ECONOMIC POLICY COMMITTEE

Brussels, 14 November 2006
ECFIN/EPC(2006)REP/56235 final

FACTOR MOBILITY IN THE GLOBAL ECONOMY: POLICIES FOR GROWTH IN AN INTERCONNECTED WORLD

Summary

The Ecofin Council has on several occasions recognised the marked shift in the pattern of global economic activity, resulting from extensive and fundamental changes in the world economy. This is driven by developments in technology, production, investment, and trade. This process must be expected to continue.

Flows of factors of production between countries are a crucial aspect of this shift. Factor flows now encompass not just physical capital and technological know how but also skilled labour and human capital. Factor flows are influenced by a number of developments:

- Skills levels are going up globally, but much more rapidly in fast growing emerging markets.
- Emerging markets share of total Foreign Direct Investment (FDI) will continue to increase while the composition of trade and FDI will see emerging markets attracting a higher share of FDI in high value added manufacture, services, and R&D.
- Advances in technology, particularly ICT, the relative rise of the service sector and change of business models have ensured that cross border flows are increasingly composed of services, R&D, financial capital and human capital, and not just of physical goods.

At present, the EU is one of the largest recipients of FDI in the world. Taking into account that emerging markets are growing rapidly and attracting a larger share of FDI and that the USA continues to attract both FDI and high skilled immigrants, the challenge for the EU is to develop more outward looking economic policies and remain the most open economy in the world, positioning itself to continue to benefit from increased factor flows and keep up with the US on leading edge research and development. Policies to attract human and physical capital – high skilled migrants and Foreign Direct Investment – should be key components of strategies to maximise growth in an interconnected global economy.

Policy at a Community level needs to recognise these circumstances and context. Across a number of aspects, the reality of increased factor mobility strengthens the case for progress with the Lisbon agenda and the Internal Market at a Community level. At a national level, greater factor mobility strengthens the need to make our economies internationally attractive, pushing ahead with structural reforms as necessary to achieve this.

The report highlights the following policy actions that could particularly contribute to attract investment and human capital.

On FDI**:**

- **Making the EU a more attractive place to do business**: enforcing the Internal Market with respect to reducing remaining barriers within the EU to inward

investments; and reviewing the multiple sets of national product market regulations that fragment the European market. Legitimate national concerns should be addressed by non-discriminatory and proportionate means and respecting the principle of subsidiarity;

- **Critically reviewing current instruments to attract investments**. Impact assessments of Member State incentive schemes designed to attract and retain internationally mobile production factors should be strengthened. The framework for state aids, and, at a global level, the apparent increasing use of selective incentives to attract investment and R&D should be reviewed. Allocation and governance mechanisms for national publicly funded R&D should be re-examined – taking account of the need for critical mass to produce internationally excellent and market relevant research.
- **Promoting outward looking policies to encourage and enable engagement with fast growing and dynamic economies.** Progress in the context of WTO with an ambitious and balanced multilateral trade agreement reducing barriers to trade and distorting subsidies, which reflects the EU's interest in transparent market conditions and access to strongly growing third markets, is a priority. A settlement of the Doha round is very important for the world economy.

On Migration:

- In respect of migration from third countries, **developing a new robust and coherent and more EU coordinated framework for policy – with a stronger economic orientation**. Such a framework would take into account the spillover effects of Member State approaches and could allow Member States to enjoy an EU support when cooperating with third countries; consider the pros and cons of an EU approach to skilled migration; and aim to develop relations with developing countries based on an overall approach that provides benefits to both sides.
- In terms of migration within the EU, concrete measures should be designed and implemented for facilitating the mobility of workers by increasing the **portability of pensions and mutual recognition of qualifications**, whilst recognising the economic consequences which could arise from expatriation on a larger scale in the source countries.

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1. Introduction

The Ecofin Council has discussed policies to respond to globalisation on three occasions within the last 18 months (Manchester September 2005, Brussels December 2005, and Vienna April 2006).[1] From these discussions have emerged a clear set of conclusions on how globalisation has so far impacted on the EU economy and what is needed to maximise and spread the potential gains for citizens in Europe:

- The world economy is experiencing significant economic change, driven by the integration of emerging market economies. Their share of world output is expected to continue to grow.
- The increased openness of the EU has brought sizeable improvements in living standards. Job losses, for the EU as a whole including for low skilled workers, from increased imports and outsourcing have so far been compensated by increased exports. Labour market reforms and a continued rise in educational attainment have made it easier for workers to respond to changing circumstances.
- The best way to manage the insecurities associated with globalisation, and maximise the opportunities, is to provide security by equipping people to manage and take advantage of change, not to protect specific jobs.
- However, in the face of public concerns about the future effects on globalisation on jobs and income distribution, and variations in the opportunities and adjustment costs across and within Member States, and across and within different sectors, there is no room for complacency. Experience shows that policy reforms along the lines of the BEPG recommendations remain a valid response.
- Macro-economic stability provides a basis for growth and helps to stimulate investment. Continued labour market reform and improvement in human capital is needed to ensure quicker labour market adjustment and to contribute to spread the gains more equally across the population. On product markets, completion of the Internal Market and enhancement of the regulatory framework remains central for improving productivity for EU firms. Both within the EU and in relation with external partners, there is need to address more sharply distorting subsidies and trading regimes across a broad spectrum of policies.

These general conclusions remain valid. The present report extends the analysis on policies more directly concerning flows of FDI and workers both within the EU and with the rest of the world. It reviews recent trends in FDI and migration relevant policies and sets out options for future reforms focusing on the areas most relevant for ECOFIN: efficient allocation of resources, productivity and public finances.

2. Trends and drivers of factor flows

The world has opened up to increased mobility of workers and of capital. As borders have become more open, factors of production have begun to move, in line with demand, to the locations where the return they generate is highest. This process has and will continue to drive a more optimal allocation of resources – and higher productivity at a global level. The question for the EU is how it positions itself in relation to a more open world. **The challenge is to ensure that the EU remains a desirable destination for FDI, that companies within the EU can invest productively in emerging markets, and that the EU**

[1] See also the 2005 report by the EPC on responding to the challenges of globalization under: http://ec.europa.eu/economy_finance/epc/documents/2005/globalisation_en.pdf.

is an attractive location for qualified immigrants, and intra-EU migration contributes to the flexibility of labour markets and enables workers to respond to changing circumstances.

The pattern of global economic activity has changed markedly, driven by extensive and fundamental changes in technology, production, investment and trade flows. The globalisation of economic activities does not only apply to industrial production and physical capital, but also services, R&D and human capital.

The **rapid growth of the emerging market economies** means that they have and will continue to account for an increased share of global output and global investments – both inward and outward. That has consequences for the relative position of the advanced and emerging economies. Projections suggest that by 2015 China will be the world's second largest national economy, and India will continue to grow rapidly.

Factor flows are closely linked with human capital developments. Skill levels are rising faster, though from a much lower base, in emerging markets than in advanced economies, and this is a main driver of their impressive growth performance. In 1998 Chinese Higher Education Institutions produced 83,000 graduates. In 2004 that number was 2.4m. In the EU in 1998 universities produced 2.5m graduates. In 2004 that number was 3.4m.[2] These developments are likely to continue over the next decade, though in some cases the headline statistics may mask important underlying differences in quality.

According to a study by the French Treasury, the supply and demand for different skills levels within the EU will be affected by changes in the patterns of global production. Some evidence indicates that by 2020[3]:

- There may be a slight fall in demand for low skilled workers but this will be more than matched by a fall in supply as less skilled cohorts exit the labour market;
- There may be an increase in the demand for high skilled workers but this will be matched by an increase in supply;
- There will be an increase in supply of medium skilled workers while demand will decrease;
- There may be a significant turnover of jobs in manufacturing at all skill levels with significant numbers of workers moving from one industry to another between 2002 and 2020.

Over time, these developments will mean that trade, FDI, and R&D with the emerging markets have the potential to cover a whole range of products, including skills-intensive products, and not just low value added segments of goods and services. The impact of trade across Europe on different segments of the job market will become more balanced. While there is no mechanistic link between educational attainment and economic performance, improving educational attainment in emerging markets is also expected to contribute to convergence of real income levels.

These developments have important implications for policy making in Member States as well as for the Community as a whole. The following sections first review the most recent trends in flows of FDI and migration and the related policies and then move on to a discussion on the options for the future direction of policies.

[2] OECD(2005), Chinese statistical bureau (2006), EUROSTAT.
[3] Delozier and Montout (2006): "New Trends in Globalisation and international Division of Labour: Consequences for Europe", Direction Générale du Trésor et de la Politique Economique Projections for the EU are based on the composition of the French economy and are subject to some uncertainty.

Foreign Direct Investment

Over the period 1990-2005 growth of FDI flows outstripped growth in world trade. The EU and the US currently dominate global flows and inflows of FDI were a main catalyst for successful transition in the countries of Eastern Europe. But as FDI flows increase in size and in importance, the relative position of the EU cannot be taken for granted:

- The share of emerging markets in global FDI inflows has risen from 18% in 1990 to 31% in 2003. Within that, the share of China rose from 2% in 1990 to 9% in 2004. The share of the EU has declined from 47% in 1990 to 33%in 2004.[4] The geographical developments of FDI reflect underlying fundamentals.
- A sharp increase in cross border M&A in 1999 and 2000 explains much of the apparent increase in FDI in the EU in recent years with Greenfield investment playing a smaller part, mostly targeted at markets with an advantage in absolute cost and more frequently in transition economies. Ireland and some of the new Member States stand out in terms of attracting inward FDI.
- Services, including financial services, telecommunications, wholesaling and retailing make up an increasingly large share of FDI. In 2002, almost 70% of Member States' inward FDI and almost 60% of its outward FDI related to services. These trends are expected to continue for some time. Opportunities for future growth in services trade are projected to be significant.
- Where, in the past, inward direct investment into emerging markets was driven mainly by low production costs, increasingly they are capturing a share of investment in research, development, and innovation. In spite of increasing R&D expenditures of foreign subsidiaries in EU countries, the importance of the EU as a location of foreign R&D subsidiaries is decreasing in both absolute and relative terms. The share of the EU in R&D expenditure abroad by majority-owned foreign subsidiaries of US parent companies decreased from around 70% in 1994 to around 59% in 2002. Most of the increase in share goes to developing countries, almost exclusively in Asia (China and Singapore in particular).[5] These trends are likely to continue, a recent survey of Multinational Enterprises (MNE) suggests that 69% of the largest enterprises in terms of R&D spending will see their share of foreign R&D increase in the future. The locations in which R&D intensive MNEs plan to locate R&D in the future will be China (for 61.8% respondents), USA (41.2%), India (29.4%), Japan (14.7%), UK (13.2%), and the Russian Federation (10.3%).[6]

FDI is an important contributor to economic welfare in both source and destination countries. Outward FDI helps source firms produce more efficiently, access new markets, and assimilate new technologies. There are also gains from international vertical division of the production process which breaks up the production process into discrete steps and allows firms to optimise costs. At a country level, these benefits have the potential to spill over into the source economy which enables other firms to develop new business activities, access rapidly growing markets, and gain access to new technologies and knowledge. In addition, at a macro level, outward investments help restructure the economy along the lines of changing comparative advantage. EU direct investment outflows increased from around $80bn in 1993 to $508bn in 2003, much of this went to OECD countries, but a growing portion now finds a place in emerging markets. In the destination countries, FDI can generate knowledge spillovers to local firms, depending on factors such as the level of human capital, availability of infrastructures, and R&D intensity, as well as other factors.

[4] UNCTAD FDI Database.
[5] UNCTAD 2005: 126-134.
[6] UNCTAD 2005: 151-152.

Policies have played a significant role in shaping the flow of FDI.[7] Over the last 20 years the EU has progressively eradicated formal barriers to investment and the free movement of capital. Remaining barriers are very unevenly distributed across sectors. By far the highest levels of FDI restriction are in electricity, followed by transport, business services, telecoms, finance, and of course the gaming and defence industries, with FDI restrictions in other sectors much lower. While non policy factors such as proximity to home country and size of markets are important determinant factors in explaining the inter-country variations in inward FDI stock within OECD countries, policy framework conditions (product market regulation, flexibility of labour markets, skills attainment and infrastructure) in addition to formal FDI barriers also play a significant role.

The use of **financial incentives to attract FDI** has considerably expanded in frequency and value. While there is substantial evidence that some of these policies have affected the location and size of FDI, the effects on overall investment and productivity levels remains more unclear. Policy implications will be discussed below.

Tax systems go some way toward explaining patterns of FDI flows. There is some evidence from recent empirical work that business location decisions are influenced more by the average effective tax rate than marginal tax rates. Greenfield investments appear to be more responsive to taxes than mergers and acquisitions. Corporate tax rates have been cut and withholding taxes on dividends reduced at a global scale over the last decades. Statutory tax rates have been decreasing in most of Europe over the last 25 years and the variation in effective tax rates has been reduced and is smaller than for statutory rates, a development which is partly explained by the base broadening pursued by countries with low corporate tax rates. Within the EU, effective rates are lowest in smaller and peripheral countries.

The Irish example demonstrates that clear sighted pursuit of policies to improve framework conditions can have a significant impact on growth and FDI flows. Success for Ireland has been based on a consistent policy approach pursued in line with a long term vision. Strong framework conditions – increasing external openness, macro-economic stability and reforms to ensure flexible labour and product markets – appear to have been the key to the transformation of the economy. Funds from the EU allowed Ireland to develop an internal infrastructure at a much faster rate than if provided exclusively by domestic funds though are now tapering off as GDP levels exceed EU averages. Finally, the close cultural affinity and shared language with large US investors are features not available to many other countries.

[7] OECD (2003), Economics Department, Working Paper 359.

Box 1: Attracting FDI – The Irish Experience

Ireland is a world leader in attracting FDI. The inward stock of FDI was 116% of GDP in 2004 while the outward FDI stock was 52% of GDP in the same year. Many firms use Ireland as an export platform for EU markets: 94% of multinational output, which accounts for around 90% of Irish merchandise exports, is exported. The USA is the main source of FDI – and its involvement is concentrated in high-tech sectors such as ICT, software, pharmaceuticals, financial services and medical devices.

There are various factors which help explain the success of the Irish economy in attracting FDI. Ireland embraced international investment flows in advance of many other countries. In terms of broad structure, the shift towards outward oriented economic policies in the early 1960s, the dismantling of tariffs and foreign ownership restrictions and membership of the EU increased the openness of the economy. Internal reforms such as investment in infrastructure, education and skills, the implementation of Social Partnership Agreements from the late 1980s, tax reform, macro-economic stability, and a commitment to flexible product and labour markets were all contributing factors. Education policies have focussed on producing graduates with skills that are valuable in the marketplace, for example Ireland has almost twice as many science and engineering graduates per capita as the EU average. Low taxes on the factors of production have resulted in large inflow of capital and a boost to the labour supply. Government investment in infrastructure is rising and will average at about 5% of GNP over the period 2006-2010. There has also been a significant rise in expenditure on science, technology and innovation in line with the Lisbon Agenda though expenditure levels are below EU averages.

EU structural funds were very important in funding investments in transport infrastructure and education, particularly in the 1980’s, at a time when the fiscal position of the Irish government was poor. While the importance of EU funding has declined significantly, (in the period 1980-95 it equated to 4.7% of GNP whereas it amounted to only 1.3% in the first 6 years of this decade), it has had other positive spillover effects; the procedures and disciplines necessary to run the spending programmes improved the management capabilities of Irish administrators.

IDA Ireland, the Irish Government agency responsible for securing new investment from overseas, has had a high profile role in promoting Ireland as a location for FDI. Industrial policy has evolved from attracting companies that sought only a low wage and low tax location, to attracting those that require the skills provided by the Irish workforce as well as the stable economic and political situation that enables them to make long-term investments. It also seeks to identify synergies between indigenous companies and multinationals, including opportunities for sub-supply and the transfer of best practices.

Finally, there are several factors specific to Ireland that made it particularly attractive for FDI. These include close cultural ties to the USA and demographic factors that created a young English speaking workforce, which for much of the 1990s provided a relatively cheap and skilled labour force. It has also benefited from first mover advantage within the EU; the success of previous foreign investors as well as IDA marketing has established Ireland high on the list of potential FDI locations.

Migration

Until 1995 migration flows to the EU, overall, remained relatively low and stable. Since 1995, there has been an increase - partly a consequence of regularisation programmes of illegal immigration especially in Southern Europe. Still, only 9 per cent of the population in Europe against 12 per cent in US and 20 per cent in Canada and Australia are foreign born. Almost all EU-25 countries are now net receivers of migration – though the dimensions vary across Member States - but the skills composition is very different.

Inflows from outside the EU continue to be dominated by family reunification and asylum seekers. The pressure of illegal immigration is increasingly felt, especially in Southern Europe. The skill composition of immigrant flows are typically below that of the local population and well below that in countries such as USA, Canada, and Australia. The Graph in Annex I sets out immigration, emigration and skilled migration for the EU as compared to the USA, Canada, Australia, and the OECD average.

Movement within the EU, although it increased substantially after 2004, remains limited. However, there is an increasing tendency – particular for movements east-west in the EU – towards very short term migration, including cross-border commuting and seasonal work, a development made easier by low cost transportation. This movement has been reinforced after the enlargement in 2004 and is probably partly due to the remaining transitional restrictions to full labour mobility between some Member States. Annex II sets out a summary of Member State policy in respect of migration from New Member States.

The historical flow of migration to the EU has impacted on economic performance in a number of areas. While most of the gains of migration probably accrue to the immigrants themselves, most studies find a small overall net gain from migration in the host country from more diversity of skills, fresh ideas, and perhaps increased labour market flexibility.[8] The impact of immigration on wages depends on the skill structure of the immigrant and native populations. The evidence on the fiscal effects of past immigration is mixed, but it appears fair to say that overall the net budgetary impact over the long run appears to be fairly small though geographic clustering can be associated with high costs for local budgets, and social impacts will need to be managed.

These trends are driven by both specific migration policies and other framework conditions providing incentives for immigration. In addition to specific immigration policies, in migration decisions for the highly skilled, the quality of educational and research institutions and the likelihood of well paid jobs in an open and flexible labour market play an important part both inwards to the EU and outwards from the EU to the USA.

Migration policies have moved up on the policy agenda, in part because of difficulties associated with integration, in part because of efforts to attract more high skilled migrants, and in part because public opinion in many EU Member States appears to regard immigration as a negative phenomenon.[9] EU Member States have moved in the direction of tightening conditions for entry via family reunification and asylum programmes while at the same time opening more for economic based migration, targeting workers in scarce supply at the local level. There has at the same time been some movement in the direction of Australian and Canadian style policies on skilled migration – though systems employed by EU Member States are far from the sophistication of the more established schemes. A number of countries have implemented systems providing tax advantages to typically high-skilled and/or highly-paid immigrants, often reflecting the fact that normal tax regimes are

[8] European Commission (2006),"Labour migration patterns in Europe: recent trends, future challenges", note to informal EPC meeting 26-27 June.
[9] FT/Harris pole, October 2006.

less attractive than in alternative host countries for example the US[10]. Policy in some countries has also recognised the benefits to growing economies of access to low skilled labour – which migration can help to supply. A summary of Member State changes to migration policies is set out in Annex III.

In the background of debate about migration policy is the **possibility of the emergence of a large informal labour market populated with illegal immigrants**. In some senses the choice facing policy makers is not between immigration or no immigration, but between managed immigration into the regulated and taxed labour market, or unmanaged immigration into the casual labour market where wages are low, taxes are not paid, and migrants themselves are at risk of exploitation. Illegal migrants may enter the territory illegally, but there are also a considerable number of people who enter legally and then lose their legal status.

The Commission's Communication on Illegal migration[11] recognises that action on illegal employment and cooperation with third countries, alongside border security, are necessary. The strategy set out in the Communication suggests that the EU should continue to address the push factors for illegal migration - considering migration aspects within the EU strategies for financial assistance to developing countries, and the pull factors, above all illegal employment.

3. Policy Challenges for the future: getting the most from factor flows

Getting the policies right for maximizing the benefits to the EU from flows of FDI, workers and R&D presents a number of challenges – both to Member States and to the Community as a whole.

Action at Member State level

Foreign Direct Investment

The general recommendations in the Broad Economic Policy Guidelines remain valid as the starting point for policy. At the national level the priority for action must be **growth and stability orientated macro-economic frameworks and general framework conditions** – which are a precondition for attracting businesses and foreign investment. Well designed and well functioning macro-economic frameworks promote continuity in economic development and enhance growth potential. They help economies avoid and respond to shocks, equipping the economy to respond to change. In a global economy, credible commitment to the right macro-economic framework is also a source of comparative advantage and complements micro reforms in labour, product and capital markets.

Framework conditions go wider than improving the quality of the workforce and of the capital stock. Investor surveys consistently identify quality of life as a key determinate of the location decisions of foreign firms and employees – so housing, environment, and cultural life also form part of the equation. With this in mind, in terms of policy issues, the challenge of global factor flows reinforces the case for continuing with action to:

- Increase the **quality of R&D and innovation policies**, especially by encouraging a more systemic approach which takes into account the need to promote further and more consistent interactions between the different agents: funding bodies,

[10] OECD(2005), "Trends in migraton policies".
[11] Commission Communication on Illegal Migration (COM (2006) 402 final).

businesses, research institutions and universities. Action in this area would underpin the globalisation efforts of domestic and foreign owned firms and increase the capacity of the host economy to absorb innovation spillovers from foreign investment;

- **Address outmoded, complex, and varied product market regulations** which adversely affect inward FDI by raising production costs or entry barriers and block the transmission channels between R&D spending and improvements in productivity;
- Ensure **labour markets are flexible** and excessive Employment Protection Legislation does not act as a barrier to investment;
- Equip individuals to adapt through providing social bridges – **skills and retraining** – rather than protecting specific jobs or sectors;
- Promote the use of independent and **proactive competition policies** to increase confidence in underlying market conditions and ensure a level playing field across the EU, particularly in sectors where competition is not functioning as it should; and,
- Design and implement R&D and innovation policies in a way that allows SMEs to participate in areas where their scale and specific competences can add value, including in cross-border projects.

There is also a need to review critically the policies that more directly affect foreign direct investment and cross-border flows of workers. These include the use of business subsidies and policy on the organisation of public R&D:

- The higher mobility of FDI combined with indications of more use or at least an unchanged **high level of business subsidies gives rise to concerns** both at the national and community level. At the national level, the general issue is whether the benefits to the domestic economy in terms of spill-overs matches the costs of financing grants. Most studies suggest that such spill-overs are better obtained by investing in the local economy's absorption capacity. In terms of design of subsidy schemes, grants favouring a specific activity rather than favouring specifically foreign investors are to be preferred. Grants to individual firms to locate in specific regions tend to be less effective than measures aimed at lowering the costs of doing business in that region. In the context of improving the "quality of public finances", efforts should be stepped up to review more generally the effectiveness of such programmes including their Community dimension.
- The **financing and organisation of public R&D** is still conducted largely along national lines. The EU suffers from a proliferation of research institutions, many of them with similar objectives. Rather than generating competitive pressures, the result in many cases is a fragmented research and development process and unproductive overlaps. In order to access the most relevant research expertise, and in some cases to develop the critical mass necessary to produce relevant work in increasingly costly areas of science and technology, Member States might consider what more could be done to open up domestic research to international competition, and to deliver national priorities by opening up public R&D to the potential in international partnership. There is scope for careful review of the effects of national public R&D programmes and the opportunities for a more optimal allocation of resources through international collaboration.

Migration

The reorientation of migration policies, which has already begun, should help Member States address a number of policy concerns. Estimates of future skills supply and demand in one study[12] illustrate that in the aggregate the EU may not lack skilled workers. However, in specific sectors and in specific regions there are likely to be skills shortages, including in the natural sciences and in a number of areas at the medium skill level. First

[12] Delozier and Montout (2006).

and foremost this suggests a need for improving the quality of education systems in the EU. The role of migration policies also needs to be revisited here. In the USA, a shortage of “domestic” graduates in key areas for business innovation has been more than compensated by a substantial inflow of researchers, many of them from Asian countries.[13] This inflow was clearly linked to more open and often targeted migration policies. An economically oriented migration policy should also take into account the benefits of access to low skilled labour.

As regards immigration from non-EU countries, one of the issues to be addressed is which **selection criteria** to put in place. At the one end of the spectrum of policy options is the pure Green Card system where entry is only conditioned by entrants fulfilling a number of objective criteria related to their pre-entry qualifications and job history. At the other end of the spectrum are schemes designed to solve specific labour shortages where entry is often conditioned on having obtained a job before entry and/or proof that the employer has been unable to fill the position otherwise. The former system may be preferable in terms of gaining new workers that have qualifications suited beyond a short term horizon. The latter system tends to win political support more easily given its focus on solving well-identified present problems. The fact that some EU Member States are moving somewhat in the direction of the Green Card approach while Canada recently has introduced more requirements for employment before entry illustrates that there are no easy solutions and learning by experience is essential. An alternative way forward may be a combination of approaches tailored to Member States’ individual circumstances.

Within the EU, increased mobility may also help address sector and professional shortages across Member States. As noted above, the reduced restrictions in terms of movements between EU15 and EU10 introduced by a number of countries from May 2005, may introduce a helpful element of flexibility in labour markets.

The **fiscal impacts of ageing populations** have also been put forward as reason for increasing immigration. Immigration from non-EU countries can probably contribute only very slightly to addressing this problem (intra-EU movements have by definition zero net effects). Present long term projections already assume net migration of 40 million persons to EU until 2050. If this was expanded to 60 million, a rough calculation suggest that this would shave off just one quarter of a percentage point of GDP of the expected increase in pension expenditures of nearly 3 percentage points over the same period (EU-25)[14].

[13] In the mean time US policies have become more restrictive due to security considerations.
[14] ECFIN(2006), “Labour migration patterns in Europe: recent trends, future challenges”, note to informal EPC 26-27 June.

Box 2: The New French Policy toward Economic Immigration

The French Parliament voted a new Law on Immigration and Integration in May 2006. It contains several new provisions aimed at attracting those migrants who may benefit most from and contribute most to the French economy:

A new stay and work card called "Competence and Talent" has been created. Eligibility is based on skills and ability to bring a significant and lasting contribution to French economic development or in intellectual, scientific, cultural, humanitarian or sporting life. Criteria to evaluate candidates' projects are set by a national commission. The card is valid for 3 years and renewable once (permanent stay being usually granted after 5 years). In order to limit possible brain drain effects, for some countries classified as "Priority Solidarity Zone", the card will only be delivered if the migrant commits to return at the end of a maximum 6-year stay. This condition may be relaxed if France has signed a co-development partnership agreement with the origin country, involving a contribution from the immigrant to economic development in his native land.

Also, the foreign student regime has been modernized. It now allows foreign students to work and earn a salary for as much 960 hours per year (namely 60 % of official full time hours). After completing successfully at least a masters degree, a foreign student may stay 6 months in France in order to find a job with a salary above a given threshold (to be established by a forthcoming decree). Once the student has got such a job, work and stay permit will be delivered automatically.

In general, foreigners will be granted a work and stay permit as soon as they have a contract with an employer belonging to a sector and area listed as suffering from shortages of qualified applicants. In other sectors and areas, verification that no French national can fill the job still applies. Seasonal work and temporary secondments from abroad are also facilitated by the new policy.

Action at Community level

Foreign Direct Investment

Action at the Community Level should look both inward and outward. Looking inward, the completion of the Internal Market is the overarching objective. Within that, addressing the diversity of product and labour market regulations, removing direct barriers to investment, considering the impact of business subsidies at a Community level, and investment in trans-European networks are important objectives. Looking outward, the Community should use its leverage to negotiate the removal of barriers to FDI in major partner countries, and continue pushing toward a successful conclusion of the Doha round.

Completion of the Internal Market

The fragmentation of markets across the national boundaries of Member States prevents firms from reaping benefits of scale and scope and reduces competition and investment. In this context, **completion of the Internal Market is crucial**, especially in services given their potential for future growth and increasing tradability. Full implementation of the Internal Market would lower the costs for inward investors and raise the incentives to invest. Despite progress towards the Internal Market, there is still scope to do more to address the obstacle course of multiple levels of regulations and requirements. The aim – without engaging in a 'race to the bottom' – should be to avoid burdening EU production sites excessively compared to third country competitors. The agreement of the Services Directive is a clear step toward the completion of the Internal Market and it now needs to be implemented, but action is still required in a number of areas:

- Diversity of **product and labour market regulations** directly impacts the capacity of the EU to benefit from the opportunities of globalisation. Action is required at all levels to ensure that there is a level playing field for companies across Europe.
- The Community as a whole should step up its efforts to **remove direct barriers to investment** – especially ceilings on foreign equity ownership, screening, approval rules, and badly-targeted and distortive State aids, which have a significant effect on FDI – raising costs and lowering incentives. National preferences such as security of supply or specific service obligations should be precisely delimited.
- The remaining barriers to the Internal Market in financial services represent a direct obstacle to investment. Lack of competition in this sector leads to a higher price for and less access to credit, suboptimal conditions for consolidation to take place, and an inefficient allocation of capital.
- Significant barriers remain in a number of sectors, particularly in the network industries, where interconnections should be developed and improved. Ongoing investments in the development of trans-European networks in transport, telecommunications and energy, especially in relation to electricity[15], will develop the interconnection and interoperability of national networks and improve access to them - increasing the attractiveness of the EU for FDI.

The importance of attracting FDI strengthens the case for progress to complete the Internal Market, including in services. In some areas there is a trade off between ensuring that national objectives are being met and maximizing the benefits at the community level. This is true in respect of some aspects of product market regulation and, even more so, in labour market regulation and tax policy, where national interests predominate. The aim must be to ensure proportionality between ensuring that national objectives are being met and maximising the benefits at the community level.

As regards **business subsidies**, the key community interest is to ensure that such schemes do not distort competition. This objective can be largely achieved if Member States focus on incentives supporting specific activities rather than foreign firms. However, even for R&D subsidies, which can certainly be helpful at the national level, experience from the US (very few EU studies exist) suggests that positive effects in one country may well be achieved at the costs of other countries as they compete to attract the same scarce researchers and high-tech firms.[16] Within the EU there are efforts to relax state aid law in cases where one single European location is competing with other global sites for business relocation. The advantages and disadvantages of such a course of action should be carefully examined and the WTO regulations should be strengthened in this area, in order to avoid a damaging international subsidy race. The clear message is that improving framework conditions – getting the regulation right, improving transport systems, investment in the skills of the workforce - is the best long term strategy to attract and benefit from FDI.

Outward FDI

On outward FDI, there is a case for increased efforts to prevent behaviour by state authorities and companies from third countries that is detrimental to market functioning and fair competition. Problems such as double pricing in the energy sector, export duties for raw materials, the infringement of intellectual property laws, and forced technology transfer, demand attention. Such practices damage European companies and jobs – and impact not only the market opportunities in the countries in question, but also in

[15] See for example Sector Inquiry under Art 17 Regulation 1/2003 on the gas and electricity markets.
[16] Stark and Wilson(2006),"What do we know about the interstate economic effects of state tax incentives?", UCLA School of Law, Research Paper Series.

third countries and in the internal market as a whole. Both the European Commission and the Member States should refer explicitly to these facts in their bilateral talks with the countries in question. **A stable and attractive investment climate with legal and regulatory certainty including investment protection rules and intellectual property rights is the key**. EU firms also have more to do to ensure that they are at the forefront of investing in and benefiting from the opening of Emerging Market economies.

FDI and trade are often complementary. The multilateral trade system continues to offer the most comprehensive method of resisting protectionism; the basis for delivering EU competitiveness; and a means of opening third country markets to the European economy. It ensures the greatest possible transparency in world trade and makes it possible for players to trade worldwide according to standardised WTO rules. This is a particular advantage for smaller national economies and developing countries, in part because it reduces the transaction costs of international trade. The trade policy contribution to globalisation and sustainable development must form a key part of EU thinking. For all these reasons **a successful settlement of the Doha round** continues to be of the greatest significance.

The emergence of regional or bilateral free trade agreements outside of the WTO system can in some cases result in favouring of foreign competitors over European companies. The EU is right to follow the development of Free Trade Agreements with close attention. In their own work, the Commission and Member States should consider the most appropriate mechanisms for achieving the EU's objectives on competitiveness and development. Alternatives such as regulatory dialogue and bilateral customs agreements should be taken into consideration. New agreements should support the EU objective of successfully concluding the Doha Development Agenda, go clearly beyond the WTO standard and ensure that the EU is treated with equality in respect of other countries. The efforts of the Commission in the Doha round negotiations to determine stricter criteria for free trade agreements are to be supported. The EU should continue to strive for a result that will deliver real cuts in tariffs and subsidies and will foster new trade flows, as part of a deal that should bring benefits to all WTO Members.

Migration

EU countries, as an integrated area in the global economy, face common concerns over migration. This generates the need to consider a more coordinated approach in some aspects of national migration policies towards both high and low skilled migrants. Firstly, this coordination could allow Member States to better manage cross-border effects of their respective policies, optimising its design and reducing incoherence among policies that could offset each other. And, secondly, this coordination could allow Member States to enjoy EU support when cooperating with third countries.

There is a case for considering the **costs and benefits of a Member State or a Community approach to policy on skilled labour immigration**. A Member State approach allows individual governments to define policies that best suit their specific needs, but fragmentation of Member State approaches could reduce the attractiveness of the EU to potential high skilled migrants. An EU approach would raise the attractiveness of a move to any given EU Member State as it would give potential migrants the option value of further movement within the EU.

Whilst we are clearly a long way from agreement on an EU policy on skilled migration the box below sets out a proposal from the Bruegel think tank.[17] It suggests that there may be

[17] von Weizsäcker, Welcome to Europe, 2006.

benefits for the Community as a whole by operating with a Community 'Blue Card' system, targeting non-EU workers that all Member States agree would be a welcome addition to the labour force, while Member States could at the same operate national programmes targeting wider group of workers. However there are disadvantages to this proposal, including the possibility of asymmetric flows of talent to particular Member States, and the risk that those admitted would not achieve their highly-skilled potential.

Box 3: The Blue Card Proposal

In order to attract skilled immigrants, the Bruegel think tank has suggested that the EU should introduce a Blue Card: a work permit similar to the US Green Card that would grant the holder permanent access to the entire EU labour market. This Blue Card could be allocated through a points system similar to that used in Canada, favouring skilled young migrants with proficiency in the relevant languages and good job prospects. In addition, students graduating with a Masters degree or equivalent from European universities or good universities abroad could be made automatically eligible for a Blue Card. This would help to attract and retain young talent early.

Bruegel argue that the Blue Card would make it easier for Europe to attract top talent than national programs because access to the entire European labour market is more valuable for migrants than access to any national labour market. Such a European approach to skilled immigration would also help to capture the positive cross-border externalities that skilled migrants are likely to project, similar to research and development activities.

One of the potential problems of an EU wide migration scheme is that it involves loss of national control in a sensitive area. However, in view of the generally positive economic impact of high-skilled migration on any Member State, it might be possible to overcome those concerns. Also, the Blue Card scheme could co-exist with national schemes for those potential migrants who are not eligible for a Blue Card. Due to increasing cross border mobility, the need for further coordination of migration may arise in the future. In the event, the Community would be able to build on the Blue Card experience.

The proposed permanent nature of the Blue Card has advantages and disadvantages. Making the Blue Card permanent would make it more attractive than the temporary H1B visa in the US, and the US Green Card, which is not permanent as it does not guarantee re-entry to the US after more than 12 months abroad. This could help to at least partially offset the partially higher wages for skilled workers in the US. The permanent nature of the Blue Card would allow for "brain circulation" instead of just "brain drain" by acting as an insurance policy for skilled workers from developing countries in the event that they decide to return to their country of origin. With the Blue Card, they could always return to Europe for a second time.

The main disadvantage of the permanent nature of the proposed Blue Card is that it does not adapt to the changing needs of the labour market and the changing absorption capacity. For example, future labour demand cannot be predicted, that is, the qualifications that are valuable today might become less valuable in the future and this cannot be addressed with this permanent system.

Critics might fear that the Blue Card proposal would push aside low-skilled migrants, with high-skilled migrants taking up their slot. But Bruegel argue that the annual absorption capacity for migration is not a given. In fact, it appears that the skill-mix of immigration to some extent determines how many immigrants a country is willing to absorb: Those countries with a points systems typically accommodate higher levels of migration overall including low-skilled migrants. This might be because the high-skilled migrants can have positive effects on the attitudes of native inhabitants towards migrants overall.

The European Commission's Policy Plan on Legal Migration might provide a framework for taking forward thinking at a European level on the economic benefits of migration and there is scope for further involvement from Ministers of Finance in line with their responsibilities.

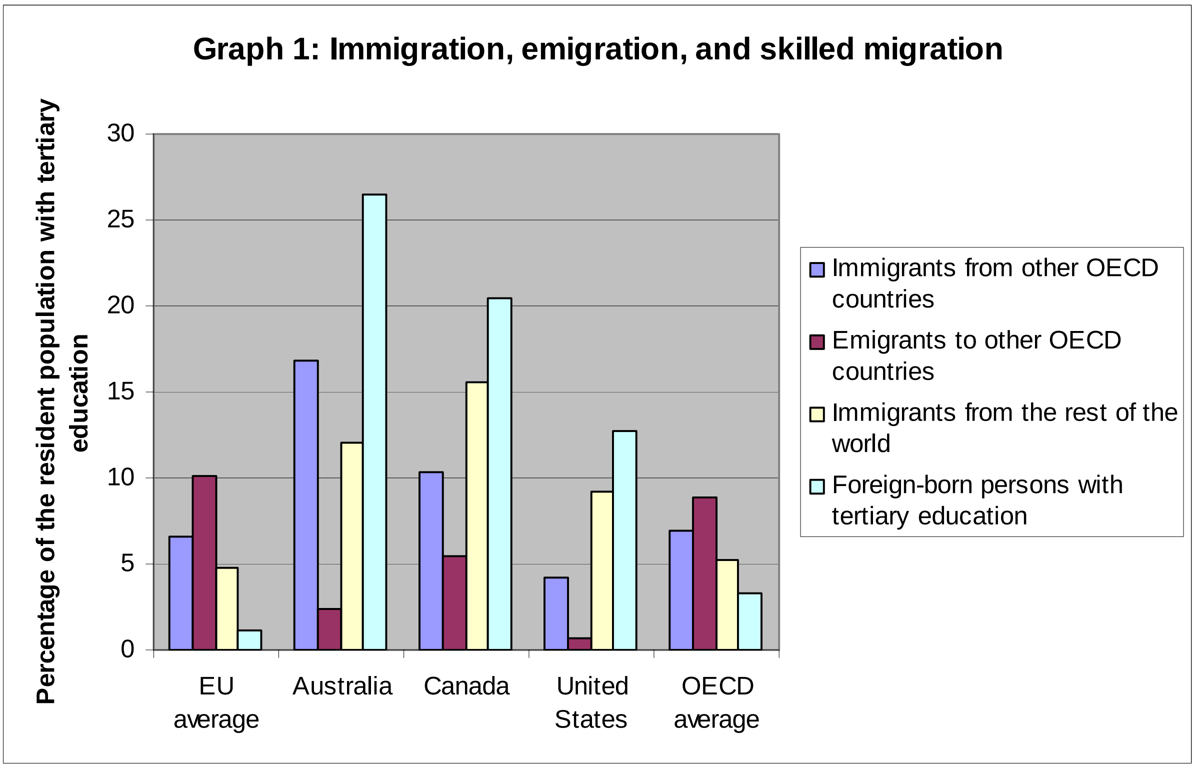
As regards intra-EU movements, there is also scope for further action at Community level to promote the free movement of labour. In particular the mutual recognition of qualifications and an enhanced understanding of different national qualification systems, and the portability of pensions are areas where further progress could be made:

- A directive on mutual recognition of qualifications was adopted on 7 September 2005[18]. This directive consolidates, simplifies and modernises 15 existing directives adopted between 1975 and 1999. It must be implemented in Member States by October 2007. This Directive has established rules that Member States are bound to respect when they receive an application for recognition of another Member State qualification in order to exercise a profession which is regulated in their territory.
- On 5 September 2006, the Commission adopted a proposal for a Recommendation of the European Parliament and of the Council on the establishment of the European Qualifications Framework for lifelong learning (EQF). The main purpose of the EQF is to act as a translation device and neutral reference point for comparing qualifications across different education and training systems. This new instrument will facilitate free movement of workers in situations not covered by the mutual recognition Directive. The proposal is now being discussed in the European Parliament and the Council, with a view to adoption in 2007. In addition, the Commission will also support projects to test and develop further the principles and mechanisms underpinning the use of the EQF, to develop guidance tools and to exchange experience in developing national and sectoral frameworks, using the EQF as a reference point.
- On pension portability, a proposal last year from the Commission is currently with the European Parliament and Council for approval. By improving workers' possibilities to accrue preserve and transfer their supplementary pension rights when changing employers the draft Directive aims at facilitating both workers' freedom of movement within the EU and their occupational mobility within the same Member State. Member States are urged to consider the Commission proposal in a constructive way in order to come to a prompt adoption of a Directive substantially improving the portability of supplementary pension rights in the EU.

Emigration also needs to be considered. The flow of skilled EU citizens to countries where their skills command a higher premium must be a subject of concern for policy makers. This might also be an issue within the EU, which comprises both receiving and source countries at different levels of economic development. For some source countries, a substantial proportion of the working population, and many of those with the most useful skills, have and continue to migrate to Member States where their skills command a higher premium, with adverse fiscal and wider economic impacts on the source country. Although there may be remittances, technology and know-how transfers to the source country from this Diaspora, it appears clear that for some countries **expatriation on a large scale represents a serious loss of human capital**. There is scope to enhance co-operation with source countries – including source countries within the EU - on the overall framework of migration policies – focussing on win-win solutions in the context of the rapid rise in global human capital. It is necessary at the Community level to understand better the possible negative economic and social consequences which arise due to intra-EU migration on the source countries.

[18] (Directive 2005/36/EC).

Annex I



Source: OECD Factbook 2006 (EU average is a simple average of AT, BE, CZ, DE, DK, ES, FI, FR, UK, EL, HU, IE, IT, LU, NL, PL, PT, SK, SE)

Annex II

Table 1: Restrictions on migration from new Member States - first phase 1 May 2004 to 30 April 2006[19]

Old Member States	
Measure	**Country**
Liberalised completely	IE, SE, UK
Maintained national measures	DK, NL, FR, BE, FI, EL, LU, ES, DE, AT
Maintain national measures plus additional quota system	IT, PT

New Member States	
Measure	**Country**
Reciprocity to restriction	PL, SI, HU
Restriction within New Member States	None

Table 2: Restrictions on migration from new Member States - second phase 1 May 2006 to 30 April 2009

Old Member States	
Measure	**Country**
Liberalised completely	IE, SE, UK, ES, FI, EL, PT
Simplified national measures	BE, FR, NL, DK
Maintain national measures	DE, AT
Maintain work permit system plus additional quota system	IT

New Member States	
Measure	**Country**
Reciprocity to restriction	PL, HU
Restriction within New Member States	None

[19] European Commission: Report on the Functioning of the Transitional Arrangements set out in the 2003 Accession Treaty.

Annex III

Table 3: Skilled worker migration – recent policy changes in EU and OECD countries		
	EU	**OECD**
Less strict policies	Portugal 2006: New work visa involving scientific and research activities. Czech Republic 2003: New procedure to attract skilled people wanting to stay permanently, covering limited number of people. France 2003: new exchange programs for young professionals. Finland 2004: Broadens right to work without permits for some skilled occupations. Netherlands 2004: stimulating highly skilled labour, possibility of permanent residence. 2006: stimulating skilled, self-employed migrants and removing remaining bottlenecks with respect to the 2004 policy change. Germany 2004: highly skilled eligible for immediate residence permits. Ireland 2005: Green card procedure introduced: Very restrictive at low pay levels and less selective for high paid group, possibility for permanent residence.	New Zealand 2004: Expansion of group considered eligible for skilled migration: the range of occupations considered as skilled was broadened Japan 2005: Plan to bring in 30000 IT professionals and facilitate permanent residence permits. USA 2005: New acts to make more than 30000 visas for skilled workers. Australia 2005: Skilled stream of migrant programme to increase in coming years.
Stricter policies	Austria: settlement of non-EU citizens only for highly skilled.	
Neutral policies	UK 2005: Move from existing two tier to a new five tier labour immigration management system. Germany 2005: Quotas for workers from new EU-member states for some sectors.	Canada 2005: Improving selection by multi year planning and better promotion.

Source: OECD, International Migration Outlook, 2006