

Securing the EU's Competitiveness and Resilience

Julio Saavedra

Key Messages

- To secure its future prosperity, Europe needs to tackle three principal challenges to its competitiveness: leveraging the power of its single market, improving its level of innovation, and building the capacity to defend itself.
- Policy measures to reduce non-tariff barriers for the EU's trade in services should include the EU-wide standardization of qualifications, and the digitalization of public administrations and services.
- To boost growth by fostering disruptive technologies, EU innovation policy should be technology-neutral, competitively awarded, and designed to leverage the powers of public procurement and of the EU single market.
- Maintaining peace by preparing for war must be the guiding principle when it comes to European defense policy.
- The EU must create a single market for defense and implement a collectively borrowed fund, similar to the EUR 750 billion COVID recovery fund.



EconPol is CESifo's economic policy platform. With key support from the ifo Institute, it seeks to leverage CESifo's globe-spanning network of 1 800 high-ranked economists – eleven of whom have won the Nobel Prize – and ifo's decades-deep research expertise to provide well-founded advice to European policymakers. Drawing on the wide range of specializations of its members, EconPol's mission is to contribute to the crafting of effective economic policy in the face of the rapidly evolving challenges faced by the European economies and their global partners.



EconPol POLICY BRIEF

A publication of the CESifo Research Network

Publisher and distributor: CESifo GmbH

Poschingerstr. 5, 81679 Munich, Germany

Telephone +49 89 9224-0, Email office@cesifo.de

Editors: Clemens Fuest, Florian Dorn

Reproduction permitted only if source is stated and copy is sent to CESifo.

EconPol Europe: www.econpol.eu

Securing the EU's Competitiveness and Resilience

Julio Saavedra

Abstract

The European Union faces several simultaneous threats to its competitiveness: weakness in the industries of the future, insufficient innovation, expensive energy, the need to green its economy, and geopolitical and trade shifts, to name but a few. The EconPol Europe Annual Conference, on whose proceedings this policy brief is based, focused on three aspects that could make a substantial contribution to securing prosperity in the EU, but are in a lamentable state: they all currently fall far short of their potential. These are the power of the **single market**, the level of its **innovation**, and the capacity to **defend** itself.

Both the high-level speakers at the conference as well as EconPol and ifo research make clear that some low-hanging fruit are there for the taking, if only the political will were there, a good dose of national chauvinism could be overcome, and an effective communication campaign were undertaken to explain to voters why some measures are not only necessary, but unavoidable.

Introduction

The world has changed, and it is not changing back. A more hostile geopolitical environment, shifting trade patterns, increased security concerns, more unforgiving climate events... and now Trump 2.0. And if that were not enough, Europe is being left in the dust compared to the US in economic growth, technological prowess and defense capabilities.

Given this unappetizing set of circumstances, what should Europe do to preserve its competitiveness in the years to come? EconPol Europe's very timely annual conference tackled some key aspects of this conundrum from three perspectives: How to unleash the full potential of the EU's single market, how to avoid getting stuck in the mid-tech trap, and how to take better charge of its own defense.

Leveraging the Single Market

Given that Europe is resource poor, what better idea than to create a single market and exploit the huge purchasing power of its hundreds of millions of mostly well-heeled consumers? Such an obviously good idea. But **Kerstin Jorna**, Director-General for Internal Market, Industry, Entrepreneurship and SMEs at the European Commission, put the finger right on the key hindrance for turning this fantastic notion into a *real* single market: “Everybody wants the single market, but *not in their own country*.”

So, we end up with 27 fiefs that can drive even the most devoted advocates to despair. Just think of the bloc’s maddening (and wholly uneconomical) air traffic control patchwork, or the strategic status bestowed upon yoghurt in France, or the difficulty of providing services anywhere but on your own national patch.

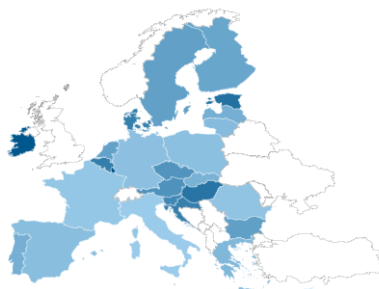
(By the by, the only good thing coming out of the babble of 27 different sets of interests is the decent quality of EU -baked regulations: the fact that they are the end product of compromises between its various governments makes them suitable for countries beyond the bloc, which often adopt them wholesale. No wonder the EU has become a world-leader in regulation exports.)

And that despite the huge benefits that opening up the market would bring. **Lisandra Flach**, Director of the ifo Centre for International Economics, pointed out that reducing by just 25 percent the non-tariff barriers that hinder a true single market for services in the EU would boost value added by 2.3—*permanently*. That’s 355 billion euros per year in the medium term (that’s nearly one Elon Musk’s worth of extra welfare gains per year). The greatest *absolute* gains, unsurprisingly, would occur in the largest economies, like Germany, France, Italy, and Belgium, while smaller ones would see the largest *relative* gains; Ireland benefits on both counts (Figure 1). But in the end, everybody wins.

And, what’s best, opening the market for services would also offer a good antidote to Trumpian tariffs hitting European industrial exports.

Figure 1: Gains in Added Value by Reducing Trade Barriers by 25%

Europe's prosperity is boosted by liberalization of trade in services...25% reduction of barriers would increase value added by 353 bn Euros per year



All EU member states would benefit in the medium term:

- Absolute welfare gains are highest in DEU, FRA, IRL, ITA and BEL
- Relative welfare gains are highest in smaller EU countries such as IRL, LUX, MLT

Source: Fuest (2024).

Another great boost would come from eliminating red tape and revising regulations. As an ifo study shows, a fundamental reduction in bureaucratic burdens would translate into a 4.6 percent average increase in real GDP per capita (which would be significantly higher than the much-admired GDP growth of the USA in 2024). If instead of reducing the bureaucratic burden a push were made to digitalize public administration, real GDP per capita would grow by 2.7 percent.

Just imagine then what the effect would be of doing both—or all three—at the same time. Low-hanging fruit, indeed.

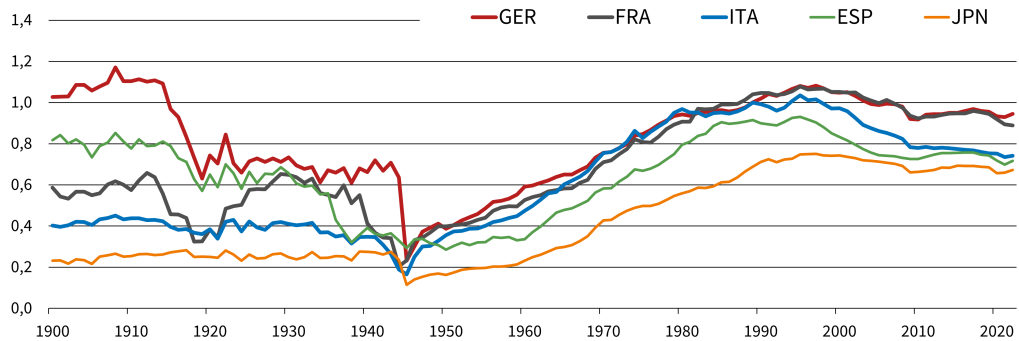
Avoiding the Mid-Tech Trap

In the year 2000, the EU set out an action plan that aimed to make the EU "the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion" by 2010.

It is astounding that *not a single one* of these lofty goals was achieved before the target date—or afterwards. In fact, as ifo President **Clemens Fuest** pointed out, productivity levels in the EU's largest economies (as well as Japan's), after nearly five decades of steady growth, started to decline in relation to the US's right before the Lisbon Strategy was announced—and thoroughly ignored the EU's action plan, continuing their downward trend all the way to the Strategy's target year. Productivity levels have stagnated thereafter at a level below the US one (Figure 2).

Figure 2

Long-Term Development in Work Productivity
Respective countries in relation to the US



Source: Long-term Productivity Database 2024.

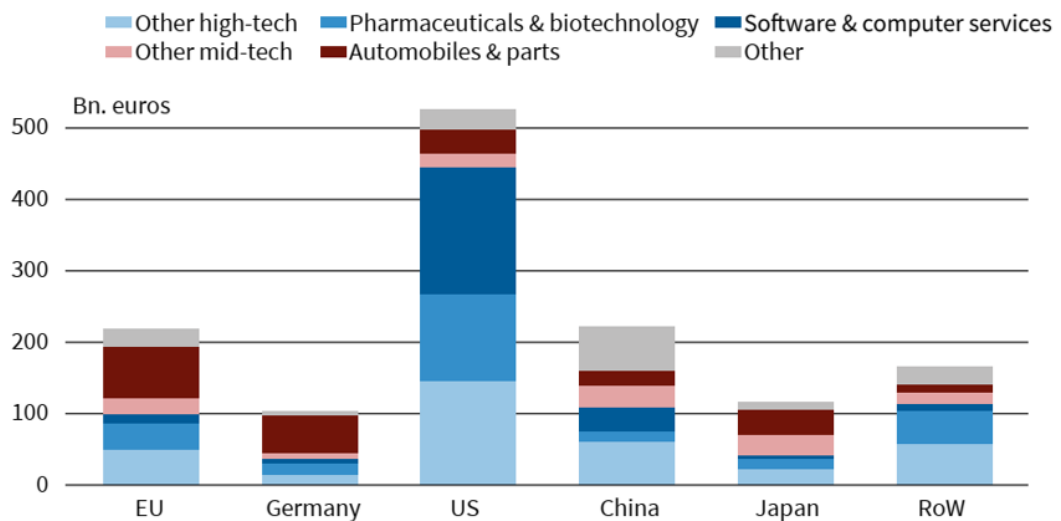
© ifo Institute

Note: Figure borrowed from Fuest (2024).

One of the reasons why the EU is falling behind is technology. Digitalization, for instance, with some brave exceptions such as Estonia, is pretty much in its infancy in the bloc, while high-tech titans are quite thin on the ground. Part of the reason for the malaise is that, while the EU has large state-funded research organizations, its corporate investment in research and development is dwarfed almost across the board not only by that of the US, but also by that of other advanced economies. Furthermore, the EU has tended to invest in mid-tech or legacy industries, such as automotive, instead of top-tech ones, where breakthrough innovations are more likely to occur (Figure 3). The EU risks getting stuck in the so-called Mid-Tech Trap.

Figure 3

Private Sector R&D Expenditure (BerD) by Tech Level (Top 2,500 Companies)



Source: EU Industrial R&D Scoreboard 2023.

© ifo Institute

Note: Figure borrowed from Fuest (2024).

As **Daniel Gros**, Director of the Institute for European Policymaking at Bocconi University, pointed out to highlight one startling fact, the ratio of R&D effort in software between the US and the EU is *15 to 1*—and it has remained so for the past 20 years. Small wonder then that the EU boasts no digital tech behemoths comparable to US ones, and few startling innovations like those of SpaceX. And then, as Professor **Reinhilde Veugelers** of KU Leuven said, we err by measuring *inputs*, such as what percentage is invested in innovation, instead of focusing on the *outputs*, i.e., the actual innovations that contribute to boosting the EU's productivity and competitiveness.

It is true that despite all of this there have been some truly remarkable global successes, such as the Netherlands' ASML or Denmark's Novo Nordisk, but some other ones are more nuanced, like BioNTech's success with the development of the mRNA anti-covid vaccines, or Airbus's dominant position in the airframer market. But BioNTech achieved global scale with the help of Pfizer, its US partner, while Airbus owes its prominence largely to the missteps of its US rival, Boeing.

So what is lacking? As **Keith Sequeira**, European Innovation Council, made clear, despite the low R&D effort there is no lack of brilliant ideas, but we are dreadful at commercializing them—unlike in the US, where research outfits and universities have close links to business, making it easier and faster to spin off ideas into successful startups. Tellingly, the vaunted Lisbon Strategy of 2000 did not contain the word “startup” a single time, anywhere.

One way to solve this, according to **Oliver Falck**, Director of the ifo Centre for Industrial Organization and New Technologies, is to design an innovation policy that, first, is technology-neutral. Second, that is competitively awarded. Third, that combines and leverages the powers of public procurement and of the EU single market. This found swift agreement from his fellow panelists, including **Andreas Zaby**, of the German Federal Agency for Disruptive Innovations, who added that for truly disruptive breakthroughs you need to bet not on the individual horses, but on the race as a whole.

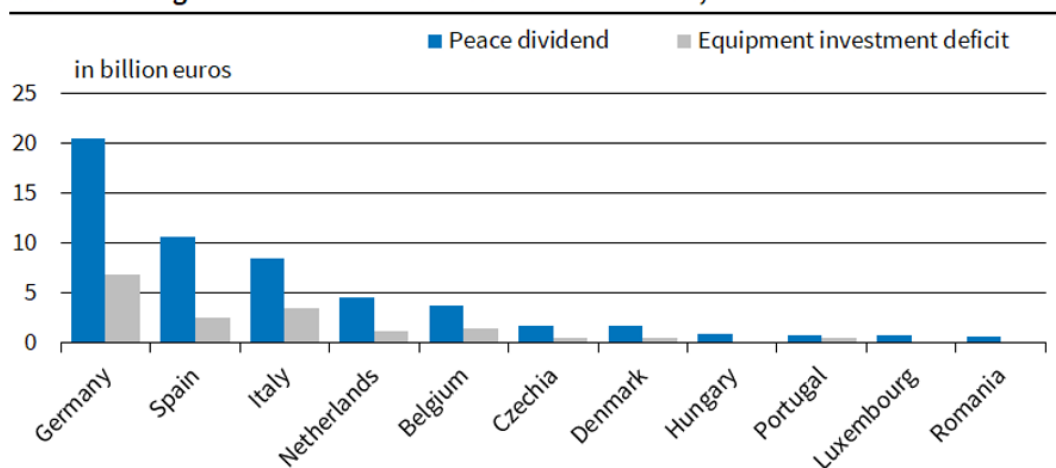
Defense: Readiness Requires Resources

The EU is still moving at the leisurely pace of peacetime. But this is no peacetime anymore, not truly. A vicious war is raging on its doorstep, while an increasingly aggressive Russia is engaging in sabotage, disinformation campaigns and, in general, hybrid warfare against the West. Of course, when talking defense, Ukraine and Trump are unavoidable topics. It was reassuring, then, to hear **Angelika Niebler**, an MEP involved among other things in EU foreign affairs and security and defense, pledge continued support

for Ukraine even if Trump turns his back on it. Even now, she stressed, the financial contribution that the EU has made to sustain Ukraine easily exceeds that of the US.

Still, the military side of things is quite weak, especially when compared to the real and immediate threat posed by Putin’s Russia. Europeans spent many decades chilling contentedly under the reassuring umbrella provided by the US, enjoying a so-called “peace dividend” resulting from not having to spend as much on defense as during the height of the Cold War. The biggest beneficiary was Germany and, worryingly in retrospect, practically no country reinvested the savings in maintaining its defense capabilities, not to mention beefing them up (Figure 4). Now, with hindsight, it is clear that it would have been much cheaper to invest in deterrence than to invest in beefing up defense under the current geopolitical reality.

Figure 4
Annual Average Peace Dividend and Investment Deficits, 1990-2023^a



^a Calculated as the gap to NATO targets: 2% of GDP for defense spending and 20% for equipment investment as a share of defense spending. Price adjusted to 2023 prices.

Source: Dorn et al. (2024).

© ifo Institute

Note: Figure borrowed from Fuest (2024).

Jan Pie, of the European AeroSpace and Defence Industries Association, explained why: both the supply and demand sides are woefully out of touch. The exceedingly long time it takes from adopting a political decision to produce a certain kit to finally issuing the respective contract is not even fit for the most peaceful of times. But when a company finally gets the contract and needs to expand production, the banks won’t lend it money and the commercial companies churning out equipment needed to produce that kit will not sell it to them—well, because you are *defense*, they explain, wrinkling their noses. And this is because at the slightest hint of banks investing in defense or companies selling equipment to produce military kit, NGOs take to social media to demonize them.

François Arbault, Director for Defence Industry at the European Commission, concurs. The EU, he says, has failed to send the right message to private finance to move in support of defense. The contrast with the US in this respect is telling. According to S&P

Global, US venture investment in defense startups is soaring, surpassing by September 2024 the level of the entire previous year. At first sight, some bright spots in Europe appear to suggest that on this side of the Atlantic the situation is not that bad. A case in point is like Germany's Helsing, a start-up that uses AI to process live data from the battlefield; it is currently rated as one of Europe's best-funded companies. But, and here is the rub, most of Helsing's funding has come from Silicon Valley investors.

This dearth of willingness to invest in European defense leads to a startling fact highlighted by **Guntram Wolff**, of the Université libre de Bruxelles: Russia, with an economy that is but a fraction the size of the EU's, is spending 40 percent of its budget (and 8 of GDP) on defense and security, being able now to produce in half a year, for instance, roughly the equivalent of the *entire* stock of Germany's Bundeswehr. So, lack of money is not exactly the problem in the EU. And yet, although the EU's NATO members have been agonizing for decades about reaching the 2 percent of GDP for defense spending demanded by NATO and in particular by the US, and most vociferously by US President-elect Donald Trump, only 23 out of the 32 have managed to reach or exceed that threshold. And while a total of around USD436 billion is now being devoted to defense, most members have not yet come around to acknowledging that 2 percent will not be enough, especially if the US draws back its protective umbrella. At the pace we are going, it would take *decades* to rebuild the stocks that we had some ten years after the end of the Cold War. Russia, in contrast, at the pace it is going, could be ready to attack a Nato country in about five to eight years.

As **Marco Butti**, of the European University Institute, put it, we need three things to effect change: threat, trust and time. Threat there is a-plenty. Trust is in short supply, and time has become a head-in-the-sand issue.

Policy Conclusions

Single Market

Non-tariff barriers limiting service provision from one member state in other member states that are hard to justify when set against the overall public good **must be scrapped**. This calls for two related measures:

- An EU-wide effort to identify such barriers and to tackle the obstacles hindering their removal.
- EU-wide standardization of qualifications for performing service activities and binding recognition of such qualifications across the Union.

A thorough assessment of **bureaucracy** at both the national and EU levels must be undertaken to eliminate unnecessary, obsolete or redundant procedures, rules and regulations, as well as to fuse closely related procedures, rules and regulations into a single, more streamlined version. The overall goal must be to speed up permitting and reduce compliance and reporting costs.

A concerted effort to **digitalize** public administration, services and bureaucratic procedures must be undertaken following best practice, adopting, for example, some of the measures introduced in Estonia. This necessarily includes strong and constantly updated cybersecurity, an EU-wide recognized digital identity, the introduction of the “once-only” principle, whereby data such as date of birth, name, gender, etc. only need to be entered once in government databases, and other measures that have proven to be highly effective in some more digitalized member states and beyond.

Escaping the Mid-Tech Trap

The EU innovation policy should be **technology-neutral, competitively awarded**, and designed to **leverage** the powers of public procurement and of the **EU single market**.

Furthermore, the **link between academic research and industry and business** must be strengthened, nurturing ecosystems where bright ideas become commercial successes. The role that the EU and the governments of its member states can play in this regard must be explored and implemented.

To stimulate innovation, a system similar to that followed by Singapore’s Temasek could be considered, whereby that organization identifies industries and ideas with both strategic and commercial potential and invests in them, helping to both bring such ideas to market and to steer industrial and technological advances towards fulfilling policy goals.

Defense

The EU unanimous vote requirement should be waived in favor of **qualified majority** in matters related to defense and security, in order to avoid individual member states blocking the bloc's decisions in these areas.

An **EU single market for defense is mandatory**, covering funding, procurement, setting of production goals and avoidance of duplication.

But that will not be enough. **Non-EU members ought to also be included**, such as Britain, Norway, Turkey, Canada and Switzerland, in addition to the US.

On the financing side, the **EU budget** must earmark at least EUR 100 billion for defense in the coming 7-year budgeting period, plus a **collectively borrowed fund** similar in both size and principle to the EUR 750 billion covid-recovery fund of 2021.

In terms of where to buy defense kit, nationalistic chauvinism disguised as attempts to bolster strategic autonomy should be replaced by the guiding principle of **who can deliver first**. Given the parlous level of military supplies and equipment, what does it matter if the items most sorely needed come from South Korea, the USA or Brazil?

Lastly, a good dose of **political courage** on the part of policymakers is needed, which includes honest, effective **communication** with the two key EU stakeholders: business and citizens. Only then it will be possible to get them on board and bring about a change of mindset regarding the need to maintain peace—by planning for war.

References

- Bradshaw, T., S. Pfeifer and T. Kinder (2024), “German AI defence start-up Helsing poised to triple valuation to \$4.5bn”, *Financial Times*, 27 June 2024, www.ft.com/content/e09f813b-e568-4afe-8e07-940a707595ca.
- Dorn, F. (2024), “Defence Spending for Europe’s Security – How Much Is Enough?”, *Intereconomics, Review of European Economic Policy* 59(4), 204-209, <https://www.intereconomics.eu/contents/year/2024/number/4/article/defence-spending-for-europe-s-security-how-much-is-enough.html>.
- Dorn, F., L. Flach and I. Gourevich (2024), “Building a Stronger Single Market: Potential for Deeper Integration of the Services Sector within the EU”, *EconPol Policy Report* 52.
- Falck, O., Y. M. Guo and C. Pfaffl (2024), “Lost Economic Output Due to High Bureaucratic Burden”, *EconPol Forum* 25 (6), 30-35.
- Fuest (2024), Presentation by Clemens Fuest at the EconPol Annual Conference 2024, “Introduction: EU Competitiveness - What Is at Stake and What Needs to Be Done?”, Brussels, 13 November 2024, econpol.eu/video/econpol-annual-conference-2024-introduction-eu-competitiveness-what-is-at-stake-and-what-needs-to-be-done.
- Fuest, C., D. Gros, P.-L. Mengel, G. Presidente and J. Tirole (2024). “EU Innovation Policy – How to Escape the Middle Technology Trap?”, *EconPol Policy Report*.
- NATO (2024), NATO Press Release: Defence Expenditure of NATO Countries (2014-2024), June 12, www.nato.int/nato_static_fl2014/assets/pdf/2024/6/pdf/240617-def-exp-2024-en.pdf.
- Steinbach, A. and G. B. Wolff (2024), “Debt Financing European Air Defence”, *Intereconomics* 59(4), 193–197, <https://www.intereconomics.eu/contents/year/2024/number/4/article/debt-financing-european-air-defence.html>.
- Thomas, D. and N. Hiteshbhai Bharucha (2024), “Rise in defense sector funding defies broader venture capital slump”, *S&P Global*, September 11, www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/rise-in-defense-sector-funding-defies-broader-venture-capital-slump-83265012.