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HOW TO PLAY THE DIGITAL POWER GAME WITH LIMITED MEANS

Policy Principles for the Next European Commission

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Digital technology is an indispensable lever for securing Europe's living standards, wellbeing, and economic growth. Yet concerns over its role in creating critical dependencies and amplifying societal risks are growing. Navigating this dilemma represents the key challenge of the EU's digital policy today.

This balancing act plays out in the shadow of escalating geopolitical rivalries. In the quest for digital dominance, the EU is usually compared to the US and China. Since the late 2010s, the aggressive trade and industrial policies driven by the rivalry between the US and China have spurred European policymakers to call for similar measures at home, aiming to reduce Europe's dependencies.

The popular notion of the EU as an equal rival to the US and China may lead Europe astray, however. It builds on a misunderstanding of what the EU is today (or likely to become anytime soon) and fails to appreciate its relative strengths. **Advocating for the EU to match US and Chinese industrial policies across the board may dilute Europe's limited resources.**

The EU falls short of matching the US and China in market size, fiscal capacity, capital markets or labor market dynamism. Despite having a combined market size which is, on paper, comparable to its global rivals, the prospect of a fully integrated Digital Single Market or a Capital Markets Union akin to that of the US remains elusive, placing the EU at a massive disadvantage. The EU cannot replicate the subsidies of the US and China due to its lack of a common fiscal capacity and restrictive rules of state aid and debt. The investment budgets of private European tech companies are nowhere near those of their American counterparts. On top of that, the EU's funding for the

digital economy is in stark competition with the high demands for various other pressing needs, in particular defense spending after the outbreak of war in Ukraine.

Current discussions on the next Commission's digital priorities should proceed from these premises, at least for the mid-term outlook. The question then becomes: How can the EU play the digital power game with limited means? How can Europe best advance its interests under these conditions?

European rules are the essential base. Now, after a period marked by the introduction of many new and important laws that have done well to position the EU as a global regulatory leader, the focus of Member States is now shifting towards the implementation and enforcement of these rules. A consensus is emerging around the need to reduce complexity for firms (SMEs in particular), resolve overlaps, and develop clear guidelines to foster innovation.

These steps to strengthen the EU digital rulebook are welcome. The EU should take measures to help businesses deal with the complexity of new regulation, an effort potentially driven by a new Implementation Commissioner. But it would be unrealistic to expect a pause in legislative activity given the rapid pace of technological advancement that frequently give rise to new concerns. Alongside streamlining efforts, politicians will inevitably seek to develop a forward-thinking and pro-active project to address worries about Europe falling behind.

So, what principles should guide the next Commission? **We suggest six points of analysis.**

1. Expanding the Digital Single Market to achieve scale is only a starting point

The Digital Single Market is the beating heart of Europe's digital strategy. Expanding it is a crucial next step, in particular to enable innovative firms to scale faster across European borders. **The digital economy would benefit from harmonizing national regulations, lowering barriers to data flows, and upgrading digital infrastructure** – taking into consideration that Europe's economies are comprised of many SMEs. Beyond the digital realm, completing the capital markets union is also key to meeting the financial demands of European scaleups.

There can nonetheless be an excessive focus on scale as an end-all solution to Europe's problems. Simply enlarging the market to rival the US and China is not a remedy alone. **The EU should draw inspiration from the paths taken by successful digital nations like Japan and South Korea and from small digital frontrunners within the EU.** These countries have obtained power by focusing strategically on areas where they leverage distinct strengths.

2. The EU should seize control of critical chokepoints rather than seeking to match American and Chinese tech giants

The EU is a regulatory leader but lacks tech giants – a gap that weakens its ability to capture digital profits, protect its economic security, and shape the technological evolution.

To assert that the EU must match the US and China across the board may be misleading, as argued above. **The EU is better served by identifying and pursuing narrow competitive advantages that allow it to seize control of critical chokepoints of the digital value chain and thus promote inter-dependencies**, following the example led by ASML.

This strategy would leverage the EU's strengths in embedding itself in global supply chains as a contributor of high value adding parts. Moving beyond a defensive stance against digital dependencies, the EU would take a more assertive approach that increases others' reliance on the EU in turn.

For the EU thus to gain leverage in the global economy, export controls should be managed at a European level.

3. Industrial policy can, if narrowly targeted, mitigate critical dependencies and increase others' reliance on the EU

The EU cannot regulate itself out of dependencies; the Digital Single Market alone will not solve its economic security issues or guarantee the European model for the digital economy. Here industrial policy emerges as a pivotal tool.

The EU should focus its digital industrial policy and use it in the service of two goals:

- a) **Seizing control of critical chokepoints** in the value chain, as explained above, and
- b) **Mitigating social risks** linked to the most critical dependencies

While the EU cannot match the US and China across the board, some digital dependencies pose unbearable social and security risks to European societies. Dependency on foreign firms for critical infrastructure, whether physical or digital, is not a viable path in the present geopolitical context.

Effective industrial policy can mitigate these risks when focused narrowly on single, long-term objectives. A general rule for industrial policy, as formulated by the Harvard political economist Dani Rodrik, is that the more things you try to achieve with it, the less likely you are to get them. Still, the EU can offset the potential adverse effects of industrial policies on smaller and peripheral Member States by utilizing other policy instruments, such as cohesion policies, to mitigate these risks.

4. A painful prioritization exercise is urgent

Urgently needed is a political debate on what constitutes Europe's most pressing dependencies. To this end, **the EU should conduct a prioritization exercise, employing stress testing to evaluate the economic security risks of key dependencies.**

The Commissions' current list of critical technologies cannot serve as the basis for a targeted industrial policy given the EU's resource constraints. It is too wide, including ten very broadly defined targets from 'advanced connectivity, navigation and digital technologies' to 'space and propulsion

technologies'. The long list of technologies mentioned in the STEP-regulation suffers from the same weakness, being out of proportion with the allocated funding of just €1.5bn.

Four out of the Commission's ten target areas are currently being assessed (semiconductors, AI, quantum tech, and biotech). This is a welcome start, but so far insufficient.

5. Invest in the basics – the importance of digital infrastructure, skills, R&D, and adoption of technology

At the heart of the EU's digital agenda must remain the basics of its digital economy: Investing in infrastructure, skills, basic research, and widespread digitalization. These elements are the prerequisite for achieving the EU's policy objectives.

Neglecting these fundamentals also poses its own risks. Expanding digital infrastructure across Europe is, for example, important to prevent deepening the divide between rural and urban areas or between richer and poorer Member States. Disparities in digital skills could similarly exacerbate the economic imbalances of Europe. In this regard, the EU's budget programs, and especially cohesion funds, are vital.

6. Effective enforcement is the bedrock of the Digital Single Market, but requires more resources and streamlining

Digital legislation is only as good as the enforcement of it. As a range of new laws come into effect, enforcement costs are surging, both within Member States and at the Commission. Authorities demand people with similar digital skills as economic actors, skills that are in woefully short supply. **A more streamlined approach to enforcement**, adopting a tiered responsibility model akin to the Digital Services Act or Digital Markets Act where the Commission assumes a central role, **could prove beneficial in more areas.**

Central to this effort is the vigorous application of competition law, including the Digital Markets Act. Ensuring a competitive environment is essential for innovation and for strengthening Europe's digital competitiveness.

The policy brief is based on a roundtable conversation on March 13, 2024. In addition to the network members, Zach Meyers, Assistant Director at the Centre for European Reform, participated in the meeting. The authors thank him for sharing his ideas and comments.