ECIPE | EUROPEAN CENTRE FOR INTERNATIONAL POLITICAL ECONOMY

Global Economy Podcast – Episode 106

Europe's Competitiveness Compass: Lost or Just Misdirected?

Full Transcription

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Oscar Guinea: Hello and welcome to ECIPE's Global Economy Podcast. I'm not Fredrik Erixon, the usual host of the podcast. My name is Oscar Guinea. I'm a Senior Economist at ECIPE and today I'm very pleased to welcome Pieter Garicano to talk about EU competitiveness.

Pieter is the co-author of Silicon Continent, a weekly blog trying to understand why the EU economy is falling behind. It is an excellent blog, and I recommend everyone listening to the podcast to sign up for Pieter's blog in Substack.

Pieter, welcome to the podcast.

Pieter Garicano: Thank you for having me.

Oscar Guinea: Great, so on the 29th of January, the European Commission published its Competitiveness Compass. Don't get too excited about travelling because the Competitiveness Compass is a policy document where the European Commission presents a number of strategies and regulations that aim to raise Europe's competitiveness. So, Pieter, if you have to mark the Competitiveness Compass between zero being completely awful and ten being the best policies that you can think of to boost the competitiveness of the European economy, which score will you give?

Pieter Garicano: I think I'd probably assign it whatever the lowest possible passing grade is. A five and a half or a six out of 10. I think that the big strength of the Compass, what you see, is that they acknowledge that growth is a priority. That growth is a kind of a necessary condition to preserve the kind of European way of life, to preserve our societies as they exist today.

They make a very strong case for growth and the factors that underpin it, which is not a thing that you should take for granted given that this is the same Commission President who no more than two years ago spoke at a degrowth conference that they organised in the European Parliament. And so that bit is very heartening and it's a good step. Unfortunately, the actual substantive policies of the competitive compasses don't necessarily indicate that they both have a meat muscle behind them, and they've understood what tactically the right steps are to take to increase growth, so the lowest passing grade, 5.5 out of 10.

Oscar Guinea: Very good, very good. Now, if you are a policymaker listening in Brussels, you get a five or six over 10, that's not bad. But you have published a blog about it, so this is the title, it has something like 20 thoughts on the competitiveness compass. So, let's get a bit more detail on this. We don't have time to discuss the 20 points, but what are your three main criticisms of the Compass?

Pieter Garicano: If you have to boil it down to three, the first one has to be workability. So, the compass itself doesn't come with money assigned to programs. In fact, probably the best policy in the Competitive Compass is this 28th legal regime. They acknowledge that employment law, taxation, labour law, and bankruptcy law all disrupt the ability of EU startups to scale. And so, they say what we want to do is standardise these things across the EU, creating what they call the 28th regime. But there is no indication within the compass, first of all, that the member states are willing to hand over this

amount of power to the Commission. And second of all, the 20th legal regime mentions this thing it's going to be for innovative companies, whatever that means. And that kind of implies that there's going to be thresholds for this, that some smaller firms, perhaps what they call startups in Europe are going to have the right to having this 28th legal regime. But actually, if you're a larger company, you won't. Well, it does the same thing every other EU law does, which keeps firms small. And so that's the first thing. Is it workable?

The second problem is that the Compass continues to pretend that trade-offs don't exist. One of the big problems with the EU growth politics or we might even say European politics in general is that we think we can have it all. We think we can have peace without investing in defence, we think we can have growth without, liberalising economies. The Compass does this again, but the compass says for example, that decarbonisation is the only by pursuing net zero renewable carbon renewable energy strategies can secure cheap and secure electricity. Renewable energy is a great thing that we should aim to reduce carbon emissions. But we should be honest about the fact that reducing carbon emissions is going to probably lead to a high energy price. Trade-offs are real and trade-offs should be acknowledged. And the document doesn't do as if trade-offs exist.

The third thing, very briefly, that I think is an issue with this Compass is that it continues to go down the path of believing that it's the government's policies that drive growth rather than private sector enterprise. So, they have this extremely brilliant line where they say the bioeconomy is the economy of the future and how they're going to fix this. Well, they say the EU bioeconomy strategy will position the EU with significant growth potential in bio-based materials. So, this is like a magical strategy. Rather than thinking what are the things we can do to make our bio companies work better, they say the way we're fixing this is by coming up with a strategy. And you see this everywhere else. Their big plan to save EU heavy industry is announcing more action plans, an action plan for steel, and an action plan for chemicals. And so, what you're seeing is this continued idea that the way we're going to have growth is by bureaucrats coming up with 10-step plans for growth, rather than saying, OK, we're going to acknowledge that we need broad-based liberalisation to let private enterprise drive prosperity.

Oscar Guinea: Very good. So basically, if I could summarise your three points, first of all, is the 28th regime that you see as a positive, but not easy to work out. The second is magic thinking. And the third one will be kind of a Brexit complex of having your cake and eating it that you point out on energy.

And energy is the next question because higher energy costs are one of Europe's comparative disadvantages. But at the same time, there is and there's been a lot of investment in renewable energy. So, my question is, how do you explain that on the one hand, Europeans invest so much in energy perfection, and on the other hand they get some of the most expensive energy bills among the rich countries?

Pieter Garicano: So, this, at least as far as and when in our process of writing and researching for these essays we write, this does seem to be in part due to the investment in intermittent renewables.

So, here's a stylised fact, which is that since 2000, in the last 20 years, Germany has grown its nominal capacity by 60%. It's invested 500 billion dollars in energy transition. Capacity is up, but generation has gone up just 5% and prices are much higher than they were 24 years ago. So, what explains that? And it seems to be that a lot of the investment is in renewables whose utilisation rate, their capacity rate, which is how often you are actually utilising them, is much, much lower. So, I just checked the dashboard just before entering this podcast. Right now, for wind power in Europe, the utilisation rate onshore is roughly 22%. So, if you have a rated maximum output of 10 gigawatts, and this is what they announced, they say we're building an offshore wind park, which is going to provide X 100 megawatts of power. Well, right now, you're just producing 20% of that. And in Germany right now, the current energy mix, as we are recording this podcast, they're generating four times as much power using gas as they are using solar and wind combined. And so, you've invested an immense amount in power, but

you've done most of it by ripping out existing capacity and replacing it with capacity, which is very intermittent. And so that's these are very, very high price variability.

And to give you a sense of how extreme this can get, in the UK, of course, not in the EU, but very similar situation. Just two weeks ago, they came within 500 megawatts, 500 megawatts out of roughly 50 gigawatts utilisation. So, we're talking about 1% of total power usage at the time. Within 500 megawatts of a blackout, because there were solar shortages. The marginal price at which they were generating additional power was five euros per kilowatt hour. We're talking about almost 25 times the normal price for power in the UK. And so, it seems to be, to answer your question, to push back to what you're asking, we've invested a lot of money, but we've invested in replacing old base load capacity with new intermittent capacity.

This doesn't mean we have to let go of the green agenda, but we need to focus on base load, nuclear, what actually investing in storage looks like, and how we rapidly scale up fish and plants.

Oscar Guinea: So, your point is that when we substitute base capacity with renewals, what we have is higher variability of prices.

And if we know something from business schools or universities in general is that businesses don't like uncertainty and don't like this variability, and the industries that will be affected the most by higher energy prices are energy-intensive industries.

Pieter Garicano: Yes.

Oscar Guinea: So, we all think, when we think about these industries, we all think about mining, steel, or chemicals, kind of traditional industries. But there are also that will also, these higher energy prices also can have an effect on the industries of tomorrow, which are also energy intensive, right?

Pieter Garicano: Certainly. I mean, the most obvious example here is data centres. And data centres are a really interesting example. From the lay-in in the competitive competitiveness compass, they actually announced we have to build an AI Gigafactory for frontier models. And so that's a very maximalist approach to AI. We've really embraced that we have to be doing our be it's at the cutting edge, both in the software and algorithm side, but clearly also in the hardware side and the data centre side. And it turns out that for data centres, the big constraint apart from obviously the availability of computing of chips is power and it's not so much power price because all these very big companies are quite price insensitive as power availability. So out of your operating costs, this is according to semi-analysis, which is the best data centre research firm out of operating costs for a data centre roughly 80% of the costs are power but because the data centre is so capital intensive because most of your cost is just upfront buying the chips and buying actually you buying the chips it means that actually out of the total cost of ownership power is a very small share so it's not so much that you care about the power price as much as you care about having power consistently because you can't afford to have downtime. So that means for data centres you want to have very predictable, very available, very large amounts of power, multiple gigawatts available all the time for these very, very big front-end data centres. And what you see is that the availability of power is a big problem in Europe right now.

Let me give you an example of the Netherlands, which is where I'm from. The Netherlands has a lot of traditional data centres because it was these big transatlantic computing and nodes. There are all kinds of financial services there as well on telecoms. and The Netherlands currently has a complete ban, a moratorium with the exception of one location and two locations so for data centres over 70 megawatts because there's no power availability. They realised that we could reroute power to data centres if we wanted to, but that means that consumers face higher prices and consumers don't like that. And so, the fact that when it comes to data centres, it's really hard to build them in Europe because of a lack of power availability.

Now, the kind of slider side here is that we have lots of nuclear coming offline, particularly in Germany. We're talking about 10 gigawatts in Germany, 10.7 I think they could bring back within a so short number of years. And so that's the kind of thing that if you were thinking about amping up base load and also driving down emissions, that's a complete no-brainer. There's a guy called Mark Nelson. He recently received a grant. He's a very brilliant American energy guy who's trying to work on bringing back nuclear to Germany. He's done the research here and he says two or three years for 10 gigawatts of power.

The last thing I'll say about this is that it's not immediately clear that you actually want to have data centres. At least it depends on how much stock it seems you place on national security. It's clear that data centres are important for sovereignty. You don't want to be expropriated, you don't want to have your data transferred to another country, and you might think that having control over your own AI, whatever that means, so is very important. And so having your data centres might be important for national security. But notwithstanding that, imagine that we're building data centres in Canada, it might be the case that having a kind of an FDI model where European firms are building their computer abroad, doesn't necessarily seem a very big problem. It can be a question of comparative advantage.

The one caveat to that about whether it's OK to have your data centres abroad is that it seems that for some uses, like voice, like AI agents if we were talking like this on a podcast, except instead of you and me, it would be to me talking to the advanced voice mode of OpenAI. In that case, latency matters. If latency matters, you might want to have more local computing taking place.

So yes, for industries of tomorrow, data centres in particular, the lack of power is a huge problem, but it's not immediately unambiguous that we actually need to be the ones placing them in Europe.

Oscar Guinea: Very good. So, we have kind of started with energy, then we moved to data centres, and you have at the very end of your answer alluded to regulation, which is going to be kind of the next kind of part of the podcast.

Pieter Garicano: Yes.

Oscar Guinea: So, let's turn our focus to one of the leitmotifs of your blog. which is the productivity gap between the EU and the US in information and communication technology, ICT. In the description of your blog, you have a quote from the Draghi report, which says that the productivity gap between the EU and the US is largely explained by the technology sector. And this, the EU is weak in emerging technologies that will drive future growth. That's the end of the quote.

Pieter Garicano: Yes.

Oscar Guinea: So, my question is, why is Europe's productivity in the ICT sector lower than the productivity of the ICT sector in America?

Pieter Garicano: So, one story you can tell here is that it has a lot to do with scale and weird take-all dynamics. So, what are what are the things that characterise the ICT sector in particular? Well, one feature is that it's basically, all the costs are upfront. You have your fixed cost of writing your software or building your data centres. However, the marginal cost of having additional users is quite low. And so, being able to scale is very important. It's a very strong return to scale. And the flip side is, for the same reason, and for reasons like imperfect substitution,

For most users, most users will cluster, and of course network effects as well, most users will cluster around the very best products. All of us use Google, and all of us use WhatsApp. It means that a very small number of firms basically serve the entire market and are responsible, for example, in the case of AI, three labs, which employ 0.2% of the tech workforce in the US, do all the AI advances. write One firm, Nvidia is responsible for 95% of AI chip design. That's to say that being the best is really important. Scale is a really, really important factor of leadership in ICT or leadership in tech.

Europe has created conditions such that it's very hard to scale up a firm. The conventional, of course, things you'll hear from the tech sector have to do with capital availability. They'll say solvency two requirements mean that it's bad for pension firms to give money to VC funds. These things are true. but one theory, which is more fundamental, and I think is very convincing, comes from Olivier Coste, who has the idea of failure costs, and he says that fundamentally, employment. Innovating in tech is a very inherently very risky business. He says roughly 80% of all in-house tech ventures fail. And so, the firms that do well are the firms that can easily take risks and then take the hit if the project fails. So, what do I mean by this? Well, for example, you have a story like Apple with its driverless car. Apple spent, I don't know, a decade working in a driverless car. It didn't work and they recently laid off the entire team and just got rid of the team. They realised it didn't work, and they just closed shop. And the costs of doing so for a US firm of closing shop and doing something else are very, very low. And he calls these costs failure costs. The failure costs mostly have to do with the costs of restructuring and employment protection. He says the statistics he finds in his paper roughly that that heuristic is the cost of restructuring in the U.S. is roughly a tenth of the cost of restructuring in Europe. And so that means across the board every time a, where we're talking about a medium-sized firm getting larger or a large firm getting super large,

Every time they have to innovate to stay on top, their costs, and their risks are much, much lower in the United States. And so, they're much more likely to make that choice. And if you look at these, if we take this theory and apply it to these super cap tech companies, these very big US giants, it kind of seems true. Google didn't necessarily just do the search engine. They brought in AdSense. They brought in Android. They brought in YouTube. And these are all very big revenue drivers for them. If we look at, for example, no Microsoft. Microsoft currently gets more revenue from its cloud computing service than it gets from its Windows OS. And so, a lot of these very, very, very large companies have reinvented themselves many times. And this basic theory is that more flexible employment law and more flexible capital markets, more flexible bankruptcy law, all make it the case that reinventing yourself in Europe is simply more expensive. So, reinventing yourself in the US is less expensive and in Europe it's more expensive. and so that's one theory for why we're falling behind.

Oscar Guinea: Let me say that and put a bit of advertising here for ECIPE itself that quite recently we did an event with Olivier, and it was excellent I recommend everyone to go to our website and watch the event and I suppose it will also be published as a podcast here.

I think you make it from the mental point here, which kind of connects with your criticism of the Competitiveness Compass, which is about European policy. So, there's been an obsession with whether Europe should have a European Google. But I think we go about it in the wrong way. We go about it in the way that we can design, we can select a company, give it a lot of money and create a European champion. when and this is also part of Olivier's way of thinking is that, and many others too, we should focus on the conditions, on the horizontal conditions for these kinds of companies to emerge. That is the question of why he hasn't emerged rather than and we, Europe, creating artificially from the top down by subsidising or providing government money.

So, hovering about this conversation during the whole time has been the topic of industrial policy. Industrial policy has moved from being known as the Voldemort policy, the policy that cannot be named, to a must-have for each government. Let's now assume that our definition of industrial policy, is not set in stone, but let's assume for the sake of the argument that is one that includes all public policies that incentivise an economy to move towards a desired state of production. Traditionally, this has been activities with higher productivity from agriculture to manufacturing and so on. But it can be activities with lower carbon intensity or boosting the defence sector. And the EU has embraced industrial policy, and it is about promoting certain sectors or technologies over others and also securing supplies.

So, my question is pretty broad. Pieter, what is your take on Europe's industrial policy? What is right? What is wrong?

Pieter Garicano: Yes, it's a very interesting question, of course, an extremely salient topic at the moment. If it seems that, and we wrote a piece on this, some stack was titled Will Europe be able to save its car industry? Because that's a great example of an industry we were desperate to save. And the two things, in it we cite this literature review by Dani Rodrik from last year about what characterises successful industrial policy.

And he basically identifies two things that make industrial policy work. One is that you have to be willing to let the losers fail. So, rather than choosing firms you want to win; you have to choose industries you think are important or certain goods you think are important and subsidise those. But you cannot choose actual firms themselves because it is a recipe for rent-seeking and inefficiency and you create an interest group which is very potent and eventually, you're just throwing good money after bad and so, you have to be kind of willing to let losers die and just become a bit ruthless with the industrial policy. The second part that they identify is that you have to have a clear objective or one objective and one instrument. Industrial policy trying to do all the above will usually end up doing either none of the things or definitely not the most important thing you want to be doing. If you and this is a very big topic in the US right now, we had a CHIPS Act, the CHIPS Act also did all kinds of democratic policy priorities it provided childcare, it did equity, and social programs. And so, what's the result of that? Well, the rule that is you get less get fewer chips and so your end industrial policy is very inefficient.

And so let me give a counterintuitive example of a country that's actually doing industrial policy about as well as a good liberal economist wanted to do, which is China. So, what's the story with China and EVs? And I got to write a paper about this last year, which was quite interesting. The story with China and EVs is that roughly 20 years ago, they decided that they won't catch up with a hybrid, they won't catch up with ICE. And so electric vehicles are the next big thing. They call them EVs, and in 2007, I think it was a five-year plan where they mentioned that Chinese leadership in EVs is the big priority.

So how do they do it? Well, the first thing they do is they don't actually pick winners. So, they do consumer subsidies. You get a very big purchase credit. They do have favourable access to financing. But the EV market is extraordinarily competitive. I think at the peak of the EV market, there were roughly 500 companies vying to be Chinese EV firms. And that dropped down to I think now it's 100 and something, that stat could be wrong. But in any case, between 60 and 80% of Chinese EV firms have gone bankrupt. And so rather than choosing a big state champion, what we expect of a common system, they said, we will subsidise this market because we think it's important. We think it's very important, very strong spillovers. And it's important for national security. But we're not going to be choosing winners and losers. We're going to say you can vie and be competitive.

And the second part of this, I think it's really quite surprising for Europeans to hear, is one of the ways they make their market more competitive is by letting foreign competitors enter. So, the single largest recipient of EV subsidies in China, at least consumer subsidies, I think for a very long time is Tesla. And there's a great quote where the Shanghai party secretary, when they're discussing whether Tesla built a factory in China, says, we must let Tesla in. Tesla is the catfish that will make our company swim faster. And so that's the second thing they did. The second thing they did was allow foreign competition to make sure the market was efficient.

The third thing they did was invest in upstream R&D. This is batteries in particular. Lithium-ion batteries have been the industry standard for a very long time, and China has gone all in on lithium-iron batteries, so LFP batteries, while it is in that.

The fourth thing they did was use public procurement to kind of cross the Valley of Death initially. They basically had these LFP batteries which weren't very good at the start, the range was very short. But if

it's the state which is buying the products, that means that the state has very different purposes for the consumer. and so, for example, they would have electric buses or electric taxis running on these new batteries, which meant they created a pretty strong initial market. An advanced market commitment for the companies that were innovating in lithium-iron batteries, these new batteries. That's a pretty textbook case of what good industrial policy looks like.

If we apply this framework to Europe, what do we see? Well, Europe's industrial policy doesn't seem to be about letting losers fail. When we're talking about industrial policy and EVs, we're talking about saving walks by, we're talking about saving Renault, rather than saying, we want to have an EV industry, and we don't really care what it looks like. And when we talk about having an EV industry, we're also talking about saving the jobs. We had this criterion of you need to have one objective and one instrument. But really, when it comes to the car industry, for example, we are trying to optimise for a lot of things. We're trying to optimise perhaps for emissions, but not really, because we're not letting in Chinese cars. and We're trying to optimise for innovation, but not really because we're actually only saving the incumbents rather than helping startups. And we're also optimising very obviously for employment. We're trying to protect these firms from dying. And it means that the industrial policy is going to be less successful than it otherwise would be. It's going to actually not achieve its state objectives and going to lead to inefficiencies and rent-seeking. And if you had a not textbook way, an inverse textbook way of doing industrial policy, choosing a big national champion and throwing money at them is probably what that looks like.

Oscar Guinea: Absolutely. I couldn't agree more with you. And I think you have done something that very few have done before, which is actually to connect or show what Chinese industrial industry policy and a US industrial policy have in common, which is that both of them, the subsidies, the consumer subsidies you referred to, and also the tax cuts from the Inflation Reduction Act, what they do is to they give a price to a company when it's as when the price has succeeded. So, they don't need to choose the winner. There is a self-selection there. And as you said, in Europe we go about it in a different way. We select the company that receives the subsidy. Many times we just select a failing company, which is also connected to Oliver Costa's thinking and what you have explained very well in the previous answer about the cost of failure. The cost of failure is about creative destruction and allowing companies to transform and move from one sector to the other because reinvention is better than bankruptcy. And in that sense, we need an ideal industrial policy will be one that will allow companies to actually do that.

Pieter Garicano: Exactly. and to tie it together to what you asked about originally, which is ICT productivity in the future if progress in AI is anything like what people who are close to it think it's going to be like. So, for example, I just came back from San Francisco this weekend and people who work at these AI labs genuinely believe that they will be out of a job in three or four years. This is entirely serious; they will straight-face tell you that I as a computer software engineer will not be useful in any way in three years.

If that prognosis is even two or three times as optimistic as the truth. If we take a really bearish assessment, we think AI progress is going to be a bit slower than they say it is, it's still going to be extraordinarily disruptive. And it means that firms will have to adjust and restructure a lot very quickly and we saw this already with US tech firms. US tech firms have fired 50% of their workforce in the last two or three years.

And so, the stakes when it comes to being agile and being able to very rapidly scale and deploy new products and also cut them loose if they fail, the stakes are going to rise in the future rather than decline. It's going to be more rather than less important that our companies can take risks. They can try things out, deploy new AI systems, and also just decide to let them go if they don't work. And that's right now the primary thing that we're really getting wrong.

Oscar Guinea: And this is pretty worrying for the European industry itself. In a way, you alluded that if you agree that a larger share of any industrial good, the value added that comes from ICT will be higher. And then you have also you have explained that in this particular sector, there is a higher rate of economic dynamics and economic creative destruction and so on. Europe's inability to restructure or label laws became a comparative disadvantage, right?

Pieter Garicano: Yes, exactly that. And of course, we haven't even talked about it in this podcast, but we have tons of AI-specific tech regulation, which worsens these things. like GDPR, of course, is a great obstacle to small firms. I mean, the AI Act, which I've had the pleasure of writing a few things about is the AI Act basically is all about preventing the rollout of AI. So, a very quick example, like educational AI systems, which seemed to be one of the biggest use cases. It was just recently a paper that came out from Nigeria where it turned out that students with access to a GPT tutor had one SD better performance in classes. Education is a use case where the EU AI Act basically makes it impossible because it's because it's high risk. And so, you have to go through a 14-step plan, you have to do a bunch of risk assessments, you have to do a fundamental rights risk assessment, you have to build security systems and designate a special EU representative. And what that means is that if you are a small startup trying to do education for AI in Europe or if you're a major company or if you are a public school system, it's just going to be extremely hard to make use of what's going to be the biggest single change to education in the last X millennia.

One more example for me, because it's just so striking. So, if you want to have a bank teller, so someone who's a cashier at a bank, which is like AI, every time it recognises a customer's face, which I assume is a very simple AI use case. Just the AI system sees you and recognises you. That needs to be verified by at least two humans. So, every time an AI system sees you and does biometric recognition, that's a high-risk use case since it requires two humans to verify that. And so, what it means is that we have a perfect storm of very poor fundamentals in bankruptcy law, employment law, and capital markets for these firms in general. And then specifically when it comes to the role of tech, we've made it harder by tacking you on the AI Act, by tacking on the GDPR, which means these firms really struggle and struggle with deployment and rollout. And it could lead to very substantial growth Delta between us and the bodies between the Americans and the Europeans

Oscar Guinea: Yes, I mean, that this is an absolutely crucial point. Going back to the Competitiveness Compass, the Competitiveness Compass wants to reduce the regulatory burden in Europe. This is a very good thing. But in a way, what is really the critical effect of regulation on the economy is not so much the regulatory burden in terms of the amount of stamps you have to put in a paper, but the incentives that it creates for companies to do something or something else.

And in this way, what the kind of the take on these digital regulations is that because they're making it more difficult to use data, more difficult to work on digital technologies, you are incentivising your companies to do other things which are not digital. Now, you can import digital services from the US, let's say, but the truth of the matter is a lot of the technology, and the productivity gains are coming from this particular sector. So, you really want to have these companies, large or small or medium in technology because this is where the sources of new productivity gains are.

Pieter Garicano: I definitely concur.

Oscar Guinea: Great. Pieter, it's been a real, real pleasure to talk to you and I'm looking forward to reading your next Substack.

Pieter Garicano: Thank you for having me.