

Where Draghi's Report missed the plot: Europe's Great Degeneration on the eve of Trump's Second Coming

Eduard Gracia

"The 'stationary state' [is] the condition of a formerly wealthy country that has ceased to grow." [...] "Countries arrive at the stationary state" [...] "when their 'laws and institutions' degenerate to the point that elite rent-seeking dominates the economic and political process." [...] "This is the case in important parts of the Western world today."

Niall Ferguson (2014): *The Great Degeneration: How Institutions Decay and Economies Die*¹

"The more corrupt a republic is, the more laws it has."

Tacitus (1st century): *Annals*²

The writing on the wall

Prospects shone brightly for Europe when the Cold War came to an end. In 1991, as the dust from the Soviet Union's collapse was still settling, Lester Thurow, the American economist, compared the competitive outlook of what he saw then as the three core global players in a book with a provocative title: *Head to Head: The Coming Economic Battle among Japan, Europe and America*. At that time, as Mikhail Gorbachev's vision of a Common European Home from Lisbon to Vladivostok felt more feasible than ever, Thurow wrote that, in the global chess game, "if [Europe] makes the right moves, it can become the dominant economic power in the twenty-first century, regardless of what Japan and the United States do" because "If Europe can truly integrate the European Economic Community (337 million people) into one economy and gradually move to absorb the rest of Europe (more than 500 million people) into the House of Europe, it can put together an economy that no one else can match."³ This did not seem too farfetched a vision: after all, Western Europe's GDP per capita had steadily approached the US' during the 1970s and 80s, so one could imagine that deepening that prosperity machine and expanding it to Eastern Europe would make it even more effective.

Some economists back then already expressed scepticism that in the long run Europe's penchant for interventionism could best the United States' more *laissez-faire* approach⁴, but otherwise agreed that deepening and expanding the European Union's market went in the right direction... And during the following decade, this advice was followed at a speed previously unseen in the sluggish, consensus-driven

¹ Ferguson (2014), p. 8 and 150.

² "Corruptissima re publica, plurimae leges" Annals III, 27,3.

³ Thurow (2007), p. 250.

⁴ For example Peterson (1992).

EU: in 1995 the Schengen Agreement removed most of its internal borders, in 1999 most of its currencies were replaced by the Euro and (although it never reached Vladivostok) by 2004 the EU had already expanded so far east that it incorporated three former Soviet republics, as well as Finland and Cyprus.

Yet, when in 2003 Thurow wrote an introduction for the book's reprint, he had to acknowledge that a lot had not gone as expected. Europe's core economies (France, Germany, Italy and the UK) trailed behind the US to the point that "the relative gains of the 1970s and the 1980s were all lost, and Western Europe's relative GDP per capita was back to where it was in the 1960s."⁵ He suggested this was because "while Europeans were the leaders in both the first and the second industrial revolutions, Europe is not fully participating in this third industrial revolution" and "everywhere across Europe there is a failure to grow big new firms" [...] "that can dominate the new technologies", as a result of which "Europe is falling behind when it comes to private research and development (R&D) spending on new technologies."⁶ Then, somewhat underhandedly (as it contradicted his earlier interventionist advice as well as his long-time Keynesian beliefs), Thurow attributed this problem to the obvious excess of regulation in Europe as compared to the US.

Fast forward to 2012. Just as the Eurozone crisis reached its nadir (on 26th July of that year Mario Draghi, then the ECB's President, pronounced his famous speech promising to do "whatever it takes" to save the Euro), the World Bank, prompted by the Polish presidency of the EU, published a remarkably thorough report: *Golden Growth: Restoring the lustre of the European economic model*.⁷ The tone was even-handed, when not openly positive, yet it did not refrain from highlighting some uncomfortable truths, particularly regarding the drag that the four main Southern European economies (Portugal, Italy, Greece and Spain – i.e. those sometimes known disparagingly as the PIGS⁸) represented for the EU as a whole. The report wondered why these four countries did not to catch up with their northern neighbours before their natural competitors in Central and Eastern European joined the EU and, tellingly, provided an unusually sharp answer:

"Did the south need more time to adjust, or did it squander opportunities? The latter seems more plausible. Ireland has shown that EU institutions and resources can be translated quickly into competitiveness. The Baltic economies are now doing the same. The chief culprits for the south's poor performance were high taxes and too many regulations, often poorly administered. While these mattered less when its eastern neighbors were communist and China and India suffered the least business-friendly systems in the world, they are now crippling southern enterprise"⁹

The report went on to compare the PIGS (without ever calling them so, of course) with much better performing countries like Denmark, Finland, Germany¹⁰, Ireland, Sweden

⁵ Thurow (2007), p. 3.

⁶ Thurow (2007), p. 3 and 4.

⁷ Gill & Raiser (2012).

⁸ This unflattering acronym goes back at least to the 1990s: the oldest published mention may be a *Le Monde* article (Vernet 1997), which already quotes it as a widespread nickname for "les pays moins «vertueux», ces membres du «Club Med» que l'argot communautaire a affublés d'un sobriquet peu élégant dans sa signification anglaise: «PIGS» pour Portugal, Italy, Greece, Spain..."

⁹ Gill & Raiser (2012), p.12.

¹⁰ Although Germany's economy is always tricky to compare with others because since 1991 it aggregates East Germany (which was communist until then) with West Germany (which was not).

and Switzerland – whose generous welfare states were no obstacle for a world-class business climate – and hinted that this performance gap was primarily due to institutional quality differences. Hence, however tactfully put, the implication was obvious: to improve their performance without sacrificing their welfare states, Southern European economies needed to imitate the policies and institutions of their most successful neighbours.

Almost equivalent conclusions came from the World Economic Forum's (WEF) *Europe 2020 Competitiveness Report*¹¹, which was issued in 2014, as it concluded that "a persistent knowledge divide between 'innovation rich' and 'innovation poor' economies prevails" [...] "with Northern and North-Western Europe performing strongly compared with a lagging Southern Europe and Central and Eastern Europe." Furthermore, the report warned that "while a concerted and united effort is desired from all EU Member States to improve Europe's knowledge-driven economy, it is clear from the large regional disparities that paths towards this goal, and priorities for improvement, will differ across countries."

The future of European competitiveness, according to Mario Draghi

Then, in September 2024, another major report popped up, this time ordered by the European Commission (EC): *The future of European competitiveness* – otherwise known as the "Draghi report" since it was signed off by Mario Draghi, a former ECB President and Italian Prime Minister¹². The starting point is again the performance gap between Europe and the US that Lester Thurow had already highlighted back in 2003 and which has kept growing steadily ever since. From 2002 to 2023, the gap in GDP per capita on a purchasing power parity (PPP) basis grew from 31% to 34%, and around 70% of this decline is explained by lower productivity in the EU¹³. The report highlights 3 core areas for action to foster growth¹⁴:

1. Most importantly, according to the report, Europe must collectively focus on closing the innovation gap with the US and China, especially in advanced technologies.
2. In addition, Europe must invest to bring down its currently very high energy prices while continuing to decarbonise and shift to a circular economy.
3. Finally, Europe must respond to increasingly uncertain geopolitics, so it no longer has to rely on others for its security.

The report identifies weak pan-European coordination (leading to the prevalence of country-level interests) as the single major obstacle to addressing these challenges, and it bases its recommendations on the following four main building blocks:

1. Full implementation of the Single Market for goods, services, capital and labour.

¹¹ Klaus Schwab et al. (2014).

¹² A particularly lucid, balanced, synthetic assessment of Draghi's report is in Pelkmans (2023).

¹³ Draghi (2024), p. 8. The report also notes that, as US population has grown faster than that of the EU, "The EU-US gap in the level of GDP at 2015 prices has gradually widened from slightly more than 15% in 2002 to 30% in 2023, while on a purchasing power parity (PPP) basis a gap of 12% has emerged" where in 2003 the EU's total PPP GDP (with the same countries) was 4% above the US'.

¹⁴ For the most succinct overview of these areas of action, see the introduction of the report, p. 1 to 5.

2. Europe-wide industrial, competition and trade policies (centrally designed and coordinated instead of fragmented by country and driven by local pressure groups).
3. Massive investment: raise the total investment-to-GDP rate by around 5% of EU GDP per year (i.e. like financing another Next Generation EU programme every year).
4. EU governance reform to deepen coordination and reduce regulatory burdens (e.g. centralising coordination and budget, easing consensus requirements, preventing local rule “gold plating”, allowing Member States willing to move faster to do so...)

It all makes sense, of course, and the report's nearly 400 pages provide a wealth of valuable analysis. Yet, strikingly, there is no acknowledgement of the fact, so central to previous reports, that Europe's economic performance is not just poor but also highly heterogeneous, nor of the danger that the institutional quality deficiencies of a growing number of EU members pose as they converge to Western Europe's welfare standards. Moreover, Mario Draghi proposes financing its recommendations by raising some €800 billion *every year* (i.e. around 4.7% of the EU's GDP – roughly the size of the entire EU Next Generation programme). However, it does not explain how these funds would be managed to prevent past pitfalls – when the evidence suggests (more on that below) that past EU investment efforts have all too often just led to resource waste on a massive scale.

For such an exorbitant expense would only be justified if its benefits unambiguously exceeded its costs, yet nowhere does the report make a convincing case that siphoning off such colossal resources would truly add more value to Europe than leaving them in private hands. Repayment would require additional taxation of close to 5% of GDP on top of the already crushing burden taxpayers bear in most EU countries, where public spending already ranges between 50-60% of GDP. Worse still, the report laments the weakness of Europe's private initiative (e.g. in its venture capital markets, which represent the biggest drawback of European innovation compared to the US¹⁵) but attributes it primarily to country-level overregulation and lack of market integration¹⁶ without giving much weight to the impact of heavy taxation, high-handed interventionism and low institutional quality in discouraging entrepreneurial risk-taking.

One might therefore be forgiven for regarding the report, despite its insightful diagnostic and proposals, as a bit of a budget land grab: no wonder Christian Lindner, then Germany's Finance Minister, flatly rejected the plan within three hours of its being made public¹⁷. In the words of Daniel Gros, director of the Bocconi Institute for European Policymaking: “Overall, Draghi's report has been well received in the Brussels bubble. But that's because, when someone is recommending spending €800 billion, nobody's looking at the fine print.”¹⁸ Within that fine print, perhaps the report's most glaring omission is the crucial role that low institutional quality plays in

¹⁵ Draghi (2024), p. 2 & 24.

¹⁶ Thus reiterating what Enrico Letta's report (Letta 2024) had concluded the previous April.

¹⁷ Faggionato & von der Burchard (2024).

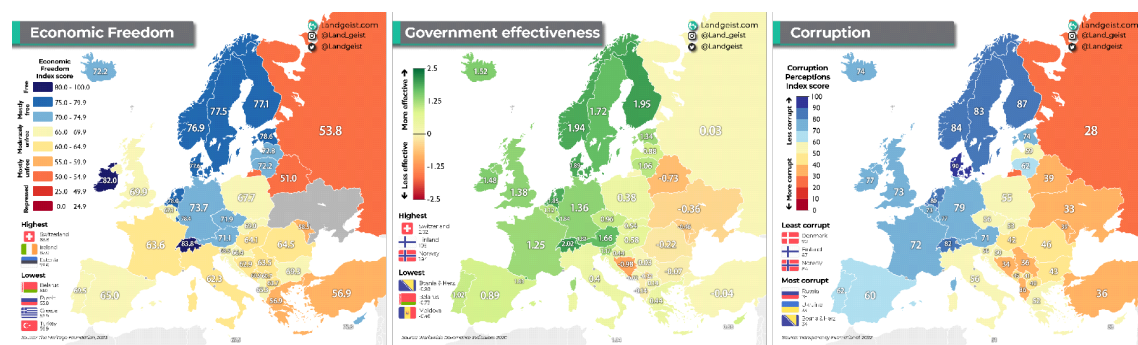
¹⁸ Gros, Daniel (2024).

Europe's competitive decline and how those institutions are likely to make most of those well-meaning recommendations go to waste. Let's see why.

Institutional quality and the post-war social bargain

Economic freedom, government effectiveness and low corruption are closely correlated (Figure 1): some countries are strong on all three counts (the usual suspects: Ireland, Netherlands, Switzerland, Germany, Austria, the Nordics and, as a relatively recent addition, the Baltics), many are weak on all three (most of Southern, Central and Eastern Europe) and a few stand in-between (Belgium, Cyprus, Czechia, Slovenia...).

Figure 1: Europe's institutional landscape¹⁹



The link is institutional quality. An institution's quality is low to the extent its control is captured by interest groups (also known as "elites" or, more appropriately, distributive coalitions²⁰) that use their coercive power to extract rents for themselves to the detriment of the institution's broader community of intended beneficiaries. Low institutional quality is thus tightly correlated to high corruption and low government effectiveness (as the institutions prioritise the insiders' welfare) as well as low economic freedom and a weak rule of law (for ruling elites are reluctant to give up their discretionary power). Since power tends to drift towards concentration into fewer hands over time,²¹ the question should rather be how some countries have ever managed to improve their institutional quality.

For, indeed, once at the helm of the state, firmly in control of its coercive power, bureaucratic processes, economic resources and cultural legitimacy²², a ruling elite is extraordinarily difficult to topple. It may, however, be persuaded to release its grip if and when its core members perceive it to be to their own advantage. Then, so the theory goes, as the opening leads to widespread prosperity, the wider social groups benefitting from these gains may wield their enhanced economic power to advance their own interests by further liberalising economics and politics... Thus, at least, runs

¹⁹ Data: The Heritage Foundation 2023, Worldwide Governance Indicators 2020 and Transparency International 2022. Graph: Landgeist.com.

²⁰ Somewhat simplistic interpretations of more nuanced studies (e.g. Acemoglu & Robinson 2012) all too often fail to highlight that the term "elites" is a convenient shorthand that does not solely refer to narrow "aristocracies" but also encompasses any sort of rent-extracting distributional coalitions, no matter how humble their individual members may be (see e.g. Olson 1971 and 1982).

²¹ This astonishingly pervasive rule is known as Michels' Law, or as the Iron Law of Oligarchy. Interestingly, Robert Michels, who first established this law in 1911, later became an active member of the Italian Fascist party from 1924 to his death in 1936.

²² Here I reflect of course on the quadripartite power typology proposed by Michael Mann (as in Mann 2012): military/coercive, political/bureaucratic, economic and ideological power.

a version of modernisation theory²³, which helps to explain why every wave of globalisation since the 19th century has been so closely correlated to political liberalisation and improvements in institutional quality.

Modernisation theory has stood at the kernel of Western governance at least since the end of World War II: it is the idea behind the Marshall Plan and later the IMF and World Bank's aid packages as well as the successive waves of European integration – all of which typically tied access to external funding and markets to economic and political liberalisation. Its success has been spectacular in some instances but disappointing in others. The same IMF/World Bank recommendations to transition from communism to capitalism, for example, led to both resounding success in Poland, Czechia, Slovakia, Slovenia and the Baltic republics and to tragic failure in Russia and most of the former USSR – and the secret sauce that tells one from the other is a subtle combination of incentives.

Obviously, rent-seeking elites may also be persuaded to release their grip on power through brute force. Such a natural experiment took place when, by the end of World War II, the Allied armies that had obliterated the Axis powers imposed democratic capitalism on the European countries west of the line from Stettin to Trieste (i.e. what Churchill famously called the Iron Curtain) save for Spain and Portugal. While evidently all prior power structures (from aristocracies and rentier classes to trade unions and employers' associations) had been severely damaged everywhere, the impact was no doubt hardest in Germany and softest in Britain, with Italy, France and the Benelux somewhere in between. It therefore bears witness to the stagnating power of rent-extracting social structures by which, in the subsequent three decades, Germany experienced the most amazing economic miracle whilst the UK's performance was comparatively dismal – substantially worse than France's and Italy's, despite their remarkable political instability during those years.²⁴

Yet reform does not always require a war: ruling elites can become surprisingly well-behaved when they fear enough for their place. Taiwan, South Korea and Singapore²⁵, the 20th century's most economically successful independent nations in East Asia save Japan²⁶, all have in common their facing a very real risk of invasion by hostile neighbours (respectively mainland China, North Korea and Malaysia), which arguably led their local elites to restrain their grafting instincts, enabling the economic freedom, rule of law and respect for private property that would make their economies successful. The case of Taiwan is perhaps the most telling, because general Chiang Kai-Shek's *Kuomintang* regime was outlandishly corrupt while it ruled mainland China (until 1949) as well as during its first years in Taiwan, but then, out of sheer self-preservation, had no choice but to improve its institutional quality lest its weakness made it too easy a target for the communist regime on the mainland. Similar reasons explain the much faster growth rates of South Korea and Singapore compared with that of other East Asian economies that in the 1950s started from a similar or even better place (e.g. Philippines, Thailand, Malaysia, Indonesia...).

Arguably, a similar external threat explains the extraordinary performance of the three formerly-Soviet Baltic republics bordering Russia – particularly given their large

²³ For an empirical validation of this mechanism, see e.g. Boix (2009).

²⁴ Olson (1982) made this point quite convincingly.

²⁵ The fourth "tiger economy", Hong Kong, was never effectively independent, as it was under British suzerainty until 1999 and then became part of the Popular Republic of China.

²⁶ Japan, of course, went through a post-war experience very similar to Germany's.

Russian ethnic minorities (22% of the population in Estonia and 24% in Latvia). In other cases (most notably Ireland, but also others like Czechia and Slovenia), the stimulus had more to do with the advantages that foreign investors would bring if local governments were able and willing to provide them with an attractive business environment. This is the path all newcomers were expected to follow as they joined the EU – but many have not.

True, the possibility of joining the EU conditioned to institutional quality improvements has been routinely (and quite successfully) dangled in front of accession candidates to push them in the right direction. The problem is that, once those countries join the club, there are very few weapons, if any, that the EU can wield to prevent relapse and, as a result, institutional quality has been steadily eroding in most of the EU's periphery for the last few decades. For the last two decades the phenomenon has been most visible in Central and Eastern Europe e.g. in the increasingly authoritarian regimes of Hungary and Poland²⁷, or in the huge, growing government influence of the Bulgarian mafias²⁸, and there is also strong evidence that institutions have been steadily degrading in the four PIGS²⁹ – starting from a higher level, no doubt, but drifting in the same gloomy direction. Why? Perhaps because EU subsidies have created an artificial version of an age-old disease: the oil curse.

Europe's welfare version of the oil curse

Just as external threats and the will to attract foreign investment may trigger the right behaviours, large sources of income the government can easily control may lead in the opposite direction. Indeed, when control of the state's power levers gives privileged access to the rents generated by certain commodities (most characteristically oil) whose revenue represents a substantial share of the country's income, then integration into a global market where these resources can generate even more rents further strengthens the ruling elite's position, thus leading to a steady institutional degradation³⁰. However, this so-called Resource Curse is not solely related to natural resources: the same happens, for example, when a government takes hold of large international aid transfers – which is why aid funds have so often proven counterproductive in underdeveloped countries³¹.

Yet this rent curse impacts countries differently depending on their institutional starting point: countries like Norway, Canada or Australia, despite their huge natural resources, do not seem to have experienced any visible institutional decay, whereas similar endowments in economies subject to lower quality institutions, like so many in Africa, the Middle East and Latin America, generally correlate to institutional corruption. This should be no surprise: after all, graft is all about the balance between reward and opportunity.

Which takes us back to the EU. Evidently, the carrot of EU accession conditioned to compliance with certain institutional standards is a powerful motivator for local elites to release their grip on power until the accession takes place. Yet, once in, the incentives change. Not only does the EU provide generous regional development, cohesion, and social and agricultural funding to its poorest members, but integration

²⁷ Bernhard (2021).

²⁸ See e.g. European Commission (2019).

²⁹ See e.g. Challe, López & Mengus (2016).

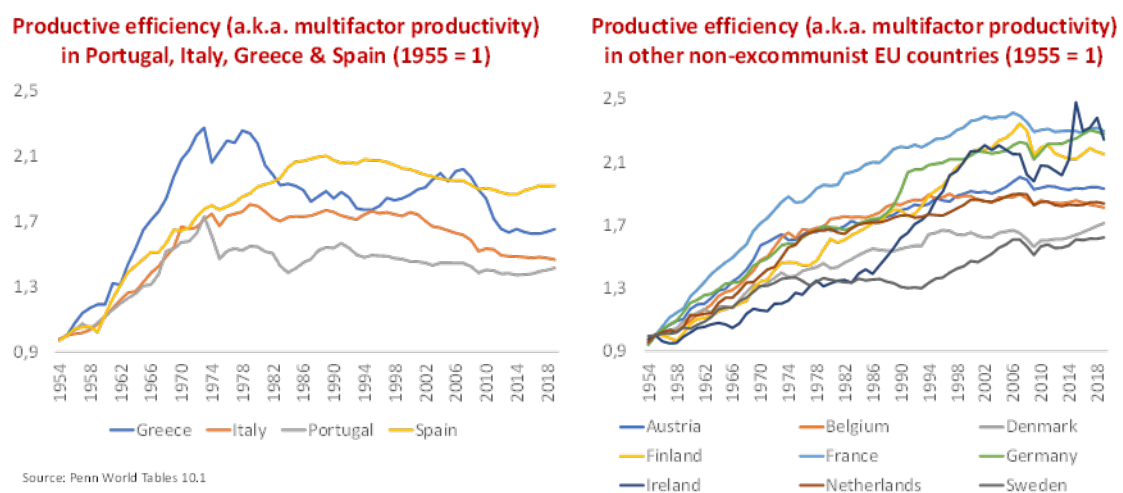
³⁰ See e.g. Kolstad & Wiig (2009).

³¹ As compellingly highlighted e.g. by Easterly (2001) and (2006).

into the EU's single financial market, combined with an unwritten assumption (particularly within the Eurozone) that overborrowing countries will always end up being bailed out, provides the EU's weakest economies (and above all their public sectors) with access to cheap financial resources at a scale they had never seen before. Combine this with the fact that integration into the European single market provided these countries with the prosperity they needed to pay for welfare states like those in northwestern Europe: this undoubtedly offered enormous benefits but, by also increasing their public sectors' weight in the economy, it therefore expanded the opportunities it generated for graft.

This is particularly evident in the productive efficiency (which economists somewhat cryptically call Multifactor Productivity, Total Factor Productivity or just TFP) of Portugal, Spain, Italy and Greece³². From the 1950s to the 1980s these countries improved their productive efficiency steadily as their integration into the wider economy allowed them to climb out of their then desperate poverty. Yet, as they joined the ranks of developed countries, they also built their welfare states. Thus, Italy in the late 1960s (as the most developed of the four, as well as a founding EEC member³³), Portugal and Greece in the 1970s (with the fall of Salazarism and of the Greek Colonels' dictatorships) and Spain in the 1980s (with the first socialist governments after the end of Francoism) raised their government spending from ca. 15% to around 50% of their GDPs. This simply followed the steps of their northwestern neighbours, which has done the same as they exited their own postwar periods – yet the impact on their productive efficiency was very different (Figure 2).

Figure 2: Productive efficiency (a.k.a. multifactor productivity)³⁴, 1954-2019



Why? The countries on the left and on the right have all since had public spending representing around 50% of their GDPs since the mid-eighties at the latest, so this is not differential. The gap is in their institutional quality, as shown in Figure 1. Portugal, Spain and Greece certainly improved their institutional quality considerably since the days of, say, the Salazar, Franco and Greek colonels' dictatorships³⁵, but have not

³² Communist countries obviously had huge public sectors, albeit hideously inefficient, before they became capitalist and eventually joined the EU.

³³ As a result of the Maastricht treaty, the European Economic Community (EEC) became the EU.

³⁴ Data: Penn World Tables 10.1 (from the University of Groningen website). Graph: author's design.

³⁵ Italy's case is somewhat different, as it has been a democracy since the end of World War II, but its institutional framework, particularly in the *Mezzogiorno*, resembles to a great extent those in the other PIGS.

brought it close enough to their northwestern neighbours' while, on the flip side, their modern welfare states manage funds at a scale unimaginable back then, so the opportunity to finance well-paid jobs and colossal public works for the benefit of various political supporters have multiplied – and the dead weight this creates is halting these countries' productivity growth.

Thus, when these countries go through a new wave of European integration (as when all but Italy joined the EEC in the 1980s, or when they all joined the Eurozone between 1999 and 2001), their economies first surge because of the new opportunities this change puts forward and the investments it fosters. Yet their insufficient liberalisation and poor institutional quality lead them to misallocate their credit into investments that favour the countries' powerful distribution coalitions (e.g. property investments, unnecessary public works, chronic government deficits...) but have a low, nil, or even negative impact on productive efficiency. As a result, debt accumulates without sufficiently boosting their productive capabilities to ensure repayment, so when a financial crash eventually comes (as in the 1992-93 currency crisis or, even more painfully, the 2009-2012 Eurozone crisis), these countries are much more severely impacted than their northwestern neighbours³⁶.

The over-obsequious overseer

Overlay now EU institutions on top – not only the European Commission (EC) but also the European Central Bank (ECB) and the European Court of Justice (ECJ). Their oversight works well enough as a filter to ensure that accession candidate countries shape up before they join the Union but, once in, the power balance goes in reverse and EU decisions end up being driven by the largest states. Ramon Tremosa, who was a European MP for ten years, and Aleix Sarri, his collaborator during those years in Brussels, witnessed the issue first hand and explained it in a highly compelling book: *Why Europe Fails: State centralism against European integration*, where, among many other insights, they concluded that:

“The senior officials of the great capitals, ensconced in their age-old control of the public administration in countries like France and Spain, strive to ensure that in practice the real power remains in state capitals and not in Brussels, thwarting European reforms that could generate economic convergence and bring all the benefits of deepening the single European market to fruition.”³⁷

Indeed: with the sole – and very partial – exception of the EC president, whose name is proposed by the member states (through the European Council) but ratified by the European Parliament, all the other top appointments within the EC, ECB and ECJ essentially result from negotiations among member states. Hence, as Tremosa and Sarri add, “the theoretical power of the European institutions is being systematically sliced up by the largest states in day-to-day life by planting officials who profess greater allegiance to their respective capitals than to the European institutions.” Furthermore, European institutions can levy no taxes, nor otherwise wield any formal

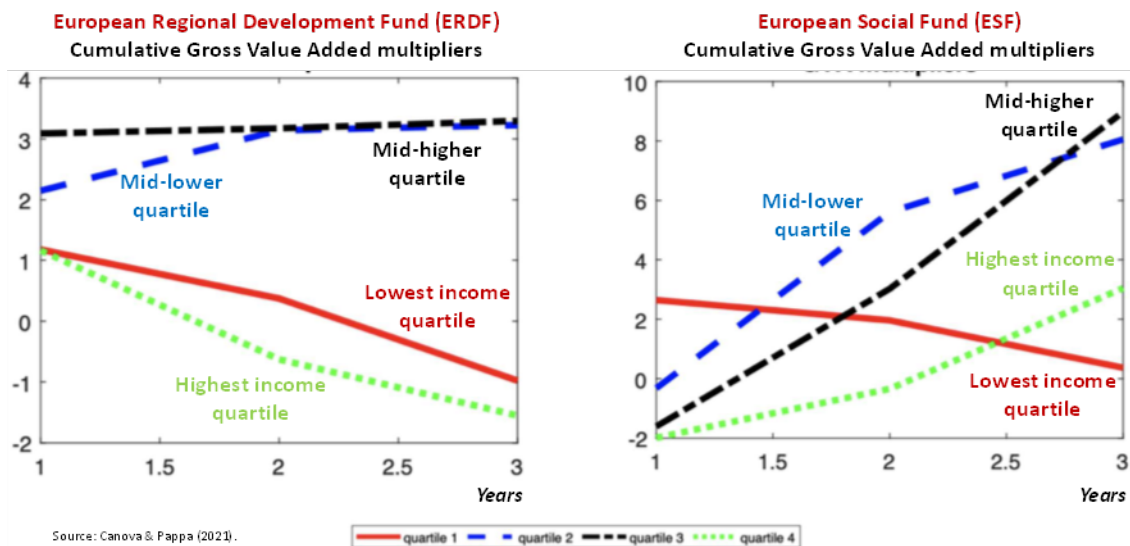
³⁶ This mechanism has been thoroughly studied in response to these countries' remarkably poor performance during the Eurozone crisis; see e.g. Reis (2013) and Brunnermeier & Reis (2019).

³⁷ Tremosa & Sarri (2017), p. 332.

coercive power to enforce their rules,³⁸ so despite their pretence, they are much weaker than US federal institutions.

From an economic perspective, this not only means that non-compliance with EU rulings and directives is largely tolerated, but also that the execution of Europe-wide projects funded through EU institutions (e.g. the Trans-European Network or the Next Generation programmes) is generally delegated to the member states, which then may or may not manage those funds as intended. The result is that, paradoxically, the poorest countries (which are typically those with the lowest institutional quality) are the ones that **least** benefit from European subsidies. For example, a recent study³⁹ on the multiplier impact of European subsidy funds on Gross Value Added (GVA) observed that impact over the last 30 years for two major EU funds: the European Regional Development Fund (ERDF), aimed at fostering innovation, research as well as small and medium firms, and the European Social Fund (ESF), which focuses on education, health and the fight against poverty (Figure 3).

Figure 3: Cumulative GVA multipliers, ERDF and ESF programmes, last 30 years⁴⁰



That the highest-income countries benefit less from EU subsidies seems logical, as they are already more developed and therefore have fewer low-hanging fruits. Conversely, that the lowest-income countries do worst of all suggests that their lower institutional quality leads them to misallocate systematically the funds assigned to them. The result is widespread waste: think of the gross misuse – and the local mafias' appropriation – of Next Generation EU funds e.g. in Bulgaria⁴¹, or the Trans-European Network of Transport (TEN-T) where billions of euros spent for over a decade have so far failed to reduce European road transport's share below the 82-83% of land transport it already represented 20 years ago⁴².

³⁸ Arguably the ECB can choose whether to buy the debt of a given country on a given date but, although this ability has occasionally been employed to achieve political aims, it is not a power that has been formally bestowed on the ECB, so its use constitutes, *strictu sensu*, a form of power abuse.

³⁹ Canova & Pappa (2021).

⁴⁰ Data and diagram: Canova & Pappa (2021).

⁴¹ See e.g. Roussi (2024).

⁴² FERRMED (2023).

Technology, welfare and the Great Degeneration

This inefficient, fragile, even shaky institutional construct is now facing a global social crisis whose primary driver is the advent of the Third Industrial Revolution – or as Carles Boix calls it, Silicon Valley capitalism⁴³. There is of course a causal link to globalisation: just as the First Industrial Revolution was made possible by the Age of Discovery after 1492 and the Second by the globalisation between 1815 and 1914, the globalisation wave after 1945 created (again) the competitive environment and global economies of scale that led to the technology progress behind Silicon Valley capitalism. It is equally true that liberal capitalism⁴⁴, by promoting global free markets, made this technological transformation possible – so one could somehow argue that it is precisely democratic capitalism's success since World War II that has led to its current crisis. For globalisation has indeed created unprecedented prosperity and rapidly reduced global income inequality but also, by fostering new technologies that replace human work, has polarised labour demand, boosting economic rewards for the most qualified professionals while bringing down wages for the least skilled – which heats social tension to levels welfare states struggles to handle.

It is somewhat ironic that so many authors blame today's welfare state's drawbacks on neoliberalism (otherwise known, in IMF and World Bank parlance, as the "Washington consensus"), for the liberal policy surge in the 1970s was the most successful response to the welfare state's first existential crisis. Indeed, after decades of Keynesianism, public spending in the most developed countries already then represented half, or more, of the GDP, so addressing social tension via further redistribution was increasingly unfeasible.

Perhaps the best example was Britain, whose growth rates after World War II were notably disappointing – fostering greater social tension than, say, in Germany. True to form, the government at first paid the bills via confiscatory taxes (e.g. 98% marginal income tax⁴⁵ from 1974 to 1978) and debt monetisation (peaking in 1975 at a 24.2% inflation rate⁴⁶) among other predatory measures which – unsurprisingly – soon proved counterproductive. The answer, forcefully deployed by Margaret Thatcher's government after she became prime minister in 1979, was reasserting free markets to promote prosperity and so finance the welfare state itself, while being aware that too heavy a welfare system could choke itself by overwhelming its own economy. The recipe was hence much more broadly adopted in many countries (albeit often in softened versions) and then proven spectacularly right when communism crumbled between 1989 and 1991. No wonder Francis Fukuyama felt it was justified to proclaim *The End of History*⁴⁷ in 1992 – for democratic capitalism had just won.

Yet the success of liberal, democratic capitalism was always about keeping the delicate balance between free markets (for prosperity), the welfare state (for social peace) and political freedom (to limit elite power). It never worked well in countries with a low institutional quality (think of most of the post-Soviet states' transition to capitalism), nor have its bitter pills against well-established forms of privilege and protection ever been popular. In the early 90s Ireland (and to a lesser extent, the

⁴³ Boix (2019) provides an excellent analysis of this shift and its impact on democratic capitalism.

⁴⁴ "Liberal" understood in the classical sense, i.e. meaning "in favour of freedom", not its modern US common parlance meaning of "left-leaning" or the European pejorative use as "right-wing."

⁴⁵ World Inequality Report (2018) according to the Our World in Data website.

⁴⁶ World Bank (2024) according to the Our World in Data website.

⁴⁷ Fukuyama (1992).

Nordics) deployed broad liberal reform packages, and so did most of the central and eastern European countries that started at the time the transition from communism to capitalism. Yet, despite the spectacular success that these policies had in those countries, they have by no means set the trend in Europe.

For a long time, EU institutions played the role of the sensible grandparent, devoid of coercive power but able to leverage moral authority to nudge reluctant countries towards lower local intervention and higher market integration. But then the Great Recession hit and, somehow, things changed. Perhaps, under the pressure of widespread social discontent, it was just too tempting for Europe's technocratic elites to fend off populist attacks by conceding intervention to regain some popular support. For the last 10-15 years, for example, the European Central Bank (ECB) has gone from being a severe manager of money supply (just as the German Bundesbank had been before) to routinely monetising national governments' deficit as it does now – a role that, as it happens, was originally set to be temporary but is now regarded as permanent. Yet the best examples of Europe's populist flip may be in the European Commission and Parliament's policies.

For some of EU policies seem so misguided they almost beggar belief. No other major economic bloc pushes greenhouse gas reduction so hard, to the point of almost sponsoring “de-growth” – as when, in May 2023, the EU Parliament hosted a “Beyond Growth” conference promoting “post-growth Europe”⁴⁸. Even Draghi's report presents the contradictory goals⁴⁹ of cheap energy and decarbonisation as equally relevant. Yet in truth, Europe is already extremely decarbonised. As of 2023, the EU generated just 6.6% of the world's carbon-dioxide-equivalent (CO₂e) emissions, vs. 31.3% China and 12.7% the US⁵⁰. Hence, despite having a far higher GDP per capita than China (which should drive higher energy consumption), for every 2 tonnes of CO₂e the average EU resident generates, a Chinese one generates 3, and a US one 5. This, incidentally, has been achieved while phasing out nuclear plants, the most reliable non-carbon energy source, whose generation by 2023 had already declined in Europe by 33.3% (i.e. one third) below its 2004 peak.

Meanwhile, the regulation that has led Europe down this path has achieved only a mild shift to cleaner sources of energy, but a massive migration of industrial activities whose costs it has made uncompetitive. Thus in 2023, the US generated 60% more CO₂e per unit of GDP⁵¹ than the EU, yet CO₂e emissions *per unit of energy consumed* in the US were only 8% higher than in the EU: in other words, as energy consumption is only 8% more polluting in the US, the 52% gap is explained by the departure from the EU of many energy-consuming industrial activities that its overwhelming regulation has expelled. It would be hard to find a more blatant contradiction of the EU's avowed objective of reindustrialising Europe.

Similar self-defeating policies are widespread. For example, European performance in the early stages of innovation is in early stages performance comparable to that of the US (a testimony of Europe's research and education strengths), but to develop those innovations commercially, innovators typically have to move to the US to find venture capital and escape Europe's bureaucratic maze. Yet, despite duly noting this, Draghi's

⁴⁸ European Parliament Research Service (2023).

⁴⁹ For renewables have severe technical limitations, and so many regulatory constraints weigh on nuclear energy since the Fukushima incident that new plants are no longer profitable in the EU.

⁵⁰ The energy data in this section are all taken from the Statistical Review of World Energy 2024.

⁵¹ Per World Bank data in PPP (Purchase Power Parity) to neutralise the impact of price differentials.

report still puts much more emphasis on the research part of R&D than on facilitating that the private sector scale it up to mass production. Taxes, labour protection rules, licences and bureaucratic obstacles of every kind (not just, as Draghi's report suggests, a want of common standards) discourage the development and deployment of innovative industrial processes.

Applied innovation in Europe is thus largely locked into a “middle technology trap”⁵² consistent with governments' inclination to bail out their flagship companies when in trouble to preserve local jobs and political control. Thus, by privileging otherwise uncompetitive firms against fitter players (whose taxes pay for such privileges), European governments steer their economies into mediocrity⁵³. Conversely, the US' more *laissez-faire* approach made e.g. US average labour productivity grow in 2000-2019 over 0.5% *per year* faster than the EU's⁵⁴ and is turning it into the world's largest microchips producer⁵⁵.

The EU's penchant for bureaucracy is indeed fearsome to behold, for Europe, much more than the US, illustrates what historian Niall Ferguson calls the Great Degeneration⁵⁶. Government and government-sponsored institutions have taken so much control over all economic and social processes, and so colossal are the rents these institutions extract from the productive sectors, that rent extraction has become a lot more attractive a source of income than productive activities, and the result is a society mired in distributive conflict.

Many of Europe's dysfunctional institutional behaviours may be the short-term-focused responses of a ruling establishment distressed by mounting social discontent. Across developed Europe (with very few exceptions like Ireland and Switzerland), public sector spending consistently exceeds 50% of GDP: if the ruling elite of any society is the group controlling most of its economic resources, the leading group in Europe today must be the public sector itself – which is ideologically dominated by the so-called “Brahmin left”⁵⁷. Just as when you only have a hammer everything looks like a nail, Europe's establishment (including European institutions as well as most of the country governments behind them) steers every solution towards public intervention; but, as public intervention stiffens the private sector yet another notch (particularly where institutional quality is low), it fosters an increasingly lethargic European economy – which further intensifies social pressure.

This, incidentally, sets a subtle difference with respect to the US⁵⁸. There, the challenging counter-elites are the same: on one side, the far-right coalition of oligarchs like Trump and Musk, with the undereducated feeling left behind by globalisation, and on the other, the far-left mass of overeducated college graduates with majors (mostly arts & humanities) that the private sector does not demand so much of and the public sector's slow growth cannot absorb. Yet, as befits an economy where public spending only represents around 35% of GDP, the commanding technocratic elite is more biased towards the private sector.

⁵² Draghi (2024), p. 24, makes a strong point about this.

⁵³ Reis (2013) developed and then validated empirically a model reflecting this process.

⁵⁴ Draghi (2024), p. 20.

⁵⁵ Roy (2024).

⁵⁶ Ferguson (2014).

⁵⁷ The expression is used for example in Gethin, Martínez-Toledano & Piketty (2022).

⁵⁸ Turchin (2023) provides an impressive, mostly US-centric analysis in historical context of today's correlation of forces between the dominant elites and their challenging counter-elites.

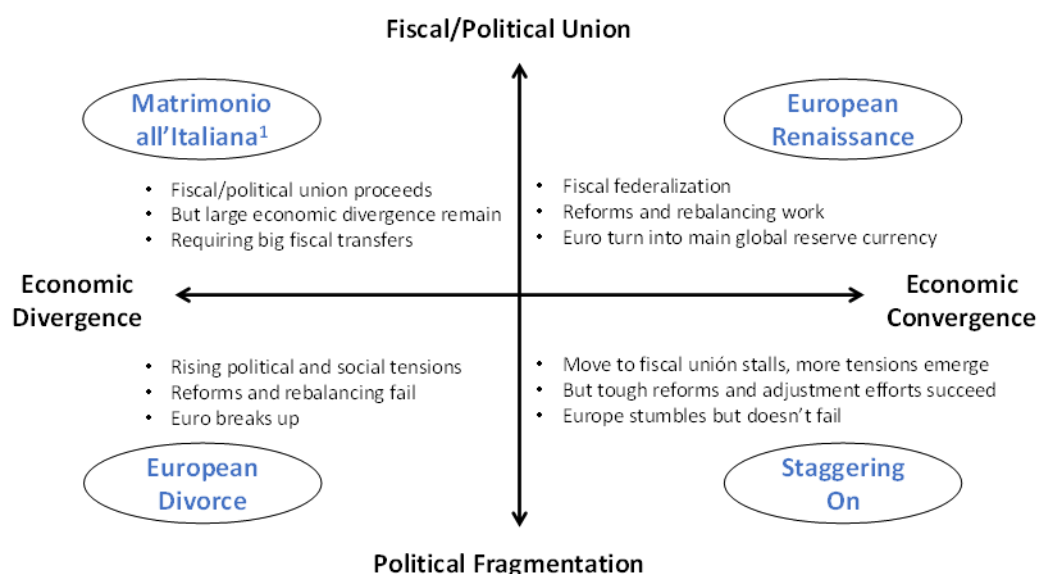
The European establishment seems therefore to be buying time through scattershot crowd-pleasing policies to keep at bay its challengers: green policies (for the left), immigration controls (for the right) and a maze of rules, taxes and subsidies. It generously subsidises inefficient activities (e.g. agriculture) and low-quality institutions (e.g. in the PIGS) while stiffening private initiative through an overwhelming regulatory burden. The US is by no means immune to these perversions, and fares even worse in a few areas (e.g. curbing the power of health care and pharma oligopolies), but is more *laissez-faire*, less willing to limit the private sector's competitiveness, and the result is its superior economic performance.

If these trends continue, Europe may head down a very dark path. Let's have a peek into it.

Europe's future: *Matrimonio all'Italiana*

In that momentous year of 2012, just a few months before Draghi famously uttered his "whatever it takes" to express his commitment in defence of the euro, the research team of Morgan Stanley, the investment banking firm, issued a report identifying four potential future scenarios for the European Union (Figure 4).

Figure 4: What future for Europe? Four scenarios according to Morgan Stanley⁵⁹



Source: Morgan Stanley Research (2012)

1. The original paper spelled this scenario's name as "Matrimonio a l'italiana", but this name has been corrected here to follow standard Italian spelling.

The report considered two obvious axes (Fiscal/political union and Economic convergence) and defined four scenarios as the combinations of those two axes' polarities. If the EU fragmented economically and politically, the obvious result would be a *European Divorce* – something that ended up happening with Brexit but has so far not gone any further. If fiscal/political union stalled but somehow economic convergence progressed, then the EU would essentially keep *Staggering On*. If the EU managed to integrate economically and politically, then of course it would be a *European Renaissance*. Yet if there were progress on the fiscal/political integration front but the various EU economies took divergent paths, the resulting Union would

⁵⁹ Andreopoulos, Fels & Pradhan (2012). Unfortunately, the paper is no longer available on the web.

somehow come to resemble what Italy has been since its unification – hence the scenario's name, *Matrimonio all'Italiana*⁶⁰.

This last scenario seems by far the most likely today. Economically, as we have seen (Figure 2), north-south productive efficiency⁶¹ convergence, after its spectacular run from the mid-fifties to the mid-eighties, stalled almost four decades ago as countries with lower-quality institutions deployed welfare states as generous as their northern neighbours'. East-west convergence has evidently been a resounding success since the 1990s (on the same grounds as north-south convergence until the 1980s: because those countries started from such a low base), but the same productive efficiency growth slowdown is already visible in the countries with the lowest institutional quality – particularly in Hungary and Bulgaria⁶².

Productive efficiency may not matter that much from one year to the next, but it has proven to be one of the best predictors of long-run economic performance⁶³: thus, just as the PIGS' efficiency convergence halt in the late 1980s heralded their subsequent economic stagnation⁶⁴, the evidence suggests that in the next few years we will most likely witness a similar process unfold in countries like Bulgaria, Romania and Hungary.

On the other hand, after many years of debate, the EU seems to have found a backdoor to a “get cash now, pay much later” sort of fiscal union, at least within the Eurozone: debt issued by the EC, backed by a commitment of member countries to pay it back at some point in the future, and combined with the ECB's ability to monetise it by buying it in the open market. This is the tool Mario Draghi recently invoked as a way to finance his report's investment recommendations and, despite the initial rejection statements, it may soon prove too tempting for member countries to use this trick to get cash from the EC while kicking the financial can further down the road – particularly if the EC then gives them as much leeway to spend those funds as it has so far.

For the Eurozone (paradoxically, considering it was originally conceived to mimic the strict control mechanisms of the Federal Republic of Germany) now allows more financial latitude to its country governments than the US –where there is a permanent federal debt cap whose changes Congress must always approve and where, since 1840, the federal treasury is forbidden to bail out any member state. With Britain now “brexited” and Germany in a deep structural crisis, those small, successful countries the World Bank recommended imitating back in 2012 (Ireland, the Nordics, the Baltics...) and that EU parlance often describes as the “frugals” for their cautious budgeting practices may well see EU policies drift ever closer to the profligate preferences of France, Italy and Spain.

As it happens, this downslide to decadence is likely to feel gentle and soft at first. Europe, and particularly its eternal southern laggards, has long got used to just

⁶⁰ The paper spelled this scenario's name as “Matrimonio a la Italiana” (= “Marriage Italian Style”) but it has been corrected here to follow standard Italian spelling (and also per the title of a memorable 1964 Italian film directed by Vittorio de Sica, starring Sofia Loren and Marcello Mastroianni).

⁶¹ That is, what economists know as Multifactor Productivity, Total Factor Productivity or simply TFP.

⁶² According to data from the Penn World Tables 10.1.

⁶³ A particularly famous, compelling paper making this case is Krugman (1994).

⁶⁴ Here we ought to distinguish between short and long-term: for example, both Spain and Portugal have been hailed as economically successful due to their recent GDP growth rates (compared with, say, Italy's) but, as their TFP growth rates remain dismal, this success is unlikely to be sustainable.

muddling along, piling further bureaucratic burdens on its economic engine and hoping it will keep humming as usual. Yet this may be a particularly bad time for Europe to keep sliding down this slope.

So far, Europe has had a lot going in its favour: it is, together with North America, one of the two major economic blocs where democratic capitalism truly rules and this, combined with US military protection, has kept it safe for a long time. Going forward, however, the US under Donald Trump's second presidential term is likely to behave "in the same narrowly self-interested, frequently exploitive way as many great powers throughout history"⁶⁵, which will probably entail a weakening of US military support and a blatantly protectionist push for American production. Even in a Reagan-like scenario where tax cuts and investment stimulus force the Federal Reserve to raise interest rates to control inflation, thus revaluing the dollar and increasing EU exports into the US, the technology gap between Europe and the US is bound to keep widening if the EU does not take some major steps to liberalise its economy – not just to stimulate innovations that then move into more investor-friendly environments like the US to become wealth-generating productive processes.

Matrimonio all'Italiana, the EU's most likely long-term scenario, is particularly gloomy because fiscal/political convergence without economic discipline fosters a form of moral hazard that degrades institutional quality across the board – just as the corrupt practices that sired the Mafia in Sicily and the Camorra in Naples gradually spread to all Italy after unification. This is the slope down which Europe is indolently sliding today: let's just hope it somehow finds the strength to change course before reaching a point of no return.

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⁶⁵ In the eloquent words of Brands (2024).

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