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Eurosclerosis 2.0 in a Changing World: From Repetition to Rupture

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1. Introduction

The European Union and its Member States are currently navigating choppy waters. Economic growth is slowing, in particular compared to the US, while demands on government budgets are increasing. The Draghi (2024) report clearly pointed to a lack of economic dynamism in the European economy. That said, concerns about European growth are not new. In many ways, we have been here before, on more than one occasion. In fact, Europe was formed through hardship and crises. The latter have generally led to increasing European integration. Yet there is a growing awareness that the recipes of the past can no longer be applied to today's world. The theme of this paper is therefore one of both recurrence – the same observations leading to the same proposals – and a deep break with the past or a "rupture", in the words of Mark Carney (2026) in his recent address at the World Economic Forum.

In the early 1980s, the European economy was recovering from two oil shocks, which caused rampant inflation and economic stagnation, coupled with structurally high unemployment and rigid labour markets. This situation came to be described as Eurosclerosis and was a defining moment for Europe. The policy response entailed the creation of a single European market which boosted the EU economy. This key initiative happened against the backdrop of a stronger consensus on trade openness and the need for a stricter competition policy (or rules limiting State aid) in order to avoid wasteful national subsidies to ailing industries. In fact, trade and competition are among the European Commission's few exclusive powers.[2] These principles allowed the EU economy to rise out of the Eurosclerosis doldrums, for the most part, and continue to shape and underpin EU policies to this day.

Despite significant welfare growth in the last decades, questions about the relatively less dynamic European economy have resurfaced periodically. In tech industries in particular, Europe lags behind the US, with the most important innovations originating outside the continent. Over the years, European policymakers have tried to address this issue, usually with ambitious multi-year plans. However, these "grand plans" typically overpromised and underdelivered. Economic growth has gradually declined further, and the gap

1 This policy paper represents the views of the authors, not necessarily those of the National Bank of Belgium. The authors would like to thank without implicating André Sapir, Hans Dewachter, Tomas De Keyser and Raïsa Basselier for helpful comments and discussions.

2 These exclusive powers can be traced back to the Treaty of Rome, but it is fair to say that they became part of a stronger European consensus after the failure of more "activist" policies in the '70s and early '80s and the general trend towards more market-friendly policies coinciding with the Reagan and Thatcher years in the US and the UK.

with the US has even widened. Forty years after the launch of the single market, Europe has drifted into Eurosclerosis 2.0.

This article looks at the similarities as well as the differences between the current situation and the first period of Eurosclerosis. The symptoms are somewhat different now and probably less painful for the population as a whole. Unemployment, in particular, remains near all-time lows. However, public debt levels have kept on rising, while productivity growth has further declined and Europe is stuck between a more innovative US and an ever more competitive China, especially in the green industries that were supposed to boost EU economic growth.

Europe finds itself, once again, at a pivotal moment. However, while the response to Eurosclerosis 1.0 was a clear paradigm shift from – to put it simply – more activist, government-led economic policies towards market-oriented solutions, economic integration and openness, there is no such movement today. Our economic model is showing cracks under pressure; there are some new emphases and parametric changes here and there, but it is mostly piecemeal. Europe seems to be lacking a consistent approach to dealing with a world that is not moving in its direction and is in fact gradually leaving us behind. In this context, the prevailing inclination is to look for the next "great" European initiative and encourage more integration.

We have no new paradigm to offer but believe it is necessary to start by acknowledging a number of trade-offs, some of which are historical and some of which relate to the current international environment. We cannot have it all. The world is rapidly changing, and the global economy is more supply-constrained than in the past. In addition, the traditional, stable rules-based order has been replaced with a more chaotic, transactional one based on geopolitical power. In this context, there are growing tensions between trade openness, the preservation of the single market and the European climate ambitions, as well as a need for more strategic autonomy. This implies that Europe's "technocratic" approach to trade and competition policy is no longer sustainable. In addition, we argue that Europe's lag in terms of technological innovation is partly due to deep-seated societal preferences. Europeans are less comfortable with disruption, favour greater redistribution and are more risk averse. Europe leads the pack in terms of regulation while the US, and ever more China, is winning the innovation battle. Finally, Europe's ability to export its norms and standards to the rest of the world – the so-called "Brussels effect" – is coming up against greater resistance. The time when Europe could deal with the rest of the world on its own terms is past, and we now face a difficult choice of either retreating to rules-based trade with like-minded democracies or accepting a more transactional world in which power politics is the name of the game.

This is an article that was born out of concern for Europe's future. How should Europe respond to today's challenges and how can we avoid a longer period of relative economic decline and reduced geopolitical relevance in a rapidly changing global environment? It raises more questions than it answers, which is probably unavoidable given the dramatic changes taking place today. The discussion is organised as follows. We start by examining the original period of Eurosclerosis and the roots of the EU's economic model. We then look at how consecutive multi-year policy programmes have failed to resolve Europe's lack of dynamism, explore the extent to which relatively slower growth in the EU reflects deeper societal choices and argue that economic and geopolitical changes will require addressing certain tensions in the EU's current economic model. The third section is the heart of the paper: we specifically analyse Europe's economic and political situation through the lens of three critical and intertwined challenges – technological, institutional and geopolitical – and point to a number of (uncomfortable) trade-offs. The final section sets out our conclusion.

2. From Eurosclerosis 1.0 to Eurosclerosis 2.0

The key tenets of the European economic policy model date back to the 1980s. After a boom in the 1960s, two oil shocks (in 1973 and 1979-1980) took a severe toll on the European economy. Economic growth fell sharply from more than 5% per year on average in the period 1960-1973 to just above 2%. In a period of strong demographic growth, this was insufficient to provide jobs for everyone, and unemployment surged. Despite the significant economic slowdown, inflation rose sharply as well, reflecting the fall-out from the unprecedented energy supply shock and accommodative monetary policy.

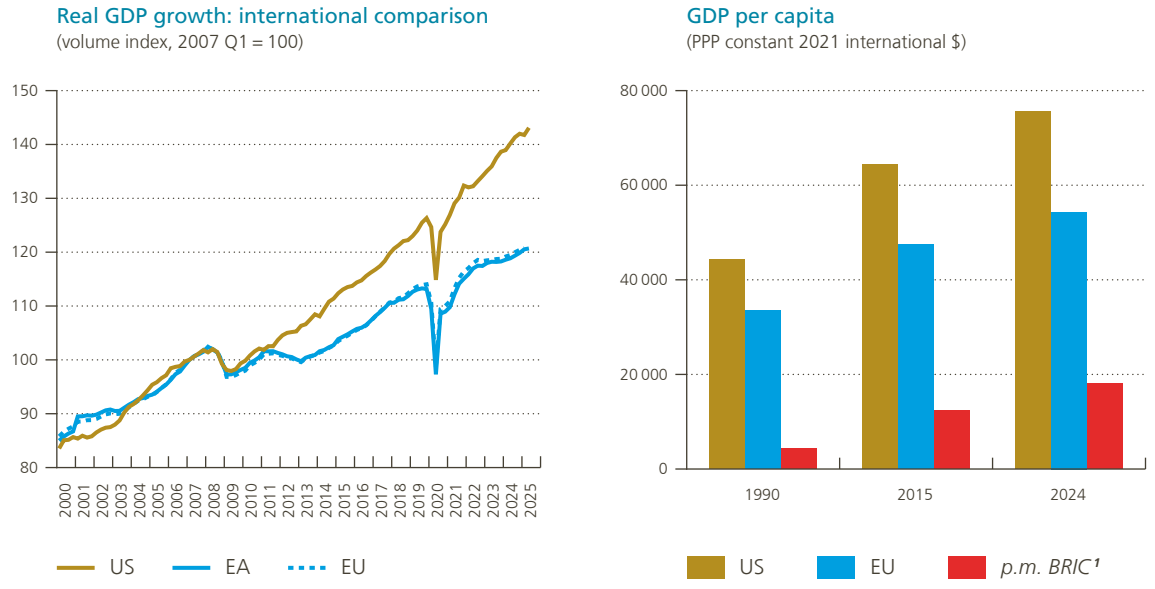
At the same time, public expenditure skyrocketed, partly due to maturing welfare systems and high unemployment but also because of the largely wasteful subsidies doled out by national governments in an attempt to keep ailing, uncompetitive industries afloat. National governments were essentially competing with one another. Strong increases in government revenue were required to curb government debt, but this further weighed on the growth outlook. German economist Herbert Giersch (1985) coined the term "Eurosclerosis" to describe this period.

Confronted with this situation, Europe made a bold choice by adopting the pivotal Single European Act (1986) to create a single internal market by 1992, through the removal of barriers to the free movement of goods, services, capital and people and the setting of strict limits on State aid. This legislation fostered market integration, competition and economic efficiency and boosted cross-border trade and investment. It provided a strong boost to domestic demand and productivity and reversed the economic slowdown. The Single European Act also modernised certain European decision-making processes by expanding qualified majority voting.

The basic principles laid down at the time – openness to trade, a more integrated single market and restrictions on State aid – have shaped EU policy until today. This model transformed the EU from a shattered, ailing country

Figure 1

Europe is lagging behind the US, and emerging markets are catching up



Sources: Eurostat, World Bank.
1 Weighted average.

bloc into an economic powerhouse. However, over time, growth began to decline again, to no more than 1% to 1.5% in recent years. A large number of policy plans were then elaborated with a view to making the European economy more dynamic, but none proved to be a game-changer. The US economy, for instance, still has a higher potential growth and is outpacing Europe. Measured by GDP per capita and adjusted for purchasing power parity, material welfare in the US exceeds the EU level by close to 40% on average. At the same time, the EU is also losing ground with respect to the emerging market economies.

2.1 The EU's grand plans: a story of repetition and only limited success

Slow EU growth, as well as the persistent growth gap with the US, has sparked political debate and led to the commissioning of the Draghi (2024) report by the European Commission (EC). In this lengthy document, Draghi argues that the EU is facing a competitiveness crisis, with productivity growth stalling and a widening innovation gap with the US and China (particularly in digital technologies). The report identifies three main areas for action: closing the innovation gap in key technologies, accelerating decarbonisation while maintaining industrial competitiveness, and enhancing economic security by reducing reliance on external suppliers for critical materials and technologies. The report calls for massive coordinated action: €750 to €800 billion per year in public and private investment (4% to 5% of EU GDP, comparable to the Marshall Plan), a new industrial strategy that reforms competition policy to allow larger European champions, the completion of the single market and the creation of a capital markets union (now broadened to include a savings and investments union) to channel household savings into productive investments, radical regulatory simplification through unprecedented deregulation or at least administrative simplification efforts, greater use of qualified majority voting to overcome decision-making paralysis, and common debt issuance for strategic projects.

While the Draghi report was a wake-up call, it was by no means the first time that European policymakers have raised the alarm about a lack of economic dynamism and a growth gap with other jurisdictions. In fact, Schoefer (2025) points out that many passages in the Draghi report are "strikingly similar" to what Giersch wrote in his 1985 article on Eurosclerosis. Several almost interchangeable reports were written between 1985 and 2025. The EU's policy response has typically been the announcement of a grand multi-year plan that promises deep reforms but, in practice, tends to combine further EU integration with more, usually debt-financed, public spending.

Already in March 2000, for example, the European Council (2000) argued that the EU was "confronted with a quantum shift resulting from globalisation and the new knowledge-driven economy". As a result, the so-called Lisbon Strategy was developed, aimed at making the EU "the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion" by 2010. The strategy combined ambitious targets – 3% of GDP earmarked for R&D, a 70% employment rate, a reduction in poverty – with the "open method of coordination" to encourage Member States to undertake comprehensive and interconnected reforms. However, it gradually became clear that the strategy would not be able to deliver on its promises. A 2004 report by the high-level group tasked with reviewing the Lisbon Strategy described a "mixed [Lisbon] picture" (High-level group chaired by Wim Kok, 2004). Interestingly, one of the reasons given in the report for this finding was an overloaded agenda with conflicting priorities. By the end of the programme period, policymakers and academics alike broadly acknowledged that the strategy had had very limited success (e.g. EC, 2010; Wyplosz, 2010).

Grand plans that overpromise but ultimately underdeliver is a recurring pattern. Immediately after the Lisbon Strategy, the so-called Europe 2020 strategy was conceived for the period 2010-2020. Its objectives were remarkably similar to those of the Lisbon Strategy, including the focus on "smart, sustainable and inclusive growth". Eight headline targets, to be met by the end of 2020, were set, accompanied by measurable indicators. These pertained to employment, research and development, climate and energy, education, and social inclusion and poverty reduction. An analysis by Becker *et al.* (2020) shows that, towards the end of the programme period, progress had been very uneven and only one target indicator (relating to tertiary education) had actually

Table 1

Europe 2020 development goals

Employment	1	75% of the population aged 20–64-years in employment
R&D	2	3% of EU GDP invested in R&D
Climate change and energy sustainability	3	20% lower greenhouse gas emissions (or even 30%, if the conditions are right) than in 1990
	4	20% of energy from renewables
	5	20% increase in energy efficiency compared to 2005
Education	6	Lowering of the rate of early school leaving to below 10%
	7	At least 40% of the population aged 30-34 years with a tertiary degree
Fighting poverty and social exclusion	8	At least 20 million fewer people in or at risk of poverty and social exclusion

Source: Becker *et al.*, 2020.

been met at the level of the EU. At any rate, the decoupling of economic growth from that in the US did not change fundamentally in that period.

In 2014, yet another plan was launched to boost the European economy and address low investment levels in the aftermath of the sovereign debt crisis. The EC's Investment Plan for Europe, commonly known as the "Juncker Plan" or the "EU Infrastructure Investment Plan", was an ambitious programme that aimed for at least €315 billion in investment, financed by public and private sources, over a three-year period (2015-2017). The EC claims that the programme was successful and that it "contributed to" the creation of 750 000 jobs and a 0.6% increase in EU GDP by 2017 (EC, webpage a). However, the European Court of Auditors (2019) expressed a much more nuanced opinion. In addition to questions about additionality (regarding whether the investments would have been made in any case), the Court specifically challenged the technical estimates of the impact, which relied on controversial multipliers between public and private investment. Finally, the court also pointed to allocation issues. This raises another valid question, namely whether bureaucratic allocation through such plans is in fact superior to market allocation.

Most recently, the Next Generation EU (NGEU) recovery fund, agreed in July 2020, made an unprecedented €750 billion available to invest in the economy after the COVID-19 pandemic. Unlike previous plans, though, NGEU is largely financed through common EU debt. Higher expenditure goes hand in hand with rising administrative complexity. The centrepiece of the programme, the Recovery and Resilience Facility, requires Member States to submit detailed national recovery plans aligned with EU priorities. (Borrowed) Funds are gradually made available upon reaching certain policy milestones and targets tied to key implementation steps in the aforementioned programmes and conditional on a positive assessment by the EC, taking into account the opinion of the Council. Unsurprisingly, fund deployment has been relatively slow.

This non-exhaustive overview illustrates that the findings of the Draghi report and proposals for a further deepening of EU integration, typically accompanied by significant spending, are not new. While positive in some respects, [3] these plans have not succeeded in fundamentally changing the EU's growth trajectory. The policy paradigm that allowed Europe to escape Eurosclerosis 1.0 (the single market, free trade, restrictions on State

3 NGEU has been lauded by some sources (e.g. Bankowski *et al.*, 2024; Bankowski *et al.*, 2022) for stabilising the EU macroeconomic environment and restoring market confidence after the pandemic.

aid), accompanied by ever-growing integration, produced, on average, relatively steady but low growth until the early 21st century. This contrasts strongly with the higher, "more organic" growth in the US. As Janan Ganesh put it: "The US did not 'plan' to outgrow Europe. It did not have a version of Mario Draghi's new competitiveness report. It did not produce an equivalent of the Lisbon agenda, which in 2000 committed the EU to building the most 'dynamic knowledge-based economy in the world'. The US has been deplorably negligent on the report front. Yet here we are" (*Financial Times*, September 2024).

This begs the question as to why these grand plans have failed when the single market is largely perceived as a success. This question certainly deserves more attention in the EU debate. In this paper, we can only point at some possible explanations.

First, as mentioned, the single market never actually allowed Europe to catch up with the US on the technological front, especially in the area of ICT. In the next section, we argue that lower economic dynamism in Europe reflects deeper societal choices that are not addressed by – and are probably beyond the reach of – EU plans. We revisit this issue in Section 3.1.

Second, some of the aforementioned plans were not that "grand" to begin with. To paraphrase Joseph Stalin, *"how many divisions does the EU have?"*. Not so many, it turns out, when it comes to fiscal capacity. With the exception of NGEU, there was never much money on the table to support ambitious policies or objectives. And when funds were available, they were not always effectively spent, reflecting low absorption capacity. The same can be said about initiatives to deepen the single market, which typically encountered substantial resistance and were sometimes more aspirational in nature than fully developed action plans. The need to create political momentum often implied starting with high-level goals, presented as game-changers, only to end up with much less ambitious results. At times, it is not even clear which version of a proposal is being discussed. Europeans agree on the need for a 28th regime, for instance, but we may have very different ideas in mind. In addition, it is not clear how many people actually have detailed technical knowledge of the issue. We will come back to the issue of absorption capacity and the potential benefits of more EU integration in a changing world in Sections 2.4 and 2.5.

Third, over time, the increasing integration of very diverse constituencies has led to massive growth in regulation, which has weighed on Europe's growth potential. This may also be the area in which the Draghi report has had the most significant impact: it is no longer heresy to call for a lower administrative burden in the EU. As Garicano (2024) puts it quite bluntly: "Europe is creating a new ruling class – but they don't make laws or deliver services. Instead, they check boxes and issue stamps of approval. These are the compliance officers who ensure other people follow rules. From ESG reporting to sustainability audits, from data protection to supply chain verification, checkers and verifiers have become a fast-growing segment of the economy. European business is increasingly governed by a group of rule-enforcers that, rather than create economic activity, shrink it".

Finally, the fact that the EU approach to boosting the economy tends to follow the same recipe also reflects the institutional set-up and the specific responsibilities of the European institutions. As the saying goes, "when you only have a hammer, all problems look like a nail". EU institutions are, by nature, centralising forces that produce common policies, greater harmonisation and regulation. For instance, if we compare the US and EU financial markets, it is easy to conclude that the problem is a lack of harmonisation and then call for a single supervisor (ESMA). Alternatively, though, we can observe that Sweden has a well-developed tech sector supported by a dynamic capital market and venture capital ecosystem. One could then ask why Germany could not reproduce such an ecosystem at scale in the same (EU) environment, potentially resulting in a "European California".[4]

4 Innovation, capital markets and venture capital investments are quite concentrated in the US, with other States lagging behind the best performers in the EU.

Coming out of a typical European seminar, one might wonder what countries that are not part of the EU could possibly discuss. As they already have the national equivalent of EDIS, safe assets or the SIU, they certainly must feel a deep sense of despair as to how they could improve their economic prospects. Fortunately, there is more to politics than the debate about more (or less) Europe. But, by construction, the EU's plans rarely involve or target systemic changes to the underlying socio-economic model, e.g. as regards taxation or redistribution, competences that belong to the Member States.

Also, EU majorities tend to be very broad, [5] and EU politics are different from national politics. In this regard, the old debate between Simon Hix and Stefano Bartolini (Bartolini and Hix, 2006) on how we should understand the structure of political competition in Europe, remains relevant, more specifically, as to whether the traditional left–right axis can become the dominant organising principle of EU politics or whether the desired level of EU integration will remain the dividing line.

2.2 To what extent is lower economic dynamism a societal choice?

GDP per capita is an indicator of material welfare but does not capture all aspects of wellbeing or quality of life, even if they are usually strongly correlated. One example is healthcare: the US spends substantially more on healthcare (propping up GDP per capita) but has clearly worse health *outcomes*, on average, than Europe (Zucman, 2025). More generally, the quality of life in Europe is usually assessed as good. European cities are typically ranked higher in the Global Liveability Index than their US counterparts. Finally, different societies may put a different weight on material welfare as opposed to other social objectives such as low inequality. These social preferences will then be reflected, via the democratic process, in the institutions that determine the economic environment.

About twenty years ago, Olivier Blanchard (2004) noted that the end of "catch-up growth" in Europe required "nothing short of a complete transformation of economic and social relations". He immediately added that the main difference between Europe and the US was that a portion of the increase in productivity was used to increase leisure in the former, while the US had done the opposite. Nonetheless, he remained optimistic that a "deep and wide-ranging reform process" was taking place in Europe that would improve its economic performance.

There is indeed some truth to the fact that part of the EU-US growth differential is due to lower working hours in the EU: according to OECD statistics, average working time, on an annual basis, is significantly higher in the US than in most larger EU countries, including Germany, France, Spain and Italy. Only Poland has average working hours close to US levels. However, the key driver of the transatlantic difference in welfare growth remains productivity growth. In this connection, other factors also matter. We focus here on two specific cultural differences between the European and American societies that are relevant for economic outcomes. Both are deeply rooted in past developments, with the American frontier mentality and the belief in the American dream contrasting with the historical European class culture.

First, Alesina *et al.* (2018) show that beliefs in intergenerational mobility differ significantly between the US and Europe. Americans tend to be much more optimistic and view market outcomes as relatively fair and resulting from ability and effort, while Europeans tend to believe that social mobility is low and the economic system is inherently unfair. This difference in mindsets accounts for different views on wealth and redistribution. Interestingly, Alesina *et al.* (2018) also argue that actual differences in social mobility are smaller than perceived and may even be non-existent. Americans typically overestimate the probability of a child from a family in the bottom quintile making it to the top quintile, while Europeans are too gloomy in this respect. However, institutions are more closely linked to people's perceptions. Studies (Alesina and Glaeser, 2004 and 2006;

5 This used to be a European specificity but is increasingly being observed at national level.

Alesina and Giuliano, 2015) tend to show that cultural beliefs and, in particular, views on fairness, are critical determinants of preferences for redistribution and, hence, of the welfare state. The latter is typically larger, on average, in Europe than in the US. Voters prefer less redistribution (and lower or less progressive taxes) if they are more optimistic about upward mobility in the future.

Second, European households tend to be more risk averse than their US counterparts. This can be seen in the size of the venture capital and private equity market, which is much larger in the US. This is not just a regulatory feature. Studies show that the willingness to take risks in financial investments is clearly smaller, on average, in European countries. Ferreira (2018) reviews evidence from an international survey about potential investments in financial instruments and finds that there are significant cross-country differences in both risk perception and risk aversion. In all cases, attitudes towards risk seem much more conservative in the EU countries in the sample than in the US (but also Türkiye and the UK). There is also some heterogeneity within the group of EU countries: respondents from the more dynamic Polish economy exhibit risk attitudes that are closer to the ones in the US, while risk aversion is much higher in the 'older' EU Member States, including France, Germany, Belgium and the Netherlands (but also Romania). Ferreira (2018) also shows that attitudes towards risk are reflected in portfolio choices. Bekhtiar *et al.* (2019) use different survey information on households' willingness to take financial risks but their findings are similar: both risk tolerance and holdings of risky assets are significantly higher in the US than in Europe. They also show that risk aversion is not only generally higher in the euro area but it is also decreasing less with net wealth.

These cultural differences tend to be reflected in the institutional set-up. Schoefer (2025) provides a broad overview of the key institutional differences between Europe (the EU) and the US and relates them to Eurosclerosis. He argues, in particular, that Europe's labour market institutions – important features of the welfare state – are the main drivers of the transatlantic gap in macroeconomic performance. The EU is generally more heavily regulated than the US – reflecting the aforementioned lower risk tolerance – but the gap has narrowed over time in the area of product and financial market regulation, while it has actually widened somewhat for labour market institutions. This has led to much more rigid labour markets in the EU, where workers stay with the same employer significantly longer than in the US, and is coupled with lower business dynamism, as companies tend to remain on the market longer in Europe due to, among other things, differences in bankruptcy procedures. This rigidity contributes to lower productivity growth as the factors of production are "trapped" longer in low-productivity industries and firms. Schoefer (2025) argues that this also explains Europe's specific underperformance in tech, R&D, disruptive innovation, and ICT adoption, where creative destruction requires fluid reallocation. European risk aversion is clearly somewhat at odds with the tech mantra of "move fast and break things".

One particular feature considered by Schoefer (2025) is the tax wedge on labour. Higher taxes tend to reduce wage dispersion and, hence, labour mobility. As such, the higher tax rates in the EU are clearly related to higher social expenditure, in line with the aforementioned societal preferences. However, progressivity in the personal income tax system – another indicator of the degree of redistribution – may also play a role. The latter is typically higher in older EU Member States in Western and Northern Europe than in the US. Progressivity is lower in many faster-growing Eastern European countries, some of which have nearly flat tax rates. Using a long-run dataset covering 33 OECD countries, Jalles and Karras (2025) find that tax progressivity is negatively correlated with output per capita, in line with standard predictions of neoclassical growth models. An increase in tax progressivity is associated with a temporary reduction in the economy's growth rate for about four to seven years, leading to a permanent, sizeable and statistically significant reduction in the level of income per capita.

All in all, the EU-US growth and productivity gaps appear to be partly caused by structural features that are institutional in nature but also reflect deep societal choices. The EU is a low-risk, low-return society with a clear preference for incremental progress as opposed to disruptive change, which may come with higher social adjustment costs. This raises the question as to why Europe cannot simply muddle through. If this model is what

the median voter wants, perhaps it can be sustained through Eurosclerosis 2.0. After all, the EU has a substantial current account surplus and is performing well (sometimes even very well) in more traditional industries where technological progress is incremental in nature, such as internal combustion engine cars, pharmaceuticals, chemicals and airplanes. We will come back to this question in Section 3.1.

2.3 The world is not moving in Europe's direction

In the period leading up to the global financial crisis, EU internal demand was supported by the creation and deepening of the single market and, later, the enlargement of the EU. External demand benefitted from the integration of European firms into international supply chains and production networks. In addition, foreign companies wished to access the EU single market of more than half a billion wealthy consumers (including the UK at the time). This helped the EU "export" its regulation and standards. However, as the impact of these factors waned, European growth began to decline and, with it, the bloc's relative economic importance. More recent geopolitical shifts have further eroded the leading position of Europe. In short, the EU has seen both its economic importance and political clout decline over the years.

(Critical) observers have referred to the EU way of doing things as the "Brussels effect": Europe was seen as the global leader in terms of standards and regulation. It was implicitly assumed that its policy ambitions would ultimately be shared by the rest of the world. This led to a trend of effectively imposing EU standards and values on other countries through an increasing number of legal instruments that affect the operation of multinationals. This trend probably culminated in the Corporate Sustainability Reporting Directive (CSRD) and the Corporate Sustainability Due Diligence Directive (CSDDD), two key pillars of the EU's sustainable finance and corporate responsibility framework under the European Green Deal, aimed at promoting responsible business practices. In both cases companies outside the EU are affected as the CSRD reporting requirements apply to corporations with significant activity in the EU, while the CSDDD imposes "sustainable and responsible" corporate behaviour in terms of human rights and environmental impacts across global value chains for companies doing business in EU countries.

However, many jurisdictions, such as the US but also China and oil and gas exporters, such as Qatar, are no longer prepared to follow the EU's lead. The Brussels effect could therefore become the Brussels curse as it is increasingly sparking international tensions and producing asymmetric regulatory costs for European businesses and consumers. These developments have to some extent been acknowledged by the EC, which has launched several initiatives to reduce and simplify regulation in the framework of the so-called Omnibus package. However, the proposed changes typically pertain only to the scope and timing of rules, not their underlying rationale.[6]

The fact that European regulations, standards and policies are no longer the obvious reference for other countries is creating growing tension within the EU as well. As illustrated by the recent debate around Mercosur (and previously CETA), there is not necessarily a consensus on free trade within Europe when it is not based on European rules and values. This means that one aspect of Eurosclerosis 1.0, namely openness to trade, is being challenged internally as Europe's capacity to impose its norms wanes.

However, the fading of the Brussels effect is not the main challenge faced by the EU in international relations. The world has changed dramatically in the past decade, with the pace of change accelerating since the re-election of Donald Trump as US president. Today, international relations are determined less by a commonly agreed set of rules[7] and more by ad hoc transactions, often reflecting the geopolitical clout or bargaining chips

6 The scope of the CSDDD, for instance, was revised to exempt smaller firms but not large ones. This maintains the fiction that EU multinationals will be able to operate fully green value chains by 2050 in a world in which many countries have lower climate ambitions than the EU and in which EU SMEs are not required to comply with the CSDDD.

7 Admittedly, the erosion of the rules-based order did not happen in a day. The WTO, for instance, has been losing clout for decades. However, until recently, we could behave as if theory and practice were aligned.

of the jurisdictions involved. These bargaining chips are distributed across a broad range of policy areas, from trade to defence. The EU's orderly, rules-based approach no longer sets the tone for the rest of the world. Carney (2026) describes this as a "rupture" and argues that the rules-based order was even "partially false", as it was always overshadowed by geopolitical power. Only now it is more obvious.

This new world order is a source of stress for the EU, which typically relies on relatively slow-moving and consensual decision-making. In Europe, power is less concentrated than in other jurisdictions, and its use is constrained by the need to build internal consensus among Member States as well as between the European Commission and the Council. The cost of this set-up was less of a constraint in a world that relied on international institutions or fora to deal with cross-border issues. In a way, Europe sometimes even had an advantage in this rules-based environment. However, Europe's institutional setup now needs to adapt, as will be discussed in Section 3.2.

2.4 Investment in a supply-constrained world

Many European plans of the last decades have featured (massive) increases in investment. Draghi (2024) even pleaded for an €800 billion annual boost in this regard. Does Europe have an investment problem and, if so, can such plans help to resolve it?

As regards the first question, OECD statistics suggest that total (public and private) investment as a percentage of GDP in the US and the EU is actually quite similar, at just above 21%. However, business investment is somewhat higher in the US. In this regard, the ECB (2025a) notes that business investment growth in the euro area has significantly lagged behind that in the US in the post-pandemic period and that prospects remain less favourable. Investment in intangible assets (such as intellectual property products, IPP) accounts for most of the gap. This situation contributes to higher productivity growth in the US than in Europe. As a percentage of 2024 GDP, investment in venture capital was also twice as high in the US. The gap is much smaller for other types of investment, although machinery and equipment investment has declined in the euro area while growing slightly in the US. This seems to suggest that the issue is not so much related to overall investment levels – these do not differ much – but rather to the kind of investment being made, with the US focused on high-growth investment.

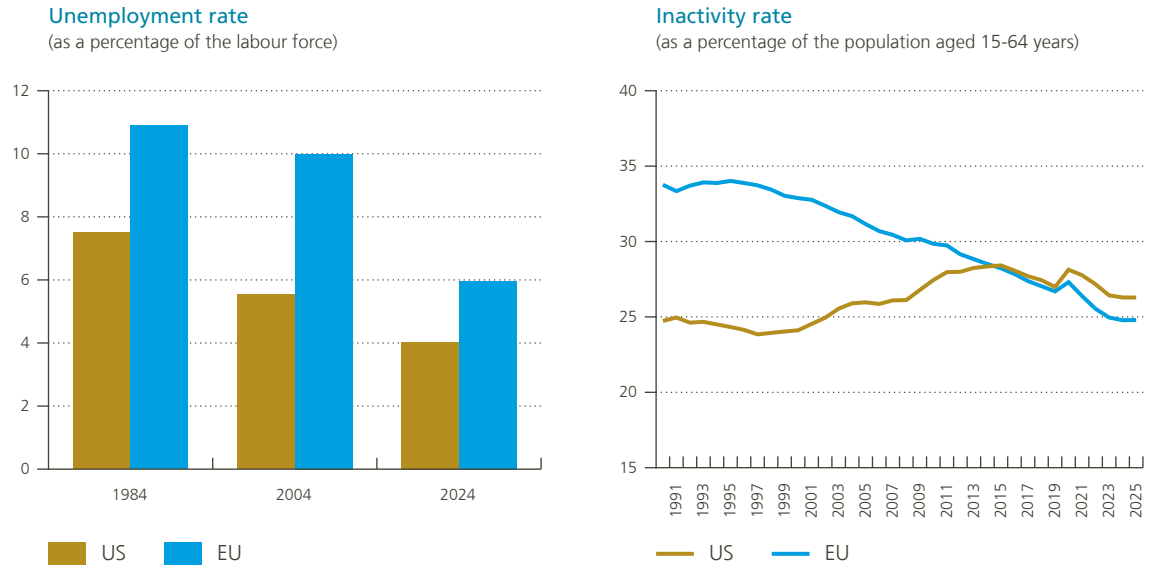
Turning to the second question as to whether EU plans can help boost the "right" type of investment, the short answer appears to be probably not as much as one would hope. At the end of 2025, for instance, only 58% of the funds from the Recovery and Resilience Facility had been disbursed. This suggests that the absorption capacity of EU countries is not very high, partly due to a lack of viable investment projects and/or low administrative capacity.

More generally, the economy is currently more supply-constrained than in the 1970s and 1980s. Despite weak economic growth, the EU unemployment rate remains historically low. While still higher than in the US, current levels in many countries are relatively close to the structural employment rate. In addition, the inactivity rate is also significantly lower than in 1985, partly owing to rising female labour market participation. All in all, the European labour market is still quite tight and likely to remain structurally so as the population ages. In this environment, an increase in EU spending or large-scale investment may not be a panacea for Europe's woes. In addition, such a spending hike could become inflationary. A recent example is the Biden era stimulus package in the US which exacerbated pre-existing inflationary pressures.

Even if additional spending is not Keynesian in nature but targets an increase in production capacity, supply-side constraints will hinder its implementation. Questions related to the efficiency of public versus market allocation also remain. In any case, judging from past EU plans, there is not much room for publicly incentivised investment to quickly increase the EU's potential growth. To come back to the quote by Janan Ganesh (Financial Times, 2024): the US did not plan to outcompete the EU. China, on the other hand,

Figure 2

Unemployment and inactivity rates



Source: Brookings Papers on Economic Activity, 2:1986, Eurostat, U.S. Bureau of Labor Statistics via FRED®, Federal Reserve Bank of St. Louis, World Bank.

probably did. However, the EU can most likely not conduct the kind of industrial policy that China manages to conduct in a much more centralised political system, with significant transfers from consumers to strategic industries. The remaining focus is then typically on improving the general business environment at the national and European levels. This brings us back to the issue of deeper EU integration, which is discussed in the following section.

One final observation regarding the difference with Eurosclerosis 1.0 pertains to the sense of urgency that existed at the time due to the high level of unemployment. Today, the social costs of low growth are less obvious or visible. A sense of urgency may be present at the expert level or at some institutional level but less so within society at large. On the contrary, certain populist movements deny that hard choices have to be made. At any rate, there does not seem to be a strong constituency or coherent political will to bring about radical change across Europe, which could mean that reform is unlikely to come from the top-down and more likely to arise from the bottom-up, at country level. The hope is then that successful experimentation in *some* of our democracies will ultimately lead to broader emulation.

2.5 More European integration as a silver bullet?

Aside from the investment dimension, EU plans have typically promoted further market integration as a way to improve the bloc's economic performance. As such, it is obviously not possible to disagree with the objective of better functioning European markets. However, it is reasonable to ask what went wrong in the past and how much boost can be expected from greater market integration.

Garicano, Holmström and Petit (2025) argue that the main issue is a lack of focus and regulatory overkill: "The European Union currently pursues a long list of goals, including (as given by the Commissioner titles): promoting the 'European way of life,' 'health and animal welfare', 'environment, water resilience and a competitive circular economy', 'intergenerational fairness, youth, culture and sport' or 'social rights and skills, quality jobs

and preparedness'. Meanwhile, the internal market has become so fragmented that, according to recent IMF analysis, internal trade barriers are equivalent to a 44 percent tariff on goods and 110 percent on services".

The authors point to a mountain of rules justified by the Brussels effect and are particularly critical of the General Data Protection Regulation (GDPR) and the AI Act which "impose technical requirements for market access on an emerging technology before Europe has even created one major AI company". For them, the EU should prioritise exclusively the free movement of goods, services, capital and workers. It should seek to eliminate entry barriers that favour incumbents, support market exit, and promote deep financial markets and legal certainty for risk-takers.

The discussion becomes more complicated, however, when looking at the issue of uniformity versus diversity. The authors argue in favor of "variable geometry" and genuine mutual recognition that allows for different competing approaches to determine what works best. We are sympathetic to the idea that there is a tension between harmonisation and competition. After all, the industrial revolution took place in Europe, not in the great empires of the time, precisely because of fierce rivalry between middle powers. However, there could be a contradiction in saying that the EU should stop regulating everything and the idea that one should prevent conflicting national rules from hindering the single market.

As the aforementioned IMF analysis suggests, the negative impact of residual trade barriers within the EU could be quite high. However, estimates in this regard vary substantially and are dependent on the methodology used. Gravity models are generally considered to generate upper bounds to the benefit of integration as their results tend to capture non-policy-related factors, such as language[8] or historical national preferences. The ECB (2025b) therefore also adopts a comparative approach by evaluating intra-EU trade costs against a "friction-light" benchmark country. This study estimates that if other countries were to achieve similar levels of integration as this benchmark, intra-EU trade frictions could be lowered by around eight percentage points for goods on average and 7% for services. This, in turn, would lead to a welfare gain of 1.3% and 1.8%, respectively.

However, one could argue that the gains from further integration have reached a point of diminishing returns and are largely offset by an increasing administrative burden, at least in recent years. As Philippe Aghion (2026) points out, trying to create a capital markets union with 27 Member States may be too ambitious and cumbersome. Our take on this issue is that there is little remaining low-hanging fruit, at least when taking political feasibility into account. Many discussions on further European integration refer to the need to harmonise bankruptcy laws, labour market regulations, consumer protection rules or taxation. This could be desirable but would require a substantial transfer of powers from the Member States to the EU. We are not convinced that there is sufficient appetite for such a transfer today. In any case, it would have to be accompanied by a fundamental reform of EU political governance along the lines sketched by Hix (Bartolini and Hix, 2006).

Finally, European plans à la Draghi tend to be very broad endeavours. They rarely acknowledge tensions between different objectives or principles. Implicitly at least, they give the impression that more European integration would allow hard constraints to be alleviated, without the need to prioritise. Interestingly, on many European issues, there is an apparent "consensus". In fact, however, disagreement is often (unduly) qualified as "resistance", as if the only choice is to agree or disagree (i.e. resist) with greater European integration. However, as indicated above, this is self-evident and not really a choice. In this regard, dismissing the opposition can have a cost and may lead to overambitious plans that underestimate existing tensions or constraints.

In the art of dramaturgy, the main character is generally faced with a choice at the end of the story. A hard choice, not simply between being a hero and falling into oblivion. For a long time, the European Green Deal was presented as a great opportunity: we could choose between saving the planet and boosting investment or letting the planet die and missing out on an opportunity. But then… it became less obvious. The sad reality is

8 One anecdote in this regard: one well-known Belgian/Walloon unicorn entered the French market before expanding to the Flemish market in the north of the country for the simple reason that the CEO's mother tongue was French rather than Dutch. Language seemed to be more of a barrier than different national rules.

that we probably cannot have more innovation, more investment, and a greener planet, and greater strategic autonomy and sustainable public finances. We need to make choices.

A greater awareness of the relevant trade-offs would therefore be beneficial to the quality of the European debate. In the current resource-constrained world, great ambitions in one area often imply lower ambitions elsewhere. The next section illustrates some of these trade-offs and the policy choices that will have to be made, through the lens of three intertwined challenges.

3. The EU through the lens of three challenges and related choices

3.1 The technological challenge

Economic progress is closely linked to the adoption of technological innovations. This was underscored by the award of the Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel 2025 to Joel Mokyr, Philippe Aghion and Peter Howitt. Their work shows how creative destruction is key to economic progress and that it must be managed in a constructive manner, rather than impeded. Otherwise, innovations that can improve overall welfare will be blocked by existing companies and interest groups that are set to lose (The Royal Swedish Academy of Sciences, 2025). This goes to the root of the differences between the European and US economic models, as discussed in Section 2.2. The European model is clearly less at ease with the disruption that creative destruction entails. While this observation holds true though throughout the economy, it is perhaps most visible in the technology sector.

Draghi (2024) argues that the key driver of the rising EU-US productivity gap has been the digital technology sector. In this view, failure to capitalise on the digital revolution ushered in by the internet – in terms of both creating new tech companies and diffusing digital technologies throughout the economy – was the reason why transatlantic productivity trends started to diverge more strongly around the turn of the century. In other words, while Europe was the first-mover on regulation, it was a follower as regards technological innovation.

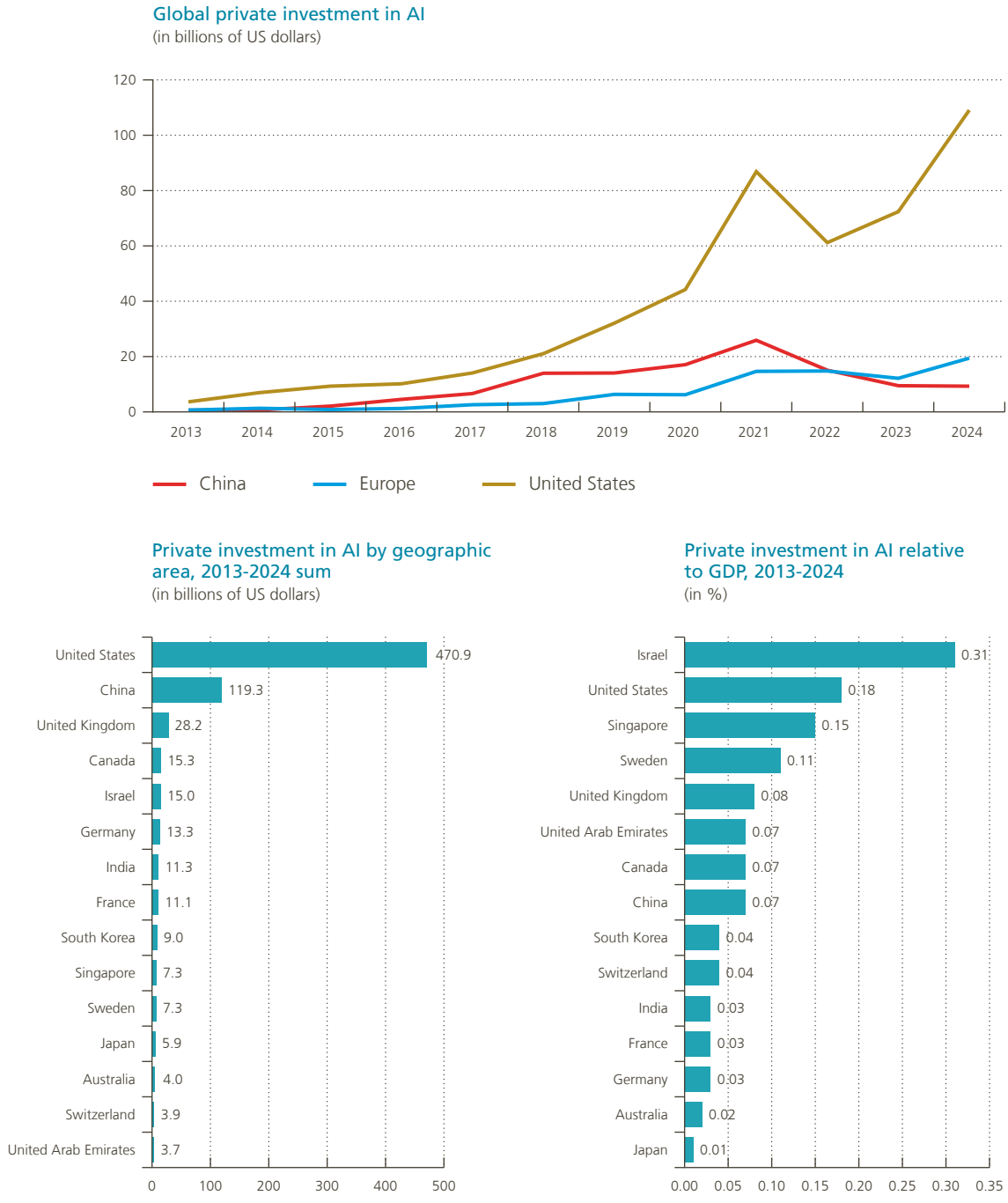
One particularly relevant question for Europe in this regard is whether the first-mover advantage in the field of technological development is significant and lasting. If not, the EU could lag behind the US (and also, more and more, China) without this economic divergence increasing as time passes. One could argue, for instance, that the internet has by now been "commodified" and spread around the world. In that case, it seems fair to say that the first-mover advantage was only temporary, at least in terms of its impact on productivity. This was also the case for the production of mainframes (which have virtually disappeared) and PCs. The first-mover advantage is typically more significant and persistent when faced with network economies. This may explain the dominant position of some Magnificent Seven tech companies – Meta (Facebook), Google and Microsoft (operating systems and MS Office) – which have all enjoyed a strong position in their niche for a long time. All in all, ICT progress often happens in waves. Europe was clearly not at the forefront of the previous waves (personal computers and mainframes, networks, etc.) but has generally adopted these new technologies.

The current tech wave is mostly being driven by artificial intelligence (including the required physical investment in data centres) and robotics. Clearly, in both areas, Europe is, once again, not the first-mover and lags behind the US and China. The role played by regulation (the GDPR and the AI Act) in this subpar performance is open to debate. However, the reality is that we have gotten used to Europe being far from the technological frontier in fast-moving sectors.[9] As indicated, the relevant question is not whether Europe can quickly move to a leading position – this will not happen – but rather whether the fact that it lags behind will lead to a structural growth disadvantage or only a temporary differential as the US invests massively in AI.

9 Beyond ICT, Europe also missed the electric vehicle revolution despite a very strong car manufacturing industry. This is yet further proof that Europe can handle incremental progress relatively well but is uncomfortable with disruptive growth, which mostly originates outside Europe.

Figure 3

AI investment in different jurisdictions

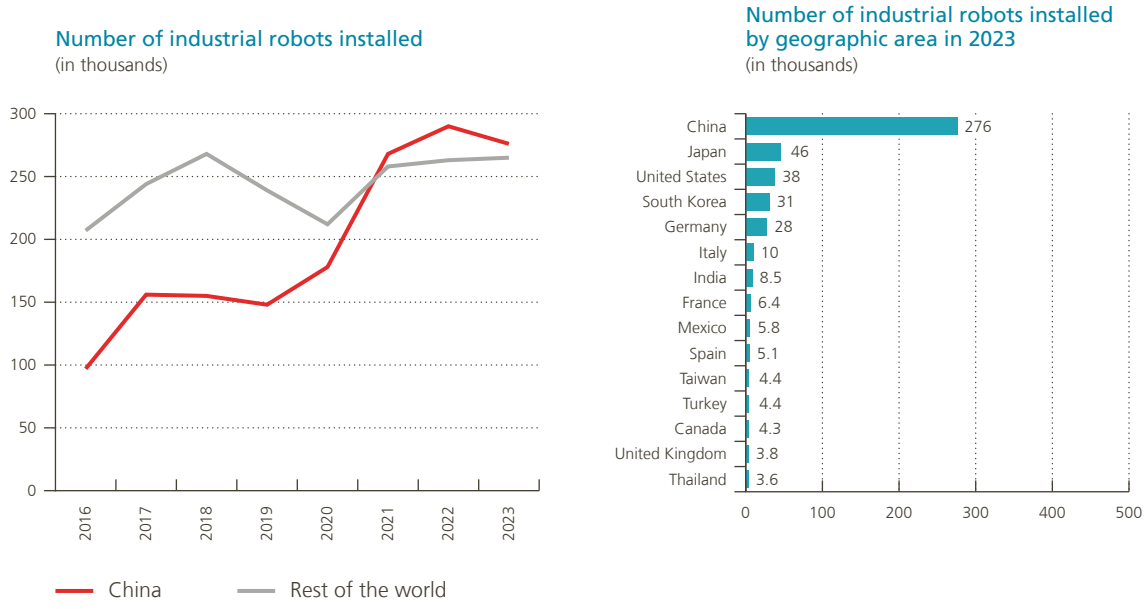


Source: Stanford (2025).

While it is not easy to define precisely, total AI-related investment by the US private sector exceeded $ 100 billion in 2024 (Stanford, 2025) and in all likelihood was even stronger in 2025. This level is far higher than in China and Europe. The picture is the same when looking at cumulative investment since, say, 2013, and the gap grows if these numbers are expressed in terms of GDP or when considering only generative AI and is also evident in other metrics such as the number of new AI companies (Stanford, 2025). In fact, Europe is likely further behind China than what the statistics suggest for two reasons. First, in China, AI investments are partly financed using government funds, possibly on top of private investment. Second, the comparison of amounts in US dollars may be somewhat misleading as the average investment is likely significantly lower in China. All in all, it seems safe to say that Europe is far behind both the US and China as regards investment in AI.

Figure 4

Importance of robotics in different jurisdictions



Source: Stanford University (2025).

As regards robotics, China is the clear leader (even correcting for the relative size of the manufacturing industry). China surpassed Japan as the world leader in robotics in 2013 and, recently, has installed more industrial robots than the rest of the world combined. EU countries are far behind China. Today, Europe is at best in third place as regards these two key technologies.

How will this affect productivity developments? Given the relatively high number of competitors in the field of AI (among the Magnificent Seven and between the US and China), it seems plausible that any direct economic rent from AI will be limited or short-lived. A leading AI researcher, Toby Walsh (2024), argues that AI will evolve into a pervasive, general-purpose technology whose positive impact on productivity will emerge through broad, global adoption over time and will not be limited to the leading countries. In this connection, he compares it with personal computers or even electricity: countries simply need to "adopt" the new technology.

The framework developed by Acemoglu *et al.* (2026) can be applied to AI as well as other new technologies and, by and large, confirms a positive link between distance to the global technology frontier and economic performance (i.e. between technology adoption and income per capita). It describes the conditions that facilitate the adoption and diffusion of new technologies. The absorption capacity of an economy is determined by

a number of factors, including the quality of its education and management practices, regulatory barriers to technology adoption, institutional distortions, credit market frictions and mismatches between frontier technologies and the needs of firms in the country. Walsh has made a related point in various interviews (e.g. InnovationAus, 2023), namely that governments need to invest sufficiently in the economy's capability to adopt new technologies, and points to education in this regard. He also advocates for a "sovereign" AI, tailored to the needs of the adopting country, to reduce dependency on the innovating country.

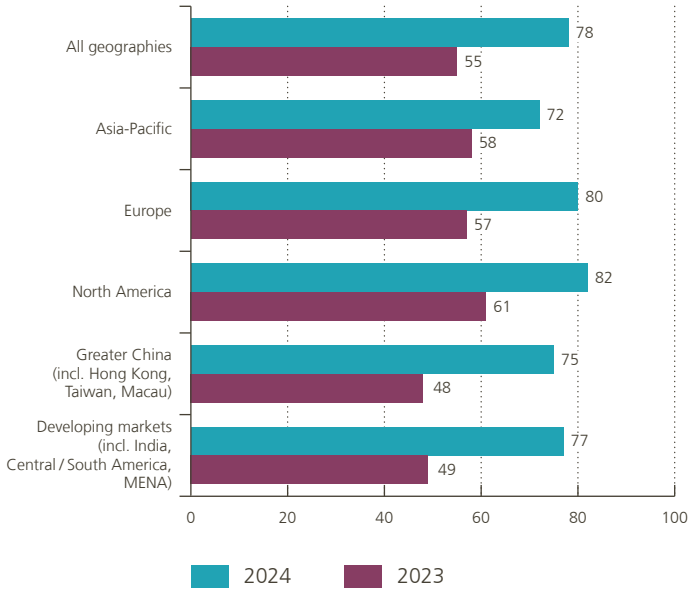
All in all, the literature and past technology waves suggest that Europe is relatively well positioned to adopt new technologies, provided regulation does not get in the way. The current broad geographical spread of generative AI applications also points to the possible commodification of AI. In fact, statistics on current adoption suggest that, in terms of use, AI seems to have become ubiquitous already, with Europe not far behind the US.

The market view is, however, rather different. If the high valuations of big AI firms can be trusted (Krugman, 2026), there must be a significant first-mover advantage. Then again, talk of a possible AI bubble indicates uncertainty. In this regard, it is important to determine whether AI will lead to use cases that bring about an acceleration in productivity growth and the share of value created that can be captured by those currently investing vast sums in the technology.

Figure 5

AI adoption across jurisdictions

(in %)

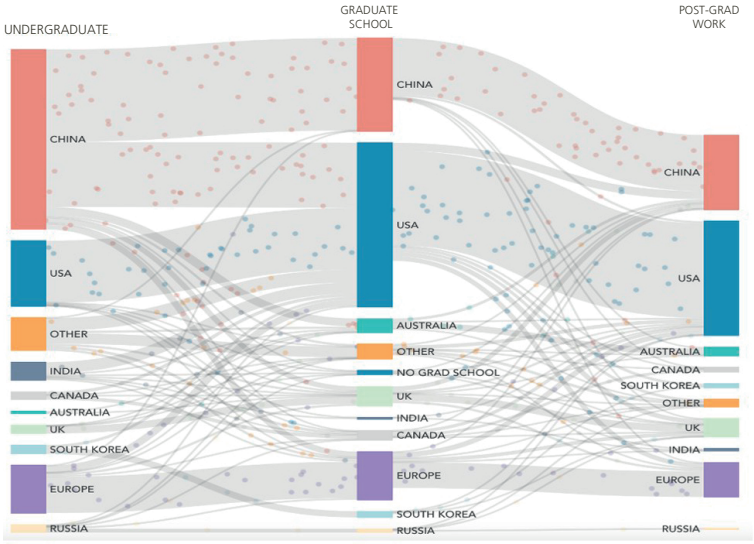


Source: Stanford University (2025).

Turning to robotics, the International Federation of Robotics (2025) distinguishes between two sub-markets: industrial robots and service, mobile and medical robots. As regards the former, China's share is increasing, which may simply reflect the manufacturing industry's weight in the country. Service-related robots are likely to spread more quickly, at least in the developed world, as they address common trends such as population ageing. The same is true more generally for both types of robots to the extent they can be used to alleviate staff shortages in jurisdictions with tight labour markets and adverse demographic projections.

Figure 6

AI talent largely flows to the US



How to keep / attract talent in EU ?

- Close the salary gap with the US (for talent)
- Simplify visa processes
- Connect academia and industry
- Harmonise and simplify equity taxation policies
- Modernise labour laws
- Talent tax incentives
- Strong tech brand & political message during the Trump era

Source: Macro Polo (based on Pierre Alexandre Balland and Andrea Renda).

All in all, it seems likely that the current technological wave will ultimately raise productivity across the board, including in Europe despite the latter's lack of a first-mover advantage. While this will not help to close the relative productivity gap, further widening of the gap should remain limited.

So, does it really matter if Europe is at best a distant third in the technology race? One issue is that first-movers typically produce the leading technology firms, with large profit margins and decision-making centres. Gravitational forces then attract the most talented tech workers from around the world. In addition, innovation ecosystems and networks are created that will likely be at the forefront of the next big technological breakthrough as well. Hence, Europe remains a follower, reliant on non-European suppliers for the technology it needs.

From this perspective, the cost of lagging behind the US might be growing with each wave of technological progress. The US has built a unique tech ecosystem which is becoming increasingly difficult to emulate and is reducing Europe's capacity to control key technological developments. Europe is ever more in the position of a technology laggard. A key problem in this respect is not innovative capacity per se – this is present in Europe – but rather the speed of change and the transition of start-ups to scale-ups and larger companies.

There is no easy solution to this problem. While efforts to create a common European financial market can provide marginal gains and specific proposals to enhance tech financing have been made (e.g. Angeloni and Cavallini, 2025), they are unlikely to turn Europe into the world's tech leader overnight. Reducing Europe's technology lag without imposing a Chinese-style industrial policy, which would be at odds with democratic principles and the EU's current set-up, requires a broad and coherent set of policies to make the economic environment more growth friendly. This also relates to the fundamental debate on how society rewards risk-taking, e.g. by tech entrepreneurs. Finally, the emigration of top tech talent is often driven by the large wage gap between the US and Europe. In this respect, the more egalitarian and risk-averse European mindset may come with a growing cost, the extent of which will depend on how rapidly new technologies are dissipated and commodified.

Muddling through may be a viable option if Europe can stabilise its distance to the technology frontier. However, preserving the welfare state could entail deeper and more disruptive changes. An informed democratic debate should start by recognising this risk. Something may have to give.

3.2 The institutional challenge

As mentioned above (see Section 2.5), in the European debate, policy choices tend to be framed as a matter of more (or less) Europe. In doing so, prevailing tensions or trade-offs between different policy objectives may be obscured. In this section we argue that, in a number of areas, the bandwidth of EU policies or stated objectives is simply no longer sustainable. We use two examples to illustrate this point.

The climate trilemma

First, there are increasing tensions surrounding the EU's climate policies. The EU's target of reaching net zero emissions by 2050 (with ambitious intermediate goals) is no longer shared by other jurisdictions, including the US. This is a problem insofar as it is likely to delay decarbonisation at the global level and puts the European economy at a competitive disadvantage. The issue here is not so much the non-market sector of the economy[10] but the market sector, especially energy-intensive industries. Apart from a heavier regulatory burden, climate policies contribute to significantly higher costs for such industries compared to their peers in other jurisdictions.[11] Planned projects (e.g. the Port of Antwerp's chemical cluster) are being cancelled or will be developed outside Europe. To put it bluntly, without support, many of the EU's energy-intensive firms are set to disappear in the medium to long term (given the long lifespan of investments).

In this context, the EU could, of course, decide to sacrifice part of its manufacturing industry, but this would be a lose-lose situation as emissions would simply move abroad and well-paid European jobs would be lost. The alternative is to support these industries and compensate them for the policy-driven competitive disadvantage they face. Such compensation could take the form of either protectionism or subsidies, i.e. a return to industrial policies, but these are precisely the types of policies that were banished from the post-Eurosclerosis 1.0 paradigm which is based on openness and strict rules on State aid.

There is thus a trilemma between the EU's climate ambitions, openness and the preservation of the single market. Free trade and climate ambitions can be reconciled but, in that case, it will be necessary to prop up firms with national subsidies, a practice which undermines the level playing field in the single market.[12] Alternatively, it is possible to abide by the rules of the single market and adhere to the asymmetric climate objectives but at the cost of constraining free trade. Lastly, both the single market and free trade can be preserved, but only by scaling back climate ambitions, lest energy intensive industries largely disappear from Europe. In short, it is not possible to achieve all three goals at the same time under the current circumstances.

The situation would be different if direct support for industry could be organised at EU level. This would release the tension between meeting climate ambitions and preserving the single market. As with the carbon border adjustment mechanism (CBAM), though, tensions could still arise with trading partners, as was the case with the Inflation Reduction Act in the US.

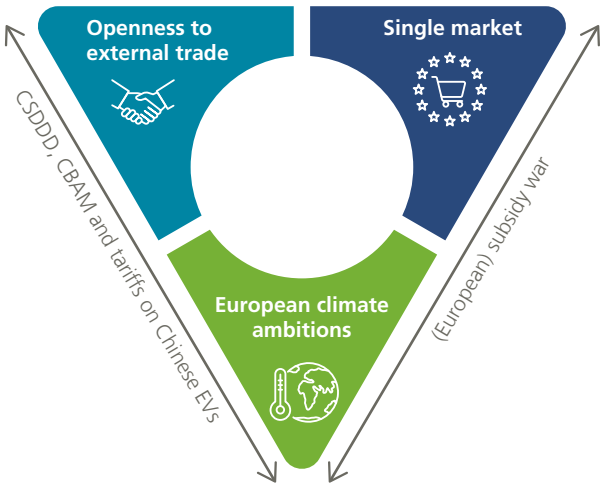
10 So-called transition costs in the non-market sector are likely to be significant as well and slow down economic growth somewhat (see e.g. Wunsch, 2025) but do not directly affect the international competitiveness of firms. The issue here is therefore essentially one of political acceptability. Cement, for instance, is essentially non-tradable and although the cost of decarbonising cement production is high, it is not specifically a competitiveness issue.

11 These higher costs depend to some extent on whether electrification with industrial heat pumps is feasible and economically relevant. If it is necessary to rely on decarbonised fuels, cost differences between the US and Europe can be very substantial. Natural gas is typically three times more expensive in Europe than in the US (about €10/MWh compared to around €30/MWh, not related to climate change), and reliance on carbon capture, for instance, can add an additional €40/MWh in Europe (green hydrogen would be even more expensive).

12 One could of course argue that subsidies are not per se compatible with free trade but insofar as they make up for higher climate ambitions, they may not distort the "pure" comparative advantage of the EU compared to the rest of the world.

Figure 7

The climate trilemma



Looking at the illustration of the climate trilemma, the reality is that Europe is already moving away from the three corners of the triangle. First, higher carbon prices in Europe are set to be compensated via CBAM. However, this instrument does not fully level the playing field for EU firms, notably when they export outside Europe as they will still have a cost disadvantage in third markets. Second, the EC currently tolerates significant national subsidies to energy-intensive firms, typically in the form of lower electricity prices, as well as reduced grid or distribution tariffs or direct investment supports.[13] Finally, the EU has already reduced its 2040 emissions target somewhat, from 90% to 85%.

The import of Chinese electric vehicles (EVs) is another case in point. Chinese EVs are now subject to relatively high tariffs, which goes against the principles of free trade and climate objectives but is meant to protect the European car industry and, indirectly, the internal market (as the alternative would likely be national support mechanisms).The CSRD and the CSDDD (see Section 2.3) tend to prioritise the climate aspect (and other EU norms) while creating tensions on the free trade front. In fact, to the extent the EU's trading partners no longer accept its standards, these instruments effectively restrict trade to a limited number of "like-minded" jurisdictions.

The issue of strategic autonomy

A comparable issue exists with respect to strategic autonomy. For geopolitical reasons, it may be desirable to retain control over certain production processes (for medical products, food, defence, the mining of rare earth elements, etc.). However, in many cases, comparative advantages are such that adherence to free trade principles would cause these production processes to move overseas, possibly to countries that are considered undesirable from a geopolitical point of view. One example of the tension between free trade and strategic autonomy is the closure of Xellia Pharmaceuticals' Copenhagen plant in May 2025. This was one of the EU's last major production facilities for an active pharmaceutical ingredient (API) used in certain vital antibiotics. Production was shifted to more cost-competitive sites, including in China. Despite concerns about the offshoring of pharmaceutical supply chains and the production of critical medicines during the COVID-19 pandemic, the EU now depends almost exclusively on Asia (particularly China) for the production of antibiotics. More generally, this discussion also touches on the reshoring of critical supply chains.

13 This is not entirely new. France has long offered lower prices to its industry. However, there is now, once again, a much broader trend towards actively supporting national industries.

Hence, an emerging European priority is again at odds with the basic characteristics of the "old" EU model. It is easy to say that production should be brought back to or remain in Europe. However, unless European firms are "naturally" competitive, some form of support will be required, and the options are limited: either interfere with free trade or contravene the limits on State aid. The choice of instrument used to bring production back to Europe or to keep it in Europe is less relevant and can range from subsidies or various trade restrictions (tariffs and the like) to outright nationalisation. In all cases, it will imply a trade-off between different EU objectives. Similarly, as geopolitical constraints are increasingly intertwined with economic issues, there are mounting concerns about reliance on certain countries to maintain the EU's critical infrastructure, such as the for US weapon systems, ICT firms and military hardware and China for communication and renewable energy technologies. This once again creates tension with free trade principles.

All this is obvious in a way but one should not underestimate the inertia inherent in the system. Trade and competition policies are exclusive powers of the EC. For more than forty years, these policies have been based on clear guidelines that are, to a large extent, at arm's length from political interference. In other words, the implementation of trade and competition policy is essentially outsourced to civil servants who apply the European consensus;[14] it is a world of "corner solutions", to use economic jargon, with limited trade-offs. Industrial policies are highly constrained, with the EC pursuing ever more trade integration. This all made perfect sense in a world in which one could trust trading partners and peers to follow rules-based behaviour and, in particular, abide by the Brussels effect. But this world has now disappeared.

In search of a new governance model

There is a growing awareness that the complicated decision-making structure of the EU, with conflicting national interests, significantly reduces the EU's ability to adjust to a changing global environment. Now more than ever, a more agile and lighter governance model is warranted.

First, as illustrated above, the "old" EU economic paradigm can no longer serve as the only compass, as new policy objectives and priorities are increasingly coming into conflict with the principles of free trade and competition. Recognition and assessment of the trade-offs involved are thus required, rather than the mechanical implementation of fixed rules. As regards the climate trilemma, for instance, a realistic compromise needs to be sought between the abovementioned three corner solutions. This is not a bureaucratic matter but first and foremost a political choice between objectives that are difficult to reconcile. Where and how to address these tensions is a complex question. Europe needs to move away from repeated defensive moves (such as CBAM, tariffs on Chinese EVs, etc.) towards a more pro-active strategic discussion of the trade-offs [15] involved and their policy implications.

Second, Europe's institutional architecture was conceived for a rules-based world but is now facing a very different reality. By nature, EU decision-making is fragmented across different policy areas. In a more transactional world, this fragmentation is more difficult to sustain, as instruments from distinct policy areas (tariffs, fines, control over supply chains, etc.) are often combined, leveraged or even weaponised in negotiations on broader policy objectives.

Europe's geopolitical competitors, the US and China, can more easily combine different instruments into a multidimensional policy package. To liken geopolitical strategy to a game of cards, they can play with a full deck,

14 The EC has the right to propose new legislation (the right of initiative) and is therefore more political than the typical national administration. The point here is that trade and competition policies have for some time been a pure matter of routine. This changed recently with some voices, echoed in the Draghi report, arguing that competition policy has become too restrictive and does not allow the emergence of European champions. In this regard, the EC has decided to amend its Merger Guidelines and, of course, trade policy will have to adapt to Trump's vision of the world.

15 Our understanding is that the EC now recognises the problem faced by energy-intensive firms in the EU but claims that the only practical solution is to accelerate the transition while allowing national governments to subsidise their industries. This approach risks opening a Pandora's box without solid guardrails. If history is any guide, subsidies breed subsidies, and it may not be long before we see a return to the damaging subsidy wars triggered by the oil shocks of the 1970s-80s.

while, in Europe, the cards are held by different players (the Members States and the various EU institutions, with different majorities for different constituencies). The US Inflation Reduction Act is a case in point as it combines climate considerations with protectionist elements and industrial policy (domestic content requirements) through massive tax incentives. Another example is the fact that negotiations on trade deals with the new US administration often lump together aspects of trade policy (tariffs) with commitments to purchase a certain level of goods from the US or spend more in a particular area (e.g. defence). In the current EU framework, such measures cannot easily be matched, as they combine responsibilities of Member States (or even private-sector firms) with those at EU level. In addition, there is no independent fiscal capacity at EU level to raise – or reduce – taxes and direct or increase spending in all EU countries. Hence, in this increasingly transactional world, new forms of overall strategic policy coordination appear to be required at EU level.

As decisions move away from the rules-based technical sphere to the political arena, the decision-making power should follow suit and become more politicised and less compartmentalised. Here, the fundamental challenge is not finding better technical solutions within existing structures but recognising that these structures can themselves be constraints. Ideally, Europe needs to move from administration to politics, from (automatic) rule-following to strategic choice-making, from compartmentalised tools to coordinated deployment. This ties in with the recent call by Belgian Prime Minister De Wever (De Tijd, 2026) for a clearer division of responsibilities between the European Council and the European Commission. He argues that only the former (the political actor, in his view) should determine key European policy priorities, while the latter should focus more explicitly on the implementation of these policies rather than extending its reach into a broad range of areas.

The key question in this respect is whether the EU political realm – often marred by competing national interests – can really be transformed into an agile and effective institution for strategic policymaking. There is clearly no electoral appetite for either of the two most extreme solutions: full federalisation that strips all important government functions away from the Member States and consolidates them at EU level or a return to a mere free trade area. Flexible forms of cooperation, far removed from more rigid EU procedures, may be a more promising avenue. This is somewhat similar to what Draghi (2024) called "pragmatic federalism", which is in essence layered integration ("lasagna federalism"). Likeminded countries could cooperate in a specific area, while other coalitions could be formed around other topics (e.g. defence, energy security, strategic autonomy, etc.). The key difference would be that while, currently, such discussions typically relate to the speed and geographical scope of EU integration, the question would be how the EU, ideally with allies, can become more transactional and wield power if need be. As argued above, this implies a capacity to mobilise trade and competition (i.e. industrial policy) more strategically. The Anti-Coercion Instrument (ACI) adopted in November 2023 is a step in this direction, but it has yet to be used, perhaps in part because it is not easy to be both rules-based and transactional at the same time. This change in approach requires striking a fine balance between signalling a willingness to enter predictable, mutually beneficial economic relations and not excluding the use of force in some cases.

3.3 The geopolitical positioning challenge

The institutional challenge discussed in the previous section was all about reshuffling the deck of cards and making sure that Europe can operate more flexibly in an increasingly transactional world. The third related challenge pertains to the geopolitical positioning of Europe, i.e. the broader geostrategic goals to be achieved. This is of course a very wide-ranging question which is only sketched briefly here. Sapir *et al.* (2025) describe different scenarios for a multipolar world and call for policies that increase Europe's strategic autonomy from the two superpowers, both for protection and to increase its bargaining power. Internationally, Europe should also defend and promote reform of the rules-based international order by forming coalitions with other countries from the Global North and some from the Global South, prioritising trade and climate policy.

The EU is still an important economic bloc, accounting for about 15% of global GDP, but finds itself increasingly squeezed between two great powers, the US and China, each pursuing its own interests with a more agile

institutional set-up. Currently, Europe depends on the US for security and technological innovations, while it depends on China for critical commodities, consumer goods and, increasingly, specific technologies, including renewable energy products. In a world where rules are becoming subservient to geopolitical power Europe will also have to fundamentally review its external strategy.

In this regard, a greater sense of geopolitical realities is called for. As mentioned above, any attempt by the EU to impose its standards or values as a precondition for international trade comes at a greater cost – in terms of welfare foregone – in a more volatile world in which an increasing number of countries do not wish to copy these policy standards. This does not mean that Europe should drop the pretence that its international relations depend on the values or norms others follow, simply that it can no longer be assumed that leverage is always on our side.

Obviously, another aspect of increasing geopolitical resilience is reducing European dependencies overall. This goes back to the point made about strategic autonomy. Europe needs to diversify its supply chains, including for energy, and build up stronger defensive capabilities. This will be a very gradual process but, in both cases, it is urgent that it be a broadly shared policy priority among European countries.

Navigating international relations is easier from a position of strength. Hence, it is important to create strategic alliances with other jurisdictions. This chimes in with Carney (2026). He explicitly called on the "middle powers" to act together and, essentially, to form a third pole in a multipolar world, alongside the US and China. In this respect, recent steps towards greater trade integration between Europe and India, as well as (hopefully) the Mercosur countries, will at least have an important signalling function regardless of the immediate economic impact. Similar policies could be pursued with other high-growth regions, notably in Africa, Southeast Asia and the Middle East.

Reliance on flexible coalitions, however, raises an obvious trade-off (yet another one!) between a sufficiently strong core that carries weight vis-à-vis the rest of the world, where being big matters, and the gain in agility resulting from more *à la carte* arrangements. The ambition should be for the EU institutions to provide a geopolitical anchor that is heavy enough while allowing for some degree of diversity in the coalitions that gravitate around it, which could include key partners from other jurisdictions. This of course requires that our national democracies make clear choices and take strong commitments at the EU or international level, which is not always a given.

As for how to relate to Carney's "Hegemons" (the US and China), flexible yet assertive cooperation may prove to be in the best interest of Europe, not least because the aforementioned dependencies will continue to exist in the short to medium term. On the other hand, recent experience has shown that having some clear red lines in certain areas is warranted. Those that constantly bend under pressure will not be respected in the new world order. In this regard, it should be acknowledged that the actions of both China and the US are increasingly at odds with European interests. Thus far, Europe has been rather passive, if not outright naïve. If current trends continue, the question will need to be raised at some stage whether the EU should rebalance its relationship with one or other of the Hegemons. The pros and cons of increasing tariffs on the US (given the current discrepancy) or on China (given its support for Russia, Iran and North Korea, as well as its heavy subsides for controlling critical value chains) should certainly be considered.

It should be stressed that Carney (2026) painted a rather pessimistic picture of the current rupture with the rules-based order. His speech echoes the belief that we are witnessing a permanent or at least long-lasting regime shift, not just a hiatus. This is not certain. Popular support for policies can shift over time; the next US elections will give some indications in that respect. New politicians may again come to power who embrace cooperation and multilateralism based on commonly accepted rules. Hence, strategic alliances between Europe and "non-aligned" jurisdictions should not necessarily be confrontational in nature.

4. Conclusion

The EU has been a massive economic and political success story. The economic bloc that was gradually built in the aftermath of the Second World War contributed to maintaining peace and brought unprecedented prosperity to its citizens. However, economic progress was not linear and in the early 1980s, after two oil shocks, Europe went through a period that became known as Eurosclerosis. Economic growth declined and unemployment rose sharply. Individual European countries tried to spend their way out of the crisis, by subsidising their own manufacturing industries, but this only led to rapidly rising government debt ratios and countries were forced to raise taxes, which exacerbated the slowdown. This doom loop only came to an end with the bold decision to create the EU single market and gradually move closer to a full-fledged economic union.

The economic paradigm that was established (or reinforced) at the time – based on free trade, the internal market and strong restrictions on State aid – has shaped European economic policy until today. It halted the slowdown but did not allow Europe to close the technology gap with the US, while China became a dominant geopolitical and industrial force. A string of grand plans was launched to boost the EU economy, typically combining deeper EU integration (and more regulation) with higher public spending, but they generally overpromised and underdelivered. In the meantime, Europe's relative decline, in terms of material welfare, compared to other jurisdictions continued, so much so that the current period can be referred to as Eurosclerosis 2.0.

The Draghi report is the latest to sound the alarm. It points to the regulatory burden on firms and the complicated EU governance structure as impediments to more dynamic growth. However, apart from these issues, the report essentially proposes familiar solutions. It also calls for Europe to "do better" in a very broad range of areas, without identifying potential trade-offs between different priorities.

We argue that another grand plan is unlikely to solve the Europe's current economic woes. First, while Eurosclerosis 1.0 was characterised by shortfalls in demand, gradual population ageing has turned most advanced countries, including in the EU, into supply-constrained economies. In this context, higher spending is less relevant and could even translate into higher inflationary pressures. Second, the global rules-based order – with a central role for Europe – has been replaced with a more brutal geopolitical reality based on power relations. Other jurisdictions no longer accept EU policy standards, leaving EU firms, as well as households, to bear the burden of asymmetric regulation that further reduces the competitiveness of the EU economy. Third, while further EU integration does offer some potential in the medium to long run, it largely fails to address other causes of Eurosclerosis, which are based on deeply ingrained societal preferences. Deepening the single market is a valuable objective and will remain on the European agenda, but it is not an alternative to a clear political project.

Against this backdrop, we argue in this policy paper that Europe needs to better identify and confront some uncomfortable trade-offs, both old and new ones arising from a changing world. The EU cannot attain all of its policy objectives at the same time. Climate policy is a case in point: as the EU objectives and timeframe are no longer shared by other jurisdictions, these policies come with higher welfare costs and lead to tensions with principles of free trade and strict State aid rules. The same applies to strategic autonomy objectives, which cannot be pursued without some compromise in terms of openness and/or industrial policy.

We looked at the current European situation through the lens of three challenges: technological, institutional and geopolitical positioning. In all three areas, action is required which is likely to pull Europe out of its comfort zone. If the EU wishes to remain a welfare-creating powerhouse, it needs to become a more flexible and agile Union, with a market that swiftly adopts technological changes, rather than overregulating them and a governance structure that allows for more flexible cooperation and more rapid decision-making, one that can navigate new geopolitical realities and form alliances instead of insisting on a moral leadership role which is no longer universally accepted.

This will not be easy as the required policy choices may touch on deeply rooted societal preferences. In the area of technological innovation, in particular, Europe is clearly more risk averse and uncomfortable with disruptive change than the US or China. This preference translates into more regulated markets (in particular the labour market), higher taxes and less inequality but also lower economic growth than elsewhere. While there is growing dissatisfaction among at least certain segments of the population about overregulation and subpar growth in Europe, there may not be enough democratic support to move in the direction of a more volatile and disruptive economic model, like in the US. Likewise, further market integration may yield diminishing returns unless one is willing to consider harmonising politically sensitive areas such as taxation, bankruptcy laws, labour markets or consumer protection.

As regards the institutional challenge, the inertia of the past forty years and the diversity of national views will render it difficult to strike a good balance between saving what can or needs to be saved of the European paradigm and leveraging trade and industrial policy instruments to address the climate-related and strategic autonomy challenges. In addition, the painful discussions surrounding Mercosur showed that it is not easy to reach a consensus when it comes to preserving standards and trading with the rest of the world. Europe could learn that its openness to trade was partly contingent on others agreeing to accept our rules, which they are ever less inclined to do.

Finally, with respect to the geopolitical challenge, positioning Europe against an erratic US and a more assertive China will require stamina and consistency, which will not be easy with 27 around the table. The hope, expressed by Mark Carney (2026) and others, is that enough like-minded democracies will be able to form a core group that is sufficiently strong and agile to resist being stuck between a rock and a hard place.

This paper is about Eurosclerosis 2.0 meeting a new world order which is more difficult to navigate. It is not a Eurosceptic paper but rather one that deeply cares for Europe's future. To escape Eurosclerosis 2.0, difficult choices will need to be made and the trade-offs involved acknowledged. This point seems somewhat absent from public discourse, which continues to be dominated by old policy recipes. We believe that Europe cannot "plan" a higher growth rate into existence without making some hard choices or adopting new ways of dealing with challenges.

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