

What Do Competitiveness Comparisons Tell Us?

Finland's high ranking in international competitiveness comparisons has delighted Finns in recent years. Although this is certainly something to be happy about, caution should be taken in reaching extensive conclusions based on such rankings. Experience has shown that a strong ranking in competitiveness indices does not guarantee favorable economic growth in subsequent years.

The best-known competitiveness indices are published by two Swiss organizations. The Institute for Management Development (IMD) and the World Economic Forum (WEF) currently construct their own indices, though the two have a shared history. The WEF left the joint cooperation in the mid-1990s, when it began to publish its own index.

In the beginning of the 1990s three countries, namely Japan, Germany and Switzerland, ranked high in the IMD competitiveness index. Economic growth in these countries, however, subsequently slowed. In Japan, growth virtually stagnated at the end of the decade. Noteworthy is the fact that Japan continued to rank high in the competitiveness indices despite the sharp slowdown in GDP growth. Over time, Japan's position in the rankings naturally fell (see the figure on page 75).

COMPETITIVENESS INDICES POOR LEADING INDICATORS OF GROWTH

Standard-of-living comparisons are typically made using GDP per capita as a benchmark: the higher the GDP per capita, the higher the standard of living. This can also be viewed as an indirect measure of competitiveness. Common sense would suggest that a country with a high GDP per capita must be competitive at least in the sense that its economy is capable of generating a high level of welfare for its citizens.



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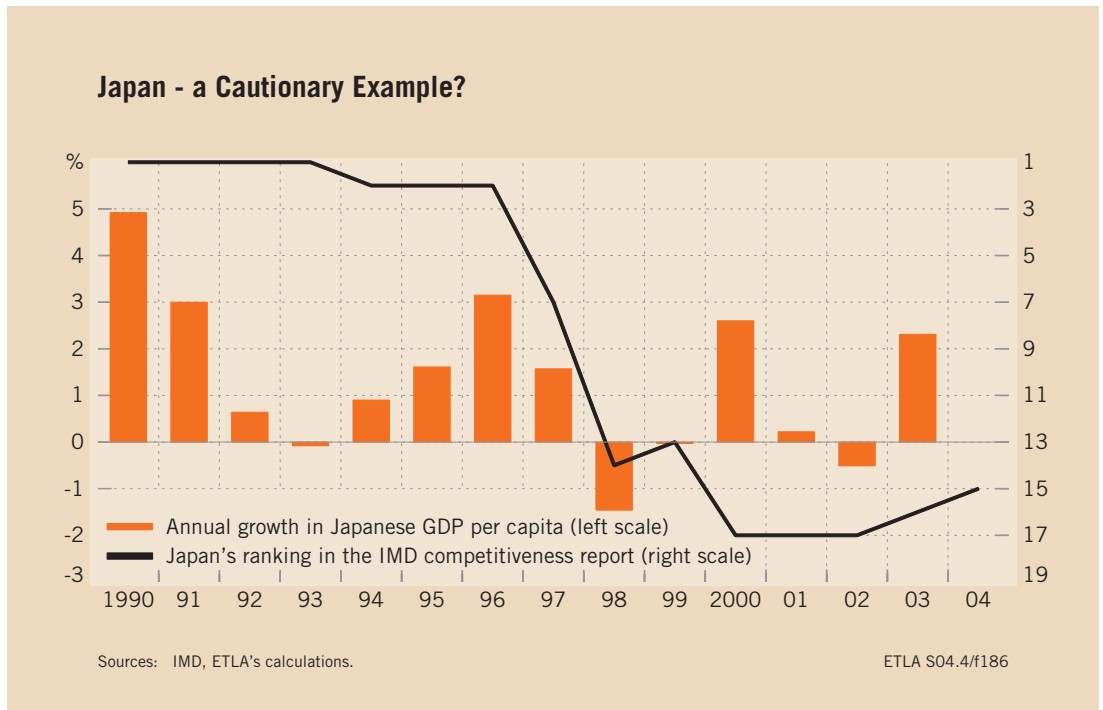
But is there a correlation between GDP growth and competitiveness ranking as is often purported? The figure on page 76 presents IMD and WEF rankings and average annual GDP growth per capita by country. The competitiveness rankings are from 1996. Average annual GDP growth was calculated from data covering the 1995-2003 period.

A cursory glance at the figure suggests that, at best, only a weak correlation exists between competitiveness ranking and growth in GDP per capita. This is also confirmed by basic statistical analysis. The correlation between ranking and GDP growth is for all practical purposes zero.

The IMD and WEF measures of competitiveness are not identical. They rank countries slightly differently, though there is a clear correlation between the two rankings of a given country: the correlation coefficient between two rankings is 0.88. Despite small differences in how each index ranks countries, both the IMD and WEF measures appear to predict GDP growth just as poorly.

SOME INTERESTING DETAILS

A closer look at the data reveals some interesting details. China and Ireland enjoyed the



fastest growth during the time period examined. The WEF rankings in 1996 placed these countries below the average. The IMD index ranked Ireland slightly higher than the average, but only slightly.

In 1996, both the IMD and WEF indices showed that Russia was the least competitive country. The Russian economy has nevertheless grown much faster than average.

Of the top ten countries ranked by the IMD, only one posted noticeably stronger growth than average during the period examined. Seven countries grew at a much slower pace than average. Only two countries ranked in the top ten by the WEF grew appreciably faster than average; five countries grew much slower than average.

WHAT DO COMPETITIVENESS INDICES MEASURE?

Competitiveness indices are poor at predicting growth and are therefore also not good at

measuring growth competitiveness. They do measure something, but what? One possible interpretation is that they are an indicator of risk: a high competitiveness ranking may imply fewer business risks and vice versa. Basic Nordic strengths, such as a developed infrastructure, a stable society, lack of bureaucracy, nonexistent corruption, low crime, etc., receive much weight in the indices.

The competitiveness indices attempt to compress different aspects of competitiveness into one key figure. This may also be a problem. The index number is the average of various components of the index: in computing the average some important determinants of growth may be underestimated, even if attempts were to be made to weight each determinant by their average importance. The impact of some determinants of competitiveness may also vary depending on the situation. An educated population may be a precondition for growth, but not necessarily sufficient in gener-

ating growth. If educational efforts are misdirected from a perspective of competitiveness, or if the educated workforce is fully employed and the working-age population either grows slowly or contracts, then the preconditions for growth remain uninspiring despite the high level of education prevailing.

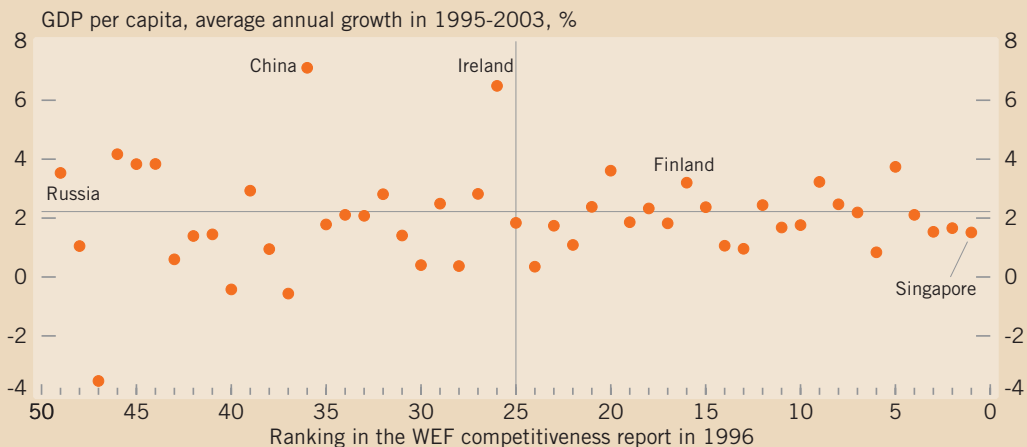
Needless to say, extensive conclusions should not be made based on a country's ranking in a given year. It is very possible that the most

important indicators of competitiveness and future growth are included in the indices. Identifying them, however, requires further study; a joint research study between Tekes (Finland's National Technology Agency) and ETLA addressing this issue is already underway.

TAXATION AND WAGE FORMATION ARE FINLAND'S WEAKNESSES

Even without further study, there are sufficient grounds for noting that a good ranking in both

Competitiveness Ranking Does Not Predict Growth



competitiveness indices should not encourage complacency. Rather, it should encourage efforts to improve known weaknesses.

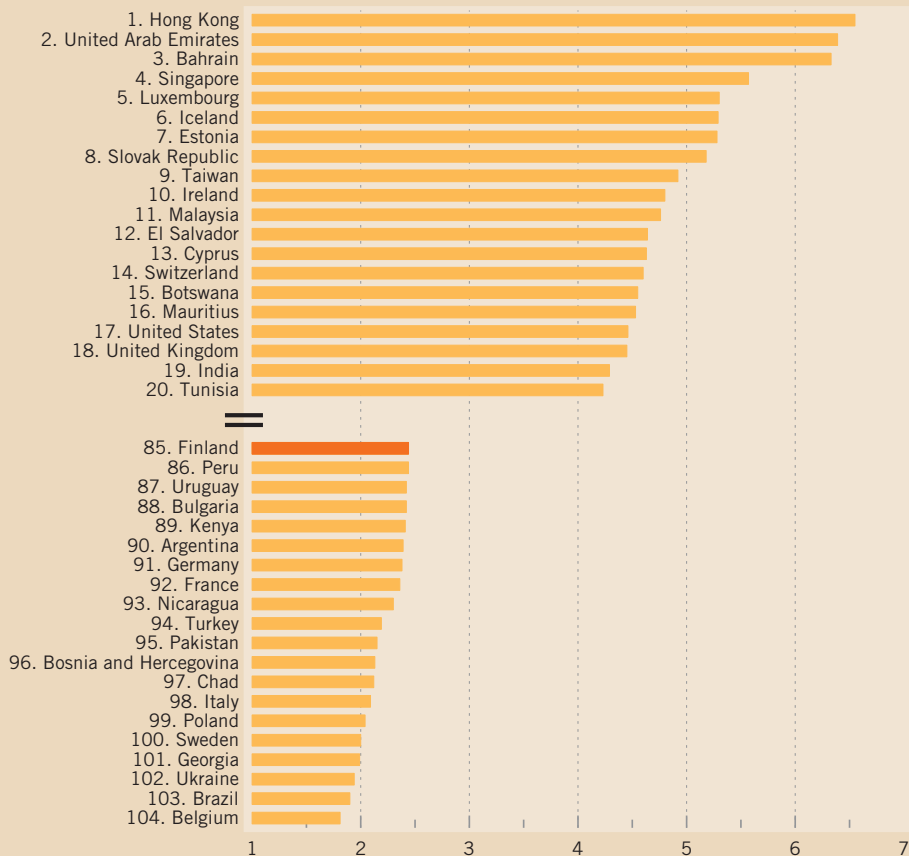
Finland's strengths include heavy investment in research and development, the extensive network between businesses and universities as well as its highly educated population. Attention should be paid to maintaining and enhancing these strengths. At the same time, however, efforts should be made to correct

existing weaknesses and, preferably, turn them into strengths.

Finland's weaknesses pertain to, for example, taxation and wage formation. The competitiveness reports are partly based on survey information; Finland's performs poorly when questions are asked regarding the effect of taxation on incentives or the flexibility of wage determination.

The Extent and Effect of Taxation

The impact of the level of taxes on incentives to work and invest (1=significantly limits incentives, 7=has little impact on incentives)



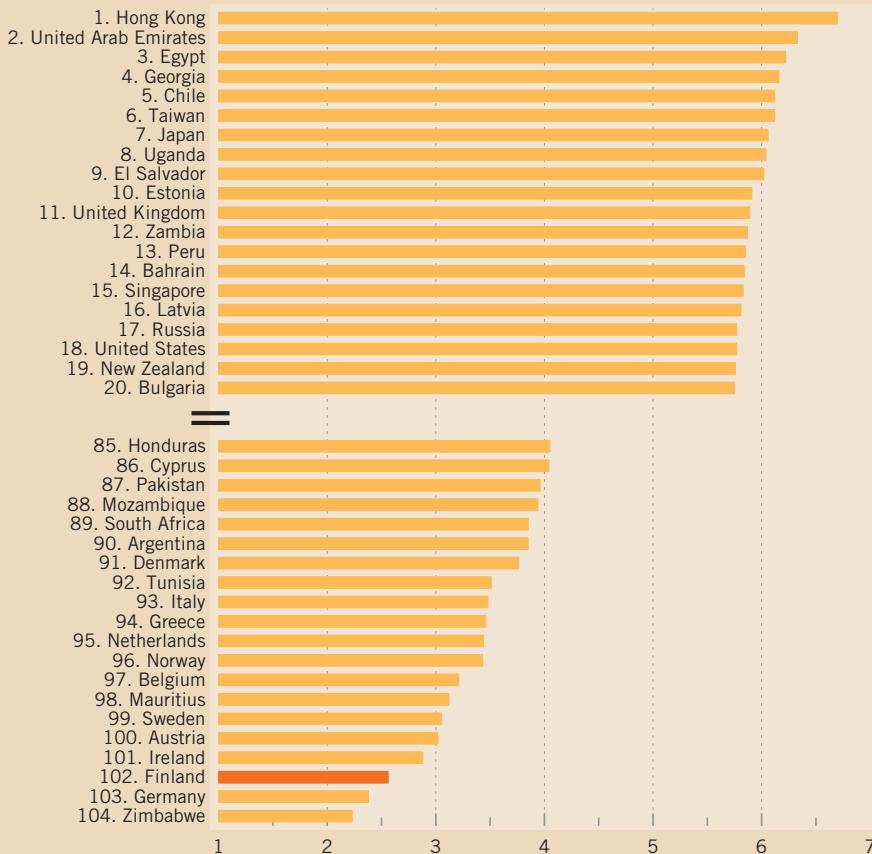
Source: WEF.

In Finland, wages are centrally negotiated. Of course, this does not mean that wages are inflexible. In practice, however, wages tend to move in only one direction. Wage gains are greater than the general increase negotiated in those industries and firms whose profitability allows for it and labor demand and supply conditions call for it. Wages do not adjust downwards in the same way, which leads to unemployment.

Industries vary in their ability to raise productivity. If general wage increases are based on average productivity gains and cost-of-living increases, then over the longer term businesses operating in industries with low productivity growth tend to see their prospects weaken cumulatively. The employment situation weakens, unless the number of jobs in other industries grows rapidly at the same time. If the economy's resources are not used as efficient-

The Flexibility of Wage Determination

Wages are determined by (1=a centralized bargaining process, 7=each individual company)



Source: WEF.

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ly as possible, then the preconditions for growth also weaken.

The WEF competitiveness report cited above states poignantly:¹ “Despite its enormous importance, the determinants of the growth rate of a country remain one of economies’ biggest mysteries. This is true even though the greatest economic minds of the last two centuries have tried hard to explain what can be done to increase a country’s growth rate.” This is true, but should not be used as an excuse for not exploiting existing opportunities.

REFERENCE

¹ Blanke, Jennifer, Paua, Fiona ja Sala-i-Martin, Xavier: The Growth Competitiveness Index: Analyzing Key Underpinnings of Sustained Economic Growth, Global Competitiveness Report 2004-2005, World Economic Forum 2004.