



McKinsey Global Institute

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## Briefing note

### **Beyond austerity: A path to economic growth and renewal in Europe**

Economic growth remains fragile in many parts of Europe but there is little remaining scope to stimulate growth from public funds given high debt and deficit levels. And the threat to growth is unlikely to dissipate in the short or even the medium term as a potentially prolonged period of deleveraging coincides with pressure on growth from an ageing population. Adding more strain are significant imbalances in unit labour costs and current account balances in some parts of Europe.

Europe has made progress on reform, notably in labour markets. In the ten years prior to the global crisis, Europe's per capita GDP growth matched that of the United States as reform helped cut unemployment and boost labour market participation by 6 percentage points in 20 years. Europe created 24 million new jobs between 1995 and 2008, more than in the United States over the same period despite slower population growth. But Europe clearly needs to do more to regain momentum on growth. After decades of catch up, the region's productivity gap with the United States is widening again. To match historic rates of GDP growth, Europe needs to accelerate productivity growth by 25 per cent or decide to work more; to close Europe's \$4.5 trillion per capita GDP gap with the United States, productivity acceleration would have to be even more rapid.

#### **What's new?**

MGI sets out a comprehensive agenda for European structural reform on the basis of analysis of existing best practice within the region. The paper highlights effective recent examples of labour market reform and argues that priority should be placed on boosting participation by seniors and easing the transition of women from part-time to full-time work. The paper identifies the service sector, rather than high-tech industries most often discussed, as a key weakness. MGI draws on extensive on-the-ground work by McKinsey in key sectors to examine ways in which some European companies and governments are boosting service sectors or leveraging new growth and innovation opportunities that can be emulated.

Productivity in 2009 is 15 per cent lower in the EU-15 than in the United States.

Local services account for two-thirds of Europe's 1995–2005 productivity growth gap with the United States.

Europe ships twice as many exports as the United States to the BRICs (Brazil, Russia, India, and China).

### What business can do to help meet the growth challenge

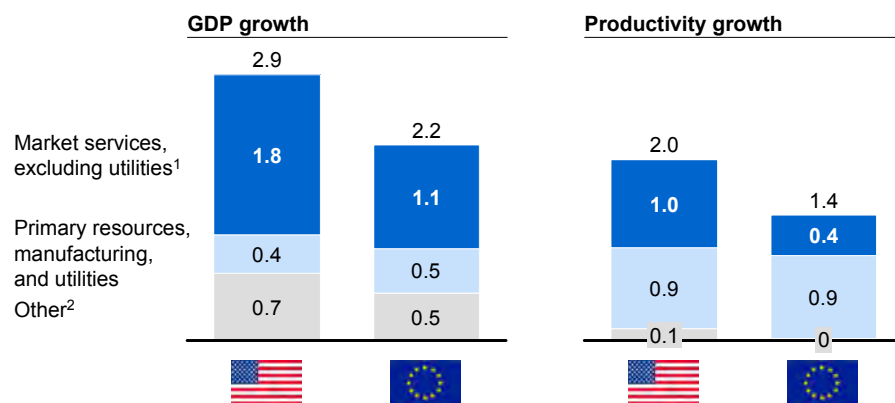
- Businesses can take away a sense of optimism. A series of reforms, all of which are well within Europe's reach, will enable the region to get back on a path to growth.
- On labour market reform, businesses can do a lot to enable more flexible working patterns for women and senior workers and to create special programs to get relatively unskilled young people into the workforce.
- In service sectors that still face constraints from regulation and monopolistic structures, executives should encourage governments to remove the remaining barriers to competition and embrace reform as the route to a more competitive rapidly growing economy.
- In advanced manufacturing and services sectors, business leaders need to look for ways to increase their own R&D effectiveness. Private sector R&D spending is lower in Europe than in the United States. Companies need to develop even closer links with universities and academics to fund research and then take that research to market. Businesses need to invest in the growth markets of emerging economies and in innovative areas in which Europe is already strong such as clean tech, biotech, and nanotech.

A major cause of the gap in both absolute productivity and productivity growth is Europe's relative weakness in service sectors (Exhibit 1).

### Exhibit 1

#### Services sectors are the source of the GDP and productivity growth gap between the EU-15 and the United States

Sector contribution to 1995–2005 GDP and productivity growth  
Compound annual growth rate, %



<sup>1</sup> Construction; transport; retail; wholesale; hotels and restaurants; professional and financial services; computer and related activities; research and development; legal; technical and advertising services; renting of machinery and equipment; other community; social and personal services; and private households with employed persons.

<sup>2</sup> Education, health and other public goods, real estate, and mix effect.

Note: Numbers may not sum due to rounding.

SOURCE: EU KLEMS; McKinsey Global Institute analysis

As in all high-income countries, service sectors have accounted for all of net job growth in Europe. However Europe's value added and productivity growth severely lags those in the United States. Local services including retail, wholesale, hotels and restaurants, private and other community services, and rental, alone accounted for five out of a total seven percentage points productivity growth difference with the United States. Reforms to stimulate service sectors across the broad range of European economies would boost economic growth and employment, and need to be a priority for economic policy makers.

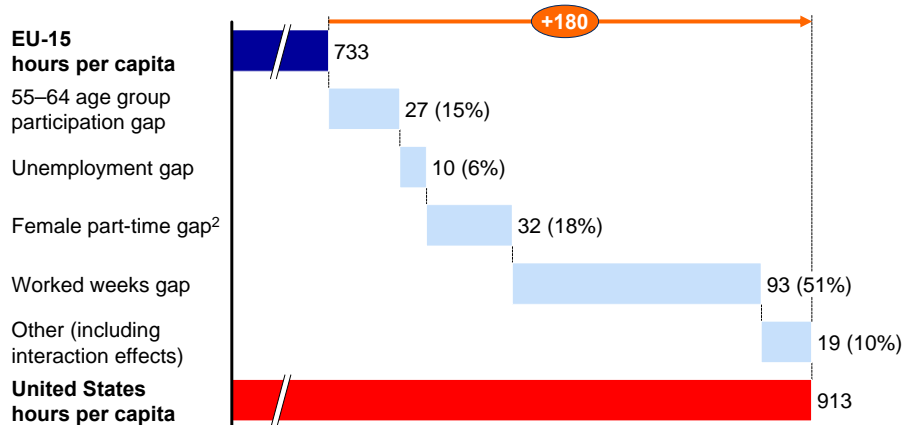
Another challenge for Europe remains its relatively inflexible labour market. Despite progress, senior participation stands at 51 per cent compared with 65 per cent in the United States; unemployment has averaged 2.5 percentage points higher; and a higher share of women, on average, tend to work part time, rather than full time. In addition, Europeans have made a settled societal choice in favour of more free time—absences from work due to longer vacations and other paid leave total five weeks more per year than in the United States (Exhibit 2).

**Exhibit 2**

**Europe's labour utilisation is much lower than in the United States**

ESTIMATES

Decomposition of hours worked per capita gap between the United States and the EU-15  
Annual hours per capita,<sup>1</sup> 2008



1 Standardised hours used for cross-country comparison. Official hours adjusted using the adjustment factors in OECD *Going for Growth*, 2008; using official hours, the gap would be around 60 hours smaller (overall and in terms of worked weeks).  
2 Assuming female part-time incidence aligned to US level and keeping current average weekly hours in part-time/full-time jobs.  
Note: Numbers may not sum due to rounding.  
SOURCE: OECD; Eurostat; McKinsey Global Institute analysis

Europe has sufficient competitive strengths on which to build to emerge from the current crisis on a path of higher and more sustainable growth. But Europe needs to undertake bold reform in three areas in parallel:

- Further reforming labour markets in four areas: (1) Boosting participation among older workers as spearheaded by Nordic countries as well as The Netherlands; (2) reducing structural unemployment through reforms as implemented in Denmark or the United Kingdom; (3) reducing unemployment among young workers through successful policies such as those implemented in The Netherlands; and (4) balancing the mix of part-time and full-time work for women as one way to increase the average number of hours worked.
- Unlocking the full growth potential of service sectors in four ways: (1) Further opening up competition in those service sectors that remain constrained by a high level of regulation (e.g., professional services) and monopolistic structures (e.g., network industries); (2) boosting productivity by continuing smart regulation of product, land, and labour markets, and supporting greater operational efficiency and professionalism incl. change of public procurement practices in sectors such as retail, land transport, or construction; (3) unlocking growth by setting the direction and providing crucial enablers like standards, education, infrastructure in, for instance, business services, tourism, and telecoms; and (4) ensuring European scale across national borders.
- Aligning policies to growth and renewal: Capturing opportunities in growth and innovation areas such as expanding emerging markets, cleantech, or longer-term technological innovation (e.g., biosciences and nanotechnology) by (1) re-prioritizing funds and allocating them in innovative and competitive ways to support R&D and innovation; (2) developing clusters; (3) improving the link between academia and business; and (4) developing a more entrepreneurial mindset.

If Europe boosted the participation of senior workers from the EU-15 average to Swedish best practice, overall participation would rise 6 per cent.

In 2005, local, business, professional and financial services contributed 29 per cent to GDP in the EU-15 compared with 38 per cent in the United States.

### Takeaways

- To sustain historical GDP growth levels, EU-15 needs to further reform labour markets, unlock the full growth potential of service sectors, and align policies to major global growth opportunities.
- In each of these areas, some European countries have already implemented best practices that have delivered success; effective reform will draw on these.
- The current crisis can be a major opportunity to tackle such reform.

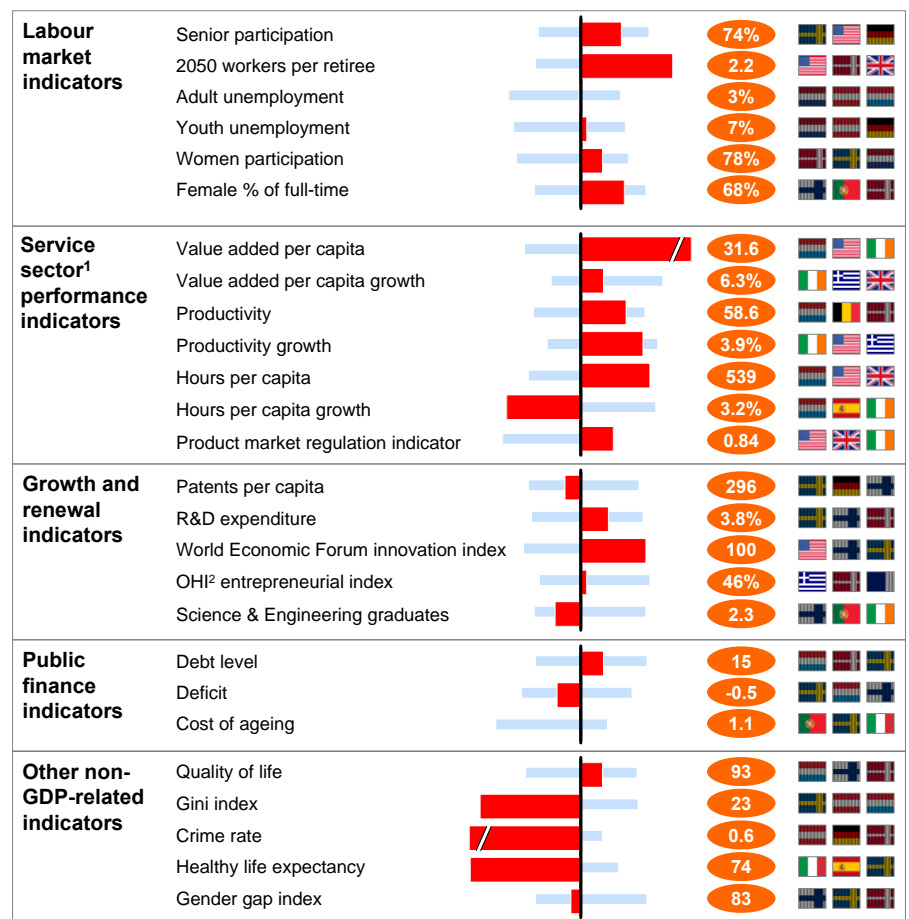
European service sectors have vast potential to increase their productivity and growth. Take food retail. If the EU-15 were to achieve the productivity levels of its top-quartile countries today—admittedly not an easy task in many countries—the region could achieve a 44 per cent boost in food retail productivity. This would translate into a 21 per cent increase in productivity in retail overall, or a 0.75 per cent increase in the value added generated by the European economy overall. In road freight, emulating best practice would boost the productivity of land transport by 50 per cent, adding 0.4 per cent of incremental GDP to Europe’s economy.

### Exhibit 3

#### For most indicators, EU member countries define the best practice

— EU-15 average    ■ United States  
■ EU-15 range    x Best practice

Best practice indicator values and top three performers



1 Local, business, and professional and financial services. Range and values indicated exclude Luxembourg due the small economy strongly skewed to financial services.  
2 Organizational Health Index.

SOURCE: Conference Board; OECD; Eurostat; EU-KLEMS; World Economic Forum; *Newsweek*; CIA; UNODC; IMF; European Commission; McKinsey Global Institute analysis