

- A **dynamic economy** demands enterprise and innovation; an enterprising and innovative society is best able to deliver gains to all its citizens. ‘Entrepreneurship’ is invariably difficult to quantify, but such proxy indicators as exist point to an EU doing better than it once was, but far from as well as it should.
- One constraint may be the lack or cost of funding, and of **venture capital** in particular – valuable not only in itself, but in the managerial and technical know-how which often accompanies its provision; another may be regulation. Good regulation helps correct market failure and strengthens competition. Unnecessary, opaque or badly designed regulation restricts competition, stifles innovation, deters investment and has a disproportionate impact on small businesses and entrepreneurs.
- Besides these, **US outperformance** appears to have rested on a range of other inter-related factors: more intense competition; the more rapid development and adoption of ICT; differences in tax structure, labour markets and culture; and a favourable, confidence-engendering macroeconomic environment. Some of these factors, such as culture, are uniquely ‘US’; others are common sense. Without its large, single market; without its broad and liquid capital markets; without its skills base; and without the market opportunities that effective competition and regulation provide, the US drive for enterprise and innovation – and hence its job creation – would have been blunted.
- An EU wishing to **learn from best practice** must learn from both its own and others’ experience. It must also judge which lessons may be applicable within the context of its own traditions, markets and social models. A challenge, but one which EU leaders cannot afford not to rise to.

## INTRODUCTION

*“To recreate Europe we must recreate enterprise policy – and then retool it to foster entrepreneurship in the new economy.” (European Commission)<sup>1</sup>*

### Risky business: enterprise and innovation

**5.1** A **dynamic economy demands enterprise and innovation**; an enterprising and innovative society is best able to deliver gains to all of its citizens. While measuring either characteristic can be difficult, such estimates of “entrepreneurship” as are attempted (the number of people starting a business, or the rate at which individuals invest in other people’s start-up companies) tend to be correlated with growth<sup>2</sup>.

**5.2** Clearly, the link runs in both directions: business start-ups may fuel growth and employment, but buoyant growth and employment may equally be expected to encourage start-ups. As has already been noted, however, the entry of new firms into a market does appear to have implications for productivity; and in an environment of rapid technological change, where competition tends to come less from an item being produced more cheaply than from a new design which renders its predecessor a museum-piece, enterprise and innovation may reasonably be regarded as increasingly important to economic success. This

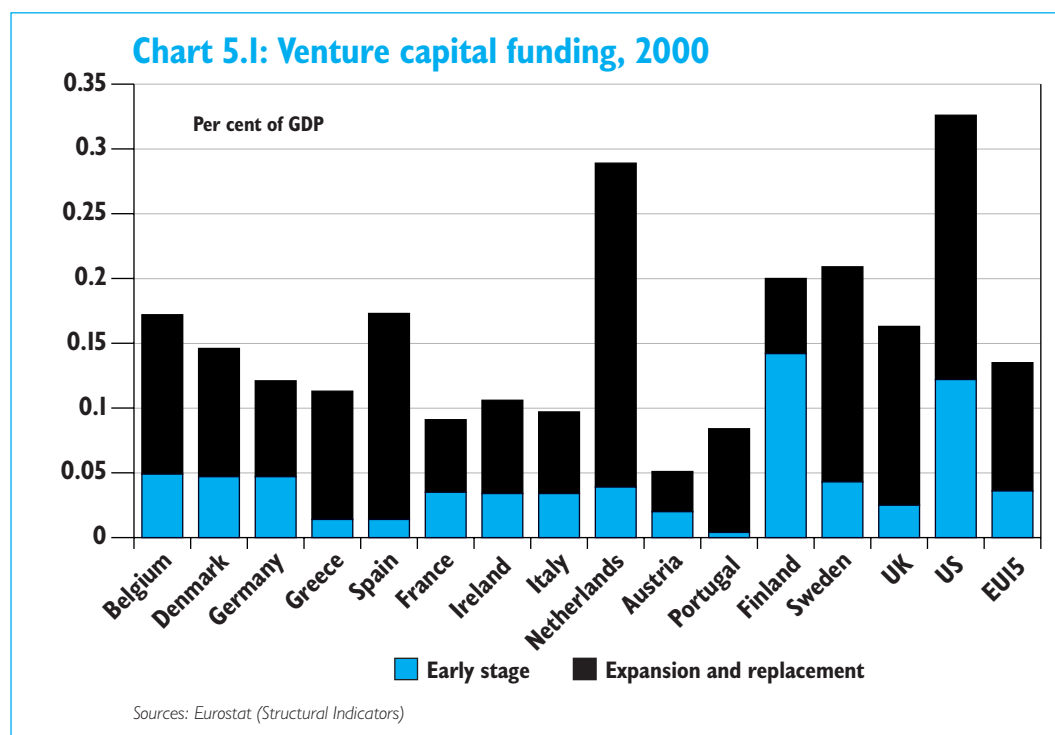
<sup>1</sup> *Enterprise Europe*, European Commission, Enterprise Directorate-General, September 2000.

<sup>2</sup> See for example *Global Entrepreneurship Monitor 1999 UK Executive Report*, London Business School, 1999.

chapter considers some of the factors likely to influence enterprise and innovation: access to venture and risk capital; regulation; R&D expenditure; and the flow of information and funding between business, government and academia, and across borders. Chapter 6 then takes a closer look at capital markets and investment, while skills are brought into the spotlight in Chapter 7.

## VENTURE AND RISK CAPITAL

**5.3** For policy-makers, an **innovation-friendly framework** is the holy grail; universally aspired to, but difficult to pin down. Comparisons with other countries can help cast some light on where improvements might be made in the EU. Accessing venture and risk capital to back new technologies and help expansion, for example, is one well-publicised problem area for innovative firms in many EU Member States. The benefits of ease of access to venture and risk capital are evident from recent US experience, and go beyond the provision of the capital itself. Management and technical skills are also often provided by the investing institutions; a valuable transfer of know-how which has helped the small firm sector in the US create a significant number of jobs.



**5.4** **The absence of a single European capital market** hampers the efficient allocation of funds within the EU. The 1988 Cecchini report estimated the lost consumer surplus from the lack of a Single Market in financial services at Ecu 22 billion: translated into today's money, the shortfall would clearly be substantially greater<sup>3</sup>. It should be noted, however, that the costs of misallocated funding go beyond the extra costs paid for finance by existing firms, and beyond even the constraints faced by firms unable to raise capital at any cost, and which therefore stagnate or exit the market. It includes also those companies and start-ups which fail to get off the ground in the first place, potential entrepreneurs having been discouraged at the outset by the difficulty of raising funds. Remedying this fragmentation does not necessarily require action at an EU level; national inefficiencies and obstacles constitute a major aspect of the problem, and are more appropriately tackled by Member States. In the

<sup>3</sup> Up-rating Cecchini's figures for growth and inflation would imply a loss in 2000 of about €44 billion.

meantime, however, the cost to society of 15 separate financial markets accrues not just in the effects on existing EU businesses and employees, but also in the shape of those EU businesses which have failed to materialise.

**5.5** In March 2000, the EU had only 785 companies listed on small company exchanges compared to the US 4800. In the same year, the total volume of venture capital investment in Europe was €19.6 billion from €10 billion in 1999; less than a third of US venture capital investment in each year. True, institutional venture capital funding in Europe reached a larger number of companies; 8,500 in the year 2000, against 5,500 in the US. Whether this implies greater European success in reaching the smaller end of the market, perhaps through publicly supported schemes, or indicates greater problems for European companies in obtaining the ‘critical mass’ of funding needed for rapid large-scale growth that only the private sector can provide is, however, a moot point.

**5.6** This does not imply that there is no un-met demand for risk capital in the US (especially given the collapse in investment in venture capital-backed US companies in 2001 – down 65 per cent from a record \$91.6 billion in 2000, to \$32.1 billion<sup>4</sup>). The problem is, however, likely to be even worse in the EU. Some of this may reflect **demand-side** differences; that fewer SMEs in Europe than in the US consider external risk capital in response to similar financing problems.

**5.7** From the **supply side**, however, a recent report to the European Commission<sup>5</sup> identified three possible reasons for the risk-capital differential:

- **the smaller scale in the EU of informal business activity.** Business angel networks (BANs) are a recent arrival in Europe. Despite rapid growth of 25 per cent in the number of EU BANs between 1999 and 2001, the total of 130 remains relatively small and highly concentrated (53 in the UK, 29 in Germany, 25 in France)<sup>6</sup>;
- **the more diverse nature of the US banking sector**, which provides a wider range of financial products for SMEs including higher risk, higher return products such as mezzanine and debt-equity hybrids; and
- the significant contribution made to the supply of US risk finance by the activities of leveraged **Small Business Investment Companies (SBICs)**. The US Small Business Administration’s leveraged programme for SBICs is well-established, though it is not, as is often mistakenly regarded, a guarantee scheme. The SBIC is a private sector investor which, in gaining accreditation and providing access to leverage through the SBA, shares the risk with the latter and is commercially oriented in its choice of projects.

**A tale of two gaps; venture capital...**

**5.8** The report noted two elements of the financing gap. The **venture gap**, mainly pure equity, applies to small, high risk, high growth, innovative and new firms which fall below the size threshold of most institutional venture capitalists; about 5000 firms per year, on the report’s estimates. The difficulty for such companies is that fixed transaction and monitoring costs make investment in their business uneconomic for most commercial investors.

<sup>4</sup> Financial Times, 29 January 2002.

<sup>5</sup> *Innovative Instruments for Raising Equity for SMEs in Europe*, Bannock Consulting, 2001.

<sup>6</sup> *Sustaining the commitments, increasing the pace*, Communication from the Commission to the Council and the European Parliament, November 2001.

**...and risk capital** **5.9** The **risk capital gap** stretches beyond equity to encompass also mezzanine debt and debt-equity hybrid financing, and affects a much larger number of moderate growth, moderate risk companies (about 100,000 to 200,000 per year, according to the report). This area of finance tends to fall between two stools; neither the high risk, pure equity provided by venture investors, nor the conventional low-risk lending of banks. There are simply too few European financiers active in this segment of the market, discouraged in some cases by the lack of network facilities such as specialized support services and shared knowledge, or by fragmented secondary markets which are insufficiently liquid to guarantee easy investor exit.

**5.10** Several EU countries have used **public sector equity guarantees** providing loss-sharing for investors in SMEs, to help bridge the gaps. Some, such as Germany, have bolstered this with soft leverage or co-funding. The disadvantage of such risk-sharing is that it removes the investment decision ever further from market conditions. It has also, with the exception of Germany (where, as the Commission's report notes, "the public resource input has been high"), had little impact on the target market. This prompts the report to recommend that public sector support be focused not on loss-sharing guarantees, but on commercial-rate leverage programmes channelled to experienced teams willing to invest their own risk-capital in any part of the SME sector. (Risk-sharing instruments such as loan guarantees may, however, have an important role to play in EU candidate countries which lack an equity financing tradition and have a less developed banking sector.)

**5.11** There may also be a gender dimension to be taken into account. The 2001 Global Entrepreneurship Monitor highlights, for example, the lack of entrepreneurship among women in particular, in the UK. Around 11 per cent of UK men are described as entrepreneurial, against just over 4 per cent of women. This compares with 14 per cent of men and 10 per cent of women in the US, and is a divergence confirmed by a recent Small Business Service (SBS) survey which found that 24 per cent of UK men were involved in business ownership, but only 11 per cent of women. The SBS, which aims to increase the number of people considering going into business, is focusing on women and other under-represented groups in order to meet its objectives.

**Promoting enterprise** **5.12** Clearly, US outperformance stems from not just one, but from a bundle of inter-related factors. These include not just access to venture capital, but also more intense competition; different responses to globalisation; the more rapid development, adoption and exploitation of information and communications technology; a different tax structure; differences in labour markets; and a favourable, confidence-engendering macroeconomic policy environment. Without its wide and deep capital markets; without its skills base; and without the market opportunities that only an effective competition policy can provide, the drive for enterprise and innovation – and hence job creation – in the US would have been profoundly blunted.

## REGULATORY REFORM – CUTTING RED TAPE

**Good regulation...** **5.13** **Well-targeted regulation** is the complement to effective policy on competition and state aid. Good regulation can bring important benefits to businesses and the economy by correcting market failures, and to citizens through increased fairness and public safety. Where market outcomes do not deliver the quality and safety consumers demand, for example, market performance cannot be considered satisfactory, and policy intervention required through, for example, different standards, a more coherent analysis of the risks to consumers, tighter enforcement and a better response to emergencies. One recent example of market failure that had to be tackled with special actions, was in the area of food safety with regard to BSE. The UK's White Paper on Food Safety, corresponding national actions by other Member States, and the establishment of an independent European Food Authority should all be seen in this context.

**...and not so good regulation** **5.14 Unnecessary or inefficient regulation**, in contrast, carries serious costs: the restriction of competition, the stifling of enterprise and innovation and the deterrence of productive new investment. The European Commission has put the cost to the EU of badly drafted regulation at about €50 billion per year<sup>7</sup>. Member States continue to introduce regulation at a rapid pace. The number of notifications of draft technical regulations by Member States stood at 591 in 1999 and 751 in 2000. A rise in quantity is, of course, entirely consistent also with rising quality; it is impossible to say purely from the numbers whether or not the legislation passed is 'good' or 'bad'. It is also difficult to ascertain whether it reflects citizens' demand for greater reassurance, or governments' attempts to respond to increasingly complex issues. Balancing these against the need for simplification and clarity is a key and very difficult challenge.

**A welcome Presidency focus** **5.15** At both a domestic and European level, the Government is committed to ensuring that regulation is transparent, accountable, targeted, consistent and proportionate to the problem it is intended to solve. Efforts by governments elsewhere in the EU to the same end are welcome. Spanish Economy Minister Rato, for example, recently announced plans to reduce the amount of time taken to create a new business in Spain from an average of over two months to a maximum of two days. The time taken to register a new private limited company in the EU currently ranges from less than one week to four months, depending on the Member State<sup>8</sup>.

**Regulatory Impact Assessment** **5.16** More generally, a majority of Member States have adopted a means of assessing existing and proposed regulations, known as **Regulatory Impact Assessment** (RIA). Approaches to RIA vary considerably. In Italy, where it was introduced in 2000, it takes the form of a two-step submission: first, a preliminary assessment of the parties affected, the rationale for the policy, the budgetary, economic, financial, organisational and social constraints, the alternatives to regulation and the appropriate level of regulation; and, second, validation of the initial findings, expected results, a description of the analytical method, and the direct and indirect impact (based on cost-benefit analyses) of the parties involved and the public administration. The RIA programme is managed by the Regulatory Simplification Unit and the Department for Legal and Legislative Affairs. The latter has the capacity to delay a poor quality regulation or law, and can report to the Prime Minister; important for the system to be perceived as having credible reviewers.

**5.17 Product and labour market regulation** each affect investment as well as employment decisions. As the OECD suggests, restrictive regulation and labour market rigidities are directly related to low investment growth, while the level of state involvement in economic activity is also influential. Even controlling for a number of policy and institutional factors affecting the labour market, one OECD study<sup>9</sup> found that **anticompetitive product market regulations** (establishing entry barriers in potentially competitive markets or unduly restricting market mechanisms) had significant negative effects on non-agricultural employment rates of OECD countries. Their study also suggested that strict **employment protection policies** could lower innovation activity in manufacturing. However, the impacts differ depending on industrial relations regimes (bargaining arrangements, business associations, business codes of conduct, etc.) and the technology level of the industry concerned.

<sup>7</sup> *Internal Market Scoreboard*, November 2001.

<sup>8</sup> *Sustaining the commitments, increasing the pace*; Communication from the Commission to the Council and the European Parliament, November 2001.

<sup>9</sup> *Product and labour market interactions in OECD countries*, OECD, September 2001.

**EU legislation 5.18** The EU has an important bearing on the UK's domestic environment. **Around 40 per cent of new legislation** with a non-negligible impact on UK businesses originates in the EU<sup>10</sup>. It is clearly in the national interest to ensure that such regulation meets the standards of transparency, consistency etc. expected of domestic regulation.

**5.19** The UK therefore strongly supported **the high-level political commitment to regulatory reform** made at the Lisbon European Council. Two years on, it urges the taking forward and implementation of the recommendations outlined in the Commission's Governance White Paper of July 2001: impact assessment; the use of alternatives to regulation; minimum standards for consultation; and the review and simplification of Community legislation. The Government welcomes, in this context, **the Commission's intention to withdraw 108 legislative proposals** on the grounds of their now being out-of-date or redundant.

**The Mandelkern Group 5.20** A detailed set of recommendations on better regulation was produced by **the high-level advisory group on better regulation**, also known as the Mandelkern Group. This group, which numbered representatives from all EU Member States, published its final report in November 2001. It recommended that all Member States establish systems providing for impact assessment of new regulations, for effective consultation, and for consolidation and simplification of existing regulations. Similarly, it recommended that the Commission:

- establish a system to assess the full impact of a regulation before that regulation is put in place;
- improve access to policy-making for all stakeholders through better and earlier consultation;
- reduce the volume of legislation through codification, targeting a 40 per cent reduction in Community Acts by June 2004 and thereby easing the compliance burden for both current and future Member States;
- launch a wide-ranging programme of simplification of existing legislation; and
- create a network throughout the Commission to support this work and promote better regulation in general.

Given the importance which the Government places on getting regulation right, **it welcomes the Mandelkern Group's recommendations** to the Commission and Member States. As agreed at the Laeken European Council in December 2001, an action plan is needed to implement the recommendations of the Mandelkern Group as soon as possible in the first half of 2002.

**National measures – getting the frameworks right 5.21** Measures being taken by the EU go some way to answering the challenges of fostering a more enterprising and innovative society. Ultimately, however, the Government believes that getting the framework conditions right at a national level is fundamental to the exercise. Ensuring, for example, that barriers to entry within the domestic market place are low through a rigorous approach to competition policy, or that inefficient firms are not propped up by state aid are crucial steps towards this goal.

<sup>10</sup> Based on the average proportion of UK RIAs concerning EU legislation.

## NEW FIRMS, NEW SECTORS

### Helping small firms grow

**5.22** A recent OECD study<sup>11</sup> comparing EU and US performance highlighted the importance of small firms being able to grow and ‘contest’ a market. Looking at employment over the first two years of a company’s life, the study found that employment growth among new entrants was over 500 per cent higher in the US than in European countries. It also noted the higher entry and exit rates of EU firms, and the much higher survival rates of start-ups in the US. The evidence also suggested that, in the EU, it might be easier to close down a firm (or have someone else purchase and close down the firm) and re-start production elsewhere, than to undertake internal restructuring.

**5.23** Taken together, these conditions and others appear to have allowed smaller, more nimble firms in the US to reach quickly a stage at which they can hold their own against incumbents, forcing them to seek ways to maintain their market position. Strong competitive pressures have forced all firms to look continually for ways to reduce slack, drive down costs, and organize production more efficiently.

### Best practice in a global context

**5.24** It is not suggested that the EU ‘import’ a US model, or even adopt any parts of its economic structure unthinkingly. Careful consideration must, however, be given by Member States to the conditions which appear to have promoted enterprise and innovation elsewhere, especially in promising new technologies such as biotechnology (Box 5.1). Europe’s lag behind the US in this field may in part reflect late entry, but a range of other factors also appear to be at work. In the words of the European Commission, “*Success in this industry depends on a delicate blend of competencies and incentives and requires the integration and coordination of several differentiated agents, capabilities and functions*”.<sup>12</sup>

**5.25** Europe’s problems are illustrated by the observation that, while Europeans carry out a level of biotechnology research in the US comparable with that in other sectors, comparatively little US research is done in Europe – an apparent unattractiveness of Europe to US research which is particular to biotechnology.

**5.26** Best practice is not a purely European phenomenon. US experience illustrates the importance of ensuring that markets are open to vigorous competition, that appropriate funding and regulatory frameworks are in place, and that regional and global networks and collaborative relationships are up and running, and suitable for the sector in question.

### The possibility that size matters

**5.27** The idea that country size may have played a more important role in the extent to which countries have exploited new sectors such as biotechnology or ICT, also repays attention (though is as yet far from proven). The latest European Competitiveness Report from the European Commission<sup>13</sup> raises the possibility that the completion of the Single Market, together with the intensification of competition, contributed to the understanding of smaller Member States that they had more to gain from economies of scale in a wider market, and that this therefore encouraged their commitment to developing strategies to take advantage of it (by, for example, e-commerce). The growth of biotechnology is, in the Report’s judgement, consistent with this theory. Certainly, it is an idea with interesting implications for the design at a regional level of future policies intended to promote the take-up of new technologies.

<sup>11</sup> *Comparative analysis of firm demographics and survival: micro-level evidence for the OECD countries*, S. Scarpetta, E. Bartelman and F. Schivardi, OECD, 2001.

<sup>12</sup> *European Competitiveness Report 2001*, European Commission.

<sup>13</sup> *Ibid.*

**Box 5.1: Biotechnology**

The Government has outlined its belief that a successful biotechnology strategy will be a key asset for Europe in the 21st century. With global revenues from the sector expected to more than triple in the next ten years, European countries should be playing a leading role in responsible international decision-making on the use and development of biotechnology. Europe still, however, needs to do more to develop a strategic approach to the industry if it is to reduce the general technological gap with the US and match its performance in biotechnology in particular, by 2010.

The Government fully recognizes that biotechnology raises difficult ethical and social issues. These cannot be ignored. They must be addressed carefully in an open debate using the latest scientific evidence and taking into account the views of all parts of society. But the Government is also convinced that, within the appropriate regulatory framework, biotechnology has a key role to play in generating significant improvements in the quality of everyday life (in food, health and the environment) and in the sustainability of economic activity.

**The EIB as a source of support** **5.28** The role of the **European Investment Bank (EIB)** can be significant as a source of support for enterprise, R&D and innovation. The EIB is the European Union's financing institution. Capitalised by the Member States and operating on a not-for-profit basis it has, since its creation by the Treaty of Rome, used its good standing on the capital markets to lend on a favourable basis, thereby contributing to the EU's policy objectives and its balanced and steady development. In 2000, it lent €36 billion (£22.5 billion).

**5.29** The EIB responded to the Lisbon European Council of March 2000 with the Innovation 2000 Initiative (i2i), a programme channelling €12-15 billion (£7.5-9.5 billion) over three years to cutting-edge, value-added sectors. The focus is on the key ingredients that promote innovation and encourage enterprise:

- the **development of SMEs and entrepreneurship**, through expanded venture capital operations with the European Investment Fund;
- the **dissemination of innovation**, by financing projects that foster the propagation and deployment of innovation, and the skills needed to accompany it;
- **research and development**, by supporting research programmes and especially those that bring together private enterprise and public bodies;
- **information and communications technology** networks, by financing access to networks in all regions of the EU; and
- **human capital formation**, by financing computer take-up and use in schools, colleges, universities and at IT training centres.

**5.30** EIB lending through i2i is also available to **candidate countries**. The EIB, in partnership with the EBRD, sees an important part of its role as helping pave the way towards the smooth integration of accession countries in the Single Market. The institution also seeks itself to provide maximum value-added to the EU's capital markets. Acting as a catalyst for private investors, it has the capacity to expand market boundaries by filling gaps in such important areas as SME financing, start-up venture capital and urban regeneration.

**European Charter for Small Enterprises** 5.31 It is also essential that the [European Charter for Small Enterprises](#) be fully implemented. The Charter provides the blueprint for a range of actions at both a national and European level to encourage enterprise. To be effective, however, it must enjoy a commitment which is both wholehearted and ongoing.

## GETTING THE MOST FROM INNOVATION

5.32 Innovation and technological progress are important inputs to employee and firm productivity<sup>14</sup>. While productivity can occasionally take large steps, its more usual trend is a continual stream of inventions and innovation affecting both technologies and working practices<sup>15</sup>. Effective competition, concluded a recent ECOFIN study into European R&D and innovation<sup>16</sup> (a good example of Member States sharing their experience of best practice) is one of the most important ways to stimulate this. Ownership structures, and the concentration of ownership, may also have an influence.

5.33 Efforts to stimulate innovation are not, of course, confined to the EU. The importance of innovation to improved productivity is widely recognised, and not only in the US. National programmes to this end have been implemented in countries as diverse as Canada, Australia and the Republic of Korea (Box 5.2).

### Box 5.2: Republic of Korea

In September 1999, the government of the Republic of Korea launched a long-term strategic initiative, Vision 2025, to:

- shift the innovation system from government-initiated to private sector-initiated;
- improve the effectiveness of national R&D investment;
- align the R&D system from a domestic to a global network; and
- meet the challenges of the information and biotechnology revolution.

The Government prioritises funds for technologies where Korea is judged to have a leading edge or be capable of developing one. For the period to 2005, approximately £5 billion has been allocated to research and development in five selected “next generation” sectors; information technology (IT), biotechnology, nanotechnology, environmental technology and cultural technology. To encourage small businesses in these areas, the Government is channelling around £600 million towards venture companies in 2002, primarily for investment in the IT sector. Some £500 million is also going to education and training, including the provision of an additional 50,000 IT specialists.

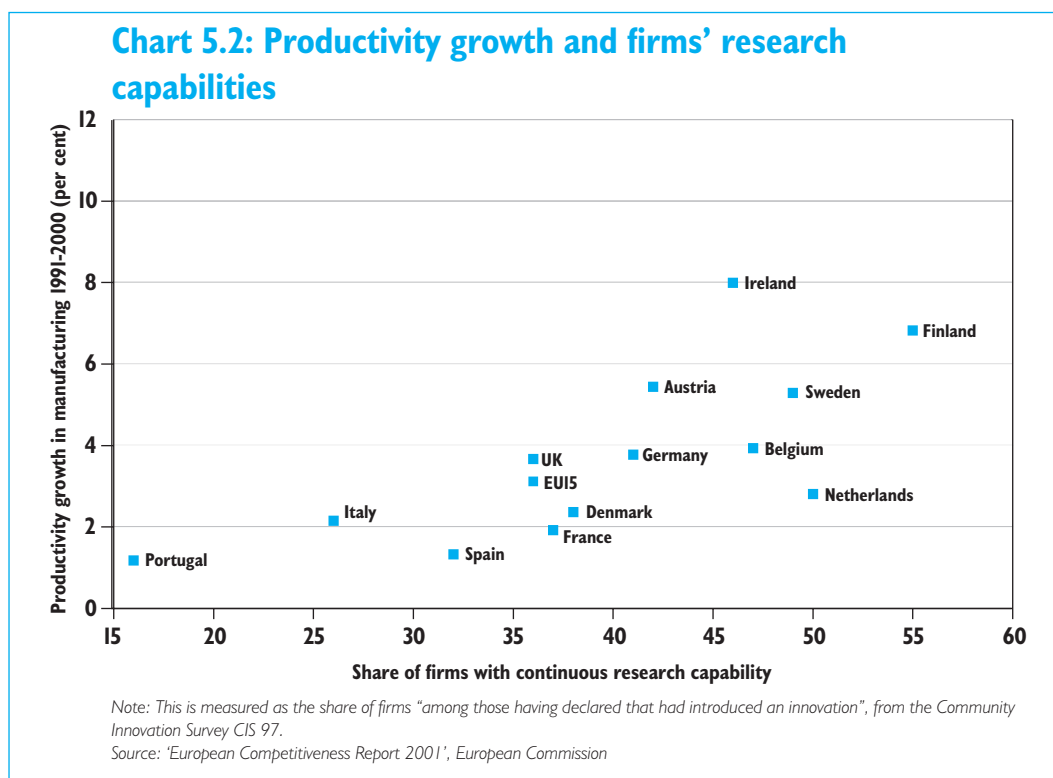
Restrictions on universities and research institutions are being loosened. Universities are being allowed to establish separate corporations to liaise with business or manage research programmes, while researchers in government-funded universities will be entitled to 30 per cent or more of the profits from their patents.

<sup>14</sup> See for example *The Search for R&D Spillovers*, Griliches, Scandinavian Journal of Economics, 1992; *R&D and Productivity: the econometric evidence*, Griliches, Chicago University Press, 1994; and *Mapping the two faces of R&D: productivity growth in a panel of OECD industries*, Griffith, Redding and Van Reenen, 2000.

<sup>15</sup> For instance, a recent study by McKinsey Global Institute suggested that much of the recent productivity improvement in the US resulted from shorter product cycles in the semiconductor industry, regulatory changes in telecoms, and better inventory management and electronic data interchange in wholesale and retail trade. (*US Productivity Growth, 1995-2000*, McKinsey Global Institute, 2001).

<sup>16</sup> *Report on research and development*, EPC report to ECOFIN, January 2002 [www://ue.eu.int/emu/en/index.htm](http://www://ue.eu.int/emu/en/index.htm)

**5.34** Evidence<sup>17</sup> suggests that firms which invest in research and development (R&D) have higher levels of productivity and innovation. Chart 5.2 plots productivity growth in EU Member States against the share of firms reporting continuous research activity. Again, the links can work both ways: firms and sectors investing in R&D may be successful, and successful firms and sectors may be more able to pursue R&D. Successful innovators may, however, reasonably be assumed to be able to gain a competitive edge through investment in R&D, as well as in human and physical capital, thereby increasing their chances of sustained success.



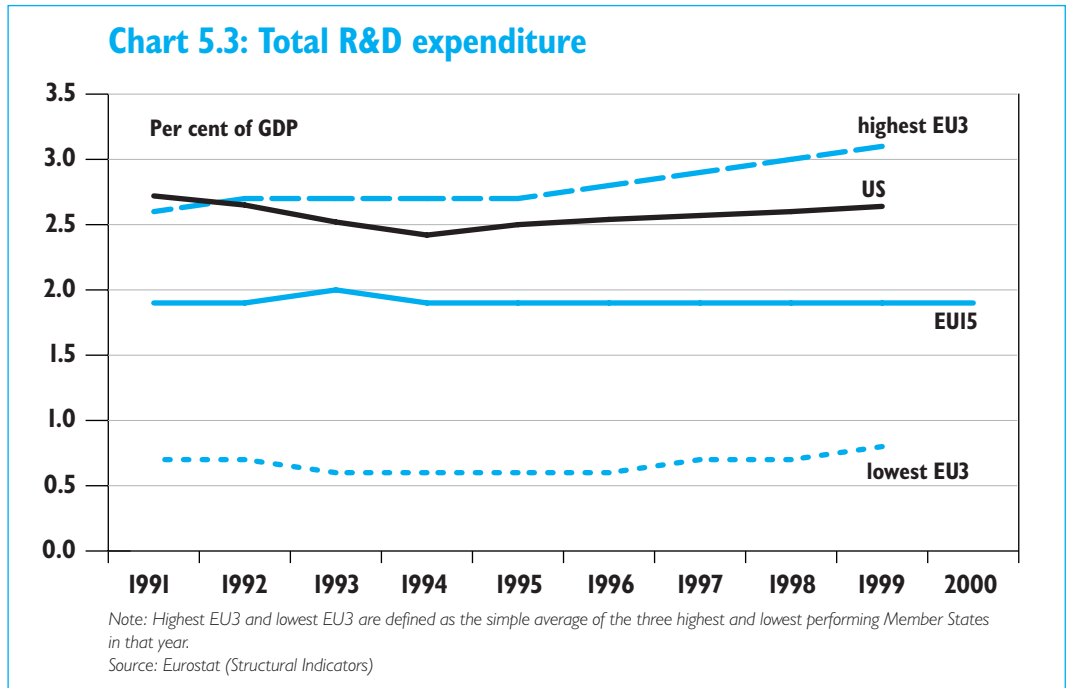
**5.35** As outlined earlier, there are strong links between these inputs to production. Investment in physical capital allows firms to take advantage of technological advances, but only if the workforce has the skills to utilize those technologies. In the same way, a skilled workforce may encourage firms to invest in more complex or expensive equipment. At the level of the entire economy, the skills base may constrain the extent to which new ideas and techniques can be adopted. For the firm and, to an even greater extent, the economy, skills and technological innovation are complementary<sup>18</sup>.

### Low levels of investment in R&D

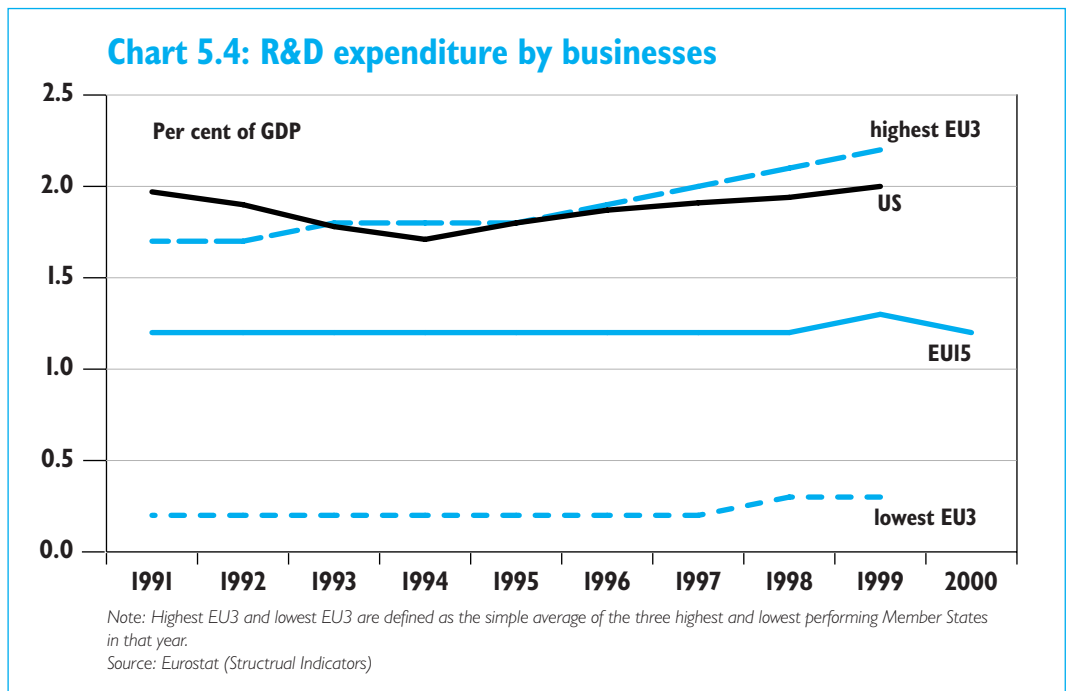
**5.36** Focusing specifically on R&D, Chart 5.3 illustrates total R&D expenditure as a per cent of GDP for the EU and the US, highlighting the resources invested also by the three highest and three lowest investing EU Member States. A knowledge-based economy – if the US offers any guide – might be expected to devote a higher proportion of its resources to research and development than the EU's fairly stable and sub-2 per cent allocation. Intra-EU variation is once again substantial; the difference between the highest and lowest performers in any one year is striking (and widening).

<sup>17</sup> *The Impact of R&D Investment on Productivity – New Evidence Using Linked R&D-LRD Data*, Lichtenburg and Siegel, Economic Inquiry, 1991 and *Advanced Technology Usage and Productivity Growth*, McGuckin, Streitweiser and Doms, Econ Innovation New Tech, 1998.

<sup>18</sup> See *Endogenous Growth Theory*, Aghion and Howitt, MIT Press, 1998.

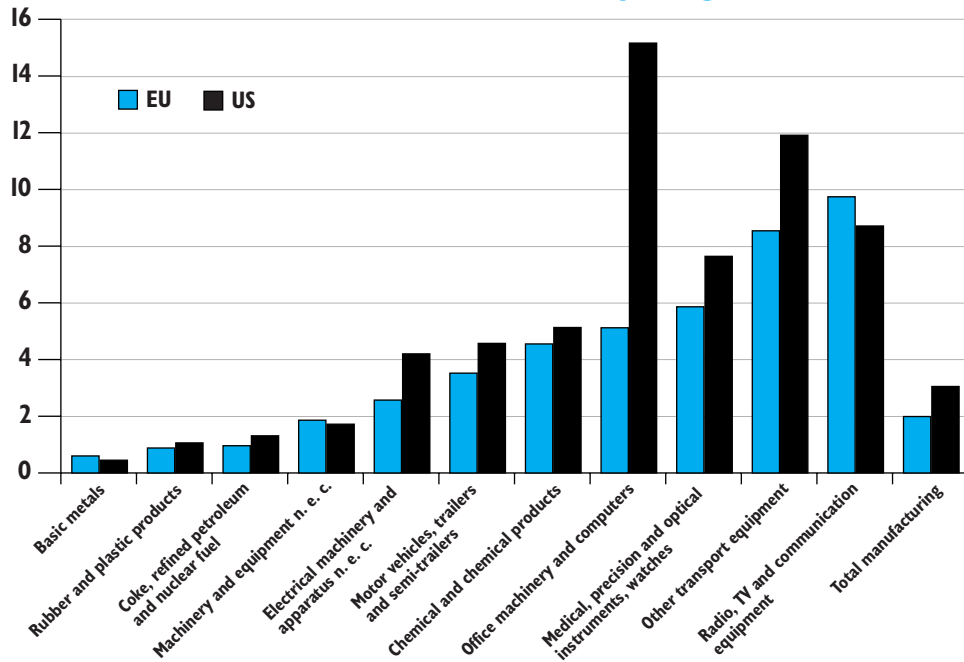


**5.37** Chart 5.4 concentrates on private sector R&D. The contrast between EU and US investment behaviour during the latter half of the 1990s is all the more substantial.



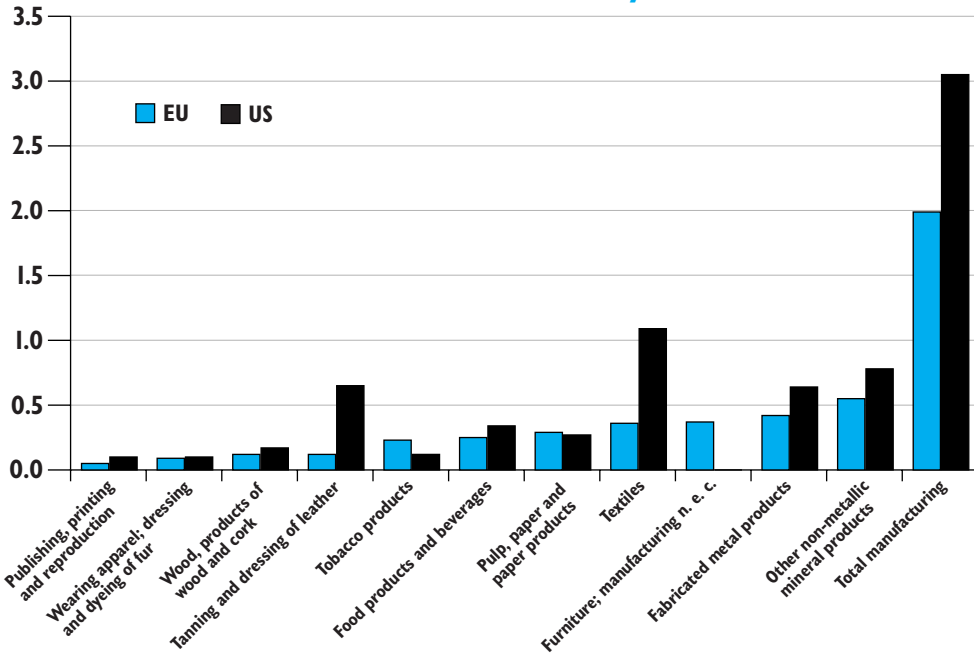
**5.38** Part of the difference in R&D expenditure may reflect different sector weights within the economy. Some sectors, such as chemicals or ICT, are inherently more R&D-driven than others, and these sectors feature more prominently in some economies than in others. As Charts 5.5 and 5.6 show, however, a comparison of research intensity across individual sectors, whether traditionally 'high' or 'low' R&D industries, confirms a gap which, in the majority of cases, favours the US.

**Chart 5.5: EU and US research intensity – high R&D sectors**



Note: R&D expenditure as per cent of production, average 1990–1997; n.e.c. = not easily classified.  
Source: European Competitiveness Report 2001, European Commission

**Chart 5.6: EU and US research intensity – low R&D sectors**



Note: R&D expenditure as per cent of production, average 1990–1997; n.e.c. = not easily classified.  
Source: European Competitiveness Report 2001, European Commission

**5.39** There is substantial evidence<sup>19</sup> that the social returns to R&D exceed the private. ‘Spillover’ benefits accrue to other firms by way of new and improved products, processes, services and know-how. As not all of these gains are registered by the company concerned, the level of R&D may be below that preferred by society as a whole; an economic rationale for governments to tackle the externalities that may surround private sector R&D.

**5.40** Only when markets offer sufficient rewards and information will firms invest in risky R&D. As well as improving the framework conditions that stimulate innovation, the ECOFIN study concluded that Member States may also need to consider:

- **boosting private sector R&D** through the wider use of measures such as tax credits;
- **improving access to start-up capital for smaller firms in R&D intensive sectors;**
- **addressing** why many EU firms, compared with their US counterparts, appear to ‘under-protect’ with **intellectual property rights** the knowledge they generate; and
- **improving the flow of knowledge** across economies and between research institutions and industry.

**The ‘European paradox’**

**5.41** The last point is worth noting. Spillover benefits are not automatic. To raise innovation, it is unlikely to be enough simply to apportion more resources to R&D without also having the ‘knowledge networks’ in place to transfer the ideas and knowledge created by the research base. In this context, such initiatives as the Commission’s planned launch in April 2002 of a new website, Gate2Growth.com, are to be welcomed. The aim of this initiative is to support innovative entrepreneurs by providing a portal to networks of financiers, corporate growth experts and incubator professionals, patent officers and academia.

**5.42** The EU generates much of its knowledge at universities and research institutes. Some Member States, such as Sweden, have put in place mechanisms to deepen links between industry and academia and make the most of its ‘knowledge producing’ sector. On the whole, however, Europe has not taken advantage of this knowledge and translated into commercial success. There is ample room for Member States to learn from best practices in countries such as Sweden, while still meeting the basic function of universities – providing a skilled workforce. Europe must do more to exploit the take-up of new ideas and giving a greater commercial and private sector airing to research generated by the public research base.

**UK, German and Austrian experience**

**5.43** The **UK** has established a number of schemes to support universities in their new role as centres of excellence for knowledge transfer. The Higher Education Innovation Fund aims to create a climate of enterprise by providing incentives for researchers to exploit their work; the University Challenge Competition provides ‘seedcorn’ funding for commercial developments at an early stage. Greater use is also being made of government and research council-sponsored Faraday Partnerships, which link universities and independent research and technology organisations with business and finance companies; and a Small Business Research Initiative sets a target for public procurement of R&D undertaken by SMEs.

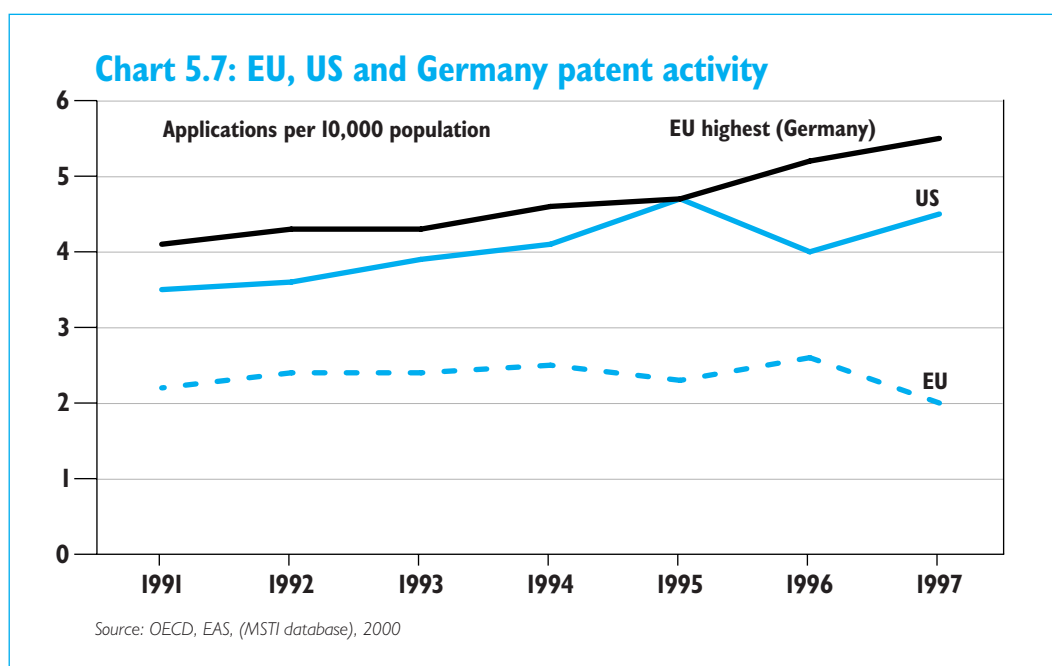
<sup>19</sup> See for example the evidence presented in *Measuring the Social Rate of Return to R&D*, Jones and Williams, Quarterly Journal of Economics, 1998; and *How important is business R&D for economic growth and should the Government subsidise it?*, Griffith, Briefing Note No. 12, Institute for Fiscal Studies, October 2000.

**5.44** In **Germany**, the government has launched the “EXIST Programme – Start-up Entrepreneurs from Universities” as part of a package of measures to facilitate the transfer of research and technology, and to foster innovative business start-ups. The programme began as a competition for universities working alongside external business partners from their region, and thereby encouraged regional networking even among those entrants who failed to win a ‘prize’. And in **Austria**, research programmes of several years duration have been carried out under the auspices of competence centres, which aim to improve access to new technologies through cooperation between research institutions and universities on the one hand, and business and finance on the other.<sup>20</sup>

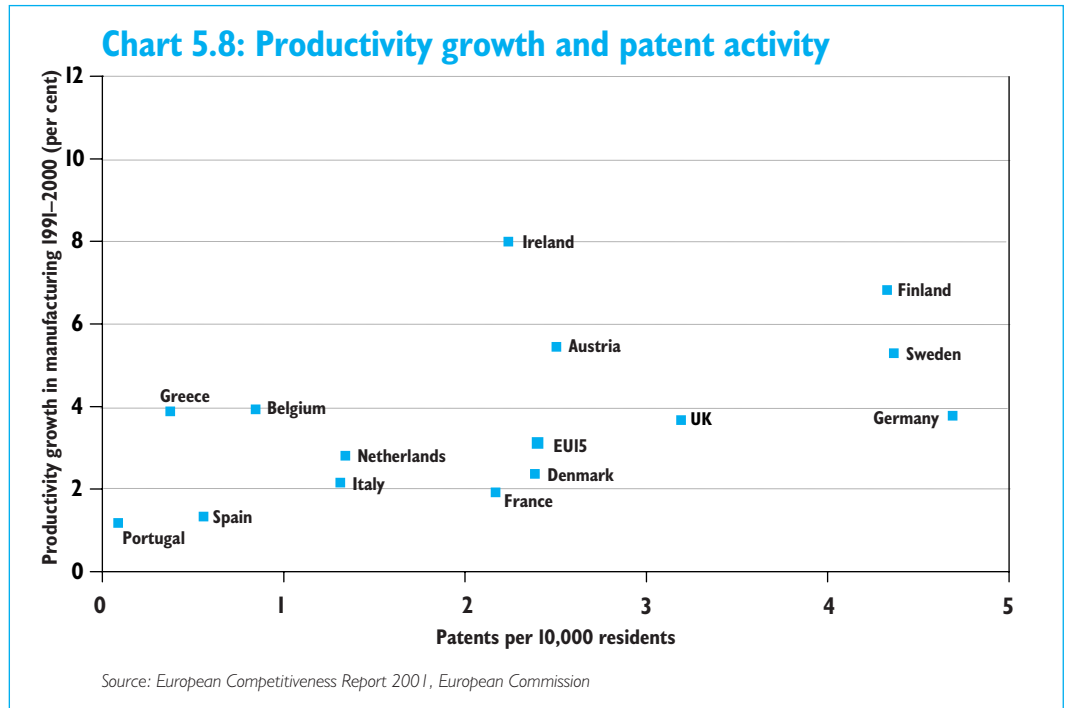
#### European knowledge networks

**5.45** The challenges ahead suggest that **Member States will need increasingly to pool their efforts, knowledge and resources** in order to compete on a global scale. They will need to go beyond the current European Research Area to create a **European Research and Innovation Area (ERIA)** – a coherent EU-wide ‘innovation system’ underpinned by clear principles. The core principle must be that knowledge itself should be treated as an input to production, and needs to be allocated where it is most productive. This implies that investors and those who use knowledge are brought together with those who *generate* it. Just as there are barriers to the fully productive allocation of labour across the EU, so there are also blockages in the diffusion of knowledge. The removal of these blockages should in future become a key principle guiding the allocation of the **EC research budget**. An effective ERIA also highlights the importance of the design, transparency and affordability of **intellectual property rights**, which both structure the incentives of those who generate knowledge and are crucial valuation tools for investors and users of knowledge.

**5.46** Concern over R&D ‘inputs’ is not alleviated by indicators endeavouring to measure **innovation ‘outputs’** of research activity, such as patents. Chart 5.7 compares EU and US patent activity, as well as that of the EU’s ‘best’ patents performer, Germany. As Chart 5.8 shows, however, high patent activity has not necessarily been a good guide to productivity growth. Within the EU, Germany ranks highly on the former, but has performed only modestly in terms of the latter.



<sup>20</sup> For further examples, see the *EPC Annual Report on Structural Reforms 2001*, ECFIN/EPC/171/01-EN.



**5.47** Even after allowing for differences in patenting arrangements between the US and the EU, as well as for sector variation (some sectors are more ‘patent-intensive’ than others, and feature more prominently in some national economies than in others), there remain significant gaps in innovation activity across the Atlantic and within the EU. The Government believes that measures are therefore required not only to address the root causes of this weakness, but also to encourage and reward the definitively risky business of innovation and enterprise.

**Challenges to come** **5.48** While progress has been made in addressing the EU’s innovatory weakness, the overall innovation environment remains unsatisfactory, not least compared with the US. This chapter has suggested many reasons for this discrepancy, all of which add up to the need for Member States to put into place a more appropriate and innovation-friendly policy framework in which considered risk-taking is rewarded, and ‘demand-pull’ factors encourage new ideas and technologies to be translated into saleable products and techniques.

**Innovation in the services sector** **5.49** The EU needs in particular to grapple with the changing nature of innovation. The importance of the service sector continues to increase both in terms of competitiveness and job creation. Evidence suggests that services innovate differently from manufacturing, relying, for example, less on technological R&D and more on client knowledge<sup>21</sup>. They may also undertake more incremental innovations and be more dependent on achieving organisational innovations. Understanding innovation in this sector, and understanding also how to foster it, are central issues.

<sup>21</sup> *Services and Innovation: Dynamics of Service Innovation in the European Union*, PREST/CRIC, December 2001 (Annex to the ECOFIN study on research and development).

**Intangible assets 5.50** In this respect, the Government urges a greater appreciation of the increasing importance of **intangible assets**<sup>22</sup>. An innovating service sector often draws its inspiration and knowledge from a range of different sources, and finds the result less easy to protect using intellectual property rights and less easy to codify, which is why careful examination of the way in which intellectual property is used by innovators is so important. These factors also reinforce the importance of **skilled personnel**; often the storehouse of a company's most valuable know-how, and a crucial means of absorbing knowledge from elsewhere.

**Taking action at the EU level 5.51** The Government recognises that, while some Member States individually have excellent records, few can match the all-round strength in innovation and enterprise of the US. It believes, however, that the EU has the potential to do precisely this, thereby meeting its Lisbon goal of becoming the "*the most competitive and dynamic knowledge-based economy in the world*". To help achieve this, ECOFIN's study identified action in the following areas as necessary:

- in future **R&D Framework Programmes**, continue the process initiated by the Commission, working with Member States, to link research efforts both inside and outside the EU; focus on funding likely to give the EU a 'critical mass' in promising technologies; put innovation at the heart of the EU's objectives; increase funding which enhances researcher mobility so that new discoveries are rapidly taken up and disseminated; and improve ease of access to funds for smaller companies;
- introduce an easy to obtain and low cost **Community patent** (as recognised at Lisbon, this would represent a significant improvement over current European arrangements) and promote the greater use of other pan-European intellectual property instruments such as design rights;
- review **the Community State Aid Framework for R&D, to ensure that aid is better focused**. This review should not discourage the efficient and appropriate use of state aid to address Europe's under-investment in R&D. While it is essential that the Commission maintains a strict focus on aid proportionate to the level of market failure (which tends to be higher, the further away from market), the scope for valuable R&D and innovation must also be recognised, as must the variety of possible market failures (in particular, of the numerous interfaces and networks which both develop and disseminate new ideas); and
- encourage a deeper, more liquid capital market, reduce the cost of finance and encourage a stronger entrepreneurial culture. The Government fully supports the principles underlying the **Risk Capital Action Plan**. The UK accounts for 38% of the European risk capital market and is well placed to benefit from liberalisation in this area. It is, however, unfortunate that some of the original objectives of the Plan are not properly reflected in the Commission's proposed **Prospectus Directive** which, as drafted, threatens to raise costs of finance for small firms rather than lower them. The Government is working closely with City institutions, business representatives, the Commission, and other Member States to secure the necessary amendments.

<sup>22</sup> See for example *Creating value from your intangible assets*, DTI, May 2001, [www.innovation.gov.uk](http://www.innovation.gov.uk)

## THE WAY FORWARD TO THE LISBON GOALS

### Box 5.3: Priorities for action

A **dynamic economy** demands enterprise and innovation; an enterprising and innovative society is best able to create employments and deliver gains to all its citizens. An economic environment in which risk-taking is appropriately rewarded and which fosters enterprise and innovation, must encompass:

- access to **venture and risk capital** (and to the management expertise which often accompanies such finance) for entrepreneurs;
- a fair and friendly **tax** environment, especially for small businesses;
- well-targeted and fully justified (in terms of cost-benefit analysis) **regulation**;
- a two-way flow of ideas and **research** between academia and business, and across borders; and
- a **skilled, flexible labour force**, and a culture of risk-taking and enterprise.

In a number of important respects, the EU as a whole falls short on most measures of enterprise and innovation compared with the leading knowledge-based economy in the world: the US. The ingredients of success are widely acknowledged. It is now the task of Member States, supported by the Commission, to translate these measures into action, notably:

- put in place **framework conditions** that encourage and support enterprise and innovation;
- raise private research efforts through wider measures such as **tax credits**;
- invest in higher education, **to provide the skilled workforce** demanded by the knowledge-based economy; and
- ease the access to, and lower the cost of, **risk capital** by putting in place the Risk Capital Action Plan.

Furthermore, an integral part of this must be the creation of a **European Research and Innovation Area (ERIA)**, allowing knowledge to flow unimpeded throughout an EU-wide innovation system. To achieve this, it will be necessary to:

- address the low use of the full portfolio of **intellectual property rights**, and ensure that a range of protection is available at a Community level. Agreement on a Community patent is central;
- reform how the EC spends its **research programme**, with a focus on priority areas and creating a European knowledge network through more researcher mobility; and
- enhance **links** between the **science base and industry**.

In addition, the EU needs to rise to two particularly important challenges:

- the scope and incentives for innovation in the **service sector**; and
- the growing importance of **intangibles**.



# 6

## EFFICIENT GROWTH: INVESTMENT AND CAPITAL MARKETS

- The quality and quantity of investment has an important bearing on growth and employment, and the breadth and depth of capital markets has an important bearing on that investment.
- The **Spanish EU Presidency** has highlighted the **Single Financial Market** as one of its five key priorities for Barcelona, and with good reason. An integrated financial marketplace would allocate capital more efficiently at lower cost; allow better diversification of risk; be more competitive, and hence more innovative and able to offer a wider range of services at lower cost to a broader range of borrowers and investors; enjoy economies of scale; and be better placed to win ‘export’ market share outside the EU.
- The **UK Government**, too, attaches high priority to creating an **effective and dynamic** European financial services market that will efficiently link the sources of capital – investors and savers – to the firms and individuals seeking to use it.
- **Delivering the benefits of an effective single EU capital market is central to the EU’s wider reform agenda** and its long term economic health. Progress to date has been disappointing, and EU consumers and firms have paid the price. At Barcelona, and in the months and years following, EU leaders must turn good intentions into action.

### INTRODUCTION

*“Full liberalization and integration of the capital market is a priority; like the rest of the EU, Spain attaches importance to integrating and liberalizing the financial markets so as to progress with the completion of the internal market and provide better consumer creation and to boost growth and job creation in our economies...” (Spanish Presidency)<sup>1</sup>*

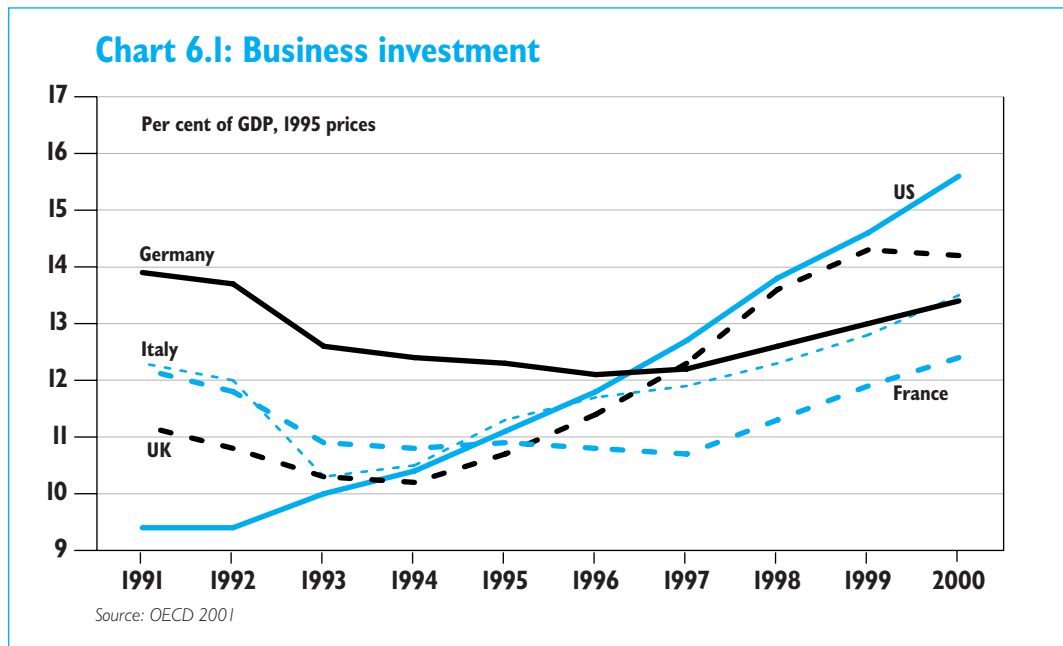
#### The importance of investment

**6.1** Investment in physical capital is an important determinant of economic growth, and clearly affects how much each worker is able to produce<sup>2</sup>. Governments can complement and enhance private economic activity through investing in high quality public services such as a sustainable transport system and modern schools and hospitals; in a context of economic stability and sound public finances, the overall productive potential of the economy can thereby be raised.

**6.2** On international comparisons, and as Chart 6.1 illustrates, the EU has traditionally performed well on measures of business investment as a proportion of GDP.

<sup>1</sup> Spanish Presidency website: <http://www.ue2002.es/principal.asp?idioma=ingles>

<sup>2</sup> See for example Nicholas Oulton, ‘Why do foreign-owned firms in the UK have higher labour productivity?’, in *Technological Change and Growth*, ed. Nigel Pain, Macmillan, 2000, who showed that in the UK, much of the higher labour productivity in foreign owned firms compared to domestically owned firms could be explained by their higher levels of capital.



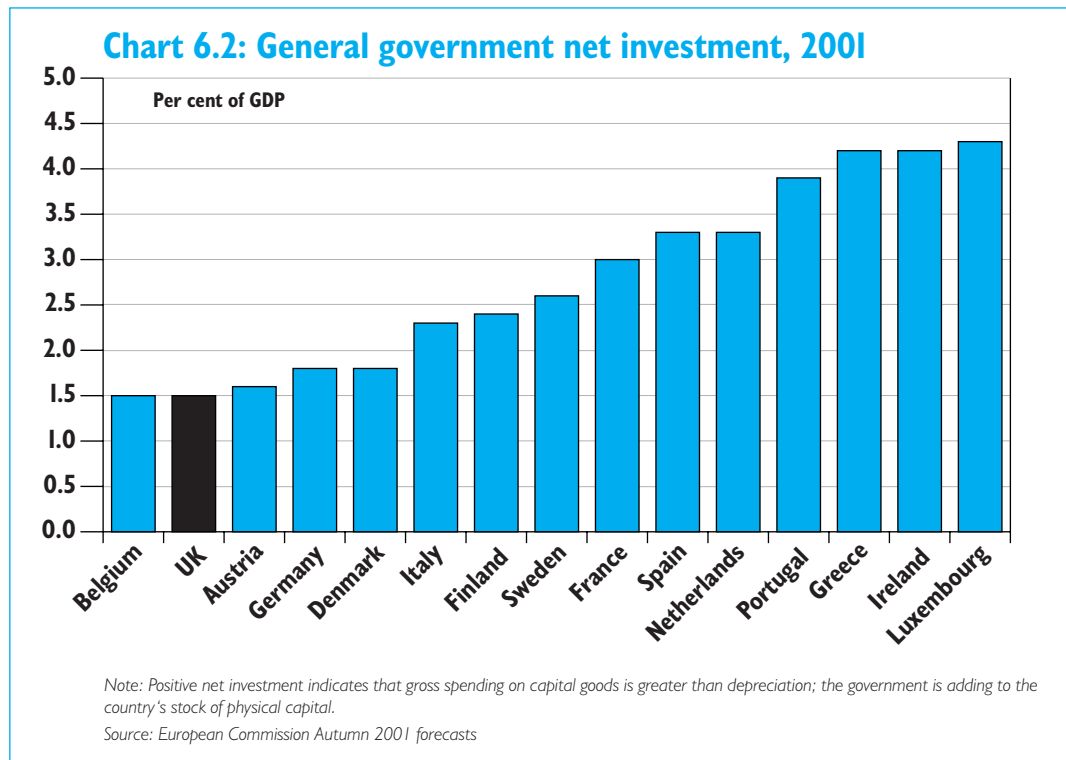
**US business investment overtaking that of the EU**

**6.3** As Chart 6.1 also shows, however, while the EU may have been a traditional strong performer on investment, times change. From a low base, business investment in the US grew rapidly through the 1990s, encouraged both by a positive macroeconomic outlook and by favourable microeconomic conditions. Particularly strong growth was seen in the information, communication and technology sector (ICT).

**6.4** Similarly, healthy levels of public investment have been a feature of European government spending, though here, as Chart 6.2 illustrates, the UK ranks poorly compared with other Member States, having suffered several years of under-investment. The Government is committed to delivering rapid growth in investment so as to renew and modernise the capital stock. From 0.7 per cent of GDP in 2000–01, public sector net investment is projected to more than double to a projected 1.8 per cent in 2004–05<sup>3</sup>. This is fully consistent with the Government's fiscal rules which allow prudent borrowing for investment and help to ensure that growth-enhancing capital spending is not sacrificed to meet short-term current pressures. With public sector net debt at the historically low level of 31 per cent of GDP, the Government is able to pursue its goal while comfortably meeting the sustainable investment rule.

**6.5** Higher public capital investment in the UK is being accompanied by continued use of Public Private Partnerships and the Private Finance Initiative to deliver significantly improved public services by releasing the full potential of public sector assets. By improving the economy's infrastructure and the quality and efficiency of public services, the Government's strategy will provide a further boost to productivity and sustainable growth.

<sup>3</sup> The spending plans set out in the 2000 Spending Review targeted these additional resources to priority services. Investment in transport is increasing in real terms by more than 25 per cent in each year from 2001–02 to 2003–04, while capital expenditure on education and health is increasing by over 9 per cent in the same period.



## THE FINANCIAL SECTOR AND INVESTMENT

**6.6** Private sector investment requires finance. Some funding may be internal, from profits or reserves. For most companies, however, external financing plays a key role, and for Europe as a whole the importance to investment of **competitive, efficient capital markets** cannot be over-estimated. Broader and deeper capital markets reduce the cost of capital and improve the efficiency of its allocation, giving a larger number of firms access to a wider variety of funding instruments offered by a greater range of lenders.

**6.7** In the long run, the evidence underlines the importance of **competitive, efficient capital markets**, showing a strong positive link between the functioning of the financial system and economic growth<sup>4</sup>. Efficient stock markets, for example, tend to be positively related to investment growth; large, liquid stock markets are generally considered to have been an important factor in US growth during the 1990s, especially for innovative, fast-growing companies in new sectors. This is not to imply that the amount of capital raised on European stock markets has been negligible. As Table 6.1 shows, new capital raised by EU domestic companies as a per cent of EU GDP has been increasing towards US levels, and in 2000 even exceeded it.

**Table 6.1 Gross capital raised on stock markets as per cent of GDP**

	1997	1998	1999	2000
EU	1.1	1.8	2.8	4.5
US	2.6	2.2	3.0	3.6

Source: Eurostat 2002.

<sup>4</sup> See for example *Financial development and economic growth: views and agenda*, Ross Levine, Journal of Economic Literature, 35, 688-726, 1997.

**6.8** Total volumes, however, say nothing about the accessibility of stock markets, whether for initial listing or for subsequent capital raising, to firms in different sectors or of different sizes. The numbers are also vulnerable to the impact of, for example, large privatisations. Furthermore, while US companies raise a comparable amount of equity finance, relative to GDP, to their EU counterparts, they also benefit from much more liquid corporate debt markets. European corporate bond markets are, as yet, relatively underdeveloped, and European companies in general are far more reliant than US companies on bank loans. This can be advantageous for established firms in familiar sectors and where banks traditionally extend fixed rate, long term lending; but it may be less so for smaller, riskier companies operating in sectors less well-understood by, or less attractive to, their banks.

**6.9** The link between the financial sector and the broader economy does, of course, run in both directions. Efficient funding fuels economic growth; a strongly growing economy generates high demand for financial services. A key objective of Government policy is to create an effective and dynamic European financial services market that links efficiently the sources of capital – investors and savers – with the firms and individuals seeking to use it. An effective single financial market would:

- reduce the cost of accessing capital and improve the efficiency of allocation across the EU; and
- give retail consumers access to a wider range of more competitively priced financial services products.

**The benefits of an integrated capital market for business...**

**6.10** The link between the efficiency of the financial sector and economic growth appears to be particularly marked with respect to **funding for small businesses and start-ups**, especially in new and/or high-growth industries. Such businesses are also an important source of job creation, and a sector where the US track-record outdoes that of the EU. This may be related to the availability of venture or seed capital in the US, as well as, of course, differences in a variety of other areas such as regulation and culture. While it is difficult to isolate the influence of a historically fragmented financial sector on the EU's economic performance to date, it is possible to identify some potential advantages of financial sector integration:

- an **integrated financial sector across the entire EU** would encourage the mobilisation of savings and a more efficient allocation of capital. Funds would be more easily placed where they earned the best return, and improved informational flows would allow both investors and businesses to identify where new opportunities lay;
- a **more innovative, lower cost and broader based financial sector** in the EU is better placed to win market share outside the EU;
- **broader and more liquid equity markets and bond markets** permit greater diversification of investment portfolios, reducing the cost of managing risk and promoting investment in growth enhancing activities;
- **more open markets in financial services**, and increased competition for the providers of 'traditional' bank loans (not only from other financial institutions, but also from more accessible capital markets) imply tighter margins, lower funding costs for borrowers, and faster financial innovation;
- a **larger market for financial services** offers economies of scale, reducing average administration costs and increasing the scope for developing new services; and

- an integrated financial marketplace should be a **'safer' financial marketplace**; stronger, better-informed, and better equipped to withstand shocks from internal or external crises.

**...and the costs to consumers of a lack of integration** **6.11** The lack of an effective single capital market not only harms businesses seeking to raise capital; it also affects consumers, who are denied the benefits of innovation and price competition such as higher returns on savings when purchasing financial services. To give just a few examples of the consumer consequences of fragmented EU financial markets<sup>5</sup>:

- in Belgium the cost of a credit card is three times that in the Netherlands;
- the mean annual cost of a standard bank account in France or Germany is ten times that in the UK;
- the cost of an unsecured personal loan in France or the UK is 30 per cent higher than in Germany<sup>6</sup>;
- average annual charges for mortgages in France and Germany are twice those in the UK;
- the interest margins on deposit accounts in the UK are four times greater than in Germany; and
- cross-border bank payments cost up to twenty times as much as bank payments within Member States<sup>7</sup>.

**What is to be done?** **6.12** EU Member States have long been conscious of the disadvantages stemming from fragmented capital and financial services markets. Agreeing a response has, however, been less straightforward. Heads of State and Government, meeting in Cardiff in 1999, approved two measures to remove barriers to Single Market integration, and timetables for their adoption (Box 6.1 provides more detail):

- **the Financial Services Action Plan (FSAP)**. This is a programme of largely legislative measures to create a single EU financial services market; and
- **the Risk Capital Action Plan (RCAP)**. This focuses on policy measures to develop an effective EU wide market for SME and start-up company finance.

**6.13** Heads of State and Government have called for the **FSAP to be implemented by 2005** and the **RCAP to be implemented by 2003**.

<sup>5</sup> Unless otherwise stated all examples are drawn from Annex E of *Competition in UK Banking*, Don Cruickshank, March 2000.

<sup>6</sup> Cost calculated at the present value of all charges and loan repayments discounted at the money market rate less the cost of the loan.

<sup>7</sup> Source: *Survey of bank charges for cross border payments*, European Commission, July 2001.

**Box 6.1: The FSAP and RCAP**

The **Financial Services Action Plan, or FSAP**, has four objectives:

- (i) **create a single wholesale financial services market.** This entails upgrading the prospectus and company law directives, proposing new directives on cross border collateral and pensions and revising the Investment Services Directive;
- (ii) **establish open and secure retail markets.** Update the harmonised rules for retail investment funds set out in the UCITS Directive; propose new Directives on the distance marketing of financial services and the regulation of insurance intermediaries; launch a Commission action programme to reduce fraud in cross border payments;
- (iii) **agree state-of-the-art prudential rules.** This requires Directives on the winding up of insurance undertakings and banks, revisions to the solvency margin for EU insurance companies, and the development of prudential rules for financial conglomerates; and
- (iv) **optimise the broader conditions for a single EU financial services market.** Review and improve coordination in the taxation of supplementary pensions, and examine the taxation of financial services products.

The **Risk Capital Action Plan, or RCAP**, aims to promote a more liquid and more integrated risk capital market, thereby increasing the supply of lower-cost capital to small firms and promoting a more entrepreneurial EU culture.

**Community actions** are:

- adopt rules to promote investment by institutional investors in venture capital;
- upgrade the Prospectus Directive to facilitate cross-border raising of capital; and
- introduce a Community-wide patent.

**Member State actions** are:

- improve tax incentives for new firms and venture capital;
- reform insolvency and bankruptcy legislation; and
- promote employee ownership schemes.

**The Gyllenhammar report** **6.14** As a means of focusing attention on what more needs to be done and on the cost of inaction, the UK Government welcomed the initiative of the European Financial Services Round Table in commissioning a **new Cecchini-style report**, chaired by Pehr Gyllenhammar,

on the economic costs resulting from the lack of an effective single EU financial services market. The report, just published, suggest that the potential benefits of a single financial market could be very substantial, for EU consumers and for the economy as a whole. The benefits would include:

- greater product choice, particularly for consumers in smaller countries;
- reduced prices;
- economies of scale – savings, perhaps, of £5 billion for the EU fund management industry alone; and
- greater international diversification of investors' portfolios, and a growing international role for the euro.

**6.15** The study's authors suggest that the potential for growth through financial integration could be 0.5 per cent year, or €43 billion added annually to EU GDP. If correct, these would be very significant gains.

**Progress, though not everywhere...** **6.16** Clearly, progress has been made since Lisbon. Some individual dossiers are even running ahead of schedule; the Directive on financial collateral arrangements, for example, was targeted for adoption in 2003 but has a current estimated arrival time of mid-2002. But some important measures have slipped. Adoption of a Directive on the distance marketing of financial services, for example, has crept from end-2000 to mid-2002, while in two important areas no progress at all has been made: the 14th Company Law Directive, and the proposed Directive on Takeover Bids. (The European Parliament rejected a compromise text on the latter in July 2001, though following the report of the high level Group of Company Law Experts, a new proposal is expected by mid-2002.)

**6.17** Ticking off dossiers is, however, not necessarily the most appropriate approach to creating a single financial services market, in that it does not ascertain whether (or to what extent) the overall objectives of the single market are being met.

**...and what needs to be done...** **6.18** An integrated financial services market remains some way off; the benefits to EU firms and consumers are taking longer to be delivered than was hoped. The Government believes that it is important to focus on the key outputs which policy is intended to deliver, and identifies **four important steps** which should quickly be taken:

- 1) develop and publish output orientated indicators of success, so as to gauge progress and highlight areas suffering from stalemate;
- 2) prioritise the FSAP as a key driver of broader economic reform, concentrating on the measures that would most quickly deliver the objectives;
- 3) implement the Lamfalussy recommendations, ensuring a principles-based regulatory framework; and
- 4) favour mutual recognition over harmonisation, thereby facilitating both financial market integration and a degree of regulatory competition.

## STEP I DEVELOPING INDICATORS OF SUCCESS

**6.19** Developing and publishing output orientated indicators and measures of success constitutes a key practical step in the promotion of an efficient, effective and dynamic Single Market. Progress must be benchmarked, failure gauged, and the benefits of integration made visible to everyone. This should help revitalise the case for economic reform. In undertaking this, the EU should agree core standards against which Directives should be judged. Objectives might include:

- reducing the cost of access to capital in the EU; and
- cutting the cost of basic financial services products to EU consumers.

**6.20** A number of initiatives have required the European Commission to develop output indicators in order to monitor progress towards an integrated marketplace. The Government is continuing to work with the Commission and to promote the case for these indicators to be published with respect to both wholesale and retail financial markets. There are encouraging signs that the Commission is making progress.

## STEP 2 PRIORITISING THE FSAP

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**6.21** There are four topics on which the Government considers agreement to be particularly important in the interests of rapid progress towards a single capital market:

- a definition of professional investors to facilitate **proportionate regulation of inter-professional business**. This should be combined with **country-of-origin regulation** so as to eliminate any doubts as to which Member State's conduct of business rules might apply;
- a Prospectus Directive to allow companies to **raise capital across the EU on the basis of a single prospectus**. This is currently being discussed in the Council and the European Parliament. In its present form, however, it risks increasing the cost of capital to some issuers of securities, undermining the competitiveness of the EU's financial markets, and producing fragmentation rather than integration;
- a set of globally-accepted **international accounting standards**, allowing financial reports to be produced on a consistent, comparable and transparent basis. The Government favours the adoption of International Accounting Financial Reporting Standards (IFRS, formerly IAS) as developed by the International Accounting Standards Board (IASB), which could be adopted quickly and without amendment by an EU endorsement mechanism; and
- a new collateral Directive providing **increased legal certainty as to the validity and enforceability of collateral backing cross-border securities transactions**. Current proposals should reduce the cost of collateral arrangements and allow for greater flexibility in the capital involved; this should help reduce the cost of capital and encourage cross-border lending, thereby making the Single Market more efficient. The UK, however, believes that a wider range of firms should be able to benefit than is allowed in the current proposals.

## STEP 3 IMPLEMENTING LAMFALUSSY

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**6.22** ECOFIN asked Baron **Lamfalussy** to examine the way in which EU laws concerning financial securities were devised and agreed. Lamfalussy and his colleagues – the 'Wise Men' – recommended that EU securities legislation should be **principles-based**, and these framework principles agreed at political level with the involvement of the European Parliament. They advocated arrangements which could be easily updated to keep pace with market developments, and recommended that the Commission should consult extensively with market participants in developing formal legislative proposals. Such consultation is strongly supported by the UK; so, too, is the concept of principles-based legislation in this sphere, allowing the detail to be set by comitology or increased coordination of national laws.

**6.23** Heads of State and Government accepted Lamfalussy's recommendations when they met in Stockholm, and agreement has also been reached within the European Commission and the European Parliament. It is important that all of these Community institutions now make every effort to put the Lamfalussy recommendations into practice.

## STEP 4 MUTUAL RECOGNITION INSTEAD OF UNIVERSAL HARMONISATION

**6.24** It is also important that the benefits of a single capital market are extended to **retail consumers** of financial services. In the Government's view, this will be achieved most effectively if there is a fundamental break with the traditional approach to retail regulation based on the application of host state rules.

**6.25** To date, much of the drive towards a single financial services market has comprised an effort to agree universally harmonized rules. The Chancellor, however, has put forward an alternative strategy<sup>8</sup> based on the principle of mutual recognition (outlined in Chapter 3). While this approach shares the traditional aim of ensuring that providers face only one set of rules when selling across the EU, it proposes achieving this not through harmonising the rules, but by **mutual recognition** of established procedures and practices as accepted by the provider's home state authorities. The result would be reduced costs and greater certainty for financial service providers able to follow one rather than fifteen sets of regulations.

**6.26** Clearly, mutual recognition demands good communications between national regulators. It also requires agreement on the core standards underpinning national regulatory regimes, and on the basic principles of conduct providing business and consumer safeguards. Such core standards and principles would vary across products and customers. They would, however, rest on similar concepts and need not of themselves be particularly complex. In the area of consumer information, for example, the customer needs to know:

- what return a product offers;
- how much the product will cost;
- rights of withdrawal; and
- what redress mechanisms are available.

**6.27** The proposed Distance Marketing of Financial Services Directive, on which the European Council has now reached a common position, provides a good opportunity to start putting these protections into place.

**6.28** Mutual recognition implies some scope for competition between different regulatory regimes; a process frequently depicted by its detractors as a 'race to the bottom', with Member States falling over themselves to introduce ever lower standards of customer protection so as to attract business. However, and as was argued in Chapter 3, in the correct regulatory environment, market forces are likely to produce quite the opposite result. Brand names and reputation matter to financial institutions, and consumer confidence, once lost, can be difficult to regain. Some studies even suggest that, where regulatory competition exists in European capital markets, pressure from market participants prompts the adoption of higher, not lower, standards<sup>9</sup>.

**6.29** Competition in regulation also carries the very large advantage of helping guard against unnecessarily burdensome regulation. It encourages a more effective evaluation of the design and impact of rules. **In short, regulatory competition in the EU can be a means to better regulation.**

### Empowering consumers through reform

**6.30** To benefit from broader, more integrated financial service markets, consumers must have both knowledge of the new choices on offer, and the confidence to take advantage of them. Reform must therefore be supported by:

- improved consumer education; and
- effective cross-border redress mechanisms.

<sup>8</sup> In his paper to ECOFIN on 17 July 2000.

<sup>9</sup> See *Completing a Dynamic Single European Financial Service Market: a Catalyst for Economic Prosperity for Citizens and Business across the EU*, HM Treasury, July 2000.

**6.31** The UK Financial Services and Markets Act has, for the first time, given the UK's Financial Services Authority a new statutory obligation to promote consumer education; an example of good practice which other Member States might wish to follow. The need for consumer education was also recognised at EU level in the Financial Services Policy Group report on e-commerce, approved by EU finance ministers in May 2001.

**6.32** The Government also welcomes the recent establishment of Fin-Net, the EU-wide network of financial services ombudsmen and redress schemes. While a good start, this initiative should be built upon by extending Fin-Net's coverage and ensuring that it develops into an effective redress mechanism of real benefit to consumers.

#### Achieving social justice

**6.33** Returning to the particular problems of low income groups, the UK's Cruickshank report on banking services noted the need for banking sector reform in order to **prevent exclusion** of such households from basic banking services. It noted that, in order to be able to fully participate in the economy, a consumer needed to be able to receive and make electronic payments, deposit cash or cheques, and obtain cash from machines.

**6.34** Low-income households are also often uncertain-income households; work may be part-time or temporary, for example, and low-skilled employees may be more easily replaced. Reforms to improve access to affordable credit can help poorer households weather temporary gaps in income, to the benefit of the individuals affected and society as a whole.

**6.35** That increased competition in the financial sector can reduce costs has not been a purely UK experience. As noted in paragraph 6.11, the cost of a credit card in Belgium is three times that in the Netherlands; and while exclusion from basic banking services is recognised as a problem by the UK, there are indications that access to a standard bank account is still more expensive elsewhere.

## THE WAY FORWARD TO THE LISBON GOALS

### Box 6.2: Priorities for action

**Today's investment is tomorrow's prosperity. The quality and quantity of investment has an important bearing on growth and employment, and the breadth and depth of capital markets has an important bearing on investment. The Spanish EU Presidency has highlighted the Single Financial Market as one of its five key priorities for Barcelona – and with good reason. An integrated financial marketplace would allocate capital more efficiently; allow better diversification of risk; be more competitive and hence more innovative, offering a broader range of services at lower cost to both borrowers and investors; enjoy economies of scale; and be better placed to win 'export' market share outside the EU.**

**A genuinely EU-wide financial marketplace is an urgent priority requiring, in the UK Government's view, action in several directions:**

- **developing indicators of success to track progress towards (and failure in) completing the Single Market, and to highlight the benefits of reform;**
- **focusing efforts on those aspects of the FSAP which will deliver the most important and/or immediate Single Market benefits;**
- **changing the EU legislative process in financial services so as to improve both the speed and quality of legislation; consulting more openly on proposed legislation, and allowing for easier updating of legislation as markets develop; and**
- **moving to regulation of cross-border financial services by the authorities of the provider's home state, rather than by the Member State of the consumer.**