

European Governance
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MT Week 5: The EU and state intervention in the economy

PART I) Mini-lecture - outline

- (a) Why should we care about and study policies for promoting economic innovation and development?

*“The central puzzle of human history is to account for the widely divergent paths of historical change. How have societies diverged? **What accounts for their widely disparate performance characteristics?** (...) This divergence is even more perplexing in terms of standard neoclassical and international trade theory, which implies that over time economies, as they traded goods, services, and productive factors, would gradually converge.” [Douglas North 1990, *Institutions, institutional change and economic performance*]*

*“Last spring I went with my children to buy new bicycles. We entered the store to buy a product whose design, shape, and mechanics were finalized over a hundred years ago. There is a diamond-shaped frame, two wheels, pedals attached to a gear-controlled chain-operated power transmission system, and brakes. What innovation can happen here? And why should anyone care? The answers are simple and powerful: a lot of innovation, and we should care, because those innovations allowed two companies, one Japanese and one Taiwanese, to completely transform the global bicycle industry, enlarging the market by making bicycles a much more appealing and convenient transportation solution for all sections of society, and **moving production, profits, and jobs to their local communities in Taiwan and Japan**, and thus away from Europe and the United States.” [Dan Breznitz 2021, *Innovation in real places*]*

*“The Brexit vote revealed **a country divided by place**, reflecting the diverging trajectories of economic development and politics taken by locations that have prospered in a globalised knowledge economy—predominantly cities—contrasted with places on the periphery, in towns and rural areas.” [Jennings and Stoker 2018, ‘The Divergent Dynamics of Cities and Towns: Geographical Polarisation and Brexit’]*

*“Labour must rethink growth strategy to curb rise of far right, says top economist: Former Bank chief economist Andy Haldane says **left-behind communities need investment to stem populist tide**” [Guardian, 17/9/25, <https://www.theguardian.com/politics/2025/sep/17/labour-growth-far-right-economy-andy-haldane>]*

- (b) Three approaches to promoting economic innovation and development:

- Top-down state intervention
- Market
- Coordination

- (c) Top-down state intervention approach:

- Renewed enthusiasm among academic and policy circles for this approach after decades of almost complete dismissal in the European context.

“Today we are in the midst of an economic stagnation that some (like American economist Larry Summers) call ‘secular stagnation’, which implies that a long-term period of near zero-growth rates is inevitable and persistent. But this somewhat doom-laden diagnosis misses the underlying causes of the disease. The causes are not the exhaustion of profitable technological opportunities or a lack of effective demand per se (declining levels

of income per capita). **The fundamental causes are related to what the State is doing—or, better, what it is not doing.** (...) In innovation, the State not only ‘crowds in’ business investment but also ‘dynamizes it in’—creating **the vision, the mission and the plan.**” [Mazzucato 2015]

- **Key idea:** The public authorities set precise goals for the economy, direct economic resources to reach those goals, and use conditionality to bring the private sector on board.
- **Instruments:** Subsidies, tariffs, foreign technology acquisition and transfer, public procurement, infrastructure investment, R&D and innovation policy, state ownership
- What examples do proponents of this approach have in mind?
 - Role of the state in fostering innovation in the US:

“Across the globe, countries, including in the developing world, look to emulate the success of the US economy. In doing so, they look at the power of ‘market-driven’ mechanisms, versus what might seem like old-style, State-driven mechanisms in places like Europe or the ex-Soviet Union. But the United States is not what it seems. The preacher of the small State, free-market doctrine has for decades been directing **large public investment programs in technology and innovation** that underlie its past and current economic success. From the Internet to biotech and even shale gas, the US State has been the key driver of innovation-led growth—willing to invest in the most uncertain phase of the innovation cycle and let business hop on for the easier ride down the way. If the rest of the world wants to emulate the US model they should do as the United States actually did, not as it says it did: more State not less. A key part of this lesson should be to learn how to organize, direct and evaluate State investments, so that they can be strategic, flexible and mission-oriented.” [Mazzucato 2015]
 - Literature on the ‘developmental state’ in East Asia:

“The state has traditionally played an important role in mobilizing capital in late-industrializing nations. In this vein, scholars of the “East Asian tigers” developed a distinctive theory of state-led capitalism. This “developmental state” can be broadly defined as **a state in which bureaucrats are appointed on meritocratic principles and insulated from political pressure with a mandate to promote industrialization and a strong esprit de corps.** Under these conditions, powerful pilot agencies can use nationalization, subsidized credit rationing, and other instruments to allocate resources to strategic industries.” [Ornston and Vail 2016]
- Examples from the EU:
 - EU space programme, e.g. Galileo, the EU’s satellite navigation system
 - Several policy instruments in the EU’s strategy to promote the digital and green transitions, e.g. European Battery Alliance, EU Chips Act, digital & green conditionalities in the Recovery and Resilience Fund (RRF)
 - Some programmes within cohesion policy (e.g. subsidies to promote novel product R&D by SMEs in Poland, Breznitz & Ornston 2017) and research & innovation policy (e.g. initiatives related to the European Research Area, Mosconi 2015)

(d) Market approach:

- **Key idea:** Through the operation of the price mechanism, markets ensure that firms produce what consumers want in the most efficient possible way. The more we dismantle the barriers to competition and trade, the more efficient the allocation of resources becomes,

and the more firms can benefit from economies of scale, improving their competitiveness. Market failures are corrected through regulation, which forces firms to take into account the social costs and benefits of their actions. Innovation is further promoted through institutions that allow firms to capture rents, such as patents.

*“The opening up of new markets, foreign or domestic, and the organizational development from the craft shop and factory to such concerns as U. S. Steel illustrate the same process of industrial mutation — if I may use that biological term — that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one. **This process of Creative Destruction is the essential fact about capitalism.** It is what capitalism consists in and what every capitalist concern has got to live in.”* [Schumpeter 1943, *Capitalism, Socialism and Democracy*]

- Example from the EU: The Single Market programme

“Delors did not enthuse about the single market because he was a born deregulator. He thought it would arrest Europe’s economic decline, relative to America and the Asian economies. Delors revealed a concern for Europe’s rank in the world which echoed de Gaulle talking of France.” [Charles Grant, *Delors: Inside the House that Jacques Built*, London: Brealey Publishing, 1994, p. 67]

(e) Coordination approach:

- **Key idea:** Firms develop the capabilities to design, produce, and distribute goods and services profitably through coordination with other actors, whether these are other firms, trade unions, education and training providers, banks, the public sector, etc. The state can enhance firms’ innovative capabilities by offering a governance framework that facilitates inter-firm and public-private cooperation.

- This is the approach of Coordinated Market Economies (CMEs):

*“In coordinated market economies, firms depend more heavily on non-market relationships to coordinate their endeavors with other actors and to construct their core competencies. These non-market modes of coordination generally entail more extensive relational or incomplete contracting, network monitoring based on the exchange of private information inside networks, and more reliance on collaborative, as opposed to competitive, relationships to build the competencies of the firm. (...) Although markets and hierarchies are also important elements of coordinated market economies, **firms in this type of economy draw on a further set of organizations and institutions for support in coordinating their endeavors.**”* [Hall and Soskice 2001]

- But cooperation is important for innovation everywhere, not just in CMEs!

“Cooperation between different actors is integral to innovation within liberal and coordinated market economies alike. It is particularly important for SMEs, who frequently lack the human and financial capital to conduct expensive R&D. Many of the most successful innovation-based economies, from Taipei China to Denmark and Germany, developed an array of mechanisms to directly solve these issues and induce cooperation between actors.” [Breznitz and Ornston 2017]

- How can public authorities facilitate cooperation among economic actors?

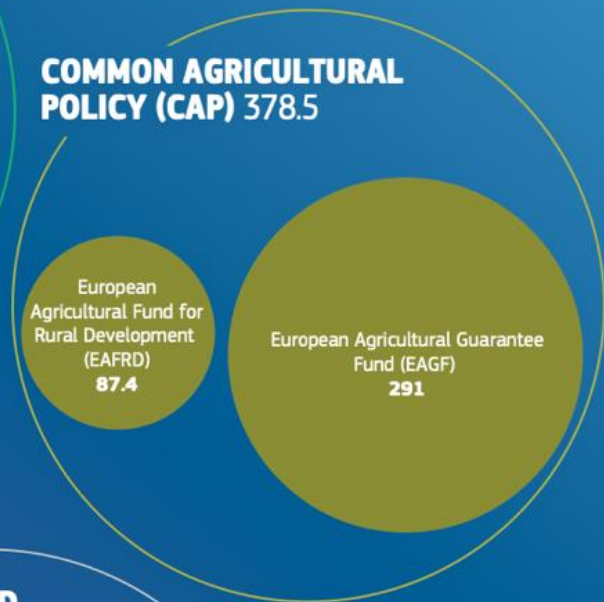
- One answer: By providing **facilitative institutions**, which address the cognitive obstacles to cooperation by offering opportunities for deliberation and subsidizing the upfront costs of cooperation; and make it easier for economic actors to resolve collective action problems by allowing them to set their own rules and helping them enforce those rules (Gartzou-Katsouyanni 2024).

MULTIANNUAL FINANCIAL FRAMEWORK 2021-2027: KEY FIGURES

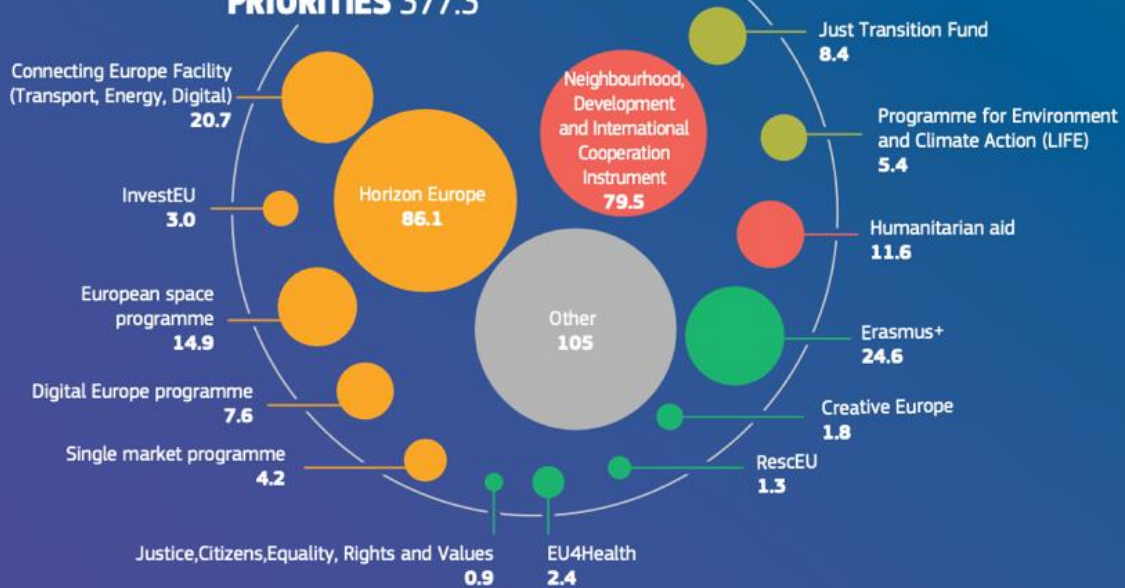
COHESION POLICY 372.6



COMMON AGRICULTURAL POLICY (CAP) 378.5



NEW AND REINFORCED PRIORITIES 377.3



Amounts in billion euros.

Source: https://commission.europa.eu/publications/multiannual-financial-framework-2021-2027-commitments_en

PART 2) Class discussion

(a) Together with a partner, take 5-7 minutes to begin filling out the table below. Focus particularly on the last two rows. Under what circumstances does each of the approaches to promoting innovation and economic development work best, and what are the shortcomings of each approach? If you want, you may draw inspiration from the three quotes in the next page, each of which corresponds to one of the three approaches.

	Top-down state intervention approach	Market approach	Coordination approach
Agent of innovation			
Key institutional tools			
Method of ensuring that resources are well spent			
Conditions where the approach works best			
Shortcomings			

Discussion provocations:

- On the top-down approach: Excerpt from the Draghi report (2024) on goals & instruments:
*“Europe’s position in the advanced technologies that will drive future growth is declining. (...) Europe urgently needs to accelerate its rate of innovation both to **maintain its manufacturing leadership** and to **develop new breakthrough technologies**. Faster innovation will, in turn, help raise the EU’s productivity growth, leading to stronger growth in household incomes and stronger domestic demand.”* (p. 14)

*“Europe must improve the conditions for breakthrough innovation by addressing the weaknesses in its common programmes for Research & Innovation. The report recommends reforming the EU’s next Framework Programme for R&I [i.e. Horizon] in terms of its focus, budget allocation, governance and financial capacity. First, the programme should be refocused on **a smaller number on commonly agreed priorities**. Second, an increased share of the budget allocation should be allocated towards **financing disruptive innovation** and, to make efficient use of this funding, the European Innovation Council (EIC) should be reformed to become a genuine “ARPA-type agency”, supporting high-risk projects with the potential of delivering breakthrough technological advances. Third, the governance of the programme should be managed by project managers and by people with proven track record at the frontier of innovation and – to maximise access for young, innovative companies – application processes should be faster and less bureaucratic. The organisation of the programme should be redesigned and streamlined to become more outcome-based and efficient. Finally, conditional on reforms, **the budget of the new Framework Programme should be doubled to EUR 200 billion per 7 years.**”* (p. 33)
- On the market approach: *“Low-income countries can compete in international markets by producing labor-intensive, low-cost products using technologies developed abroad. Large productivity gains occur through a reallocation of labor and capital from low-productivity agriculture to high-productivity manufacturing. As countries reach middle-income levels, the underemployed rural labor force dwindles and wages rise, eroding competitiveness. **Productivity growth from sectoral reallocation and technology catch-up are eventually exhausted, while rising wages make labor intensive exports less competitive internationally. If countries cannot increase productivity through innovation (rather than continuing to rely on foreign technology), they find themselves trapped.** (...) Of 101 middle-income economies in 1960, only 13 became high income by 2008 – Equatorial Guinea; Greece; Hong Kong; Ireland; Israel; Japan; Mauritius; Portugal; Puerto Rico; Republic of Korea; Singapore; Spain; and Taiwan.”* [World Bank report, 2013, “China 2030”, p. 12]
- On the coordination approach: Description of an institution meant to prevent deforestation in Brazil, the extractive reserve → *“The idea... was to lease public land to a community according to a scheme that balanced various interests. 20% of the territory would be assigned to individual families to use as they liked. The remainder would be jointly controlled by the reserve’s member families, with access and proceeds divided according either to customary rules or new rules determined by a managing council representing the common interest.”*

The limits of the institution → *“**[The most] consequential marker of disarray was the breakdown in internal governance in the supposedly self-governing areas.** Only half of the reserves and conservation units are estimated to have management plans directing development, and only 45% have a representative management council charged with making such plans.”* [Sabel and Victor 2022, pp. 133 and 141-2]

(b) Which of the approaches to innovation and economic development that we have discussed is best-suited to help catalyze (i) the digital transformation, (ii) the green transition and (iii) economic development in Europe's low- and middle-income regions?

(c) From the point of view of research design, what is the best way to study whether the approaches to innovation and economic development discussed in this class are effective? What methodologies are used or referred to in the readings and why?

(d) *“Successful industrial policies today require strategies that span investment, taxation, education, access to finance, regulation, trade and foreign policy, united behind an agreed strategic goal.”* (Draghi report, p. 63). From an institutional and political point of view, can and should the EU pursue an industrial policy of this type?