COMPETITIVENESS, NOVEL REGULATORY PHILOSOPHIES AND BETTER REGULATION

HIGHLIGHTS NOTE 26

- **This Highlights Note forms part of the ERIF contribution to the new Commission's Better Regulation Agenda.[1] It focuses on the impact of the regulatory framework on the economic competitiveness of the EU.**
- **Existing failings in the regulatory framework weaken the 'pillars' on which economic competitiveness rests. Without reform, the adoption by the EU of new ways of managing risk (Novel Regulatory Philosophies) will exacerbate these failings, making it more difficult for the EU to achieve its ambitious socio-economic goals of prosperity, transition and resilience.**

BACKGROUND

Ensuring that the EU's economy is competitive is a critical pre-condition for increasing prosperity, achieving the green transition and strengthening strategic resilience. Economic competitiveness is not inimical to social or environmental progress. On the contrary, it generates resources for investment and welfare, sustains living standards and helps underpin consent for change.

Traditionally, competitiveness of economies was considered to be part of a zero-sum struggle for critical resources. The modern approach to understanding the competitiveness of an economy focuses rather 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,[2] supported by appropriate and effective public sector interventions, including the design and implementation of the regulatory framework.

There are three primary 'pillars' on which economic competitiveness rests:

- **Innovation** – development and widespread dissemination of new and improved products, processes and ways of doing business. In turn, this is the most important determinant of growth in productivity.
- **Operating efficiency** – intensive and effective 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.
- **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 try to prescribe the direction of future economic activity or create obstacles to the application of new or existing technologies.

The modern concept of competitiveness recognises the importance of both incremental and radical change, employing 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 higher standards of protection**. (See *ERIF Highlights Note 20 Regulation and Management of Risk: Likelihood of Harm, Safety and Safe Use' 2022*.)

[1] See *ERIF Communication 23 Better Regulation, Prosperity, Transition and Resilience – Ideas for the New Commission, 2023*.

[2] In the EU, private investment is likely to account for more than 85% of the total investment needed to accelerate the green and digital transitions, enhance resilience and boost the Union's competitiveness. See for example European Commission (2023) 'Long-term competitiveness of the EU: looking beyond 2030' (COM (2023) 168 final).

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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.

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 also systemic weaknesses in the framework conditions for investment by the private sector in risk-taking and innovation and for allocating capital to the EU. Major limitations include:

- The Single Market is incomplete;
- The level of investment in R&D is inadequate;
- Political and social attitudes are risk averse; and
- Capital markets lack depth, sophistication and scale.

War in Ukraine, high energy costs and policy divergence between the EU and its most important trading partners have added new stresses.

Regulatory frameworks, especially for the management of technologies, can adversely affect competitiveness, notably if they deter investments.

ISSUES OF CONCERN

As a result of these weaknesses and other failings, the EU has experienced a steady and objective loss of competitiveness over the last two decades.

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.

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.

These issues, and the need for reform, are now beginning to be recognised by the EU institutions. The 2023 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 revising the mandate of the Regulatory Scrutiny Board and revising the existing tests of competitiveness, as outlined in the Better Regulation guidelines.

The EU has also established an expert group, led by Mario Draghi, the former Prime Minister of Italy, to identify ways of improving competitiveness.

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.

However, to be effective these initiatives will need to consider factors beyond macro-economic conditions. Reforms must also focus on the impact of the regulatory framework on investment decisions by the private sector.

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 *ERF Monograph Fostering Innovation: Better Management of Risk 2015*.)

EXISTING REGULATORY CHALLENGES

Significant progress has already been made by the European Commission to identify some of the impacts of regulatory decisions on competitiveness, for instance through guidance included in the Better Regulation Toolkit (including a recently added checklist).

Whilst these reforms are to be welcomed, they do not fully resolve the existing negative impacts of the regulatory framework on the competitiveness of the EU's economy. Four major areas of concern persist:

- **Allocation of capital and its pre-conditions** – there are a series of historic regulatory weaknesses that make it more difficult to justify allocation of capital to the EU. These include: **(1)** Extended time-to-market that erodes investment returns; **(2)** Regulation of new technologies that stigmatises new ideas and creates uncertainty; **(3)** Defensive R&D that limits funds for investment; and **(4)** Failings of the EU's Administrative State that create systemic uncertainty and undermine business value. (See

ERIF Highlights Note 24 Allocation of Capital, Novel Regulatory Philosophies and Better Regulation 2023.)

- **Framework conditions for innovation** – enabling conditions strengthen incentives to innovate, one of the primary 'pillars' of competitiveness. (See *ERF Highlight Note 07 Risk Regulation and Innovation 2016*.) Those conditions are not leveraged systematically and major negative regulatory impacts include **(1)** Loss of markets and technologies due to restrictions, limiting opportunities; **(2)** Stigmatisation of technologies, reducing consumer acceptance; **(3)** Extended time-to-market, creating barriers to access; **(4)** Loss of access to new ideas, due to upstream restrictions; and **(5)** Defensive R&D, limiting dynamism and creating incentives to retain old technologies (See *ERIF Highlights 25 Innovation, Novel Regulatory Philosophies and Better Regulation, 2023.*)
- **Diversion of resources** –the EU regulatory framework often causes the diversion of resources towards compliance with new mandatory requirements, and away from investments in new ideas and in up-grading the operating efficiency of existing assets. This encompasses the costs 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.) These problems are becoming more acute, especially for SMEs, because of the cumulative scale of regulatory activity at EU-level. (See *ERF Highlights Note 08 Defensive R&D and Innovation, 2016.*)
- **Policy design for structural adjustment** – research by the OECD and ERIF has identified a series of good practices that should be embedded in the regulatory framework, if it is to facilitate structural adjustment. Specifically, they should facilitate safe use of technologies, secure property rights, reduce regulatory uncertainty, create incentives, focus on outcomes and technological neutrality, and ensure coherence. Too many regulations fail to meet these standards.

These existing failings are likely to be exacerbated by the adoption by the EU of Novel Regulatory Philosophies (NRPs) for the management of risk.

NOVEL REGULATORY PHILOSOPHIES

Technological evolution is central to the process of achieving greater economic competitiveness and hence delivering the EU's ambitious socio-economic objectives. There are 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. (See *ERF Monograph Fostering Innovation: Better Management of Risk 2015*; *ERF Highlight Note 07 Risk Regulation and Innovation 2016*; and *ERIF Highlights Note 18 Allocation of Capital, Better Regulation and the Delivery of the Green Deal 2022*.)

The ERIF Novel Regulatory Philosophies study (NRP), completed in 2023, builds on this work and highlights new, major concerns. 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. (See *ERIF Monograph Novel Regulatory Philosophies in the European Union: Directions, Implications and the Role of Better Regulation 2023*.)

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.

Looked at in greater detail, this new approach (Novel Regulatory Philosophies) has a number of defined characteristics. These include:

- **Limited focus on the core principles of Better Regulation**, including evidence-based decision-making and impact assessment. Restrictions are proposed even though there is no adequate and specific evidence underpinning them, with weak intervention logic and an inadequate assessment of costs and benefits.
- **New ways of assessing and managing potential harms**, particularly precaution, intrinsic properties, groupings, non-toxic criteria, perceived risk and social concern. Toxicological and associated scientific knowledge is marginalised and existing vertical and expert risk assessment is lost, thereby undermining scientific integrity.
- **Use of widespread restrictions and bans** on uses of substances and technologies based on intrinsic properties, often with economy-wide impacts, with use in specific applications permitted through time-limited derogations and after satisfying subjective tests of social betterment.
- **New subjective, non-toxic and social criteria, most notably essentiality, as primary tests of market access.** Safety and safe use of technologies, based on likelihood of harm, are secondary considerations.
- **Interventions focus on prescription, inputs and processes** rather than outcomes and incentives. Regulation seeks to drive technological development rather than ensuring safety, facilitating safe use and enabling innovation.

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.

Moreover, this new approach to risk management (NRPs) is largely untested and hence the claimed benefits remain highly uncertain and are not supported by robust evidence of causality or empirical experience. In contrast, it is highly likely that the costs and other negative unintended consequences will be significant.

COMPETITIVENESS AND NOVEL REGULATORY PHILOSOPHIES

Without reform, the approach proposed by the EU for the future management of technology and materials poses a number of major problems for economic competitiveness. Likely costs include:

- **Loss of critical technologies needed for prosperity, green transition and strategic resilience** – regulation of risk using intrinsic properties, unscientific grouping, widespread bans and non-toxic harms will stigmatise technologies, limit technological advance and reduce access to safe use of existing technologies.
- **Systemic uncertainty** – this constitutes a strategic risk for investors and is therefore of critical importance for the allocation of capital. Systemic uncertainty is likely to increase due to the loss of scientific integrity, growth in regulatory unpredictability and administrative discretion, lack of coherence, weakening of property rights and the use of 'essentiality' as a test of market access (see *ERIF Highlights Note 16 'Essentiality, Better Regulation and Management of Risk from Technologies' 2021*; and *ERIF Highlights Note 18 'Allocation of Capital, Better Regulation and the Delivery of the Green Deal' 2022*.)
- **Diversion of resources away from investment in safer and more sustainable technologies** – if disproportionate and unscientific (i.e. not based on toxicological evidence), risk regulatory requirements will increase compliance, trigger reformulation to maintain existing performance and limit improvements in operating efficiency. Fewer resources will be available for investment in new ideas. An example of such requirements include further limits on exposures without evidence of significant measurable improvements in health or environmental outcomes.
- **Reduced incentives to innovate** – adoption of NRPs is likely to weaken demand conditions, make it more difficult for investors to capture the benefits of risk-taking, increase time and cost of new product development, and reduce access to ideas and capital. The use of the concept of essentiality to determine market access will further erode incentives to innovate (See *ERIF Highlights Note 19 'Innovation, Essentiality and Better Regulation' 2022*.)
- **Structural damage to the eco-system of SMEs** – SMEs are a critical part of the eco-system of the EU's economy. However, SMEs also have structural weaknesses, which may make it more difficult for them to withstand the cumulative regulatory challenges posed by the EU's proposed novel approach. They typically lack the financial, technical and managerial capacity to absorb the simultaneous requirements of the EU's NRPs. They will also lose access to markets and critical inputs. Over time, this may lead to a diminution in competitive intensity and a loss of dynamism, damaging the structure of the EU's economic eco-system.
- **Erosion of competitiveness of formulator industries**[3] – loss of scientific integrity will weaken consumer trust and confidence, undermining demand conditions. Loss of safe use will limit the scope for innovation and differentiation. Resources will be diverted into reformulation, so as to retain existing efficacy rather than innovation. Business value may be eroded through disproportionate and unscientific restrictions.
- **Destruction of value for major industries** – upstream production facilities may become uneconomic due to the loss of applications and markets, as a result of widespread bans based on intrinsic properties and not grounded on toxicological evidence. Loss of safe use and other limitations on innovation may restrict the development of new sources of value. Widespread restrictions on the use of technologies may undermine value creation in high-tech sectors.

In turn, NRPs are unlikely to increase the level of health and environmental protection due to the loss of focus on safety and safe use based on likelihood of harm, the erosion of scientific integrity and increased emphasis on non-toxic tests of market access in place of safety. (See *ERIF Highlights 23 Scientific Integrity, Novel Regulatory Philosophies and Better Regulation, 2023*.)

A systematic programme of reform should be undertaken by the new Commission in conjunction with the EU institutions to avoid the potential negative outcomes identified by ERIF's detailed research. This should focus on immediately addressing the negative consequences of current initiatives; strengthening governance of the regulatory process; reinforcing confidence in scientific integrity in decision-making; and strengthening conditions for the allocation of capital.

[3] Formulator industries are motors of innovation and, because of their scale, impact and strategic positioning in value chains, they are of critical importance for strategic resilience. They bring together upstream and other speciality technologies, combine them with their own unique insights, market understanding and scientific investments, and create complex products to meet the needs of a wide range of consumer and business-to-business markets. These industries include sectors such as adhesives and solvents, personal care, household care, cosmetics, professional cleaning and hygiene and fragrances.

BETTER REGULATION AND COMPETITIVENESS – REFORMS

These reforms, if implemented, will help to strengthen governance structure in line with the enhanced focus of the EU institutions on improving economic competitiveness, as well as complementing the current scope of the European Commission's 'Competitiveness Test'.

- The European Commission should restructure the responsibilities of Commissioners and **allocate an over-arching mandate for Competitiveness to a specific Vice-President**. The Vice-President will exercise political oversight over the development and implementation of a new Technology Management policy. (See *ERIF Highlights Note 25 Innovation, Novel Regulatory Philosophies and Better Regulation, 2023.*) The role will focus on ensuring policy coherence across all interventions so as to retain and attract business activity and investment in the EU. The Vice-President will work with other Commissioners to support the wider application of the Innovation Principle. It will oversee the work of the new group of Senior Economic Advisors.
- The European Commission should adopt a Commission Decision establishing a new **group of Senior Economic Advisors** to support the process of evaluating the potential impacts of proposed interventions. The group, drawn from officials of the European Commission and outside eminent experts, should report to the new Vice-President for Competitiveness. Its role will be to support Commission services and endorse assessment of the potential impacts on competitiveness of all significant policy, legislative and regulatory interventions throughout the policy cycle. It will focus on micro-economics with particular reference to investment decision-making by the private sector and the dynamism of SMEs.
- 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. The contribution of the National Productivity Boards to the development and assessment of EU policy, legislative and regulatory interventions, should be co-ordinated by the Group of Senior Economists of the European Commission, under the leadership of the Vice-President for Competitiveness. Properly implemented, this recommendation will create a network effect between Member States and their EU counterparts. Lessons can be drawn from the network of national competition authorities.
- The European Commission should **expand and complement the current Competitiveness Test**, preferably through a Communication, and by up-dating the Better Regulation toolkit. The new Competitiveness Test should form part of the formal process of assessing proposed and existing interventions, including policy ideas and implementation decisions. Its application should be mandatory.

  The test should be based on the modern understanding of competitiveness and should ensure that four key factors are considered: (1) Allocation of Capital and its pre-conditions; (2) Framework conditions for innovation; (3) Diversion of Resources; and (4) Policy design for structural adjustment. (See *ERIF Highlights Note 22 Competitiveness Test and Better Regulation, 2023.*)

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