The future of European competitiveness

Part A | A competitiveness strategy for Europe

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Foreword

Europe has been worrying about slowing growth since the start of this century. Various strategies to raise growth rates have come and gone, but the trend has remained unchanged.

Across different metrics, a wide gap in GDP has opened up between the EU and the US, driven mainly by a more pronounced slowdown in productivity growth in Europe. Europe's households have paid the price in foregone living standards. On a per capita basis, real disposable income has grown almost twice as much in the US as in the EU since 2000.

For most of this period, slowing growth has been seen as an inconvenience but not a calamity. Europe's exporters managed to capture market shares in faster growing parts of the world, especially Asia. Many more women entered the workforce, lifting the labour contribution to growth. And, after the crises of 2008 to 2012, unemployment steadily fell across Europe, helping to reduce inequality and maintain social welfare.

The EU also benefitted from a favourable global environment. World trade burgeoned under multilateral rules. The safety of the US security umbrella freed up defence budgets to spend on other priorities. In a world of stable geopolitics, we had no reason to be concerned about rising dependencies on countries we expected to remain our friends.

But the foundations on which we built are now being shaken.

The previous global paradigm is fading. The era of rapid world trade growth looks to have passed, with EU companies facing both greater competition from abroad and lower access to overseas markets. Europe has abruptly lost its most important supplier of energy, Russia. All the while, geopolitical stability is waning, and our dependencies have turned out to be vulnerabilities.

Technological change is accelerating rapidly. Europe largely missed out on the digital revolution led by the internet and the productivity gains it brought: in fact, the productivity gap between the EU and the US is largely explained by the tech sector. The EU is weak in the emerging technologies that will drive future growth. Only four of the world's top 50 tech companies are European.

Yet, Europe's need for growth is rising.

The EU is entering the first period in its recent history in which growth will not be supported by rising populations. By 2040, the workforce is projected to shrink by close to 2 million workers each year. We will have to lean more on productivity to drive growth. If the EU were to maintain its average productivity growth rate since 2015, it would only be enough to keep GDP constant until 2050 – at a time when the EU is facing a series of new investment needs that will have to be financed through higher growth.

To digitalise and decarbonise the economy and increase our defence capacity, the investment share in Europe will have to rise by around 5 percentage points of GDP to levels last seen in the 1960s and 70s. This is unprecedented: for comparison, the additional investments provided by the Marshall Plan between 1948-51 amounted to around 1-2% of GDP annually.

If Europe cannot become more productive, we will be forced to choose. We will not be able to become, at once, a leader in new technologies, a beacon of climate responsibility and an independent player on the world stage. We will not be able to finance our social model. We will have to scale back some, if not all, of our ambitions.

This is an existential challenge.

Europe's fundamental values are prosperity, equity, freedom, peace and democracy in a sustainable environment. The EU exists to ensure that Europeans can always benefit from these fundamental rights. If Europe can no longer provide them to its people – or has to trade off one against the other – it will have lost its reason for being.

The only way to meet this challenge is to grow and become more productive, preserving our values of equity and social inclusion. And the only way to become more productive is for Europe to radically change.

Three areas for action to reignite growth

This report identifies three main areas for action to reignite sustainable growth.

In each area, we are not starting from zero. The EU still has general strengths – such as strong education and health systems and robust welfare states – and specific strengths on which to build. But we are collectively failing to convert these strengths into productive and competitive industries on the global stage.

First – and most importantly – Europe must profoundly refocus its collective efforts on closing the innovation gap with the US and China, especially in advanced technologies.

Europe is stuck in a static industrial structure with few new companies rising up to disrupt existing industries or develop new growth engines. In fact, there is no EU company with a market capitalisation over EUR 100 billion that has been set up from scratch in the last fifty years, while all six US companies with a valuation above EUR 1 trillion have been created in this period.

This lack of dynamism is self-fulfilling.

As EU companies are specialised in mature technologies where the potential for breakthroughs is limited, they spend less on research and innovation (R&I) – EUR 270 billion less than their US counterparts in 2021. The top 3 investors in R&I in Europe have been dominated by automotive companies for the past twenty years. It was the same in the US in the early 2000s, with autos and pharma leading, but now the top 3 are all in tech.

The problem is not that Europe lacks ideas or ambition. We have many talented researchers and entrepreneurs filing patents. But innovation is blocked at the next stage: we are failing to translate innovation into commercialisation, and innovative companies that want to scale up in Europe are hindered at every stage by inconsistent and restrictive regulations.

As a result, many European entrepreneurs prefer to seek financing from US venture capitalists and scale up in the US market. Between 2008 and 2021, close to 30% of the "unicorns" founded in Europe – startups that went on the be valued over USD 1 billion – relocated their headquarters abroad, with the vast majority moving to the US.

With the world on the cusp of an AI revolution, Europe cannot afford to remain stuck in the "middle technologies and industries" of the previous century. We must unlock our innovative potential. This will be key not only to lead in new technologies, but also to integrate AI into our existing industries so that they can stay at the front.

A central part of this agenda will be giving Europeans the skills they need to benefit from new technologies, so that technology and social inclusion go together. While Europe should aim to match the US in terms of innovation, we should aim to exceed the US in providing opportunities for education and adult learning and good jobs for all throughout their lifetimes.

The second area for action is a joint plan for decarbonisation and competitiveness.

If Europe's ambitious climate targets are matched by a coherent plan to achieve them, decarbonisation will be an opportunity for Europe. But if we fail to coordinate our policies, there is a risk that decarbonisation could run contrary to competitiveness and growth.

Even though energy prices have fallen considerably from their peaks, EU companies still face electricity prices that are 2-3 times those in the US. Natural gas prices paid are 4-5 times higher. This price gap is primarily driven by Europe's lack of natural resources, but also by fundamental issues with our common energy market. Market rules prevent industries and households from capturing the full benefits of clean energy in their bills. High taxes and rents captured by financial traders raise energy costs for our economy.

Over the medium term, decarbonisation will help shift power generation towards secure, low-cost clean energy sources. But fossil fuels will continue to play a central role in energy pricing at least for the remainder of this decade. Without a plan to transfer the benefits of decarbonisation to end-users, energy prices will continue to weigh on growth.

The global decarbonisation drive is also a growth opportunity for EU industry. The EU is a world leader in clean technologies like wind turbines, electrolysers and low-carbon fuels, and more than one-fifth of clean and sustainable technologies worldwide are developed here.

Yet it is not guaranteed that Europe will seize this opportunity. Chinese competition is becoming acute in industries like clean tech and electric vehicles, driven by a powerful combination of massive industrial policy and subsidises, rapid innovation, control of raw materials and ability to produce at continent-wide scale.

The EU faces a possible trade-off. Increasing reliance on China may offer the cheapest and most efficient route to meeting our decarbonisation targets. But China's state-sponsored competition also represents a threat to our productive clean tech and automotive industries.

Decarbonisation must happen for the sake of our planet. But for it also to become a source of growth for Europe, we will need a joint plan spanning industries that produce energy and those that enable decarbonisation such as clean tech and automotives.

The third area for action is increasing security and reducing dependencies.

Security is a precondition for sustainable growth. Rising geopolitical risks can increase uncertainty and dampen investment, while major geopolitical shocks or sudden stops in trade can be extremely disruptive. As the era of geopolitical stability fades, the risk of rising insecurity becoming a threat to growth and freedom is rising.

Europe is particularly exposed. We rely on a handful of suppliers for critical raw materials, especially China, even as global demand for those materials is exploding owing to the clean energy transition. We are also hugely reliant on imports of digital technology. For chips production, 75-90% of global wafer fabrication capacity is in Asia.

These dependencies are often two-way – for example, China relies on the EU to absorb its industrial overcapacity – but other major economies like the US are actively trying to disentangle themselves. If the EU does not act, we risk being vulnerable to coercion.

In this setting, we will need a genuine EU "foreign economic policy" to retain our freedom – a so-called statecraft. The EU will need to coordinate preferential trade agreements and direct investment with resource-rich nations, build up stockpiles in selected critical areas, and create industrial partnerships to secure the supply chain of key technologies. Only together can we create the necessary market leverage to do all this.

Peace is the first and foremost objective of Europe. But physical security threats are rising and we must prepare. The EU is collectively the world's second largest military spender, but it is not reflected in the strength of our defence industrial capacity.

The defence industry is too fragmented, hindering its ability to produce at scale, and it suffers from a lack of standardisation and interoperability of equipment, weakening Europe's ability to act as a cohesive power. For example, twelve different types of battle tanks are operated in Europe, whereas the US produces only one.

What is standing in the way?

In many of these areas, Member States are already acting individually and industrial policies are on the rise. But it is evident that Europe is falling short of what we could achieve if we acted as a community. Three barriers are standing in our way.

First, Europe is lacking focus. We articulate common objectives, but we do not back them by setting clear priorities or following up with joined-up policy actions.

For example, we claim to favour innovation, but we continue to add regulatory burdens onto European companies, which are especially costly for SMEs and self-defeating for those in the digital sectors. More than half of SMEs in Europe flag regulatory obstacles and the administrative burden as their greatest challenge.

We have also left our Single Market fragmented for decades, which has a cascading effect on our competitiveness. It drives high-growth companies overseas, in turn reducing the pool of projects to be financed and hindering the development of Europe's capital markets. And without high-growth projects to invest in and capital markets to finance them, Europeans lose opportunities to become wealthier. Even though EU households save more than their US counterparts, their wealth has grown by only a third as much since 2009.

Second, Europe is wasting its common resources. We have large collective spending power, but we dilute it across multiple different national and EU instruments.

For instance, we are still not joining forces in the defence industry to help our companies to integrate and reach scale. European collaborative procurement accounted for less than a fifth of spending on defence equipment procurement in 2022. We also do not favour competitive European defence companies. Between mid-2022 and mid-2023, 78% of total procurement spending went to non-EU suppliers, out of which 63% went to the US.

Likewise, we do not collaborate enough on innovation, even though public investments in breakthrough technologies require large capital pools and the spillovers for everyone are substantial. The public sector in the EU spends about as much on R&I as the US as a share of GDP, but just one-tenth of this spending takes place at the EU level.

Third, Europe does not coordinate where it matters.

Industrial strategies today – as seen in the US and China – combine multiple policies, ranging from fiscal policies to encourage domestic production, to trade policies to penalise anti-competitive behaviour, to foreign economic policies to secure supply chains.

In the EU context, linking policies in this way requires a high degree of coordination between national and EU efforts. But owing to its slow and disaggregated policymaking process, the EU is less able to produce such a response.

Europe's decision-making rules have not substantially evolved as the EU has enlarged and as the global environment we face has become more hostile and complex. Decisions are typically made issue-by-issue with multiple veto players along the way.

The outcome is a legislative process with an average time of 19 months to agree new laws, from the Commission's proposal to the signing of the adopted act – and before new laws are even implemented across Member States.

The objective of this report is to lay out a new industrial strategy for Europe to overcome these barriers.

We identify the root causes of the EU's weakening position in key strategic sectors and lay out a series of proposals to restore the EU's competitive strength. For each sector we analyse, we identify priority proposals for the short and medium term. In other words, these proposals are not intended to be aspirations: most of them are designed to be implemented quickly and to make a tangible difference to the EU's prospects.

In many areas, the EU can achieve a lot by taking a large number of smaller steps, but doing so in a coordinated way that aligns all policies behind the common goal. In other areas, a small number of larger steps are needed – delegating tasks to the EU level that can only be performed there. In still other areas, the EU should step back, applying the subsidiarity principle more rigorously and reducing the regulatory burden it imposes on EU companies.

A key question that arises is how the EU should finance the massive investments needs that transforming the economy will entail. We present simulations in this report to address this question. Two key conclusions can be drawn for the EU.

First, while Europe must advance with its Capital Markets Union, the private sector will not be able to bear the lion's share of financing investment without public sector support. Second, the more willing the EU is to reform itself to generate an increase in productivity, the more fiscal space will increase, and the easier it will be for the public sector to provide this support.

This connection underscores why raising productivity is fundamental. It also has implications for the issuance of common safe assets. To maximise productivity, some joint funding for investment in key European public goods, such as breakthrough innovation, will be necessary.

At the same time, there are other public goods identified in this report – such as defence procurement or cross-border grids – that will be undersupplied without common action. If the political and institutional conditions are met, these projects would also call for common funding.

This report is coming out at a difficult time for our continent.

We should abandon the illusion that only procrastination can preserve consensus. In fact, procrastination has only produced slower growth, and it has certainly achieved no more consensus. We have reached the point where, without action, we will have to either compromise our welfare, our environment or our freedom.

For the strategy outlined in this report to succeed, we must begin with a common assessment of where we stand, the goals we want to prioritise, the risks we want to avoid and the trade-offs we are prepared to make.

We must ensure that our democratically elected institutions are at the centre of these debates. Reforms can only be truly ambitious and sustainable if they enjoy democratic backing.

And we must take a new stance towards cooperation: in removing obstacles, harmonising rules and laws, and coordinating policies. There are different constellations in which we can move forward. But what we cannot do is fail to move forward at all.

Our confidence that we will succeed in moving forward should be strong. Never in the past has the scale of our countries appeared so small and inadequate relative to the size of the challenges. And it is long since self-preservation has been such a common concern. The reasons for a unified response have never been so compelling – and in our unity we will find the strength to reform.