

Europe in the world: The state of the union

facts, analysis and views



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Foreword

Since 2008 Europe and European Union has been plagued by the economic crisis and its consequences. A large part of the political attention has been directed much more to the symptoms than to the reasons for the crisis. And far too much of the attention has focused on changes of the institutional structure of the European Union as such rather than on reforms of Europe and the European society, be it on European level or in the Member states.

The most obvious symptoms but also the causes of the crisis are the deficits and the growing debt burden.

A number of countries had big deficits from the beginning, which did not provide any beneficial stimulus to their economies, and a large number of governments decided to meet the crisis by stimulating their economies through even bigger deficits and debt burdens, which did not help.

And now we can once again hear the calls for fiscal stimulus through less consolidation of public finances and more public spending, alongside proposals on new ways of financing the debts and the deficits, as if making it cheaper to finance ever bigger debt burdens would solve the problem of the debt burden.

All this would only delay recovery and growth while deepening the crisis. There is an alternative agenda, however, for fostering growth through supply side oriented structural reforms.

It includes deregulation, cutting red tape, increased competition, abolishment of monopolies, tax reforms attracting more domestic and foreign investment, budget policies with more value for the money giving priority to research, science as well as infrastructure, increased opportunities for entrepreneurship and reforms of the internal market and the digital market which would render Europe not only the biggest economy in the world but also to the leading global market.

This report from my office in the European Parliament is presenting a number of indicators for reforms that would lay the ground for a new and better State of the Union. If we could overcome these shortcomings we would go from the current state of crisis into a position of global economic leadership.

Stockholm, May 2013

Gunnar Hökmark

Europe in the world: The state of the union

Where does Europe stand in the world? That is a question on many people's minds these days. The financial crisis exacerbated the rise of the East and the South and the relative demise of the West. And the following sovereign debt crisis as well as the subsequent economic crisis of many parts of the European Union exacerbated Europe's shortcomings.

But the game is not over yet, on the contrary. Europe is still the world's largest economy. From a number of perspectives, we are still the world's leading player. In too many other aspects, however, we are falling behind. And it is in these areas where we must focus our reform efforts.

In this paper, we present a number of indicators giving a picture of how the continent, the Union and the countries that make it up are doing in comparison to the rest of the world: in politics and democracy, in terms of economic freedom and when it comes to economic growth, competitiveness and innovation and lastly as regards human development in a wider sense. This is the state of the Union, based on a number of facts and statistics crucial for our leadership and competitiveness in the future. But it is also the most concrete agenda for reform we can find.

The world consists of some two hundred countries and there are 193 members of the United Nations. The European Union is soon to have 28 member states.

We start with political freedom and quality of government.

Political freedom and quality of government

During the last few decades, research in political science, economics and economic history has suggested that what matters most for the success of a country's development are its institutions, or as some prefer to call it, its "governance".¹ These are very broad concepts and we are going to treat them from several different perspectives.

Let us start with political freedom. It is both an end in itself and a means. The protection of political rights and civil liberties are preconditions for taking part in society, the shield against tyranny. And in the long run political freedom is associated with economic development.

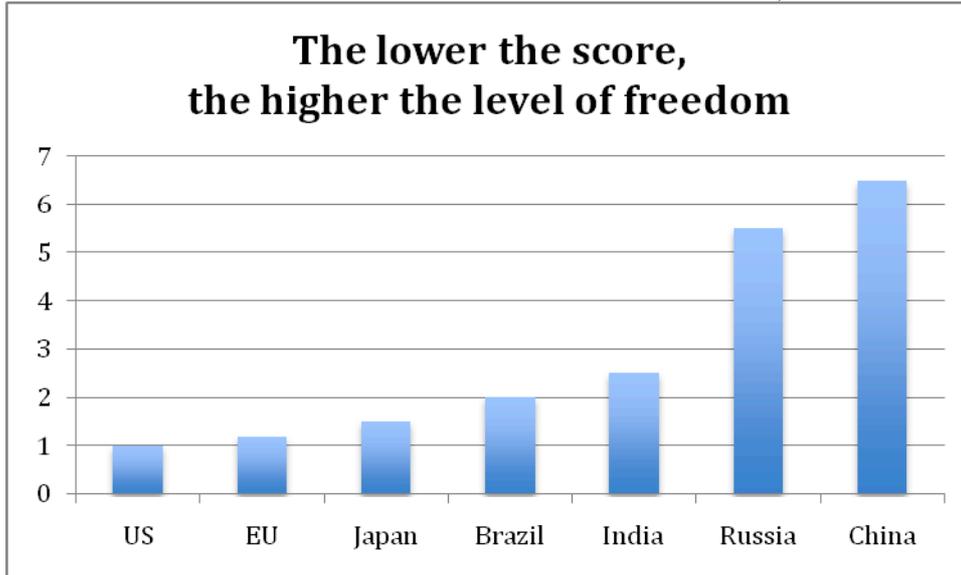
The most authoritative source when it comes to cross-country comparisons of political freedom is the think-tank and advocacy body *Freedom House*, whose index of political freedom measures political rights and civil liberties in 195 countries and 14 related and disputed territories. Freedom House gives each country a score, as follows:

¹ See e.g. Douglass C. North, *Institutions, Institutional Change and Economic Performance*, Cambridge University Press, 1990 and Rodrik, Dani, Arvind Subramanian and Francesco Trebbi. "Institutions Rule: The Primacy Of Institutions Over Geography And Integration In Economic Development," *Journal of Economic Growth*, 2004, v9(2,Jun), 131-165.

- 1.0-2.5 politically free
- 3.0-5.0 politically almost free
- 5.5-7.0 politically un-free

The lower the score, the freer is the country. The un-weighted global average is 3.3, revealing that the average country in the world is politically almost free. The EU average score is 1.2. Together with the US, Europe is thus a beacon of political freedom in the world, something to remember and to be proud of. Our system of government is still the envy of millions of people around the world.

Score in Freedom House Political Freedom of the World, 2011



Source: Freedom House

Unsurprisingly, given the Copenhagen criteria for accession to the EU, Freedom House considers all EU member states to be politically free. Every member state gets the best score (1), except for Hungary and Italy (1.5) and Romania, Latvia, Greece and Bulgaria (2).

It is important to bear in mind, however, that institutions are not only about democracy or even political freedom. The *quality* of government is also important. You can have free elections without being a well-functioning liberal democracy.

The World Bank has a database of what it calls "six indicators of governance". These are:

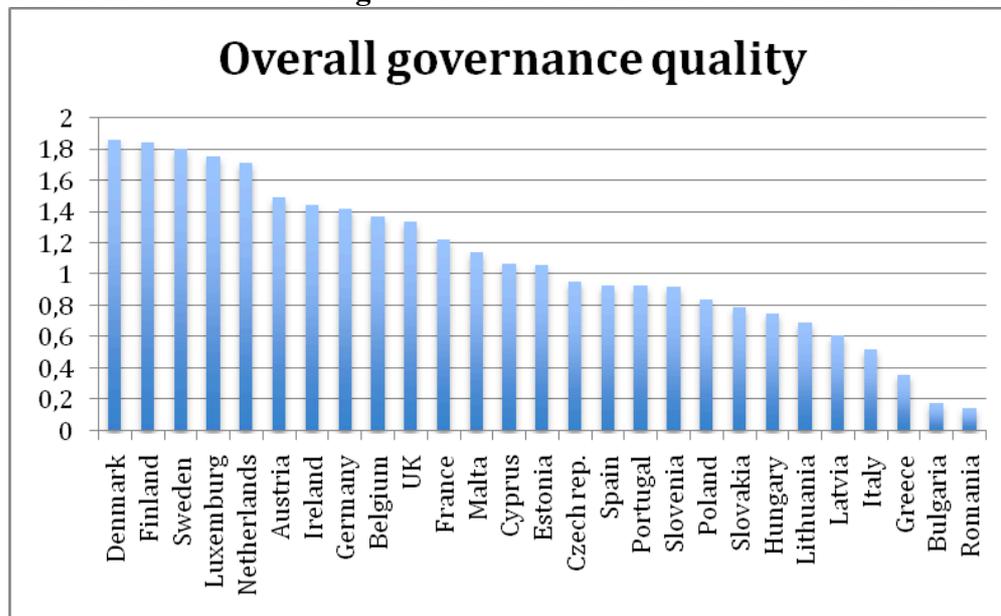
- Voice and accountability
- Political stability and absence of violence
- Government effectiveness
- Regulatory quality
- Rule of law
- Control of corruption

For each of these indicators, every country gets a score from -2.5 (weak) to 2.5 (strong), where 0 is the global average.

In general, the European Union scores quite well at an average of 1,08 (27 member states and six indicators). Europe is a well-governed region, slightly behind the US at 1.24.

There are important differences among the EU member states, however.

EU member states' average score on World Bank's Governance Indicators, 2011



Source: World Bank database, World Governance Indicators

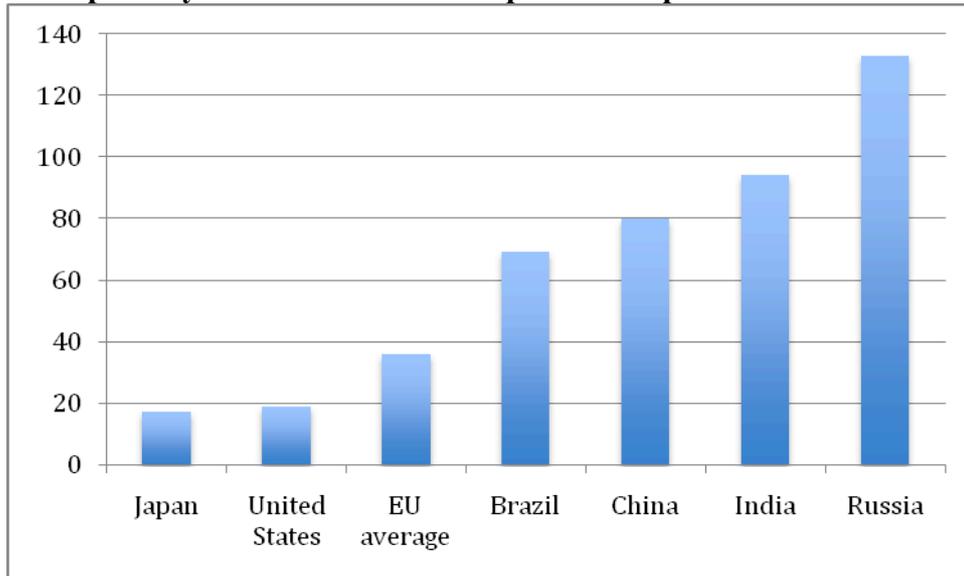
It is difficult not to notice that among the countries in deepest economic and financial trouble right now, there are very few at the top of the governance ranking. Some member states have particular problems in particular areas. For example, Greece scores below zero in both political stability and control of corruption, Romania is below zero in government effectiveness and control of corruption and for Bulgaria the minuses are rule of law and control of corruption. A score below zero indicates a quality that is lower than the global average.

A few decades ago, there was an academic discussion about whether corruption was a serious problem or not.² In light of new institutional research, however, it is clear that corruption is indeed an obstacle to growth and development.³ Let us therefore look more in detail at the most recognized data in this field, the non-governmental organization Transparency International's Corruption Perception Index (CPI), ranking 176 countries in the world according to *perceived* corruption. The EU average member state ends up at 36th spot. Let us look at the ranking of the world's major economies.

² In Anne O. Krueger, *The Political Economy of the Rent-Seeking Society*, The American Economic Review, volym 64, nr 3, ss 291-303, juni 1974, the author argued that corruption could be a lubricant in societies with a heavy burden of government.

³ See e.g. Robert E Hall & Charles I Jones, "Why Do Some Countries Produce So Much More Output per Worker Than Others", *Quarterly Journal of Economics*, (1999) 114 (1): 83-116. On institutions in general, see Daron Acemoglu and James Robinson, *Why nations fail – the origins of power, prosperity and poverty*, 2012.

Transparency International's Corruption Perception Index 2012



Source: Transparency International

The EU thus has more problems with corruption than Japan and the US, but scores better than poorer countries.

Again, there is great diversity among member states. Eight of them are ranked better than the US, whereas a few are below the global average.

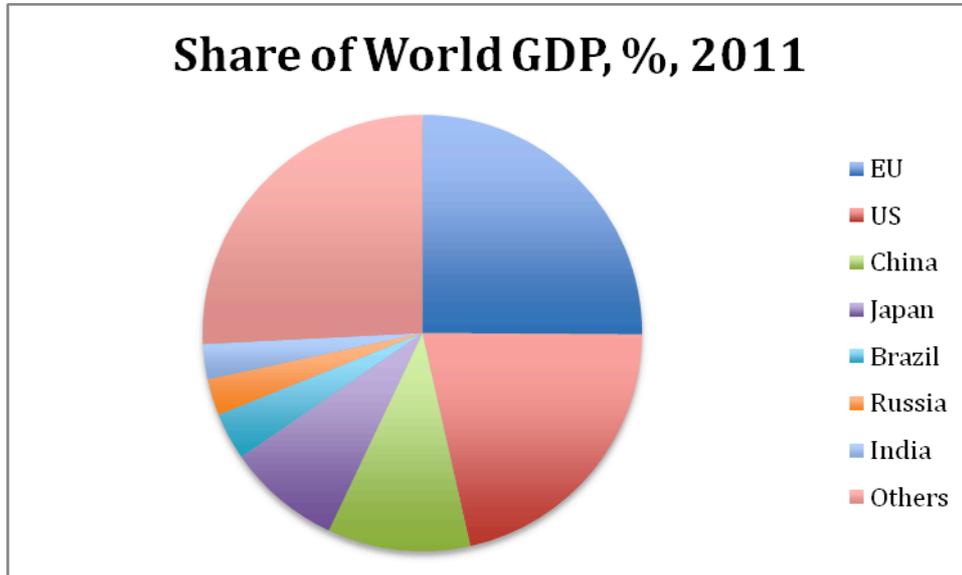
Ranking in the 2012 TI Corruption Perception Index

| | |
|----------------|----|
| Denmark | 1 |
| Finland | 1 |
| Sweden | 4 |
| Netherlands | 9 |
| Luxemburg | 12 |
| Germany | 13 |
| Belgium | 16 |
| United Kingdom | 17 |
| France | 22 |
| Austria | 25 |
| Ireland | 25 |
| Cyprus | 29 |
| Spain | 30 |
| Estonia | 32 |
| Portugal | 33 |
| Slovenia | 37 |
| Poland | 41 |
| Malta | 43 |
| Hungary | 46 |
| Lithuania | 48 |
| Czech rep. | 54 |
| Latvia | 55 |
| Slovakia | 62 |
| Romania | 66 |
| Italy | 72 |
| Bulgaria | 75 |
| Greece | 94 |

Source: Transparency International

In the world economy

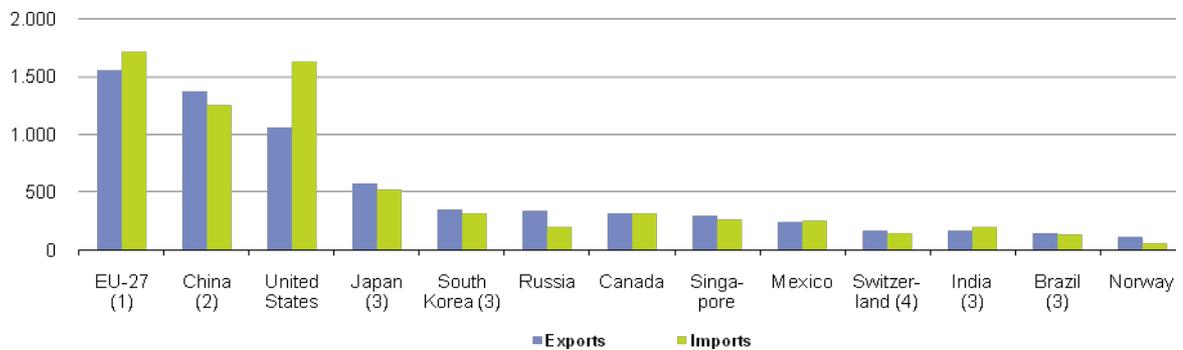
The European Union is the world's largest economy. The EU GDP makes up some 25 per cent of the global total, compared to 21 per cent for the US and 10 per cent for China.



Source: World Development Indicators Online.

Also, the EU is the world's largest trading bloc, both when it comes to imports and exports of goods. We sell more than China. We buy more than the US.

International trade in goods, EUR 1 000 million, 2011



Source: Eurostat. Not including intra-EU trade.

However, there are some worrying signs of European weakness, not least in the corporate world. In the Fortune 500 list of the world's largest companies, the EU comes in third, after Asia and North America.

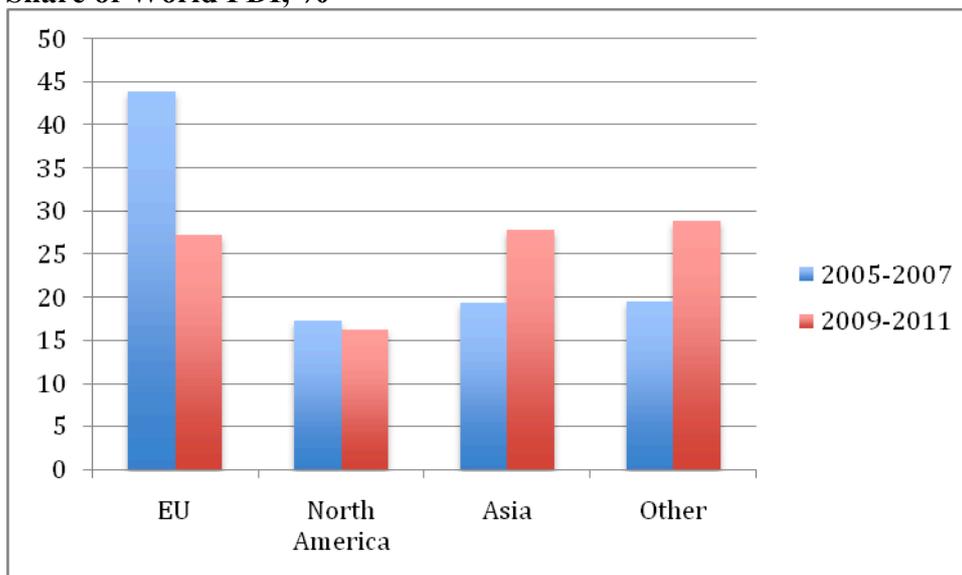


Source: Global Fortune 500.

The most worrying sign for the short- and medium-term future, however, is the drastic fall in investment in the EU. According to the McKinsey Global Institute, investments in the EU fell by 350 billion euro between 2007 and 2011, four times the fall in real GDP. In 2011 companies listed in Europe had excess cash holdings of 750 billion euro.

By the same token, the EU has lost its place as the world's prime recipient of foreign direct investment (FDI). In the period 2005-2007, the European Union was the host of as much as 44 per cent of global FDI. In 2009-2011, the share was as low as 27 per cent, Asia having passed Europe as the prime location.

Share of World FDI, %

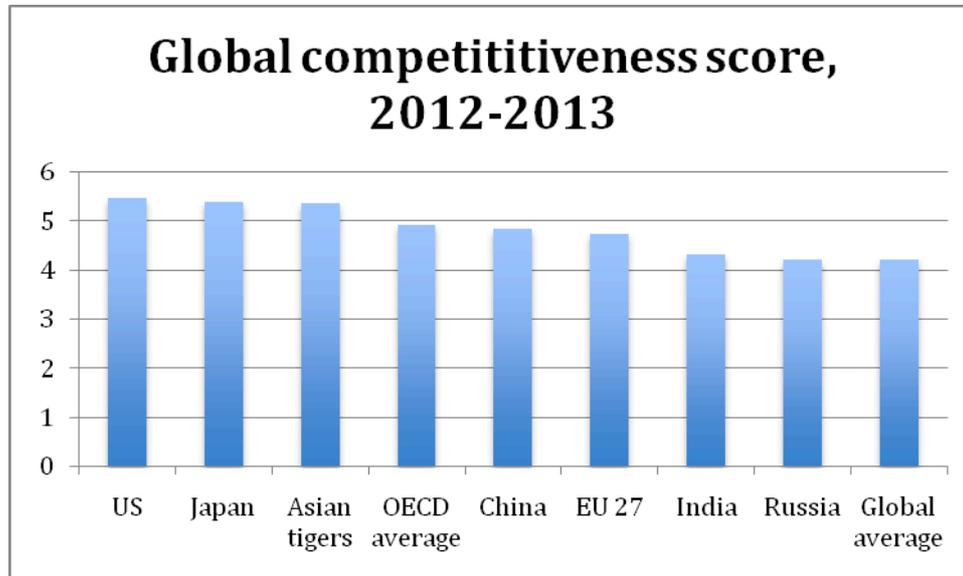


Source: UNCTAD World Investment Report 2012

Competitiveness

It is not only in investment and growth in large companies that Europe is falling behind. Rather, the negative development in these two fields is but a consequence of our problem with competitiveness.

According to the World Economic Forum, the average EU member state is the world's 30th most competitive economy, between China and Puerto Rico.

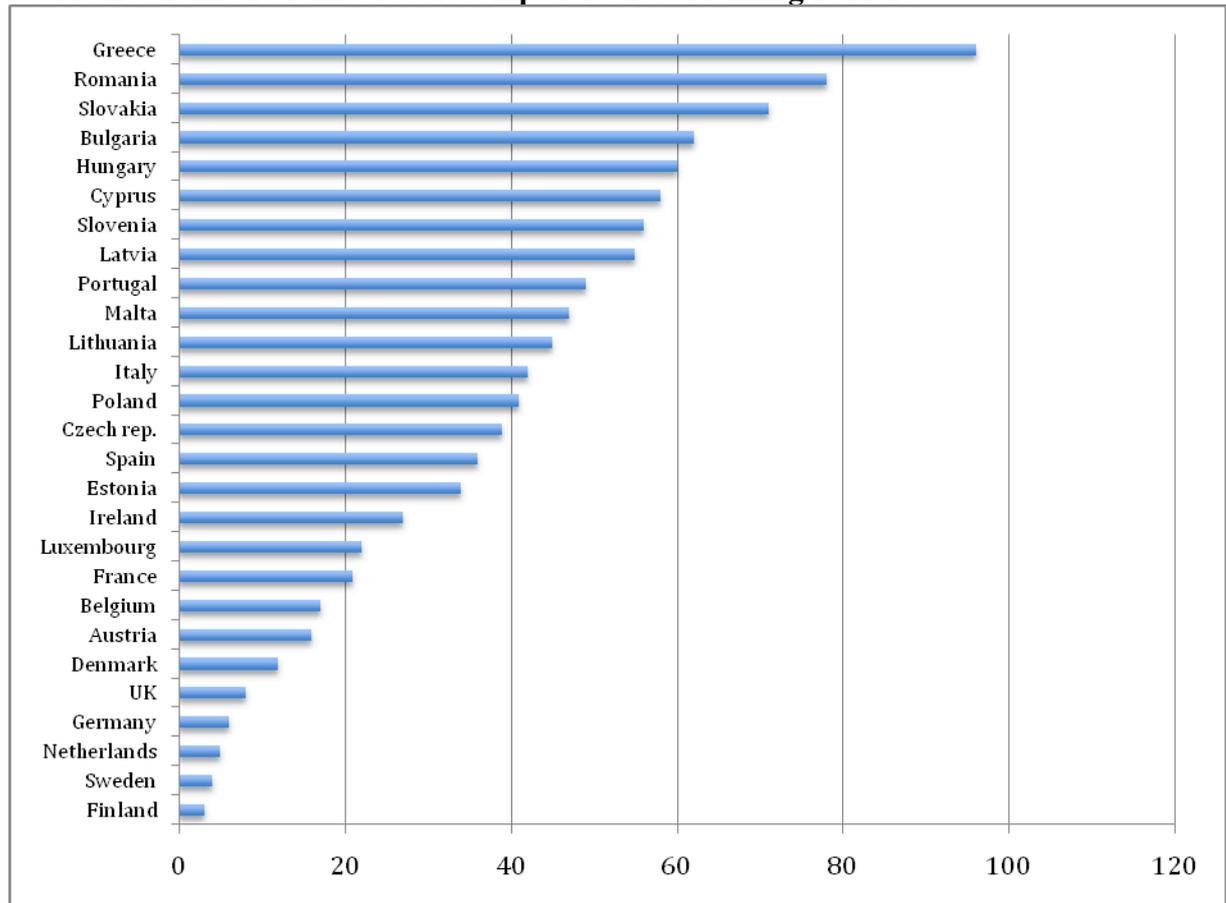


Source: World Economic Forum

This is obviously not good enough for a region that strives to be world leading. Not only are we less competitive than China, we are also well behind the US, Japan, the Asian tigers and the OECD average. The EU has second-class competitiveness among industrialized economies.

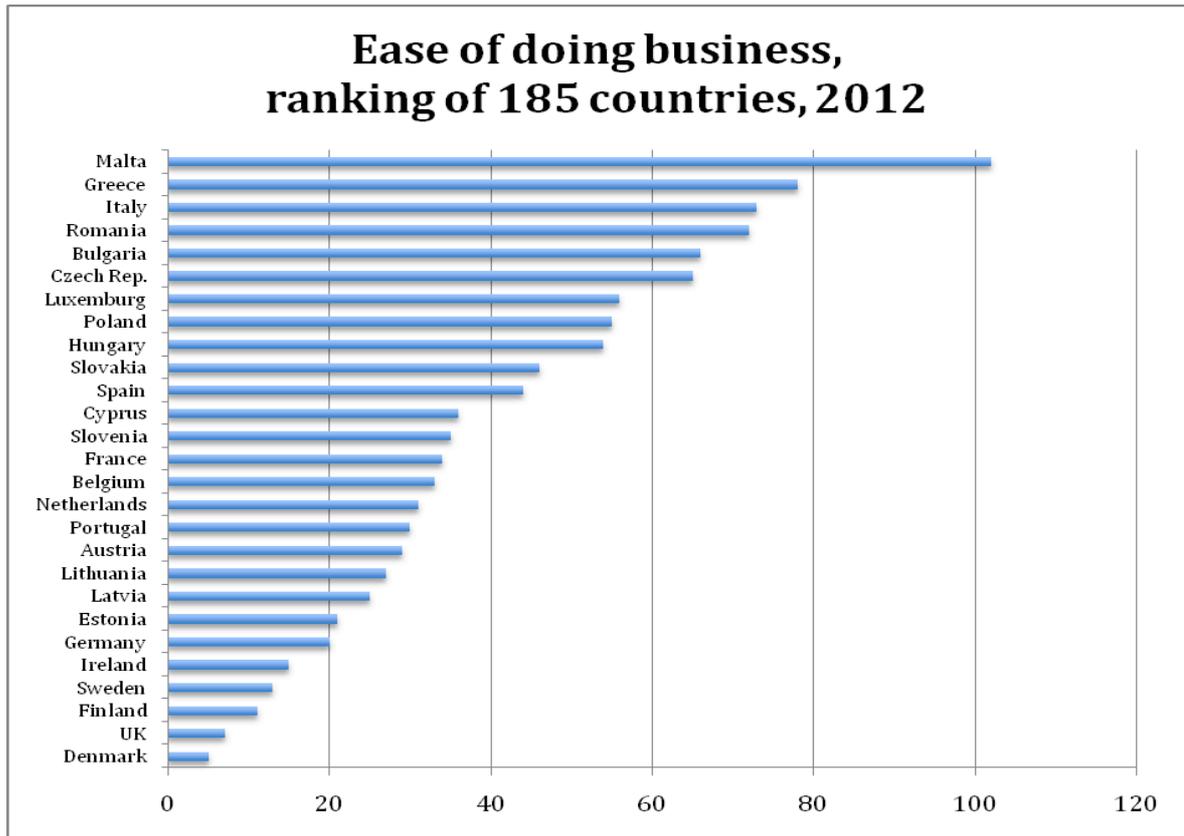
Again, there are huge differences among member states. North/West European countries are among the world's most competitive economies, whereas Southern and Eastern countries are lagging behind. In the graph below, we look at the ranking rather than the score.

World Economic Forum Global Competitiveness Ranking 2012-13



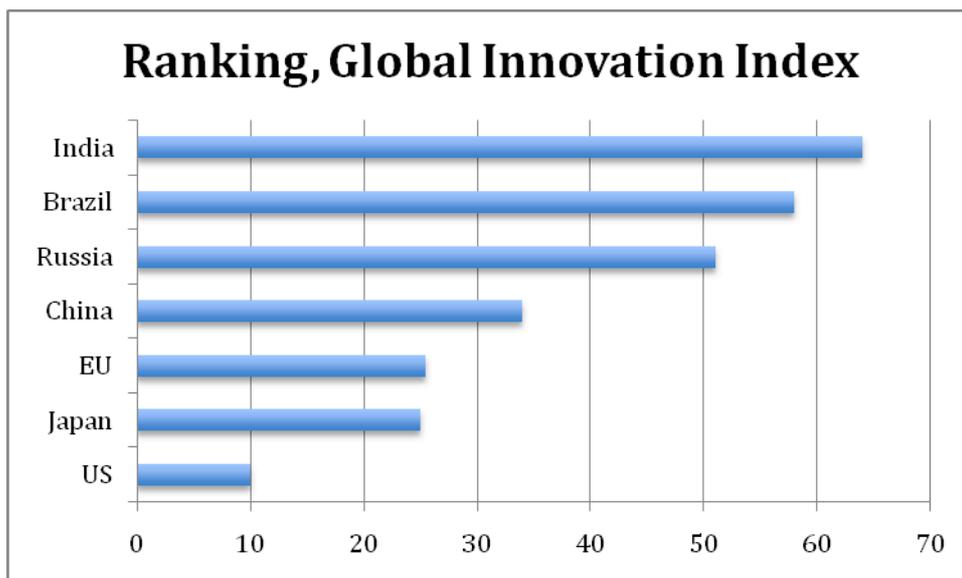
Source: World Economic Forum

One of the most fundamental issues when it comes to competitiveness is business regulation, or red tape. The World Bank has an index which measures the ease of doing business according to a number of sub-indices and ranks 185 countries. On average, the EU member state ends up at spot number 40, which from a global perspective is not that bad, but for a continent that strives to be number one it is not good enough. Again, the difference between the north and south is striking.



Source: The World Bank.

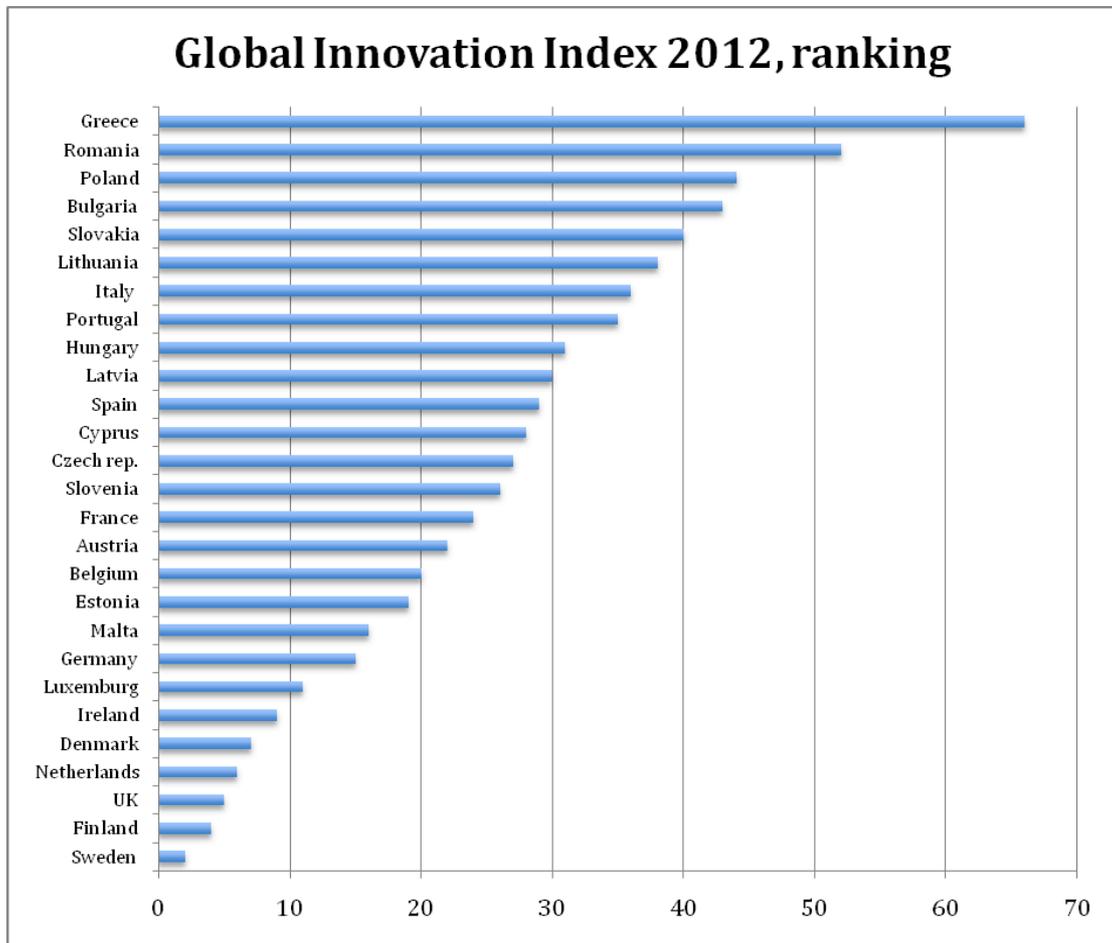
In advanced knowledge-based economies, innovation is key to success. The French Business School INSEAD and the World Intellectual Property Organisation (WIPO) publish an annual Global Innovation Index, ranking 141 countries. The average EU member state is found at the 25th spot, on par with Japan, but well behind the US. China is not that far behind, as the country is moving from imitation to innovation.



INSEAD/WIPO

Source:

And again, there are important differences within the union. It is useful and encouraging to note that among the ten most innovative economies in the world, six are found in the European Union. On the other hand, China is better ranked than eight EU member states.

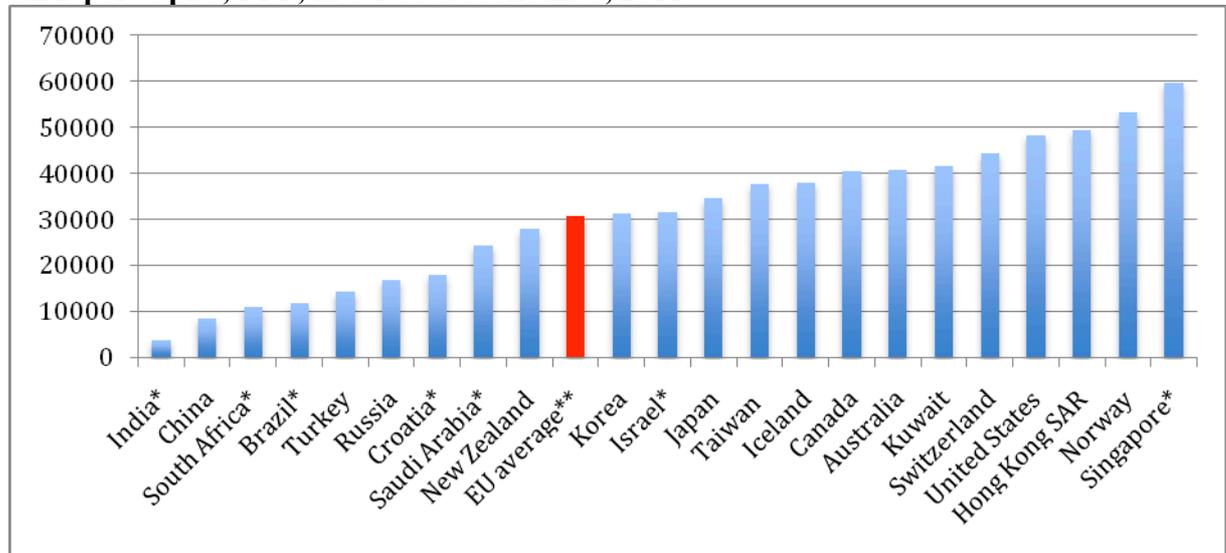


Source: INSEAD/WIPO

Income levels

Economic factors such as competitiveness and innovation capacity are not ends in themselves, but means to a certain end: higher living standards. The most widely accepted measurement, at least in the material perspective, of living standards is GDP per capita adjusted for differences in purchasing power (PPP).

GDP per capita, PPP, in selected economies, 2011



Source: International Monetary Fund, World Economic Outlook Database, October 2012

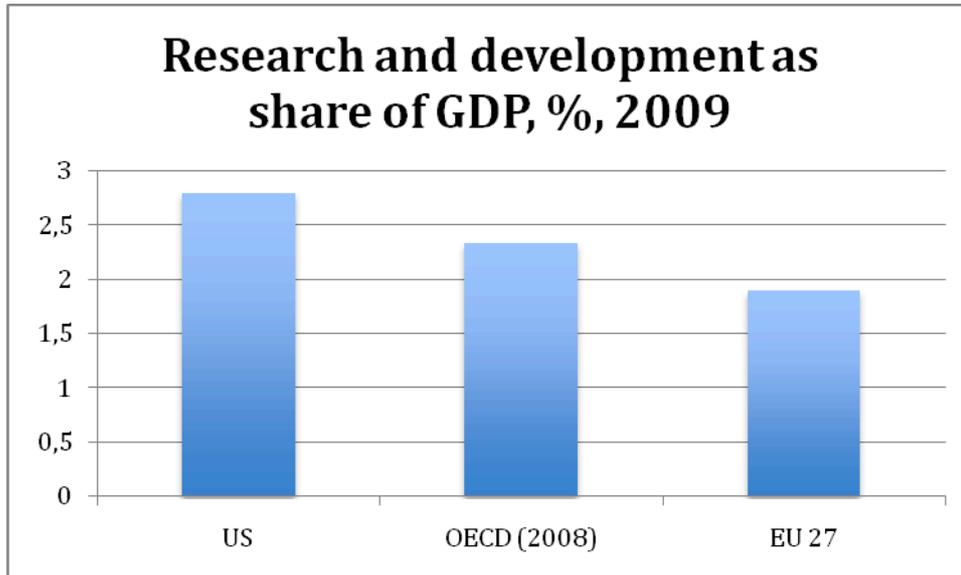
* Estimate

** Un-weighted average

In the graph above we can see that regarding income levels, the EU is behind a number of countries, such as Korea, Israel, Japan, Taiwan, Canada and Australia, not to mention Switzerland, the United States, Hong Kong, Norway and Singapore. The EU is about to become a second rank economy.

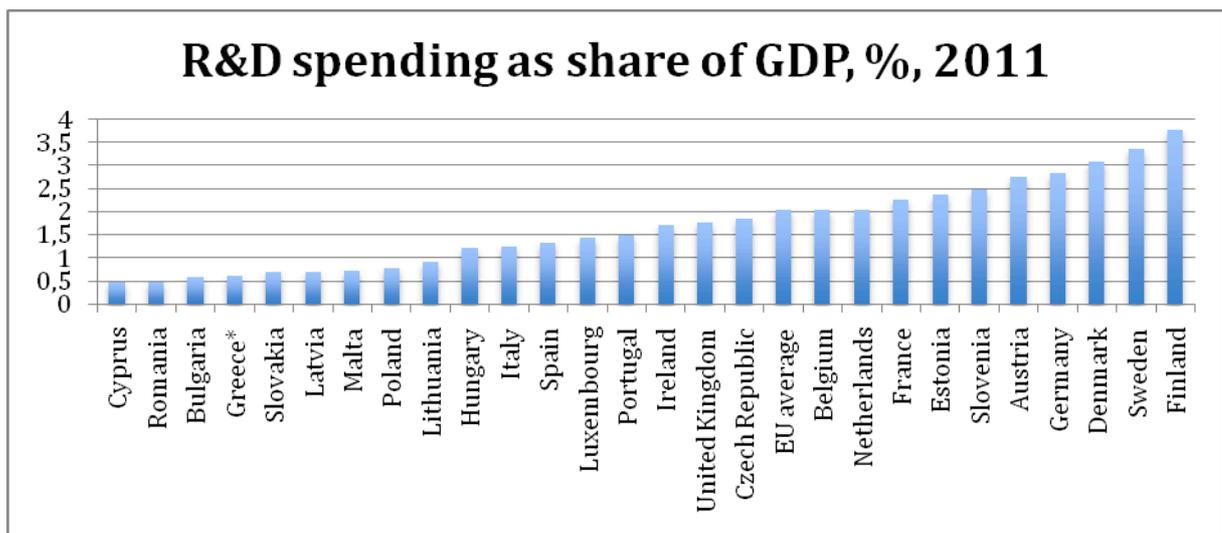
Technology

We know that investment in technology is key to future economic growth and higher living standards. We also know that Europe is lagging behind in research and development (R&D). In 2009, the EU devoted 1.9 per cent of GDP to R&D, compared to 2.5 per cent in the average OECD country and 2.8 per cent of GDP in the US. This does not bode well for the future.



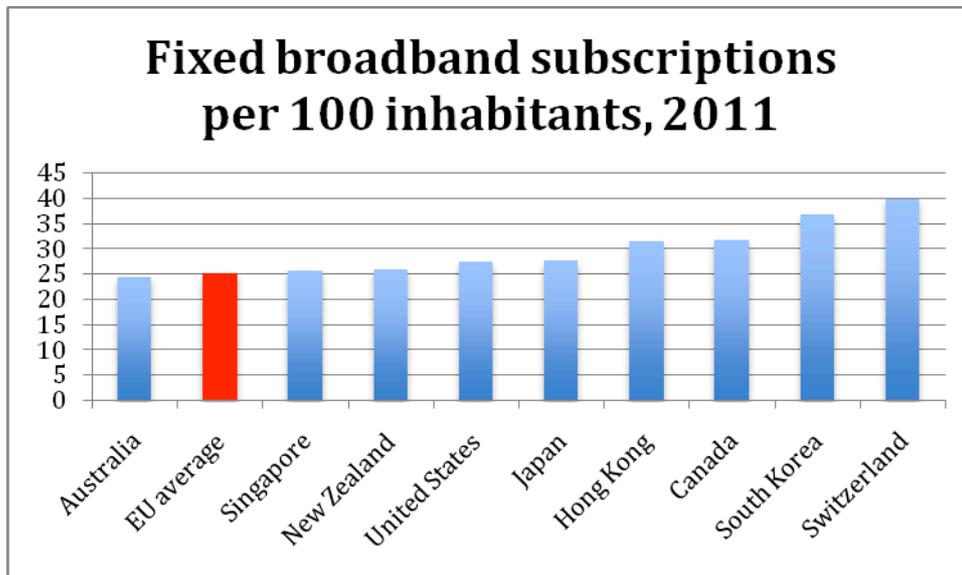
Source: OECD.

Eurostat has more updated information on all member states (Bulgaria, Cyprus, Latvia, Lithuania, Malta and Romania are not members of the OECD). And again we see that there are big differences between member states. In 2011, four member states (Finland, Sweden, Denmark and Germany) had a higher level of R&D spending than the US had in 2009.



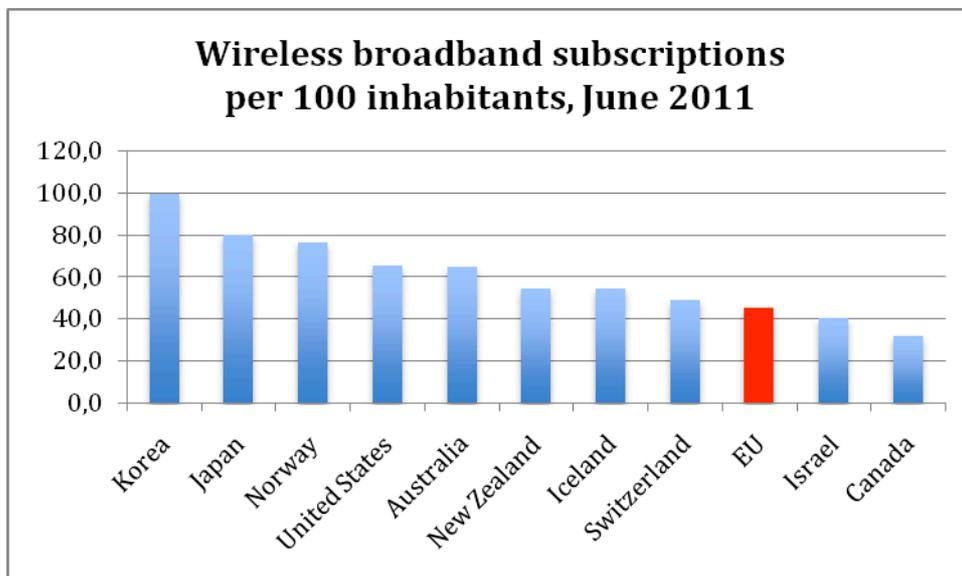
Source: Eurostat.

Also when it comes to investment in information and communication technologies (ICT), Europe is falling behind. We have fewer fixed broadband connections per inhabitant than most other advanced economies.



Source: ITU.

The same goes for wireless connections.



Source: OECD.

Quality of life

The United Nations Development Program (UNDP) each year ranks the world's countries in its Human Development Index, made up of indicators of income levels, health and education. Countries are divided into the following levels of human development: very high, high, medium, low, very low.

25 EU member states enjoy "very high" human development, with only Romania and Bulgaria ending up in the "high" human development category. The average EU state is ranked as the 28th best country in the world.

Europe also has some of the most liveable cities in the world. In the 2012 Mercer Quality of Living Survey, measuring 39 economic, social and political factors, 22 of the 50 best cities in the world are located in the European Union.

Conclusion

Europe is a fantastic place to live in, with some of the world's most stable democracies, open societies and with respect for fundamental rights that is never questioned, along with prosperity that still, in spite of the crisis and of our problems, leaves us richer and better off than in most other parts of the world. In Europe we have life opportunities that are bigger than in most other societies. And during the last 20 years of unification we have achieved what is the world's biggest economy, peace and stability with a rule of law as the predominant force from Finnish Lapland in the north to Malta in the south, from the Hebrides in the west to the beaches of Cyprus in the east.

What we have achieved is the result of political leadership and reforms in different times. And today it is obvious that there is a need for reform, if we want Europe to be not only the biggest economy but also the most dynamic and leading market in the world, if we want European values of freedom and democracy to dominate the international community and if we want to contribute to the development of other societies putting the individual in the centre of their future.

We also inhabit a union of relatively well-governed countries. However, when it comes to our economies, the picture is not as positive. We lag behind in growth, innovation and competitiveness.

But if we really want to be world economic leaders in the future, if we really are serious about competitiveness, growth and jobs, if we still think that Europe has an important part to play in the world, then it is time for us to get our act together and seriously start taking up the challenge, and get an earnest discussion going on how we can improve the areas where we, as demonstrated by this paper, without doubt are falling behind. That is something we can do in each country, thereby lifting the standards for all of us, but also on European level, thus changing the opportunities for everyone all over the union.

The present economic state of the union is not good enough. If we change this we can change Europe from crisis to leadership. The good thing is that we can do better.

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Gunnar Hökmark is Vice-Chairman of the European People’s Party Group and the Chairman of the Delegation to the EU-Croatia Joint Parliamentary Committee.