# REVIVING PRODUCTIVITY IN THE EU



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## How Europe can revitalize growth and innovation

**Europe is falling short of potential due to a lack in reforms.** Europe's per capita income is 27.4 percent below the US—not far from where it was two decades ago. Had it not been for Europe's rising labor force participation, the gap would be even higher given Europe's underwhelming productivity growth. Europe's structural shortcomings became more penalizing with the unfolding of the ICT revolution, which put a premium on scale and reallocation. Between 2005 and 2025, real GDP per hour worked increased by 0.9 percent annually in Europe, compared to 1.4 percent in the U.S. Low growth also reduced resilience in a world where supply disruptions and uncertainty have become commonplace. The good news is that better policies can change all that.

**Closing Europe's productivity and income gap requires action at both domestic and EU level.** Fully adjusting domestic structural policy to best practice and lowering intra-EU cross-border barriers to trade and labor mobility to those observed within the US would raise EU productivity by about 20 percent.[1] This would nearly close the existing productivity gap. As powerful as each lever is, neither of them can be operated in Brussels or Member States' capitals alone: about half of these gains come from addressing domestic shortcomings, and the other half from fully integrating the EU's product and labor markets. What is more, even a moderate effort towards addressing fragmentation in financial markets would not only bring gains in its own right, but also magnify the benefits of non-financial reforms.[2] The EU's Single Market Roadmap provides a useful framework for advancing reforms that could help realize part of these gains.

**Reforms would also spur private investment…** Sustained capital formation depends on firms seeing profitable opportunities to expand and innovate. We estimate that the productivity lift from closing domestic and EU-level gaps would raise private investment such that Europe's GDP per capita increases by at least 35 percent. In a virtuous cycle, higher growth would also help ease fiscal policy tradeoffs.[3]

**… including in innovations needed to remain at the frontier.** Productivity growth at the frontier comes from high-growth innovations, yet Europe tends to focus on incremental innovation in traditional, low-growth sectors. Why are there not more emerging European firms going big? The answer is large policy barriers prevent firms from adjusting up and down production capacity. Scaling-up constraints—such as limited access to foreign markets through trade, or tax disincentives to grow—limit the potential returns to innovation and growth. Scaling-down constraints—such as costly bankruptcy procedures and employment protection legislation that shields jobs instead of workers—prevent firms from adjusting production down or exiting when investments fail, disincentivizing risky investments where flexibility is most valuable. But the benefits of these domestic and EU-level reforms go beyond higher productivity and income. Many of the same reforms would also make Europe more adaptable and less sensitive to shocks.

**Industrial policy can help with growth and resilience if used carefully and in moderation.** While more direct support, such as R&D subsidies, can aid innovation activity, these policy instruments must be very precisely targeted, otherwise they can hurt competition and become more costly than structural reforms. Policies that directly weaken competition (e.g., relaxed merger rules, or trade protection that goes beyond addressing economic security vulnerabilities) can undermine long-run incentives to innovate.

**Careful design and communication will go a long way in easing implementation of reforms.** Any reform brings concerns that need to be taken seriously. But a careful analysis of the combined domestic and EU-level reforms aimed at reducing intra-EU barriers to trade, labor mobility, and capital flows show that all EU member states will benefit. This suggests that an ambitious reform effort yields gains that can be shared through the existing tax and social benefits systems. Europe's own experience shows that successful reforms are possible when policymakers clearly communicate the costs of inaction, build social consensus, and bundle measures so that gains are widely shared.

*This article was co-authored by Diego Cerdeiro (IMF).*

1. *Making European Reforms a Success on the Ground, IMF 2025.*
2. *Deeper and More Integrated Financial Markets to Foster Growth and Resilience in Europe, IMF 2026.*
3. *Europe's Fiscal Squeeze: Tackling Rising Spending Pressures, IMF 2026. The choice is not between national and European solutions; both should be pursued together.*



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# The 2026 European semester: Restoring productivity, credibility and convergence

**The Productivity Challenge**

The EU stands at a crossroads. For many years, productivity growth has lagged behind major global competitors, weighing on competitiveness, innovation and long-term prosperity. This challenge goes beyond economics: weak productivity affects wages, public finances and the capacity to deliver quality public services and social cohesion.

The euro area recommendation for 2026 rightly points to productivity as the central economic issue. Mario Draghi's report underlined the need for coordinated action, but the answer is not a single top-down strategy. Europe's strength lies in combining a common direction with reforms tailored to national conditions.

Three priorities should guide action:

- closing the innovation and technology gap;
- accelerating decarbonisation while preserving industrial capacity;
- reducing strategic dependencies in key sectors.

Achieving these goals requires stronger public and private investment, better framework conditions for firms, and labour markets that support adaptation and inclusion. This is also where the Union of Skills matters: Europe cannot raise productivity without improving skills, matching workers to changing labour market needs and supporting transitions across sectors and regions.

**Fiscal Credibility and Social Investment**

A stronger euro area also depends on fiscal credibility. High debt in several Member States limits room for action and can weaken confidence. Sound public finances are therefore not optional; they are a condition for sustainable investment and resilience. Credibility means not cutting productive or social spending that supports future growth and ensure social services (eg early childhood assistance, general childcare, workers updkilling and reskilling) that foster higher employment rates.

This balance is especially important as the Recovery and Resilience Facility (RRF) is approaching its end this year. The RRF showed that European financing can help drive reform and investment, but it was temporary. As it winds down, Member States will need to maintain momentum with credible national fiscal paths while protecting expenditure that strengthens productivity, skills and social resilience.

This includes investment in education, training, childcare, housing and active labour market policies. It also includes fair wage-setting and job quality. In this respect, the Minimum Wage Directive remains relevant as part of a broader effort to support upward convergence and reduce in-work poverty. The EU Anti-Poverty Strategy, launched in May 2026, gives further political impetus by linking economic coordination more clearly with social inclusion.

The proposed Quality Jobs Act can further support this agenda by encouraging labour market reforms that combine competitiveness with security, better working conditions and stronger participation in training.

**The Role of the European Semester**

The European Semester remains the main framework for translating these priorities into coordinated action. It does not replace national policymaking, but connects common objectives with country-specific guidance, surveillance and peer learning. In a monetary union where economic choices spill across borders, this coordination remains essential.

Still, the Semester can only be effective if it focuses on implementation. Too often, recommendations identify the right challenges without creating enough follow-through. The key task is therefore to make the Semester more operational: better alignment between fiscal surveillance, reform priorities and investment needs; clearer benchmarks; and stronger national ownership.

The Semester should also help ensure that the end of the RRF does not create a policy vacuum. It can support continuity by linking reform commitments, budgetary planning and social objectives in a single framework. In that sense, it remains indispensable to delivering on the euro area recommendation for 2026.

**Realistic Outcomes**

In the short term, euro area prospects for 2026 are improving, but cyclical relief should not be mistaken for structural renewal. Europe's diversity means progress will remain uneven, and many reforms depend on political choices made nationally.

But that does not make coordination ineffective. If the euro area recommendation for 2026 is used to sharpen national priorities, the European Semester to improve delivery, and post-RRF fiscal strategies to protect productive and social investment, meaningful progress is possible.

The most realistic outcome is not a dramatic leap, but a stronger basis for sustained improvement: higher productivity, more credible public finances, better skills, lower poverty and better-quality jobs. That is how the EU can strengthen competitiveness while preserving its social model and narrowing internal gaps.




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## Europe's competitiveness test: spend better, unlock scale

At a time of growing geopolitical tensions, rising defence needs and weak growth prospects, Europe faces increasing pressure to do more with limited fiscal space.

Debt markets have remained remarkably resilient despite rising borrowing needs. The OECD Global Debt Report 2026 shows that central government borrowing from debt markets across OECD countries reached USD 17 trillion in 2025 and is expected to rise to USD 18 trillion in 2026. Yet higher debt, shortening maturities, and more price-sensitive investors leave no room for complacency.

For Europe, high debt and abundant savings alike must be channelled into productive investment capable of raising competitiveness and productivity.

First, fiscal discipline should be recognised as part of a growth strategy. Resources should increasingly be allocated towards skills, digital and energy infrastructure, R&D, childcare, labour-force participation and public-sector efficiency. Expenditure that raises productive capacity strengthens both long-term growth and fiscal credibility.

In a more demanding financing environment, credibility becomes a source of competitive advantage. As central banks unwind years of quantitative easing, investors increasingly price sovereign debt according to the soundness of public finances, regulatory predictability and implementation capacity. In Europe, differences in institutional quality can quickly result in different financing conditions.

Since the Global Financial Crisis, years of fiscal and monetary support stabilised demand but did not remove structural constraints: too much capital remains trapped in fragmented markets, scale-up financing is limited, innovation diffuses too slowly, and administrative barriers delay investment. Liquidity itself is not productive capacity, and Europe's task is to turn the capital it has into the productivity it needs.

Second, Europe possesses abundant savings and innovative firms yet struggles to achieve scale. Fragmented financial markets divide savings, investment, supervision and risk-sharing along national lines, weakening firms' ability to grow and compete globally.

The consequences are visible: IMF analysis shows that, in the US, young public firms – those under 50 years old – are valued at USD 42.9 trillion. In the EU, that figure is closer to USD 5 trillion. In fact, over the past 50 years, only 14 companies with a market capitalisation above USD 10 billion have been founded in the EU, compared to more than 240 in the US.

A deeper Single Market, a credible Savings and Investment Union and greater supervisory convergence can reduce these barriers, improving the allocation of savings and broadening financing options for growing firms. Yet common initiatives must go hand in hand with credible domestic reform: persistent divergence in fiscal credibility, administrative quality and reform momentum would limit their impact.

Third, demographics add urgency to both agendas, as ageing raises pension and healthcare pressures while reducing the contribution of labour-force growth. Pension sustainability, labour participation and skills policy are therefore part of the same productivity challenge. Longer lives must be matched by longer, healthier and more flexible working lives, supported by incentives to make provision for retirement, lifelong learning and measures to mobilise underrepresented groups.

Ageing affects both the supply of labour and the supply of long-term capital. Well-designed pension systems protect retirement income, support fiscal sustainability and strengthen citizens' participation in growth: directly through longer working lives and indirectly through long-term savings.

**Debt must finance productivity; savings must finance scale!**

OECD data shows that assets earmarked for retirement reached USD 70 trillion in OECD countries by 2024, representing a major pool of long-term capital. Asset-backed pensions can thus support productive investment, provided they remain retirement systems first rather than captive buyers of public debt.

Pension funds and insurers can be stabilising long-term investors, but they remain sensitive to price, duration, liquidity, solvency and regulation. Their contribution to productivity depends on trust, governance, transparency and sound supervision.

Europe's productivity challenge ultimately lies in how effectively it can deploy both borrowed and accumulated capital. Meeting this challenge will depend on its ability to align (i) fiscal credibility with investment ambition, (ii) national reform with EU coordination, and (iii) long-term private capital with credible institutions.

Resilience in debt markets is an opportunity, not a guarantee - Europe must use it to build productive capacity before adjustment is imposed on less favourable terms.



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# Productivity, competitiveness and convergence: Why Europe needs a deeper single

We are living in an era of one shock after another: COVID-19, inflation, Russia's unprovoked war against Ukraine, rising trade tensions and US tariffs, and now renewed instability in the Middle East. At the same time, productivity growth in the euro area has remained weak for almost two decades. According to the IMF, income per capita in Europe is around 70% of that in the United States, and the gap continues to widen.

Meanwhile, national budgets are under increasing strain from long-term spending pressures, including the rising pension and healthcare costs associated with ageing populations, the costs of the green transition, and growing defence expenditure needs.

To restore productivity growth, regain fiscal credibility, and restart economic convergence across the euro area, the policy debate has moved beyond marginal adjustments. The renewed focus on European competitiveness is reflected in key policy documents, most notably the Draghi Report on European competitiveness and the Letta Report on the future of the Single Market. Together, these reports have shaped the European Commission's policy agenda, which aims to strengthen Europe's innovation capacity, productivity, and global competitiveness.

An emerging consensus is taking shape that a core set of reforms can no longer be postponed.

Policy discussions have largely focused on two crucial drivers of future productivity growth. First, there is substantial untapped potential from completing the Single Market associated with "low hanging fruit", including through regulatory simplification and the removal of remaining barriers to cross-border activity. Too many conflicts persist between EU and national rules and priorities, and too many barriers continue to hinder cross-border services, digital activities, finance, energy, and labour mobility. Second, significant productivity gains can be achieved by fostering innovation and strengthening the diffusion of new technologies across sectors and industries.

Key priorities for completing the Single Market include removing regulatory barriers to cross-border services, creating a genuine Digital Single Market, and reducing the administrative burden faced by companies operating across multiple Member States.

At the same time, Europe faces an estimated annual investment gap of approximately €800 billion. The Draghi Report and the EIB have both highlighted the urgent need to finance strategic priorities, including the green transition, digital and AI transformation, and defence capabilities. Developing a truly integrated savings and investment market that channels Europe's substantial pool of household savings into productive investments across the Union will be essential to closing the investment gap and strengthening competitiveness.

For smaller Member States, deeper integration offers particularly significant benefits. Small economies are inherently constrained by domestic demand. A more integrated Single Market allows businesses to serve more than 400 million consumers under a common regulatory framework. Greater integration increases competitive pressure, encourages innovation, accelerates the adoption of new technologies, and improves efficiency.

Smaller Member States often prosper by specialising in niche activities within broader European value chains rather than attempting to build complete industrial ecosystems domestically. Integration also reduces dependence on domestic economic cycles by allowing businesses to diversify customers, suppliers, talent, and financing sources across Europe.

> Deeper market integration should be viewed not merely as a project of market enlargement.

However, integration does not automatically benefit all regions equally. Without appropriate safeguards, there is a risk that headquarters functions become increasingly concentrated in major metropolitan areas, venture capital flows predominantly towards already established innovation hubs, highly skilled workers migrate disproportionately to larger economies, and smaller markets become consumers rather than producers of high-value-added goods and services.

For this reason, deeper market integration should be viewed not merely as a project of market enlargement but as a project of shared prosperity and economic convergence. Under such a model, both large and small economies stand to benefit. Larger economies benefit from scale, while smaller economies gain improved access to markets, greater resilience, stronger specialisation opportunities, and faster productivity growth.




# MICHAEL WEST

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## Europe has the capital to compete - the challenge is to channel it

Europe does not lack the resources to compete. It has a single market of 450 million consumers, a deep talent base and €39 trillion in household financial assets - of which around 30% sit in cash and deposits.

What it needs is the speed and cohesion to deploy them. Interlocking economic, technological and geopolitical pressures are exposing the limits of the EU's economic model and fragmented institutional architecture. The question is not whether Europe has the means to build long-term resilience, but whether it can mobilise them in time.

The pressures compound one another. Start with the economic challenge: sluggish long-term growth prospects, intensified by an ageing population and rising defence spending, are straining public finances.

Growth-enhancing policies remain key to safeguarding fiscal sustainability and sovereign credit quality - and some member states show what is possible. The Netherlands and Scandinavia rank among the OECD's top 10 for labour productivity, delivering forward-looking pension and labour market reforms that preserve resilience and underpin Aaa credit profiles.

The economic challenge is closely linked to a second, technological one. EU labour productivity per hour rose only 3% between 2019 and early 2026, against 12% in the US2, reflecting lower business spending on innovation and a smaller tech sector: EU R&D spending has stagnated at 2% of GDP over the past decade, versus 3.5% in the US.

US leadership in AI has been reinforced by surging private investment, with hyperscalers expected to lift capital spending to around $1 trillion by 2027, up from our previous estimate of $800 billion. These strengths have enabled the US to have more resilient growth prospects than the EU despite heightened policy uncertainty. AI offers the EU a generational opportunity to strengthen productivity - but without decisive action at scale, it risks falling further behind.

The technological deficit magnifies a third challenge: geopolitical exposure. The EU holds strategic leverage in parts of the AI value chain - ASML in lithography, Siemens in industrial software - but relies heavily on non-EU providers for computing, frontier models and cloud infrastructure, leaving it vulnerable to supply-side disruption if the US restricts access to advanced models, which could weaken the EU's competitiveness and economic resilience.

This is why the execution and timing of the European Commission's proposed digital sovereignty package will be decisive. As in many areas, EU policy effectiveness is constrained by a long, complex legislative process that struggles to keep pace with rapid technological change. Delivery hinges on channeling capital to critical investments and establishing a clear, simple framework enabling viable European alternatives at scale.

Digital infrastructure is where these threads converge. European data center capacity has grown at roughly half the global average rate over the past decade, which widens the imbalance between supply and demand.

Continued underinvestment in data centers risks undermining European data sovereignty and prolongs the region's dependence on international service providers, which increases latency using current technology and further weighs on the region's competitiveness. Europe accounts for only around 15% of global installed capacity, against about half in the US and a quarter in China.

Underinvestment reflects grid constraints, stricter environmental rules and market fragmentation: grid connection waits in the UK, Germany and the Netherlands can run five to ten years, versus one to three in the US.

**Productivity initiatives are key to long-term creditworthiness.**

With nearly half of Europe's operational capacity concentrated in its five largest cities, we expect increasing growth in the Nordics and Southern Europe given computing capacity and power constraints in the largest cities, a shift the EU's AI Continent Action Plan actively encourages.

A fragmented financing landscape compounds the challenge. Tripling EU data centre capacity will require an estimated €250–500 billion over five to seven years - beyond bank balance sheets alone, and requiring equity, structured finance, project finance, corporate issuance and a growing role for private credit.

Which brings the story back to where it began: Europe's untapped savings. Delivering the Savings and Investments Union and developing pillar II pension systems at national level, are crucial to mobilising the region's deep private savings pools - converting idle capital into the productivity-enhancing technology on which long-term competitiveness, and creditworthiness, depend.



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# Europe's productivity challenge: investing for growth

Europe's productivity challenge is one of the defining economic issues of our time. At the turn of the century, the euro area economy was converging with the United States. Since then, especially after the financial crisis, that convergence has reversed. GDP per capita growth has been almost twice as strong in the US as in the euro area, while productivity growth has consistently lagged.

The reasons are structural as much as cyclical. Europe recovered more slowly from the financial crisis, has experienced weaker population growth, and has not captured the full productivity benefits of the digital revolution. Mario Draghi's report on the future of European competitiveness makes this point clearly: the productivity gap between the EU and the US can "largely be explained" by developments in the tech sector and Europe's failure to capitalise on the digital revolution.

Fiscal and monetary support were essential in stabilising economies through crises, but they were never a substitute for investment, innovation and reform. Accommodative monetary policy can support demand, but over time may misallocate resources. Similarly, fiscal policy can boost productivity when directed towards infrastructure, education, skills and innovation, but high debt levels and heavy current expenditure can reduce the room available for future-oriented investment.

The lesson is that macroeconomic support must be matched by supply-side action. Europe needs deeper capital markets, stronger incentives for innovation, and a renewed focus on scaling businesses across the Single Market. Without that, fiscal and monetary policy can cushion shocks, but they cannot deliver the sustained productivity growth that Europe needs.

Against this backdrop, high-debt countries must show their public finances are sustainable. That is essential for confidence, lower uncertainty and ultimately investment. But fiscal consolidation must not come at the expense of the investments that drive long-term growth.

Europe has too often responded to fiscal pressure by cutting public investment. Investment in infrastructure, education, energy, housing, transport and digital capacity can lift productivity. It is not simply expenditure, it is the foundation for future competitiveness.

One approach worth considering is a carefully designed "green golden rule", under which defined green public investment would be treated differently within fiscal rules. Such an approach would need strict definitions and robust safeguards to avoid greenwashing, but it could help protect investment in the energy transition while encouraging discipline elsewhere in public spending.

Public-private partnerships also have an important role to play where risks are properly allocated and value for money is clear. The public sector cannot fund every productivity-enhancing project alone. By combining public policy objectives with private sector capability, Europe can accelerate investment in critical infrastructure and the transition to a more sustainable economy.

Regulation matters. Europe needs high standards, but it also needs a regulatory environment that supports enterprise, innovation and investment.

At the same time, Europe does not lack productive investment opportunities. On the contrary, the opportunities are significant: artificial intelligence, digitalisation, clean energy, energy infrastructure, transport, housing, defence and advanced manufacturing all require investment at scale. The problem is less a shortage of ideas and more a shortage of scale, speed and integrated financing.

The Draghi Report estimates that Europe faces an additional investment need of around €750-800 billion per year between 2025 and 2030. That is a substantial figure, reflecting the scale of the challenge if Europe is to remain competitive, resilient and strategically autonomous.

A key issue is that Europe has not been as effective as the US in turning innovation into large, globally competitive firms. In the US, research and innovation investment has shifted strongly towards software, hardware and digital platforms. In Europe, investment leadership has remained more concentrated in traditional sectors.

Europe's productivity challenge is one of the defining economic issues of our time.

That is why the Savings and Investments Union is so important. As highlighted in the Letta report, Europe has deep pools of private savings, but too much of that money remains in low-yield deposits or flows outside Europe rather than being channelled into productive investment.

The issue, therefore, is not whether Europe has productive projects. It does. The challenge is creating the financial, regulatory and market conditions that allow those projects to become investable, scalable and competitive globally.