



FOREIGN AFFAIRS

Europe Can't Get Out of Its Own Way

The Real Barriers to Competitiveness and Innovation Are Still in Place

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The European economy is falling behind. At the turn of the century, EU labor productivity was on a steady upward trajectory and had reached almost 95 percent of U.S. levels. Then the trend reversed. EU productivity is now 20 percent lower than that of the United States. One important cause of this decline is Europe's failure to participate in the digital revolution. Of the world's 100 most valuable high-tech companies, only two are headquartered within the EU. The bloc has no global-scale companies in cloud computing, online advertising, mobile devices, or chip design, and it has only one competitor—France's Mistral—remaining in the race to build the large language models powering the current AI surge.

The publication in 2024 of former Italian Prime Minister Mario Draghi's report on European competitiveness heralded a shift in attitudes. The report recommended several policy interventions, including increased public investment in R & D and a capital markets union. By mid-2026, around 30 percent of its recommendations had been implemented. That is a good start. But even if the report's proposals were fully adopted, they would not be enough to revive Europe's flagging competitiveness—because they do not address the root cause.

The problem is not that the EU and its national governments are not doing enough to spur competitiveness. It is that they are doing too much to impede it. Through the slow accretion of layers of labor and tax policy, red tape, and technology regulation, they have erected barriers to the creation of the kind of large, vibrant startup ecosystem currently thriving in the United States. This ecosystem has been the cradle of many major innovative high-tech companies, as well as those sparking innovation and growth in other sectors. If the EU does not create the conditions for such companies to develop, then the bloc's decline may become irreversible.

DRIVE ON

Big companies are hard to change. Global, long-standing, historically successful ones might be the hardest of all. And Europe has many of these. The 50 most valuable EU companies trace their origins back more than 150 years, on average. When such companies are confronted by fast, broad, and deep technological change, they struggle to respond effectively. The differing trajectories of the European and U.S. auto and space industries—which have historically driven growth and innovation—reveal the importance of fostering a healthy startup ecosystem.

In the first quarter of the twenty-first century, carmakers have experienced two immense changes. First, owing to a combination of regulation and demand, they have begun the transition from manufacturing internal combustion engine vehicles to manufacturing electric ones. Second, breakthroughs in digitization and automation have necessitated further changes in their offerings. Europe's carmakers have floundered in the face of these changes. Volkswagen has probably tried hardest. It committed to an entirely new EV platform in 2015, announced ambitious electrification goals across the brands of the VW Group, and created Cariad, a new software subsidiary. Since then, Volkswagen has sold

approximately two million EVs. But it is hard to label the carmaker's overall electrification effort a success. Cariad was reorganized multiple times, updates arrived late, and several executives, including the CEO, left the company. Other brands within the VW Group, including Porsche, Audi, and Bentley, announced major delays of EV models and platforms, and Porsche took approximately \$5 billion in write-downs associated with its electrification efforts.

In China, still VW's largest overseas market, car buyers have shifted to EVs—but not European ones. As a consequence, profits from VW's Chinese operations fell by 80 percent in the decade to 2026. The market capitalization of the entire VW Group followed a similarly dire trajectory, dropping by more than 60 percent in real terms between the end of 2015 and the second quarter of 2026. By the middle of 2026, VW Group as a whole was in deep trouble, with the *Financial Times* reporting that its CEO, Oliver Blume, proposed shuttering four factories in Germany, and laying off as many as 100,000 workers.

Europe's other large automakers have not fared much better. Mercedes's market capitalization has declined by more than half since the end of 2015, and BMW's by almost 60 percent, according to my analysis. Stellantis took more than \$20 billion in EV-associated write-downs in 2026, and saw its market capitalization decline by 76 percent since it first floated shares in the first quarter of 2021. The auto industry is the source of approximately ten percent of EU manufacturing employment, or more than three million jobs, according to the European Automobile Manufacturers' Association. That number seems likely to fall further, unless there is an increase in foreign-owned production, or a huge reversal in fortunes among legacy European automakers. The valuation trajectories of these companies indicate that investors do not anticipate such a turnaround.

Like car manufacturing, space exploration and commercialization have been transformed in recent years. And like carmakers, European space companies have stumbled. The Ariane 6 rocket from Europe's ArianeGroup was scheduled to begin operation in 2020, but launched only in 2024. Its estimated development cost grew from about \$2.7 billion in 2015 to about \$4.2 billion in 2022, and its operations are supported by an annual subsidy of up to about \$370 million committed by the French, German, and Italian governments. The EU's

sovereign IRIS² satellite network has also been delayed. Having been originally scheduled to enter service in 2024, it now has first launches scheduled for 2029.

The same pattern holds across several other industries: the EU's legacy companies have become less competitive and have lost ground to foreign competitors. A quarter century ago, European companies accounted for 36 percent of the total market capitalization of the world's 100 most valuable companies. By the end of 2025, this figure had fallen below ten percent. In a 2026 speech, Draghi made clear the consequences if these trends are not reversed: "This is a future in which Europe risks becoming subordinated, divided, and deindustrialized at once. And a Europe that cannot defend its interests will not preserve its values for long."

WAY OUT WEST

The United States has outcompeted the EU in recent decades, in part because legacy American companies have responded better to digitization, globalization, and other twenty-first-century changes and disruptions. But like their European counterparts, American incumbents in the automobile and space industries have also stumbled. Neither General Motors nor Ford has produced any hit EVs, and both have dramatically scaled back their ambitions. In the past year, GM has recorded write-downs of at least \$8 billion related to EVs, and Ford nearly \$20 billion. The United Launch Alliance—a partnership between Lockheed Martin Space and Boeing—has experienced a series of setbacks, and its Vulcan rocket program is years behind schedule. Meanwhile, the 2024 flight to certify Boeing's Starliner spacecraft for crewed missions experienced such grave problems that NASA refused to let it return from the International Space Station with astronauts aboard.

Despite these companies' struggles, the United States still launches far more rockets and puts more payload into space than the rest of the world combined, and holds a near-monopoly outside China in satellite-based Internet connectivity. The United States also produces the only fully driverless cars on the road in the West and produces the top-selling EV models both domestically and in Europe. These accomplishments come not from legacy firms but from the country's venture-backed startup ecosystem.

"Silicon Valley" is a convenient shorthand for this ecosystem. Originally, the area's entrepreneurs and investors concentrated on the computer hardware, software, and network

industries. In recent years, however, Silicon Valley's ambitions have grown, and it has brought its innovations to many other sectors. A notable example is Tesla, which, since its founding, in 2003, has designed, produced, and sold over ten million EVs, built a network of around 40,000 charging stalls in the United States and 20,000 in Europe; since 2020, it has made \$45 billion in profit, according to Tesla's annual reports. The company is currently operating robotic taxis in six U.S. cities, and in Texas, it has begun testing the Cybercab, which accommodates two passengers, and has no steering wheel or pedals.

Brussels needs to rethink its onerous technology regulations.

More recent companies have also transformed their industries, including the defense tech startup Anduril, which was founded in 2017. In early 2024, the company beat out Boeing, Lockheed Martin, and Northrop Grumman to be named one of the two main suppliers to the Air Force's Collaborative Combat Aircraft program. In 2026, Anduril's aircraft moved past the prototype phase and won a contract to provide drone wingmen.

A similar story can be found in space technology. SpaceX, founded in 2002, became the first to relaunch an orbital-class rocket booster 15 years later. It has now executed more than 600 such relaunches. Meanwhile, Jeff Bezos's Blue Origin has relaunched an orbital booster once, and the rest of the global aerospace industry combined has yet to do so. SpaceX also holds a dominant position in the global market for Internet connectivity from space. Its Starlink service boasts approximately 11,000 satellites in orbit and 12 million customers across about 160 countries and territories. And when Boeing's Starliner mission failed, it was a SpaceX Crew Dragon spacecraft that brought the astronauts safely back to Earth.

These companies have all benefited from some combination of U.S.-government-funded research, subsidies, federal procurement, and loans. Many have also profited from the willingness of regulators to allow experiments in risky domains, including autonomous driving on public roads. None of these factors is unique to the United States, or, indeed, to Silicon Valley. Yet Silicon Valley is unique. As the financial historian Sebastian Mallaby puts it, "Silicon Valley [is] the most durably productive crucible of applied science anywhere, ever."

COPY WHAT WORKS

It is essential for Europe to develop its own productive crucible. Recent high valuations for some continental startups have sparked optimism that the region's entrepreneurial ecosystem has turned a corner. But the fundamentals remain poor. There have been other false dawns. Indeed, in 2023 and 2024, overall EU venture capital investment jumped to more than 20 percent of the U.S. total. In 2025, however, this figure dropped back to about 12 percent, near its average of 12 percent since 2010. For the past 12 years, the total valuation of EU unicorns (private, high-growth companies worth at least \$1 billion) has hovered around ten percent of the U.S. total. In 2025, and so far in 2026, the figure has dropped to approximately eight percent.

It will be difficult to increase these numbers and build an EU startup ecosystem capable of supplying the new growth that engines Europe needs. But imitating the U.S. example would be a good place to start. Silicon Valley's experience strongly indicates that high-powered employee incentives such as stock options (that are not taxed until exercised), flexible labor markets, pass-through partnerships (the legal structure of most U.S. venture capital firms), and minimal paperwork are all important elements of a vibrant tech ecosystem. All are also under the control of individual EU members, and therefore do not require coordination across national governments. European countries have implemented some of these measures. Denmark, for example, has a highly flexible labor market, and Luxembourg has enabled U.S.-style limited partnerships—but none has a bundle of tax and labor policies as friendly to entrepreneurs and startup investors as that found in the United States.

Europe could also learn from the example of a much smaller country than the United States. Israel emerged as a “startup nation” after making structural changes including opening up pass-through partnerships to foreign investors. The results have been impressive. Despite having a population smaller than Belgium's and a primary language shared by no other country, Israel currently has almost four times as much unicorn valuation per capita as France, and more than three times as much as Germany. Israel's example challenges the argument outlined by Bo Becker and other researchers at the Center for Policy Research that an insufficient home market size is a key impediment to scaling up young European companies.

NO MORE RED TAPE

Brussels should reevaluate its approach to technology regulation. It seems at times as though EU officials believe that regulation imposes few, if any, meaningful constraints on innovators and entrepreneurs. Sometimes they speak as though greater regulation might even unleash innovation and entrepreneurship. In 2023, Margrethe Vestager, then the executive vice president of the European Commission, embodied this attitude when she maintained that the EU's AI Act would "not harm innovation and research, but actually enhance it." The AI Act was adopted in 2024. It came on top of the Digital Services Act and Digital Markets Act, both passed in 2022, and the General Data Protection Regulation (GDPR), in 2016. As evidence has accumulated about the effects of these regulations, it has become harder to sustain a belief in the harmonious relationship between competitiveness and EU red tape.

The GDPR, for example, has decreased venture capital investment into the EU, increased the market share of already dominant U.S. tech companies, hurt the financial results of companies targeting the European market, and inconvenienced consumers. One study by Rebecca Janssen, Reinhold Kesler, Michael E. Kummer, and Joel Waldfogel found that GDPR led to the disappearance of about a third of the apps available on the Google Play Store and a 50 percent reduction in the number of new apps added over time. GDPR accomplished these outcomes by imposing substantial compliance costs and limiting companies' ability to collect efficiency-enhancing data.

But Brussels does not seem to be changing its approach to technology regulation. The European Parliament, while introducing simplifications to the AI Act in June, insisted that its "main provisions and risk-based approach" would be maintained. And while a 2026 report on improving EU startup financing acknowledges "industry stakeholders'" arguments about the high costs of regulatory compliance, it neither made nor endorsed these arguments. Yet these arguments have merit. Many of the AI Act's requirements—including those related to risk management, data governance, technical documentation, logging, transparency, human oversight, accuracy, and robustness—apply prior to market entry. Compliance with these rules would be costly and time-consuming for any firm, let alone a startup. Investors and entrepreneurs take such costs into account, and many will choose to take their business—or themselves—elsewhere.

The EU cannot close the competitiveness gap without deeper and different reforms than those currently under consideration. Brussels needs to reverse course and rethink its onerous technology regulations. At the same time, national governments need to follow established best practices and create attractive environments for top innovators, entrepreneurs, and venture capitalists. It is true that Europe has great strengths. It is a populous, prosperous region with strong institutions, excellent educational systems, and no shortage of talented builders. But it is also true that, at present, entrepreneurs face many barriers that impede their ability to scale their businesses, attract the world's best sources of risk capital, and make an impact at a global level.

Unless those barriers are dismantled, the EU will fall farther behind. And Brussels does not have the luxury of time. European industries are going to come under stringent challenges in the coming years. Near-term policy choices will determine whether the new growth engines that rise to this challenge will be European. As things currently stand, they will not.

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