

BRAVER, GREENER, FAIRER

Memos to the EU leadership 2019-2024

EDITED BY:
Maria Demertzis
Guntram Wolff



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INTRODUCTION

It has become almost a tradition that Bruegel scholars prepare a set of memos or briefings for the incoming European Union leadership.

Five years ago, we argued that the EU had significantly lost ground since the financial crisis. We identified strikingly high unemployment as one of the key challenges and argued that the reform of the EU's monetary union was incomplete. While employment has now risen to record heights and unemployment is overall low, some challenges persist while new ones have emerged.

Geopolitical tensions were less apparent five years ago, the risks associated with climate change had not penetrated societal dialogue by quite as much, and the digital transformation was less visible. Also, now we are 10 years on from the financial crisis, we can see the process of economic convergence has slowed or stopped in some regions of the euro area.

The May 2019 European elections with their increased voter turnout showed that citizens care about Europe. At the same time however, there are substantial differences of opinion about how to move forward.

This set of 16 memos is the product of a collective exercise under our editorial leadership. We started the process some 12 months ago with a call for ideas within our team. Many and lengthy debates followed, with all of us – and our members and external stakeholders – acting as one another's sounding boards, reviewing and testing our ideas. We debated, questioned and critiqued. We have not tried to be exhaustive and have focused only on those areas where we have the expertise, bearing in mind our economic policy remit. We didn't always agree and these memos, like all Bruegel publications, represent the views of their authors alone. However, they all have one objective: to provide concrete policy suggestions to the incoming leaders on how to deal with the challenges the way we understand them.

All memos follow a common format. Where do we stand on the main issues concerning the specific file? What do we believe are the key challenges for the next five years? And importantly, what are the steps policymakers should take to address them? We take into account the constraints commissioners face without being timid: a number of memos recommend bold actions to their addressees.

Each of the memos can be read as a stand-alone piece. However, there are a number of clear overarching messages for the presidents of the European Commission, the European Council, the European Parliament, the European Central Bank and their colleagues to take on board.

The EU needs to step up its game. Economic sovereignty, or the capability to pursue its own economic objectives, requires the EU to exert power, which in turn requires a Europe of scale that speaks with one voice. This is a challenge for a union of sovereign states, but experience has shown that when the EU manages to unite, for example on issues of trade or competition, it can project effective leadership and protect its economic values. This becomes increasingly difficult, however, in areas that touch on core competences of member states, such as security. The EU therefore faces a governance challenge. The EU must continue to fight to preserve a multilateral system but does so while recognising that the global rule book is being re-written by less cooperative and less like-minded partners. A number of memos in this volume also provide input into how the EU's competition and industrial policy framework can be rethought to address the challenge.

Climate change is not a distant challenge. It is visible, it is here and it requires huge efforts from all. Europe has already taken a leading role. But the EU's policy framework is insufficient and the policy response needs to be much braver, while ensuring that the burden of adjustment does not fall disproportionately on the weakest.

When it comes to cohesion, there are questions about the actual macroeconomic policy decisions as well as on the broader governance. Monetary policy rightly employs bold measures to stimulate demand but fiscal policies across the union are incoherent. The commissioner responsible for economic and financial affairs and the new ECB president will both have a role to play in promoting a better macroeconomic policy mix, especially if there is a new recession. More structurally, completing the Economic and Monetary Union architecture is necessary for the better functioning of the euro area and for the EU to be a credibly stronger global player.

A further overarching and immediate challenge is the European budget, which remains in many parts outdated and inefficient. The multiannual financial framework represents an opportunity for change.

The EU's new leadership must also tackle issues around more efficient regulation at EU and country level, and strong governance: respecting the rule of law, reducing corruption and maintaining independent judiciaries. Our democracies are being challenged by media outlets that promote extreme views, social media utilised by domestic and foreign agents that oppose democracy and populist political parties – a broad set of topics that we can only cover partially.

When it comes to equity, a key argument from the memos is that better macroeconomic policies matter for good outcomes for all citizens. A crucially important memo in this book covers taxation and makes concrete suggestions about how tax havens and the erosion of top income tax rates can be addressed. We did not cover social and employment policies with a separate memo this time, but argue in the memo to the presidents of the EU institutions that the good work in this area should be continued.

Lastly, the European Commission cannot propose laws in an apolitical way – after all, it is the essence of democracy that electoral choices lead to political choices in legislation. But the EU is also an enforcer of rules and a guardian of the treaties. In this function it needs to apply rules with flexibility but also be non-partisan and even handed to preserve its credibility.

Throughout the preparation of this volume, Bruegel's publications editor Stephen Gardner has contributed considerably to improving the formal and substantive quality of the individual memos. We are grateful to him and to all of those who have given feedback throughout the process of preparation of the memos.

Maria Demertzis and Guntram Wolff

TO THE PRESIDENTS OF THE EUROPEAN COMMISSION, COUNCIL AND PARLIAMENT

By Maria Demertzis, André Sapir and Guntram Wolff

* You inherit a relatively healthy European economy, but you face three formidable challenges in the next five years. First, you must define Europe's place in an increasingly bipolar world driven by a geostrategic rivalry between the United States and China. You should avoid protectionism and instead strengthen Europe's technological, financial and security capacities. You should continue to support multilateral institutions and stand ready to retaliate against trade aggression. Second, global warming is a reality and temperatures appear to be rising faster than forecast. You need to impose higher prices on greenhouse-gas emissions, guide a deep transformation of our economies, minimise the resulting social fallout, ensure border carbon adjustment and globalise the EU's decarbonisation. Third, you need to manage the economy and EU cohesion. The main worry is a deep recession or even a new crisis. Guide European policymakers on the use of pro-active fiscal policy, reform the governance of the euro area and address tax fraud and evasion.

- * GEOPOLITICAL CHALLENGES
- * LOW-CARBON TRANSFORMATION
- * CRISIS RISK

1 STATE OF AFFAIRS

Congratulations on your appointments! First, the good news: you face a much more benign macroeconomic situation than when your predecessors assumed office five years ago. Then, the European Union was just emerging from the worst economic and financial crisis in its history. Economic growth was still very weak, unemployment was close to 12 percent in the euro area (and just above 10 percent in the EU), and the public debt-to-GDP ratio was above 90 percent. Now, after five years of economic growth at an average of roughly 2 percent, unemployment is down to about 8 percent in the euro area (and less than 7 percent in the EU), and the debt-to-GDP ratio is approaching 80 percent.

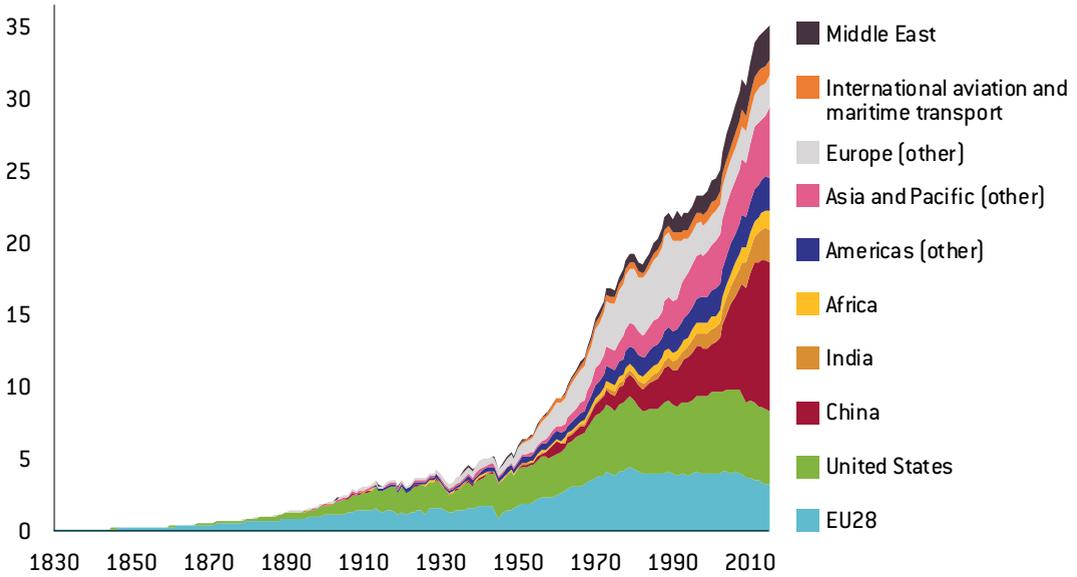
*GEOPOLITICAL
CHALLENGES

However, the global landscape has shifted dramatically in the last few years. A G2-like world, characterised by a broad geopolitical confrontation between the United States and China, has become a reality. Five years ago, the extent to which Sino-US relations have deteriorated was not yet obvious, and it was not clear that the EU would have to define clearly its own way forward. China's fast rise is a tremendous achievement. It has lifted millions out of poverty and China is increasingly becoming an engine of global innovation. But the Chinese economic and political model also poses a challenge to Europe and the West in general. In some quarters, China's illiberal political model is even viewed as an alternative to our sometimes slow-acting liberal democracies. China is an important market and economic partner but also poses an economic challenge. Meanwhile, the US has become a less reliable partner than it was five years ago and some even doubt how strongly it will defend liberal democracy.

*GLOBAL
WARMING

The last five years have also seen continued increases in global greenhouse gas emissions (Figure 1), despite the 2015 Paris Agreement. The frequency of extreme weather events has increased and the world has become warmer (IPCC, 2018). Increasingly, scientists point to positive feedback-loops where the increased temperature leads to further increases in global temperature¹. In that light, the Paris goals might even be insufficient². So far, the EU has not managed to reduce its greenhouse gas emissions convincingly despite the Paris Agreement being politically

Figure 1: Annual CO2 emissions by world region



Source: Carbon Dioxide Information Analysis Center. Note: Annual CO2 emissions measured in billion tonnes per year. Emissions data have been converted from units of carbon to CO2 using a conversion factor of 3.67. Regions denoted 'other' are given as regional totals minus emissions from the EU28, USA, China and India.

*UNEMPLOYMENT AND INEQUALITY

widely accepted. It has not strengthened its policy framework necessary for a profound and deep transformation of our economy, which is simply not happening fast enough. Biodiversity was not a priority for your predecessors and has been allowed to deteriorate in Europe³.

Though EU employment has increased substantially and income inequality remains less pronounced than anywhere else in the world, inequality and exclusion remain important concerns. Youth unemployment is still worryingly high in some EU countries, resulting in the social disenchantment of an entire generation. More broadly, one worrying tendency in many EU countries has been cuts to the top tax rates levied on companies, wealth, inheritance and high incomes⁴. Low progressivity and a high tax burden on the working middle class to fund Europe's social market economy nurture a sense of injustice in society. A key challenge is to reconcile equity and efficiency⁵.

Institutionally, perhaps the most significant change of the last five years has been the transformation of the Commission,

*TRUST IN
GOVERNMENT

traditionally viewed as the guardian of the treaties, into an explicitly political Commission, led by a strong president who claimed an electoral mandate to lead. This controversial change of orientation has allowed the Commission president to a greater extent than before to exercise leadership and impose priorities on the entire Commission. The centralisation of communication and political decision making has been seen by Commission staff as a major change compared to the previous Commission, allowing the Commission to set the EU's agenda (Kassim and Connolly, 2018). This institutional change is an important modification of the way the EU works.

The EU and national institutions are confronted with a lack of trust. The situation for the EU has improved in the last five years, with trust increasing and support for the EU higher among the young than the population overall, but the number of citizens distrusting the EU still exceeds those who trust the EU. This is particularly visible in some southern European countries⁶. Certainly one of the main reasons for this is the lack of convergence and the severe recessions that parts of the south of Europe experienced. Such lack of convergence and trust risks undermining the sustainability of the euro area and the EU. Furthermore, traditional political parties are losing ground, resulting in a more pluralist political system. Elections also confirm certain established cleavages of voter preferences across countries, which might make compromises more difficult in future.

The significantly higher turnout in the 2019 European elections is a sign of a renewed demand from citizens that Europe should deliver on the big topics of our times. Citizens want the EU to prioritise maintaining peace, creating jobs and tackling climate change⁷. More than three quarters of citizens consider the fight against terrorism, tackling unemployment and protection of the environment as the three key priorities for the EU, but the first two priorities have declined in importance (Eurobarometer, 2018). Moreover, citizens are broadly divided on whether the EU should wait until all countries are ready before proceeding with new initiatives, or whether some countries should move ahead. Citizens, however, are convinced that when it comes to the big international



If the trade conflicts initiated by President Trump had been only about trade, the EU would have been well placed to defend its interests

questions, such as dealing with China, Russia and the United States under President Trump, the EU should speak with one voice.

2 CHALLENGES

Three main challenges await you, coinciding with the areas that citizens increasingly believe the EU should deliver on: (1) the EU's capacity to establish itself as a stronger and more independent global player; (2) a climate and environmental strategy that delivers; (3) the EU's capacity to increase cohesion, boost employment and react to a deterioration in the economic situation.

Europe's place in the world

The first, and perhaps defining, challenge of your presidencies will be to ensure that Europe still has a place in a world which is rapidly shaping into a bipolar system dominated by China and the United States. Citizens clearly want the EU to act on issues of global importance and understand that the member states in which they live, even the biggest, cannot act alone. Reinforcing the EU's capacity to be a global force is therefore an opportunity to demonstrate the EU's significant added value.

By some key economic measures, in particular GDP and trade, the EU is on par with China and the United States, and far bigger than any other player. Its single voice on trade and standards commands respect in global bodies such as the World Trade Organisation (WTO), and bilaterally with partners, including China and the US.

If the trade conflicts initiated by President Trump had been



Europe's geopolitical weakness is partly the result of its lack of strength in some key technologies; leverage over networks matters

conflicts about trade only, the EU would have been relatively well placed to defend its commercial interests. But the reality is that these trade battles are part of a geopolitical rivalry between China and the United States, and when it comes to geopolitics, the EU is ill-equipped. The EU's weakness stems in part from its lack of a defence capability. Without the US participating in Europe's defence, European countries would be vulnerable to foreign aggression.

Europe's weakness in this area is also the result of its lack of strength in some key technologies, including digital hardware and software systems that are vital for security. A number of globally-important networks (such as financial or data networks) have developed in an asymmetric way, giving the states with physical and legal jurisdiction over them the ability to extract information and leverage power. These networks tend to have central nodes of influence in the US and increasingly in China - while the EU still has an institutional weakness in terms of exercising power over those networks it can influence (Farrell and Newman, 2019).

The EU has much to lose from the emergence of a bipolar world, and from the rivalry between China and the United States. The threat is to both the EU's economic interests and its political values. The EU is closely intertwined with the United States and China, which are its two main trade and investment partners. A Sino-US trade war is sure, therefore, to have significant negative consequences for the EU economy.

But the bigger consequences are political. The two rival powers will aim to lure the EU into their camps because of the EU's economic assets, and in particular its large market. The EU obviously wants to preserve its values of democracy and the rule of law,

*US-CHINA RIVALRY

social justice and multilateralism, and given its history and values, is clearly politically much closer to the US than to China. However, the rejection of multilateralism by the Trump administration has made the EU uncomfortable with the US position, and has opened the door to closer political relations with China, which has assumed the mantle of multilateralism.

It would be a nightmare scenario for the EU if it had to choose between liberal democracy and the United States on one hand, and multilateralism and China on the other. In both cases, the EU might have to compromise on social justice, which is practiced neither by China nor by the United States.

To avoid compromising on our political values, you need to succeed in escaping the bipolar scenario. You should be under no illusion. Unfortunately, the bipolar scenario is by far the most likely, but it is also the most dangerous for Europe, and probably for other parts of the world which share our values. You should aim not only to strengthen Europe but also to support all multilateral frameworks that can help offset a bipolar scenario

Important further elements of Europe's strategy in defining its place in the world are the relationship with our neighbouring continent, Africa, and the EU's strategy on migration. Both topics are clearly important priorities for EU citizens.

Climate and the environment

When it comes to climate change and the environment, your challenge will be to overcome vested interests, and manage the social and economic fallout of a truly transformative agenda. Citizens want you to address this pressing challenge. At the same time, they aren't likely to accept the consequences of strong climate action easily. The yellow-vests movement in France serves as a powerful reminder that addressing the social consequences of climate policies needs to be an integral part of a successful climate strategy.

Vested interests will want to prevent you from addressing climate change. But you should be clear: climate change is a dramatic reality for humanity. Industrial economies have been leading contributors in the past and have a moral obligation to address their emissions head-on. Moreover, by doing so, they produce a

*LOW-CARBON
TRANSFORMATION

*CAP AND LOST
BIODIVERSITY

template that others can follow and that in itself can also be a business opportunity. Failing to address the challenge head-on would be unacceptable to citizens, and could also mean that the EU loses out on key technological developments – such as electro-mobility – that will shape the future. Meanwhile, a powerful lobby will try to prevent you fundamentally changing the EU’s common agricultural policy – which you must do if you want to restore lost biodiversity in Europe (Pe’er *et al*, 2014) and free financial resources for more forward-looking expenses.

Growth and convergence

The EU’s long-term prosperity and sustainability depends on innovation, growth and convergence. Those countries with a serious productivity growth challenge typically have comparatively weak institutions and perform less well in education, innovation and research. But without more growth in those countries, debt dynamics will be unfavourable. Your challenge is to find ways to contribute to convergence and growth, while most of the levers to do so are at member-state level.

*CRISIS RISK

The challenge could be compounded by deterioration in the economic situation and even the re-emergence of crisis. A recession would increase unemployment, which even now after many years of recovery, remains a key concern for citizens. Beyond the macroeconomic ups and downs, you could face a sovereign debt crisis in a euro-area country that would require emergency summits and assistance. But you have relatively few instruments under your control to deal decisively with such a situation. There is no euro-area budget to use for countercyclical fiscal policy and the current negotiations are unlikely to lead to a budget of macroeconomic relevance. The main truly European institution that could respond, the European Central Bank, would have to find new tools because of low interest rates and the political limits to further bond purchases. Meanwhile, the main euro-area financial-assistance programmes are in the hands of an inter-governmental institution, the European Stability Mechanism, and the member states. You must aim to complete the euro area’s governance set-up to make it more robust. This is all the more important as a badly functioning euro area also has long-term social consequences.



To be able to act and respond on a more equal footing you need to reduce dependence on China and the US in key strategic domains

3 POLICY RECOMMENDATIONS

(1) Europe's place in the world

When it comes to strengthening Europe's position in the world, you will have to design and drive a transformative agenda for Europe. In trade policy, your task is relatively well-defined: you need to vigorously defend the multilateral trading system, including by fostering its reform, while being ready to retaliate against protectionist measures. But to be able to act and respond on a more equal footing you need to reduce dependence on China and the United States in some key strategic domains while strengthening the EU's own capabilities. This will require tackling three issues:

The EU's capacity to innovate and remain a technological leader: You should strengthen investment in R&D, education and improve conditions for innovation and conditions that encourage key players in networks to locate in the EU. For example, the platform economy is dominated by the American GAFA (Google, Apple, Facebook and Amazon), and increasingly by the Chinese BATX (Baidu, Alibaba, Tencent and Xiami). Technological capacity influences the structure of global networks, which in turn is important for the projection of power⁸. But if the EU cannot trust the US to not turn its network hegemony against it, it needs to revisit its strategy and aim to attract key network nodes and hubs and to create institutional capacity to deal with those hubs.

The EU does not lack large digital platform companies because of the EU's competition policy. It lacks such companies because of a fragmented market, including a fragmented market for risk

*TECHNOLOGICAL
LEADERSHIP

*COMPETITION
POLICY

capital, and because of lack of public infrastructure, meaning that, all too often, innovative young companies go to the US to grow.

You should continue the work that your predecessors started to deepen and complete the single market, strengthening the digital single market in particular, exploiting data-privacy rights and developing a European approach to the digital age with the citizens at the centre.

The effectiveness of the EU's competition policy is globally recognised. Relaxing current policies to encourage the creation of large European champions might lead to higher domestic prices, greater inequality and rather limited benefits in terms of innovation and growth⁹. By contrast, tough competition typically spurs innovation. While we are not in favour of subsidising specific large firms, there might be a case for supporting them when they compete in third countries with subsidised firms from other jurisdictions. Ideally, however, this issue should be addressed through improvements to, and better implementation of, the WTO rules on subsidisation. There might also be a case for revising the definition of dynamic markets.

The EU should have an industrial policy that goes beyond the single market strategy. A deeper single market is critical for the EU's economic strength. But a clear view of which sectors will drive future innovation is also necessary given the targeted Chinese approach (European Commission, 2019). The EU needs to develop a methodology to identify key sectors of relevance and go beyond the current *ad-hoc* approach to supporting specific industries. In the US, three federal institutions (the Defense Advanced Research Projects Agency, National Institutes of Health and National Science Foundation) play crucial roles in pushing forward the frontier of knowledge, and enabling private-sector R&D in key areas. Similarly, the EU should use the EU budget more than today (roughly €10 billion in 2018) to boost digital hardware and software systems, including artificial intelligence, which are critical for autonomy and even security.

The second area where you need to act to boost the EU's role in the global economy is the euro's role as a global currency.

The euro is already a global currency but its role is below potential

on account of the incomplete economic architecture of Economic and Monetary Union. To change that, you will need to make concrete progress on EU governance. We will return to this in our third set of recommendations.

Third, you need to increase Europe's capacity to safeguard its own security. This is not a question of a 'European army'. Instead it is about being able to defend EU territory by collaborating in case of aggression and to intervene in cyberwar, intelligence operations and small rescue operations. Investments in the range of €100 billion to €300 billion could be needed if Europe wants to have sufficient defence capabilities without US involvement (ISIS, 2019). The EU should remain a peace project, capable of defending itself but without any ambition to project force in military adventures in third countries¹⁰.

This gives rise to important organisational questions that you need to answer. How would EU countries support each other in case of military aggression? Should the EU create a 'security council' which includes even some non-EU countries (potentially the UK) and is capable of taking military decisions outside of NATO? How can the various weapon systems of national armies be made compatible? Can the Permanent Structured Cooperation (PESCO) process be further advanced and procurement be unified? Can EU countries form joint capabilities to counter cyberattacks and what capacity does the EU have to deal with targeted fake-news campaigns that undermine our democracies? You will need to exercise leadership in these domains but not pursue unrealistic and even undesirable goals.

The question of defence is important because, unfortunately, the EU cannot fully chart its own course in trade, technology and investment policies without ensuring its own security. But, as you know, this view is not accepted equally by different EU countries and several countries will not be ready to question reliance on NATO as the main defence cooperation agreement. In our view, you will therefore have to accept a certain degree of multi-speed in this domain¹¹.

Finally, we consider it important that you strengthen the EU's



Citizens want you to address the climate challenge but will dislike the social consequences. The transformation also offers opportunities for business

Africa policy. Africa is connected to Europe in many ways. As our direct neighbour, its economic health and political stability are core EU interests. This topic cuts across trade, investment, development, climate, energy and migration policies. You will need to further develop your migration strategy, which is still a great concern for many citizens and goes beyond the relationships with African countries. This strategy cannot be narrowly focused only on illegal migration but needs to be comprehensive and cover also legal migration and its implications for the internal functioning of the single market.

[2] Climate and the environment

The EU is already politically committed to reducing greenhouse gas emissions in line with the Paris Agreement. But progress is limited and certain sectors lag behind in their efforts to reduce their impacts on the climate (in particular the transport sector; see Tagliapietra and Zachmann, 2018). Coal phase out is too slow in several countries.

***CARBON PRICE**

Putting a price on greenhouse gas emissions in all sectors is indispensable to reduce emissions. You will need to ensure that the EU carbon price becomes high enough to lead to more rapid and significant changes in behaviour. Other sectors not currently participating in the EU emissions trading system will also need to be covered, possibly with a tax. Industrial policy can support decarbonisation and you should mobilise the EU's instruments in that regard. Regulation on sustainable finance is a further lever the EU has to manage climate risks.

Your climate strategy will need to address distributional concerns or risk failing politically (Zachmann *et al*, 2019). To this end, the carbon tax proceeds could be redistributed to reduce the burden on low-income households¹².

Don't underestimate how transformative serious climate action will be for the entire economic system. The rising carbon price and the carbon tax should be accompanied by public funding for innovation to accelerate the emergence of new technologies, which will create new activities and also cut the cost of clean energy. It is crucial to understand the importance of digitalisation for the green revolution and support it with public policy. Lowering the cost of clean energy is all the more important because key industries depend on access to affordable energy and you need them to support the transformation.

The EU's climate strategy also needs to have a global perspective. Global greenhouse gas emissions continue to rise quite dramatically, in particular driven by emerging economies. We consider three policies as central. First, the EU should continue and redouble its efforts to support emerging economies in basing their economic models on green growth. Financial and technological support for green infrastructure is good climate policy¹³ and it can also create economic opportunities for leading green EU companies. Second, the EU, like other industrialised economies, has managed to reduce emissions in production, but not as much in consumption of greenhouse gases. Some form of carbon border adjustment will be necessary to tackle this¹⁴.

Finally, given that global emissions continue to grow so rapidly, scientists increasingly talk of the Anthropocene – a geological period in which human activity is the dominant force shaping the Earth's ecosystem. Given that the earth's climate might be increasingly influenced by self-reinforcing feedback loops, we consider it essential to study how to manage the fallout from global warming and how to reduce emissions by other means¹⁵. You should exercise global leadership on this.

(3) Growth and convergence

You should support the improvement of the quality of institutions,

*BETTER
INSTITUTIONS

which varies significantly in different EU countries. Governance structures and institutional quality are known to go hand-in-hand with good and sustainable economic outcomes (Acemoglu and Robinson, 2012; Acemoglu *et al*, 2005)¹⁶. Even though improving institutional quality is, above all, a job for national politics, you could and should support such endeavours more than currently. You should use the EU budget as a tool to support institutional reform programmes and review the EU's approach to promoting good governance (Mungiu-Pippidi, 2019).

*EU BUDGET

One of the first challenges you will face when taking office is to complete the negotiations on the multiannual financial framework. In our view, you should aim to significantly reduce the share of spending that goes to the common agricultural policy, while boosting spending on innovation and research. The EU budget should finance projects with true European added value, such as the European space programme and European infrastructure and innovation policy. Structural funds are probably your main instrument to boost growth in the parts of Europe that have a productivity problem, but their effectiveness needs to be increased (Darvas *et al*, 2019). Meanwhile, the common agricultural policy should be changed so it focuses on increasing the sustainability of our food production¹⁷, increasing biodiversity¹⁸ and ensuring the best results in terms of farmers' incomes (Ciaian *et al*, 2015). In short, it should be a basic goal to use the budget better and create space for spending on new priorities such as migration policy and border protection.

You should devote significant political capital to combatting tax evasion and fraud and support a fairer distribution of the tax burden. Social and tax policies are national policies, but the single market makes it easier for large companies and rich individuals to reduce their effective taxation. An increasing tax burden on the working middle class is incompatible with the promises of Europe's social market economy. The EU growth strategy should also build on useful EU instruments such as the European Social Fund and the European Pillar of Social Rights.

You should also contribute to a better management of macro-economic policy. In case of an economic downturn, you should

”

Rigid application of the fiscal rules might lead to faulty recommendations, but politically partisan interpretations would undermine your institution as a broker of compromises

support the relevant authorities in responding rapidly. With interest rates at the zero lower-bound, monetary policy will have little to contribute to stem the next downturn. Your role as Commission President, together with your responsible Commissioners, will be to raise awareness about the importance of national fiscal policies to stabilise the EU economy. You will have to identify risks to the macroeconomy early on and organise a coordinated fiscal response.

On the fiscal rules, we believe that rigid application might lead to faulty recommendations. But at the same time, a politically partisan interpretation of rules would undermine your institution as an independent and neutral broker of compromises. In our view, you should therefore not only propose changes to the fiscal rules to increase their usefulness for fiscal macro-management. You should also clearly explain what you think should be the right fiscal policy in any given circumstance – thereby increasing political buy-in. A reform of the European Semester with more convincing communication than currently is much needed.

In this respect sovereign spreads, while useful in enforcing fiscal discipline, can also hamper the ability of some countries to use fiscal policy when they need it most and hamper the transmission of monetary policy. Your role will be to communicate wisely and broker compromises among key players. You should support the European Central Bank's outright monetary transactions programme and the European Stability Mechanism as a crucial institution for the stability of the euro area.

*MACROECONOMIC
POLICY

Last it is clear that you should continue to strengthen the architecture of the euro area in order to improve its capacity to deliver better performance in terms of growth and cohesion. Failing to do so risks leaving the system more fragile than it should be. To this end, aim to complete banking union. Reducing the exposure of banks to national sovereign debt is necessary for your attempt to Europeanise the banking system and introduce a European deposit insurance scheme (EDIS; see Wolff, 2016). The problem you face is that the EU has debated this strategy for the last five years without much action. Resistance comes from a fear that EDIS would be a transfer to weaker countries while resistance to sovereign bond limits remains high because of a fear that funding might become more difficult or even impossible for the fiscally weaker countries. The result is that the unstable status quo has prevailed. You will have to look for innovative ideas to break that deadlock¹⁹. It is difficult if not impossible to implement banking union without at least some additional instruments to support governments' fiscal policies. You should also look for innovative ways to create deep and integrated capital markets, as current legislative proposals have not been enough²⁰. How can you best secure the support of ministers in promoting this project further? Finally, do not abandon the idea of creating a safe asset; instead weigh carefully how to do it in a way that does not distribute risk unfairly and counterproductively and prepare a template that could be used in the next crisis.

4 INSTITUTIONAL ISSUES

In order to deliver an ambitious strategy, you will need to tackle three important institutional issues:

- The governance of the EU and Europe more generally;
- The role of the Commission and its relationship with the European Council and the European Parliament;
- The internal organisation of the Commission.

As far as EU governance is concerned, the first issue to consider is what to make of the motto "*unity in diversity*". The EU is a unique construction based on a diverse set of countries with a relatively low degree of centralisation of decision making. This diversity and

decentralisation sets us apart from the United States and China. The coming years will be decisive on whether the EU can preserve and succeed with this unique model.

At the 9 May 2019 summit in Sibiu, European leaders reaffirmed their *“belief that united, we are stronger in this increasingly unsettled and challenging world”*²¹. The method of sustaining unity has been effective in maintaining sanctions against Russia and also keeping a united front in the Brexit negotiations.

The challenge is to reconcile the pledge of unity with the reality of diversity. The differences between the 27 (or 28, should the UK decide to remain in the EU) member states make it sometimes difficult, or even impossible to make progress in some areas. Unity can come at the expense of speed and depth. Unanimity can also lead to a lack of experimentation and flexibility.

There are two ways to deal with this issue:

- First, one can move to majority decision making at the level of 27 or 28. This should be possible if the union increasingly thinks that in the long-term, the pros outweigh the cons. However, the option of moving to qualified majority voting on foreign-policy decisions has already been rejected several times.
- Second, one could advance in smaller groups on specific issues. The EU treaties allow for smaller groups of countries to advance more speedily with specific projects. We consider it important not to exclude some type of differentiation. Any move to advance in certain groupings should be based on the core European institutional structure: the Commission and the European Parliament. It should always be clear that groups of EU countries are open to others that wish to join. Within groups, it is again possible to see unanimous decision making or majority decision making.

While we prefer greater use of majority voting at EU level, we believe you should not exclude advancing in smaller groups on some key issues where no unanimity is possible. In taxation for example, by moving forward in a smaller group, you would also increase the pressure for all to advance. Differentiation might be the only politically feasible way to deepen integration on some of these contentious topics.

The question of multispeed advancement also concerns non-EU countries. The UK and the EU's neighbourhood are of paramount importance for the EU's position in the world. Without a stable neighbourhood, the EU's influence in the world will decline. And the UK is and should remain an important ally in global forums such as the G7 or the United Nations. Your predecessors have been busy managing Brexit, but to date, no Brexit deal has been ratified. One of your main challenges will be to define the relationship with the UK and the EU neighbours more broadly, including with Turkey and the Western Balkans. This indicates a need to reflect on how to arrange multiple levels of integration and cooperation in a way that does not create unnecessary political tensions. You should not shy away from exploring new models of cooperation or limit yourself only to existing models.

The second issue is the relationship between your three institutions. Given the increased participation rate in the 2019 European elections, we believe that the European Parliament's role in deciding on key strategic issues will and should increase²². At the same time, the European Council also sets out the main strategic guidelines for the EU's future. All three of you will have to work together to advance this strategic agenda.

One of the priority issues in the relationship between the three institutions will be the interpretation of the political nature of the European Commission. One of the most important institutional changes of the last Commission was the explicit political interpretation of the mandate of Commission president. This approach has yielded results. For example, Jean-Claude Juncker prioritised ending austerity and interpreted the fiscal rules flexibly, which we consider to be one reason for the improving economic situation of the last few years. The Commission President has also exercised political leadership in the context of the Greek crisis and has been a strong political voice in the EU-US relationship. Jean-Claude Juncker also exercised leadership and rejected some possible nominations from member states for the Commission College. But this approach has also led to accusations that the interpretation of fiscal rules was not only done 'flexibly' but also in a partisan way – reducing trust in the Commission among some countries as a neutral arbiter.

*THE 'POLITICAL'
COMMISSION

*RULE OF LAW

What does a 'political' Commission mean? The Commission is obviously a political body, since many of the thousands of decisions it takes, as guardian of the treaties or initiator of legislation, are based on political value judgements. In our view, the Commission should strive to interpret its role of guardian of the treaties, ie when it has to interpret the treaty and the rules, in an even-handed and non-partisan way. The EU should not interpret the rules more strictly for countries that are run by a government from a different political party, nor should countries be treated differently for reasons unrelated to the issue at hand. Otherwise, the Commission would no longer be credible as a neutral institution at the service of the union.

Conversely, this also means that the Commission should devote sufficient resources and tools to monitoring and enforcement of the application of the treaty and rules by member states. The EU needs to strongly uphold the core principles of the union: the rule of law and the defence of core EU values.

Finally, as the nominated Commission President, you should fully use your powers to reject the nomination of candidate commissioners who do not support key European values. Those candidates would also be rejected by the European Parliament and the Commission President has a duty to anticipate that and to ensure a strong college.

When it comes to proposing or updating legislation, we consider a party-political interpretation of the role of the Commission as legitimate.

*COLLEGE ORGANISATION

Once the Commission takes office, one of your first tasks as Commission President, will be to organise the College. Here, much will depend on your managerial approach. You might prefer a more hierarchical structure with vice presidents or a more network-like structure. We consider it fundamental that you ensure the strong collaboration of commissioners responsible for a number of related areas – which could be done in clusters or hierarchies. The key areas where we see the need for close collaboration are:

- European economic sovereignty
- Sustainability

- Growth, industrial policy, innovation and the relationship with competition policy
- Migration, asylum, border protection, Schengen, internal security

An important prerogative of the Commission President is to define the mandate of the commissioners. The outgoing Commission president gave more detailed work programmes to his commissioners than any of his predecessors. We think this is a useful way of leading the Commission and is also a good way to construct a coherent programme in line with the priorities of the various parties that support you in the European Parliament.

Europe faces major challenges, it needs an ambitious agenda and the three of you need to work together and with leaders in Europe and the world to deliver on this ambitious agenda.

NOTES

- 1 For example, by releasing methane currently stored in permafrost. Methane is a more powerful greenhouse gas than carbon dioxide. Scientists debate how strong the release of methane currently is; see for example Saunois *et al* (2016). Knoblauch *et al* (2018) points to the relevance of thawing permafrost for methane release.
- 2 See Voosen (2019) for a recent summary pointing out the more significant increase in global temperature.
- 3 For detailed reports, see United Nations (2019) and Intergovernmental Science-Policy Platform on Biodiversity and Ecosystem Services (2018).
- 4 And despite a rising share of national income going to capital income, the tax revenue from taxing capital income seems to be a rather stable percentage of overall revenue.
- 5 See Brys *et al* (2016) for proposals.
- 6 Citizens in southern European countries, however, tend to trust the EU more than their national authorities. In northern Europe, national authorities tend to be trusted more than the EU. See Eurobarometer data as reported in Demertzis *et al* (2019).
- 7 Survey conducted for Friends of Europe think tank (2019). Stopping climate change, ensuring citizen rights, managing migration, securing peace, fighting terrorism and taming globalisation are mentioned among the top issues that citizens want the EU to deliver on; see De Vries and Hoffmann (2019). Compared to the early 1990s, when Europeans were split 50-50 on the issue of defence, the share of people who think defence should become an area of joint decision-making was more than 70 percent in 2018 (Eurobarometer).
- 8 The EU has relied on the US lead when it comes to, for example, intelligence gathering.
- 9 There is a separate discussion about the screening of foreign direct investment to protect strategic sectors and key public infrastructure. While these measures reduce competition and the free flow of capital, they are warranted if there are clear geostrategic concerns.
- 10 We consider it unlikely and undesirable that the EU will form a political union that

- could legitimise and decide on such actions. Here we disagree with, for example, Bildt (2019).
- 11 For example, we could imagine France, Germany and the Benelux increasing collaboration or perhaps even creating a European intelligence agency. That would be an important step towards reducing dependence on US intelligence.
 - 12 Simple models for such a scheme have been designed, see for example the carbon dividend plan from the Climate Leadership Council (2017).
 - 13 See https://ec.europa.eu/clima/policies/international/finance_en for a summary of the EU's international climate finance commitments. Many emerging economies have made their support for the Paris Agreement conditional on financial support. See also Wolff and Zachmann (2015)
 - 14 See Horn and Sapir (2013) for an early discussion on some key ideas how to do so.
 - 15 Research is needed on how to increase carbon sequestration through natural means, other carbon capture technologies and on what geoengineering would imply.
 - 16 Demertzis and Gonzalves Raposo (2018) provided a summary of six World Bank governance indicators for all EU countries since 1996 and argued that the EU needs to increase its monitoring of institutional quality.
 - 17 Different initiatives exist that propose better ways forward. See for example International Panel of Experts on Sustainable Food Systems (2019).
 - 18 See, for example, Food and Agriculture Organisation of the United Nations (2019).
 - 19 You might want to consider introducing a European-level deposit insurance scheme with lower coverage as a base, to be supplemented by the current national schemes. The lower European level would still cover the vast majority of deposits and would send a strong signal to EU consumers, without being seen as a scheme for redistribution.
 - 20 In Demertzis *et al* (2019), we proposed looking into a 28th regime post-Brexit for segments of the capital markets, and the use of digital technologies to integrate capital markets.
 - 21 To this effect, they made a number of commitments, including that *"We will defend one Europe - from East to West, from North to South...There is no place for divisions that work against our collective interest"* (European Council, 2019).
 - 22 Currently, much of the legislative impetus comes from the European Council, which asks the Commission to make proposals to the two co-legislators, the Council and the Parliament. Several Spitzenkandidaten have proposed that the European Parliament should also be able to ask the Commission to make legislative proposals. We support this idea, but with two caveats. First, all legislative proposals made by the European Commission, regardless of their origin (the Commission itself, the European Council, or the Parliament), should be in line with an overall work programme of the Commission. Second, requests by the European Parliament should be in areas in which the parliament is a co-legislator, and should have the support of a majority of its members.

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TO THE PRESIDENT OF THE EUROPEAN CENTRAL BANK

By Grégory Claeys, Maria Demertzis and Francesco Papadia

* Monetary policy must reinvent itself in the wake of the crisis. Reinvention is particularly important because the system is riddled with uncertainties and the scope for applying both conventional and unconventional instruments is limited. The architecture of Economic and Monetary Union makes the challenge even greater because alignment of preferences and policies can only go so far. The European Central Bank will have to be clearer on what it can do, while remaining flexible in order to manage current uncertainties and unknowns. While the ECB's main objective is price stability, it will also have to contribute to the identification of, and response to, financial imbalances, while preserving its independence.

- * MONETARY POLICY
- * FINANCIAL STABILITY
- * UNCERTAINTY

1 STATE OF AFFAIRS

You take over responsibility for price stability in the euro area at a time of a slowing but continuing recovery¹. Unemployment has fallen rapidly since 2015, and deflation fears have receded as headline inflation has slowly increased. However, core inflation has persisted at around 1 percent for the last four to five years, inflation expectations have renewed their downward trend and wages still only partially reflect better employment conditions. Meanwhile, digitalisation and global geopolitical risks add to the unknown. Markets have little faith that the European Central Bank will manage to bring inflation back to its close to 2 percent target in the next five to 10 years (Figure 1), believing instead that this can be achieved only in the very long run. How can you, as the new ECB president, convince them otherwise?

You begin your term with the legacy of the Great Recession. The ECB was confronted with challenges: inflation volatility, risk of deflation visible in the downward trends in both actual and expected inflation, and a break in the transmission mechanism as a result of the banking crisis and the emergence of redenomination risk. While inflation might not be as volatile today, all other issues remain very relevant.

In response to these challenges, the ECB reduced its interest rates sharply, even into negative territory, and committed, via forward guidance, to staying there. However, constrained by the lower bound on interest rates and the resulting difficulty of lowering the whole yield curve, the ECB, like other advanced-economy central banks, resorted to balance-sheet management, culminating in Quantitative Easing (QE) – the purchasing of covered bonds, asset-backed securities, public-sector bonds and corporate bonds.

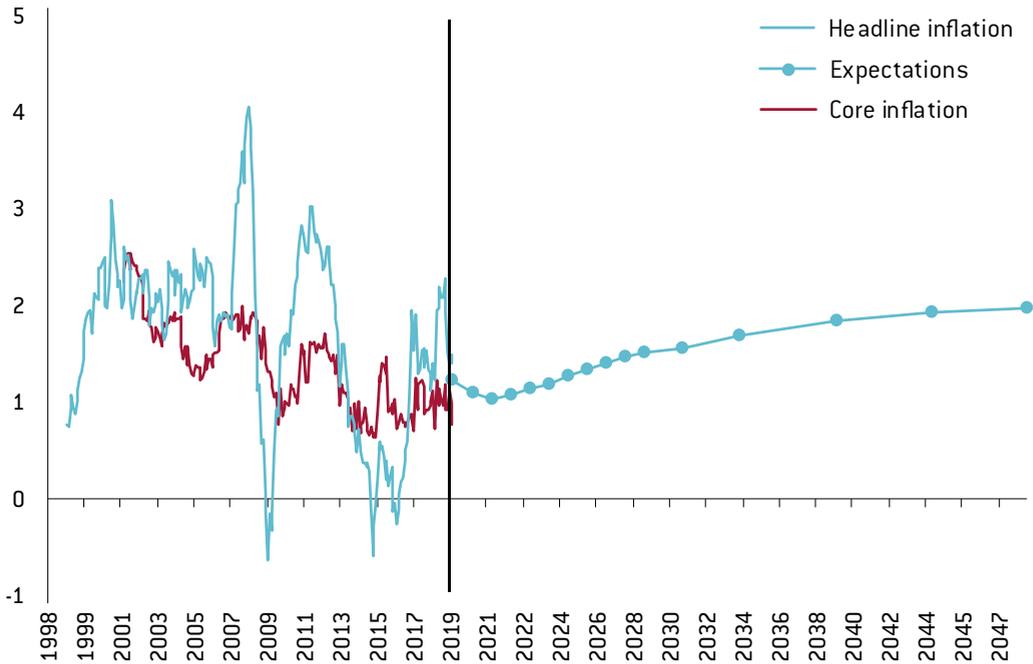
In parallel, the ECB introduced tools to restore the transmission mechanism of monetary policy, first through the Securities Market Programme (SMP) in 2010 and, second – and more successfully – through the announcement and specification of the Outright Monetary Transactions (OMT) programme in 2012.

You therefore start your term with a big balance sheet, an interest rate with limited space for further downward movement and a system in need of reassurance that the OMT is ready to be used, if need be.

*INFLATION

*MONETARY
POLICY
TRANSMISSION

Figure 1: Euro-area inflation, core, actual and market expectations (year-on-year, %)



Source: Bruegel based on Bloomberg. Note: inflation expectations as of April 2019, derived from inflation zero-coupon swaps of different terms (1 year, 2 years, up to 30 years), which provide information on market expectations of average yearly inflation over the contract term. Expectations for 2020 inflation, for instance, are derived from expected inflation over the next year (2019), given by the 1-year swap, and expected inflation over the next two years (2019 and 2020), given by the 2 year swap. Expectations are related to the Eurostat Harmonised Indices of Consumer Price (HICP) excluding tobacco.

Looking back at macroeconomic policies implemented in the course of the past 10 years, it is our view that the ECB played a disproportionate role in dealing with the euro crisis. As the ‘only game in town’, the ECB acted in ways that have arguably brought it to the limits of its competences. The borders between fiscal and monetary policy have been blurred, adding to the complexity deriving from the fact that the ECB operates in a monetary union of 19 fiscal preferences that are only partly aligned. At the same time, the persistence of low rates implies that their distributional consequences have become more visible, subjecting the ECB, its policies and even its independence to greater scrutiny.

This picture has not really changed much and you could again be confronted with fiscal ‘inaction’ in the next recession, in which case you would have to respond, again, with more force than what a fully coordinated fiscal-monetary action would dictate. Only this time, you would have limited room to manoeuvre with your current tools. You start therefore with an overextended monetary policy, in which you may need to do more to achieve less, compared to your predecessors.

2 CHALLENGES

You face three broad challenges.

You will continue to operate in an incomplete monetary union. The single currency is unique in terms of its governance and the tools available to manage it. This requires a degree of adaptability from the ECB that is not asked of other similar institutions.

The first consequence of this incompleteness is that the coordination of fiscal and monetary policy in normal times is at best imperfect, given that the former happens at national level and the latter at euro-area level. There is no tool to carry out countercyclical fiscal policy at euro-area level in combination with monetary policy to manage the cycle. This has put the burden on monetary policy, a reality you also will probably be confronted with in the next recession. But this time the space to manoeuvre with the tools currently available will be considerably more limited. Reducing this risk requires you to play an active role in Eurogroup meetings. Your challenge will be to try to inform debates in order to help align national fiscal policies with one other and with monetary policy. Meanwhile, you must safeguard your independence from political pressure that would have you deviate from your mandate.

Timeliness of decision-making is equally important. The multi-country nature of monetary union implies that policies like QE might be delayed because they are politically difficult to implement. Indeed, the ECB started its programme six years after the Federal Reserve and the Bank of England. Your challenge will be to ensure timely responses to shocks.

*OUTRIGHT
MONETARY
TRANSACTIONS

The euro crisis also revealed the vulnerability of the Economic and Monetary Union architecture and the crucial role the ECB must play to deal with this. Given the prohibition of monetary financing, the issuance of debt to implement national fiscal policy comes under greater market scrutiny. We saw this during the crisis when some countries were cut out of the markets. But market scrutiny does not always differentiate between a shortage of liquidity and an unsustainable fiscal debt. Thus the provision of ample liquidity at early stages of stress, after a technical and political agreement that the debt is sustainable, is crucial to prevent liquidity shortages threatening solvency for euro-area members.

Your predecessor's 2012 "*whatever it takes*" promise, and its formalisation through OMT, has proved effective in dealing with this problem and became a pivotal piece of the euro architecture reform during the crisis. OMT has not had to be deployed so far. Nevertheless, should a euro-area country experience difficulties, the ECB must be prepared to apply it in full.

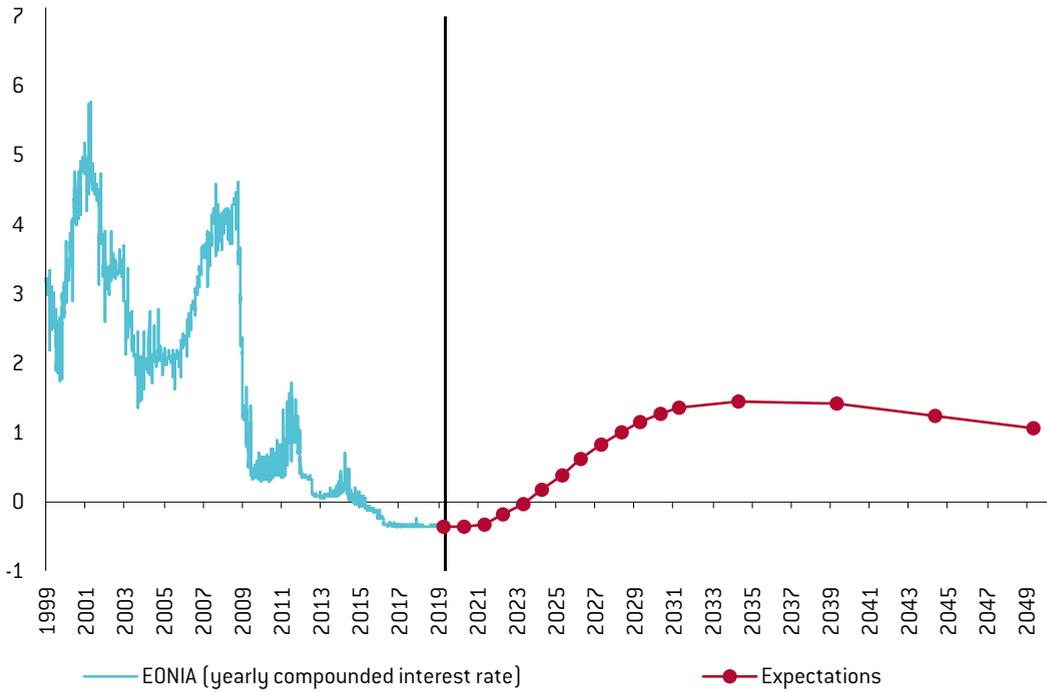
Last, the composition of the governing council and the ECB decision-making process are also direct reflections of the incomplete monetary union. Taking monetary policy decisions by unanimity, or at least by consensus, was deemed necessary at the start of the monetary union to ensure that the ECB speaks with one supra-national voice. But during the crisis, an increasing number of decisions were taken by majority (Claeys and Linta, 2019). It will be your challenge to contain disagreements so that they do not undermine your decisions.

The second challenge you face is the significantly reduced scope to apply your tools. In terms of tightening policy rates, there is no constraint, but there is limited room to ease monetary policy further, given that nominal interest rates are at their lowest level for more than two centuries and probably ever (Papadia and Välimäki, 2018). In addition, interest rates are expected to stay at very low levels for the next three decades. Financial market participants expect nominal short-term rates in the euro area to be still around 1 percent in 2049 (Figure 2).

It is important to try and understand the economic and financial drivers behind this situation, whether it is a short-lived

*LIMITED
ROOM FOR
MANOEUVRE

Figure 2: Short-term interest rates and market expectations (%)



Source: Bruegel based on Bloomberg. Note: Interest rate expectations as of April 2019, derived from EONIA zero-coupon swaps of different terms (1 year, 2 years, up to 30 years), which provide information on market expectations of the compounded overnight EONIA over the contract term. Expectations for 2020 interest rate, for instance, are derived through expected compounded EONIA over the next year (2019), given by the 1 year swap, and expected compounded EONIA over the next two years (2019 and 2020), given by the 2 year swap.

* BALANCE-SHEET
MANAGEMENT

phenomenon or whether this long-term picture is accurate.

What this picture does however suggest is that the ECB will have to rely more on balance-sheet management and less on interest-rate changes to deal with the next recession. This poses two challenges: first, while QE has helped to reduce the risk of deflation, asset purchases are more difficult to calibrate than rate cuts, and their macroeconomic effects are less clear. Second, when the ECB stopped its net purchases at the end of 2018, it had reached the 33 percent issuer limit for sovereign bonds for some jurisdictions (Claeys *et al*, 2018), which it put in place when it started its sovereign asset purchase programme. The rationale for this limit was that the ECB did not wish to be in the position of having the power to block the restructuring of a euro-area country’s ECB-held



Very low interest rates raise financial-stability concerns. Persistently low interest rates can lead financial institutions to search for yield by pursuing excessive risk taking

debt, on the basis that not blocking such a restructuring might be interpreted as monetary financing. Combined with the rule requiring purchases to be proportionate to the shares of different national central banks in the ECB's capital, this limit reduces drastically the scope of asset purchases.

At the same time, the economy continuing to operate with very low interest rates raises financial-stability concerns. Persistently low interest rates can lead financial institutions to search for yield by pursuing excessive risk taking (Dell'Ariccia *et al*, 2017). Though the problem of non-performing loans is being reduced, households and firms in the euro area already have high levels of indebtedness. Extra debt, encouraged by low interest rates can increase the debt overhang and financial vulnerabilities, all other things being equal. There is the risk therefore that the ECB could be torn between wanting to raise rates for financial-stability reasons while needing to keep them low for price-stability purposes².

The obvious solution to this dilemma should come from macro-prudential measures, and indeed a number of euro-area countries have resorted to such measures to deal with local issues. There are doubts, however, whether macro-prudential tools can address financial instability effectively. First, there is a cumbersome division of responsibilities between national authorities, the ECB and the European Systemic Risk Board. Second, macro-prudential measures are intrinsically prone to regulatory arbitrage. Third, the analytic apparatus guiding the

*MACRO-
PRUDENTIAL
MEASURES

*THE NEW
ECONOMIC
NORMAL

adoption and calibration of macroprudential measures is still under development.

The third challenge you will be confronted with is our lack of understanding of what a new ‘economic normal’ looks like.

Some characterise this lack of knowledge of what the new steady state is, and therefore the lack of understanding of what the new equilibrium will be, as fundamental uncertainty. How can you decide on your policy response if you do not know where you are heading? It is in the nature of fundamental uncertainty that you cannot measure it. But in your internal deliberations, your staff will confront you with a number of arguments that will point in the direction that we are indeed operating in an environment of fundamental uncertainty.

First, while most economists argue that the neutral interest rate has decreased, econometric estimates of this rate are very poor (Beyer and Wieland, 2019). This implies that underlying models – our interpretation of how the economy works – are also poor³. In fact, Figures 1 and 2 considered together indicate the unusual result that markets believe that in the long run (ie in equilibrium), the real interest rate is negative (as expected inflation is 2 percent and the nominal interest rate is 1 percent by 2049). Here your challenge is to plan for contingencies: if the low market expectations shown in Figures 1 and 2 prove wrong and inflation and policy rates move back towards 2 percent and 4-5 percent respectively, monetary policy would again have space to manage both sides of the business cycle. In this scenario, the ECB will have to manage and communicate the means and timing of its exit from negative rates and, if necessary, of a gradual reduction in the Eurosystem balance sheet.

However, if market expectations turn out to be correct and the neutral rate remains very low or even negative, as suggested by Holston *et al* (2017), the difficulty for the ECB will be of a different order of magnitude, as we discussed when we described the limited scope for using your tools.

Second, your staff will tell you that the link between employment and wage developments has weakened as the Phillips curve might have flattened (at least in some countries; see Bonam *et*

*MARKET
EXPECTATIONS

al, 2018), while the relationship between wage and price developments has also become less certain. Critical variables, such as that for the non-accelerating inflation rate of unemployment, have become difficult to gauge. So it appears there is both less space for monetary policy and its effect might be smaller. Darvas (2019) showed that the ECB's inflation projections in recent years have been systematically wrong. Such observations imply that we understand much less well the monetary-policy transmission channel. This could jeopardise monetary policy effectiveness and threaten the ECB's credibility.

Last, broader developments render the shape and form of this new normal unknown. The digital transformation, the emergence of China, trade wars and the risk of the collapse of the multilateral system indicate that the past is not necessarily going to be a good predictor of the future. Your challenge will be to navigate those waters, partly in the dark, to achieve and maintain price stability and contribute to financial stability.

3 RECOMMENDATIONS

Our main recommendation is to start your term by reviewing the monetary policy framework. The Bank of Canada decided to review its monetary policy framework in late 2018, ahead of the 2021 renewal of the inflation control agreement⁴. The US Federal Reserve Board at around the same time reached a similar conclusion⁵. As the ECB faces significant challenges that call for more than just small changes, it should also thoroughly review its own framework and toolbox. Your appointment as president and the renewal of two thirds of the governing council between 2018 and 2019 present a good opportunity to reflect on whether the current framework is well suited for the uncertainties of the future.

High uncertainty, in terms of both the environment in which the ECB will have to operate and the effectiveness of the available tools, requires that monetary policy design pay attention to both robustness and flexibility.

Robustness implies that policy design cannot be based solely on what is best in the baseline scenario. The ECB will rather

have to design policies that can deliver as good a performance as possible across a range of possible scenarios. In other words, the ECB should not rank its policy alternatives in terms of what performs best for the most likely circumstances, but should rather rank them in terms of whether they do well enough for the most varied circumstances (Ben-Haim and Demertzis, 2016).

At the same time, the ECB must use flexibility to adapt its operations as it increases its knowledge about the new economic environment and the effectiveness of its tools. But this must be combined with sufficient consideration for continuity, in order to make monetary policy as transparent and as predictable as possible, in order to manage expectations effectively. Last, communication will also have to reflect the lack of knowledge that uncertainty implies. More than about monetary policy intentions, communication should be about how monetary policy is able to deal with the possibility of adverse outcomes.

What next for monetary policy?

If inflation convincingly moves towards its close to 2 percent target, the ECB should communicate the modalities of a return to positive interest rates, and start to plan for its optimal balance sheet size in the long run and its preferred operational framework. If, on the contrary, there is no progress towards the inflation target and, even more, if the euro area faces a new downturn, the ECB should be ready to apply a range of tools. Our main recommendations in this case are that:

- The ECB should maintain generous refinancing operations and balance-sheet management in its monetary policy toolbox.
- In order to restart its asset purchase programme, if necessary, the ECB should be ready to update its self-imposed constraints (ie the 33 percent issuer limit and/or the capital key distribution) and/or include other asset classes in its purchases, such as bank loans and possibly equities. One could consider whether the 33 percent limit achieves the right balance between the risk of monetary financing and the risk of not meeting the price-stability objective. For instance, the risk of monetary financing of an AAA-rated government appears currently to be negligible

*NEW TOOLS

and should not act as a constraint on the implementation of the asset purchase programme and the fulfilment of the ECB's mandate. In order to facilitate the implementation of its QE programme, should it need to use it again, the ECB should thus relax the limit, at least for highly-rated countries⁶.

- Last, the ECB should also start to evaluate potential new tools in case it proves insufficient to regain and maintain price stability. Direct injections of cash into the economy by the central bank (ie helicopter money) or interventions in other markets (eg the market for inflation derivatives; see Papadia, 2015) should not be discarded without careful evaluation. Given the limited space the ECB has, new tools should be studied so that, if ever needed, they can be applied with adequate knowledge of what they might achieve and at what risk.

More broadly, when reviewing its framework, the ECB should consider two issues:

- First, the ECB should reinforce the message that the 2 percent inflation objective is the best quantification of the Treaty mandate of price stability. Providing some clarity through precision is crucial. This is particularly relevant given the other uncertainties we have described. If a statistically measured 2 percent inflation means that, in reality, prices do not change, then any rate lower than that means prices are reducing. On the other hand, raising the target above 2 percent, even if it increases the policy space, would imply that the ECB would no longer aim at price stability, as required by the Treaty, not to mention that in the current circumstances a higher target seems very difficult to attain. In order to reap the benefits of an effective *focal point*, in other words an explicit, clear and well-understood numerical inflation target, the ECB should consider introducing explicitly defined tolerance bands around a precise numerical target, which has been shown to reinforce credibility via accountability (Demertzis and Viegi, 2008, 2010).
- Second, the ECB could also consider modifying other elements of its price-stability definition: it could put more

*INFLATION OBJECTIVE

”

An important role that the ECB has had to play and might have to play again is to provide policy certainty when other forms of uncertainty prevail

emphasis on core inflation and consider targeting inflation on average over, say, the business cycle instead of ‘over the medium term’. This could help prevent rushed policy reversals and could have helped to avoid the erroneous interest rate increases of 2011 (Claeys *et al*, 2018).

- Last, you will have to manage decision making in the governing council. In doing this you should try as much as possible to foster convergence in the governing council, free from national considerations. However, you should not try to reach unanimity or consensus at all costs, as this could lead to timid or late decisions that could damage the euro-area economy.

The ECB’s crucial role in the euro-area architecture

An important role that the ECB has had to play and might have to play again is to provide policy certainty when other forms of uncertainty prevail. The “*whatever it takes*” speech of President Draghi provided this clarity when the level of uncertainty threatened the euro’s existence. While the announcement of OMT convinced the markets that the ECB had both the tools and the willingness to intervene, the ECB needs to re-examine the framework behind this programme and ensure that it serves its purpose of reducing uncertainty as much as possible.

Our main recommendations here are that:

- The new ECB leadership should reconfirm that it is ready to use OMT to avoid liquidity crises in the sovereign debt markets of euro-area members.

*EURO-AREA
ARCHITECTURE

*COLLATERAL
FRAMEWORK

- Important steps have been taken to ensure the soundness of the OMT's architecture: the involvement of a European Stability Mechanism (ESM) programme as a precondition necessary to avoid moral hazard requires a neutral assessment by the European Commission of the sustainability of the fiscal position, and the political commitment to back it up provided by the ESM board, ie the euro-area finance ministers. In further considering the role of the ESM, the ECB should clarify the unnecessary ambiguity in its original OMT press release (ECB, 2012) and state that an ESM Precautionary Conditioned Credit Line, which is the natural candidate to be used in liquidity crises, should be considered sufficient as a pre-condition to access an OMT programme (Claeys and Mathieu Collin, 2018).
- Another important element to reduce the fragility of sovereign debt in the euro area would be for the ECB to re-examine its collateral framework to make sure it does not participate in compromising the safe-asset status of the sovereign bonds of euro-area members (Claeys and Goncalves Raposo, 2018) and also increase its transparency when it comes to these potentially controversial and crucial decisions.

The ECB's role in promoting financial stability

Low interest rates for a long time might contribute to the build-up of financial imbalances⁷ that might be difficult to identify in real time but proliferate in very unpredictable ways. As we have noted, there is a risk that policy and market rates in the euro area will remain low for a very long time. This implies that financial instability will remain a significant threat to the system, even if we cannot precisely predict in what form. It is doubtful that, with the current institutional framework and given the uncertainty about their effectiveness, macro-prudential measures can provide effective protection against financial instability. While we do not believe that monetary policy should directly target financial stability at the detriment of price stability (Agur and Demertzis 2019), the ECB does have a role to play in the pursuit of financial stability.

We recommend that:

- The ECB should contribute to deeper analytical foundations for macro-prudential policies as a first line of defence against the build-up of financial stability risks; cooperation with the European Systemic Risk Board should be enhanced on this issue.
- The ECB should make proposals for the establishment of a better institutional set-up for the use of macro-prudential tools, so that it can act in a timely and effective way.
- The ECB should monitor carefully financial stability risk in the euro area, and alert the relevant institutions responsible for implementing macro-prudential policies when it identifies signs of build-up of financial imbalances.

NOTES

- 1 We focus in this memo on your responsibility for monetary policy, not on your supervisory role.
- 2 This dilemma becomes even more acute if one also considers that the ECB, through the Single Supervisory Mechanism, is the supervisor of systematically relevant banks in the euro system.
- 3 And there is even a view that the neutral rate is not even relevant for policy (Borio *et al*, 2017).
- 4 <https://www.bankofcanada.ca/2018/11/bank-review-monetary-policy-framework-ahead-2021/>.
- 5 <https://www.federalreserve.gov/monetarypolicy/review-of-monetary-policy-strategy-tools-and-communications.htm>.
- 6 The Court of Justice of the European Union in 2018 seemed to imply that the relevant limit of the public sector purchase programme is not to buy all the bonds issued, as it states that the European System of Central Banks (ESCB) is “*not permitted to buy either all the bonds issued by such an issuer or the entirety of a given issue of those bonds*” and that monetary financing is avoided when “*a private operator necessarily runs the risk of not being able to resell them to the ESCB on the secondary markets, as a purchase of all the bonds issued is in all cases precluded*”. See the judgement in case C-493/17, 11 December 2018, available at: <http://curia.europa.eu/juris/document/document.jsf?text=&docid=208741&pageIndex=0&doclang=EN&mode=req&dir=&occ=first&part=1&cid=6032640>.
- 7 Zero interest rate means that asset prices become very volatile as any change in future returns of these assets, even if 20 years ahead, is not discounted. So, volatility necessarily increases for rates equal to zero.

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TO THE HIGH REPRESENTATIVE OF THE UNION FOR FOREIGN AFFAIRS AND SECURITY POLICY

By Jean Pisani-Ferry and Guntram Wolff

* Economics used to play a limited role in foreign policy, which was about wars, conflicts and human disasters – and how to avoid them. But neither China nor the United States now separates economics from geopolitics. The competition between them is simultaneously an economic competition and a security competition. This is a threat to the multilateral system the European Union has relied on for nearly seven decades and to the EU's separation of external economic relationships from geopolitics. You and your Commission colleagues must redefine for the EU its concept of economic sovereignty and the instruments it needs to defend and promote it.

- * ECONOMIC SOVEREIGNTY
- * CHINA-US COMPETITION
- * FLEXIBLE STRATEGY

1 STATE OF AFFAIRS

Your predecessors rarely spoke to economists, let alone received memos from them. High Representatives deal with wars, conflicts and human disasters – and how to avoid them. Economists, and your colleagues in charge of economic issues within the Commission, deal with peacetime concerns: growth, inflation, jobs, public finances, trade, competitiveness. Every now and then, economic mismanagement results in a country entering your orbit (like Venezuela currently). Every now and then, an opposite transition takes place and economic development must be supported after peace or civil concord has been restored. But otherwise there has not been much communication between the foreign affairs and security sphere and the economic sphere. It is becoming clear, however, that in the current context increasing interlinkages between economics and power politics mean you must play a greater role in reinforcing and defending Europe’s economic sovereignty. This memo summarises and expands on Leonard *et al* (2019) a June 2019 Bruegel and European Council on Foreign Relations paper that discusses in detail the economic sovereignty issue.

There were good reasons for the division between the foreign policy sphere and the economic sphere. Through the first decades of its history and up until very recently, the European Union took it for granted that the global system provided a functional framework for international economic relations. For sure, the economic rules were determined by power relations in the wake of the second world war. But in the years that followed, even the United States by and large kept to them. It regarded economic integration as conducive to the strength of the free world, and it stood by this principle even after the Soviet Union ceased to exist and was no longer a security challenge.

The EU has always believed in the primacy of economics. As a consequence, sovereignty for the EU as a whole was and remains first and foremost *economic* sovereignty. The collective capacity of the EU and its member countries working together to preserve their economic independence underpins the bloc’s value to Europe’s citizens. That argument is bolstered by the EU’s ability to participate in defining the rules of the game for the global economy – what Chancellor Merkel calls *Handlungsfähigkeit* and the

*ECONOMIC
INTEGRATION

* ECONOMIC
SOVEREIGNTY

* CHINA-US
COMPETITION

French call *Europe puissance*.

In this context, the EU's international economic policy was reasonably insulated from geopolitical concerns. Its construction – with most international economic powers given to EU-level bodies and most security and foreign policy instruments left at member-state level – reflected this assumption.

But perhaps the EU has been lucky so far. Perhaps the EU's apparent economic independence in the global context was always the result of a lack of geopolitical interference. It is becoming ever clearer that neither the US nor China separate economics from geopolitics. The competition between them is simultaneously an economic competition and a security competition.

Our separation between the economic and the geopolitical spheres was always fragile. It now looks outdated. National security issues are gaining prominence everywhere, as is the almost-forgotten relationship between economics and national security. Economic connections, from cyberspace to financial links, are becoming the primary areas of great-power competition and are increasingly at risk of being weaponised. Powerful countries often no longer abide by the primacy of economics.

* ECONOMIC
NATIONALISM

In this new world there are more and more cases in which the US and China follow neither the letter nor the spirit of the rules in their relationships with the EU and its member states. The US decision in 2018 to make full use of the centrality of its currency and its financial system to enforce secondary sanctions against Iran was a major shock to its European partners. The US decisions to abandon core principles of the global multilateral trading system and to withdraw from the Paris Agreement have been further shocks for the EU and the world.

On China, the EU has been slow to realise that, as your predecessor noted together with the European Commission in their joint communication of March 2019, China behaves as “*an economic competitor in the pursuit of technological leadership, and a systemic rival promoting alternative models of governance*” (European Commission/High Representative, 2019).

This new linkage across policy areas is deeply destabilising because the EU's own rules and the organisation of its governance

were designed under the assumption that external economic relationships would be ringfenced from the interference of geopolitics. In this new context, it will be your responsibility and that of your Commission colleagues to redefine for the EU its concept of economic sovereignty and the instruments it intends to use to defend and promote it.

2 CHALLENGES

European economic sovereignty faces many threats, ranging from structural demographic and technological trends to lone-wolf hackers in their parents' basements revealing state secrets. But China and the United States represent specific and particularly difficult problems.

China

China simultaneously pursues economic growth, technological development and geopolitical influence. For this reason, the acquisition of a European company by a Chinese company might be motivated by long-term national or even Chinese Communist Party priorities rather than private profit-making objectives. Similarly, trade and investment relationships with third countries might be motivated by China's search for influence and its desire to secure commodity supplies, rather than by the intrinsic economic value of any particular project.

The EU has three main concerns when it comes to China: China's influence over individual EU countries, the blurring of economic interests and security/military goals, and China's divergence from multilateral standards.

On the first, Chinese influence over individual EU countries is a potential obstacle to effective foreign policymaking in the EU. China has already leveraged investment and other economic tools to influence EU positions, for example to soften opposition to its policies and its domestic human rights record. These problems stem mostly from the EU's unique internal organisation, particularly the requirement for unanimity on foreign-policy decisions. Other powers including the US and Russia have long used bilateral relations to undermine EU

* CHINA'S
SEARCH FOR
INFLUENCE



China is a major rising power with increasingly global interests; the EU has awoken to the challenge but it has not yet defined its response

foreign-policy unity.

Second, China has an ambitious strategy to gain economic leadership. From a historical standpoint, this is a normal goal for a rising nation, but China's stated ambition to win the global competition over emerging technologies such as artificial intelligence and biotech, the breadth of policy instruments at the disposal of the government – including through direct or indirect influence over companies' strategic choices – and the very asymmetric character of the bilateral investment relationship all pose challenges to the EU.

* BELT AND ROAD

Third, China takes liberties with multilateral rules, as demonstrated by the Belt and Road initiative, which aims to leverage Chinese trade flows to build infrastructure and create a broad network of partner countries. The BRI is explicitly not a multilateral framework for trade, investment and financial relationships. Rather it is centred on China. Some worry that China's financial claims over over-indebted countries could be turned into control of strategic infrastructure.

In short, China is a major rising power with increasingly global interests that might collide with European interests. The EU has awoken to the challenge but it has not yet defined its response. It needs to shape a strategy for its foreign policy, its technology and investment policy and its policy on China in third markets and multilateral institutions.

* TRUMP
ADMINISTRATION

The US

The United States has been Europe's most important ally since the second world war. The ongoing alliance with the United States reflects Europe's democratic values and history. However, the presidency of Donald Trump has created serious doubts in the EU



The Trump administration has reduced the support it gives to the multilateral order and has used its unique position within the global economic order to extract immediate economic gains or secure geopolitical goals

about the reliability and implications of that alliance. Moreover, the Trump administration has actively reduced the support it gives to the multilateral order and has used its unique position within the global economic order to extract immediate economic gains or secure geopolitical goals. The dollar, the US's financial system and its current role as a hub for the global digital architecture provide the US with an unrivalled ability to use the global system to serve its own security goals.

*IRAN

On Iran – over which the crisis appears to be deepening at the time of writing – a 1996 EU regulation (Regulation (EC) No 2271/96) is intended to protect European companies from US enforcement of secondary sanctions. The EU attempted to leverage this to negotiate an EU exception from US secondary sanctions. But in the context of globalisation, the even more central position of the US financial system now means that such regulations no longer have the same deterrent value. European banks and companies do not believe in the EU's ability to protect them and place too much value on their access to the United States to even take the risk. They have pre-emptively complied with US sanctions, even as their governments have urged them not to. More generally, the economic relationship with Iran has not been stopped by technical problems but by often direct political pressure. The challenge the EU faces in preserving its economic sovereignty is compounded by its security dependence on the US.

Europe's strategic challenge

Europe's response to this new situation has been piecemeal. It has shown a readiness to address the new challenges in fields

including trade, foreign direct investment, finance and currency internationalisation. But what it needs is a more encompassing strategy for the new context in which partners and competitors are prepared to let economic relationships serve broader geostrategic goals. Such a strategy should be based on, first, a definition of what the EU considers the key tenets of economic sovereignty; second, on a clarification of the EU's goals and strategy for achieving them; and third, on a review and reform of the EU toolkit so it has the right instruments.

* EU OPENNESS

The starting point should be a confirmation that it is in the EU's interest to remain highly open and intertwined with international partners. In the US, there is a growing debate about decoupling from China. But a decoupling strategy cannot be in the EU's interest. First, EU prosperity critically depends on global economic exchange. Second, China is set to become an increasingly relevant trading partner for the EU and it is therefore in the EU's interest to engage with China. Third, while the US is in direct geopolitical confrontation with China, the EU is not. The central challenge for the EU is therefore to uphold its economic sovereignty while staying highly intertwined with both the US and China.

3 RECOMMENDATIONS

The EU needs a change of mindset to address threats to its economic sovereignty. It must learn to think as a geopolitical power, define its goals and act strategically. After decades during the priority was internal integration – through the single market, common regulations, common policies and the creation of a common currency – the EU needs to refocus its attention on its relationship with the rest of the world.

* GLOBALISATION

Building economic sovereignty does not imply turning one's back on globalisation or refraining from taking an active part in global collective action. Global competition and linkages are good for growth, innovation and consumer choice. Europe's aim is not, and should not be, to reduce trade or investment links with the global economy. It should be to strengthen the rules-based order, not to undermine it.

* TECHNOLOGY

Nor does building economic sovereignty mean containing the spread of technology. Such an attempt would probably be unsuccessful: even at the height of the Cold War, technology diffused broadly within a matter of years. In the current much more interconnected world, technological leadership depends on continuous investment and innovation and benefits from engagement and cooperation. Concretely, the EU is certain to benefit from cutting-edge Chinese technology. The EU's aim should be common and effective rules for intellectual property, investment and subsidies. Simultaneously, it should strengthen Europe's capacity to protect core infrastructure where direct security interests are at stake and respond effectively to foreign initiatives that undermine its economic sovereignty.

Building economic sovereignty, however, requires the EU to stop thinking and acting as a 'fragmented power'. Currently, European economic governance purposefully ignores geopolitical considerations. Because of a division of tasks in which Brussels deals with international economic concerns such as trade, while related geopolitical issues belong largely to EU member states, the EU has behaved as a fragmented power (Sapir, 2007). It has enormous potential power, but its decision-making structures are too disjointed to capitalise on that potential. It is high time to unlock this potential.

* BUILDING
ECONOMIC
SOVEREIGNTY

Building European economic sovereignty will involve patient negotiation between European partners on a series of specific, often technical measures, and a gradual implementation period. Not all EU countries have the same perception of their sovereignty and the threats to it. Some are simply too dependent on the US security umbrella to oppose almost any US initiative. Some have built strong economic ties with China and refrain from criticising it. In the fields of trade policy or single market regulations, where policy initiatives are by nature common, compromises will need to be found. In others such as industrial policy or cyber security, variable-geometry approaches can be implemented.

Details matter. It is easy for economic measures justified on geopolitical grounds to be captured by special interests and to

lapse into protectionism with lasting negative consequences for both economic growth and national security. State aid intended to maintain technological competitiveness can easily become inefficient jobs programmes. Efforts to broaden the use of the euro could easily morph into subsidies for favoured banks. These risks imply that such measures need to result from a considered process that is capable both of weighing the trade-offs between economic efficiency and national security and of maintaining a reasonable distance from special interests.

To both achieve a change in mindset and to give it institutional expression, we recommend a four part strategy for the EU:

1. An economic sovereignty agenda
2. A reformed policy toolkit
3. Effective machinery
4. A flexible implementation strategy

An economic sovereignty agenda

As a priority, we suggest that when you take office you start by working out with your Commission colleagues an economic sovereignty agenda focused on European and national measures that will create opportunities and incentives to integrate economic and geopolitical considerations at the appropriate levels of governance. The agenda should have four goals:

- Boost Europe's research, scientific, technology and innovation base;
- Protect assets critical to national security from foreign interference;
- Enforce a level playing field in both domestic and international competition;
- Strengthen European monetary and financial autonomy.

We would suggest that the new Commission president should outline this economic sovereignty agenda in his or her first speech to the European Parliament, and should publish a more detailed proposal by early 2020.

A reformed policy toolkit

The EU has reasons to be proud of its policy system. It has been able to grow into a respected regulatory, trade, competition and monetary giant whose initiatives measure up to those taken by other major powers. It has done this while ensuring levels of transparency, integrity and effectiveness that meet the best global standards.

But the EU has to adapt its policy toolkit to cope with the new reality of greater geopolitical and geo-economic competition. New initiatives are necessary in several key fields, some of which concern you directly:

* COMPETITION POLICY

1. Building on a strong and independent competition policy, the EU should define precise procedures to take into account economic sovereignty concerns in competition decisions. European Commission merger control and the abuse of dominant position decisions should continue to be based on economic criteria and on independent, legally-grounded assessments. Importantly, competition policy exists to protect consumers not producers. The EU needs to avoid politicising competition enforcement or it risks capture by powerful producer interests. However, competition policy decisions should also take into account the broader scope of internationalised markets and whether incumbents' market power can be tamed by the threat of potential entry. To address cases in which competition policy decisions might raise security concerns, you as High Representative should be given the right to invoke a security clause and object to a decision proposed by the competition commissioner.

* INVESTMENT SCREENING

2. Because foreign investment gives access to the entire internal market, the EU cannot regard investment control as a purely national affair. It should develop a common approach and common procedures for the screening of foreign investments and empower the Commission with the right to recommend on security grounds the prohibition of certain foreign investments. The Council should be given the right to decide by qualified majority to block foreign investments based on a Commission recommendation, in which you will play a

strong part. The current investment-screening mechanism is a step in the right direction but it is insufficient to tackle the common dimension of decisions relating to foreign investment. The EU should also develop instruments, such as a dedicated investment fund, to offer member states alternatives when foreign investments are disallowed.

3. The EU should prepare for the possibility of a politically- or geopolitically-motivated stalemate over the provision of International Monetary Fund assistance to a neighbouring country. It should consider how an external role could be given to the European Stability Mechanism or how to strengthen EU-budget funded balance-of-payments instruments available to third countries. Such cases will most likely have a strong foreign policy dimension, which implies that you will play a key role in activating EU assistance.
4. The EU needs a strategy for development banks. It should determine whether it intends to develop the external role for the European Investment Bank or rather to leverage its investment in the European Bank for Reconstruction and Development to turn it into a truly multilateral development institution based in Europe and controlled by European shareholders. You should work with your colleagues to determine which strategy offers more opportunities.
5. The EU should also stand ready to respond to unilateral sanctions it disagrees with through appropriate and proportionate economic retaliation measures. While it can explore ways to overcome secondary sanctions and permit domestic companies to continue to trade with third countries recognised by the EU as legitimate partners, the creation of special vehicles for such transactions will never lead to significant outcomes. Retaliation decisions will involve your trade colleague and other commissioners, but you will need to be part of them throughout the process.
6. The EU should preserve and leverage its influence over multilateral institutions. But this requires consenting to an accelerated rebalancing of quotas and votes, without

* DEVELOPMENT
BANKS

* SANCTIONS



European governance was not built to implement an encompassing economic sovereignty strategy, but to manage sectoral policies separately; reforms are thus needed

which European countries could end up enjoying oversized power in diminished institutions. Rebalancing should also be accompanied by a consolidation of European chairs, although that might not in some cases increase European influence. You are not a decision-maker in this field, but you should definitely have a voice in the process.

Other initiatives fall outside your remit, but are part of the same economic sovereignty agenda and for this reason you should monitor them:

* STATE-AID
CONTROL

1. State-aid control should not be limited to EU companies. The EU should vigilantly monitor distortions to of international trade and investment resulting from support provided to industry by foreign governments. Direct and indirect subsidies should, if possible, be tackled in the context of the World Trade Organisation. If not possible, the EU should consider reviewing its competition policy instruments and their possible application to state aid granted by foreign governments.

* EURO'S
INTERNATIONAL
ROLE

2. As the world evolves towards a multi-currency system, economic sovereignty will increasingly require a greater international role for the euro. But the euro will not become a truly international currency without EU initiatives to support it in this role. Three conditions are crucial: first, a deep and integrated capital and banking market; second (and related), the creation of a euro-area safe asset; third, the ECB should

be able to extend swap lines to partner central banks so they can serve as lenders of last resort to local banks conducting business in euros.

Effective machinery

European governance was not built to implement an encompassing economic sovereignty strategy, but rather to manage sectoral policies separately. Reforms are thus needed, as follows:

A European Commission Economic Sovereignty

Committee: the European Commission has already prioritised making the EU a stronger global player. The priority area brings together several relevant European commissioners (foreign and security policy, neighbourhood and enlargement, trade, international cooperation and development, civil protection and humanitarian aid under your chairmanship). It would introduce an economic-security element by including key commissioners whose portfolios are not generally thought of as having sovereignty implications, including competition policy, economic and financial affairs, and research, science and innovation. It will be important to create strong links with the staff of similar bodies in EU member states, to enable coordination of economic sovereignty efforts across the levels of governance.

In addition, a **Committee on Foreign Investment in the European Union**, staffed by some of the economic sovereignty staff and containing representatives of relevant directorates-general, should be charged with making recommendations on the national security implications of large foreign (non-EU) investments or mergers in the EU. This committee would present its recommendations to you and the College of Commissioners. Also, an office of **Financial Sanctions Enforcement** staffed by representatives of the European External Action Service, the Directorate-General of Economic and Financial Affairs, and relevant member-state representatives, would closely coordinate with banks and other financial institutions to ensure that European sanctions regulations are strictly enforced. It would also impose penalties on entities that violate sanctions.

* ECONOMIC
SOVEREIGNTY
COMMITTEE

* FOREIGN
INVESTMENT

A flexible implementation strategy

Implementing these changes cannot be just a Brussels-based EU-wide effort. Many relevant powers remain with the member states and economic sovereignty issues can be divisive within the EU. Perceptions of threats and attitudes towards Russia, China and the United States are far from uniform. Therefore the EU and its member states will need to coordinate closely with other European partners, starting with the post-Brexit United Kingdom, which is likely to share many of its neighbour's priorities and concerns.

While an EU-wide approach is desirable, a more flexible approach based on 'minilateral' groups of states is likely to be necessary. As we have noted, EU countries differ significantly in their perceptions of security threats, their vulnerability to external pressures and their attitudes towards both the US and China. Decisions involving the functioning of the single market or the customs union will need to be agreed by the whole EU, but for other aspects, a club-type approach, centred on a strong institutional core and similar to that advocated by Demertzis *et al* (2018), is likely to be the best short-term option. The overarching intent is to create structures that integrate economic and national security considerations at both European and member-state levels.

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TO THE COMMISSIONER RESPONSIBLE FOR BETTER REGULATION

By J. Scott Marcus, Catarina Midões and Adriaan Schout

* In the face of substantial Euroscepticism, diverging approaches to policy among EU countries and concerns over burdensome legislation, protecting the credibility of EU policy formulation is of vital importance. Better regulation tools and processes are a vital part of this. Transparency, objectivity and independence are key.

Though the better regulation process overall is an area of strength for the EU, you should make impact assessments more consistent and work to improve the quality and consistency of economic analysis. You should also give greater weight to the ex-post evaluation process and connect it better to the ex-ante impact assessment process.

In addition, you should push for more resources for regulatory scrutiny and prioritise communication to demonstrate that EU policy has a sound basis and delivers real benefits.

- * TRANSPARENCY AND CONSISTENCY
- * REGULATORY SCRUTINY
- * CREDIBILITY AND LEGITIMACY

1 STATE OF AFFAIRS

Better regulation (BR) tools and processes contribute to the European Union's perceived legitimacy and to the maintenance of public confidence by ensuring that policies are fact-based, that policy processes are transparent and that EU actions are fit for purpose. In the face of substantial Euroscepticism, diverging approaches to policy among the member states and concerns over burdensome EU legislation, protecting the credibility of EU policy formulation is of vital importance.

Better regulation is a vital part of EU governance. It seeks to ensure that measures are no more burdensome than necessary, and that EU actions are appropriately undertaken at EU rather than at member-state level, in line with subsidiarity.

The BR process¹ serves not only to rigorously evaluate new proposals *ex ante*, but also to assess the added value of EU policies *ex post* in order to determine whether the intended benefits have materialised, and to improve or eliminate programmes that fail to perform.

The better regulation process

BR comprises a detailed methodology that provides policymakers with an objective basis for designing and evaluating policies. Importantly, BR helps to identify policy options but does not determine policy choices – the crafting of legislation is inherently a political process.

Transparency, objectivity and independence are key to the credibility of BR.

Under the logic of BR, the strengths and weaknesses of a current policy should be identified by means of an *ex-post* evaluation before new interventions are formulated by means of an *ex-ante* impact assessment. This is the *evaluate first* principle.

A BR *ex-ante* impact assessment begins by clearly identifying a problem. Objectives in addressing the problem are formulated, together with a small number of promising options starting with the 'business as usual' option. Options are compared on the basis of their expected effectiveness in dealing with the problem, the efficiency with which they achieve their effects, their coherence with other EU policies and the degree to which they are relevant in addressing citizens' concerns.

*TRANSPARENCY

*INDEPENDENT
OVERSIGHT

Over time, the Commission's BR system has been progressively improved to provide for a measure of independent oversight, primarily by means of a Regulatory Scrutiny Board (RSB) that operates under the auspices of the Commission, and by an Impact Assessment Unit (IAU) within the European Parliament. To date, the Council has undertaken only limited oversight of the BR process whereas the European Parliament has set up a BR support unit.

In reviewing the current state of affairs, we consider: 1) regulatory simplification and the role that BR plays in it; 2) the consistency with which BR *ex-ante* impact assessment reports are delivered with legislative proposals; 3) the quality of the BR process; 4) the consistency of economic analysis as part of the BR process; and 5) the relationship with *ex-post* evaluation.

Regulatory simplification

The Juncker Commission sought simplification of the EU *acquis*, in particular by introducing less new regulation, in line with being "*bigger on the big things, and smaller on the small things*". The avoidance or elimination of needless or ineffective regulation is in line with BR principles. It is therefore useful to consider whether the EU has followed through on the commitment to simplification.

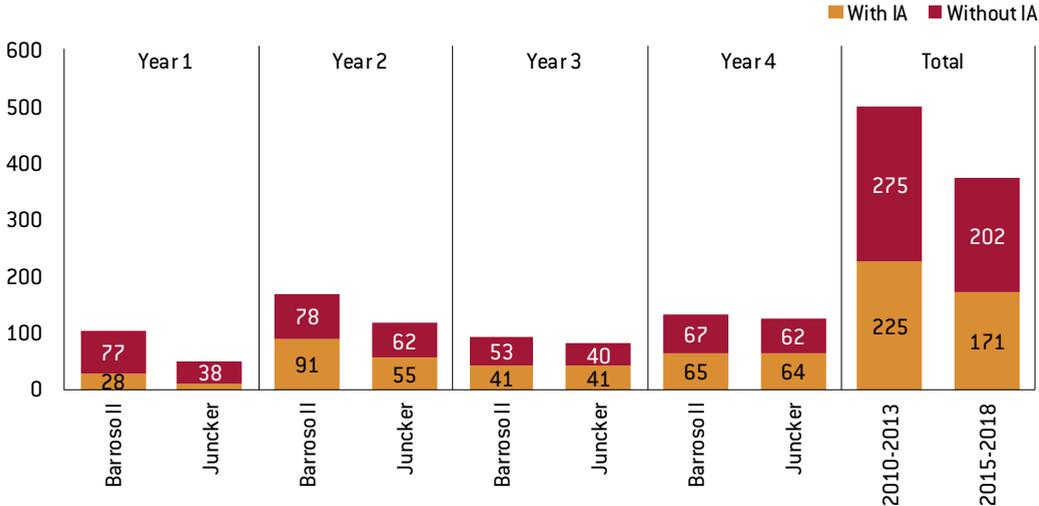
There is a tendency to introduce more legislation in the middle of a legislative cycle than at the beginning or the end. Comparing the first four years of the Barroso II Commission to the corresponding years of the Juncker Commission, it is clear that the Juncker Commission introduced substantially fewer legislative measures (Figure 1) – a drop of 25 percent compared to Barroso II (373 versus 500 measures). This is not in and of itself definitive, since the complexity of measures also needs to be considered, but it suggests that the Commission delivered on its promise to focus more its activities.

Measures introduced without an impact assessment (IA)

The *ex-ante* impact assessment document that is submitted with a legislative proposal is a key part of the legislative process. In assessing the quality of IA documents that have been submitted in recent years, a key question is whether an IA was submitted at all. The percentage of legislative proposals submitted without an IA was similar for the Barroso II and Juncker Commissions (55

*IA QUALITY

Figure 1: Commission legislative proposals introduced with and without an impact assessment



Source: Bruegel based on data from EUR-Lex. Note: only legislative proposals made under the ordinary legislative procedure (previously, the COD), as listed in EUR-Lex, are covered. Year 1 corresponds to the first full year after elections, thus 2010 and 2015 (for Barroso II and Juncker respectively). Year 5 for the Juncker Commission (ie 2019) is not shown because the results are not known at time of writing.

percent from 2010-2013 for Barroso II, 54 percent for Juncker from 2015-2018; Figure 1). Neither Commission submitted many IAs during Year 1 of its legislative cycle (just 27 percent and 22 percent under Barroso II and Juncker, respectively).

There are a number of reasons for not submitting an IA as identified in the BR Toolbox: when there is no policy decision to be made, when the policy decision is effectively pre-determined by some other policy decision that has already been taken (eg a treaty), or when the decision has no significant impacts, such as in a codification of a law and its amendments into a single new act.

In most cases where IAs appear to have been required, they were in fact conducted. However, under the Juncker Commission, for quite a few (important) legislative proposals, neither an IA nor a valid justification for its absence is apparent (Table 1). In nearly half of these cases, no reason for the omission was given².

Urgency is sometimes claimed as a basis for the lack of an IA. The BR Guidelines explicitly recognise that the BR process must have sufficient flexibility to enable it to respond to political urgency (European Commission, 2017b). There will sometimes

*MISSING ASSESSMENTS

Table 1: Impact assessments missing without sufficient substantiation

	Of the proposals without IA	Of the total number of proposals
2015	42.1%	32.7%
2016	27.4%	14.5%
2017	33.3%	16.0%

Source: Bruegel.

be a need to skip or abbreviate the IA (which, as the Toolbox notes, often takes a year to prepare) for reasons of urgency.

From 2015 to 2017, there were many instances where urgency was claimed for reasons we view as valid (for instance, in relation to measures that involved the migration crisis or security). In a few cases, however, we are not convinced that the claim of urgency was sufficiently substantiated³. Where the Commission claimed urgency as the reason for not submitting an IA, and where we considered the claim to have a reasonable objective justification, we did not treat the IA as missing without sufficient substantiation.

We have some concern that a number of IAs that were missing without apparently sufficient substantiation seemed to be associated with substantial impacts, and dealt with legislative proposals that were politically sensitive. Examples include the legislative proposals for a European Deposit Insurance Scheme (COM(2015)586), for the European Fund for Sustainable Development (COM(2016)586), and for the European Fund for Strategic Investments (COM(2015)10 and COM(2016)597).

The quality of the Better Regulation process

The BR process overall is an area of relative strength for the EU; indeed, the EU receives high marks in external assessments. Nonetheless, further improvements and refinements are possible, as we explain under Recommendations.

The OECD has rated the EU third best (after the UK and Mexico) in terms of its *ex-ante* IA process, and fourth best (after Australia, the UK and Korea) in terms of *ex-post* assessments (OECD, 2018). The OECD assessed the EU to be the best performing policymaking institution worldwide in 2018 in stakeholder engagement,



In a few cases, impact assessments justify a preferred option without adequately exploring alternatives and can be less fastidious when done under time or political pressure

having improved substantially since the previous assessment in 2015, when it ranked fifth. The EU public consultation process is highly consistent, with most proposals benefitting from substantial stakeholder input.

The majority of IAs appear to be of good quality. The assessment in OECD (2018) and our discussions with the Parliament's Impact Assessment Unit (IAU) point to visible improvements in the process over time. Reports from the Parliament's IAU suggest guidelines are being followed more closely than in the past, and that difficulties with unclear goals and weak problem definition are better addressed than in the past.

We have nonetheless identified a few possible concerns in a few IAs, including:

- A possible rush to justify a preferred option without adequately exploring alternatives⁴;
- An occasional tendency to be less fastidious when there is time pressure or political pressure⁵.

The Parliament's IAU has also identified a number of IAs in which alternatives do not appear to have been considered to a sufficient degree, such as the proposal for a pan-European Personal Pension Product (PEPP) (COM(2017) 343) and the proposed Regulation of small pelagic stocks in the Adriatic Sea (COM(2017)97). The Impact Assessment Institute (a private firm) claims that the majority of EU IAs have major shortcomings in terms of analysis, methodological rigour, transparency and their subsidiarity and proportionality justifications (Impact Assessment Institute, 2017). The Parliament's IAU has also expressed concerns over the quality of analysis of subsidiarity and proportionality in IAs.

*CONSIDERATION
OF ALTERNATIVES

Analysis of economic costs and benefits needs to be improved

Despite the high quality of the BR process overall, there is room for improvement, especially as regards the consistency of economic analysis. Marcus *et al* (2019) reviewed for the European Parliament the economic assessments embodied in the impact assessments submitted with most of the legislative measures associated with the Digital Single Market (DSM), totalling nearly 40 IAs. In no case was a coherent comparison of costs and benefits provided. Some provided assessment of benefits, but not of costs. A few analysed only costs. Some analysed implementation costs for the EU, but neglected to assess transaction costs and other burdens imposed on market players. Even when an analysis was done, cost and benefit assumptions were not consistent across the IAs.

These observations are fully in line with Schout and Schwieter (2018), who found:

- No quantification of administrative costs in 42 percent of IAs;
- No quantification of compliance costs in 29 percent of IAs and evaluations; and
- No quantification of enforcement costs in 55 percent of all IAs and evaluations.

Nevertheless, the trends over time are positive. From 2016 to 2017, the share of IAs and *ex-post* evaluations that quantified benefits increased from 69 percent to 80 percent, while the share of IAs that quantified regulatory costs rose from 69 percent to 89 percent (Schout and Schwieter, 2018).

In fairness, there is often very little basis in practice on which to base a sound assessment of costs and benefits; even so, it is difficult to see how coherent policy can be crafted on the basis of economic analysis that is so patchy and inconsistent.

This is an area that would benefit from serious further work. Costs and benefits for stakeholders and for EU and member-state institutions should be estimated wherever feasible. Where a cluster of interrelated measures is put forward (as was the case, for instance, with the Digital Single Market strategy; see Marcus *et al*, 2019), a combined economic assessment is likely to be both more practical and more valuable than a series of fragmented and mutually inconsistent assessments.



More work is needed to ensure that economic analysis is conducted, and that where it is conducted, it is comprehensive and consistent

*EVALUATION

The *ex-post* evaluation process seems to be under-developed in comparison with *ex-ante* impact assessment

The *ex-post* evaluation system has changed and improved over time, but the changes have tended to prioritise efficiency over effectiveness. The Commission made this clear in its communication on ‘Completing the Better Regulation Agenda: Better Solutions for Better Results’, that the ‘evaluate first’ approach aims to identify potential for simplification and cost reduction (European Commission, 2017c). The Commission has sought to improve these aspects of *ex-post* evaluation with initiatives such as ‘fitness checks’, which cover all legislative proposals in a given policy sector, and the REFIT platform. Such elements have, according to the OECD (2018), resulted in improvements to the *ex-post* evaluation system.

But such initiatives still leave gaps. As the *ex-post* evaluation section of the interinstitutional Agreement on Better Law-Making of the three EU institutions notes, evaluations of existing law and policy should consider not only efficiency, but also effectiveness, relevance, coherence and value added (European Union, 2016).

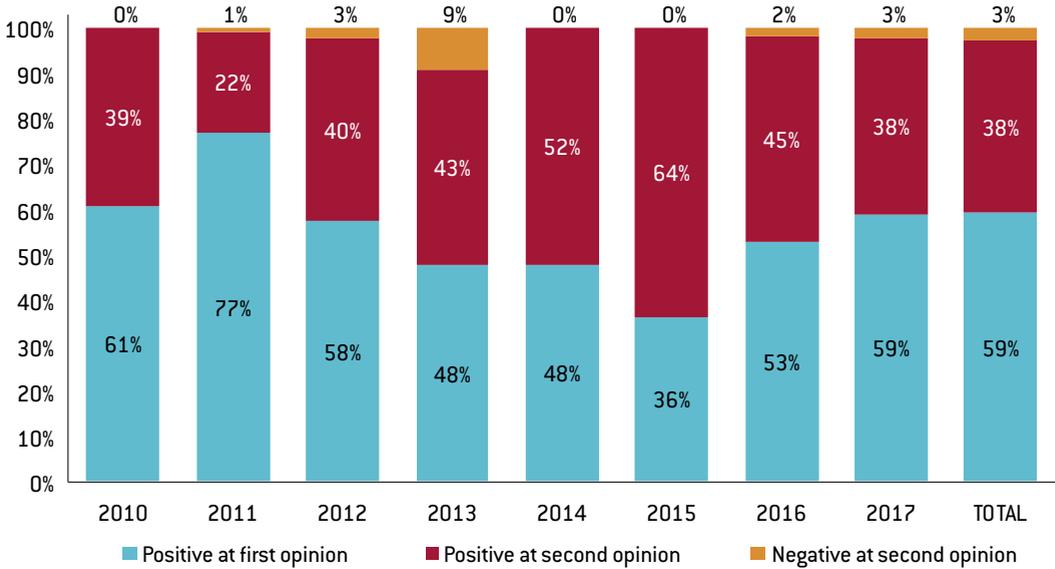
As we have noted, further work is also needed to ensure that economic analysis is conducted, and that where it is conducted, it is sufficiently comprehensive and consistent.

2 CHALLENGES

Credibility of the BR process depends on independence and objectivity. A fully effective and independent Commission review of *ex-ante* and *ex-post* BR submissions is therefore essential. In the absence of fully independent review, stakeholders and the public will always wonder whether legislative proposals

*CREDIBILITY

Figure 2: RSB (IAB) opinions on IAs



Source: Bruegel.

truly reflect an impartial assessment of the best available evidence.

The review process has benefitted from successive improvements over many years. Even so, none of the current review bodies are simultaneously: 1) absolutely independent, 2) properly resourced, and 3) able to cover all necessary elements of policy design and evaluation.

The Regulatory Scrutiny Board, the main entity responsible for IA quality, has seen its role progressively strengthened. Unlike its predecessor (the Impact Assessment Board), the RSB is required to give a positive or a negative opinion of each IA. Moreover, under the new guidelines, its views are more binding, with a second negative opinion in principle preventing the Commission from proceeding with a proposal. In 2016, only one proposal was pushed through despite having received a second negative opinion, while prior to 2015, five out of the six proposals with two negative opinions were nonetheless pushed through to interservice consultation.

Between 2010 and 2017, the RSB issued an initial negative opinion for 41 percent of legislative proposals submitted with an IA. Of these, the IAs for 134 legislative proposals received one negative opinion, while the IAs for 10 legislative proposals received two

*REGULATORY
SCRUTINY BOARD

*RSB
INDEPENDENCE

negative opinions⁶. Although it is clear that the RSB does not shy away from initial criticisms, it is not clear whether the high rate of ultimate approval (97 percent) reflects substantial improvements in resubmitted IAs, leniency on the part of the RSB, or both.

In its annual reports, the RSB regularly stresses that there is usually a significant improvement in the quality of IAs after the first review by the RSB, and that upstream meetings between the board and the relevant Commission official prior to the first draft IA usually lead to an IA of significantly higher quality⁷. Even so, and despite the fact that the Commission describes the RSB as acting “*independently from the policy-making departments and from any European institution, body, office or agency*”⁸, the board is not fully independent. It is made up of three outside experts and three high-level Commission officials, and is chaired by a Commission director-general. It is also not adequately resourced, considering the volume of impact assessments and the importance of its function. These shortcomings threaten its credibility as a review body.

The Parliament’s IA team, which is part of the European Parliamentary Research Service (EPRS), is potentially in a stronger position to exert oversight over the Commission; however, it is severely resource-constrained. Moreover, although the team conducts appraisals of all impact assessments submitted by the Commission, it only undertakes complementary or substitute assessments at the request of the Parliament.

The European Court of Auditors, an independent institution, performs audits of the regulatory management system, yet its evaluations do not appear to be fully integrated into the BR process.

3 RECOMMENDATIONS

The EU has a unique institutional structure. Many citizens and residents are geographically and politically distant from the seat of European power, but their support is essential to the current and future success of the EU.

In order to maintain (or in some cases to regain) the full trust of the public, it is essential that the public comes to view the EU

*ACCOUNTABILITY

as responsive to real public needs, and as fully accountable to the public. The BR process is a key instrument through which this could be achieved, and the EU has good reason to be proud of the BR process, but it is very little understood outside of the Brussels bubble (or even within the Brussels bubble for that matter). A key point of clarification is that BR does not, by design, make the EU more technocratic. *Ex-ante* and *ex-post* assessments are meant to support policy decisions: to complement, not to limit politics.

*LEGITIMACY

In order to enable the BR process to achieve its full potential, not only in terms of ensuring that EU policy instruments are effective and efficient, but also that the EU is perceived as having democratic and policy legitimacy, you need to play an active role first in promoting the continuous improvement of the process, and second in serving, together with your staff and other EU bodies, as a public champion or evangelist for the openness, transparency, objectivity and robustness of the policymaking apparatus of the Commission in particular, and of the EU institutions in general.

With this in mind, we recommend you should:

- **Further strengthen consistency in providing an IA when required:** You should ensure impact assessments are always provided unless there are valid grounds for exemption, in which case the grounds for exemption should be submitted to the RSB, presumably as part of the required explanatory memorandum.
- **Economic analysis:** You should work to improve the quality and consistency of economic analysis. Both the costs and benefits should be analysed to the greatest extent possible, and costs should consistently consider not only costs to the EU, but also costs to stakeholders and the public at large. Where several measures are closely related, it might be appropriate to provide a joint analysis; failing this, the inter-related IAs should at least use a common basis for estimating effects, with common metrics.
- **Strengthen *ex-post* evaluation:** In terms both of management focus and any future revisions to the guidelines, you should



Reaching out to stakeholders, including the general public, is vitally important so the public understands that EU policy has a sound basis and delivers real benefits

ensure that greater weight is accorded to the *ex-post* evaluation process, and that it is better integrated in practice with the *ex-ante* IA process (*evaluate first* is a nominal goal, but is not consistently implemented). You should strengthen the focus on effectiveness – efficiency alone is not enough. You might also want to consider a more integrated role for the Court of Auditors.

- **Strengthen the regulatory scrutiny function:** The regulatory scrutiny function needs adequate resources and full independence. You should bolster the autonomy of the RSB and provide it with more staff support. You should also encourage the Council to play its full role in the BR process – proper scrutiny by the Council is conspicuous by its absence today.
- **Better communication with the public:** You should make the most of the Commission’s capabilities to do a better job of reaching out to stakeholders, including the general public. It is vitally important that the public understands that EU policy has a sound basis, and that it delivers real benefits⁹.

NOTES

- 1 The BR process has been set out by the Commission in its role of executive institution of the EU, and has been adapted over the years. The BR framework and collection of methodologies are presented found in the Commission's 'Better Regulation Guidelines' and the 'Better Regulation "Toolbox"' (European Commission, 2017a, 2017b). With the Inter-Institutional Agreement on Better Law-Making, the Commission, Parliament and Council have jointly agreed to follow this approach (European Union, 2016).
- 2 Our assessment of the grounds for omission are based on the information provided in the Explanatory Memoranda submitted with the legislative proposals.
- 3 There is necessarily some subjectivity in this classification. However, any proposal which is automatically excluded from the IA requirement as per the 2017 BR Toolbox - including codifications, repeal of redundant legislation, signature/application of international treaties (because no policy alternative exists), implementation by EU agencies - has not been counted as 'problematic'. Many cases of 'problematic missing IAs' involve proposals for which the Commission says sufficient evidence has been collected already, where the scope of the proposal is argued to be too small to merit an IA or where the proposal is deemed urgent without clear justification. Proposals pertaining to the migration crisis and terrorism have been considered justified in missing IAs due to urgency.
- 4 The BR process lends itself to temptation for the Commission first to choose the politically desired outcome and then to make the IA fit, or to structure the options to "*set up a straw man in order to knock it down*" (Dunlop and Radaelli, 2015).
- 5 From the 2016 activity report of the Parliament's IAU: "*There were a number of cases - often where the impact assessment was prepared under clear time and/or political pressure - where the impact assessment was found not entirely to meet the quality standards defined in the guidelines*". The 2017 activity report noted: "*Some Commission impact assessments appear to have been prepared under substantial time and/or political pressure. [...] This does not contribute to the quality of either the evaluation or the impact assessment.*"
- 6 These numbers differ slightly from those in Figure 1 because an IA sometimes covers more than one legislative proposals, and because we were unable to locate an RSB opinion on the IAs of three legislative proposals.
- 7 See for example Regulatory Scrutiny Board (2017), Annual Report 2017, available at https://ec.europa.eu/info/sites/info/files/rsb-report-2017_en.pdf.
- 8 See the European Commission webpage on the RSB at https://ec.europa.eu/info/law/law-making-process/regulatory-scrutiny-board_en.
- 9 The Inter-Institutional Agreement (2016) explicitly recognises this need, but more needs to be done: "*The three Institutions will improve communication to the public during the whole legislative cycle and in particular will announce jointly the successful outcome of the legislative process in the ordinary legislative procedure once they have reached agreement, namely through joint press conferences or any other means considered appropriate.*"

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TO THE COMMISSIONER
RESPONSIBLE FOR THE
EUROPEAN UNION BUDGET

* You take over responsibility for the EU budget at a difficult time. Budget discussions have deepened divisions between member states over agriculture, cohesion, better spending, innovation and new priorities. Views on the desired size of the budget also diverge, while Brexit (if it happens) will leave a hole in the budget. Rule-of-law issues in some countries complicate matters.

You will need to address a number of issues including the shares of spending on different objectives, the revenue side of the budget and accounting practices. You should also promote the idea of a cyclical stabilisation instrument for the euro area, such as a common unemployment benefit scheme. And when a calmer period arrives after the EU budget is approved, you should initiate a fundamental rethink for the post-2027 period.

- * REVIEWING PRIORITIES
- * NEW SOURCES OF REVENUE
- * AVOIDING DUPLICATION

* DIVISIONS OVER
PRIORITIES

You take up your role at a time when intense discussions are ongoing about the 2021-27 Multiannual Financial Framework (MFF), proposed by the previous Commission. The debate has deepened the divisions between EU countries in terms of their differing emphasis on agriculture, cohesion, better spending, innovation and new priorities. Views on the desired size of the budget diverge similarly, while Brexit (if it happens) will leave a hole in the next MFF. This already complicated situation is coupled with concerns about the rule of law in some member states, which is particularly relevant for the EU budget, since rule-of-law deficiencies might undermine the sound use of EU funds. It is likely that the unanimity requirement for MFF approval will result in an outcome similar in structure to the current MFF, and will limit changes, even if they are desirable.

Because a lot should be changed. The EU budget has a number of shortcomings. You have an important role in pushing the discussion in the right direction first within the new Commission, and then by convincing the representatives of member states and the European Parliament. Given the advanced stage of the negotiations and the time constraints – there must be agreement on the new MFF before the end of 2020 – you might not be able to put a fundamentally new proposal on the table, but you will be certainly able to steer the discussion. And importantly, after the next MFF is approved, in a calmer environment, you will be able to initiate the analytical work necessary to support a more fundamental reform of the EU budget for the post-2027 period.

1 STATE OF AFFAIRS

1.1 A peculiar and complicated budget

The EU is a group of developed states with significant and large government sectors. EU spending is just about 1/50th of what member states spend. The key questions are which functions can be delivered more effectively jointly, and how should the EU budget best complement what countries already do at national level. This requires careful thinking about European public goods and how to provide them (Darvas and Wolff, 2018a).

Federations often provide economic stabilisation during cyclical

* COMPLEMENTING
NATIONAL
SPENDING

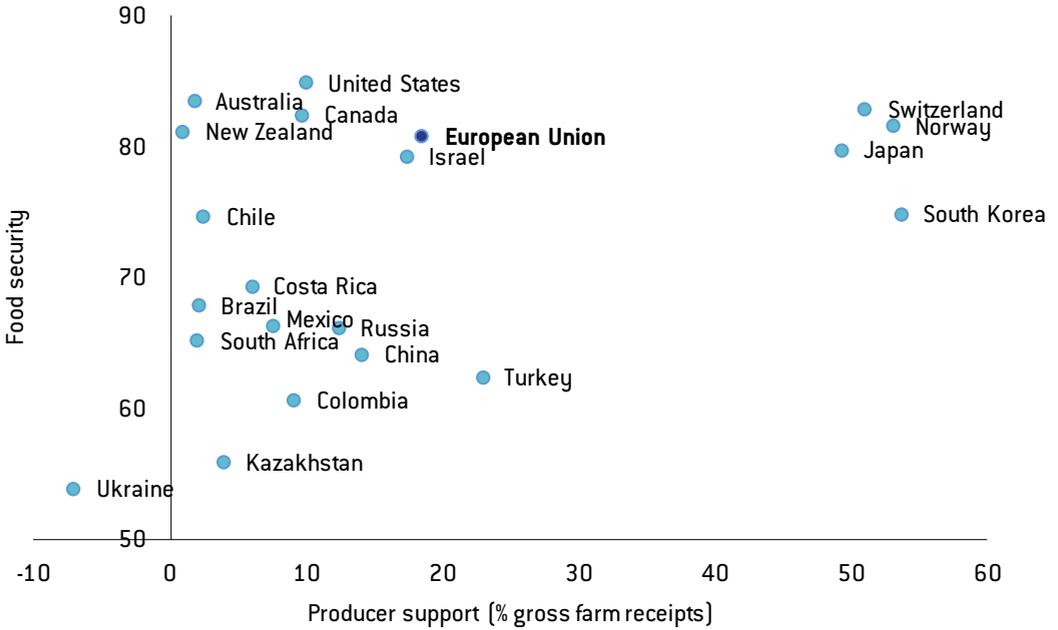
downturns primarily at federal level, which is intrinsically linked to the allocative function of public finance, or redistribution between individuals. But in Europe, the welfare state is large and basically national. There is no EU or euro-area wide cyclical stabilisation instrument, only crisis-management facilities to help countries that lose market access¹. Proposals for alternative fiscal-stabilisation instruments are off the table because of strong resistance from some member states. The December 2018 Euro Summit conclusions called for a budgetary instrument for convergence and competitiveness for the euro area, to be part of the EU budget, without mentioning a possible counter-cyclical instrument² and indeed counter-cyclical was not mentioned in the June 2019 Eurogroup conclusions³. Without such a centralised fiscal-stabilisation instrument, fiscal-policy coordination remains the only tool to influence the EU or the euro-area fiscal stance. While the Barroso Commission was able to coordinate a synchronised fiscal stimulus in 2009, the success of the coordination of national policies crucially depends on whether there is a common shock and therefore a common interest.

While the current MFF proposal includes some simplifications, such as the reorganisation of several spending programmes and a reduction in the number of such programmes, the structure of the proposed budget remains overly complex and outdated. The continued distinction between ‘commitments’ and ‘payments’ leads to an ever-rising stock of spending commitments (*reste à liquider* – RAL). No other country, federation or international organisation – including the United Nations, International Monetary Fund, Organisation for Economic Cooperation and Development, and also organisations that make long-term investments, such as the World Bank and the European Investment Bank – uses such a complex budgeting framework.

1.2 A budget with an outdated rationale and contestable effectiveness

The rationale behind the largest EU budget spending item, the Common Agricultural Policy (CAP), is weak. Nor is it clear CAP spending has achieved its goals, despite some triumphant

Figure 1: Agricultural support vs food security, 2017



Source: Bruegel based on OECD for producer support, Economist Intelligence Unit (EIU) for food security. Note: The OECD’s producer support estimate is the annual monetary value of gross transfers to agricultural producers from consumers and taxpayers, arising from government policies that support agriculture. The EIU’s food security indicator measures affordability, availability, and quality and safety of food in 113 countries. It is available for 20 European Union countries (14 of the first 15 EU members with the exception of Luxembourg, and six newer members), from which we calculated the GDP-weighted average.

* AGRICULTURAL SUBSIDIES

communications from the previous Commission. The European Court of Auditors (2017) found the CAP’s ‘greening’ policies to be likely ineffective at reducing the climate impact of agriculture in Europe. Alliance Environnement (2017) suggested inefficiencies in managing environmental impacts, while Pe’er *et al* (2014) concluded that the new environmental prescriptions are so diluted they are unlikely to benefit biodiversity. ECORYS *et al* (2016) raised serious concerns about the national implementation of the CAP and the policy’s overall impact.

Figure 1 shows that countries with higher agricultural subsidies do not achieve better food security. The EU has less food security than the United States, Canada and Australia, and is broadly similar to New Zealand, while these countries provide far lower

agricultural subsidies. Campbell-Baier and Darvas (2019) found that food prices tend to be higher in countries with higher agricultural subsidies, contradicting the perception that agricultural subsidies can help keep food prices low. And there is some evidence for subsidies restraining productivity.

While further research is needed to better understand the drivers and implications of cross-country differences in food security, food prices and agricultural productivity, these findings raise concerns about the general effectiveness of agricultural subsidies. Considering the specific analyses of CAP's environmental impacts, it thus seems that the only goal the CAP unambiguously achieves is income support. Income support is essentially a social policy, but there are doubts about its fairness, and whether it is desirable in the first place. Richer EU countries, where agricultural wages are higher, receive much more CAP funding per agricultural worker than poorer countries (Darvas and Wolff, 2018b), when common sense would suggest that the greatest income subsidy should be given to those who earn the least. European Commission (2018) highlighted that 80 percent of direct payments go to 20 percent of farmers, questioning the fair distribution of CAP allocations. The proposal of the previous Commission to direct CAP funding away from large farmers towards small and medium farmers was welcome but insufficient to eliminate the distortions caused by the subsidies.

* COHESION
POLICY

The second largest EU budget spending item, cohesion (or regional) policy, has various EU-wide social, political and economic rationales, but needs major reform. The academic literature on the effectiveness of the EU's cohesion policy is inconclusive: some studies find positive long-term impacts, others find positive but only short-term impacts, while others find no or even negative impacts⁴. Such a diversity of results suggests that the policy does not always fulfil its potential. Similar conclusions were reached in the seminal work of Bachtler *et al* (2013, 2017), who also argued that progress in addressing the problems has been slow and inconsistent, and some regions experienced a deterioration of implementation quality during the 2007-13 period. Interview conclusions reported by Darvas *et al* (2019) suggested

* CORRUPTION
RISK



Several priorities for EU spending have gained more importance and new priorities have emerged. These priorities require more EU resources, while Brexit (if it happens) will leave a hole in the next MFF

that in some countries, local stakeholders have different attitudes towards cohesion and national funds, which sometimes leads to less-careful management of EU funds. Corruption is a risk in some countries, as are rule-of-law deficiencies, which might hinder the detection and punishment of fraud.

1.3 New spending priorities

Several priorities for EU spending have gained more importance and new priorities have emerged. Environmental pollution has clear cross-border implications and more environment-related EU funding is welcome. In a globalised and digitalised world where Europe lacks sufficient productivity growth, research, innovation and digital transformation – areas with a pan-European rationale – have become more prominent. Likewise, the benefits of student mobility help not only the individuals involved, but also host universities and, more indirectly, the EU by fostering more knowledge about it and support for it. The immigration crisis of 2015-16 highlighted deficiencies in the EU's asylum system and the vulnerability of EU borders, which again have major pan-European implications. For example, the way Greek and Italian borders are protected has an impact on the arrival of illegal migrants in Denmark or the Netherlands. The increased security threats justify some common funding of defence-related projects, even though defence remains an entirely national prerogative. Some projects would perhaps be unrealistic at national level, such as the EU's satellite programme. While the EU combined (both the EU budget and EU member-state budgets) is a larger donor of foreign aid than any non-EU country,

* SPENDING WITH
PAN-EUROPEAN
IMPLICATIONS

the achievement of the United Nations Millennium Development Goals requires more support. It would also be in the best interests of the EU to engage more with Africa, given Africa's importance as a source region for immigration to the EU.

These spending priorities require more EU resources, while Brexit (if it happens) will leave a hole in the next MFF. The proposal by the previous Commission essentially entails a nominal freezing of CAP and cohesion spending from the 2014-20 MFF to the 2021-27 MFF, along the lines of the recommendation in Darvas and Wolff (2018a), which leaves a reasonable amount of money to be spent on new priorities if national contributions as a share of GDP remain the same. The proposed relative decline in total cohesion spending is broadly in line with the diminishing share of EU27 citizens (not including the UK) living in less-developed regions, while the proposed cut in CAP direct payments should have been larger.

2 CHALLENGES

Your biggest challenge will be the finalisation of the MFF negotiations. This will prove to be difficult for numerous reasons. Beneficiaries of existing programmes, such as the CAP and cohesion, will insist on keeping their privileges, while member-state representatives who are less convinced of the usefulness of such EU spending will be reluctant to agree to more contributions. Meanwhile, new priorities require more resources, while Brexit will leave a financing hole. The discussion about linking EU funds to participation in the European Public Prosecutor's Office or a procedure analysing the sound observance of EU rule-of-law principles, make the debates even more contentious. The unanimity requirement for the approval of the MFF might limit desirable changes. It will be a major challenge for you to avoid such an outcome.

While the EU's decision-making history shows a record of last-minute compromises, you cannot exclude the possibility that the MFF will not be approved by the end of 2020. That would result in a major difficulty, given that the 2020 annual budget ceilings will be carried over to 2021, without the implementing legislation necessary for new programmes. In this case you will have to ensure the smooth continuation of ongoing programmes, while further

* COMBATING
FRAUD

intensifying the already intensive discussions about the new MFF.

Once the MFF is approved, your job will be much easier, but not without further challenges. An immediate task will be to negotiate and approve the implementing legislation. If the MFF is approved only in late 2020, then the new MFF period will start without the implementing legislation being ready, similar to the situation at the start of the 2014-20 MFF. In that case you will face a major challenge in mitigating the adverse impacts of the lack of implementing legislation.

The adoption of annual budgets, which does not require unanimity and essentially translates the agreed MFF into concrete annual plans, is a much smoother process.

The implementation and control of adopted budgets will provide additional challenges, especially in countries where the risk of corruption and inappropriate management is high. While the existing European anti-fraud office, OLAF, will continue its administrative investigations into irregularities and fraud affecting the EU's financial interests in all EU countries, the European Public Prosecutor's Office, an independent EU office, will from 2020 be responsible for investigating and prosecuting crimes against the EU budget, such as fraud, corruption or serious cross-border VAT fraud, in its participating member states⁵. More intensive regular checks in those countries that have not joined the European Public Prosecutor's Office could be recommended. If approved, it will be a challenge for you to evaluate the appropriate level of the intensity of checks.

* RULE OF LAW

In addition, a new rule-of-law procedure is under discussion⁶, which would enable the Commission to suspend payments in case of general deficiencies in the rule of law. The proposed procedure has a number of sensible elements (Claeys and Darvas, 2018). If this procedure is approved and becomes operational, you will have to cooperate with other commissioners and face the major challenge of objectively measuring rule-of-law deficiencies. And should the Commission conclude that there is a general deficiency in a particular member state, you will have to propose a sanction, knowing that the Council has a tendency to reject financial sanctions against member states.

3 RECOMMENDATIONS

Given the advanced stage of negotiations about the next MFF, the diversity of member states' views and the time constraints, you might not be able to influence the next MFF decisively. Still, you should try to steer in line with the following recommendations. And when a calmer period arrives after the MFF is approved, you should initiate a fundamental rethink of the EU budget for the post-2027 period.

3.1 Agricultural policy

Direct payments should be phased out, or, at least, national co-financing should be introduced (in line with Hoelgaard, 2018). It would be similarly important to develop a uniform formula for agricultural support, to correct the current uneven distribution of CAP payments across EU member states.

Since there is an EU-wide rationale for correcting market failures and promoting public goods, such as environment and biodiversity, and for insuring against large risks such as earthquakes and animal disease epidemics, as in the US, you should retain and even reinforce the CAP's environment goals, but make the CAP more impactful, along the lines recommended by the European Court of Auditors and several other organisations and academic researchers.

The current rural development goals of the CAP would be best integrated into cohesion policy, thereby strengthening the synergies between different EU funds and avoiding possible overlaps between CAP and cohesion policy.

3.2 Cohesion policy

You should reconsider whether cohesion funding needs to be provided to more-developed regions. The minor share of EU funding in the combined GDP of more-developed regions⁷ shows that very few local beneficiaries can access EU funding and the funding cannot make a sizeable difference in terms of the achievement of EU goals. Countries dominated by more-developed regions could easily replace EU cohesion funding with national funding. You should either work to eliminate the allocation of cohesion funding

* ENVIRONMENTAL
GOALS

* MORE-
DEVELOPED
REGIONS

* PERFORMANCE
FRAMEWORK

to more-developed regions, or condition it on interregional cooperation with regions from less-developed countries, as found to be beneficial by Darvas *et al* (2019).

The effectiveness of cohesion policy should be improved by making it results-oriented (that is, tackling the actual problems for which an intervention was designed), and not indicator-oriented (such as measuring the length of roads built). The current Performance Framework has not been able to achieve such a change (Darvas *et al*, 2019). The Commission's proposal to shorten and simplify the rulebook and to eliminate some procedures is welcome, but more is needed to focus cohesion policy on results. *Ex-ante* evaluation of the real needs and objectives should not be only a formal commitment to comply with an obligation, but the most important step in designing cohesion programmes. It is important to define the basic method to be used for the reports providing justifications, and there should be comparison of methodologies when they are different.

* CORRUPTION
RISK

Another way to improve the effectiveness of cohesion policy would be to focus on longer-term strategic programmes and projects, which involve more planning and greater implementation efforts. But setting up long-term strategies does not require such a high degree of flexibility in terms of reallocation as the previous Commission proposed.

To improve the control of cohesion spending, and more generally all kinds of EU spending, you should rectify the various shortcomings of the EU's fraud-fighting framework, as recommended by the European Court of Auditors (2019). In addition, you should push forward the proposal for more intensive checks for countries not participating in the European Public Prosecutor's Office and implement it vigorously once adopted. Likewise, once the rule-of-law procedure is approved, you should work out an operational procedure and implement it forcefully. There is also great potential when the focus is on results in wider use of the simplified cost option⁸ and financing not related to costs, but to results⁹. Such a shift in focus could also alleviate problems associated with possible corruption and improper use of the funds, since beneficiaries will have to demonstrate that they have achieved results, instead

of just declaring costs, which (in case of corruption or mismanagement) could be much higher than reasonable costs under sound management. For high corruption-risk countries, national public procurement practices should be analysed very strictly, as should whether purchase prices for EU-funded projects correspond to market prices.

To improve the ownership of projects, some increase in national co-financing rates would be welcome, which should be feasible given the improved economic situation and the low interest rate environment, which greatly helps fiscal sustainability in the member states¹⁰.

3.3 Other spending priorities

Beyond improving agricultural and cohesion policies, the top priority in the EU spending debate should be to assess which spending areas constitute European public goods and how best to provide these goods, in light of the significant budgets of member countries and competences stipulated in the EU treaty. EU spending should focus on issues with clear pan-European implications, which can be delivered more effectively jointly.

Areas including environment protection, research, youth mobility, border protection, defence, security and migration have clear pan-European implications, as do some mega-projects such as the Galileo satellite system. You should increase the funding available for these areas at the expense of lower agricultural income subsidies.

The EU has a responsibility for helping its less-fortunate neighbours and other parts of the world, and has an interest in doing so if it wants to reduce the migration pressure in the long run. Yet the communication of the previous Commission showed that certain elements of this spending category are planned to be multiplied by a factor of either 1.2 or 1.3 compared to the current MFF (at current prices, excluding the UK from the current MFF), while EU27 GNI is expected to increase by a factor of 1.28 (again, at current prices). So an increase in spending with a factor of 1.2 implies a decline as a share of GNI. You should push to significantly increase the funding for the EU's external actions as a share of GNI.

* COMMON
CORPORATE TAX
BASE

3.4 EU budget revenues

Most of the proposals by the previous Commission to change the revenue side of the EU budget are quite reasonable and you should support them.

The provision of EU public goods would justify the introduction of ‘genuine’ own resources, in order to align some objectives of the EU with the bloc’s revenue sources. The three concrete proposals of the previous Commission point to the right direction. A plastic-waste levy and a share of the revenues of the EU emissions trading system would contribute to the EU’s climate and environment goals, while a share of corporate taxes based on the Common Consolidated Corporate Tax Base (CCCTB) would require an agreement on CCCTB in the first place, which would help tax avoidance. Though the CCCTB discussion seems to be stuck, you should actively advocate for it, while also exploring the potential for further environmental taxes.

Since the EU is a customs union with a common external trade policy, it is reasonable to direct customs revenues to the EU budget, minus the collection costs. The actual collection costs are much lower than the 20 percent share currently retained by member states, but also much smaller than the 10 percent value proposed by the previous Commission. You should reduce the retained value to reflect actual costs, but if it is difficult to estimate, then to a symbolic value of, say, 1 percent.

* NATIONAL
CONTRIBUTIONS

However, even in the most ambitious scenario about genuine own resources, national contributions will remain the major source of financing of the EU budget. Given the proposed increase in the provision of truly European public goods that benefit every European country, moving national contributions even closer to the distribution of GNI is sensible, to which *ad-hoc* corrections (like the rebates) are not necessary. You should pursue elimination of all rebates and other revenue correction mechanisms, starting from the first day of the next MFF.

3.5 EU budget structure

The EU should scrap its outdated and overly complex budgeting methodology, and instead adopt the best practices used by governments and multinational organisations based on accrual multi-annual budgeting, supplemented with a cash budget.

3.6 Euro-area budget

The term sheet¹¹ approved by the June 2019 Eurogroup for the

budgetary instrument for convergence and competitiveness for the euro area is quite general and suggests that it will duplicate the goals of the existing EU budget, in particular cohesion policy (accounting for 34 percent of the 2014-20 MFF) and ‘competitiveness for growth and jobs’ (accounting for an additional 13 percent of the 2014-20 MFF). You might have little leverage to influence the discussion about this new instrument, as it is driven by the Eurogroup, but you should encourage the Eurogroup to develop an instrument that offers added value compared to existing instruments. A counter-cyclical stabilisation instrument, such as a common unemployment benefit scheme, would be such a tool. It could also involve a higher level of harmonisation of labour markets to the benefit of a better-functioning monetary union.

NOTES

- 1 Facilities include the European Stability Mechanism, Balance of Payments Facility and Outright Monetary Transactions.
- 2 See <https://www.consilium.europa.eu/en/meetings/euro-summit/2018/12/14/>.
- 3 Available at <https://www.consilium.europa.eu/en/meetings/eurogroup/2019/06/13/>.
- 4 See Hagen and Hohl (2009), Marzinotto (2012), Pienkowski and Berkowitz (2015), Crescenzi and Giua (2017), and Darvas *et al* (2019).
- 5 At the time of writing, 22 EU countries have joined the European Public Prosecutor’s Office, with the exceptions of Denmark, Hungary, Ireland, Poland, Sweden and the United Kingdom.
- 6 See http://europa.eu/rapid/press-release_IP-18-3570_en.htm.
- 7 In the 2014-20 MFF, more-developed regions receive cohesion funding amounting to a mere 0.07 percent of the combined GDP of these regions, which would fall to an even lower value in the 2021-27 MFF.
- 8 Simplified cost options (SCOs) designate the “*the use of flat rate financing, standard scales of unit costs and lump sums*” when declaring costs as part of projects, with the European Commission paying out such costs instead of only reimbursing ‘real costs’. It is expected that by 2020, SCOs will cover approximately 33 percent of the European Social Fund, 2 percent of the European Agricultural Fund for Rural Development and 4 percent of the European Regional Development Fund/Cohesion Fund budgets. More-developed regions make greater use of SCOs than less-developed regions (Brignani and Santin, 2018).
- 9 Article 125(1) of the financial regulation applicable to the general budget of the Union allows EU contributions in the form of financing not linked to costs in two alternative cases: either (i) the fulfilment of conditions set out in sector-specific rules or Commission decisions; or (ii) the achievement of results measured by reference to previously set milestones or through performance indicators.
- 10 See the memo to the commissioner responsible for economic affairs in this volume.
- 11 See <https://www.consilium.europa.eu/en/press/press-releases/2019/06/14/term-sheet-on-the-budgetary-instrument-for-convergence-and-competitiveness/>.

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TO THE COMMISSIONER RESPONSIBLE FOR ECONOMIC AFFAIRS

* The good news is that the economic situation has considerably improved compared to the first half of this decade. New jobs are being created in every member state. But there are signs the upswing is slowing and the growth potential is weak. In this context, the need for structural reforms remains pressing. Major questions also remain over the euro-area architecture.

You should reinforce the European Semester, including by focusing more on climate policies, and push countries to reduce their debts. As part of this, you should establish a European Fiscal Council. More broadly, the low interest rate environment creates the opportunity for a richer discussion on fiscal policy.

Meanwhile, progress is needed on deepening the euro area. You should aim to influence the discussion, in particular on completing the banking union and the development of sovereign contingent debt and a euro-area safe asset.

- * STRUCTURAL REFORMS
- * PLANNING FOR SLOWDOWN
- * EUROPEAN FISCAL COUNCIL

Your portfolio is important for fostering competitive, employment-rich economies by promoting structural reforms, sound public finances, investment and a deeper and fairer euro area¹. You will have a major influence over the implementation of the European Union's fiscal rules, which is a strong macroeconomic instrument. You'll be able to influence the country-specific recommendations (CSRs) made via the European Semester, which is a much lighter instrument. The advice you will give to other commissioners and to national politicians on economic policies will have a significant impact on policymaking in the EU.

*COORDINATION

To achieve your goals, you will have to coordinate with other commissioners responsible for financial stability, innovation, digital and climate issues – to name just a few – which are areas with major implications for economic development. Similarly important will be the coordination with the commissioner responsible for social issues to improve the perceived fairness and acceptability of economic policy measures. You should also coordinate with the commissioner responsible for the Joint Research Centre, since about a fifth of its more than 2,700 staff work on issues closely related to your area.

Your predecessor had to combine medium- and long-term issues with firefighting duties in the aftermath of the euro crisis, including the completion of the Cyprus financial adjustment programme and the design and the completion of the third Greek programme. Now that all EU countries have exited their adjustment programmes and job creation has returned, you will be able to execute your work programme for the next five years in a calmer environment. Nevertheless, there will be multiple challenges.

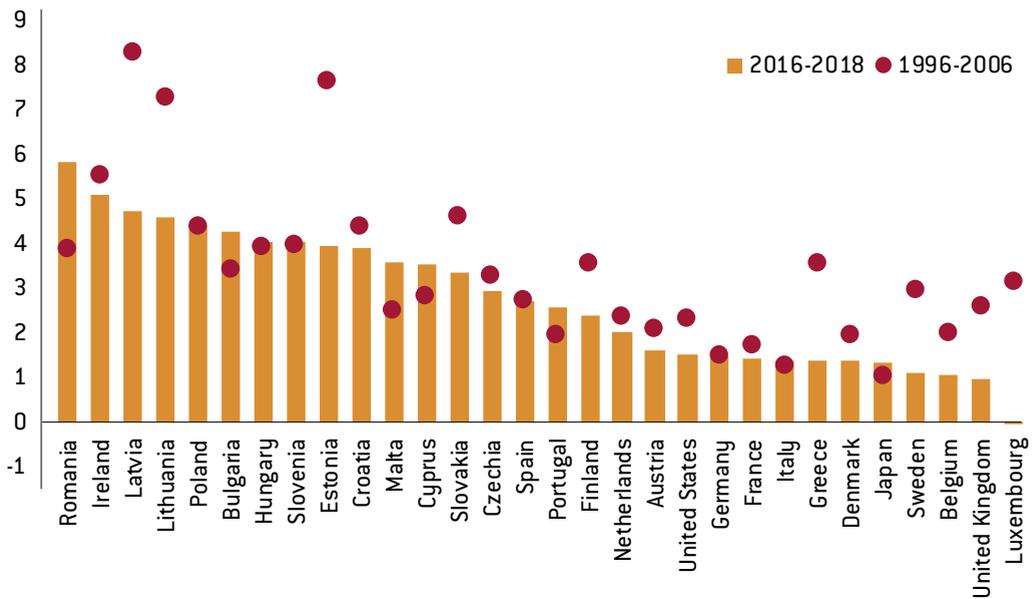
1 STATE OF AFFAIRS

We draw your attention to five pertinent issues.

First, the economic situation has improved considerably compared to the first half of this decade, and new jobs are being created in every member state. This is good news. However, the recent cyclical upswing is slowing. Productivity growth is weak, while actual *per-capita* growth rates have fallen in most EU countries (Figure 1). There are major labour shortages in some countries

*SIGNS OF SLOWDOWN

Figure 1: Growth rate of GDP per capita, average of 1996-2006 and 2016-2018



Note: The growth rate is calculated on the basis of the indicator: ‘Gross domestic product at 2010 reference levels per head of population’. Source: Bruegel based on European Commission’s AMECO dataset, May 2019.

*STRUCTURAL REFORMS

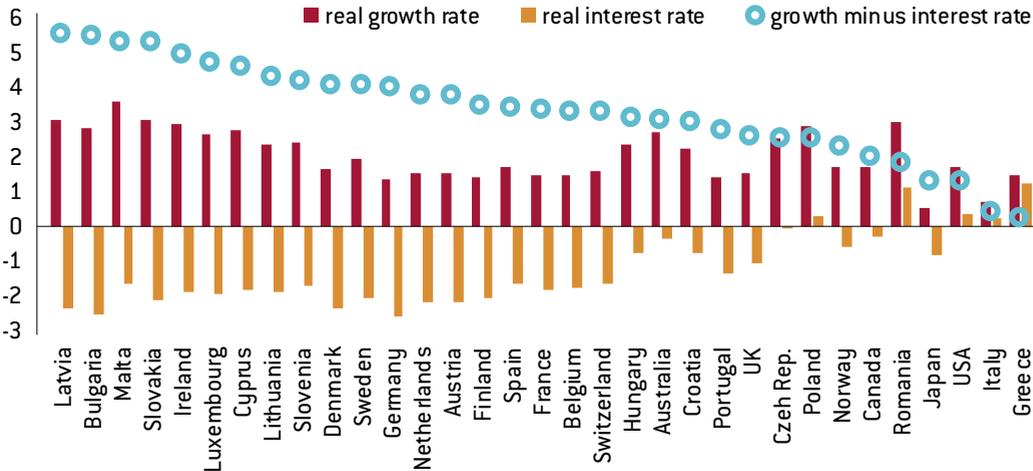
while in others there is persistent high unemployment, especially high youth unemployment.

Second, while there has been some progress with structural reforms, there remains a pressing need for more. The European Semester, the EU’s main economic policy coordination tool, has had mixed impacts. Efstathiou and Wolff (2019) concluded that implementation rates of Semester recommendations are modest, and have worsened since the economic environment has improved and market pressure on sovereigns has subsided. They also concluded that stronger surveillance does not drive implementation rates.

*LOW INTEREST RATES

Third, safe interest rates are low and are expected to remain so for the foreseeable future (Blanchard, 2019). Real interest rates on new borrowing are negative most EU countries. The expected growth-interest rate differential is positive and generally quite large (Figure 2). Such a positive gap greatly helps the gradual reduction of the debt/GDP ratio – which is set to decline even when there is a certain level of primary deficit. At the same time, the negative impact of public debt on private capital accumulation is likely very small given the low interest rates and the abundance of savings.

Figure 2: The 5-year ahead expected real interest rate on new borrowing and the real economic growth rate, 2019-2024



Source: Bruegel. Note: Real growth rate: average annual growth rate from 2019-2024 according to the April 2019 IMF World Economic Outlook (WEO). Real interest rate: the 5-year government bond yield (January-April 2019 average) deflated by the average annual GDP deflator change from 2019-2024 as projected by the April 2019 IMF WEO. Estonia is excluded because of the lack of government bond yield data.

***EURO AREA**

Fourth, partly because of favourable interest rate developments and fiscal consolidation efforts, progress has been made towards meeting the EU fiscal targets. At the time of writing, a recommendation had been made for the last country under the Excessive Deficit Procedure (EDP), Spain, to be taken out of EDP. However, in some countries the debt ratio has increased in recent years (Italy, France) and Italy might face a new EDP. Some fiscal-rule decisions are seen as political and in our assessment EU fiscal rules have rather low credibility, not least because they have become overly complex².

Finally, significant progress has been made to complete the architecture of the euro area, primarily related to the banking union. But important questions remain, of which the most prominent is to mitigate the doom-loop between banks and sovereigns. Capital market development remains a major issue and will be even more prominent after Brexit (Sapir *et al*, 2018). The proposals for a euro budget, including the Budgetary Instrument for Convergence and Competitiveness, are weak (Claeys and Darvas,



Global uncertainties could have repercussions for the EU economy; reinvigorating actual growth and boosting potential growth in such an uncertain environment will be a challenge

2018). It is also notable that discussions on the international role of the euro and the need for a safe asset have been revived.

2 CHALLENGES

Several factors will make your job challenging during your mandate.

*POPULISM

First, there are uncertainties in Europe, including uncertainties related to a large share of non-mainstream parties in national parliaments and governments and the European Parliament, Italian economic policies (which might fuel a new crisis) and Brexit. The reasons for the EU cyclical economic slowdown in 2018 are also not well understood. Global uncertainties could have repercussions for the EU economy, such as the China slowdown, US trade policy and the erosion of support for multilateral arrangements. Reinvigorating actual growth and boosting potential growth in such an uncertain environment will be a challenge.

*INFLATION

Second, inflation has been low for several years with core inflation stuck at 1 percent, while headline inflation fluctuates with energy-price movements. European Central Bank (ECB) and European Commission inflation forecasts have turned out to be systematically upward biased, so we cannot rely on current forecasts being more accurate (Darvas, 2018). Inflationary expectations have become de-anchored from the 2 percent medium-term objective, causing uncertainty for business. Inflation in highly-indebted euro-area countries might be even lower than the euro-area average, which would make deleveraging difficult.

Third, European economic policy and governance reform will be difficult in a politically more diverse EU, when the threat of a

*BREXIT

crisis is distant and mainstream political parties are weakened in many member states. Overcoming the divides within the EU will be a major challenge.

Fourth, from an institutional perspective, Brexit will imply a profound changing of the equilibrium between the euro ins and outs, because the relative economic weight of the outs will decline significantly. This could lead to a potentially destabilising institutional disequilibrium in several areas, including the division of work between the Eurogroup and the Economic and Financial Affairs Council.

Fifth, the risks of a dollar-centred payment system become more evident. Dollar liquidity shortages after the collapse of Lehman Brothers in 2008 caused financial difficulties, requiring global cooperation among central banks. More recently, the US administration is using the dollar, and the dollar-based payment system, to foster foreign policy goals, such as punishing companies that trade with Iran. The dollar-based payment system exposes the EU to US foreign policies, even if EU foreign policy has different priorities.

3 RECOMMENDATIONS

The issues we have outlined require you to push for changes to economic policies both at the national and the European levels in order to return Europe to a path of sustainable and inclusive growth, employment and productivity, and to make the EU a strong and credible global player. European instruments and policies mostly have a guiding, coordinating and incentivising nature. It is only in conjunction with the right set of national policies that they can produce the desired outcomes.

3.1 Structural challenges, imbalances and the European Semester

The EU as a whole needs to focus more than in the past on its growth and productivity dynamics in a way that fosters convergence within and between countries (Demertzis *et al*, 2019). Economic divergence might lead to dissatisfaction, fuelling votes for non-mainstream political parties, which sometimes challenge core EU principles. Coherent macroeconomic, fiscal, financial

*CONVERGENCE

and structural policies have to be implemented by member states. The European Semester is the main European policy instrument to help this process. We appreciate the efforts to give the recommendations a higher degree of visibility, at the political level and among civil society and in the media. This process should be vigorously continued.

However, the low implementation rates of CSRs suggest lack of ownership. While low implementation rates might reflect the inherent difficulties in economic policy coordination between sovereign countries, you should aim for greater implementation and ownership, otherwise the rationale for making recommendations is questionable. A higher level of engagement with national stakeholders, including ministries, national parliaments, competitiveness councils and other national institutions, might reinforce ownership. Stronger analytical underpinnings would boost the credibility of the CSRs and thus we call for higher-level involvement of the EU's Joint Research Centre to support the scientific basis of recommendations, in order to foster theory- and evidence-based policymaking. It is vital that good economics should not become politicised.

While several countries violate key criteria of the Macroeconomic Imbalance Procedure (MIP), your predecessors always found an excuse not to launch an Excessive Imbalance Procedure. Such a lenient attitude undermines the credibility of the MIP and encourages the neglect of other EU rules, such as the fiscal rules. You must be the unbiased guardian of EU economic rules and leave political considerations to the Council.

Publishing the CSRs for all member states on the same day has traditionally made a big splash in Brussels, but the respective national echo has been more muted. We suggest reforming the instrument in a way that focuses more attention on the individual member states, and their associated recommendations.

Institutional quality and governance arrangements do not meet European standards in some member states, which can have economic repercussions. Devising instruments to incentivise good governance is a perennial challenge, but well worth investing in. We advocate raising this issue in the CSRs.



Climate policies have major economic and budgetary implications; without a concerted strategy, finance ministers might block major initiatives

Climate policies have major economic and budgetary implications. There is a need for leadership by you and national finance ministers. Without such a concerted strategy, finance ministers might block major initiatives. We advise you to push climate issues even more in CSRs.

3.2 Fiscal rules and institutions

Fiscal policies need to operate within the triangle of cyclical stabilisation, fiscal sustainability and their impact on long-term growth and productivity in the context of a rules-based system, the broad outline of which is enshrined in the EU Treaty. But the EU fiscal framework has become a highly complex, non-transparent and error-prone system, exposing the Commission to criticism. The rules are used as a scapegoat by anti-European populists because they are seen as a manifestation of centralised micro-management that infringes on national sovereignty. This is counterproductive.

After a number of reforms (the Six Pack in 2011, Fiscal Compact in 2012 and Two Pack in 2013), there might be little appetite for a major overhaul, even if that is desirable (Darvas *et al*, 2018). Therefore, you should first try to restore trust in the fiscal framework by applying the current rules in an objective, non-political and transparent way, while initiating changes that are possible without changing the legal texts. Second, you should work on a major reform to be presented in the second part of your term.

An immediate priority is to reinstate the principle of “*identifying gross errors*” (Article 126 of the TFEU), instead of focusing on every detail. The central aim of bringing high debt levels down to sustainable levels must remain. Much less emphasis should be placed on the imprecise estimates of structural balances. The rules need to become clearer and implementable in practice.

*FISCAL
FRAMEWORK



You should establish a European Fiscal Council, with a mandate to safeguard the proper implementation of the fiscal framework

A system based merely on automaticity does not do justice to the complexities of economic developments. A certain amount of discretion needs to be retained, but it cannot be a central feature. Whenever discretion is exercised, the Commission should provide more detailed explanations, including to a committee of the European Parliament, to enhance democratic accountability and transparency.

A helpful element of trust building would be the delegation of some of the analytical work, including the medium-term GDP growth and inflation projections, to national independent fiscal councils, provided that their minimum standards are raised – they currently range from fairly efficient to barely noticeable, in our view. They should be independent, competent and effective (OECD, 2016). They could be entrusted with making recommendations to their governments on how to correct fiscal policies that violate the rules. Such moves would spare the Commission from being criticised and might increase the sense of national ownership of recommendations. Member states might approve such a change in exchange for less Commission intrusion.

In the medium term, we recommend the establishment of a European Fiscal Council (EUFC), with a structure similar to the ECB's Governing Council: about six executive board members (with the same appointment and accountability procedures that ECB executive members face), plus the heads of national fiscal councils. The EUFC's mandate should be to safeguard the proper implementation of the fiscal framework with a focus on gross errors and cross-border spillovers. EUFC decisions would not be binding, but decisions would be made public in a timely manner, providing a major input into the Commission's recommendations to the Council. The European Fiscal Board, which was set up in

*EUROPEAN
FISCAL COUNCIL

2016, has a different mandate, and different appointment and accountability procedures, to what we recommend for the EUFC.

A deeper reform of the rules necessitates addressing the issues of:

- Increasing the credibility of the system and making decisions more enforceable;
- The trade-off between realism and complexity;
- Making the application of the rules more predictable;
- Looking at the use of incentives, possibly to partially substitute for sanctions;
- A better way of treating investment in fiscal rules;
- The role of institutions versus market mechanisms, which necessitate reflecting on the role of debt restructuring;
- The degree of discretion the Commission should have in the application of rules.

There are various different proposals along these lines, which involve various trade-offs.

Finally, you should keep up the analytically sound work on the quality of public finances, which should focus both on the process of budgeting (planning, execution, control and audit) and the composition of taxes and expenditures to support long-term growth and productivity. A higher degree of public awareness of cross-country comparisons of input costs, efficiency and outcomes would foster the adoption of best practices.

3.3 Fiscal policies

The low interest rate environment (Figure 2) creates the opportunity for a richer discussion on fiscal policy. You should lead the discussions on how to channel the excess of euro-area savings, as reflected in the sizeable current-account surplus, to investments including public investments, such as the transition to a carbon-neutral economy, rail and road, research and development, and digital infrastructure.

However, the situations in member states vary widely and the boost to public investment needs to be done within the framework of EU fiscal rules.

Progress on debt reduction has been varied across member states. Consequently, countries have differing scope to make use

*PUBLIC
INVESTMENT

*DEBT REDUCTION

of the present low interest rate environment. Nevertheless, for most EU countries the growth/interest rate differential is so large, and public debt levels not that elevated, meaning there is some room for manoeuvre. But the highly-indebted countries should not repeat past mistakes of pretending that they can spend their way out of the debt sustainability trap.

A crucial issue is that the money needs to be spent on investment (both physical and human capital) in future productivity and sustainability, while recognising the risks of a possible medium-term reversal of interest-rate developments. You should make such recommendations to EU member states. But you need to be aware that it is national parliaments that decide the distribution of resources – your role is strictly advisory.

An important question is how to manage the next economic slow-down or crisis. If that happens in the near term, before monetary policy is normalised, the ECB and most central banks in non-euro area EU countries will have limited scope for additional monetary easing³. Therefore, fiscal policy will have to play a greater role in cyclical stabilisation. In the absence of an EU or euro-area counter-cyclical fiscal stabilisation instrument, you will have limited tools, including fiscal policy coordination and speeding-up payments from the EU budget. The Barroso Commission in 2009 provided a good example of coordinated fiscal stimulus of about 1.5 percent of GDP, which was differentiated between member states depending on their fiscal space.

The fiscal challenge will obviously depend on the severity of the next economic downturn. A mild slowdown or recession without a financial crisis would be easier to manage given the improved fiscal situation of member states and the low interest rates. But a severe recession, similar to the wake of the 2008 crisis, especially if it is combined with a financial crisis, would be tough. In such a case you should coordinate a discretionary stimulus, while allowing countries to run their automatic stabilisers to their full extent. You should explain to member states that they should not fear an excessive deficit procedure and in your analysis and recommendations to the Council you will consider the favourable interest rate environment.

However, an eventual deep recession would find EU members



The process of deepening the euro area has been excruciatingly complex and slow as fragmentation risks have receded and national differences in approaches persist

*ITALY

in different fiscal situations. For example, Germany would have ample fiscal space, while Italy would hardly have any. The shakiness of Italian fiscal sustainability might give rise to a deep financial crisis and could have major social and political consequences⁴. Brokering a European Stability Mechanism programme for a large country like Italy could be difficult, given that such a programme would come with unpopular conditions (including fiscal adjustment). The politics of such a programme could be hugely destabilising, not only in Italy, but also in the rest of the euro area. Capital flight would increase the liability to the Eurosystem of the banking system of the country under stress, which could require the ECB to grant a large amount of emergency liquidity assistance, especially if sovereign credit rating downgrades make the government bonds of the country under stress into unacceptable collateral for standard monetary policy operations. In any case, in the event of a deep fiscal crisis, early decisive collective action by member states should be advocated in order to avoid prolonged adjustment problems, as seen in Greece.

3.4 Deepening the euro area

After setting up banking union, the process of deepening the euro area has been excruciatingly complex and slow as fragmentation risks have receded. Significant national differences in approaches persist, making it increasingly difficult to engage in genuine policy cooperation that takes into account the interests of the euro area as a whole.

One of your tasks will be to engage in a broad political debate on these issues in search of more common ground. You might have to accept a certain degree of intergovernmental cooperation in order to move forward at least a few steps. While not optimal, this

*EURO-AREA
REFORM

approach can give democratic legitimacy at the national level in certain policy areas for which the EU is not yet equipped.

Important elements of the reform are beyond your direct responsibilities, such as completing the banking union, fostering capital market integration and supporting the soundness of financial institutions to ensure financial stability. But the economic analysis your team produces can influence the discussion, and your cooperation with other commissioners can ensure that the interface between macroeconomic policies and financial-sector policies within the Commission is seamless and mutually supportive.

*EURO-AREA
SAFE ASSET

A particular aspect relates to the introduction of new financial instruments in the form of sovereign contingent debt (debt with payment obligations that are contingent on the economic conditions of the sovereign) or a euro-area safe asset. We suggest you actively advance the ongoing discussions. Especially in the context of introducing single-limb collective action clauses by 2022, contingent debt can play multiple roles and serve as buffers. Contingent debt provides countercyclical buffers, opportunities for long-term investors to invest in the “*wealth of the nation*” (an argument made by Kamstra and Shiller, 2009), and automatic extensions for countries entering an adjustment programme (as suggested for the European Stability Mechanism by Andritzky *et al* 2016). It could also contribute to breaking the bank-sovereign doom loop from the sovereigns’ side, complementing current efforts to break the loop from the banks’ side⁵. In this regard, a euro-area safe asset could decouple banks’ balance sheets from individual sovereign risk and might foster a greater international role for the euro.

The current weak euro-area budget proposals, put on the table by the Juncker Commission in May 2018 and by the Eurogroup in June 2019, are perhaps the most realistic in the current context. You will have no choice but to keep working on these proposals. You should ensure that financed projects offer genuine value added from an overall euro-area perspective, and are not mere co-financing of projects in the national interest. You should also call on the Eurogroup to not replicate the EU budget’s existing cohesion and competitiveness instruments. We also would

encourage you to support further the work on a euro-area unemployment insurance scheme.

Enlargement of the euro area will figure prominently on your agenda. The criteria in the Treaty are quite clear, even if subject to dispute (Darvas, 2010). But the euro area has changed since the Maastricht Treaty, necessitating reflection. In particular, we consider that joining banking union at an early stage is an important aspect in signalling how prepared a country is to join ERM II and ultimately adopt the euro. This also shows preparedness in relation to important aspects of the economic governance structure of the member state concerned.

The issue of the international role of the euro was the subject of a December 2018 European Commission communication (COM(2018) 796/4). We trust that this issue can move forward under the next Commission, recognising that such developments are largely demand-led. Practical measures can be taken to facilitate a greater global role for the euro, requiring the cooperation of a variety of economic players, within the EU and outside.

We consider that installing a full-time Eurogroup Chair could contribute to finding good solutions for some of the issues facing the euro area. It would also contribute to better anchoring euro aspects in national economic policies. However, you as the commissioner should not take over this role, as this would involve conflicts of interest (Wolff, 2017).

NOTES

- 1 See https://ec.europa.eu/info/departments/economic-and-financial-affairs/mission-statement-economic-and-financial-affairs_en.
- 2 See Wieser (2018) and Darvas *et al* (2018). ECA (2018) highlighted a number of worrying European Commission decisions and called for a change in the implementation of the rules and the Commission's practice.
- 3 However, the tools used during the recession, such as asset purchases and targeted long-term lending, could be adopted again while interest rates can be cut to deeper in negative territory, as the example of the Swiss National Bank shows. Central banks might also invent new instruments.
- 4 An important underlying problem for Italian public finances is the halting of productivity growth since the 1990s (Pellegrino and Zingales, 2017).
- 5 Demertzis and Zenios (2019) suggested that these instruments could provide insurance for euro-area countries in future crises.

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TO THE COMMISSIONER RESPONSIBLE FOR TAXATION AND CUSTOMS UNION

* Taxation policy is largely reserved to member states, but the European Union should nevertheless do more to address the concerns of its citizens and combat tax avoidance, evasion and fraud.

You should also take measures to sustain tax revenues to fund social protection and to plug flows to non-EU tax havens. You should speed up the introduction of a new system to combat VAT fraud, work to tackle profit shifting and address taxation of the digital economy.

In addition, energy taxes are ripe for revision to underpin the low-carbon transition, and you should engage fully in the discussion on tax fairness.

None of this implies harmonisation of tax rates; in fact variation in tax rates in different EU countries can be desirable to enable countries to address their specific circumstances and needs.

Tax policy should increasingly be designed in relation with general EU objectives such as fair competition, energy transition or social justice.

- * TAX COORDINATION
- * ANTI-TAX AVOIDANCE
- * CARBON TAXES

1 STATE OF AFFAIRS

You take over responsibility for an area that citizens in Europe consider a high priority for the European Union. Three-quarters of EU citizens would like the EU to intervene more in the fight against tax fraud, according to a 2016 Eurobarometer survey (Nancy, 2016)¹. Since taxation is also a source of distortion in the single market, measures you take will complement those of your fellow commissioner for competition. Although EU action in the area is limited given the subsidiarity principle and the unanimity rule for Council decisions, the timing of your appointment is relatively favourable for action.

*WEALTH
INEQUALITY

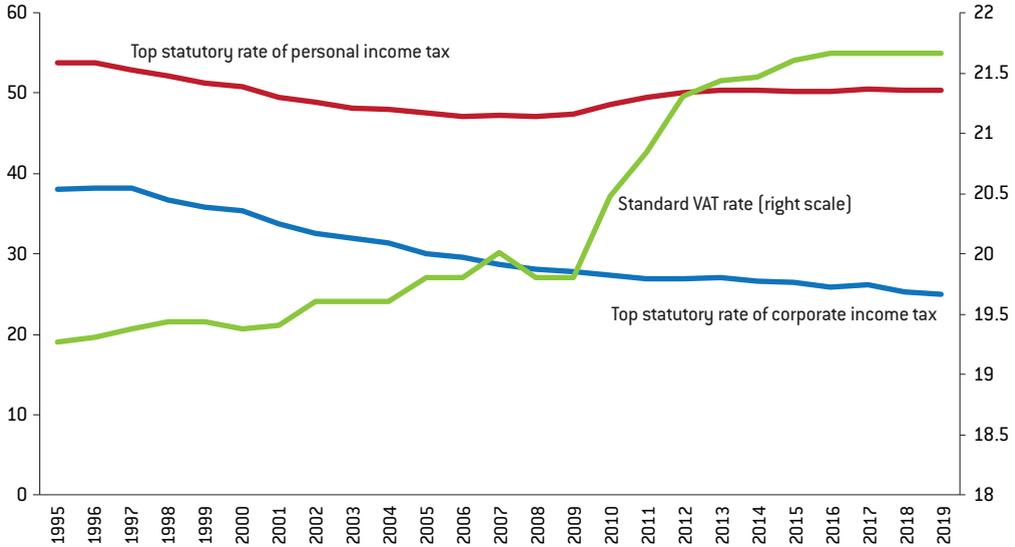
The international landscape is changing fast, under the pressure of public opinion that has become better informed thanks to various leaks of confidential information (eg the ‘Panama papers’ published in 2016), and in the context of rising wealth inequalities. The Organisation for Economic Cooperation and Development’s comprehensive project on Base Erosion and Profit Shifting (BEPS) and the 2017 tax reform in the United States² offer the EU new opportunities to make progress on taxation of corporate income. Finally, achieving the EU commitment of reducing greenhouse-gas emissions by 40 percent by 2030 relative to 1990 will likely require tax instruments.

*AVOIDANCE
AND EVASION

Why should the EU intervene in taxation beyond the historical coordination on value-added tax? There are three fundamental reasons. First, goods, services, capital and labour are more mobile within the EU than between the EU and the rest of the world. This mobility is at the core of the single market strategy. It is beneficial in terms of efficiency, innovation and, ultimately, income *per capita*. However, it also creates opportunities for tax avoidance, evasion and fraud. And it triggers a ‘race to the bottom’ in terms of taxation of the more mobile tax bases, at the expense of the less mobile (Figure 1). In recent years, the digitalisation of the economy has given a new impulse to this dynamic: the effective average tax rate on investments in digital assets is around 8.85 percent on average for OECD countries, against an average statutory rate of 23.7 percent according to the OECD³.

Second, the EU differs from the rest of the world in its high

Figure 1: Top statutory tax rates in the EU15, 1995-2019, %



Source: Bruegel based on European Commission. Note: simple average of 15 pre-2004 EU members.

*TAX
COORDINATION

level of social protection, which requires relatively high taxation that cannot be sustained without some form of cooperation. Fortunately, the EU can benefit from a large-country effect: foreign investors will accept slightly lower after-tax returns – in other words higher tax rates – when investing in this large market. This is the third reason for cooperation at EU level: to reap the large-country benefit and to plug flows to non-EU tax havens.

These three motivations for tax coordination do not imply harmonisation of tax rates. In fact, there are good reasons for tax rates to differ in different EU countries. For instance, peripheral countries need to compensate for their geographic disadvantage, and different countries might have different social preferences. Tax coordination should rather be viewed as a way to preserve the sovereignty of individual member states.

Existing arguments *against* tax coordination have lost traction in recent years (see eg Becker and Englisch, 2019). A previously powerful argument was that tax competition would put pressure on governments to produce public goods more efficiently, but this idea has lost ground because wealthy households and multinational firms today can enjoy public goods (infrastructure, services)

in a jurisdiction without paying their costs. A second argument *against* tax coordination is that it might increase compliance costs for companies and for governments. Today, however, compliance costs are substantial in the EU with little progress in the last decade (KPMG, 2018). Tax coordination might actually offer an opportunity to downsize the existing complex network of anti-abuse rules. A third concern about tax coordination is the risk of double taxation. This risk is real but should be balanced against the risk of double non-taxation. In fact, the *lack* of a coordinated reform of the corporate income tax has already pushed several member states to introduce their own digital taxes, giving rise to a serious risk of double taxation.

2 CHALLENGES

Tax systems in the EU are confronted with three challenges: 1) lost resources; 2) reduced efficiency; and 3) unfairness. These challenges are not specific to the EU. However, as argued above, in the EU they are both more acute and more solvable.

*UNPAID TAXES

1 **Lost resources:** revenue losses due to cross-border tax avoidance, evasion and fraud total at least 1 percent of GDP – a similar amount to the EU budget⁴. Recovering these amounts is key not only for budgetary reasons, but also in order to preserve consent to taxation and to contain induced inequalities among households and among companies.

*PREFERENTIAL TREATMENT

2 **Reduced efficiency:** preferential tax treatment distorts the level playing field for firms. The previous Commission ordered Apple to pay a €12.8 billion to the Irish tax administration as an adjustment for illegal tax rulings that, according to the commissioner for competition, amounted to state aid. However, *ex-post* action on a case-by-case basis entails delays and uncertainty whereas monopolistic positions can build up fast. Additionally, economic theory suggests that rents can be taxed at no cost in terms of efficiency. Thus, fighting aggressive tax planning contributes to a healthy single market. But it needs to be done in a way that does not increase the complexity of the tax system. In fact, simplifying the tax system is a precondition for the corporate sector



The top 1 percent of the European population has reaped more benefits from growth than the rest of the population, and wealth inequality has increased

*PROGRESSIVITY

to support the reforms.

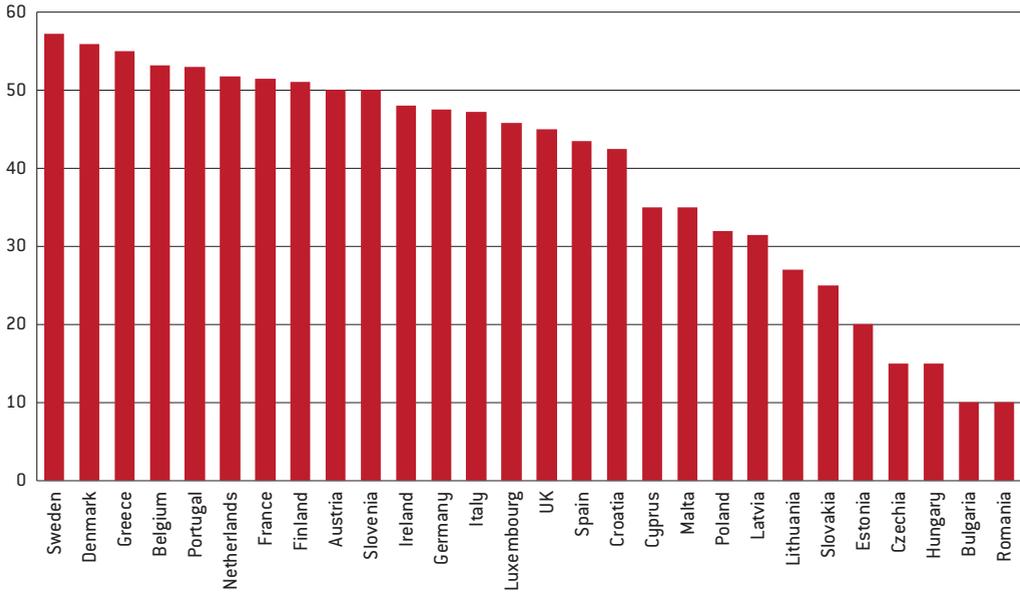
3 **Equity:** the decline in the top personal and corporate income tax rates, together with the hollowing out of wealth and inheritance taxes, have reduced the progressivity of tax systems in the EU. Part of this flattening of tax schedules is related to globalisation (Egger *et al*, 2019). Although Europe on average has performed relatively well compared to the United States in terms of inequality, the top 1 percent of the European population has reaped more benefits from growth than the rest of the population, and wealth inequality has increased (Blanchet *et al*, 2019).

*REDISTRIBUTION

Whether the EU should be involved in subnational redistribution is highly controversial. It is the responsibility of national governments to ensure the level of redistribution that corresponds to their citizens' collective choices, consistent with the subsidiarity principle. However, Article 3 of the Treaty states that the EU "*shall combat social exclusion and discrimination, and shall promote social justice and protection*". The European Pillar of Social Rights, adopted in November 2017, is an attempt to coordinate national policies in terms of inclusion, equality and protection, without extending the powers of European institutions.

You should take a pragmatic stance in this debate. First, disregarding entirely inequalities within countries could risk a backlash through a rise in anti-globalisation, anti-European public opinion. Previous Commissions understood this risk when introducing the European Globalisation Adjustment Fund in 2006 and the Youth Guarantee in 2013. Second, without international cooperation, taxing high incomes or wealth has proved increasingly difficult in recent years, since these tax bases are highly sensitive to taxation⁵.

Figure 2: Top personal income tax rates in 2019 (%)



Source: European Commission, taxation trends database.

Third, your fellow commissioner responsible for the budget might find it increasingly difficult to convince net contributor member states to continue channelling transfers to less advanced regions without minimal contributions from the relatively better-off in receiving countries. In 2019, top personal income tax rates ranged from 57.2 percent in Sweden to 10 percent in Bulgaria and Romania (Figure 2).

3 RECOMMENDATIONS

Your predecessor was especially active in two areas of tax coordination: VAT and corporate income tax. Your priority should be to finalise what has been started, while coordinating on energy and carbon taxes with your colleague responsible for climate action, and starting the discussion on personal taxation.

Your success will depend on your ability to articulate tax policies with more general objectives of the Commission such as fair competition, energy transition and social justice.

Value added tax

VAT fraud is made easier by the exemption of intra-EU cross-border business-to-business supplies: under the ‘transitional’ system introduced in 1993, intra-EU cross-border supplies of goods are VAT exempt. This exemption breaks the incentive for intermediate suppliers, the effective VAT collectors, to file returns and claim the refund, which ensures a level of self-policing in the system. It exposes the system to so-called missing-trader fraud and consequently to carousel fraud.

Although some countries have been successful in fighting VAT fraud (see eg Sarnowski and Selera, 2019, on Poland), VAT gaps remain a major issue in the EU. The development of e-commerce has meant more potential for fraud, while imperfect coordination between tax administrations makes it difficult to identify fraud in real time. From a business point of view, cross-border activity involves high compliance costs since, above a sales threshold, companies must register in each country of final consumption sales. The burden, which has been estimated at 2-8 percent of VAT tax collection (Adam *et al*, 2011), is especially high for SMEs, and penalises digital activities since their business models rely on economies of scale.

In April 2016, the Commission adopted an Action Plan on VAT (European Commission, 2016) to modernise the system and create a single EU VAT area. The idea is to treat cross-border sales the same as domestic sales, consistent with the single market approach, while keeping the destination principle. Businesses will file for VAT only in the country where they are established, and a ‘one-stop shop’ will allow them to charge VAT on their cross-border sales according to the rates of each country of destination. The country of origin will then transfer the corresponding revenue to each country of destination. As a first step, a mini one-stop shop was introduced for e-services in 2015. The second step will concern e-commerce and distance selling in 2021. Eventually, the one-stop shop will be generalised, while keeping the option of having the VAT paid by ‘certified’ customer firms at the destination.

It was initially intended for the EU VAT system to switch at some point from destination-based to origin-based. Consistent with this objective, VAT rates were tightly coordinated. Moving instead to

*VAT
COORDINATION

*SINGLE VAT AREA

a definitive destination-based tax allows for more diversity in the rates. In practice, member states will have more leeway to decide on reduced rates provided the weighted average of all VAT rates exceeds 12 percent.

Based on the first experiences of one-stop shops, your task as commissioner will be to convince member

states that the new scheme can deliver on both fraud and compliance costs, provided information systems are quickly harmonized and upgraded, and anti-fraud strategies are better coordinated between tax administrations. You may want to organize national tax authorities as a network coordinated by the Commission in a similar way as for competition authorities. Tax collection meets the various conditions for being delegated to independent authorities. In particular, it has a clear, verifiable mandate with no political trade-off involved. Furthermore, it has to deal with the pressure of specific interest groups, which is less difficult for an independent authority.

To build mutual trust, accelerate IT projects and strengthen resistance against external pressure, you could explore the idea of merging these administrations with customs services and granting them autonomy at national level, in the spirit of the European network of national competition authorities. These agencies would be accountable to their national parliaments, and could be inspected by national auditors and (possibly) by the European Court of Auditors.

Corporate income tax (CIT)

While VAT is destination-based, CIT is source-based: it is levied where the value is created. If all companies were held by domestic shareholders, raising the tax at the level of the firm (source) would be equivalent to raising it at the level of the shareholder (residence). With foreign shareholders, however, CIT can be viewed as a way of having foreign-owned firms contribute to the funding of domestic public goods, some of which (including infrastructure and education) directly affect their productivity⁶. In order to avoid double taxation (at the source, and then at the residence), complex networks of bilateral tax treaties have been developed. These provisions have created loopholes that have become more and more difficult to combat in the era of the intangible economy.



The digitalisation of the economy has multiplied the opportunities for tax optimisation

*COMMON CORPORATE TAX BASE

To tackle these problems, the Commission has proposed a comprehensive reform – the Common Consolidated Corporate Tax Base (CCCTB), which dates back in 2001, with the first draft directive proposed in 2011. The idea is to harmonise the various definitions of the corporate tax base applied by member states, to consolidate the bases at the EU level and to apportion the consolidated base to the various countries where the firm is active based on a formula that depends on physical capital, employment and sales in each country. Member states would then be free to tax their apportioned profits at whatever rate they wish. In 2016, the Commission proposed a new version that splits the project into two steps: first, base harmonisation; second, consolidation and apportionment formula. However, no agreement has been reached in the Council. One reason for disagreement is the redistribution of tax revenues across member states. Another, more fundamental, reason is that CCCTB will not prevent a company from escaping taxation in one country if the company does not have a “*taxation nexus*” (a permanent establishment that carries out some key activities for the local market).

*ANTI-TAX AVOIDANCE

The discussion has been taken up by the OECD with its 2013 international 15-point action plan against BEPS⁷. The 2016 EU Anti-Tax Avoidance Directive (ATAD) (Box 1) is consistent with this international effort. However, ATAD will not prevent a company from creating value in a member state while not being taxed there (Collier *et al*, 2018). The main channels for transferring profit to low-tax jurisdictions include transfer mispricing, the strategic location of intellectual property and of headquarters, international debt shifting, tax-treaty shopping and tax deferral (Beer *et al*, 2018). The digitalisation of the economy has multiplied the opportunities for tax optimisation. For instance, data and algorithms are generally not exchanged on a market, hence the arms-length principle can

*DIGITALISATION

Box 1: The Anti-Tax Avoidance Directive (ATAD, (EU) 2016/1164)

1. Limited deductibility of interest payments (up to 30 percent of earnings before interest, tax, depreciation and amortisation);
2. Exit tax in case of transfer of an asset to a low-tax jurisdiction;
3. General anti-abuse rule: no preferential tax treatment will apply to an arrangement or a series of arrangements whose main purpose or one of the main purposes is to obtain a tax advantage;
4. Controlled foreign company (CFC) rule re-attributing the profit of a controlled foreign subsidiary in a low-tax country to the parent company;
5. To the extent that a hybrid mismatch results in a double deduction, the deduction shall be given only in the member state where such a payment has its source.

Transposition was required by 31 December 2018.

The Directive is complemented by: 1) country-by-country reporting; 2) recommendation on tax treaties; 3) external strategy (ie common lists of third countries); 4) study of aggressive tax planning within the EU.

hardly apply. Digital activities also generate a problem in that user participation (eg through search on the internet) creates value (and possibly location-specific rents) at the market without being taxed.

Accordingly, the European Commission in March 2018 proposed to introduce the concept of “*significant digital presence*” that would be sufficient to create a taxable nexus (European Commission, 2018c)⁸. Alternative schemes being discussed at the OECD relate taxable nexus and profit allocation to “*market intangibles*” or to “*active user contribution*” (OECD, 2019)⁹. The common idea behind these various solutions is that part of the value is created at the market, rather than in the source country. As the commissioner responsible for taxation and customs union, you should use the momentum provided by BEPS to push forward the EU digital presence proposal, which is relatively simple and will prevent disorderly national initiatives to tax the digital economy. Since large importing countries could benefit from this reform at the expense of smaller exporting countries, it might be advisable to implement the reform in a progressive way, eg by changing

*PROFIT SHIFTING

smoothly the profit split method. In any case, since the EU is relatively divided on this issue, the best strategy will be to work in line with the OECD, which aims to deliver in 2020¹⁰.

Other forms of profit shifting (such as the payment of royalties for the use of a brand) could be addressed through a revision of the Interest and Royalties Directive (2003/49/EC) that would allow the market country to levy a withholding tax on the royalties paid on intellectual property when the payments are made to a country with a low tax rate (with appropriate tax credit in the residence country, see Fuest *et al*, 2013; Collier *et al*, 2018). The Commission project along these lines has been blocked by the Council since 2012. However, the US tax reform of 2017 might be a game changer. Through this reform, the US has switched from a worldwide to a territorial system (where repatriated profits are exempted). But at the same time it has introduced a minimum tax rate on profits made by controlled foreign companies (CFCs) and on outbound payments to related parties¹¹. A similar reform in the EU would complete and strengthen existing CFC rules, while simplifying the complex and uncertain system of anti-abuse rules (Becker and Englisch, 2019). Set at a low level (eg at 12 percent, the US level being 13.1 percent), such a minimum tax rate would not constrain those member states with low rates and would protect them from non-EU tax havens¹². It would also provide a backstop for bilateral tax treaties, which remain a national prerogative. Here again, the OECD initiative offers a good opportunity to overcome internal divisions in Europe.

Greening the tax system

A major challenge for the new Commission will be to coordinate national efforts in pursuit of EU emissions-reduction goals. The EU emissions trading system (ETS), introduced in 2005, only covers 45 percent of the EU's greenhouse gas emissions. The 2030 climate and energy framework (European Commission, 2014) requires non-ETS sectors to reduce their emissions by 30 percent by 2030 compared to 2005, with national targets ranging from zero to minus 40 percent. National Energy and Climate Plans are monitored at EU level to assess their consistency with the emissions targets¹³. So far, few EU countries have introduced a carbon

*CARBON TAXES



Effective taxes on carbon emissions vary widely across EU countries, energy sources and sectors, distorting the internal market and raising the cost of reducing emissions

tax, although carbon emissions are taxed indirectly through levies on energy. Effective taxes on carbon emissions vary widely across EU countries, energy sources and sectors (see OECD, 2018). These differences distort the internal market and raise the cost of reducing carbon emissions. You should aim to revise the 2003 Directive on energy taxation (2003/96/EC) in order to: 1) make minimum rates consistent with the carbon content of the different energy sources; 2) eliminate the numerous exemptions and preferential treatments; and 3) index the minimum rates on the ETS carbon price.

Personal taxation

In the last few decades, EU coordination on personal taxation has been limited to the difficult introduction of automatic exchange of information between national tax administrations, first through the Directive of 2003 on taxation of savings income in the form of interest payments (2003/48/EC) and then with its various amendments ending with the full implementation of the new OECD standard on automatic exchange of information for interest income, dividends and other types of capital income (Directive 2014/107/EU which entered into force on 1 January 2016).

In the United States, a debate has recently developed on taxation of personal wealth¹⁴. A similar debate will unlikely emerge at EU level since it is a matter for national tax policy. You could nevertheless try to emulate the initiative that led to the proclamation of the European Pillar of Social Rights in November 2017, and work on tax fairness tests to be used as an element of the new conditionality approach to EU transfers¹⁵. Such a test could be viewed positively by those who criticise EU policies as excessively focused on the free market; it could also attenuate the divide between eastern EU

*WEALTH TAXES

members who are attached to continuing structural funds and western members that consider such funding increasingly unfair without wealthy eastern citizens contributing more to the funding of infrastructure and public services in their own countries.

NOTES

- 1 Although fraud should be distinguished from avoidance and evasion, it is unclear whether this distinction actually matters for citizens.
- 2 Tax Cuts and Jobs Act of 2017.
- 3 Unweighted averages, source: http://ftp.zew.de/pub/zew-docs/gutachten/Digital_Tax_Index_2018.pdf.
- 4 This approximate figure encapsulates: €50 billion per year lost to cross-border VAT fraud (European Commission, 2016; the total VAT gap being about €150 billion according to CASE/IAS (2018) for the European Commission), €20-70 billion lost due to profit shifting (Dover *et al*, 2015; Cobham and Jansky, 2017; Álvarez-Martínez *et al*, 2018; and Bruegel calculations based on Tørsløv *et al*, 2018), and around €56 billion lost because of evasion of personal income taxes on capital income (Zucman, 2014). 1 percent of GDP is a lower bound; some authors estimate the revenue loss up to 5.6 percent of GDP (see Murphy, 2019). Crivelli *et al* (2016) estimated revenue losses because of profit shifting alone to be around 1 percent of GDP.
- 5 Saez and Zucman (2019) report wide differences in the elasticity of net wealth to taxation depending on enforcement and on the existence of exemptions.
- 6 The CIT also acts as a backstop for personal income tax.
- 7 Source: www.oecd.org/ctp/beps-actions.htm.
- 8 A firm that supplies digital services would have a significant digital presence if it meets one or more of the following criteria in a member state: 1) turnover above €7 million annually; 2) at least 100,000 users over the fiscal year; 3) over 3,000 commercial contracts generated between the firm and active users over the fiscal year. The member state could then tax the related 'residual' income. This proposal is fully compatible with the CCCTB: the related income would eventually be introduced in the apportionment formula.
- 9 The BEPS strategy was endorsed by the G20 in Osaka (29 June 2019) and by the G7 Finance in Chantilly (17-18 July 2019). In particular, the fact that the tax nexus needs to be adapted to the digital economy is now accepted internationally, and so is the idea of a minimum taxation rate.
- 10 See <https://www.oecd.org/tax/beps/international-community-agrees-on-a-road-map-for-resolving-the-tax-challenges-arising-from-digitalisation-of-the-economy.htm>.
- 11 The provisions are complementary since a minimum tax on repatriated profits from CFCs could incentivise company inversions in which the headquarters becomes the affiliate and vice-versa.
- 12 A more fundamental reform would be to switch to a destination-based cash-flow tax, which would involve raising the corporate income tax at the destination instead of the origin. Since such reform requires worldwide coordination (see IMF, 2019), we consider it as not achievable within the mandate of the new European Commission.
- 13 See the memo in this volume to the commissioner responsible for climate action and energy.
- 14 Notably, US senator and potential presidential candidate Elizabeth Warren has em-

- braced the Saez-Zucman idea of a wealth tax of 2 percent on a family's wealth above \$50 million, with an additional surcharge of 1 percent on wealth over \$1 billion (Saez and Zucman, 2019).
- 15 For instance, that the ratio of the disposable income of the top 10 percent to the bottom 10 percent (or bottom 50 percent) should be below a certain threshold.

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TO THE COMMISSIONER RESPONSIBLE FOR FINANCIAL SERVICES

By Nicolas Véron

* Among the many challenges you face, the most pressing is the unfinished banking union. This perpetuates a major fragility of the euro area that still threatens its survival in case of future crises, and undermines the efficiency of financial intermediation and the international role of the euro.

Completing the banking union is thus what will define your term's overall success or failure. This highly complex project encompasses banks' concentrated sovereign exposures, European deposit insurance, other aspects of the policy regime for non-viable banks (including the resolution/insolvency framework and aspects of state aid control), and phasing out barriers to cross-border integration.

You should also promote EU-wide integration of capital markets infrastructure, step up the fight against money laundering and reaffirm the EU commitment to global financial standards.

- * BANKING UNION
- * TACKLING FRAGMENTATION
- * ANTI-MONEY LAUNDERING

1 STATE OF AFFAIRS

Your area of responsibility has gone through momentous recent developments. The good news is that Europe's decade-long systemic financial crisis, from mid-2007 to mid-2017, has been over for more than two years, despite lingering anxieties. You thus enjoy more tranquil starting conditions than your three immediate predecessors. The less good news is that the reform programme initiated at the height of the crisis is only half-finished, even after abandoning any unnecessary items. As a consequence, you face a massive policy agenda.

*UNFINISHED
REFORMS

This memo focuses on your role in the legislative and regulatory process, under which the Commission proposes financial services legislation and endorses proposals from the relevant European Union agencies for binding standards. It leaves aside your role (and that of your colleague in charge of competition) in inherently unpredictable future cases of financial crisis management.

* BANKING
SECTOR

The banking sector remains the core of Europe's financial system, despite President Juncker's Capital Markets Union initiative (on which more below). The banks are in a better state than at any point in the last twelve years, but still not great – even though the overwhelming majority of them appear to be solvent under any reasonable definition. The EU/European Economic Area (EEA)¹ are overbanked. European banks have retreated dramatically from their pre-crisis expansion overseas (McCauley *et al*, 2017), and have lost EU/EEA wholesale market share to their American competitors (Goodhart and Schoenmaker, 2016). The vagaries of Brexit, and the possible future disruption from new financial technology (fintech), generate additional concerns. For banks to be viewed as viable, further consolidation, restructuring and cost-cutting are needed. In terms of cross-border integration, the EU/EEA system has the worst of both worlds: too integrated to be immune to cross-border financial contagion, but too fragmented to have the resilience that would come with genuine system-wide risk-sharing.

The continued dominance of banking reinforces the system's most glaring current weakness, namely the bank-sovereign vicious circle that revealed itself in 2010-12 as the primary driver of the euro-area crisis. The radical policy response known as banking

union was explicitly developed from mid-2012 to break that vicious circle, but remains a halfway house².

- On the positive side, the European Central Bank, in its capacity as hub of the Single Supervisory Mechanism (SSM) under the SSM Regulation (Regulation (EU) 1024/2013), fully assumed the role of licensing authority for all credit institutions in the euro area³ in November 2014. Not everything in this transition has been smooth, but the ECB is now a credible and respected banking supervisor (see for example ECA, 2016; Schoenmaker and Véron, 2016; European Commission, 2017b; IMF, 2018).
- More awkwardly, the regime for non-viable banks⁴ that was introduced during the crisis, with high hopes of substituting market-discipline-enhancing bail-in for wasteful bail-outs⁵, is not working as intended by the crisis-era legislators. Under the EU Bank Recovery and Resolution Directive (BRRD, 2014/59/EU), non-viable banks are either resolved by an administrative authority using an EU-harmonised procedure, or if the resolution authority declines to take action (based on specific public-interest criteria), banks are liquidated under non-harmonised national law known as “*normal insolvency proceedings*”. In the euro area, the Single Resolution Board (SRB) was established in 2015 and acquired full authority in 2016 as a central resolution authority. But cases so far have revealed a general preference for normal insolvency proceedings over BRRD resolution, and correspondingly for national bail-out over BRRD-compliant bail-in, despite state aid control strictures. The only BRRD resolution by the SRB so far was that of Banco Popular Español in June 2017, but that case was not one of unambiguous insolvency and thus did not establish a precedent of senior creditor bail-in. There is a growing perception that, unless the legal regime for non-viable banks is significantly reformed, BRRD resolution and the SRB will play only a limited role, if any, in future cases of bank unviability. This perception might have been compounded by the SRB’s own difficult start (ECA, 2017; Véron, 2019).

* NON-VIABLE
BANKS

* SOVEREIGN EXPOSURES

- Most problematic, the structural drivers of the bank-sovereign vicious circle remain in place. Banks retain high levels of concentrated domestic sovereign exposures. Deposit insurance is a national competence. Because of the preference for national proceedings over BRRD resolution, and the resulting incapacitation of the SRB's Single Resolution Fund (SRF, several dozen billion euro strong but so far unused), additional (implicit) public guarantees tend to be also national – eg government guarantees of bank bonds, allowing them to be used as collateral for central bank liquidity. The instrument for direct recapitalisation of banks by the European Stability Mechanism (ESM), decided in mid-2012 but never plausibly operationalised, was officially phased out in 2018. Even assuming its future use, the SRF is widely viewed as insufficient to address a major systemic crisis, and there are ongoing discussions on how it could be complemented by mechanisms to provide liquidity in resolution. Most banks have a predominantly national scope of activity, and even those with cross-border diversification are forced by national authorities to ringfence their capital and liquidity across intra-euro-area national borders.

* UNFINISHED BANKING UNION

The Juncker Commission was not able to lead the EU to address the banking union's unfinished elements. In 2015, it made an ambitious legislative proposal to create a European Deposit Insurance Scheme (EDIS, COM/2015/586), but that has not been approved by the European Council and was watered down by the Commission itself less than two years later (COM/2017/592). The Commission has declined to address the problem of concentrated sovereign exposures, arguing unconvincingly that: 1) any regulatory changes in that space must wait for the completion of EDIS and other “*outstanding elements of the Banking Union and Capital Markets Union*”; 2) it would require an “*agreement at the global level*”; and (3) it should be part of a “*joint political decision*” that also includes a component establishing a “*European safe asset*” (European Commission, 2017a, page 23). The completion of the banking union was thus not considered in a holistic manner when euro-area reform was widely discussed during 2018. Largely as a

consequence, there has been no major cross-border consolidation in the euro-area banking sector since the crisis, despite the pent-up need for further restructuring.

2 CHALLENGES

The EU/EEA financial system is bank-dominated, overbanked and fragmented. This is not good for the European economy.

- **The system is too bank-centric.** Alternative forms of finance, including various capital-market segments, venture capital and equity finance more generally, are comparatively underdeveloped. The Juncker Commission's project of a capital markets union was ill-defined from the start, and suffered from the early decision (justifiable in the context of the then forthcoming UK referendum on Brexit, but no less crippling for that) to rule out significant changes to the market supervisory architecture. Bank financing may be best suited for traditional patterns of corporate growth, but the more dynamic sectors of Europe's economy, including advanced services and high-growth entrepreneurial firms, typically seek other forms of external financing. Rebalancing Europe's financial system away from overreliance on banking is a structural, long-term endeavour that would raise Europe's growth potential.
- **The system is overbanked.** The banking sector remains bloated with too many banks and barriers to both exit and entry, undermining its competitiveness and profitability (ESRB, 2014). Many banks survive with high cost structures within semi-protected national markets. Incumbency is protected by a dense web of national regulatory and tax distortions, governance and ownership patterns, and other idiosyncratic practices that entrench established banking structures. In stark contrast to both the US and emerging economies, there have been almost no significant new entrants into the EU/EEA banking market for more than a century. The sector's low profitability is associated with greater difficulty maintaining or replenishing adequate capital levels and with a comparatively lesser capacity to invest and innovate. The transition

* TOO MANY
BANKS



Powerful disincentives or outright barriers to cross-border integration exist both for banks and for market infrastructures

* CROSS-BORDER
INTEGRATION

- to a healthier landscape, with less incumbency protection and more scope for future new entry, would make the sector more resilient and better able to serve a dynamic European economy.
- **The system is fragmented.** Powerful disincentives or outright barriers to cross-border integration exist both for banks and for market infrastructures. National authorities insist on national ringfencing of banks' capital and liquidity, even for fully-owned subsidiaries of banking groups headquartered elsewhere in the EU/EEA⁶. This is also true in the banking union, because national authorities retain a separate mandate to ringfence under the guise of depositor protection (since deposit-guarantee schemes remain national) and/or crisis prevention (given the above-highlighted lingering implicit national guarantees)⁷. In the non-bank sector, the preservation of national capital market infrastructures, including trading platforms such as stock exchanges, clearing houses and information intermediaries, is a powerful obstacle to European capital market integration. The motives for such financial fragmentation include banking/financial nationalism, meaning the protection and/or protection of national champions in the financial sector, and what economists loosely refer to as 'financial repression', meaning the use by governments of 'their' financial sectors to pursue national objectives that might include the preferential financing of the government itself or of other favoured stakeholders. From an EU/EEA perspective, the fragmentation is detrimental for financial stability, as the bank-sovereign vicious circle during the euro-area crisis powerfully illustrated, and for investment and growth, since investors and issuers/borrowers miss out on cross-border opportunities that would be economically beneficial

* FINANCIAL
NATIONALISM

compared to what is available in closed national financial systems.

These are not the only challenges in the current situation. A major new theme has emerged in 2018 with the multiplication of high-profile cases of apparent breaches of EU anti-money laundering (AML) legislation, itself a transposition of a global framework developed since the 1990s. In turn, the ineffective AML supervisory framework could contribute to further system fragmentation along national lines, as national authorities understandably seek to protect their countries from other member states' AML failures. More broadly, the supervision of financial firms' conduct of business, and the corresponding protection of financial-services consumers, savers and investors, may have suffered from the overarching priority given to financial stability and prudential concerns during the decade of systemic fragility. Specifically, there have been massive cases of banks selling their own high-risk equity and debt to their own clients in several member states, thus egregiously exploiting the asymmetries of information inherent to finance – occasionally with the acquiescence, if not the encouragement, of national authorities.

The relative lack of global attractiveness of the EU/EEA financial system is a major cause of the comparatively underdeveloped international role of the euro: the ECB president noted that *“if markets are to entertain the possibility of an enhanced [international] role for the euro, we need to consider what the conditions are that underpin the [US] dollar’s dominance. The list is long, but the fact that the dollar is an expression of an integrated capital market is certainly one of those conditions”* (Draghi, 2019). An additional challenge is to ensure that the policy framework for the financial system adequately takes into account issues of long-term investment and environmental sustainability (Schoenmaker and Schramade, 2019).

3 RECOMMENDATIONS

The following recommendations assume no prospect of EU treaty change during your term. They do not include issues outside of your scope that were envisaged under the Juncker Commission's capital markets union agenda, such as corporate or individual insolvency

law reform. They also do not examine the case for reforming the banking communication on state aid, last revised in July 2013, which is a matter for your colleague in charge of competition.

General framing

Given the centrality of banks in EU/EEA finance, the completion of the banking union, understood as breaking the bank-sovereign vicious circle, must be your highest priority. It is challenging but possible to achieve it during your term, and this opportunity should not be missed this time. None of your other issues is nearly as important.

The EU/EEA financial system's rebalancing away from bank dominance is a longer-term objective, for which you should lay sustainable foundations. You should not feel obliged to retain the Juncker Commission's slogan of "*capital markets union*", which implies a false symmetry with the banking union and frankly has become associated with failure. You may rather simply refer to achieving a true single market for financial services, including capital markets.

You should also complement the past decade's emphasis on financial stability during the crisis years, and more recently on financial development, with a long overdue reaffirmation of the need for financial protection – appropriately protecting depositors, savers, investors, consumers of financial services and the integrity of the EU/EEA financial system. The most urgent task is to restore credibility to European AML policy.

Banking union

Breaking the bank-sovereign vicious circle means delinking bank credit conditions from sovereign credit inside the euro area⁸. You should adopt a four-pronged approach:

- 1. Reduce banks' concentrated domestic sovereign exposures** so that each member state's banking system can plausibly survive an episode of sovereign debt restructuring. You should focus on the problem at hand, which is concentration risk not credit risk. (Addressing sovereign credit risk is neither necessary nor sufficient to break the bank-sovereign vicious circle, and would undermine euro-area stability in the absence of a fiscal

union). To tackle it, you should introduce ‘sovereign concentration charges’ for euro-area sovereign exposures of euro-area banks, as an amendment to the EU capital requirements regulation (Véron, 2017). Contrary to an often-heard fallacy, such sovereign concentration charges would not put euro-area banks at an international competitive disadvantage, since banks can avoid any additional capital requirements by properly diversifying their euro-area sovereign exposures without necessarily reducing their aggregate level.

* EUROPEAN
DEPOSIT
INSURANCE
SCHEME

2. Protect explicitly insured deposits identically across the euro area with a well-designed EDIS. This is critical for mass confidence and should be the bedrock of political acceptance of the banking union. Your proposal should ensure that insured deposits, currently under a maximum of €100,000 per account, benefit from the exact same credible and unconditional protection in all euro-area member states, with no ifs and no buts. Otherwise, the differentials in public confidence will leave too much scope for disruptive national bank runs in some crisis scenarios. For the same reason, the EDIS should be centrally managed by a single EU agency (most likely the SRB), with national authorities deprived of any role other than as automatic paying agents⁹.

3. Review the regime for non-viable banks so that it works similarly in all member states and does not rely on implicit national fiscal guarantees. This implies significant and perhaps full harmonisation of ‘normal insolvency proceedings’ for banks in the euro area, and presumably also a role for the SRB in administering these. You should also consider, possibly at a later stage, enabling either the European Stability Mechanism (ESM) or the SRB to wield, under appropriate conditions, financial tools that might be necessary to defend financial stability, such as providing liquidity guarantees to banks or participating in precautionary recapitalisations, in addition to the ESM’s role as backstop to both the (existing) SRF and (future) EDIS.

* NATIONAL
RINGFENCING

4. The three previous actions will allow the passing of legislation to put an end to national ringfencing of bank capital and/or liquidity within the euro area. In addition, the financial stability



Measures to complete the banking union should be a single package of decisions by EU leaders, though their implementation would necessarily be differentiated

* FINANCIAL
STABILITY
CONCERNS

benefits of banks' geographical diversification should be properly acknowledged in the regulatory and supervisory framework (Jokivuolle and Virén, 2019).

The last point underlines the fact that despite their complexity, these four action items should be envisaged as a single package of decisions by EU leaders, even though their implementation would necessarily be differentiated in terms of legislation and transitional arrangements. Such a comprehensive package would be unambiguously beneficial to every member state, even though some of its individual components might not be perceived as such. It would powerfully incentivise the market-driven restructuring, diversification and cross-border integration that the European banking system needs, as argued in the previous section of this memo.

Capital markets supervision

To promote less fragmented and thus deeper and more liquid EU/EEA capital markets, you should prioritise the integration of their underlying infrastructures. This will not happen as long as infrastructures located in different member states, even those that are systemically important or even critical at European (let alone global) scale, are separately supervised by national authorities. You may think of it as a textbook case of application of the treaty principle of subsidiarity. The post-crisis EU/EEA financial framework stipulates that no financial firm or market should remain unregulated if it potentially raises financial stability or integrity concerns. If these concerns have pan-European significance, which is evidently the case for systemically critical financial infrastructure, they should be supervised at European level, as banks in the euro area already are.

The European Securities and Markets Authority (ESMA), which already supervises credit ratings agencies and trade repositories¹⁰, is the obvious candidate for such a mandate, complemented where relevant by the ECB. But for that, ESMA itself needs to be reformed in order to become a credible and independent financial supervisor, a role that was not immediately envisaged when EU legislators enacted the legislation creating it in 2010. This entails more compact governance, akin to that of the permanent session of the SRB, and a revised funding framework.

Anti-money laundering

The importance of proper AML supervision and enforcement, in an era of rising geopolitical threats, and the failure of the existing EU regime to defend its credibility given the multiple above-mentioned cases of breaches, should force a fundamental rethink. The EU/EEA's AML problem can be analysed as another vicious circle: criminal money laundering tends to concentrate in member states with more permissive regimes, which generates local benefits, which create incentives for the national regime to become more permissive not less. Given the binding EU/EEA single market framework, the system is only as strong as its weakest (national) link or links. As memorably put by one EU head of government, *"it's a little bit like fighting rats. I can make sure that I get the rats out of my house and my house will be clean, but what about my neighbours?"*¹¹

Creating yet another EU agency should not be envisaged lightly, but is justified by the significance of the EU/EEA's AML challenge. You should propose legislation to establish a European AML Authority as an independent AML supervisor, working with national competent authorities and the SSM, but empowered to directly access information and impose financial penalties on significant offenders. Its remit should cover not only banks but also all other 'obliged entities' under the EU AML legislation (Kirschenbaum and Véron, 2018).

Global leadership

The EU has an obvious strategic interest in a functioning rules-based international order. First, you should better align EU legislation with global standards where divergence is not evidently in the EU

interest. This could include phasing out the EU ‘carve-outs’ from international financial reporting standards (unless the global standard-setter itself modifies the relevant standards in a way that would be endorsed by EU regulation); amending EU bank capital requirements legislation to make it fully compliant with the Basel accord (see BCBS, 2014); and strengthening the independence of the SRB in line with the Financial Stability Board’s key attributes for effective resolution regimes (IMF, 2018, paragraph 34).

Furthermore, Europe’s representation in global financial regulatory bodies has failed to catch up with changes in the global financial landscape and in the EU’s own internal arrangements. Specifically, the Basel Committee on Banking Supervision includes representatives from seven euro-area countries as full members, plus those from the ECB. This situation constitutes indefensible overrepresentation, given that individual euro-area member states no longer set bank prudential supervisory policy, and undermines the reputation of both the EU and the Basel Committee in the eyes of the rest of the world. You should encourage the relevant euro-area countries to voluntarily terminate their memberships. A comparable approach could be applied to the Financial Stability Board (especially its Steering Committee) and possibly also to other global bodies.

Concluding thoughts

Many more technical aspects of financial services legislation and regulation will also require revision or reform during your term, but cannot be mentioned here for lack of space. One of these could be a revision of the EU insurance solvency legislation to better incentivise investment in long-term high-return assets. The recommendations in this memo might seem daunting. You should keep in mind, however, that they are much less radical than what was actually achieved during the Commission’s crisis term in 2010-14. Your duty now is to make what started then work, and to finish the job.

NOTES

- 1 Unless otherwise indicated, EU/EEA refers in this memo to the territorial scope of the internal market in financial services, namely where EU financial services legislation has binding effect. This is meant to also encompass the United Kingdom should it stay in the single market after Brexit, eg during the transition period as defined in the Withdrawal Agreement.
- 2 The banking union area is currently identical to the euro area, but is expected to expand beyond it during your term, through the process known as close cooperation defined by the SSM Regulation (Regulation (EU) No 1024/2013). Bulgaria has applied for close cooperation, and other EU member states are likely to follow.
- 3 The European Central Bank is the second banking supervisor in the world by aggregate assets of supervised entities, behind its Chinese counterpart but well ahead of US ones. Contrary to a widespread misconception, its authority covers all euro-area banks no matter how small. While the ECB generally exercises its mandate over smaller banks indirectly through the delegation of day-to-day supervision to the relevant national authorities, it is the only decision-making authority for core matters such as license approvals and withdrawals and the vetting of significant changes in ownership ('qualifying holdings').
- 4 'Non-viable' is used here as shorthand for the qualification of "*failing or likely to fail*", defined in the BRRD.
- 5 'Bail-out' is a colloquial expression that generally refers to the use of public money to reimburse a weak or failing bank's claimants, especially creditors. 'Bail-in' is specifically defined in BRRD as an administrative decision by a bank resolution authority to impose losses on liability-holders in certain resolution scenarios. Bail-in is also used colloquially in a broader sense to refer to the imposition of losses in situations other than BRRD resolution, eg in precautionary recapitalisations (also defined by BRRD). The currently applicable EU Banking Communication (2013/C 216/01) refers to bail-out and bail-in in this colloquial sense.
- 6 In Poland, national authorities also insist on a separate domestic listing for the largest banks.
- 7 The recently enacted revision of the BRRD further expanded the ringfencing capacity of national authorities.
- 8 Non-euro-area EU countries will inevitably retain some correlation between bank credit and sovereign credit, even if they join the banking union through close cooperation.
- 9 This rules out 'deposit re-insurance' designs (other than during an initial transition), because these leave the possibility of deposit insurance being held hostage to political negotiation in a systemic crisis, as happened in Cyprus in March 2013. However, the system may legitimately retain country-specific features to account for differentiated banking structures and risk patterns that are not directly correlated with sovereign credit. It may also accommodate idiosyncratic sub-national arrangements (or 'pillars' as currently exist in Austria, Germany, Italy, and Portugal) and voluntary top-up regimes (as for German commercial banks). The design could ensure that the system's 'first loss' in case of idiosyncratic bank failures is incurred at national (or 'pillar') level, thus preserving sound incentives (Schnabel and Véron, 2018).
- 10 Due disclosure: the author is an independent non-executive board member of the European trade repository arm of DTCC (the Depository Trust and Clearing Corporation), which is supervised by ESMA.
- 11 Latvian Prime Minister Krisjanis Karins to Latvian parliamentarians, quoted in Foo Yun Chee, 'EU needs central supervisor to tackle money laundering "rats": Latvia's PM', *Reuters*, 17 April 2019.

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TO THE COMMISSIONER RESPONSIBLE FOR INVESTMENT

* You take office at a time of strengthening aggregate investment, and corporate investment in particular. Nevertheless, you face major challenges to foster strategic investment that will raise productivity and develop a carbon-neutral economy. Among your tasks will be addressing the shortcomings of policies you inherit: the Investment Plan for Europe and the Capital Markets Union (CMU).

The successor to the Investment Plan for Europe will be InvestEU. You should make further improvements, in particular by reinforcing the additionality criteria in the choice of projects that can benefit from the EU guarantee. On CMU, you should push and persuade national regulators and encourage cross-border integration, while emphasising equity finance for smaller companies and companies in periphery and cohesion states.

Your overarching goal should be to develop a financial ecosystem of diverse and cross-border funding sources, in which investment funding is less vulnerable to banking crises.

- * INVESTEU
- * CAPITAL MARKETS UNION
- * CROSS-BORDER FUNDING

1 STATE OF AFFAIRS

In the wake of the crisis, European public and private investment declined dramatically. The previous Commission recognised this was damaging the European economy by exerting a drag on growth and employment through the fall in aggregate demand in the short term, and was undermining Europe's growth potential over the longer term. The two main drivers behind the fall in investment by non-financial corporations in the EU were low domestic demand after the crisis and significant financing constraints (Döttling *et al*, 2017). Surveys (for example, ECB, 2014) underlined how vulnerable small and medium-sized companies (SMEs) were, given their strong reliance on bank financing.

However, aggregate investment, and corporate investment in particular, has strengthened steadily throughout Europe amid a belated recovery. The significant investment gap has been partly closed in the last five years and capital expenditures are now almost back to pre-crisis levels. From an aggregate-demand perspective, investment no longer seems to be a major brake on growth.

Financing constraints on investment have also eased in recent years as credit growth finally recovers and interest rates on loans are at record lows. But dependence on bank finance and the fragmentation of the single market in financial services remain key vulnerabilities. This is a particular problem for SMEs, which are less likely to access financial markets, and for innovative companies seeking to finance intangible investment. Capital market fragmentation is also a weakness for the euro area, which has yet not fully addressed vulnerabilities in its banking system, and which lacks effective mechanisms for risk sharing.

In addition, with the exit of the United Kingdom from the European Union, the EU27 will become separated from its pre-eminent financial centre. The risk is that Brexit will disrupt access to a deep pool of financial expertise and capital, and that the alternative financial centres that are emerging will lack the required scale and innovation.

Overall, therefore, you take office at a relatively favourable time as far as investment is concerned, but there are still major

* INVESTMENT
RECOVERY

* BREXIT

challenges ahead of you to build a more resilient financing environment.

In dealing with these challenges, you inherit the policies of your predecessor, whose main achievements were, first, delivering the Investment Plan for Europe promised by the Commission president as a tool to boost growth and jobs in the EU and to speed-up the recovery (Juncker, 2014) and, second, contributing to building a Capital Markets Union (CMU), which would maximise the benefits of capital markets and non-bank financing for the economy, in particular for SMEs. As you will rely, at least partly, on these inherited policies, you will also have to address their shortcomings.

1.1 The Investment Plan for Europe

* JUNCKER
PLAN

The Commission's Investment Plan for Europe (widely known as the 'Juncker Plan') was intended as a short-term demand stimulus and, given the Commission's limited resources, anticipated substantial leveraging of private financing.

The main tool is the European Fund for Strategic Investments (EFSI) to address the financing constraints that riskier investment projects face and, more generally, to stimulate investment and maximise private sector investment. EFSI received a €16 billion guarantee from the EU budget and €5 billion of the European Investment Bank's own resources. This was intended to enable the EIB Group to invest in inherently riskier projects or take a more junior position among other creditors without risking its AAA rating. The combined Commission guarantee and EIB capital was supposed to generate at least €315 billion of additional investment before mid-2018 by crowding in private investors.

Both the speed with which projects would be mobilised and the leverage factor of 15 struck some observers as ambitious. Undeterred by the operational and financial complexities, the Commission in 2017 extended EFSI until 2020 and increased the combined guarantee to €33.5 billion (€26 billion from the EU guarantee and €7.5 billion from the EIB) with the goal to mobilise €500 billion of additional investment by 2020.

However, it is very difficult to assess if the Juncker Plan really contributed to this reduction in the overall investment gap. For



Five years into the CMU initiative, European capital markets remain underdeveloped and fragmented, and banks still dominate the funding of European companies

* ADDITIONALITY

instance, the European Court of Auditors (2019) and Claeys and Leandro (2016) were sceptical about the additionality of investments made under the plan.

According to the European Court of Auditors (2019), at least one third of the projects of the Plan were not additional, ie they could have been done without EFSI, either by the EIB without EU budget support, or with alternative private financing sources. Another issue with the plan comes from the slow disbursement of the funds. According to the EIB's own model (EIB, 2018b) the peak impact of the plan will be in 2020-21, six years after its design and 12 years after the beginning of the crisis. The Juncker Plan could not function as a stimulus tool. At best it has increased the effectiveness of the EIB by pushing it to invest in riskier and more innovative projects that have some difficulty finding other sources of financing, and has reduced its potential crowding out effect.

* CAPITAL MARKETS

1.2 Improving financing for investment: The Capital Markets Union initiative

The Capital Markets Union (CMU) agenda is aimed at building a new financial ecosystem in the EU, diversifying the forms of finance available to companies and integrating national capital markets. After a slow start, ten directives or regulations planned under the legislative programme were either adopted or agreed at a political level during your predecessor's term.

CMU is a long-term project of regulatory reform. Shifting financing patterns will be a gradual process so it might be too early to assess it based on indicators of market development and integration. Nevertheless, five years into the initiative, European capital markets remain underdeveloped and fragmented, and

banks still dominate the funding of European companies. External equity, either from public markets or from private asset managers, still plays a marginal role in company financing. This risks depriving European enterprises of much needed capital, innovation financing and expertise in corporate governance.

2 CHALLENGES

2.1 Substantial investment needs remain

The encouraging observation that the aggregate investment gap has been closed in the last five years should be qualified. There remain overall substantial and pressing investment needs.

First, the level of investment is still below what should be expected based on the historical trend (even when accounting for the possibility that there was overinvestment in some countries in the years preceding the crisis), and is also much lower as a share of GDP than before the crisis.

Second, despite some improvement, there are still major differences across Europe: capital expenditure is still very low compared to its pre-crisis level in some EU countries, in particular in the south of the euro area (eg in Italy and Spain).

Third, despite the recovery in investment in the last few years, underinvestment has persisted for almost a decade, meaning the capital stock has been depleted and has not been fully replaced or maintained. This is the case for non-financial corporations, which might not have invested enough to adopt new technologies. This is detrimental for their own productivity but also for potential growth overall. The public capital stock has also depreciated as public investment was slashed heavily during the crisis and remained depressed, especially in the countries heavily hit by the crisis.

Finally, historical levels or trends provide only simple benchmarks: the investment levels needed in coming years to achieve certain strategic goals might be much higher, in particular if the EU wants to raise productivity and develop a sustainable economy.

The EU has major economic ambitions to foster research and development, scale up innovative SMEs and develop ICT and digital infrastructure (eg broadband networks), in order to boost productivity and improve its growth prospects. This requires a lot

* SUBOPTIMAL
INVESTMENT

* RESEARCH AND
DEVELOPMENT



The dependence of European companies on bank funding will undermine resilience in the next downturn

* CARBON
NEUTRALITY

more investment than what is currently undertaken. For instance, looking at the detail of non-financial corporations' capital expenditures, investment in intellectual property products (ie investment in R&D, databases and other intangibles) is much lower in terms of GDP than in the United States, where it represents above 5 percent of GDP, while it represents only 3 percent in countries including Italy and Spain, and is below 4 percent in Germany.

The other EU top priority is the transition towards carbon neutrality. This implies mobilising significant resources and redirecting financing from brown towards green activities. Massive and urgent investment will be necessary in energy storage, public transport and energy efficiency in buildings¹ to meet the targets agreed in Paris in 2015. For the energy transition in the EU up to 2030, €11.2 trillion will have to be invested, according to the EU High-Level Expert Group on Sustainable Finance (2018). Currently the EU falls short by about €177 billion annually – €1.77 trillion for the whole period 2021 to 2030.

2.2 Financing of investment is still an issue

The funding of European companies remains characterised by a bias towards debt (and in particular bank credit), and against external equity. This is problematic for investment for two reasons.

First, the dependence on bank funding will undermine resilience in the next downturn. EU corporate debt ratios have declined only modestly since 2008 (and have in fact increased slightly in some core euro-area countries). Less-leveraged firms appear to be more resilient in terms of capital investment in times of economic downturn. In the European financial crisis, the most severely impacted economies were also those with the shallowest equity bases.

* DEPENDENCE ON
BANKS

Second, limited funding sources will also impact productivity growth. A bank-based financial system is less likely to fund innovation (Rajan, 1992) and young fast-growing SMEs without collateral (Philippon and Véron, 2008). Equity investors seek out companies that are growing but are capital constrained. By establishing significant stakes, these investors support the expansion of firms over extended periods. Private equity investors in particular exert a positive impact on the performance of firms, which will subsequently fund themselves in the market.

This debt bias is particularly acute for SMEs, which account for about 57 percent of EU value added, and which are even more prominent, and smaller, in the EU periphery and in central and south-eastern European countries. For SMEs, external finance from public equity or bond markets is marginal. This is not surprising, given the lack of transparency and other information problems. But the scarcity of IPOs relative to the US market is pronounced for smaller companies in Europe, even when taking account of lower growth in these companies. Moreover, the fixed costs of issuance and the ongoing compliance costs seem to be particularly onerous in the EU.

*EQUITY FINANCE

Stock exchanges are the most visible aspect of capital markets. But net funding from listed equity issuance has declined in recent years as large companies have withdrawn their listings. Markets in many member states are highly illiquid. Efforts to develop public markets in all member states and prepare SMEs for issuance have shown limited success. However, private equity has rapidly expanded and is back to pre-crisis levels. This is on the whole a welcome development. Compared to public equity, private equity is accessed by a wider range of smaller companies, though excess leverage within portfolio companies has become a concern.

*VENTURE CAPITAL

Start-up finance and venture capital remains particularly underdeveloped in the EU, but could play an important role in funding businesses that scale up to become more established firms. Venture capital investors have the risk appetite and have developed tools to cater to firms with technology that is yet not ready for commercial application and for which returns are highly uncertain. Given the numerous market failures and risks, national



Obstacles to a more developed equity base and other risk capital are rooted in national policies

development banks account for a significant share of funding, as do the EIB's private equity operation and regional development banks. A liquid pan-European venture capital market still does not exist.

Obstacles to a more developed equity base and other risk capital are rooted in national policies, many of which have not been touched by the CMU agenda. Company law and corporate governance practices often deter dilution of control by established owners. Minority shareholders tend to have weak rights. The shield for interest payments is a feature of tax systems in most of the EU, though some member states have designed innovative schemes to encourage equity financing.

*HOME BIAS

In addition to its debt bias, capital market financing in the EU is also constrained by a strong home bias. Private equity funds, which are most relevant for SMEs, remain heavily dependent on funding from within home countries. In the euro area, the indicator for total cross-border financial exposures remains below its pre-crisis peak.

*FRAGMENTATION

Capital market fragmentation is a particular constraint in countries where institutional investors, such as pension and insurance funds, are poorly developed. This is a key concern in the cohesion countries of central and south-eastern Europe. Elsewhere in the EU, legislation on insurance, such as Solvency II (Directive 2009/138/EC), has complicated access to private equity and venture capital. Such regulations seem to unduly limit risk exposures for long-term investors. New laws, such as MiFID II (Markets in Financial Instruments Directive, 2004/39/EC) and the Market Abuse Directive (2014/57/EU), have addressed integrity issues such as insider trading. This might have come at the cost of complicating access to public funding by smaller companies, because

issuance costs are higher and research coverage might be scarcer.

Finally, the United Kingdom will remain Europe's preeminent centre for asset management in the near future. In private equity alone, it is home to about a fifth of the firms in Europe, and accounts for nearly half of the assets under management. The UK industry seems to play a crucial intermediary function in investments across the EU. The loss of UK firms' passporting rights within the single market could prove highly disruptive to fund allocations by European institutional investors, and therefore to the equity funding of European companies.

3 RECOMMENDATIONS

3.1 Refocus the CMU agenda to build a financial ecosystem conducive to investment

In order to build a financial ecosystem that will raise investment in innovative and risky projects, you should focus on two key aspects: strengthening the equity base, and fostering SME and start-up finance.

Ownership of, and ambition for, the CMU agenda among member states and their private investors and issuers should be strengthened. Many national capital market development strategies, in particular in central and south-eastern Europe, seem to pay little regard to the changes in European markets and legislation. You should be closely engaged in national debates, pointing out the potential for capital market integration across the EU and the emergence of new investors. Your presence could underline how the CMU agenda will underpin national growth strategies centred on innovation and SME support.

Liquidity in the markets of smaller countries is inherently limited as few sizable issuers or institutional investors exist. National capital markets in small countries are unlikely to develop sufficient liquidity, and home bias in funding will diminish only gradually. Overcoming this fragmentation through cross-border risk sharing will be doubly important for the euro area. The future CMU agenda should therefore target regulation that hinders cross-border integration.

*NATIONAL
MARKETS



The next phase of the Capital Markets Union project should emphasise to a greater extent equity finance for SMEs and for companies in periphery and cohesion states

*EQUITY FINANCE
FOR SMEs

A crucial building block would be joint post-trade infrastructure among groups of countries in the same region. Also, you should make the identification of impediments to equity finance and market integration a greater focus of the European semester, while offering the EU's Structural Reform Support Service to member states to build capacity. The ongoing work on pricing indices for EU cross-pools of securities should be speedily concluded.

The next phase of the CMU project should also emphasise to a greater extent equity finance for SMEs and for companies in the periphery and cohesion states. The post-crisis period has seen much EU legislation aimed at containing risks for professional investors and retail investors, including those with considerable experience. But large institutional investors, such as pension and insurance funds, should not be discouraged from taking greater exposures to long-term and riskier assets, including in private equity and venture capital funds. Legislation aimed at market integrity might have come at the cost of access to market-based finance for smaller issuers. Here, the balance between these two objectives should be redrawn in favour of encouraging the latter.

* REGULATORY
UPDATES

Specifically, the review of the Solvency II Regulation, which will be completed during your term, should adapt the risk calibration and market valuation requirements that have so far disincentivised long-term investment in private equity. MiFID II should be reviewed with the aim of sustaining research coverage of smaller issuers. Overall, proportionality should be the guiding principle in a comprehensive review of recent EU capital-markets legislation. This could help adapt legislation to the requirements of member states with large SME sectors, or with under-developed capital markets.

You should also lend your full support to the ongoing review of the European supervisory authorities. Supervision of investment funds is still largely a national competence. Integration of powers in supervision and strengthening the European Securities and Markets Authority could lead to greater efficiencies and market integration and help dismantle national barriers to the cross-border distribution of investment products.

The UK remains the deepest pool of capital and plays a key role in funding enterprises across the EU. Post-Brexit, it will be in the EU's interest to continue to draw on skills and capital in London. A reliable regime for determining regulatory equivalence and passporting rights for third-country investment funds could accomplish this.

Several smaller financial centres are now jockeying for the pole position in the EU27. They should compete based on factors such as skills, but not on laxer national supervision. A key part of your portfolio will be to ensure a level playing field, while facilitating conditions that will help alternative centres for asset management and investment banking services to emerge. You should lend your weight to a common regulatory system and warn against the dangers of a regulatory race to the bottom.

3.2 Instruments to foster strategic investment in the EU

Your overarching objective for the next five years should be to develop a financial ecosystem of diverse and cross-border funding sources, in which investment funding is less vulnerable to banking crises. However, establishing a genuine capital markets union will take time, so, in the meantime, how can the EU foster investment and finance innovation, R&D, digitalisation, and the energy transition to fight climate change?

'InvestEU', an upgraded version of the Juncker Plan, is supposed to be part of the next Multiannual Financial Framework (MFF) for the period 2021-27. This will be your main tool to steer investment.

Despite its flaws as a stimulus plan, the Juncker Plan was a smart way to try to leverage the limited EU resources with private capital markets. Moreover, improvements were made when the plan was renewed in 2017, and others are part of the InvestEU

proposal². The objective is to put less emphasis on volume and more emphasis on solving market failures and on investing in the EU's top priorities, including fighting climate change and promoting innovation to boost productivity and growth.

However, to ensure that InvestEU fulfils these objectives, you should make additional changes to the programme and its governance to overcome the shortcomings of the original Juncker Plan. In particular, you should improve the additionality criteria in the choice of projects that can benefit from the EU guarantee.

First, to ensure that these projects are additional, they need at least to be riskier and more innovative than the usual EIB projects. The internal rating of the EIB currently plays an important role in determining if projects can be submitted to the independent committee in charge of granting the EFSI label. However, the ratings themselves are provided by the EIB team, creating a risk that the EIB has an incentive to under-rate projects to make them eligible for the EU guarantee and to reduce its own risks. As a safeguard against this, the rating could be delegated to an independent team. In addition, to ensure that financed projects are different from traditional EIB projects, other changes could be considered, such as the systematic use of subordinated instruments or of instruments with longer maturities.

Second, to be truly additional, InvestEU should focus on projects that lack financing options. In particular, for innovation and SME scale-up, the EIB should seek other partners than banks, which might not be the best placed to finance these activities. The Commission should push the EIB and other national promotional banks that will participate in InvestEU to envisage partnerships with other types of private financial institutions. The substantial fund-of-funds programme in venture capital managed by the European Investment Fund has started promisingly. Based on an early evaluation, this scheme could be replicated.

A more radical option would be to try to convince the EIB board of governors—the finance ministers of the EU – to change how the EIB functions and the projects it invests in. A duplication of investments already made using national budgets or the structural funds, or that could be financed by the private sector, is not the

best use of limited EU funds and EIB expertise. Instead, the EIB should be refocused on two objectives:

- Financing investments that are 'strategic' in the energy transition, in R&D and innovation, or that have a cross-border significance; and
- Solving market failures by financing valuable projects that face financing constraints because their social desirability arises from positive externalities that are not internalised by private investors, or arise beyond the maturity of traditional financial instruments (which is particularly the case for green and R&D investments).

For investment in R&D and innovation in particular, two other EU programmes play an important role and offer some financing: EU research funding through Horizon Europe should total €100 billion in the next MFF, while the European Regional Development Fund also invests heavily in innovation (which represented 20 percent of its €200 billion budget from 2014-20). Other commissioners are responsible for these programmes, but you should at least ensure that these initiatives to foster investment are coherent and complementary. There should be a comprehensive strategy for all elements of EU financial support, crucially including the structural funds.

Finally, from a quantitative perspective the most powerful public policy to boost investment is to use public investment. However, given the small size of the EU budget, most public investment is done at the national level. Therefore, the strategic orientations and the funds devoted to them are in the hands of member states and not under the control of the EU. If the European Commission wants to foster strategic investments and in particular to boost innovation and accelerate the energy transition, it must encourage public investment in member states and steer it towards strategic objectives using indirect measures. The two main tools to do this are: 1) the country-specific recommendations made under the European Semester, which have recently highlighted the need for investment in some particular sectors at the local level to fulfil common objectives including the fight

against climate change (European Commission, 2019); and 2) the European fiscal framework.

In particular, a much-needed reform of the fiscal rules could aim at influencing public investment or at least at deterring countries from slashing public investment when they consolidate their public finances, and ensuring they are able to take advantage of low interest rates to invest in public goods. One way to do that would be to include some form of golden rule in the European fiscal framework to allow the financing of investments through issuing of debt. Alternatively, as proposed in Claeys *et al* (2016), public investment could be accounted for in the same way that corporate investment is accounted for: its costs could be distributed over the whole service life of the investment, rather than smoothed over four years as is the case now. In addition, given the importance of investment in the business cycle (and the willingness of the previous Commission to use investment as a stimulus tool), another way of boosting investment in downturns in particular would be to put in place countercyclical co-financing rates for the regional funds so that European funds devoted to investment can be used during downturns, even when national public finances are under stress.

NOTES

- 1 See the memo to the commissioner responsible for climate action and energy.
- 2 See <http://www.europarl.europa.eu/news/en/press-room/20190410IPR37569/investeu-programme-big-boost-for-jobs-growth-and-investment>.

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TO THE COMMISSIONER RESPONSIBLE FOR CLIMATE ACTION AND ENERGY

By Simone Tagliapietra and Georg Zachmann

* To decarbonise in line with the Paris Agreement, you will have to unleash a deep energy transformation in Europe. Policy choices made up to 2024 will define the shape of the EU energy system in 2050.

Fortunately, most of the necessary technologies are now available at declining costs and an increasing share of the population understands that Europe stands to gain from such a transformation in the long-term

You should fight for a price on all greenhouse gases in the EU and offer policies that enable all technology options to play to their full strengths in the decarbonisation process. Crucially, you must face up to the distributional effects of climate policies. Unless the distributional consequences of climate policies are addressed, there is a risk of a social backlash against decarbonisation.

* PARIS AGREEMENT

* ENERGY CHOICES

* FAIR TRANSITION

1 STATE OF AFFAIRS

Your predecessor helped to deliver the Paris Agreement, which marks a historic juncture in global action against global warming. He spent a significant part of his mandate fostering international support for the Agreement, ensuring its continuation after the United States' withdrawal, and pushing for the adoption of a clear and comprehensive rulebook to make it operational. By doing all this, he further strengthened the European Union's position as a leader in global climate action.

Meanwhile, your predecessor worked on a tidal wave of more than 40 EU laws, addressing issues including new targets for renewable energy and energy efficiency, EU energy and climate governance, new rules for the EU's electricity market, a clean mobility package and a 2050 vision for carbon neutrality (European Commission, 2019a).

You will be no less busy. You will have to unleash a much deeper energy transformation in Europe, to decarbonise in line with the Paris Agreement and also to seize the economic and industrial opportunities offered by this global transformation. You must also ensure the social acceptability of the energy transition, creating the right policy framework to manage the distributional effects of deeper decarbonisation. You have a major responsibility, because policy choices made up to 2024 will define the shape of the EU energy system in 2050.

Paris Agreement

The Paris Agreement is both resilient and delicate. Its resilience was demonstrated when, after the US announced its withdrawal from the agreement, countries, cities and companies around the world reconfirmed their commitment to implementing the Agreement and enhancing its ambition. However, the Agreement is a delicate legal hybrid, blending binding elements of accountability with non-binding emissions targets. It bets on the power of improving standards and ambitions rather than legally binding and effective rules. It remains a risky bet, particularly considering that about 78 percent of the nationally determined contributions (NDCs) – notably of developing countries – contained within the

Agreement are conditional on external financial and technical support (Day *et al*, 2016). This shows the key role of international climate finance in implementing the Paris Agreement and helping developing countries deal with climate change.

Energy Union

Proposed in the aftermath of Russia's annexation of Crimea in 2014, the Energy Union concept was born with a strong focus on energy security –notably the reduction of the EU dependence on Russian gas (Tagliapietra and Zachmann, 2016). Since then, the Energy Union has become a framework for existing and developing EU policies on energy security, internal energy market, energy efficiency, decarbonisation of the economy and low-carbon research and innovation.

Competence for energy policy is shared between the EU and its member states and the choice of the national fuel mix is explicitly left to member states. Consequently, much EU energy and climate policymaking in the past was conducted through the competition and environmental policy competences of the EU. The core innovation of the Energy Union is that it introduces a new governance system to improve coordination between national and European energy policies.

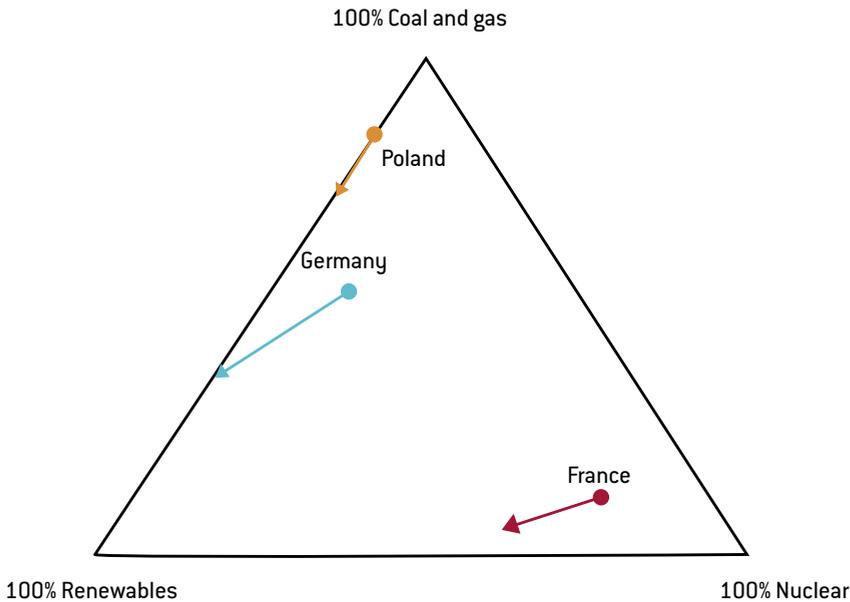
Member states must develop integrated (10 year) national energy and climate plans (Figure 1), consulting each other on their respective plans. Brussels will evaluate whether these plans are in line with the EU 2030 targets. The Paris Agreement requires a first revision of NDCs in 2020 and one of your first critical exercises will be to ensure that member states implement the European Commission's June 2019 recommendations on their national energy and climate plans¹. You must ensure that all EU countries move towards the achievement of the 2030 targets and are on a trajectory to achieve the EU vision of climate neutrality by 2050 (European Commission, 2018).

This internally flexible framework enabled member states to agree on more ambitious 2030 energy and climate targets than initially expected. The 32.5 percent energy-efficiency target and the 32 percent renewables target should mean the EU overachieves against its target of cutting greenhouse gas emissions by at least

*NATIONAL
ENERGY AND
CLIMATE PLANS

*2030 TARGETS

Figure 1: Planned changes to electricity fuel mixes of France, Germany and Poland from 2015 to 2030, according to their draft energy and climate plans



Source: Bruegel based on Eurostat and National Energy and Climate Plans (December 2018 drafts).

40 percent compared to 1990 – the EU’s current pledge under the Paris Agreement.

Technology trends

The share of renewable energy in EU gross final energy consumption rose from 10.6 percent in 2007 to 17.5 percent in 2017. In the same year, electricity generation from renewables contributed more than 30 percent of EU gross electricity consumption, led by wind power (Eurostat, 2019). This positive development was the result of both policy support and technological developments. The EU’s target for the share of renewable energy in gross final energy consumption to be 20 percent by 2020 has led to the deployment of renewable energy subsidy schemes across the EU, mainly in the form of fixed feed-in tariffs. This has come at a cost to European households, which paid on average €24 /MWh for renewable energy subsidies in 2017 (12 percent of the total electricity price; see European Commission, 2019b). Subsidies have decreased since 2016. Meanwhile, the share of renewables has continued to

*RENEWABLES

*ENERGY PRICES

grow as a result of falling costs. Solar and wind electricity costs fell by 88 percent and 69 percent respectively between 2009 and 2018 (Lazard, 2018).

Cost for conventional generation technologies have not declined, while the cost of the few remaining nuclear projects has escalated massively. Moreover, the prospects for carbon capture and storage solutions for the energy sector – that were only a few years ago expected to shoulder a significant share of the decarbonisation burden – have significantly deteriorated. This rapid shift in the cost structure of electricity generation technologies enables a rethink of our future low-carbon energy system, but it also cautions against narrowing down policy support to too-few technology options.

Energy and climate: an increasingly politicised area

*POLITICISATION

Energy and climate are now among the most divisive EU topics. The FridaysForFuture movement has mobilised mainly young people to demand more ambitious climate policies. In contrast, the *gilets jaunes* movement in France and beyond has protested against fossil-fuel price increases that were perceived as unfair. Consequently, you will have to navigate a politically highly sensitive area.

2 CHALLENGES

*FALLING COSTS

Your overarching goal should be to foster a deep transformation in Europe. Fortunately, most of the necessary technologies are now available at declining costs and an increasing share of the population understands that Europe stands to gain from such a transformation in the long-term.

Your challenge will be to engineer a framework that ensures this transformation: 1) is sufficient to achieve climate neutrality² by 2050; 2) seizes the economic opportunities for European companies; 3) is managed in a cost-efficient way; and 4) distributes cost fairly across society.

Notwithstanding technical progress and increasing societal awareness, the challenge will be huge. All industries that are built on burning fossil fuels will have to transform or vanish within only



Industries that are built on burning fossil fuels will have to transform or vanish within only 30 years

30 years. This will affect the regions that generate a large share of wealth from these industries, and ultimately the people who work in these industries, live in these regions or consume these products. You must therefore: 1) create the policy framework for the swift deployment of already available no-regret options (renewables, energy efficiency, coal phase-out, transport decarbonisation); 2) moderate a societal discussion to promote ambitious national climate action; and 3) prepare the political and technical ground for cutting difficult emissions (including industry, agriculture and aviation) in the coming decades.

Renewables

Electricity from renewables will be a main vector to decarbonise our economy – including transport and heating. Despite the falling costs of wind turbines and solar panels, increasing the share of renewables remains an uphill battle. The key challenge is to ensure that if the wind is not blowing and the sun is not shining in a certain place, consumers still get all the electricity they need. You should devise a regulatory framework that unlocks investment in a well-coordinated system of storage, networks, dispatchable plants and demand response. Otherwise, the system cost of renewables will substantially increase, or unmanaged variability will put at risk security of supply.

Energy efficiency

Numerous laws³ have been put in place to reduce energy consumption but progress has been uneven. In 2016, EU final energy consumption was 7 percent lower than in 2005, as a result of the economic downturn, of structural changes towards less energy-intensive industrial sectors and of the implementation of energy

*INVESTMENT

*HEATING AND
COOLING

efficiency policies (EEA, 2018a). Since 2015, EU final energy consumption has risen as the economy has recovered from the crisis, jeopardising the achievement of the 2020 energy efficiency target. In the heating sector especially, energy efficiency is crucial to enable the switch to clean electricity and fuels.

Heat constitutes about half of EU energy consumption. Just replacing oil, gas and coal in heating by 'clean' fuels (eg electricity from renewables) would require massive investment in generation, transmission and distribution. Combining the switch to clean fuels with energy efficiency measures will most likely be a more economical solution.

The persistence of coal

*SUBSIDIES

Coal remains the most polluting component of the EU energy system – it alone represented about 15 percent of EU emissions in 2018. This is profoundly damaging not only for the climate, but also in terms of air pollution, substantial fiscal subsidies for coal and global credibility (Tagliapietra, 2017). Your challenge will be to push member states to implement a speedy coal phase-out, while supporting the most-affected regions with plans to help them re-skill the labour force, re-purpose decommissioned sites and find alternative income sources for their local economies. A sensible carbon price would help the coal phase-out, but alone would not be sufficient.

Transport emissions

*ROAD
TRANSPORT

Between 1990 and 2016, EU emissions decreased significantly in all sectors except transport, which has seen an 18 percent increase (EEA, 2018b). Transport is thus becoming a key obstacle to EU decarbonisation and more aggressive policies are needed to decarbonise this sector. A particular focus should be decarbonising road transport because it is responsible for more than 70 percent of overall transport emissions. Decarbonising road transport would also improve air quality in cities, air pollution remaining the number one environmental cause of premature deaths in Europe. Tighter vehicle fuel economy standards have not sufficiently delivered and the latest EU clean mobility policies⁴ – which should be duly implemented – are still insufficient to ensure EU



You must foster transport decarbonisation, including by exploring options to reduce demand altogether

transport decarbonisation. You must foster the sector's decarbonisation including by exploring options to reduce transport demand altogether. To replace the kilometres travelled by road vehicles, public transport, alternative transport modes such as walking and cycling, and more integrated modes of mobility should be promoted. To reduce the environmental impact of freight transport, a switch from road to rail and maritime transport should be promoted, and the environmental costs of transport should be included in the final purchase price of goods. Moreover several European air routes (both within and between countries) are suitable for substitution by high-speed trains.

Guaranteeing security of supply

Ensuring stable energy supplies is one of the three pillars of EU energy policy. The EU is the world's largest importer of gas, and the decline in domestic production implies a continued reliance on imports. However, since 2014, the EU gas security of supply situation has substantially improved, as a result of developments on the international markets and the EU's internal market. First, international gas markets have become more resilient, particularly as global liquified natural gas (LNG) capacity substantially expanded across the world. In the EU, this has led to a battle for market share between Russia and the rising international supply of LNG, to the benefit of both the EU's gas security and competitiveness. Internally, declining gas consumption has mitigated the EU's import dependency. Furthermore, infrastructure developments and improved market rules have helped to create a more European marketplace for gas and reduced the excessive dependence of some member states on individual suppliers.

*GAS MARKETS

Nevertheless, you will need to make renewed efforts to further enhance EU gas security of supply, especially as the coal phase-out could increase gas demand. Several EU countries continue to remain isolated from gas hubs and remain sensitive to dependence on single gas suppliers. Regional cooperation related to gas security remains challenging, security concerns are used by several member states to undermine market rules, and the EU remains severely divided on strategic issues, from the role of gas in the EU decarbonisation process to strategic pipeline projects.

*RUSSIA

The first gas supply challenge is already on the horizon: with the end of the gas transit contract between Russia and Ukraine at the end of 2019, there will be extremely tough negotiations on a new contract. As half of EU gas imports from Russia come via this route, the EU will have an important mediating role.

Distributional consequences of climate policies

You must make every effort to ensure that decarbonisation policies are designed with a careful weighing of their distributional consequences. Managing this risk requires that the EU and its member states to properly assess the distributional effects of their energy and climate policies, and take adequate measures to address them.

3 RECOMMENDATIONS

You should fight hard to push Europe towards climate neutrality by 2050, to meet the Paris Agreement objectives and also to seize the economic opportunities offered by this global energy (and overall economic) transformation. As political capital is – as usual – limited, you should focus on a specific set of priority actions. We make five recommendations:

*CARBON PRICE

Fight for a sensible price on all greenhouse gases in the EU

Without an appropriate price on emissions, there is a risk that most other policy measures such as efficiency standards or public support for low-carbon technologies will be washed away by ‘rebound effects’ – the fact that if policies reduce the

*EMISSIONS
TRADING SYSTEM

demand for carbon-intensive production factors in one sector, those factors tend to become cheaper and will subsequently be used in other unregulated sectors. Furthermore, current taxation systems often still entail implicit subsidies to carbon-intensive activities (for example, commuting). Hence, taxation is a key policy tool to foster decarbonisation.

Currently only half of all emissions fall under the EU emissions trading system (ETS) and prices for emission allowances remain at the level as before the financial crisis (about €25/tonne) and hence significantly below the levels required for full decarbonisation. A reform is needed that makes carbon prices higher, wider (covering the not yet covered sectors) and more long-lasting (providing longer-term price signals). You should seek a European approach to avoid distortions to the internal market.

*ENVIRONMENTAL
TAXATION

To increase the sectoral coverage, you should promote a new EU-wide discussion on environmental taxation. Moreover, decarbonisation will dramatically change the demand for some highly taxed products such as electricity (increased demand) or road fuels (reduced demand). Consequently, a discussion on the fiscal impacts of decarbonisation could be a good starting point for a discussion with the ministers of finance on making the fiscal system into a driver of decarbonisation. You will need to spend a significant amount of your time and political capital on this crucial question.

Credible long-term carbon price signals are crucial for directing investment to lower-carbon solutions. One concrete proposal for enabling investment in low-carbon technologies is to protect individual investors against too-low carbon prices in the future. The European Investment Bank, for example, might issue financial guarantees that protect today's investors against the political risk of too-low future carbon prices (Zachmann, 2013). This would create investment security for the protected investments and would serve as a credible signal to unprotected investors. Such a financial commitment to reasonable future carbon prices can act as a carbon floor price and ensure a much smoother investment pathway, helping to reduce decarbonisation costs substantially.

Make electricity systems fit for high shares of renewables

Your policies should focus on allowing all technology options to play to their full strengths in the decarbonisation process. While large renewable energy units, big hydro storage and the high-voltage cross-border transmission system will continue to be the backbone of a decarbonised electricity system, new technology options such as decentralised storage, generation and load management (eg through electric vehicles and heat pumps) will provide a bottom-up vector for decarbonisation. Such decentralised solutions that can reduce the need for costly and sometimes controversial investment in the high-voltage system should be hosted by a growing and more digitalised distribution network that can become the core of the electricity system of the future. You will have to try to ensure that the regulatory system finds the right balance between providing credible signals for investment in capital-intensive infrastructure without blocking disruptive innovation.

Furthermore, jointly optimising the provisioning of transport, heating, computing and electricity services might open up a more cost-effective decarbonisation pathway (for example, using electric vehicles for electricity storage or using heat storage to reduce peak electricity demand). Allowing market participants to fully reap such efficiency gains without developing anticompetitive monopolies will require sophisticated regulatory changes.

You should work on corresponding policies, rules and standards that can make the European approach into a global blueprint for managing this complex system, and thereby supporting EU companies that develop the corresponding soft- and hardware for an emerging global market.

Fair climate policies

You should face up to the crucial issue of the distributional effects of climate policies. If climate policies are crafted without extensive consideration of their distributional consequences, there is a risk of a social backlash against decarbonisation. In order to mitigate these potential social consequences, and to ensure that the decarbonisation process moves forward with strong social acceptance, it is crucial that policies put no undue burden on the weakest shoulders. Decarbonisation can be achieved through different policy

*DECENTRALISATION

*SOCIAL FAIRNESS



Using some of the money that is currently for companies to compensate the most-affected households would be a signal that carbon pricing can reduce inequality

*REVENUE
DISTRIBUTION

pathways, and some will be better for minimising the impact on low-income households. For instance, transfers to the most vulnerable segments of the society could allow space for an increase in fuel taxes without compromising social acceptance. Public programmes to improve the energy efficiency of social housing can actually make low-income households better off in various ways. You should compare the distributional effects of different policy options in the impact assessments you will have to do for each major policy initiative. In this field, countries have the main responsibilities and competences. However, you should guide this discussion and make sure they act in a sensible and consistent manner. You could also revise the way in which revenues from the ETS are distributed. Currently, more than half of the money goes back to polluting companies, some of the money is used for low-carbon projects and the remainder is used in the general budget. Using some of the money that is currently for companies to compensate the most-affected households would be an important signal that carbon pricing can actually reduce inequality.

Export the transition – an EU flagship project

You should reinforce EU international action on energy and climate. The EU only produces 10 percent of global emissions. This implies that the only way for the EU to exercise global leadership in climate change is to move beyond its borders. To do so, you should make ‘exporting the transition’ into a flagship project. Together with other commissioners and willing member states you should design a €10 billion fund that will invest in low-carbon assets abroad. The fund’s investment in a certain country would be made conditional on regulatory

*LOW-CARBON
FUND

reforms in that country, thereby enabling and de-risking investments beyond the directly financed projects.

This will be a triple-win. First, it will help to meet Europe's climate-finance obligations and achieve the 'conditional' emission reduction commitments of the EU's partner countries. Second, it will enable European industry – which is very competitive in many of these technologies – to find new markets. And third, it can help economic development in partner countries, providing an invaluable stability dividend.

Streamline governance

You should ensure that the EU institutional structure is able to accommodate the rapid structural changes occurring in the field. This implies going beyond the established silo-thinking, fostering greater cooperation between various Commission directorates-general, including energy, climate action, environment, mobility and transport, internal market and industry and financial stability and services. For instance, electric-vehicle policies imply close cooperation between the commissioners responsible for mobility, energy, environment and growth. These services will increasingly have to interact to ensure policy consistency in areas – from electric vehicles to sustainable finance – that are inevitably cross-cutting.

You should also promote the deployment of better-informed policies. Given the limits in your competences, you must build on the soft power of transparent and convincing analysis in order to coordinate national energy and climate policies meaningfully. Energy and climate issues are typically complex and interwoven. Policymaking must therefore rely on large-scale models to inform decisions, not directly observable indicators and detailed data. The Commission cannot do such analysis on its own. Currently, the Commission outsources individual questions to many different institutions⁵. As a result, these analyses suffer from costly duplication, inconsistency, lack of transparency and potential conflicts of interest⁶. This is a wasted opportunity to build consensus on facts between decision-makers⁷ and the wide array of stakeholders (including civil society,

unions and companies) and decision-makers. To overcome this, you should establish a European Energy Agency as a go-to place for models, forecasts, indicators and data used for energy and climate policymaking⁸. For specific policy processes (including impact assessments, network development plans and assessments of national plans and targets) analyses produced by this Agency should be the formal inputs into the policy process. The Agency should be given the mission to become a trusted and transparent reference point that is also used by national and subnational parties.

NOTES

- 1 See <https://ec.europa.eu/energy/en/topics/energy-strategy-and-energy-union/governance-energy-union/national-energy-climate-plans>.
- 2 Climate neutrality means that the EU's greenhouse gas emissions do not exceed the emissions absorbed through natural (eg forests) and man-made (eg carbon capture and storage) sinks.
- 3 For example: the Energy Efficiency Directive; the Energy Performance of Buildings Directive; the Ecodesign Directive; the Labelling Directive; CO2 performance standards for cars, vans and trucks; increased financing through EU structural and investment funds, Horizon 2020 and dedicated facilities; the EU emissions trading scheme and the Effort Sharing Decision for non-ETS sectors.
- 4 CO2 emission standards, rules on public procurement of clean vehicles, rules on promoting the combined use of different modes for freight transport, and measures on batteries.
- 5 Including different Joint Research Centres, Horizon 2020 project consortia, consultants, the European Environment Agency, and Eurostat.
- 6 For example in the electricity and gas sectors, the association of network operators (an interested party) is legally required to provide input on network development plans and EU energy market design.
- 7 Including on the national level: ministries for energy and climate, energy regulators and competition authorities, national environment offices, (often state-owned) transmission system operators for electricity and gas. On the European level: Commission directorates-general responsible for energy, climate and competition; the agency for the cooperation of energy regulators; and the semi-official association of transmission system operators.
- 8 The US Energy Information Administration with an annual budget of about €100 million can serve as an inspiration. The EU already possesses an Environment Agency in Copenhagen (EEA) with a budget of around €55 million (2019) and the Agency for the Coordination of Energy Regulators with a budget of €13 million (2017), but neither carries out the described tasks.

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TO THE COMMISSIONER RESPONSIBLE FOR TRADE

By Alicia García Herrero and André Sapir

* You face three big challenges. Probably the most important is preserving the multilateral trading system, including by reforming the World Trade Organisation. Second, you must build stronger bilateral trade relations with key partners, such as the US, China and the United Kingdom. Third, you need to deal with issues such as e-commerce and climate change.

You should make contingency plans in case the WTO becomes dysfunctional or even ceases to exist.

Meanwhile, you should pursue strong bilateral trade relationships with the hope that they can form the basis for a reformed WTO. Post-Brexit negotiations with the UK should also top your agenda.

The increasing role of services, investment and e-commerce will also require much of your attention, and you will have to reflect on trade and the goals of the Paris Agreement.

- * PRESERVING THE MULTILATERAL SYSTEM
- * BILATERAL TRADE RELATIONS
- * E-COMMERCE AND CLIMATE CHANGE

1 STATE OF AFFAIRS

The European Union's trade policy, which has the goal of contributing *"in the common interest, to the harmonious development of world trade, the progressive abolition of restrictions on international trade and on foreign direct investment, and the lowering of customs and other barriers"*¹, has never faced such a difficult international environment.

EU trade policy has always been embedded within the international trading system embodied in the General Agreement on Tariffs and Trade and its successor the World Trade Organisation. When established in 1995, the WTO was given the authority to enforce trade rules through a quasi-judicial dispute-settlement mechanism, covering an increasingly large number of countries². The scope of WTO rules has also been broadened beyond trade in goods to cover foreign direct investment in services and trade-related aspects of international property rights. Unfortunately, these successes have also brought with them conflicts between WTO members, with the result that the system has become partly dysfunctional and, most importantly, risks collapsing.

A clear assessment of why the WTO has become dysfunctional should be your starting point as the new commissioner responsible for trade. Three main reasons can be identified. First, the increase in membership has brought about heterogeneity as more emerging countries joined the club. This is clearly shown by the lack of agreement on concluding the Doha round of trade liberalisation measures, which launched in 2001. Second, some new members, especially China but also Vietnam, are still state-led planned economies, a model the WTO rules have not been designed for. Third, under the Trump administration, the United States has clearly turned its back on the WTO as an institution that can solve the US's perceived trade problems.

While the EU has tried to play a constructive role in the Doha round, the lack of progress has pushed the EU to embark on a programme of bilateral trade deals with major trading partners. Between 2009 and 2013, the European Commission obtained mandates to start negotiations with the ASEAN countries³, India, Canada, Japan and the United States. It also obtained a mandate to

*INTERNATIONAL
CHALLENGES

* WORLD TRADE
ORGANISATION

negotiate a Comprehensive Agreement on Investment with China.

The EU-Canada Comprehensive Economic and Trade Agreement (CETA), the EU-Singapore Free Trade Agreement (EUSFTA), and the EU-Japan Economic Partnership Agreement (EUJPEA) will be fully operational by the time you take office. However, other bilateral negotiations remain unfinished or are pending: the EU-India talks were brought to a *de-facto* standstill in 2013 because of differences in objectives between the two parties; the EU-Vietnam trade agreement has been signed but awaits ratification at the time of writing; the EU-China investment agreement has made little progress, despite the 16 rounds of negotiations held up to April 2019; and the negotiations with the US on the Transatlantic Trade and Investment Partnership (TTIP) were frozen by President Trump a few days after he took office in January 2017.

President Trump's decision to halt the TTIP negotiations was a major setback for the EU, because, together with his support for Brexit, it sent a clear message that he considers the EU more as an irritant than as an economic partner. Along those lines, in 2018 President Trump adopted a series of decisions that further crippled the rules-based multilateral trading system. The first was the imposition of additional tariffs on imports of steel and aluminium, justified by national security concerns⁴. For the EU, the measures impacted €7 billion of exports (in 2018) to the US, and led to retaliation against EU imports from the US for an equivalent value. The Juncker-Trump meeting at the White House in July 2018 extracted a promise from President Trump to "*hold off on further tariffs*" against the EU. It also paved the way for revived negotiations on an EU-US trade free trade agreement, though much less ambitious than TTIP. In April 2019, the EU Council approved guidelines for the Commission to open negotiations with the United States on two agreements: a trade agreement limited to the elimination of tariffs for industrial goods, excluding agricultural products; and an agreement on conformity assessment that would have as its objective the removal of non-tariff barriers, by making it easier for companies to prove their products meet technical requirements both in the EU and the US.

* TARIFFS AND
RETALIATION

President Trump also imposed tariffs on imports of products from China⁵, following a determination by the US Department of Commerce that the Chinese government had engaged “*in unreasonable or discriminatory activities that harm American intellectual property rights, innovation, and technology*”. Like the EU, China has retaliated against the US, leading to further US counter measures. The EU has inevitably been affected by the US-China trade war both economically and politically. In addition to the impact on trade and investment flows, and the induced macroeconomic effects, the EU has felt the pressure from both China and the US to side with them in their mounting trade and political bilateral conflict. The EU has pushed for WTO reform as a way to reduce trade frictions and preserve the multilateral system. At the same time, the EU has hardened its position on China’s industrial policy and its impact on global trade. More specifically, the Commission has urged China to change its behaviour with respect to industrial subsidies, intellectual property, innovation and technology transfer (European Commission/High Representative, 2019).

* WTO APPELLATE
BODY

A further decision by President Trump that unsettled the global trading community in 2018 was the announcement that (continuing a policy initiated by President Obama) the US would block reappointments to the WTO’s appeals panel, on the grounds that the appellate body took too long to reach decisions and tended to overreach. At the time of writing, the appellate body is down to only three members (out of seven) of which two will end their terms in December 2019. If the US administration continues to refuse new appointments, the WTO’s dispute settlement mechanism will no longer be able to function.

No matter how difficult the external environment, that fact that the EU continues to be a large player in trade globally, even when compared to the US and China⁶, gives it the ability to influence the course of global affairs.

This is especially true since for trade policy the EU speaks with one voice. But the strength of this voice also depends on the Commission’s ability to assemble a majority in the Council and the European Parliament. Obtaining a negotiating mandate from the Council can be tricky, as was the case for the latest EU-US trade

negotiations⁷. But the more difficult part is getting the approval of the Council and the European Parliament once negotiations are completed. Members of the 2014-2019 European Parliament were split into three groups: one consistently in favour of trade deals, one consistently opposed, and the third deciding on a case-by-case basis to be in favour, to oppose or to abstain. Because neither of the first two groups commanded a majority, members of the third group played a crucial role in determining the fate of trade agreements, which meant that lobbying was intense.

All these recent international and domestic developments suggest that you will face unprecedented challenges.

2 KEY CHALLENGES AND SOME PROPOSALS

* WTO REFORM

You face three key challenges. The first and probably most important one is preserving the multilateral trading system, including by reforming the WTO. The second is to build stronger bilateral trade relations with key partners, such as the US, China and the United Kingdom. The third is to deal with issues such as e-commerce and climate change.

2.1 Multilateralism at risk

The EU's overarching principle for trade has so far been to keep the multilateral trading system working by taking an active role in reform of the WTO. The Commission has already presented a concept paper for reform⁸, mainly covering two of the three main missions of the WTO – rule setting and dispute settlement – while leaving aside further liberalisation. This is reasonable because there would be little room for additional liberalisation at a time when the existence of the WTO itself is under threat. This threat comes two sides: President Trump's profound disdain for multilateralism, and China's state-led system, which is not compatible with the liberal nature of the global trading system and might have weakened the WTO's foundations.

China has influenced the WTO's rule setting, which is intended to ensure a level playing field. In fact, it has become increasingly clear that the existing rules governing the WTO cannot adequately control the use of non-market measures designed to favour a



Several emerging countries emulate China's economic model, implying that they might not support reform of the WTO oriented towards improving the level playing field

* CHINA'S
ECONOMIC MODEL

specific trading partner (namely China) over others. To this end, the EU proposal for reform of the WTO focuses on measures including the notification of subsidies and disciplinary actions against market distorting actions by state-owned enterprises (SOEs). It should be acknowledged, though, that China's importance for global trade will increase as China's economy grows. This will be even more the case if we consider that several emerging countries emulate China's economic model, implying that some of them might not support a full-fledged reform of the WTO oriented towards improving the level playing field. This means that the EU will have increasingly difficult time in gaining acceptance for its proposal at least part of the emerging world. This is particularly the case if the US continues to disengage from the WTO.

2.2 Relations with key trading partners

There are three key trading partners that the EU can simply not obviate in its quest for relevant bilateral trade and investment relations, namely China, the US and the UK.

China

EU-China trade relations have evolved from the trust built by China's accession to the WTO to a much more cautious relationship. Still, given the large and increasing size of the Chinese market, engaging in negotiations with China to improve market access for European goods and, especially, services, should be one of the key tasks of the new Commission.

As for investment, the negotiations to conclude a bilateral investment agreement between China and the EU hinge on finding a workable solution to the structural economic differences between the two. One of the practical ways in which China's

economic model influences the EU-China investment relationship, and the conclusion of negotiations, is the leading role of Chinese state-owned companies in China's outward foreign direct investment⁹.

United States

It is hard to think of a more rapidly worsening trade relationship – besides the China-US relationship – than that between the US and the EU. One of the EU's key objectives is to reach a free-trade agreement with the US in industrial products, but the omens for such a deal are frankly not good. On the US side, there is clear dissatisfaction that the EU negotiating mandate explicitly excludes agricultural products, an area where the US generally enjoys a comparative advantage relative to the EU. On the EU side, there are also reasons to be dissatisfied. One is that the US continues to maintain additional tariffs on steel and aluminium products from the EU imposed in 2018. President Trump has even threatened to impose tariffs on cars from the EU and other countries.

United Kingdom

After Brexit, the United Kingdom will become one of the EU's key trading partners. A crucial task therefore will be to negotiate a trade deal between the EU and the UK. The EU's position is that it is willing to envisage many possibilities. It is willing to sign a customs union (CU) arrangement with the UK, which would imply the UK adopting the EU's common external trade policy, at least for goods. The EU, however, is not willing (nor legally able) to share decisions on its common external trade policy with the UK (or with any other non-EU country), which might at some stage lead to clashes between the UK and the EU over the EU policy, which the UK would be obliged to follow. The *quid pro quo*, however, would be that by staying in the EU's CU, the flow of goods between the EU and the UK would be greatly facilitated compared to a situation in which the UK would be outside the CU. If the UK decided to stay outside the CU, it would probably seek to negotiate an FTA with the EU that could be similar either to the CETA agreement with Canada or the FTA agreement with Norway, which is supplemented by an agreement that gives Norway full access to the EU's single market. Whichever option the UK chooses, difficult trade

* TRADE TENSIONS

* CUSTOMS UNION



Whichever option the UK chooses after Brexit, difficult trade negotiations will be required

negotiations will be required. It would be important to try and speed up these negotiations to maintain trade relations between the EU and the UK that are as close, and as similar to the current state of affairs, as possible.

Finally, you will need to work closely with the Council and the European Parliament to ensure ratification of the bilateral agreements that your trade negotiators reach. It was already hard enough for the previous trade commissioner and it can only get harder with the new political configuration in the European Parliament.

2.3 Services, investment, e-commerce and climate change in trade negotiations

* SERVICES

There are a number of increasingly important aspects of trade, and even more so of investment, are not fully covered under WTO rules. This is particularly the case for trade in services and e-commerce. In addition, preventing dangerous climate change is becoming a key topic on which the EU could use bilateral trade deals as leverage.

For services, the WTO rulebook is insufficient and a widely agreed definition of services is needed. Currently, WTO rules are generally looser for services than for trade in goods, and are also less widely accepted by WTO members (via reservations or exclusions). The need for greater harmonisation of definitions and practices for trade in services has become increasingly evident in the realm of forced technology transfer. While provisions exist in the WTO rulebook, their scope of application is simply too limited.

In addition, there is a lack of underlying data. For example, while the largest components of EU services trade are research and development, management and consulting, technical and trade-related services, comparable statistics only cover tourism

for most of the less-developed countries. Your first step should therefore be to further harmonise trade in services statistics. For services, WTO most-favoured-nation (MFN) principles cover tourism and, to some extent, infrastructure services, but much less so education and health services, while government-related services are virtually excluded, though the latter is becoming critical for fostering a level playing field for trade in services, which has been at the core of modern international economic transactions. In the realm of investment, one of the key issues is how to move beyond the trade-focused international dispute settlement system to a system that also covers investment issues.

The harmonisation of trade rules and dispute settlement is even further away for the newly-emerging digital trade. Regulating digital trade requires information on data flows, but control of data is increasingly being viewed as a key comparative advantage and, thus, not necessarily sharable. The reality is that if e-commerce data is not shared between different countries, the authenticity of the information is hard to verify, which could lead to a rapid increase in e-commerce-related trade disputes.

A final aspect is climate policy. The EU has taken the lead in fighting climate change but it needs to do much more to become carbon neutral by 2050. Assuming it takes the necessary measures to reach this objective, the issue of border carbon taxes will become relevant.

More generally, any bilateral trade deal signed by the EU in the future would definitively need to include chapters on services, investment, e-commerce and climate policy.

3 RECOMMENDATIONS

We make three recommendations.

First, WTO reform should be your key objective. The first-best scenario would be to convince both China and the United States to bring their bilateral discussions to Geneva and to engage in multilateral negotiations with the rest of the WTO membership to reform the WTO. However it must be admitted that the chances of succeeding in this endeavour are relatively small for the moment. You might need therefore to consider alternative approaches.

One approach would be to form an alliance. The EU would benefit from forming an alliance with key partners (including those with whom it has close bilateral partnerships, including Canada, Japan and Singapore) to uphold the principles of the multilateral trading system under the auspices of the WTO. It seems wise not to invite China and the US to this alliance in the first instance because the objectives of the participants should be fully aligned with those of the EU, namely preservation of the liberal trading system and rejection of unilateral action. In a second step, the alliance should put forward its proposals to the entire WTO membership, including China and the US, and work with them to create new rules that address fundamental issues, including the level playing field and the threats posed by state-led economies.

If this approach fails, you will be faced with two potential scenarios, both of which imply difficult choices for the EU.

First, if the reason for the failure is the refusal of the US administration to engage in multilateral negotiations aimed at upholding the system's fundamental principles, you could aim to continue operating the system in the absence of the US, but with China. The difficulty in this would be that the EU would need to accommodate China and other emerging economies that choose to follow China's state-led economic model. Clearly, such accommodation could only take place for an agreed transition period. Otherwise, the WTO would lose its liberal nature and its appeal to the EU and other like-minded economies.

In the second scenario, the WTO, or more generally the multilateral trading system, would become fully dysfunctional or even cease to exist. In this situation, we can identify two options for the EU, which could even be complementary. First would be to replicate the WTO rule setting outside of the WTO with as many partners as possible. How much Europe can push rules that are close to its current proposal for reform of the WTO will hinge on the ability to form a group of like-minded partners while being inclusive with respect to emerging economies in the second round of negotiations once the alliance has been formed. The elephant in the room is obviously China as we are assuming that the US would have no interest in a European initiative which replicates an institution that the US administration has decided to abandon

* MAINTAINING
THE SYSTEM

* CONTINGENCY
PLANNING

* BILATERAL
AGREEMENTS

or prevent from functioning. Replicating the WTO outside of the WTO would obviously not be an easy task.

Given the difficulties in pursuing a new multilateral trading system without the US, a second – more pragmatic but complementary – route, would be to launch new negotiations of bilateral trade agreements with countries relevant for the EU and willing to take this route.

Our advice is to treat these options as complementary since the former is more appealing but more difficult than the latter. The bilateral route is obviously a second best, but worth pursuing for a big trading bloc, such as the EU, which has more negotiating power than other smaller economies. Although safer, there are two clear drawbacks to pursuing both routes in parallel. The first is manpower to design and reach agreement on an inclusive new multilateral trading system, while still negotiating bilateral trade agreements. The second drawback is related to the EU itself, as starting negotiations with trading partners is becoming controversial among EU member states, as experienced in the recent EU-US case.

Our second recommendation deals with bilateral trade agreements. Here a distinction should be made between two groups of countries. China and the US fall into the first group. The second group includes like-minded countries with which the EU should pursue strong bilateral trade relationships with the hope that these relationships can also form the basis for a reformed WTO if and when the circumstances are right.

The bilateral relationship with the United States is obviously of paramount importance to the EU, but the chances of an EU-US free-trade agreement any time soon are not high. A realistic view of the EU's position on the EU-US FTA negotiation is that it must aim above all to keep the dialogue between the two partners alive, and to hope that continuing talks would signal a truce in terms of further trade measures, in particular in the automotive sector. We would caution you that President Trump, assuming he is re-elected, is likely to confront the EU with a one-sided trade negotiation under the threat of auto tariffs, and that threat will be more credible after a successful re-election and once other trade agreements are concluded and ratified. The EU needs to prepare for such a scenario.



Trade talks with China could serve as a basis to negotiate China's better adherence to WTO principles in a future reform of the system

*CHINA

The bilateral relationship with China is also crucially important to the EU. Here the negotiations need to focus on finalising the existing bilateral investment agreement. Given the prominence of the role of SOEs in such negotiations, talks could actually serve as a basis to negotiate China's better adherence to WTO principles in a future reform of the system.

As far as like-minded countries are concerned, the EU should concentrate on the G20 countries. By now the EU already has bilateral trade deals with many of these countries and it is negotiating with others including Australia. One country with which the EU has made little progress so far is India. You should devote some time and effort to exploring whether the negotiations with India should be relaunched, with a view to reaching an agreement before the end of your term.

* UNITED KINGDOM

The other obvious candidate among the like-minded countries for bilateral trade negotiations is the United Kingdom. Given the economic and political proximity between the EU and the UK, these negotiations should be top of your bilateral agenda.

Thirdly and finally, the increasing role of services, investment and e-commerce will require much more of your attention as the existing multilateral trading system covers them in a rather limited way (especially for e-commerce). Moreover, the increasing importance of climate change in the EU's policy objectives will result in trade policy being one of the levers the EU has to influence the behaviour of other trading partners in relation to environmental protection and, more specifically, adherence to the goals of the Paris Agreement. Assuming the EU adopts bold policies in order to become carbon neutral by 2050, you will have to reflect on whether and how the EU should introduce border carbon adjustment taxes in relation to countries that do not take the necessary domestic measures to comply with the Paris Agreement. On services and

*PARIS
AGREEMENT

e-commerce, the scope of the multilateral rule book needs to be extended, for which widely agreed definitions and data sharing are clearly needed. This is especially true for government-related services and, in the investment realm, for forced technology transfer. Finally, improvements in the investment realm would clearly require establishment of an international dispute-settlement system covering investment. This is obviously also true for e-commerce. More generally, to be sufficiently comprehensive, any bilateral trade deal to be signed by the EU in the future would definitively need to focus on services, investment, e-commerce and, of course, climate policy.

NOTES

- 1 Article 206 Treaty on the Functioning of the European Union.
- 2 In 1994, the GATT had 127 members. Today the WTO has 164 members.
- 3 Association of Southeast Asian Nations: Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam.
- 4 National security concerns require the use of Section 232 of the 1962 US Trade Expansion Act which is very rare.
- 5 Section 301 of the US Trade Act of 1974 was used in clear violation of WTO rules.
- 6 The EU is one of the three world trade giants, together with the US and China. In 2017, the EU accounted for 16.2 percent of world trade (exports and imports combined) in goods and services, compared to 14.1 for the US and 12.8 percent for China. But obviously the share of China has been increasing, partly at the expense of the EU and the US.
- 7 The Council granted the mandate in April 2019 with 26 countries voting in favour; see <https://www.consilium.europa.eu/en/press/press-releases/2019/04/15/trade-with-the-united-states-council-authorises-negotiations-on-elimination-of-tariffs-for-industrial-goods-and-on-conformity-assessment/>.
- 8 Available at http://trade.ec.europa.eu/doclib/docs/2018/september/tradoc_157331.pdf.
- 9 Since 2014, more than half of the value of China's overseas M&A has been conducted by SOEs (MERICS, 2019).

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TO THE COMMISSIONER RESPONSIBLE FOR COMPETITION

By Mathew Heim

* Market regulation is increasingly political and, for good or ill, competition intervention is seen as offering solutions to deeper socio-political challenges. You will face the challenge of the growing overlap between competition and trade policy. Nevertheless, your commitment should be to your core responsibilities: promoting the competitive process and guarding against anti-competitive practices, in order to maximise economic efficiency. You must continue to demonstrate that protectionist rule changes will undermine EU competitiveness in the medium- to long-term.

Your overarching task is to maintain the independence of competition enforcement and to ensure the efficient allocation of resources, applying sound economic theory to provable facts. Competition policy also needs to increase its flexibility to address the challenges posed by digital markets. On the international stage, you must more forcefully advocate a uniform understanding of the dynamic goals of competition regimes.

- * DIGITAL TECHNOLOGIES
- * INDUSTRIAL POLICY
- * INDEPENDENCE

1 STATE OF AFFAIRS

You take over the European Union's competition portfolio at a challenging time for competition policy. First, there is the rise of nationalism and significant scepticism about the European project; second, growing wealth disparity is causing scepticism about globalisation; third, concern that the European economy is losing ground to the United States and Chinese models is resulting in calls for economic populism; and fourth, there is concern about the influence of technology on the democratic process, firm concentration and systemic shocks that can be expected from technology development, notably artificial intelligence and the internet of things. European competition policy finds itself at the epicentre of these interlinking issues, putting pressure on the integrity of the competition system

*POLITICISATION

Market regulation is increasingly political and, for good or ill, competition intervention is seen as offering solutions to some of these deeper socio-political challenges. As you set out your priorities, one of your more important tasks will be to consider how far competition law can be a response to some of these issues, while ensuring competition enforcement does not become politicised. However, underlying your reflections must be a commitment to maintain the *acquis* of European competition law and the competition directorate-general's (DG Competition's) core function, as set out in the Treaty: promoting the competitive process and guarding against anti-competitive practices, in order to maximise economic efficiency.

2 CHALLENGES

Challenge 1: competition policy and industrial policy

The unravelling of multilateralism has spurred protectionist tendencies in a number of important economies, threatening the ability of European companies to compete equally. The overlap between competition policy and trade policy is therefore becoming starker. Competition policy can no longer be seen in isolation from these trends. Nowhere is this more evident than in relation to concerns about state-driven Chinese mercantilist policies that

*PROTECTIONISM

use state-controlled enterprises to further geopolitical goals. There have been calls from national European capitals for competition policy to support attempts to create European champions, to foster European economic autonomy or even to be used as blunt tool of industrial policy. While European competition policy is not able to address measures taken by third countries, it may have a role in addressing the effects of such distortions, once empirically measured.

*INDUSTRIAL;
POLICY

One of your challenges will also be to know where to draw the line between industrial policy and competition policy. The new Commission will be expected to help drive the digitalisation of European industry, and competition policy will have a role in this. Are industrial policy and competition policy merely complements? To what extent should competition policy actively support European industrial policy, for example by ensuring effective competition in particular sectors identified as key to European competitiveness? For example, should competition policy assist in fulfilling the goals of the Treaty on the Functioning of the European Union that, under Article 3, include economic growth, price stability, a highly competitive social market economy and the promotion of scientific and technological advancement? Or should competition policy be limited to executing the competition objectives outlined in the Treaty (while not undermining the other elements of the Union's objectives)?

*DIGITAL
PLATFORMS

Another challenge you will face is how to revise competition policy tools to effectively address the market power of digital platforms, where distortion has occurred. The debate is not limited to the competition community but is occurring at the highest political levels. Europe has an important role to play and should be at the forefront of these developments in competition. You will need to decide whether the arguments put forward for intervention have merit and, if so, whether these are indeed competition law issues. You should look strictly at the evidence and avoid following simplistic political argumentation and vested interests. There are clearly competition law challenges in the digital space, as there are in any other, but in addressing these challenges you should consider whether competition policy should primarily be focused on the

consumer-welfare interests of users in Europe, or on competitive dynamics. The distinction might be subtle but the impact on industry dynamics and long-run consumer welfare could be significant.

You will therefore need to consider what competition policy can bring, within the scope of the law, to the European industrial policy debate while not threatening the integrity of the competition system in Europe or the international competition system. In fact, in the international context European competition law is recognised as a gold standard globally and so your policies and acts can have major implications for global competition policy for both good and ill. As a result, you will always need to consider the impact of what you do on other jurisdictions and how the measures you take might be interpreted in third countries.

Challenge 2: competition policy and technology

Competition authorities and policymakers around the globe have been seeking the right analytical framework to assess digital technology markets, notably digital platforms, and what appropriate remedies to apply when evidence of harm is established. Despite many years of debate on whether traditional competition analysis or competition tools are sufficient, there is no consensus or whether new approaches or new tools are needed. We have seen calls (including from US presidential candidates) for the structural break-up of dominant digital platforms, for the application of essential-facilities doctrine to data, and for more nuanced measures, such as requirements to share non-replicable data.

It is likely that a consensus will form during the period of your mandate on what the role of competition policy may be. The European Commission should be at the head of policy developments on these matters. The discourse is often framed in terms of dominant digital platforms and the treatment of data harvesting, ownership and analysis (as highlighted by Crémer *et al*, 2019). Given the importance of digital technology development and dissemination, Europe should consider an approach appropriate to its market, based on accepted tenets of empirically sound competition policy.

It goes without saying that digital technologies affect all areas of the European economy. Sectors critical to European economic growth, such as financial services and the automotive sector, will see digital technologies fundamentally change their market structures. While competition from digital players, which are nimbler and less constrained by fixed costs, can bring significant short-term consumer welfare, disruption can create longer-term industrial policy challenges, such as the shift of value creation from the consumer product (such as a vehicle) to the application (such as on-board digital services). Disruption can also result in higher systemic risk (such as in financial services), or can result in a long-term shift of production of high value components from Europe to third countries. If competition enforcement occurs in such sectors, you might therefore have a significant influence over the evolution of entire value chains, critical to European interests.

Competition policies affect digital technologies across the board. For example, the Commission faces challenges related to selective corporate tax benefits for digital companies, state subsidies supporting emerging technologies that fall under Important Projects of Common European Interest (IPCEI), consolidation in innovation markets or of ‘killer acquisitions’, collusion cases arising from artificial intelligence, and standardisation efforts and dissemination. DG Competition will need to offer a coherent response across these different areas of law and policy.

Challenge 3: international antitrust comity principles

The European Commission will also face significant international challenges. There is a need for leadership in the international competition community to defend the basic precepts of modern competition law from undue political influence, while also ensuring that mechanisms exist to prevent competition authorities from using competition proceedings for protectionist measures. But it is imperative, notably in the context of digital platforms and data markets, that different jurisdictions do not take divergent approaches that would create uncertainty and costs for business, while potentially resulting in a ‘race to the bottom’.

In pursuing long-run consumer welfare, you must not lose



It is imperative, notably in the context of digital platforms and data markets, that different jurisdictions do not take divergent approaches that would create uncertainty and costs for business

sight of the fact that competition policy should also have the effect of incentivising investment in Europe and lead to the development of innovative solutions and services and their take-up by the market and consumers. And as your priorities in these areas take shape, actions taken by DG Competition must be based on objective criteria and the rule of law, in order to inoculate itself from political interference.

3 RECOMMENDATIONS

Recommendation 1: competition policy and industrial policy

There is as yet no agreement on what role competition policy should play in addressing concerns expressed by certain EU governments, notably France and Germany, about how Europe can remain a global manufacturing and industrial power . This might be because Europe's global competitiveness challenges still need to be clearly defined (Leonard *et al*, 2019). In the first instance, DG Competition must engage more confidently with member-state governments in order to set out what European competition law seeks to achieve and how it does so. This would be relevant where proposed industrial policy intervention occurs at one particular level in a value chain but will have effect the whole ecosystem.

DG Competition's strength in its analytical abilities can assist governments to identify what the underlying problems of industrial policy might be and to tailor-make appropriate solutions, whether involving a regulatory or enforcement approach. In this context it would be important to ensure that there is a clear

*COMPETITIVENESS
CHALLENGE

(structural) separation between competition policy formulation and competition enforcement function.

*SINGLE MARKET

In this debate, DG Competition must continue to demonstrate that protectionist rule changes will undermine EU competitiveness in the medium- to long-term (and indeed affect international competition comity). Rather, DG Competition should continue to support the creation of a truly single European market. Therefore, DG Competition should create a mechanism enabling a regular dialogue with member states outside individual cases (where the established mechanism remains the Member States Advisory Committee on Concentrations and on Restrictive Practices and Monopolies).

*INDEPENDENCE

Notwithstanding these challenges, your overarching task is to maintain the independence of competition enforcement and to apply your considerable powers to ensure the efficient allocation of resources, applying sound economic theory to provable facts. Competition pushes companies to enhance their productivity and output, reduce marginal costs and lower their prices or improve their products and services, thereby promoting the selection of the most efficient firms. This stimulates investment and the development of new services and products, helping to close the gap between the European Union and other leading economies on innovation performance. Therefore, you should continue to promote the use of effect-based analysis in competition assessments, based on sound empirical data. To assist you, you should continue to support the role of the Chief Economist's Office within your services, to act as a check and balance and fresh pair of eyes, in order to advise you and your senior team in case there are deficiencies in preliminary assessments.

*EFFICIENCY GAINS

There should also be a greater acceptance of the benefits of long-term efficiency gains over static losses, notably if there are sufficient guarantees that gains will materialise as a trade-off against short-term losses. This is particularly important in markets where businesses need to make significant up-front investments that need to be recouped to incentivise further investment, or where technology creation and dissemination need time to reach a pricing equilibrium reflecting economies of scale.

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Competition policy should not be seen as punishing the most successful firms without clear evidence of harm to consumers

If the competition dynamic is to reward successful firms, it is critical that competition policy should not be seen as punishing the most successful firms (whether through the chilling effect of scrutiny or through sanctions), without clear evidence of harm to consumer welfare. Otherwise, the message to the market is that ‘too much’ success in Europe is a liability and this can have a significant effect on the attractiveness of Europe as a market for investment, whether for fundamental research or for new products or services.

Finally, given how impactful competition proceedings are, DG Competition should be mindful of how intervention at one level of a value chain could affect the entire value chain. Standardised technologies are a good example, as standardisation can be the foundation of entire ecosystems. Competition intervention at a particular point in the value chain will affect incentives for companies to engage in technology research and development and have an impact on standardisation of key enabling technologies, components and devices. This, in turn, will affect competition between operating systems that build on standardised technologies, as well as the plurality of services that are provided on top (European Commission, 2017). These considerations are particularly important given the geopolitical characteristics of key enabling technologies, of global value chains, and European long-term competitiveness at each level of these value chains. In the automotive sector, for instance, the long-term objective should be to ensure the plurality of players at each level and not to, in effect, create a gatekeeper at any one level of the value chain. This will require DG Competition to have a broad overview of sectoral dynamics, and it is recommended that DG Competition should regularly pull in expertise from other relevant Commission services or external sector experts in order to understand value chains

*VALUE CHAINS

*SECTORAL
DYNAMICS

and, where needed, to set out remedies that avoid unintended consequences.

*STATE AID

Critical European sectors face pressure from international competition and from disruption brought by digitalisation. During times of economic pressure, member states might be tempted to prop up selected businesses or sectors and will call for protectionist or special interest measures. But supporting inefficient businesses often results in long-term costs. It will therefore be critical to maintain the core of the state-aid system. Guidance on European state aid rules should therefore be updated, notably to speed up approvals. Competition authorities should therefore increase their interaction with national authorities to clarify how state aid can be legally applied. The EU is already looking to state-aid measures, including Important Projects of Common European Interest¹, which can be used to increase European competitive capacity without distorting competition.

*CREATING CHAMPIONS

The European Commission has committed to “*appropriately deal with the distortive effects of foreign state ownership and state financing of foreign companies on the EU internal market*” (European Commission/High Representative, 2019). What the role of DG Competition should be in ensuring a level playing field remains controversial, with some member states calling for the relaxation of competition rules to permit the creation of European champions. It is strongly recommended that accurate data is gathered to assess the actual market impact of distortions created by third-country governments. This should be undertaken by a taskforce drawn from across the Commission services. The understanding of markets and analytical skills that DG Competition possesses will be an important addition to such a taskforce. Once a source of distortion is identified, a horizontal taskforce should coordinate the range of possible solutions including trade defence, procurement rules, competition rules or proactive investment and growth policy. Such taskforces can be set up for any significant threat to European economic autonomy, and be structured around a country, sector or even a technology. Competition enforcement decisions would stand outside this process.

European competition policy might have a role where there is *prima-facie* evidence of market distortion caused by

*STATE-OWNED ENTERPRISES

state-controlled enterprises (SOEs), directed by third-country governments. It is strongly recommended that DG Competition sets out clear policy guidance on how it addresses competition abuse by SOEs, covering notions of control and coordination; of market power (given that SOEs might not be profit maximising and can therefore behave independently of competitive constraints); theories of harm to the competitive process, such as buyer power, predatory pricing or discrimination; and touching on pragmatic matters including sanctions for lack of cooperation with the European Commission. Such guidance will also assist DG Competition in taking a coherent approach to SOEs and in its enforcement prioritisation.

*MERGERS

In the merger field, DG Competition can also issue guidance on its practice of reviewing SOE transactions and take a more consistent approach. Such guidance will notably be important for national competition authorities (NCAs) when they scrutinise transactions involving SOEs, given the divergent approaches taken to date. Indeed, DG Competition could consider amending the European merger control rules to give it jurisdiction over notifiable SOE transactions in order to ensure coherence in approach (or at the very least, to require NCAs to notify to DG Competition of the existence of such a transaction). On a more technical point, there is some logic to more flexible analyses of market contestability and market entry, if the threat of market entry can be established in fact (eg where industry players are actively seeking to mitigate threat of entry over that period, even in the long term). If it cannot be established, then the European Commission or member states should have the time to institute pro-competitive industrial policies to address any threat, rather than relying on competition enforcement.

Recommendation 2: competition policy and digital technologies

Competition policy needs to increase its flexibility to address the challenges posed by digital markets because digital markets might – although not always – challenge received wisdom born from ‘brick-and-mortar’ competition-policy solutions. For example, notions of ‘classic’ competition enforcement are being challenged

*DIGITAL MARKETS

by new business models relating to zero-price markets, competing for the market, multi-sided markets, reliance on economies of scale and data-heavy markets. As a result, the simple application of traditional analytical tools might not be appropriate. Market shares might not be a relevant proxy for market power where a dominant platform ‘envelops’ a new market, and classic price increase methodologies (eg the small but significant and non-transitory increase in price – SNNIP – test) might not be relevant in non-price markets. However, we do not believe that notions of market power, market definition and contestability require a revolution in themselves. Rather it should be possible to rely on triangulation of multiple scientific measurement systems in order to establish critical elements in competition cases, whether related to market definition or power, because the notions of contestability, lock-in and distortion of the competitive process remain core to the competition analysis of digital platforms.

DG Competition has a critical role to play in setting what could become a globally-recognised framework for analysis of digital and technology markets. This is particularly important in relation to data-centric markets. Technology markets are increasingly complex, raising additional challenges given their rapid evolution and as technology becomes implemented across more ‘traditional’ sectors of the economy. Importantly, the debate could be further clarified by breaking down definitions. We see the policy debate focused on ‘dominant digital platforms’ and ‘data’ whereas, by their very nature dominant digital platforms are heterogeneous (especially where the competition is for the market, rather than on the market), depending what data they gather, and how and what it is used for (eg data gathered by supermarkets, search engines, credit-card companies, machine-to-machine or cars). DG Competition should seek to promote a common understanding to address verifiable competition distortions. This is in particular relevant when considering potential remedies to ensure contestability and to maintain the competitive processes. For this reason, a more appropriate filter through which to view competition issues might be harmful to the competitive process, as it encompasses dynamic consumer welfare and establishes contestability criteria.

*DIGITAL
DOMINANCE



You should engage in proactive market monitoring, as a standard practice in markets that are key to European economic competitiveness, including financial services, automotive and internet of things

You should ensure that DG Competition engages in proactive market monitoring, as a standard practice in markets that are key to European economic competitiveness, including financial services, automotive and internet of things. We further recommend that DG Competition should hire more software and technology engineers to better understand market dynamics and ensure relevant enforcement action. This is important in order to correctly assess dynamic or innovative markets and issues linked to them, such as the debates on innovation mergers, efficiency defences and killer acquisitions. We further recommend that DG Competition should identify future topics on which it could launch a dialogue with the competition community in order to reach common understandings and provide preliminary guidance to markets. For example, DG Competition could engage with companies, legal advisers, engineers and others on understanding how artificial intelligence and deep-learning algorithms could potentially result in market distortion, and how this could be avoided, for example through instructions to avoid price parallelism.

The greater the focus on industrial value chains by policymakers, the more important it will be for DG Competition to understand market trends and how market intervention might affect the competitive balance throughout value chains. In order to continuously refine DG Competition's understanding of digital markets, we recommend, in addition to *ex-ante* monitoring, proportionate *ex-post* assessment of decisions as standard practice in order to assess the effect of intervention on long-run consumer welfare and on non-competition effects including data protection, network security and financial stability.

*EMERGING TOPICS

Recommendation 3: international antitrust comity principles

On the international stage, DG Competition should more forcefully advocate a uniform understanding of the dynamic goals of competition regimes, including through the Organisation for Economic Cooperation and Development (OECD) and the International Competition Network (ICN). In particular, DG Competition should work more closely with other Commission services, notably your trade colleagues, to promote a hard-edged and effective international comity regime (giving effect, where appropriate, through competition chapters in trade agreements), so that DG Competition can assist in ensuring that Europe's *important interests* under comity principles – in both competition and industrial policy respects – are protected, when third-country jurisdictions apply competition rules to such interests. This will be important if authorities around the world diverge in their analyses and competition enforcement in the digital sector. Given that sometimes Europe's important interests will not relate to competition matters but broader industrial policy interests, or that third-country jurisdictions might act on direction from ministries, other services in the Commission will need to be informed, engaged and if need be, enabled to act towards their natural third-country interlocutors, as needed.

In addition, DG Competition must continue to play a full role in the work of international organisations, such as the OECD and ICN, to foster fundamental due process norms that will help prevent antitrust protectionism by avoiding enforcement with a predetermined outcome, and also to improve the quality of competition law around the world. European competition law principles must continue to be influential in competition jurisdictions across the world, to avoid an 'race to the bottom' or undermining of the entire system.

NOTES

- 1 See https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1517560605813&uri=OJ:-JOC_2018_039_R_0003.

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TO THE COMMISSIONER RESPONSIBLE FOR SINGLE MARKET AND INDUSTRY

* A well-functioning single market with enforced competition rules has traditionally been considered the best industrial policy the EU could choose. But global developments, related especially to the emergence of big digital technology firms from China and the United States, have left European companies behind.

You will need to tackle the horizontal challenge of reinforcing single market policy areas, especially for services and public procurement, while taking on the vertical challenge of identifying key targets on which to concentrate, being careful to avoid picking losers.

In choosing targets for support, it is better to support many initial endeavours, addressing the difficulties of emerging networks. You should also work to coordinate national industrial development programmes, and regional smart specialisation initiatives.

- * HORIZONTAL CONDITIONS
- * CHOOSING PLATFORMS
- * COORDINATION

*GLOBAL
COMPETITION

You take over a file that is critical for Europe's economic future. A well-functioning single market with enforced competition rules has traditionally been considered the best industrial policy the EU could choose. Specific interventions supporting champion firms have been considered as distorting competition, and not effective in promoting growth and jobs. But global developments, related especially to the emergence of big digital technology firms from China and the United States, have left European companies behind. To restore and secure the EU's position in a new global competitive environment, you will have to ask if we can still rely on an industrial policy focused on the single market and competition policy, or if we need a new version of industrial policy. Before we make some recommendations on what this new version might look like, we first describe the state of affairs and the challenges you inherit.

* DIGITAL
TECHNOLOGIES

1 STATE OF AFFAIRS

The European Union continues to lag behind in terms of technological developments compared to the US and China, in particular with respect to digital technologies. At the same time, there is an increasing dispersion of productivity across firms. Some 'superstar' firms are pushing forward the frontier of technological evolution, and are star performers in productivity growth (David *et al*, 2017; Van Reenen, 2018). These superstar firms are typically bigger, more innovative and have higher rates of digital technology adoption (Bessen, 2017). Laggard firms, often small and medium-sized (SMEs), have a hard time to keep up, falling further behind on productivity growth. With superstar firms increasingly dominant, many industries are becoming 'winner-takes-all' and are experiencing increasing concentration. This is the case particularly for sectors in which digital technologies, especially digital services, are developed or intensely adopted. In these sectors, the leaders are typically American or Chinese (Calligaris *et al*, 2018). As far as the EU is concerned, there is evidence of a somewhat smaller concentration of market power in superstar firms compared to the US (Gutiérrez and Philippon, 2018). For some, this is evidence that EU competition policy works better than its counterpart in the US;

* SUPERSTAR
FIRMS

* ARTIFICIAL
INTELLIGENCE

another aspect, however, might be down to the EU largely lacking leading firms at the technology frontier, especially in digital technologies (Veugelers, 2018).

While the EU has fallen behind in the digital technologies and services race, which is currently dominated by US or Chinese companies including Amazon, Qualcomm, Google, Huawei and Alibaba, the question is whether the EU will be able to take leading positions in the new races to come. These will be centred on the integration of new digital technologies, including advanced digital services, the internet of things (IoT) and artificial intelligence (AI), into manufacturing and services, with the emergence of network-based production processes that will profoundly reshape traditional value chains. For example, car manufacturing, a pivotal sector for the EU economy, faces the shift from the internal combustion engine to electric propulsion (Fredriksson *et al*, 2018), with the required technological advancements to make this happen, most notably better battery technology. But car manufacturing also faces the development of a whole series of new digital services (smart electricity grids, personalised entertainment systems, smart mobility), which are all part of a network centred on the physical ‘platform’ represented by the car. These services are based on the evolution of IoT and AI technologies, the development of which in turn depends on the setup of an ecosystem adequate for their emergence. The Galileo Global Navigation Satellite System, to be completed by 2020, will be a physical platform via which advanced digital services can be provided, but its commercial development at full potential critically hinges on the ability of EU firms to develop those services.

* DIGITAL
SERVICES

If European firms are unable to develop and integrate new digital-technology intensive services into the evolving paradigm of production, they will not win the races of the future, even in those sectors where they are currently still leading. It is concerning, for example, that the EU in 2018 was responsible for only a 10 percent share of global digital services research and development, and an 8 percent share of global digital services sales, compared to 73 percent and 57 percent, respectively, for the US (digital services refers to software and computer services). Europe’s shares of AI

and digital data transfer patents from 2010 to 2015 were only 12 percent and 7 percent respectively¹.

In this context, you should take steps to redesign EU industrial policy to avoid repeating past failures and falling further behind.

2 CHALLENGES

* INDUSTRIAL
POLICY

Single market regulation for products and services is a major instrument for EU industrial policy. The integrated EU market, in which fair and open competition is guaranteed, remains the world's largest and as such offers unparalleled economies of scale in the development of new production processes that, by their nature, are characterised by high fixed entry costs. However, the single market is still incomplete, particularly in services, including services that are pivotal for formation of some of the new production platforms. To be effective, the single market should not be confined to product and services markets, but should extend to integrated capital and labour markets, to allow EU firms unimpeded access to skills and risk capital for their innovative efforts. These important complementary single market policy areas are, however, outside your portfolio and will require coordination with other commissioners, a challenge your predecessors all struggled with. Beyond the need to further integrate the single market, there is also the need to protect it in its current form against the forces – including Brexit and populism – that would move it into reverse gear.

* IDENTIFYING
TARGETS

In addition to the horizontal challenge of reinforcing single market policy areas, there is the vertical challenge of identification of key targets on which to concentrate. There is the ever-present risk of picking 'losers' or those that need permanent support, or those that did not need the support in the first place. There is also a risk of capture and rent-seeking, especially when selection processes are not transparent and the rules of selection are not clear.

Another challenge you face in developing an integrated industrial policy at the EU level is the current proliferation of industrial-policy initiatives at national or even regional level across the EU. For example, Germany, France and Italy have all developed their own versions of 'Industry 4.0' programmes – programmes aimed at supporting the adoption by companies of state-of-the-art,

* NATIONAL
INITIATIVES

* SMART
SPECIALISATION

* CHINA AND
THE US

digital-intensive technologies. The German government is coordinating some of the technology platforms developed by large German multinationals². The French government has identified a number of key technologies on which to focus public and private investment, among them aerospace and car batteries³. The Italian government has created a tax credit scheme to stimulate investment in ICT⁴. Moreover, EU regions are developing ‘smart specialisation’ strategies, in particular within less developed EU regions and countries, an action explicitly stimulated by the EU through its regional policy framework (RIS3)⁵. Coordination of all the national and regional ‘Industry 4.0’ industrial policy initiatives will be another key challenge for you. In particular, it is important to develop common standards across national boundaries for the communication and machine-to-machine integration protocols required for the development of new technologies, while avoiding duplicating initiatives. Failing to coordinate would hamper the full exploitation of the size of the EU market and the related economies of scale: these are key for EU firms to establish sustainable positions from which they can compete on a global scale, in particular in those winner-take-all settings where size is critical.

Another challenge is related to the external dimension of the new industrial policy, taking into account the tough global competition and the global configurations of technology platforms and value chains. The rise of Chinese state-controlled or sponsored business and policy models, and the recent attitude of the US government, which has become more inclined to protectionist intervention aimed at nurturing and protecting local champions, both clearly challenge EU companies that must compete fairly in the global arena, both between and within platforms. You must maintain an open perspective in this context, in terms of developments both inside and outside of the EU, while defending a fair level playing field for EU companies.

3 RECOMMENDATIONS

Before reading our recommendations, it is worth recalling some of the key technological races that will shape the near future. These



Digital technologies, big data and services are being continuously improved, and will be the basis for more and more complex arrays of activities and offerings

will revolve around a number of platforms, powered through digital technologies (such as AI), big data and services, which are being continuously improved, and on which a more and more complex array of activities and offerings will be developed. Among the most prominent examples of such platforms are connected cars and connected products and devices (IoT).

While the EU in principle could be well placed, thanks to its strong industrial tradition, EU success still requires, among other factors:

* BOOSTING
INNOVATION

- A boosting of R&D and innovation efforts, both at the basic and applied level, with a particular focus on applications based on digital technologies;
- As data is essential as an input for these platforms, entry barriers should be reduced through adequate forms of data access and sharing, and through the development of common communication protocols. Clearly, as the ongoing debate around the EU general data protection regulation (GDPR, (EU) 2016/679) has shown, an adequate balance has to be found between economic opportunities and privacy;
- Aiming at the widespread adoption of the newly developed digital technologies and services by firms, especially SMEs;

* SKILLS

- Developing an adequate pool of skills in the workforce, to match the required capacities associated with these new digital technologies;
- Channelling sufficient financial resources available via capital markets to the large fixed and risky technology investments needed, especially for start-ups and scale-ups;

- Refining regulatory policies in the area of energy and environment to make them suitable to the emerging needs of new production processes⁶.

This non-exhaustive list makes it clear that you will need to navigate between different policy instruments, areas and levels. What follows are recommendations on how to do this.

Find a good mix of horizontal and vertical approaches to industrial policymaking at EU level

The pure horizontal approach of creating general framework conditions (the approach more or less used by your predecessors, using the single market and competition as EU instruments), has failed to boost adequately the EU's competitiveness and has failed to put the EU at the frontier of the digital transformation. However, taking a pure vertical approach involving picking specific technologies, sectors or champion firms, and throwing money at them can also be ineffective. Both approaches will have to be pursued as complements.

The vertical approach allows a more specific targeting of those activities that are strategic for the EU's long-term competitiveness and welfare, in which the EU has unique sustainable capabilities to develop and capture value-added, and where policy interventions are needed to address missing framework conditions. Meanwhile, the horizontal approach addresses those missing framework conditions that are non-specific to the chosen targets. A solid horizontal policy base will reduce the costs of picking the wrong targets or missing the right targets. For example, should the EU choose electric cars or hydrogen or both? Framework conditions also enable the blurring of boundaries across sectors and technologies to be better dealt with. For example, in the case of electric mobility, should the EU target all of, or only some of, car manufacturing, car components such as batteries, complementary infrastructure such as charging stations, or mobility sharing services? Adequate framework conditions would mean market forces can easily compensate should the EU priorities not deliver, miss relevant targets or be shown to have been focused on the wrong or too narrowly defined targets.

* STRATEGIC
TARGETING

* FRAMEWORK
CONDITIONS



You should seek to ensure an adequate ecosystem for the birth and development of technologically advanced production platforms

Improving the horizontal approach: deepening the single market

The aim of the horizontal approach is to ensure an adequate ecosystem for the birth and development of technologically advanced production platforms. This requires at EU level an extended combined single market and competition approach.

You should aim to:

- Complete the single market for non-digital services (as diverse as retail, transport, hotels and banks) and eliminate the market fragmentation still existing: the enlarged market and the increased competition stemming from a truly integrated single market for various services would incentivise the development of new offerings based on technology platforms making use of digital products and services.
- Complete the single market for public services/public procurement: a large, open and competitive public procurement process would ensure access to more efficient and effective public services; it would also create a larger enhanced market for EU firms supplying to public services.

Outside your direct policy competence, with instruments in the hands of colleague commissioners, it is necessary to:

- Complete the digital single market by creating a large, open and competitive single market for digital products and services: increased access to digital technologies and data for business-to-business services will create a positive feedback loop for new technology platforms that make use of digital products and services⁷;
- Complete the integration of EU financial markets, especially the capital market segments most relevant for the financing of the research, innovation and digital investments needed to support the development of new technology platforms;

* COMPLETING THE SINGLE MARKET

*DIGITAL SKILLS

- Create a single market for skills, ie make it easier for firms to access skills, especially digital skills, across national borders. This requires more work on mutual recognition of diplomas, and the introduction of a European professional card to reduce intra-EU mobility costs. It also requires a recalibration of the European Social Fund for the 2021-27 EU budget, broadening support for specific national initiatives on digital education and on the training and retraining of workers;

*COMPETITION ENFORCEMENT

- Implement transparent enforcement of competition rules; competition enforcement should be up to date in terms of detecting and redressing harmful abuse in the new digitally powered platforms, without jeopardising any static and dynamic efficiencies from their large size.

For such a horizontal EU industrial policy, effective coordination between your instruments and those of other commissioners (particularly those responsible for digital services, competition, research,) is needed. As you hold the pivotal single market portfolio, you should play a driving role in this coordination process.

Addressing the vertical challenge: identification/targeting of 'champion platforms'

Extending the single market to the previously identified policy areas will allow the creation of relevant framework conditions in which market forces can efficiently identify winning platforms.

*PLATFORMS

But on top of this, you will also need to take a vertical approach that targets specific platforms. You should be very explicit on the criteria used to select specific targets. Platforms can be given favourable treatment to help them maintain or build sustainable positions on world markets, positions that they, without government support, would not be able to achieve because of market failure (for example, EU firms might be too small or young to reach critical scale and overcome barriers to entry) or unfair competition (rival firms supported by their governments).

To avoid policy-choice errors, it is better to support many initial endeavours, addressing the difficulties of emerging networks, rather than a few large permanently funded projects. Also, targets should be chosen through a process of calls and competitive

selection of bottom-up proposals, rather than the selection of a few targets through a top-down, ill-motivated political selection process. Finally, it is important that the selection process does not result in protection for incumbents. The process should be fully open to new innovative approaches.

Once targets have been identified, the next step is identify the missing critical conditions for developing activities within the selected targets, and the policy actions that are needed to address these, above and beyond a pure horizontal approach. Clearly, the policies in such a vertical approach are not so much about providing a pot of public money for the selected winners, but more about developing a target-specific horizontal policy, ie creating framework conditions/removing barriers for the development of activities in the selected target area.

*CLIMATE GOALS

High priorities as target areas should be those aimed at addressing climate change, one of the most pressing challenges for European society. Empowered with the newest (digital) technologies, these industrial policy target areas can contribute to reaching the EU's climate goals, while carving out new competitive strengths for EU firms on global markets. But these target areas could be vulnerable to market failures. Because of this, a more biting carbon price instrument should be part of the industrial policy toolbox. Although it is not your portfolio, you should still push for it, because without a proper price on carbon, your instruments will be much less effective.

Addressing the coordination challenge

To coordinate the various 'Industry 4.0' programmes at national and regional level, the EU can leverage the national reform programmes developed within the European Semester and the regional RIS3 smart specialisation programme: the broad EU industrial policy framework should become embedded in the member state national reform programmes and the regions' smart specialisation programmes. Regular evaluation of these programmes by the Commission should be high on your agenda, as it will create the space for coordination of national industrial policy initiatives.

*NATIONAL
REFORM
PROGRAMMES

Moreover, in defining the new Community Support Framework for the use of Structural Funds in the 2021-27 budget period,

specific references should be made to policy actions centred on the development of the identified technology platforms at EU level, which would better link the national and regional operational programmes to the overall EU industrial policy approach, and would naturally improve coordination. Specifically, it would be important to reorient the competitiveness objective of the European Regional Development Fund (implemented by already developed EU regions) towards the EU's industrial policy goals. Finally, it would also be important to target part of the funds traditionally reserved to cross-border regional initiatives to the development of cross-border industrial policy actions. All this will require close coordination with your colleague responsible for regional policy.

External issues

The process of selection of the key technology platforms on which the EU should concentrate its policy measures should not generate protectionist pitfalls, ie it should not lead to the protection of incumbents from the creative-destruction process associated with the new global situation. Rather, it should empower EU firms to be global winners.

*OPENNESS

In order to maximise the creation of value added within the single market, the EU market should also remain open to the import of frontier technologies and best practices, wherever they are initially developed. For this, it is important to continue the work at the World Trade Organisation on trade-facilitation measures.

Adequate opening has to be maintained also for foreign investors to access the single market, clearly within the boundaries of the European strategic interests, as defined by the new EU framework for the screening of foreign direct investments, which entered into force in April 2019⁸.

Addressing the lack of an evidence and effects-based industrial policy strategy

In order to implement effectively a coordinated industrial policy strategy, which is well balanced between horizontal and vertical approaches, you should move towards an evidence/effects-based approach. You should invest in building a sufficiently large

monitoring and evaluation unit within your directorate-general that will provide you with the evidence you need to guide your policy choices on targets and instruments, and that can coordinate with other such units in other directorates-general. In assessing effects, a set of key performance indicators, differentiated in terms of the platforms around which the policy is going to be organised, need to be identified at the time of selection of the target. Their (total or partial) fulfilment should be used as part of *ex-post* monitoring and evaluation. Examples of these key performance indicators could include the percentage of worldwide electric car batteries that are EU-made by a given year, the EU's share of connected machinery in industry worldwide, the EU's share of worldwide R&D in key platforms, or the number of workers whose retraining in key digital-related activities has been supported by the European Social Fund by country.

NOTES

- 1 Patent data refers to share of patent families file at the five major patent offices (European Patent Office, US, Japan, China and Korea).
- 2 See <https://www.bmbf.de/en/the-new-high-tech-strategy-2322.html>.
- 3 See https://www.economie.gouv.fr/files/nouvelle_france_industrielle_english.pdf.
- 4 See for Germany; for France https://www.economie.gouv.fr/files/nouvelle_france_industrielle_english.pdf; for Italy <https://www.mise.gov.it/index.php/it/industria40>
- 5 See <http://s3platform.jrc.ec.europa.eu/what-is-smart-specialisation->.
- 6 For example, in the case of the electric car platform, the EU would need to develop multiple, high-powered recharging stations throughout its territory compatible with electricity grids, while new types of waste (eg used batteries) will need to be treated.
- 7 See the memo in this volume to the commissioner responsible for digital services, content and networks.
- 8 See <http://trade.ec.europa.eu/doclib/press/index.cfm?id=2006>.

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TO THE COMMISSIONER RESPONSIBLE FOR DIGITAL SERVICES, CONTENT AND NETWORKS

By J. Scott Marcus

* Digitalisation will be at the core of maintaining Europe's economic sovereignty, supporting the EU's climate strategy and ensuring economic growth, employment and competitiveness. Relevant and fast-moving developments include artificial intelligence (AI), the data economy and robotics – areas in which the EU has weaknesses.

Key measures you should take include pushing for public funding for AI and robotics, and promoting private funding for digital start-ups and scale-ups. You should also examine how digital technologies can help the EU reach its climate and environment goals, for example through new approaches to transport.

Because digital is everywhere, you will need to work closely with your colleagues, including the commissioners responsible for climate, energy, employment, transport and industry.

- * ARTIFICIAL INTELLIGENCE
- * DIGITAL INVESTMENT
- * GREEN ICT

You take over a vitally important file for the future of Europe – digitalisation. Moreover, you step into this role at a critical point in time, implying a need to follow a different line to your predecessors. Whereas they might have viewed themselves as stewards of the digital sector, today digital is nearly everywhere, and a large part of your task will be: 1) to take whatever steps are necessary to facilitate the completion of the ubiquitous transformation of European business, government and society to a modern, digital basis; and 2) to ensure the continued competitiveness of Europe in an increasingly globalised and digitalised world.

That digitalisation has become widespread poses a challenge for you – the potential scope of your responsibilities greatly exceeds your authority. An integrated approach to digitalisation as a horizontal enabler for all sectors is called for, and this has implications not only for the policies you will pursue, but also for the manner in which you will interact with other European Union institutions, with your colleagues within the Commission, and with the member states. It also implies a need to maintain focus, since your area of responsibility touches nearly everything the Commission does.

The centrepiece of digital policy from 2014 to 2019 was the Digital Single Market (DSM) Strategy (European Commission, 2015a). This sought to boost the European single market primarily through the facilitation of cross-border electronic commerce within the EU. Dozens of legislative measures have been enacted (Marcus *et al*, 2019). This is all well and good, and has likely produced real benefits, but most of the gains that could potentially be achieved in this way have already been achieved. The next round of problems will not be solved using the same tools. It is time to declare victory and move on.

1 STATE OF AFFAIRS

The challenges Europe faces overall flow directly into the challenges you will confront as the commissioner responsible for digital services, content and networks.

Digitalisation is key to ensuring Europe's economic sovereignty (Leonard *et al*, 2019), supporting the climate strategy and ensuring economic growth, employment and competitiveness for the EU¹.

The world stands on the threshold of a transformative change thanks to digitalisation with possibly huge effects and resulting losers and winners. Consider for example:

- **Artificial intelligence (AI) and machine learning:** The collective potential value of these technologies in conjunction with the use of big data is enormous. For instance, McKinsey (2013) estimated that automation tools could take on knowledge work *“.. equal to the output of 110 million to 140 million full-time equivalents ... [with] as much as \$5.2 trillion to \$6.7 trillion in economic impact annually by 2025.”*
- **The data economy:** IDC Italia and the Lisbon Council (2018) estimated the direct value of the data market in the EU28 at €50 billion in 2017, with the potential to grow to €77 billion in 2020 and €110 billion in 2025. Spill-overs into the broader EU28 economy based on the use of the data are much larger, representing €787 billion in 2025.
- **Robotics:** Take-up in Europe is substantial, especially in Germany. Globally, advanced robotics *“has the potential to affect \$6.3 trillion in labour costs,”* according to McKinsey (2013).

Pressure from global trading partners and competitors

In just the past few years, the geopolitical system has been transformed. Many of the geopolitical challenges are directly relevant to you because many of them relate to digital technologies.

The EU is weak in key digital areas. Leadership in key technologies such as AI and machine learning has historically rested with the US, but is shifting rapidly to China. In 5G, another key technology, the US is not even a player while EU firms lag behind the frontier. Europe notably lags in AI, and much of Europe’s expertise in AI is in the UK, which might soon be leaving the EU. None of the largest digital business-to-consumer platforms are based in Europe.

At the same time, Europe has strengths that should not be underestimated. Europe does better than the US on business-to-business online platforms, and tends to be much better than the US in a number of areas involving industrial automation and its intersection with AI.

Is Europe's weakness in some areas a problem? In the past, we might have argued that it was largely irrelevant whether enabling technologies were produced by European firms or by firms headquartered in our main trading partners. A corollary argument was that the gains to the EU from cross-sectoral use of these technologies were more important than potential gains from producing the technologies.

This argument is not convincing today. Technologies including AI and robotics are clearly dual use, which is to say that they have both civilian and military applications. Partly as a result, there are moves in the US to limit foreign investment in these areas, to limit visas for visiting foreign nationals (including citizens of NATO allies) and to impose export controls, with enabling legislation already enacted². US measures have mainly targeted China, but the reliability and predictability of supply chains is inevitably called into question.

The most obvious ways in which to address the lack of predictability and stability of supply are: 1) by broadening the number of countries or regions from which Europe is supplied in order to spread the risk; and 2) by becoming increasingly self-sufficient in the production and deployment of key transformative technologies such as AI, machine learning, big data, robotics, the internet of things, transmission technologies such as 5G and key networks (Leonard *et al*, 2019; Farrell and Newman, 2019). The EU cannot hope to become self-sufficient in all of these areas, so it will be important to focus on technologies that are: 1) most critical; 2) most vulnerable to supply disruptions; or 3) for which it is most difficult to find alternate sources of supply.

This naturally raises the question of whether Europe is investing enough. This is a matter for public and private investment. This has implications not only for EU and member-state investments (which typically also hope to encourage private investment), but also for those aspects of the Capital Markets Union that seek to facilitate private investment in high technology. In terms of public investment:

- China has launched a comprehensive initiative to lead the world in AI development³, and intends to invest massively in AI

*PREDICTABILITY
AND SECURITY

*INVESTMENT

*ARTIFICIAL
INTELLIGENCE

research and development (He, 2017; Webster *et al*, 2017). The magnitude of the investment is difficult to estimate, but is large.

- The United States, its historical scepticism about industrial policy notwithstanding, is deeply concerned about the Chinese programme. The US already invested roughly €1 billion of public money in 2016 (European Commission, 2018; US National Science and Technology Council, 2016). Expanded countermeasures in response to the Chinese programme can be expected with the risk that Europe suffers ‘collateral damage’.
- Europe has fallen behind in private investment in AI. In 2016, European private investment in AI amounted to €2.4-€3.2 billion in 2016, compared to €6.5-€9.7 billion in Asia and €12.1-€18.6 billion in North America (European Commission, 2018).

Thanks to its purchasing power, the EU can influence policy, and in some cases can lead. On data privacy, for example, even though many US firms initially opposed the general data protection regulation (GDPR, (EU) 2016/679), many of the largest US platforms now hope that most countries will adopt GDPR-like privacy arrangements. These firms have already internalised the cost of compliance, and would prefer to comply with one rigorous set of rules rather than with dozens of sets of rules of varying quality.

*CYBERSECURITY

Diverging approaches to cybersecurity are also evident, especially in relation to government surveillance for national security purposes. Since these reflect different views about the degree of free expression that should be allowed, divergent approaches are likely to persist in relation to cyberwarfare, fake news, election manipulation and more.

Worldwide agreement on these difficult themes seems unlikely in a world in which cooperation is breaking down; even so, some multinational initiatives show promise. Within the World Trade Organisation, the plurilateral initiative to establish new rules for e-commerce might gain sufficient traction. It might also conceivably be possible to reach agreement on rules for autonomous weapons.



The shift from fossil-fuel power plants to high shares of variable renewables such as wind depends on digital technologies

* GREEN ICT

Climate and environment

The EU remains committed to the goals of the Paris Agreement, but results have been mixed and greenhouse gas emissions have not yet fallen convincingly. The aspects most relevant to your portfolio relate to energy consumption, and especially to green ICT. The shift from fossil-fuel power plants to high shares of variable renewables such as wind depends on digital technologies that serve to adjust demand, dispatch power and adapt network operations to fluctuating feed-in of renewable energy in real time.

A special challenge for climate and environment measures is the risk of rebound effects. If a public policy measure improves the efficiency of energy utilisation, it is likely to lower the cost of the product or service in question, which will tend to increase the level of consumption. The increased consumption might wipe out part or all of the gains that the measure sought to achieve (Zachmann and Marcus, 2019).

2 CHALLENGES

Key challenges for the coming five years include: 1) the pace at which technological change is driving transformational change not only in firms and government, but in all societal arrangements, including the nature of work, and the need for digital training and re-training; 2) the breadth of policies that need to be addressed simultaneously; 3) limited EU competence in many of the areas where joined-up action appears to be needed; and 4) the increasing difficulty of achieving international cooperation, especially with the US and China.

Pressure from global trading partners and competitors

Ensuring that the EU achieves its potential as a digital player

is largely within your remit. Responsibility for most of the key actions needed rests with other commissioners, but you will need to act as a ‘digital champion,’ maintaining pressure to enact measures that promote innovation and the digitalisation of European business and society. Key portions of the Capital Markets Union, for instance, have been stalled for too long.

Digital has been prominent in disputes between the US, China and the EU. For these issues and for more to come, you will have a key role to play. On a range of issues including privacy, cybersecurity and fake news, you will need to show leadership. Relative to cybersecurity, the European Network and Information Security Agency is a key asset.

There is in particular a thought leadership role you could play in cases where the US or China try to push inappropriately Europe to take sides in their conflicts over digital technology. The Commission recommendation on ‘Cybersecurity of 5G networks’ (European Commission, 2019) is a case in point.

Climate and environment

Your primary challenge in this area is that, while digital plays a supporting role in most of the measures that are needed, in most cases the lead responsibility is elsewhere. Only in relation to green ICT will you have lead responsibility.

3 RECOMMENDATIONS

Your staff could employ instruments to directly implement policy within your explicit remit for digital services, including:

- **Regulation** of digital services, and also of relevant equipment;
- The **setting of standards**;
- The use of **trustmarks**;
- The creation of **public-private partnerships**;
- The creation of **expert panels** to provide guidance and to inform the public; and
- Any portions of the **Horizon Europe** research funding programme that are allocated to your area of responsibility.

Some of these are ‘soft’ mechanisms, but they can nonetheless have useful effect. In discussing digital measures that could be



Strengthening European entrepreneurship is important for reducing the risk of ICT supply chain disruption and to enhance EU global competitiveness

* BETTER
REGULATION

used to benefit climate and environment, we provide an example of how these mechanisms could work in concert.

Other measures might require cooperation with other commissioners, or with the member states. For issues where digital technology is central, you need to demonstrate leadership and to line up the necessary institutional support.

General principles that you should follow include:

- **In formulating public policy, take a strategic view and adopt an EU Better Regulation perspective:** Define problems, identify possible solutions, provide comparative assessments of options and choose approaches that are most likely to be effective, efficient and coherent with one another and with other EU policies. More focus on top-down policy analysis and economic analysis is needed.
- **Do not be afraid to lead at international level:** In many of these areas, Europe can move the global debate forward. Tools for doing so are not limited to formal negotiations.
- **Enlist the public:** More can be done to facilitate the European public's understanding of digitalisation, and thus to enlist their support.

* ICT SUPPLY
CHAIN

Pressure from global trading partners and competitors

Strengthening European entrepreneurship is important not only as a means of reducing the risk of disruption of the ICT supply chain, but also as a means of enhancing EU global competitiveness. You should promote of the following key measures:

- **Public funding for AI and robotics.** More public investment is likely to be needed in these potentially transformative

*EQUITY FUNDING

technologies (beyond that already foreseen in the 2021-27 Multiannual Financial Framework and the Digital Europe Programme), especially in AI and robotics, in order to maintain EU competitiveness. The Commission's proposal⁴ to invest €9.2 billion through Digital Europe is in the right direction. Digital (and also climate) are major focus areas for Horizon Europe funding⁵.

- **Private funding for start-ups and scale-ups.** The Capital Markets Union (CMU), which included some measures in this area, has made scant progress. EU start-ups and scale-ups continue to suffer from a lack of venture capital, challenges in conducting IPOs, and problematic and inconsistent insolvency regimes. You should push your fellow commissioners to take steps to facilitate equity funding, especially for innovative SMEs⁶.

Protecting competitive advantage where Europe has it is likewise important, and has arguably received too little attention to date. You should work with your colleagues to take appropriate steps to better protect EU intellectual property, both for EU firms working in third countries and where third-country firms have invested in EU firms.

Promotion of the use of ICT is likewise important and might be more actionable than many of the measures to promote production. Use of ICT in the EU by large corporations is reasonably good, but ICT use by SMEs continues to lag. E-government could also benefit from more focus. You should be sure to make effective use of any allocations from InvestEU and from the European Innovation Council (an updated version of the Horizon 2020 SME Instrument).

*E-GOVERNMENT

Actual deployment of cross-border e-government services has languished, not primarily for technical reasons, but rather because the relevant services in the member states are so diverse.

Lack of trained ICT professionals is an impediment to both production and use. Training and education are important in dealing with the disruption to jobs that digitalisation is causing. Education and training are primarily a member-state responsibility, but you should be alert to opportunities for the EU to play a supporting role.

Issues related to privacy, cybersecurity, fake news and election manipulation will continue to percolate over the coming years. You will not have the lead in all of these areas, but are likely to be involved in all cases. Your role as head of a centre of expertise will be vital.

International negotiations addressing many of the same issues, as well as taxation of digital firms, will be challenging during your term, but they are not hopeless. You should look to build alliances with your counterparts in like-minded countries and find common ground where possible with countries that tend to have a different approach.

Climate and environment

No single ‘silver bullet’ will achieve the European goal of carbon neutrality by 2050, but there are a huge number of individual measures that could potentially help. Many of those measures are mutually complementary, but others are not, and in any event there are trade-offs to be made as to the amount of energy and resources to be applied to each instrument.

Broadly, a distinction can be made between measures that affect residential, commercial or industrial consumption of energy, and measures that affect production of energy.

On the consumption side, some measures seek to reduce consumption, while others seek to improve efficiency and to reduce waste. Some seek to reduce or improve the use of energy, while others seek to reduce or improve the use of materials (since materials also play a large role in global warming)⁷. Many of the most promising measures benefit from digitalisation.

On the production side, most measures entail shifting the production of energy from fossil fuels to various non-polluting and renewable sources. Digital technology is fundamental to the ability to flexibly shift from one power-generation source to another, and to take advantage of a mix of renewable sources and of energy storage (such as, for example, the batteries of electric cars).

On the consumption side, there are many sectors where digitalisation could generate substantial net gains. For example:

- **Digitalisation of agricultural production and distribution**

*TRANSPORT

could offer surprisingly large benefits. The FAO (2013) estimated that roughly one-third of all food produced for human consumption in the world is lost or wasted, corresponding to 3.3 billion tonnes of CO₂ needlessly produced per year.

- Continued modernisation and digitalisation of the **transport sector** to favour public transport over the ownership and use of private vehicles saves both energy and materials. Sharing vehicles (a collaborative economy activity) could generate 13 percent to 18 percent less CO₂ emissions (Nijland and van Meerkerk, 2017). Avoiding transportation altogether through increased telecommuting and teleconferencing could play an important complementary role.

Green ICT is an aspect of consumption that is specifically within your remit. Improving data-centre efficiency, for instance, is an area where you could do more to work with market players, including US online platform providers.

Extending the product lifetime of ICT devices is another aspect of Green ICT. Exploring creative potential approaches to a particular problem can serve to demonstrate that you have tools that can be brought to bear.

*PRODUCT LIFECYCLES

Consider, for example, that mobile phones and tablets are typically able to operate in principle for four to five years, but most are replaced within two years (which historically was roughly the lifetime of the battery). Some users always want to have the latest technology, but there is good reason to believe that at least half of mobile devices are replaced either 1) because the manufacturer no longer is willing to support the software; or 2) because the battery has died, and cannot be replaced by the user. There are valid economic reasons why a manufacturer might prefer a design that does not permit the battery to be changed⁸, but this economic calculation is made without pricing in the negative externality of the e-waste generated.

A general EU framework is already in place to promote energy efficiency (the Ecodesign Directive, 2009/125/EC), but it has mainly been brought to bear on devices such as clothes dryers with high energy consumption, rather than on low energy

*ECODESIGN

consumption devices that require frequent replacement. It has not been applied to mobile phones or tablets – an area that is highly visible to EU consumers. There have been multiple calls to take stronger action on smart phones and tablets at EU level (European Parliament, 2018; ANEC and BEUC, 2018) in order to promote sustainability over the full product life cycle, taking into account composition, durability, disassembly, reparability and recyclability.

There are different ways in which policy might attempt, consistent with the existing EU codesign framework, to shift the balance to reduce needless waste. An outright prohibition on the sale or importation of devices with short product lifetimes has been tried elsewhere⁹, but is an extreme solution that has negative impacts on competition and on consumer choice. A much less-intrusive approach, but with uncertain effectiveness, would be to create or adapt trust marks or ecolabels to favour mobile devices for which the manufacturer has committed support for at least, say, four years, and where either the battery is exchangeable or the battery can be shown to have an effective lifetime under normal use of at least four years. A more forceful approach would be to levy an excise tax on mobile devices that fail to meet these criteria, which ideally would be coupled with a subsidy (funded by the excise tax) for devices that comply. Reducing the cost of compliant devices with a subsidy would help to avoid burdening price-sensitive consumers.

Institutional issues

Digital is everywhere. This means that your remit is very broad, broader than your authority.

*COOPERATION

This implies a need to shift from a vertical, sector-specific focus to a horizontal focus where much of your work will entail cooperation with other commissioners. For climate and environment, this implies closer interaction not only with your colleagues responsible for those areas, but also with colleagues responsible for transport, energy and industry. For issues of social protection, you should work closely with your colleague responsible for employment. The portfolio you inherit has already been moving in that direction, but the shift from vertical to horizontal needs to accelerate¹⁰.

NOTES

- 1 See the memo in this volume to the presidents of the EU institutions.
- 2 Measures taken by the Trump administration against China in general and against Huawei and ZTE in particular demonstrate that supply chains can be disrupted abruptly and arbitrarily, with little warning. See for example Jon Russel, 'Huawei can buy from US suppliers again — but things will never be the same,' *TechCrunch*, 1 July 2019, available at <https://techcrunch.com/2019/06/29/huawei-us-supplier-ban-lifted/>, and CBS News, 'Huawei ban could hurt chipmakers, raising fears of tech layoffs,' 21 May 2019, available at <https://www.cbsnews.com/news/huawei-ban-sanctions-could-hurt-chipmakers-raising-fears-of-tech-layoffs/>.
- 3 The 2017 *Next Generation Artificial Intelligence Development Plan*, available in English at <https://chinacopyrightandmedia.wordpress.com/2017/07/20/a-next-generation-artificial-intelligence-development-plan/>.
- 4 See http://europa.eu/rapid/press-release_IP-18-4043_en.htm.
- 5 See the memo in this volume to the commissioner responsible for research and innovation.
- 6 See the memo in this volume to the commissioner responsible for investment.
- 7 Circle Economy and Ecorys (2016) claim that more than “50% of our greenhouse gas emissions are related to material management”.
- 8 Raymond Wong, 'Smartphones with removable batteries are never coming back,' *Mashable*, 1 January 2018, available at <https://mashable.com/2018/01/01/why-phones-cant-have-removable-batteries-anymore/>.
- 9 Joel Hruska, 'New Bill Mandates Replaceable Batteries in Consumer Electronics,' *ExtremeTech*, 31 January, available at <https://www.extremetech.com/mobile/263101-washington-state-mulls-bill-mandating-replaceable-batteries-easily-repaired-consumer-electronics>.
- 10 A number of institutions and experts have suggested that it is time to re-integrate the approach to the digital and the non-digital aspects of the single market. Notably, a 2018 Presidency discussion paper on the future of the single market (Council of the European Union, 2018) observed that “there is no need for a Digital Single Market but rather for a digitised Single Market.” This emphasises the need for a more joined-up approach to digital policy.

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TO THE COMMISSIONER
RESPONSIBLE FOR
RESEARCH AND
INNOVATION

* The EU's science and innovation performance is mixed. Overall spending on science is still behind EU targets, with business R&D a particular contributor to the lag. However, the EU has caught up with the US in scientific quality terms.

Your main focus will be Horizon Europe funding. You should aim to make it as effective as possible in supporting socially and environmentally sustainable EU growth, including by addressing major challenges, including climate change.

You should ensure good mixes in Horizon Europe of top-down and bottom-up instruments, and of upstream science, pre-commercial research and downstream innovation. You should build on the success of the European Research Council and ensure the EU offers a high level of researcher mobility and is open to talent from around the world.

- * HORIZON EUROPE
- * BUSINESS RESEARCH AND DEVELOPMENT
- * EFFECTS-BASED APPROACH

1 STATE OF AFFAIRS

Science, research and innovation have the power to take Europe into a prosperous, clean, safe and healthy future for its citizens. But what progress is the European Union making? Table 1 shows some key data on its past research and innovation performance.

Depending on how optimistic you are, you can read the current state of affairs as encouraging or as a wake-up call.

*RESEARCH
SPENDING
GOAL

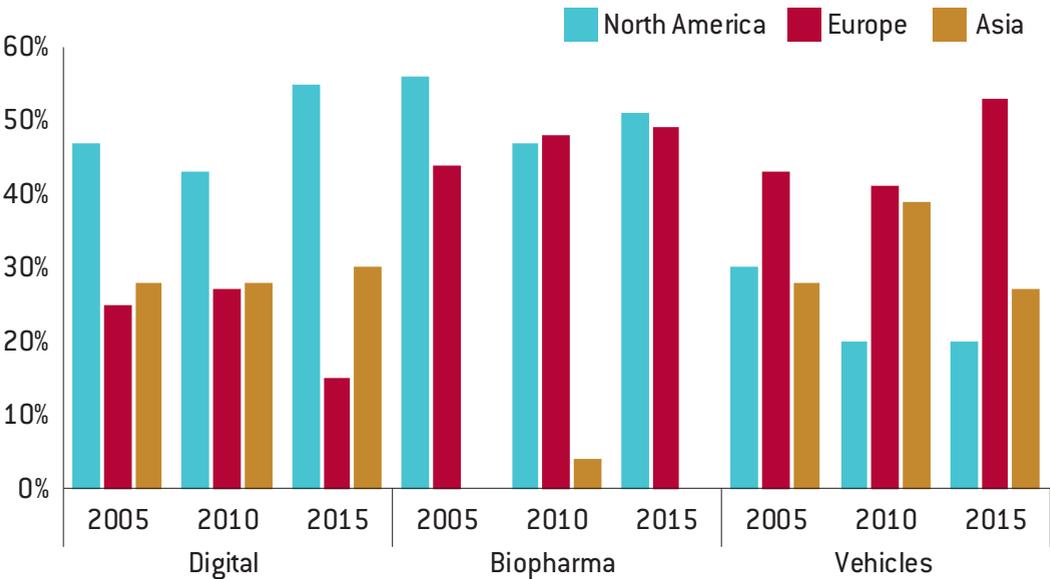
- On the share of GDP spent on research, the EU is, with less than 2 percent, still far away from the 3 percent target that was supposed to have been achieved by 2010¹. The EU continues to have a persistent R&D deficit compared to the US. There has been some progress, but this has been confined to some EU countries, most notably Germany, while others, such as Italy and Spain, have continued to lag behind or have even gone backwards. The business sector is responsible for most of the persistent EU deficit. In terms of public spending on R&D, the deficit relative to the US and China is less problematic. The EU has progressed slowly while China has moved rapidly, and has overtaken the EU in R&D-to-GDP numbers, including for corporate R&D.
- On science, quality matters. The key issue is whether the EU is producing high-quality science, as measured, for example, by the EU share of the world's top 1 percent of most cited scientific publications. Here, there is some cause for optimism, as the

Table 1: R&D comparative data, EU, US and China

		EU28	US	China
Research and development (% of GDP)	2010/2016	1.84%/1.93%	2.74%/2.74%	1.71%/2.11%
Business R&D (% of GDP)	2010/2016	1.12%/1.24%	1.86%/1.95%	1.26%/1.63%
Government-financed R&D (% of GDP)	2010/2015	0.65%/0.62%	0.89%/0.70%	0.41%/0.44%
Share of global corporate R&D spending	2014/2018	29%/27%	36%/36%	4%/10%
Share of top 1% most-cited science publications	2010/2014	35%/36%	41%/36%	10%/17%
Share of world top 100 universities	2012/2017	29%/30%	53%/48%	0/2%

Sources: OECD, Main Science and Technology Indicators; National Science Foundation; Academic Ranking of World Universities (Shanghai Ranking); EU Industrial R&D Investment Scoreboard of 2500 Largest Corporate R&D spenders in the world.

Figure 1: Regional R&D spending: shares of spending by top 10 percent largest R&D spenders in their sectors



Source: Bruegel, based on EU Industrial R&D Investment Scoreboard data. Note: numbers are calculated from a time-comparable sample of 202 biopharma companies, 466 digital companies and 99 automotive companies.

***SCIENTIFIC QUALITY**

EU has caught up with the US. China is a rising star in quality science, but still has some way to go before it catches up at the frontier of science. There has been catching up by continental EU countries, but about 30 percent of the EU’s top 1 percent publications originate in the UK, a scientific powerhouse the EU might soon lose. The EU’s science quality performance is thanks to pockets of excellence in specific sub-fields. Continental EU countries still do not have enough world-class universities that excel in a broad range of fields and are able to compete with their US counterparts in world university rankings, such as the Shanghai Ranking. Of the top 20 universities, only UK and Swiss institutions represent Europe.

***BUSINESS AND R&D**

- In terms of business-sector research and innovation, the EU’s persistent business R&D gap is not due to its incumbent innovators in classic sectors of strength – automobiles and pharmaceuticals – but because Europe is missing innovators who can assume world-leading positions in digital sectors (especially in

digital-services sectors). In these sectors, which are increasingly important parts of the corporate R&D landscape, the new leading firms are US or Chinese. And even in the EU stronghold of automobiles, firms are increasingly being challenged by the new wave of interconnected, autonomous and electric cars.

2 CHALLENGES

The challenges you face are many and various. EU science, technology and innovation (STI) policy should help to address the challenges of ensuring a prosperous EU economy that provides well-paid jobs, health, safety and a clean environment for all.

The challenges are not new. Up to now, the EU's STI approach has not been particularly successful in responding to these challenges. Unfortunately, the challenges have become more urgent and must be addressed in the context of a changing global environment in which China is becoming an STI powerhouse. The EU still needs to learn how to interact better with China's growing STI capacity in order to use it to accelerate the EU's catching up.

On climate change, the risks are increasing. The EU STI machine needs to be switched into higher gear to deliver faster. The longer this is delayed, the more difficult it will become, as delivery of research results cannot be easily speeded up.

While the challenges are sizeable and urgent, your powers to address them are being undermined. First, with Brexit, you run the risk of losing a pivotal part of the EU's STI capacity. The UK is a research powerhouse, and even a temporary pause in its participation in European research programmes and policies, and particularly an interruption of researchers' mobility, will be a loss.

But even within the EU27, there is an increasing divergence between countries on the importance of supporting STI. Scepticism is increasing on the value added of EU STI policy instruments.

Your major tool is the part of the 2021-27 EU budget that will go to research: Horizon Europe, the successor to the current Horizon 2020. Although a sizeable budget is proposed for Horizon Europe – about €100 billion at time of writing – and although this is set to

*SOCIETAL
CHALLENGES

*BREXIT



Stakeholders and member states mainly see the discussions on the Horizon Europe budget as a zero-sum exercise in which they ask “what’s in it for me?”

increase over time, reflecting the EU’s commitment to research, it represents only a small share of the total public budget for STI spent in the EU by member states. Even more problematic is that in the discussions on how to use the budget, it is mostly seen by stakeholders and member states as a zero-sum exercise in which they ask “*what’s in it for me?*”, rather than as an instrument that will enable the EU’s STI machine to address EU societal challenges to the benefit of all.

3 RECOMMENDATIONS

Most of the focus at the start of your term will be on how the Horizon Europe budget will be allocated to which pillars and instruments.

Your main aim should be to get the most out of Horizon Europe, making it as effective as possible in supporting socially and environmentally sustainable EU growth.

3.1 An effects-based approach

Taking an effects-based approach will require not only looking at how to best spend the €100 billion Horizon Europe budget, but also at how to best leverage that spending. It also means ensuring that Horizon Europe complements other public funding at EU level (eg structural and regional funding), European Investment Bank and European Fund for Strategic Investments funding, and the much bigger pots of national and regional funding for research and innovation. It also means ensuring that complementary policies are in place at EU and member-state level to address any

*HORIZON
EUROPE

*COMPLEMENTARY
FUNDING



Taking an effects-based approach requires a capacity to make micro and macro assessments of long- and short-run impacts from public science funding

*MONITORING
AND
EVALUATION

missing framework conditions necessary to leverage research and innovation investment into sustainable economic effects. Such conditions include open and competitive product and services markets and well-functioning capital and labour markets. You will have to coordinate closely with colleagues because the tools to shape the framework conditions, including competition policy, trade policy, regulations and standards, and carbon pricing, are mostly in their hands, or are the responsibility of member states or regions. You should therefore seek to influence the working of the many formal and informal bodies involved in EU STI policy.

Taking an effects-based approach requires a monitoring and evaluation capacity that encompasses *ex-ante* and *ex-post* micro and macro assessments of long- and short-run impacts from public STI funding. This cannot be done on the basis of *ad-hoc*, outsourced, confined exercises, but should involve a permanent in-house monitoring and evaluation capacity that will be able to combine internal and external expertise much more effectively. A pivotal tool for assessing impact beyond STI will be proper macroeconomic and environmental models that encompass the full potential of STI as a driver of sustainable growth, with all its direct and indirect effects. What makes STI particularly powerful as a driver of growth is its indirect spillover effects, which can only be assessed within a broader macro framework. Such macro models will enable better assessment of the overall short- and long-run impact of EU research and innovation policies, such as Horizon Europe, and also of other research and innovation funding at country and regional levels, and complementary policies affecting the functioning of product and labour markets and educational

systems. You should therefore invest in an in-house monitoring and evaluation capacity, with appropriate resources and expertise.

You will need this resource not only to improve your own major instrument, Horizon Europe, but also to support your pivotal role in coordinating with other EU and member-state policymakers, by providing evidence on what is needed to maximise the benefits from Horizon Europe. You will need the backing of quality analysis if you want to be in the driver's seat in the multitude of coordinating bodies you will have to participate in.

3.2 Horizon Europe

Cohesion and excellence

In the ongoing discussions with national stakeholders on Horizon Europe, you will need a convincing strategy to rebuild trust in EU instruments and move national stakeholders towards taking a positive-sum perspective, away from their zero-sum perspectives. This will require hard evidence of how Horizon Europe and an integrated EU area for innovation will provide benefits for member states beyond the euros that are directly allocated to them. You will need to instruct your monitoring and evaluation unit to identify which complementary national or regional policies are needed to get the most out of Horizon Europe in each member state.

Such evidence will help you switch the debate on 'excellence versus cohesion' to a debate on 'excellence for cohesion', showing that cohesion should not be seen simply in terms of equal distribution of inputs. What matters more for cohesion is the extent to which an excellence-based EU STI policy can generate greater impact for all, also in cohesion regions.

The sharing excellence pillar proposed under Horizon Europe, with 2 percent of its total budget, fits into this discussion. It can be used as an argument for the cohesion criterion to not be applied as a selection criterion for the other pillars, which should be solely based on excellence and/or impact. The sharing excellence pillar is also rightly targeted at supporting member states and regions in improving their national or regional capacities to absorb and benefit from excellent research and innovation created anywhere in the EU and beyond. You will need to instruct your monitoring

*SHARING
EXCELLENCE

and evaluation unit to assess whether this sharing excellence pillar will be effective.

Top-down versus bottom-up

Horizon Europe should have a good mix of bottom-up and top-down instruments. The trend in Horizon Europe compared to the past is to move more towards top-down instruments.

It is proposed that more than half the Horizon Europe budget will be allocated to ‘global challenges/missions’ (pillar 2), which is the top-down pillar. The bottom-up pillars, with investigator-driven proposals, are the open science and open innovation pillars (pillars 1 and 3). These take up respectively 25 percent and 14 percent of the proposed budget. Whether this is a good allocation or not should be analysed by your monitoring and evaluation unit. It is important to note that the bottom-up open science and open innovation pillars, even if their selection criterion is solely excellence and not impact, will also be important contributors to the addressing of global challenges/missions. You should ask, for example, the European Research Council to report to you how many climate-change projects they funded and their impacts. You will be pleasantly surprised. In the current political climate of asking for more immediate results from public funding, you should protect these bottom-up pillars from top-down pressures. These pillars will give you the option to address challenges that you might not have yet identified, but that the entrepreneurial scientists and innovators might have. Even under the global challenges pillar, the challenges are and should be sufficiently generally described so that there is room for bottom-up initiatives to identify how best to address them.

Horizon Europe’s top-down second pillar – challenges/missions – should be sufficiently openly specified to avoid capture – in other words, to avoid being suitable only for incumbent capacities. The missions, especially those in the new EU-wide research and innovation missions programme², will be co-designed with citizens, stakeholders, the European Parliament and member states. Such co-design and co-determination of missions risks leading to stakeholder-driven allocations and specifications

*OPEN
SCIENCE

*EUROPEAN
RESEARCH
COUNCIL



It will be important to ensure a good mix in Horizon Europe of upstream science, pre-commercial research and downstream innovation

*CLUSTERS

that best fit existing stakeholders. They should be open to new approaches and new participants. You should work to keep these missions open to all.

In line with the EU's overall priorities, the proposed allocations to clusters from the roughly €50 billion budget under the second pillar prioritise the climate and digital challenges (30 percent each to digital and industry, and to climate and energy). The urgency of the climate change challenge could easily justify even higher funding. The remaining allocations (food and natural resources, 20 percent; health, 15 percent; inclusive and safe societies, 5 percent), look very path-dependent. The inclusive and safe societies priority in particular arguably has too small a share in light of the current societal challenges.

From science to innovation

*OPEN
INNOVATION

A next important issue is to ensure a good mix in Horizon Europe of upstream science, pre-commercial research and downstream innovation. Horizon Europe takes a clear step forwards towards supporting innovation. This is most clear in the introduction of an Open Innovation pillar, with €13.5 billion of proposed funding and a new instrument: the European Innovation Council (EIC)³. You can easily justify increased support for innovation in relation to issues raised in section 1 of this memo. Europe produces great science, but typically succeeds less in turning this great science into great innovative successes. The EU's aspiring entrepreneurs, particularly young more-radical innovators, face obstacles in bringing their ideas to commercial fruition, particularly in relation to access risk finance. Public funding support could help to address this barrier.

This problem is well known and longstanding, and various support schemes already exist in member states and at EU level (for example, the European Investment Fund). The question is whether there is a role for a new instrument, as proposed in Horizon Europe. You can justify the value added of the EIC over other similar instruments by referring to its scope. Building on the success of the ERC, which has a selection process that has become a true seal of excellence, the EIC could likewise exploit applications and evaluating experts from across the EU and become a reputable label of excellence. Similarly to ERC grantees, being an EIC grantee could and should become a valuable certification for successful applicants, which will help them secure additional funding and other recognition. For the EIC to offer value added over and above national schemes, it is critical for to become a quality label, like the ERC. For this, it is critical that you install an EIC governance model like the ERC, based on a sufficiently autonomous council composed of recognised technology leaders, who can design the programme and select the evaluators. The potential for EIC value added is more obvious for the early stages of financing, when certification is much more critical, less so for later accelerator phases of financing. You should therefore prioritise the early-stage pathfinder EIC instrument over its accelerator instrument.

Back to science

The open science pillar, with about €25 billion of the proposed Horizon Europe budget, is perhaps the pillar that might be seen as less of a priority, simply because of its well-established instruments. But it would be wrong to take them for granted.

The ERC's success story might have been remarkable but its formula needs to be protected. A critical ingredient of its successful formula (to be replicated by the EIC) is the autonomy and independence its scientific council has in designing grants and selecting evaluators⁴. This autonomy is accompanied by accountability against clearly-defined targets aligned to the ERC mission of supporting frontier research, and there is no need for further oversight of the ERC. But you should protect the ERC autonomy-accountability model.

*MARIE CURIE ACTIONS

The excellent science pillar contains another instrument, Marie Skłodowska Curie Actions (MSCA). This programme is pivotal, but has not been recognised as such (see Box 1). It is pivotal because it is the EU's dedicated instrument for supporting the mobility of EU researchers between EU countries and to non-EU countries, the mobility of researchers who come to the EU from outside, and mobility between academia and industry. Researcher mobility is key for STI capacity. Mobile researchers bring their knowledge and the connections when crossing geographical or institutional boundaries. Researcher mobility is thus a critical pathway for knowledge networks, collaboration and spillovers. Mobility underpins better leverage of the full benefits of public investment in STI.

*RESEARCHER MOBILITY

Some time ago, for unclear reasons, this instrument left your portfolio and ended up with the commissioner responsible for education. It should be moved back into your portfolio, or you should at least work closely with your colleague. In any case, it needs to be revamped. Only a very small part of the current MSCA budget, itself already relatively small, is spent on individual fellowships for mobility and research-staff exchanges. Most of the MSCA budget is for doctoral training. The sums spent on mobility between academia and industry, and on fellowships for non-EU researchers and EU researchers outside the EU, are also minimal. Most of MSCA mobility is intra-EU and so far, exchanges involving the countries that joined the EU in 2004 and after have been limited.

MSCA should be expanded to cover more exchange between academia and industry. It should also introduce new fellowships involving academia and start-ups. Sending EU researchers across borders from academia to industry and from academia to start-ups will help bridge the gap between science and the commercialisation of innovative ideas.

*ACADEMIA- INDUSTRY EXCHANGE

There should be more individual fellowships and return fellowships aimed at helping lagging member states catch up. Enabling researchers to move from catching-up countries to excellent research destinations will help in building research excellence and will boost lagging countries when their researchers return home.

Box 2: Marie Skłodowska Curie Actions (MSCA) in Horizon 2020 (2014-20)

- 8 percent of the Horizon 2020 budget went to the MSCA programme, equivalent to about €6 billion, an increase from €4.7 billion in the previous seventh framework programme budget;
- Most MSCA funding goes to training of doctoral students: 54 percent of the MSCA budget is for Innovative Training Networks;
- Only 27 percent of the MSCA budget goes to individual fellowships for PhD holders. Another 9 percent goes to research staff exchanges;
- 80 percent of the budget for individual fellowships is for intra-EU mobility. Only 20 percent is for mobility to and from third countries;
- The US is the major third country, accounting for somewhat more than 40 percent of all third-country participants. China accounts for less than 5 percent;
- Countries that joined the EU in 2004 and after account for only 6 percent of all MSCA participants; the EU15 for 87 percent. The UK is the major beneficiary, accounting for about one quarter of all MSCA participants;
- Only 1 percent of the MSCA budget goes to the ‘Society and Enterprise’ panel, which funds individual fellowships in companies. Another 4 percent goes to European Industrial Doctorates. Of the research staff exchanges, less than half is for mobility between academia and non-academia;
- 2 percent of the MSCA budget goes to reintegration: fellowships to bring back EU researchers from outside the EU.

Source: Bruegel, based on Cordis and the European Commission’s interim evaluation of Horizon 2020 (https://ec.europa.eu/info/publications/interim-evaluation-horizon-2020_en).

There should be more individual fellowships and return fellowships linked to non-EU countries. Hosting top non-EU researchers and sending EU researchers to the best places outside the EU, and maintaining links with those places, will help the EU connect better to leading research countries. China, in particular, is significantly underrepresented currently in MSCA.

More targeting of MSCA to specific challenges/missions would help improve the knowledge spillover in key challenge areas. More

mobility between academia and industry in targeted areas, such as digital technologies, would help address the skills shortfalls that hold up industry from engaging in these new technologies.

This revamping could be done by reshuffling the MSCA budget, but in view of its small size, it would be better to find extra money to support MSCA fellowships by dedicating some of the other Horizon Europe funding (for example, from the sharing excellence pillar or the challenges pillar), or other parts of the EU budget (such as the structural funds).

Finally, the selection process for MSCA individual fellowships should be improved. The fellowships should become, like the ERC, a recognised seal of excellence.

Open to the world

It is important that the EU is connected to the other global centres of science excellence. Past and current framework programmes have not been very successful in establishing links with the best science countries. The EU's relationships with third countries that are at the frontier of science should be greatly intensified. Selection on the basis of excellence should become the priority for agreements with third countries, with the US and China being among the highest priorities. Links with China in particular should be strengthened.

You also need to consider the future relationship with the United Kingdom. The UK has been a major net recipient of framework programme funding and has also been a major contributor to EU STI excellence and impact. The UK has also been an important hub for incoming and outgoing EU talent and for intra-EU collaboration, and has been a major gateway to non-EU countries, collaborating with and attracting their talents. You should be concerned about the loss inflicted on the EU27 by separation from an important source of EU science and innovation excellence. Minimising this loss should be your focus, rather than the money the EU27 would recover from the UK leaving or what price the UK should pay to join the European Research Area. Minimising the damage requires an integrated research area with the UK, with the opportunities for cross-border mobility of talent and collaboration

*THIRD-
COUNTRY
LINKS

*EUROPEAN
RESEARCH
AREA

safeguarded as much as possible. Your monitoring and evaluation unit should help you with the evidence on the win-win areas to be safeguarded. Such evidence will also allow you to quantify how much the EU27 would be willing to pay to keep the EU on board, and also what should be asked for from the UK for its continued participation.

Open science

*OPEN ACCESS

The principle of maintaining open access to publications and data that result from EU-funded research should be applied to Horizon Europe. Scientific results from public funding should be available to everybody. But you could give the world of open science a big boost by using your power as an important funding agency to negotiate with publishers fair prices for providing open access. You can also ask your colleague responsible for competition to look into pricing behaviour in this sector. What should be ensured is that EU public funds designated for open research do not end up being transferred into excessive publishers' mark-ups.

NOTES

- 1 See http://ec.europa.eu/invest-in-research/action/history_en.htm.
- 2 See https://ec.europa.eu/info/designing-next-framework-programme/mission-oriented-policy-next-research-and-innovation-framework-programme_en.
- 3 The EIC is not really new, but a revamping of the SME instrument from past framework programmes.
- 4 Between 2012 and 2016, the author of this memo was a member of the ERC Scientific Council.

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TO THE COMMISSIONER
RESPONSIBLE FOR
ENLARGEMENT AND
NEIGHBOURHOOD POLICY

* Preparations for accession in the formal and potential EU candidates have slowed down as a consequence of slow progress in institutional and economic reform, unresolved regional conflicts and limited appetite for further enlargement among EU member states. Meanwhile, in the last five years, the security situation in the EU's immediate neighbourhood has deteriorated markedly.

In terms of enlargement, you should maintain potential EU accession as a credible and attractive option for candidates and potential candidates, while finding models of cooperation with adjoining countries that do not include the prospect of membership.

European Neighbourhood Policy needs a profound revamp to enable institutionalised cooperation in mutually beneficial areas, which will be open to each country that fulfils the specific criteria and whose strategic interests do not undermine the EU.

- * ENLARGEMENT READINESS
- * NEIGHBOURHOOD POLICY
- * STRUCTURED COOPERATION

1 STATE OF AFFAIRS

In the last five years (2014-19), the European Union's enlargement and neighbourhood policies have recorded modest results.

1.1 Enlargement

Since Croatia became a member state in July 2013, the preparations for accession in the formal and potential EU candidates in the Western Balkans have slowed down. This is a result of slow progress in institutional and economic reform, unresolved regional conflicts (Dabrowski and Myachenkova, 2018) and limited appetite for further enlargement among EU member states. The latter has been caused by, among other factors, the legacies of the European financial crisis of 2010-2015, the refugee crisis of 2015-2016, external migration pressures and deterioration in the area of rule of law, civil and political freedoms in some of the member states that joined the EU in 2004 and 2007.

It was only in September 2017 that European Commission President Juncker publicly suggested that Montenegro and Serbia might join the EU in 2025¹. The subsequent European Commission (2018) communication put forward concrete measures to accelerate EU accession negotiations with both candidates. Political changes in North Macedonia in 2017-18 and compromise reached with Greece in June 2018 over the country's name have removed obstacles to starting EU accession negotiations.

Turkey's EU accession process was practically frozen in 2017-18 as result of the deterioration in the rule of law, human rights and authoritarian changes in its political system. However, in March 2016 the EU was able to conclude with Turkey a deal on controlling migration from the Middle East.

1.2 Neighbourhood

In the last five years, the security situation in the EU's immediate neighbourhood has deteriorated markedly. The Russian annexation of Crimea in March 2014 and Russia's support for separatists in Donbas violated Ukraine's territorial integrity and represent a severe challenge to Europe's security architecture. The US and EU, supported by several partners (including Norway, Canada, Japan

* APPETITE FOR ENLARGEMENT

* RUSSIA

and most of the EU candidates), have responded with political, economic and personal sanctions against Russia and have frozen the political dialogue. Russia has introduced counter-sanctions on food imports. Meanwhile, other countries in the east – including Moldova, Ukraine, Georgia, Kazakhstan, Uzbekistan and even Belarus – have sought closer relations with the EU.

* MEDITERRANEAN
REGION

The wars in Syria, Iraq, Libya and Yemen, the rise and then fall of the Islamic State of Iraq and Syria (ISIS), and the unresolved Israeli-Palestinian conflict have led to a series of humanitarian crises in the southern and eastern Mediterranean region. This fuelled massive refugee flows to Europe, underpinned a wave of terrorism and negatively affected EU economic cooperation with the crisis-affected countries. These crises remain unresolved, and other countries in the region – such as Algeria and Lebanon – might also become unstable.

* ASSOCIATION
AGREEMENTS

Against this background, the record of the European Neighbourhood Policy (ENP)² is mixed. Association agreements with Georgia, Moldova and Ukraine were implemented, increasing the economic integration of these countries with the EU. Their citizens gained the right to visit the EU without visas. The EU also provided financial and technical aid to support economic and institutional reforms in these three countries, and in Tunisia and Morocco³. Less progress was made in deepening the free trade agreements with southern Mediterranean partners. The EU has shown limited or no ability to prevent negative political developments in its neighbourhood and to resolve ongoing conflicts.

2 CHALLENGES

* EU ACCESSION

Historically, the promise of EU accession has been the most powerful instrument to promote and incentivise positive developments in the neighbourhood. The two preconditions for this to be effective were the EU's readiness to accept new members and the desire of potential candidates to join the EU and accept the *acquis communautaire*.

However, the role of enlargement has shrunk over time. Because of deepening European integration and an ever-expanding *acquis*, EU accession became a more complex and lengthy

process than it was 20 or 30 years ago. From the candidates' perspective the potential benefits became weaker while the risk the accession process will fail has increased.

Some EU neighbours are not eligible to become EU members because they are located outside Europe (southern and eastern Mediterranean, Central Asia). They therefore cannot benefit from enlargement-related incentives such as eventual EU membership, full access to the Single European Market and large-scale financial transfers. Other countries are for the foreseeable future not interested in membership. Others still, which are potentially eligible and interested (Georgia, Moldova, Ukraine), are not being offered the promise of membership by EU members. There is even a reluctance to continue enlargement in the case of the Western Balkan countries.

Against this background, the EU faces three major challenges:

- Maintaining potential EU accession as a credible and attractive option for candidates and potential candidates (to encourage their further reforms), while not compromising on accession conditionality;
- Conducting an intra-EU institutional reform that would prepare the EU to absorb more member states. This is particularly important for the European Commission, in which every member state currently has one commissioner;
- Finding models of cooperation with neighbouring countries that do not include the prospect of membership. These models should fulfil a dual function: they should be mutually beneficial in the concrete areas of cooperation, and they should establish the EU as an anchor for universal values, economic stability and security in the region.

The third challenge has been an issue for neighbourhood policy from its very beginning (in 2004). For countries with high trade exposure to the EU, instruments such as free-trade agreements or sectoral cooperation may be attractive. The same is true for visa-free travel, but this is limited to countries that meet criteria for a visa-free regime. Development aid and technical assistance are less powerful tools, unless a given partner is strongly interested in

* INSTITUTIONAL
REFORM

* COOPERATION
MODELS



Some countries cannot or will not fulfil EU membership criteria; the EU should devise a neighbourhood policy that enables various models of institutionalised cooperation

a certain kind of assistance or investment project.

Also, from the very beginning there has been a dilemma over what extent neighbourhood policy should be organised on a country-by-country basis, recognising individual country interests and policies (compared to building common rules and policy frameworks for the entire neighbourhood region). The uneven progress of reform, differing geopolitical priorities of EU members and serious regional conflicts in the eastern and southern neighbourhoods suggest an individualised approach. Such an approach would create scope for quick responses to new reform and cooperation opportunities when they arise – such as political changes in Armenia in 2018 or Algeria in 2019.

3 POLICY RECOMMENDATIONS

The EU should strive to cooperate with all its neighbours to its maximum benefit. This implies that European countries should have the right to become EU members if they fulfil a set of criteria that ensure that their EU-membership is beneficial for EU citizens. Policies directed towards EU candidates should aim for full harmonisation of their political, institutional and socio-economic systems with the *acquis communautaire* to ensure that their future EU membership is beneficial for them and for incumbent members (see section 3.1).

But as some countries cannot or will not fulfil these criteria, the EU should also devise a neighbourhood policy that enables various models of mutually beneficial institutionalised cooperation.

* ACQUIS
COMMUNAUTAIRE

This should explicitly not exclude the partial harmonisation of neighbours' economic systems with the *acquis* (see section 3.2).

3.1 Enlargement policy

On several occasions, the EU has promised that European countries that fulfil the Copenhagen criteria can become EU members of the EU (Article 49 of the Treaty on European Union).

Withdrawing this promise would raise severe doubts about the credibility of existing and future EU long-term political commitments, and would also leave neighbouring countries that engaged in the accession process in a dangerous vacuum. The EU should not push its natural partners into other powers' zones of influence. Furthermore, even countries that are currently not interested in joining the EU or that do not meet the membership criteria might at some point need a new vision to anchor a domestic transformation process towards a European model. Consequently, the EU should uphold its membership offer to all European countries.

But the offer of enlargement is not a 'gift' to the EU's partners. Each enlargement needs to be beneficial both to the acceding country and current members of the EU. Consequently, the criteria need to be firmly interpreted in a way that protects the interest of EU citizens of the EU and cannot be compromised. Based on the experience of recent enlargements, the European Commission and Council of the EU should review the accession criteria to ensure that they safeguard the interests of the EU and candidate countries. Such a process can help to manage expectations in candidate and potential candidate countries, and can lead to a more fact-based debate on further enlargement in the EU.

The strategy, priorities and sequence of accession negotiations should be individually tailored to each candidate country, putting upfront the most difficult and complex issues (such as governance, rule of law, judicial reforms and anti-corruption).

The accession process has been the anchor for very successful transformations in most of the most recent EU member countries and in candidate countries. The European Commission and Council should strive to ensure that this process is more than ever based on measurable progress on equivalent and transparent

* COPENHAGEN
CRITERIA

* MUTUAL
BENEFITS

criteria for all candidates and potential candidates. Progress in meeting accession criteria should be rewarded by acceleration of accession negotiations and increased flows of financial aid and technical assistance. The advanced candidates should be able to participate in EU structural and cohesion funds and EU investment programmes. However, advantages should be withdrawn if progress is rolled back in accession countries.

To be credible in its enlargement policy, the EU needs to adapt its own institutions and decision-making processes to a larger number of member states in future. In first instance, this concerns the right of each member state to nominate a commissioner. Voting rules in the Council, especially in policy areas in which unanimity applies, should also be reviewed to make decision-making easier and more effective.

To avoid cases of reform reversal or breaches of the *acquis* after accession, the EU must strengthen its internal rule-enforcement mechanisms. The key roles should be played here by the Commission as the guardian of the Treaties, and by the Court of Justice of the European Union, which should have greater power to invalidate national legislation that contradicts the Treaties and EU secondary law.

3.2 Neighbourhood policy

European Neighbourhood Policy (ENP), which is based on Article 8 of the Treaty on European Union, should not be limited to the current list of countries participating or potentially participating in the ENP. The geographic coverage of the ENP, which was determined in 2004, is arbitrary. It covers direct neighbours (that is, countries with a direct land or sea border with the EU) and some countries that are not direct neighbours (Armenia, Azerbaijan, Jordan), but excludes others (in post-Soviet Central Asia, the broader Middle East or Saharan Africa) that might be equally important for the EU political and economic interests in its neighbourhood. We suggest that the external borders of the ENP should be treated more flexibly, depending on the political and economic circumstances and EU interests.

ENP potentially offers partners far-reaching access to the EU

* INSTITUTIONALISED
COOPERATION

internal market in exchange for adopting a respective part of the *acquis*; visa facilitation or liberalisation in exchange for adopting certain legal, regulatory and administrative standards, offer development aid and technical assistance as well as cooperation in several policy areas, for example, research, education, culture, transportation, energy, environment, climate policies, security, counterterrorism and many others.

Such close cooperation with neighbouring countries in specific areas can be hugely beneficial for both sides. We therefore suggest a profound revamp of the ENP to enable institutionalised cooperation in mutually beneficial areas (we call them Circles), that will be open to each country that fulfils the specific criteria and whose strategic interests do not undermine the EU. The idea is that the EU institutions will not have to find a common position on the relationship with each neighbouring country in each area of cooperation, but that neighbours can only choose from a limited number of cooperation frameworks that have some fixed institutional setting.

For each Circle, the EU would define the rights and obligations of all the members. Those will typically be borrowed from the corresponding part of the *acquis*. Each Circle would have a secretariat that monitors the implementation of the rules – and that is able to sanction individual members for non-compliance. If countries fall behind on the membership requirements in any Circle, they can be excluded. Each Circle also needs a governance structure so that rules can be adjusted to changing circumstances, and a juridical structure, for example an arbitration mechanism with the option to move disputes up to the level of the Court of Justice of the EU. With the Energy Community, one such Circle exists already. It has allowed very structured collaboration in the energy field with 11 EU neighbours in the Balkans and in eastern Europe.

An important principle underpinning such structured cooperation would be that only EU members can vote on how the *acquis* develops, and those outside the EU might only vote on whether they are willing to adopt it in their Circle – or whether they prefer to diverge from EU rules.

The Circles would cover areas of Community competence, for example visa facilitation, environment, transport, research, education and trade. Within a given area of cooperation there can be various institutional forms of cooperation (of different depth), for example, a free trade agreement or a customs union. The creation of the proposed Circles would allow the EU to offer different cooperation templates between the prospect of full membership perspective and standard external relations.

Collaboration in Circles can be linked to directly visible benefits for the populations of partner countries, such as economic development, travel facilitation and financial instruments. EU financial instruments should become more targeted to helping countries that want to cooperate with the EU in specific Circles to meet necessary preconditions.

The development of the institutional and thematic setting of the proposed Circles would be a complex task for the Commission. It would require more horizontal collaboration of the neighbourhood policy directorate-general with the respective sectoral directorates-general and with EU member states. The main challenge would be to determine the rights and obligations so that the package is as beneficial as possible for the EU while being attractive to its partners.

EU financial instruments should be used more strategically – also in cooperation with corresponding member-state instruments. Stronger conditionality can ensure that financial assistance serves as an anchor for reform – with a positive multiplier effect in the recipient countries. If, for example, EU financial support is conditioned on improvement in the business climate in partner countries, investors would find such reforms more credible as the partner countries would stand to lose money if they renege on reforms. This will enable the bringing in of more foreign direct investment from the EU.

NOTES

- 1 See http://europa.eu/rapid/press-release_SPEECH-17-3165_en.pdf.
- 2 Although European Economic Area members (Norway, Iceland and Liechtenstein) and Switzerland are geographical neighbours of the EU they are not formally part of the ENP. Their economic and institutional ties with the EU are much stronger than in those of the EU candidates and neighbours.
- 3 However, by its design EU financial aid (the Macro-Financial Assistance, MFA) has a supplementary character to IMF programmes, which offer larger amounts of money to countries in trouble. Disbursement of MFA depends on meeting IMF/ World Bank conditions. Sometimes, the European Commission adds something to the IMF conditions, for example, in the governance sphere.

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The policymakers who will lead the European Union until 2024 take office in the context of a more favourable economic environment than their predecessors faced. Growth is steady, employment is up and investment is recovering. But in other ways, the new leadership confronts formidable challenges. The multilateral consensus is breaking down and a geopolitical confrontation between the United States and China has become a reality. Global warming has not been tackled and the world's emissions continue to rise. Digital technologies are challenging traditional notions of society and work.

Europe must be brave in facing up to the new circumstances. It must aim at a green transformation of the economy. And it must ensure social fairness so the costs of change do not fall on the weakest. This set of 16 memos assesses the state of affairs and the main challenges for the incoming commissioners and presidents, and provides them with concrete policy recommendations.

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