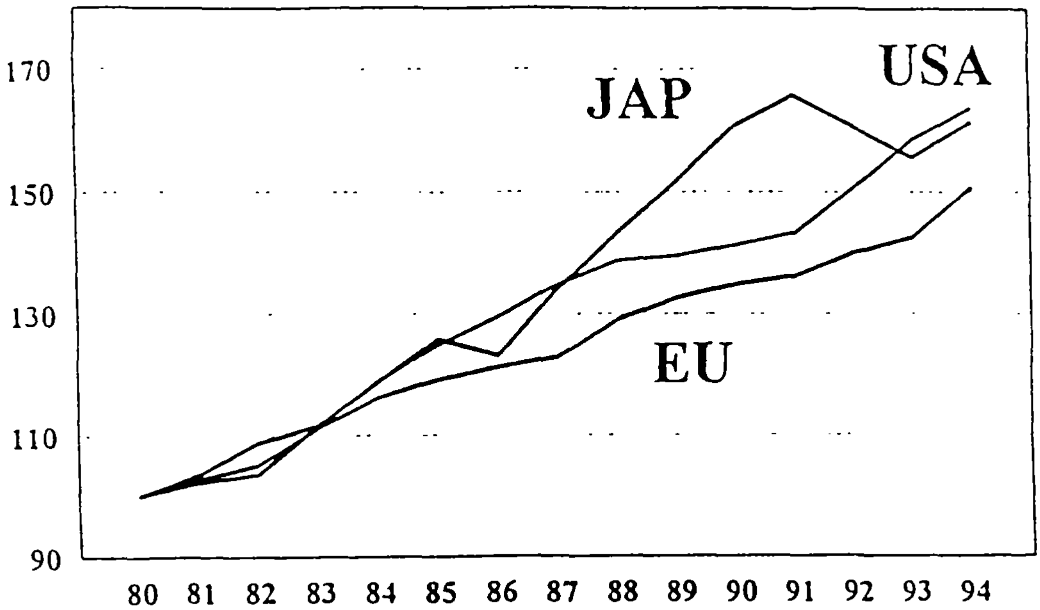


Source : European Commission

Graph 3

Productivity in manufacturing, 1980 = 100

(gross value added at 1985 prices per pers‾r ‾mployed)

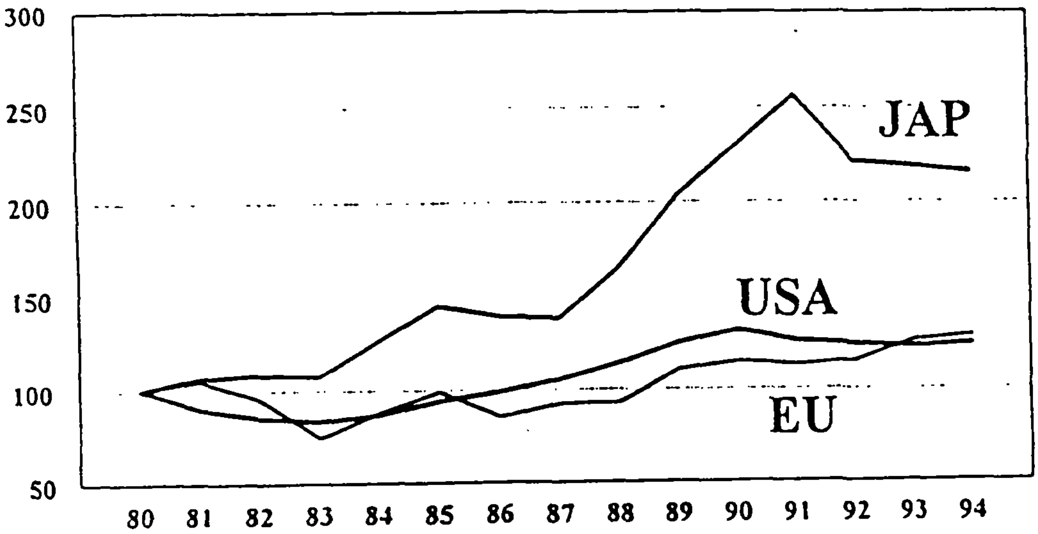


Source : European Commission

Graph 4

Investment in manufacturing, 1980 = 100

(at 1985 prices)



Source : European Commission

Looking at invisible investment in technological innovation, Europe has done some catching up in R&D, taking into account the bigger presence of small and medium sized enterprises and production-based technologies which typically call on a relatively smaller amount of formalised research. The European Union, however, still lags behind the USA and Japan in terms of patenting, and behind Japan in terms of ability to transfer and apply new technologies.

Finally, if we look at some disaggregated indicators of value added and trade performance, the European disadvantage vis-à-vis the United States and Japan has even increased in terms of the sectorial specialisation in low-to-medium technology, relative to high technology, and in slow demand growth, relative to fast demand growth, sectors.

International trade is both a determinant and an effect of competitiveness. Through international trade in goods and services, national factors of production implicitly move across countries, even when they are geographically immobile. International trade in intermediate and final goods is a very powerful instrument allowing trading partners to participate in the expansion of productivity and technological capability in a virtuous circle going from investment to productivity, to trade, ultimately to rising standards of living.

However, additional competitive disadvantage stems from Europe's weaker trade links with the world's fastest growing developing markets. This is due to its stronger geographical orientation toward the Middle East and North Africa. Enlargement to Central and Eastern Europe now potentially constitutes an opportunity for growth and employment. Western European prosperity is intimately tied to encouraging economic and social transformation in its neighbours to the East and across the Mediterranean. In international trade flows, today's most dynamic developing exporters tend also to be the fastest-growing importers of manufactures, especially of intermediate and capital goods, but also of an increasing share of consumer goods to satisfy rapidly increasing domestic demand.

II. COMPLETING THE INTERNAL MARKET

II. 1 The Internal Market - Accelerate Implementation

The CAG emphasises the urgency of acceleration of the internal market process. The essential issues here are twofold: how to speed up implementation, and how to move forward to deeper market integration thanks to less, but better quality, Union legislation. Progress has been made with an average 91% transposition (EU-12 only). Implementation in critical economic sectors has, however, been uneven across the Member States. The enlarged Europe of the 15 is thus still a long way from being a big, truly open, internal market. This when the benefits of completing the single market would accrue to small and medium sized enterprises as well as to Europe's large and multinational corporations, to consumers as well as to producers.

One major advance would be adoption of the European Company Statute. Even more important than the potential cost savings involved, the ease for both smaller and larger companies to expand Europe-wide would greatly stimulate integration. In fact, the internal market will remain unfinished business so long as European companies cannot operate across the whole Union in a more flexible and efficient way.

An increasing number of companies have adopted a pan-European strategy, structure and market approach in order to improve economies of scale, increase flexibility and speed to meet the new single market opportunities. Unlike in the United States, however, such European companies still have to operate through a complex and costly network of subsidiaries incorporated under the laws of the various Member States.

The cost/benefit analysis of the Statute for a given European company will depend on its size, the extent of centralisation of its existing activities as well as the number of national operations. Operating cost savings for a large European company, with country-level holding companies, many individual legal entities and lots of cross-border trade, would be substantial. Estimates Europe-wide indicate total potential savings in the order of 30 billion ECU annually.

While progress on the ECS would considerably improve European business competitiveness, for SMEs as much as for bigger firms, it needs to be accompanied by further advances on fiscal and social legislation.

Other internal market priorities must not be overlooked. The CAG calls attention to each of the following:

- elimination of the remaining internal market barriers in critical areas where transposition at national level is too slow. Public procurement is one prime example of a still restricted activity which, if barriers were removed, would offer extensive opportunities for firms to invest across Europe, with positive fallout for jobs and for the quality of services offered to Europe's citizens;

- speeding up of deregulation and liberalisation. The proper functioning of the market implies simple and transparent rules. National monopolies, public and private, and the lack of cross-border competition are often reasons for high energy, telecom and other infrastructure costs which penalise European firms competing internationally. Other sectors of emerging importance, such as environment, may need new forms of regulation;

- implementation of EMU as soon as possible for the largest number of Member States able to participate. Both business and investment conditions will improve greatly by eliminating today's monetary and exchange rate uncertainties. A single currency accepted across Europe remains a crucial element in achievement of a fully effective single market and in enhancing the competitiveness of European business;

- fiscal harmonisation, also with reference to taxation of financial assets in order to prevent distortions in capital movements;

- simplification and review of Union legislation. The CAG is strongly in favour of the application of cost/benefit analysis to new and revised legislation. The issue of subsidiarity in its interplay with EU legislative initiatives should be considered.

Specific policy recommendations for some of these five further internal market priorities will be discussed in greater detail in future CAG reports.

II. 2 Improved Infrastructure - Trans European Networks (TENs)

Completion and integration of the internal market both for the consumer and for business must be supported by a stronger and more competitive pan-European infrastructure in telecommunications, road and rail transport, air transport and energy.

Trans European Networks are an irreversible process endorsed at the Essen Summit. They involve expenditure of almost 600 billion ECU for the realisation of major projects up to the year 2000. While it should be possible to finance most energy and telecom TENs from private sources (as indicated by the Information Society projects), public transportation projects in both the Union and Central and Eastern Europe (CEE) require a supporting regulatory environment and public funding through public/private partnerships. In these projects, as well as the purely economic benefits, any least cost analysis should also consider overall social and long-term benefits of resulting European integration.

Outstanding obstacles affecting TENs include:

- the uneven degree of liberalisation in energy, telecoms and transport systems across the Union and in the CEE;
- political delays in agreeing upon an improved legal and financial regulatory framework to implement a long-range pan-European infrastructure policy;
- regulatory issues related to technical standardisation, interoperability, environmental and integrated planning systems between national authorities and private sector corporations;

- the financing gap, roughly estimated at 80% for certain of the transportation projects requiring public and private financing. A lack of coordinated cost/benefit analysis between certain Member States on some of the priority TEN transport projects does not favour either financing, or the interest of private investors.

To develop TENs, the CAG recommends:

- *the Council of Ministers entrust the Commission and the EIB with a mandate to re-accelerate the TEN priority projects, given the excellent co-ordination by the Commission in 1994;*

- *the Commission, the EIB/EIF and interested public/private partners conduct cost/benefit analyses on specific TEN transport projects. The outcome of such analysis should contribute to any decision concerning which priority projects could usefully be accelerated with some increased public/private financing and EIB support, and which projects should be rescheduled. Geo-economic criteria and the Union goal of cohesion should also be taken into account;*

- *priority projects move ahead more rapidly. Current obstacles, such as the financing gap, the reservations expressed by the ECOFIN Council and the difficulties encountered by public/private partnerships, need to be overcome; as well as outstanding regulatory obstacles.*

II. 3 The New Europe: West & East stronger together

Many people in Western Europe tend to see the re-emergence of their Eastern neighbours after decades of isolation as a potentially costly political necessity, rather than an economic opportunity. A threat from these still low-wage countries is perceived, giving rise to defensive and protectionist attitudes in many circles. Foreign direct investment (FDI) in the countries of the region is low, as is financial support (credits, guarantees, grants), mainly motivated as a way to avoid problems such as political instability, a return to totalitarianism, a flood of immigration, military conflict. This attitude is fundamentally wrong.

There are major win-win opportunities:

a) Infrastructure: A gradually stabilised and then growing CEE offers an enormous market for Western Europe on its doorstep. The build-up of telecommunications, the exploitation of oil and gas and other resources, the revamping of energy and transport systems, the retrofitting of huge but inefficient and polluting industries will represent a major opportunity for Western industry. Even though it will take time for sufficient domestic funding to be generated, in some countries of Central Europe such funding is starting to become available.

b) Trade: Rapidly increasing trade in both directions will lift living standards in both halves of Europe. The more the East is allowed to export to the West, the more it can earn to finance higher imports from the West. Moreover, a partnership in global trade is possible. With the greater respect in the East to social issues accompanying consolidation of democratic systems, together Europe as a whole wins - and becomes more competitive in the global arena.

c) Investment: Western European investment in companies in the East is another route to economic integration. Investment of capital and, especially, of business and management know-how can speed up the integration process. In this respect, Central and Eastern Europe has a big advantage over developing countries due to the presence of a large number of highly qualified people, especially in science and some areas of technology. What these people lack is modern Western management and organisation, quality control, computers, costing and pricing and experience from operating in a market economy. High performance "islands", mostly in Western-owned businesses, have already increased productivity a hundred fold, reduced floor space and working capital to a fraction of pre-reform levels, and reached Western levels of quality and commercial reliability in spite of poor infrastructure.

The CAG supports maintenance of the following key policy programmes within the agreed time-frame :

- *the Europe Agreements: these provisions, covering access by Hungary, Poland, the Czech Republic, Slovakia, Bulgaria and Rumania to Union markets, represent an instance of radical and challenging trade liberalisation on the part of the EU. The three Baltic Republics and Slovenia have also initialed such agreements. Most of the agreed market access measures (e.g. abolition of quantitative restrictions and specific tariffs; gradual 2 to 5 year abolition of tariffs other than those in sensitive sectors) appear to be working well; some contingent protective measures remain;*

- *Partnership and Cooperation Agreements with the Commonwealth of Independent States: The European Union is potentially the most important partner of the CIS. Enforcement of this agreement will improve the investment climate, foster economic liberalisation, expand trade links and provide financial assistance also in strategic areas such as nuclear safety;*

- *the White Paper for Pre-Accession Strategy: the main objective being to serve as a guide to assist associated countries in aligning themselves with the internal market by establishing their own sectorial priorities in order to further improve their overall industrial restructuring and trade performance. While the White Paper is expected for the Cannes Summit, the CAG expresses the hope that it will not represent merely a legal document, but rather a strong decision-making mechanism to propel East-West integration. The CAG welcomes the proposal to create a Technical Assistance Information Exchange Office which will provide the necessary expertise from both the Commission and the public and private sector.*

III. STRENGTHENING THE EUROPEAN ENTERPRISE

The ability of businesses, large and small, to add value is a key factor determining the aggregate performance of any economy, its level of competitiveness and the living standards of its people - directly through employment and indirectly through welfare systems and income transfers. In an open international market economy, firms within Europe must be able to compete and win profitable business in their home markets and internationally if they are to provide employment and be a source of wealth generation.

III. 1 Benchmarking performance

Europe's track record in terms of competitiveness . be measured by direct comparison with that of its main trading partners. Similarly, the track record of individual sectors and enterprises can be compared to that of their competitors internationally.

The application of benchmarking can be an important instrument to identify ways to raise the level of productive employment within the European economy and improve competitive performance. Though not an end in itself, benchmarking - at the level of the sector and, above all, the enterprise - can provide both a set of simple measures which, through regular testing, can help us identify trends in competitive performance, and a basis for setting targets, backed by appropriate plans for reaching those targets.

Benchmarking takes many forms. There is no single universally applicable set of tests and no single standard of performance. The key is simplicity, which will make the measures readily accessible to all concerned, coupled with consistency in order to assess progress against an agreed set of benchmarks over a sustained period.

In terms of the competitiveness of the individual enterprise, the CAG believes that the principal benchmark is the ability to generate wealth available to the enterprise and to society generally for reinvestment and distribution.

III. 2 Removing the barriers to innovation and the application of technology

The performance of European business depends on its ability to innovate and to apply technology in order to raise productivity and to develop new products. A programme to enhance competitiveness must therefore remove the barriers which inhibit innovation and the application of new technology.

Although there is no absolute shortage of research in Europe, too little attention is devoted to applied science and technology. At all levels, there is a need for scientific education and research to reflect more the priorities of industry. As well as developing the skills of individuals, closer linkage would help Europe apply its knowledge in ways which generate wealth. New incentives, including changes in funding mechanisms, could encourage a much closer relationship between the academic research community and firms, to the benefit of both.

Successful innovation also means identification of technologies that will be critical to the future of Europe's industries. Greater dialogue is needed here too, involving companies, labour, consumers, the academic community and the whole knowledge base. Such dialogue must take place in awareness of the potential contribution coming from the exercise of technology foresight.

The process of innovation can be further enhanced by improving links between companies. Large companies can promote a chain of innovative development, involving one or more creative smaller enterprises. Companies of all sizes can benefit from collaborative ventures, pooling skills and resources in pursuit of common gains. Europe lags behind its competitors in the development of such collaborative links.

Innovation and the diffusion of new technology has also been hindered by excessive and inappropriate regulation and the constraints which limit free and open trade within the Union.
All these limitations are holding back the potential of a number of sectors of the European economy. Their removal would allow existing and new companies to expand their activities geographically and offer new products and services. Both factors would add to long term employment and permit European companies to win more business in the global market.

Telecommunications is identified as one of the key trans-European infrastructures. It is the nervous system of the information economy in which the ability to capture, transfer, process and utilise information is becoming increasingly central to competitive advantage. The path to liberalisation of telecommunications services and infrastructure, currently scheduled for 1998, has been slow and tortuous, with costs for some telecommunications services 22 times their level in the US according to one recent study, leaving individual firms in the sector competitively disadvantaged in world markets.