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The invited contributions: introduction and summary

Globalisation Challenges for Europe and Finland
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Economic globalisation has an unenviable reputation. It is blamed for the offshoring of jobs from developed countries such as those in Europe to low cost countries that exploit cheap labour and disregard environmental considerations. In particular, low wage jobs in developed countries are under threat, and it is often argued that job losses can only be avoided by further cuts to already meagre wages. Due to tax competition and loss of tax base, globalisation is also seen as a threat to the European social model.

The Lisbon agenda to make Europe “the most competitive knowledge based economy in the world” can in part be regarded as a response to these challenges. Naturally, other factors have also been important, ranging from the EU’s high unemployment and generally inferior economic growth performance in comparison to the US, to the looming pressures on public finances created by population ageing. But in many ways, the Lisbon agenda is indeed an agenda for making Europe competitive in the face of new global competition. It is also a very European agenda. By emphasising knowledge and upgrading skills through extensive education, it aims at avoiding the main perceived threat to Europe posed by globalisation: the widening of social disparities through a weakening of the position of the non-skilled.

It is no news that the Lisbon process has disappointed expectations. Such disappointment led to a revision of the agenda last year, placing more emphasis on growth and jobs and creating a new co-ordination method giving national reform programmes a key role. Of course, just reforming the agenda and procedures is not sufficient. As has been stated many times, the problem does not lie in a lack of grand visions or objectives but the slow and piecemeal implementation of concrete policy reforms.²

A host of factors hamper Europe’s ability to take the decisions necessary to true economic renewal. At one level, there is disagreement about the degree to which the global economic environment is changing and the nature and severity of the resulting challenges. At another level, opinion varies on Europe’s current competitiveness or capacity to grow and, as a consequence, how much more really needs to be done. It is still more difficult to agree on policy measures, since these are often at least perceived to be against the short-term interests of some important constituencies. This applies both to national and Union level decision making.

This set of papers seeks to improve our understanding of some key aspects of the above issues and introduce new or at least refined policy ideas to the discussion. We start from the basics with an analysis of globalisation and its implications for Europe. This is followed by a discussion of how best to assess

² See e.g. the so-called Kok Report (2004), Aho Report (2006) and Pisani-Ferry and Sapir (2006).

Europe's competitiveness and the likely success of various types of structural policy in its enhancement.

A potential major handicap in Europe in comparison to the US lies in the fragmentation of its markets. We will therefore take a look at the liberalisation of two important segments of the internal market: the services market and the network industries. How important are the gains from further integration and how should we reap them?

Promoting education, research and innovation is a policy area of great expectations but one in which Europe has fallen badly behind not just the US but, in many cases, the dynamic emerging economies of Asia. Several papers analyse various aspects of innovation policy in a broad sense: where do we stand in Europe and what should (urgently) be done?

The final two papers discuss political governance, the first examining the division of labour between Union level and member state level within the Union: is it right? The second discusses the need for global governance and what Europe could and should do to improve it.

These papers, the contents of which are briefly described below, are contributions by individual experts. As such, they do not necessarily represent the views of the affiliations of the authors or those of the Finnish Government. There has been no attempt to forge a consensus of the views the papers express. Nevertheless, it emerges that the analyses paint a rather consistent picture of policy challenges and the required policy responses, even if they do not wholly agree.

Globalisation: the second unbundling and its implications

In his review of the economic theory of globalisation, **Richard Baldwin** starts by claiming that a new paradigm of globalisation is emerging. Roughly speaking, this new-paradigm globalisation differs from the old in that it is occurring at a much finer level of disaggregation. Due to radical reductions in international communication and co-ordination costs, EU firms can offshore many tasks that were previously considered non-traded. This means that international competition – which used to be primarily between firms and sectors in different nations – now occurs between individual workers performing similar tasks in different nations. An important new feature is that the new-paradigm globalisation will seem quite unpredictable from the perspective of firms and sectors.

Since individual tasks can be offshored, globalisation may help some workers in a given firm while harming others. Moreover, the old globalisation's correlation

between skill groups and winners and losers breaks down. Certain, highly skilled tasks may turn out to be vulnerable to offshoring, while others, just as highly skilled, are not. Increased offshoring will therefore not systematically help or hurt skilled workers in the EU.

The new paradigm will not change the basic message of economic theory about the overall benefits of free trade. Nevertheless, it will change the view on how the initial wins and losses are distributed among different types of labour in developed countries. The highly skilled are not automatically the initial beneficiaries and the low-skilled the losers. Referring to very recent work by Grossman and Rossi-Hansberg (2006), Baldwin emphasises that task-level offshoring allows non-skilled labour to move to more productive tasks, which increases their wages.

Reviewing the empirical evidence on offshoring, Baldwin concurs that offshoring seems to have had a relatively modest impact on employment so far, in comparison with overall job destruction and creation. Nevertheless, the new paradigm suggests that changes in the optimal location of jobs can be very sudden when given thresholds in cost reductions are surpassed. Thus, even the recent past may not be a reliable guide to future changes.

Baldwin emphasises that the "old" story about international competition at the level of individual firms is not over. Despite the new competition at the task level, global competition will continue to create pressures to reallocate economic resources at the sector and firm level, too.

Nevertheless, the paper argues that the potential of task level globalisation has important new implications for the EU's competitiveness strategy, education strategy, welfare states and industrial policy. Flexibility, the capacity to respond to new circumstances quickly, is the key to allowing Europe to seize the opportunities of globalisation while minimising the adjustment costs. Constraining prices (including wages) and quantities from adjusting will cost more in terms of a nation's income than before. Offshoring is likely to be most attractive to firms in nations with the most rigid labour markets.

On the other hand, the increased unpredictability should make EU leaders more cautious about moving workers or skills in a particular direction. In particular, many "Information Society" jobs are prone to offshoring, so EU policies aimed at moving workers into Information Society jobs may be wasted, since those jobs are only 'good jobs' because they do not yet face direct international competition. The ability of the education system to provide learning skills rather than a specific skill required for a given task will become even more important than before. Similarly, in industrial policy, trying to pick winning sectors will be more risky than before.

Some European specialisation patterns consistent with Baldwin's unbundling theory

Baldwin's globalisation analysis is commented on and complemented in two papers. **Mika Widgrén** investigates the recent development of selected countries' revealed comparative advantage, and discusses in the light of his empirical analysis the plausibility of Baldwin's unbundling theory. The question he asks is whether there is any evidence for an increasing overlap in countries' specialisation patterns as this might be a sign of increasing unbundling of industrial output

The analysis shows that that specialisation patterns have become more heterogeneous. Taking Finland as the reference country, Widgrén argues that observed trade patterns are consistent with the Baldwin story. From the Finnish point of view, the most interesting cases are Estonia and Hungary in Europe and China in Asia. The factor content of these countries' exports has shifted rapidly towards intensive use of human capital and, especially in Estonia and Hungary, has become more similar to Finnish specialisation patterns.

At the same time Finnish firms have invested actively in these countries, particularly in the telecommunications industry. Finnish firms' overall FDI stock has grown almost five-fold during the same period. The FDI stock of the manufacturing industry is four times and that of the services industry ten times bigger than a decade ago. However, rapid expansion of Finnish FDI stock in Estonia and Hungary and ensuing job creation in the Estonian and Hungarian industrial sector has not been associated with job destruction in the telecommunication industry in Finland. At least qualitatively it seems that unbundling of Finnish telecommunication industry's production has led to a 'hollowing out' tendency Finnish industry, especially in electronics: some tasks have been offshored but the level of activity and the control of the production chain has remained in Finland.

Flexibility, risk-sharing and training – the key aspects of labour market adjustment

In his discussion of the implications for the labour market, **Torben Andersen** agrees to a large extent with Baldwin. Andersen concurs that the main determinant of the relative net-gain is not necessarily closely related to the level of education, but to the extent to which economic activities can be relocated across borders. Increasing globalisation effectively creates increased job mobility, and the direction of job movements depends on comparative advantages relative to the scope for relocating production and jobs. Empirical evidence shows that export opportunities tend to improve labour market prospects, while the import threat does the opposite.

A key policy challenge is to support structural change and adjustment without leaving a disproportionate amount of the risk burden with individuals. This can be done in the short term in the form of income insurance, and in the medium to long run through re-education and training. Increased investments in education are a popular remedy. While the return – both private and social – is generally high, there is a danger of over-investment in education if it is perceived that all labour market problems can be solved by adopting an education policy based on the view, “the longer, the better”.

How should we assess Europe’s “competitiveness” and its determinants?

Jean-Philippe Cotis and **Jørgen Elmeskov** affirm that the EU15 has not only ceased to catch up with the US in terms of GDP/capita but has in fact fallen further behind during the last 10 years. However, some countries have done much better than others, growing at rates considerably higher than the US benchmark. There are wide disparities in both the utilisation of labour resources and productivity. Clearly, there is no single European story.

The authors argue that EU policy debate, rather than focusing on competitiveness, ought to address the reasons for disappointing aggregate growth outcomes as well as intra-EU heterogeneity. They claim, on the basis of a large body of OECD analyses, that the weaknesses in growth performance in many countries can to a large extent be ascribed to inadequacies in the structural policy framework. Cotis and Elmeskov examine policies and policy reforms in the labour, product and financial markets and also concerning innovation and human capital policies. In their view, growth enhancing reforms have gone further in the product market than in the labour market, and on the basis of the OECD’s reassessed Jobs Strategy, several areas of further labour market reform are identified. The authors agree on the importance of innovation as the main driver of growth. Nevertheless, they caution against applying uniform policies, such as the 3 % R&D spending ratio, in countries with widely differing circumstances.

Based on the emerging empirical literature concerning the political economy of structural reform, the authors suggest a number of actions governments could take to facilitate the reform process. For example, structural reform may be assisted by having scope for the macroeconomic accommodation of any negative short-term impacts, which constitutes an additional argument for establishing more sound fiscal positions. Moreover, the tendency for structural reforms to have ripple effects across different markets suggests that trade globalisation, which is desirable in itself, could help reform in other areas. Finally, they also emphasise the role that analysis by institutions regarded as independent and credible can play in terms of unblocking the reform process.

How much will pooling the European services markets help?

Henk Kox and **Arjan Lejour** provide a concise review of the European services market and discuss the effects of the proposed Services Directive, which seeks to lower barriers to services trade across Europe.

The starting point of their analysis is the fact that services markets in most segments are still very much national. Therefore, there is substantial scope for reaping economic benefits from European market integration.

Several studies indicate that bilateral trade and foreign direct investment in services will increase substantially in response to the new Services Directive. GDP and consumption could go up by 0.5% to around 1% on average in Europe. The effects on the Member States will vary depending on the size of the barriers in their services markets and specialisation. These results take account of scale effects, and forward and backward linkages in the economy.

A much harder question lies in the dynamic effects of liberalisation. Kox and Lejour discuss the various channels through which an integrated European services market may generate dynamic gains. Improved market access will stimulate competitive selection and productivity growth. Furthermore, through trade and investment, knowledge spillovers will increase, and innovation will be fostered. However, quantitative evidence on the dynamic effects is hard to come by. In the authors' view, these may be significant and are likely to arise mainly from the effect of new market entry by firms from other EU countries.

Finally Kox and Lejour note that the Single Market Programme for services is still far from accomplished. First, the directive covers only a relatively small fraction of services industries. Second, the country-of-origin principle would help reduce barriers to access much more effectively than the directive in its current form.

Network Industries: another area in need of further action

For the last two decades, the European Commission has engaged in a major effort to liberalise network industries in order to make them more efficient for the benefit of consumers and to enhance Europe's competitiveness. **Damien Gerardin** reviews these efforts and assesses the current situation.

The liberalisation policies are based on three pillars. First, directives had to remove exclusive rights granted to incumbents. Second, these directives provide for the development of regulatory frameworks designed to facilitate the arrival of competition, as well as the establishment of regulatory authorities in charge of implementing such frameworks. Finally, the application of EC competition

rules has made a significant contribution to the promotion of competition in network industries.

The liberalisation effort pursued by the Commission is generally considered a success. Today, two sectors (air transport and electronic communications) are completely open to competition, while liberalisation is well underway in the other sectors (postal services, energy and rail transport). However, according to Gerardin, some bottlenecks remain and impede competition in a number of sectors.

First, a serious problem originates in the inadequate implementation of liberalisation directives in some Member States. This is delaying the liberalisation process and distorting competition by creating regulatory asymmetries between Member States. Second, the absence of EU-wide regulatory authorities is negatively affecting the creation of truly integrated markets, since national authorities are poorly adapted to dealing with cross-border issues as their scope of action is typically confined within their Member State borders. Third, the arrival of competition in network industries markets is often impeded by incumbents' tendency to rely on their market power to prevent entry into the market. Finally, the creation of EU-wide markets in network industries is being negatively affected by various forms of economic patriotism whereby Member States try to protect their incumbents.

The role of sector-specific regulation is currently the subject of much debate. Gerardin argues that while a deregulatory movement can already be observed in a number of sectors, some degree of sector-specific regulation is probably here to stay for two reasons. First, some network infrastructures (such as electricity transmission systems) have natural monopoly features and thus require continued regulation. Second, because competitive markets are unlikely to provide for universal services, universal service obligations will need to be maintained.

For innovation to take off, supply side measures must be complemented by bold action on the demand side

Luke Georghiou considers the overall framework of innovation policy. His starting point is that recent trends such as open innovation have created a networked innovation ecology which requires new kinds of policy support. Any policy which seeks to help firms, singly or collectively, to improve their capacity to innovate may be seen as an innovation policy.

Georghiou presents a taxonomy of research and innovation policies. In it the key distinction is the one between supply-side (finance and services) and demand side support. Georghiou claims that the demand side (systemic policies,

regulation and public procurement) has been under-exploited. This is especially so in Europe where the problem of under-investment in business R&D and other innovative activities is strongly linked to the fragmented condition of European markets in scale, regulation, IPR terms etc. Only recently, following publication of the report by the so-called Aho group, has the need for innovation-friendly markets started to receive the attention it deserves. New policy documents have responded positively and now feature promotion of lead markets in a central role.

Georghiou concludes by assessing what the implementation of procurement and regulation-based policies would involve. In his view, there is still a lot of reluctance to pursuing the kind of bold large-scale measures that would be needed to begin the transformation of Europe as an environment for innovation. To break the deadlock, the policy makers should urgently take action on launching large scale projects to create innovation-friendly markets. Such action could be based for example on the nascent technology platforms. Secondly, it should finally be decided how to develop the fragmented patent system in Europe. Finally, Georghiou argues that the new demand-side policies he favours in no way implies the old industrial policy of "picking winners". What the new policy seeks to promote is competitive arenas rather than specific technologies or firms.

Investment in education is essential but increased investment is insufficient in itself

Angel de la Fuente surveys the findings of a broad range of literature on the effects of education and skills on labour market outcomes at individual level and on the level and growth rate of productivity at the country level. Recent estimates of the growth effects of human capital seem to imply significant social returns on educational investment in all European countries. This suggests that investment in education and training should indeed remain a priority as part of a European strategy for promoting growth without sacrificing social cohesion.

In terms of targeting education efforts efficiently, conclusions are harder to arrive at. Cross-country aggregate studies used to infer growth effects offer little guidance. However, drawing on a considerable body of micro econometric research in the economics of education, de la Fuente makes two general points.

First, providing the right incentives for all participants in the education process is probably much more important than increasing resource inputs. Second, the returns are likely to be highest in the case of early interventions, particularly when they focus on youngsters from disadvantaged socioeconomic backgrounds, because they can at least partially compensate for an

unfavourable family environment at an age that is critical to the acquisition of basic skills.

Therefore, de la Fuente would give priority to pre-school education and incentive-improving measures, such as the introduction of standardised examinations, the publication of school performance indicators, increased school autonomy in certain areas, performance pay for teachers, and greater inter-school competition and parental choice.

Balanced reforms needed in the European system of intellectual property rights

Dietmar Harhoff looks at the key issues relating to intellectual property rights (IPRs), which, having been an arcane technical matter prior to the 1990s, now attract attention, not only among the users of the respective IPR systems, but also among the citizens of Europe.

Harhoff notes that it is now generally accepted that IPRs can play an important role in fostering innovation, but the design choices for IPRs remain contested. Some of the renewed interest is created by the perception that the IPR systems have strengthened the position of rights owners over those of the users of protected subject matter. Harhoff argues that this perception is at least partly correct. In the field of copyright, technical and legal developments have contributed to a shift of control towards commercial content providers. In the area of patent rights, changes in the behaviour of applicants have led to strong increases in the demand for patent protection, coupled with some signs of quality deterioration in the patent system. While Europe may have fared relatively well when compared with the US, problems are emerging in the EU as well.

As policy recommendations, Harhoff emphasises three points: (1) there is a clear need for harmonization of European administrative and legal practices in the area of IPRs, (2) increasing the quality orientation of the system is pivotal and should not be compromised when reforms hopefully make patenting less costly, (3) a new balance between the owners of rights and users of the protected subject matter needs to be found in many areas.

European risk capital market needs to be improved – and there are ways to do so

Markku Maula and Gordon Murray analyse the European market for risk capital, with particular reference to the US benchmark. The authors begin by asserting that the availability of risk capital in all its variants is a critical resource for a modern and adaptive economy. The effective exploitation of new

knowledge requires a commercialisation process that depends on informed, skilled and risk accepting investors both as individuals (business angels) and professionals (venture capitalists). Similarly, the restructuring and re-invigoration of large established corporate businesses, often on an international or global scale, has been materially assisted by the advent of a finance industry focused on management buy-out activity.

In Europe, the provision and use of equity based financing is both patchy across countries and materially lags behind development levels seen in the USA. Both inefficiencies in the supply of venture capital and in the demand from informed and growth oriented entrepreneurs has resulted in parochial and nationally focused risk capital industries that are individually and collectively weaker than their US competitors. There is a real need to develop a more pan-European private equity industry.

Maula and Murray argue that (1) business angels are collectively more important than venture capital for early stage ventures. Therefore, the national fiscal environment should incentivise and reward risk taking by entrepreneurs and their early-stage financial backers. (2) The costs associated with avoiding multiple taxation of private equity firms form a material barrier to a European market for risk capital. (3) Governments should try to encourage the involvement of private and commercial investors rather than seeking to substitute for their unique skills by acting as a direct investor of public monies in new enterprises. Where governments support 'hybrid' venture capital funds by co-investing, they should stipulate that such funds must be of a commercially viable scale.

Clearer responsibilities and more peer pressure called for in the Union

Sixten Korkman starts his discussion of the EU system of economic governance by emphasising, like Cotis and Elmeskov, the considerable diversity of the economic and social performance of the EU member countries. He furthermore identifies the varying roles of the public sector and labour market institutions as the factors behind this diversity.

The EU system of economic governance is based on principles of subsidiarity and assignment and according to Korkman can be regarded as largely successful. Problems are confounded rather than resolved when the two principles are disregarded or compromised, as with the Lisbon process and attempts at macroeconomic policy co-ordination. The roots of the economic weakness of the EU are not in a lack of action at Community level or faults in the EU system of economic governance. Instead, the blame should be laid on governments unwilling or unable to reform their economies, to adapt labour

markets and public sectors to changing circumstances such as technological change, globalisation and aging populations.

Korkman claims that little can be done about this at EU level, although more emphasis on multilateral surveillance and peer pressure could help to shape policy debate and enhance a fruitful process of mutual learning. Co-ordination at Community level, while a popular feature in EU rhetoric, risks confusing responsibilities and shifting blame to the Community for matters in which it has no real authority.

Global institutions matter and Europe must bear its responsibility

Alan Ahearne, Jean Pisani-Ferry, André Sapir and Nicolas Véron discuss the role of the European Union in the governance of globalisation. In their view, the system of multilateral rules and institutions that constitutes the global economic governance regime trails behind the rapid transformation of the world economy and the rise of pressing global issues, climatic change being a prime example. It also faces significant challenges such as the resurgence of economic nationalism. It needs to adapt to changes in the geopolitical background and to a growing number and diversity of participants in global economic integration. It must learn to coexist with regionalism and market-led governance.

The authors argue that while it is possible for globalisation to proceed with weak global governance, it cannot do so without significant risks being posed to its sustainability. The EU, which has a stake in the multilateral system and a probable comparative advantage in institutional design, should be a key player in its reform agenda. The difficulty of the task is no excuse for avoiding it and for hiding behind US leadership. To equip itself with the ability to take reform initiatives, the EU requires changes in its own internal governance and external representation. Contrary to conventional wisdom, these changes need not imply a federalisation of external relations.

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- ***Challenges created by the new EU Member States and third countries*** by Mika Widgrén, (Turku School of Economics)
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