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Insight INVESTMENT

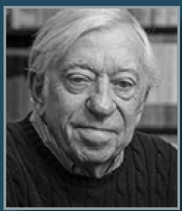
REFLECTIONS ON EUROPE VERSUS THE US
IT GOES BOTH WAYS

APRIL 2025

BNY | INVESTMENTS

EXECUTIVE SUMMARY

Professor Robert J. Gordon



Robert Gordon is a macroeconomist with a particular interest in unemployment, inflation, and both the long-run and cyclical aspects of labour productivity. He is the author of a textbook in intermediate macroeconomics, now in its 12th edition, and has completed a new book, The Rise and Fall of American Growth, published by the Princeton University Press in January, 2016. He is a Fellow of the Econometric Society and the American Academy of Arts and Sciences. In 2014 he was elected as a Distinguished Fellow of the American Economic Association. In 2016 he was named by Bloomberg as one of the 50 most influential people in the world. For more than three decades, he has been a member of the National Bureau of Economic Research's Business Cycle Dating Committee, which determines the start and end dates for recessions in the United States.

At Insight's Summit 2025, Professor Robert J Gordon offered insights into why the European and US economies have diverged. On a purely financial basis the US appears to lead Europe, but a more holistic analysis indicates that the US may not be so far ahead.

IS THE US ECONOMY THE ENVY OF THE WORLD?

Despite common assumptions, the US economy is not the envy of the world.

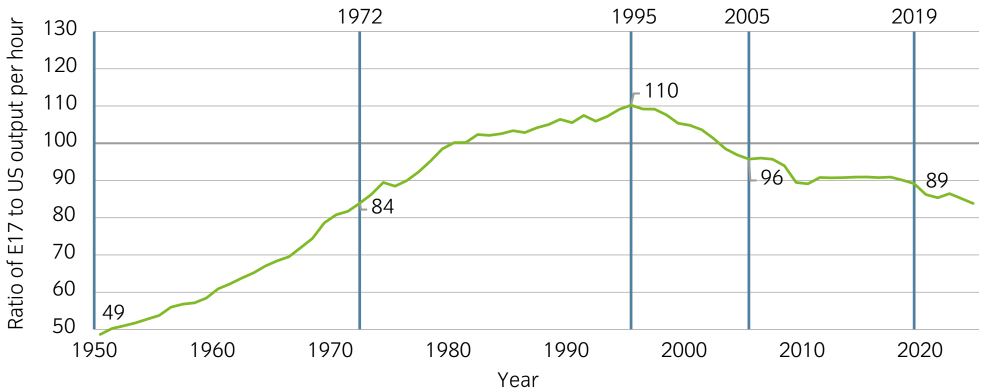
There are many reasons why conventional comparisons of income per capita between Europe and the US exaggerate the extent of the US advantage.

One of the most significant reasons is that welfare in the US is overstated. Europe's lead in that sphere has a significant equalising effect on quality of life, countering the financial disparities.

HOW THE US AND EUROPE'S ECONOMIES HAVE DEVELOPED

European countries (those outside the Communist bloc) emerged from the Second World War with far lower productivity than the US, and while both grew in the following years, Europe caught up rapidly. US growth slowed after 1972, while Europe continued to grow. European output relative to the US peaked in 1995 (see Figure 1).

Figure 1: Real GDP per hour in Europe relative to the US grew rapidly after the war, then fell back[1]



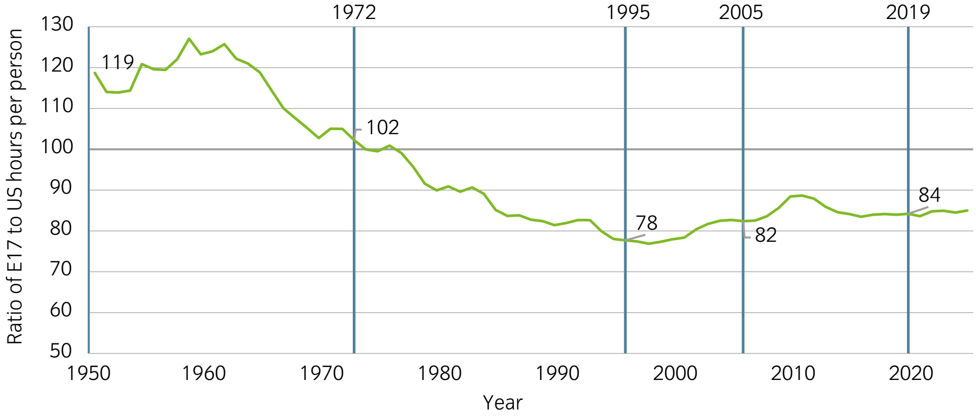
[1] Source: World Development Indicators, World Bank; Banque centrale du Luxembourg (BCL); Total Economy Database (TED). Ratio shown is based on average of BCL and TED data. E17 includes European countries that were not historically in the Communist bloc: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, UK.

At this peak in 1995, 11 of the 17 European countries had productivity above the US, and the three largest economies – the UK, France and Germany – were broadly in line. But by 2024, European output had fallen back significantly on a relative basis, with only four still exceeding the US.

Why Europe fell back after 1995 remains something of a mystery. It is generally assumed that the US outperformed due to technological advances and the internet, but Europe could have also enjoyed related gains.

On a key measure, per capita income, Europe has lagged the US. This is in part due to a fall in the working hours per capita in Europe relative to the US: this measure declined significantly from 1960 and remains well below that of the US today (see Figure 2).

Figure 2: European working hours per capita lag far behind the US[2]

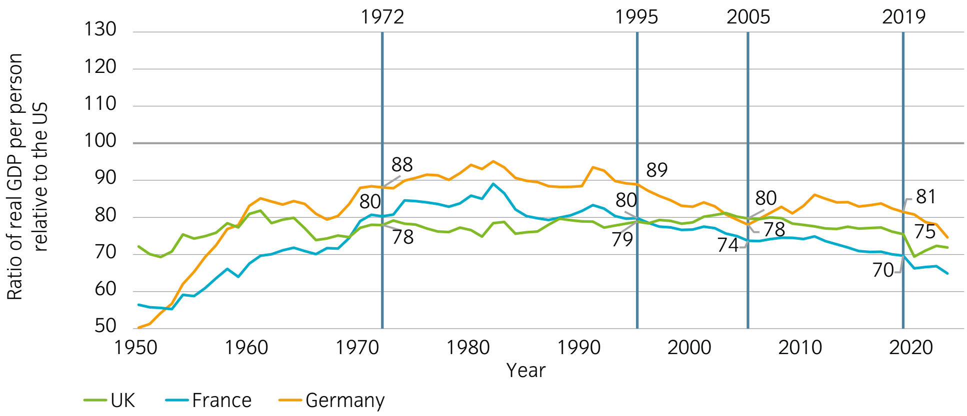


This decline occurred for two key reasons:

1. the European employment rate declined from 1960 to 1995, though this has since recovered back to US levels; and
2. hours worked per employee declined in Europe relative to the US – Europeans have more time off work, and their working hours are even restricted by law.

Thanks to such factors, real GDP per capita is materially higher in the US than in the UK, France or Germany (see Figure 3).

Figure 3: The US real GDP advantage – ratio of real GDP per person of three European countries relative to the US[3]



[2] Source: World Development Indicators, World Bank.
[3] Source: BCL, TED, Federal Reserve Economic Data (FRED). Ratio is averaged from the three sources.

QUESTIONING US PRODUCTIVITY LEADERSHIP

The measures we have been considering so far exclude a wide range of variables that put the overall productivity leadership of the US in question.

- **Time off work:** In Europe, workers typically have a right to more time off work. This could account for a significant proportion of the gap between Europe and the US.
- **Climate and environment:** In the US, the climate is generally harsher, with more extreme temperature variations, requiring greater energy use for heating and air conditioning. There is also a higher incidence of natural disasters, with hurricanes, tornadoes and wildfires driving US insurance premiums upwards.
- **Energy use:** The US is significantly less energy efficient than Europe, driven by restrictions on new housing development, which have led to low-density urban sprawl. Extended commuting distances create a greater need for private vehicles, exacerbated by a lack of public transportation. Tax conditions mean houses are generally larger and consume more energy.
- **Prison population:** The US prison population per capita is several times larger than that of any large European country, driven by higher crime rates, less effective gun control, and longer sentences for drug use.
- **Healthcare and life expectancy:** In the US, there is no universal health insurance with many uninsured, yet 17% of US GDP is spent on medical care. Meanwhile, life expectancy and infant mortality rates rank the US as 33 out of 38 among OECD countries.
- **Inequality:** Comparing the bottom 50% of earners in the US to the top 1% highlights a significant inequality problem: after tax, the bottom 50% of earners make 20% of national income, while the top 1% of earners make 15% of national income. This inequality has steadily increased over time.

Such large income inequality in the US is due to many factors. Downward pressure on the incomes of lower earners is driven by the decreasing role and influence of unions in the private sector, globalisation and automation hollowing out many industries, and the real federal minimum wage being the same today as it was in 1959.

At the same time, the highest earners have benefited from rising stock markets, with economic ‘superstars’ able to command very high incomes. In 1990, the pay of the average CEO was 30 times that of the average worker; today, it is 300 times.

The Gini co-efficient is a measure of inequality: a co-efficient of zero means everyone receives the same income, while a co-efficient of 100 means one person receives all the income available (and the remainder receive nothing). The co-efficient for the US has been materially higher than that of the UK, France and Germany for many years, suggesting the US is much more unequal in terms of income distribution (see Figure 4).

Perhaps the clearest illustration of this is a comparison of mean and median real incomes of the three largest European economies with that of the US (see Figure 5). The median of the three European companies is broadly comparable with the US, while the mean is materially lower – emphasising that higher income per capita in the US is driven by the higher income for the wealthiest in society.

Figure 4: The Gini co-efficient suggests US income distribution is less equal than in major European countries[4]

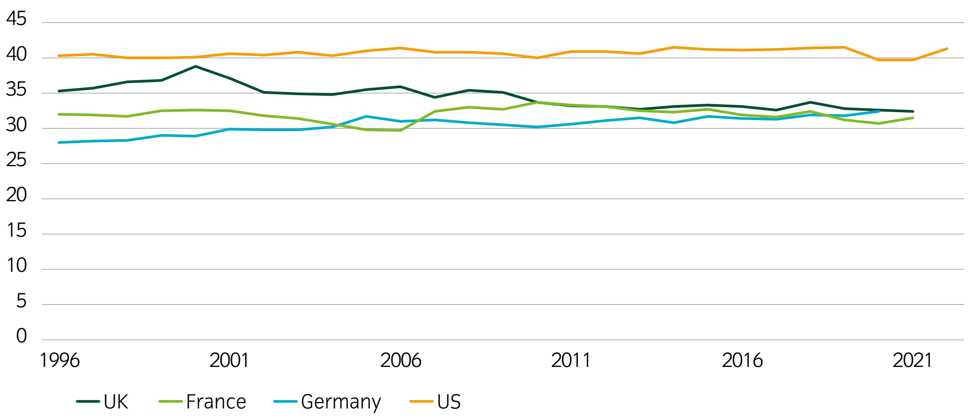
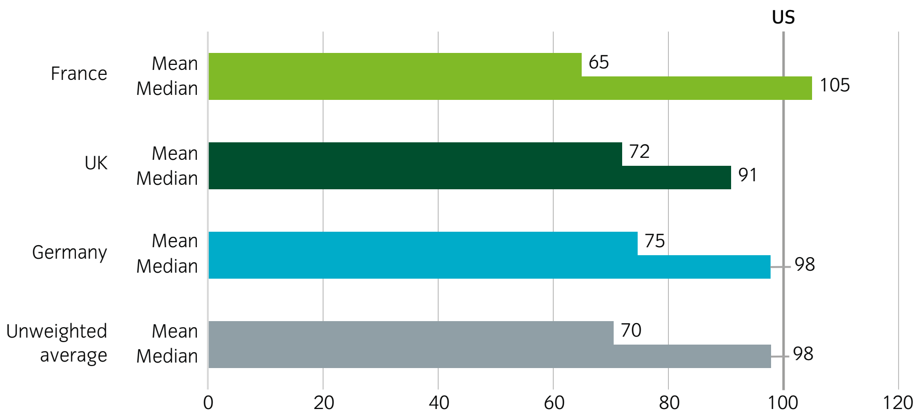


Figure 5: Comparing mean and median incomes highlights US inequality[5]



- **Social issues:** the US also lags Europe on a range of other social issues, including the broad lack of paid maternity leave and subsidised childcare; the lack of subsidised college tuition; and elevated housing costs.

RELATIVE DECLINE: WHY EUROPE FELL BEHIND THE US

To return to the economic comparison between the US and Europe, it is instructive to consider why European output per working hour was so high relative to the US in 1995. We can then highlight several factors that have favoured the US since that point.

- **Labour costs:** Up to 1995, European labour had become more expensive, as strong unions negotiated better working conditions, including a higher minimum and overall level of wages, and fewer working hours. Such factors led to a decline in relative levels of employment per capita in Europe, as marginal workers did not produce enough to cover their wages. Labour market reforms since that time have helped to reverse some of these pressures and return European relative employment per capita in line with the US.

[4] Source: World Bank.
[5] Source: FRED, Early.

- **The internet:** The invention and widespread adoption of the internet from 1995 may also have had an impact, with the economics of the internet economy leading to increasing returns to scale. High fixed costs and low to zero marginal costs meant that additional users of services such as Windows and Google cost effectively nothing, yet generated more revenue for the providers. The growth of the internet was dominated by US companies, though the extent to which the internet contributed to relative US economic performance remains debatable.
- **Scale and fragmentation:** Europe has a larger population than the US, but it is much more fragmented. The US benefits from the common use of English, while Europeans speak many different languages; and innovation in areas such as technology yield smaller returns in Europe as research is duplicated across individual markets and even in different languages. Sweden and Switzerland, for example, are home to many innovative companies and industries, but these are too small to make a difference at a regional level.

  Also, the US federal budget for research is much larger than the European equivalents, which are fragmented and divergent. US agencies such as the National Institutes of Health (NIH), National Science Foundation (NSF) and Defense Advanced Research Projects Agency (DARPA) are examples of US strengths in this area.
- **Regulation:** European markets broadly apply more regulation than the US, with opposition to mergers leading to smaller European companies. Green legislation and regulation, such as UK restrictions on building on 'green belt' land, also add to barriers and costs for European companies.
- **Resources:** The US benefits from abundant resources, including oil, and more freely allows their exploitation.
- **Currency:** The US dollar is the world's reserve currency, which means the US, all else being equal, can run higher fiscal deficits than other countries because of inherent foreign demand for US dollars and US debt.
- **Corporate productivity:** In terms of productivity growth, US companies tended to do better over the decade from 1995, except in transportation, utilities and IT. But then the US improved in technology and European companies began to underperform, with many reporting declining productivity.

THE SIGNIFICANCE OF THE US FINANCIAL INDUSTRY

A key advantage of the US over the European economy is the size and success of its financial industry. The US stock market is valued at over 200% of GDP, while the European stock market is value at c.50% of GDP.

One reason the US stock market is so highly valued is that corporate profits as a share of GDP have doubled over the last 20 years. Another significant shift has been the move from defined benefit to defined contribution pension schemes: the latter typically invest a much higher proportion of their assets in equities than bonds.

Despite these factors, there remains c.$7trn invested in money market funds.

The global factor: China

The US economy is almost two-thirds larger than China's in nominal terms, but in purchasing power parity terms the Chinese economy is around a fifth larger than the US, according to estimates from the World Bank and the IMF. China's dominance in manufacturing has had a global impact.

A striking example is semiconductor manufacturing: in 1990, when the US and Europe were responsible for over 80% worldwide. In 2024, their share had fallen to just 19%, and China's share had increased to 22%, with other Asian countries also manufacturing at meaningful scale.

MAKING UP LOST GROUND: THE CASE FOR MORE UNION IN EUROPE

To increase competitiveness relative to the US, there are various steps that European economies can take, including more integration and collaboration in key areas.

- A common budget for research and development, higher education and defence would help to offset fragmentation and duplication and could move efforts forward collectively.
- Europe would benefit from a move towards a common language. English is the second language everywhere in China, just as much as it is in most of Europe; and educated people who make the majority of decisions are already largely fluent in English.
- Immigration is positive as an offset against declining fertility rates and an ageing population, but it is important to focus on skilled immigrants. It is notable that Apple was founded by Steve Jobs, the son of a Syrian immigrant; and Google was co-founded by Sergei Bryn, a Russian immigrant. Points-based systems, such as those used in Canada and Australia, could help in this regard.
- It is crucial that European regulations are eased, and the European bias towards preventing mergers is set aside: as the quantity and complexity of regulation inhibits development with features such as environmental or permitting delays.
- The goal of achieving net zero by 2050 is a significant headwind to growth. Any time you legislate that companies or households have to replace gas boilers with electric heat pumps, you reduce the resources for productive investment and innovation, and more pressure is put on the electrical grid, which in turn will need more investment. The result is what I refer to as “green crowding out”. Delaying the target date for net zero, by a decade or two, will reduce the impact of such measures.

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