Europe’s Pitch Book: Rethinking the productivity gap

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Europe's productivity gap with the US is real. So is the potential to narrow it. Stronger institutions, clear policy ambitions, frontier regions at the technological cutting edge, and the scope for further catch-up in Central and Eastern Europe all warrant a fresh look

In the long run, economic growth can only come from two sources: more hours worked or more output per hour worked. In other words, higher productivity. On that measure, Mario Draghi's report on European competitiveness delivered a stark warning: Europe is falling behind the United States.

The numbers are sobering. Using the report’s figures, productivity per hour worked was some 10% below the US level in 2000. Between then and 2019, labour productivity grew by roughly 0.7 percentage points a year in Europe compared with 1.2ppts in the US, widening the gap by around 0.5ppts each year. What's more, the divergence accelerated between 2018 and 2025, reaching an estimated 2.1ppts per year, with productivity growing by 2.4% in the US compared to just 0.3% in Europe.

These are disappointing numbers to be sure, but I see five reasons to view the glass as half full.

The productivity gap between Europe and the US is remarkably concentrated. The Draghi report notes that when the ICT sectors are stripped out, the annual growth gap for 2000-2019 falls to 0.2ppts from the above-mentioned 0.5ppts. Similarly, about 45% of US total factor productivity growth between 1988 and 2023 can be traced back to the IT sector. Analysis for 2018-2025 attributed just over a third of the recent gap to digital sectors.

In other words, much of the gap reflects US strength in the most productivity-enhancing sector of the past 25 years. That suggests that up to half of Europe's productivity gap is a digital challenge. Recent research shows that most of the remainder is explained by differences within industries. Many firms struggle to adopt new technologies, scale successful innovations and reorganise around new business models.

This points to two key priorities: strengthening digital capabilities and improving the adoption and diffusion of innovation.

Draghi clearly outlined the policy prescription in his report: Europe needs to lower barriers to cross-border services, pool public support for research and innovation at the European level, improve scale-up financing, and reduce regulation that hurts larger firms relative to smaller ones. It also needs to invest in education and skills and ensure that competition continues to push companies to innovate and improve.

Encouragingly, estimates suggest that the gains from policy reform could be much larger in Europe than in the US. A fragmented and suboptimal baseline also creates opportunities.

The key question now is whether Europe is capable of real change.

Weak productivity growth since the turn of the century is related to Europe’s institutions. The euro area entered the financial crisis with major design flaws. Several member states were forced into prolonged deleveraging as the banking sector and governments reinforced each other's weaknesses. Fiscal policy became pro-cyclical during parts of the sovereign debt crisis. But over the last 15 years, much has changed.

Europe has advanced towards a banking union with common supervision and resolution mechanisms. While the project remains incomplete, it has been transformative. Banks have cleaned up their balance sheets. Europe has set up a permanent crisis fund, the European Stability Mechanism (ESM). The European Central Bank committed to its role as the lender of last resort and developed new instruments such as the Transmission Protection Instrument, which contains the spillovers from market stress.

The aggressive interest-rate increases of 2022-23 provided a real-world stress test, and euro-area banks remained broadly resilient. Cross-border financial integration and private risk-sharing have strengthened in recent years, reducing the feedback loop between banks and governments.

Having learnt from the euro crisis, and standing on firmer institutional ground, politicians shifted their fiscal preferences. During the pandemic, Europe responded with rapid, substantial national support, bending its fiscal rules. The Next Generation EU recovery programme mobilised common financing at scale, and was later followed by joint borrowing for defence and Ukraine. This fiscal integration helped stabilise sovereign debt markets. Europe's new fiscal rules for member states are more growth-friendly, while the Commission also proposes a larger, more growth-orientated common budget. Germany has not only supported common financing, it has also made a U-turn on domestic fiscal policies, which are now supporting growth.

At just below 90%, government debt-to-GDP ratios in the eurozone (83% for the EU) are just below 2012 levels. This compares to a 20ppt increase in the US, where concerns around the central bank and government debt are building.

Europe has been moving in the right direction. Its institutions remain imperfect, but reforms that once seemed politically impossible are now part of the policy landscape. It is not only a better basis for growth, it should also give greater confidence that further change is achievable.

The analysis of Europe's productivity problem often focuses purely on the euro area, sometimes adding Denmark and Sweden. This misses one of the most important developments of the last three decades: the rapid catch-up of Central and Eastern Europe. Starting from a lower level, across the region, labour productivity grew strongly between 2000 and 2024, and more than doubled in Bulgaria, Poland and Romania.

Total labour productivity growth in purchasing power parity terms from 2000-2024

Draghi's headline charts do not take these countries into account. In a footnote, the report mentions that including them would have added 0.2 to 0.3ppts of annual productivity growth. On a measured annual growth gap of 0.5ppts, that halves the gap. The productivity performance of countries representing roughly 100 million Europeans deserves more than a footnote.

Looking forward, these regions retain enormous catch-up potential. We believe that capital deepening, the reallocation of workers towards high productivity sectors and the scaling up of firms can help close the 30% productivity gap per hour worked.

Catch-up, however, is only part of the geographical story. Europe is also home to regions at the productivity frontier.

Recent research shows that frontier regions such as Paris, Munich, Stockholm and parts of Ireland combine world-leading innovation ecosystems, deep talent pools, and concentrations of advanced services and corporate headquarters. Meanwhile, near-frontier regions including Lombardy, parts of Finland, Bavarian regions and western Poland offer strong industrial foundations alongside growing innovation capabilities.

EU regions with nominal labour productivity per hour worked in purchasing power terms at 55-65 euro (orange) and above 65 euro (maroon) in 2024.

For investors and corporates, these regions provide exposure to established, high-productivity ecosystems that are positioned to benefit from further innovation and productivity growth. Together with the catch-up potential elsewhere in Europe, they broaden the continent's investment appeal.

Let's now consider the extent to which productivity gaps really matter.

A final point has attracted considerable attention lately: productivity and welfare are related but are not the same thing. While American workers have become much more productive over recent decades, this has not translated into proportionately greater spending power than that enjoyed by European workers. Although American incomes have grown faster, the cost of many domestic services has also risen more quickly while Europeans have benefited from lower costs of imported US digital services. Consequently, the gap in what Europeans could buy with an hour's work, relative to Americans, has narrowed.

This helps to explain why 62% of Europeans believe they enjoy a better quality of life than the average American.

Responses to ‘In general, would you say that the quality of life in the EU is currently better or worse than in the US?’

This track record offers no guarantees for the future, not least because it was built in an era of open global trade and relatively stable geopolitics, which are now under strain. Nevertheless, it's a reminder that productivity is not the only measure that matters.

This series focuses on the glass half full. Yes, there is another half and Europe still has plenty of work to do. But the picture is not one of decline. Despite weak productivity growth, Europe continues to deliver a good quality of life. It has a clearer diagnosis of its challenges, a broad roadmap for addressing them, and stronger institutions than it did a decade ago. It offers opportunities at both ends of the spectrum: catch-up regions with room to converge and frontier regions operating at the forefront of innovation. From that perspective, Europe's productivity story can be read not as a catalogue of challenges, but as a source of opportunity.

Source: https://think.ing.com/opinions/europes-pitch-book-rethinking-the-productivity-gap/