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A productivity prescription: how the US has pulled away from Europe and Japan
By Chris Giles
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You could call it the productivity myth. It goes like this. European economies trail behind the US because their citizens would rather people-gaze from a pavement cafe than labour loyally in the corporate saltmines. Americans, on the other hand, are a bunch of stakhanovites so preoccupied with boosting their nation's gross domestic product they take just a week's vacation a year.

The conveniently simple notion that Europeans are poorer because they prefer leisure to work can no longer be supported by the data, however. In Japan, another troubled economy, it has never been true. The real explanation for the regions' undistinguished record is both more complex and - for the global laggards - more challenging.

One fact is indisputable. Over the past decade the US has stolen a march on its competitors so marked that it can no longer be dismissed as a statistical blip. Internationally comparable figures for 2005, published last week by Professor Bart van Ark's team at Groningen University in the Netherlands, demonstrated that last year sealed a decade of European and Japanese underperformance.

The trend had been obvious for some time before that. Europe's post-war catch-up with US living standards petered out in the 1970s, and the Americans have moved decisively ahead in the past decade. Japan sustained its relative improvement until 1991 but since then its decline has been rapid.

A country's performance is traditionally judged by its level of economic growth and its GDP per head. Many people object to measuring well-being by adding up the marketable goods and services an economy produces and dividing that total by the population (see below), but GDP's domination of international league tables reflects its twin virtues of clarity and comparability.

US GDP figures can appear higher because of the methodology its statisticians use (see below right). But GDP per head in the 15 longest-established members of the European Union was only 73 per cent of US levels in 2005 - demonstrating that average living standards from New York to San Francisco are considerably higher than between Dublin and Athens. Japan's living standards, meanwhile, are on a par with the EU15.

The US has not always held so unassailable a lead. In the 1950s and 1960s, European per capita incomes steadily rose towards US levels, spurred on by the rapid recovery from the devastation of the second world war and the successful integration of European economies.

The former West Germany's per capita income increased from half the US level in 1950 to 89 per cent by 1976. Over the same period, France advanced from 57 per cent to 84 per cent; Italy from 40 per cent to 73 per cent and Spain from 27 per cent to 60 per cent. Only the UK failed to join the advancing European party; stuck with the "British disease" of poor labour relations, its per capita incomes grew in line with the US, hovering at about 77 per cent of US levels throughout the 1950s, 1960s and 1970s.

Japan also enjoyed a remarkable rise in its living standards, with its GDP per capita growing from 21 per cent of US levels in 1950 after the destruction of its economic infrastructure in the second world war, to 87 per cent in 1991, at the peak of the late 1980s Japanese property boom.

But the good times in Europe and Japan are long gone. In the past decade, the gap between US living standards and those in other leading countries widened again.

Europe has been actively concerned about its relative decline for five years. It devised the Lisbon agenda in March 2000 with the grand goal of making the EU15 "the most competitive and dynamic knowledge-driven economy by 2010". But it has failed and the relative position of Europe's economy has declined since 2000.

For much of that period, economists have grasped at sociological and cultural straws as they sought to explain the continued disparity in living standards. They have argued it had much to do with Europeans' determination not to work themselves into the ground like their unfortunate US counterparts. Part of this is true. Europeans do work fewer hours than US employees; the average US employee (including part-time workers) works 36 hours a week with two weeks holiday a year; the average German works 31 hours a week and gets six weeks off a year.

Most of this difference is indeed a conscious choice. The decline in European weekly working hours has been a consistent feature since 1950. In the US, in contrast, hours worked stopped falling in the early 1980s and since then, while US citizens have become richer, they have not chosen to "buy" additional leisure time.

Europeans accept that lower incomes are the price of spending more time at home. If they worked US hours, Mr van Ark estimates, European GDP per capita would increase from 73 per cent of US levels to 86 per cent. The effect is particularly marked in the Netherlands, France, Germany and Austria.

A second drag on European living standards is the share of its population that is working.

Unemployment dogs Germany, France and Italy and living standards are further dented because European economies are worse at getting the young into employment and keeping older people at work. For the 30 to 50 age group, there is almost no difference between the participation rates of the US and Europe.

Weak labour markets depress average EU living standards relative to the US by another 5 percentage points; by 12 percentage points in France and by 7 percentage points in Germany.

But Europe's short-hours culture and higher unemployment levels are only part of the story. The real reason the region needs to worry is its labour productivity - output per hour worked - has begun to fall well behind the US's.

Average European labour productivity caught up with US levels in 1995, but since then it has declined by 10 per cent. Whereas between 1987 and 1995, the annual growth of the EU15's output per hour was 1.2 percentage points higher than the US, in the past decade, that trend has reversed and the US has enjoyed 1 percentage point a year faster labour productivity growth.

Japan's relative decline is not so sharp but its problem is endemic low productivity. It has always used far more capital and labour to produce one unit of GDP than Europe and the US, primarily because its service and agricultural sectors are so inefficient.

The European economy seems to have lost its ability to foster rapid efficiency gains, while the US has generated a new dynamism.

The Conference Board, the global business organisation, has found that the differences between the two can be found in just three industries: retail, wholesale and finance.

Take retail, where research from individual companies in the field has indicated that the US's advantage is almost entirely due to the building of new shops and the closure of existing stores that had become uncompetitive. The Wal-Mart effect, in other words, transformed the US economy as much as it transformed the US landscape.

By contrast, in Europe planning laws and a reluctance to allow old establishments to fail have prevented productivity growth from taking off. Prof Robert Gordon of Northwestern University thinks the outcome reflects the power of existing producers in Europe at the expense of poorer consumers. This, he believes, is a high price for Europeans to pay for the preservation of small and unproductive shops.

The idea that European economies are bad at exploiting new technology is supported by detailed research into the differences in productivity between individual US and UK companies undertaken by **Prof John van Reenen at the Centre for Economic Performance** at the London School of Economics.

Intriguingly, he found there was no difference between productivity levels in US-owned plants in the US and those located in the UK. A McDonald's or Starbucks in London is just as productive as one in New York. UK-owned multinationals in the same industries squeeze out a little less output per hour worked and UK-owned domestic companies are much less productive, even though they invest similar amounts in computer equipment.

Management differences and the use of technology explains Europe's poor performance, Mr van Reenen argues. US companies use technology better and their hire-and-fire culture keeps workers on their toes.

If Europe wants to improve its productivity levels, it seems, it must accept tougher management, the emergence of new and much more productive shopping centres and the death of many companies. The same lessons apply to Japan.

For the US, the lesson of the past decade is that it should avoid complacency: no one predicted its surge in productivity and it has taken almost a decade to believe in, and then to explain, it. If Europe were to rediscover its competitive spirit and close the gap, it could disappear as quickly as it came.