# COMPETITIVENESS TEST AND BETTER REGULATION

## HIGHLIGHTS NOTE 22

- **This Highlights Note focuses on the main issues that should be included in a revised Competitiveness Test for existing and future interventions at EU-level.**
- **Using a modern definition of economic competitiveness and drawing on research by ERIF and the OECD, the Note suggests a new Competitiveness Test based on four dimensions: (1) Allocation of capital; (2) Framework conditions for innovation; (3) Diversion of resources; and (4) Policy design for structural adjustment. Governance reforms, to support effective implementation of the test, are also identified.**

## BACKGROUND

**Ensuring that the EU's economy is competitive is a critical pre-condition for achieving the green transition and strengthening strategic resilience – the twin goals of the European Green Deal. Economic competitiveness generates resources for investment and welfare, sustains living standards and helps underpin social consent for radical change. A competitive economy is not contrary to the Green Deal objectives, rather it is essential for their successful delivery.**

**Over the last two decades, however, the EU has experienced a steady and objective loss of competitiveness.** The pace of growth in the overall economy and in total factor productivity, the most important contributor to prosperity, has slowed down significantly. At the same time, the EU has lagged other comparable jurisdictions in the development and adoption of advanced technologies, the scale of business investment, the creation of new major enterprises and the evolution of its economic structure towards new sectors and technologies.

These failings are the result of number of factors. Whilst the EU has a number of major strengths, most notably the size of the Single Market, the scale of its research base and the human and financial resources of its major companies, **there are systemic weaknesses in the framework conditions that create incentives for investment by the private sector in risk-taking and innovation and for allocating capital to the EU.** Major weaknesses include: **(1)** the Single Market is incomplete; **(2)** the level of investment in R&D is inadequate; **(3)** political and social attitudes are risk averse; **(4)** capital markets lack depth, sophistication and scale; and **(5)** the regulatory framework, especially for the management of risk and technologies, increasingly undermines incentives to invest in innovation and to allocate capital to the EU.

War in Ukraine, high energy costs and policy divergence between the EU and its major trading partners have added new stresses, further exposing the weaknesses in EU competitiveness and making it more difficult to justify the allocation of capital.

**Indeed, there is widespread concern amongst investors about the economic competitiveness of the EU.** To illustrate, surveys in 2023 indicate that investment intentions are weakening, reflecting the EU's loss of competitiveness and the failure of EU institutions to reform its structural causes, including the regulatory framework. For example, 90% of members of Business Europe believe that the investment climate in the EU has deteriorated considerably, compared to other jurisdictions, and 84% of members of the European Roundtable of Industrialists consider that the EU's industrial base is weakening. Recent research by ERIF, based on 150 direct interviews with private sector stakeholders and regulators, confirmed these concerns. None of the respondents believed that the EU was becoming more competitive.

**Major additional capital expenditure, primarily by the private sector, is key. Without it, it will be difficult for the EU to achieve its ambitious policy goals.** Total capital investment is the sum of actual capital allocation decisions made by investors. Any future assessment of policy or regulatory interventions should consider explicitly their potential impact on decisions by the private sector to allocate capital to the EU.



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**These issues, and the need for reform, are now beginning to be recognised by the EU institutions.** The recent Swedish Presidency of the EU Council placed a significant emphasis on identifying actions for improving the economic competitiveness of the EU. The Competitiveness Council has called on the European Commission to systemically apply a 'Competitiveness Test' to future initiatives. The Economic and Social Committee has made an equivalent plea. The President of the European Commission has committed to this agenda by reviewing the mandate of the Regulatory Scrutiny Board and revising the existing tests of competitiveness, as outlined in the Better Regulation guidelines.

These steps are to be welcomed. They build on the structures and processes of the European Commission's world-leading Better Regulation strategy, the most important mechanism for improving the quality of interventions at EU-level.

This Highlights Note is a contribution to the further development of an impact assessment process, and supporting governance mechanisms, that will ensure existing and future interventions will promote rather than hinder competitiveness. To that end, it will be important that the future Competitiveness Test be based on:

- A modern understanding of the nature of competitiveness and its underlying drivers;
- A recognition of the importance for competitiveness of the allocation of capital to the EU; and
- An informed awareness of how regulations affect decisions to innovate, respond to change and allocate capital.

## 'COMPETITIVENESS' – NATURE AND KEY DRIVERS

**Traditionally, competitiveness of economies was considered to be part of a zero sum struggle between societies for critical resources**, such as bullion or export markets. This approach underpinned policy philosophies such as mercantilism or specific interventions designed to restrict imports or encourage exports. Until relatively recently, the competitiveness of an economy was judged on the basis of success in exporting goods and services, achieving an export surplus or attracting Foreign Direct Investment (FDI).

From the mid-1990s onwards, new ideas about the meaning of the concept of 'competitiveness' began to emerge, initially in the United States. Policy-makers recognised the inadequacies of focusing primarily on trade and capital flows for understanding economic performance more widely. Instead, **the modern approach to understanding the competitiveness of an economy focuses on its capacity to create prosperity for its citizens, considering jobs, living standards and wealth.**

Competitiveness is the final outcome of strategic, investment and operating decisions, taken primarily by the private sector, supported by appropriate and effective public sector interventions, including the design and implementation of the regulatory framework.

**There are three primary 'drivers' of economic competitiveness:**

**(1) Innovation** – development and widespread dissemination of new and improved products, processes and ways of doing business. This is, in turn, the most important determinant of growth in productivity.

**(2) Operating Efficiency** – high and productive utilisation of all forms of productive resources (including physical, intellectual, human and financial capital) throughout the economy, particularly amongst 'lagging' enterprises and SMEs. This takes account of factors such as returns on investment, cost structures and capacity utilisation.

**(3) Structural Adjustment** – the capacity of an economy to switch productive resources into new industries, applications and technologies in response to opportunities and threats. Ideally, this occurs flexibly and dynamically. Governments may create barriers to the effective functioning of this process, if they use poorly designed policy measures to limit the social impacts of economic change or try to prescribe the direction of future economic activity.

The modern concept of competitiveness recognises the importance of both incremental and radical change, employing new Fourth Industrial Revolution technologies while fully exploiting the value of existing materials and other technological capabilities. It recognises, moreover, that prosperity should be achieved in a safe and sustainable manner, reflecting the wider concerns of citizens for high standards of protection. (See *ERIF Highlights Note 20 'Regulation and Management of Risk: Likelihood of Harm, Safety and Safe Use' 2022*.)

**Competitiveness, and creating prosperity, is not inimical to social or environmental progress. Instead, prosperity is critical for achieving this.** Competitive economies create the surpluses needed for investment in innovation, new ideas, and greater efficiency. They also create incentives for progressive upgrading of products, processes and operating methods. Modern process equipment is invariably safer, more sustainable and more efficient than the assets that are replaced, leading to gains in both prosperity and environmental and societal protection.

**The challenge for policy makers is to develop interventions and governance mechanisms that will strengthen the primary drivers of competitiveness**, creating incentives for the private sector to invest in innovation, operating efficiency and new ideas, technologies and opportunities. This includes developing a regulatory framework, and implementation mechanisms, that enhances incentives whilst also delivering high standards of protection. (See *ERIF Monograph 'Fostering Innovation: Better Management of Risk' 2016*.)

## 'COMPETITIVENESS', PUBLIC POLICY AND REGULATION

**Recent research by the OECD highlighted the characteristics of policy interventions that are likely to have the greatest impact on improving economic competitiveness.** They include:[1]

- Strengthen the framework conditions that influence decision-making by the private sector;
- Recognise the importance of the regulatory framework in creating incentives and obstacles for innovation, allocation of capital, operating efficiency and structural adjustment;
- Use economy-wide measures focused on prosperity, rather than seeking to promote specific technologies or social missions;
- Employ incentives rather than restrictions, prescription or direction;
- Strengthen competitive intensity;
- Improve the functioning of markets for capital, labour and products;
- Support property rights;
- Support the development and availability of critical inputs, most notably human capital, knowledge and finance; and
- Target support within the accepted framework of corporate investment decisions, particularly improvements in expected after-tax outcomes from individual projects.

**These insights by the OECD form part of a framework of good practices for assessing the design of interventions and as such should be included within a Competitiveness Test at EU-level.**

**Technological evolution is a critical pre-condition for economic competitiveness. An improved Competitiveness Test should also recognise the complex links between the regulatory framework and incentives to innovate, allocate capital, operate efficiently or adjust to new opportunities.** Research by ERIF over more than twenty-five years has identified many of these links.

The ERIF Novel Regulatory Philosophies study (NRP), completed in 2023, builds on this work and highlights additional concerns. (See *ERIF Monograph 'Novel Regulatory Philosophies in the European Union: Directions, Implications and the Role of Better Regulation' 2023*.) Based on an extensive research programme, including more than 150 depth interviews, it examined the evolution in the way in which the EU manages risk and hence the development and application of technologies.

The NRP study revealed a major shift in the management of risk, away from likelihood of harm, safety and safe use grounded in expert understanding of exposures, mitigated by proportionate measures. A new novel, and largely untested, approach is instead emerging across many policy domains, based on intrinsic properties, precaution, widespread restrictions, unscientific grouping and new tests of market access, specifically essentiality, non-toxic persistence and sustainability.

Furthermore, these radical changes to the way in which the EU manages the development and dissemination of technologies, are being implemented without a full or widespread debate.

The benefits of the new approach are likely to limited and uncertain. In contrast, the costs are expected to be significant and include systemic uncertainty, resource diversion (away from safer and more sustainable activities), loss of critical technologies, major damage to SMEs and complex value chains, reduced economic dynamism, diminished incentives to innovate and value destruction. All of these costs have a negative impact on competitiveness.

## EU COMPETITIVENESS TEST – PROPOSED APPROACH

Significant progress has already been made by the European Commission to identify some of the impacts of regulatory decisions on competitiveness and, using checklists within the Better Regulation guidelines, to assess their impact on proposed interventions. This provides an important foundation on which to build a **more systemic** Competitiveness Test.

**Specifically, the revised Competitiveness Test should assess all proposed and existing measures, including policies, laws, regulations and implementation measures, against four major factors:**

**(1) Allocation of capital and its pre-conditions** – measures should recognise that the path to social and environmental progress lies through investment, primarily by the private sector. This requires measures to strengthen rather than undermine decisions to justify the allocation of capital. (See *ERIF Highlights Note 18 'Allocation of Capital, Better Regulation and the Delivery of the Green Deal' 2022*.) Specific issues to consider include the impact of legislative and regulatory measures on:

- Systemic uncertainty;
- Value creation or destruction (regulations that reduce capacity utilisation, undermine gross margins, restrict revenues or distort cost structures negatively should be avoided, for example);
- Security of property rights (regulation based on derogations, for example, should be avoided);
- Scientific integrity (implementation processes should, for example, be based on widely-accepted principles and guidelines for scientific integrity); and
- Investment economics.

[1] See OECD (2022), *An industrial policy framework for OECD countries*; and OECD (2022), *Are industrial policy instruments effective?*, OECD Publishing.

**(2) Framework conditions for innovation** – productivity growth is the most powerful driver of prosperity in modern economies. Innovation determines this, as well as driving progress towards the adoption of new safer and more sustainable economic activities.

Framework conditions for innovation encompass the overall fiscal and monetary framework; social attitudes; market scale and complexity, patterns of demand, competitive intensity and market access; and critical inputs, especially knowledge, human capital, finance and infrastructure.

Research by ERIF has identified how the regulatory framework affects the framework conditions for innovation. (See *ERIF Highlights Note 07 'Risk Regulation and Innovation' 2016*.) Specific issues to consider include the impact of measures on:

- Market scale and barriers;
- Consumer confidence;
- Market access restrictions and requirements (new tests of essentiality, rather than safety based on likelihood of harm, create major barriers to access, for example);
- Market closures (due to restrictions on applications, for example);
- Competitive intensity;
- Stigmatisation of technologies or applications;
- Protection of property rights;
- Time-to-market (delays in product approvals and disproportionate testing increase time to market and capitalised costs, for example);
- Access to technologies (bans and restrictions on the use of particular technologies reduce the availability of knowledge for downstream users and value chains);
- Availability of retained earnings for investments (measures that reduce cash flows from existing products or businesses limit funds for investment in innovation, particularly for SMEs); and
- Defensive R&D (diversion of resources, to meet regulatory requirements, away from new ideas and progress and towards retaining old ideas).

**(3) Diversion of resources** – a general failing of the EU regulatory framework is the diversion of resources towards compliance and away from investments in new ideas and in up-grading the operating efficiency of existing assets. This problem is becoming more acute, especially for SMEs, because of the progressive adoption by the EU of NRPs for the management of risk and the cumulative scale of regulatory activity at EU-level.

Specific issues to consider include the impact of measures on:

- Dynamism of SMEs;
- Diversion of management time and critical technical resources, particularly within SMEs;
- Defensive R&D;
- Diversion of resources into reformulation of products that offer reduced efficacy or customer satisfaction;
- Loss of potential for improvements in productivity and operating efficiency because of diversion of resources; and
- Costs and benefits of seeking 'zero' exposures (the marginal gains from seeking to reduce all forms of exposure to zero may be unattainable, un-measurable, uncertain and limited, yet the costs are likely to be extensive, for example).

**(4) Policy design for structural adjustment** – work by the OECD and research by ERIF has identified a series of good practices that should be embedded within all measures, if they are to facilitate the structural adjustment of economies. These include:

- Safe use of technologies (rather than basing risk management and use of technologies on intrinsic properties);
- Secure property rights;
- Reduced regulatory uncertainty;
- Attractive incentives;
- Outcomes driven interventions;
- Technology neutrality; and
- Coherence and integration of measures.

**The new Competitiveness Test should form part of the formal process of assessing proposed and existing interventions, including policy ideas and implementation decisions. It should be included within the Commission's Better Regulation guidelines and its application should be mandatory.**

## EU COMPETITIVENESS TEST AND GOVERNANCE – OBSERVATIONS

**Boosting competitiveness very largely depends on the confidence of investors and entrepreneurs to invest in and operate efficiently within an economy.** There is clear evidence that investors increasingly lack confidence in the climate for business and investment in the EU. In the light of this, creating a new eco-system of governance for implementation of a Competitiveness Test, including political commitments and institutional change, is as important as upgrading the existing Better Regulation guidelines.

**A revised governance structure will deliver not only more effective policy, legislative and regulatory interventions, but will also signal to investors the intention of the European Union to establish a more competitiveness-friendly business climate and to pursue technological leadership.**

Governance reforms should include:

**(1) Political commitment**

- The European Commission should restructure the responsibilities of Commissioners and allocate an

over-arching **mandate for Competitiveness to a specific Vice-President**.

- The Council of the European Union should renew its formal commitment and reiterate its Conclusions calling for the application of a **policy for the promotion and management of technologies, including the Innovation Principle**, which will strengthen competitiveness.
- The Council of the European Union should adopt dedicated Conclusions calling for the application of **common principles, standards and guidance for Scientific Integrity in regulatory decision-making**.

### (2) Policy and Guidelines

- The European Commission should, in the form of a Commission Decision, establish a formal **policy for Technology Development and Management**. This should include a commitment to greater application of the Innovation Principle. The policy should establish a set of principles to ensure coherence of all interventions that directly, or indirectly, influence the development and use of technologies, including management or risk.
- The European Commission should, in the form of a Commission Communication, more fully define the **meaning and usage of Proportionality**. The Communication should be directly informed by the legal requirements set out in the Treaty and in the jurisprudence of the EU Courts. It should explain how the principle should be used to improve the quality of regulatory decision-making, including implementation measures.
- The European Commission should **revise the Better Regulation guidelines to include the new Competitiveness Test** (based on the four issues – allocation of capital, framework conditions for innovation, diversion of resources and policy design for structural adjustment).
- The European Commission should adopt a Commission Decision establishing a new **group of Senior Economic Advisors**, specialising in microeconomics and investment decision-making, to support the process of evaluating the potential impacts of proposed interventions. This group, drawn from Commission officials and outside experts, should report to the new VP for Competitiveness.
- The EU Member States should fully implement the Council Recommendations of 2016 on the establishment of **National Productivity Boards** and expand upon the mandates of the Boards. This will help create a network effect between Member States and their EU counterparts.

### (3) Due Process Standards

- The EU Legislature should, building on the work of the European Parliament, develop and adopt a **comprehensive Law of Administrative Procedures**. This should embed the principles of good administration into law, strengthen judicial review, provide legally enforceable standards and procedural rights, and encompass all significant rule-making and adjudication processes used by the EU Administrative State. It will strengthen accountability and transparency in the interests of all parties.
- The European Commission should adopt a Commission Decision establishing a new **Office for Scientific Standards in Regulatory Decision-Making**. The Office, drawn from officials of the European Commission and independent eminent expert scientists, should report to the Vice-President with responsibility for Better Regulation. Its role will be to oversee and support the functioning of the new Independent Appeals Board (see below) and to draw up and enforce a new horizontal policy for Principles and Guidance for Scientific Integrity in Regulatory Decision-Making.
- The European Commission should adopt a Commission Decision establishing a new **Independent Appeals Board for Scientific Assessments**. The Board, which will be overseen by the new Office for Scientific Standards in Regulatory Decision-Making (see above), will comprise expert and eminent scientists. Its task will be to review significant scientific assessments (including hazard assessments, risk assessments and groupings) where there has been evident failure to respect agreed procedural requirements, or evident failings by other scientific assessment bodies in the preparation of EU risk assessment and risk management decisions.
- The European Commission should revise the mandate of the **Regulatory Scrutiny Board** (RSB) so as to strengthen its independence, its expert capacity to review risk management interventions, and its powers to reject poor quality proposed interventions. The RSB should be required to assess the extent to which interventions meet the requirements set out in the new Competitiveness Test.

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