The Draghi Report and European business priorities for the next political cycle

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The EU fundamental problem is growth (more precisely, *lack thereof*…)

- The EU has stagnated at around 70% of U.S. GDP *per capita* for over 30 years

- Other countries have fared **much** better (as an example, China's GDP *per capita* in relation to the U.S. increased by over 10 times during the same period)

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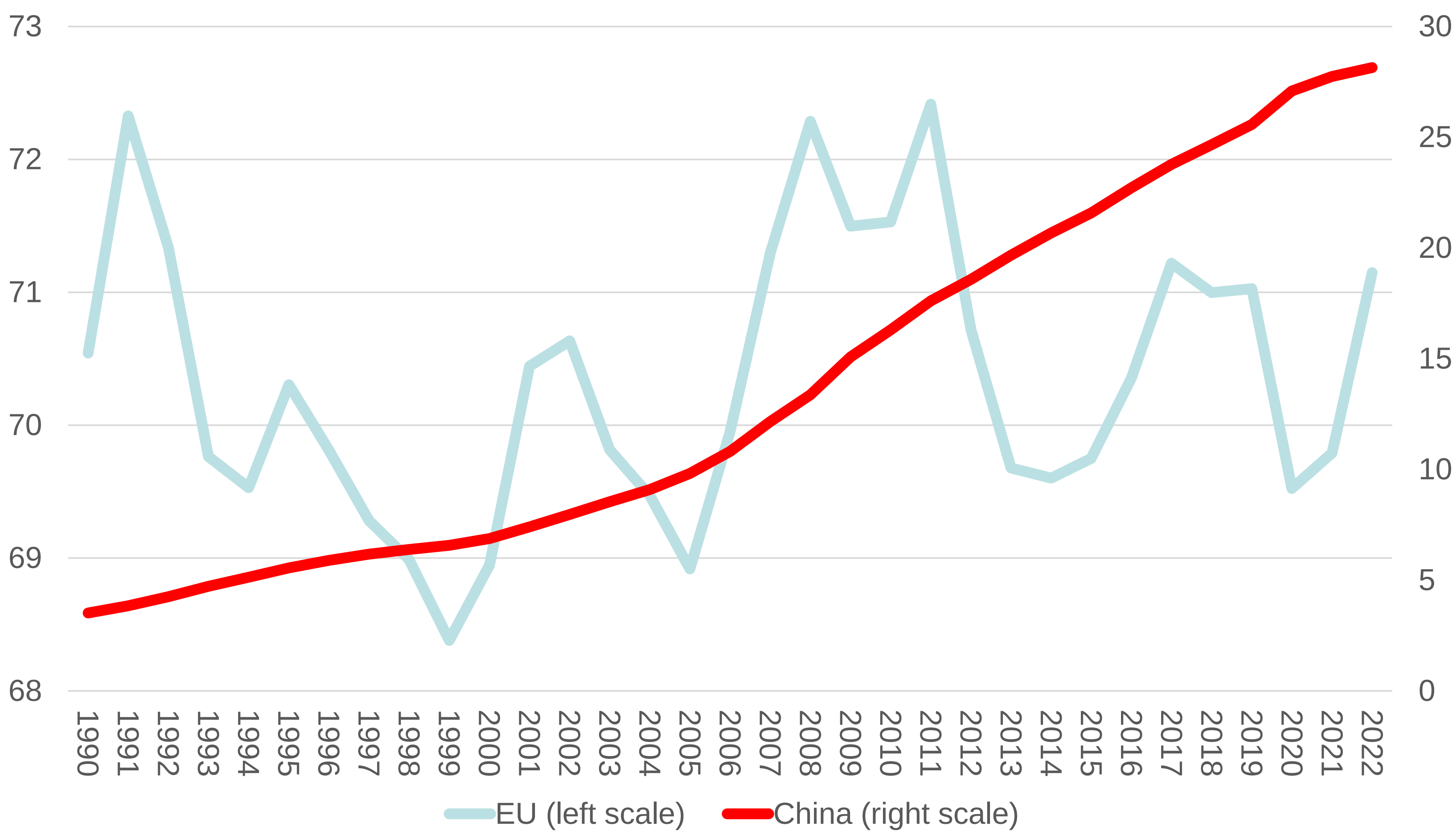
Convergence vs Stagnation: real GDP *pc*, US%



Source: World Bank.

Why? Lower productivity growth…

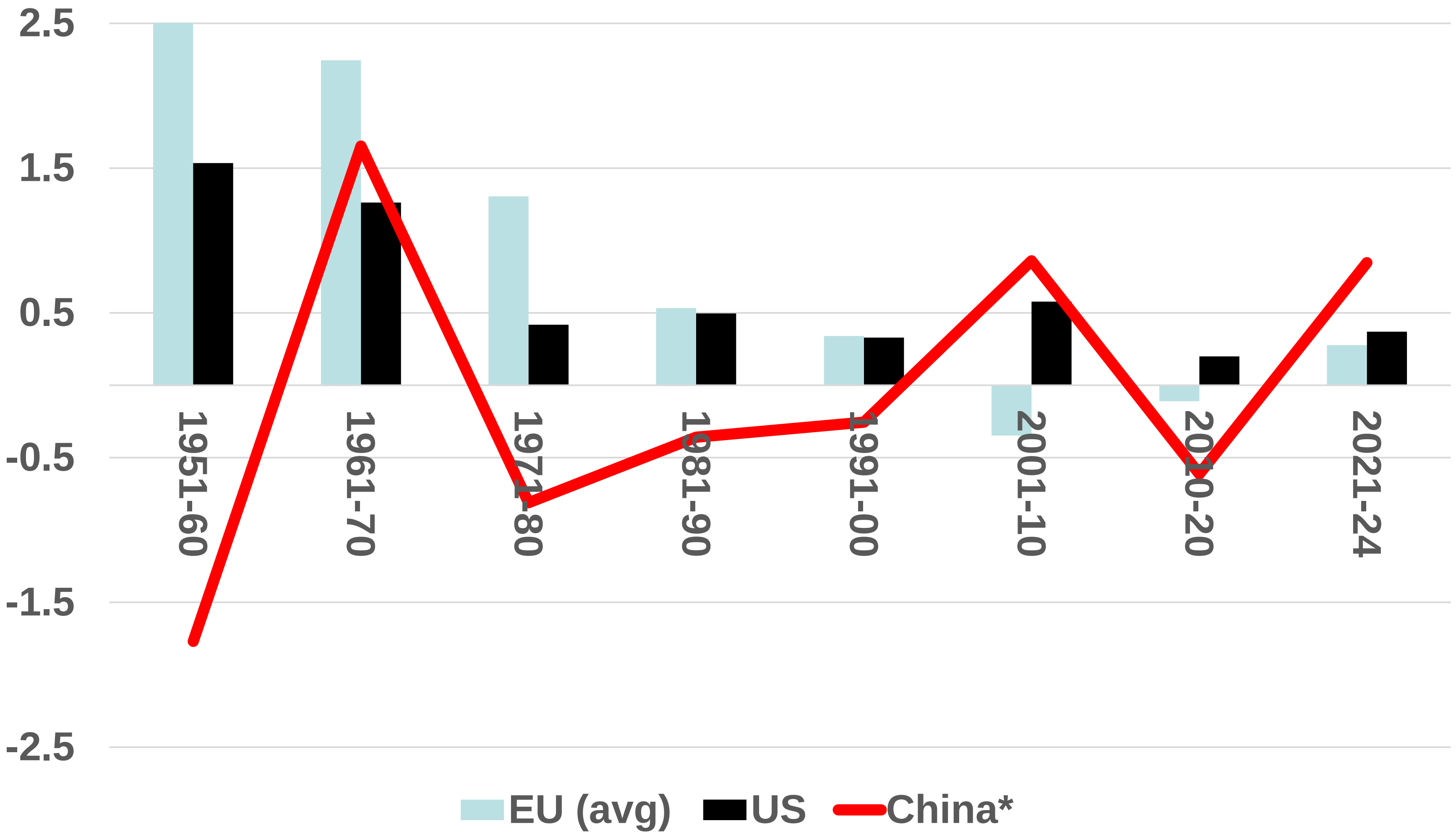
- Why? Fundamentally, different long-term productivity (TFP) trends. EU TFP has been decreasing continuously since the 1960s and is now very low (even negative…)

- This happens, *inter alia*, because of the **non-integrated state of its real and financial markets, which limit EU's companies ability to exploit marketable innovations and grow**

- This gap is widening, and not only with the US

- Lack of growth has many negative implications (including making increasingly hard to afford the EU social model)

EU, US and China: TFP contribution to growth



*Source: The Conference Board. *Using adjusted Chinese GDP series.*

A long-standing problem

- EU (many) reports share this *diagnosis* of EU economic challenges, and have for a long time:

1. 1988 “Cecchini Report” (summary was 11 pages long)
2. 2000 “Lisbon Strategy for Jobs and Growth” (the related part of the Council Conclusions was about 13 pages long, and it was developed in the context of the upcoming 2004 Enlargement)
3. 2005 Revised “Lisbon Strategy” (31 pages long)
4. 2010 Europe 2020 Strategy (37 pages long)
5. 2010 *bis,* Monti Report (107 pages long)
6. 2024 Letta Report (147 pages long)
7. 2024 *bis,* Draghi report (397 pages long)

Bigger problems demand, well, longer reports…

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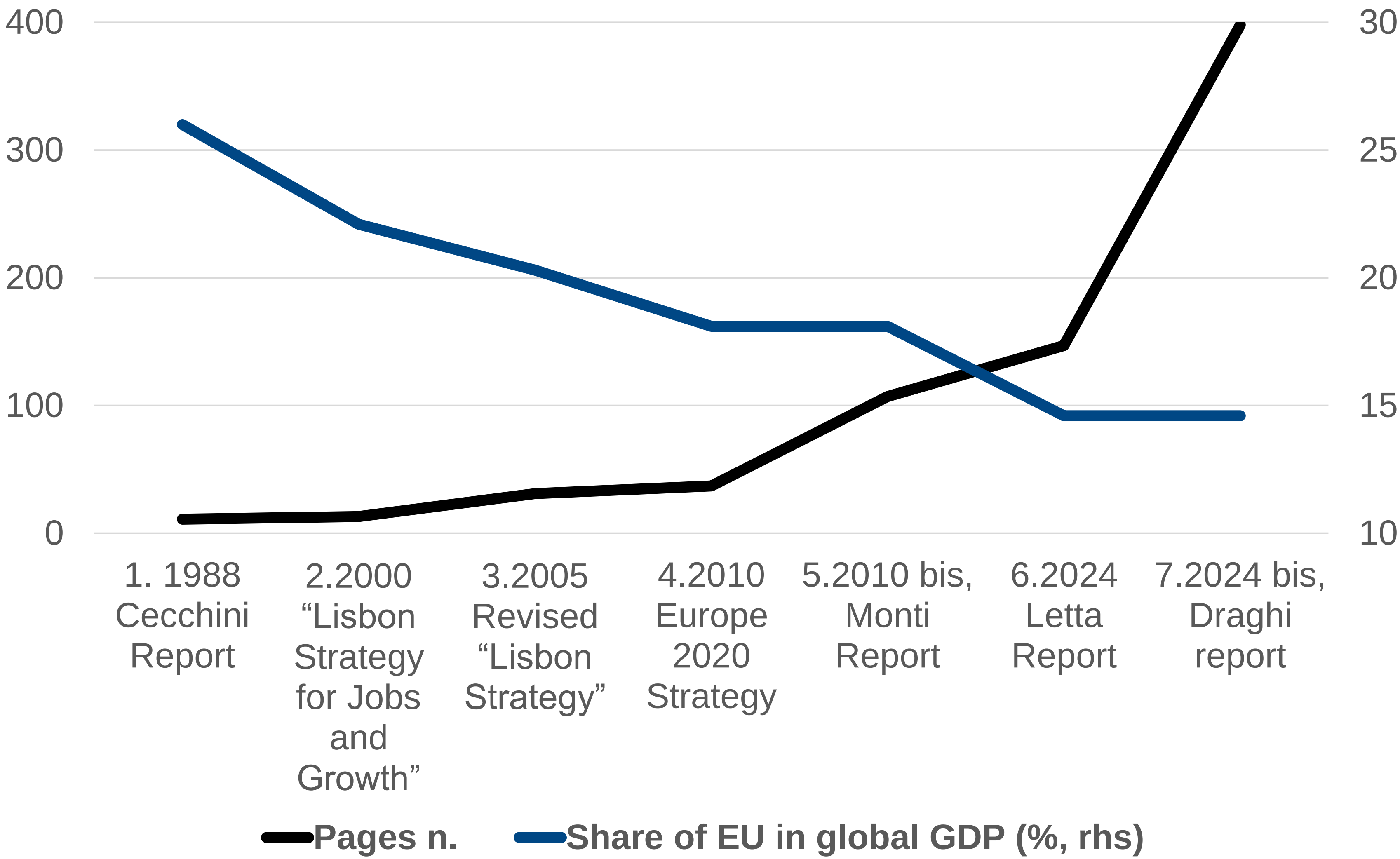

Source: World Bank.

Agreeing on the diagnostic, but not always on the policy proposals…

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- All those reports share the same fundamental *diagnosis* of EU problems, but *policy proposals and tools have differed, and their implementation have been deficient*
- A more fragile EU (more indebted, older, economically smaller) is now faced with a more contested external environment, so its policy tools are now different
- There are more centralized and “offensive” new instruments (internal and external) at EU level, and propose a more “transactional” approach towards others

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The Draghi Report

- So, reflecting this, what does the Draghi Report contains?

- Specifically, it -69 pages long overview and a 328 pages long list of specific sectoral recommendations- focuses on three main challenges for European competitiveness:

1. Innovation gap
2. Energy transition
3. Vulnerable supply chains and weak defense industry

1. The innovation gap

- An incomplete Single Market (in all dimensions, real, financial, regulatory) begets…
- …low investment, which begets…
- …low innovation (especially in services),
- ..which begets low growth

2. Costly energy transitions

- High and growing **regulatory burden cost** (by 114% between 2014-19, to 1.3% of GDP), with..
- ….higher EU energy prices (2.5x the U.S. level) also largely driven by regulation

3. Vulnerable supply chains and a weak defense industrial sector

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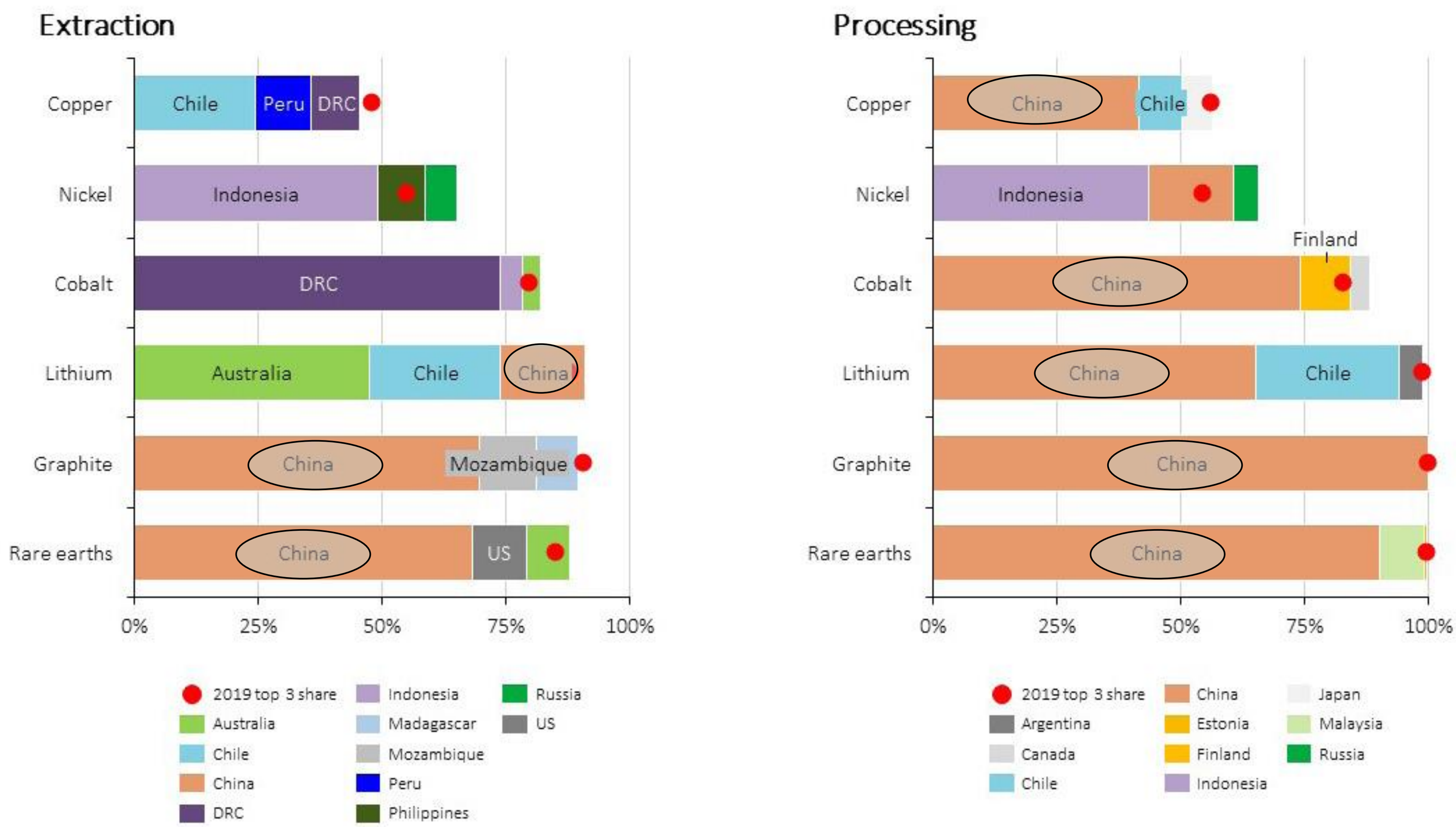
- Around 40% of EU imports are from a small number of suppliers, while 50% originate from countries not "strategically aligned" with it

- As a result, EU's exposure to "sudden stops" caused by geopolitical conflagration is high

- Deteriorating geopolitical relations also increase the need for defence spending and related industrial capacity (both of which fell after the "Cold War" end)

Concentration of extraction and processing of critical resources



Source: IEA.

The Draghi Report: recommendations

- There are around **170 different proposals** in the Draghi Report
- Most of those imply an even greater remit for EU-level policies
- The next slides talk about some of them

1. Less regulation (in certain areas) and more markets (in some others)

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- Complete the SM and the Banking Union (BU)/Capital Markets Union (CMU)
- Reduce the regulatory burden and SM regulatory fragmentation (including via a 28th Regime)
- “Flexibilise” competition rules (potentially even supported by state aid…) to enable market consolidation in sectors like telecoms, finance, defence
- Pursue a (more assertive) trade agenda that enhances the EU’s economic security

2. More money (in investment, including from the EU)…

- The report says that addressing the EU's lagging competitiveness would require €750bn-€800bn (4.4%-4.7% of EU GDP) in *additional* annual investments

- This would (just…) bring investment back to its 1970 level…

- …as EU investment as a % of GDP fell by a quarter since then (while China's increased by a third and is now almost twice that of the EU)

- This increase is to be addressed by EU frameworks leveraging MS and private investment

3…and more EU...

- Proposes a EU-level “Competitiveness Coordination Framework”, which would replace existing non-fiscal coordination frameworks, translating EU-wide competitiveness objectives into national policies, while financing each priority through a (reformed) EU budget

- Suggests stress-testing all existing EU laws and regulations at the start of each Commission mandate, using a single, clear methodology to quantify the cost of new legislation for EU institutions and Member States

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4…and even more (but less open) EU...

- Centralising *further* market supervision
- Greater use of joint procurement in the defence sector
- Considering outbound FDI controls
- Adding EU “domestic content” requirements
- Joint debt issuance (Next Generation EU model, but further/permanent) to support more investment
- Address EU governance limits by extending QMV or via a “passerelle” clause (both would require unanimity), or even “enhanced” or “intergovernmental cooperation”

“Old Europe” approach?

- It is hard to disagree with the *analysis* of the report. However, one may question at least *some* of its *policy prescriptions and approach*
- Doubling down on the SM truly is a necessity
- But ‘stress testing’ EU regulations (old and new) is also positive and necessary: Eastern European EU MS show that more market mechanisms are an effective alternative to “more and more state” (regardless if at EU or MS level)
- The needed openness of the EU to trade and FDI should also be preserved –to the extent possible.
- This is BusinessEurope view, as expressed in its “REBOOT Europe: Stronger Business, Stronger European Union”

REBOOT: A coherent competitiveness strategy-I

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For BusinessEurope, a coherent competitiveness strategy need to include the following key ingredients:

- **Sound economic policies**, which restore the sustainability of public finances, improve EU investment conditions to ensure that public debt is settled by growth, give ample access to finance for companies and pursue growth friendly tax policies;
- **Open trade** leading to improved economic security, implementing existing trade agreements, making sure they remain effective and concluding new ones;
- **Less and smarter regulation**, with simpler reporting requirements, speedy permitting procedures, more reliance on non-legislative policy tools and better quality legislation which does not seek to micro-manage companies;
- **A functioning Single Market** where goods, services, people, capital and data can move freely and creating the conditions for European SMEs and startups to scale up from Europe;

REBOOT: A coherent competitiveness strategy-II

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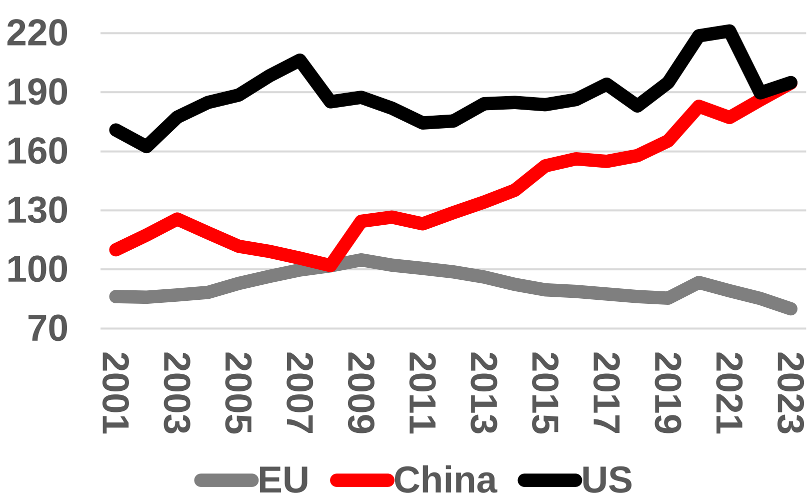
- **Supportive climate and energy policies** that address structurally energy cost differential between EU and competitors, help diversifying EU energy sources (including transition ones) & build partnerships with 3rd country providers;
- **Ambitious research and innovation policies**, which prioritise EU funding for industrial competitiveness, strengthen public-private partnerships and R&I ecosystems and facilitate international collaboration;
- **Balanced employment and social policies** which answer both companies and workers' needs, promote mobility, help to address labour shortages and skills mismatches, respect subsidiarity and leave space for solutions negotiated by the social partners.

Sound economic policy

Credit to private sector as a % of GDP in the EU, China and the US



Source: World Bank

The present situation

Meeting the investments needs linked to the 'transitions', as well as to security and defence, will require both private and public investment. Public finances are constrained, while credit to the private sector as a percentage of GDP in the EU (slightly above 70%) is much lower than in the US and China (around 190%). This is where the biggest margin of room for manoeuvre lies.

The key challenges

- Improving European competitiveness is a must if we want to increase private investment and ensure that public debt is settled by growth rather than by taxation;
- The share of manufacturing industry has shrunk (19.7% of GDP in 1991 vs 15% in 2021) and is further eroded by the cost of decarbonisation policies. Moreover, service activities are underperforming and experience negative/low productivity growth;
- Taxes higher in the EU (40% of GDP on average) than in the US (27.7%) and China (20.1%). Implementation of global tax reforms has also led to an overly complex and costly tax compliance landscape.
- Access to finance for companies is still dominated by banks. As credit to the private sector as a % of GDP is also much lower in the EU than in the US and China, EU companies are faced with a double penalty due to the effects of incomplete BU/CMU.

Sound economic policy

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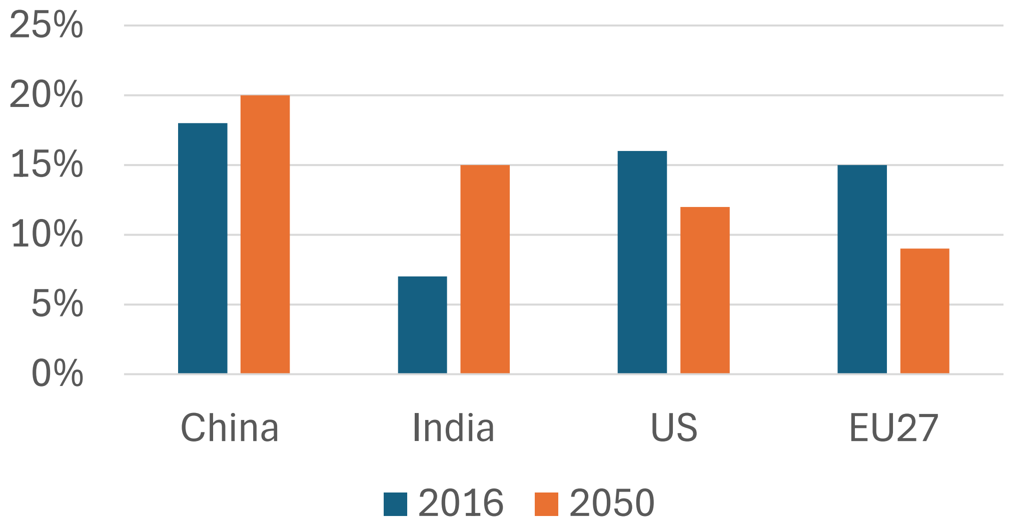
<u>The solutions</u>

During the first 100 days, the EU should ensure that the new Clean Industrial Deal includes a ambitious first set of concrete measures to reduce regulatory burden in SM, lower energy costs, encourage innovation, address skills and labour shortages, and diversify external markets. The EU should also:

- Complete the BU/CMU, reviewing financial regulatory framework to ensure that innovative, fast-growing companies and start-ups can finance their expansion by increasing availability of venture and risk capital, promoting the scaling up of investment and rekindling EU securitisation market;
- Continue to use of financial instruments such as InvestEU and RRF, using public support to leverage private investment;
- Promote a stable, globally competitive tax framework (no new regulations, lowering tax/legal uncertainties, and mitigating double taxation risks);
- Take an ambitious approach to the modernisation of the next MFF.

Open international trade and a secure world order

Europe's share in world GDP is declining



Source: IMF for 2016 estimate, PwC analysis for 2050 projections

The present situation

Europe's share in world GDP is declining. 85% of economic growth in the coming years will be generated outside the EU. We will not become stronger if we turn our back on the world. EU trade policy is crucial for future European growth and employment. It is also essential to diversify our import and export markets and improve our strategic autonomy in an increasingly uncertain world.

The key challenges

- Conducting a proactive trade agenda that supports EU competitiveness and strikes the right balance between openness and economic security;
- Overcoming internal and external obstacles to concluding and ratifying international trade agreements, while engaging with partners;
- Preserving the multilateral world order and ensuring the sustainability of the WTO by modernising it.

Open international trade and a secure world order

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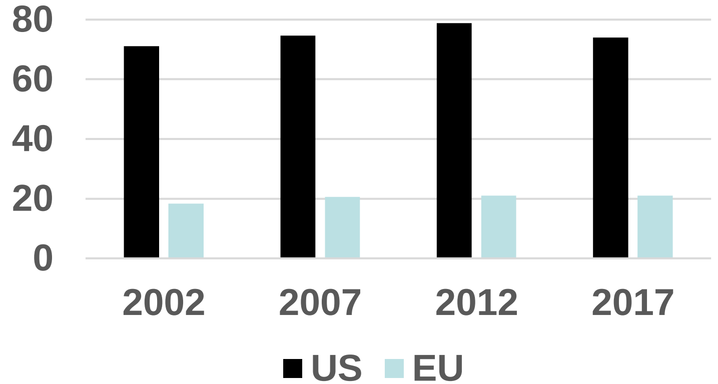
<u>The solutions</u>

During the first 100 days, the EU should define an ambitious international trade and investment diversification strategy, foreseeing a broad range of tools while at the same time continuing work to ratify outstanding deals and solve trade disputes and irritant with the US and China. Moreover, the EU should:

- Ensure balanced implementation of the “promote-protect-partner” components of its economic security strategy, on the basis of a thorough assessment of the risks in a process that involves the private sector, and results in tools that are precise, proportionate and predictable;
- Negotiate EU FTAs which entail a more straightforward ratification process, tailoring it to supply chains as well as to individual partner countries;
- Ensure that we maintain a dialogue with the US, while developing a positive economic agenda to reduce the costs of doing business across the Atlantic and find permanent solutions for ongoing disputes;
- Continue to engage with China, showing assertiveness and unity to preserve European economic interests;
- Work for the preservation and modernisation of the WTO.

A Single Market with less and smarter regulation

Inter-state trade as a % of GDP in the EU and US



Sources: U.S. Census Bureau and EUROSTAT. Nota Bene: Data for Inter-State trade for the US is based on the Commodity Flow Survey, using Shipment value of Goods across borders as a proxy for inter-State trade.

The present situation

Over the last 5 years, the EU adopted 13,000 legislative acts (3,500 in the US). This mass of legislation was largely ineffective in removing existing SM barriers and brought major reporting and compliance costs for EU companies. An underdeveloped and over regulated SM is particularly damaging for SMEs. This also discourages start-ups from scaling up from Europe.

The key challenges

- Rapidly giving clear and concrete signals of regulatory burden reduction to European companies, starting with the delivery of the promised 25% reduction of reporting requirements and compliance costs, through burden reduction measures with verifiable goals and specific deadlines;
- Removing persisting regulatory barriers to cross-border trade and investment, as well as preventing new SM fragmentation;
- Pursuing coherent policies to avoid inconsistencies in EU legislation, move away from over-reliance on regulation such as unnecessary revisions of EU legislation and privilege other policy tools;
- Ensure enforcement of existing competition laws, without new ones.

A Single market with less and smarter regulation

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The solutions

During the first 100 days, the EU should build on the momentum created by the Letta and Draghi reports to swiftly define a fully-fledged strategy to remove obstacles to free movement of goods, persons, services, capital and data, while at the same time stepping up enforcement of existing SM rules to have a rapid boosting effect on intra-EU trade and generate efficiency gains. The EU should:

- Strengthen and complete CMU/BU to improve access to finance for companies, develop risk-capital and attract more investment in Europe;
- Continue to privilege proper and more rapid enforcement of existing Single Market rules on goods and services in order to ensure a level-playing field;
- Liberalise cross-border provision of services through the ambitious implementation of the services directive and focussing on key services for industry (engineering, industrial installation and maintenance, logistics);
- Prevent national practices and regulations that are not compliant with the SM and cause fragmentation, while promoting harmonised implementation;
- Effectively enforce competition and state aid rules to preserve the level-playing field, including on third country operators in the SM.

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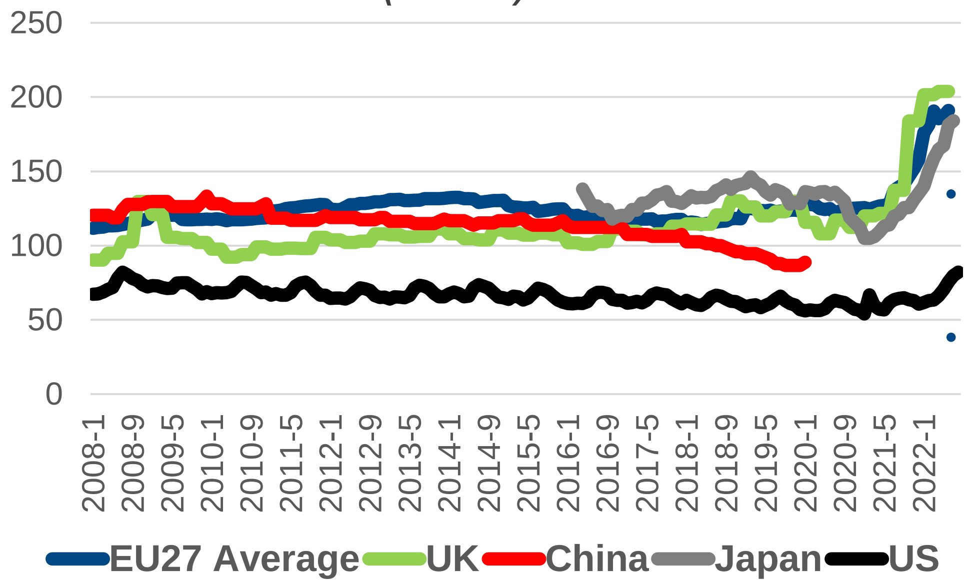
Supportive climate and energy policies

Costly transition: industrial retail electricity prices (€/MWh)



Source: EC

The present situation

EU companies continue to face electricity prices that are 2-3 times higher than in the US and natural gas prices that are 4-5 times higher. According to the report by Compass Lexecon for BusinessEurope, even in the optimistic transition scenario, energy prices in Europe could still be 50% higher than in the US, China and India by 2050. While there are major challenges ahead, a competitive energy and climate transition is still possible if the right policy decisions are made in time.

The key challenges

- Reaching climate neutrality by 2050 requires a deep electrification and an diverse energy mix (e.g. wind and solar, hydro, nuclear). Improving investment conditions for and guaranteeing technology neutrality at EU level is key;
- This starts with recognizing the enormous private investment needs and the need to create a business case for doing them;
- Some public funding will be needed to de-risk private investment, including increased EU funding for operational and capital expenditures to incentivize private investments in decarbonised energy systems, where market conditions fail to do so;
- While the Net-Zero Industry Act brought some initial improvements in permitting procedures, more needs to be done to address the lengthy permitting process, which undermines the business-case for investing;
- CBAM could help absorb part of the competitiveness gap stemming from carbon costs. Should CBAM prove to be ineffective in preventing carbon leakage, the phase out of free allowances will need to be reconsidered.

Supportive climate and energy policies

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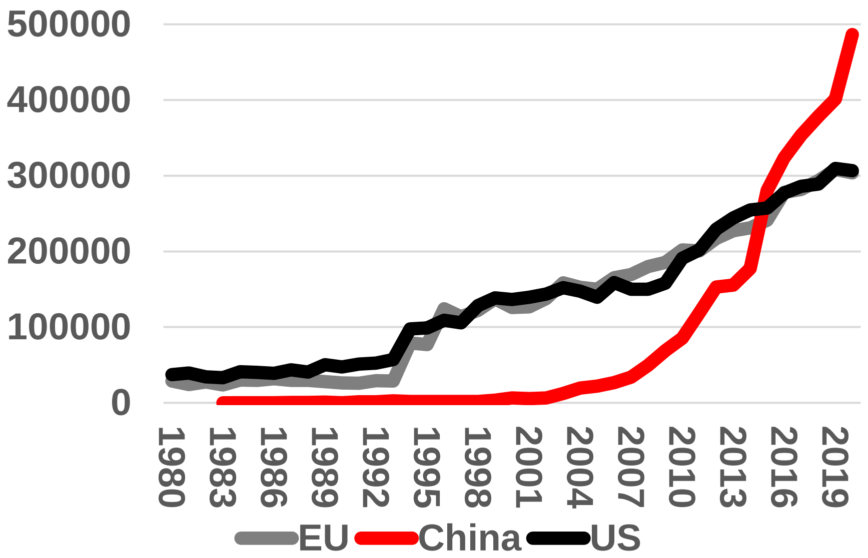
The solutions

During the first 100 days, the EU should work to introduce measures to mitigate carbon and energy costs competitiveness gap (e.g. broadening scope of industries considered at risk of investment and carbon leakage, developing recommendations on reducing exposure of industrial consumers to rising costs for energy infrastructure) and accelerate the work on CBAM critical parameters (a WTO-compatible exports support scheme). Moreover, the EU should:

- Foster stronger energy market integration and interconnections as part of a technology-neutral approach;
- Ensure increased EU funding either through existing facilities or by setting up new ones based on competition and excellence. Where state aid measures are implemented to supplement EU funding, they should be targeted, time-limited and monitored to mitigate distortions;
- Speed up approval and permitting procedures;
- Monitor CBAM implementation and reconsider the phase out of free-allowances early enough should CBAM prove ineffective ;
- Introduce and implement sustainability criteria for public under the Ecodesign for Sustainable Products Regulation.

Ambitious research and innovation policies

Number of patents introduced by EU, US and China



Source: WIPO

The present situation

Our incomplete SM leads to an investment gap, creating innovation and productivity gaps and then a growth gap with our main competitors. The EU is still a global leader in high-tech exports but our present competitiveness and future prosperity is at risk as the share of GDP we invest in R&D (2.2%) is lower than the US (3.4%) and China (2.4%), which moved from "made in China" to 'innovate in China".

The key challenges

- To meet its target of investing 3% of GDP in R&D, and ensure that we do not miss out on value creation of research, attract more investment, and successfully commercialise new solutions, products and services in Europe, the EU needs a regulatory framework that supports risk-taking and protects intellectual property;
- Improving access to finance for research, reduce over-reliance on bank financing and develop VC and other capital-risk tools as well as prioritising EU funding for industrial competitiveness and strengthening PPPs;
- Improving the ability of our education and training systems to equip more people with STEMs and entrepreneurial skills.
- Attract researchers from third countries and reduce the brain drain linked to the departure of researchers to the US, creating attractive pan-European career pathways for EU researchers.

Ambitious research and innovation policies

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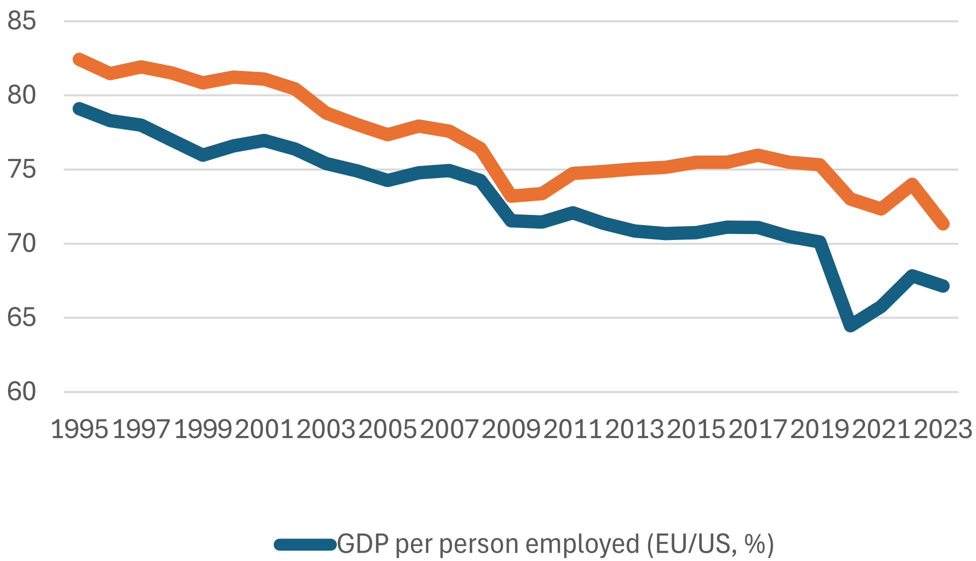
The solutions

During the first 100 days, the EU should clearly signal the importance of industrial and collaborative research and innovation projects, improve framework conditions to attract private investments and accelerate the use of regulatory sandboxes to speed up demonstration and testing of new technologies and innovations. Moreover, the EU should:

- Introduce a innovation stress-test to guide policy-makers to ensure that EU policy initiatives improve conditions for investment in R&D;
- Implement the innovation principle adequately when new legislation is considered and factor in the possible implications for Europe's innovation capacity when assessing the impact of any new legislation;
- Increase the FP10 budget and refocus on industrial and collaborative research and innovation projects, as competitiveness drivers;
- Reinforce research and innovation ecosystems by enhancing technology infrastructure as well as the dialogue between corporates, start-ups, research centres and universities.

Balanced employment and social policies

Euro area vs US labour productivity 1995-2022



Source: OECD

The present situation

In 1995 the euro area had roughly the same productivity level as the US. However, there was a divergence in terms of labour participation. In the EU, there was high unemployment of young people and low participation of older people, causing the GDP per capita to stay flat at 70% from 1980 to 2000. Then Europe increased labour participation but productivity growth suffered. Europe needs to create conditions for having both productivity growth and increased labour market participation.

The key challenges

- Companies are faced with hiring difficulties that hamper their growth and at the same time, there is unemployment and inactive people. Reducing labour market slack is an important part of the response to labour and skills shortages.
- In a context where the EU working age population already decreased by 3.5 million between 2015 and 2020 and is expected to shrink further, with the loss of an additional 35 million persons by 2050, legal migration is *part* of the answer.

Balanced employment and social policies

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The solutions

During the first 100 days, the EU should move away from its predominantly regulatory approach to social policy towards an economic and social partnership. Moreover, the EU should:

- focus EU social policy on helping to tackle labour shortages and skills mismatches with education and training measures, paying special attention to the skills needed for unemployed and inactive persons.
- address practical barriers to labour mobility in the SM, such as fragmented posting notification systems, lack of social security digitalisation, information provision, and recognition of professional qualifications,
- expand labour market participation via active labour market policies;
- future proof skills corresponding to companies' needs, bringing digital education to the forefront;
- use legal migration of skilled workers, attracting talent more easily;
- aim for competitive sustainability, avoiding duplication/overlap in social sustainability reporting.

But…

- **We cannot do everything!!**

- We must therefore prioritize, be strategic, and allocate our political and institutional capital to matters where the returns and likelihood of success are greater

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Europe's economic success – everyone's business