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# Draghi's report a year later: Beneficial but no remedy for EU challenges

**George C. Bitros, Anastasios G. Malliaris, and Mark S. Rzepczynski**

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Πατησίων 76, 104 34 Αθήνα. Τηλ.: 210 8203303-5. E-mail: econ@aueb.gr / www.aueb.gr
76, Patission Street, Athens 104 34 Greece. Tel.: (+30) 210 8203303-5

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# Draghi's report a year later: Beneficial but no remedy for EU challenges[1]

George C. Bitros,[2] Anastasios G. Malliaris,[3] Mark S. Rzepczynski[4]

**Abstract**

We assess Draghi's report and find it lacking in two main areas. The first issue is that it overlooks the fact that European citizens, and by extension European leaders, have chosen a political economy model that leans more towards socialism than the more liberal model found in the USA. An implication of this choice is that it incurs substantial costs in terms of competitiveness, productivity, and economic growth, because it does not align well with the processes of innovation and creative destruction, which in certain sectors are accompanied by the advantages of economies of scale and scope. The second issue is that the report fails to recognize that the EU's success has heavily relied on the principles of 'gradualism' and 'unanimity' among member states. However, these principles now hinder the EU's ability to swiftly adapt to shifts in international relations and trade that have occurred with force in the last year. In light of these considerations, we have concluded that the way forward for the EU is to pursue some form of "Federalism." This would involve establishing European-level union in areas such as fiscal policy, defense policy, foreign policy, industrial innovation policy, and strengthening of the European Parliament, among other institutions.

**Keywords:** Draghi's report, competitiveness, economic growth, economies of scale, unanimity, socialism, liberalism, federalism

**JEL codes**: N44, O33, O43, P16, P51

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[2] Athens University of Economics and Business, bitros@aueb.gr

[3] Quinlan School of Business, Loyola University Chicago, ORCID: 0000-0003-0568-5697, tmallia@luc.edu (corresponding author).

[4] AMPHI Research and Trading, Boston, Massachusetts, mrzepczynski@amphitrading.com.

## 1. Introduction

The European Commission study, *The Future European Competitiveness*, commonly known as the Draghi report (2024a, 2024b), has garnered significant global interest as a comprehensive blueprint for policy recommendations to address the EU's productivity and growth challenges.[5] The report is both ambitious and refreshing. It stands out for its novelty by marking a departure from the traditional, narrowly focused framework of industrial policy.[6] As for its ambition, it seeks to tackle the ongoing issue of fragmentation within the EU, which raises transaction costs for intra-EU trade, limits economies of scale across Europe, and hinders the mobility of productive resources among member states.

To achieve this objective, the report outlines a threefold approach. First, it highlights a persistent cycle of low industrial dynamism, innovation, investment, productivity, and growth across the EU. Second, it underscores the importance of EU-level governance over national interventions, emphasizing the need to reform the EU by reducing regulatory fragmentation and coordinating investments among member states; and, finally, it places decarbonization at the heart of Europe's industrial strategy, asserting that climate policy should not be viewed merely as a cost, but rather as a potential source of industrial opportunity. By adopting this perspective, the report aligns more closely with a *mission-oriented* or *systemic competitiveness* agenda than with traditional industrial policy. This alignment is likely what explains the report's widespread acclaim.

Regarding the progress of the report's implementation, the Draghi Observatory recently announced that there has been limited success. On January 20, 2026, it stated that:

> The findings are sobering. Out of **383 recommendations**, only **11.2% have been fully delivered**. Even when partial progress is counted, the EU has reached just **31.4%** of the Draghi agenda. The rest remains either "in progress" or untouched.[7]

The Draghi Observatory has committed to use the Draghi Observatory and Implementation Index as a "benchmark for accountability and tool for policy learning." Aside from the delays in im-

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5 Henceforth, if not indicated otherwise, all references to the EU should be construed to refer to the EU of 27 countries, commonly denoted by EU-27.

6 The traditional industrial policy tends to be: a) sector-specific (e.g., steel, autos, semiconductors); b) targeted (subsidies, tax incentives, R&D support for chosen industries); c) national in scope; d) incremental rather than transformative; and e) focused on competitiveness within existing structures, not redesigning them. This is the classic "pick winners, support them, protect them" model.

7 See the scoreboard for the number of recommendations in intermediate stages of progress, as well as other significant details in: Launch of Draghi Observatory & Implementation Index: Only 1 in 10 Measures Implemented - European Policy Innovation Council

plementing Draghi's report, significant changes in international relations during the same period indicate that EU governance is deeply problematic. It seems to consistently lag the current state of affairs, as it has, seemingly through inertia, adapted to govern in a world where time is abundant, security is guaranteed, and the costs of policy mistakes are often diffused and disregarded. This approach to governance is now outdated. Military might has made a resurgence, energy and tariffs have become instruments of conflict, and geopolitics no longer permits deferring pressing issues to the future. That is why, as we indicate in the title and argue in this paper, under the present circumstances, Draghi's report is anything but sufficient to confront the numerous challenges facing the EU.

At the 2026 World Economic Forum at Davos, we heard pointed criticisms of the EU from three different leaders. The first leader, reflecting on his experiences from the front lines in Ukraine, was particularly clear. He stated that Europe needs to establish a European army to defend the continent today - not in a few years or through some theoretical strategy document. This remark was especially damaging for an EU governance structure that has become accustomed to wasting time and resources on procedural matters. The second leader, hailing from the other side of the Atlantic, responded by asserting that the EU is hardly recognizable anymore. He pointed out several concerns: a) the continual expansion of public expenditures; b) mass immigration without assimilation; c) reliance on imports rather than boosting local production; d) the relocation of heavy industry abroad; and e) the replacement of affordable energy with politically mandated expensive alternatives. According to him, Europe has no future under these circumstances. Lastly, in light of these criticisms, the third leader, representing one of the most influential countries in the EU, was compelled to acknowledge that something is indeed going very wrong within the union.

As a result, the world upheavals we are currently witnessing, especially within the transatlantic alliance, have raised fundamental questions about the direction of EU governance that extend beyond competitiveness. To be more specific, history shows that before World War II, several wars were fought to unify European countries by force. All these attempts ended in failure, resulting in millions of deaths and unimaginable destruction. Drawing on historical lessons, a peaceful unification process was proposed in the 1950s, with various approaches considered by the founders of the EU. Ultimately, Jean Monnet's views prevailed, leading to the implementation of his pragmatic approach known as gradualism or incremental functionalism. This approach was first applied in the pilot cases of the European Coal and Steel Community (ECSC) in 1951 and the European Economic Community (EEC) in 1957.[8] The process was designed to begin with a few countries and to gradually incorporate additional nations and subject areas. Initially, the focus was on economic integration while allowing member countries to retain control over monetary, fiscal, defense, and other policies. The next major phase, which is still ongoing, involved the establishment of a common currency. This enabled countries willing and able to relinquish their independent monetary policies to join the monetary union. Given the current urgency, pending projects aimed at integrating fiscal and defense policies may be expedited.

While gradualism and the necessity of unanimity[9] among member states can make decision-making time-consuming, it is important to acknowledge the remarkable achievement of 75 years of peace and economic progress in Europe. This peaceful integration has allowed the EU to reach its current level of maturity. If this is not impressive, how can one account for the emergence of such valuable public goods? To name just a few, the EU has established widely respected institutions, dismantled barriers that facilitate free movement across Europe, and introduced a robust currency, the Euro, which now competes with the U.S. Dollar. In the current global turmoil, the principles of gradualism and unanimity may no longer confer advantages. If EU governance is to become more responsive to emerging challenges, it may be essential to reconsider these principles. Mario Draghi's proposals sidestep these obstacles and focus on macro-structural reforms to enhance competitiveness. In contrast, we argue that a more effective approach would involve directly addressing the challenges posed by gradualism and the requirement of unanimity.

Section 2 examines the asymmetries in institutions and citizens' choices across member states.[10] Competitiveness is shaped by the institutional environment, which in turn shapes the business climate, community preferences, and public choices. While macro-level policy reforms may support marginal adjustments, significantly improving competitiveness requires a transformation in the state's role, its interactions with markets, and community preferences. Draghi's re-

[8] In the 1950s they established also the precursors of the European Parliament, the European Court of Justice, and numerous other European institutions that grace now the functioning of the EU. For a detailed historical account on how Jean Monet's proposals on the process of integration worked wonders for the EU, see Anta (2021).

[9] Unanimity means every member state must agree on certain decisions — especially sensitive areas like foreign policy, taxation, treaty change, and enlargement. This creates veto cases that slow down integration (e.g., foreign policy decisions still require unanimity). Although unanimity didn't create the need for gradualism, it reinforced it. The EU's slow, step-by-step integration model emerged partly because unanimity made rapid, sweeping reforms almost impossible. So, gradualism became the only politically feasible path.

[10] An institutional asymmetry is a condition that gives rise to fragmentation, which in turn impedes the resilient functioning of markets and the convergence of a country or union of countries to some state of social and economic equilibrium.

port avoids these influential considerations, making it essential to include them in the analysis. Section 3 introduces another important link that is missing from "*The Future of European Competitiveness*," the connection between strategic goals with microeconomics and economic policies. This link has three nodes. The first node links competitiveness to the innovation process through the concepts of economies of scale and scope. The second node connects the enlargement of enterprises to the country's structure of democracy; and lastly, the third node highlights the roots of the so-called "democratic deficit" that has emerged in the postwar period and the implications of its different management in the EU and the USA. Section 4 identifies the roots of the key EU challenges by focusing on the gaps in its economic performance relative to the USA. Section 5 concludes the presentation by summarizing the findings and drawing conclusions.

## 2. Competitiveness and institutional asymmetries across member states

Deng Xiaoping, the founder of modern China, which, from an agrarian country in 1978, has risen to superpower status, was fixated on results. To convince his comrades in the Chinese Communist Party that, without the superior efficiency of free markets, China stood little chance to realize its world potential, he used his famous "Cat Paradigm." In the same way that people do not care whether a cat is black or white, provided that it catches mice, he advocated restoring private ownership and establishing a vibrant private sector yet under state scrutiny. On the contrary, elected governments in the EU have selectively introduced policies that on the margin infringe upon ownership rights and curtail human and economic freedoms.

Table 1 presents the scores and rankings of a sample of EU countries based on the 2024 Index of Property Rights Protections (IPRP), including the EU average, as well as data for the USA and China. When examining specific EU countries, it is noteworthy that Greece suppresses property rights to a greater extent than China. Although Greece is too small to significantly influence the EU average, which compares considerably worse than the USA but way better than China, its score serves as a valuable indicator of how competitiveness may relate to property rights. Given Greece's low competitiveness, this suggests a prima facie positive correlation that is also observed in several other predominantly Eastern European countries. By implication, if all these countries were to relax property rights controls, ceteris paribus, we would expect the improvement in the IPRP at the EU level to bring about an improvement in European competitiveness. As we have learned from a series of brilliant institutional economists culminating in the 2024 Nobel Prize in Economics, the

**Table 1**: Scores and rankings of sampled countries based on the index of property rights protections, 2024

| Countries | Property rights[1] |
|---|---|
| Denmark | 7.8 (3) |
| Fnland | 8.1 (1) |
| France | 7.0 (20) |
| Germany | 7.7 (10) |
| Greece | 5.1 (57) |
| Ireland | 7.4 (17) |
| Italy | 6.0 (36) |
| Portugal | 6.2 (28) |
| Poland | 5.4 (47) |
| Spain | 6.4 (24) |
| EU-27 | 6.5 (n.a.) |
| USA | 7.5 (14) |
| China | 5.3 (51) |

Notes:
1. https://internationalpropertyrightsindex.org/

institution of private property matters for productivity and growrh.[11] By reducing the artificial asymmetries that these countries have embedded over the years in the fundamental structure of property rights, with all other policy conditions unchanged, EU competitiveness would be expected to increase.

This conclusion can be further strengthened by examining the data on human and economic freedoms. Table 2 displays the scores and rankings of the above sampled countries based on their respective indices for 2023. Greece, which is supposedly a Western-style democracy, remains an outlier in terms of freedom. Its scores and rankings are worse than those of Poland, a country that was liberated from communism just 35 years ago. Given the extent of suppression of these freedoms, it is unsurprising that, according to Bitros (2025), Greece has experienced an annual average growth rate of only 1% since 1975. Furthermore, it is hardly surprising that productivity and competitiveness have remained stagnant for decades. The table indicates that Greece, along with countries in Eastern Europe, is holding back Western Europe in terms of these freedoms and, consequently, in competitiveness, productivity, and growth. This represents an institutional

[11] The 2024 Nobel Prize in Economic Sciences was awarded "for studies of how institutions are formed and affect prosperity." The laureates—Daron Acemoglu, Simon Johnson, and James A. Robinson—were recognized for decades of research showing how political and economic institutions shape long-term national development, inequality, and growth. The literature in the tradition of the Schools of Public Choice and Institutional Economics is vast. Just for a few references to classic sources, see Buchanan, Tullock (1962), Olson (1982), North (1981), Eichengreen (2007), and Acemoglu, Robinson (2012).

**Table 2**: Scores and rankings of sampled countries based on the indices of human and economic freedoms, 2023[1]

| Countries | Human freedom[2] | Economic freedom |
|---|---|---|
| Denmark | 9.35 (3) | 8.10 (7) |
| Finland | 9.33 (4) | 7.81 (17) |
| France | 8.18 (43) | 7.43 (47) |
| Germany | 8,82 (18) | 7.23 (23) |
| Greece | 7.89 (52) | 6.94 (72) |
| Ireland | 9.27 (8) | 8.11 (6) |
| Italy | 8.45 (32) | 7.25 (53) |
| Spain | 8.38 (35) | 7.52 (37) |
| Portugal | 8.79 (19) | 7.54 (36) |
| Poland | 8.09 (46) | 7.12 (59) |
| Western Europe | 8.46 | n.a. |
| Eastern Europe | 7.76 | n.a. |
| USA | 8.57 (27) | 8.14 (5) |
| China | 4.42 (155) | 6.18 (111) |

Notes:

1. The figures are published with a lag of two years. This implies that the results are based on data for the year 2021.
2. The index of human freedom is obtained as a weighted average of indices for personal freedom and economic freedom. The index of economic freedom comes from The Heritage Foundation and is published in: https://www.heritage.org/index/pages/report. The Human Freedom Index (HFI) comes from: https://www.cato.org/sites/cato.org/files/2023-12/human-freedom-index-2023-full-revised.pdf.

asymmetry built into the structure of the EU, arising from well-conceived geopolitical choices. As such, it will continue to hinder Europe's productivity and competitiveness for decades to come. There is little that the EU leadership can do to mitigate this drag, other than to compensate for exceptional performance in the more liberal Western parts of the union.

At this point, it would seem convenient to conclude this section. However, we would miss an important opportunity if we did not emphasize that, while some observed institutional differences among European nations may appear to be asymmetries that stir disequilibrium, they are fundamentally traits shaped by the long historical trajectories of the civilization that each country has contributed to the EU. They may not be reconciled within a few decades; in fact, it could take centuries for future generations to identify primarily as Europeans rather than simply as Greeks, Germans, or Romanians. Furthermore, it remains uncertain whether collective efforts should be made to preserve the foundational elements of national origins and identities. In the short term, these benign national differences significantly influence citizens' choices as both producers and consumers of private and public goods, ultimately affecting competitiveness, productivity, and economic growth. Therefore, the political economy model within which citizens across Europe exercise their prerogatives is crucial and deserves careful consideration.

The channels through which citizen choices exert their influence include the shares of state and private ownership of resources. This explains the foundational importance of the index presented in Table 1. If state ownership is significantly greater than private ownership, the country's political and economic organization will likely be *socialist*, characterized by state coercion and subdued individual freedoms. China's “Socialism with Chinese characteristics” exemplifies this situation. On the other hand, if the share of resources privately owned by citizens is significantly higher than state ownership, the country's organizational model will resemble a *liberal democracy*. The USA falls into this category. As shown in Table 2, state coercion modestly constrains human freedoms, whereas economic freedoms may enable citizens to influence the distribution of political and economic power through legislation. Lastly, the model of *social democracy* occupies a middle ground between socialism and liberalism. The countries of the EU have adopted this type of organization by combining elements of socialism and liberalism to varying degrees. Since these countries operate as representative democracies, it is assumed that citizens balance socialism and liberalism through elections among multiple-party candidates. The Schools of Public Choice and Institutional Economics have extensively highlighted the pitfalls of representative democracy. One of the current authors has even suggested the need for a complete rethinking of the system.[12] However, choosing greater socialism over liberalism in establishing a social democracy is not necessarily free of costs to competitiveness, productivity, and economic growth.

This holds true because of the differing objectives and incentives of public and private resource managers. Public managers aim to serve the “common good” by using supply chains and technologies that may be less exposed to competition. Operating under the auspices of the state, they often have latitude to conceal costly management errors. In contrast, private resource managers are, by definition, required to remain vigilant, employ best practices, and be prepared to absorb the costs of their managerial mistakes. Consequently, whether they realize it or not, when citizens vote for socialism, they are implicitly deciding whether resources will be managed in a less or more competitive environment, along with all the implications for overall competitiveness, productivity, and growth. Thus, when Arnal, Feas (2024) estimate that the competitiveness

[12] See Bitros (2022).

gap between the EU and the USA is widening, when Fernandez-Villaverde, Chanian (2018) find that Europe lacks productivity growth, and when Erixon et al, (2024) demonstrate that European productivity is falling behind the USA, it is not surprising. Over the span of the past years that these studies use in the estimations, competitiveness and productivity in the USA were gaining ground, in the EU they remained stagnant, and hence, the gap that has always existed keeps expanding, due among others to the difference in the choice of capitalism[13] between American and European citizens.

Further to this point, Figure 1 highlights the crucial role that citizens' choices between capitalism and socialism play in this context. The two axes of the figure represent the shares of ownership and management of a country's productive resources by public and private entities. Given current production technologies, resources, and supply-related institutions, curve AA' indexes the output per unit of labor, referred to here as the Productivity Possibility Frontier ($\overline{\text{PPF}}$), which can be achieved by a country such as China, the EU, and the USA.[14] Point A stands for a communist regime where there is no private property and all resources are managed by the state,

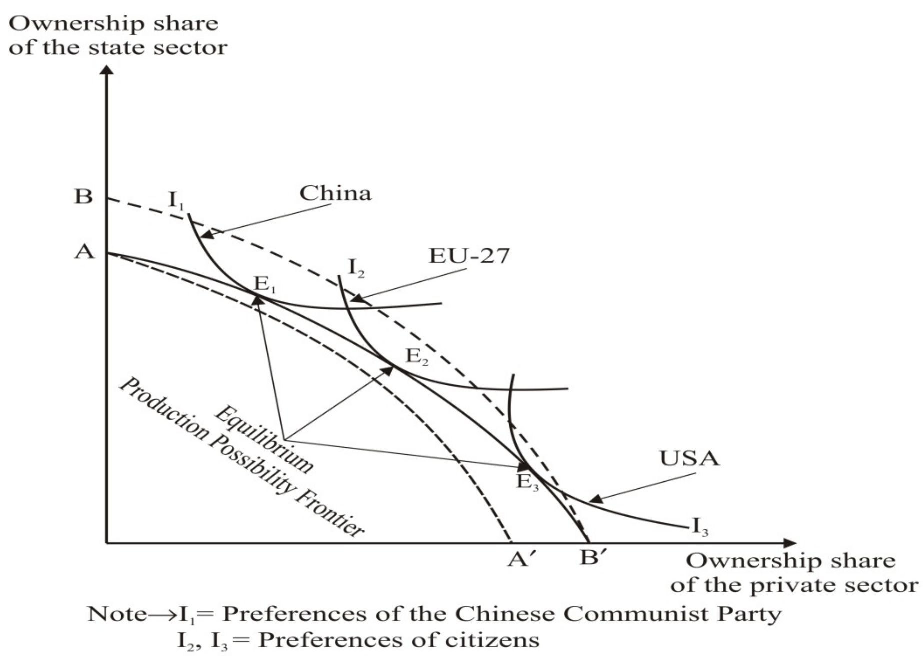



**Figure 1**: Productivity, economic growth, and the state-private shares of ownership and management of a country's resources

[13] See Hall, Soskice (2001).

[14] To differentiate between the Productivity Possibility Frontier and the classic notion of the Production Possibility Frontier, instead of the latter's standard abbreviation as PPF, we shall use the abbreviation $\overline{\text{PPF}}$.

whereas point A′ stands for a laissez faire regime where all resources are privately owned and managed. By definition, along curve AA', the productivity of labor remains constant. Curve BB' is made possible by innovations, such as Artificial Intelligence (AI) or digitization.[15] Despite the potential of reaching BB', no country can attain this curve due to constraints imposed by societal preferences, indicated as $I_1$, $I_2$, and $I_3$. These preferences are shaped by demand-related institutions such as social values, citizens' trust in societal institutions, economic incentives, and personal experiences. The space between curves AA' and BB' is significant. It represents productivity levels that are potentially achievable by the three countries, depending on the preferences of their populations regarding the ownership shares of resources. AB' serves as an envelope curve of equilibrium points, representing the convergence of ownership shares allowed by supply-related institutions with those preferred by citizens. Innovation is more likely to occur in a private market system due to the incentives the latter creates. For instance, if the Chinese Communist Party allows private ownership of only 30% of the country's resources, the highest equilibrium China can achieve through innovation is point $E_1$ on the preference function $I_1$. In contrast, the EU and the USA, operating under social democracy and liberal democracy respectively, have societal constraints that better reflect the preferences of their citizens, potentially allowing them to reach higher equilibrium points $E_2$ and $E_3$ on the preference functions $I_2$ and $I_3$. As a result, the extent to which competitive markets can foster productivity and economic growth is influenced by the distribution of resource ownership between state and private interests. If the EU aims to enhance competitiveness, productivity, and growth to fulfill its global aspirations, European citizens must support a model of social democracy that promotes greater private ownership and less state ownership and management of productive resources. A shift towards lower state budgets is likely the most effective path to achieving favorable outcomes in this regard.

## 3. Innovation, competitiveness, and the socialism-liberalism tradeoff

Increasing the private share of resource ownership and management, relative to the state share, while holding other factors constant, would enhance competitiveness, productivity, and growth in the EU based on the inherent efficiency from profit maximizers over common good maximizers.

[15] Curve BB′ has been drawn to be homothetic to curve AA′ on the presumption that the innovation offers to the public and the private sectors equiproportional possibilities to expand their output supply per unit of labor employed. If this is not the case, curve BB′ might be of any shape, but our conclusions would not change.

In addition to this direct impact, the share shift has an indirect effect by promoting innovation. The objective of this section is to highlight the channels through which these results are likely to be achieved and to explain why the EU is at a deliberate disadvantage.

### 3.1 Market driven innovation

The Draghi report does not focus on the incentives created for business firms to innovate their products and productive facilities. The report ignores the critical role that consumers, firms, and institutions play in the innovation process, as well as entrepreneurship.[16] The market mechanism,

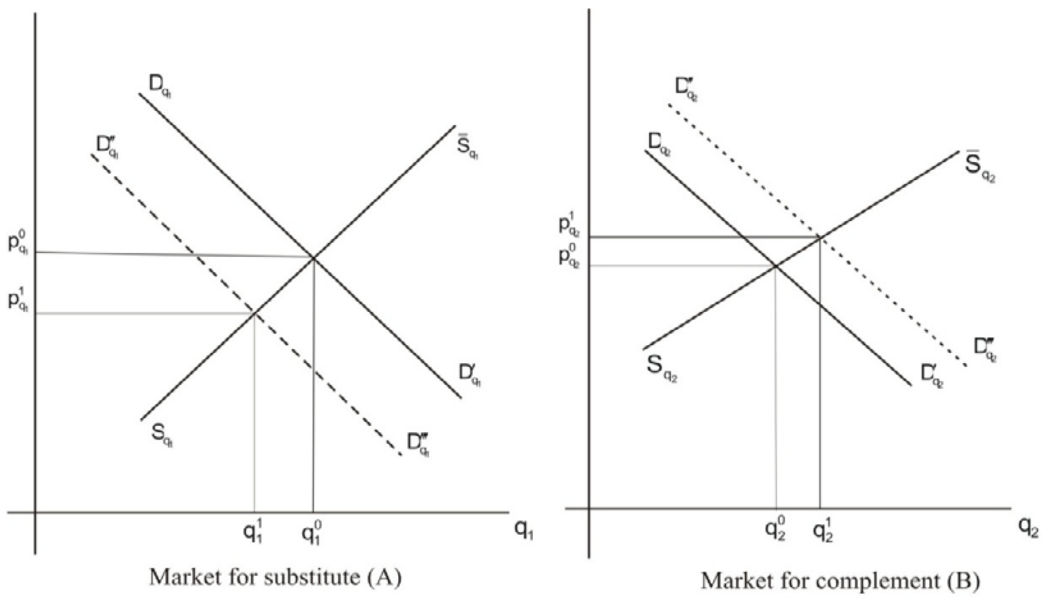



**Figure 2:** Two markets where a substitute and a complement to a given good are exchanged

which generates signals and arouses interest in firms to respond by undertaking innovative initiatives, is displayed in Figure 2. Launching an innovation is accompanied by surprise to other market participants and creates conditions of disequilibrium. Consider the sequence of expected events in the market for a substitute good $q_1$, and the market for a complementary good, $q_2$. Upon the introduction of the innovation, potential users will start to experiment with it. For some initial period, the suppliers of the substitute good $q_1$ will see their sales shrink, whereas the suppliers of the complementary good $q_2$ will be surprised by the improved demand for their good.

[16] The activities of entrepreneurs within modern enterprises are referred to in the literature as 'intrapreneurship'. For an excellent account of the difficulties involved in the implementation of intrapreneurship as well as the available approaches to dealing with them see Schollhammer (1982).

Given their uncertainty about the reception of the innovation, the suppliers of $q_1$ and $q_2$ will avoid action. But after the innovation takes hold in the market, the suppliers of $q_1$ will start responding to losses in market share by reducing prices from $p^0_{q_1}$ to $p^1_{q_1}$, whereas those of $q_2$ will respond by increasing prices from $p^0_{q_2}$ to $p^1_{q_2}$. Eventually, if the innovation proves commercially successful,[17] a new equilibrium will be established in which the sales of the two products shown in Figure 2 will be $q^1_1$ and $q^1_2$. This analysis points to two crucial links. The first of them has to do with the relationship of scale and scope economies to the production of innovations, and the second concerns the same relationship with the diffusion speed of innovations.

From the relevant literature, it is reasonable to infer that the first researcher to consider the relationship between firm scale or size and innovative activity was Schumpeter (1942). He hypothesised that innovations are promoted by two main factors: *large firms* and *imperfect competition*. Since then, both tenets of his hypothesis have been put to numerous empirical tests, and the evidence has shown consistently that markets characterized by imperfect competition are particularly conducive to innovation by large firms, whereas markets more closely resembling the competitive model are more conducive to innovation by small firms. These findings suggest that firm size is positively associated with the rate of innovative activity, not directly but indirectly through its influence on market structure. The central question that arose was to identify the ultimate forces that link firm size, market structure, and innovation.

Scherer (1980), among many others, suggested that scale economies in production may provide scope economies for Research and Development (R&D).[18] Tests of this hypothesis have led to the following findings. The capital intensity generated by economies of scale in production creates economies of scope in R&D. In turn, these economies of scope provide a barrier to small-firm innovation, thereby leading to market imperfections. Finally, by enhancing the profitability of large firms, market imperfections furnish the incentives and the resources for accelerating in-

[17] While the Draghi report refers to numerous sector proposals for innovation, it begs the question of who is demanding these changes. Industrial policy does not usually focus on consumer demand, but on who generates the innovation and production. Innovation is often a response to product demand, yet the demand for new products or incremental improvement for existing products is never considered. If these innovations are cost-beneficial for the producer, they will be engaged. If there is a desire for new products, consumers will provide signals through their purchasing behavior from companies that do business in the EU but not EU-headquartered.

[18] According to Scherer, “Research and development projects may benefit from scale economies realized in other parts of large firm’s operations’ (1980, 414)

novation. Simply put, *large firms are in a better position than small firms to exploit the gains from innovation in industries characterised by economies of scale and scope.*[19]

### 3.2 Effects of innovations and creative destruction

Schumpeter's core insight is that, while innovation benefits societies in the long run, in the short and medium term it produces certain effects that influence how receptive societies are to its acceptance. This, in turn, affects their readiness to embrace potential gains in competitiveness and economic growth. As mentioned earlier, one significant effect of innovation is the disequilibrium it creates in markets. Depending on its robustness and cumulative strength, innovation is known to contribute to the formation of business cycles that can be deep and prolonged. During the downward phase of these cycles, unemployment rises, business failures increase, government revenues slow down, and economic growth may decelerate. Both capital owners and workers experience negative impacts from these developments, and it is natural for them to appeal to the government for relief measures. This situation highlights a notable difference between social democracy in Europe and liberal democracy in the USA. Governments in Europe are more sensitive and more willing to intervene in and regulate the process than their American counterparts. Therefore, it is unsurprising that innovation, along with its beneficial effects on competitiveness, productivity, and long-term growth, tends to lag in Europe relative to the USA.

Another well-known implication of innovation is obsolescence. This refers to the process by which new products and production methods make existing ones outdated, less useful, or less effective. More technically, obsolescence can be defined as the loss of earning power, which results in a decrease in market value. This occurs when both capital and labor are replaced by new production equipment and updated labor skills, all in response to innovations. Economist Joseph Schumpeter described this process as “creative destruction” because it leads to the creation of new, valuable goods and services for society while ultimately sidelining older production facilities, labor skills, and even established ways of thinking and behaving. Therefore, on one hand, creative destruction reshapes markets by continuously replacing outdated firms, technologies, and business models with more productive options. On the other hand, it serves as an engine for

[19] The linkage regarding the diffusion speed of innovations is an integral part of the preceding analysis However, since its presentation would not add much to our discussion here, it is omitted and readers interested in this particular literature are advised to consult Bitros (2005).

**Table 4: Summary of main innovations effects**

| Effects | Innovations: |
|---|---|
| **1. Productivity growth** | • Raise output per worker by introducing better tools, processes, and organizational methods.<br>• Drives of long-run economic growth. |
| **2. New market creation** | • Give rise to entirely new industries (e.g., biotech, Artificial intelligence (AI), renewable energy).<br>• These industries often become engines of employment and investment.<br>• destroys some jobs but creates others—often more complex and better paid. |
| **3. Changes in market structure** | • Increase competition by lowering entry barriers<br>• Conversely, it can create temporary monopolies when a firm gains a technological edge. |
| **4. Changes in consumer behavior** | • Reshape preferences (e.g., smartphones changed how people communicate, shop, and socialize). |
| **5. Shifts in social norms** | • Remote work, digital identity, online communities are all products of technological change. |
| **6. Political and institutional** | • Force governments to get involved in employment policies, reeducation of workers, and inequality.<br>• Force governments to update laws (e.g., data privacy, AI governance, biotech ethics).<br>• Give nations that lead in key technologies (AI, semiconductors, energy) strategic leverage.<br>• Can improve government services (digital taxation, e-health, smart infrastructure). |
| **7. Environmental and resource implications** | • Often reduce resource use per unit of output (energy efficiency, recycling tech).<br>• Create new environmental challenges (e-waste, carbon emissions from data centers). |

long-term economic growth. This dynamic is central to the evolution of competitive markets, illustrating why no market structure remains static for long.

To summarize the extensive documentation on the mostly beneficial effects of innovations on the economy, institutions, and the environment, Table 4 highlights the areas that have attracted research interest. The available literature provides credible evidence for their significance. The table begins with the contributions of innovations to increasing productivity and long-term economic growth. As noted in the top right cell, the introduction of better tools, improved production processes, and enhanced organizational methods leads to an increase in output per worker, a reduction in unit labor cost, and greater competitiveness for businesses both domestically and internationally. Additionally, this progress results in the expansion of labor and capital employment, ultimately promoting economic growth over the long term. This sequence of events has been empirically and historically validated, leaving little doubt that the lag in innovative activity relative to the USA has caused the EU to lose ground in competitiveness and economic growth. Therefore, if citizens in the EU choose a more socialistic organizational structure for their nations, which may align with slower innovation relative to the more liberal USA, this approach is not inherently flawed, provided they also consider the potential consequences for Europe's defense and global ambitions.

Lastly, in the left-hand column, Table 4 reveals that innovations, among other factors, exert widespread effects on social norms, the structure of the political market, and a country's institutions. The breadth of the effects is briefly described in the right-hand column. From this, we can infer that practically every aspect of life is influenced, transforming citizen attitudes, which in turn determine the nature of successful innovations and the speed of their diffusion.

### 3.3 Western democracies from Schumpeter to Barber

The U.S. economy that Schumpeter observed when he introduced his theories of creative destruction was highly capitalist. During the New Deal era, public expenditure across all levels of government ranged from approximately 10% to 12% of GDP, with the federal share accounting for only about 2% to 3% of GDP prior to 1929. The private sector was predominantly large. Private markets were undoubtedly more competitive.[20] Economists with theoretical inclinations were actively analyzing market structures through the framework of the newly developed theories of monopolistic and oligopolistic competition. The Schools of Public Choice and Institutional Economics had not yet emerged, suggesting that Democracy was perceived to be working in the service of the common good; and indeed, governments at the time maintained a vigilant stance over business concentrations and intervened decisively when necessary.[21]

[20] The indices of business concentration in the USA indicate a consistent trend toward the increasing dominance of larger firms within the economy. This phenomenon has been observed over the course of a century. Prior to the 1970s, concentration was particularly pronounced in the manufacturing and mining sectors, where innovations led to economies of scale and scope. Following the 1970s, even without socially beneficial technological advancements, concentration expanded rapidly in the services, retail, and wholesale sectors.

[21] The core antitrust framework in the USA during the 1930s rested on four major federal statutes: the Sherman Act (1890), the Clayton Act (1914), the Federal Trade Commission Act (1914), and—new in that decade—the Robin-

Beginning in the 1940s, researchers in the fields of fiscal federalism and constitutional economics[22] noticed that elected officials at all levels of government acted as though they were not committed to serving the common good but rather were engaging in typical economic transactions. Drawing on a long intellectual tradition in political economy that began with Wicksell (1986) and culminated with Hayek (1960), Buchanan, Tullock (1962) established that politics operates as a form of exchange, where political actors behave similarly to economic actors, driven by incentives, self-interest, and constraints. Since that time, the changes democracy has undergone in the USA have been consistent with this proposition. Given that politicians' interests are often better served by a large state sector, this is precisely what has occurred. By 2023, general government expenditure in the USA had increased to 36.84% of GDP. Moreover, officials' election campaigns are largely funded by major private donors, and even the Supreme Court has relaxed regulations governing the financing of political parties by large corporations. In short, it seems that politicians and corporations in unison have pursued bigness in government and business as a strategy for promoting the USA interests in the world. Therefore, it is not surprising that the government's antitrust arm has taken a step back. Market concentration has increased, competition has diminished, and the ideal of democracy in the United States has transformed into a structure that Barber (2003, pp. xxxiii, ix-x) describes in the following way:

> The democratic deficit that was becoming apparent in the 1970s has become far more widespread, both within the United States and beyond its shores. The number of nominal democracies has continued to increase-which nation does not today affect to call itself a democratic regime?-but the number of nations in which democracy is seriously practiced remains restricted and cannot even be said with conviction to always include the United States.

Yet, perhaps because global power is at stake or because of limitations inherent in the federal system, politicians in the USA have not expanded the socialization of the economy to the extent that European countries have. This restraint helps explain why the USA is still classified as a liberal democracy.

Turning to the EU, let us examine the democratic deficit using abstention rates in national elections. Typically, the average abstention rate in Europe ranges from 20% to 30%. In contrast, ab-

son-Patman Act (1936). These laws defined the legal architecture for competition policy throughout the decade and shaped the aggressive enforcement wave under the Roosevelt administration.

[22] See Oates (1999) and Buchanan, Musgrave (1999).

stention rates in the USA are considerably higher: during recent presidential elections, approximately 35% of eligible citizens did not vote, while the abstention rate in midterm elections hovered around 45-50%. This discrepancy suggests that the democratic deficit is much larger in the USA than in Europe, raising the question of how we can explain this difference. We argue that, by adopting the political economy model described earlier, the U.S. government has lost control over a critical index: inequality in the distribution of income and wealth. Conversely, the governments of the EU, responsive to the will of their citizens, have managed inequality through the support by the states of extended welfare systems.[23] As noted earlier, social democracy may be a factor contributing to Europe's slower pace relative to the USA in innovation, productivity, and economic growth. Considering the attitudes of European citizens - shaped by years of conflict and social upheaval - the decision to sacrifice some competitiveness and economic growth to prevent the erosion of democracy through excessive inequality, or even out of preference for a slower way of life, may have been worthwhile trade-offs. However, currently, the security circumstances that enabled these arrangements have changed drastically, and the European model of political economy is due for a foundational change.

### 3.4 Sum-up: Innovation, economic outcomes, and the democratic deficit

Innovation, as a process of creative destruction, offers significant benefits for nations but also poses some key challenges. Driven by economies of scale and scope, innovation has transformed competition from one among many small and medium-sized firms to intense rivalry among a few large corporations. Due to their economic power, these firms can challenge the state's authority and secure concessions that governments would not have granted when antitrust policy was the first-best instrument for maintaining market order. As a result, the acceleration of innovation, coupled with the transactional nature of politics, has led to a widening array of democratic losses for citizens, often referred to in the literature as a “democratic deficit.”

In the USA, this deficit has become nearly unmanageable, primarily due to the alarming rise in income and wealth inequality. In contrast, the democratic deficit in the EU is somewhat contained, as governments across Europe have opted to finance and provide essential services beyond those typically included in standard welfare programs. However, this approach has disad-

[23] European welfare systems provide a broad package of protections designed to guarantee income security and access to essential services. They combine cash benefits (like pensions or unemployment support) with services (like healthcare, childcare, and eldercare), delivered mainly by public authorities across EU member states.

vantaged the EU in terms of innovation relative to the USA. Since public sectors in the EU are larger than those in the USA, innovation tends to be slower, which affects competitiveness, productivity, and economic growth. Simply put, the EU's model of political economy is by choice less conducive to rapid innovation, and hence by implication less prone to excessive inequality of income and wealth, which enlarges the democratic deficit.

So far, the EU has been able to maintain this arrangement mainly because the USA has significantly supported its security. However, as explained in the next section, this shield is weakening, thereby forcing Europe to bear the full costs of its own defense. As a result, the established European political economy model necessitates a fundamental restructuring that transcends the urgency of the EU to accelerate economic performance while striving to contain the democratic deficit.

## 4. Mitigating the gap in economic performance through deeper integration

As mentioned earlier, the EU and the USA differ in the perspectives of their citizens and leadership regarding their preferred position on the spectrum between socialism and liberalism. This fundamental difference has significant implications. Data show that the economic performance of the EU consistently lags that of the USA. To some extent, as we argued above, this gap can be attributed to these political-cultural preferences and choices, although it is somewhat offset by the EU's better

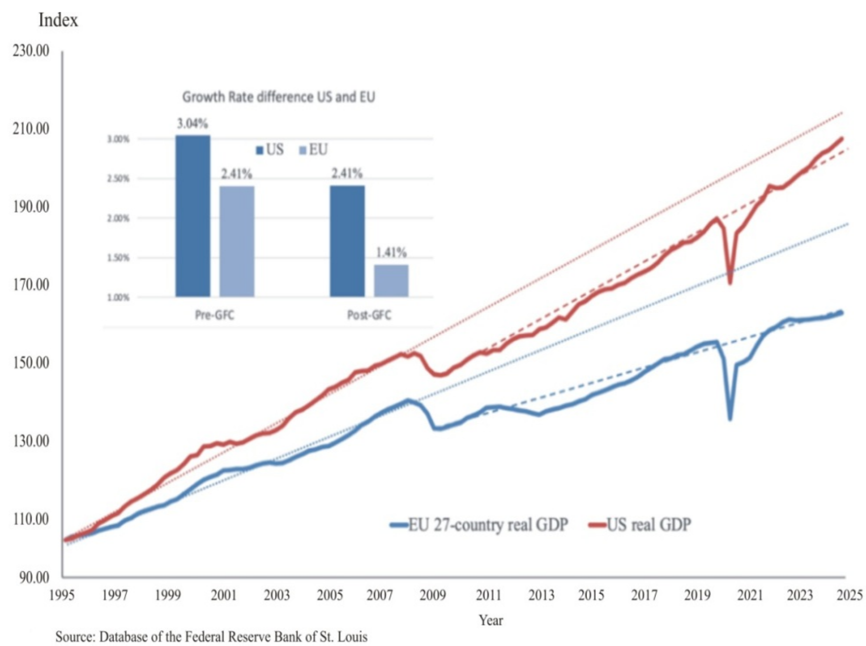



**Figure 3**: GDP differences between EU and the USA, 1995-2025

performance, as reflected in its lower democratic deficit. With this understanding in mind, we will proceed in this section to identify the key challenges facing the EU in its efforts not to close the gap, but to mitigate the differences in economic performance compared to the USA.

The gap in real GDP between the EU and the USA is not a recent phenomenon; it has long existed. What is particularly noteworthy is that, as Figure 3 shows, this gap has been widening over time.[24] The main reason for this development is that, compared to the USA, labor productivity in the EU has consistently lagged behind. Figure 4 highlights this asymmetry by comparing labor productivity in the USA with that of the EU-27 and the EU-19. It is evident that

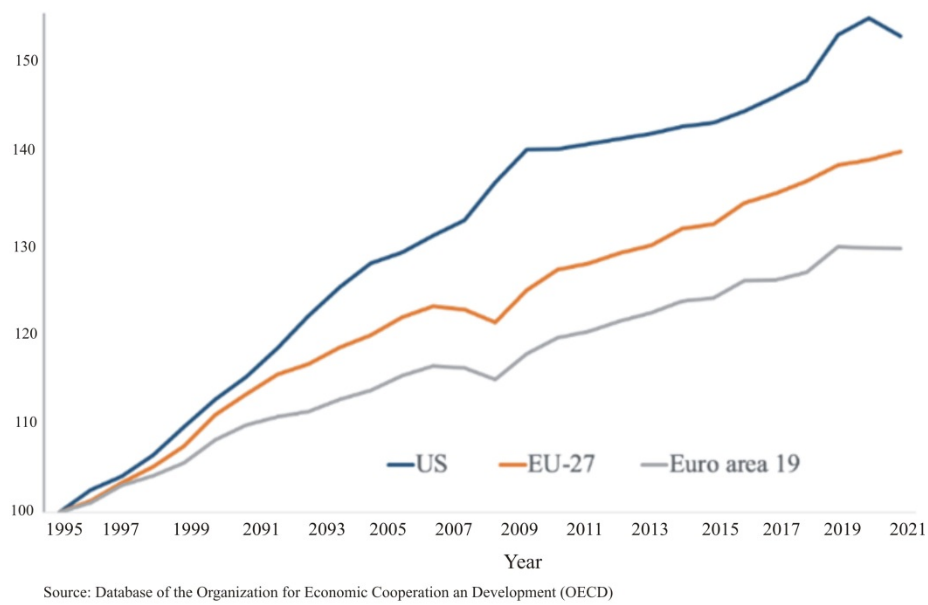
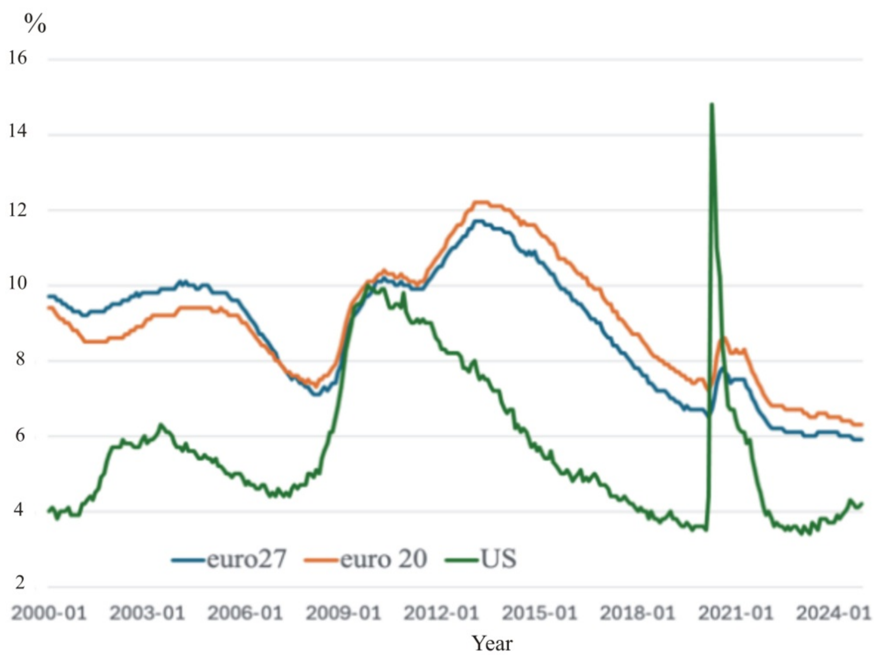



Figure 4: Productivity of labor for the USA, the EU-27, and the EU-19, 1995-2021

the gap is widening, particularly when we exclude eight Western European countries where labor productivity aligns more closely with that of the USA. Hence, to foster productivity and economic growth, it is essential that European authorities focus on enhancing labor productivity, with particular attention to member countries. Due to labor laws, labor union practices, and various other social, political, and institutional arrangements, their markets are fragmented and lack resilience, thus hindering competition and productivity at the EU level.

[24] The productivity gap has been widening for over 25 years with the shortfall between the EU and the US at approximately 40%. The shortfall in ICT investment, a poor innovation lifecycle, a limited pipeline of innovation from academic institutions, and insufficient scale of public Research and Innovation (R&I) spending are all contributors. Productivity is further hindered by fragmented financial markets that inhibit the efficient allocation of capital, and regulatory barriers that work especially against small firms and the tech sector.




Source: Database of the Federal Reserve Bank of St Louis

**Figure 5**: Differences in the unemployment rates

Another way to reiterate the importance of this diagnosis is to compare the unemployment rates. Table 5 compares data for the USA with those for the EU-27 and EU-20 for the period 2000-2024. When the comparison is made with the EU-20, which excludes Eastern European countries, the unemployment rate closely mirrors that of the USA. However, when these countries are included, the overall unemployment rate for the EU-27 decreases by several percentage points. This trend indicates a structural problem stemming from these countries' long history under communism. In this instance, it is also evident that, if competitiveness, productivity, and growth lag behind those of the USA, this may be attributed in part to the inherent asymmetries arising from the geopolitical considerations that have shaped the formation of the EU-27.

Combating fragmentation and enhancing market resilience are critical intermediate policy objectives that aim to promote competition, productivity, and growth across the EU. These objectives go beyond the unique circumstances of Eastern European and Balkan countries. Achieving them necessitates targeted policy initiatives, effective implementation mechanisms, and a strong commitment to accountability, as highlighted earlier regarding the Draghi Observatory and Implementation Index. However, due to the upheaval in geopolitical alliances, particularly in the last year, these challenges are secondary or have become part of the more urgent challenge for the EU to pursue deeper integration.

More specifically, the solution of deeper integration has emerged currently for the EU as an urgent priority because:

- The world is shifting toward great-power blocs. As a result, in the coming decades, international relations and trade will be dominated by the rivalry between the USA and China. Russia's will continue pursuing the geopolitical revisionism of recent years; and it is unclear whether India will manage to realize its world aspirations.
- As Carney (2026), Prime Minister of Canada, so eloquently described in this year's Davos Conference, medium-sized powers like France, Germany, Italy, and Spain — even combined — lack the strategic weight to act alone.[25]
- This development creates pressure for the EU to proceed to the next phase of deeper integration. By necessity, gradualism and unanimity must give way to a more effective political and economic organization, like some form of federalism.[26]
- Necessary for gaining scale are foundational reforms such as:
  - A fiscal Union with**:**
    - Shared borrowing, common budget, EU-level taxation.
  - A defense Union with:
    - Joint procurement, shared capabilities, integrated command structures.
  - A banking Union- (Already in place)
    - The single supervisory mechanism
    - The single resolution mechanism
    - European deposit insurance scheme
  - An industrial and technological Union with:
    - Coordinated industrial policy.
    - Common investment in AI, semiconductors, and green tech.
  - Institutional reform with**:**
    - Ending unanimity in foreign policy and taxation.
    - Strengthening the European Parliament's role.

[25] In the light of this realization, to us it appears very likely that the United Kingdom will change heart and seek again it return to the fold of the EU.

[26] We are pleased that Draghi (2025) himself last October recognized the need for the EU to initiate procedures for reforms in this direction,

In the past, when the EU had the luxury of time-consuming gradualism and unanimity, each of these challenges would constitute a different phase to be accomplished through protracted negotiations and haggling. This time is different because now the EU is being pushed toward deeper integration by external pressures.

The challenges facing the EU arising from this quantum transformation are well known. They include: a) Divergent national interests, as Eastern Europe prioritizes security and defense, Southern Europe emphasizes migration and fiscal flexibility, while Northern Europe focuses on fiscal discipline and rule-based governance; b) Concerns regarding democratic legitimacy, since citizens often perceive EU decisions as distant or overly technocratic. So, moving toward deeper integration without public support risks a significant backlash; and c) The dilemma of balancing enlargement with deeper integration. However, now is a suitable time to confront these challenges. The clear reason is that leaders in both large and small member countries must recognize that preserving the achievements of peace, liberty, and prosperity in Europe requires necessary compromises at the national level. This is essential for the EU to evolve into a superpower on par with the USA and China.

## 5. Summary of findings and conclusions

Draghi's report aimed to enable the EU to close its persistent economic performance gap with the USA. To achieve this, the report proposed nearly 400 reforms that, if adopted, were expected to significantly enhance EU competitiveness, productivity, and economic growth. We assessed the claims in the report and found them lacking in three main areas.

- The report overlooks the fact that European citizens, and by extension European leaders, have chosen a political economy model that leans more towards socialism than the liberalism found in the USA. As we documented, this choice, made to address the democratic deficit, entails substantial costs for productivity and economic growth.
- The political economy model chosen by the EU incurs these costs because it does not align well with the processes of innovation and creative destruction, which are accompanied by the advantages of economies of scale and scope.
- The EU's success has largely depended on the principles of 'gradualism' and 'unanimity' among member states, particularly in key treaty-changing decisions. However, these

principles now hinder the EU's ability to adapt swiftly to shifts in international relations and trade that have occurred with considerable force in the last year.

In view of these considerations, we conclude that the way forward for the EU is to pursue a form of “Federalism.” This would involve establishing European level unions in areas such as fiscal policy, defense policy, foreign policy, industrial innovation policy, and strengthening of the European Parliament, among other institutions.

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