BRIEFING

EU competitiveness: Issues and challenges

SUMMARY

Strengthening the European Union's economy in the face of rising global economic and political competition and managing the 'twin transitions' of the digital and green transformation is a key challenge for the 2024–2029 legislative term.

This briefing highlights key aspects of the debate around strengthening the EU's economy. While the term 'EU competitiveness' is not clearly defined, there is broad agreement that it entails a range of policies focusing on, but not confined to, the EU's single market. The single market is far from complete, and abolishing barriers to trade would allow for efficiencies and economies of scale.

We also look at other policies that are essential when it comes to safeguarding and strengthening EU competitiveness, in particular its industrial and energy policies, and outline the discussion around EU competition and investment policy. In doing so, it becomes clear that strengthening EU competitiveness is not a technical process confined to individual policies. Instead, it opens up deeply political discussions over the changing nature of the EU's economic and political model, with long-term distributional consequences.

Given its very nature, there is no single answer to the competitiveness challenge confronting the EU. Without claiming to be comprehensive, this briefing rather seeks to provide a structure to the debate and point to some of the fundamental political and economic questions EU policymakers need to address during the 2024–2029 political term.

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Introduction

The European Union's economy has weathered several major storms in recent years. The 2007-2009 global financial crisis and the subsequent sovereign debt crisis resulted in profound social and economic change. The COVID-19 pandemic demonstrated modern economies' vulnerability to supply chain disruptions. Russia's full-scale invasion of Ukraine in 2022 highlighted the EU's dependence on fossil fuel imports and led to a significant price shock, especially for natural gas.

In addition to responding to the long-term social and economic consequences of these shocks, the EU is facing the fundamental challenge to adapt to both digital and green transitions. These 'twin transitions' change the way we live, work, produce and consume. They offer new economic opportunities, but also challenge current practices. Companies need to offer digital products and services over a range of devices far beyond the old focus on physical goods. Consumer habits change in a digital marketplace offering instant comparisons and immediate delivery. Climate change results in the need to develop more efficient production methods using fewer resources and producing less waste.

This transformation plays out against the backdrop of profound geopolitical change. Countries such as China are offering new innovative products, taking market share from European incumbents. At the same time, the existing global trade order developed as a Euro-Atlantic framework is increasingly being questioned.

As the EU moves into the 2024-2029 political cycle, it has begun a reflection on how to respond to these challenges. The Letta Report on the future of the single market was published in April 2024. In 2023, Mario Draghi was appointed special adviser to the President of the Commission to report on the future of European Union competitiveness and published his report in September 2024.

State of the EU's economy

Since its inception, economic and monetary union (EMU) faced a number of serious economic crises. The establishment of the European Semester and the banking union were part of a fundamental overhaul of the EMU since the financial and sovereign debt crises of the early 2000s. The economic consequences of the recent pandemic gave birth to a new EU fiscal tool, the Next Generation EU programme and the Recovery and Resilience Facility, to support economic recovery in the 27 Member States. While the EU has proved it can respond to such challenges, vulnerabilities to external shocks, rising debt-levels, and competitiveness issues are looming topics for the new legislative term.

With a gross domestic product (GDP) of €17 trillion in 2023, the EU's economy is the third largest economy in the world, and accounts for almost one-sixth of global trade, while the euro is the second most traded currency globally. While risks to GDP growth have increased, an inflation soft landing is within reach. Reflecting cautious optimism, GDP growth for the EU is projected at 0.9 % in 2024 and 1.4 % in 2025. Inflation is projected to fall to 2.2 % in 2025 and undershoot the inflation target in 2026, even though the 'last mile' of disinflation is expected to be volatile.

Meanwhile, China has become the EU's second largest trading partner, with an EU-China trade balance in goods persistently in favour of China. In 2023, the EU trade deficit amounted to €292 billion As its investment-led growth model comes under increasing pressure, China's government is redoubling its efforts to spur growth through investment-centric policies, thus building up overcapacity – a level of production that (domestic) demand cannot absorb. China's production surpluses are often linked to extensive government support, which has created trade tensions with its trading partners. Over the last 20 years, Chinese export market shares have continuously increased, including in sectors where the EU has a significant production base. This rising export share to the EU exposes EU industries to competition with China. For instance, Italy currently holds an advantage in 60 economic sectors in which China has become a direct competitor; while Germany has seen the largest surge in exposure to Chinese competitiveness, as it its exposure has increased from 20 sectors in 2000 to 50 in 2022. In response to China's policy, EU and other countries are introducing increasing trade measures on Chinese products, the most high-profile of which being the anti-subsidy investigation into Chinese electric vehicles.

EU single market: Growth engine and backbone of European integration

Often considered the 'cornerstone' of European integration, the single market now serves 449 million consumers and 23 million companies, most of which are small and medium-sized enterprises (SMEs). It has delivered substantial economic benefits, ranging between 8 % and 9 % of EU GDP. Trade between Member States has risen steadily over the years, and today accounts for 56 million European jobs. The EU is among the largest trading blocs in the world, representing 15 % of world GDP, compared to the United States at 16 % and China at 19 %. Its attractiveness for foreign businesses also serves as an important geopolitical tool, enhancing the EU's influence amid geopolitical shifts.

Recent shocks, such as the COVID-19 pandemic and the war in Ukraine, have not only revealed how vulnerable the single market is to crisis, but also the extent to which the EU's competitiveness relies on a well-functioning single market, ensuring unhindered availability of goods, services, and strategic inputs required across EU supply chains.

Although the single market has generally been a success, an array of recent reports (including the Letta Report) document that the single market remains fragmented, limiting EU companies' ability to scale up and compete internationally. A 2023 EPRS study mapping the cost of non-Europe (2022-2032), finds that completing the single market could yield significant benefits for EU citizens, amounting to €644 billion collectively by 2032. For instance, 60 % of the barriers companies face today are of the same type as were reported 20 years ago. The Letta Report particularly suggests further integration in the telecom, energy, finance and defence sectors.

Completing the single market, better enforcing existing rules, reducing red tape and addressing remaining obstacles would help to create a more competitive business environment across the EU. Advancing the single market requires action in multiple policy fields, its digital dimension having become particularly important in recent years. Further key components include competition rules, standards, public procurement, and intellectual property rights.

Innovation and research are crucial to safeguard EU technological advantage and enable companies to compete globally in the market for cutting-edge technology. The EU's main funding programme for research and innovation is the Horizon Europe programme, worth €93 billion. However, it ends in 2027, and needs to be renegotiated as part of the EU's next multiannual financial budget (MFF).

Ultimately, a well-functioning single market, fit for the green and digital transitions, new technological developments and changing geopolitical realities can also be seen as an essential element of the EU's industrial policy (see below).

Competition policy: From crisis management to global perspective?

Competition policy underpins the EU's single market by ensuring that all EU companies operate under the same conditions. The policy addresses the need to prevent cartels mergers that could lead to harmful market dominance, and seeks to prevent State aid that could distort competition and internal EU trade.

To support companies during the early stages of the COVID-19 pandemic, the European Commission published the temporary framework for State aid measures in March 2020, temporarily allowing EU Member States to provide larger national subsidies.

With Russia's full-scale invasion of Ukraine in 2022 and the resulting spike in energy prices, the Commission updated the temporary crisis framework, allowing for subsidised loans and extra aid for additional costs due to the severe increases in natural gas and electricity prices. A year later, a temporary crisis and transition framework took effect, introducing the possibility of granting more State aid to sectors that are key to the transition to a net-zero economy, in line with the Green Deal industrial plan.

The discussion over the future of EU State aid received additional attention following increasing Chinese presence on EU markets, especially in the automotive sector (see above) and the introduction of the Inflation Reduction Act in the United States. This latter provides for tax credits to domestic 'clean tech' manufacturers and other subsidies, thus potentially putting EU companies at a disadvantage. Not being a fiscal union, the EU is however unable to put forward a support scheme at EU level based on tax breaks and instead has to rely on direct subsidies. This is in itself subject to discussion, with Member States having highly uneven financial resources for economic support to companies. In 2022, France and Germany granted their companies €73.7 billion and €44.8 billion in State aid respectively – more than a half of the €228 billion in combined State aid spending by all 27 EU Member States. For this reason, in her July 2024 speech at the European Parliament, Ursula von der Leyen called for the creation of a European Competitiveness Fund to finance 'common and cross-border European projects that will drive competitiveness and innovation – notably to support the Clean Industrial Deal'.

Discussion on the future of EU State aid policy is not limited to the financial resources available, however, but also which scale to refer to when it comes to the assessment of company mergers and the simplification of EU rules. France, Germany and Italy, for example, advocate a new approach in competition policy to allow larger European enterprises to compete globally. European Commission President Ursula von der Leyen is considering revamping competition policy in the next five years to allow EU firms to 'scale up' to face international competition. She also announced the creation of a Commission Vice-President for implementation and simplification of rules, who will 'stress-test' the EU *acquis*.

Twin transitions

Beyond immediate concerns over the rise of new economic competitors, the discussion of EU competitiveness is linked to the discussion on how the EU's economy can adapt to the digital and green transitions. Digitalisation already affects all sectors and jobs. The green transition creates green jobs in new and emerging sectors, while many existing jobs are changing or disappearing, with uneven impacts across sectors and regions. The green transition, too, will create new opportunities for companies and skilled workers. However, it also poses an additional challenge to those regions or job-seekers dependent on less environmentally-friendly activities (a more detailed discussion of the socio-economic effects of the green transition).

These transitions' success depends on whether they are conducted in a socially fair way, with attention paid to securing quality jobs and ensuring enough skilled workers to perform them. Given the existing shortages in terms of both occupations and skills, reskilling and upskilling of the EU labour force are essential. For instance, achieving the EU digital skills target of 70 % of the population having basic digital skills by 2025 requires training a varying part of the population in each country (Romania 42 %, Bulgaria 39 %, Italy 24 %) and covering the associated costs, which will be lower for countries where little additional training is envisaged (such as the Netherlands and Finland).

A focus on skills and education is thus unavoidable for strengthening EU competitiveness, not least due to the EU's shrinking population, which is expected to peak in 2026 at 453 million and fall to around 450 million by 2040. The EU's share in the world's population would consequently drop further. Due to longer life expectancy and falling numbers of births, the EU population is also ageing. The shrinking working-age group puts labour markets and welfare states under pressure, raising the burden of public debt.

Managing the impact of demographic change and providing education and training policies is the responsibility of national governments. The EU's supportive role is set out in the European Pillar of Social Rights and operated through its cohesion policy. The 2023 Commission toolbox for action, assembling the existing EU regulatory, policy and funding tools, is meant to help Member States mitigate the demographic change, including through legally managed migration. With the European Skills Agenda, a plan to help individuals and businesses develop new skills, the EU seeks to diminish labour shortages and avoid bottlenecks in the economy with negative consequences for EU competitiveness, as well as to ensure social fairness and improve society's resilience to crises.

Towards a new industrial policy?

Over the past few years, the need to speed up the green and digital transitions and to reduce strategic dependencies for key products has led to widespread calls for greater government involvement in the economy and to the 'rebirth' of industrial policies. Today, nearly all countries (not least China and the United States) have established forms of industrial policy.

The EU has recently embraced a more active industrial policy agenda. The Commission adopted a new industrial strategy for Europe in 2020, seeking to make EU industry greener, more digital and more competitive globally and to reinforce Europe's industrial and strategic autonomy. The 2021 update of the strategy put forward a range of additional actions to address strategic dependencies that could lead to EU vulnerabilities, due to a strong concentration of global production in third countries, with limited options for supply diversification. As highlighted by the International Energy Agency (IEA), around 90 % of mass-manufacturing capacity for several key clean energy technologies is located in China and the Asia-Pacific region. Europe remains a large importer of clean energy technologies such as batteries and electric vehicles. The market share of cars made in China in EU battery-electric sales has increased from 3 % to over 20 % in the past three years. China dominates the whole battery supply chain, with nearly 85 % of global battery cell production capacity.

During the last mandate, EU legislators adopted a number of specific regulatory frameworks targeting key industries in the net-zero industrial age. These concern batteries, semiconductors ('Chips Act') and critical raw materials (CRMS - 'CRMs Act'), and support the production of strategic technologies (Net-zero Industry Act - NZIA) and a strategic technologies for Europe platform – STEP). Regarding chips, for example, the Commission recently stressed that the launch of the European Chips Act had already attracted public and private investment commitments of €115 billion.

The Commission has supported European industrial alliances (e.g. on clean hydrogen) to help develop Europe's strategic capacities and to facilitate the identification of investment projects. Important projects of common European interest (IPCEIs) – a state aid tool designed to overcome serious market failures in breakthrough innovation and key infrastructure – have also gained in importance as a way to support strategic industrial projects (e.g. concerning the battery value chain).

Challenges for European industry remain high. A range of European companies in the car, metals, steel, chips or wind turbine sectors have recently announced job cuts. The EU's industrial policy should be fit to face the coming challenges, and will require a mix of coordinated action, including at the international level.

Energy policy

European industry faces relatively high energy prices, especially compared with other leading economies such as the United States or China. The ongoing energy transition based on energy efficiency, home-grown renewables and reduced dependence on external energy suppliers could contribute to tackling this high energy cost, provided the right instruments are chosen. EPRS estimates that decarbonisation of energy systems could boost the EU economy by over €464 billion per year by 2030 and €1029 billion by 2050.

To be competitive, the EU needs a secure and stable supply of energy. To continue domestic production of renewables, the EU needs a secure supply of raw materials to produce wind turbines, solar panels, electrolysers, batteries and storage solutions. Additionally, the security of supply framework needs diversified and trusted suppliers of gas and oil, as despite their progressive phasing-out, these remain necessary for the EU economy. The EU energy policy calls for a complete phase-out of Russian fossil fuel imports, in line with REPowerEU objectives.

In her political guidelines for 2024-2029, the President of the European Commission proposed a 'Clean Industrial Deal' to simultaneously decarbonise the economy and bring down energy prices. Building a true 'energy union' and using the power of an integrated European energy market could help reach this goal. However, the energy market will not reach full integration without sufficient grid capacity. Late in the previous term, the Commission published a grids action plan but more initiatives are needed to fill the gap in the energy transition. In particular, the EU needs to secure sufficient investment in critical infrastructure, including cross-border electricity grids.

Public and private investment

Old and new structural forces weigh on future EU competitiveness and productivity growth. While some EU Member States' relatively high level of legacy debt poses long-term challenges; weak investment and innovation, and a fragmenting geopolitical landscape are more recent threats to productivity and potential growth. More investment and innovation is essential to spur long-term growth and enhance competitiveness. Ideally, this investment should be linked to, and supportive of, the requirements of the digital and green transitions.

However EU Member States have uneven capacity to provide for additional investment (see above), not least due to several years of large discretionary fiscal support measures such as in the wake of the COVID-19 pandemic. While fiscal space is strained at national level, the EU is transitioning to new fiscal rules in the form of a revised stability and growth pact.

The EU has several instruments in place to maintain public investment, promote private investment needs and support competitiveness. To promote post-pandemic recovery and address the green and digital transitions, the EU introduced Next Generation EU (NGEU), with the Recovery and Resilience Facility (RRF), as the primary spending tool. High energy dependence and surging energy prices have forced Member States to revamp their recovery plans, and these now have to include a RePowerEU chapter to tackle rising energy prices and energy security challenges. In addition, the InvestEU fund aims at stimulating the European economy in key policy areas and attracting private investment across Europe. Each of these plans contribute to EU competitiveness. The EU also has a specific funding scheme for innovative projects. For instance, the innovation fund for climate action is one of the largest funding programmes worldwide for innovative low-carbon technologies.

Strengthening the EU's competitiveness therefore requires a discussion of the size, structure and priorities of the next EU budget, which is due for revision during this legislative term. This entails a focus on EU competitiveness, on European public goods and the financial and governance means necessary to deliver. It is important to note, that, with the RRF ending in 2026, there is a two-year gap to the next multi-annual financial framework (MFF), which will start in 2028.

Financing competitiveness and EU policies, however, also requires private resources. EU citizens' savings are often stored in bank accounts, rather than invested on the stock market. This results in higher financing costs for businesses and fewer financing options, which in turn affects the growth and innovation potential of more competitive firms. The fragmentation of European capital markets is therefore a main source of EU financing deficiencies, rendering the policies aimed at delivering a less fragmented 'capital market union' (CMU) a priority.

The European Commission launched the capital markets union (CMU) in 2015, with the primary objective of minimising the cost of capital and cross-border investment barriers, and unlocking growth financing. The plan touches upon a wide range of areas, including securities markets, securitisation, insurance companies and business insolvency law. As outlined in a second action plan, CMU was set as a priority for this legislature in the 27 June 2024 European Council conclusions, which call for work to be accelerated and reiterate the urgency and importance of the CMU as a precondition to ensuring competitiveness.

Governing tools at EU level

Improving the EU's competitiveness requires a discussion of not only who spends how much, but also on what. Economic and industrial policy decisions are still largely taken at national level, with the EU providing a coordinating role, for example in the form of the European Semester. Other EU-level steering tools relevant to EU industrial and economic policy focus on individual policies such as the single market (Internal Market Emergency and Resilience Board), raw materials (European Critical Raw Materials Board), labour markets and social protection (Pillar of Social Rights action plan), trade (international procurement instrument), or competition policy (important projects of common European interest), but remain subordinate to national-level decision making.

As part of the EU Green Deal, EU funds encourage Member States to cooperate and invest in climate, energy, industry and transport solutions to bring about the green transition. In their national energy and climate plans, EU countries are supposed to present and regularly update their own energy and climate policies. These collectively form the combined EU effort to manage the green transition.

Ensuring EU competitiveness requires not only the right regulatory policies and the necessary financial instruments to bring about and manage change, but also the governance capacity for the EU as a whole to avoid duplication and provide for economies of scale.

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