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FOREWORD

‘THERE IS NOW A DISTINCT POSSIBILITY that this crisis will be remembered as the occasion when Europe irretrievably lost ground, both economically and politically’. This was the starting sentence of our memos to the new EU leadership five years ago. Five years later, it is fair to say that this possibility has become a reality. Unemployment has reached record levels and growth has disappointed. Meanwhile, the world outside the EU has continued to change rapidly. Emerging markets in particular have increased their weight in the global economy and in decision making.

The new EU leadership – the president of the European Commission and his team of commissioners, and the presidents of the European Council and of the European Parliament – will have to address pressing challenges. Despite the significant steps taken by Europe – among them the creation of a European Stability Mechanism, the start of a banking union, the strengthening of fiscal rules and substantial structural reforms in crisis countries – results for citizens are still unsatisfactory. It is impossible to summarise all the memos in this volume but a common theme is the need to focus on pro-growth policies, on a deepening of the single market, on better and more global trade integration. Reverting to national protectionism, more state aid for national or European champions – as frequently argued for by national politicians – will not be the right way out of the crisis. On the contrary, more Europe and deeper economic integration in some crucial areas, such as energy, capital markets and the digital economy, would greatly support the feeble recovery. But in other areas, less Europe would also be a highly welcome signal that the new European leadership is serious about subsidiarity. Internal re-organisation of the European Commission to ensure that it better delivers would also be welcome.

Beyond the pressing challenges – above all crisis resolution, jobs and growth – the memo to the presidents recommends that the new EU leadership should make sure that Europe makes the necessary treaty changes to strengthen Economic and Monetary Union and to permit the coexistence within the EU of countries belonging to the euro area and those that have no intention to join it. Working towards a consensus on this within the European Council and

with European citizens is crucial for Europe's future and to enable bold decisions on pressing issues.

Our focus in these memos is on economics. But clearly, political and other challenges have multiplied in the last five years. We therefore offer strategic policy advice that we deem both sensible given the problem at hand and politically achievable.

Regrettably, we have unexpectedly not been able to include in this volume a memo to the new Commissioner for Employment and Social Affairs. Yet, we believe that this Commissioner will have the major task of setting out how to improve Europe's employment and social performance. In many countries, labour market institutions need to be modernised, for instance by making unemployment insurance systems more efficient. Benchmarking could be a way of converging on more sustainable and equitable social models. But reducing unemployment rates will also require better macroeconomic policies, on which the new Commissioner for Economic and Financial Affairs will have an important role to play.

The memos have all been written by Bruegel scholars and their preparation has been coordinated by Senior Fellow André Sapir. Like all Bruegel publications, the content reflects the views of the author(s), and there has been no intention to write a 'Bruegel programme'. But the memos have been discussed extensively within the team to improve quality and ensure coherence.

Throughout the preparation of this volume, Bruegel's editor Stephen Gardner has contributed considerably to improving the formal and substantive quality of the individual memos. Our gratitude goes to him as well as to all of those who have given feedback on drafts of specific memos.

ANDRÉ SAPIR AND GUNTRAM WOLFF

September 2014

**TO THE
PRESIDENTS
OF THE EUROPEAN
COMMISSION,
THE EUROPEAN
COUNCIL AND
THE EUROPEAN
PARLIAMENT**

ANDRÉ SAPIR AND GUNTRAM B. WOLFF

You face three challenges: the economic situation, reforming the functioning of the EU institutions while dealing with pressing external matters and facing up to the need for EU treaty change

STATE OF AFFAIRS

Your predecessors as presidents of the European Commission, European Council and European Parliament spent a good part of their mandate fighting the financial crisis and creating mechanisms – primarily the European Stability Mechanism and the European banking union – that were left out of the Maastricht design of Economic and Monetary Union (EMU). Your terms of office will be no less challenging. You will have to solve deep and difficult economic and institutional problems, while being alert in case of a new crisis. The European Council of 26-27 June 2014 defined a broad political agenda for the next five years¹, but you will have to take the lead in spelling out a more precise agenda.

Economic challenges

You face three challenges. First is the economic situation. The financial crisis is receding but huge economic problems remain. Unemployment in Europe is at record highs and goes a long way to explain voter dissatisfaction with national and European leaders. Debt levels are historically high. Economic growth has turned positive again but remains far too feeble to alleviate the high joblessness or meaningfully reduce public debt, in particular in countries with high debt levels.

But it would be a mistake to think that Europe's economic challenge stems only from the crisis. All European Union countries need to adapt their economies and even societies to the Great Transformation resulting from the combined forces of globalisation, demographic, technological and environmental change. This transformation started well before the crisis. European leaders agreed already in 2000 to modernise their societies: the Lisbon Agenda to create a competitive knowledge-based economy with sustainable growth, more and better jobs and greater social cohesion. Had Europe implemented the Lisbon Agenda, it would probably not have avoided the crisis, but it would have been in much better shape to rebound more strongly and quickly.

Global transformation

Unlike Europe, emerging countries remained relatively immune to the financial crisis. They continue to forge ahead. In this respect it is good to consider two key facts: in 2013 emerging and developing countries together accounted – for the first time since at least 1850 – for more than 50 percent of global GDP; meanwhile, the average public debt-to-GDP ratio of these countries dropped below 40 percent, while it nearly reached 110 percent in the advanced economies.

Your second challenge is twofold: reforming the functioning of the EU institutions while dealing with pressing external matters. You must deal with growing scepticism about the EU and tackle pressing strategic questions that have remained unresolved for several years. The success of eurosceptic parties in the European elections will force you to focus on results for citizens. For this, the work on economic growth is necessary but not sufficient. The EU is still perceived as wasteful, bureaucratic and undemocratic. You will have to improve the internal working of the EU and of its institutions, manage the relationship between the euro area and the EU countries outside it (the United Kingdom in particular). You will also have to rethink the EU's neighbourhood strategy and strengthen the EU's place in the world.

Your third challenge is to face up to the need for EU treaty change. The economic and financial crisis has resulted in calls for 'More Europe' but also for 'Less Europe'. These contradictory demands are not necessarily addressed to the same areas of competences that are centralised or not at European level. Many citizens might be in favour of 'More Europe' in some areas and 'Less Europe' in others. A more fruitful approach is to seek a 'Better Europe', with some further

Treaty change

You must face up to the need for EU treaty change, to seek a 'Better Europe'

competences allocated to European level while others remain at, or are even repatriated to, national level. This implies greater clarity in the division of responsibility between Europe and its member states, and also greater effort to ensure that Europe delivers better results in the areas for which it has clear responsibility.

The crisis has shown that euro-area countries need deeper banking, economic, fiscal and therefore political integration than envisaged by the Maastricht treaty. Some of your predecessors suggested the creation of a 'Genuine Economic and Monetary Union' that would go well beyond the existing EU treaty and the inter-governmental treaties put in place to strengthen the euro area's architecture. Although there might be a natural tendency to put aside this discussion while the pressure from the financial crisis hopefully continues to decrease, it would be a severe mistake to wait for the next crisis to reopen the discussion.

Such deeper integration among euro-area countries inevitably raises urgent questions about the relationship between the EU and the euro area.

You will need to work in parallel on these challenges but the timing of their outcomes should be different. The economic challenge is the most urgent. Europe needs to deliver growth and jobs soon to regain the trust of its citizens. You will need to put forward a credible growth strategy in time for the December 2014 European Council and start implementing the strategy by mid 2015. You will also have to settle some of the governance issues very soon, ideally by spring 2015. You should strive to have the June 2015 European Council adopt a Declaration on the Future of the European Union, involving a Committee on the Future of the European Union, which would make proposals for

treaty changes relating to the governance of the euro area and the relationship between the EU and the euro area.

It goes without saying that the challenges in front of you are immense. Success will only be achieved if the three of you work closely together and with the heads of state and government of the member states. Nevertheless it would be rational that the Commission, which has executive and surveillance responsibilities, leads on the economic issues and on the reform of the Commission, while all three lead on pressing external issues, and the European Council and Parliament lead on the institutional track. The rest of this memo will deal with each issue in turn.

A EUROPEAN STRATEGY FOR GROWTH

You will constantly have to remind your European Council colleagues that Europe is losing relative weight, and that its demographic developments are unfavourable. Europe needs a growth strategy based on deeper global trade integration, more openness to immigration, improved educational systems and a better functioning internal market. It will also need to step up public investment and domestic demand.

In particular, your growth agenda must provide a convincing response to Europe's immediate and medium-term economic challenges. This entails both closing the output gap and increasing potential output. The strategy therefore needs demand measures to increase aggregate demand and close the output gap, and supply measures to increase potential output. Investment, which remains depressed in most EU countries, is key. Boosting investment would increase aggregate demand in the short term and increase potential growth in the medium term. The focus of the European growth strategy should therefore be to improve the investment climate in Europe. In this respect, much of what needs to be done is ultimately the responsibility of member states. But Europe has its own instruments, which matter for investment and growth.

Member states can and must implement structural measures in several areas. The first is the functioning of product markets, into which entry by new suppliers often remains hampered by various barriers. This is especially true in services. Second are labour market

**Structural
reform**

It is simply unacceptable that the single market is still far from reality in vital areas

and social policies (including basic education, training and life-long learning), which badly need to be modernised. Greater flexibility and better security for workers are essential features in the age of Great Transformation. Third is the functioning of the state, including the justice system and public administration. Finally, higher education systems in many countries remain ill-adapted for the economies of the twenty-first century and continental Europe still lacks global top-notch universities.

Although all EU countries need to implement structural measures, some will require your special attention because of their size: France, Germany and Italy. They account for two-thirds of euro-area and half of EU GDP. Germany is healthy with low unemployment and its public finances under control. Yet German investment remains fairly weak, which is a pity first and foremost for Germany, which could use more private investment to boost its competitive position and more public investment in education and in infrastructure. But it is also unfortunate for the rest of Europe, which would benefit from more aggregate demand and higher medium-term growth in the EU's largest economy. The situation in France and Italy is much less promising. There, unemployment is dangerously high and public finances are overstretched. Further economic difficulty in one of these two countries could reignite problems in the euro area, where the economic situation remains fragile.

You have relatively little leverage over these three countries. For France and Italy, the Commission has the arsenal of fiscal rules at its disposal, but the size of the countries gives them bargaining power and everyone knows it. For Germany, which has large and persistent current account surpluses, the Commission has used and can use again the Macroeconomic Imbalance Procedure to demand reforms that would

expand domestic aggregate demand. But again there are clearly limits to what can be achieved. Your real power lies not so much in the use of formal procedures, though clearly they should be used like for any EU country, but in your capacity to convince the three big countries to act in their own interests, and that not doing so would damage the euro area and the entire EU. Of Europe's own instruments, the most important is the single market. It is simply unacceptable that 30 years after the launch of the single market programme, and more than 20 years after it was supposed to have been completed, the single market is still far from reality in vital areas such as services, digital sectors, energy and research. Your commitment to complete the single market would be an important signal that Europe is again serious about fostering investment and growth.

The second instrument is the EU budget, which needs substantial reform to enhance growth. Although the 2014-20 multiannual financial framework (MFF) contains useful tools to improve Europe's investment climate, you will have the opportunity to leave your mark in 2016 when the MFF is reviewed. The review should not just consider changes in expenditure, but also in the way the EU budget is financed. Moving away from national contributions, currently the main source of financing, is essential to turn the EU budget into a budget for Europe rather than one dominated by a national, *'juste retour'* logic. This would allow the budget to be refocused on European public goods, for example energy security, energy efficiency, a digital single market and EU-wide mobility schemes for young workers, instead of ineffective redistribution. Luckily, your predecessors appointed a High-Level Group on EU Own Resources, which will make proposals in time for the 2016 MFF review.

EU budget

The EU budget, along with regulation, can and should be used to promote better the single market in industries that require trans-European networks to link regional and national infrastructure. This includes interconnection and interoperability, mainly for transport and energy, but also for information and telecommunications technology. In this respect, it would be important to expand the European Commission-European Investment Bank Project Bond Initiative, launched on a pilot basis in 2012.

The European Commission needs reform to implement the growth strategy

But the EU budget should also be used to promote structural reform in EU countries. This could include, for example, making the disbursement of Structural Funds conditional on administrative reform. The European Social Fund should be used primarily for the modernisation of labour markets and move social policies towards greater flexibility and better security. The European Regional Development Fund should be used as a matter of priority to improve the administrative capacity and effectiveness of regional and national public bodies.

Boosting investment

But these instruments alone will be insufficient to provide a meaningful demand stimulus to kick-start EU growth. You should broker a deal in the European Council to get a European investment boost. Public investment should be increased by about €100 billion in 2015 and 2016. About half of this should be the product of national fiscal policies, by increasing public investment and creating new incentives for private investment. You should also ask member states with fiscal space to stop over-performing on the achievement of fiscal targets. The other half of the investment programme should be conducted at EU level, by boosting the capital base of the EIB and implementing project bonds. Economically weaker, high unemployment countries should benefit disproportionately.

This growth strategy will be critical for achieving higher growth, which will be paramount for employment creation and for the sustainability of public and private debt in Europe. Failure to achieve higher real and nominal growth would render debt trajectories problematic in countries with currently high debt levels.

REFORMING THE EU INSTITUTIONS AND DEALING WITH PRESSING EXTERNAL MATTERS

The European Commission needs reform to implement the growth strategy. This mostly concerns the European Commission president, but the European Council and Parliament presidents will also have to agree on certain issues.

Commission
reform

- An effective Commission would have only a dozen policy areas in which it would take action. While the number of commissioners cannot easily be reduced, you should acknowledge that not every commissioner can have a full portfolio without leading to inconsistency of policy and excessive activism. A solution would be for every commissioner to have the full rights of a commissioner with full vote in the College. However, not every commissioner would be responsible for a distinct portfolio. An alternative constellation would consist of several clusters of competences for which several commissioners would be jointly responsible.
- Reducing and focusing the activities of commissioners would also allow you to pre-empt the criticism from many member states that the Commission is too active and involved in too many areas. While the assignment of competences cannot be changed without treaty change, you as Commission president could apply a more rigorous internal review of whether any new initiative is really necessary and whether major spillovers across the union justify it. You should ensure the strict application of the subsidiarity principle².
- You as the new Commission president should appoint a senior vice president without portfolio responsible for the European growth strategy. The senior vice president would oversee all the relevant Commission activities to ensure that policies are implemented to their maximum effectiveness to promote growth. There would be a particular focus on single market and industry, digital agenda, science and research, education and skills, and regional policy. The senior vice president would have a small staff,

consisting essentially of the part of the General Secretariat currently in charge of the Europe 2020 strategy.

- The enterprise and single market portfolios should be merged into a single market and industry portfolio to emphasise that European industrial policy should be about framework conditions and deepening the single market while reducing national regulatory fragmentation. Industrial policy based on subsidies and support for national champions is not the right approach for more growth and jobs in Europe.
- Your economic and financial affairs commissioner must play a central role in the growth strategy, including by shaping the EU-wide fiscal stance, but she will have to operate independently of the many requests from within the Commission and focus on her mandate and the need to keep fiscal policy credible.
- The rigorous enforcement of competition rules is central for economic performance. Attempts to make competition policy subject to narrow industrial policy interests are unwarranted, as are claims that it prevents the emergence of European champions. Many sectors remain dominated by national operators in the different national markets, and substantial regulatory barriers still prevent companies, in particular in the services sector, offering their products in other EU countries. The single market agenda is therefore more relevant than ever.
- It is worth reflecting on competition policy decision making. Acknowledging the inherently complex nature of competition policy, a high-level committee of five impartial experts should be appointed to review once a year the actions of the European Commission, and give independent advice on the direction of competition policy. Their reports should be public and should be submitted to the European Parliament. Their recommendations would not be binding, but would guide the European Commission's strategy and increase public awareness.

For the EU as an open continent, the further development of global trade is essential

The three of you have the daunting task of rethinking and improving Europe's neighbourhood policy, in particular with eastern and southern neighbours. The association agreements promising a '*deep and comprehensive free trade area*' with Ukraine, Georgia and Moldova are interpreted ambiguously by different EU countries and the three countries themselves. The relationship with Turkey is still seen only through the prism of potential EU membership. You will have to seek Council backing for a broader approach that also includes the possibility of other types of institutional relationship with the EU, which would offer more options to stabilise trade relationships while respecting broader geopolitical goals. You will also have to define an immigration policy that not only makes sense from a European point of view but also respects the humanitarian values for which the EU stands, and you will have to re-think the various financial instruments that the EU has for its neighbourhood.

External policy

But Europe's interests extend, of course, far beyond the neighbourhood. You should further promote global trade integration and develop a strategy to deal with China's rising trade power. By 2020, the end of your term, China will be the most important trading partner for several EU member states; already it is the second most important export partner for the EU as a whole. The Transatlantic Trade and Investment Partnership has the potential to deepen trade with the US, the EU's most important current trading partner, but does not give a convincing answer to global trade questions. Yet, for the EU as an open continent, the further development of global trade is central.

Finally, the three of you have the task of reforming the EU's administration to reduce costs and perceived inefficiency. This should include a review of its staffing needs, including at the Council, salary structures and conditions of entry, the organisation of the European

Parliament, including the question of its double seat. Some of the current hostility to Brussels comes from negative perceptions of its administration. While overall the EU institutions are rather cheap and efficient, you should deal proactively with the perceptions, and not hold back from dealing with inefficiencies.

TOWARDS A NEW ARCHITECTURE FOR THE EU AND EMU

Solving the pressing growth and unemployment problems and adjusting the current EU neighbourhood strategy, while improving the functioning of the EU institutions, is, however, unfortunately not enough. Arguably many of the problems you will have to fire-fight are the result of the still incomplete overall EU architecture and the lack of consensus on what the EU is and what it is not. You should initiate and drive a discussion on further constitutional change in the EU. Europe still needs a grand new bargain. Many of the growth reforms and other pressing reforms are only possible if you broker a deal on the need for a broader revision of the EU's treaty base. Conversely, the broader revisions of the treaty base are only possible if citizens believe that further EU integration in some areas is actually to their benefit. You thus face the formidable challenge of solving many currently pressing problems while working on the long-term solutions.

Fiscal capacity

Reforms to the EU's architecture are critical because failure would mean that monetary union is based on an incomplete institutional set-up. In particular, fiscal mechanisms are critical for three reasons:

- Without a fiscal union, the European Central Bank's policy measures will continue to be more controversial than those of a national central bank, because the ECB without a fiscal counterpart is more restrained in actions that could have distributional effects across different jurisdictions. In fact, arguably, the ECB's mandate was designed by the fathers of the Maastricht treaty to prevent it from engaging in policies that could have fiscal consequences.
- For the financial system to become fully integrated across borders, a banking union with a common fiscal backstop is necessary. While the banking union currently foresees some mutualisation of the risk that remains after

EU budget reform is a critical step to advance discussions on fiscal capacity

significant bail-ins, there is no mutualisation of major risks, and the deposit insurance system remains fragmented along national lines. As a consequence, the financial system will remain fragmented, with banks and depositors behaving differently based on their location. More financial integration combined with the right regulation would be beneficial for growth and the efficiency of the EU economy.

- During the crisis, fiscal policy reacted quite pro-cyclically in many instances because of the increasing market pressure on countries in distress. Moreover, the amount of aggregate fiscal stabilisation has been insufficient because coordination has proven inadequate across the union.

It is time to significantly advance this discussion on a fiscal capacity and stronger mechanisms for economic reform. The first important step should be a serious review of the EU budget with a view to adapt its expenditures towards more growth. You should undertake this immediately within the existing treaties. Other elements should include (a) resolving the unresolved questions about burden sharing in case of ECB losses; (b) agreeing on how to increase the back-stop for the banking union – a potential measure could be to accept that taxation of banks becomes completely European; (c) working on a concrete measure that would support unemployed people – the creation of a European unemployment insurance mechanism could be envisaged if labour market institutions concurrently become Europeanised. This would also answer the pressing question of how to overcome the inconsistency between monetary union and national structural and labour market policies. Many of these changes would require treaty

change to create the democratic legitimacy needed to justify moving such policies to the EU level.

The United Kingdom

While fundamental reform of the architecture of monetary union is crucial, it will be equally important that you address the substantial mistrust between euro-area countries and some of the countries that do not want to join the euro, in particular the UK. The UK's economy is of great importance to the single market and the UK is a vital EU member. EU reform is part of the answer and the UK is right that such reforms are in the interests of all EU members. But the question of the place of the UK in the EU will be core for the debate on treaty change. A result of treaty reform could be that the UK stops participating in the EU budget, while remaining in the single market for goods, services and capital, and ideally also labour. The UK would have to be granted some basic minority rights but should not be able to block vital steps needed to strengthen the single market. Such a 'second tier' EU membership could also offer a more realistic option for countries such as Turkey.

Review of competences

This treaty debate on deepening EMU and adjusting the relationship with the UK will inevitably be connected with a review of EU competences. Reviews of competences have been started by a number of member states, most notably the UK. You should welcome such input. All EU countries would benefit from a better allocation of competences.

You should therefore propose to the European Council in June 2015 that it adopts a Declaration on the Future of the European Union and that it appoints a High-Level Committee to make proposals for a new architecture for the EU and for the euro area. The High-Level Committee should conclude its work and report back to the European Council in December 2016.

The High-Level Committee would address three sets of questions.

1. Does a monetary union require a fiscal and economic union and what exactly would this imply? The following themes would need to be explored:

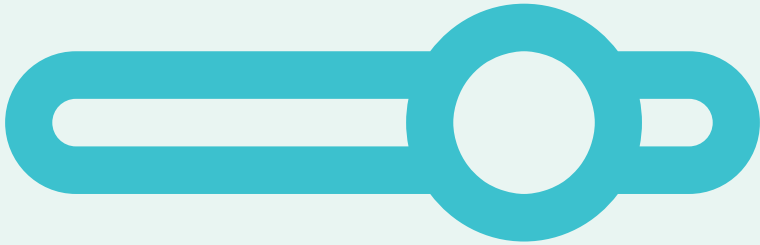
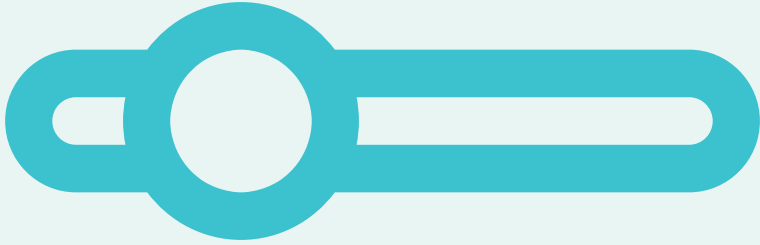
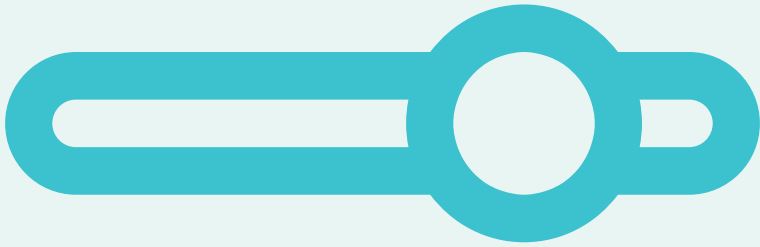
- *What kind of fiscal backstop does a genuine banking union require?*
- *Does monetary union require a fiscal stabilisation mechanism?*
- *Are the current fiscal rules adequate?*
- *Is a mechanism for sovereign debt restructuring necessary? How can the no-bail-out clause be made credible?*
- *Should the European Stability Mechanism and the European Resolution Mechanism become EU mechanisms and be part of a euro-area budget managed by a euro-area treasury? Is the EU budget reform a condition for the creation of a euro-area fiscal capacity?*
- *Does the euro area require a ‘finance minister’ with veto power over national budgets and national structural and labour market policies? Should some of these policies become EU policies?*
- *What mechanisms of political accountability should be put in place to oversee the euro-area treasury and finance minister and give them political legitimacy?*

2. What should the relationship be between euro-area and non-euro area EU countries? What safeguards should non-euro area countries receive and how closely should they be linked to the main EU decision-making processes? Should their involvement in the EU be more narrowly based on the single market only?

3. Is the current assignment of EU competences adequate? Is the current method for assignment of competences adequate? The treaty specifies that limits to EU competences are governed by the principle of conferral. The use of EU competences is governed by the principles of subsidiarity and proportionality, the application of which is specified in a protocol. Has the time come to revisit this protocol?

It is time to review all of these aspects thoroughly and come to a broader agreement about the EU’s development path. Many of the essential topics are far-reaching and complex. But failure to tackle these issues would undermine progress on current problems, and

could also leave the EU unprepared for new crises. The aim of the High-Level Committee would be to create a clear roadmap. Obviously not all the proposed treaty changes would need to be put in place at once; gradual change is conceivable. You should aim to have or at least to initiate a new treaty before the end of your mandate.



ECONOMIC AND
MONETARY AFFAIRS
FINANCIAL SERVICES

**TO THE
COMMISSIONER
FOR
ECONOMIC AND
MONETARY
AFFAIRS**

ZSOLT DARVAS AND GUNTRAM B. WOLFF

You will need to press member states to move ahead with structural reforms, implement the fiscal rules with vigour, promote demand management measures to stimulate growth and remain vigilant in case of a re-emergence of the crisis

STATE OF AFFAIRS

Many of your policymaker colleagues have declared the EU's economic and financial crisis to be over, but we would like to warn you not to be complacent: the European economy, in particular the euro-area economy, has underlying weaknesses. Nevertheless, there are several monetary and economic developments you can be positive about:

- A break-up of the euro area, which was a major source of uncertainty and a deterrent to investment throughout Europe, is no longer an immediate risk;
- The second dip of the Great European Recession seems to have bottomed out and Europe has been growing since the second quarter of 2013, though at subdued speed;
- Structural reforms are being implemented, which is also visible in indicators such as the World Bank's *Ease of Doing Business* indicator;
- Financial fragmentation has eased in the euro area and interest rate differentials across the euro area have narrowed considerably during the past two years;
- Pre-crisis current account deficits in the euro-area periphery and central and eastern Europe are turning to surpluses, supported by strong export performances in many of the countries;

- The overriding aim of fiscal consolidation – the stabilisation and reduction of public debt to GDP trajectories – is within reach in most EU countries, though significant uncertainties remain in a number of countries;
- Hungary, Latvia, Ireland and Portugal have exited their financial assistance programmes in a clean way, ie without any kind of follow-up assistance.

But there are a number of key factors that suggest you should not declare the crisis to be over.

Post-crisis vigilance

First, the recession was deeper than expected, partly because of policy mistakes, and production is still well below potential and just slightly above the previous peak level in the EU. Activity, especially in some countries of southern Europe and in Denmark, France, the Netherlands and Finland is still subdued and there is little hope of a strong recovery. Labour markets remain weak in aggregate with very high unemployment in a number of countries and low unemployment in others. Contrary to previous hopes, the euro has not resulted in significant economic convergence.

Second, neither fiscal adjustments nor the implementation of structural reforms have been completed. Major adjustments still lie ahead, which will prove difficult under weak economic conditions, likely increasing the popularity of anti-austerity political parties and the reform fatigue felt by mainstream parties.

Third, while progress was made on budget and current account deficits, high public, private and external debts pose very serious threats in a number of EU countries. History suggests that the deleveraging process will be protracted and will constrain the growth of highly indebted sectors and countries.

Fourth, while bank balance sheet weaknesses are being slowly addressed, it is far from certain that bank lending will be restored in weaker countries, in which there are currently credit supply problems that compound weak demand conditions. The development of non-bank financing is advancing, but this is happening mostly in those EU countries in which such markets were already well developed. In core EU countries where there are no credit supply constraints, credit

There are a number of factors that suggest you should not declare the crisis to be over

demand is lacking. Without credit, it is unlikely that robust growth will restart.

Fifth, inflation throughout the EU, and in particular in the euro area, is on a downward trend. There is a significant risk that inflation will remain stuck well below the European Central Bank's two percent threshold for a long period. As a consequence, inflation in the countries with debt overhangs and previous losses of competitiveness, will likely stay very low or could even move into negative territory. These countries therefore face the risk of debt deflation that will ultimately make debt sustainability unachievable.

And sixth, while current accounts deficits adjusted, surpluses remained, which has led to a sizeable EU external surplus. This situation has arisen largely because of the euro area, where a small surplus of 0.07 percent of world GDP in 2007 has increased to more than half a percent of world GDP. In addition, the combined deficit of non-euro area EU countries, amounting to 0.18 percent world GDP in 2007, has shrunk and is on the way to a small surplus, according to International Monetary Fund projections. The EU has been deservedly criticised by the rest of the world for not creating sufficient domestic demand.

Economic governance

On the institutional side, you will have to manage a major new and revamped toolkit to pursue the EU's economic objectives. EU and euro-area economic governance was significantly reformed during the past four years. The Six-pack, Two-pack, Euro Plus Pact and Fiscal Compact have reformed fiscal governance, including national fiscal frameworks, equipped the EU with a new Macroeconomic Imbalances Procedure to tackle private-sector vulnerabilities and introduced a regular annual cycle of economic policy coordination under the so-

called European Semester. You will be responsible for managing the resulting complicated system, which may not be well understood by all stakeholders.

A major additional institutional change was the creation of a European Stability Mechanism (ESM), which is primarily under the responsibility of the euro-area finance ministers. However, you have to prepare the ESM decisions, including the assessment of debt sustainability prior to a new programme, and your services work on behalf of the Eurogroup as part of the Troika in the programme countries to impose conditionality that is seen as necessary to reform the crisis countries.

European
Stability
Mechanism

The emerging European banking union, the most significant European policy initiative since the creation of the euro, will not be primarily under your authority. But we wish to highlight that it will have major implications for your work, because of the fundamental importance of the banking system for the European economy.

Banking union

You will therefore face an economic situation that has clearly improved, but about which markets might be overly optimistic. You will also have a bigger toolbox at your disposal to tackle the challenges, but this toolbox has become very complicated. In the context of financial assistance, you have to act on behalf of the Eurogroup rather than the whole European Union.

CHALLENGES

Reinvigorating growth and creating jobs will be your primary objectives: they are essential for addressing Europe's social problems. In this respect, you will face four major challenges.

The first is to foster growth when both the public and private sectors are deleveraging and the financial sector is still weak, inflation is too low and even the economically stronger countries generate only subdued demand.

Fostering growth

The second key challenge is related to the available instruments to foster growth. Many elements of the European growth strategy will not belong to your portfolio, such as the completion of the single market, labour and product market reforms, research and education, the

digital and green agendas or the development of capital markets. In the Annual Growth Survey, which kick-starts the European Semester each year, you will have a chance to propose improvements in these areas, but you will have little direct impact on them.

Application of fiscal rules

While you can influence the aggregate fiscal stance of the euro area in the way you apply the new fiscal rules and in the advice you provide to countries to change their stances, you have no direct control over deficits and both European- and national-level fiscal rules almost exclusively consider fiscal targets at the national level, disregarding the euro-area wide fiscal stance. The scope to use national fiscal policies in a number of euro-area countries is also severely hampered by the already high debt levels and the potential negative market reactions. In some countries national fiscal rules are tighter than European rules, limiting your scope to change the fiscal stance. At the same time, there is no fiscal instrument available at euro-area level except for the ESM. You are therefore faced with a framework in which your primary instrument to influence the fiscal stance is the making of fiscal policy recommendations to national policymakers.

The third key challenge is related to domestic politics and member-state attitudes to reform. The major differences in economic and social conditions mean that policy priorities are different in different countries, which will make it hard to build consensus in various areas. Member states with brighter outlooks wish to stay the course of fiscal consolidation and structural reform, while some of the member states with weaker outlooks wish to dilute the fiscal framework.

The key question for you will therefore be how strictly you want to apply the fiscal rules in the face of serious political opposition, such as that from France and Italy recently, and from Germany and France previously. You might face a formidable challenge if some member states do not meet the fiscal targets as you define them. In such a situation you will face the tough choice between:

- A. Being tough and taking the route of so far never-used sanctions, protecting the spirit of the European fiscal framework but risking a major clash between member states and a political backlash against Europe in the sanctioned countries, with potentially far-reaching consequences;

Financial assistance programmes and post-programme monitoring will last for decades

- B. Opening the Pandora's box of renegotiation of the European fiscal framework, undermining trust in it when it faces its first test and further disillusioning large segments of the societies in those countries that support tough fiscal rules;
- C. Using the complexity and vagueness of the fiscal framework to navigate through without imposing sanctions, thereby undermining its spirit and making it toothless.

Furthermore, some member states wish to design new pan-European initiatives, such as a euro-area instrument for stabilising economic cycles, while others turn a deaf ear to this issue. You will have to take a position on it that does not only refer to long-term treaty changes but is meaningful in the current context.

And fourthly, you will also face the challenge of managing financial assistance programmes and post-programme monitoring that will last for several decades. If things go well and debtor countries repay their euro-area partners easily, the creditor-debtor relationship should not pose major problems. But if growth remains subdued and debtors find it difficult to repay, you will need to broker a reasonable deal between creditors, who will accuse debtors of not implementing properly fiscal adjustments and structural reforms, and debtors, who will accuse you and creditor countries of forcing them to implement economic policies which have undermined them. Among the current programme countries, such tensions are most likely to arise over Greece. You should be ready to prepare a deal alleviating the burden on Greece even further if necessary.

Financial
assistance

RECOMMENDATIONS

We make five key recommendations.

Structural reform

First, following on from your predecessor, you should press member states to move ahead relentlessly with structural reforms. When regulations inhibit the formation or growth of firms, when it takes them an excessively long time to address administrative requirements, when competition is undermined because of protectionist regulations, when labour market regulations do not encourage workers towards higher performance and make it difficult to reallocate the labour force efficiently, and when public institutions work inefficiently and various kinds of public spending are used wastefully and need to be financed by distorting taxes, it is no surprise that investment and growth is low. Structural reform needs are different in every country. Your role is to push countries to implement reforms, while the details of the reforms will have to be decided on by the countries themselves, and you assess them from the outside.

Fiscal rules

Second, you should implement the fiscal rules with vigour. Fiscal space is limited in several countries and trust in you and your institution would be undermined if you were to play with the vagueness of the rules. This would be harmful for any further plans to create a true fiscal union and is also risky because member states might stop listening at all to you and might run uncoordinated fiscal policies. For countries with limited fiscal space the only ‘flexibility’ we suggest you exercise is to grant more time for consolidation if this can protect growth-enhancing public investment and structural reform. A contract between the Commission and the member state could be signed in which a commitment to reform is given and consolidation delays are allowed in exchange. For countries that have fiscal space, you should not be shy of calling for fiscal measures that better correspond to the optimal aggregate fiscal stance of the euro area, as we discuss below.

However, in the medium term, as we have recommended to your president and the presidents of the European Council and European Parliament, further institutional reform is necessary, also for the creation of a euro-area fiscal capacity that could potentially be integrated into the EU budget. While this work should be initiated in the European Council, you will have to play a leading role in the reflection

Without growth, it will become impossible to respect the spirit of the fiscal rules

process. You should not shy away from pointing out that a monetary union without a common budget is incomplete.

Third, you have to realise that relying predominantly on supply-side oriented structural reform and a tough adherence to current fiscal rules is not enough to stimulate growth. Demand management is similarly important. Without growth, it will also become economically and politically impossible to respect the spirit of the fiscal rules, and you might be faced with a situation in which a large number of member states will reject your recommendations. For example, both France and Italy will find it very difficult to meet the deficit targets in the next few years. Moreover, Italy will not meet the debt reduction rule during 2016-19, according to the April 2014 IMF forecast, which foresees 2.5 percent annual nominal GDP growth. The IMF-projected annual reduction in the debt ratio, 2.9 percent of GDP per year, falls short of what the 1/20th debt rule would require, which would be 3.5 percent per year. Should Italian growth disappoint relative to the 2.5 percent IMF projection (and we see a significant likelihood of this), Italy will miss the debt rule even more significantly. You will therefore have to clearly warn the Eurogroup that it will be impossible to keep debt sustainable and follow the deficit rules if growth and inflation do not pick up. In particular, you should call for the following measures:

- You will have to ensure that euro-area wide recommendations from the European Semester and its Annual Growth Survey are first of all optimal for the euro area, which was not always the case in the past few years. You should explain clearly how you derive the optimal fiscal stance of the euro area. Equally importantly, you should ensure that euro-area recommendations are translated into concrete country-specific policy recommendations

Demand
management

that ensure appropriate euro-area wide demand management.

Investment programme

- Together with your president, you should broker a deal for a new European investment programme. Given the weaknesses of the European economy, the new programme should amount to at least 1 percent of EU GDP in addition to investments currently planned. Part of this investment should be designed and implemented through national fiscal policies, by increasing public investment and creating new incentives for private investment. In particular, you should ensure that countries with fiscal space invest more and stop outperforming against the fiscal targets, while countries with limited fiscal space should not start a new deficit-financed investment programme. The perhaps greater part of the investment programme should be conducted at EU level and be financed by the European Investment Bank, project bonds and an increase and improvement in the EU budget. Countries with weaker economic situations and higher unemployment should benefit disproportionately, similarly to the EIB's practice of the past few years.
- Which projects would be worthwhile undertaking and how could they be financed? The European energy network comes first to mind. In fact, with Ukraine's gas-supply crisis, the question of an adequate EU response to a potential gas shortage has become urgent. Building a better European energy network that could address energy shortfalls caused by such external shocks is critical. Yet, much of the energy network as it stands currently is in private hands. A public intervention should avoid the crowding-out of private investment or rendering private investments unprofitable, and it therefore must focus on those parts of the network that the private sector does not deliver.

A further important area for investment of public resources is energy savings. Subsidising and supporting investment in this area would not only make sense to

meet Europe's climate goals. It also can represent meaningful amounts of resources in order to have a macroeconomic impact on demand.

Similarly, in telecommunications, building a better European network makes sense, but the public hand should not crowd out private spending. Therefore, support for broadband roll-out and other networks must be focussed on areas where the private sector would not typically invest, such as rural areas. In addition, more resources for a European mobility scheme for young workers would be useful.

- It will also be imperative that inflation returns quickly to the 2 percent threshold both in the euro area and in other EU countries. You should state this necessity clearly and support an expansionary policy stance on the part of central banks in the EU (without of course infringing on their independence), even if some stakeholders challenge expansionary monetary policies. But you should also highlight to finance ministers that monetary policy alone would be too slow in pushing inflation back to 2 percent, and therefore national fiscal and income policies should also play a major role in this process.
- It is essential that demand increases in particular in countries with large current account surpluses. For Germany, the Netherlands and some of the Nordic countries, you need to seriously press for structural reforms that allow for market-driven domestic adjustment. Public and private investment and wages will have to rise. Your main tool is to use the macroeconomic imbalances procedure to give the right policy recommendations.

Fourth, you should prepare for a re-emergence of the crisis. In particular, if you see that inflation and growth remains subdued and debt dynamics remain unfavourable, it will be only a matter of time until the next financial attack against member states. While you may sound like a Cassandra to the member states, they are best served by the truth, however uncomfortable it might be. The ECB can and should

Inflation

Post-crisis vigilance

You might hope that no new Troika programme is needed, but you cannot exclude it

intervene in case of liquidity crisis with the Outright Monetary Transactions (OMT) programme, but it should not finance insolvent countries. You should ensure that any new financial assistance programme (which is also a precondition for OMT) avoids the Greek debacle – the pretence that a non-sustainable fiscal position is sustainable. This also means that you might have to advocate debt re-profiling or even restructuring if debt is unsustainable. As this would have substantial implications for financial stability, significant work to reduce the impact on the financial sector is needed, for example by gradually introducing single exposure rules to sovereign debt. You need to remind policymakers that the best way to prevent further financial assistance programmes and the hard choices involved with them is to change the current macroeconomic policy stance towards more demand, and to press ahead with bold structural reforms and determined bank restructuring.

Financial assistance

Fifth, you need to work on a redefinition of the Troika set-up and financial assistance. While you might hope that no new Troika programme will be needed, you cannot exclude it. We see three key elements:

- First, the dual role of the European Commission needs to be revisited, because in the context of the Troika, the Commission acts only as an agent of the Eurogroup, and not as an EU institution. A more elegant solution would be to strengthen the role of the ESM and turn it into a true European Monetary Fund, which would not only grant financial assistance but would also have staff seconded from the Commission to exercise the necessary conditionality.

- Second, the role of the ECB should be reduced to that of a silent participant, because there are potential conflicts with the ECB's prime objective of price stability, with the ECB's function of lender of last resort to banks and with the ECB's bond-purchase programmes. One cannot completely exclude the ECB from the Troika because many parts of the programme conditionality are intimately linked to monetary policy and supervisory policy, but the ECB should not define conditionality.

- Third, a strengthening of *ex-post* democratic control should be envisaged. While parliaments cannot be included in the *ex-ante* definition of conditionality as this is not only a time-sensitive but also a very technical matter, they should play an increased role in the monitoring of the Troika *ex-post*. We see a special role for the European Parliament, and also for the national parliaments that provide the actual financial resources. The national parliament of the country with an assistance programme is involved in any case throughout the process.

TO THE COMMISSIONER FOR FINANCIAL SERVICES

SILVIA MERLER AND NICOLAS VÉRON

Your five main challenges: the ongoing legislative agenda; the integrity of the single market for financial services; non-bank finance and capital markets development; the new EU landscape of specialized financial agencies; and the EU's role in global financial reform

STATE OF AFFAIRS

The financial services portfolio was sizeable before the European financial crisis started in 2007. It has grown considerably since then, extending into a myriad of highly specialised issues. Your predecessor worked on a tidal wave of 56 different pieces of European Union financial legislation (regulations and directives of the Parliament and the Council), 47 of which he initiated and 37 he finalised. Yours is a massive responsibility, which requires a deep understanding of financial system developments, in addition to legal and political deftness.

The financial crisis that started in mid-2007 has been a learning experience for the Commission, as it has been more broadly for the EU. During the first few years, the crisis was blamed on external factors: the US subprime crisis, then the Lehman Brothers collapse, then fiscal mismanagement in Greece. Home-grown sources of fragility and corresponding supervisory failures were denied or ignored, not least the dramatic increase in European banks' balance sheet size, risk and leverage since the early 2000s. As a result, early crisis response was often insufficient or inadequate, and while much progress has been made, the policy orientation has occasionally appeared inconsistent.

It is impossible to list here all the substantial initiatives of the past few years, and the dense alphabet soup of acronyms they have produced.

However, it might be useful to group the main initiatives by source of original impetus. We identify four such groups:

— *The G20 agenda:* This was defined in summits of the Group of Twenty in 2008-09 and refined in global bodies including the Financial Stability Board (FSB), the Basel Committee on Banking Supervision (BCBS) and others. Arguably its most prominent items have been a new BCBS accord on capital, leverage and liquidity, known as Basel III (2010) and largely transposed into EU law by the Capital Requirements Regulation and fourth Capital Requirements Directive (CRR/CRD4, 2013); the FSB's ongoing work on bank resolution and the 'too-big-to-fail' distortion, echoed in the EU Bank Recovery and Resolution Directive (BRRD) of 2014; a series of reforms of global derivatives markets, mostly implemented in the EU through the European Market Infrastructure Regulation (EMIR, 2012) and the Markets in Financial Instruments Regulation and revised Directive (MiFIR/MiFID2, 2014); and reform of selected segments of non-bank credit markets (shadow banking), most of which is still under discussion at the FSB.

— *The Larosière agenda:* In February 2009, a high-level group chaired by Jacques de Larosière advocated a 'single rulebook' to harmonise financial regulation and supervision in the EU. A major step was the creation in 2011 of three European Supervisory Authorities (ESAs): the European Banking Authority (EBA) in London, the European Insurance and Occupational Pensions Authority (EIOPA) in Frankfurt, and the European Securities and Markets Authority (ESMA) in Paris, complemented by the European Systemic Risk Board (ESRB) hosted by the European Central Bank (ECB) in Frankfurt. The single rulebook includes Technical Standards which are drafted by the ESAs for decision by the Commission. By our count, 37 such standards have been adopted since 2011, mainly on bank capital requirements, derivatives, market abuse and short selling.

Global reform

Single rulebook, new agencies

Banking Union is arguably the most significant policy development in Europe since the euro

Banking union

— *Banking union*: In mid-2012, euro-area leaders started the transfer of responsibility for banking policy to European level. The Single Supervisory Mechanism (SSM) Regulation of 2013 empowers the ECB as supervisor of large banks in the ‘banking union area’ (ie the euro area plus any other EU member state that may voluntarily join the SSM). The Single Resolution Mechanism (SRM) Regulation of 2014 creates a Single Resolution Board (SRB) in Brussels to coordinate the resolution of future bank failures, and a Single Bank Resolution Fund. In the absence of fiscal union, this banking union remains incomplete, with the SRM an awkward hybrid and no central deposit insurance. It does not fully “*break the vicious circle between banks and sovereigns*” as initially promised. Even so, it is arguably the most significant policy development in Europe since the creation of the euro.

Own Initiatives

— Under your predecessor, the Commission also took a number of its own initiatives, often in partnership with the European Parliament and in reaction to perceived demands from the European public. These included curbs on executive compensation and short selling, a reform of audit regulation, constraints on credit rating agencies beyond those suggested at the G20 level, a reform of financial benchmarks, and still unfinished proposals to separate certain activities within bank conglomerates (proposal on structural separation, January 2014). Another notable Commission initiative that is outside your remit but impacts the financial sector is the

Financial Transaction Tax (FTT) project, first proposed in September 2011 and still under discussion.

You also need to heed drivers of change that go beyond the European financial crisis. Globalisation is reshaping international finance and fostering the rise of powerful new financial firms, centres and markets, especially in Asia. Information technology fosters innovative payment systems and peer-to-peer lending or investing platforms, and in the age of ‘big data’, information systems play an increasingly prominent role in most financial segments. These developments also mean massive new demands on European regulators and supervisors. You must adapt fast in order not to be left behind in an increasingly obsolete Western-centric, relationship-based mindset.

CHALLENGES

We identify five clusters, which combine operational and institutional concerns – assuming there is no new round of EU Treaty revision, the potential implications of which for financial services have been left outside the scope of this memo.

Crisis management and resolution, banking union build-up and regulatory streamlining

The lead players on crisis management and resolution within the Commission are your colleagues responsible for Competition and Economic and Monetary Affairs, but you also need to follow these developments closely and assess their legislative implications. The ECB’s comprehensive assessment of euro-area banks, and subsequent restructuring of the weaker ones, is the central front at this point. Close coordination and alignment between the ECB and the Commission is needed for this crucial transition to succeed in restoring trust in Europe’s banking system.

Ongoing
legislative agenda

Beyond this phase of repair, the implications of the financial regime change brought by banking union will gradually highlight new challenges. The vision of a ‘single rulebook’ remains far from realised. The respective responsibilities of the ECB and national authorities in the regulation of banks’ conduct remain unsettled. Banks are subject to widely divergent insolvency frameworks which question the very notion of a single resolution mechanism. All regulated financial firms other than banks and credit rating agencies remain supervised at

national level: for example, the ECB will rely on audits of supervised banks by audit firms that are organised and regulated on a country-by-country basis. This creates scope for tensions, regulatory arbitrage and ultimately instability.

Your legislative agenda will remain daunting for the foreseeable future. Significant pieces of EU legislation are still pending, eg on money market funds, financial benchmarks and structural separation. Meaningful flaws or unforeseen effects are likely to be identified in recently adopted regulations, directives and binding standards, justifying their revision. The sheer novelty of many aspects of the recent reform flurry made it impossible to get everything right at the first attempt. To compound the challenge, your services employ general-purpose civil servants rather than lifelong financial experts. Most of their sector expertise is built up on the job, often with a sharp initial learning curve. Under the pressure to tick as many regulatory boxes as possible, principles of what the Commission used to call 'better regulation', such as substantial consultation of stakeholders and economic cost-benefit assessments, have sometimes been practically suspended even when they were still given lip service. As a result, the regulatory burden on economic agents has occasionally been heavier than necessary.

Risk of
intra-EU split

Single market integrity

The United Kingdom, home of Europe's major financial hub in the City of London, is outside of the banking-union area, as are several other EU countries. This poses unprecedented challenges for the single market, the protection of which is at the core of your mandate. You have a duty to address these as much as possible, even though you cannot solve the broader political questions that affect the relationship between the UK and the EU.

The UK has sued the ECB on aspects of its policy to provide liquidity to central counterparties that clear transactions in euro. The ECB can also be expected to call for more harmonisation of rules within the banking-union area than is achievable for the EU as a whole. The ESAs have a mandate to foster and enforce convergence across the EU, but the Commission's rejection or amendment of several of their draft rules has raised doubts about their standing, and their intergovernmental governance framework is widely seen as a brake on their effectiveness. The

new policy emphasis on macroprudential instruments, while broadly welcome, also creates risks for the single market, because much of the decision-making on these instruments remains at national level. Beyond the ESAs, your own services also have enforcement powers but have used them only sparingly in the recent past. We identified only 44 infringement cases opened in a financial services context since 1998, and only 19 since mid-2007.

Europe's comparatively underdeveloped non-bank finance and capital markets

The domination of Europe's financial system by banks has become a drag on the European economy. The crisis fallout is a sequence of bank restructuring, deleveraging and consolidation that still has several years to run. These trends create both a need and an opportunity for the dynamic development of non-bank credit channels, through both market-based finance and non-bank financial intermediaries. If accompanied by adequate monitoring and regulation, the result can be a more diverse and more resilient financial system, and also more effective monetary policy transmission.

This pro-market narrative has gained ground in recent years, illustrated by recent calls for the revival of securitisation. But many EU and national policies still tend to repress the development of non-bank finance. Banking advocates have been successful in painting these segments as dangerous 'shadow banking', and the default attitude is often to erect new regulatory barriers rather than to foster their development. Examples of unnecessary market repression also include curbs on credit rating activity, and aspects of the Commission's proposal on bank structural separation.

The new EU institutional landscape

Until 2010, the Commission was largely alone at EU level in dealing with financial services matters. Now, the EBA, EIOPA and ESMA, the ESRB, the supervisory arm of the ECB and the soon-to-be-established SRB all have important tasks, not to mention your competition policy colleague's expanded role in bank restructuring. Your control over each of these new agencies is limited, even though you retain formal authority over the three ESAs' rulemaking activity and the SRB's resolution decisions. Moreover, and as emphasised above, the adoption by the Commission of an activist approach in rejecting or rewriting the

Bank dominance

New EU-level actors

ESAs' draft technical standards carries obvious risks for the credibility of the ESAs and ultimately of the EU itself.

The multiplicity of rulemaking parties can be seen as inevitable, as in the US, where multiple federal financial agencies have long coexisted. Nevertheless, it carries risks of turf conflict, regulatory arbitrage and policy inefficiency.

External realignment

During most of the 1990s and 2000s, the EU was at the forefront of championing and adopting global financial standards. Examples of EU global leadership include the adoption of International Financial Reporting Standards (IFRS) in 2002 and the adoption of the Basel II capital accord in 2006. In both cases, albeit for different reasons, the US did not adhere to the international standard.

The crisis, however, has changed this. EU compliance with global standards has become spottier than many Europeans acknowledge. On Basel III adoption, and in sharp contrast to Basel II, the EU has been a laggard rather than a pioneer. Like the US, the EU was late to adopt the corresponding legislation (CRR/CRD4); but unlike the US, the EU has also deviated from the international template on several important counts, including the definition of capital and the treatment of insurance arms of bank conglomerates. The EU remains far behind the US in implementing the G20-defined reform of derivatives markets, which magnifies the risk of market fragmentation. Your predecessor also repeatedly expressed dissatisfaction with choices made by the global accounting standard-setter, even though the EU has continued to adopt IFRS standards. This change in the EU's behaviour is not coincidental. It is more difficult to align the respective agendas of the Commission and of global standard-setters in the current era of re-regulation than it was in the pre-crisis period. But the negative implications of some EU choices for the global financial policy framework might not have been fully considered in the European decision-making process.

There is a parallel challenge relating to EU representation in global financial bodies. With the G20's elevation to 'premier forum' in 2009 for its members' international economic cooperation, and the corresponding broadening of the membership of the likes of the

BCBS and the FSB, the EU is less dominant in many bodies than it used to be. This might make the EU feel less committed to the global standards: US Trade Representative Michael Froman was recently quoted as noting that the “*EU often only recognises standard-setting bodies where EU members cast the bulk of the votes*”. Furthermore, banking union and other EU policy developments towards centralisation of financial policy might lead non-European jurisdictions to increasingly question why individual EU member states should be represented alongside EU institutions at all in such bodies.

RECOMMENDATIONS

General approach

You need to determine early on your general financial services policy philosophy. There are two major pitfalls to avoid. First, the financial sector will, in the name of growth, keep calling for deregulation and reversal of the tightening of the last few years, ignoring potential risks to financial stability. Second, self-styled reform advocates will encourage you to go for radical and seemingly simple measures for the sake of financial stability, without considering their economic cost in terms of making the financial system less efficient.

In reality there is no easy fix. Certain regulatory initiatives might be beneficial to both growth and stability, eg banking union in our judgment. Others might harm both, eg reducing accounting transparency by authorising fudges on asset measurement, as the Commission regrettably advocated in October 2008. The key is to better understand the financial system and how it might react to new policy initiatives, keeping in mind that this understanding will remain incomplete and largely practical. Absolutist positions are often suboptimal, in multifaceted debates that include bail-in versus bail-out in resolving banking crises, the pros and cons of asset risk-weighting in setting regulatory capital ratios, or curbing the size and complexity of financial institutions. Economists have not yet captured finance in general-equilibrium models, the way they have with other aspects of the economy. If only for that reason, there is an irreducible element of empiricism in financial regulation. This reinforces the need for ‘better regulation’ that avoids ideological certainties and takes into account feedbacks from on-the-ground observation.

Finding the
right balance

Diversity is good for finance; Europe has been too reliant on banks

You should keep in mind the benefits of diversity in the financial system. Europe has been too reliant on banks, and should create better conditions for properly monitored market-driven development of non-bank intermediation and disintermediated capital markets. It should not seek convergence of all banks towards a single business model or risk-assessment methodology, or of all asset managers towards a single investment strategy. It is easy for both regulators and supervisors to operate under the illusion that they understand financial risk better than market participants, but this is often not the case. Policy should avoid both overly prescriptive regulation that would be harmful or circumvented or both, and leaving excessive space for supervisory judgment that might eventually be captured. The balance must be continuously reassessed and readjusted, and is bound never to be perfect.

Crisis management and resolution, banking union build-up, and regulatory streamlining

Consistency & subsidiarity review

To address the need to clean up and streamline after the tidal wave of the last few years, you might consider the formation of a high-level committee to review the overall consistency and appropriateness of financial legislation and regulation in the EU. Criteria should include compliance with the subsidiarity principle, economic cost-benefit assessment and the minimisation of competitive distortions, including between banking-union countries and other EU member states. The UK Independent Commission on Banking (Vickers Commission) of 2010-11 might serve as benchmark in terms of process, including the establishment of a full-time secretariat of experts seconded from several agencies for more than a year to allow for high quality of in-depth analysis.

This is not the place to enter detailed recommendations on specific draft pieces of legislation. We nevertheless advise restraint on the contentious issue of structural separation, as the BRRD already gives wide discretion to supervisors to impose structural constraints on banks to ensure their resolvability, and predictability for investors is desirable in view of the banking restructuring wave that is expected to follow the transition to banking union. As in the US with the Volcker Rule, you should focus on prohibiting proprietary trading by banks, and leave to supervisors the intricacies of the implementation of this principle.

Single market integrity

You need to establish with the UK and with banking-union countries relationships based on trust, and to carefully avoid the twin risks of discrimination and special favours. When proposing new initiatives, not least on capital market development, you should favour EU-wide approaches over those limited to the euro or banking-union areas.

You should also ensure that EU financial policies are appropriately implemented and enforced, which is far from being the case now. Your recent predecessors and services have tended to neglect their enforcement responsibilities given the high priority of producing new rules, not least out of concern about antagonising individual member states whose support was deemed necessary to pass legislation. You should devote more resources and impetus to enforcement, and actively support the ESAs in their enforcement function.

Enforcement

Europe's comparatively underdeveloped non-bank finance and capital markets

Dynamic European capital markets and non-bank intermediation should be the main focus of your policy development agenda. This should be primarily framed in terms of development of relevant market segments, rather than their systematic integration at EU level (which could be at odds with subsidiarity) or increased regulation (in some cases, proper monitoring or even deregulation could be preferable). Securities regulation should allow for better investor protection, particularly enhanced disclosure requirements and their proper enforcement, for which you should champion more direct authority for ESMA. Prudential regulation should not create unnecessary disincentives for regulated financial entities to participate in securities

Capital markets
development

financing, as is arguably the case with, for example, the Solvency II insurance legislation. Single market enforcement and competition policy should also be actively deployed to identify and remove existing barriers to more efficient capital markets in the common EU interest.

Insolvency reform

Insolvency legislation is a prominent and difficult area for reform. Two strands are identified here: harmonisation of national insolvency frameworks, to clarify and strengthen the rights of private-sector creditors and encourage the financing of high-growth service innovators with few tangible assets, including through loan securitisation; and the creation of a single European insolvency regime for banks, at least those that are subject to the direct authority of the SSM and SRM, in order to fulfil the promise of a genuinely ‘single’ resolution regime as an alternative to insolvency. Both would be long-term endeavours, requiring close cooperation with your colleague for justice. We believe both would merit inclusion among your strategic priorities.

The new EU institutional landscape

Resist lure of micromanagement

The new reality is one of multiple financial authorities at the EU level. You should not view yourself as the master of them all, but rather as the guardian of their effective functioning and workable delineation of responsibilities. Avoid undermining the ESAs by unduly rejecting or amending their draft standards. Champion their reform and better align their governance with the European public interest, without trying to impose the same framework on all three. In particular, the EBA’s governance should be further revised to make it a more neutral mediator of possible differences, especially between the SSM/SRB and the Bank of England or Swedish authorities. ESMA should be empowered to enforce consistent IFRS implementation across the EU, as noted above, and its scope should also be gradually expanded to directly supervise more wholesale infrastructure players, such as clearing houses and audit networks with a pan-European reach.

External realignment

Lead by example

The EU’s position on global financial policy needs clarification, both on compliance and representation. The EU’s interest is to reclaim its standing as a champion of global standards, by correcting the CRR to make it fully compliant with Basel III, by resisting calls for a financial reporting path separate from IFRS and removing the EU’s decade-long deviation from IFRS on financial instruments accounting, and by even-

The new reality is of multiple EU-level authorities: don't try to be master of them all

tually revising the BRRD to adapt it to the FSB's future common bank resolution framework. As for representation, you should ensure that the EU is properly represented by the best qualified agency in all relevant global bodies. This need not be the Commission in all cases. The ECB and EBA should become full members of the BCBS, where they are currently observers, and you may also let ESMA replace the Commission on the IFRS Foundation's Monitoring Board. You should also exercise restraint in defending the status quo when it comes to the additional representation of individual EU countries in such bodies, which is being made gradually redundant by European-level representation. Finally, you could defuse the current tension surrounding the Transatlantic Trade and Investment Partnership negotiations by accepting that international financial regulation has become a global public good rather than a transatlantic preserve, and favour more engagement of large emerging economies in the global standard-setting process.



COMPETITION

SINGLE MARKET AND
INDUSTRY

DIGITAL AGENDA

RESEARCH

MIGRATION

TO THE COMMISSIONER FOR COMPETITION

MARIO MARINIELLO

Effective enforcement of competition policy benefits the economy as a whole: competition is the spark needed to fire the European economy's engine, and you must resist the pressure from those that believe the Commission's competition decisions should take current economic difficulties more into account

STATE OF AFFAIRS

No other commissioner has the executive power that you do. Fostering and protecting competition promotes the efficient allocation of resources and contributes to making society richer. Competition pushes companies to enhance their productivity, reduce their marginal costs and lower their prices, as otherwise they would succumb to their competitors. It promotes the selection of the best, most efficient firms and the exit of high-cost ones; it favours investment by making it relatively more profitable to stay ahead of the competition through innovation and the development of new products, provided that sufficient rewards are preserved after investments are made. Competition policy brings benefit to citizens in their role as consumers; it can help to regain their trust, in face of increasing scepticism about the European institutions. But effective enforcement of competition policy is also beneficial to the economy as a whole: competition is the spark needed to fire the European economy's engine.

However, the economic context in which you will start your mandate is not favourable. The economy languishes. Fragmentation still haunts the single market. In most sectors, there are high barriers to entry, differences in regulations and high switching costs for consumers. These significantly limit the competition potential of markets.

European Union innovation performance is still way below the levels of the US, Japan and Korea, while emerging economies are catching up. Enduring growth is a mirage and citizens seem to have lost their faith in the EU institutions.

Above all, you take charge in a period of great distress for competition policy. The crisis has put your office under significant pressure. Despite the very high reputation still enjoyed globally by the European Commission Directorate-General for Competition, a growing wave of criticism is coming from those who believe that the difficult economic situation is not being sufficiently taken into account in the Commission's decisions. They argue that competition policy enforcement should be more lenient and allow business the oxygen needed to survive, and that relaxing competitive pressure would funnel enough profits to companies to see them through the downturn, to invest in their production process, and to return to satisfactory productivity levels.

These arguments are undermining the fundamental pillar on which modern antitrust control is based: the independence of antitrust authorities. There are calls for the introduction of more exemptions and exceptions into merger control, antitrust and state aid decisions, and there is a real threat to the ability of DG Competition to act free from political interference.

Supporters of a relaxing of competition policy enforcement believe that Commission enforcement of merger control has been too strict in the last few years. According to this view, it prevented the creation of European champions and imposed conditions on merging companies that threatened to make investment too risky or even counterproductive, or that would prevent companies from efficiently rationalising their productive capacity. Market definition¹ has been blamed for being too stiff and anachronistic: merging companies are competing in a global market and some argue that this is not accounted for in merger decisions. Finally, the enforcement of merger control is blamed for not factoring-in socially negative spillovers, such as workforce lay-offs: the Commission might impose remedies that entail the sale of assets from merging companies to actual or potential competitors, to guarantee the same level of competition in the market is kept after the merger, but no consideration is given to the potential effect

Merger control

that such an industry reshaping might have on employees. During your predecessor's mandate² 800 merger attempts were scrutinised, 93 percent of which were cleared with no remedy imposed. Fifty-two mergers were cleared subject to conditions, the majority of which entailed a sale of assets. Only four mergers were prohibited: Olympic/Aegean Airlines (2011), Deutsche Borse/NYSE Euronext (2012), UPS/TNT Express (2013) and Ryanair/AirLingus (2013).

Abuse of dominance

Action against abuse of dominance (sanctioned by Article 102 of the Treaty on the Functioning of the European Union (TFEU)) and anti-competitive agreements (Article 101 TFEU) has been criticised for being not transparent enough. During your predecessor's mandate, just two Article 102 TFEU prohibitions decisions were taken, against Google-Motorola and Telekom Polska (only the latter received a fine), compared to eleven Article 102 investigations that resulted in commitments offered by the investigated company in lieu of a fine. Because of the scant information disclosed, little is known about the strength of the Commission's arguments when a commitment decision is taken. Detractors, therefore, complain that antitrust enforcement is too tough or too soft, depending on where they stand, with little chance for the outside world to assess if the action truly left markets and consumers better off. A number of high-profile investigations (such as Google search engine bias and Gazprom) are currently ongoing.

Cartels

Anti-cartel action has been accused of being ruthless. Sanctions can reach 10 percent of a company's global turnover. It is feared that too-high fines would further hamper the economic viability of companies, and would translate into higher prices for consumers. Since 2010, the Commission uncovered 25 cartels and sanctioned 167 companies, imposing more than €8.6 billion in fines, hitting in particular sectors such as electronics (TV and computer monitor tubes case), automotive (car parts cases) and finance (Libor and Euribor cases). An analysis of the data shows, however, that companies experiencing critical difficulties during the crisis received lower fines to account for their financial situation. Most importantly, the fines imposed appear minimal compared to the degree of harm caused to the European economy by collusion. Fines alone are unlikely to carry enough dissuasive power to significantly deter the formation of future cartels.

State aid control has been under attack by industries and member states

State aid control has been under attack by industries and member states. The Treaty prevents countries from cherry-picking companies or sectors and granting them special tax treatments or access to direct subsidy schemes. Without those rules, member states could start flooding the market with subsidies, threatening the single market's integrity. The rules are however sometimes perceived as being at odds with calls for a revamp of industrial policies: member states can feel deprived of tools to help industrial growth. The conflict between EU rules and industrial policy is exacerbated by the context in which European companies toil to compete with global competitors that might benefit from special subsidy regimes at home. In the past, exemptions to the rules were granted. Your predecessor had to navigate through the banking crisis, adopting special measures to stem the drift of the financial sector and ensure that effective restructuring or resolution plans were implemented to prevent similar crises recurring. In 2012, a state aid modernisation plan (COM/2012/0209) was published with the aim of making state aid control more efficient. It did this in two ways: by concentrating investigative efforts on those cases that are most likely to affect competition within the single market and by expanding safe-harbour provisions to approve without the need for lengthy investigation those subsidies that are unlikely to be harmful for the European economy. Since 2010, more than 1800 cases have been scrutinised, 63 of which have been prohibited with mandated aid recovery. New guidelines were adopted (particularly relevant are those for regional state aid, environmental and energy aid, risk finance and broadband). An investigation on tax sweeteners for multinational digital companies is currently ongoing.

State aid control

From a broad policy perspective, important reforms were proposed by your predecessor. In particular, new guidelines on the antitrust treatment of vertical restraints, horizontal cooperation agreements and

technology-transfer agreements were adopted, and new guidelines on the treatment of the purchase of minority stakes in merger control have been proposed. Most notably, a new framework has been adopted to guarantee a uniform right to seek damages to victims throughout Europe of antitrust abuses.

Maintaining independence

CHALLENGES

The mother of all challenges you will face will be to enforce competition policy as a key instrument for growth and to stand your ground to preserve as much as possible the independence from political interference of your Directorate-General. Only if you keep the interests of consumers at the heart of your merger control and antitrust work, and no other consideration affects your enforcement policy, the beneficial effects of competition policy can truly materialise. Of course this will require a careful (albeit complex) assessment of short- and long-term gains and losses: you should be ready to accept long-term benefits, if sufficient guarantees are provided that they will materialise, in exchange for short-term sacrifices, provided that the overall balance is positive from a consumer perspective.

Quite paradoxically, the need for independent and effective enforcement is greater during economic downturns; that is, exactly when its legitimacy is put in doubt. This applies to merger control (any attempt to stretch the law to foster the creation of national or European champions at the expense of competition would be detrimental to consumers and to the economy as a whole); to antitrust and anti-cartel action (abuses and illegal agreements mostly affect input prices for downstream companies, affecting negatively their competitiveness and, ultimately, their customers); to state aid (states have proved very bad at cherry-picking companies or industries in the past, leading to protracted agonies of ruinous business that have ultimately left markets, consumers and taxpayers worse-off).

You will however not only need to strenuously pursue a consumer welfare standard. You will also need to reinforce a successful communication strategy so that companies and consumers realise the benefits of competition policy enforcement, and to gather enough support to shield your Directorate-General from any attempt to undermine its autonomy or legitimacy.

Your challenge will be to anticipate issues before they arise, and to act accordingly

The other aspect of your number one challenge will be to develop a comprehensive approach that will allow you to identify sectoral issues and intervene to address them without necessarily being prompted by complainants or whistle-blowers. Your challenge will be to *anticipate* issues before they arise, to open your Directorate-General up to different sources of information that could indicate the existence of a potential competition problem, and to shape your strategic action accordingly. Examples are numerous: high concentration levels, stable super-competitive prices or pervasive multi-market contacts between competitors. You must advocate for deeper scrutiny of potential collusive behaviour. Likewise you should be open to learn from past experience: a reduction in supply following the shut-down of production plants, or an increase in consumer prices together with a reduction of a product's quality a few months after a merger was cleared by the Commission, would suggest the need for further investigation to uncover any link between what is happening in the market and the Commission's decision.

This 'sectoral' approach is not free from difficulties. It would mean that additional resources are needed on top of those dedicated to actual investigations in specific cases. It might also open the door to unwanted attempts to bring into your assessment elements that are not of a concern from a consumer-welfare perspective. But a sectoral approach would be most useful. *Ex-ante* monitoring speeds up intervention and mitigates the harmful effects of anti-competitive behaviour. *Ex-post* monitoring gives useful feedback on the effects of antitrust intervention; such feedback crucially helps improve future intervention.

Meanwhile, the competition authorities in developing economies have increased their enforcement activity. For example, in 2008, Chinese

Monitoring

Emerging economies

competition authorities scrutinised fewer than 10 merger applications. In 2012 this number ramped up to more than 200. This poses a number of challenges to European companies that go global, but it also offers the opportunity to establish links between antitrust authorities across the world to share information, collaborate and enhance global antitrust enforcement. DG Competition has recently increased its collaborative efforts by signing up a number of agreements with other antitrust authorities.

Global coordination

You will more and more need to deal with issues pertaining to the global coordination of state subsidy policies, merger control and antitrust law design and enforcement. Global markets require consistent competition policy frameworks. It will be up to you, in your leadership of one of the world's leading antitrust authorities, to help countries converge on an optimal equilibrium without yielding to the temptation of a race to the bottom, in which countries free-ride on the stricter regulation in other jurisdictions by backing their national champions with subsidies or favourable merger or antitrust rules. Convergence is feasible and should hinge on the consideration that the correct enforcement of competition policy yields long-term benefits, regardless of an economy's level of development, provided that dynamic effects are duly accounted for when decisions are taken. Protectionism and 'economic patriotism' instead yields only fictitious short-term benefits to the companies that are shielded by competition, harming domestic consumers and limiting domestic industries' long-term growth prospects. But your challenge will also be to ensure full uniformity of competition regimes within the European Union. Nowadays, differences in assessments by national competition authorities imply that companies *de facto* face different rules depending where most of their turnover is located. However, most decisions by antitrust authorities in Europe are enforcement decisions: anti-competitive practice decisions by the European Commission are just one fifth of the total. The realisation of a truly harmonised framework is therefore of utmost importance.

Another broad challenge will be to expand further the use of economics and effect-based analysis while pursuing competition policy cases. The Chief Economist's Office was established in 2003 in response to the identification by the European courts of serious flaws in the economic analysis of previous Commission decisions.

Since then, your Directorate-General has increasingly relied on economics in the course of its investigations. However, there are still significant margins for improvement. Antitrust intervention should entail a refined analysis of dynamic effects, particularly of incentives to innovate. Interventions against exploitative (or ‘unfair pricing’) abuses should be rare and carried out only if no other alternative tools (such as regulation) can address the identified issues. You should not look at successful companies with suspicion for the sake of it. The risk otherwise is to send dissuasive signals to companies willing to outperform rivals on their merits through more innovation, for example. These companies should expect to be rewarded, not punished through increased exposure to antitrust action. It does not really matter whether they hold part or the totality of the market. It matters only whether they abuse their power to pursue anti-competitive objectives.

Finally, your challenge will be to enhance the internal processes of your Directorate-General through a broad procedural reform. The executive power you hold makes it essential that you ensure that decision-making processes, which lead to the adoption of legally binding decisions, achieve the maximum accuracy in terms of outcomes. There is a general need to increase transparency while granting the necessary protection to the development of free internal thinking and the implementation of checks-and-balances within the walls of your DG. Long investigations (these are the norm in antitrust, for example) might result in the officials involved being locked-in to the assessment they made at an early stage of the process. This ‘cognitive dissonance’ can result in a (not necessarily conscious) biased selection of the evidence and ultimately lead to erroneous findings, if no proper precautionary measures are taken. Moreover, an accurate distribution of career incentives could lead to significant improvements in the results of investigations. Promotions and rewards should be determined through careful performance assessments and should be de-linked from the media impact of investigations. Fair rewards for an antitrust case dropped after years of investigation might be wholly justified, though the decision to drop the case might be not fully appreciated by the outside world.

Procedural reform

RECOMMENDATIONS

Using competition policy as a pro-growth tool, protecting competition and maximising consumer welfare means that you must not hesitate to take a strong active stance, stepping-up enforcement of antitrust, merger and state-aid control when needed. For example you should not refrain from blocking a merger if no benefits are foreseen and no remedies to preserve competition are available. Your ultimate objective should be to increase and refine deterrence: companies should anticipate that violating the rules will bear consequences serious enough to make the prospect of an infringement unprofitable to begin with. Conversely, companies should be confident enough that implementing pro-competitive behaviour, such as competing aggressively on prices to acquire a bigger market share, or engaging in collaborative efforts to develop R&D projects with significant positive social spill-overs, will not be mistakenly sanctioned as a violation of EU competition law. You should therefore implement a rigorous economic approach, estimating the ultimate effects on consumers. Refined quantification techniques should be used to measure the costs and benefits and the likelihood that they materialise after measures that you propose (such a merger clearance or prohibition) are implemented.

Merger control

An improved balance between cases that are by default considered anti-competitive ('infringements by object') and those instead that require the application of a rule of reason ('infringements by effect') should also be promoted. Likewise, merger control should duly account for dynamic effects and benefits that may spill-over onto markets that are not necessarily the same as those in which the merger take place. Short- and long-term efficiencies can balance reduction of competition if the merger is indispensable in order to secure them, and if the companies involved are able to provide enough reassurance that those efficiencies will ultimately be passed on to consumers in the form of lower prices or better products.

The clarity, accuracy and predictability of your actions are therefore extremely important, together with a strong commitment to enforce significant sanctions when infringements are detected.

Cartels

During your mandate you could increase deterrence of collusive behaviour by complementing cartel fines with personal sanctions aimed at company decision makers. Individual penalties for those employees

responsible for actually leading their company to commit a violation of competition law have proved very effective in other jurisdictions such as the United States. Legislative initiatives could be undertaken to empower the Commission to impose measures such as director disqualifications or personal pecuniary sanctions. Finding the political support to back such initiatives would certainly not be an easy task, but it is technically feasible and worth pursuing. Any improvement in this area could potentially be very effective in preventing future harm to consumers. Another good way to increase deterrence is to speed up investigations: the faster the sanction is applied, the greater its dissuasive power.

Enhancing the mechanisms designed to detect infringements is the other leverage you could use to further reduce the likelihood of anti-competitive behaviour. Within your directorate-general you could create special monitoring offices in charge of aggregating and scrutinising market information gathered by the Commission in the course of merger, antitrust or state-aid investigations. Such an office would prompt *ex-officio* action if, for example, evidence collected during a merger review suggests the existence of ongoing collusive behaviour in the same market. Likewise, tools already used to monitor markets (such as sector inquiries) could be reshaped to make them more practical: their duration could be reduced to allow for their more frequent use for a wider set of different product markets. Beyond the walls of DG Competition, collaboration with other directorates-general is essential. Special cross-DG taskforces could be envisaged to monitor sectors in which structural features (such as high barriers to entry or high customer switching costs) make antitrust violations more likely. For example, a task force drawing expertise from DG Competition, DG Transport and DG Internal Market and Services could investigate the level of cross-border competition in railway services. Likewise DG Health and Consumers could be involved in analysis of health sectors.

Monitoring

Sectoral issues can be identified also through more extensive collaboration with EU national antitrust authorities. For example, an institutional mechanism could be envisaged so that each time that a national authority takes an antitrust decision, an automatic follow-up check by the Commission would survey if similar issues affect different geographic markets throughout Europe where the sanctioned companies are also active. A national cartel uncovered in Italy could very well

You should promote the adoption of a common legislative framework for merger control

be a symptom of a much wider cartel affecting other EU countries, for example. Likewise, product markets might have very similar features in different geographic areas: signals of concern from national authorities should automatically prompt wider enquiries at supra-national level.

Importantly, to ensure uniform approaches in different member states, you should promote the adoption of a common legislative framework for merger control, in which national competition authorities would apply exactly the same substantive control as mandated by EU competition rules. This idea was proposed by former commissioner Mario Monti³.

Coordination

Additional coordination with other competition authorities outside the EU should also be sought, similarly to the ongoing cooperation between the European Commission and the US antitrust authorities. This particularly applies to emerging economies, and above all to the BRIC countries. Progress has been made: Memorandums of Understanding for cooperation were signed with Brazil (2009), Russia (2011) China (2012) and India (2013). But coordination can be deeper and go beyond information sharing and collaboration on violations of competition law that reach global scale. Coordination could help to reduce compliance costs for companies, for example. An initiative from your side for the promotion of standardised merger filing rules in multiple jurisdictions would be particularly welcomed by markets. If successful, it would significantly increase efficiency and speed up merger procedures.

In terms of substantive assessment, the current approach could be improved or clarified, particularly through the use of new or refined guidelines that would address:

- The treatment in merger control of dynamic and ‘out-of-market’ efficiencies (ie efficiencies that are not necessarily passed on to those consumers who are adversely affected by the reduction in competition);
- The application of Article 102 TFEU to excessive price cases and the role of economic analysis in such investigations;
- Best practices for uniform EU-wide enforcement of antitrust rules by national authorities;
- Enhanced filtering tools to select state aid awards begging for deeper scrutiny based on prima facie economic analysis (for example: a set of conditions might indicate that a state aid award is unlikely to introduce market distortion – in those cases, no further investigation would be needed);
- A well-defined methodology for the application of ‘commitment decisions’ under Article 9 of Regulation 1/2003.

Ad-hoc guidelines on all these subjects would be widely welcomed.

Finally, a number of process improvements could be made. Survey techniques used during market investigations and market tests could be significantly enhanced by promoting the adoption of standardised forms and dedicated digital tools such as web-survey forms. A horizontal team in charge of the design of market investigations with officials who are competent in survey techniques could also be set up. This would ensure higher quality surveys and a greater probability that statistically significant results are retrieved from respondents. In order to increase the quality of the outcomes of investigations, moreover, internal checks-and-balances tools should be increasingly used. Economists from the Chief Economist’s Team should be systematically involved in investigations at an early stage, and the use of panels (ie internal peer-reviews of ongoing cases) should be systematic in antitrust and should precede the issuing of Statements of Objections. Blind *post-mortem* case reviews should be done frequently and should contribute to staff performance assessment.

TO THE COMMISSIONER FOR THE SINGLE MARKET AND INDUSTRY

CARLO ALTOMONTE, MARIO MARINIELLO AND
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A truly integrated and competitive single market is the European Union's best asset for promoting European productivity and growth, and the best response to the challenges that Europe faces in the post-crisis environment

STATE OF AFFAIRS

Alongside the single currency, the single market is one of the key tools in the process of European integration. A truly integrated and competitive single market is the European Union's best asset for promoting European productivity and growth, and the best response to the challenges that Europe faces in the post-crisis environment. It is also a particularly attractive 'cheap' policy tool in these days of fiscal consolidation, when margins are tight for budgetary stimulus.

The single market encompasses a number of crucial areas, including product markets, energy, transport, services, public services, labour markets, taxation and intellectual property. Financial services have also traditionally been under the Directorate-General for Internal Market and Services, but post-crisis this has become an area of paramount importance to achieve stability and should be allocated to a commissioner for financial services. A separate memo is addressed to the commissioner for financial services, and we do not cover this sector in this memo.

However, the traditional responsibility of the Directorate-General for Internal Market and Services – guaranteeing the five fundamental freedoms of movement of goods, services, labour, capital and ideas – should be more closely integrated with industrial policy in order to

achieve greater competitiveness and higher growth. The previous Commission saw reversing the decline of Europe's manufacturing sector as a key element in restarting European growth after the crisis. The Commission even put forward a target of 20 percent of value added for manufacturing to be achieved by 2020. But the broader goal of EU industrial policy should be to make Europe an attractive place for higher value-added activities built on unique and innovative capabilities, in whatever sector they may be. The memo to the EU presidents notes that coordination of industrial policy should be in the hands of a vice president for growth who will be better able to mobilise the instruments for industrial policy that currently reside in different directorates-general. Among the commissioners with tools for industrial policy, you are the most important: access to large, open and interconnected markets remains a major location factor for high-end industrial activities and the single market is the major EU-level policy lever for industrial policy. Working with a vice president for growth, your position to some extent will mirror the situation at the beginning of the 1990s, when your predecessor Martin Bangemann in the Delors commission was also responsible for industrial affairs, and had great influence over the shaping of EU industrial policy.

Industrial policy

In the last five years, the initiatives launched under the Single Market Acts I and II have contributed in key policy areas such as networks, the digital economy and the mobility of citizens and businesses across EU borders. The Single Market Scoreboard also tells a story of moderate success: the latest figures on the transposition deficit, ie the gap between the number of single market laws adopted at EU level and those in force in member states, are between 0.6 and 0.7 percent (last semester 2013), after a 'peak' of 1.2 percent during the crisis of 2011. The figure is now close to the (suggested) Commission target of 0.5 percent, although the situation is quite different in different member states.

However, the single market is still characterised by a certain degree of fragmentation, with different levels of regulation for product and service markets, labour, taxation, consumer protection, red tape, contract law and health and safety regulations. Unsurprisingly, a recent survey of top European executives¹ reported that a further reduction in barriers to integration continues to be a key priority for the competitiveness of their industries.

Fragmentation

The incompleteness of the European single market results in the variation of key economic indicators, such as consumer prices or energy costs, for different countries. Economic research typically finds that the gap between traded goods prices in different European countries narrowed during the early 1990s to levels quite close to those in the United States. This was especially the case for durables. For non-tradables, such as consumer services, there was much less price convergence. Worryingly, high levels of price divergence and slow price convergence also characterise network industries, such as electricity, gas and telecommunications. For example, in terms of energy costs the European single market performs worse than the US, with a price dispersion of 31 percent (and increasing), compared to 22 percent (and decreasing) in the US. Recent evidence also points to a lack of absolute convergence in prices even in what should be a relatively integrated EU market, such as cars².

Admittedly, not all of the persistent price dispersion is a consequence of the lack of a single market. Less competitive markets, a concern for your colleague the Competition Commissioner, can lead to persistent price differences. Nevertheless, trade data confirms the unfinished nature of the single market, particularly in the services sectors. Trade integration in the single market for goods stands at approximately 22 percent of EU GDP, while for services it is about five percent³. Cross-border trade in services within the EU represents about 13.9 percent of EU GDP on average, a figure which is smaller than that for trade in goods, but larger than the share of services in exports to non-EU countries (8.3 percent). Nevertheless, over the last ten years the EU's trade in services with non-EU countries, measured as a share of GDP, has been growing much faster than the intra-EU share (4.1 percent compared to 2.7 percent, as an annual average). This hints at the unexploited potential for further integration of services markets within the EU.

Public sector

In the public sector, a single public procurement market continues to be a distant objective. This might be addressed by new public procurement directives (which repeal Directives 2004/17/EC and 2004/18/EC), which came into force in April 2014, to be transposed by 2016. The share of direct cross-border procurement in the EU (which means that the contracting authority awards the contract to a company from a different country) is 1.61 percent of all public procurement. The share

is above 10 percent in countries such as Belgium and Ireland, but in big countries such as France and Poland, it is below 1 percent.

CHALLENGES

Your most important challenge was neatly summarised in Mario Monti's 2012 report on *A new strategy for the single market*. He wrote that "*the single market today is less popular than ever, while Europe needs it more than ever*". This is perhaps even more true today than it was in 2012. The support of citizens and politicians for market integration has further eroded. In the midst of this 'integration fatigue', the single market needs to be deepened and further advanced. This is a challenge because this approach will push the single market into more complex areas, especially the new markets that are part of a fast-changing economy. This is particularly the case for new digital markets. To allow Europe to exploit the new global opportunities from digital technologies, new markets should be single markets from the start.

In addition, a social and cultural dimension often characterises new areas of single market policy, such as services of general interest, for example health care and education. As a result, you will have to make difficult political choices.

The fundamental challenge of being less popular than ever, while being needed more than ever, can only be tackled by taking a new approach to the monitoring of the single market.

Monitoring: a new approach

You should shift market monitoring from the current procedural emphasis on removing barriers to trade to ensuring that markets function better, benefit consumers, workers and businesses and generate sustainable and inclusive growth. To achieve this, the single market policy needs to be modernised to make it more impact-driven and results-oriented. You will therefore need to understand better the critical obstacles that prevent existing markets from functioning well and new markets from developing well. And to increase acceptability, it is crucial to provide unambiguous evidence demonstrating the overall benefits of reform and to facilitate the process of adjustment, particularly for those that are most directly affected.

Your policy would benefit from analysis and diagnosis of the results of single market measures

From this, it should be clear that your single market policy agenda would benefit from analysis and diagnosis of the results of single market measures, or the absence of them. This will enable better identification of those markets that face significant problems and identification of better, socially more sustainable, solutions. Such analysis will help you to better prioritise your efforts in the areas of greatest impact, to improve the design of policy *ex ante* and to support the *ex-post* monitoring of the results of single market initiatives.

An approach to the single market based on analysis and monitoring of impacts is often discussed⁴, but has not yet been consistently implemented. It will not be easy. A first challenge comes from the complexity of outcomes to consider in a fast-changing world. You need to look at the traditional static effects of single market initiatives, such as the impact on flows of goods and services, costs and prices. Also, and perhaps more importantly, you need to evaluate the dynamic effects on the capacity of markets to change, innovate and grow. Another analytical challenge will be to assess the multitude of influencing factors. More often than not, opening up borders alone will not do the trick. It also requires competitive product and services markets. And the success of market opening depends very much on the ability of labour markets to adjust. A results-based single-market approach will thus require much more intense coordination between single-market policies and other policies, particularly competition policy and labour market policy. Cross-policy coordination is however a challenge that the Commission so far has not been able to successfully address.

Results-based strategy

RECOMMENDATIONS

Despite the challenges posed by a results-based approach to the single market, we nevertheless recommend that you fully endorse it. It is the only way to address the challenge of the single market being “less

popular than ever, while Europe needs it more than ever". In addition to being more results based, single market policy should be simpler to implement and easier to enforce and update.

A results-based approach to the single market: market monitoring

Shifting from an emphasis on removing barriers to trade to ensuring that markets function better and benefit consumers and businesses requires identification of the obstacles that prevent markets from functioning well. The key component of a results-based approach is therefore to put in place a market-monitoring strategy. A substantial market-monitoring unit with the right mix of skills should develop your results-based approach. It would gather evidence and analyse the regulatory or enforcement barriers that most hamper market development⁵. Market monitoring should include forward-looking analysis to identify new emerging markets well in advance, particularly, but not exclusively, new digital markets.

Impact-assessment exercises when designing new regulations and evaluating existing regulations should prioritise dynamic efficiency and long-term consumer welfare and should be more closely integrated into your market-monitoring unit.

A results-based strategy for the single market has to recognise the need to work better in tandem with complementary market-opening policies. Single market regulatory design and competition policy should be deployed so that each instrument complements the other rather than having to compensate for the other. To this end, the different market-monitoring exercises taking place in different directorates-general should be coordinated.

A more nimble single market

The inflexibility of the existing procedures for new single market regulations in the face of globalisation and fast-changing markets and technologies is a major potential problem unless new, more nimble decision-making procedures can be adopted. That could be done through greater devolution of the most technical parts of directives to technical committees, a strategy which however implies even stricter supervision of the discretionary power of the same committees, and thus calls again for a stronger market-monitoring exercise.

Single-market policy needs to be made simpler in its implementation and enforcement

Single-market passport

In addition, the single-market policy needs to be made simpler in its implementation and enforcement. A way to quickly address obstacles arising from uncoordinated enforcement in different member states would be a ‘single market administrative passport’, or mutual recognition of administrative procedures: those companies that are administratively cleared to operate (eg have received a licence or authorisation) in one member state following the implementation of a new directive should be provisionally authorised to act in all the other member states, pending an *ex-post* check by the competent national authorities.

Network sectors

A deeper and a broader single market

The full potential of the single market for goods and services cannot be released without the support of interconnecting infrastructure for the single market (cross-border transport, communication and logistic channels), as well as access to skills, ideas and finance for cross-border transactions. This means that the single market for network sectors has a central role. Safeguarding and furthering the single market in sectors such as transport, telecommunications, energy, finance and business services should be particularly high on your industrial policy agenda. For manufactured goods which are increasingly produced by global value chains, access to efficient international network infrastructures and support services is important to build globally competitive positions through European value chains.

For most of the market-services sectors, the single market needs to be further deepened. You should take action to ensure uniform implementation of the Services Directive. This means not refraining from challenging the abuse of ‘proportionality requirements’ by member states or ‘gold plating’ – the imposition of unnecessary requirements to protect national professions. Bold legislative action should be envis-

For public services, measures to reduce fragmentation in Europe are extremely important

aged to address loopholes in the current regulation, such as ‘country of origin’ measures that *de facto* prevent seamless cross-border supply of professional services. Manufacturing and service sectors are increasingly intertwined and furthering the single market for services matters as much to industry as it does to services, and is therefore a pivotal part of your industrial-policy agenda.

For public services, measures to reduce the fragmentation in Europe are extremely important. Areas you will need to work on include health services and education. Particularly relevant in furthering the integration of public services will be to ensure the rapid, correct and effective implementation of the new directive on public procurement (2014/24/EU). You will need to play an important follow-up role: it will be your responsibility to ensure that the new directive is correctly implemented, through accurate monitoring of national legislation and practices. You should also be ready to promote further measures if you realise that the new directive is not meeting expectations, such as the introduction of a ‘public procurement passport’ to simplify the submission of companies’ credentials to contracting authorities.

Public services

You should take special care of new innovation-based markets, many of which will have a digital component, to ensure that they are configured from the start with minimum fragmentation, so that they can develop more quickly and develop world-leading status, riding on a single European market for new ideas. The following policy areas are of particular importance for supporting innovation:

Innovation support

- *Patents*: progress has been made during the past mandate on a single European patent, but further action is needed. The European patent adds a new layer in addition to national patent offices and the European Patent Office,

and so runs the risk of further complicating the intellectual property system in Europe. You should carefully monitor whether the costs of securing intellectual property (including enforcement) decline and converge across member states. In parallel, you should continue to improve the quality of the unitary patent system, including particular measures for young small firms to facilitate patent application, maintenance and enforcement.

- *Copyright*: the other key innovation-related area is copyright, especially for new digital markets. Your concerted action together with the Digital Agenda Commissioner will be much needed. You will need to push forward an overall revision of the copyright framework that would ensure a homogeneous approach throughout Europe. Today, fragmentation in the regulatory system and territorial restrictions tend to benefit distributors. A primary concern should be to ensure fair rewards to content producers while allowing final users to easily access content, no matter where they are in Europe.
- *Standard-setting rules* can be improved, particularly by ensuring the right balance between preservation of incentives to innovate for essential patent holders and protection of implementers from potential antitrust abuse. Rules should be designed with a technology-neutral and open perspective, supporting multiple innovation paths, which will allow future innovators to continue to compete. Rules should also be designed with a global perspective, enabling firms to build leadership in world markets.

Your revamped results-based single-market strategy will enable you to provide the vice president for growth with the most powerful tool that the EU has for industrial policy and for delivery of the Europe 2020 growth strategy.

Coordination

However, securing growth, innovation and productivity for Europe also requires the leveraging of other policy areas, including at national level. To obtain the support of citizens, a revamped single market needs to be completed by effective social policies to deal with the human consequences of rapid economic adjustment. This is the way

to safeguard the single market from the risk of economic nationalism. You will need to target the required measures for further deepening and extending of the single market at key areas for Europe's growth, and you will need to build an adequate degree of consensus around your plans. Closer coordination with your Employment Commissioner colleague could help to ensure better deployment of instruments such as the European Globalisation Fund to address any negative consequences for the labour market of deeper market integration.

TO THE COMMISSIONER FOR THE DIGITAL AGENDA

MARIO MARINIELLO

Your main task in the next five years will be to create a strong foundation from which digital goods and services can be easily developed. Europe has the resources and the skills to lead this unprecedented massive global transformation

STATE OF AFFAIRS

In the time that it will take you to read this memo, worldwide, more than three billion emails will have been sent, 17,000 websites will have been created, 30 million Google searches will have been made, 1.5 million tweets will have been tweeted, 900,000 Skype calls will have been made and 19.5 million YouTube videos will have been watched¹. There are more than 2.4 billion internet users out there, and that number will still grow. Your main task in the next five years will be to create a strong foundation from which digital goods and services can be easily developed and safely accessed throughout Europe. Europe has the resources and the skills to lead this unprecedented massive transformation in human interaction and, therefore, in economic habits. Europe has strong national and local identities, a rich cultural and historical heterogeneity, and a very wide range of consumer preferences and supply capabilities, and Europe's digital dream can either be the victim of this 'diversity paradigm', critically hampered by fragmentation into a plethora of narrow product and geographic markets, or it can exploit it as its greatest asset. Seamless digital interconnections within one of the richest and most diverse markets in the world can dramatically boost European business opportunities, magnify the potential for creativity and innovation and significantly increase the welfare of more than 500 million people.

To test Europe's digital pulse and measure your success, the focus should be on users

Europe's digitalisation crucially relies on the development of infrastructure, electronic technologies and new hardware and software. Digital markets feature strong network externalities, high fixed costs and low marginal costs of production. They give rise to complex economic questions such as what would an optimal market structure look like, in which users, content creators, service providers and software developers maximise the benefits that they mutually yield to each other, and in which operators would strive to deploy new infrastructures or offer higher quality services in terms of speed and reliability of connection.

Digitalisation

To test Europe's digital pulse, the focus should be on users. To measure your success you will need to assess how your efforts to boost a digital Europe will translate into better production capabilities for business and a higher quality of life for private citizens. Consumers and companies should have easy, frequent and reliable access to digital services; production processes should more and more rely on digital facilities; the digital interface should be the public sector's main means of providing services to citizens.

Looking at the picture from a user's perspective will allow you to put into perspective the concerns about the EU running behind the rest of the world in infrastructure terms. True, Japan, South Korea and the US have more extensive fibre coverage; by now China has already more 4G masts than the whole of Europe, and the US has taken over the lead on the 4G-LTE (Long Term Evolution) standard technology, after a decade in which Europe was the world model for mobile communication, particularly thanks to the success/uptake of 3G technology. The picture is however not as gloomy as it is often depicted. Europe is close to full coverage for basic fixed broadband; average download speed is slightly slower than Japan and Korea, but faster than in the US.

Global position

Broadband connection prices are low compared to the rest of the world. The latest data shows that Europe is catching up on 4G. The experience of member states, such as the Scandinavian and Baltic countries, which are global leaders in guaranteeing citizens' universal access to digital services, suggests that Europe as a whole could become an example for the rest of the world, if practices from leading countries can be replicated throughout a truly integrated European single market.

Telecom Single Market

A 'connected continent' was indeed the ultimate objective of the Telecom Single Market (TSM) package proposed by your predecessor. This aimed to set out a more homogeneous regulatory framework, prompt a drastic reduction in roaming charges and favour cross-border alliances between operators and the promotion of a uniform framework for regulation of the internet (and, in particular, of net neutrality isHarsues). However, despite good intentions, that proposal seems to have little chance of success. It is a patchwork of measures not backed by a clear political strategy, the outcome of a reverse approach through which the Commission attempted to balance the downsides for all key parties in the search for a satisfactory compromise. This left all parties unhappy: member states, national regulators, incumbent and challenging telecom operators, content developers, business customers and consumers. Everybody had to give up something, but with no clear link to their contribution to the construction of a single digital market. Today, despite the fact that the four main mobile telecom operators supply services to most European citizens, Europe still lacks true pan-European operators that can credibly compete for customers in all member states.

Understanding the reasons for the general scepticism surrounding the TSM reform should be top of your to-do list at the start of your mandate.

A successful approach would have moved away from the multi-dimensional conflict between the opposing parties. It would have implied that a coherent strategy first be developed, and then pursued organically across the various areas in which intervention is needed. In fact, the most important aspect of any measure that aims to foster a single digital market would be to introduce more certainty about the future prospects of the market: thus the need from the Commission for a

Market operators should be able to largely anticipate your moves before implementation

strong and coherent strategy that should be stable over time, and in which it will be clear how long-term objectives will be pursued and why certain players might be worse-off, even if only in the short term. This applies for example to roaming: if the objective is to converge to a similar tariff for domestic and cross-border calls, there should be coherent use of the available regulatory tools (such as price caps or measures to foster competition between roaming operators) in pursuit of that aim. Market operators should be able to largely anticipate such moves before actual implementation.

Alongside the TSM, other top-priority folders pile up on your desk. Most of those concern topics in which your colleagues such as the commissioners for the single market, justice and taxation are also prominently involved: copyright, privacy and data protection, internet governance, cyber security, and taxation of digital goods and services, to mention just a few. Despite their importance and the necessity for urgent action, the reforms proposed in those areas are either being watered down or are lingering in a limbo with no prospect of rapid adoption. A significant number of member states oppose revision of the copyright framework and support the preservation of a country-by-country enforcement regime, regardless of the pressing need to adapt copyright rules in the context of a highly mobile, dynamic and de-structured digital economy, in which authors struggle to retain rents that mostly accrue to publishers or distributors or are lost to piracy. Fair remuneration for authors must be guaranteed to preserve their incentive to create new content. At the other extreme of the value chain, a new framework is needed to ensure cross-border portability of copyright and to allow citizens to access digital content from any location in Europe.

Data protection

The European Parliament has adopted its position on the new regulation on data protection, with a number of welcome measures that would arguably ensure common rules across the continent: a 'one-stop-shop' for supervision of businesses active in Europe, and ultimately a higher level of protection of citizens' privacy. No doubt the reform is a step forward to ensure the trust needed to stimulate citizens' cross-border consumption of digital goods and services. However the law faces the scrutiny of the Council and is unlikely maintain its shape under the pressure of member states, keen to retain their enforcement autonomy.

Taxation of online companies

Finally, the discussion on taxation of digital companies has only just started. The de-structuring of value chains and the ability of digital companies to separate geographically the creation of value and the making of profits requires serious reflection at supra-national level. While tax harmonisation in Europe is still a utopia, a concerted and harmonised approach at European level could limit distortions in the market that penalise less mobile businesses such as small and medium-sized enterprises, and could help the implementation of a fairer contribution system. As of January 2015, new rules on consumption tax for digital services will imply taxation at the customer's rather than the supplier's place of origin. This is no doubt a good development towards an improved European framework in which no loopholes should be left open to help business circumvent national tax laws.

CHALLENGES

Your number one challenge is to establish a coherent, clear strategy that will address the complexities of the digital agenda and minimise legal uncertainty within the European digital economy. Your actions in this respect must be bold and predictable. Your ultimate objectives should be to maximise European citizens' long-term welfare and to boost European business productivity through a uniform European digital framework. You should push for a meaningful harmonisation of the European regulatory framework in all areas relevant to the digital economy. You need to build a solid consensus around the need to deal with pan-European issues at supra-national level (for example, concerning wireless spectrum management) while maintaining decentralised enforcement of uniform principles and methodologies. A digital Europe cannot afford segmentation into 28 national markets.

Supply and demand should be free to flow across borders, facing no differences in the regulatory environment.

You will also have to deal with a number of very sensitive issues, such as net neutrality or roaming tariffs, about which the public debate lately has become rather superficial. When writing up common rules, your assessment should instead be driven only by substantial considerations. This is your second challenge: the answers to key economic questions have to be based on scientific analysis.

For example, one question is the extent to which allowing price or quality discrimination can help pursue your ultimate objective of fostering the development of infrastructure and services, allowing easy and inexpensive access to them. Issues such as roaming charges, net-neutrality, copyright regulation and the use of personal data are all related to the suppliers' ability to charge different prices or to provide a different quality of service to customers with different preferences, or who live in different locations in Europe. Customer discrimination typically implies an increase in the seller's profits and a shift of surplus from customer to seller, and it is commonly perceived as a threat to the creation of a common European identity. That does not necessarily imply, however, that customers are worse-off when price discrimination is allowed. Price discrimination might, for example, increase competition and create an incentive to supply less-profitable customers (ie customers with higher demand elasticity). Imposing 'roam-like-home' tariffs could in some circumstances imply an increase in costs for customers who predominantly make domestic calls. But price discrimination can also be used anti-competitively. The owner of a telecom network could intentionally hamper the ability of 'over-the-top' services (such as Skype or WhatsUp) that use the network to compete with its own telecom services, a situation that would beg for action by antitrust authorities. Or the vast amount of personal information collected by online operators could render customers more vulnerable to exploitative pricing practices: a seller of a good or a service that can access detailed customer-profile information could be able to offer personalised prices, appropriating most of the benefits generated by transactions. Customers could be charged exactly what they are willing to pay, no less. This suggests that a case-by-case analysis of the welfare effects of price discrimination is generally desirable. That applies in particular to the net-neutrality

Price discrimination

You must find smart ways to increase the relative profitability of new investment

regulation, data collection practices and to roaming. The intentions may be good: to preserve open access to the internet and incentivise cross-border communication. But the proposed regulatory tools to pursue them are not necessarily the best ones, and a serious assessment of the benefits and costs of regulation has to be made before implementing further regulatory measures. Such an assessment is lacking today and should be one of your main priorities. A better option to correct for market failures is to preserve and stimulate market competition. Market abuses are less likely when individual companies have less market power, and competition ensures that the benefits of digital services are shared with customers in the form of lower access prices and better service quality.

Incentives for investment

Your third challenge will be to find smart ways to increase the relative profitability of new investment. Pulling down barriers to entry and preserving competition in traditional markets creates an incentive for telecom operators to try to escape the competitive pressure and seek profits in new markets. A similar effect can likewise be obtained acting directly on the profitability of those new markets by stimulating the demand for broadband connection. A successful digitalisation plan requires a holistic strategy in which measures to expand the supply of digital services are accompanied by effective measures aimed to stimulate demand. So far, measures taken by the European Commission have been strongly skewed towards stimulating supply. You need to rebalance this approach, with an appropriate focus on demand. A recent report² found that the vast majority of those who do not have access to the internet (36 percent of European households, but the proportion is higher in southern and eastern Europe and among older people) mention “*lack of interest*” as the main reason. Only a handful of respondents reported lack of broadband availability as the cause of their digital inertia. Measures that would prompt a significant shift of

public and private services online together with measures addressing digital illiteracy and availability of devices to the weaker segments of the population of potential users can have a strong effect on digital development. Likewise, fast and ultra-fast connection technologies are of little use if no applications that crucially need that speed level are developed and widely implemented. All the crucial reforms aimed at empowering and protecting customers across Europe such as data protection law and copyright reform can also contribute to boosting the profitability of the digital economy. Youtube and Netflix account for more than 50 percent of downstream traffic in the US; cleaner more unified licensing rules on digital content can have a strong impact on demand for high-speed access. This should be one of your top concerns.

RECOMMENDATIONS

Your first concrete steps should be to define a long-term strategy for the efficient allocation of competences between different government levels. Your aim should be to establish a homogeneous European regulatory approach, in which national regulators would apply the same rules and implement the same remedies to correct for market failures, the burden of bureaucracy would be drastically reduced, compliance and transaction costs would be minimised and cross-border supply of services would become truly profitable. You should therefore carefully consider the advantages of moving towards a stronger supra-national telecommunications supervisory system, ideally ending up with the establishment of a single EU regulator that can address cross-border issues and has the authority to overturn national decisions that conflict with the common rules. This would likely be the most straightforward way to overcome national fragmentation, minimise competitive distortions and promote the establishment of pan-European telecoms operators.

Equally fundamental is the establishment of a mechanism for the EU-level allocation of wireless spectrum. This would dramatically reduce costs and uncertainty for potential continent-wide mobile operators while allowing at least partial control over the structure of the European 'single' mobile market. Spectrum auctions should be designed to strike the right balance between revenues and the optimal number of competing operators in the market. Centralised auctions would also allow optimal use of spectrum capacity throughout Europe – a particularly

Regulatory
harmonisation

Spectrum policy

pressing issue given the significant increase in mobile data demand because of the increasing use of tablets and smartphones. You will of course face stiff resistance from member states. Wireless spectrum is a significant source of revenue at national level and allocation mechanisms for revenues from EU-wide auctions would not fully compensate member states for their loss. But national auctions have not always proved efficient: delays in national auctions for the allocation of spectrum for 4G are part of the reason why Europe lags behind in terms of mobile broadband services. To convince member states to move towards pan-European auctions you should emphasise the likely strong downward pressure that cross-border competition would exert on users' tariffs. The loss to national taxpayers could be largely offset by the gains that consumers would enjoy. More generally, consensus can be built through carefully concerted action. That action would necessarily rely on re-establishing a constructive relationship with the Body of European Regulators of Electronic Communications (BEREC), the umbrella organisation of the national regulatory agencies, the implementation of a clear communication strategy and the promotion of platforms to favour the open and transparent discussion of your long-term strategy.

Enforcement

You should also not hesitate to use the legal instruments at your disposal in order to enforce truly harmonised rules. For example: net-neutrality regulation ought to be the same everywhere in Europe, and you should not shy away from challenging national laws that clash with European law. National digital agendas have to converge rapidly to the European objectives, and lack of correct implementation of European directives has to be properly sanctioned. Establishing a 'tough' reputation for not tolerating national divergence from the European digital framework will be particularly critical and effective at the beginning of your mandate.

You should then make a careful cost-benefit analysis of the options available to you to reach your ultimate objective: smart new regulations to foster competition by making it easier for consumers to choose the digital services they want, while maintaining incentives for those that supply those services; direct intervention using EU Structural Funds to support demand or to finance the roll-out of networks; initiatives for coordination between member states, for example on tax issues, or cooperation between national authorities to develop support schemes for small business.

There should be expanded demand for digital services from public sector, business and citizens

You should steer the actions of the European Commission in supporting the expansion of demand for digital services. This should happen at three levels: public sector, business and citizens:

Boosting demand

- Schemes to promote eGovernment, eHealth and eProcurement, particularly facilitating cross-border interoperability, can be effective to start a virtuous circle in which public services are increasingly digital, and citizens find it increasingly natural to rely on them.
- The promotion of the digitalisation of business, particularly for small and medium-sized enterprises, which might be discouraged by high initial fixed costs. Examples are numerous: direct financial support to update production technologies (initiatives such as I4MS, *Innovation for Manufacturing SMEs*, can be particularly effective); training programmes to help the development of IT skills and the establishment of a harmonised framework for the recognition of qualifications throughout Europe; or the promotion of EU-wide technology standards to favour interoperability.
- Finally consumer demand can be directly stimulated. Cross-border eCommerce can be fostered through increased security of data handling and fair management of digital copyright that would ensure cross-border portability; the European Commission can advocate tax breaks in national systems to favour the purchase of digital devices, further stimulus can come from favouring the development and the uptake of applications requiring high-speed data transmission, such as video streaming on demand, cloud services, distance learning, live conferences or telemedicine.

Pro-competition policy

On the supply side, you should prompt an increase in the relative profitability of new generation access networks compared to copper networks. Your attention should be particularly focused on mobile broadband, given its geographic versatility, the strong demand for mobile data through portable devices and the single market long-term objective of allowing citizens to access the internet at any time and anywhere in Europe. There should be no doubt about your pro-competition policy. Regulatory schemes to favour entry, and to stimulate and preserve intra-platform and inter-platform competition are therefore well worth pursuing. It is fundamental to empower consumers by increasing tariff transparency and adopting measures to reduce switching costs, to make it as easy as possible for customers to change provider. Your task will be to guarantee that fair rewards for investment (compensating also for the risk taken) accrue to investors *ex-post*, ie after investments are made. You must establish a credible time-independent, pro-investment policy.

Investment support

When appropriate of course, direct subsidies and the use of EU Structural Funds to incentivise the deployment of new networks can also be envisaged, for example, in those cases in which demand will never be enough to ensure an appropriate return on investment, such as in rural and remote areas. Subsidy schemes should correct market failures while minimising distortion. While enforcement is guaranteed by the Directorate-General for Competition, your Directorate-General should be actively involved in monitoring the digital sector, identifying potential issues to be addressed and verifying that the tools used are indeed suited to their purpose. The expertise in your Directorate-General is crucial to ensure that efficient intervention takes place when needed. More generally, though, you should pursue a smart and courageous supply expansion support plan. There is no point in aspiring to bring Europe to full technological coverage just for the sake of it. Where the market cannot sustain multiple platform competition, you should bet on the most appropriate technology to do the job (for example mobile broadband in rural areas). The best way to find out how to do it is to let consumer preferences and needs shape your action plans.

TO THE COMMISSIONER FOR RESEARCH

REINHILDE VEUGELERS

Europe on average has consistently failed to exploit its potential for innovation-based growth. The slow pace of improvement is especially worrying because Asia's star is rising, and Europe is less inter-connected than the United States with Asia

STATE OF AFFAIRS

You inherit a portfolio about which there are great expectations. Europe's low growth prospects mean there is a focus on science, research, technology and innovation as sources of future sustainable growth. New ideas from fields such as digital technology, new materials and biotechnology are expected to generate economic growth and competitiveness, while addressing new global societal demands related to ageing, health, the environment, security and inclusion.

There are many highly innovative European companies, but the evidence shows that Europe on average has consistently failed to exploit its potential for innovation-based growth, despite a series of innovation policy strategies and targets. For example:

Innovation performance

- The Innovation Union Scoreboard (IUS) 2014, a composite indicator exercise developed by the enterprise and industry directorate-general that captures a multitude of factors for measuring Europe's innovation capacity, shows that the EU scores consistently behind the US. The gap with the US has recently narrowed (IUS, 2014). But in the meantime, China is very quickly improving its IUS position relative to Europe. Another disturbing finding from the latest IUS (2014) is the slow process of convergence of EU member

Innovation performance is improving too slowly; Europe lacks the capacity to change

state IUS performance. There has even been growing divergence in recent years.

- Since the introduction of the Lisbon Strategy target for member states to spend three percent of GDP on research and innovation, one of the closely monitored headline indicators of the health of the EU innovation system has been investment in R&D. Business R&D intensity has held up pretty well over the crisis, sitting at 1.26 percent of GDP in 2011. It nevertheless still remains far below that in the US, South Korea and Japan and even China (with more than 1.4 percent in 2011).
- Public investment in R&D has in Europe held up well on average in the face of the crisis thanks to stimulus funding. But in more recent years, under fiscal consolidation pressures, the trend has been for less public spending on R&D. This is the case especially in the weaker, innovation-lagging countries that were under fiscal pressure, resulting in an increasing intra-EU divergence in public R&D spending.
- On science, the EU has caught up with the US in terms of number of PhDs and number of publications. But the big rising star is China, both in terms of students trained and publications. But when it comes to top-quality and frontier research, the US maintains a substantial lead. The EU is catching up on in quality terms, but only very slowly, and mainly thanks to small pockets of excellence in specific sub-fields. Europe still has few world class institutes that excel in multiple and broader fields.

Public investment

Although there is good news to be found in the evidence, Europe's innovation performance is improving too slowly. Europe lacks the

capacity to change, lacking young innovators who can assume world-leading positions in new innovation-based growth markets, such as digital industries, but also in biotech, clean technologies and others. These areas and these types of firms offer the greatest opportunities for innovation-based growth. Europe's slow pace of improvement is especially worrying because, in a multipolar global science and innovation landscape, Asia's star is rising rapidly and the EU is less interconnected than the US with Asia in this respect.

CHALLENGES

Some of the challenges you face are structural and longstanding. These classic challenges relate to (i) Europe's failing capacity for creative destruction, innovation-based growth and change and (ii) the challenge of building an integrated European science, research and innovation area. The process of integration, with a single market for research and innovation, in which ideas, know-how, researchers, students and innovative products can move freely between EU countries, remains a dream, which seems to become less realistic. It remains a challenge to link regional and national innovation systems within a more integrated European innovation system, and to better link science, research and innovation players so that new science and research insights can be transferred more swiftly into commercial ideas that can command world-leading positions.

These challenges have been difficult to address in the past. Having been not seriously tackled, they have unfortunately become even more difficult, being fed by the crisis in Europe and globalisation and the speed of change outside Europe.

Pressure for fiscal consolidation

A looming danger is fiscal consolidation pressure, which leads member states to freeze or even cut their public research and innovation budgets and/or to redirect their attention and public R&I funds to shorter-term, more targeted spending that delivers more immediate returns and impacts. The risk here is that more risky long-term investment in basic science and research goes unfunded, although it is this type of investment that most clearly requires the government to play a role, because it is here that the divergence between social and private returns, and the chance of market failure, is greatest. Because these high social returns are often more risky and are accrued in the longer term, these investments

may be the least favoured ‘pets’ for politicians to keep in a situation of consolidation.

And as fiscal consolidation pressure is greater in Europe’s innovation-lagging countries, the innovation divide runs the risk of widening in future. Together with rising euroscepticism, this increasing divide threatens to completely destabilise the European Research Area project.

While the science, research and innovation world is rapidly globalising, Europe is only slowly responding. Europe is far less open than some other economies, and is less good at attracting talent from abroad and connecting to the new emerging science poles.

Your challenges are accentuated by limited powers. The resources at your disposal are, despite their growing share of the overall EU budget, still limited: public science, technology and innovation budgets are mostly controlled by member states or their regions. The challenge is therefore to use your limited budget to leverage the larger pots of national and private funding.

Furthermore, the set of tools to shape the framework conditions for innovation-based growth, such as competition policy, regulations and standards, are also mostly in the hands of other European commissioners and/or member states or regions. You therefore need to convince others to activate the most powerful instruments that can shape the demand for innovation – such as regulation and standards – a big challenge that blocked your predecessor. Your main initial challenge is therefore the governance of EU research and innovation policy. For coordination with other policy areas, the Barroso II Commission established an Innovation Group, which was led by your predecessor and included the commissioners for competition, transport, the digital agenda, energy and industry and entrepreneurship, and occasionally also internal market, regional policy, employment and education and culture. It is hard to find anybody saying that this has been a success. Also the appointment of a Chief Scientific Officer by Barroso II has only made the coordination challenge more difficult. In terms of coordination with member states, the Council of the European Union meetings on science, research and innovation with your member states colleagues have not been very impactful, and have resulted in little more than nice declarations.

Globalisation of science

Coordination

Remove innovation from your portfolio; it was a mistake previously to include it

RECOMMENDATIONS

A first recommendation is to remove innovation from your portfolio. It was a mistake by Barroso II to include it in your portfolio. Having innovation within a portfolio and directorate-general that historically had a science and research mandate runs the risk that innovation will be steered too much as a push from science and research. Innovation needs a broader approach that also includes non-technological innovation and diffusion and adoption of existing science and technology knowledge. Such a broader integrated approach requires the mobilisation of a broad set of instruments, most notably single market and competition policy. Achieving this leverage proved to be virtually impossible for your predecessor. Making the ‘innovation agenda’ the priority of one commissioner almost by definition seemed to exclude others from engagement. In an attempt to improve the governance of the Commission’s innovation policy, you should therefore recommend hand the ‘innovation agenda’ to the new vice president for growth. There it will sit at more horizontal, strategic level, more closely aligned with the Europe2020 innovation-based growth objective. The vice president for growth should be given more power to mobilise the relevant instruments from the various directorates-general that currently oversee them.

Such a restructuring will free you from time-consuming but ineffective efforts to chair coordination meetings with other commissioners. This is not to say that you no longer need to care about innovation. On the contrary, it will help you to make your science and research portfolio more powerful as the cornerstone of Europe’s innovation-based growth. How can this be done? First, save us all from yet another big ‘Communication’. The existing Innovation Union Flagship and the European Research Area, along with Horizon 2020 are the policy plans you should work with during your mandate. It’s time to walk the talk.

Horizon 2020

The relevant decisions have already been taken about the Horizon 2020 budget, and so your task is to get the most out of it. We still know very little about how to get the greatest impact from EU research funding, and you should therefore not shy away from experimenting with new programmes. But this is not a license for trial and error. Any experiments should be scientifically sound (consider randomised trials), with proper evaluation, feed-back learning and early exits if necessary. Scientifically sound evaluation is not only needed for new programmes, but should also be applied to the stock of currently running programmes. You should assess with proper counterfactuals the causal impact of Horizon 2020 funding – what the outcome would have been without this funding. You should assess its added effect on funding from member states and on private funding. Such evaluations require state-of-the-art quantitative and qualitative micro-level assessments fed into macro-modelling. The quantitative assessment should go beyond measuring the publications and patents coming out of funded programmes. It should also assess the impact on innovation and growth in Europe. These assessments should be done by independent outside experts. In addition, you should be an avid ‘open government, big data’ provider. You should make the historical data on applications and grants from previous EU research programmes (the Framework Programmes) and from the Horizon 2020 funding programmes publicly available for analysis. This would boost the emerging academic community in the ‘science for science policy’ field by giving them access to rich and large datasets. It will provide you with more scientific analysis of how to get more bang for your buck.

When looking at the individual pillars within Horizon 2020, the European Research Council (ERC) under the ‘excellent science’ pillar is widely recognised as a success story. The roots of this success, namely its independence, embodied in its Scientific Council, and its unique position as a funder of bottom-up, individual-investigator driven, frontier research should be left untouched. Your task is to prevent the ERC from being drawn into demands for more cohesion, ‘juste retour’ or the targeting of specific ‘challenges’. You must assess if the ERC is delivering, which is not just about publications in top scientific journals, but about supporting risky frontier research with the potential for major breakthroughs. The assessment should also consider the ERC’s role in global science, in attracting top talent from outside

Getting the most
from Horizon
2020

European
Research Council

Europe and a catalyst for EU researchers to link with the best non-EU researchers. Finally, you should ensure that the best ERC-funded science results are diffused more easily within Europe and can cross into the realm of research and innovation. The ERC's own small 'Proof-of-Concept' programme shows that a bottom-up science programme like the ERC grant programme can generate brilliant ideas that can be brought to market. Other instruments in the Horizon 2020 programme which are more dedicated to helping bring ideas to market, should be better connected to ERC-funded science.

An important bridging programme, long awaited, but still in the pipeline, is a Small Business Innovation Research (SBIR) type of programme, which would fund proposals from young innovative firms that would help bridge the gap between idea and market. You should speed up the launch of this programme, while ensuring that it is properly designed. It should be a bottom-up programme, which funds entrepreneur-driven proposals. The quality of the selection is crucial because it provides a form of certification to the beneficiaries, which will help them to access other financing and partners. The European value added comes from the economies of scale in selection and evaluation. You should avoid an insistence on European networks of proposers, which would not be the right format for this programme. It should be an entrepreneur-focused programme. A proper *ex-post* evaluation should be included in the design of the programme from the start.

The other programmes under the Horizon 2020 'excellent science' pillar (Marie Curie Fellowships, Research Infrastructure and Future Emerging Technologies), which rest on the principle of bottom-up proposals selected on the basis of scientific excellence, should be organised in line with the successful formula adopted by the ERC, or should be integrated into the ERC.

Cooperation programmes

A major part of the Horizon 2020 budget goes to the large-scale cooperation programmes under the 'societal challenges' and 'industrial leadership' pillars. These are much more targeted programmes compared to the 'excellent Science' pillar. They deal with specific technologies and applied research, and consequently involve greater industry participation. Nevertheless, they are and should remain pre-competitive and sufficiently broad, with room for bottom-up proposals

The European Research Area has lost momentum in recent years; this should be remedied

within the targeted areas, and scope for selection to be made on the basis of excellence-driven potential for impact. These pillars would gain tremendously from having a better mission orientation, call description and selection process, designed by an independent agency, such as in the case of the ERC. The agency could be structured similarly to the ERC, with an independent Technology Council that would organise the calls and be responsible for the selection of the panel members that will review the proposals. The Technology Council would be a collection of several parallel mini-technology councils, one for each area/grand challenge, and the technology councils would include, in addition to academics, experts from industry and civil society. Such a governance structure should lead to greater excellence, particularly by improving the selection process through the composition of panels. You would oversee the selection committee that nominates the Technology Council, and would monitor and evaluate its performance.

A bit hidden among the Horizon 2020 programmes are the policy support calls. These are very much top-down projects, with the objective being to provide support for specific policies. For these projects, policy users (from the relevant Commission directorates-general or from national and regional levels) should be more systematically involved in identifying the topics for calls, the selection panels, project monitoring and *ex-post* assessment. Then there are two ‘special cases’ in Horizon 2020: the autonomous European Institute of Innovation and Technology (EIT) and Joint Research Centre (JRC), each with a specific mission and dedicated budget. Both of these (and also EURATOM) still require a serious *ex-post* evaluation of their accomplishments in order to justify their special status in Horizon 2020. This should be part of your overall evaluation strategy. The Horizon 2020 pillar on widening participation, although modest

Policy support
calls

in budget, is nevertheless important. It will allow you to clearly focus the objectives under the other pillars solely on excellence, freeing them from cohesion concerns. Coordination with cohesion objectives can be further improved, for instance by convincing the regional development commissioner to allocate a greater share of the Structural Funds to making scientific teams ready to compete for Horizon 2020 funding, to fund runners-up in Horizon 2020 contests and to award fellowships to researchers to stay at hubs that have been successful Horizon 2020 applicants.

The European Research Area (ERA)

European Research Area

ERA, and its vision of free movement of knowledge within Europe as the fifth dimension of the single market, has lost momentum in recent years. This should be remedied. Furthering the integration of Europe as a common market of ideas and knowledge is perhaps the most important contribution you can make to the European growth agenda. The problem with ERA is that the creation of a single market for knowledge requires material progress in many fields that are not under your direct control, such as immigration, social security or labour laws. Nevertheless, you can set up a ‘big-data’ ERA infrastructure to measure the various channels through which knowledge flows (or not) inside the EU. This will help to better monitor the progress being made towards ERA, to better understand how the various channels operate, and to evaluate their impact. This will form a valuable evidence base for ERA policy making.

Researchers crossing national borders are important carriers of knowledge and important bridge-builders between their host and home locations. In the same vein, mobile researchers can be important carriers of knowledge between science institutes, technology institutes and industry. It is unfortunate that in Horizon 2020, the programmes for intra-EU mobility and networking – the Marie Curie Fellowships – are in the portfolio of the Commissioner for Education and Culture and are managed by the autonomous Research Executive Agency. These fellowships are potentially the most powerful instrument the Commission has for furthering ERA. To make the most of this instrument, the responsibility should be transferred to you.

But ERA is not only about removing barriers to mobility inside the European block. ERA is also about making Europe attractive for top

If Europe wants to be a research powerhouse, it should be more open to the outside

non-EU talent. A global perspective on science and research is indispensable for you. Countries such as China and South Korea have established themselves as science and technology giants, and are making genuine breakthroughs in fields from green energy to microelectronics. The US is much better connected to these emerging giants thanks to the mobility of researchers into and out of the US from these emerging powers. If Europe wants to be a research powerhouse, it must not only be internally integrated, but should also be open to the outside. International research cooperation should be much higher on your agenda. Partners for bilateral cooperation should be much more strategically chosen. These should be first and foremost partners that offer complementary research excellence. In particular, improving the EU-China link should be among your first priorities. Rather than installing top-down collaboration projects, the aim should be to build bottom-up links and networks involving EU and Chinese researchers. To facilitate this, the Marie Curie extra-EU mobility fellowships are a pivotal instrument, and you should be able to operationalise this tool, either by having it transferred to your portfolio or at least through close coordination with your internationalisation strategy.

Finally, open access to publications and scientific data should be much more than a technical issue in your portfolio. It is a strategic ERA issue that can improve the free flow of scientific knowledge as codified in publications. You should use your power as big funder in negotiations with scientific publishers to establish fair conditions for the allocation of the true cost of open access. It would harm ERA integration tremendously if only the well funded can access scientific publications and data.

Open access

**TO THE
COMMISSIONER
IN CHARGE
OF MOBILITY,
MIGRATION,
ASYLUM AND
BORDER
MANAGEMENT**

RAINER MÜNZ

European labour markets are mismatched in terms of supply and demand for labour and skills. You must work to address this through migration policies in a period of negative public attitudes towards migration and mobility. Europe also has an obligation to care for people in need of protection

STATE OF AFFAIRS

You take office at a time when Europe is confronted with several challenges related to mobility, migration and demographic change¹.

Intra-EU mobility

Labour mobility

Wherever the limits of your competences fall, you will be confronted with high levels of unemployment, especially in southern and south-eastern Europe. In many regions of Spain and Greece and in one Italian region, the unemployment rate today is above 20 percent. And at the same time you will hear serious complaints about a shortage of labour and skills in a growing number of regions and industries – not least in countries such as Germany, Austria and Sweden. This clearly hints at mismatches between supply and demand of labour and skills, caused by fragmentation of European labour markets along national boundaries.

Obviously there is no single European Union labour market, but 28 national ones. And in contrast to public perception, mobility of labour within the EU is not a large-scale phenomenon. It grew from 2004-08 because of east-west flows resulting from two rounds of EU enlargement. Then, as a result of the recent crisis, it receded.

Since 2011, intra-EU mobility has picked up again. Now citizens of crisis-hit southern EU countries (plus Ireland) leave for better

economically-performing places. Nevertheless, only 8.1 million EU citizens work and live in another EU country. Many occupy positions for which they are overqualified. In addition, there are some 1.1 million cross-border commuters in the EU. Together, these two groups represent 3.8 percent of the total EU labour force. On top of this, about 1.2 million posted workers perform short-term assignments annually related to the free movement of services.

The main obstacle to intra-EU mobility is the way European labour markets and welfare systems function. Educational systems, vocational training, labour market regulation and related social security systems are strictly organised at member-state level. The second most important obstacle is transfer of language and skills: a considerable number of Europeans who might find work abroad simply lack the linguistic competence that would give them access to adequate jobs in economically-thriving regions and industries. Others fear job offers below their skill levels, leading to de-qualification and lower pay.

There are also structural barriers to mobility. In most EU countries, various professional groups, trades and services successfully maintain entry barriers that favour insiders. The outcome is obvious. Even if skilled EU citizens would show more interest in moving, and readiness to move, to another country, or if EU member states would try to become more attractive for skilled third-country nationals, mobile people with skills could not easily become lawyers, teachers, civil servants, or establish themselves in protected trades in chosen European countries of destination.

Such barriers also prevent intra-EU mobility from playing an equalising role when dealing with macro-economic imbalances between EU and euro-area countries. While exchange rate fluctuations can no longer serve as a 'safety valve', mobility in Europe is far too small to have a similar effect. For comparison: in a normal year, some 2.7 percent of US workers move from one of the 50 states to another. In Europe, on average, 0.2 percent of EU workers are mobile across internal EU borders annually.

In this context, there is room for expansion of the European Network of Employment Services (EURES). Today it has over

Obstacles to mobility

EURES

1.7 million job vacancies and over 1 million CVs available online, representing only a small fraction of Europe's jobseekers and vacancies.

Third-country immigration

Labour migration of third-country nationals

Within the EU, some 10.5 million workers are non-EU citizens, representing 4.3 percent of the total EU labour force. The shortage of skills in certain regions and industries, however, seems to indicate that Europe, in the absence of significant intra-EU mobility, also has difficulty attracting enough third-country nationals with high and medium qualifications. In many EU member states with a positive migration balance, third-country nationals from non-EU countries on average have lower qualifications than the native work force. As a result they have been hit harder by the recent crisis than native workers. The unemployment rates of third-country nationals on average are twice as high as overall unemployment rates in the EU. And third-country nationals are employed at significantly lower rates (53 percent) than nationals of the host countries (65 percent). In countries that experienced considerable GDP contraction during 2009-13, notably Greece, Ireland, Portugal and Spain, the problem is particularly acute.

The average profile of third-country nationals living in the EU unfavourably contrasts with the foreign-born population in traditional immigration countries. Australia, Canada and New Zealand select immigrants through points systems, in which education, skills and language abilities play an important role, while the US attracts talent and skills through a combination of world-class universities and the promise of the American dream that everybody has the chance to be upwardly mobile. There is no matching European dream offering similar prospects. Many well-informed people with the ambition to migrate globally instead see Europe as a continent characterised by highly developed welfare states, but also by high taxes, less innovation and greying populations.

Border management

Asylum, irregular migration, border management

Europe's geography and neighbourhood do not make migration and border management an easy task. The boundaries of the Schengen area consist of 7,700 kilometres of external land borders, but 42,600 kilometres of external sea borders – those of southern Italy, Greece and Malta being most exposed to irregular inflows. Additional border

crossings exist at international airports and sea ports, but they are much easier to control. During a single year, some 700 million regular crossings of the external Schengen borders take place. Only a tiny fraction – maybe 0.5 percent of these border crossings – is related to international migration.

At the same time, Europe's humanitarian tradition and international conventions (including the 1951 Convention and various European legal provisions) require EU member states to admit asylum seekers and to grant them refugee status if they qualify. Upholding this tradition and legal obligation, however, becomes more difficult when an increasing number of people manage to cross Europe's land and sea borders – with many of them asking for protection. In 2013, more than 430,000 people claimed asylum in one of the 28 EU member states – a 29 percent increase compared to 2012, but still below the peak of 670,000 recorded in 1992.

Still, many asylum seekers enter the EU legally via land borders and airports. Many other citizens of third countries do not look for protection. They enter as tourists or travellers with the aim of becoming economically active on informal labour markets within the EU. Their existence serves as a key pull-factor attracting irregular migrants and inducing people to overstay their work or residency permits.

In the past your predecessors supported efforts to control migration not only at external EU borders, but also at likely points of departure for Europe. The EU concluded readmission agreements and engaged in capacity-building activities in neighbouring countries with the clear aim of reducing irregular flows. The EU also created Frontex and implemented joint instruments such as the Schengen Information System, the Visa Information System, Eurodac and, more recently, the European Border Surveillance System (EUROSUR), and the European Asylum Support Office (EASO), to assist member states.

Irregular entrants mainly enter Europe via the southern/south-eastern sea borders and eastern land borders. Countries such as Italy, Greece, Malta and Bulgaria have to shoulder the main burden of dealing with these inflows – including increasingly costly rescue operations in the Mediterranean. In 2014 alone, more than 120,000 irregular migrants and asylum seekers will arrive via Europe's southern sea borders.

Irregular migrants

For some countries, there is little political will or incentive to process asylum applications

Many of them would not have made it without assistance from Italy's and Greece's coast guard and navy patrolling the Mediterranean. At the same time, only seven EU countries, all of them located in north-western Europe, handle three quarters of all asylum applications.

Under current EU rules there is no truly functioning mechanism for burden-sharing, which the southern EU countries with large irregular inflows are asking for. At the same time, countries with large numbers of asylum applications (namely Austria, Belgium, France, Germany, the UK and Sweden) call on member states in southern and south-eastern Europe to live up to their obligations to process asylum applications. Under the Dublin Regulation, the member state in which an asylum seeker first sets foot is responsible for handling the request. Obviously, for some countries, there is little political will or incentive to process asylum applications. The European Court of Human Rights even concluded that one country, Greece, does not offer reception conditions meeting minimal standards. This legally prevents other member states from returning asylum seekers, even if Greece was the first EU country they entered.

Public opinion

Public resistance

An Ipsos survey carried out in 2011 in the main European migrant-receiving countries indicated that a majority of citizens think that migration has more negative than positive effects. A German Marshall Fund survey also showed that a majority of Europeans tend to believe that governments have lost control over migration flows. For many Europeans, this loss of control has come to be symbolised by asylum seekers and people desperately looking for economic opportunities, crammed into small boats trying to cross the Mediterranean.

The number of industries confronted with shortages of labour and skills is likely to increase

Furthermore, in several destination countries, a considerable share of citizens also opposes intra-EU mobility. According to Ifop, a pollster, more than 80 percent of Dutch and some 60 percent of French citizens believe that freedom of movement should be restricted for Bulgarians and Romanians. According to the Bertelsmann Foundation, two-thirds of Germans see mobile EU citizens as a potential ‘extra burden’ on their country’s social welfare system.

Reflecting and reinforcing these trends, political parties with a restrictive agenda are becoming more popular in western Europe. In the most recent elections to the European parliament, in Denmark, France and in the UK, parties that campaigned in favour of restricting the mobility of EU citizens and drastically reducing immigration by third-country nationals came first in the polls.

CHALLENGES

With the Stockholm Programme – the EU’s justice and internal security strategy – approaching the end of its five-year cycle, the Commission has published a communication on *‘An open and secure Europe: making it happen’*, while the European Council in its 26-27 June 2014 meeting adopted Strategic Guidelines for legislative and operational planning in the area of freedom, security and justice. You will need to work with member states on how to translate this into policy goals that will guide EU institutions and member states in the fields of mobility, migration and asylum.

Intra-EU mobility and labour migration of third-country nationals

During your time in office, European populations and work forces will continue to age. And while unemployment and underemployment will probably continue to be a burning issue for many years to come in some EU countries, the number of regions and industries

Stockholm
Programme

confronted with shortages of labour and skills is also likely to further increase.

The resulting gaps can be closed: (A) through an increase in retirement age; (B) by increased productivity and/or outsourcing of labour-intensive activities to non-European locations; (C) through a better allocation of labour based on more mobility between EU member states; and (D) by recruiting skilled third-country nationals from outside the EU. These options are by no means mutually exclusive.

Option C requires action both at Commission and at member state levels to address existing and well-known obstacles to labour mobility. When it comes to option D, the Commission has no direct competence. You can only remind member states about the following: if they decide to recruit or admit migrant labour from third countries, they will need to focus more on skills. This will not become easier over time. The Gulf States and Singapore are already competitors. In a not too distant future many more economies – including China and South Korea – will also be in need of migrant labour. As a consequence, more countries will enter the global race for talent and skills.

Asylum, irregular migration, border management

Given Europe's geography and place in the world, managing external borders will remain a challenge. Facilitating border crossings and liberalising or even abolishing visa requirements for people who travel for legitimate business, leisure or family purposes can give Europe comparative advantages in the areas of trade, academic exchange and tourism. However, border management and visa regimes serve the purpose of protecting Europe from irregular migration flows and denying certain people – namely those posing a threat to our security or seeking irregular employment – access to EU territory.

Refugees

You and EU ministers responsible for justice and home affairs will need to address Europe's dilemma: we face a lot more people in need of protection than European countries are willing and able to accommodate. This dilemma will not go away. On the contrary, this disproportionate relationship will only grow. Entrenched political conflicts and civil war are unfolding in Europe's neighbourhood – namely in Iraq and Syria, to a smaller extent in Libya, but also in parts of sub-Saharan Africa. The pull-out of NATO forces from Afghanistan

is likely to increase refugee flows from this country as many more people now speak western languages and have some connections to Europe. Furthermore, the number of political refugees and destitute people, including climate refugees – who have no claim under existing asylum law – will undoubtedly increase during the years to come.

Controlling irregular flows will not become easier because it partly depends on the willingness and ability of neighbouring countries to cooperate. Countries like Libya and Tunisia, however, definitely have other priorities, while Jordan, Lebanon and Turkey are already overburdened with 5-6 million Syrian and Iraqi refugees. You and EU ministers responsible for justice and home affairs should expect reduced cooperation when dealing with transit migrants and refugees using these countries as hubs for their journeys to Europe, as long as the EU has nothing to offer in return.

Public opinion

In many countries eurosceptic narratives are dangerously mixing with negative attitudes towards migration and mobility. While intra-EU mobility remains a popular option in member states where flows originate – for example in Poland or Romania – it is evident that at the receiving end in north-western Europe tabloid media and extreme right-wing parties, and also mainstream politicians and governments, are assigning free movement within the EU with responsibility for ‘stealing’ jobs from native workers or encouraging ‘welfare tourism’. Addressing the latter in a populist move, in 2013, the governments of Austria, Germany, the Netherlands and the UK wrote a letter to the Commission asking for the free movement of (some) EU citizens to be restricted.

The twin challenge will be to make European citizens understand the following: on the one hand – beyond the free movement of people governed by European law – it is the responsibility of member states and not of EU institutions to control borders, manage the immigration of third-country nationals and process asylum applications; on the other hand closing labour market gaps through more intra-EU mobility and the selective admission of skilled third-country nationals leads to higher economic output, not to higher unemployment.

Freedom of movement for labour must not be dissociated from the other single-market freedoms

RECOMMENDATIONS

Intra-EU mobility and labour migration of third-country nationals

Mobility of labour within the EU is an area in which the European Commission can and should act. In this situation you should make clear a few things:

Principle of freedom of movement

- As a founding principle of European integration, the freedom of movement for labour is non-negotiable. It has existed since 1 January 1968, and must not be dissociated from the other freedoms that make up the single market.
- High unemployment in some regions of the EU and an unmet need for labour and skills in other regions is not just a misallocation of resources, but creates a permanent loss of GDP.
- Improved mobility of labour within the EU requires sound procedures for the mutual recognition of educational attainments and acquired skills based on comparable standards. EU-wide standards of recognition would be helpful. A reference base similar to the European university credit and accumulation system (ECTS) could make qualifications acquired in one country more easily understood by employers and institutions in another.
- The former point is not only a matter of fairness, but an important measure to counteract brain waste and to maximise economic gains from intra-EU mobility. In line with a directive adopted in April 2014, member states must ensure that bodies at national level advise and support mobile EU workers and jobseekers (including the enforcement of their rights). You should monitor progress in this field and from 2016 evaluate the effects of such support.

- The same should apply in dealing with the Posting of Workers Enforcement Directive, which was adopted in May 2014. You should monitor to what extent member states actually engage in detecting and preventing abuse of posting and exploitation of mobile EU workers and social dumping across borders.
- You should make it very clear that existing EU treaties and legislation are not the source of wage undercutting and social dumping. The European commission cannot be a substitute for national administrations that are insufficiently enforcing labour laws, minimum wages (wherever they apply) and social security regulations.
- The same is true when dealing with complaints about cases of so-called welfare tourism. EU member states are responsible for the handling of welfare benefits. You should remind them that European law does not extend the freedom of movement and settlement to EU citizens who cannot support themselves. In any given EU member state, social benefits only have to be granted on a non-discriminatory basis to citizens of the member state and to long-term residents. Mobile EU citizens have to ‘earn’ social protection in the receiving country through prior contributions and/or residency.
- The EURES database is an important tool, but could include many more jobseekers and vacancies. To achieve this, you should invite the 28 national labour market administrations to expand EURES with the clear aim of placing more EU job-seeking citizens throughout Europe.
- Domestic regulations restricting entry into professional occupations tend to protect insiders against competition while discriminating against practitioners not trained in the country in which they want to become active. As a consequence, mobile EU citizens and third-country nationals must often undergo time-consuming and expensive assessments or training to demonstrate their skills. Such procedures need to be simplified without sacrificing their quality checking role. The aim should be to eliminate the need for case-by-case assessments when qualified migrants have been trained in systems conferring essentially comparable skills. You should encourage

Welfare
benefits

Portable rights

the regular updating of the common rules that facilitate the process of recognition.

- You should continue to promote social security coordination to make acquired rights and benefits fully portable. In a next step, this has to be fully extended to employer benefits such as occupational pensions, as stipulated in a recent directive on improving the acquisition and preservation of supplementary pension rights for mobile workers.

Labour migration of third-country nationals

The admission of labour migrants from third countries is not part of your portfolio, but should remain a matter of concern.

- You should remind member states that are managing migration at their discretion that global competition for talent is becoming tougher. EU economies in need of labour and skills will have to develop smarter selection and admission policies.
- EU countries have to improve their image as attractive destinations for skilled migrants.
- Member states should also try to avoid brain waste. Adequate jobs for skilled migrants will directly translate into higher wages and eventually into higher remittances. The latter directly reduces poverty in migrant-sending regions and increases their local GDP. Both have a stabilising effect, which is in our particular interest when these regions of origin are part of the EU's neighbourhood.

Skilled migrants

Asylum, irregular migration, border management

The dilemmas Europe faces in the field of asylum and irregular migration urgently need to be addressed:

- You should make improving the credibility of Europe's border control and asylum systems a priority, while acknowledging that perfect solutions are not available. This requires a discussion about what solidarity between EU member states could mean in practice.
- You should therefore explore enhanced mechanisms of burden sharing between the EU member states that have

Burden sharing

The EU's borders can never be fully controlled without close cooperation with neighbouring countries

to manage considerable irregular inflows or large numbers of asylum seekers, and the member states not affected by asylum seekers and mixed irregular flows. The new mechanism could combine financial compensation and a new division of tasks between member states, including territorial redistribution of asylum seekers. The latter will require capacity building in countries not affected by these flows.

- Although there are in principle EU-wide asylum standards, the likelihood that an asylum seeker gets protection still depends on which EU member state handles the request. You should encourage member states to harmonise further.
- The EU's external land and sea borders can never be fully controlled without close cooperation with neighbouring countries. You will have to find ways to assist countries that face violent conflicts and civil wars on their own borders, or that have to deal with large numbers of people in transit heading for Europe. If financial and logistical means are readily available, it is usually more efficient to deal with large-scale refugee flows in the vicinity of countries in crisis.
- At the same time you should propose alternative ways of protection, in particular resettlement programmes that bring some of the refugees to Europe in an orderly manner. In this context, you should take the lead in supporting EU member states in negotiating EU-wide quotas.
- Neighbouring countries willing to co-operate with the EU and its member states in managing borders and irregular flows should be granted preferential treatment in other

Cooperation with
neighbouring
countries

areas: for example trade, development cooperation, visa regimes and work permits.

- EU member states should be encouraged to reduce incentives for irregular migrants by reducing the size of informal labour markets and related informal economic activities. You should pursue a recent Commission proposal: the creation of a European Platform to prevent and deter undeclared work through enhanced cooperation between national labour inspectorates, fiscal authorities and other relevant enforcement bodies.

Regardless of the route you and European governments choose, many policies that address demographic change and the labour and skills demand and supply mismatches require a time horizon well beyond an electoral cycle. The only quick-fix one can think of is greater intra-EU mobility and pro-active recruitment of third-country nationals. This requires a better understanding of, and consequently more popular support for, mobility between EU member states, leading to better allocation, and for selective admission policies that target skilled migrants from non-EU countries. Europe as a rich and safe place also has an obligation to care for people in need of protection. But this should not be placed on the shoulders of just a few member states.



TRADE

ENERGY

CLIMATE POLICY

NEIGHBOURHOOD

TO THE COMMISSIONER FOR TRADE

SUPARNA KARMAKAR AND ANDRÉ SAPIR

Your challenges are to promote the benefits of the multilateral trade agenda and respond to the rise of regionalism worldwide, and to assess the future of EU trade policy in the new era of global interconnectedness centred around global value chains

STATE OF AFFAIRS

The global trade landscape has undergone marked changes in the last decade. The European Union remains the world's largest trader; in 2013, the EU accounted for nearly one-sixth of global (excluding intra-EU) merchandise trade (exports 15.3 percent, imports 14.8 percent). However, in 2013 China (exports 14.7 percent, imports 12.9 percent) for the first time became the world's second largest merchandise trader, pushing the United States (exports 10.5 percent, imports 15.4 percent) to the third position.

According to the World Trade Organisation (WTO), in addition to creating a downward shift in the level of global trade¹, the global recession of 2008-09 might also have reduced its average growth rate. Pre-crisis global trade grew at an average annual rate of 6.0 percent from 1990-2008, a figure attained only once since the onset of the crisis. Looking ahead, if GDP forecasts hold true, the WTO expects a broad-based but modest upturn in global trade growth in 2014, much of which is expected to be generated by emerging markets, in particular in Asia.

In 2013, the US was still EU's largest merchandise trade (exports plus imports) partner (with a 14.2 percent share), followed by China (12.6 percent) and Russia (9.6 percent)². However, bilateral EU-US trade has

EU trade with Asian emerging economies, in particular China, has increased significantly

become less significant for the EU in recent times; transatlantic trade accounted for 24.2 percent of extra-EU trade in 2000. On the other hand, EU trade with Asian emerging economies (and in particular China) has increased significantly; China accounted for 12.6 percent of the EU's merchandise trade in 2013 (exports 8.6 percent, imports 16.7 percent), up from 5.2 percent in 2000. In general, there has been a relative decline in EU trade with developed economies, while with emerging economies, there has been a relative increase.

The situation was both the same and different as far as trade in services is concerned. The EU is again the largest trader, but its share of services is far bigger than its share of merchandise trade, accounting for well over one fifth of global trade (exports 25.0 percent, imports 19.9 percent). The US comes second (exports 18.8 percent, imports 12.7 percent), while China is a distant third (exports 5.9 percent, imports 9.8 percent). However, on both the export and import sides, growth in European services trade turned sharply negative in 2012 before rebounding into positive territory in 2013, indicating very high volatility.

The most notable features of the last decade from a trade policy perspective have been: (a) the rapid increase in regional trade agreements (RTAs) worldwide³; (b) the lack of progress in the Doha Round of trade negotiations; (c) and yet, the remarkable resilience of the multilateral trading system, with relatively little increase in global protectionism. While the progress in WTO-led negotiations on trade liberalisation leaves much to be desired, the WTO's rules and governance mechanism have rather successfully resisted protectionist pressures at a time of extreme global economic weakness and even persistent recessionary conditions, unparalleled since the 1930s.

Global trade trends

Revival of regionalism

A recent development in the world's major trading nations is the revival of preference for regionalism, with negotiations for three new mega-regional trade agreements taking place in different parts of the globe: the Trans-Pacific Partnership (TPP), the Transatlantic Trade and Investment Partnership (TTIP) and the Regional Comprehensive Economic Partnership (RCEP). EU trade policy under your predecessor took a significant pro-regional turn. The EU today has trade agreements with nearly 50 partners, and discussions are ongoing with several large partners, including the US, Japan and India. Of course the EU is not alone in this: the preference for regionalism is prevalent in the US too, where companies and policymakers have openly prioritised the TPP and TTIP mega-regionals over WTO trade negotiations. In the Asia-Pacific region, the Association of Southeast Asian Nations (ASEAN) is leading regional economic integration by consolidating its ASEAN+1 agreements into a larger ASEAN+6 (China, India, Japan, Korea, Australia and New Zealand), or RCEP, agreement. Additionally, at the Asia-Pacific Economic Cooperation (APEC) meeting of trade ministers in mid-May 2014, China aggressively pushed the idea of a new free-trade zone in the region, despite objections from the US, Japan and some other TPP members.

In addition, within the WTO system, the preference for plurilateral, rather than multilateral, negotiations is on the rise in key sectors such as services and environmental goods, given the inability of the full WTO membership to come to an agreement on the Doha market access negotiations after nearly 13 years. Some view this failure of the WTO as an outcome of the massive shifts in the world economy that have challenged twentieth century power configurations and enhanced responsiveness to special domestic interests; as a result, WTO negotiations deteriorated into repeated declarations of unchanging positions.

Global value chains

An added challenge for trade policy arises from the increasingly important role that global value chains (GVCs) play today in determining production location, trade and investment flows across the world, and in setting trade rules and product and operational standards (including private standards) to suit the specific needs of the globalised production and distribution systems.

Your first challenge is to save multilateralism and the World Trade Organisation

It is in this context that you must focus on shaping trade and investment policies in order to ensure sustainable trade and investment growth, and ultimately production and employment creation, safeguarding the interests of business and consumers within the EU and in the rest of the world.

CHALLENGES

Your first challenge is to save multilateralism and the WTO, and to balance the costs and benefits of multilateralism in the face of regionalism. After more than a decade of negotiations on the Doha trade round, the interim agreement reached in Bali in December 2013 remained narrowly focused on trade facilitation, and will most likely need time before it yields some of the gains it promised. This slow pace of multilateral trade liberalisation negotiations has encouraged a focus on the less cumbersome regional trade agreements.

A decline in multilateral economic governance will have adverse effects for the EU's trade prospects, not least the potential demise of the familiar rules-based multilateral order and its implications for dealing with large emerging economy powerhouses that might prefer to settle matters through unilateral action or, at best, bilateral deals. The latter often tend to be both arbitrary and unequal in the negotiating status of the participants, in contravention to the fairness and legitimacy that WTO-led multilateralism provides. Thus, crafting an appropriate trade strategy to manage this shift is as important as creating the right narrative to address the sensitivities of the unequal gains from globalisation, and the perceived benefits from regional agreements that bring together less disparate trade partners.

Furthermore, geopolitical developments have made multilateral forums and organisations increasingly important, even if they are

Reinforcing
multilateralism

more difficult to manage. Sustained economic growth and prosperity calls for stability in global systems, and a major challenge for you will be to manage geopolitical rivalries and reintegrate rivals into a common global system.

TTIP

A second related challenge will be to respond to the rise of regionalism worldwide, and its implications for the large emerging markets and for EU trade with them. TTIP is a potential game-changer for the EU, and a closer trans-Atlantic engagement can help soften the impact of the shifts in global power structures, and can even act constructively on global common interests. More importantly, this is the most complex and highest-profile dossier that you have inherited, and you must somehow bring it to a satisfactory conclusion. Your challenge will be to recalibrate expectations of reaching a very deep and comprehensive TTIP agreement in a relatively short time period (by 2015!), especially given that the lack of a trade negotiating fast-track mandate with the US President makes it difficult for the EU negotiators to make credible and deal-making offers because of the threat of the deal being unravelled by the US Congress. The current politico-economic conditions on both sides of the Atlantic mean there are poor prospects for a rapid conclusion of TTIP. Meanwhile, the large emerging Asian markets have become systemically critical for the EU given their: (a) increasing importance as significant trade partners, both as export destinations and source of critical intermediate inputs to European goods and services; (b) rise in significance as final consumers of EU products; and (c) key nodal status in the presently largely Asia-Pacific centred GVC production system.

India and China

Sceptics of the current regionalism initiatives in fact doubt the ability of these mega-regional agreements to integrate large emerging market trading partners at a later date, when they were not party to the negotiations setting the initial rules. Also, it has been argued that it is difficult now to imagine large emerging economies like India and China queuing up to join the new developed country-led RTAs any time soon. China's and India's recent decisions to join the plurilateral negotiations on information technology products, services, government procurement and environmental goods clearly indicate that these two Asian emerging economies are participating in these western initiatives based primarily on their domestic economic imperatives rather than the fear of being left out of global systems/markets. It is however

clear that in the long run, an integrated global trade governance regime will have to include these high-growth zones and large consumer markets, both from the legitimacy perspective and because of the economic imperatives.

Clearly, much will depend on the credible threat of economically meaningful discriminatory outcomes that the new mega-regionals can actually create within a definite timeline (ie ability to negotiate and implement ambitious agreements before the WTO Doha agreement is signed). The on-going TTIP negotiations can potentially emerge as a threat to the WTO-led trading system, by firmly shifting global rule- and standard-setting (including those regarding dispute settlement) to the two sides of the Atlantic, though this will obviously depend on the timeline of the TTIP negotiations and the depth of the realised ambition. Additionally, you will need to address the challenge of new environment, health and labour regulations likely to be enshrined into the new-age RTAs; these are essentially domestic policies but often act as *de-facto* trade barriers for both imports and exports.

Even the investment agreement negotiations have turned pro-regional in recent times (in preference to bilateral and multilateral agreements) as more and more countries are negotiating investment agreements as part of their larger trade agreements or as standalone international investment agreements. However, a challenge in the context of the current international investment agreements stem from the contours of the international investor arbitration (investor-state dispute settlement, ISDS) processes that often also impinge on domestic policies of sovereign states, in particular the national investment policies geared towards new development strategies (productive capacity building and sustainable development). There has been rising scepticism and resistance in both developed and developing countries against the ISDS mechanism, an issue that the EU will also need to resolve in the interests of promoting trade and investment while retaining adequate national-interest policy space.

Your third challenge arises from the new nature of globalisation that is dominated by the GVCs. Heightened global interconnectedness linked to rising GVC production and trade has challenged the ability of national governments to adopt protectionist policies. The high and

Global value
chains

Global interconnectedness has challenged governments' ability to adopt protectionist policies

rising import content of domestic output and exports have increased the cost of protection and resistance from business and consumers to proposed trade defence measures. Clearly, it is no longer a simple case of black-and-white economic relationships, in which one is either a friend or an enemy. The economic needs and compulsions of nations, both large and small, have become more complex and interdependent as a result of GVCs. As a result, the environment for sovereign policy-making has changed, and the role of trade and investment rules in this regime of global supply chains will necessarily differ from those in the past, and might even lead to changes in future global trade and investment relationships. This development calls for a nuanced assessment of what trade policy the EU can and should adopt in the years to come.

RECOMMENDATIONS

The challenges outlined above necessitate some priority measures. First, globalisation (in particular the GVC-centred variety of our age) is best served by multilateral rules, irrespective of the many short-term economic benefits that regional trade agreements offer. Regional agreements are also almost always less welfare enhancing when compared to multilateral rules. Given the relatively greater overall benefits, it is therefore imperative that you act as the champion of multilateralism at EU and global levels. In that vein, the EU should continue to lead the Doha negotiations, and make necessary commitments to ensure a balanced outcome in all the pillars of the Doha Development Agenda negotiations, in both the traditional and new trade issues. Unlike in the Uruguay Round, the EU has not been a major dissenting voice in the Doha negotiations, and the clashes in the WTO have largely been between the US and the large emerging economies. This gives you an opportunity to act as a power broker. The EU can and should act to help push the Doha Round to a conclusion, and make the necessary compromises befitting the world's

Doha

largest trader. Interestingly, with the recent Common Agricultural Policy reforms, the EU has carved an advantageous position from which to lead the agriculture subsidy negotiations in the WTO. Constructively engaging trade partners at the WTO will further help the EU to reduce its costly trade protection in agriculture, in addition to garnering market access in some large, growing emerging markets, which are already or will shortly turn into net agricultural importers. In attempting to bring a rapid closure to the current WTO Round, which is necessary before one can start a new and future-focused WTO Round, the EU should lead in ensuring that the new trade rules continue to enshrine the core WTO principles of inclusiveness and flexibility. To that end, while encouraging the WTO to continue to adopt the more nimble mode of negotiating plurilateral agreements in new areas with a critical-mass group of interested parties (as in the Tokyo Round), you should strive to ensure that these plurilateral agreements remain open to all interested parties that may wish to join at a later date.

The second set of recommendations pertains to reconciling regionalism with the shift in economic weight to emerging economies, and, in particular, accommodating peacefully the increasing power of high-growth emerging markets and large consumer blocs, in addition to maximising the potential gains from the TTIP. It is important that the new EU trade policy is cognisant of the new growth markets given the flagging consumer base in the EU, which might require an appreciation that very stringent regulatory regimes can create economic fortresses that compromise the ability of European firms to competitively price their products in the high-growth emerging markets. The most dynamic of the emerging markets, China, has seen its middle class grow from 18 million people in 2000 to nearly 500 million in 2014, earning, on average, \$9,000 to \$34,000 per year. However, averages hide the fact that it is the third-tier cities in China with incomes at the lower end of the middle-class spectrum that will be the main drivers of growth in the years to come. The story is the same for India, and even Brazil, albeit at different levels of *per-capita* income. Global European firms are naturally rushing to adjust, and an appropriate policy nudge can further benefit businesses and help them identify the most suitable product portfolios.

Accommodating emerging economies

With respect to the EU's bilateral and regional initiatives in trade and investment, in particular the TTIP, your focus should be to conclude an ambitious agreement, with as much regulatory coherence and mutual recognition in the key export sectors as is feasible without compromising consumer interests. China's accession to the WTO twinned with increased possibilities for slicing up manufacturing production processes boosted the relocation of low- and even medium-value-added intermediate goods production from the EU to lower-cost Asia, in particular China. Arguably, today's trans-Atlantic trade in final goods incorporates inputs from many third countries. However, had the two partners agreed to tear down regulatory barriers earlier on, the savings from the costs of meeting multiple regulations would probably have helped to offset (at least in part) the huge labour cost savings from relocating to China, thereby moderating the rapid relocation of manufacturing units and manufacturing employment away from the EU. Thus, eliminating unnecessary regulatory costs through TTIP as a competitiveness boosting measure should be viewed also in terms of protecting labour interests, as much as it promotes business interests.

Furthermore, TTIP is important to the EU not only because of the common challenges that the two economies face from global economic rebalancing and the rise of the emerging markets, but also because of the high inter-dependence of the two partners in each other's trade basket. The US accounts for 20 percent of EU exports and 20 percent of EU imports (excluding intra-EU trade), while the EU accounts for 28 percent of US exports and 24 percent of US imports. However, measured in value-added terms trans-Atlantic trade flows are even more important than when measured in gross terms. In 2009, the US received 23 percent of total EU exports and provided 21 percent of EU imports on a value-added basis, while the EU accounted for 29 percent of US exports and 27 percent of US imports. The services share in US value-added exports was 52 percent and that of the EU 56 percent in 2009. The higher value-added trade-based interdependence also argues in favour of an ambitious agenda. Deep reduction of non-tariff measures that regulate the production and trade of goods and services should be central to this effort.

The non-economic imperatives of regional and multilateral trade policy and engagement should not be under-estimated when design-

You should strive to avoid TTIP becoming viewed as a ‘west against the rest’ strategy

ing your overall trade strategy. It is an open secret that the US uses trade and investment policies as instruments of its broader foreign policy. In that vein, the geopolitical merits of the TTIP agreement should not be ignored. Notwithstanding the infrastructure, licensing and other legislative challenges that exist on both sides of the Atlantic, the possibility of importing natural gas from the US (even as a temporary measure) under the TTIP to reduce the EU’s dependence on gas imports from Russia should not be treated lightly⁴.

That being said, the EU should also strive to avoid TTIP becoming viewed as a ‘west against the rest’ strategy – a risk not only in the EU and the US, but also in third countries. The twenty-first century is bound to see a relative decline of the west and a return to a situation in which Asia plays an economic (and political) role more commensurate with its demographic weight, a situation that prevailed until the middle of the nineteenth century. The trick here is to avoid falling into the trap of thinking that TTIP will help the EU and the US retain their twentieth century positions as uncontested global economic leaders. TTIP must be a strategy to project ourselves into the future, not the past. To that end, you must ensure that TTIP remains open and inclusive, and is also designed to foster structural reforms within the EU to equip it better to face the challenges of the twenty-first century. In terms of scope and timing, reaching by 2017 an agreement consisting of the elimination of tariffs and a framework for future regulatory cooperation, should be seen as a realistic and satisfactory outcome.

Finally, in view of rising economic interconnectedness and the role of GVC networks, effectively managing globalisation is not going to be easy, even for the world’s largest trader. Rising internal conflicts and the dichotomy in the motivations and actions of the different groups of stakeholders can lead to domestic resistance to proposed trade

Managing
globalisation

policy measures, as demonstrated in the EU-China solar panel anti-dumping case. Similarly, the diverse pressures of incentivising foreign investment in the EU without compromising on the ability to embark on national-interest policy reforms and legislation, which is at the heart of the ISDS debate in the context of the TTIP negotiation, is going to be a challenge. The trick will be to marry the external trade strategy with the right narrative that reflects citizens' concerns and sensitivities. You must therefore enhance both transparency and stakeholder engagement in the EU external trade policy process, and also reinforce the dialogue with the European Parliament. Furthermore, your overall external trade strategy should also make a realistic assessment of the limits of trade policy. Inclusion of non-trade regulatory issues in trade agreements (such as environment, labour) is often mandated by interest-group demands and national policy imperatives. However, the WTO's experience has been that these tend to slow down the negotiation process (which could lead to loss of opportunities in other sectors) while also causing issue overload. A smarter way could be to focus trade policy (and trade agreements) on core trade-related issues, while using complementary policies to address the legitimate non-trade concerns. Rather than treating trade policy as the most critical policy game in town and including all economic issues in trade agreements, negotiating the non-trade policy issues separately but simultaneously with the trade negotiations would be useful in speeding up the trade negotiations while linking non-trade concerns with the progress of trade negotiations.

TO THE COMMISSIONER FOR ENERGY

GEORG ZACHMANN

You must respond to a changed context for EU energy policy characterised by concerns about security of supply, the emergence of low-cost fossil fuel sources and obstacles to decarbonisation policies; you must work for a long-term strategy and reverse the trend of renationalisation of energy policy

STATE OF AFFAIRS

European Union energy policy has three primary objectives: security of supply, competitiveness and sustainability. The ‘green package’ of 2009 translated these three objectives into three targets for 2020: reduction in greenhouse gas emissions by 20 percent, increase in energy efficiency by 20 percent and a share of renewable energies of 20 percent in the energy mix. These 20-20-20 targets represented a quite ambitious plan based on an – at the time undisputed – narrative. In 2008, the oil price reached a new peak and it was generally expected that increasing energy demand from emerging economies and the slow-down or even decline in oil and gas production would result in continues increases in energy prices. Furthermore, oil and gas production was expected to decrease faster in regions that are associated with low risk (eg the EU itself), reducing the security of supply. Finally, it was expected that the nations of the world would embark on a joint strategy for decarbonisation. Consequently, the 20-20-20 targets that initiated the shift to a low-carbon economy in the EU were very much in line with the three objectives: sustainability, security of supply and competitiveness.

Targets

The EU is now (almost) on track to meet the targets that were seen as quite ambitious when they were adopted five years ago. Final energy consumption fell by 7 percent in the period 2005-11, energy produc-

tion from renewable sources increased by 5.8 percent points to 14.1 percent in the period 2005-12, and greenhouse gas emissions dropped by 13 percent in the period 2005-12. While an active renewables policy has contributed most to these achievements, the effectiveness of the emissions cap was not tested because much of the emission reduction was delivered by the economic crisis, and almost none of the observed reduction in energy consumption can be attributed to energy efficiency policies.

Despite being on track to achieve the targets, EU energy policy is generally not perceived as a success. This is for two reasons. First, recent events have changed important assumptions on which the 2020 package was built, and hence the selected targets were insufficient for meeting the objectives. Second, the policies for achieving the targets – although at first sight effective – were far from efficient.

Since 2009, five major events have significantly shaped the environment for EU energy policy.

First, the emergence of shale gas and shale oil in the United States heralded a new ‘golden age of gas’ and shifted the resource constraints by two decades. This has severe consequences for EU energy policy: (1) new low-carbon technologies will find it much more difficult to become competitive globally when hydrocarbon prices do not increase; (2) increasing availability of fossil fuels in ‘safe’ countries could reduce European concerns that oil and gas consumption is a security-of-supply issue; (3) the increase in hydrocarbon resources further reduces the prospects for a global climate pact. The owners of these additional resources worth about \$86 trillion have a strong interest in preventing any deal that implies not burning a part of this bounty.

Shale gas

Second, the nuclear accident at Fukushima turned the political climate in many member states against nuclear power. In addition, two other new technologies – hydraulic fracturing (fracking) to extract shale gas and carbon capture and storage to decarbonise coal plants – are confronted with public safety concerns that will further delay or even prevent their deployment in many European countries.

Fukushima

Despite being on track to meet targets, EU energy policy is generally not seen as a success

Third, the economic crisis in Europe shifted the focus of economic policymakers from long-term industrial policy projects such as developing a renewable energy industry, to shoring up in the short term the competitiveness of existing sectors such as energy-intensive aluminium and steel production. A good example is Spain, where a massive renewables deployment programme was curbed in the face of the crisis. Apart from an important shift in time horizon, the recession also pulverised the assumptions that underlie the 20-20-20 targets. Reduction of industrial production translated into lower carbon emissions and lower energy consumption, making some EU policies redundant.

International climate talks

Fourth, the international community failed to deliver a post-Kyoto framework with binding decarbonisation commitments by the major emitting countries. Consequently, there is less appetite for unilateral European climate action.

Russian gas

Finally, policymakers all over Europe are regretting that Europe's dependence on natural gas imports from Russia (in 2013, 30 percent of EU gas consumption) reduced the political room for manoeuvre in the Ukraine-Russian crisis. Consequently, the objective of supply security – with respect to the sourcing strategy – has become more important.

National markets

In addition to dramatic changes in the factors underlying the energy strategy, energy policy in Europe also suffered from inherent problems. National energy policies undermine the internal energy market. Most investments in power plants, networks and consumption continue to be based on national remuneration schemes – such as German renewables support, UK contracts for new nuclear plants or French capacity mechanisms. These national investment incentives failed to deliver a well-balanced European energy system that can

deliver simultaneously on the three energy policy objectives. Energy prices are also largely determined by national policies. About 70 percent of the final electricity price for companies consists of components not determined on European markets. The cost of energy for a steel plant is determined far more by which side of the Rhine it is located than by how energy efficient it is.

CHALLENGES

You will face two overarching policy challenges. The first challenge is to resist all those *ad-hoc* interventions that are counterproductive in the long-term, and that will certainly be tabled in the dozens by industry, member states, the European Parliament and others. There is a substantial risk that you will be pressed hard to take ineffective short-term action against structural issues. In the energy sector, short-term thinking has more severe negative effects than in most other sectors because asset lifetimes of often more than 40 years require clear long-term signals to all stakeholders. Your second challenge is to reverse the trend of renationalisation of energy policy. The currently observed renationalisation is not only undermining the benefits of further integration but is already depriving European energy policy of the means to achieve Europe's energy policy objectives. Security of supply could be improved at no cost when reserves are shared and the operation of assets is coordinated. Competitiveness increases when energy companies from different countries compete and the best resources from all member states are shared. And optimal geographic deployment of low-carbon technologies and joint technology development reduce the cost of making the European energy sector sustainable.

To avoid both short-termism and renationalisation, you should work to: (1) complete the internal market for energy, (2) decarbonise the energy sector, (3) increase energy efficiency and (4) improve security of supply.

It would be hugely welfare-enhancing for Europe to have a functioning internal energy market in which companies and technologies freely compete to provide the best energy services at the lowest price while respecting societal and environmental constraints. Despite three EU legislative packages, neither gas nor electricity supply is organised in such markets. In electricity, the approach to create a European market by coupling national day-ahead markets proved only partly successful.

Reversing the
renationalisation
trend

Internal energy
market

A European electricity market will not spontaneously evolve; it needs to be designed

National market prices have somewhat converged, but no internal electricity market has developed, because important parts of the electricity sector are still subject to widely differing national rules and arrangements. As a consequence, investment decisions in the electricity sector are based on national policies and not on European markets. This non-cooperation is costly, and the corresponding welfare loss is set to increase with rising shares of renewables in the European power system.

The past 20 years have demonstrated that a European electricity market will not spontaneously evolve based on the enforcement of some first principles. Functioning electricity markets need to be designed. That is, products need to be defined and schemes for their remuneration need to be engineered. An efficient market design needs to include all parts of the relevant system. That is, the design needs to ensure efficient incentives for trade-offs, such as demand response versus storage, transmission lines versus decentralised generation or solar versus lignite. And to be efficient, this design needs to be European.

Decarbonisation

Global decarbonisation is an essential insurance policy against potentially catastrophic climate change. It is only feasible with technologies that are more or less competitive with hydrocarbons (see the memo to your colleague in charge of climate policy). The big challenge is to organise public support to bring these technologies to the market. In the past, national support schemes for the deployment of politically selected technologies, such as nuclear in the 1970s or solar photovoltaic in the 2000s, cost huge amounts of money without so far making these technologies commercially viable at large scale in the European context. So there is a risk that the energy transition will become prohibitively expensive when public hands prescribe the investments the ‘market’ should deliver. Your challenge is to ensure that technologies and support schemes are primarily selected based on their potential

Issues such as dependence on imports from uncertain sources and rising hydrocarbon costs will return

contribution to decarbonisation, and not only based on secondary policy targets, such as regional development, or social or industrial policy.

Improvements in energy efficiency would simultaneously benefit security of supply, competitiveness and sustainability. Corresponding policies are, however, extremely difficult to engineer because optimal policy would involve addressing numerous market failures (for example the ‘owner-tenant-dilemma’) and policy failures (such as capped energy prices) at either the local, regional, national or European level. This shared responsibility was one of the main reasons precluding a binding energy-efficiency target. So your challenge will be to push member states to do more, without allowing them to conduct policies that undermine the ability of the internal market to select the lowest-cost solutions. Furthermore, energy-intensive companies will fight for preferential prices to maintain their competitiveness. But subsidies to specific sectors will not only reduce the incentives for efficient energy usage, they will also undermine Europe’s competitiveness in the long term.

Energy efficiency

The perceived vulnerability of the EU to a reduction of gas (and oil) supplies from Russia in the context of the Ukrainian crisis has put supply security back to the agenda. Individual stakeholders will try to push for support for individual projects to ensure supply security. But expensive publicly-funded flagship projects that render private investments unprofitable will discourage the best supply security investments conducted by private investors.

RECOMMENDATIONS

You should fight hard to establish an institutional framework that enables market forces to deliver a secure and sustainable energy system at the lowest cost. You should focus on four areas in particular:

Renewables

Re-focus renewables support on innovation

Though the context has changed since the EU decided in 2008 on the 20 percent target for renewables by 2020, in the longer-term, issues such as dependence on imports from uncertain sources and rising costs of hydrocarbons will return. Most importantly, affordable decarbonisation of the energy sector in Europe and elsewhere will require competitive renewable energy sources (RES).

The major market failure that policy should address is that private companies invest too little in new low-carbon technologies because they will be unable to fully reap the benefits of such an extended investment programme. Consequently, you should shift the focus of renewables support from a ‘deployment target’ that encourages the quick build-up of the cheapest currently-available renewable energy technology, to an ambitious ‘innovation target’ that encourages investment in bringing down the cost of RES. This implies that support should shift from almost only subsidising deployment (currently more than 99 percent of support) to also supporting research and development (R&D) to a sensible degree.

If successful, an innovation target will be the greatest possible contribution of Europe (and its partners) to saving the global climate, and it might be instrumental in developing a competitive edge in what will eventually become an important global market (the value of annual fossil energy production and the corresponding oil and gas-consuming appliances is in the order of 10 percent of global GDP). To achieve this, you should make sure that Europe has a renewables policy that incentivises a well-balanced, timed and coordinated mix of deployment and R&D policies for a wide portfolio of promising technologies.

Single Electricity Market

Revamping the market

To achieve a single electricity market, you need to prepare a fourth legal package outlining the framework of a functioning European energy market. This proposal should not shy away from curtailing the role of national energy policymaking. It should propose one or several

generic market designs that are consistent and comprehensive¹. The co-legislator (European Parliament and Council) should then decide which of those generic designs should be developed further. Because of the complexity, the strong information asymmetries between stakeholders and the significant redistributive effects, this task of developing a market model should be entrusted to a well-staffed and accountable institution that will also be responsible for organising the evolution of the design after it has been implemented². For example, the Agency for the Cooperation of European Regulators (ACER) – which has built up substantial expertise in European energy markets – can be trusted with this role. This would, however, require resources matching the level of its responsibility and an overhaul of the decision-making process. The final design then has to be approved by the European Parliament and Council.

Creating a functioning internal energy market would be a major shift that will not be achieved by a smooth convergence of existing national markets. However, the alternative to a comprehensive single market would be to get back to a system of more-or-less administered national electricity systems – with some unreliable cross-border exchanges of energy. This will not only make the systems less efficient. It will also make national security of supply more costly, and deployment of renewables beyond a certain penetration level will become prohibitively expensive.

Energy efficiency

Reducing wasteful energy consumption would be a major contribution to mitigating greenhouse gas emissions and to reducing import dependency. The key tool to ensure efficient energy usage is confronting all users with market-based price signals. Wasteful usage does not only refer to using more energy to produce a certain good, but also artificially maintaining a specialisation in energy-intensive goods. As Europe should not strive to subsidise its labour cost to make the European textile industry competitive with Asia, Europe should not subsidise its energy cost to make European aluminium production competitive with the US. Europe should not waste resources on such an uphill battle, especially as defending energy-intensive sectors at all costs locks in high energy consumption and implies that Europe needs to draw on more expensive supplies for all other sectors.

Energy efficiency policy

Beyond price, the question is whether energy efficiency needs to be regulated and whether this should be done at the European level. The need for regulation is often deduced from the finding that even efficiency measures with positive net present values are not delivered by the market, for example because of myopic consumer preferences or split incentives, such as those of tenants and landlords. Consequently, policies can make everybody better off by enabling these measures. As energy efficiency is an issue in virtually all sectors, there is a myriad of existing and proposed measures. The effectiveness and efficiency of corresponding policies strongly depends on the implementation. For example, predictably tightening performance standards (for cars, light bulbs, etc) has been praised for encouraging innovation and promoting a fast transition. If applied ignorantly, however, this approach might feature three substantial drawbacks. First, standards are typically defined on the basis of usage (for example, emissions per kilometre). This can put an undue burden on rarely-used items. In the worst case, the higher upfront energy investment in the more efficient installations cannot be recovered during the lifetime of the product – such as an LED in the basement. Second, at certain hours even wasteful electricity use can be efficient. For example, two cheap and inefficient installations that only run when excess electricity is available might be a better use of energy than one efficient installation that has to run 24/7 to recover its high cost. Third, if prices are not adjusted, energy efficiency measures might be foiled by the ‘rebound effect’. That is, the lower energy consumption of products encourages consumers to use more energy. So, energy-efficiency policies can be welfare enhancing, but their efficiency depends very much on the detailed design of the measures.

Subsidiarity

The same holds for the question of subsidiarity. The obvious argument for a European energy-efficiency policy is its interdependence with the single market. National energy-efficiency standards for products, national energy-efficiency schemes for energy companies or even distorting energy taxes and levies could be a burden on the integrity of the single market. But the structure and regulatory environment for important energy-consuming sectors (eg buildings) differs markedly between countries. This might make a one-size-fits-all European energy-efficiency policy very inefficient in these fields.

So the somewhat generic conclusion on energy efficiency is that individual market failures should be addressed by the most efficient meas-

Security of the gas supply is about maintaining unused alternatives that could be tapped into

ures at the right level of government. For the broad portfolio of regional, national and European policies necessary, a binding European target in terms of maximum amount of energy consumed in 2030 is not well suited because it neither addresses who has to deliver nor does it properly take economic developments into account. To benchmark energy-efficiency policies you should pursue a bottom-up approach. Based on the *ex-post* evaluation of each individual energy-efficiency policy, the incentivised demand reduction and the corresponding policy cost should be reported. For example, the energy-efficiency loans in Germany in 2011 had an estimated cost of about €1 billion and encouraged annual savings of 0.1 million tonnes of oil equivalent (Mtoe).

Two targets would then serve to benchmark the success of the overall policy framework up to 2030: one for total incentivised energy savings (for example, more than 400 Mtoe of induced energy savings between 2020 and 2030) and one for the total energy-efficiency policy cost (for example, less than €1,000 billion). This target might be broken down by member state (or even to sub-national levels) and even be made binding.

Supply security

A particular issue for you will be security of gas supplies. It is here that the failure of individual suppliers might have the greatest impact. Security of the gas supply is not primarily about reducing dependence on imports (overall or from individual sources) or increasing Europe's negotiating power with foreign suppliers, but about maintaining unused alternatives that could be tapped into for an indefinite period of time in case the most important supplier fails for technical or political reasons.

Possible targets

A secure gas supply

There is a long-standing debate about whether completing the internal market will on its own deliver supply security. A functioning internal market offers the most efficient rationing mechanism in times of crisis, and market-based long-term prices in Europe ensure that suppliers have the right incentives to develop new sources. However, the market – that typically goes for the cheapest available source – might fail to sufficiently diversify. For example, the current market design will not provide infrastructure connecting normally uncompetitive sources that can serve as insurance in case the cheapest supplies become unavailable.

But, administered approaches, such as providing security via administered investment in certain infrastructure, run the risk of crowding out private investment if not properly shielded from the market. If, for example, Europe financially supports a pipeline from Turkmenistan, the business case for the corresponding volume from the Levant region might disappear. Furthermore, national administered approaches regularly fail to select the most efficient portfolio of options (such as demand curtailment, storage, liquefied natural gas plants, pipelines, domestic production or domestic fuels).

So neither the current market design nor *ad-hoc* administrative approaches appear well suited to efficiently ensure security of supply. You should pursue a European market-based approach to gas supply security – a market for ‘reserve supplies’. Each domestic gas supplier would be legally required to have available a certain amount of alternative supplies. A sensible volume could be 20 percent of the contracted energy demand for three years. The domestic suppliers can meet their obligation in very different ways, such as (1) interruptible contracts with their customers; (2) volumes stored in gas storage facilities; or (3) option contracts with other domestic and foreign suppliers. The domestic suppliers would need to make sure that the infrastructure needed to deliver the corresponding volumes to its customers is available when needed. That is, it has to reserve enough transport capacity with the infrastructure providers to deliver the secured reserve supplies (eg domestic and foreign pipelines and LNG Terminals). Furthermore, it has to be ensured that reserve supplies cannot be met by options involving pivotal suppliers/infrastructure. That is, holding an option for additional supplies from Russia would not qualify as reserve supplies. To ensure this, a European security-of-supply report

‘Reserve
supplies’ market

will have to define which suppliers/infrastructure are pivotal. In case a supplier finds itself in a situation in which all existing infrastructure is either already used or pivotal, it will have to invest in new infrastructure. Only in cases of security crises, which would be politically established through an ordinary legislative procedure, would suppliers be allowed to draw on these reserve supplies. This system, the cost of which domestic suppliers will largely pass-through to the final customers, should ensure security of supply for all customers at the lowest cost and without undermining the internal market.

Such an approach would obviously have distributive effects. Consumers in well-connected regions such as central-western Europe that face a very limited risk of supply disruptions, will have to pay for 'their' share of reserves, which most likely only their eastern neighbours might need. But this solidarity will not wash away regional differences resulting from different infrastructure endowments. Suppliers in areas with less-developed infrastructure will find it more costly to ensure the level of supply security. This is efficient because it provides an incentive against locating the most vulnerable sectors in vulnerable markets. For example, a chemical plant in Cyprus will only get an interruptible contract because no supplier could secure the required reserve capacities at an affordable cost.

**TO THE
COMMISSIONER
FOR
CLIMATE POLICY**

GEORG ZACHMANN

Your focus should not be single-mindedly on immediate decarbonisation, but on the three ‘ins’: instruments, innovation and international agreement. This should not mean that less financial and political capital is spent on climate policy, but that climate policy becomes even more ambitious

STATE OF AFFAIRS

There is almost unequivocal consensus that, above a certain threshold, global warming reduces welfare and increases inequality, because the effects are predicted to be strongest in less-developed countries. There would be a limited case for concern when comparatively minor effects happen in a distant future. But Europe and all other parts of the world are facing the risk that climate change might have highly non-linear effects – that is, there are tipping points which cause irreversible and highly expensive events (for example, a shift of the Gulf Stream). The non-negligible possibility of such extreme events calls for quick action to reduce the probability that such tipping points will be breached. To avoid catastrophic events, policymakers from 193 countries agreed in Cancun in 2010 that they want to stabilise the concentration of greenhouse gases (GHG) in the atmosphere at a level that implies a fair chance to contain the temperature increase at two degrees Celsius above pre-industrial levels (in 2013, we were already at 0.8 degrees Celsius).

The EU was a pioneer in acknowledging the need to fight climate change. The EU15 over-fulfilled its 1997 Kyoto Protocol commitment (a 10.6 percent GHG cut instead of 8 percent between 1990 and 2012) and the 2008 energy and climate package included the binding target of a reduction in greenhouse gases by 20 percent by 2020, which Europe reaffirmed at the 2009 Copenhagen climate summit. The EU is

on track to meet this target. In 2010, the European Commission college for the first time featured a Commissioner for Climate Action – highlighting the importance of this area.

To avoid a damaging level of climate change, decarbonisation has to continue beyond 2020. To stay within the two degree limit, mankind has to cut emissions by half by 2050. Given the responsibility of developed countries for past emissions, and their relative wealth, it was argued that developed countries should reduce emissions by 80 to 95 percent by 2050. Along these lines the European Commission proposed in 2011 a low-carbon roadmap to achieve the goal of 80-95 percent decarbonisation by 2050. This document has not been adopted by the Council of the EU, so no formal overarching European commitment beyond 2020 exists. That said, there is a substantial sectoral commitment to long-term decarbonisation. The linear reduction in the annual issuance of emission permits to participants in the EU emissions trading system (ETS) implies that by 2067, the volume of permits issues will be zero. This implies that the sectors covered by this system – which represent half of Europe’s current emissions – will need to be essentially carbon-neutral by this date.

Decarbonisation post-2020

CHALLENGES

The primary challenge that you will face is to keep smooth decarbonisation until 2050 on Europe’s agenda. In order for Europe to do its share to preserve a fair chance of limiting the global temperature increase to two degrees Celsius, Europe would actually need to do more than the 40 percent greenhouse gas reduction target for 2030 relative to 1990 proposed by the European Commission in early 2014. But, given the lack of an international agreement, a significantly more ambitious target (60 percent, for example) would be both environmentally ineffective because of carbon leakage and politically unrealistic.

At the international level, climate policy is largely about the distribution of cost in order to avoid an uncertain collective risk in the future. This creates for you the challenge of an extremely difficult coordination task, both within the EU and globally.

Renationalisation of climate policy

The economic crisis caused a reduction in industrial production and hence in carbon emissions. This resulted in the main European

The emissions trading system is well set up to incentivise the optimal decarbonisation balance over time

Emissions trading system

instrument for decarbonisation – the ETS – becoming largely redundant, with about one year’s worth of emission allowances going unused in the past six years. As a consequence, several member states started to introduce national schemes to encourage particular investments in low-carbon technologies on their territory. If successful, these measures will incentivise emission reductions only in the respective countries and sectors and will thereby undermine the idea of a European market providing the lowest-cost decarbonisation options.

Nevertheless, the ETS is an effective and efficient tool to mitigate GHG emissions. As a European tool, that covers most carbon-emitting industries and that will run indefinitely (with a reducing annual supply of allowances) it is well set up to incentivise the optimal decarbonisation balance over time between countries and sectors. Its success has made it a model for existing and proposed systems in other parts of the world such as California, New Zealand and China. Maintaining the central place of the ETS in the EU’s decarbonisation efforts, and preventing fragmentation, will be one of your top priorities.

Member state attitudes

In addition, you will continue to have to handle the divergences in the attitudes of member states, which have increased with the economic crisis. While some member states, in particular central and eastern European countries, prefer to prioritise low-cost energy to maintain their competitiveness in difficult times, others, such as Germany, would prefer to maintain Europe’s role as a decarbonisation frontrunner, partly to improve the competitiveness of their industries that benefit from such policies (for example, renewables technology providers). To date, this schism has prevented a decision on a decarbonisation strategy beyond 2020. The lowest common denominator would be a fragmentation of climate policy during your mandate. This

The increase in viable hydrocarbon resources reduces the prospects for a global climate pact

could have huge repercussions for the internal market (eg the energy market), mute the overall decarbonisation ambition below what is economically sensible, and weaken Europe's role in international climate negotiations.

Lack of a strong international agreement

The United Nations Framework Convention on Climate Change has repeatedly failed to deliver a strong multilateral commitment to curbing greenhouse gasses. While emerging countries such as China and India have never committed to binding national targets, countries such as Australia, Japan and Canada have essentially shelved their climate ambitions. The increase in viable hydrocarbon resources in the last decade (for example, shale gas) further reduces the prospects for a global climate pact. The owners of these additional 144 billion tonnes of oil equivalent of oil and gas, worth about \$86 trillion, have a strong interest in preventing any deal that implies not burning a part of this bounty. These factors create a major challenge for you. The lack of international agreement makes strong European unilateral commitments difficult, both politically and economically. Politically it is difficult to convince businesses and citizens that a small continent can make a measurable contribution and should bear the economic cost. Economically, there is a risk that domestically-produced carbon is replaced by foreign-produced carbon.

UNFCCC

RECOMMENDATIONS

The most effective contribution Europe could make to combatting climate change would be to help reduce the cost of decarbonisation in Europe and elsewhere. Lower decarbonisation costs would make a global agreement more likely and, together with such an agreement, would make it easier to implement more aggressive decarbonisation policies in Europe.

There are essentially two vectors for reducing the cost of decarbonisation. The first is developing and demonstrating policy instruments that enable cost-effective decarbonisation. The second is developing and demonstrating low-carbon technologies that are competitive with hydrocarbon energy sources. Your focus, therefore, should not be single-mindedly on immediate decarbonisation, but on the three 'ins': instruments, innovation and international agreement. To be clear, this should not mean that less financial and political capital is spent on climate policy, but that climate policy becomes even more ambitious than in the past five years.

The international level

Global deal?

Decarbonisation must eventually be conducted at global scale. Without a global agreement of all major economies, the efforts of individual countries to curb greenhouse gasses are futile because the hydrocarbons deliberately refused by some countries would just be burned in other parts of the world. But a stable agreement of all major economies to not take advantage of the low cost of fossil fuels to boost their competitiveness is hardly thinkable. Therefore, it is essential to bring down the competitive advantage of fossil fuels by improving low-carbon technologies (innovation) and reducing the competitive disadvantage of decarbonisation policies (institutions).

COP21

Already, it seems late 2015 might be pivotal. President Obama's plan to cut carbon emissions in the power sector and the Chinese policy to set-up regional emission trading mechanisms leading to a national scheme seem to create a positive momentum for the 2015 Paris climate summit (COP 21), which is supposed to result in a new globally binding climate agreement. So your difficult task will be to coordinate a European strategy to achieve a credible (though maybe not legally binding) commitment from all major countries on GHG reductions. In this respect, Europe's role will need to be more reactive than it was for Copenhagen 2009. Neither threats of trade measures ('carbon border adjustments') nor reduced European ambitions are likely to go down well with the US and Chinese delegations. Europe should prepare a toolbox for facilitating a deal. This might include supporting innovation and institutions beyond the EU and opening the European emission trading system (and its governance) further to other countries. This would achieve GHG reductions much more cheaply than unilateral European decarbonisation measures, and might allow EU

companies to capitalise in other markets on their ‘green economy’ expertise.

But even if international negotiations fail once more, it still makes sense to reinforce the development of institutions and technology to mitigate climate change. This would keep open the option to conduct quick decarbonisation as soon as a corresponding agreement is reached, and it would increase the likelihood of such an agreement by reducing the cost for international partners to join the decarbonisation efforts.

The only alternative to preparing the tools to combat climate change is to stop all explicit mitigation efforts, such as emissions trading, invest more in adaptation measures – higher dykes – and hope that the international community comes to its senses. But this strategy would be high risk. Every year of non-action makes the decarbonisation path steeper and hence more expensive. Furthermore, the portfolio of technologies available to mitigate climate change in a certain year gets smaller, for every year we do not invest in corresponding innovation. So we would continue to rely on more expensive and less-effective tools than we could have had if properly prepared. At a certain level of cost, an international agreement becomes unrealistic, so not preparing today would risk making Europe jointly responsible for what might become one of the greatest man-made disasters.

Institutions

Strengthening the ability of the EU ETS to encourage the lowest-cost emission reductions is essential. For this, you will have to (1) safeguard the system against recent challenges and (2) develop it further to address future decarbonisation needs.

The ETS has been in troubled waters since about 2008. The price for emission allowances in the ETS has collapsed because of an oversupply of allowances and the undermining of the system’s credibility. These developments risk making the ETS irrelevant – being replaced by less efficient national, sectoral and time-inconsistent measures. Revamping the ETS is important for incentivising the use of existing low-carbon alternatives (for example burning gas instead of coal) and for ensuring investments in low-carbon assets and innovation.

Adaptation

Emissions
trading system

Every year of non-action makes the decarbonisation path steeper and more expensive

Your predecessor as Climate Action Commissioner proposed to revamp the ETS by increasing the speed by which the annual allocation of allowances is curtailed (reducing the volume of distributed permits by 2.2 percent every year after 2020 compared to 1.74 percent today). This would bring forward the year in which the number of allocated allowances reaches zero from 2067 to 2057.

The increase in the speed of reduction of the annual allocation after 2020 is a sensible step to ensure that Europe contributes to the containment of global warming. In addition, this increases the consistency between the decarbonisation roadmap and the ETS, thus reducing uncertainty in the market.

Your predecessor also sought to stabilise (or even push up) the carbon price in the short term by removing some surplus allowances from the ETS, for reintroduction closer to 2020 – ‘backloading’. This was supposed to send a signal that the EU is sticking with the ETS as the central pillar of its decarbonisation strategy. However, backloading was also an *ad-hoc* political intervention that demonstrates that policy-makers are able and willing to change the supply of allowances at their convenience. To counter this perception of arbitrary intervention, the Commission proposal for ETS reform foresees a mechanical ‘market stability reserve’ that adapts the supply of allowances to demand. The workability of such a mechanism is debatable. In fact, forward-looking market participants might undo the effect of such a mechanical rule, and the proposed volumes are probably too small to have a major impact on prices. So instead of being a definitive reform of the ETS, the ‘market stability reserve’ looks more like the first of a series of reforms.

A more promising way to restore credibility in the ETS, which you should consider as part of the negotiations on ETS reform that will

take place in the next two or three years, would be to shield it from political interference by ensuring that future policymakers that decide to undermine the ETS will have to compensate companies that invested based on the claims that the ETS is stable made by policymakers today. This could be organised in form of a private contract between low-carbon investors and the public sector. For example, a public bank could offer contracts that agree to pay in the future any positive difference between the actual carbon price and a target level. Low-carbon investors would bid to acquire such contracts to hedge their investments. This would produce three benefits. First, the public bank would be able to collect initial payments (a sort of insurance premium) and make a profit if a sufficiently tight climate policy is maintained. Second, the private investor would significantly reduce its exposure to the – political – carbon market and hence would accept longer pay-back times for its investments. This would unlock long-term investment that is currently too risky. Third and most importantly, public budgets would be significantly exposed to the functioning of the ETS. If future climate policymakers take decisions that lead to increases in the volume of available allowances, they might be called to account by the treasuries, because this would activate the guarantee pledged to investors. All participants – including investors not covered by the scheme – would know that there is money on the table. This would serve as a much stronger and hence more credible commitment to preserving the integrity of the ETS.

In addition, to make the ETS fit for the future you will need to ensure that it covers more sectors and is linked to international carbon-price developments.

More sectors – such as transport and heating – need to be covered because a significant contribution to decarbonisation will have to come from these sectors in the future. Bringing these sectors into step with the ETS is important because of interdependencies between sectors. For example, electricity for electric vehicles and heat pumps falls under the ETS, while cars with combustion engines and oil heating do not. The most elegant solution to avoid different carbon prices for different technologies would be to extend the scope of the ETS to all relevant sectors. For practical reasons, this might not be done directly (ie not every car would fall under the ETS), but through indirect measures, such as an emission-price related fuel-tax component.

ETS scope

Extending the geographical scope of the ETS will be a strategic exercise. While some smaller countries might be happy to join the ETS if they receive sufficient free allowances that they might sell to the European market, larger countries will be more reluctant to join a 'global carbon currency' managed in Brussels. On the other hand, Europe would not benefit from losing control over the allocation of allowances in its system and being possibly forced to buy foreign 'hot air'. So while for the time-being bottom-up linking of individual systems is a welcome perspective, at some point you should engage in a serious discussion with your non-EU counterparts on setting up a generally accepted international governance structure.

Innovation

At current prices, almost all proven reserves of oil and gas will be produced and ultimately burned, taking us beyond the two degrees Celsius limit. In addition, at current prices, most of the carbon in proven coal reserves would also be released into the atmosphere and more not-yet proven hydrocarbon resources will be explored and partly brought to the market at some point.

Keeping this valuable bounty under the ground requires the availability of alternatives that are competitive with hydrocarbons. Currently, apart from some specific applications (eg distributed generation of electricity from renewables), most parts of the incumbent fossil-energy system cannot be challenged by existing low-carbon energy sources. In some areas, such as transport, we are very far from low-carbon technologies becoming competitive with oil and gas. An underestimated problem in the long term is that competitiveness is a moving target. If demand for hydrocarbons decreases, their price might fall. But most of the oil reserves would be produced even at prices significantly below the current level.

Fossil-energy system

Competitive low-carbon technologies

Making available low-carbon technologies that can compete with fossil fuels at a politically feasible carbon price is also of paramount importance to allow the introduction of carbon pricing in all relevant sectors at global scale. You should have a strong focus on innovation as a channel for domestic decarbonisation and competitiveness, and to enable climate action beyond the EU.

Driving innovation in low-carbon technologies at the necessary scale is an enormous task

Driving innovation in low-carbon technologies at the necessary scale is an enormous task. There remain many open questions concerning the optimal choice of the technologies to be supported, the optimal size of support and the optimal mix of policies. But there are a number of no-regret options. To be on the safe side, Europe should support a wide portfolio of technologies, resilient to the failure of any individual technology. Based on existing European coordination platforms, such as the Strategic Energy Technology Plan, you can – in coordination with the commissioners for energy and research – develop a technology-neutral mechanism for allocating support to individual technologies. The overall envelop for supporting ‘green innovation’ should be brought in line with the size of the task. A meaningful order of magnitude would be the amount spent on defence R&D (in the order of €10 billion per year). To get the most innovation for this money, you should work to rebalance spending away from large-scale deployment of immature technologies (currently about 99 percent of the money on renewables) to a more targeted disbursement of funds throughout the entire innovation chain.

**TO THE
COMMISSIONER
FOR
NEIGHBOURHOOD
POLICY**

JIM O'NEILL

You should bring four large, in some cases more distant, neighbours into neighbourhood policy – Iran, Russia, Saudi Arabia and Turkey – and be more realistic about the prospects of EU membership for some current official neighbours

STATE OF AFFAIRS

The European Union's official neighbourhood policy extends to 16 countries, most of which are immediate geographical neighbours via land and/or sea, to the south and east. Six of these neighbours (Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine) are on the same land mass of Europe, and the other ten are in north Africa or the Middle East (Algeria, Egypt, Israel, Jordan, Lebanon, Libya, Morocco, Palestine, Syria and Tunisia). The combined GDP of the 16 is about \$1,350 billion, with three of the neighbours being responsible for about half: Algeria, Egypt and Israel. In the slightly wider neighbourhood, Iran, Russia, Saudi Arabia and Turkey have a combined GDP of around \$4,200 billion, close to a quarter of EU GDP. Only one neighbour is regarded as wealthy in a general sense – Israel – and many are regarded as quite unstable, with Ukraine and Egypt being particular, though not exclusive, examples currently.

Ukraine

Looking at the recent troubles in Ukraine as a specific example, one might quite quickly come to the conclusion that the EU's neighbourhood strategy has not been a success. The same could be said about Egypt and Libya, two of the other most troubled countries that border Europe.

As part of this assessment, one can ask: what was the specific strategy towards these countries as neighbours? Did Europe really have a clear outward strategy? Did or do these countries regard the EU's official treatment of them as part of the neighbourhood strategy as being relevant? In all three cases, they probably regard their relationship with the United States as more important, and in at least two of the cases, Ukraine and Egypt, other countries, namely Russia and Saudi Arabia, have had at least as much influence as the EU, if not more in the past twelve months. A valid question is: was this inevitable, and is this something that the EU must accept, or is there a smarter, more positive alternative?

CHALLENGES

A useful starting point for a more productive neighbourhood strategy is to think about the future shape and size of the world economy by 2050, highlighting the world's largest emerging economies in terms of their population. Of the four so-called BRIC nations, Russia is the EU's most important reasonably close neighbour. Of the 'next 11' most populated emerging economies, Egypt is one, and two others, Iran and Turkey, are essentially also close neighbours. Crucially, like Russia, they have significant interests in the EU's immediate geographic neighbours.

Russia, Egypt, Iran and Turkey have close to 250 million people between them, which is about half as many as the current EU, and their populations dwarf the other 15 countries identified as immediate geographic neighbours. Russia is the ninth largest economy in the world. Turkey is within the top 20. If they, and Egypt and Iran, were to pursue productivity enhancing paths, they would all likely contribute at least one percent of world GDP by 2050, and would possibly all be within the world's top 20 economies. Saudi Arabia, not a geographic neighbour, but a country of major influence over some geographic neighbours, especially Egypt, does not have a large population but its GDP is about the same as Turkey. While Saudi Arabia is not likely to be one of the world's top 20 economies in 2050, it will be close.

Russia, Egypt,
Iran, Turkey

The official neighbours (the 'N16'), with their combined GDP of about \$1,350 billion, are currently in economic terms less than 10 percent of the size of the EU. By 2050, the combined GDP of the N16 could be about \$7 trillion in current values, more than five times larger. Given

EU trade with larger but less close neighbours would presumably offer the greatest potential

the EU's slower growth potential, the N16 could become nearly 20 percent of the size of the EU.

Wider neighbourhood

The four countries in the wider neighbourhood – Iran, Russia, Saudi Arabia and Turkey – could increase their GDP from about \$4,200 billion today, around three times more than the N16, to about \$18.5 trillion in 2050, a fourfold increase to about half the GDP of the EU.

If you add the four to the N16, to make a broader list of EU neighbours of 20, this would suggest a current GDP of around \$5,500 billion, bigger than Germany, and a 2050 potential of around \$25 trillion, nearly 70 percent of the size of EU GDP. Having a clearer strategy towards this group would seem to be very beneficial to the EU. Many of these countries are currently rather volatile and challenged, but they have the potential to be much more successful and therefore helpful to the EU.

In terms of 'enlightened self-interest', EU trade with the larger but less close geographic neighbours would presumably offer the greatest potential to the EU collectively, although of course, for individual EU countries, their trade with some immediate closer geographic neighbours might be more important. But, as mentioned already, many of these neighbours are greatly influenced by events in the larger, more populated nations, so their prospects are at least partially a derivative of their neighbours' fortunes. Consider the examples. The sphere of influence of Syria, an official neighbour, depends greatly on Iran, Saudi Arabia and Turkey. Obviously, all six geographic neighbours in eastern Europe are influenced to varying degrees by Russia, so surely your neighbourhood strategy needs to be, at least partially, thought of in terms of what can be done to help the EU relationship with Russia.

Opposition to Turkish membership of the EU cannot be justified on the grounds of economics

RECOMMENDATIONS

A supplementary way of thinking of the EU's neighbours is to consider if each of them is likely to become an EU member in the future, as presumably that will influence significantly how you choose to engage with them. In the context of the previous section, the same thought process should be applied to the other 'broader neighbours': Egypt, Iran, Saudi Arabia and Turkey.

From this starting position, perhaps three sub-categories can be considered: countries that the EU would definitely want to be EU members in the future; countries that the EU highly likely would neither want nor expect to be so; and those that the EU is currently unsure about. A probable immediate objection to such an approach is what might be called the 'Turkish dilemma', meaning you might not want to be so clearly specific about dismissing a country's desirability as a future EU member. There are two valid responses to this. First, countries would not necessarily have to be permanently in the same group, and the EU would have the right to change its view. Second, more clarity might enable a more productive policy towards these neighbours.

In some ways, Ukraine is a good example of why such an approach might be more helpful. The lack of an apparent strategy with respect to its potential to become an EU member – a kind of 'it's out there' stance – could arguably be one reason why the EU has not had a coherent strategy to tackle the current malaise, especially as the EU also might not have thought too much about its neighbourhood strategy with Russia. Classification of Ukraine as, for example, a neighbour that is most unlikely to ever be an EU member, might have led to a different engagement with Russia, ahead of the ongoing crisis. Some observers might argue that the Russian strategy was motivated by concern that

Catagories of
neighbour

Ukraine might be dragged towards becoming an EU member. Now that the crisis is upon us, you appear to have a position forced upon you of wanting Ukraine to be closer to the EU. Is this coherent?

Turkey

Of the four large populated 'broader neighbours', none, with perhaps the exception of Turkey, would be thought of as future EU member. As is well known, in reality, neither is Turkey. Why not make this clear? Turkish policymakers have realised in recent years that some of the original attractions of being an EU member might not be what was once thought, especially given the financial and economic crisis and the subsequent slow recovery of the euro-area economies. Turkey has realised that it is well positioned to benefit more from the rapidly growing economies of its own immediate neighbours to its east and south, as well as those of 'older' neighbours to the west.

From a simple economic perspective, the case for Turkey becoming an EU member has always struck me as being highly attractive. The nation has a young vibrant population and a labour force that is likely to grow in the future. Its demographics are everything that the EU currently does not have but needs. Of course, with current chronic unemployment, especially youth unemployment, and recent events in Turkey, the resistance to Turkish EU membership is likely to be strengthened.

By 2050, Turkey has the potential to be one of the top 15 economies of the world, and bigger than any EU economy except France, Germany and the United Kingdom. It is likely to be larger than Italy.

Of course, Turkey also has a unique combination of a strong Islamic religious faith and acceptance of liberal capitalist economics. It already has some global competitive companies such as Beko, the washing machine specialist, and Turkish Airlines.

Opposition to Turkish EU membership is not unanimous within leading EU countries (the UK is favourable) but remains the dominant opinion, though opposition does not make good economic sense. The opposition can perhaps be justified on the grounds of compatible politics and religion, but not economics. These are important points to recognise more clearly because the EU needs to consider more carefully when engaging with its neighbours what precisely the terms of engagement are.

Recognise more frankly what will motivate neighbour countries, especially in terms of what they need

Another reality of the EU relationship with its neighbours is to recognise more frankly what will motivate neighbouring countries, especially in terms of what they need. Egypt and Ukraine are starkly contrasting examples. Following the removal of the Muslim Brotherhood in Egypt, which took place without a democratic election, the balance-of-payments-constrained nation needed quick financial support, for which it turned to Saudi Arabia, a country where policy-makers were happy to back a new Egyptian leadership opposed to such a form of democracy. Such an environment is clearly inconsistent with many of the beliefs of the EU but you need to recognise this kind of reality when trying to set your own terms of engagement. While we embrace democracy for ourselves, is it best always for everyone else, especially those at much lower levels of development and wealth? The stark answer is not always, and it is better to acknowledge this than pursue pretence.

The delicate matter of Ukraine needs to be thought about not least because similar issues could easily arise with other official neighbours. When Ukraine needed financial support in late 2013, this did not appear to be a major priority for the EU, and Russia was only too happy to step in, but of course on their terms. If the EU was not prepared to accept this relationship, it needed to have had a credible response, which was not forthcoming.

For the future, do you want to engage Ukraine as a neighbour that has potential to become a much larger economy and trading partner, or do you want to encourage them to become an EU member? If it is the latter, then you need to take a more proactive and supportive position, irrespective of the EU's perceived internal constraints.

Ukraine

Against this and given the constraints facing the EU, it might more realistic to not pretend that EU enlargement can occur any time soon. Clarity on this would free you to concentrate on helping neighbours achieve their potential, without the straitjacket of thinking of them as potential EU members. Given the concerns within the EU about immigration, housing and social welfare availability and youth unemployment, such a clearer stance may boost the credibility of the EU within its current member states.

NOTES

01 EU PRESIDENTS

1. 'Strategic agenda for the Union in times of change', European Council conclusions, 26-27 June 2014.
2. Also, the President of the European Parliament should accept that national parliaments use the subsidiarity review more often.

04 COMPETITION

1. The antitrust definition of a market is conventionally based on tests that identify the boundaries of a market by measuring the degree of competition that different products exert on each other. If two products are very good substitutes – such that a significant proportion of demand and/or of supply would shift to one product if the price of the other is changed – then the products are considered to belong to the same market.

2. All figures quotes are up to April 2014.

3. See Mario Monti (2010) *A new strategy for the single market*, report to the president of the European Commission José Manuel Barroso, available at http://ec.europa.eu/bepa/pdf/monti_report_final_10_05_2010_en.pdf.

05 SINGLE MARKET

1. The European House – *Ambrosetti, 2014 European Business Leaders Survey*, June.

2. Eyal Dvir and Georg Strasser (2014) 'Does Marketing Widen Borders? Cross-Country Price Dispersion in the European Car Market', mimeo, available at <http://fmwww.bc.edu/EC-P/wp831.pdf>.

3. Trade integration of goods (or services) as a share of GDP is defined as the average of imports and exports of goods (or services) divided by GDP.

4. See for instance the series of reports accompanying the 2007 Single Market Review exercise http://ec.europa.eu/citizens_agenda/single_market_review/index_en.htm

5. Some initial steps towards a framework for implementing a market monitoring exercise in the Commission were already developed in 2008, laid down in Commission Staff Working Document SEC(2008) 3074.

06 DIGITAL AGENDA

1. Sources: Domo.com: www.domo.com; onesecond.designly.com; and Intel: <http://www.intel.com/content/www/us/en/communications/internet-minute-infographic.html>.

2. Scott Marcus, J., I. Godlovitch, P. Nooren, D. Elixmann, B. van der Ende, and J. Cave (2013) *Entertainment x.0 to boost broadband deployment*, ISBN: 978-92-823-4760-7.

08 MIGRATION

1. This memo is written to a European Commissioner responsible for EU mobility, international migration, border management and asylum. In the past, these competences were divided between DG Home, DG Justice and DG Employment. A few points raised in this memo cut across other portfolios (European External Action Service, DG Development and Cooperation). The author would like to thank Elizabeth Collett, Robert Holzmann, Khalid Koser and André Sapir for their helpful comments.

09 TRADE

1. Global trade in goods fell by 12.2 percent in 2009, by far the largest decline since 1950.

2. The direction of trade and ordering of trade partners varies for exports and imports. In 2013, the EU28's top three import sources were (in descending order) China, Russia and the US, while the top three export destinations were the US, Switzerland and China. All the data in this Memo excludes intra-EU trade.

3. As of 31 January 2014, 435 physical RTAs (counting goods, services and accessions together) were notified to the GATT/WTO, of which 248 are currently in force. The overall number of RTAs in force has increased steadily since the 1990s, a trend likely to be buttressed by the many RTAs currently under negotiation.

4. US domestic law permits targeted energy exports only to countries with which the US has free-trade agreements.

10 ENERGY

1. That is, it should discuss the schemes to remunerate electricity, the roll-out of renewables, networks, demand response, capacity, system services, etc, and assign the responsibility for the development and operation of networks, renewables, etc.

2. There is some legal issue with delegating powers from the Council and the Commission to community agencies ('Meroni Doctrine') that has been widely discussed in the context of the institutions of the 'banking union'.

BIOGRAPHIES

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Jim O'Neill is a Non-resident Scholar at Bruegel. Jim worked for Goldman Sachs from 1995 until April 2013. He joined Goldman in 1995 as a partner, Chief Currency Economist and co-head of Global Economics Research. From 2001 to 2010, he was Chief Economist and head of Economics, Commodities and Strategy Research (ECS). In September 2010, he became Chairman of Goldman Sachs Asset Management (GSAM). Jim is the creator of the acronym BRICs. He has published much research about BRICs (which has become synonymous with the emergence of Brazil, Russia, India and China) and the broader emerging markets, as the growth opportunities of the future.

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