Flash Economics

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The many vicious circles from which the European economy suffers

The European economy is suffering from several vicious circles:

- Under-investment, particularly in new technologies, is leading to a low return on capital, which is pushing European savers to invest their savings outside Europe, thereby perpetuating under-investment ;
- The high level of spending on social protection means that investment (both public and private, due to the high level of taxation) is insufficient, which depresses the supply of goods and services, and leads to a low level of tax revenue, which, given the incompressible nature of social spending, further depresses investment;
- Europeans' savings are absorbed by the financing of public deficits and investment in housing; too little savings are devoted to financing technological innovation, and the production of new technologies has increasing returns to scale, so the technological sector remains inefficient, which discourages the allocation of savings to this sector and perpetuates the unproductive use of savings.

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The vicious circle of under-investment

Europe (we are looking at data for the eurozone) **has too low an investment rate**, particularly when it comes to investment in new technologies (**Charts 1A/B**).

Chart 1A
Investment of corporations
(in value terms, as % of nominal GDP)

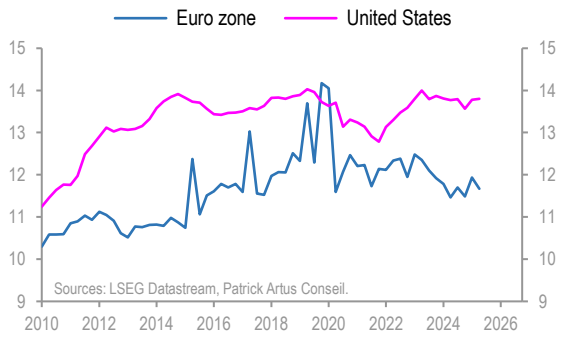
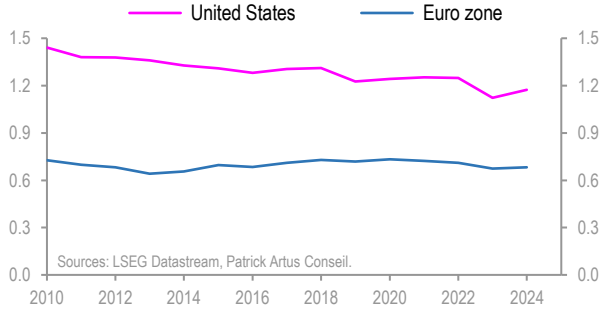
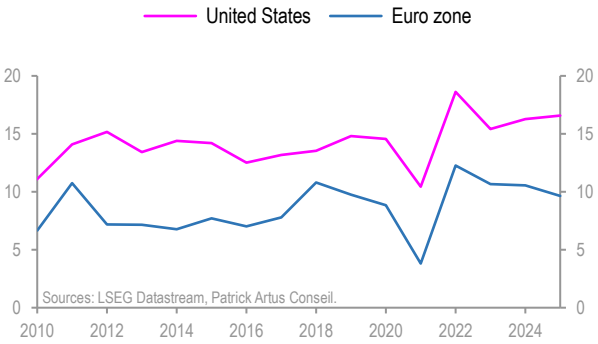


Chart 1B
Investment in information and communication technologies excluding software
(in value terms, as % of nominal GDP)



This situation of under-investment is reflected in **a low return on capital** (**Chart 2**), which is pushing European savers **to use part of their savings to invest** (or lend) in the rest of the world (the consensus estimate is that €350 billion of European savings are transferred to the United States each year).

Chart 2
RoE

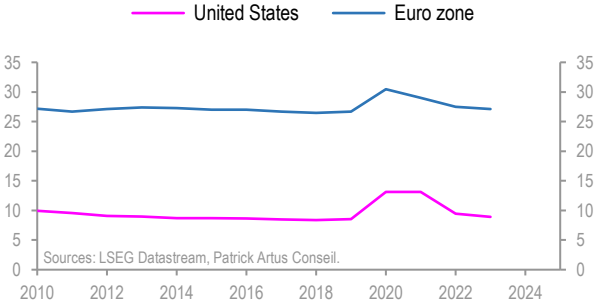


The low level of funds available for investment resulting from these capital outflows perpetuates the situation of under-investment.

The vicious circle of heavy social protection and weak growth

The burden of social protection is too high in Europe (**Chart 3**).

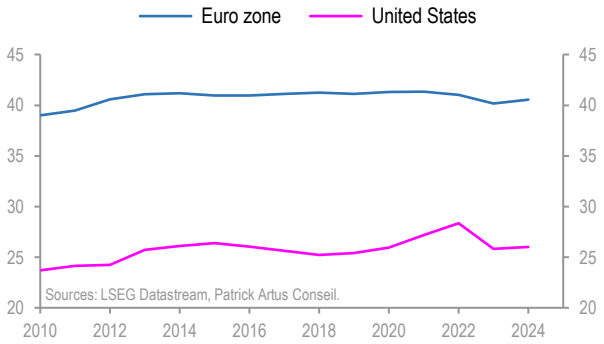
Chart 3
Public expenditure on health and social protection
(as % of nominal GDP)



This very high level of social protection:

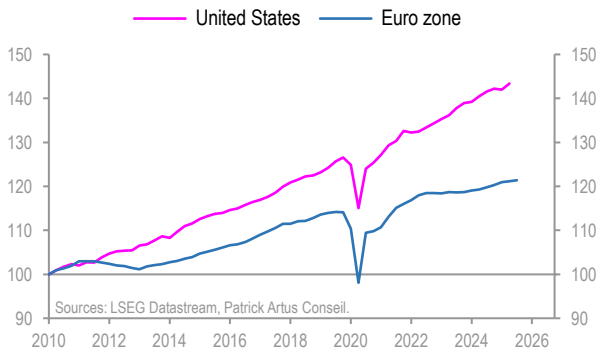
- Diverts public money from productive uses (support for investment in new technologies, education, etc..) ;
- Means that the **tax burden** is very high in the eurozone (**Chart 4**), which reduces the resources available for the private sector to invest.

Chart 4
Tax burden (as % of nominal GDP)



There is therefore an abnormal weakness in public and private investment, **resulting in weak potential growth** (**Chart 5**), **and a consequent weakness in the level of tax revenues**.

Chart 5
Real GDP (100 = 2010.Q1)



Given the de facto incompressible nature of social protection spending, this weakness in tax revenue leads to a weakness in public and private investment (by maintaining the need for a high tax burden), and results **in permanently weak growth**.

The vicious circle of the use of savings

Europeans' savings are being absorbed to finance public deficits and investment in housing (**Charts 6/7**).

Chart 6
Euro zone: Fiscal deficit (as % of nominal GDP)

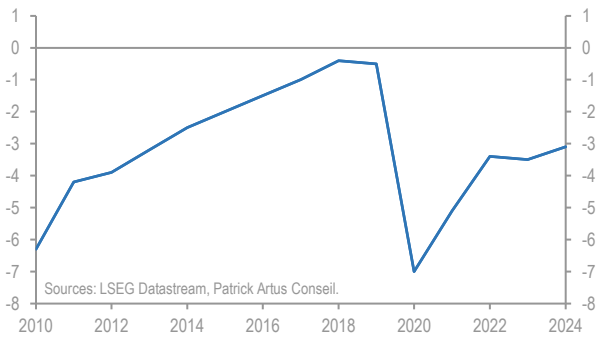
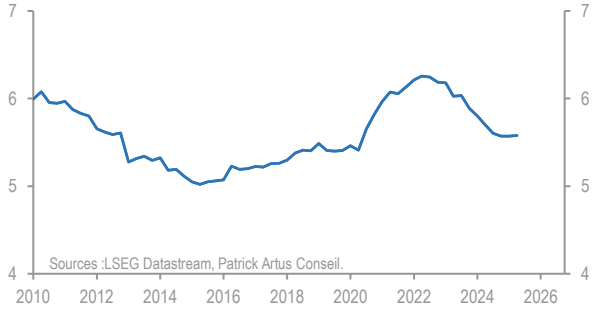
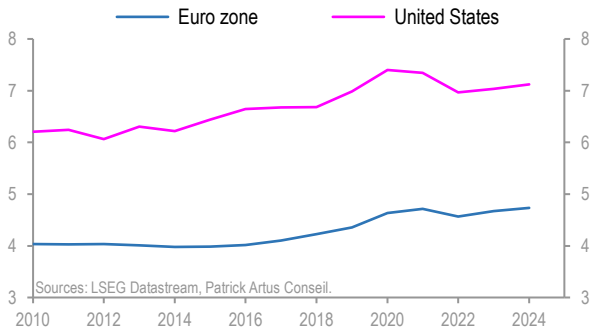


Chart 7
Euro zone: Household housing investment (as % of nominal GDP)



Too few savings are therefore available to finance the technology sector. Since this sector has **increasing returns**, **its small size** (**Chart 8**) **means that it remains inefficient**, which discourages the use of savings to finance this sector and perpetuates the unproductive use of savings.

Chart 8
Gross value added of the ICT sector
(as % of nominal GDP)



Summary: how do we get out of the three vicious circles that characterise the European economy?

The three vicious circles affecting the European economy are :

- The vicious circle of low returns on capital and capital outflows ;
- The vicious circle of low tax revenues, and consequently low investment, due to the high level of social welfare spending;
- The vicious circle of savings being absorbed by public deficits and housing investment, hence the small size and low efficiency of the technology sector.

To break out of these vicious circles, European countries need to:

- Reduce the weight of social protection spending in favour of investment in the future ;
- Which would improve the efficiency of the technology sector and the profitability of capital;
- This would result in additional tax revenue and a greater incentive to invest in Europe.

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