Testing the resilience of Europe's inclusive growth model

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The combination of six global megatrends is increasing the stress on Europe's inclusive growth and the EU social contract.

Europe's inclusive growth model and the European Union's (EU) welfare-based social contract appear to be under threat amid limited growth in median income in recent years, falling trust in institutions (both EU and national), discomfort about mass migration, worries about security as well as the resilience of global agreements, and a rise in populist politics that challenges the status quo.

Europe now needs to respond to six global—and interacting—megatrends that could push inequality higher within EU member states and among them and increase social and economic divergence, placing the inclusive growth part of the EU social contract in even more peril.

Given these trends, Europe needs to be proactive about testing new ways in which the social contract might work in the case of the future of work, low-carbon lifestyles, and technology ethics, for instance. Overall, however, we find that Europe may be able to preserve the essence of its welfare-style social contract, if it delivers superbly on all its current initiatives that are linked to, and aim to respond to, the megatrends.

Among initiatives with the best outcomes for inclusive growth, the EU and European countries might have to scale up green and technological innovation and develop new skills. While inequality will likely grow as new social policies unfold, these new approaches might be financed by the returns on those policies, and, in the process, mitigate rising inequality, and helping to head off anti-EU sentiment. Social divergence within member countries is likely to persist and must be tackled with the EU complementing the actions of member states.

New McKinsey Global Institute (MGI) research, *Testing the resilience of Europe's inclusive growth model* *(PDF—839KB)*, focuses on prospects for inclusive growth in the period to 2030—possibly the largest driver of citizens' life satisfaction. It simulates the challenges and opportunities ahead in several scenarios and focuses on the impact of the six megatrends.

1

Much of Europe has returned to growth, but its inclusiveness remains under pressure

The European Union has long strived to reinforce a vision of an inclusive Europe for its member states. However, when the European Union's focus started to shift from the completion of the Single Market to the strategic vision of "smart, sustainable, and inclusive growth" that was a major theme of the Treaty of Lisbon, the timing was unfortunate. The treaty came into force on December 1, 2009, a year when the eurozone and the EU-28 were in a severe recession. Fiscal austerity reigned after 2010 and the sovereign-debt crisis, fueling debate about the institutional setup of the eurozone. Investment rates have not recovered to pre-crisis level, trust in national governments is still falling in one-third of European countries, and populist parties have won greater shares of the vote.

It is evident that rising social tension and falling trust in institutions do not happen in a vacuum; citizens' perceptions of their economic well-being are key. There is a clear and established link between the momentum of economic growth, and strength in social cohesion, citizens' satisfaction, and trust in institutions and politicians.

On average, Europe has performed solidly in terms of GDP growth, and had reduced income inequality in the 15 years before the crisis hit in 2007. After the crisis, inequality in parts of Europe rose—in market income by 5 percent between 2007 to 2013 for the working-age population, and in terms of disposable income by 3 percent.

Incomes, particularly at the bottom of the income distribution, stagnated or even fell. MGI research has shown that market and disposable incomes did not advance for the majority of the population in the post-crisis years from 2005 to 2014. So far, Europe has failed to meet its laudable goal of lifting 20 million of EU-27 citizens out of poverty between 2008 and 2020. Indeed, since 2008, an additional 1.6 million have become at risk. There has been a growing perception that younger generations are destined to be poorer than their parents in some European countries.

Today, the pressure on Europe's social model appears to have receded somewhat as the economic recovery has gathered a measure of momentum, but is far from having disappeared.

On the bright side, the number of people at risk of poverty declined by close to five million between 2012 and 2015 in the EU-28. Mean and median income growth resumed in most of Europe. In general, our analysis in the period to 2016 suggests that all quintiles and deciles experienced an increase in their disposable income, while the ratio of top to bottom 20 percent disposable income earners stabilized or fell slightly, mostly as a result of top 10 percent earners increasing their disposable income at a lower rate than any other decile.

On the dark side, however, populism has continued its inroads in many parts of Europe—witness the emergence of social protests in France, for instance—and trust in institutions remains low.

The average picture may mask cracks in Europe's inclusive growth that bear watching. Looking at regions (or clusters) within Europe, there have been distinct differences. Nordic countries have achieved the largest income growth, but in Southern Europe, all income quintiles have lost between 1 to 3 percent a year of disposable household income, with those on the lowest incomes experiencing the largest losses (Exhibit 1).

Exhibit 1

Social clusters' performance has diverged in Europe since the crisis, the Mediterranean cluster appearing worst off.

Performance by region and metric

Very positive · Positive · Moderate · Challenging

Metric ↓ / Region →	**Social democratic** Nordic	**Eastern** Central and Eastern Europe	**Corporatist** Continental Europe	**Liberal** Anglo-Saxon	**Mediterranean** Southern Europe
TOP 20% progression of disposable income,[1,2] 2008–16 compound annual growth rate (CAGR), constant prices	1.7	2.5	0.3	–0.8	–1.1
MEDIAN disposable income,[1] 2008–16 CAGR, constant prices	1.3	2.9	0.8	–0.4	–1.3
BOTTOM 20% progression of disposable income,[1,2] 2008–16 CAGR, constant prices	1	2.4	0.4	0	–2.9
RATIO of income of top 20% vs income of bottom 20%, 2008–16 change, constant prices	0.4	0.3	–0.2	–0.5	0.9
TRUST in European Union, 2008–16 percentage-point change	2	4	3	10	–14
TRUST in national governments, 2008–16 percentage-point change	–7	–12	–13	6	–16

Note: Country aggregation through population weighting.
[1]Estimates of disposable income are based on current average tax rate of income tax bracket, which has been corrected for inflation using Harmonised Index of Consumer Prices.
[2]Estimated change over time in median income of the quintile.

Source: Eurobarometer; Eurostat; Organisation of Economic Co-operation and Development; World Bank World Development Indicators; McKinsey Global Institute analysis

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2

Six megatrends could test the resilience of Europe's inclusive growth model

The resilience of Europe's social contract may be tested by six global megatrends: aging; digital technology, automation, and artificial intelligence (AI); increased global competition; migration; climate change; and shifting geopolitics.

MGI has simulated the likely long-term evolution of inclusive growth in the European Union and its social clusters in light of these six megatrends. There is a great deal of uncertainty about each trend, and the interconnections among them, and the simulation is therefore intended to give a rough "dimensionalization" of the challenges and opportunities ahead in several scenarios rather than precision and point forecasts.

Our model suggests that, overall, the six megatrends may put more pressure on inequality and institutional trust in the next decade rather than being a cause for relief. The trends will have different impact depending on whether Europe responds to them vigorously or passively. All six play a role, but sometimes asymmetrically. Our analysis suggests that technology will be the largest swing factor, and further large impact will come from aging and globalization.

3

The megatrends may mean that Europe faces higher inequality and more social divergence

To gauge the impact of the six megatrends, we have developed two contrasting long-term scenarios from today to 2030.

The first is a "denial" scenario in which Europe takes no action to mitigate the impact of the trends. If this (unlikely) scenario were to unfold, Europe would, for instance, not counteract aging demographics, and would block progress on digitization and AI, risking losing competitiveness vis-à-vis China and the United States, the world's digital and AI leaders. It could also find itself at the mercy of significant economic risk linked to climate change and pollution, for instance. In this scenario, Europe could face prolonged economic stagnation, rising inequality, and growth in welfare costs outstripping gross income growth.

The average outcome of our various simulations suggests that the strength of the headwinds induced by the megatrends could be sufficiently large to reduce baseline income growth from an average of 1.6 percent per year to 0.3 percent (an 85 percent drop), not accounting for the likely depressive effect of rising inequality on income growth.

In this scenario, not only would growth come under challenge, but the inclusivity of growth would decline, increasing social tensions. The level of unemployment might rise further by 4 to 5 points by 2030 than today, and the quintile income ratio could increase by 10 percent compared with today, creating rising inequality. Last but not least, extra costs required to finance pensions, healthcare, and increased unemployment could be in the range of €1,350 per capita, or 9 percent higher than today in real terms. On average, this would be more than the amount of additional extra gross income generated by anemic growth. There would, therefore, clearly be questions about where the funding would come from, underlining the risk to the welfare-like social contract in Europe.

The second is a "deliver" scenario where European countries, for instance, invest at the same pace in the circular economy and continue their path to decarbonization according to the Paris Agreement. The EU implements its objectives for the Digital Single Market, and starts to diffuse AI technologies, achieving success in line with its existing progress in innovation, education, and digitization. In this scenario, our results suggest that annual per capita income growth could be between 1.2 and 2.5 percent a year, with a European average of 1.9 percent per year.

Such a scenario may limit the risk of unemployment, and prosperity might continue. Total social funding in real terms (and excluding healthcare costs) could be around €1,000 per capita by 2030, or less than about a 1 percent increase in the social budget a year. This would be a relatively small hurdle considering the increase in funding would be half as much as expected income growth.

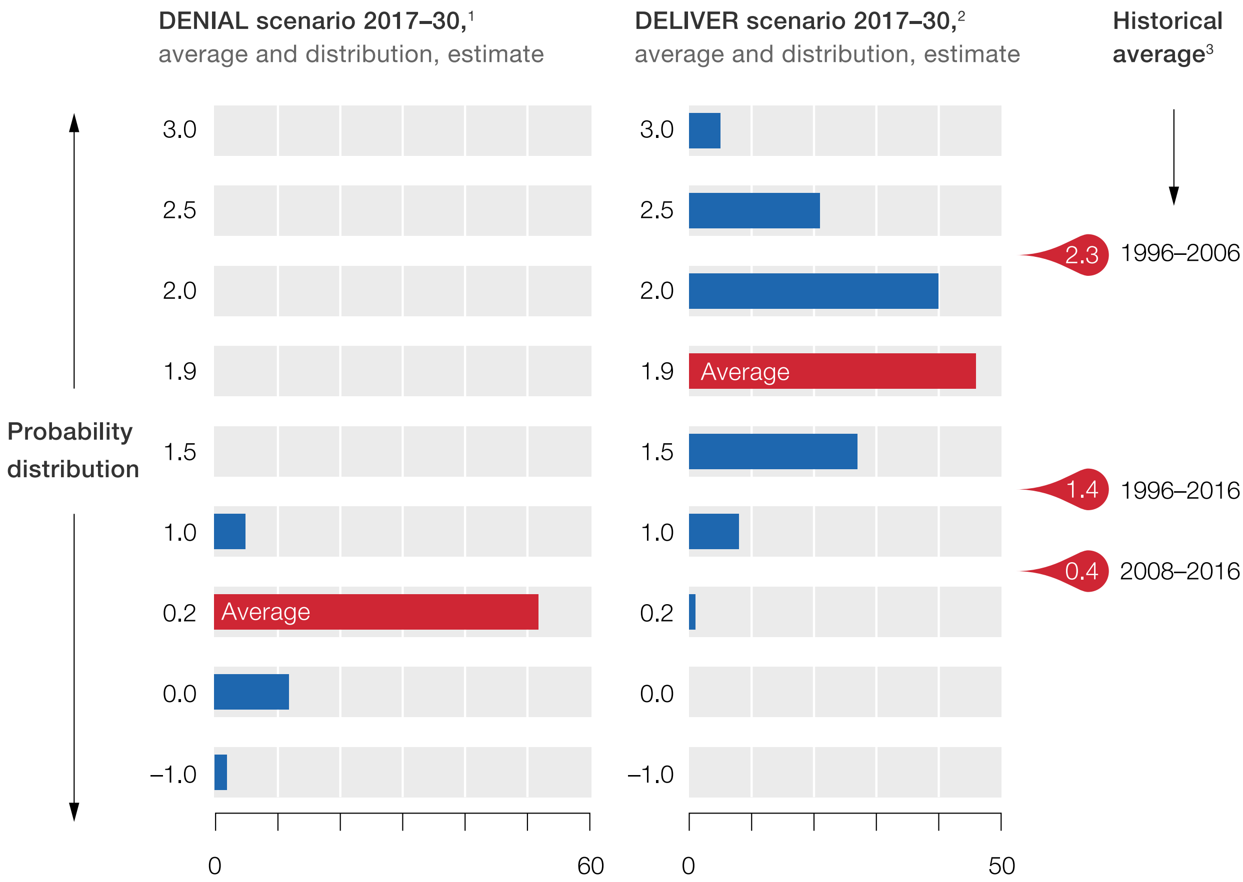
Even in a deliver scenario, the larger risk may be social. Europe could face rising inequality —within *as well as* among countries. Digitization and AI, as well as global competition, could amplify skills premiums and put pressure on wages of routine jobs, superstar effects among firms and cities could continue, and aging as well as migration could further increase the wedge between top- and bottom-income households.

In our simulation, and for the average European country, some additional €1,200 transfer income per capita for the bottom quintile would have to be made to stabilize within-country income quintile ratios at current levels. Adding this to the social funding needed to see Europe through the transition, the burden may not be financed through normal redistribution channels. Governments would need to reallocate among priorities and be more effective (Exhibit 2).

Exhibit 2

European inaction (denial) of megatrends could lead to secular stagnation; action (deliver) could lead to growth of around 2 percent.

Per capita gross-national-income growth for EU-28,
probability distribution of scenario-simulation results, %



[1]Denial scenario: Europe does not take action to mitigate impact of megatrends.
[2]Deliver scenario: Europe continues to pursue, and scale up, current policies and develops new approaches that leverage existing assets and competencies to respond to newer trends, such as diffusion of artificial intelligence.
[3]Average of multiple years.

Source: World Bank World Development Indicators; McKinsey Global Institute analysis

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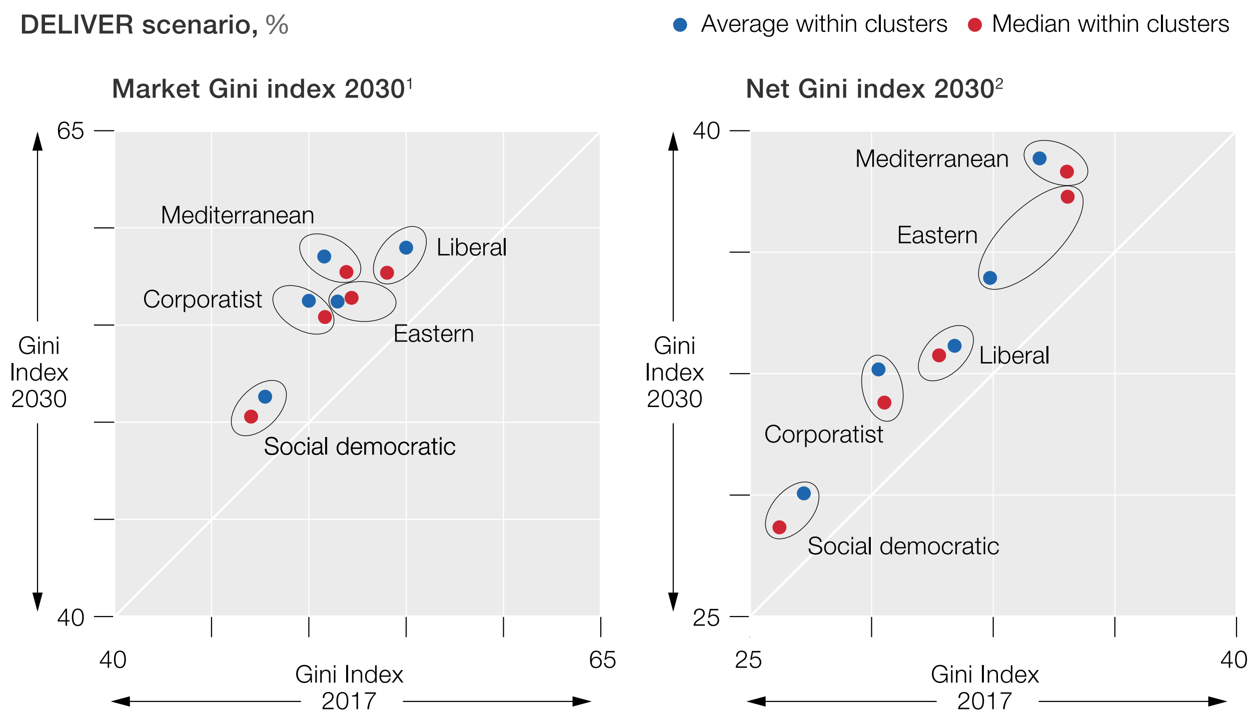
Another significant challenge facing the EU-28 is continued social divergence within the region in light of expected slower per capita income growth in Southern Europe and a larger increase in inequality there. Even in a deliver scenario, Southern Europe is challenged by its demographics, and, on average, seems to have lower current assets to benefit from technology. This technology divide is already visible in the case of current digital technologies and will likely continue with respect to new advanced technologies such as AI because of less availability of human capital and high-tech innovation. Southern Europe typically ranks lower on those dimensions than, say, Northern Europe's digital front runners.

Our estimate suggests that the cluster of Mediterranean countries may generate less than 1.5 percent of per capita income growth, compared with more than 2.0 percent in the other European clusters (Exhibit 3). Furthermore, Southern Europe has one of the lowest social coverage, including some of the largest inequality ratios in the EU-28.

Exhibit 3

Social divergence may spread within the EU-28, even in a deliver scenario.



[1]Before taxes and transfers: Gini index on wage income only.
[2]After taxes and transfers.

McKinsey&Company | **Source:** Eurostat; World Bank; McKinsey Global Institute analysis

4

Action in three areas is required to strengthen Europe's inclusive growth model

There are three areas where European countries, the EU, as well as the private sector will need to act—sometimes in concert—to bolster the resilience of Europe's inclusive growth model:

1. Fully execute a deliver scenario

Achieving sufficient economic growth is a necessary requirement for inclusive growth to be sustained in light of the six megatrends. In particular, Europe may need to deliver on its reform and ambition regarding the Digital Single Market, the Paris Agreement, and pension reform.

Achieving growth in—or even beyond—the deliver scenario would require Europe to make progress in areas where headway has stalled in recent years such as scaling and delivering innovation and diffusion and boosting human capital. It is imperative that Europe (1) increases its competitiveness in research and development in key growth areas, most importantly in AI and other digital technologies; (2) enables growth of competitive EU companies in this new environment; (3) triggers further investments in a low-carbon economy; and (4) modernizes education and training systems to enable the significant shift in skills that is likely to be necessary.

2. Complement growth with improved measures to promote income equality within and across countries

Income inequality will need to be tackled on two levels: within European countries, and among them. Within countries, the least controversial approach to countering an increasing income inequality is to make sure that as many people as possible get a chance to receive an income in the first place. This requires increasing employment rates.

Public social expenditure should be allowed to rise to support the transition, not only to comply with Europe's welfare philosophy, but also because such investment has strong social returns—in particular returns on skills. Higher public social spending may not necessarily mean a long-term increase in such spending, however, because, in theory, productivity gains may be higher than the cost of extra social expenditure.

Our work indicates, however, that achieving high employment rates alone will likely not be enough to counter the trend toward higher income inequality. Technological trends are expected to increase the inequality of market incomes during the process of new technology diffusion. One crucial driver to mitigate inequality will be to ensure that AI diffusion focuses more on innovation of products and services than pure labor automation, and that skill shifts happen as fast as possible.

At the cross-country level, our simulations suggest rising divergence of particularly the Mediterranean cluster. Further support for investment, training, and to deal with debt levels may be needed that complements more reform at the cluster level. In the past, Nordic countries undertook major economic and social reforms in the 1990s, providing the backbone for their current inclusive growth model, and they may provide lessons for other member countries.

European institutions need to engage in a dialogue, as European countries with social challenges have a tendency to try and close borders. While trust in the European Union is low in the Mediterranean cluster, the share of citizens who trust the European Union is still up to twice the share of those who trust their domestic institutions, according to European Commission Eurobarometer surveys.

3. Amend the parameters of the social contracts

The six megatrends not only affect outcomes such as inequality but also change the nature of many components of the social contract—between firms and workers, among citizens of different generations, between citizens and government, firms and government, as well as at the intergovernmental level.

- *Firms and workers:* As firms increase their adoption of disruptive technologies, how can they best contribute to the reskilling and lifelong learning of their workers, and how do workers need to invest in their own development? How can incentives be created for companies to prioritize technologies that complement workers over those that displace them? Or what are the right structures of worker representation and protection particularly as the gig economy gains ground?

- *Firms and government:* What is the right public–private collaboration to develop better ecosystems, be it for financing sustainable infrastructure and energy efficiency, pushing innovation and the adoption of technology, orchestrating cross-sector ecosystems like autonomous mobility, or raising the game on cybersecurity?
- *Citizens and government:* The European Union as an institution and national governments will have to regain the trust of their citizens and win their support for the reforms needed to sustain the inclusive growth model—from improving the way they deliver government services (from trash collection to tax collection) to making decision making more transparent, to increasing the engagement of citizens on policy, regulation, and budgeting. But if inclusive growth does become more challenging, how should the European Union evolve social security and transfers mechanisms in order to provide the fiscal flexibility to execute on the deliver scenario? And how should European countries further develop their education systems so that they produce more technological, and social and emotional skills, and enable lifelong learning?

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