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ROME REDUX: NEW PRIORITIES FOR THE EUROPEAN UNION AT 60

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DISCUSSION PAPER



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CONTENTS

In brief

Introduction

Page 4

1. Six decades of economic and social progress

Page 5

2. Three global forces that will shape Europe's future

Page 13

3. Europe at an inflection point

Page 21

Annex: 60 years in numbers

Page 27

IN BRIEF

ROME REDUX: NEW PRIORITIES FOR THE EUROPEAN UNION AT 60

Sixty years after the heads of government of Belgium, France, Germany, Italy, Luxembourg, and the Netherlands signed the European Union's founding Treaty of Rome in March 1957, setting in motion an extended process of economic and political integration, the EU today is at an inflection point, facing long-term challenges and internal divergence and doubts highlighted by the 2016 British vote to leave the union. This discussion document takes stock of what the EU has achieved and highlights the global forces that it must address if it is to reinvent itself for future generations beyond managing the aftermath of the crisis.

- The European Union has been a force for economic prosperity and social progress since the signing of the Treaty of Rome, although its achievements over six decades have been partly obscured by sluggish GDP growth and signs of political malaise in the past decade. Economically, the EU accounts for about one fifth of global GDP. Its GDP per capita performed solidly when compared with the United States until the financial crisis in 2007–08. Labour productivity, which caught up and briefly overtook that of the United States in the 1990s, has fallen behind and stayed weak post-crisis. Despite elevated unemployment rates, the EU is closing the gap on the employment rate. The EU remains a world leader across a range of social indicators, from gender equality to the use of renewable energy, and the social welfare gap to the US is smaller than the gap in GDP per capita.
- The creation of the single market in 1986–1992 remains a singular achievement that broadened the existing customs union for free trade in goods to include free movement of people, services, and capital. An extended period of liberalisation of sectors including services followed, giving a boost to GDP that various studies have estimated in a range around 5 percent, or more than €650 billion annually. However, the single market remains

unfinished business, with continuing national barriers or uncoordinated and unharmonised policies in a number of key areas, including services, energy, capital markets, and digital.

- Among many forces that will challenge the European Union in coming years, three global ones will be critical. First, ageing will create an economic growth gap as the working-age population declines, putting the onus for future GDP growth on productivity, which is currently waning. Second, rapid advances in digitisation and automation will disrupt the European economy, expose it to new competition, and raise difficult questions about the future of work, even as they provide the potential to boost productivity and close the growth gap created by the demographic changes. Third, the EU faces increasing competition from emerging economy companies and digital multinationals, rising migration pressures, and a broader backlash against globalisation and global institutions as many citizens feel left behind.
- As it confronts these challenges, the EU is pulled between powerful forces of convergence and divergence, and must contend with its own unstable equilibrium of a single market and a common currency meeting mostly national decision structures. Citizens and government leaders face a range of options about how to proceed with their union. Whichever path they choose, success factors will include: the EU's ability to rekindle growth, ensure it is inclusive, and build on its assets through new investment; leverage its scale by continuing to fill in the gaps in its single market; innovate to prepare for a changing world of work, including through developing new types of skills; and engage more deeply with citizens and new constituencies to shore up its legitimacy. To win over an increasingly sceptical European public, the EU will also need to form a new narrative about its aims and relevance in a rapidly changing world.

Evolution of the European Union

Historical milestones of the European Union

1951

Treaty of Paris signed by Belgium, France, West Germany, Italy, Luxembourg, Netherlands, establishing the European Coal and Steel Community (ECSC)

1960

European Free Trade Association (EFTA) established

1950

1960

1970

1980

1990

2000

2010

1957

Treaty of Rome established the European Economic Community (EEC) and the European Atomic Energy Community (Euratom)

1965

The **Brussels Treaty** merging the executives of the three Communities (ECSC, EEC, Euratom) signed; entering into force in 1967

1979

First direct elections to the **European Parliament**

1992

Maastricht Treaty on the European Union signed, leading to creation of the euro, and the "pillar" structure of the European Union

2001

Treaty of Nice signed, reforming the EU institutional structure to allow for 2004 eastward expansion

1986

European Council in Luxembourg signed the **Single European Act** to establish a single market

1995

Schengen Agreement came into force

2002

Euro currency entered circulation

2007

Treaty of Lisbon signed which formed the constitutional basis of the EU

EU member state accession

1957

- Belgium
- France
- Germany
- Italy
- Luxembourg
- Netherlands

1973

- Denmark
- Ireland
- United Kingdom

1981

- Greece

1986

- Spain
- Portugal

1995

- Austria
- Finland
- Sweden

2004

- Czech Republic
- Estonia
- Hungary
- Latvia
- Lithuania

- Poland
- Slovakia
- Slovenia
- Cyprus
- Malta

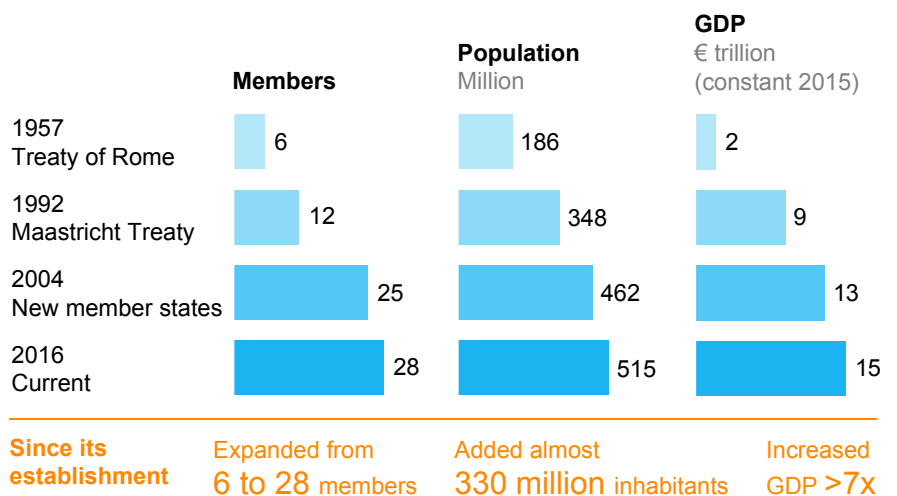
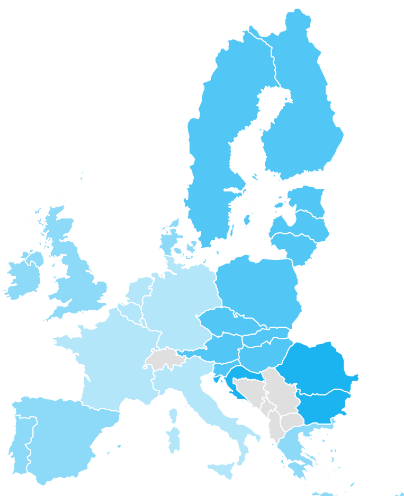
2007

- Bulgaria
- Romania

2013

- Croatia

Member states, inhabitants, and GDP



INTRODUCTION

Sixty years ago, on March 25, 1957, the heads of government of Belgium, France, Germany, Italy, Luxembourg, and the Netherlands met in the Palazzo dei Conservatori on the Capitoline Hill in Rome to sign the treaty establishing the European Economic Community, the forerunner of today's European Union (EU). The document was explicit about its objectives: the preamble announces that the treaty will “lay the foundations of an ever closer union among the peoples of Europe” and improve living and working conditions through “common action to eliminate the barriers which divide Europe.”¹

From six initial members, the union has since grown to 28 countries with a combined population of more than 500 million and GDP of €15 trillion.² That makes the EU the second-largest economic entity in the world after the United States, representing about one-fifth of global GDP.³ The customs union for the free circulation of goods that the accord set up now includes free movement of people, capital, and services. Living and working conditions have improved in ways the treaty signatories may not have imagined. The EU has also played an essential geopolitical role during its six decades, ensuring peace and stability among European neighbours who had spent previous centuries at war with one another, and helping shore up young democracies in countries including Greece, Portugal, and Spain, as well as in the 10 Eastern European nations that have joined since 2004.

Yet even for the most ardent advocates of European integration, the 60th anniversary of the treaty is a time of questioning and concern, not just celebration. The past decade has been an especially difficult and turbulent one, a time of weak economic growth as the global financial crisis gave way to a sovereign debt crisis, and of political fragility, as the EU's reputation, achievements, and ability to act have been called into question. The British vote in June 2016 to leave the EU has been the clearest manifestation of such doubts. To mark the anniversary, the European Commission released a white paper listing five possible paths for the future. They range from continuing along roughly the same path to a move to stronger integration.⁴

As it looks not just backwards but forwards, Europe will need to address the challenges posed by global forces, and in particular by three that will shape its future: demographic change, which threatens to weaken its economies; technological disruption in the form of increased digitisation and automation, which has major implications for both productivity and employment; and challenges to its competitive position in the world from emerging economies and rising divisions over issues such as global institutions, free trade, and open markets. All three forces amplify existential questions for Europe arising from internal divergence between and within countries economically, socially, and politically. What should the responses be?

This discussion document aims to provide a fact base and contribute to the ongoing debate about Europe, past, present, and future. Drawing on research by the McKinsey Global Institute, we take a 60-year perspective that highlights the EU's economic and social achievements as well as its key challenges. The first section is an examination of the EU's 60-year track record across economic and social dimensions. The second section focuses on the global forces that will shape its future. The third and final section reflects on the opposing forces of integration and divergence currently battling within the union and lays out

¹ The treaty's full text is available at http://ec.europa.eu/archives/emu_history/documents/treaties/rometreaty2.pdf.

² Real (constant 2015) GDP. Eurostat.

³ Nominal GDP 2016. IMF data.

⁴ *White paper on the future of Europe: Reflections and scenarios for the EU27 by 2025*, European Commission, March 2017. Other official documents to mark the anniversary include *The European story: 60 years of shared progress*, European Political Strategy Centre, March 2017, and the dedicated website *60 years of the Rome treaties*, https://europa.eu/european-union/eu60_en.

a number of solution spaces for the EU as it seeks to regain its dynamism and cohesion in a fast-changing world.

We welcome feedback. This document is part of an ongoing series of MGI publications and other initiatives on the future of Europe, including a June 2015 report on the EU's economic prospects, and a 2016 essay prize on European reform (see box, "MGI research on Europe"). A follow-up paper examining European business attitudes to Europe will be published later this year.

1. SIX DECADES OF ECONOMIC AND SOCIAL PROGRESS

A 60-year perspective shows how far Europe has come since the Treaty of Rome in terms of its economic and social development, notwithstanding the sluggish growth and political malaise of the past decade which can sometimes obscure its achievements over six decades. Comparisons with the United States show the progress made in terms of growth, productivity, and employment rate, as well as continuing gaps and challenges. The EU's single market has been a major driver of integration, but remains unfinished business, with more work to be done in a range of domains including energy and digital.

THE EU HAS BEEN A FORCE FOR ECONOMIC GROWTH AND SOCIAL ADVANCEMENT FOR MOST OF THE PAST 60 YEARS

The growth in the EU's GDP per capita has performed solidly when compared with the United States, at least until recently. Europe's GDP per capita growth was especially buoyant from the Treaty of Rome until 1982. It lost some edge and underperformed in the late 1980s and 1990s but picked up again relative to the United States until the 2007–08 financial crisis. However, the sovereign debt crisis in 2012–13 threw Europe into a double-dip recession that the United States managed to avoid (Exhibit 1). In the period from 2007

MGI research on Europe

MGI reports on Europe over the past 25 years have reiterated several imperatives—ensuring competitive intensity, strengthening innovation, raising skills, and improving the fluidity of labour markets to increase employment. Our most recent report, *A window of opportunity for Europe*, was published in June 2015. It found that Europe could close its output gap, return to a sustained growth rate of 2 to 3 percent over the coming decade, unleash investment of €250 billion to €550 billion a year, and create more than 20 million new jobs. This would have a cumulative effect greater than the entire current size of the United Kingdom's economy by 2025 compared with a slow-reform, slow-growth scenario.

To achieve this goal would take a combination of structural reforms, about 75 percent of which would be made at the national level, in lockstep with measures to stimulate demand at the European level. Three areas of reform—investing for the future, boosting productivity,

and mobilising the workforce—could help deliver on European aspirations.

As part of the report, we conducted a survey of 16,000 Europeans in eight countries. It showed a clear majority willing to make significant trade-offs for growth and higher incomes.

We followed up the report by launching an "Opportunity for Europe" essay prize in the course of 2016. We felt there was a need for fresh thinking about how pro-growth reforms could be implemented, and that crowdsourcing solutions would be a way to stimulate it. Submissions included ideas such as finding ways to compensate "losers" of reform efforts in order to facilitate change, writing off European sovereign debt to unblock new investment, and putting in place a comprehensive industrial cluster strategy that would leverage European strength in a range of sectors.¹

¹ *A window of opportunity for Europe*, McKinsey Global Institute, June 2015. MGI reports and winning entries for the essay contest are available at www.mckinsey.com/mgi/overview.

to 2016, the EU's GDP per capita grew at half the rate of the United States, at 0.3 percent compared with 0.6 percent.⁵

Exhibit 1

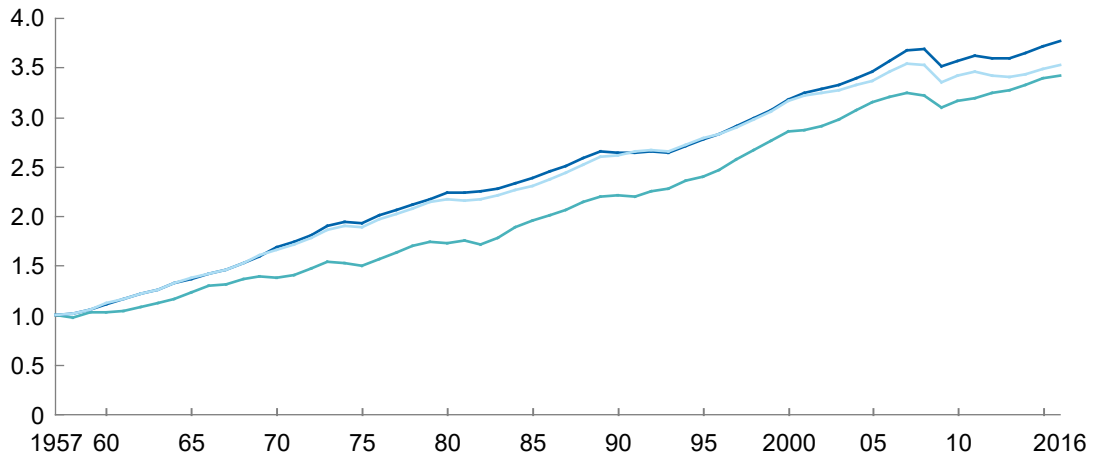
Europe's economy, in per capita terms, performed solidly compared with the United States until Europe's double-dip recession after 2008

GDP per capita, purchasing power parity-adjusted¹

United States EU-28 EU-15

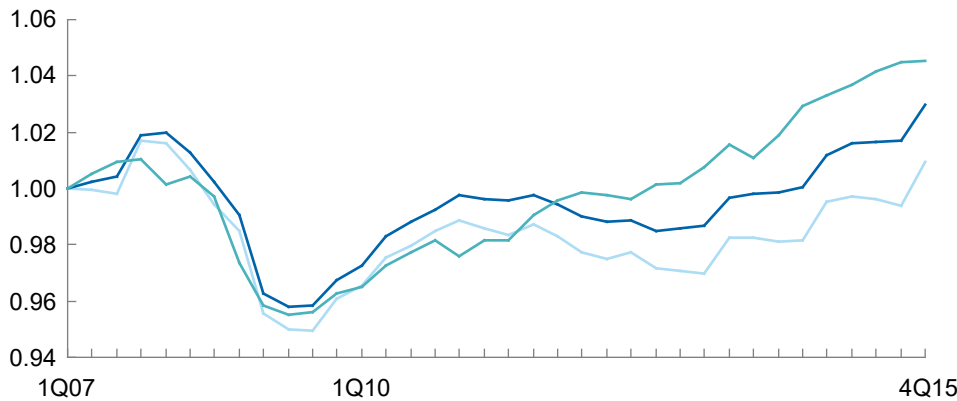
1957–2016

Index: 1.0 = 1957



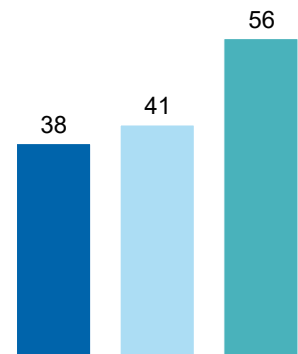
1Q07–4Q15

Index: 1.00 = 1Q07



2016

\$ thousand



¹ Annual EKS GDP data from The Conference Board, converted to 2015 price level in US dollars using 2011 EKS purchasing power parity (PPP); European countries' per capita GDP weighted with respective year population.

SOURCE: The Conference Board; Eurostat; McKinsey Global Institute analysis

Social welfare provides a more compelling indicator of the success of the European Union, which has been a powerful engine for strong social progress over the past six decades. Viewed on a welfare basis, for example, the gap between the United States and the EU is narrower for various indicators of welfare than it is for GDP; two US economists have calculated that the EU's welfare gap with the United States is the equivalent of 5.2 years, whereas the gap in GDP per capita is more than double, at 14.8 years.⁶ Gender equality in society is among the highest in the world in the European Union, although it can further improve in the workplace; the EU ranks particularly strongly on issues of legal protection

⁵ In the period between 1999 and 2007, the EU GDP per capita growth average of 2.34 percent was slightly lower than US per capita GDP growth of 2.55 percent.

⁶ See Charles I. Jones and Peter J. Klenow, "Beyond GDP? Welfare across countries and time", *American Economic Review*, volume 106, number 9, September 2016.

and the political voice of women.⁷ The EU as a whole scores strongly across a range of social indicators, from the quality of health care and education, to environmental protection, public safety, social protection and work-life balance. For example, it is a global leader in the transition to renewable energy, with more than 13 percent of its electricity coming from wind, solar, and geothermal sources.⁸ The United Nations Human Development Index measurement for the EU in 2014 was just 4 percent below that of the United States, although the economic gap is about 30 percent.⁹ Within that overall picture there is considerable variation among countries; Nordic member states and continental European countries tend to perform better than Southern Europe or the Eastern Europe nations that have joined the EU since 2004.

In a number of ways, the EU has brought people across Europe together; the 1996 Schengen agreement eliminated border controls and was a major step towards greater mobility and ease of travel. Since its establishment in 1987, the Erasmus programme has given nine million people the chance to study, train, volunteer, or gain professional experience abroad.¹⁰

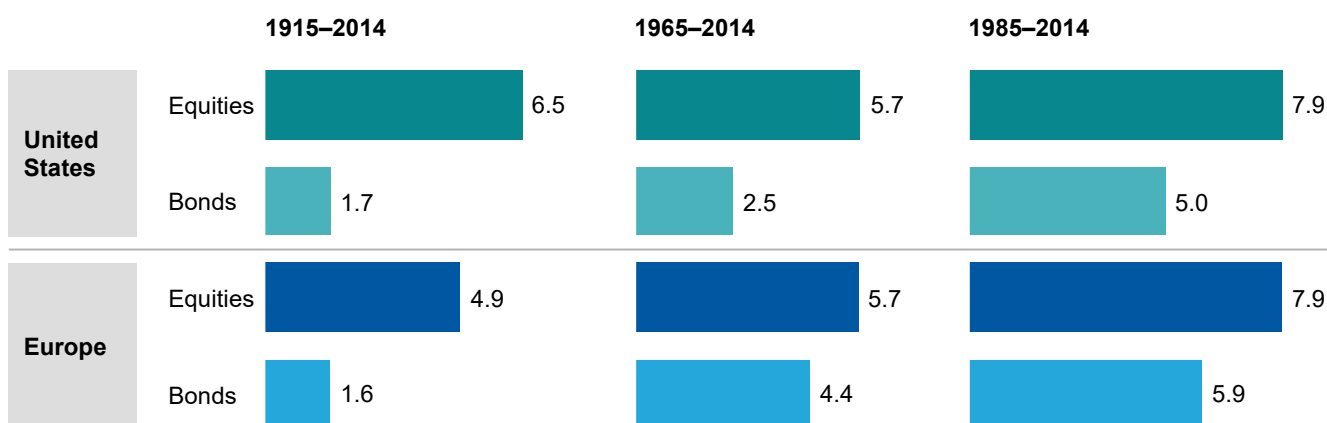
From an investor perspective, while the United States has the largest and most liquid capital markets in the world, Western European bonds have posted higher total inflation-adjusted returns in the past half century than US bonds (4.4 percent vs. 2.5 percent), while the return on Western European and US stocks has been similar, around 5.7 percent (Exhibit 2).¹¹

Exhibit 2

European bonds have outperformed US bonds over the past 50 years, while stock returns have been similar

Total real returns

%; based on 3-year average index at start and end year (range refers to start-of-year to end-of-year)



SOURCE: Dimson-Marsh-Staunton Global returns database; Maddison-Project database, 2013 version; Prof. Damodaran database, NYU Stern School of Business, The Conference Board, McKinsey Global Institute analysis

The past decade has cast a pall over the EU's economic track record, however. Recovery from the 2008 global recession was considerably slower than in the United States. Investment has not recovered to pre-crisis levels; while there has been some pick-up since

⁷ *The power of parity: How advancing women's equality can add \$12 trillion to global growth*, McKinsey Global Institute, September 2015.

⁸ Enerdata 2017.

⁹ UN Human Development Index, 2015.

¹⁰ *The European story: 60 years of shared progress*, European Political Strategy Centre, March 2017.

¹¹ Total real returns for Western European bonds averaged 4.4 percent annually in 1965-2014 compared with 2.5 percent for US bonds. Returns averaged 5.7 percent for both US and European stocks. See *Diminishing returns: Why investors may need to lower their expectations*, McKinsey Global Institute, May 2016.

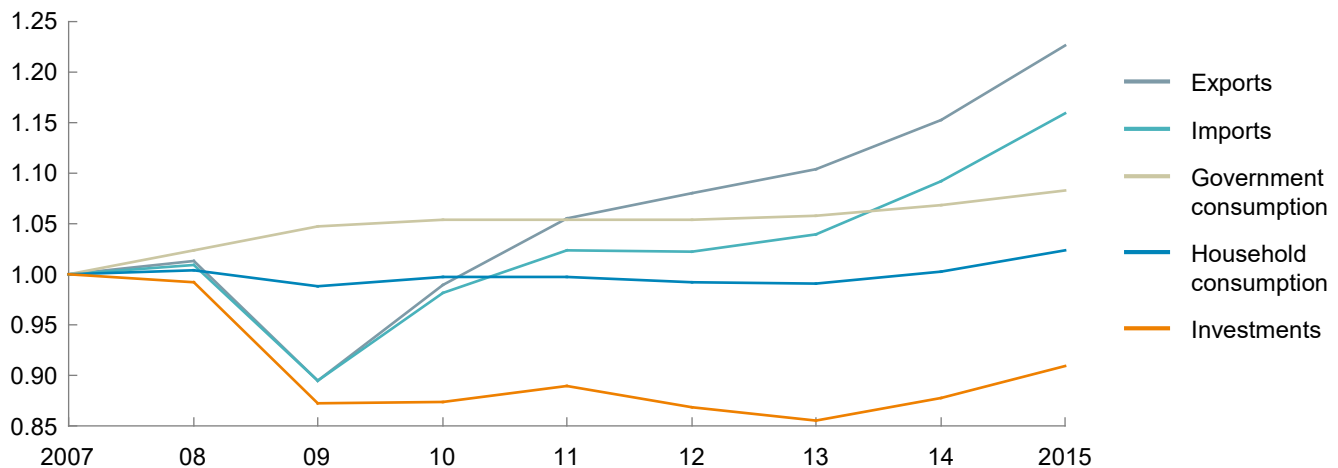
2014, it is still far below its historic trend (Exhibit 3). In 2015, public investment was €34 billion below 2008 levels in real terms following austerity policies, while household investment was down €118 billion following the collapse of the real estate bubble, and corporate investment was down €109 billion. European companies did not take full advantage of historic low interest rates to raise investment, even though the returns on invested capital, which had dropped post-crisis, rose back to almost pre-crisis levels and all time highs.¹²

Exhibit 3

Real investment is the only component of EU GDP that has not returned to pre-crisis levels

Components of GDP for EU-28

Index: 1.00 = 2007



NOTE: Household consumption: all goods and services purchased by households, Government consumption: all goods and services purchased by the state, local and federal government, Investments: investments in fixed capital, for example dwellings, machinery and equipment, other structures, Exports: Goods and services sold to other countries, Imports: Goods and services bought from other countries.

SOURCE: Eurostat; McKinsey Global Institute analysis

Debt as a percentage of GDP peaked in 2014 at 262 percent, but deleveraging has not yet started.¹³ Southern European economies still face significantly high levels of bad loans: in Greece, more than one-third of total gross loans in 2015 were non-performing, while in Italy the ratio was almost 18 percent. In the EU overall, the proportion of non-performing loans, at 5.6 percent of total gross loans, is more than three times the proportion in the United States or Japan.¹⁴

Some of the imbalances that were at the centre of the Eurozone crisis have been partially corrected. Unit labour costs, which rose sharply in a number of periphery countries including Spain and Greece after the 1999 introduction of the euro, have reconverged. Current account balances have also reconverged after similarly diverging following the birth of the single currency, now used in 19 of the 28 member states (Exhibit 4). However, unit labour costs in Greece today are still 30 percent higher than they were in 2000.

Growth has finally picked up in the EU in the past two years, bolstered by the fall in the value of the euro against the dollar, lower energy prices, and to some extent the European Central Bank's monetary easing. The Eurozone's GDP grew at 2.2 percent in 2015, almost back to

¹² For details, see *A window of opportunity for Europe*, McKinsey Global Institute, June 2015, and *Secular stagnation and low investment: Breaking the vicious cycle*, McKinsey Global Institute, April 2016.

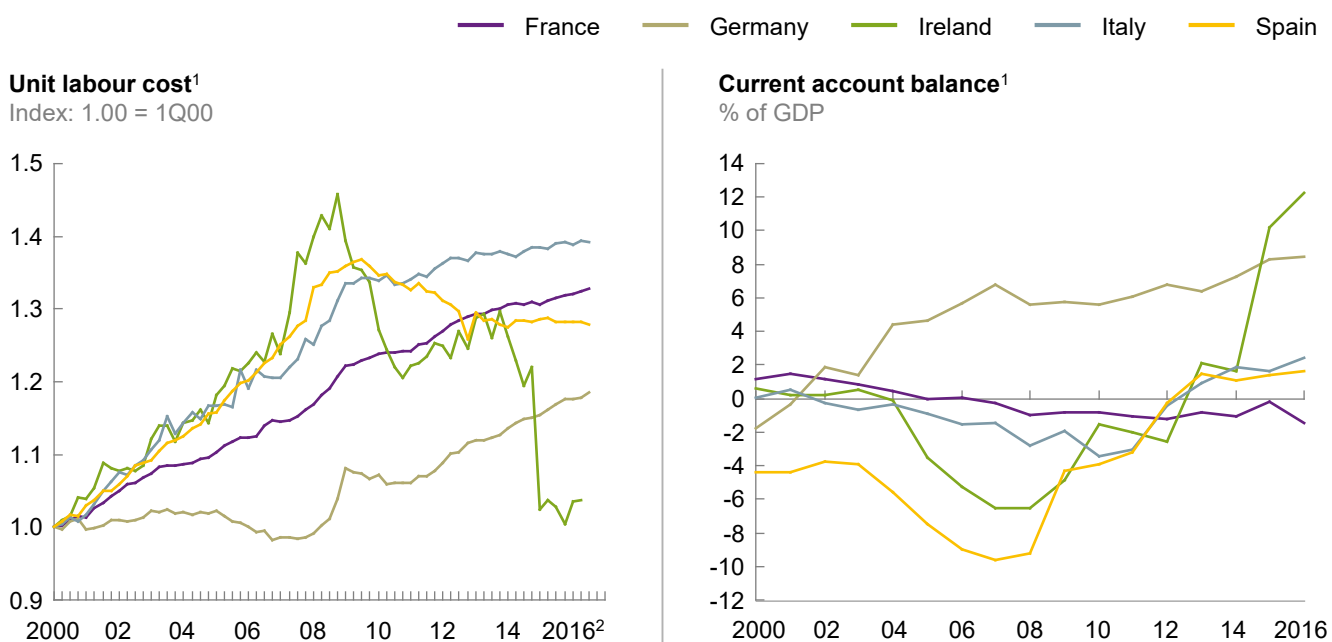
¹³ OECD. These figures exclude financial sector debt. See also, *Debt and (not much) deleveraging*, McKinsey Global Institute, February 2015.

¹⁴ Data for 2015. *World Development Indicators*, World Bank; *Global financial stability report*, International Monetary Fund.

the average pre-crisis level, and is estimated to have grown at about 1.7 percent in 2016, compared with 2 percent between 2000 and 2007.¹⁵ The crisis has also spurred reform efforts at the EU and national levels that may otherwise have taken longer to implement, if they had been agreed to in the first place. For example, the EU has taken a range of decisions to improve its management of sovereign debt, including the Fiscal Compact and the establishment of the European Stability Mechanism.

Exhibit 4

Though unit labour costs and current account balances diverged after the introduction of the Euro, they have recovered and begun to converge



1 Data up to 3Q16.
2 Ireland data up to 2Q16.

SOURCE: Eurostat; OECD; McKinsey Global Institute analysis

EUROPE'S LABOUR PRODUCTIVITY PERFORMANCE, FOR YEARS STRONGER THAN THAT OF THE UNITED STATES, HAS FALTERED AND FALLEN BACK

Europe's labour productivity grew strongly in the 1950s, '60s, and '70s, catching up and overtaking that of the United States. The initial Treaty of Rome countries overtook the United States in the late 1970s. By the early 1990s, the entire EU, then comprising 15 nations, was ahead. The trend subsequently turned when US productivity, particularly in services, accelerated from the late 1990s, leaving Europe behind (Exhibit 5).¹⁶

Since the 2007–08 financial crisis, labour productivity growth has been similarly weak on both sides of the Atlantic, depressing prosperity advances and stirring a debate as to whether advanced economies more generally are in a phase of "secular stagnation."¹⁷

Public-sector productivity in this context becomes ever more critical. One feature of the European economy is its relatively high level of public spending, which has risen to almost 59 percent of GDP in Finland and 57 percent in France. Across all EU countries, public

¹⁵ Eurostat. For 2016, data for the fourth quarter is an estimate.

¹⁶ Ali M. Kutan and Taner M. Yigit, "European integration, productivity growth and real convergence", *European Economic Review*, January 2007.

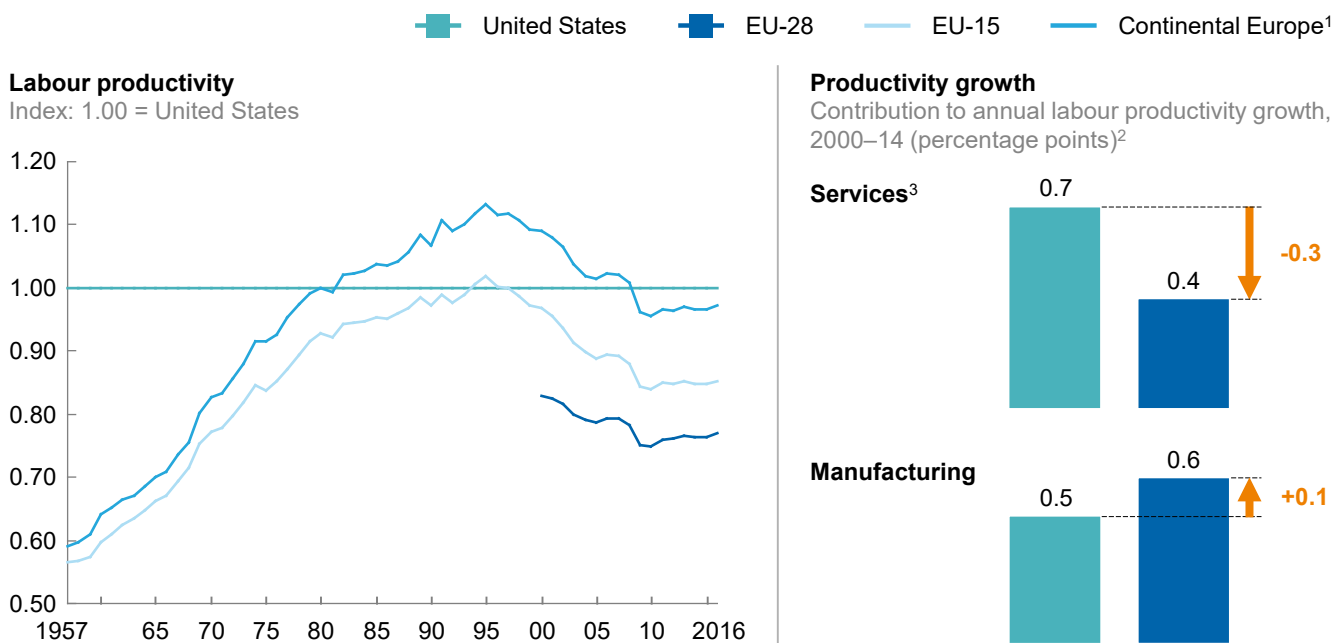
¹⁷ Lawrence H. Summers, "The age of secular stagnation: What it is and what to do about it", *Foreign Affairs*, March/April 2016; *Secular stagnation and low investment: Breaking the vicious cycle*, McKinsey Global Institute, April 2016.

spending exceeds 48 percent of GDP, ten percentage points higher than the 38 percent in the United States.¹⁸ This spending has driven the social progress already cited, but how well is the money spent?

In some sectors including health care, Europeans appear to spend less per capita while getting similar or better outcomes. In other areas including education, however, by some indicators, outcomes are not commensurate with the level of spending, and incremental improvements do not match the level of investment. In education, the results of Programme for International Student Assessment tests—which gauge the performance of 15-year-old pupils in mathematics, reading comprehension, and science—show that pupils in many European countries including Germany, France, and the United Kingdom perform only at the average level, behind Asian countries including Korea and Singapore.¹⁹ Some European countries, notably Estonia and Finland, do perform well on PISA tests, although the Finns have slipped in recent years.²⁰ EU governments spend between 2.4 percent (Hungary) and 4.9 percent (Denmark) of GDP on primary to non-tertiary education.²¹ Our research suggests that in health and education more broadly, unit costs have generally risen by around 20 percent in real terms in the past decade, while health and education outcomes have improved only marginally, if at all.²²

Exhibit 5

Europe's labour productivity caught up with and in some cases overtook that of the United States in the early 1990s, but then fell back due to a weaker performance in services



- 1 Austria, Belgium, France, Germany, Luxembourg, and the Netherlands.
 2 2001–14 for EU.
 3 Excludes public services, real estate (other than construction), and utilities.

SOURCE: The Conference Board; McKinsey Global Institute analysis

¹⁸ Eurostat; OECD, 2015.

¹⁹ See Hubert Ertl, "Educational standards and the changing discourse on education: the reception and consequences of the PISA study in Germany", *Oxford Review of Education*, volume 32, 2006; Michael Dobbins, "French education politics after PISA and Bologna—rupture or continuité?" in Kerstin Martens, Philipp Knodel, and Michael Windzio, eds., *Internationalization of education policy, A new constellation of statehood in education? Transformations of the state series*, Palgrave Macmillan, 2014.

²⁰ *Programme for international student assessment*, OECD.

²¹ OECD.

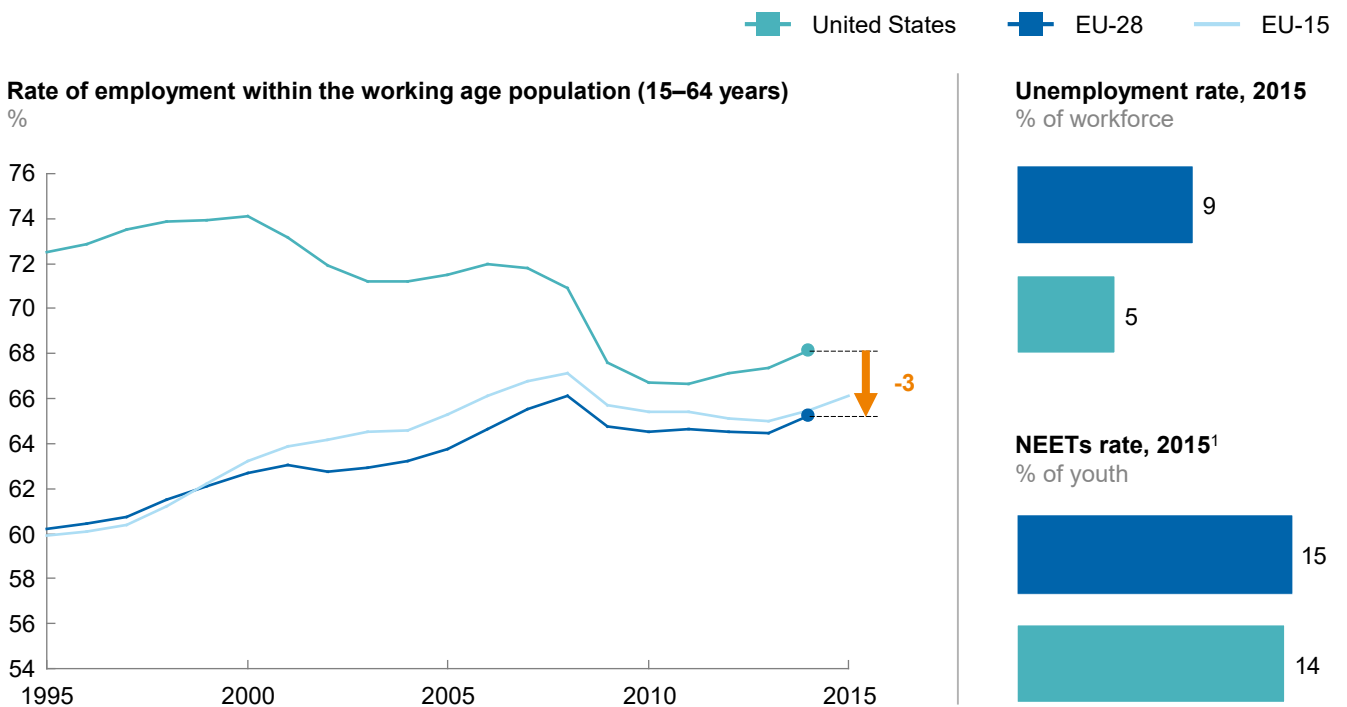
²² Indicators we use to assess education outcomes include PISA scores, education employment premium, education income premium, teaching quality, and graduation rates over the past five years. Forthcoming research on government productivity by McKinsey Center for Government.

THE EU'S EMPLOYMENT RATE HAS INCREASED STEADILY SINCE THE 1990S, BUT UNEMPLOYMENT REMAINS HIGH IN SOME MEMBER STATES

Unemployment has been a significant focus of political attention in many European Union nations since the 1980s, and by international comparison it remains elevated; only recently has it drifted below 10 percent for the EU overall. However, the employment rate—the proportion of the working-age population who are working—tells a different story: employment increased steadily from the early 1990s until the financial crisis as female and senior participation rose, almost closing the gap with the United States. During the crisis, the US employment rate fell more sharply (5.1 percentage points decline from the 2007 peak to 2011 trough) than it did in the EU. For the 28 EU nations, the decline was 1.65 percentage points (from the EU 2008 peak to 2013 trough), while for the 15 members excluding Eastern Europe over the same period it was 2.1 percentage points (Exhibit 6).²³

Exhibit 6

Although the EU's employment rate has increased since the 1990s, nearly closing the gap with the United States, an unemployment challenge remains



1 NEETs = Young people 15–29 not in education, employment, or training.

SOURCE: OECD ; Eurostat; McKinsey Global Institute analysis

The overall employment data for the European Union masks what are, in fact, sizeable disparities among its member states. While countries such as Austria, Denmark, Germany, and the Netherlands have high labour participation and relatively low unemployment rates, other member states including Belgium, France, Spain, and Greece have low participation and relatively high unemployment.

Since the crisis, much of the public and media focus has been on youth unemployment rates, which have soared to nearly 45 percent in southern Europe and to almost 21 percent in central and Eastern Europe. In the EU as a whole, youth unemployment in 2015 was 20 percent, a 4.4 percentage point increase since 2007. Taking into account other factors, including young people in education or training, the proportion of Europeans between the

²³ OECD employment rate 2007–16.

ages of 15 and 29 who are not gainfully employed or in vocational or tertiary education is on average about the same as in the United States. Nonetheless, given the advent of a new technological age that will likely reshape the workforce, the question of whether young people are acquiring the skills they will need for their future is more topical than ever.

EUROPE'S SINGLE MARKET, A CROWNING ACHIEVEMENT OF ECONOMIC INTEGRATION, REMAINS UNFINISHED

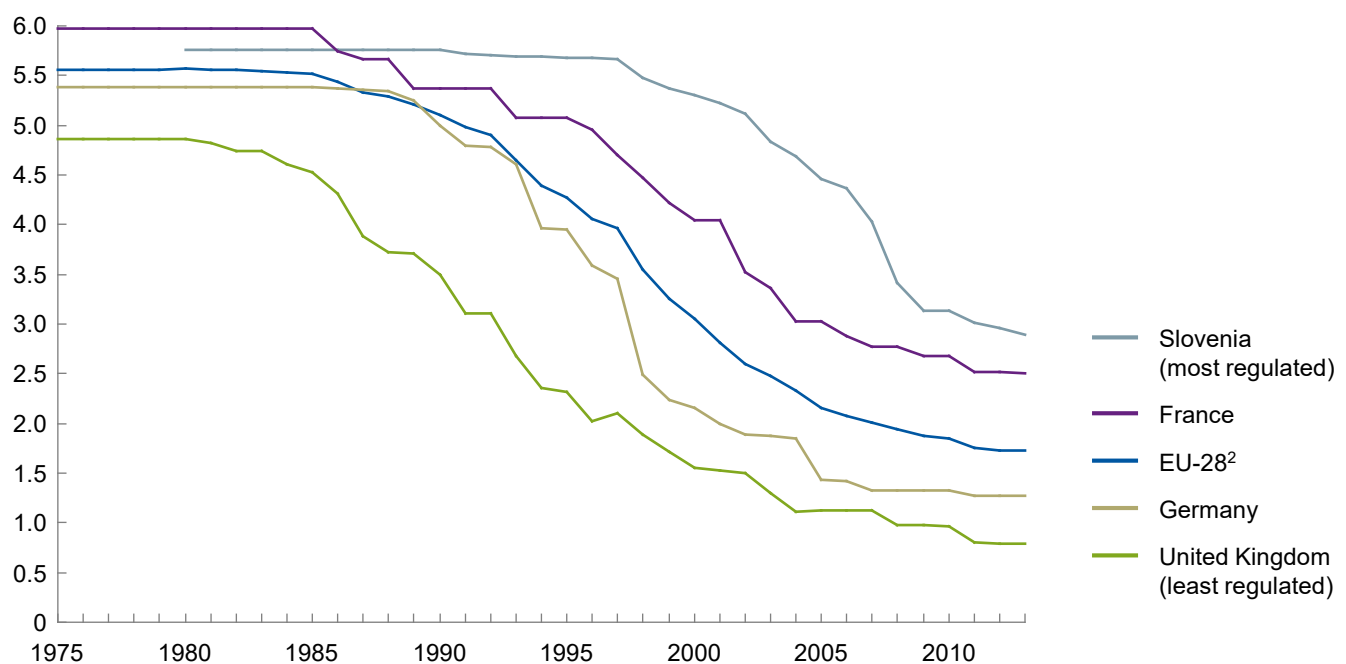
Among the milestones of the past 60 years, the creation of the single market in 1986–92 stands out as a singular achievement. The founding Treaty of Rome had established a customs union for free trade in goods, allowing them to cross borders without tariffs, but the Common Market, as it was widely known, increasingly came under criticism for being bureaucratic and overregulated. With the single market programme implemented by then EU Commission president Jacques Delors, the EU put a new emphasis on free movement of people, services, and capital. The programme ushered in an extended period of liberalisation of network industries and services, and contributed to the interconnectedness of the EU and the ability of individual member states to leverage the large internal market (Exhibit 7).

Exhibit 7

Europe has broadly liberalized network industries and services, although progress remains uneven

OECD product market regulation index

Network industry aggregate (0 = least regulated; 6 = most regulated)¹



¹ Aggregate of OECD Product Market Regulation indices of following sectors: Airlines, Telecoms, Electricity, Gas, Post, Rail, Road.

² GDP-weighted average. Due to the absence of historical data on product-market regulation, excludes Bulgaria, Croatia, Cyprus, Latvia, Lithuania, Malta, and Romania before 2013.

SOURCE: *Indicators of product market regulation*, OECD; McKinsey Global Institute analysis

The effect has been felt by European citizens and businesses. For individuals, the cost of making and receiving a mobile call abroad is 73 percent lower today than in 2005.²⁴ Many professional qualifications are now recognized across the union, and about 3 percent of European citizens live in an EU country other than their own.²⁵ European businesses have

²⁴ *The European story*, European Political Strategy Centre, 2017.

²⁵ 2010–11, currently living abroad.

benefited from the customs union, which has greatly facilitated cross-border business, reducing time and expenses. Heavy-duty freight vehicles make about 80 million road crossings within the Schengen area annually, and the European Parliament has estimated that even a 30-minute delay at the border would cost countries between 17 million and €95 million annually for imported goods, demonstrating the benefits of open borders.²⁶ Businesses also benefit from EU harmonisation aiming to provide a clear and predictable legal framework. Chemical companies are governed by EU-wide standards on registering and controlling chemical substances, for example, while simplified value-added tax rules introduced in 2010 enable small businesses to pay VAT in their home country rather than in countries where they sell. Toys, construction equipment, and a host of other products are also subject to EU-wide norms and standards.²⁷

Various attempts have been made to estimate the economic benefits of the single market. A 2014 report from the European Parliament estimated that GDP across all EU members could increase by an additional 5.00 to 8.63 percent, or between about €650 billion and €1.1 trillion.²⁸ However, the single market remains unfinished business. Full harmonisation has yet to take place across a range of sectors and policy areas, including energy and capital markets, and considerable incremental efficiencies and savings could still be achieved. For example, the European Parliament estimates that achieving a full digital single market could unlock €415 billion per year, while completing the free movement of services could deliver €338 billion per year and consolidated EU-level e-procurement could add €100 billion per year to GDP.²⁹ An independent body of experts advising the Commission since 2007 has estimated that compliance with national taxation and customs rules cost €87 billion in 2014.³⁰

2. THREE GLOBAL FORCES THAT WILL SHAPE EUROPE'S FUTURE

Economic recovery after the 2007–2008 financial crisis and the subsequent Eurozone sovereign debt crisis is finally gaining momentum, but key challenges remain. Over the longer term, the European Union will need to address and adapt to an array of global forces that will shape its future, three of which will be especially critical: demographic change, the rise of digitisation and automation, and challenges to its competitiveness from emerging economies and internal divisions.

A SHRINKING WORKING-AGE POPULATION IS PUTTING PRESSURE ON GROWTH AND PUBLIC FINANCES

Demographic changes including lower fertility and ageing pose a considerable challenge to future economic growth and public finances across the world, from Brazil to China, and especially in European Union economies. A “demographic dividend” helping to fuel global growth in the past half century has come to an end, and the working-age population is starting to decline in many countries, including in Germany and Italy, where the fertility rate has dropped sharply.³¹ This is creating an economic growth gap that needs to be filled by rising productivity if living standards are to be maintained. At historical productivity-growth rates, long-term GDP growth would be 40 percent slower than its rate over the

²⁶ Costs by country; unloaded goods only. *Cost of non-Schengen: the impact of border controls within Schengen on the single market*, European Parliament, 2016.

²⁷ For further details see the European Commission website on harmonised standards, https://ec.europa.eu/growth/single-market/european-standards/harmonised-standards_en.

²⁸ Zsolt Pataki, *The cost of non-Europe in the single market*, European Parliamentary Research Service, September 2014.

²⁹ *Ibid.*

³⁰ *Reducing costs and barriers for businesses in the single market*, DG for Internal Policies, European Parliament, 2016.

³¹ *Global growth: Can productivity save the day in an aging world?* McKinsey Global Institute, January 2015.

past 50 years. Yet productivity growth in the European Union has been weakening. The ageing population also can create political tensions, and some studies suggest that older generations are more likely to vote conservatively.³²

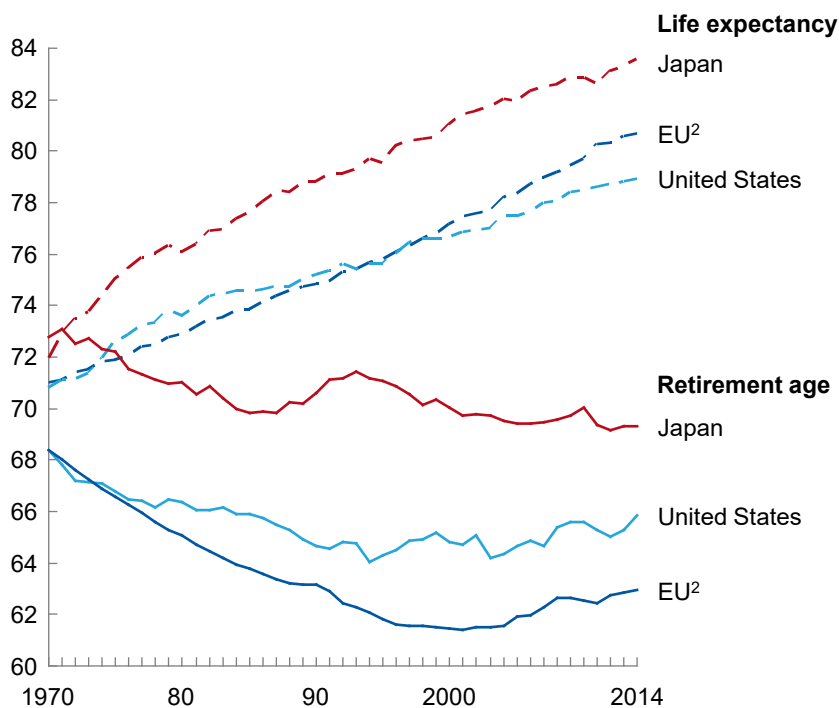
Government policy in many European countries risks exacerbating the effect of ageing. If maintained, policies such as low retirement ages will put an increasing burden on public finance and growth (Exhibit 8). Life expectancy has increased by more than nine years since 1970, but, over the same period, the male average effective retirement age has fallen by six years.³³

Exhibit 8

EU seniors are living longer and working less, which is driving up senior dependency on the working population

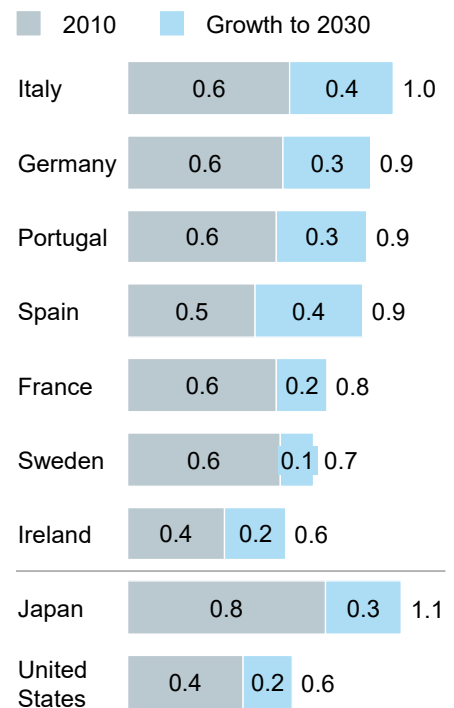
Effective retirement age and life expectancy¹

Age (years)



Senior dependency rates (55 years+)³

Ratio of dependent seniors to prime age population



1 Average effective male retirement age and total average life expectancy at birth.
 2 Not including Croatia, due to absence of historical data.
 3 Senior dependency rate is calculated as population above 55 years old divided by prime-age population (15-54 years old).

SOURCE: United Nations Population Database; OECD; McKinsey Global Institute analysis

However, some European countries are successfully dealing with these demographic challenges. For example, the United Kingdom has phased out a default retirement age, allowing people to work as long as they want. Germany has a jobs training programme that provides training and communications skills for people over 50, alongside internships and job counselling. Spain has raised its retirement age from 65 to 67 years.

Beyond such efforts to keep people in work longer, European Union members will need to look at other measures that can raise productivity or otherwise counteract the

³² See Ronald F. Inglehart and Pippa Norris, *Trump, Brexit, and the rise of populism: Economic have-nots and cultural backlash*, John F. Kennedy School of Government, Harvard University, faculty research working paper 16-026, August 2016.
³³ *A window of opportunity for Europe*, McKinsey Global Institute, June 2015.

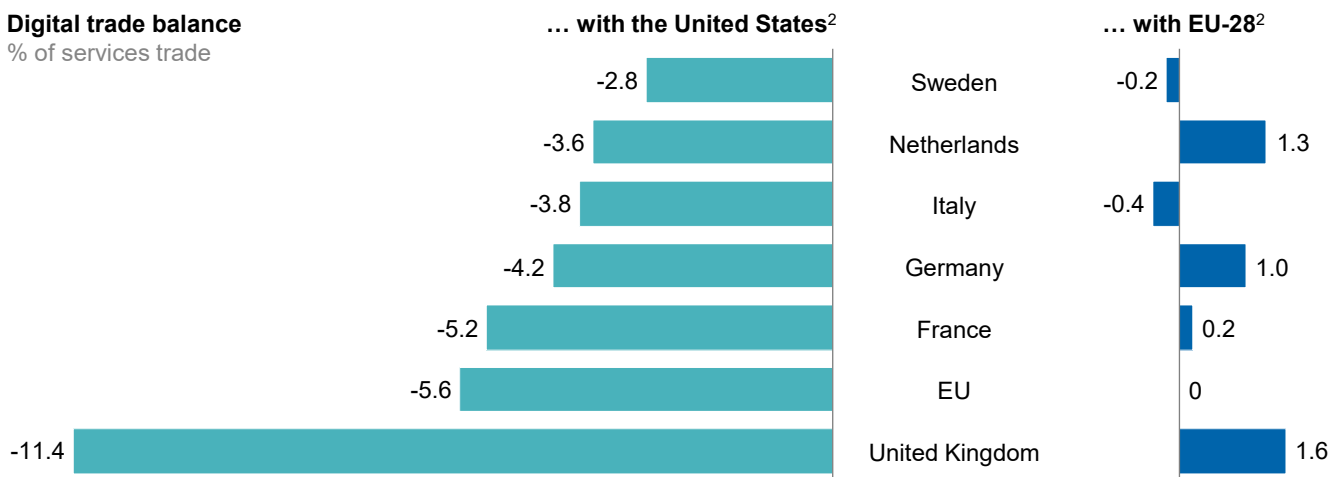
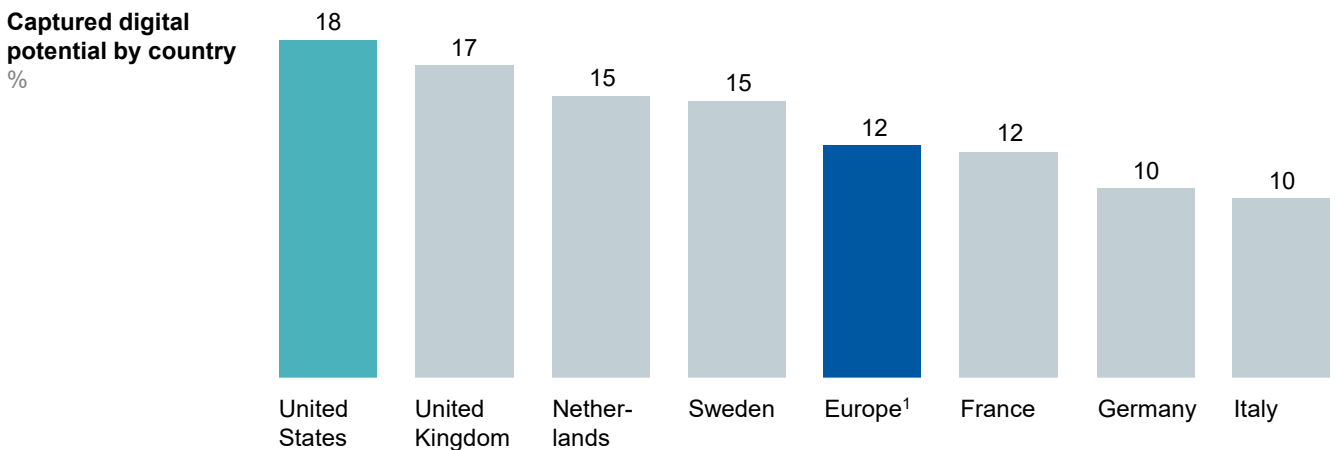
growth-dampening effects of ageing and demographic change. Opening the doors wider to migration is one possibility, although a politically controversial one. Raising female participation in the workforce is another. While Europe has a relatively good track record for female participation, it lags behind the United States and more can be done to bring women into the workforce and assure a gender-equal workplace. For example, only 30 percent of European women say their company's evaluation system is gender neutral.³⁴

RAPID TECHNOLOGICAL ADVANCES WILL DISRUPT THE EUROPEAN ECONOMY AND RAISE COMPLEX QUESTIONS ABOUT THE FUTURE OF WORK

Europe has strengths in manufacturing and some services, but in terms of digitisation it still has considerable ground to make up. MGI research has estimated that Europe overall is realising only 12 percent of its digital potential, compared with 18 percent in the United States (Exhibit 9).

Exhibit 9

Most European countries have not captured the full value of the digital economy, and rely on US digital imports



1 Europe is the weighted average of the six countries shown here. These six countries make up 60% of the population, and 72% of GDP, in the EU-28 grouping.

2 Trade within digital economy—examples include digital services commerce platforms; content services; and software services.

SOURCE: Eurostat; OECD; International Trade Centre; European Commission Joint Research Centre; CSIMarket; McKinsey Global Institute analysis

³⁴ *The power of parity: How advancing women's equality can add \$12 trillion to global growth*, McKinsey Global Institute, September 2015.

Companies with advanced digital capabilities in their assets, operations, and workforce outperform in terms of growth in revenue and market shares. They improve their profit margins three times faster than the average and, more often than not, have been the fastest innovators and the disrupters in their sectors and in some cases beyond them. These are the digital leaders operating on the digital frontier.³⁵

For now European nations rely heavily on digital imports from the United States and have not created global technology companies to rival titans such as Amazon, Google, Facebook—or China’s Alibaba. However, despite funding limitations, Europe does have pockets of digital strength, including the rise of “deep tech” companies engaged in cutting edge activities such as artificial intelligence (AI), virtual reality, and robotics. Some 950 deep tech startups were founded in Europe between 2014 and mid-2016, almost doubling the number founded since 2011–2013. That compares with 1,250 founded in the United States, where the number also doubled.³⁶ Some of the most vibrant European AI and data companies are being acquired by US firms.

The next technological frontier—automation of knowledge work—is rapidly approaching, and it will have significant implications for European economic growth and the future of work. Recent advances in robotics, machine learning, and AI are pushing the frontier of what machines are capable of doing in all facets of business and the economy. About 46 percent of the work activities currently carried out in the European Union’s five largest economies have the potential to be automated by adapting currently demonstrated technologies. That amounts to about 60 million full-time equivalents and \$1.9 trillion in wages.³⁷

That does not mean 60 million jobs will be replaced by robots anytime soon; in fact, our research shows that less than 5 percent of occupations could be fully automated by adapting currently demonstrated technologies. However, a large number could be partially automated; we estimate that about 60 percent of occupations have at least 30 percent of activities that are automatable (Exhibit 10).

European business and government leaders have strong incentives to embrace these automation technologies and become early adopters of them. Relatively high wage levels in Europe will make the business case for automation more compelling for companies. The performance benefits from automation go far beyond labour substitution; they include the potential to increase throughput and scale, reduce errors, and improve quality and safety. A second major incentive for Europe to become an early adopter of automation is related to the demographic trends we discussed in the previous section, which will put pressure on future economic growth. MGI has estimated that automation could give a productivity boost to the global economy amounting to between 0.8 percent and 1.4 percent of GDP annually. This would be enough to ensure that most European Union nations maintain their current GDP per capita growth rates. Implementing other productivity-enhancing measures could raise per capita GDP growth beyond current levels.³⁸ To reap the benefits, however, Europe will need to undertake significant catch-up efforts more broadly in technology, since delays in connectivity, big data use, and artificial intelligence can compound one another.³⁹ Moreover, Asian countries are fast becoming key players for global data flows, even as some European countries, especially smaller ones including Belgium and in Scandinavia, are losing their international relevance.⁴⁰

³⁵ *Digital America: A tale of the haves and the have-mores*, McKinsey Global Institute, December 2015. See also, *Digital Europe: Pushing the frontier, capturing the benefits*, McKinsey Global Institute, June 2016.

³⁶ *The state of European tech*, Slush and Atomico, November 2016.

³⁷ *A future that works: Automation, employment, and productivity*, McKinsey Global Institute, January 2017.

³⁸ *Ibid.*

³⁹ For a detailed discussion of interconnectivity and flows, see Jacques Bughin and Susan Lund, “The ascendancy of international data flows”, *Vox*, January 9, 2017.

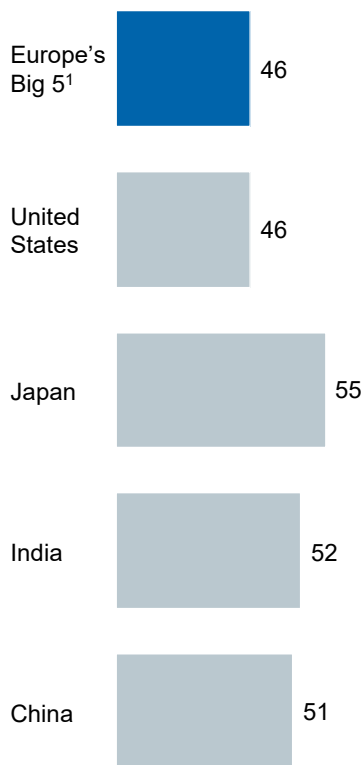
⁴⁰ *Ibid.*

Exhibit 10

Almost half the workplace activities in Europe could be automated by adapting currently demonstrated technologies

Technical automation potential

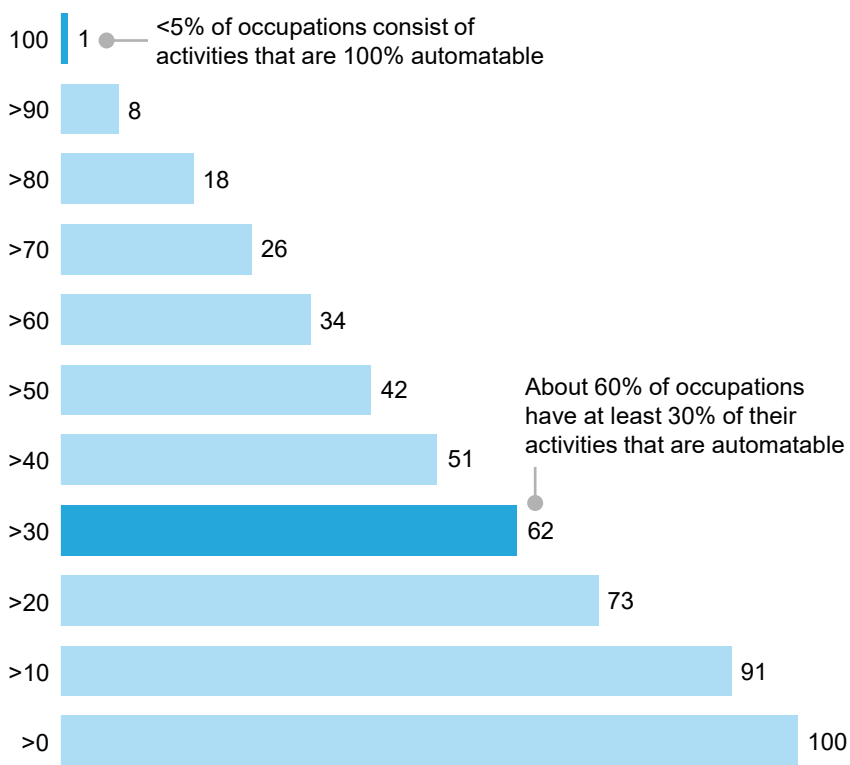
% of work activities that could be automated by adapting currently demonstrated technologies



Automation potential of occupation titles based on demonstrated technology (cumulative)²

Share of roles

% of the 820 roles considered



1 France, Germany, Italy, Spain, and the United Kingdom.

2 We define automation potential according to the work activities that can be automated by adapting currently demonstrated technology. Data based on US occupations.

SOURCE: Oxford Economic Forecasts; Emsi database; US BLS; McKinsey Global Institute analysis

What will automation mean for employment and the future of work? This is a common question—and cause of anxiety—about technological innovation that dates back more than 200 years, since “Luddite” textile workers in Nottingham, England, smashed the automated looms deployed in their mills in 1811. Some work activities are more susceptible to automation than others, including physical movement in a predictable environment—commonplace in manufacturing—and the collection and processing of data, which are found in a wide range of sectors and occupations at all skill and wage levels.

History has shown that while technological innovation has caused labour dislocation and sometimes difficult adjustments, in the long term it has created many more jobs than it has destroyed. In economies around the world, technology-driven productivity growth has been accompanied by employment growth (although often in different sectors of the economy). In the past two decades, the share of the workforce working in agriculture has fallen almost by half in the European Union, from 8.7 percent to 4.7 percent, for example. In the same period, new jobs that could not have been imagined at the time, such as app developers and MRI technicians, have replaced obsolete ones like switchboard operators. It is unclear whether the coming wave of automation driven by robotics and AI will be of a scale similar

to technological advances in the past or whether it will cause more dislocation.⁴¹ It is also unclear what future jobs might become available for dislocated workers and whether they will be socially and financially attractive.

European countries will need to examine their education and vocational training systems to ensure that the skills needed in the new automation era are being acquired. In general, people will have to work more closely with machines, which will require considerable professional training and learning new skills. Lifelong, iterative learning will be essential, as will skill proficiency in literacy, numeracy, and problem solving in a technology-rich environment. However, recent studies by the OECD suggest that adults in some European countries, including France and Italy, have below average abilities in some of these areas, although adults in Scandinavian countries such as Sweden and Finland can excel.⁴²

Technology itself can provide some of the answers to technology-driven employment shifts. For example, digitisation can change how people work and how labour markets operate, as digital platforms such as Uber start to complement or challenge traditional organisational and employment structures. Independent work is a broader phenomenon than often estimated, affecting 40 million and 54 million workers in Europe in primary and secondary occupations, respectively.⁴³ While independent work is sometimes viewed negatively in some European countries, a survey we conducted found that those who choose to work independently report higher levels of satisfaction than those in traditional jobs.⁴⁴ Around two-thirds of independent workers are independent out of preference, while solutions need to be found for the remaining third that lacks choice of traditional employment.

EUROPE FACES HEIGHTENED GLOBAL COMPETITION AT A TIME OF RISING ECONOMIC ANXIETY AND ANTI-GLOBALISATION SENTIMENT

Flows of trade, services, capital, people, and data are essential indicators of globalisation, and have been closely associated with economic growth. Over the past three decades, Europe has been a leader in terms of its openness to these flows, which in turn has been at the core of its competitiveness.⁴⁵ In our index of global connectedness, ten of the top 20 nations are European.

The EU maintains a sizeable trade surplus, of 3.4 percent of GDP in 2015, increasingly driven by knowledge-intensive goods and services.⁴⁶ Intra-European trade remains larger than the EU's trade with the rest of the world, although external trade has been growing as a proportion.⁴⁷

The mix of flows in the global economy is shifting, however: digital flows are becoming more important than all other types of flows, including physical trade.⁴⁸ As already noted, Europe is a net importer of digital services and has yet to find common ground on the digital single

⁴¹ See David Autor, "Why are there still so many jobs? The history and future of workplace automation", *Journal of Economic Perspectives*, volume 29, number 3, 2015.

⁴² See Edward D. Hess, *The No. 1 job skill needed for the smart machine age: knowing how to iteratively learn*, University of Virginia Darden School of Business, February 7, 2017; John P. Martin, *Policies to expand digital skills for the machine age*, IZA Institute of Labor Economics, policy paper number 123, January 2017; *Skills matter: further results from the survey of adult skills*, OECD Skills Studies, 2016.

⁴³ EU-15.

⁴⁴ *Independent work: Choice, necessity, and the gig economy*, McKinsey Global Institute, October 2016.

⁴⁵ *Digital globalization: The new era of global flows*, McKinsey Global Institute, March 2016.

⁴⁶ Eurostat, 2017.

⁴⁷ Intra-EU trade stands at 63.2 percent of total EU trade in 2016. Extra-EU trade grew by 93 percent between 2002 and 2015, while intra-EU trade rose by 63 percent.

⁴⁸ Cross-border capital flows, which include foreign purchases of bonds and equities, foreign direct investment, lending, and other investments, have declined by more than 70 percent in absolute terms since the global financial crisis. A decline in cross-border lending by Western European banks accounts for much of the reversal. Their stock of foreign claims fell by \$8.4 trillion in nominal terms, or more than 35 percent, between 2007 and 2015. See *Financial (de)globalization: The new dynamics of cross-border finance*, McKinsey Global Institute (forthcoming).

market and on important issues around data protection and privacy. Moreover, digital technologies are enabling new forms of competition. This includes technology or other outsider companies muscling in on new turf, along with small and medium-sized businesses that leverage digital platforms such as Alibaba and Amazon to create “micromultinationals” able to compete globally at a fraction of the overhead cost of incumbents.⁴⁹

At the corporate level, Europe’s ability to harness globalisation is also evident. Of the largest global companies in the Fortune 500 ranking in 2016, 146 were European (126 of them were from the EU), compared with 134 from the United States. However, new competition from China and other emerging economies is already being felt and will likely affect future growth and earnings (Exhibit 11).⁵⁰ In the past decade, the 50 largest firms from emerging economies have doubled their share of revenue from overseas activity, from 19 percent to 40 percent. By contrast, the share of global revenues of EU firms has markedly declined, dropping from 36 percent in 1980 to 23 percent in 2013.⁵¹ China today invests more in innovation as a share of GDP than the EU; Chinese research and development spending was just over 2 percent in 2015, while in the EU it was 1.95 percent. Both are behind the United States, where R&D spending amounts to almost 2.8 percent of GDP.⁵²

Even as it faces these challenges, the European Union is encountering a growing backlash against the free movement of goods and people that has underpinned its economic growth since the Treaty of Rome. In opinion surveys and elections, a growing proportion of Europeans is expressing scepticism or outright hostility to free trade and especially immigration. This sentiment is partially linked to measures of economic progress and anxiety about the future. MGI research shows that about two in three households in countries including France, Italy, and the United Kingdom did not see any market income advancement from wages and capital over the past decade, and indeed incomes declined for some income groups. Anti-globalisation sentiment is quite marked among those affected by this flat or falling income trend.⁵³ An MGI survey of households in France and the United Kingdom shows that, among those pessimistic about their own and their children’s incomes in the future, 57 percent feel that foreign labour is creating unfair competition, while 42 percent believe that trade leads to job losses at home.⁵⁴

Indeed, the political reaction in some member states to the influx of more than two million refugees from Syria, Iraq, and other countries in 2015–16 has put pressure on the EU to review its rules regarding the free movement of people, in particular the Schengen treaty that eliminated border controls. The influx has also proved a complex integration challenge. About 70 percent of the asylum seekers are male, and 30 percent are under the age of 18.⁵⁵ Migrants to Western Europe tend to be low-skilled; only about 26 percent of the more than 48 million migrants to Western Europe in 2015 were high-skilled, compared to 35 percent of migrants to North America.⁵⁶

Addressing challenges and concerns about immigration, trade, and globalisation more broadly will require a twofold response. The competitiveness of European firms will need

⁴⁹ See Jacques Bughin and James Manyika, “Measuring the full impact of digital capital”, *McKinsey Quarterly*, July 2013; *Playing to win: The new global competition for corporate profits*, McKinsey Global Institute, September 2015; *Digital globalization: The new era of global flows*, McKinsey Global Institute, March 2016; and Erik Brynjolfsson and Andrew McAfee, *The second machine age*, W.W. Norton & Co. 2014.

⁵⁰ *Playing to win: The new global competition for corporate profits*, McKinsey Global Institute, September 2015.

⁵¹ *Ibid.*

⁵² OECD, 2015.

⁵³ *Poorer than their parents: Flat or falling incomes in advanced economies*, McKinsey Global Institute, July 2016.

⁵⁴ *Ibid.*

⁵⁵ *Europe’s new refugees: A road map for better integration outcomes*, McKinsey Global Institute, December 2016.

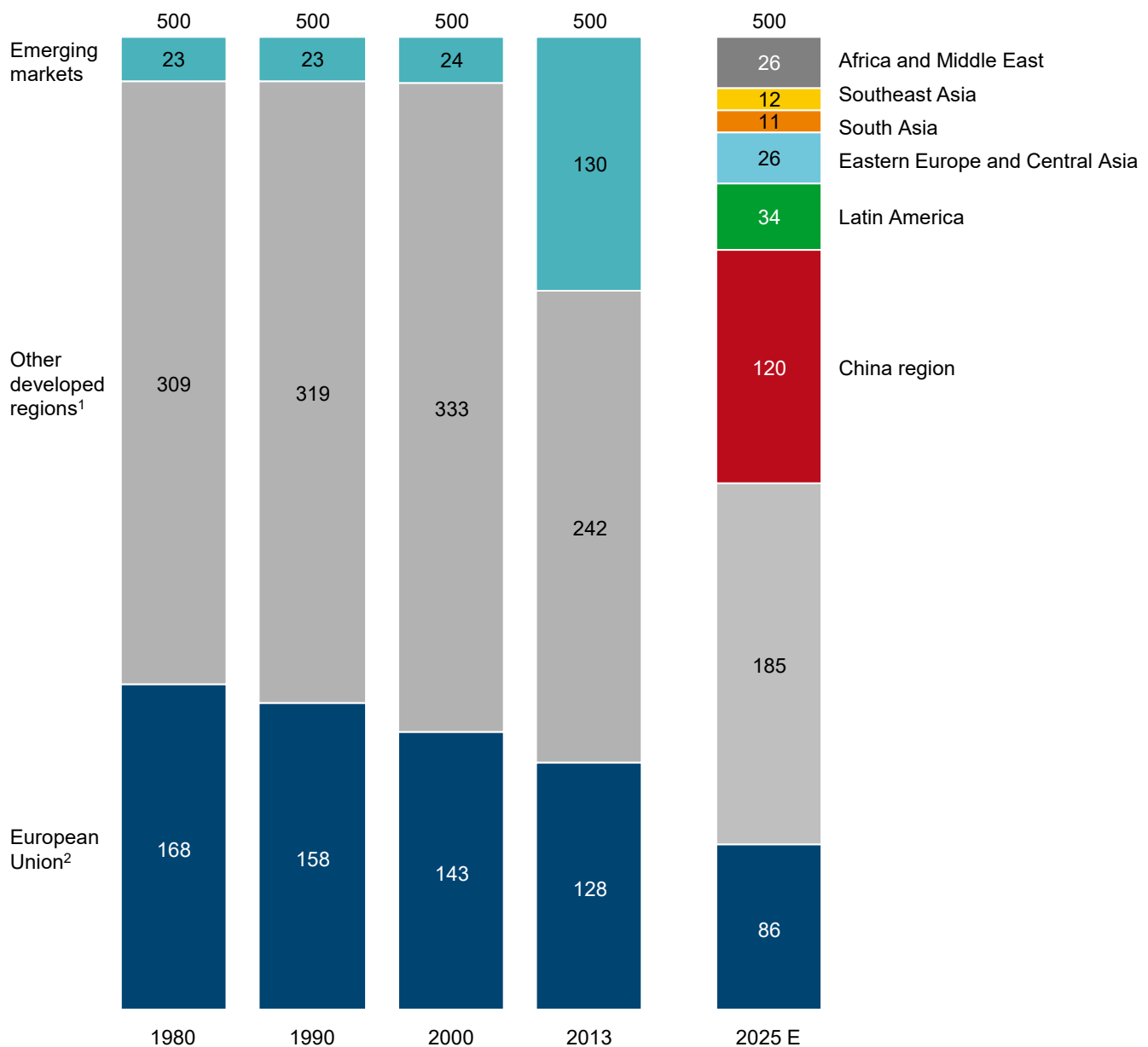
⁵⁶ Long-term migrants only. *People on the move: Global migration’s impact and opportunity*, McKinsey Global Institute, December 2016.

to be bolstered, even as future economic growth becomes more inclusive, to ensure that people are not left behind. Our research has shown that government taxes and transfers can play a role in offsetting the impact of flat or falling incomes in an economic downturn, although this is not sustainable. Other policy responses can include broad efforts to enable job creation, and specific measures aimed at low and middle-income households, including by upgrading skills and easing the transition from education to employment. In addition, where there is a political consensus, direct payments such as guaranteed basic income schemes or expansion of programmes such as the US earned income tax credit could be used to maintain disposable income, although such measures can be highly controversial.⁵⁷

Exhibit 11

By 2025, European Union countries are predicted to represent 86 companies in the Fortune Global 500, down from 168 in 1980

Number of Fortune 500 companies by region



¹ Australia, Canada, Japan, South Korea, United States, and Western Europe excluding EU-28.
² Includes all current EU-28 countries.

SOURCE: Fortune Global 500; MGI CompanyScope; McKinsey Global Institute analysis

⁵⁷ Ibid.

3. EUROPE AT AN INFLECTION POINT

Since the 1957 Treaty of Rome, European integration has evolved in fits and starts—and often in reaction to crisis. Today, the EU is at an inflection point. It must take action to address the long-term challenges we have highlighted, even as it is being pulled between powerful forces of convergence and divergence. The British vote in June 2016 to leave the EU was just one sign of how strong the forces opposed to European integration have grown across the continent. How the EU responds to these challenges will largely shape its future.

The European Commission’s white paper marking the 60th anniversary of the Treaty of Rome airs five scenarios for the EU to 2025: carrying on with limited reforms; recentering on the single market; allowing member states to create “coalitions of the willing” who will work on some common policies together; doing less, but more efficiently; and doing much more together, such as agreeing to share more power, resources, and decision making.⁵⁸ The Commission’s scenarios do not include withdrawal from the EU by member states other than Britain, or the breakup of the union entirely. Writing a new Rome treaty is beyond the remit of this discussion document, but whichever path European governments decide to take, they will need to build on a more solid foundation. In this final section, we examine the EU’s current unstable equilibrium and its fault lines, and signpost some conditions for success as the EU and its members seek to adapt to changing times and construct a vibrant future.

AN “UNSTABLE EQUILIBRIUM” IS CHALLENGED BY ECONOMIC DIVERGENCE AND SOCIAL INEQUALITIES

The European Union is currently in a state of “unstable equilibrium.” National economies have integrated tightly including with open borders and, for Eurozone members, a common currency. Yet political decision making for matters of common concern including fiscal and economic policy, security, and issues such as migration largely remains the purview of national governments. This has led to uncoordinated policies, moral hazard, and a growing lack of trust among member states.⁵⁹ The lack of coordinated policies also created turbulence around the euro during the sovereign debt crisis. While the currency has since stabilised, some economists and financial market participants continue to believe that the euro in its current form is not sustainable.⁶⁰

After 60 years of integration, the EU today has the scale to be a major player on the world stage, and can benefit from the economic bolstering of its single market. They both amount to strong reasons for continued or intensified unification. Yet increasing divergence is exacerbating political differences among countries, and supporting the rise of political movements in member states that are opposed to European integration or would like to withdraw from the EU, following the UK example.

The fault lines in today’s Europe go beyond the fundamental question of pro- or anti-EU. Sixty years after the Treaty of Rome’s pledge to lay the foundations of an ever closer union, the differences and divergences in Europe today remain substantial, across economic, social, political, and cultural dimensions. While economies have on the whole begun to converge closer to Germany’s, the EU’s largest economy, they remain far apart and have moved further from one another since the 2007–08 crisis (Exhibit 12).

⁵⁸ See, *White paper on the future of Europe: Reflections and scenarios for the EU27 by 2025*, European Commission, March 2017.

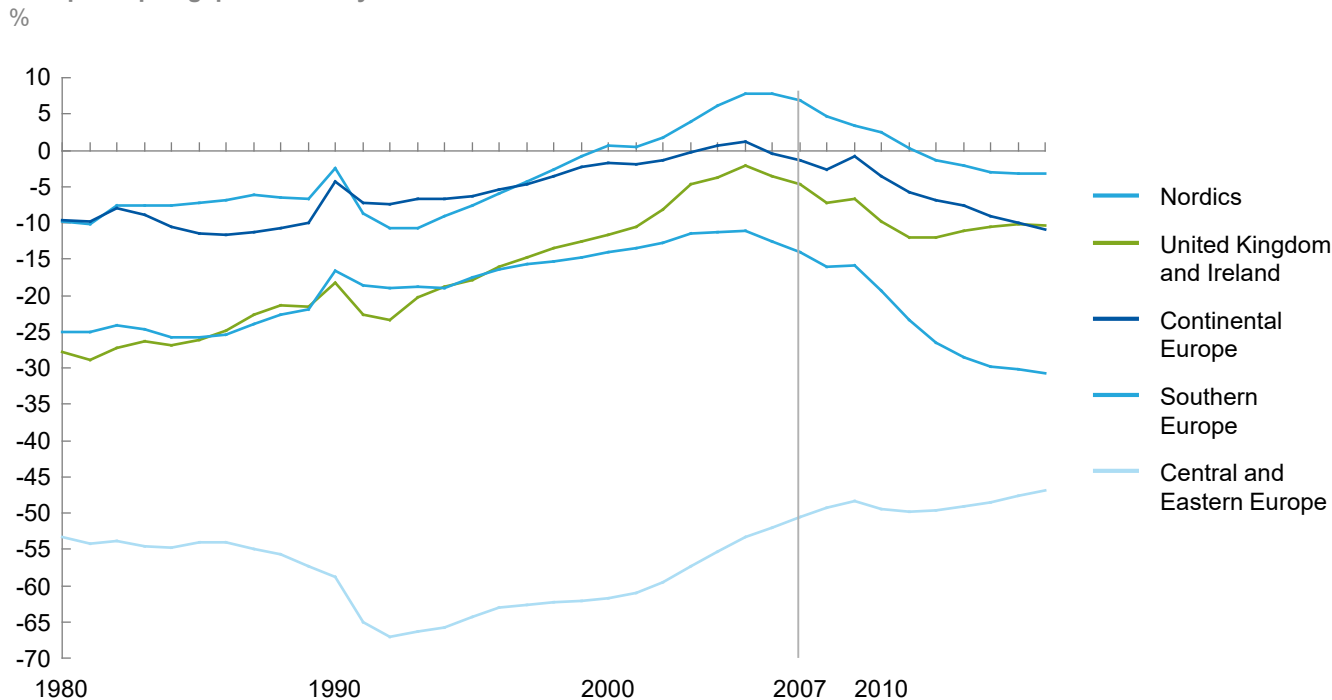
⁵⁹ For more details, see *A window of opportunity for Europe*, McKinsey Global Institute, June 2015.

⁶⁰ See for example Joseph E. Stiglitz, *The Euro: How a common currency threatens the future of Europe*, W.W. Norton & Co, 2016.

Exhibit 12

There has been inconsistent economic convergence with Germany across the groups of EU members, and the 2007 financial crisis has further slowed progress

GDP per capita gap to Germany



NOTE: Southern Europe: Cyprus, Italy, Greece, Malta, Portugal, Spain; Continental Europe: Austria, Belgium, France, Germany, Luxembourg, Netherlands; Nordics: Denmark, Finland, Sweden; CEE: Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia. Annual EKS GDP data from The Conference Board, converted to 2015 price level in US dollars using 2011 EKS purchasing power parity (PPP); European countries' per capita GDP weighted with respective year population.

SOURCE: The Conference Board; OECD; McKinsey Global Institute analysis

Decades show inconsistent convergence. Exhibit 13 shows the trajectories of GDP per capita of the different clusters of member states beginning with their accession to the EU.⁶¹

Today, economic fault lines divide north and south, east and west, and young and old. They are also mirrored in social and cultural divisions. Finland has the world's highest social progress index scores, at 90.9 out of 100. Eastern European countries have scores in the 70s (Latvia, Romania, and Bulgaria are the lowest), next to Panama, Jamaica, Kuwait, and Brazil. Welfare payments and social expenditure also vary significantly across countries. France and Denmark devoted more than 34 percent of their GDP to social expenditure in 2012, more than double the proportion spent by Estonia (15 percent) and Latvia (14 percent) on the same programmes.⁶²

The divergences among EU member states exist across a wide range of social and economic indicators, from energy intensity and housing quality to air quality and homicide rates. For example, primary school enrolment is between 97 and 99 percent in most European countries, but in Croatia the figure is below 90 percent.⁶³ Just over 55 percent of Romania's population were internet users in 2015; in the Netherlands, 95 percent are.⁶⁴

⁶¹ For a discussion of convergence issues, see Mihaly Tamas Borsi and Norbert Metiu, *The evolution of economic convergence in the EU*, Deutsche Bundesbank discussion paper number 28, 2013, and *Real convergence in the euro area: evidence, theory, and policy implications*, ECB Economic Bulletin, issue 5, 2015.

⁶² *Social Progress Index*, 2016; Eurostat 2016.

⁶³ *Social Progress Index*, 2016.

⁶⁴ OECD.

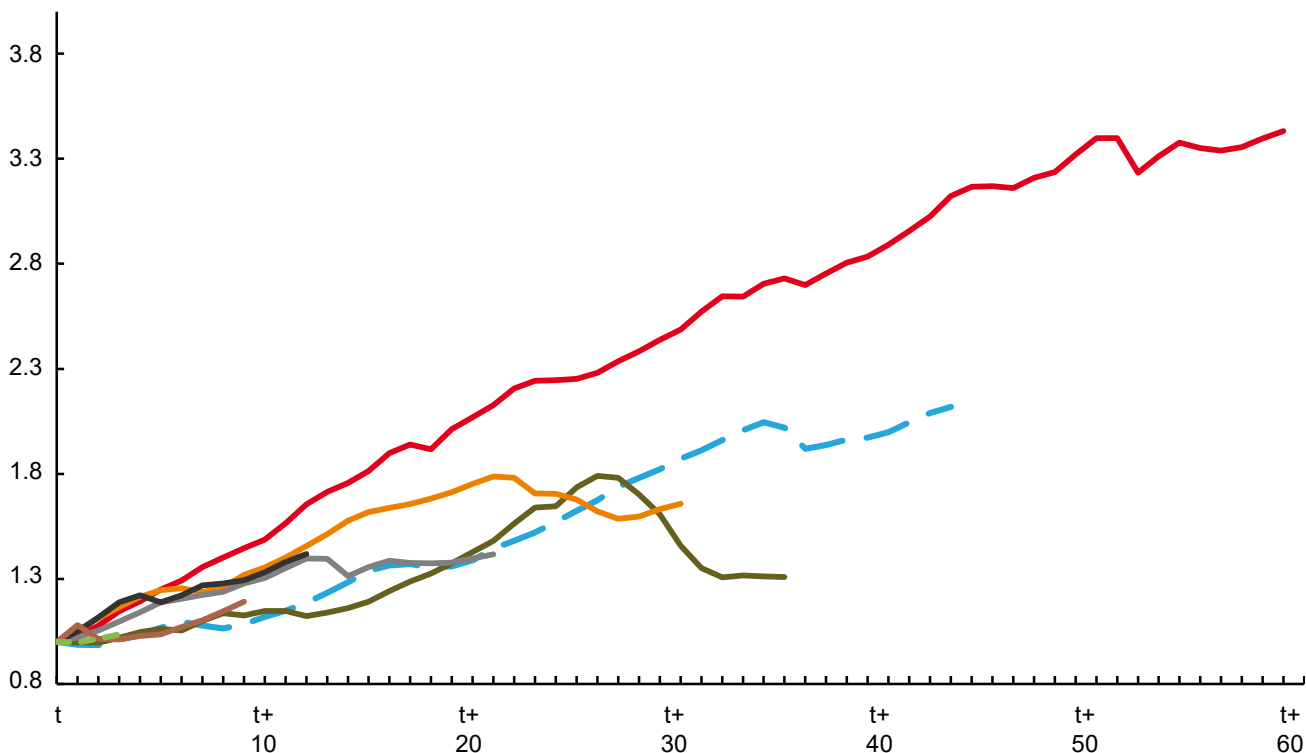
Exhibit 13

There is a significant divergence in economic growth between member states depending on when they joined the EU

Purchasing power parity-adjusted per capita GDP¹

Index: 1.00 = Date of accession to the EU

- | | | | | | | | | |
|---------------|------------------|-------------|-------------|-------------|------------------|------------|-------------|-------------|
| 1957 | 1973 | 1981 | 1986 | 1995 | 2004 | | 2007 | 2013 |
| ▪ Belgium | ▪ Denmark | ▪ Greece | ▪ Portugal | ▪ Austria | ▪ Czech Republic | ▪ Poland | ▪ Bulgaria | ▪ Croatia |
| ▪ France | ▪ Ireland | | ▪ Spain | ▪ Finland | ▪ Estonia | ▪ Slovakia | ▪ Romania | |
| ▪ Germany | ▪ United Kingdom | | | ▪ Sweden | ▪ Hungary | ▪ Slovenia | | |
| ▪ Italy | | | | | ▪ Latvia | ▪ Cyprus | | |
| ▪ Luxembourg | | | | | ▪ Lithuania | ▪ Malta | | |
| ▪ Netherlands | | | | | | | | |



¹ Annual EKS GDP data from The Conference Board, converted to 2015 price level in US Dollars using 2011 EKS purchasing power parity (PPP); European countries' per capita GDP weighted with respective year population.

SOURCE: The Conference Board; OECD; McKinsey Global Institute analysis

The fault lines are also demographic: While populations across most Southern and Eastern European cities are poised to decline due to demographic changes and emigration, cities in Scandinavian countries continue to grow (Exhibit 14).

In income terms, there is also growing divide between rural and urban populations. Across Western Europe, average GDP per capita is 33 percent higher in large cities than it is elsewhere.⁶⁵ As incomes diverge, so do political opinions. While London voted heavily in favour of staying in the European Union in the UK 2016 referendum, for example, many other parts of the country that have not benefited as much economically voted strongly to leave.

⁶⁵ McKinsey Global Institute Cityscope database 2015.

Exhibit 14

Populations across most southern European cities are declining but the Nordics continue to grow

Western Europe region urbanisation

Population, latest available data

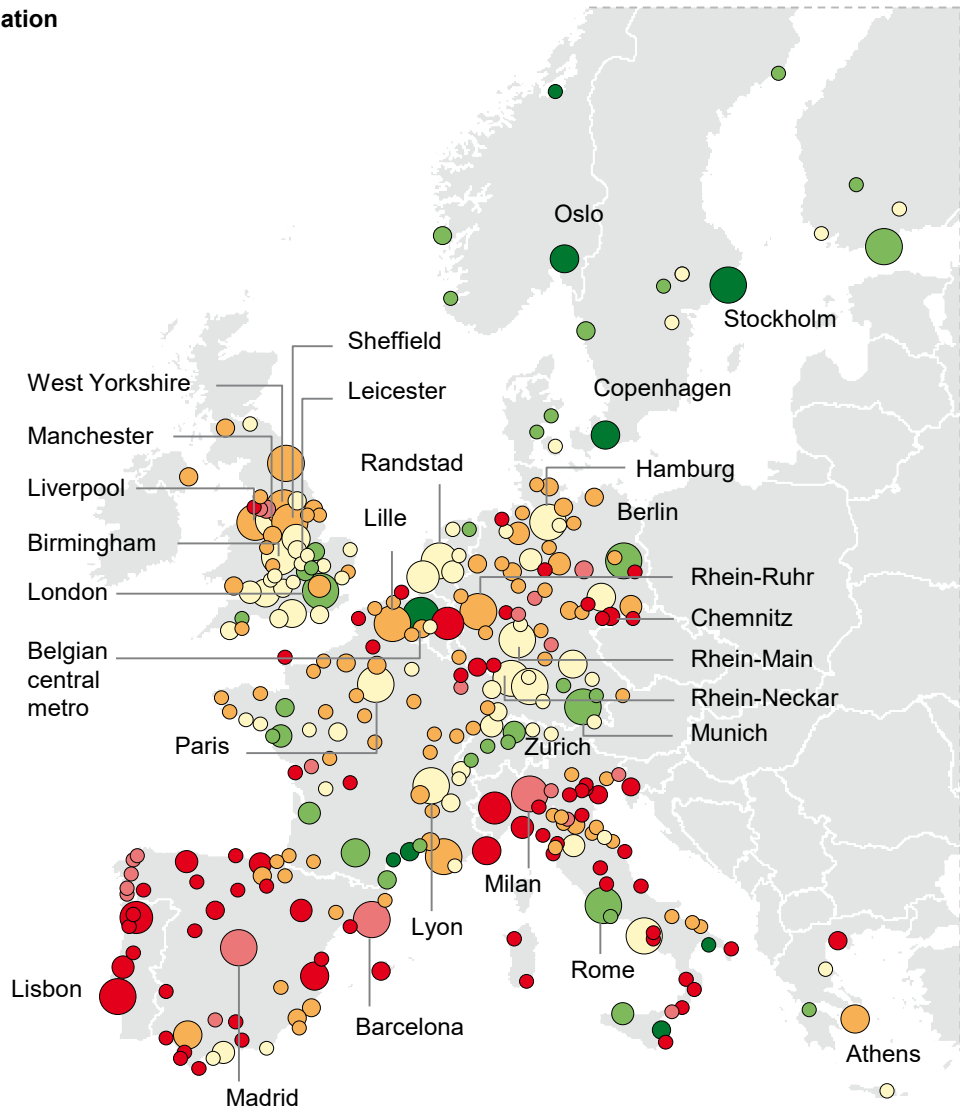
Thousand

- ≤200
- 200–400
- 400–600
- 600–800
- 800–1,000
- >1,000

Compound annual growth rate, latest 3 years of available data

%

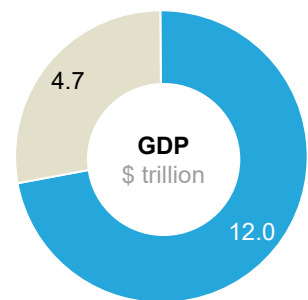
- ≤ -0.1
- -0.1–0.0
- 0.0–0.5
- 0.5–1.0
- 1.0–1.5
- >1.5



GDP statistics for Western Europe, 2015

- Large cities
- Other cities

Per capita GDP
\$ thousand



NOTE: Map not to scale. The city-level projections rely on demographic and economic data from MGI's Cityscope database, which covers almost 3,000 metropolitan areas in the world that have at least 150,000 inhabitants in developed regions, and at least 200,000 inhabitants in emerging ones. For details of methodology, see the technical appendix of Urban world: Cities and the rise of the consuming class, McKinsey Global Institute, June 2012.

SOURCE: McKinsey Global Institute Cityscope database; McKinsey Global Institute analysis

ROME REDUX: REINVENTING THE EUROPEAN UNION FOR THE NEXT 60 YEARS

Europe today is a far more affluent place than it was in 1957. Memories of the calamitous world war, which the government leaders who signed the Treaty of Rome had all experienced first-hand, have faded into history. Yet now, as then, the world is changing rapidly, and filled with uncertainty. Just as they are today, the challenges back then were economic, but also political and security-related. For today's leaders, finding the scenario that will be most appropriate for the future of the European Union is a political question beyond the remit of this discussion paper. Given the challenges we have outlined, however, any scenario will come with essential conditions of success. In the solution spaces below, we discuss some of those conditions of success, together with a number of the actions needed to achieve them.

- **Rekindling growth and building on critical assets.** Europe needs a new growth spurt; we estimate 2-3 percent annual GDP growth could be feasible through a combination of structural reforms and demand stimulus.⁶⁶ Investment will be critical to underpin economic growth and allow Europe to remain competitive in the future. Public investment has languished since the 2007–08 crisis and governments need to find ways to ramp it back up to required levels despite austerity; we estimate the EU has an infrastructure investment gap of 0.4 percent of GDP, or just over \$850 billion.⁶⁷ Individual European members states are leaders across a range of growth drivers, from senior participation in the labour force to energy productivity and effective education to employment. Accelerating reform by learning from and emulating these best practices of other EU members could make a decisive difference to the prosperity of the European Union as a whole in the years ahead.
- **Leveraging the EU's scale.** Making Europe a prosperous place again by leveraging the scale of a common market was a primary concern in 1957. Today, the European Union has economic scale, but it could go much further to build out unfinished areas of the single market. Completing the market in services including energy and delivering synergies on defence and other public procurement spending can foster growth and save on resources in an ageing world. Creating a digital single market and EU-scale support for innovation will be needed in increasingly winner-takes-most global digital business models. Building a capital markets union can make the EU more resilient to shocks that have exposed divergences. Further aligning defence, security, foreign, and trade policies may also be needed, as global institutions come under attack from new sources in challenges that require an innovative, coordinated, and future-looking response. Different configurations of interested member states or the EU as a whole are conceivable, and agility will be as important as scale.⁶⁸
- **Innovating and providing new skills to adapt to the changing world of work.** Significant measures will be required to overcome divergence and ensure future growth is inclusive, in order to counter the feeling of EU citizens that they are being left behind. Economic divergence between countries will need to give way to re-convergence if common action and achieving scale is desired. Discussions on how to achieve that ambition may entail controversial topics such as targeted investments, transfers, or debt restructuring. Within national borders, all European countries need to address major social and economic challenges around the future of work. Europe could be a leader here, both in spawning new types of technology-enabled employment opportunities and in putting in place innovative social security systems that help deal with any dislocation

⁶⁶ *A window of opportunity for Europe*, McKinsey Global Institute, June 2015.

⁶⁷ *Bridging global infrastructure gaps*, McKinsey Global Institute, June 2016.

⁶⁸ A scenario involving voluntary coalitions of willing members states agreeing on specific cooperation measures is one of the five possibilities laid out by the European Commission. See *White paper on the future of Europe: Reflections and scenarios for the EU27 by 2025*, European Commission, March 2017.

from automation. The EU successfully managed to deal with previous challenges, including the decline of its steel industry and, post German reunification, ways to help a “lost” generation in Eastern Germany. Automation will likely require systemic changes rather than reallocations within the existing systems. Member states could individually or collectively take the lead in examining the implications for education and training, for example emphasising creativity and social interaction, or for social safety nets. The likely significant changes in the workplace, including the rise of independent work, will require an overhaul of education systems to place greater emphasis on literacy, numeracy, and problem solving skills, and on the importance of iterative and lifelong learning.

- **Reconfiguring Europe to better serve its citizens.** In the public mind, Europe today is often associated with opaque and technocratic practices that can seem removed from the everyday life of most citizens. Whatever form the future European Union takes, it will need to be reconfigured to better serve and interact with its citizens, the people of Europe. New forms of governance and accountability will be needed. These could include a greater involvement in EU matters for regions, cities, and companies, not just national governments, that allows for agility, experimentation, and competition at sub-EU level. More citizen engagement and direct democratic interaction can be achieved by leveraging technology; for example, digital platforms can give ordinary citizens a voice and can be used to crowdsource solutions. In fact the public is eager for change that will move away from the economic and income stagnation of the past decade. A survey of 16,000 Europeans we conducted in eight member states showed that a majority of citizens are willing to make trade-offs such as cuts in social spending or working longer hours in return for stronger growth, better public services, and higher incomes. Entries to our 2016 essay competition suggested options to restore trust in Europe institutions, including through clearer delineation of what those institutions should do and what national governments should handle, more flexible and experimental policies, and ways to compensate people who are affected by reforms.⁶⁹



When the Treaty of Rome was signed in 1957, the need for Europe to live and work together in peace and harmony was self-evident, as the continent sought to bury old enmities and rebuild after savage wars. Safeguarding peace remains a core objective today, but a new vision and narrative are needed to convince businesses and an increasingly sceptical European public that working together as “Europeans” remains a worthwhile cause for their lives. Difficult political decisions lie ahead for government leaders as they seek to ensure that the EU remains relevant and vibrant for another 60 years. The global challenges that loom ahead are daunting ones. If Europe is to reinvent itself for the future, it will need to do so in a way that citizens across the continent can recognize, and with which they can identify and engage.

⁶⁹ *An opportunity for Europe? The McKinsey Global Institute 2016 Europe essay prize: Key themes and winning entries*, McKinsey Global Institute, October 2016.

ANNEX: 60 YEARS IN NUMBERS

	Indicator	Unit	1957	1992	2015
Economic basics	Population ¹	Million	185.7	348.4	513.8
		US comparison	172.0	257.0	322.0
	EU membership	Number	6	12	28
	GDP per capita	\$ ²	10,017	26,561	37,178
		US comparison	16,437	36,985	55,825
	Productivity per hour	Value added per hour worked, \$ ²	12	35	51
		US comparison	21	44	67
	Investments	% of GDP		22.2	19.7
	Employment rate	% of working-age population		59	66
		US comparison		71	69
	Female participation	% of working-age population		46	51
	Unemployment rate	% of labour force		9	9
	Public sector spending ³	% of GDP		51.1	47.3
US comparison			38.7	37.7	
Military spend	% of GDP		2.4	1.5	
Global trends	Old age dependency	Dependency ratio of 55+ years to working-age population	0.35	0.45	0.61
	Average retirement age	Years	68.4 ⁴	62.4	62.9
	Life expectancy at birth	Years		75	81
	Fertility rates ⁵	Births per woman	2.6	1.6	1.5
	Fortune 500 companies based in Western Europe ⁶	%		34	29
	Trade (imports + exports), intra-EU	€ billion		3,722 ⁹	6,050
	Trade (imports + exports), extra-EU	€ billion		1,822 ⁹	3,517
	Migration from extra-EU countries to EU ⁷	Million		19.5	45.5
Convergence	Urban/rural split of population	% of population in urban centres	61.2	70.8	74.8
	Median income	\$		28,834 ¹⁰	39,372
	Highest GDP per capita in EU ⁸	\$ ²	15,033 Netherlands	34,987 Netherlands	48,927 Netherlands
	Lowest GDP per capita in EU ⁸	\$ ²	2,804 Malta	9,304 Latvia	18,934 Bulgaria
	GDP per capita standard deviation ⁸	\$ ²	4,005	9,399	10,049

1 Population of current members of EU in 1957, 1992, 2015.

2 Annual EKS GDP data from The Conference Board, converted to 2015 price level in US Dollars using 2011 EKS purchasing power parity.

3 Spending: 1995 data available instead of 1992 for EU.

4 Data from 1970.

5 Fertility rates: 1960 data available instead of 1957.

6 Fortune 500: 1990 data available instead of 1992.

7 Stock migration, excluding to and from Western Europe, but including migration to Switzerland and Norway. Data from 1990.

8 Excluding Luxembourg.

9 2002 data, the earliest available.

10 Weighted average household median income using population as a weight; includes Austria, Belgium, Bulgaria, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Italy, the Netherlands, Poland, Portugal, Romania, Slovakia, Spain, Sweden, and the United Kingdom.

NOTE: 28 member state data back-extrapolated in the following data sets: GDP per capita, productivity, investments, employment, female participation, unemployment, public sector spending, old age dependency, average retirement age, life expectancy at birth, fertility rates, Fortune 500 companies, trade, and urban/rural split.

SOURCE: The Conference Board; EIU, Eurostat; Fortune 500; IMF; McKinsey & Co. Global Growth Model; OECD; UNCTAD; UN Population Division; McKinsey Global Institute analysis

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