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RESPONDING TO THE CHALLENGES OF GLOBALISATION

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RESPONDING TO THE CHALLENGES OF GLOBALISATION

Part 1 – Trends, drivers and outlook

Globalisation is not a recent phenomenon, but it has accelerated and evolved in character in recent years increasingly affecting sectors of the economy previously sheltered from international competition.

Trends

Over the past fifty years economic integration between developed countries has increased, generating significant benefits for European countries. Increased integration has been driven by the liberalisation of rules governing internal and external markets, falling communication and transport costs, and economic reforms in emerging economies such as China and India.

There have been three main indicators of globalisation: i) increased world trade; ii) significantly increased capital flows; and iii) relatively stable migration.

World trade growth in goods and services has accelerated. It has grown at an average rate of three percentage points faster than global output over the past 15 years. As a consequence, world trade as a percentage of GDP has risen over this period. The rise has been steady, with some acceleration in more recent years.

Table 1: Trends in growth and world trade in goods and services

%	1980-1989	1990-1999	2000-2004
Global GDP growth	3.3	3.2	3.8
World trade growth in goods and services	4.5	6.5	6.2
World trade (% of GDP)	19	21	25
EU15 trade* (% of domestic GDP)	12	12	15

*Note: * is EU12 until 1991, EU15 thereafter. Data in this row is for 1985-1989, 1990-1999, 2000-2002*

Sources: OECD Statistics on International Trade in Services; OECD/Eurostat

Global trade patterns have also been changing, with the emerging markets taking a higher share. Although world trade has been expanding, the EU15's share of it fell substantially, from around 44 per cent to 38 per cent between 1990 and 2002, while the emerging markets such as Asia, increased their share by a similar amount (see Table 2). The new member states' share of EU15 trade rose from 9.4 per cent in 1993 to nearly 17 per cent by 2003. China's share of EU trade rose from 2 per cent to nearly 7 per cent over the same period. EU15 trade with the US and Japan remains significant, although recently it has fallen back both in relative terms and as a share of GDP. The overall net trade balance of the EU has been stable (a small deficit turning into a small surplus)¹.

¹ See EU Commission's 2005 Annual Economic Review on Globalisation.

Table 2: Shares of world trade by region

% total	1990	1995	2002
Industrialised countries	72	67	63
US	12	12	11
EU15	44	39	38
Developing Countries	28	33	37
Asia	13	19	20

Source: IMF Direction of Trade Statistics

Capital flows have also increased significantly. Both foreign portfolio investments and direct investments (FDI) have also risen very strongly over the last 15 years in both industrial and emerging economies. Global FDI inflows peaked at more than 4 per cent of GDP in 2000, and the stock of FDI has risen above 20 per cent of GDP. The stock of total outstanding foreign assets now exceeds 180 per cent of global GDP.

Table 3: Trends in global capital flows

	1989	1999	2003
Stock of FDI (% of GDP)	8.0	16.0	22.1
Foreign assets (% of GDP)	62.6	139.6	186.1

Source: IMF, Unctad

The strength of FDI, inter alia, reflects, among other factors, an increase in international investment in service sectors. Between 1970 and 2002, the share of services in world FDI grew from 25 to around 60 percent. Traditionally, most FDI flows have been between developed economies, particularly the US and the EU member states. But in 2003, over 30 per cent of global FDI was targeted at emerging markets.

A small but growing share of outward FDI from the EU has been targeted at China and India (See table 4). Whereas 10 per cent of the EU15's outward investment was targeted at Asian emerging markets², US investment in Asia was considerably higher at 13.7 per cent of total outflows. However, for both inflows to and outflows from EU15, the main trading partners remain the US and other OECD countries.

² Between 2000 and 2003.

Table 4: EU15 Foreign Direct Investments, inflows and outflows: shares by region

Share of total (%)	1995-1999		2000-2003	
	Inflows	Outflows	Inflows	Outflows
US	61.5	50.8	44.0	30.5
Asia:	1.8	6.9	5.1	10.0
- of which China:	0.0	1.2	0.1	1.5
New Member States	n/a	n/a	1.1	5.1
Others	36.7	41.1	49.7	52.9
Total	100	100	100	100
% of EU15 GDP	0.9	2.1	1.5	2.8

Source: Eurostat

Migration has overall been more stable. Annual net migration into the EU15 has remained below 5 persons per 1,000 inhabitants over the past 40 years. It increased in the 1990s, partly because of the legalisation of illegal migrants, but then stabilised again in 2002 and 2003. Around 9 per cent of Europe's population was born outside the EU, compared with 12 per cent in the US and around 20 per cent in Canada and Australia. What is most noteworthy is that Europe, in general, seems to be less successful than the US in integrating migrant workers into the labour market and in attracting high-skilled workers³, both of which are key in respect of fostering the innovative potential of our economies.

Drivers of globalisation

The main drivers of globalisation have been:

- **multilateral trade liberalisation**, which has reduced trade barriers and increased growth potential, providing a significant impetus to globalisation. Successive rounds of multilateral tariff liberalisation have removed some of the barriers to trade in manufacturing goods. Average tariffs fell over the last decades from over 30 per cent, to just over 10 per cent in developing countries; and from 9-10 per cent, to 4 per cent in industrialised countries⁴, whilst substantial financial market liberalisation has been a main driver of capital flows. However, significant barriers remain, including tariff peaks and non-tariff barriers;
- **successful economic reforms in emerging markets, such as China and India, have boosted world output, trade and FDI flows.** Per capita incomes having risen six-fold in China and two-fold in India over the past 30 years. Other Asian economies have also experienced high growth rates. This has driven Asia's increased share of world trade and FDI flows. China's shares of world output, exports and FDI, have risen from 3, 1 and 2 per cent to 13, 6 and 10 per cent respectively, over the last three decades⁵;

³ Trends in Migration, OECD, 2005 and EU Commission's 2005 Annual Economic Review on Globalisation

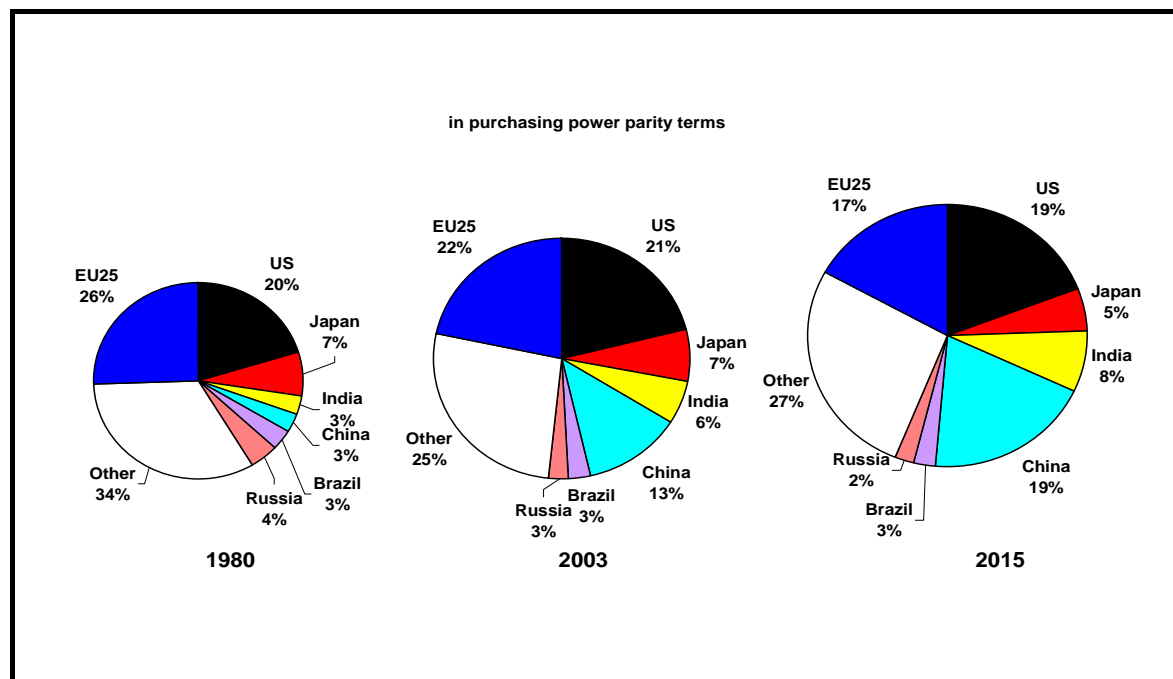
⁴ World Economic Outlook, April 2005 chapter on Globalisation.

⁵ Reference period refers to figures for share of world output and exports only, 1974-2004.

- **technological progress, especially in the fields of ICT and transportation - very often spurred by regulatory reform - has dramatically reduced the costs of trade.** Prices of sea, freight and air transportation; telephone calls; and satellite charges, have fallen (by 21, 30, 95 and 88 per cent respectively) over the last 20 years. This has facilitated new modes of production and supply models for all sectors of the economy, benefiting producers and consumers, as well as encouraging more “traditional” trade in goods. Manufacturing trade in the EU15 has risen from under 40 per cent to nearly 90 per cent of manufacturing GDP over the past 30 years; whilst
- **technology has also eroded the borders between what can and cannot be traded, providing an impetus to trade in services.**

The outlook

Chart 1: Shifting shares in global output, 1980-2015



Note: Areas indicate size of global economy
Source: IMF, Consensus Forecast, HM Treasury

Differences in factor endowments (labour, skills, capital) will be key drivers of change. These drivers are expected to continue to be important factors in the coming years. **China and India are projected to continue to increase their share of global output.** While the EU's share will continue to decline, this will represent a smaller share of a considerably larger total (see Chart 1) and therefore a larger volume than was the case in 1980. China and India now account for 40 per cent of the world's population, and their populations are still growing. Their economies are also continuing to 'catch up' with the EU (with per capita incomes, in terms of purchasing power parity, that are still only 20 and 11 per cent respectively of the EU average). The stronger growth in emerging, transition and developing countries is also likely to be reflected in their energy demand and other commodities: latest estimates suggest that the world's primary energy

demand will rise by 50 per cent over the next 25 years, with more than two thirds of this increased demand coming from developing countries⁶.

The geographical distribution of EU trade and investment is likely to shift further to reflect the changing pattern of global economic activity, with more focus on the emerging markets. EU15 exports to Dynamic Asia⁷ were unchanged as a share of GDP in 2004 from 1995, despite the rapid growth of China and India. This suggests that the EU could draw more benefits from globalisation than they have to date.

The trend towards “intra-industry trade” and off-shoring is also expected to continue, as countries further specialise production, focusing on final and intermediate goods, rather than particular industries. Technological change and deepening economic reforms are likely to drive a further increase in trade in services, particularly through off-shoring. Growing educational attainment in Asian countries, especially English-speaking ones, may also contribute to this trend. Services outsourcing is structurally easier than manufacturing outsourcing in terms of the resources, space and equipment it requires, so it may proceed more quickly⁸. Estimates of the potential effects of outsourcing vary. One study found that 80,000 EU15 service jobs were moved offshore during 2004⁹, and they expect this figure to rise to a cumulative 1.1 million by 2015, with half of the jobs being off-shored from the UK. Another report estimated that 4.1 million jobs will be off-shored from the service sector in developed countries by 2008¹⁰.

Firms, savers and mobile workers will increasingly make decisions about production, investment, studying and work within a global framework, rather than a national one.

⁶ World Energy Outlook 2005, IEA, 2005.

⁷ Hong Kong, China, Korea (Republic of), Singapore, Chinese Taipei, Indonesia, Malaysia, Philippines and Thailand.

⁸ EU Commission's 2005 Annual Economic Review on Globalisation.

⁹ Forrester Inc, Parker (2004).

¹⁰ “The Emerging Global Labour Market”, McKinsey Global Institute (June 2005).

Part 2 – The Impact of Globalisation

The Benefits of Globalisation

Globalisation provides incentives for firms and workers to excel in what they do best while sourcing other goods and services at lower costs on a global scale, providing consumers with substantial benefits. A recent review suggests that 20 per cent of the gains in living standards in EU15 over the last 50 years can be attributed to the EU15s growing integration with the world economy and another 10 per cent may be attributable to growing trade between member states¹¹. These gains are reached through a number of channels:

- **direct benefits for consumers** as reduced barriers to imports increase product variety and provide lower prices;
- **dynamic gains to EU productivity through competition.** Globalisation presses firms to improve performance, forces ailing firms to improve and gives new and innovative firms a chance to enter markets. Lower trade barriers and reduced costs of transportation and telecommunication have also facilitated the delivery of products and services often in areas where this has been prohibitively expensive, introducing competition into previously sheltered parts of the economy;
- **efficiency gains for firms generating higher incomes.** Firms can optimise production through off-shoring or more in-depth vertical integration of production across borders, resulting in lower costs. Reorganising production intelligently can result in substantial cost savings. Firms can also benefit from greater economies of scale and scope through access to larger markets¹²;
- **capital market integration** has fostered the allocation of world savings to more productive and diversified investments thus achieving a higher rate of return for investors;
- **inward foreign direct investment (FDI) benefits EU firms** through technology transfer, skills and managerial know-how, by stimulating competition and innovation, and by providing domestic investment that would not otherwise have been possible. Inward FDI has in particular played an important role in the recent successful economic development of Ireland and many new Member States; and
- **new opportunities for EU firms due to increased demand for EU products from the emerging economies.** Business services directly across borders is now one of the fastest growing trade components, an area where the EU is very successful. Outsourcing of business services to Asia has received perhaps the greatest public attention. However, a number of EU Member States have also been very successful at exporting business and computer services as well as manufacturing goods to the rest of the world.

¹¹ EU Commission's 2005 Annual Economic Review on Globalisation.

¹² "The Emerging Global Labour Market", McKinsey Global Institute (June 2005).

The Challenges of Globalisation

Nonetheless, the benefits of globalisation do not come automatically. **Europe's economies need to be able to move resources, both workers and capital, more swiftly** to alternative uses to take advantage of new opportunities and potential income gains, and minimise adjustment costs.

Labour markets

Globalisation raises three key issues for EU labour markets. The first is in terms of its effect on overall employment. The second is whether EU labour markets allow for a swift adjustment of jobs and activities from contracting to expanding firms, as globalisation implies ongoing restructuring. Third the extent to which increased globalisation with emerging countries with abundant supply of low-skilled workers adversely affects the prospects of low-skilled workers in the EU, either through downward pressure on wages, increased unemployment or lower participation.

In that context, the main challenge for Member States is to implement policies that ensure their economies can adapt quickly. Labour market adjustment is particularly important in ensuring that resources are redeployed swiftly in accordance with new areas of comparative advantage and avoiding short-term or localised concentrations of dislocated workers.

Aggregate employment

The risks to employment as a result of globalisation must be kept in perspective. There is little robust evidence to support the concern that globalisation has already had a marked impact on overall employment levels in Europe. **Most surveys suggest that international trade, has not led to a net reduction of employment** over more than a short period of time, if at all¹³. At the aggregate level, there is no evidence that countries with a higher (increase in the) degree of openness to trade, suffer from a higher (increase in the) rate of unemployment. Indeed, in the case of Ireland, openness to trade has been associated with falling unemployment. For the EU15, trade with Dynamic Asia accelerated in the mid-1990s, broadly coinciding with unemployment rates starting to fall and employment rates increasing, after a long period with weak labour market performance.

The evidence also suggests that trade integration has had only a minor impact on the decline in employment in the sector most affected by trade - namely manufacturing. During the period 1980 to 2000, for example, trade factors are estimated to have accounted for up to 20 per cent of the decline in the share of manufacturing employment in the EU15¹⁴. The remainder of the decline in manufacturing employment is explained by other factors, notably the impact of productivity improvements and the sectoral shift due to higher consumer demand for services. Moreover, the wider decline can be absorbed, to a large extent, through labour market turnover¹⁵. But, it is recognised that the impact may be greater for some Member States that have a higher level of specialisation in traditional manufacturing sectors.

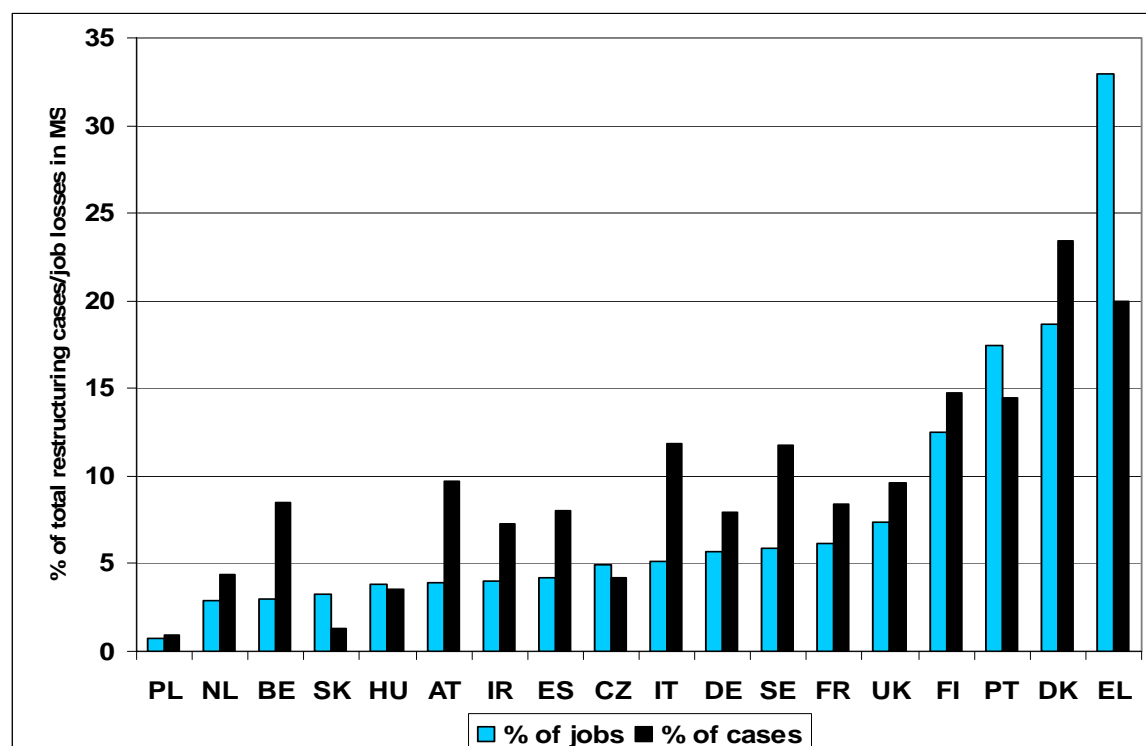
¹³ EU Commission's 2005 Annual Economic Review on Globalisation, 2005.

¹⁴ *Ibid.*

¹⁵ Manufacturing turn-over rates range from 3 to 10 per cent of total manufacturing employment while EU15 manufacturing employment was essentially stable from the mid 1990s to 2001, with a 2-3 per cent annual decrease in subsequent years. The EU's experience mirrors experience in the US, where the general decline in manufacturing employment has largely been managed through attrition rather than displacement.

Similarly, more recent anecdotal evidence covering the period 2002-2005 suggests that only 6 per cent of all EU job losses due to restructuring result from relocation or off-shoring of activities - this figure exceeds 10 per cent in just four countries: Finland, Portugal, Denmark and Greece. Off-shoring was not reported as responsible for any job losses associated with restructuring in Slovenia, Estonia, Lithuania and Luxembourg.

Chart 2: Share of job losses due to relocation/off-shoring in total restructuring, EU Member States, 2002-Spring 2005



Note: Observations ordered by percentage of job losses. The share of job losses due to relocation/off-shoring was zero in Slovenia, Estonia, Lithuania and Luxembourg. No data was available for Cyprus, Malta and Latvia.

Source: European Restructuring Monitor, Commission Services.

Speed of reallocation of labour

One of the key failings of EU labour markets in the context of globalisation is the lack of speed with which displaced workers find new employment. In a global economy of increased specialisation, sectoral composition will change, and the job choices faced by individuals are likely to change. The successful redeployment of labour remains critical to ensuring high levels of employment and alleviating the fear of globalisation, underlining the importance of lifelong learning, and regional and sectoral mobility of workers and wage flexibility to avoid regional pockets of lower employment.

If labour is not redeployed efficiently, the overall economic benefits of outsourcing and off-shoring are much smaller and the adjustment costs much higher for the persons involved. One study estimated that for every US dollar / Euro spent on off-shoring in India, the US recaptures 110 per cent in direct and indirect benefits, whereas France recaptures 85 per cent, and Germany only 73 per cent¹⁶, with much of the difference due to the greater length of time it takes displaced European workers from finding new jobs (see table below). This is also reflected in higher long-term unemployment rates in

¹⁶ "The Emerging Global Labour Market", McKinsey Global Institute (June 2005).

Europe, compared with those in the US¹⁷. As table 5 shows, displaced workers in the EU have a lower probability of finding a new job than those in the US, but those that find alternative employment, see a smaller shortfall in their earnings,

Table 5: Labour market prospects of displaced workers

	EU15* 1994-2001			USA 1979-1999		
%	High Competit ion Manuf.	Total Manuf.	Services	High Competit ion Manuf.	Total Manuf.	Services
Share reemployed two years later	52	57	57	63	65	69
Share with no earnings loss or better	44	46	50	36	35	41
Share with earnings loss of 30% or greater	5	7	8	25	25	21

Notes: Columns relate to 'manufacturing with high international competition'; 'total manufacturing'; and 'services' (including utilities for the USA).

Source: OECD(2005) on basis of the ECHP for EU15 countries (*not including Sweden); Kletzer(2001) for USA on the basis of biannual displaced worker surveys.

Low-skilled workers

Concerns about the prospects of low skilled workers have been voiced in the context of China and India's increased presence in the world economy, given their relatively abundant supplies of cheap and low-skilled labour. The concern is greater in those Member States which have specialised heavily in traditional low skilled manufacturing sectors. **Nonetheless, most, if not all, indicators suggest that the trade-related negative impact on employment and relative wage prospects for low skilled workers has been offset by other factors:**

- between 1998 and 2003 unemployment rates fell, and employment rates rose, more for low-skilled than medium-skilled workers in the EU¹⁸ despite a stabilisation of their relative wages reversing the opposite trend during the 1980s and the first half of the 1990s (low-skilled workers in the US have also seen a stabilisation in their wage levels relative to medium skilled workers)¹⁹; and
- between 1995 and 2000, the share of total wage incomes for the bottom 20 per cent of wage earners stabilised or increased after having fallen, in many countries, during the decade before²⁰.

¹⁷ For example, the proportion of the labour force unemployed for more than 12 months stood at just over 3 per cent in the EU15 in 2004 compared with less than 1 per cent in the US. Source: Employment Outlook (2005) and Groeningen database.

¹⁸ Education at a glance, OECD, 2005.

¹⁹ Top earnings have tended to increase at a faster rate than median earnings particularly in the US. It should be noted that changes in wage levels are influenced not only by globalisation, but also the impact of institutional factors, such as the tax system.

²⁰ Foerster, OECD working paper, 2005. Available data suggests that earnings of the self-employed fell but at a slower pace than in the previous decade. However the data in this area is limited.

A number of factors may be behind this:

- first, a steady increase in educational attainment in the EU implies that the net supply of low skilled workers fell by roughly by 0.75 million per year in the period 1998-2003;
- second, while imports from developing countries used to be biased towards goods produced in the EU mostly by low paid or skilled workers, this is diminishing. Increased educational attainment in Asia, for example, has allowed this region to produce and export a growing number of higher value-added products. As a result, the share of imports of textiles, clothing and footwear (traditionally a low wage sector) has fallen from 27 to 16 per cent between the 1980s and 2003, while the share of ICT imports has risen from 25 to 43 per cent over the same period; and
- labour market reforms during this period have explicitly or implicitly targeted an improvement in the employment prospects of low skilled workers, though such means as strengthened availability criteria, reduced social security contributions, an easing of employment protection legislation particularly for short term contracts, and the introduction of in-work benefits.

However, while there is no strong evidence of a significant overall adverse impact on employment from trade and off-shoring, and the impact on the income distribution has been offset by other factors, **this should not lead to complacency in dealing with the challenges:**

- despite labour market reforms in the 1990s and improvements in educational attainment, the EU is still failing to match displaced workers with new job opportunities;
- there is every reason to assume that emerging economies, such as China and India, will further increase their share in world output and trade in the coming years, implying a continuing need for labour market adjustments. As educational attainment in these countries continues to catch-up with levels in the EU, albeit starting from a very low level²¹, the burden of adjustment will be more broadly shared across industries and skill groups. For example, by 2006, Chinese graduates with a degree in science and engineering will nearly equal EU15 levels, at 8 per cent of new entrants to the workforce²²; and
- increased specialisation, as discussed in Part I, will continue to lead to significant sectoral, and sometimes regional, changes in employment, increasing the need for speeding up industrial adjustment.

This points strongly in the direction of continued labour market reforms, the orientation of which will be discussed in Part III.

Product markets

For product markets, globalisation raises two major challenges: first, the EU needs to address indigenous barriers to business development to ensure European companies

²¹ Average years schooling in Dynamic Asia rose from 4 years to 6 years between 1980 and 2000; but for the EU15 the corresponding figures are 7 and 9 years. For the lowest 4 members it is 6 years and 7 years. Source: Harvard University Center for International Development (2005).

²² EDRC Survey, China, OECD(2005), annex 1A4.

are able to develop and market products and services globally. Second, there is a need to look beyond Europe and examine the framework conditions for exporting to, operating and investing in other countries and address barriers to trade.

While Europe's labour markets have to bear much of the adjustment cost of globalisation, intensified competition increases the challenges facing Europe's product markets and makes the need for reform more urgent.

Rapid advances in technology, and in particular the rate of innovation in information and communication technologies (ICT), are changing the nature of the world economy. According to some indicators, the share of high tech products in total world manufacturing rose from 14 to 28 per cent value added between 1981 and 2000, with many emerging economies now diversifying their exports towards high-tech manufactured goods²³.

The increased importance of innovation, combined with strong growth in emerging markets, suggest two important implications:

- first, traditional patterns of comparative advantage as also underlined in the labour market section are changing with the consequence that previous sources of growth and income in Europe may no longer be sustainable. Recent studies, for example, show that China's market share in EU imports of electronics rose from 5 to almost 20 per cent between 1995 and 2003, and the composition has shifted to higher skilled products. The proportion of high tech manufacturing output in China is already similar to that in the EU at around 20 per cent reflecting the more general trend for exports from Asian emerging economies; and
- second, continued technological progress, not least in ICT, combined with the growth in global supply chains based increasingly on intra firm and intra industry links, is breaking down traditional geographical barriers to economic activity. As a result, the boundary between what can and cannot be traded is being steadily eroded, and many companies can no longer rely solely on local or national markets as key sources of revenue, but to international or global markets instead, this applies particularly to small and medium sized businesses. Increased competition may also prompt small and medium sized firms (SMEs) to establish innovation clusters and networks to enable them to compete on a par with larger firms²⁴.

It is these developments that provide the backdrop to policy development, at the national, European and global level. There are two broad consequences.

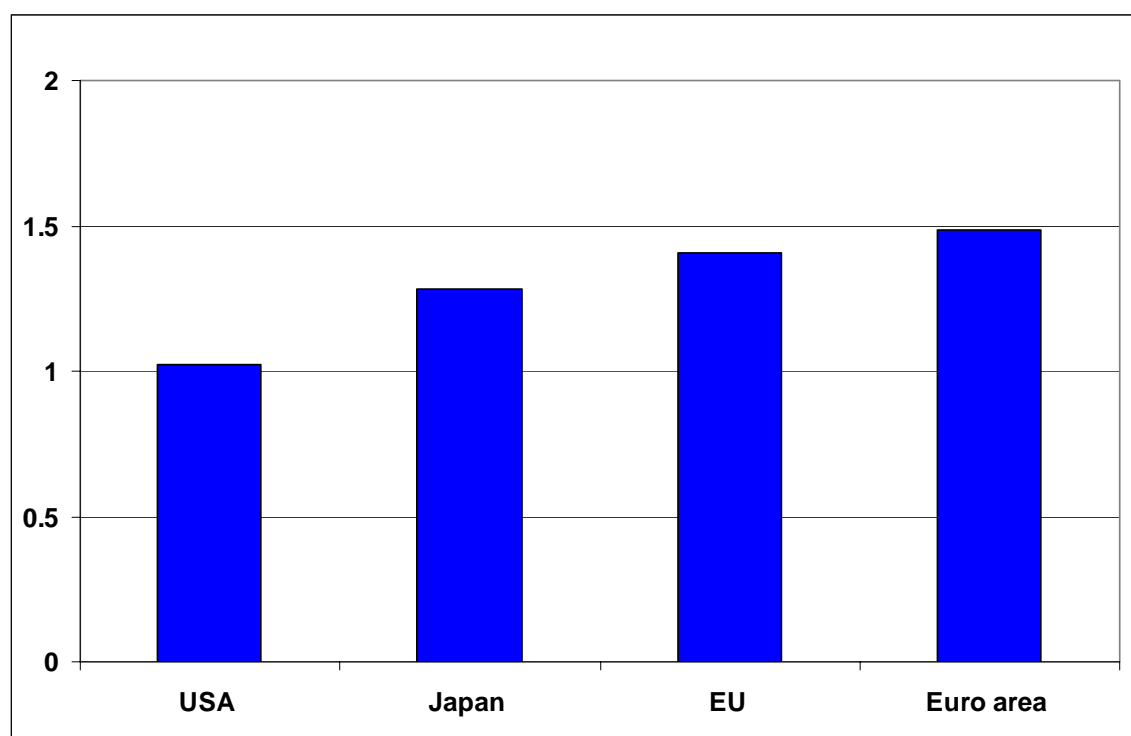
First, as cited above, **there is an urgent need for Europe to address indigenous barriers to business development and ensure that European companies are able successfully to develop and market their products and services globally.** The establishment of supportive framework conditions in Europe, which promote business investment and efficiency, is crucial in this respect. And the evidence suggests there is considerable room for improvement:

²³ Moreover, India's software industry saw increases in employment and revenues of between 30 and 40 per cent in the last decade.

²⁴ See OECD, 2004, Facilitating SMEs access to international markets, 2nd OECD Conference of Ministers responsible for small and medium size enterprises, Istanbul, Turkey.

- for example, the US leads Europe on nine out of eleven input and output performance indicators²⁵, including patenting, business R&D expenditure, tertiary education and early and expansion stage venture capital;
- levels of enterprise in Europe are low by key international standards. The cost and time taken to start a business in many Member States compares unfavourably with the US, while surveys also indicate more favourable public attitudes to entrepreneurial activity in the US than EU²⁶;
- levels of intra-EU competition - a key driver of efficiency and innovation - remain sub-optimal. Increasing competition within the euro area to US levels could boost output by over 12 per cent²⁷; and
- overall levels of product market regulation in Europe remain substantially above those in the US or Japan (see Chart 3 below).

Chart 3: Overall product market regulation, 2003



Notes: a lower value implies a less restrictive level of regulation (on a scale of 0-6). EU is EU19 – does not include Estonia, Slovenia, Latvia, Lithuania, Cyprus and Malta.

Source: Product market regulation in OECD countries: 1998 to 2003, WP, OECD, 2005.

Second, there is a need to look beyond Europe and examine the framework conditions for exporting to, operating and investing in other countries:

- the counterpart to emerging countries challenging European firms in ever more sectors as they catch up on productivity is that consumers in these countries will

²⁵ 'European Innovation Scoreboard 2004: Comparative Analysis Of Innovation Performance', Commission Staff Working Paper, Brussels, 19 November 2004.

²⁶ See, for example, Flash Eurobarometer n° 160: Entrepreneurship. Survey conducted on behalf of The European Commission, Directorate-General Enterprise and Industry by EOS Gallup Europe, Survey: April 2004. Analytical Report: June 2004.

²⁷ Bayoumi, T; Laxton, D & Pesenti, P: 'Benefits and spillovers of greater competition in Europe: a macroeconomic assessment', European Central Bank working paper series, No 341.

increasingly buy the kind of products EU firms are producing, making access to these markets increasingly important;

- furthermore, with trade patterns becoming more orientated towards a global supply chain structure, it become increasingly important for the involved firms that they have justified confidence in the quality of regulation in host countries in such areas as protection of property rights, transparency in financial markets, fair and swift judicial systems; and
- the upshot is that the trade policy and international co-operation agenda of the EU increasingly must be focused on market access to the rapidly growing economies and that broader economic and regulatory issues will need to be tackled in addition to more traditional issues such as tariff reductions and increased formal market access.

Public finances

The higher mobility of capital, firms and labour associated with globalisation could potentially put pressure on the public finances, in relation to both tax and expenditure, for example, if firms avoid locating in high tax countries or trade adversely affects distributional objectives.

However, looking across EU countries there is little evidence of significant pressure. Tax is only one minor element in the choice of location for companies²⁸, and taxes also finance expenditure that boost local productivity. The overall tax take as a per cent of GDP, adjusted for cyclical factors, is roughly unchanged over the last 5 to 10 years in EU countries. Member States' performance in relation to fiscal sustainability varies.

EU corporate tax rates have been reduced considerably over the last decade - on average from 38 per cent in 1995 to 31.4 per cent in 2004²⁹ – but financed largely by base broadening³⁰ as also evidenced by the overall increase in the corporate taxes as a per cent of GDP over the same period (see chart below³¹). The reductions have been motivated as much by a desire to reduce distortions within the tax systems, as a factor aimed at attracting companies by lowering statutory rates. It should be noted that companies are not only liable to corporation tax but may also be liable to, local and property taxes. However, liability to these taxes differs between individual Member States, as do the revenues raised as a per cent of GDP.

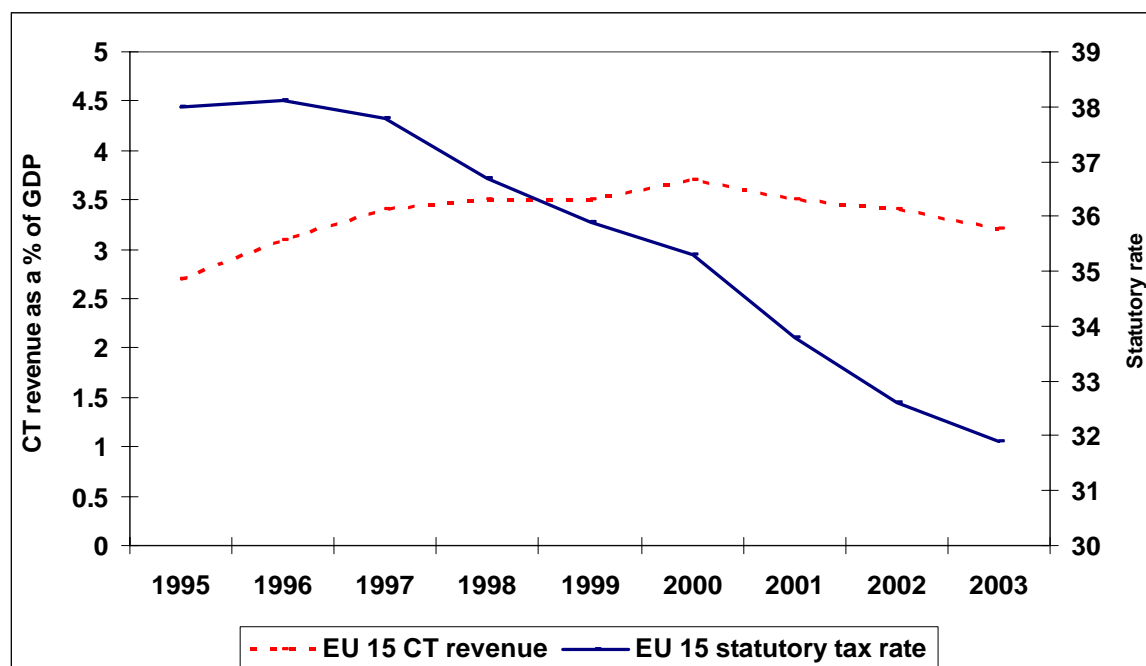
²⁸ Study by Agoria Panel (Belgian Manufacturers' Federation). Federation of German Industries believe that overall tax burden, tax stability and the simplicity of the tax system may be more important factors than tax rates. (BDI, 'Die Steuerbelastung der Unternehmen in Deutschland', September 2004).

²⁹ EU15 effective top statutory rate, 1995-2004. Source: Eurostat 'Structures of taxation systems in the EU'

³⁰ See for example "Recent Tax Policy Trends and Reforms in OECD countries", OECD, 2004.

³¹ Other factors such as GDP growth, falling wage shares and record profits for firms may also have contributed to this development.

Chart 4: Evidence of base broadening and rate cutting



Sources: "Structures of Taxation Systems In The EU 1995-2003"; Eurostat, October 2005; and "OECD Revenue Statistics 1965-2003"; OECD, October 2005.

The reduction of top marginal income tax rates in the EU countries since the 1980s has been financed largely by base broadening. A number of EU countries, typically with high tax rates, have established specific regimes for expatriates to attract highly qualified persons³², but so far with relatively low overall budgetary costs.

The risk that trade with low wage countries could give rise to increasing unemployment for low skilled workers has so far been limited overall, though workers in certain sectors have been strongly affected as discussed in the labour market section above. This could increase pressure on public finances if there was increased use of budgetary instruments, such as in-work benefits, or targeted reductions in social security benefits for low-wage workers. In line with the analysis above, however, this is not expected to be a significant pressure.

While there is no clear evidence so far that pressures on public finances have been a major issue in the context of increased globalisation, prudence is called for. As discussed in Part III, preserving a certain welfare level in the EU implies a need for higher tax revenues (including social security contributions) than in the US or Asia, although the exact level of public spending will reflect national preferences. Increasing support for priorities, such as innovation, provides an additional motivation for a more efficient use of public funds to avoid further tax rises. Moreover, efforts should be strengthened to ensure that the use of obviously distortionary instruments to attract investment is discouraged within the EU and globally as discussed in Part III.

³² Trends in Migration, OECD, 2005.

Part 3 - Policy Responses to Globalisation

Introduction

Globalisation raises both policy challenges and opportunities for Europe's policy makers. Parts I and II of this report showed that the rapid integration of the emerging economies into the new global economy has the potential to generate new sources of wealth. However, in order to fully reap these benefits, European economies must adapt more rapidly to technological and market changes, to minimise adjustment costs, recognising that there are time lags between implementation of policies and their results.

The challenge for EU policy makers is two-fold 1) communicate clearer the tangible benefits and opportunities of globalisation to Europe's citizens 2) implement at the same time policies that address citizens real and perceived concerns about the risks associated with globalisation and equip their economies to adapt to change. The achievement of these two objectives is essential for fostering public support for reforms and helping to defuse protectionist tendencies. However, the private sector also has a crucial role to play in coping with the challenges of globalisation, for example employability is the responsibility not only of governments but also individual firms and workers, and the social partners.

The re-launched Lisbon Strategy, with its renewed focus on growth and employment, is intended to give renewed momentum to reform within Member States and at the Community level. The updated Broad Economic Policy Guidelines, as reflected in the Integrated Guidelines, identify the right reform priorities in the main areas where Member States and the Community as a whole need to increase their adaptability in response to globalisation, whilst taking into account the need for policies to vary reflecting the different circumstances, starting points and factor endowments of individual Member States. Member States that have made better progress in implementing the BEPGs over the last few years appear to be the best placed to respond to the challenges of globalisation.

Growth and Stability Orientated Macroeconomic Framework to Underpin Reform

The BEPGs rightly underline the importance of a stable macroeconomic framework as a vital foundation for growth and employment creation in a global economy. Indeed, the realisation of current growth potential and to raise growth potential over time, is best achieved through growth- and stability-orientated macroeconomic policies and comprehensive structural reforms. A favourable macroeconomic environment contributes to a dynamic economy, and experience shows that this makes structural adjustment swifter. A stable macroeconomic framework which underpins growth, along with sustainable public finances fosters well functioning financial markets. It also helps to keep interest rates low and encourages private investment, by increasing access for firms to low-cost credit that is needed to finance restructuring and modernisation.

In an era of globalisation, where production factors and financial flows, are becoming more mobile, a growth and stability orientated macroeconomic framework helps to attract businesses and foreign investment. It also strengthens the robustness of economies putting them in a stronger position to adjust to a changing world, for example, from fluctuations in real exchange rates and sudden changes in external demand.

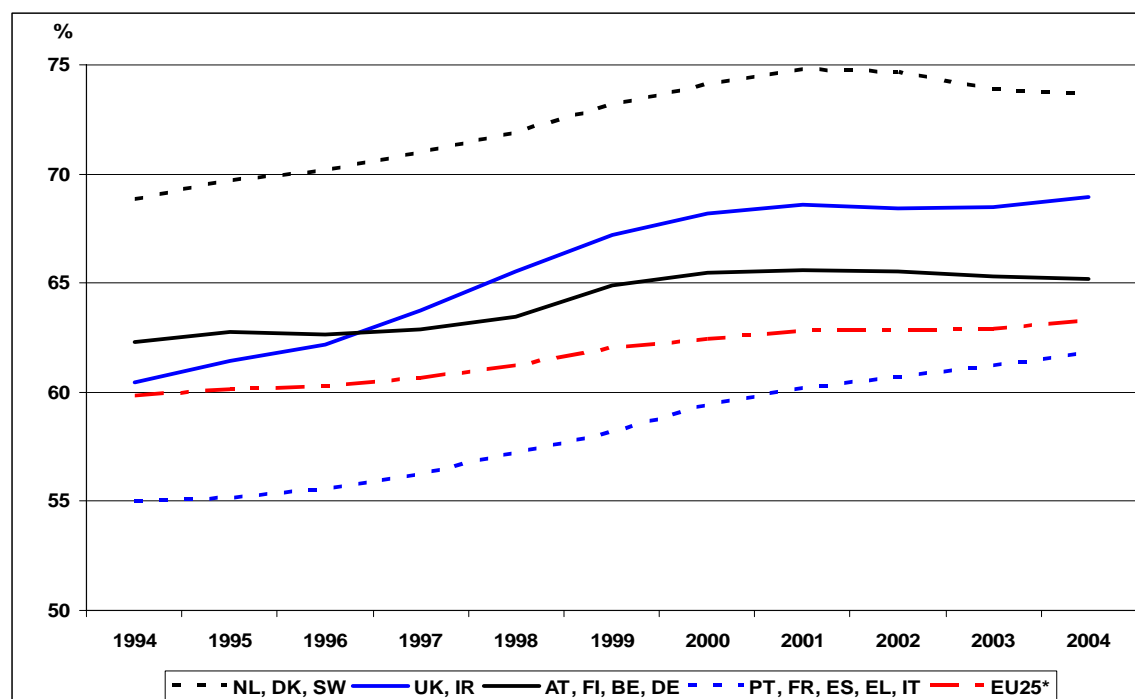
Labour Market Reform

Globalisation affects labour markets through the international division of labour. As discussed in Part II, benefits come from consumers and firms sourcing cheaper goods and services from abroad, while shifting workers from contracting industries that are no longer competitive, to expanding firms and sectors. However, Part II identified as a challenge the need for a swifter and less costly adjustment process for the firms and workers involved.

Delivering this requires continued labour market reforms and to promote policies to increase flexibility and that continually equip workers with updated skills to ensure their employability and adaptability to participate and progress in the labour market. Social welfare systems need to continue to be modernised so they can better manage the social consequences of technological and market changes. A successful EU will be characterised by its ability to change without experiencing long-lasting increases in unemployment or withdrawals from the labour force.

However, Europe is not confronting these challenges from a favourable economic position due to persistent under-performance in its labour markets, particularly in respect of employment and unemployment levels³³. While the evidence in Part II clearly suggest that lack of employment is not substantially linked to globalisation, the challenges ahead remain real, and public perception of these challenges can fuel resistance to open borders. This only adds to the urgency of moving forward on labour market reform.

Chart 5: Employment rates in selected EU countries



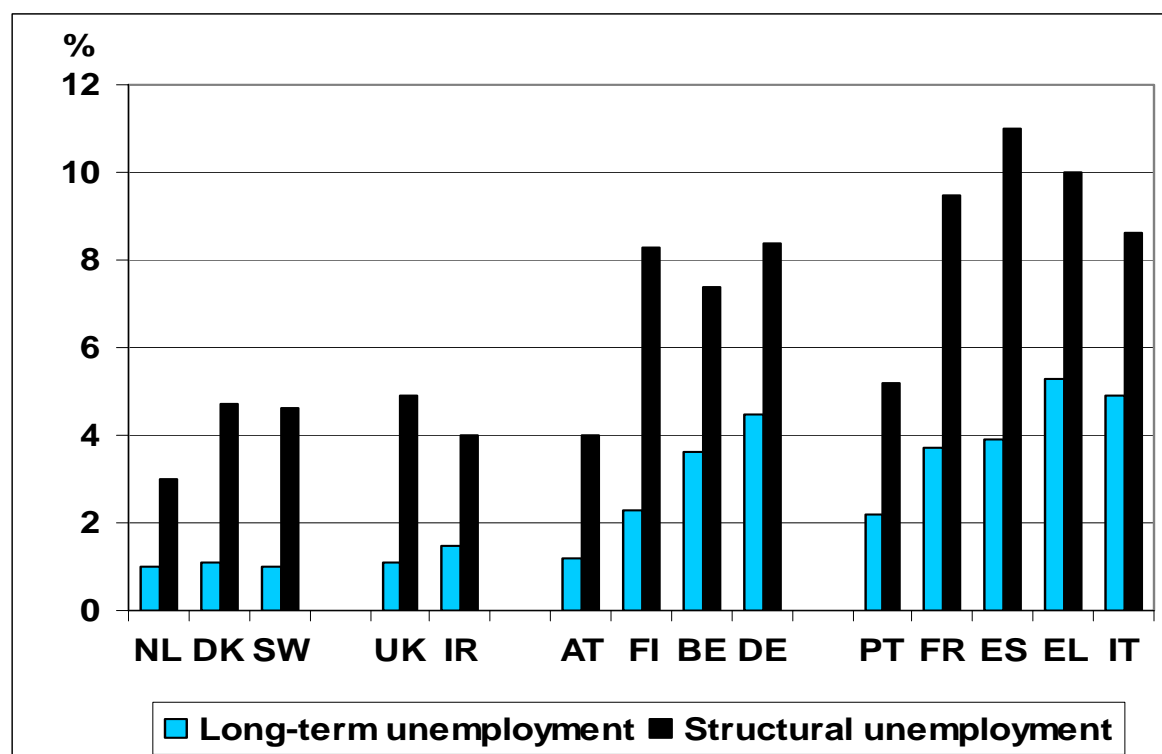
Note: Data point is the average of the employment rate for each country in the grouping, in each year. *For reasons of data unavailability, this series is EU15 countries for 1994-1996, EU25 from 1997 onwards.
Source: Eurostat, *Employment in Europe 2005*.

Experience over the last decade shows that structural reform policies in line with the recommendations of the Broad Economic Policy Guidelines and tailored to national circumstances have been successful in increasing employment rates (see Chart 5) and

³³ OECD, *Economic Policy Reforms: Going for Growth*, March 2005.

reducing unemployment (see Chart 6). EU15 employment rates increased and some Member States, such as Spain, Ireland, Italy and Greece, experienced rapid employment growth as they continued to close the gap with other Member States. Finland has also seen large and sustained growth of employment rates since the recession in the early 1990s.

Chart 6: Structural and long-term unemployment in the EU, 2003



Notes: 1, The measure for structural unemployment is Eurostat's Non-accelerating wage rate of unemployment (NAWRU) series on the basis of agreed EPC methodology. Long-term unemployment is defined as the share of the labour force unemployed for 12 months or more.

2, Calculation for Spain does not take account of updates to national accounts and employment data. A revised calculation is under way and initial results yield a lower structural unemployment.

Source: OECD and Eurostat

Unemployment has also fallen or remained low, over the last decade with a number of countries achieving both structural and long-term unemployment rates at US levels (Sweden, Netherlands, Ireland, UK, Denmark, and Austria) (see chart 6). At the same time, other member states have seen a significant reduction in overall and/or structural unemployment rates over this period, such as Spain and Finland.

However, the EU as a whole has performed less well - despite the reforms mentioned above - . Employment growth has slowed over the past three years to only 0.65 per cent in 2004 compared with 1.1 per cent in the US, with the EU25 employment rate at 63.3 per cent in 2004, well below the Lisbon target for 2010 of 70 per cent. EU unemployment is also high, at 9 per cent and totalling nearly 19.5 million. Long-term unemployment exceeds 4 per cent of the labour force, and there are 92 million inactive people of working age across the EU25³⁴.

As Member States have faced many of the same external challenges from globalisation, their varied performance in terms of structural and long-term unemployment can provide

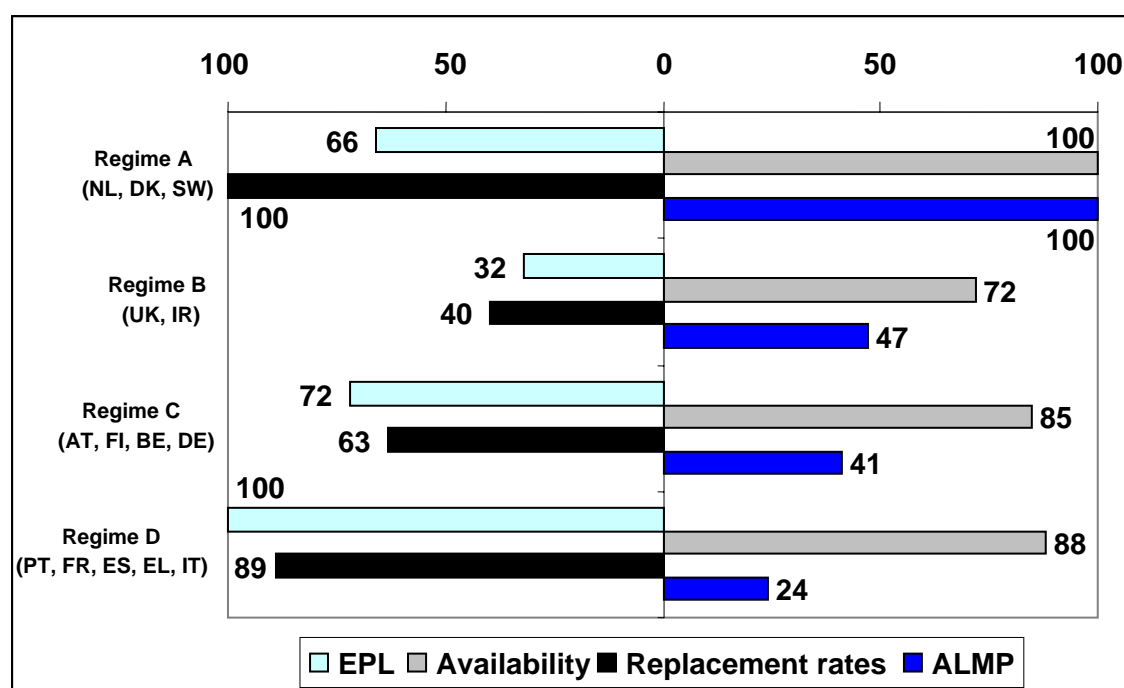
³⁴ Employment in Europe 2005, European Commission.

a useful guide as to what mix of labour market policies have worked best in practice. The framework for analysing the trade-offs is based upon four key parameters and recommendations in the Broad Economic Policy Guidelines on labour markets.

- (Group A) Sweden/Netherlands/Denmark are characterised by relatively low to medium levels of employment protection legislation (EPL), high active labour market policies (ALMP), high availability requirements and high compensation for unemployment (particularly for low wage earners).
- (Group B) UK/Ireland are characterised by low EPL, low ALMP, low replacement rates and low availability requirements.
- (Group C) – Finland/Belgium/Germany are characterised by medium levels of EPL, availability requirement, replacement rates and spending on ALMP. Austria is close to The Group C countries on EPL and has low ALMP, but has high availability requirements (like group A) and lower replacement rates (like group B).
- (Group D) – Spain/France/Greece are characterised by high EPL, medium availability requirements and replacement rates, and low ALMP. Portugal is mainly in this group but differs by having high availability requirements, while Italy now has medium EPL.

Due to limited availability of data for EU25 the analysis is restricted to EU15 Member States, but the conclusions should be generally applicable to the New Member States³⁵.

Chart 7: Characteristics of labour market policy regimes



Note: The regime indices are calculated using a simple average of the indicators covering the given countries' labour market policies. For each indicator, '100' denotes the regime with the highest score on the given indicator. The data are based upon values in 2003. Availability requirements are based upon a survey from Danish Ministry of Finance from 2004

Source: OECD secretariat database of labour market structural indicators.

³⁵ "Key structural challenges in the acceding countries: The integration of the acceding countries into the Community's economic policy coordination processes", occasional paper no.4; Economic Policy Committee, July 2003.

The analysis above shows that different packages (Groups A & B plus Austria) can lead to low unemployment and a short duration of unemployment, so no single “social” model is right. High benefit levels (relative to previous salary) reduce work incentives and raise structural unemployment. But, the analysis shows high benefit levels can be combined with low unemployment, if accompanied by strict enforcement of eligibility rules, active labour market efforts and flexible hiring and firing rules. Member States with very strict employment protection legislation experience higher than average unemployment rates and employment rates well below 70 per cent, as it protects the wage bargaining power of those already in the labour market and decreases employers’ willingness to hire, particularly the young, old or long-term unemployed. This can lead to segmentation in the labour market and exacerbate problems of ‘insiders’ and ‘outsiders’.

The challenge for Member States is to choose a package of measures and incentives, consistent with employment creation and facilitating structural adjustment. The package should be tailored to national circumstances and preferences in terms of income distribution, tax and spending levels, and the design of labour market rights, but there are constraints. Low unemployment cannot be combined with strict employment protection legislation, high compensation, low availability requirements and only limited efforts to guide and train people back to work.

Member States need to focus on labour market reforms which **combine increased flexibility with fairness**. This involves further structural reform to extend opportunity for all and equip individuals to move swiftly between jobs, helping to ensure high and stable levels of employment and participation. In line with recent OECD recommendations, labour market institutions must be flexible enough to help reduce adjustment costs, but such flexibility must also be applied in the context of fair labour rights, that neither increase unemployment nor protect labour market insiders at the expense of outsiders. Crucially, the focus should be on equipping individuals to deal with necessary change, rather than on distortive and costly support for industries in decline, which can only postpone the necessary adjustment³⁶. Action is needed in five key areas:

- **renewing impetus in tax and benefit reforms to improve incentives and make work pay.** This is as true for workers entering the labour market for the first time as it is for those seeking re-employment as a consequence of economic restructuring. Further progress by strengthening the availability requirement of benefits is being proposed in four member states (DE, DK, FI and UK)³⁷;
- **equipping employees with the skills to move to higher value-added activities.** Trade displaced workers often possess obsolete skills and require support to acquire new skills and hence new employment. Such support is most effectively embedded in a general labour market framework which targets the obstacles the individual worker is facing in regaining a job in terms of skills and employment, rather than why the worker was displaced in the first place³⁸. Similarly, education and lifelong learning policies have a key role to play in addressing the challenges of globalisation in the longer-term, since highly skilled workers tend to have relatively high job-to-job transition rates and are more mobile across occupations, industries and regions. The vast majority of member states are trying to improve quality of education and vocational training, often focusing on improving outcomes rather than increasing the already considerable budgetary resources committed³⁹;

³⁶ “Trade and industrial Adjustment”, OECD, 2005.

³⁷ Taken from 2005 National Reform Programmes.

³⁸ “Employment Outlook 2005”, OECD; EDRC USA study; “Trade and Industrial Adjustment”, OECD, 2005

³⁹ Taken from 2005 National Reform Programmes.

- **active labour market policies** should target the obstacles that prevent people from gaining employment and so facilitate an acceptance and awareness of change. To be effective they should be targeted carefully at particular disadvantaged groups or barriers to work;
- **ensuring employment protection legislation is well designed**, so that it does not increase the risk and duration of long-term unemployment by making employers reluctant to fill vacancies. Poorly designed or overly strict EPL creates negative incentives, as workers are less willing to change employer, slowing down the necessary reforms. It may also impede firm creation and expansion, preventing the full realisation of the benefits of globalisation. There is also some evidence that workers perceive strict employment protection legislation as a weak instrument against job losses (a high level of EPL is correlated with a high number of people expressing fear for their jobs in surveys)⁴⁰. A number of countries with medium or high EPL have in 2004 and 2005 either implemented, or committed to implementing an easing of such provisions (CZ, DE, ES, IT, NL, PT and FR)⁴¹; and
- **ensuring sufficient flexibility at regional and sectoral level, for example wage negotiations and increased labour mobility**, to enable a better match between labour costs and labour productivity across regions and sectors. Globalisation requires efficient and realistic wage formation behaviour, which implies an important role for the private sector.

In choosing a package of policies **Member States must consider the fiscal sustainability of the overall labour market and social models** (bearing in mind that fiscal positions are already under considerable pressure in some Member States). To maximise the benefits of globalisation and minimise insecurities, Member States need efficient and sustainable social models that facilitate adjustment to change. There are budgetary implications to consider:

- Improving overall employment rates and especially the employment rate of older workers, young people and women, and reforms to encourage the fiscal sustainability of pensions are important for maintaining the affordability of welfare systems;
- Low employment rates and high rates of unemployment place a very high fiscal burden on Member States in terms of the cost of social security expenditure. It also results in lost productive potential for Member States' economies;
- Unemployment can be reduced and employment raised by Active Labour Market Policies, but these can also be costly, so design features are very important; and
- The costs of unemployment benefits can be reduced through tighter conditionality rules, as the unemployed are encouraged to seek work and take an available job.

Product Market Reforms

Increasing globalisation and rapid technological change mean the challenge for Europe is to ensure that it has the right framework conditions in place that allow enterprise and innovation to flourish, and that increase the attractiveness of Europe as a global destination for economic activity including FDI. Part II highlighted two main consequences: the need to address barriers to trade and business development within

⁴⁰ "Employment Outlook 2004", OECD.

⁴¹ Taken from 2005 National Reform Programmes.

the EU; and the need to look beyond Europe and to tackle the barriers to external trade and investment. This section draws three main policy conclusions:

- first, further action is needed to extend and complete the Single Market, particularly in services;
- second, urgent and ambitious agreements are needed to address the barriers to open markets globally; and
- third, continued steps are needed to improve the climate for business development, innovation and growth in Europe.

Completing the Single Market

The EU needs to complete the Single Market in goods, services, labour and capital. The Single Market already allows firms benefit from economies of scale, and trade freely across borders, unhampered by 25 different sets of regulations and product standards. The Commission estimates that over the past ten years, the Single Market has created around 2.5 million jobs and generated around €5,700 per household⁴².

A genuine **Single Market in Services** has the potential to deliver further gains, through greater productivity, increased employment, higher real wages, cheaper prices and more variety for consumers in all Member States. As explained in Part I, the service sector is increasingly important in the EU economy, making it imperative to reduce barriers to trade in services, promoting a fully operational internal market of services, while preserving the European social model. The services sector now accounts for around 70 per cent of EU employment and gross value-added, but only 20 per cent of intra-EU trade. Estimates have suggested that the removal of national regulatory barriers could increase trade in commercial services by between 15 and 30 per cent⁴³. Looking forward, agreement on the legislative steps to establish a single market in services has the potential to make a significant contribution to realising these goals. A recent study has suggested that economic benefits to consumers from removing barriers to trade in services would total €37 billion and net employment in the EU would rise by some 600,000⁴⁴.

An **integrated EU financial services market** would also bring considerable benefits to the EU as a whole, reducing the cost of capital, providing firms with increased opportunities to access markets, and giving customers access to a wide range of competitively priced products. Building on the Financial Services Action Plan, action should now focus on the effective implementation and enforcement of EU legislation, including through regulatory alternatives, ensuring the Lamfalussy arrangements work well, and joint working with financial centres outside the EU. Small firms and entrepreneurs are likely to bear the brunt of regulatory barriers increasing the costs of capital.

Alongside legislative action to establish an open and dynamic Single Market, the EU needs to ensure the benefits of open markets are translated into real productivity improvements on the ground. The OECD estimates that restricted competition could be reducing productivity by over 10 per cent in some EU markets. The focus should be on:

- joint working by the Commission and Member States to improve the implementation of existing market-opening legislation;

⁴² The internal market – ten years without frontiers, European Commission, 2003.

⁴³ The Free movement of Services within the EU, CPB, 2004.

⁴⁴ Economic assessment of the Barriers to the Internal Market for Services, Copenhagen Economics, 2005.

- active use of competition policy to continue to ensure a level playing field for firms in the EU with selective screening of markets and regulations by competition and regulatory authorities in order to identify and remove obstacles to competition and market entry. Including through the use of sectoral enquiries, aimed at removing existing impediments to competition and preventing incumbents from raising new barriers;
- ensuring effective control of national state aids, because sheltering businesses from competition will not equip them to deal with the rigours of international competition. The EU state aid regime should prevent distortive aids and a subsidy race between regions, whilst encouraging growth and employment in the least-developed areas. Member States have a responsibility to use state aid effectively and efficiently, ensuring value for money; and
- remove the regulatory barriers that prevent the development of a strong and coherent infrastructure across EU borders, that facilitates business transactions, trade, and knowledge transfer within the Single Market, promoting growth. Public-private partnerships that involve the private sector can be used to build up infrastructures effectively.

Removing External barriers to trade and investment

The new opportunities of globalisation mean the EU must also look to maximise the benefits from the free movement of goods and services across its borders through greater external trade liberalisation. Trade liberalisation has the potential to deliver benefits on a similar scale. Estimates suggest that existing barriers, such as tariffs, quotas and restrictive standards could cost Europe's consumers up to 7 per cent of EU GDP, or around €600-700 billion a year⁴⁵. Greater openness to trade is needed to boost Europe's growth and productivity. The dynamic effects of openness derive from exposure to imports as well as from opportunities to export.

Although many barriers to trade have fallen over the years, the EU stands to win from the further multilateral opening of markets. As regards the cost of barriers to EU imports it has been estimated that the cost of safeguarding employment in the EU's 22 most protected sectors is eleven times the average wage – 244,000 jobs were saved (only 3 per cent of employment in these sectors), at an average consumer cost of €211,000 per job each year⁴⁶. Barriers to trade are often aimed at encouraging investment, or safeguarding employment in specific sectors. But providing shelter from international competitors is typically inefficient, costly, and provides weak incentives to improve productivity. The impact is often greatest on the poorest consumers, with the heaviest costs of protection tending to fall on necessities of life such as food, clothing and footwear.

⁴⁵ Messerlin (2001) 'The real cost of European protectionism', Institut d'Etudes Politiques de Paris. "Trade and Industrial Adjustment", OECD, 2005

⁴⁶ Messerlin, *ibid.*

Table 6: EU tariffs on selected products, 2005

%	Average MFN* rate	Maximum rate
Cereals	14.0	15.2
Meat	11.2	12.1
Dairy products	9.7	10.3
Other agriculture	8.9	179.7
Food products	19.5	236.4
Tobacco	47.3	81.9
Clothing	11.6	13.0
Footwear	7.4	17.0

Note: MFN - 'most favoured nation', the standard tariff rate faced by those exporting goods in to the EU.

Source: "Liberalisation and Globalisation: maximising the benefits of international trade and investment"; UK Department of Trade and Industry (2004); Economics paper No10; first published in 2004 but data current for 2005.

An ambitious multilateral trade deal would be one of the most effective ways to generate economic growth, create potential for development and raise living standards across the world. This requires substantial reductions in trade-distorting subsidies, including the elimination of agricultural export subsidies, significant increases in market access for developing countries, especially in agriculture, effective special and differential treatment, and opportunities for expanded trade in services.

Europe should also tackle the barriers to trade and investment flows and other shared economic challenges (including environmental and social) with its most significant economic partners, including India, China and the US, that are not usually dealt with through multilateral channels - including regulatory co-operation for example on competition policies, financial markets integration and energy policies. A recent study showed that if the EU and US together reduced regulatory and other barriers to international trade, investment and competition to best practice levels, this could permanently increase per capita GDP by up to 3 ½ per cent in the EU and 3 per cent in the US, or up to a full year's worth of earnings over an average working life⁴⁷.

In addition, enhanced regulatory cooperation and a more forward-looking dialogue on financial markets regulation could help financial markets to remain competitive and efficient, supporting their contribution to growth and job creation in the new global economy. The EU should work to realise these potential economic benefits by strengthening our relationships with our most important economic partners, including through closer economic cooperation on regulation, stimulating open and competitive financial markets and innovation⁴⁸.

The EU's strategy in dealing with CO₂ emissions must also increasingly reflect the shift of global energy demand in the direction of emerging economies, which makes it even more important to put in place global and bilateral commitments to tackle energy efficiency and to use market based instruments to achieve this goal.

⁴⁷ The Benefits of Liberalising Product Markets and Reducing Trade Barriers to International Trade and Investment: The Case for the United States and the European Union. – OECD May 2005.

⁴⁸ The Commission will update Finance Ministers in the run up to the 2006 EU-US summit.

Improving the Business Environment

It is first and foremost the role of private firms to develop the entrepreneurial attitude which is necessary to benefit from increasing export possibilities and, more generally, from the potential gains from globalisation. Nonetheless, there are clear challenges for policy makers in promoting enterprise, better regulation and raising innovative capacity, as described below.

Promoting Enterprise

Evidence suggests that Europe's entrepreneurial potential remains greatly untapped, with levels of business start-ups far below those in the US and China. Member States and the EU need to develop measures to promote enterprise, in particular by improving access to finance, and overcoming regulatory, cultural and social barriers and implementing policies that allow SMEs to grow. In addition, the Community should focus its resources on tackling the barriers to finance and increasing provision of risk capital, particularly for start-ups.

Better Regulation

Better regulation that reduces the burdens on business and improves the regulatory environment for companies and their staff is vital for enhancing the competitiveness of EU businesses and ensuring EU firms are able to respond efficiently to globalisation, moving resources swiftly from declining to expanding areas of economic activity⁴⁹. The purpose is not to encourage growth at the costs of other objectives. However, badly developed regulation doesn't achieve its objectives and can have damaging consequences for jobs and growth. Better regulation is therefore key to improving the efficiency of regulation, which often results in both improved regulatory outcomes alongside a more competitive business environment. SMEs in particular are likely to benefit from an improved regulatory framework.

Despite recent progress, overall EU product market regulation is higher than in the US or Japan, (as noted in Chart 3, Part II). A review of these regulations is needed to suppress those that are restricting competition. Further action is needed to reduce the burden of EU regulation, which accounts for around 50 per cent of regulation with significant impact on business in many Member States. Welcome progress has been made, including the development and piloting of an EU methodology for measuring the administrative cost of regulation, including competitiveness testing in impact assessments, and the Commission's commitment to withdraw 68 items of pending legislation. According to the OECD, improvements in the regulatory regime could increase productivity levels by up to 6 per cent in many EU economies. Further action is needed to reduce the burdens on business and competitiveness imposed by EU regulation, building on and extending the progress already made.

Raising the EU's Innovative Capacity

In a global economy, the EU needs to push forward the boundaries of technology through more effective research and development, encouraging new and high-growth innovative companies. Finally it is up to individual firms to develop the entrepreneurial attitude which is necessary to benefit from increasing export possibilities. But, the EU

⁴⁹ 'Trade and Structural Adjustment', OECD, 2005.

lags behind the US on nine of the eleven key (input and output) measures of innovation and, as explained in Part II, the educational attainment for new workers in the emerging economies are approaching EU levels and their specialisation tends to be more business orientated. Many EU countries spend more on education than the US or emerging economies, yet this is not reflected in quality (a number of emerging economies perform better in international tests scores).

A number of the emerging countries in Asia have R&D spending at or above EU levels, with a much higher share of funding coming from the private sector, probably reflecting improvements in their framework conditions and their rapidly expanding supply of graduates in science and engineering. The lack of supply of high skilled researchers is already a constraint on business innovation in EU. The potential for increasing entry of high skilled labour in to the EU should be explored, especially in light of the poor performance relative to the US discussed in Part I; but the supply problem can only realistically be resolved by increased production of graduates within the EU.

The challenges for the EU are clear. Globalisation makes further reforms of pensions and labour markets more important as an ageing population will increase the pressure for higher spending and consume a higher proportion of tax revenues leaving less room for spending in areas that are vital for improving Europe's global competitiveness such as innovation and R&D.

Beyond creating the fiscal room for manoeuvre to sustain and increase public budgetary support for R&D and other potentially productivity enhancing expenditures, Member States and the EU must:

- improve framework conditions by refocusing and improving the delivery of support for R&D, including by rewarding excellence at national level and EU level, and through better governance structures that support improved links and collaboration between science and industry and increase potential output from R&D spending through strengthening the framework for commercialisation of output and diffusion of innovation;
- ensure that national education and training strategies address the skills needs of innovative and high-tech businesses, including by, focusing on more autonomous management of institutions combined with more rigorous evaluation and accountability of results, enhancing quality of education and increasing the supply of graduates in science and engineering⁵⁰; and
- strengthen the international character of innovation systems by fostering the mobility of students, researchers and recognising the need for more co-operation across borders to achieve economics of scale, division of labour and more healthy competition also among public institutions.

⁵⁰ See also "Education Policy Analysis, 2003", OECD, Paris and "Governance of Public Research, towards better practices", OECD, 2003.