Unite, defend, grow

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Memos to the European Union leadership 2024-2029

Edited by Maria Demertzis, André Sapir and Jeromin Zettelmeyer

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Foreword

The *Memos to the European Union leadership* have been a Bruegel tradition since 2009. Every five years – after the European elections but before a new European Commission takes office – we take stock of the state of affairs of policies related to EU economic prosperity, reflect on the main challenges facing the EU and make recommendations on how the new EU leadership should address them. Except for the two opening memos – one to the Presidents of the European Commission, European Council and European Parliament, the other to the High Representative of the Union for Foreign Affairs and Commission Vice President – the memos are addressed to incoming commissioners responsible for specific policy areas. As Commission portfolios relevant to economic prosperity have grown in scope, so have our memos. This edition covers 18 individual policy areas in addition to the two flagship memos, up from 11 in 2009 and 2014, and 14 in 2019.

By coincidence, each election to the European Parliament in the last 15 years – and hence each edition of our memos – was roughly aligned with a turning point in the EU economy. The 2009 memos were written after the global financial crisis had hit Europe with full force, but before the onset of the euro debt crisis (a risk that we clearly flagged). In 2014, the crisis had been overcome, but unemployment remained high, banking systems weak and Economic and Monetary Union governance reforms were a work in progress. Five years later, the EU had succeeded in significantly reducing unemployment and lowering the risk of renewed financial instability. But the challenge of invigorating medium-term growth remained and the EU was confronted with new challenges: mounting geopolitical tensions, the need to accelerate the green transition and the social consequence of digital transformation. Accordingly, our 2019 memos implored EU policymakers to be 'braver, greener, fairer'.

During the past five years, the EU has faced two unprecedented economic and political crises: COVID-19 and the war in Ukraine, a European country bordering four EU member states. From an economic perspective, these two crises were much better managed than the crises of 2010-2012. Weeks after the onset of COVID-19 in 2020, the EU initiated NextGenerationEU, a groundbreaking temporary recovery instrument. And in 2022, shortly after gas supplies from Russia were cut, the EU was able to organise itself partly by jointly procuring gas from alternative sources. Yet, like in 2014, the EU economy is recovering too slowly and medium-term growth prospects remain weak.

Many of the problems we face today reflect a return to longer-term challenges that were already visible before the latest string of crises: growth, geopolitics, green transition, social cohesion. It is not surprising that Commission President Ursula von der Leyen's political guidelines, issued before her re-appointment in July 2024, overlap to a significant degree with her 2019 political guidelines. But the external and internal conditions under which the EU needs to tackle these long-term challenges are significantly more adverse than they were in 2019. Geopolitical threats are much more acute, with a direct security threat at the borders of the EU in the context of a less-dependable United States, and a more aggressive and authoritarian China. Economic nationalism has become entrenched, threatening the multilateral order. Higher energy prices have hurt growth and competitiveness. Fiscal needs have grown, but fiscal space has shrunk. The effects of climate change have become acute, but the pace of emissions reductions is far too slow, particularly outside the EU. Parties representing political extremes have gained support at both national and EU levels, making it harder to chart a way forward.

This darker backdrop is reflected in the title of our memos. Today's challenges are, first, to unite EU countries and citizens behind a shared agenda. Second, to defend the EU from external threats and EU values from corrosion. Third, to grow: in economic terms, but also in the sense of successful enlargement to new members.

What policy recommendations follow? The answer depends on each policy area, but it is possible to identify a few general themes. First, the EU should not jump on the nationalist bandwagon (even collectively). Multilateralism, openness and competition remain cornerstones of EU prosperity and essential to its credibility in the world. Second, the EU cannot be naïve: it must assign much greater priority to both national and economic security. Support for Ukraine remains a top priority, as does higher investment in defence. Third, improving the single market is even more important than in the past: it is one of the few things that the EU can do that creates no trade-off between growth and security. This includes the creation of a single market for defence production – which should include the United Kingdom. Fourth, the EU must persevere with its European Green Deal. But this can only succeed if it preserves industrial competitiveness and ensures that vulnerable groups are protected. Fifth, the EU must pay far greater attention and devote more resources to partnerships with developing countries, focusing on the Sustainable Development Goals and including the provision of help to those countries to accelerate emissions mitigation.

Most important, the EU must be creative and bold: in this sense, 'braver' applies to this edition of the memos even more than to the 2019 edition. It must do more with less: the needs are overwhelming and public resources are scarce. This implies that political red lines preventing coordination and single market deepening must be challenged when the efficiency gains from doing so are high (as in energy policy, the digital economy, services trade, defence and capital markets). Closing public investment gaps in European public goods cannot be reconciled with fiscal consolidation unless a greater share of investment is undertaken and financed at EU level. And the EU must find creative ways to conduct industrial policy that do not fragment the single market or weaken the rules-based international system. In these and other areas, the memos offer specific recommendations.

As in previous editions, each memo is self-contained. The opinions expressed are those of the authors of each memo: Bruegel does not have an institutional view. Readers may nonetheless find the arguments and recommendations broadly consistent and coherent. This reflects extensive discussions among authors and across memos; a review process overseen by Katja Knezevic, Bruegel's head of communication, and ourselves; and – most importantly – the steady hand and discipline imposed by Stephen Gardner, Bruegel's indispensable, long-serving editor. To the extent that our 20 memos have a consistent style and clarity of argument, it is his achievement.

Maria Demertzis, André Sapir and Jeromin Zettelmeyer

Brussels, 1 September 2024

Memo to the Presidents of the European Commission, Council and Parliament

Maria Demertzis, André Sapir and Jeromin Zettelmeyer

The pandemic recession and energy-support measures have squeezed fiscal space. European Union industrial competitiveness has been eroded. The productivity and *per-capita* income gap with the United States has widened. Meanwhile, the world around the EU has become more threatening and fragmented.

In the face of all this, the challenges confronting you are substantial. You must continue to support Ukraine while implementing measures to reinvigorate EU growth, meet the 2030 climate targets and lay the ground for meeting the 2040 goals, and secure faster emissions reductions beyond the EU's borders. Social cohesion needs to be restored to head off threats to the EU model. More needs to be done to improve EU external security. Underpinning all of this, a serious effort must be made to improve EU governance – and it must be done without creating further division.

Continue to support Ukraine

Lay the groundwork for meeting the 2040 climate goals

Defend competition, openness and multilateralism

State of affairs

In the last five years, the European Union managed to find a way through unprecedented crises: a global pandemic, leading to the sharpest economic downturn since the Great Depression; a massive spike in energy prices, caused by Russia's war on Ukraine; and a sharp rise in inflation. Team Europe by and large rose to the challenge and European solidarity was preserved.

The NextGenerationEU (NGEU) funds, temporary EU unemployment insurance and prefinancing of vaccine purchases prevented human and economic catastrophe during the pandemic. A coordinated reduction in energy demand and the commitment to keep energy markets open prevented gas shortages during the winter of 2022-23. Economic and military assistance to Ukraine helped beat back Russia's initial assault, and remains essential to Ukrainian resistance. Ukraine, Moldova and Bosnia and Herzegovina obtained EU candidate status and were invited to start membership negotiations.

The world around the EU has become more threatening and fragmented

However, these crises have left the EU in a bruised state. Unlike the United States, the EU suffered a large and persistent terms-of-trade shock in the form of higher energy prices. While the EU managed to avoid a second recession, the erosion of industrial competitiveness is expected to lead to lower medium-term growth in Europe's industrial heartland. Some of this slowdown will be offset by higher growth in Europe's south and southeast thanks to greater energy diversification, abundant solar energy and the beneficial impact of their EU-funded recovery and resilience plans. The net effect, however, is a widening productivity and *per-capita* income gap with the United States.

Meanwhile, the world around the EU has become more threatening and fragmented. The military situation in Ukraine remains precarious. China has become both more authoritarian and more assertive, engaging in economic coercion against the EU and its allies. The US shift toward protectionism, initiated by President Trump, has continued under President Biden. Donald Trump's return to the White House could spell the end of US support for Ukraine and joint US-EU action against Putin, and may lead to new tariffs and other hostile US actions against the EU. Even if Trump does not return, US support for Ukraine and its engagement in Europe is likely to diminish, requiring the EU to fill the gap, strengthen its defensive capability and defend its interests and values more vigorously.

The pandemic recession and energy-support measures have squeezed, but not eliminated, the EU's fiscal space. The public debt ratio jumped by over 12 points of EU GDP in 2020, but has since come down by almost 9 points, reflecting the economic recovery and the surprise burst in inflation. More worrying than the level of debt *per se* is the fact that deficits remain high in many high-debt countries. In June 2024, the European Commission announced it would recommend opening excessive deficit procedures for Belgium, France, Italy, Hungary, Malta, Poland and Slovakia (in addition to Romania, which has been in the procedure since 2021).

Climate action has become more urgent while the political space for it has shrunk

At the same time, the EU has lost both 'climate space' – making climate action more urgent – and political space for climate action. Though EU emissions have been on a declining trend for about 15 years, worldwide emissions remain high and rising. Emissions in 2023 alone may have depleted 11 percent of the remaining global carbon budget consistent with limiting global warming to 1.5 degrees Celsius compared to pre-industrial levels (Liu *et al*, 2024). The effects of climate change are being felt faster and more violently than expected, as the floods, droughts and wildfires of 2023 showed. Yet, parties opposed to climate measures and EU-level action made significant gains in the European Parliament elections. This reflects widening political and social polarisation, including in the largest EU economies.

The EU passed several landmark laws in the previous cycle. These include the Recovery and Resiliency Facility financed by common borrowing (February 2021), the European Climate Law (June 2021) and a set of digital laws (the Digital Markets Act and Digital Services Act in 2022; the Artificial Intelligence Act in 2023). Economic security took centre stage (the European Chips Act, Critical Raw Materials Act and Anti-Coercion Instrument in 2023; the 2024 Cyber Resilience Act). The 2024 Migration and Asylum package and the 2024 revamp of the European fiscal rules represented hard-fought compromises and are for the most part improvements.

But not all new legislation has been good, and progress has been slow or absent in important areas:

- Some regulation has been rushed out without proper impact assessment, resulting in high compliance burdens and/or high-profile failures (such as the Farm-to-Fork Strategy). Despite the European Commission's efforts, the quality of *ex-post* evaluation remains poor.
- The Council failed to agree on new own resources to help repay NGEU borrowing, notwithstanding good proposals from the Commission in 2021 and 2023 and their endorsement by the European Parliament.
- The Commission's response to declining EU competitiveness has been lopsided: while it attempted to expand EU-level industrial policy (the 2024 Net Zero Industry Act), it has not succeeded in passing major legislation to deepen the single market.
- There has been no progress on banking union and only small steps on capital markets union (CMU).

This said, the single market debate has been invigorated by the publication of the Letta Report on the Single Market (Letta, 2024), European Central Bank calls to accelerate CMU and the return of CMU to the Council agenda in 2024.

Challenges

Provide effective support to Ukraine

The most urgent challenge is to support Ukraine in its existential war against Russia. A Ukrainian defeat would be a humanitarian and political catastrophe and a blow to the EU's security.

Invigorate growth

High energy prices, a declining working-age population, skills shortages, sluggish private and public investment, insufficient exit of inefficient firms and slow adoption of digital technology are exacerbating the long-standing growth differentials between 'advanced Europe' and the United States ('emerging Europe' – the central and eastern EU members – are projected to grow much faster, at about twice the EU average, and to continue converging with richer EU countries).

Meet the 2030 climate targets and lay the ground for meeting the 2040 goals

Following through on the European Green Deal is more important than ever

Following through on the European Green Deal is more important than ever, but it will be difficult in light of sluggish growth, political backlash against the costs of climate action and reduced fiscal space.

Accelerate climate action outside the EU's borders

A successful European Green Deal is necessary but not sufficient for curbing climate change. The EU needs to devote much greater energy (and resources) to accelerating emissions reductions outside its borders, particularly in emerging markets and developing economies, where emissions are continuing to rise.

Restore social cohesion

Greater political and social polarisation in the EU threatens not only the Green Deal but potentially the entire European project. Addressing this at EU level is, however, challenging because most of these divisions are happening within member states rather than across member states.

Improve the EU's external security

In a structurally more dangerous world, the EU must boost its defence capabilities and do more to protect critical infrastructure, including cyber-infrastructure. It must also reduce its vulnerability to trade disruptions and acts of economic coercion, both from China and (given the potential return of President Trump) from the US.

Improve EU governance

Too many EU decisions require unanimity, giving vetoes to countries that attempt to free ride on the rest of the EU or where governments do not fully share the EU's democratic values. With further enlargement, the EU will become even more diverse. Unless the power of potential holdouts is reduced, the EU will not be able to enlarge, nor will it be able to act decisively in areas essential to its security, including provision of support to Ukraine.

Invigorating growth will help in dealing with all of these challenges. The same is true for reform of EU governance. For other objectives, however, you will face difficult trade-offs:

- Supporting Ukraine, following through on the Green Deal, scaling-up international climate finance and improving security all cost money. Your services estimate that EU countries collectively face a total (public and private) annual investment gap of at least €356 billion for the climate transition and €125 billion for the digital transition, up to 2030. The gap is much larger if one also considers rearmament needs and the reconstruction of Ukraine. But fiscal space is tight, and raising own resources or agreeing to new EU borrowing will be difficult and divisive.
- Accelerating decarbonisation will have a negative impact on growth at least in the short term (in particular, after the emissions trading system (ETS) is extended to most areas of the economy, including buildings and transportation, in 2027 – known as ETS2). Higher and broader carbon pricing will further strain social cohesion and fan polarisation around climate action.
- Improving the EU's economic security and accelerating the green transition may require greater recourse to industrial policy and trade policy than in the past. But a ham-fisted approach that embraces protectionism and/or takes a hostile approach to China will hurt EU growth and make international climate action more difficult.

Higher and broader carbon pricing will further strain social cohesion

You will need to choose policies that minimise these trade-offs, bearing in mind not just their primary objective but also unintended consequences.

Recommendations

Our recommendations have two common elements: first, doing more with limited resources; second, avoiding micromanagement of business, member states and their key constituencies, which breeds opposition to European integration and can become an impediment to growth. We group our recommendations according to their main purpose.

Promote growth and enhance cohesion

Deepen the single market in the areas of highest growth impact

Electrification is Europe's best bet to decarbonise without locking in a perpetual energy-cost disadvantage

- *Energy policy.* Electrification is Europe's best bet to decarbonise without locking in a perpetual energy-cost disadvantage. EU-wide coordination of investment in electricity generation, transmission and storage and the creation of a joint electricity market will reduce the cost of electricity by exploiting geographic resource advantages, avoiding costly duplication and lowering capital costs.
- *Labour mobility and the internal market for services.* Together with high energy costs, skills shortages are the number one impediment to investment in the EU (EIB, 2023). To promote the efficient allocation of skills and services, barriers to occupational mobility must be reduced, by removing or reforming professional regulation that impedes mobility, extending automatic recognition of professional qualifications and improving the coordination of social security. The Letta report recommendations provide a good starting point (Letta, 2024).
- *Banking and capital markets union.* Banking crisis management should be consolidated into a strengthened Single Resolution Board that integrates all national relevant entities and merges deposit guarantee systems. Banks that are highly reliant on national sovereigns (and vice versa) should be given regulatory incentives to diversify their sovereign exposures. A common and independent securities market supervisor would be a feasible and effective way to propel the capital markets union forwards.

Curb regulatory excess and make EU regulation more growth-friendly

Regulation can backfire if compliance burdens are too high or implementation is poor

Regulation can backfire if the compliance burdens are too high or implementation is poor.

- Pressure to regulate too much or too early can come from all directions, including member states (pushing for replication of their legislation), the Commission (seeking to pre-empt inconsistent member-state legislation) or even business (seeking legal certainty). You need to be aware of these biases and push against them.
- Recommit to the 2016 Interinstitutional Agreement on Better Law-making and the 'REFIT' programme to reduce the regulatory burden. Impact assessment must be systematic, include assessment of delegated and implementing acts, and should be updated to account for major changes introduced in the legislative process. To improve quality, a more radical change is needed: *ex-post* evaluation should be carried out by an independent authority, such as the European Court of Auditors, which could have its remit extended.
- Implement the digital rules enacted in the last five years in a way that stimulates competition among data-driven services, does not undermine innovative start-ups and minimises the cost of regulatory compliance, especially for small firms. This will require strong coordination of digital supervisory bodies and possibly the creation of a single digital regulator.

Improve the governance, mission and funding of EU-level innovation support

The EU was right to create the European Innovation Council (EIC) to support 'breakthrough innovation' alongside its existing support for scientific research. But the EIC's governance needs to be strengthened by establishing an autonomous council composed of recognised technology leaders responsible for project selection. EU innovation support should also be extended by a separate, mission-oriented pillar, led by an independent institution along the lines the US Advanced Research Project Agencies, which are able to take discretionary support decisions in pursuit of a politically-set mandate (Pinkus *et al*, 2024).

Focus the EU budget on EU public goods

The EU budget should be refocused on European public goods, including cross-border infrastructure, innovation support, green public investment in the EU, international climate finance and funding for international partnerships. To create the resources to fund these priorities, the share allocated to the Common Agricultural Policy should be reduced, by introducing co-funding by EU member states. Having a larger EU budget should also be explored, but only if current policies that absorb most of the EU budget funds (CAP and cohesion) are also reformed.

Expand the Blue Card programme and make it a stepping stone for permanent residency in the EU

The Blue Card has not succeeded in attracting more skilled workers to all of the EU

The EU's main instrument for employment-based immigration, the Blue Card, has not succeeded in attracting more skilled workers to all of the EU. Recent reforms to the Blue Card Directive (2021) and the Single Permit Directive (2024) go the right way but are insufficient. Foreign nationals graduating from tertiary education or doing relevant professional training in the EU should receive an automatic EU Blue Card, enabling them to stay and work in the EU for at least one year beyond their study or training. Workers who have exhausted their Blue Card stay but otherwise satisfy all relevant criteria should have the option to remain resident and employed in the EU by creating explicit links between the Blue Card system and member-state provisions on permanent residency.

Defend competition, openness and multilateralism

Competition enforcement and state-aid rules remain essential for the exit of inefficient firms and to allow entry and growth of firms at the productivity frontier. A rules-based trading system remains essential to ensure access to exports market and to imported goods and services at lowest cost, including intermediate products and raw materials that are essential to EU competitiveness. Together with like-minded advanced economies including the United Kingdom, Japan, Canada and South Korea, the EU should continue to be a force to keep world markets open and fight protectionism. This requires defending and reforming World Trade Organisation rules, particularly their treatment of subsidies, and making the WTO more effective as an institution.

Safeguarding the Green Deal and extending its global reach

Boost green industrialisation and establish a green social contract

Green deal goals will have medium-term costs for European industrial competitiveness

Green deal goals will have medium-term costs for European industrial competitiveness, particularly after the loss of free ETS allowances and, later, when ETS2 applies. This should be addressed by strengthening the EU's comparative advantage in clean tech through instruments such as the mission-oriented innovation support proposed in the third recommendation, above.. A further obstacle to meeting Green Deal goals is the disproportionate burden of carbon pricing and regulation borne by vulnerable groups. To address this, the existing Just Transition Fund and Social Climate Fund must be better targeted to help those with lower incomes adjust to the energy transition, while the Common Agricultural Policy should be transformed into a 'Rural Green Deal' supporting farmers.

Scale-up international climate finance. The EU needs to stop thinking of international climate finance as a form of development aid

Climate finance that meaningfully accelerates decarbonisation in emerging and developing economies is in the direct economic interest of the EU and other advanced countries, and is at least as cost-effective as money spent on decarbonisation within the EU. The EU and its G7 members should sponsor a G7-EU initiative to both scale-up and widen support for emission mitigation in emerging and developing economies. This should include sufficient grant funding to pay for the social transitions of coal communities, making financial support conditional on agreed policies to phase out coal (including domestic carbon pricing).

Strengthen the EU's security

Support Ukraine and strengthen EU defence autonomy

- Do whatever it takes to ensure that Ukraine has both sufficient fiscal support and sufficient military hardware to defend itself, even if US support were to decline. Stopping Russia's aggression would justify: 1) common EU borrowing; 2) prefinancing of (or purchase guarantees for) defence production (along the lines of prefinancing for the development of vaccines).
- Create a single market for defence production and procurement. While the EU Treaty (Article 346) does not require such a single market, establishing it is allowed and will lower the cost of rearmament and increase the flexibility of arms supply.
- Create a temporary off-budget EU fund to accelerate rearmament. This could be financed either by common borrowing or by member-state contributions. The allocations of funding (or arms purchased through common funding) should follow an efficiency logic – for example, with a higher share distributed to countries on the borders of the EU with higher levels of defence spending.

Address economic security blind spots

The Commission's economic security strategy risks being too focused on the calamities of the past

While the Commission's economic security strategy has been commendable – in particular, the creation of the Anti-Coercion Instrument – it risks being too focused on the calamities of the past (import disruptions) rather than the possible risks of the future (dependence through export and profit concentration, asset expropriations and financial weaponisation). The EU needs to address these risks in conjunction with like-minded allies, including the UK and Japan. It also needs to leverage the single market agenda with security in mind.

Reset the relationship with the UK

The EU-UK relationship is important to both partners for security and economic reasons. A closer relationship should be sought particularly in defence – with a closer EU-UK relationship within

NATO, to forestall and (if unavoidable) manage a reduction in US engagement – and common defence procurement. The development of a European single market in defence production should include the UK – if necessary, underpinned by an intergovernmental treaty. Improvements or extensions of the existing EU-UK Trade and Cooperation Agreement should also be sought in areas such as regulatory alignment, and to ensure that there is no friction between the EU and UK carbon border adjustment mechanisms.

Reform EU decision-making both for greater efficiency and to prepare for enlargement

The EU should be innovative in readying for the next wave of enlargement

The EU should be innovative in readying for the next wave of enlargement, including Ukraine's accession. Staged accession should be considered seriously. It is unlikely that Ukraine or any other candidate country will join the EU during your term in office and you may be tempted to simply negotiate accession with candidate countries and ignore the reforms that the EU itself needs to implement to be able to function after the next enlargement. But this would be a huge mistake: EU decision-making and governance are problematic even today.

You should not be afraid to start the institutional debate because it is highly divisive. Neither enhanced cooperation nor even treaty changes should be off the table. At the same time, governance should not be an ideological exercise pitting pro- and anti-further EU integration against one another. It should be pragmatic. More integration may be needed in some areas, but not in others.

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Memo to the High Representative for Foreign and Security Policy

Alicia García-Herrero, Heather Grabbe and Jean Pisani-Ferry

Your job was designed for a different world than the one the European Union now grapples with: a world built on principles and governed by law, in which the EU was a force of attraction because of its mass, prosperity and good governance. Today's EU is weaker. It faces Russian aggression on its borders, while economic security has become a much bigger priority. In this context, the EU's external policy is more important than ever.

But your role is constrained by a confusing and contested institutional structure. A stark choice must be made on how to adapt your role to a world dominated by intimidation and brute force. The best option would be for you to have a stronger mandate to act on matters on which member states have decided to take common action. This would require greater legal and financial capabilities to coordinate relevant policies in the EU institutions.

Confront the big challenges posed by China, Russia and the US

Build new momentum with India and the Global South

Better define the HRVP role

State of affairs

The job of High Representative for Foreign and Security Policy and Vice-President of the European Commission (HRVP) was designed for a different world than the one Europe now grapples with: a world built on principles and governed by law, where the European Union was a force of attraction because of its mass, prosperity and good governance. Five years ago, few Europeans worried about their reliance on Russian energy and Chinese supply chains, and engagement in conflicts was largely a matter of choice.

The EU has become more vulnerable, facing Russian aggression on its borders and a conflict in the Middle East where it has little influence

Today the EU is weaker and more vulnerable, facing Russian aggression on its borders and a conflict in the Middle East where it has little influence. Economic security has become a much bigger priority since the COVID-19 pandemic and the realisation that dependency on other countries can become toxic. Not even the largest EU countries have much clout in the United States-China rivalry. Internal problems with rule-of-law violations and democracies undermined by disinformation have reduced Europe's self-confidence in defending its values abroad.

Since 2022, the EU has made some progress in its security policy. It is no longer dependent on Russia for energy. Defence spending has risen as member states have sought to replenish stocks of weapons donated to Ukraine and to reduce dependence on the US for their own security. This is adding to pressure on public finances, increasing the need for better coordination of spending. A flurry of economic security-related instruments have been put in place: to reduce import dependency (Chips Act, Critical Raw Materials Act), to deter coercion (Anti-Coercion Act) and to protect sensitive technology and infrastructure (screening of foreign direct investment, export controls, the Cyber-Resilience Act). However, the effectiveness of these instruments remains to be tested. In the meantime, the EU's relative economic weight is falling as others grow faster.

The 2024 US election could force Europe to develop its strategic autonomy. Whoever is elected as the next US president will continue the rivalry with China, and Washington will continue to be more absorbed with the Indo-Pacific than with Europe.

On foreign policy, the EU still finds it difficult to build and maintain consensus. Its quest for strategic autonomy from the US is not balanced by enough engagement with other regions. It has failed to win the support of the Global South for Ukraine. The rise of anti-western and anti-European narratives in many parts of the world has been boosted by three consecutive shocks: Europe's failure to share COVID-19 vaccines at the start of the pandemic, the rise in energy and food prices globally in 2022 as Europeans sought to buy whatever they could after the full-scale Russian invasion, and the EU's unwillingness to break with the US on the Middle East. The EU now finds itself in the unenviable position of having almost no influence over Israel yet being blamed for the suffering of the Palestinians.

Many European leaders focus on transactional relationships with neighbouring countries to contain and control migration

Meanwhile, many European leaders focus on transactional relationships with neighbouring countries to contain and control migration. There is a lack of EU long-term thinking about the major pressures that are causing people to move, most notably demographic change (such as fast-growing young populations in Africa) and climate change, and the corresponding policy responses. Economic needs to fill labour shortages in Europe are not matched by political willingness to build win-win relationships with the countries of origin and transit.

China is now widely acknowledged to be a rival, and even a threat, by most EU governments. It is perceived as reshaping the rules-based international order and building an alternative power centre. Yet it remains an essential trade partner and has also become a formidable economic competitor, thanks in part to massive industrial policies. While President Trump was engaged in a trade war with China, many in Europe believed they could remain bystanders. In 2020, the EU even signed a landmark deal with China, the Comprehensive Agreement on Investment (CAI). But in March 2021, the EU decided not to ratify CAI after China imposed sanctions on European parliamentarians and civil society. Then China decided to lean towards Russia after the 2022 invasion of Ukraine.

However, the broad consensus within the EU around the need to 'de-risk' the relationship with China is not matched by an agreement on how to achieve it. Politically powerful sectors such as the car industry are keen to maintain their access to the Chinese market, and European economies still depend heavily on Chinese supply chains. China's influence on EU candidate countries and even a member, Hungary, is undermining values and the rule of law, and challenging cohesion within the EU.

The EU must prepare for the changes in its economic relationships resulting from European Green Deal policies

Your substantive role will include the climate transition as a major issue. The EU needs to prepare for the changes in its economic relationships resulting from European Green Deal policies. Climate justice will be a recurring theme in relationships with countries affected by EU climate measures and with those that want more help with adaptation. Climate diplomacy, led by you, will need to be linked to more conditional funding to help partners along their transition paths to sustainability, particularly with the goal of phasing out fossil fuels as quickly as possible.

Challenges

Confronting the EU's major foreign policy problems

Reconciling a strong transatlantic alliance with EU autonomy. Reconciling the role of the United States as protector and close ally with EU autonomy has become much more challenging. First, attitudes to China are different. As a global power, the US sees China as a threat to its supremacy, while Europe is concerned about its security and competitiveness, but has no supremacy to defend. Second, the US has been increasingly distancing itself from global rules that it helped create, particularly in international trade. The EU remains committed to these rules, partly because it is more trade-dependent, and partly because unconstrained exercise of discretion is not a plausible strategy for a union of sovereign countries, which often disagree. Third, US commitment to Europe has declined structurally – because of the rising importance of Asia – and it has become more volatile. A second Trump presidency might mark a return to isolationism of a kind not seen since the 1920s.

Manage threats from China while maintaining a constructive relationship. While the three terms coined by the 2019 EU-China Strategic Outlook – partner, competitor and systemic rival – continue to apply (European Commission/HRVP, 2019), another aspect needs to be added: the threat. China's acts of economic coercion, and its support for Russia in its war against Ukraine, show that China is itself a potential security threat to the EU. Your challenge will be to manage this threat while preserving cooperation on trade and climate change, and in international forums.

Building stronger relations with the Global South

The EU's prosperity depends much more on the Global South than it used to

The EU's prosperity depends much more on the Global South than it used to for three main reasons: 1) to meet global emissions reduction targets, rapidly growing economies such as India need to accelerate their decarbonisation; 2) to diversify trade relationships away from China and ensure stable supply chains that support the EU's green transition; (3) for controlled immigration that helps address the EU's demographic and skills challenges while avoiding social and political backlash. Your challenge will be to strengthen all three aspects of the relationship at a time when the Global South needs the EU less than in the past.

Addressing the internal challenges to your role

Your role is constrained by a confusing and contested institutional structure in which multiple external representatives speak on behalf of Europe and control different external instruments. The prominent roles of the President of the Commission and President of the European Council on the world scene have shrunk the space for the HRVP. Presidents and prime ministers seek the limelight, leading to competition, and even contradictions, in the EU's positions. Even where the EU can wield external instruments, its capacity to use them strategically is limited by the diversity of its members. Some are former global powers that want to shape EU external policies in ways that promote their national interests, while others are smaller countries primarily concerned with their immediate neighbours.

The original intention for the HRVP role was policy coordination through 'double-hatting' as chair of the Foreign Affairs Council – on the assumption that substantive decisions would be taken by the foreign ministers – and as the second most senior Commissioner. However, since the post was established 15 years ago, many more foreign policy decisions have moved up to the European Council instead, with heads of state and government taking them over from their foreign ministers. Meanwhile, the HRVP position inside the Commission has been demoted from first vice-president to one among many with that title.

This smaller role for the HRVP contrasts with the growing interlinkages between economic and hard security. For example, the Biden Administration's economic-security doctrine was set out by National Security Advisor Jake Sullivan. The HRVP, meanwhile, does not control the most powerful external instruments of trade, development funding, enlargement and neighbourhood policy, or representation in the G7. Paradoxically, Ursula von der Leyen's ambition to create a 'geopolitical Commission' has further marginalised the HRVP's role. If she creates a new defence commissioner who reports directly to her, your job could be eviscerated of its substance also on security.

For the moment, the EU is mostly sticking together on providing support to Ukraine and imposing sanctions on Russia. But with the growing external challenges, internal fragmentation and the dispersal of external policy resources and representation are increasingly costly.

Recommendations

Confront the main foreign policy challenges

You need to work on options for the EU's response to the US becoming a more unpredictable and unreliable partner, especially if President Trump returns to the White House. Risks could include withdrawal of US troops from European bases.

You must work to bring member states together around a common vision for relations with the US

You must work to bring member states together around a common vision for relations with the US, developing a transatlantic economic security strategy that creates more common ground (if the next president is a Democrat).

You must play a crucial role in reshaping EU strategy on China as rivalry intensifies and Beijing continues to support Russia, while also conducting massive industrial policies with negative consequences for European exports and for the functioning of the single market. Furthermore, the use of EU defensive tools is hampered by differing views across countries and fear of retaliation. You should widen the High-Level Economic and Trade Dialogue with China from trade to economic security, and aim to clarify the EU's position on Taiwan as well as boosting its role in a free and open Indo-Pacific.

Relations with India could be a highlight of your mandate

Relations with India could be a highlight of your mandate. You should engage with the new governing coalition (still led by Prime Minister Modi) to regain momentum on negotiations on a comprehensive economic package, following the example of the Economic Comprehensive Agreement signed between European Free Trade Association members and India in March 2024. Use the EU-India Trade and Technology Council as a platform to deepen technology cooperation and also broader economic security.

Your basic job is to build and maintain relationships. This is especially important in working with the majority of the world, beyond the advanced, industrialised economies. Presence is vital. You simply won't have time to maintain meaningful relationships with enough leaders in many parts of the world. Your best tactic is to appoint deputies with specific regional responsibilities, ideally from EU member countries without a colonial past in that region.

Now that other powers are also building ties in the Global South, the EU has to move on from post-colonial relationships based on resource extraction and donor-driven aid. The establishment of the Global Gateway (European Commission, 2021) was the first step in defining a new paradigm, and you should work with the commissioner responsible for international partnerships on a follow up that brings together your diplomacy with the EU's money and other external instruments. That means leveraging Council relationships as well as coordinating policies run by the Commission, such as trade and development.

You will need to take a more sophisticated approach to two issues where some EU countries would like to have primarily transactional relationships: raw materials agreements, where resource-rich countries now find themselves in a sellers' market, and migration, on which longer-term thinking is needed on the EU's strategic goals and options for steering the movement of people and responding to EU labour-market needs.

On climate diplomacy, you must make sure partners are not surprised by EU moves

On climate diplomacy, you must make sure partners are not surprised by EU moves, as they were by the Deforestation Regulation (Regulation (EU) 2023/1115). The regulation was itself needed, as the carbon border adjustment mechanism will be, but partner-country leaders felt betrayed by lack of forewarning and discussion. You will need to work with the commissioners responsible for climate and environment to show that the EU really does support partners' own chosen transition paths.

Better define your role

A stark choice has to be made on how to adapt the HRVP role to a world dominated by intimidation and brute force, where European influence is declining and its engagement needs to intensify in many regions simultaneously. Unfortunately, the Treaty on European Union lacks a precise definition of the powers of the HRVP. There are two possible options.

The first and best option is for the European Council to give the HRVP a stronger mandate to act on matters on which member states have decided to take common actions. In a world in which security and economic threats are linked, this would require stronger legal and financial capabilities to coordinate relevant policies in the EU institutions. In this model, you would be 'first among equals', both among the foreign ministers and among all commissioners with portfolios that touch on EU external relations.

- On the Commission side, you would reassume the role of First Vice-President of the Commission (HRFVP), with responsibility for supervising the commissioners responsible for trade, international partnerships, enlargement and the neighbourhood, crisis and humanitarian operations, and defence. You would convene these commissioners regularly to set a strategic direction and coordinate the use of Commission instruments.
- On the Council of Ministers side, you as HRFVP would chair the foreign affairs, defence and possibly development and trade councils, to bring more coherence to the discussions among these different ministers. If an Economic Security Council is created (as proposed by Letta, 2024), it would also be chaired

by you. To make the job manageable, you should designate other commissioners and/or individual foreign ministers as deputies responsible for particular issues and/or geographical relationships, reviving a tradition used by previous HRVPs.

In the European Council, you should use your seat rather like the National Security Advisor does in the US Cabinet

- In the European Council, you as HRFVP should use your seat rather like the National Security Advisor does in the US Cabinet, preparing external policy packages for leaders to decide, working closely with the European Council President to link the external policy Councils (including trade, development and defence) to that power centre, and doing the preparatory work across the institutions. That would require the European External Action Service to support you with strategic thinking and more innovative proposals.

The President of the Commission could still decide to keep within her exclusive domain certain matters belonging to EU competence, while the President of the Council would always be able to move issues up to the European Council for decision. The two Presidents and you as HRFVP would have to work together closely as a team.

A second option would accept that your authority as HRVP is today more circumscribed than envisaged by the Lisbon Treaty, and could shrink further if the role of the commissioner responsible for defence extends beyond military procurement into defence policy. The aim would be to establish a clear division of labour between yourself and other commissioners whose portfolios have an external dimension, to avoid turf battles. This would imply forsaking responsibility for trade policy, development, enlargement and neighbourhood, which would remain the remit of dedicated commissioners.

To maintain coherence on hard security, the commissioner responsible for defence would take over the military staff and intelligence, mirroring the division between foreign and defence ministers at national level, and replace you as chair of the Steering Board of the European Defence Agency, in order to link security and industrial policies. In this minimalist model – which is less than the responsibilities given to you on defence under the EU treaties – you would be assigned a leading role in just three fields: 1) coordination of common positions on foreign and security matters where the 27 member states can agree, 2) external representation of EU common positions and the diplomatic network of EU delegations through the European External Action Service (EEAS), 3) proposing and announcing economic sanctions once decisions have been taken by member states.

The second option would change the institutional balance. Lack of coordination on the Council side would increase the dominance of the Commission in relationships that are both geo-economic and geopolitical. That could increase free-riding and hostage-taking, as member states would be more reluctant to expand the use of qualified majority voting and constructive abstention in Council decisions. Under the second model, you would not play a significant role in policy relating to the US, China or other crucial relationships, where the Commission president and large member states would lead.

The advantage of the first model is its efficacy, as you would have the space to take initiatives – largely still regarding coordination – and to improve the functioning of the EEAS and its relationship with the Commission. Responsibility for sanctions, which now lies with you, would be coordinated better with the activation of economic-security instruments, which is the responsibility of the Commission. With this model working more effectively, it would be easier for you to argue for an increase in external-action funding in the next EU budget.

EU delegations should be upgraded in terms of personnel and expertise

Even if only the second model proves to be feasible, several improvements should be made to the current situation. In particular, EU delegations should be upgraded in terms of personnel and expertise, and should be given stronger roles in coordinating EU instruments on the ground. Furthermore, you should have a final say in the appointments of heads of delegations (together with the Commission President), so that these top diplomats have personal links to you.

We believe the first model is preferable. But most important is that the EU makes a choice and breaks the bad habit of nominally assigning powers to you while depriving you of the ability to exercise them in practice. Disempowering your position would make the system even more dysfunctional.

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Memo to the commissioner responsible for defence

Guntram Wolff

You face the major challenge of Russian imperialism in the context of a potential retreat from Europe by the United States. The outcome of the war in Ukraine will shape European security for decades. EU defence spending is neither sufficient nor efficient. You must push for expanded military production and improved procurement, making the most of the EU single market. You will have to convince EU governments of the benefits of greater integration of the defence market and a reduction in national gold-plating and local industrial policy, while also preventing unjustified protectionism against foreign producers.

You also need to focus on the innovation benefits of greater defence spending. Your role will need clear demarcation in relation to the High Representative for Foreign and Security Policy and the commissioner responsible for the single market. With some ambition, your role could include broader security and intelligence files, surpassing the weak role of the European External Action Service.

Support Ukraine and resist the Russian threat

Expand military production and improve procurement

Maximise single-market benefits

State of affairs

European Union citizens expect their governments to protect them from external threats. Ensuring territorial integrity is a core strategic, political and economic priority and any infringement of it would have incalculable consequences for the EU. While national forces provide for security, they also provide a European public good. In defending national territory and thereby EU territory, they protect neighbouring countries and contribute to collective deterrence. EU treaties foresee the possibility of mutual defence support to be provided to other EU countries. In surveys, European citizens want the EU to play a larger role in defence. In this context, you need to reflect on three major issues.

Russian neo-imperialism

Europe faces the biggest threat to its security since the end of the Cold War

Europe faces the biggest threat to its security since the end of the Cold War. Russian imperialism is an existential threat to Ukraine and may well be a direct threat to EU countries. The outcome of the war in Ukraine will shape European security for decades. Putin's Russia might be emboldened to further territorial conquests if it succeeds in Ukraine, and in this scenario would be able to draw on the joint resources of 140 million Russians and 40 million Ukrainians. The credibility of NATO's Article 5 deterrence and the EU's mutual defence obligation[1] would then be tested. But Putin's totalitarianism is not only dangerous in countries under his control and in Russia's neighbourhood. Russia has engaged in hybrid warfare, influence operations, disinformation campaigns and interference in elections and referenda in many EU countries, the United Kingdom, United States and other allies.

European defence spending exceeds that of Russia. Yet Russia's ammunition production capacities are greater than that of all NATO allies. Moreover, Russia – while having suffered significant losses in land forces in Ukraine – has been able to reconstitute that force; its army is now 15 percent larger than when it invaded Ukraine in February 2022, and has learned significantly on the battlefield.

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1 Treaty on the Functioning of the EU, Article 42(7): "*If a Member State is the victim of armed aggression on its territory, the other Member States shall have towards it an obligation of aid and assistance by all the means in their power*."

In response to Russia's attack on Ukraine, European countries and G7 allies have implemented various sanctions, including export controls on dual-use equipment and battlefield goods, and military, financial and humanitarian support for Ukraine. Sanctions and export controls initially limited Russia's weapons production capacity, but export controls are being circumvented. Russian weapons continue to operate with substantial amounts of Western technology (Hilgenstock *et al*, 2024).

Western allies have delivered substantial amounts of weapons and ammunition to Ukraine. To meet the greater demand for military equipment, European production has expanded but remains insufficient compared to Ukraine's needs. European ammunition stocks have therefore declined substantially. As the amounts delivered to Ukraine are insufficient for it to hold its position, Russia is making territorial gains. Europe is critically dependent on weapon imports to stabilise its security situation while expanding the European Defence and Technology Industrial Base (EDTIB). The US is Europe's key foreign supplier of weapons.

US retreat

The security situation is compounded by the gradual retreat of the United States from Europe. During and since the Cold War, the US presence in Europe has been of central importance to collective security. But depending on the 2024 US election outcome, US interest in Europe in general and Ukraine more specifically may decline quickly. The questions then would be if and how Europe can organise defence with less-to-no US involvement, and how it could provide the necessary support to Ukraine to prevent a Ukrainian defeat and even empower Ukraine to liberate its full territory. The EU and Ukraine need to import military equipment and US industries dominate global markets.

Dependence on the US exists at strategic level because EU capitals have little capacity to design a security strategy

Dependence on the US exists at strategic level because EU capitals have little capacity to design a security strategy, let alone agree on a common approach. The EU's 2022 Strategic Compass falls short of the leadership provided by the US. The EU is also dependent on US military capabilities, industrial capacity and financial resources. European countries lack critical military assets (for example troop deployment capacity, intelligence, satellite communication and geolocation, a nuclear umbrella) (Gonzales-Laya *et al*, 2024; Biscop and Murillo, 2024). Since February 2022, the US has contributed about 40 percent of total aid allocated to Ukraine. The US retreat is already visible as these financial flows have become less certain in the pre-election competition, while many influential US voices call for restraint on weapon supplies to prioritise US strategic interests in Asia[2].

EU defence governance

The idea of integrating European defence capacities is not new. It dates to the 1950s when a European defence community treaty had been negotiated but not ratified. Since then, European defence has been mostly organised in a NATO framework. The recent accessions of Finland and Sweden to NATO further underline the importance of NATO.

Defence is and will remain a national responsibility of the European Union's 27 countries, yet there have been some EU-level developments. In particular, the EU's Common Security and Defence Policy encompasses a Commission Defence Industry and Space directorate-general, a crisis-management and planning directorate within the European External Action Service (EEAS), an EU military staff, a Foreign Affairs Council meeting with defence ministers (with meetings prepared by the Military Committee, EUMC) and agencies including the European Defence Authority (EDA), which was created in 2004 to promote defence collaboration in the EU. The principal task of the EDA is to help EU countries spend better, including by managing joint projects and helping acquire military assets. EU governance in the defence area is thus fairly complex and decision-making is mostly intergovernmental with a unanimity requirement.

EU defence governance is complex and decision-making is mostly intergovernmental with a unanimity requirement

2 See, for example, J.D. Vance, 'The Math on Ukraine Doesn't Add Up', *The New York Times*, 12 April 2024, https://www.nytimes.com/2024/04/12/opinion/jd-vance-ukraine.html.

Challenges

You face two sets of challenges. First, you need clarity on your job description. Second, you will have to focus on the substantial challenges facing the European defence industry, military procurement and the organisation of arms deliveries.

Defining the role

You are not a defence minister and you do not command any army (with the possible exception of the EU Rapid Deployment Capability, to be established by 2025, which is currently foreseen to be politically led by the Council and the military planning and conduct capability of the EEAS). You also have limited strategic resources, intelligence and planning capacities, which all essentially reside with member states and NATO and to a limited extent with the EEAS.

The EU will have to define how its relationship with NATO will evolve

The EU will have to define how its relationship with NATO will evolve and this will directly impact your job description. Within the EU it is still unclear how exactly your responsibilities will interact with those of the High Representative of the Union, who currently heads foreign and security policy, including on defence matters. The High Representative is in charge of the EEAS, the European Union Military Staff and chairs the Foreign Affairs Council (including in its defence composition). The High Representative also heads the EDA. Your role will also have to be defined clearly relative to that of the Commissioner for the single market, who also oversees the defence industrial agenda at the EU level.

Expanding military production and improving procurement

The war in Ukraine is turning into a war of attrition. Winning such a war is a question of production capacity, cost effectiveness and willingness to pay. You will need to show leadership in each of these three areas.

After decades of European underinvestment in defence and restrictive export permission rules, domestic production capacity was at minimal levels. Production is still too low compared to demand, despite some increases in the last two years. Defence spending and the share of spending on equipment has increased, especially in Eastern European countries. As equipment spending increases, the defence industry will tend to grow and how the market will shape up will be a key topic for you (see Figure 1). However, imports have increased substantially, reflecting the limited capacity of EU industry to meet rising demand.

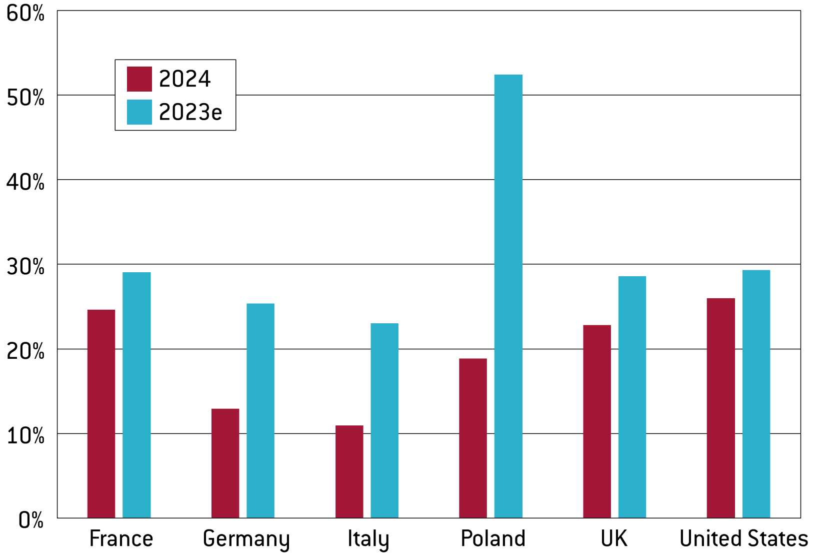
EU markets for defence products remain fragmented with national gold-plating and industrial policy preferences contributing to excessive costs per unit. Neither EDA nor the Defence Procurement Directive and the Intra-Community Transfers Directives (2009/81/EC, 2009/43/EC), nor the Permanent Structured Cooperation (PESCO), a mechanism agreed by 26 EU member states to advance cooperation on defence, have addressed the issue. The defence industry strongly depends on its main customer – government – that regulates production and exports.

Cumbersome administrative processes hold back increases in production capacity

The home bias in procurement has allowed national champions to acquire dominant positions in some of the national markets, while still producing relatively low quantities with possibly low margins because of the limited size of the domestic market. Relatively low production numbers – related to fragmented markets – drive up unit prices. Cumbersome administrative processes hold back increases in production capacity. Because supply lags demand, unit prices of 155mm shells, for example, increased by a factor of four[3]. The EU defence industry also faces some critical dependencies in supply chains for some weapon systems. Speeding up the use and integration of advanced digital technology is another major challenge for European defence industry policy. Artificial intelligence and autonomous systems play increasingly important roles on the battlefield; US companies are increasingly taking the lead in this sector.

3 Sam Skove, 'In race to make artillery shells, US, EU see different results', *Defence One*, 27 November 2023, https://www.defenseone.com/business/2023/11/race-make-artillery-shells-us-eu-see-different-results/392288/.

Figure 1: Defence equipment spending as a % of total defence spending, selected countries



Source: Bruegel based on SIPRI. Note: the figure shows an indicator of arms imports that measures the volume of international transfers of conventional weapons, as opposed to their financial value, thus providing an indicator of transfers of military capability. 2023 shares are estimated. See https://www.sipri.org/databases/armstransfers.

In sum, Europe needs to strengthen its defence industrial base to increase output and reduce strategic dependence and vulnerabilities, while catching up and advancing the technological frontier. The European defence industrial strategy (EDIS) proposed by your predecessors is a good start but is too optimistic on the short-term capacities of the EU's EDTIB. It overemphasises the goal of reducing weapon imports and offers no concrete ideas on how to address the fragmentation of the market and reduce costs (Wolff, 2024).

Recommendations

Si vis pacem para bellum – if you want peace, prepare for war.

Two models for defence commissioner

If your role is defined narrowly, your main task will be to work on defence industrial strategy and advance European armament. You will rely on the EU's regulatory powers to advance production and the functioning of the single market for defence. A small European Defence Fund will give you a limited instrument to advance defence research and development.

In this scenario, you would cooperate, possibly under the authority of the High Representative, on the nexus between defence and security strategy and industrial policy. The High Representative heads the EDA and manages with member states the European Peace Facility, the financial instrument to support weapon purchases. Your role would be to support the High Representative in ensuring the coherence of the overall package and that defence industrial policy measures are fully anchored in the Commission's broader industrial policy strategy.

Armaments policy and joint procurement

However, if your role is defined more broadly you might have greater authority over armaments policies, joint procurement and, possibly, also the preparation of military strategy and military intelligence. Similarly to a national context, in which the foreign ministry is not in charge of defence but rather of the diplomatic services, it would make sense to transfer significant parts of the EEAS military and intelligence operational and executive capacity to the Commission under your authority. This model would overcome the weakness of the EEAS model in the face of the relatively large influence of member states, and would create a more powerful European Commission with major geopolitically relevant powers in trade, finance, single market, intelligence and defence procurement.

The advantage of this model would be to advance a European strategic culture and military capabilities. The transfer of existing EU intelligence and EU military staff to your authority would improve operational effectiveness in providing intelligence needed for executive decision making to the Council and the Presidents. The Commission President could rely on you to prepare strategic option papers reflecting European interests, which would be brought before the European Council. You would automatically participate in all Foreign Affairs Council meetings, particularly those with defence ministers. In that constellation, you should provide intelligence to ministers and update them on the defence industry and support for Ukraine. The High Representative role would correspondingly become focused on foreign affairs, leading the diplomatic missions and chairing the Foreign Affairs Council. The advantage of that model would be to clearly strengthen the Commission as the EU executive while moving the High Representative to the Council, effectively bringing to an end the current, ineffective 'double-hat' construction in which the High Representative is in the Council and the Commission at the same time.

Defence industrial strategy

You will have to convince member states of the benefits of greater integration of the defence market

To boost production, reduce prices and advance innovation in defence, your most powerful tool will be the single market. Integrating the single market and overcoming national biases in defence procurement is a difficult task. You will have to convince member states of the benefits of greater integration of the defence market and a reduction in national gold-plating and local industrial policy. Increasing competition and increasing the size of the market will help the European defence industry to lower prices while increasing output. Reducing fragmentation and increasing competition will of course be resisted by national industries and governments, as it has in many other sectors. In defence, powerful arguments will be made about how important specific national requirements for military success are; you will have to judge those critically. The growing demand for defence products should provide sufficient incentives to convince companies that the increased competition is acceptable. And the long and sustained demands on public budgets will be your most powerful argument in making the case for bringing down costs through more market integration.

Joint procurement will help you integrate markets and reduce costs

Your starting point will be the European Peace Facility, a fund worth €17 billion for 2021-27 and mostly used to support Ukraine, and a European Defence Fund of €8 billion for 2021-27 to support companies with cooperative projects in defence R&D. You will have to convince those countries that are increasing their defence budgets to also allocate some funds to such EU instruments. Since some of that spending will be forward looking and will have the character of investment that should last for years, joint borrowing mechanisms will be high on your agenda, for both the funding of innovation and Ukraine support.

Joint borrowing mechanisms will be high on your agenda, for both the funding of innovation and Ukraine support

When advocating for the integration of the European market for defence products, you should not lose sight of partner countries. The UK is a major ally and defence industry player, essential for European security. Ukraine has become a major producer of weapons and many companies now want to produce in Ukraine, not only because it is relatively cheap but also to directly test new systems. In your industrial strategy, you should also advance cooperation with partners such as Japan.

The European market for defence companies is characterised by a mix of private and public companies. Experience suggests that private companies in which management operates with authority and without government intervention through government shareholding tend to perform better – with more effective and faster deliveries at lower prices[4]. You should organise EU procurement, for example by the EDA, for several member states to overcome slow, fragmented and excessively bureaucratic national procurement processes, while protecting the autonomy of defence companies to deliver the best products following market logic. You will also have to define a position towards the Franco-German development, agreed in April 2024, of a next-generation tank known as the Main Ground Combat System, a project in which you should encourage market forces and limit bureaucracy.

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4 See for example Sylvia Pfeifer and Leila Abboud, 'How the Storm Shadow missile maker launched a new model of defence co-operation', *Financial Times*, 8 April 2024, https://www.ft.com/content/3914c6b7-3f3f-4be8-8342-52f5fefa62f3.

A greater domestic share of production may make sense in products with substantial intellectual property benefits

Deter unjustified protectionism against foreign producers

Europe benefits from importing weapons, in particular if they are cheaper and more effective than domestically produced systems. At the same time, you want to direct some of the European demand to the domestic industry to ensure that innovation in Europe advances – a major benefit of a strong defence industry. A greater domestic share of production may therefore make sense in products with substantial intellectual property benefits. This suggests focussing the EDIS domestic-share goal (to purchase a larger share from domestic producers; Wolff, 2024) on specific high-tech military equipment, rather than mass-produced products.

The defence market is undergoing huge changes with the increasing use of AI and autonomous systems. You need to ensure that new entrants into the European market find a level playing field and access to public procurement – which is dominated by large domestic incumbents. A bigger European budget could be a way to nurture new emerging high-tech firms in particular and make them truly European players.

Further single-market integration

An important question is about how EU procurement will support single-market integration. Under EDIS, a European Defence Industry Programme has been proposed, with extremely limited financial resources until the next EU budget. There is also a Structure for European Armament Programme to complement the current PESCO programme. Your role is to make these initiatives work. You will have to avoid excessive bureaucracy and make them into flexible instruments that drive innovation and industrial development.

Maintain the transatlantic relationship

Europe will remain dependent on strategic weapon imports from the US for military and capacity reasons. Also from a foreign policy perspective, purchases from the US may serve important strategic goals in the transatlantic relationship. While you want to boost domestic industrial production, you will need to approach the US with appropriate strategic embeddedness.

As you want to develop the European defence industry, you should aim to coordinate the strategies for rules on weapon exports and foster a joint understanding on which destination countries are appropriate customers for which types of weapons.

The defence industry itself also faces funding challenges. Private funding for the defence industry remains stigmatised and funding costs for SMEs are more expensive than outside the defence sector. You will have to play a major role in tackling private-sector funding bottlenecks in collaboration with the commissioner responsible for financial services.

As you take up your position, the security situation on the continent remains fragile and your job will receive a lot of attention and scrutiny. In defence more than in many other fields fundamental differences exists among EU member states, including between France and Germany. Visionary leadership combined with humbleness and realism will be a winning mix as you approach the job.

The security situation on the continent remains fragile and your job will receive a lot of scrutiny

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Memo to the commissioner responsible for trade

Petros C. Mavroidis and André Sapir

You face three main challenges: maintain the EU's commitment to open markets at home and abroad by continuing to adhere to the multilateral rules-based trading system; continue to sign and implement free-trade agreements; and head-off the resistance from the Global South to trade-climate policies such as the carbon border adjustment mechanism.

To meet the challenges, you must champion open trade and multilateralism despite the headwinds, continue to facilitate security and climate cooperation, tackle distorting industrial policy by pushing for World Trade Organisation reform, resist Chinese or US trade coercion and find new ways to address the trade-climate-development nexus.

Champion open trade and multilateralism

Resist coercion; push WTO reform

Address the trade-climate-development nexus

State of affairs

Until recently, the objective of European Union trade policy was mainly economic: to foster (together with the single market) an environment favourable to the economic wellbeing of EU firms and consumers. The main task was to maintain open markets at home and abroad by promoting adherence to the multilateral rules-based trading system. The success of this strategy is reflected by the fact that the EU's rank in world goods trade (excluding intra-EU trade) is second in exports (behind China) and imports (behind the United States). The EU ranks first in the export and import of services.

This state of affairs persisted while geopolitical considerations played only a minor role in the conduct of trade policy in the EU and elsewhere – first during the Cold War, when globalisation proceeded only within the Western sphere, and then after the Cold War and before the China-US confrontation, when all countries joined the multilateral trading system by adhering to the World Trade Organisation (WTO), and 'hyper-globalisation' meant truly global trade and investment integration, dominated by purely economic considerations and global value chains.

Today, however, geopolitical and climate considerations often dominate purely economic ones in the shaping of economic policies, including trade policy. The EU and other economies have put in place various economic policies in response to concerns about 'economic security' – a term that more often than not has a strong national security or geopolitical flavour. The EU and other economies have also been deploying various economic policies to meet international commitments to reach climate neutrality.

Increasingly, security and climate objectives are part of the deployment of economic strategies

Increasingly, security and climate objectives are part of the deployment of economic strategies in China (with 'Made in China 2025'), the US (with the Inflation Reduction Act) and the EU (with the Net Zero Industry Act), as well as in other major trading countries. Such strategies typically involve subsidies and other forms of industrial policy, often with a protectionist angle if not intent.

Altogether, these various policies have started to fragment world markets, though the term 'deglobalisation' is probably incorrect at this stage. The period of hyper-globalisation, during which world trade increased much faster than world production, seems to be over, but globalisation has not reversed, at least if one considers trade in goods and services together. Instead, it seems to have levelled off, hence the term 'slowbalisation' to characterise the current period.

The current geopolitical situation has led to paralysis at the WTO

The current geopolitical situation, in particular the economic and strategic competition between China and the United States, has led to paralysis at the WTO. Suspension of the Appellate Body because of the US's continuing objections is just one aspect. The WTO, which now counts 166 members, has suffered from two main problems for a while. First, some of its rules, including those that relate to security and climate measures, and also subsidies and digital trade, are outdated. Second, the economic and political diversity of its members and the fact that decisions are taken by consensus, which essentially gives veto power to any member, make reform very complicated.

Despite these problems, the WTO continues to play a central role in the trade policies of all its members, including China, the US and the EU. Despite WTO paralysis, none of its members has decided so far to disregard existing rules completely – although the US is openly flouting some of these rules. We estimate that 80-90 percent of world trade continues to fall under WTO rules, the main exception being the US tariff surcharge on imports from China added by President Trump and further increased by President Biden. In addition, WTO members all participate actively in daily meetings held at the WTO headquarters in Geneva, and in Ministerial Conferences held every two years, most recently in Abu Dhabi in March 2024.

Against this background, EU trade policy has remained attached to multilateralism and global trade rules, but has had to adjust with a grain of realism. This has meant the continuation of its long-standing pursuit of free-trade agreements with bilateral and regional partners, but also a shift in attitude, with the adoption of an arsenal of unilateral, autonomous instruments.

Multilateral initiatives

Despite – or perhaps because of – the difficulties at the WTO, the EU has been very active in trying to forge consensus among WTO members on reform of WTO rules and practices. It has attempted to resolve the crisis of the Appellate Body, was one of the instigators of the Trade Facilitation Agreement and the Fisheries Subsidies Agreement, and has participated in all WTO plurilaterals and joint statement initiatives among sub-sets of WTO members. The EU has also promoted the greater involvement of the WTO in the discussion on the interplay between trade and industrial policy.

Bilateral and regional measures[5]

Your predecessors launched new FTA negotiations, but progress has been slow

The EU has the largest network of bilateral and regional FTAs in the world, which your predecessors sought to widen and deepen. They launched new FTA negotiations with Australia, India and Indonesia, but progress has been slow. An FTA was reached with New Zealand and entered into force in 2024. Updated agreements were also concluded (with Mexico) and ratified (with Chile and Kenya), or negotiated but not concluded (with South Korea and Singapore). Finally, there was a push, without success, to amend a signed but never ratified FTA with the Mercosur countries (Argentina, Brazil, Paraguay and Uruguay). The EU has also concluded digital trade or sustainable investment facilitation agreements with some countries.

By contrast, China and the US have far fewer FTAs and have been far less active than the EU in recent years. China was the engine behind the Regional Comprehensive Economic Partnership agreement (signed in 2020 and implemented in 2022), which counts 14 Asia-Pacific members besides China. Under President Biden, the US has not negotiated new FTAs. However, his administration has concluded a number of partnership agreements with strategically important countries, such as the Indo-Pacific Economic Framework for Prosperity (IPEF) with 13 Asia-Pacific countries. Neither the IPEF nor similar partnerships, however, have so far included a trade component.

A clear motivation for the recent expansion of the EU's FTA network is the current geopolitical situation, which requires security of foreign-market access for EU exporters at a time of uncertainty about the fate

5 We do not cover the EU's trading relationship with the United Kingdom. The EU has a trade agreement with the UK, but it represents a step back from the UK's previous membership of the EU customs union and single market, and is not comparable to EU trade agreements with other partners, which are aimed at opening up trade.

of the WTO system, and security of access to critical raw materials for EU buyers, especially in the context of the green transition.

Unilateral measures

Like other WTO members, the EU has always used unilateral trade measures to defend its interests, but before the first von der Leyen Commission, it only used trade defence instruments (mainly anti-dumping and anti-subsidy) explicitly allowed by WTO rules.

The Commission has innovated by introducing new autonomous instruments that are not explicitly allowed by WTO rules

The first von der Leyen Commission continued to use traditional trade defence instruments, but has gone further by applying them to new situations, such as imports of electrical vehicles from China. It has also innovated by introducing a vast array of new autonomous instruments, which are not explicitly allowed by WTO rules though they may (or not) be judged WTO-compatible if and when countries decide to launch WTO dispute settlement cases against the EU.

These new autonomous instruments, which were designed mainly in response to the current geopolitical situation and the green transition, fall into two broad categories:

1. Tools designed to defend the EU against unfair practices and aggressive unilateral actions by the EU's trading and investment partners; these can be viewed as an extension of the EU's trade-defence instruments. The new autonomous instruments include the Foreign Investment Screening Mechanism, the Enforcement Regulation, the International Procurement Instrument, the Foreign Subsidies Regulation and the Anti-Coercion Instrument. Although these instruments are not country-specific, it is clear that they are mainly intended to protect the EU from unilateral actions by economically and politically powerful countries, including China and the US.

2. Instruments intended to reduce EU and global carbon emissions. Instruments in this category include the carbon border adjustment measure (CBAM), the Deforestation (Regulation (EU) 2023/1115), and the Corporate Sustainability Due Diligence Directive. These instruments are also not country-specific, but in reality, they will mainly affect Global

South countries, which account for two-thirds of current global carbon emissions – though far less on a *per-capita* basis.

For the most part, these new EU autonomous instruments are not trade instruments *per se* nor did the trade commissioners during the first von der Leyen Commission play a central role in their design. Nonetheless, measures adopted using these instruments will have significant trade effects, potentially leading to WTO disputes or trade retaliation by affected countries.

Challenges

As EU trade commissioner, you will face three main challenges.

The first will be to maintain the EU's commitment to open markets at home and abroad by continuing to adhere to the multilateral rules-based trading system, despite looming political changes in the EU and US. This will not be easy, but it is crucial both for the EU, which is far more dependent on international trade than the United States, and for developing and emerging countries, which need to continue to export in order to develop their economies.

The second challenge will be to continue being able to sign and implement FTAs with important trading partners. The EU-Canada Comprehensive Economic and Trade Agreement (CETA), signed in 2016, is still not ratified by ten EU national parliaments. More worryingly, trade negotiations with three large emerging partners – India, Indonesia and Mercosur – have hit a problem that goes far beyond the usual difficulty in trade negotiations, which is the need to find a compromise between what the EU wants from its partner and the market access it is willing to grant in exchange. These large countries from the Global South are increasingly assertive and unwilling to yield to EU demands mandated by the Lisbon Treaty that EU trade agreements "*be guided*" (Art. 21(1) of the Treaty on European Union) by EU values, which they may not necessarily share. There may, therefore, be a trade-off between geopolitical and economic interests, and values, which the EU will have to grapple with.

Large countries from the Global South are increasingly assertive and unwilling to yield to EU demands

The third challenge relates to the trade and climate issue. During the first von der Leyen Commission, the EU rightly made the green transition one of its strategic priorities. Although the new Commission may have to slow down the implementation of the European Green Deal, the need to meet the net zero emission target will not go away. This means that autonomous instruments such as CBAM will continue to be implemented and will create increasing resentment from Global South countries. Adding a development aspect to the trade and climate issue will therefore be essential to ensure avoidance of trade clashes with the Global South, and above all that they play their part in meeting global climate objectives.

Recommendations

Champion open trade and multilateralism despite the headwinds

Open strategic autonomy became the centrepiece of the EU's geopolitical strategy

Champion open trade and multilateralism despite the headwinds. The first von der Leyen Commission rightly made 'open strategic autonomy' the centrepiece of its geopolitical strategy. The term reflects the EU's desire to chart its own course on the global stage, shaping the world through leadership and engagement, while preserving EU interests and values. The term 'strategic' captures resilience, and to a necessary degree, self-reliance. 'Open' is the counterbalancing factor suggesting that free-trade policies will continue to be the bedrock of the EU approach. The two components of the strategy can and should be married together. There is no either/or dilemma.

Pursuing open strategic autonomy within a vibrant multilateral context is the appropriate insurance policy to avoid sliding towards protectionism. The EU should continue to be the champion of multilateralism. The US is unwilling to play this role, and China is incapable of doing so, so the EU must carry the flag of multilateralism and be the voice of reason at a time when global cooperation is necessary more than ever in recent history, including to fight climate change.

There are two priority areas for it to take the lead in fostering multilateral solutions: security and climate

Continue to facilitate security and climate cooperation
The EU should continue strive to keep channels of communication open across all nations. Realising gains from continuing liberalisation of trade is the platform to better understand gains from cooperation in other fields, such as climate. The EU should assume the role of the instigator in this realm. There are two priority areas for it to take the lead in fostering multilateral solutions: security and climate. Another important area for the EU is digital trade. The unipolar world has been shown to be a fallacy. The question is what is the best forum to discuss conflicting views?

Unilateral action has led and can lead again to a spiral of counter- and counter-counter measures. The world community has paid the price of similar behaviour a few times already. Redressing the WTO adjudicatory function is a priority, but it is only the starting point in the quest to revive multilateralism.

Address geopolitical concerns with appropriate instruments
Industrial policy is making a return everywhere (for good and bad reasons), often on grounds of national security. This trend is difficult for WTO rules and practices to handle, given the sensitivity of the trading system towards legitimate security concerns.

The WTO Subsidies Agreement is outdated and ill-conceived, and adjudication of national security-related concerns has led to increased trade frictions.

Push for WTO reform
The EU should propose a new WTO framework to address the role of state intervention amid geopolitical uncertainty. The EU's long experience in dealing with state aid is unparalleled. Building on this experience, it should propose a new agreement on subsidies that punishes cross-national subsidies (something WTO current rules do not do, despite the considerable importance of global value chains in world trade) and exonerates from liability certain categories of subsidies, including some that seek to fight climate change.

The EU has also gained substantial experience in handling the interplay between its common commercial policy and the 27 national security policies of its member states. There are voices in the global community arguing against any involvement of the WTO in scrutinising national security invocations by its membership. This is not desirable because of the danger that what constitutes legitimate security concerns will be abused in the slant towards protectionism. But scrutiny should not necessarily entail judicialisation of national security-related disputes at the WTO.

The EU should propose the establishment of a WTO Committee on National Security, where disagreements and disputes can be handled through deliberations seeking to answer questions like: What is the aim pursued? Why were the specific means chosen? Are alternative less-intrusive means reasonably available?

Maximise FTA leverage

The EU could also do the same and more through its FTAs. It could, for example, condition trade benefits on firm commitments to non-aggression. In addition, in relation to the potential trade-off between economic and geopolitical interests and values, especially when dealing with countries in the Global South, the EU should tread carefully to avoid being perceived as wanting to impose its values on others, while continuing to maintain those values. To bridge the potential gap between the EU's values and what partners may be willing to accept, the EU should consider what transitions it is ready to accept from its FTA partners before they can meet its standards, and what financial assistance it could provide to developing countries to help them meet those standards. Finding the narrow path that combines EU interests and values will be crucial to advance the important EU's bilateral trade and investment agenda with countries in the Global South.

The EU should tread carefully to avoid being perceived as wanting to impose its values on others

Resist coercion and adopt de-risking policies

Finally, the EU should not hold back from using its new autonomous instruments against China and the US, should they try to coerce the EU through trade.

The EU can also use WTO rules to adopt policies aimed at de-risking trade. Taxing exports of sensitive material is always possible if the EU has made no WTO export tariff commitments, and the export duty is applied uniformly on all WTO members. An alternative is to block exports to certain members on national-security grounds. Fostering less reliance on China for certain critical products is perhaps desirable and can be achieved using instruments other than trade policy. At the same time, enforcement of multilateral trade rules could help the EU (and others) avoid Chinese export bans on critical products. Assuming China imposes export taxes on certain products, the EU could invoke China's commitments in its WTO Protocol of Accession, which forbids such taxes. If, instead, China imposes (lawful) production quotas on certain products, it will have to manage them without discriminating between domestic and foreign buyers of those products.

Respect for WTO rules and the goal of open strategic autonomy can go hand-in-hand

Hence, respect for WTO rules and the goal of open strategic autonomy can go hand-in-hand.

Address the trade-climate-development nexus with appropriate instruments

Including developing and emerging countries in the fight against climate change is indispensable; their current share of two-thirds of global carbon emissions will probably increase as their economic development advances.

Inspired by the WTO Agreement on Trade Facilitation, the EU should propose a framework to address trade, climate and development jointly. The priorities for financing green infrastructure projects should be set jointly by donors and beneficiaries. The volume of carbon emissions should be a key consideration in establishing a hierarchy of beneficiaries. Monitoring of compliance with agreed parameters for financing should be a pre-condition for continuation of financing. Financial assistance is important not only to help acceptance of CBAM by developing countries. The fact is that CBAM is neither a sufficient 'stick' nor 'carrot' for the necessary domestic decarbonisation by most EU trading partners. It may be useful, but not more than that. Climate finance, including financial assistance, is far more important.

Coordinate CBAM-like policies

The WTO is also the right place to discuss the modalities of CBAM and similar schemes that other jurisdictions may introduce. In particular, there is a need for an international agreement on the carbon content of traded products and, more generally, on climate policies and international trade. With such an agreement, there is a risk that CBAM will be challenged at the WTO by some affected countries, or even that some of them adopt countermeasures against EU imports. We would caution the EU against fuelling such a trade war, which would be detrimental to both its trade and climate objectives. Instead, the EU should promote international dialogue and agreement.

The EU could use its FTAs to incentivise trading partners to take the fight against climate change more seriously

But CBAM cannot be addressed only at the multilateral level. The EU should also engage with developing and emerging countries in looking for bilateral or regional approaches to help them shift their production to greener alternatives. For instance, the EU could use its FTAs to incentivise its trading partners to take the fight against climate change more seriously, implement legislation domestically to this effect and propagate a cooperative culture. The EU could make the provision of trade benefits and financial assistance conditional on certain climate targets.

Dealing effectively with the trade-climate-development nexus – at multilateral, regional, bilateral or even unilateral levels – will require greater coherence between EU trade, climate and development policies and therefore greater coordination with your colleagues in charge of these policies.

Memo to the commissioners responsible for international partnerships and reform of the multilateral development banks

Heather Grabbe, Hans Peter Lankes and Jeromin Zettelmeyer

The European Commission has revamped its strategy toward developing countries, with better coordination of European Union donors ('Team Europe'), blending of aid with private finance, less paternalism, better branding and an emphasis of financing physical infrastructure (the Global Gateway). These changes are welcome but bring risks: inability to deliver on promised financing volumes, potential conflict with the Sustainable Development Goals, and tensions with emerging and developing economies, which accuse the EU of double standards.

To address these risks, you should recommit to the SDGs as the primary objective of the Global Gateway, embed infrastructure investment in a comprehensive development strategy, create a separate instrument to fund international emissions mitigation and ensure it is amply resourced, create an institutional mechanism to coordinate Team Europe, seek member state coordination and consolidation of seats on the boards of multilateral development banks (MDBs), and use this to leverage MDB reform and operations through country climate platforms.

Maximise the impact of the Global Gateway

Defuse tensions with emerging and developing partners

Improve coordination internally and externally

State of affairs

EU member states and institutions provide close to half of global bilateral official aid and more than one third of all aid

European Union member states and institutions provide close to half of global bilateral official aid (grants and other grant equivalent subsidies) and more than one third of all aid (including multilaterals and private donors). About a quarter of the EU total comes from the EU budget, specifically, from the Neighbourhood, Development and International Cooperation Instrument – Global Europe (NDICI-GE), which amounts to about €80 billion for 2021-2027 (6.5 percent of the EU's multiannual financial framework, MFF).

Total EU net disbursements have risen significantly in recent years, from about €58 billion in 2019 (United Kingdom not counted) to almost €96 billion in 2023, driven initially by disbursements related to COVID-19 and more recently by aid to Ukraine. If disbursements to Ukraine are excluded, EU aid peaked in 2022 at €79 billion, before falling to €73 billion in 2023. In inflation-adjusted terms, 2023 EU aid to emerging and developing economies (EMDEs) other than Ukraine was slightly below its 2020 level (but above its 2019 level).

Your predecessors made significant changes to how EU development spending is allocated and branded, involving: 1) greater focus on physical infrastructure; 2) stronger, Commission-led coordination of 'Team Europe' (EU countries and development finance institutions controlled by the EU and/or its member states); 3) greater use of blended finance (use of public funds to mobilise private finance, via guarantees and risk sharing); and 4) better branding, including by shifting away from paternalistic donor-recipient relationships (European Commission, 2021). In line with these changes:

- The Directorate-General for International Cooperation and Development was renamed to DG International Partnerships (DG INTPA) in January 2021;
- The NDICI-GE Regulation (Regulation (EU) 2021/947) was adopted in June 2021. This commits the EU and its members to coordinate assistance policies and programmes, and includes risk-sharing instruments for up to €40 billion under the European Fund for Sustainable Investment Plus (EFSD+);

- A new flagship initiative, the Global Gateway, was rolled out in December 2021. This aims to mobilise funding of up to €300 billion by 2027 for – mainly infrastructure – investments in partner countries, combining funding from the EU budget, EU countries, the European Investment Bank (EIB), the European Bank for Reconstruction and Development (EBRD) and the private sector.

The Commission has framed the main objective of the EU's international partnerships as being to promote the direct self-interest of the EU

Most of these changes have been years in the making but one is new and radical: the way in which the European Commission seeks to rationalise EU international partnerships. While development aid was previously justified through a mix of moral obligation and enlightened self-interest (such as promoting growth and political stability in trading partners), the Commission has framed the main objective of the EU's international partnerships, and specifically of the Global Gateway, as being to promote the direct self-interest of the EU at a time of geopolitical rivalry. The NDICI-GE was "*at the service of our geopolitical objectives*" in the words of one of your predecessors [6]

How much these shifts matter in practice is not yet clear (Perez *et al*, 2023). EU blending facilities have supported about 100 projects since 2021, but most are small, and so is the EU financing contribution (about €1.3 billion). A few high-profile infrastructure projects have been launched under the Global Gateway brand, including the Lobito economic corridor and the Medusa fiberoptic cable. But projects branded as part of the Global Gateway cover many other sectors, including health and education. Net disbursements to energy projects have increased but are no higher than prior to the pandemic. The share of EU-level disbursements to health and education (about 14.6 percent of total) remains almost twice as high as the share of disbursements to energy, industry, mining and transport (7.7 percent). This could be because any major change in strategy takes time to implement, but also because of some contradictions inherent in the new approach.

The external environment, meanwhile, has seen major changes

6 See 'Speech by Commissioner Urpilainen at the European Parliament plenary debate on Neighbourhood, Development and International Cooperation Instrument 2021-2027 – Global Europe', 8 June 2021, https://ec.europa.eu/commission/presscorner/detail/en/speech_21_7583.

since 2019. Most of these either place additional demands on EU international partnerships or make it harder to meet those demands:

- Most EMDEs have suffered significant setbacks in reaching the Sustainable Development Goals (SDGs). Some of these setbacks will be long-lasting, in part because food prices are expected to remain higher over the medium term than pre-pandemic levels. Improvements in SDG indicators are happening at a frustratingly slow pace. Most 2030 targets will likely be missed.
- For related reasons, fiscal space has narrowed in most EMDEs. Although a generalised debt crisis has been avoided so far, many low income and some emerging market economies are up against their borrowing limits; some have defaulted. Orderly debt restructuring has become more difficult, because it requires China – by far the largest creditor, but with comparatively little influence over the International Monetary Fund and the World Bank – to agree with Western creditors.
- The world has become even more multipolar and fragmented than was already expected in 2019. Tensions between China and the US and other democracies have continued to rise. Growth prospects have shifted, with the IMF expecting lower medium-term growth in China than it did before the pandemic. Several other developing economies are growing quickly and becoming more assertive.
- Global carbon emissions continue to rise, and biodiversity is declining at alarming rates. Nationally determined contributions to mitigate emissions pledged by EMDEs are not nearly ambitious enough to keep global temperature rises below 2 degrees above pre-industrial levels, even if advanced countries fully meet their 2050 net-zero targets.

North-south climate finance remains far too low

- North-south climate finance remains far too low. While it surpassed $100 billion a year for the first time in 2022, this includes all finance (not just grants and grant-equivalents). The climate financing commitments of advanced countries remain small compared to the costs of investing in renewables and shutting down coal (Bolton *et al*, 2024).

European influence in the development finance debate is increasingly blunted by an erosion of trust

A further complication is that European influence in the development finance debate – and more broadly its soft power – is increasingly blunted by an erosion of trust, fuelled by the hoarding of COVID-19 vaccines, perceived double-standards on Ukraine and Gaza, and the perception that the EU, far from building equal partnerships, likes to impose its norms and standards on the developing world. The imbalance between large EU voting blocks in the international financial institutions and the EU's declining share of global GDP has fuelled questions about the fairness and legitimacy of the global financial architecture and is a factor behind the creation of parallel financing structures, ranging from international reserve buffers and swap arrangements to the creation of the BRICS bank. Further structures of this type could weaken Europe's influence on development finance in core areas of interest.

Challenges

Most of your predecessors' strategic decisions go in the right direction. But they also create new challenges relating to implementation and unintended consequences. There are also rising challenges relating to emerging EU policies, reduced fiscal space and the more difficult geopolitical environment.

The Global Gateway

The Global Gateway's focus on physical investment, Team Europe and avoiding paternalism all make sense. There is also nothing wrong with openness about what the EU hopes to get out of its partnerships. That said, the new strategy carries risks.

One risk is that the new framing of international partnerships will exacerbate the perception of EU hypocrisy, further weakening EU credibility in the global south. The Commission has declared that EU aid must henceforth serve EU economic and geopolitical interests but it also continues to insist that its partnerships serve the greater good: the SDGs, democratic values, good governance. These objectives could clearly clash. For example, aid allocated based on geopolitical interests needs to give disproportionate attention to the preferences of ruling elites, perhaps to the detriment of democratic values, transparency and some of the SDGs.

Physical investment alone does not achieve growth and prosperity; indeed, it may create debt traps

A related risk is that the emphasis on physical infrastructure could be taken too far. There is indeed a large physical investment gap, and filling this gap should be one of the purposes of EU aid (directly, and by catalysing private finance). But physical investment alone does not achieve growth and prosperity; indeed, it may create debt traps (a lesson learned in the 1970s and again through the Belt and Road Initiative).

Finally, the Team Europe approach will not work if large EU countries prefer to run their own projects and maintain their own visibility in partner countries. The willingness of countries including Germany and France to deliver a lot more of their bilateral aid through the Global Gateway will determine whether it succeeds.

Tensions with EMDEs

The EU has begun to implement policies to bolster its industrial competitiveness and prevent carbon leakage that could hurt its EMDE partners. These include industrial policies aimed at reshoring manufacturing and the carbon border adjustment mechanism (CBAM). Even if this is implemented in an entirely non-discriminatory way (that is, foreign products are taxed exactly like domestic products), CBAM creates a new burden for certain EMDE producers. Some EMDEs see CBAM as imposing EU carbon pricing on developing countries that have a claim to 'differentiated treatment' and often have little capacity to trace carbon in value chains.

Measures such as the Deforestation Regulation (Regulation (EU) 2023/1115) add to the perception that the EU is imposing its climate strategies on the rest of the world even when these limit EMDE options for development. As the EU pushes new policies to increase its energy and economic security (for example, by expanding mining and hydrogen production in Africa to the detriment of local needs in water-scarce regions), this perception may be aggravated.

Budgetary pressure

With fiscal space slim or non-existent in many partner countries and the high cost of capital as a barrier to large-scale private finance, official aid flows will continue to be crucial, especially for low-income countries. But fiscal space has also narrowed significantly in the EU. Discussions on the size and structure of the next MFF (2028-2034) will begin immediately after you take office. There will be pressure on the EU's aid budget, even while you are being asked to pursue objectives that go beyond traditional aid: accelerating the energy transition, addressing conflict and fragility, funding projects essential to EU economic security and assisting with climate adaptation.

Making resources go further

To make limited budgets go further, your first objective should be to scale up blended finance

To make limited budgets go further, your first objective should be to scale up blended finance, particularly in renewable energy, digital infrastructure and transport infrastructure. Your predecessors worked on the foundations, but the results remain unsatisfactory. The Global Gateway is struggling to leverage the private sector investments that would scale it up to the €300 billion target[7]. And north-south private climate finance remains ridiculously low in both absolute and relative terms: just \$22 billion of the \$116 billion reported by the OECD for 2022 (and less than \$15 billion per year during 2017-2021).

The second – related – objective is effective multilateral development bank (MDB) reform. Successive G20 and United Nations panels have argued that MDB balance sheets could be used more efficiently, lending volumes could triple and mandates could shift more decisively towards global public goods. MDBs could do more to mobilise private capital, recycle Special Drawing Rights and support coordination of the climate transition through country platforms. The G20 has been preparing a roadmap for MDB reform. With EU countries holding almost 23 percent of shares in the World Bank, the EU should be well-positioned to influence reforms. But European positions on MDB strategy are not always coordinated.

7 This is not helped by the EU's own rules in areas such as public procurement, where the principle of non-discrimination can end up preventing the Commission from financing European companies to deliver Global Gateway projects.

You and your allies will need to shepherd multilateral development banks down a path that requires uprooting of much of the *status quo*

To make MDB reform happen, you will need to align Team Europe behind key strategic decisions. You will also need to get low- and middle-income countries to engage fully on an agenda prioritised by the EU that they sometimes view as an imposition. And you and your allies will need to shepherd MDBs down a path that requires uprooting of much of the *status quo*: creating greater financial capacity through financial innovations and more risk-taking, crowding in private finance, building project pipelines in systematic collaboration with regional and national development banks, and helping to create and increasingly operate through country climate platforms.

Geopolitical tension

Even with effective coordination within Team Europe, adequate fiscal resources and a good relationship with developing country partners, EU interests in the Global South will hit a roadblock unless the EU is able to maintain a close and collaborative relationship with G7 partners and large emerging markets such as India and Brazil, while at least maintaining a functioning business relationship with China. These relationships are essential for effective MDB reform, to resolve developing country debt crises (in which China is often the largest creditor), to accelerate the energy transition and to reduce the EU's strategic dependencies without escalating tensions with China and without forcing its partners to choose between China and the West.

Facing this challenge is a matter for the entire Commission and all of Team Europe. But international partnerships must be a well-articulated pillar of this broader strategy.

Recommendations

An effective Global Gateway

Recommit to the promotion of the SDGs as the primary objective of the Global Gateway. This includes facilitating the energy transition in partner countries to cut global emissions

The Commission must stop undermining the credibility of the Global Gateway by raising suspicions about its motives. The Global Gateway should remain investment- and infrastructure-focused and should use innovative financing instruments rather than traditional official development assistance. It can and should pursue objectives that promote both the SDGs and EU global priorities, such as climate action and reducing conflict and fragility. But projects should not be selected or designed to promote the commercial or security interests of the EU when this creates a potential trade-off with the SDGs. The EU has other instruments to promote its geopolitical aims.

Embed infrastructure projects in a broader development strategy

Filling critical physical investment gaps is necessary but not sufficient for development

Filling critical physical investment gaps is necessary but not sufficient for development. Large infrastructure projects pose fiscal and environmental risks and do not generate economic returns unless embedded in a holistic development strategy. The latter requires human development and better institutions. Furthermore, health and education are important SDGs in their own right. Spending on those SDGs should be protected.

Adequate EU-level fiscal resources

Create a new MFF instrument specifically to fund international climate mitigation, and ensure it is amply resourced

International climate mitigation finance should be massively scaled up because this is in the EU's self-interest. Carbon abatement has the same economic value for the EU wherever it happens and it is cost-effective to fund reductions outside the EU. It also makes

Funding of climate mitigation should be separate from the funding of other development goals

no sense to create a trade-off between emissions mitigation and other SDGs by forcing both into the financing envelope of the same budget line. Funding of climate mitigation should be separate from the funding of other development goals, even if both are delivered through the Global Gateway.

Active policies to defuse tensions between EU and EMDE interests

Use international partnerships and EU external action to offset the economic costs of EU climate mitigation and green industrial policies

Measures such as CBAM and the Deforestation Regulation are necessary to achieve the green transition. But they require flanking measures to help development partners make the transition. A large share of CBAM revenues should flow back to partner countries to help them reduce the carbon content of their exports and to protect their forests while still meeting their industrialisation and development goals. Some of this money should support climate adaptation. The EU should monitor whether its green industrial policies benefit EMDEs by creating supply chains that include rather than exclude them.

Seek agreement on a proportionate reduction in member state voting shares and consolidation of board seats in relevant MDBs

Anachronistically large EU voting blocks are an obstacle to MDB reform and undermine trust. The EU needs to accept a reduction in its shares, to the benefit of EMDEs, as part of a broader package to modernise and refocus MDBs. Freed-up voting shares and board seats should be offered to recipient countries based on long-available formulas. The floor on collective EU shareholdings in the World Bank Group might be set at the level of the United States, while conditions and appropriate solutions will differ at the regional development banks.

Maximum impact through improved coordination

Create institutional mechanisms to ensure alignment within the Commission and with Team Europe

Mechanisms to ensure consistency at various levels, inside EU institutions and with EU countries, are a logical next step for the Team Europe approach. Given dispersed responsibilities within the Commission, there will be a continuous need for internal alignment. A separate mechanism to achieve Team Europe consistency in order to increase the EU's collective impact in partner countries might be created under the Council of the EU, with the Commission providing secretariat functions.

Build on those mechanisms to coordinate Team Europe positions on strategic and reform decisions for the MDBs

Team Europe's shares in the MDBs, even if reduced, could be leveraged more purposefully in the EU's interests. Taking account of MDB governance, agreements reached under a Council of the EU mechanism would be transmitted to board representatives but would be advisory. Board representatives (or governors, as the case may be) would use their regular, existing caucus meetings to align positions and coordinate EU voting power to drive MDB reform.

Coordinate with the World Bank, the EIB and other European instruments, regional MDBs and national finance institutions in EMDEs, with a focus on increasing blended finance for climate mitigation, and addressing other global challenges

The World Bank and regional MDBs are critical complements of EU international partnerships, because of their expertise and balance sheets, but also because they are co-owned by EMDEs. MDBs are crucial to scaling up blended finance – for instance for climate mitigation – in which official finance subsidises private investment only to the degree that is necessary and only in conjunction with supportive national policies. The Team Europe toolkit can also be leveraged by cooperating with MDBs in other contexts, including infrastructure, human development and conflict prevention.

The Council of the EU decided in June 2021 against a unified European Climate and Development Bank[8]. If effective coordination between the EBRD, the EIB, other EU instruments and MDBs fails, it will need to be revisited.

Cooperation within the G7 and beyond

Expand and upgrade multi-donor partnerships, including Just Energy Transition Partnerships

Effective emissions mitigation and protection of biodiversity in EMDEs requires coordination not just within Team Europe, with EMDE partners and with reformed and strengthened MDBs, but also across the G7 and other international partners who share responsibility, and should share the financial burden. Apart from the expansion of international emissions trading – handled by your climate colleague – the main means to do so is the invigoration and expansion of mitigation finance through country platforms. These exist in embryonic form: Just Energy Transition Partnerships (JETPs) with South Africa, Indonesia, Vietnam and Senegal. But they are insufficient. The financing promised is far too low, and not explicitly linked to specific policy actions. JETPs should be developed to scale and expanded to additional countries.

Just Energy Transition Partnerships should be developed to scale and expanded to additional countries

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Memo to the commissioner responsible for enlargement

Zsolt Darvas and Heather Grabbe

Russia's full-scale invasion of Ukraine dramatically changed geopolitical risk calculations and brought new momentum to enlargement, especially in relation to Moldova and Ukraine. The accession process for the countries of the Western Balkans has also gained new impetus. However, continuing Russian aggression brings security challenges not faced in previous enlargements, and an inconsistent accession process for Western Balkan countries has undermined the EU's credibility.

In this context, you will need to renew the EU's commitment to enlargement and propose, but not guarantee, a target date for countries to join. You should ensure that the focus on Ukraine and Moldova does not disadvantage the Western Balkans, and that each country can advance on its merits within a streamlined process. You should find new ways to ensure post-accession compliance with rule-of-law standards, while dispelling myths about the EU being unable to cope with further enlargement.

Recommit to enlargement and boost credibility

Remove blockages from the accession process

Involve candidates progressively in EU policies

State of affairs

Russia's attack on Ukraine dramatically changed geopolitical risks and brought new momentum to enlargement

Enlargement is back. Before Russia's full-scale invasion of Ukraine in February 2022, the enlargement prospect for the countries of the Western Balkans was at best remote, negotiations with Türkiye remained frozen, while eastern neighbourhood countries were not expected to enter the European Union in the foreseeable future. But the Russian attack dramatically changed geopolitical risks and brought new momentum to enlargement. After applying and receiving candidate status in 2022, Moldova and Ukraine have just started official negotiations, while Georgia's candidate status was confirmed in 2023.

After slow progress over two decades, the process for the countries of the Western Balkans gained new impetus, with Bosnia and Herzegovina gaining candidate status, along with Albania, North Macedonia, Montenegro and Serbia. Kosovo remains a potential candidate, partly because five EU countries have not yet recognised its independence. Accession negotiations with Albania and North Macedonia have continued since 2022. Montenegro and Serbia have not passed any major milestone towards the EU since 2021, but the new political leadership in Podgorica is now accelerating the process.

The Commission's new Western Balkans Growth Plan aims to advance inclusion in the EU's single market, boost economic integration within the region and accelerate fundamental reforms. The plan adds to pre-accession assistance €2 billion in grants for investments and €4 billion in loans for reforms for 2024-27. While these amounts are small, they could foster progressive integration with the EU ahead of membership.

The eleven countries that joined the EU in 2004-2013 have substantially narrowed the gap with advanced EU economies, contrasting sharply with the weak convergence record of the three eastern and the six Western Balkan countries. This has likely fuelled emigration, especially of the young, from these candidate and potential candidate countries. From 2000 to 2021, the combined population of the three eastern countries declined by 15 percent, while that of the six Western Balkan countries declined by 4 percent, partly due to net emigration. However, actual emigration could have been higher, as indicated by the large amounts of remittances some of these countries receive (between 9 percent and 17 percent of GDP in five western Balkan countries), suggesting that a large share of the population lives abroad.

The EU has lost influence over the past decade. The slow progress of enlargement after Croatia joined in 2013 has coincided with rising Russian and Chinese influence in both the Western Balkans and the EU's eastern neighbourhood. Ruling political parties in several Balkan countries have turned towards autocracy and stalled reforms that would have improved governance and economic performance, and many actors on the EU side prefer stability over democracy in their surrounding regions.

Challenges

You will face numerous challenges in fostering domestic reforms in candidate countries.

This is the first enlargement where the EU faces strong external opposition. Ukraine is preparing for accession negotiations and making deep reforms while fighting an existential war that is draining its human and financial resources. Moldova, Georgia and Armenia remain vulnerable to Russian hybrid warfare, with disinformation and strategic use of corruption affecting elections and political debate, as in several of the Balkan countries. Moldova's pro-EU government is successfully continuing reforms, but Georgia's current government has turned towards Russia, and Armenia's has not applied for membership.

Accession conditionality for the Western Balkans is less effective since citizens became disillusioned

Accession conditionality for the Western Balkans is less effective since citizens became disillusioned. In the 20 years since the EU declared that the future of the Western Balkans lies in joining the Union, only Croatia has joined; other countries have made slow progress. Bilateral disputes – especially with Greece and Bulgaria – have several times undermined the EU conditionality intended to encourage governance and economic reforms. The delay in providing European vaccines during COVID-19 further soured public opinion.

Deep reforms are needed for domestic institutions, governance and the rule of law. When ruling parties in Belgrade and Podgorica sought to reduce checks on their power and to take over state institutions, the EU failed to respond strongly and in a manner that showed to the Serbian and Montenegrin people that authoritarianism slows progress towards membership. In Ukraine, surveys show that citizens perceive corruption as pervasive. Disinformation from Russian and other anti-western influences is helping self-serving elites in the Balkans and Caucasus to resist reforms intended to improve governance, such as independence of the judiciary and transparency in public procurement.

There are several internal challenges for the EU to overcome as well.

An inconsistent accession process has undermined the EU's credibility

An inconsistent accession process has undermined the EU's credibility. The EU failed to maintain a fully merit-based process under your predecessor because one or two of member states have several times prevented countries from advancing, because of party political preferences or bilateral issues. In particular, the EU's failure to support a reformist and pro-European government in North Macedonia after the resolution of the name issue in 2019 caused people across the region to lose trust in the EU's objectivity. The reversibility principle – under which benefits can be withdrawn if a candidate stops meeting certain conditions – has not yet been applied in practice.

In the EU, overblown fears about the impact of enlargement on the EU's budget and institutions, and on the Common Agricultural Policy, are cited as reasons not to move forward, which risks demotivating the candidates.

Recommendations

Restore the transformative power of the accession process

This requires consistent commitment from the EU side, which must reward progress based on merits without favouritism. The EU must set clear and detailed conditions for reforms, and then support and reward those reforms or use reversibility to deter backsliding.

Propose a target date for the next enlargement but never guarantee it

To catalyse difficult reforms, countries need to feel like accession is just over the horizon

Motivation depends on momentum: to catalyse difficult reforms, countries need to feel like accession is just over the horizon. If the EU were to set an indicative target date for its next enlargement, that could promote positive competition among candidate countries to be among the first new joiners. Voters could see whether their government is falling behind others, improving political accountability.

Nevertheless, a target date should never be communicated as a guarantee of accession, and if a candidate fails to meet the conditions, it should drop behind. However, there is a risk in setting a date: if the EU decides not to admit new members that have met the conditions because one or more of its members vetoes the accession for reasons not related to merit, it would cause huge disillusionment and negative political repercussions for pro-EU governments across the region.

Ensure merit-based treatment of candidates

The rapid start of Ukraine and Moldova should not disadvantage the Western Balkans. Rather, each country should advance on its merits and readiness.

Foster greater specificity

To preserve democratic governance, you must hold firm on conditionality on media freedom, human rights, the rule of law and democratic practice. The enlargement methodology should be adapted with clearer conditions and more detailed reform requirements. Ukraine will need detailed guidance for the removal of martial law after the war and the restoration of full independence to state institutions.

Streamline the accession negotiations

EU officials have calculated that the 27 members have more than 150 veto-points during the negotiations. In addition, the European Parliament and every current member must ratify the eventual accession treaty. Some of these veto-points are the result of the Commission submitting more and more micro-stages in the negotiations to unanimous votes in the Council. The process needs streamlining so that current members still decide unanimously on major steps, particularly the start and end of negotiations, but technical steps no longer require unanimity, which is too often used to delay decisions for reasons unconnected to whether the candidate has met the conditions. When an individual member state blocks a candidate's progress on an issue unrelated to the accession conditions, it weakens the EU's collective leverage to push for domestic reforms. Countries that block should have to justify their objections in an open debate and risk being outvoted.

Countries that block enlargement decisions should have to justify their objections in an open debate

Support dispute resolution with and in the Western Balkans

A functioning bilateral dispute mechanism – one that can resolve issues raised by members with candidates, not only between candidates – is vital to restore credibility and consistency to enlargement. The EU should play an active role in the normalisation of Serbia-Kosovo relations, which is a precondition for the EU entry of the two countries.

Promote progressive integration

Focus on what brings benefits directly to citizens, and bring candidates into EU policies and funds progressively as they meet key conditions, rather than giving them benefits only once they are members. Prioritise the positive steps proposed in the Western Balkans Growth Plan to extend the Single European Payments Area in the Balkans (which would reduce transaction costs in a region where the euro is used widely and many families depend on remittances), and to abolish roaming fees and geo-blocking for all the candidates. Moldova and Ukraine would benefit from rapid certification of their organic products, including wine and food. You should explore further steps for integration into EU policies and programmes to reward progress in difficult areas, and to help vulnerable candidates with their security and defence.

Integrate candidate countries into EU energy policies and infrastructure

Energy is a key area for sectoral integration, to deliver benefits for citizens and counter Russia's attempts to preserve fossil-fuel infrastructure. Extend the European Green Deal to candidates, using the Western Balkans Growth Plan and other programmes to invest in interconnectors, grid upgrades and renewables deployment, to bring energy independence and the immediate benefits of reliable supply, fewer blackouts and lower prices. Candidates should join the EU's emission trading system to avoid the carbon border adjustment mechanism, and to facilitate their integration into clean-tech supply chains. The EU should bring the candidates into the European energy system and involve them in the governance of its energy market.

The EU should bring the candidates into the European energy system

Involve candidates in the European Semester process

The experience gained by the six Balkan countries and Türkiye in participating in national Economic Reform Programmes since 2014 would help integration in the European Semester economic surveillance process. The risks and costs for the EU are low and it could benefit both sides (Darvas, 2023).

Better communication about EU membership requirements

This should be done especially on rule of law and governance, so that citizens can hold their governments to account. The EU's requirements for reforms should be very clear, visible and widely discussed – also to prevent disinformation.

Design Ukraine's reconstruction with other donors in synergy with the accession process

The EU's Ukraine Facility provides €17 billion in grants and €33 billion in loans for 2024-2027 to support recovery, reconstruction and modernisation, including technical assistance to support the accession process. This funding accounts for a small share of the estimated €400 billion needed over the next ten years. The Commission should coordinate the reconstruction process with other donors, prepare a follow-up EU instrument in the next Multiannual Financial Framework (MFF) due to start in 2028, explore options to make Russia pay for the damages it caused and foster connectivity with Ukraine's other neighbours.

Increase funding for Western Balkans following the Growth Plan

The €6 billion Western Balkans Growth Plan – €1.5 billion annually – should be upgraded to a larger facility under the next MFF to focus on energy and other areas of progressive integration. The current Growth Plan provides all €2 billion in grants (plus €1 billion loans) for investments and €3 billion in loans for reforms, but the opposite would be better. Most investments should pay for themselves by generating future revenues and economic growth, which allows for the repayment of loans. The economic returns on reforms, especially those which include politically difficult measures, are more indirect and therefore better supported by grants.

Develop effective post-accession compliance

In further enlargement, the EU cannot afford to compromise on the quality and resilience of the rule of law, which is fundamental to democratic accountability and the functioning of the single market (Grabbe and Lehne, 2019). However, the EU has very limited institutional means to contest violations once a country has joined. The accession process is therefore a vital opportunity to improve the quality of governance and to root out corruption.

The EU has several options to enhance its capability to improve rule of law. The first and least controversial is to start applying the rule-of-law toolbox in advance of accession, whereby candidate countries would join the annual reporting cycle to establish across the public administration clear standards that are capable of lasting after accession. If it proves possible to change the EU's treaties, that could include reform of Article 7 TEU, the extension of rule of law conditionality to all EU funds and the MFF, and the creation of a joint chamber of the higher courts and tribunals of the EU (as recommended by Costa *et al*, 2023).

Accession treaties should include institutional reforms to protect the rule of law

If treaty change proves impossible, accession treaties should include institutional reforms to protect the rule of law in future, such as the suspension of voting rights or access to EU funds. Accession treaties have the force of primary law in the EU, which can be used to institutionalise important changes. Any sanctioning measures would also apply to existing members through the accession treaty.

Budgetary conditionality is another way to discipline ruling parties that capture state institutions and remove democratic checks and balances after accession.

Combat myths about the implications of future enlargement for the EU's budget and institutions

Fears are exaggerated about further enlargements creating an excessive financial burden

Fears are exaggerated about further enlargements putting an excessive financial burden on current members and stopping the EU from functioning effectively with 36 members. Although the candidates' economies are much poorer than the EU average and more dependent on agriculture, the budgetary impact can be managed through the creation of a long transition period. In the previous enlargements to Central Europe, the EU took 12 years to phase in agricultural subsidies in the new members. That gives plenty of time for the EU to introduce a 50 percent national co-financing rate for Common Agricultural Policy (CAP) direct payments in the next MFF. In addition to freeing-up one-sixth of the MFF funds for the provision of European public goods, this would reduce the cost of enlargement via the EU budget by one-fifth. This should be introduced along with a fundamental reform of the CAP to improve its environmental impact; the CAP could otherwise damage biodiversity in the candidate countries.

Moreover, even under unchanged budget allocation rules, the annual cost of adding nine countries to the EU budget would be 0.17 percent of EU GDP, or €26 billion per year (Darvas and Lopez, 2024). This would hardly change the net recipient/payer positions of current EU members. Payments to ten net beneficiaries (Bulgaria, Czechia, Hungary, Greece, Latvia, Lithuania, Malta, Poland, Romania and Slovenia) already fell in 2021-2022, and additional reductions due to enlargement would be small in comparison. Most net payers would need to contribute about 0.13 percent more of their GDP to the EU budget in this scenario.

In practice, these costs are bound to be much lower. The EU is likely to change its budget rules and impose transition periods on new members' access to the funds. Unfortunately, it is also possible that Russian aggression will result in a reduction in Ukraine's territory, population and GDP, also lowering its budget receipts.

Some of the budget transfers to the new members would come back to the current EU members via their companies participating in EU-funded projects in the new members. Enlargement would boost current EU members' GDP via trade, migration and foreign direct investment, as well as employment, production and tax revenues

The EU institutions would cope with further enlargement. The combined population of the nine candidates is 57 million, so the enlarged EU's population would not regain its level when the United Kingdom was a member. Seats in the European Parliament and votes in the Council of the EU could be reallocated, as happened in previous enlargements, while other EU governing bodies and institutions, such as the Court of Justice of the EU, are sufficiently regulated for future accessions by the current treaties. As for the Commission, the Lisbon Treaty declared that a reduced number of Commissioners could be selected "*on the basis of strictly equal rotation*" between the members. If the members insist on maintaining one Commissioner per country, the President will have to give Commissioners different levels of responsibility.

Lack of progress on EU institutional reform should not block enlargement

While reform of the EU's institutional framework would be desirable, lack of progress on it should not block enlargement. Many potential solutions can be found as long as the new members observe the EU's fundamental principles after their entry.

Prepare for opportunities and crises in the eastern and southern neighbourhood

The current leaders of Türkiye and Georgia are not oriented towards EU accession, although significant sections of their society would like to move closer to Europe. Future elections could change this situation, giving you the opportunity to create a new agenda with these countries.

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Memo to the commissioner responsible for the internal market

Niclas Poitiers, Simone Tagliapietra,
Reinhilde Veugelers and Jeromin Zettelmeyer

Despite many attempts to improve implementation of single-market rules, significant barriers to intra-EU services trade and cross-border mobility of people persist. A further challenge is how to reconcile industrial policies with competition and the single market.

Addressing these challenges requires a two-pronged strategy. First, you should make a new legislative push to improve the rules rather than just enforce existing rules, backed by stronger single-market governance, including effects-based monitoring and evaluation. This should focus on the elimination of sector-specific barriers to services trade, recognition of professional qualifications, transferability of social security entitlements and the creation of a '28th regulatory regime'. Second, you should implement single market-friendly industrial policy at the EU level, including by using EU funds to top up Important Projects of Common European Interest that have benefits beyond the participating countries, and by expanding EU-level 'Auctions as a Service' with member state contributions but EU-wide criteria for allocating subsidies.

Strengthen single-market governance

Make a new push to break down single-market barriers

Develop single market-friendly industrial policy instruments

State of affairs

Your portfolio is critical to the European Union's most important economic objectives. First, to vigorous, sustained and sustainable growth: Europe's post-COVID-19 recovery has been weaker than in the United States. Tepid growth is expected to persist: International Monetary Fund projections put medium-term growth in advanced Europe at just 1.2 percent of GDP, while the US is projected to grow at over 2 percent. Second, your portfolio is critical to economic security. Between 2020 and 2022, the EU suffered two large disruptions: COVID-19 and the largest spike in energy prices in many decades. While these crises were overcome relatively quickly, they have persistent effects, such as higher energy prices than prior to 2021, and have highlighted EU vulnerabilities. These include concentrated imports, exports and foreign direct investment in areas that could make the EU vulnerable to new geopolitical shocks.

The EU's internal market has come a long way since the mid 1980s, when the European Economic Community embarked on its first comprehensive attempt to reduce non-tariff barriers to internal trade, officially creating the single market in 1992. Trade inside the single market has grown considerably faster than trade with partners outside. Membership of the EU has a much greater impact on trade among its members than membership in a typical regional trade agreement (Fontagné and Yotov, 2024). The costs of intra-EU trade have been falling continuously since the 1990s, with a substantial drop in the costs of services trade since the mid-2000s (Head and Mayer, 2021). This suggests that continued efforts to improve the single market have indeed borne fruit.

It is clear that the internal market remains a far cry from the largely frictionless national markets inside EU countries

But it is also clear that the internal market remains a far cry from the largely frictionless national markets inside EU countries. Goods trade between regions within the same member state is four times as large as trade across regions located in different EU countries (Santamaria *et al*, 2024). At around 6 percent of EU GDP, intra-EU services trade is only barely higher than services trade with extra-EU partners. Costs of migration across EU borders remain almost ten time higher than across US states (Head and Mayer, 2021).

Multiple reports by both the European Commission and outside authors (eg Dahlberg *et al*, 2020) have sought to identify the actual barriers that cause these frictions. Some relate to differences in national regulations in areas in which EU legislation does not apply or leaves room for national differences ('goldplating'). Some relate to poor transposition or poor implementation of EU rules, and some to information gaps on the side of consumers, businesses and local authorities. For the last fifteen years or so, the Commission has sought to close these gaps through better information, coordination, monitoring and enforcement. Examples include Points of Single Contact (required since 2009) that make it easier for service-sector companies to understand and meet administrative requirements online, an Internal Market Information (IMI) system to facilitate the exchange of information between local administrations, and SOLVIT, a problem-solving network that helps people or businesses when their cross-border rights are breached by public authorities.

Your predecessor doubled down on this approach, with a 2020 long-term action plan for better implementation and enforcement of single market rules (European Commission, 2020), led by a Single Market Enforcement Task-Force (SMET) of Commission and member state representatives. By 2023, most of the SMET's action items were reported as completed. How much of a difference this has made is unclear, in part because the pandemic led to a wave of state aid and national regulation and pushed single market implementation onto the back burner. The transposition deficit (percentage of EU directives not transposed into national law) rose from 0.6 percent before the pandemic to 1.6 percent in 2021 (far above a ceiling of 1 percent set in 2007 by the European Council), but has since fallen back to just 0.7 percent. The conformity deficit – treaty infringement procedures for inadequate transposition as a share of directives that member states notify as transposed – also rose sharply, and remains about twice as high as before the pandemic.

The last five years were not notable for new legislation pushing the boundaries of the single market

Except in the digital area, where landmark legislation was passed, the last five years were not notable for new legislation pushing the boundaries of the single market. Nevertheless, there has been important defensive legislation. The 2024

Internal Market Emergency and Resilience Act[9] aims to ensure a functioning internal market for critical goods and services in emergencies triggered by a pandemic or an international conflict is a cornerstone of EU economic security. The 2024 Corporate Sustainability Due Diligence Directive (Directive (EU) 2024/1760) was a reaction to national supply chain due diligence laws and seeks to avoid internal trade barriers that could arise from them.

Significant obstacles to banking union remain unaddressed, and capital markets union remains elusive

There has also been modest progress in improving the internal market for financial services, but significant obstacles to banking union remain unaddressed, and capital markets union remains elusive. Access to venture capital and equity finance remains a major barrier to the expansion of young firms, while energy costs and skills are the most important barriers to investment by firms of all sizes.

In the second half of his mandate, your predecessor's attention shifted from improving the single market and fighting the pandemic to industrial policy. Part of this was a reaction to the use of industrial subsidies in China and, beginning with the 2022 Inflation Reduction Act, in the United States. Part of it arose from a sense that the EU had been too complacent in tolerating import dependencies, in particular on Russian gas.

The result was a series of regulations – the European Chips Act (Regulation (EU) 2023/1781), the Critical Raw Materials Act (Regulation (EU) 2024/1252) and the Net Zero Industry Act (Regulation (EU) 2024/1735) – designed to strengthen EU production capacity in specific sectors. Given the lack of EU-level funding, the main instruments of these acts are regulatory, such as shortened permitting times or strengthened circular economy rules, or changes in the rules governing member states' public procurement). In addition, the Temporary Crisis Framework for State Aid, originally created as a reaction to COVID-19, was amended to allow member states to subsidise clean-tech manufacturing under certain conditions, including to match clean-tech manufacturing subsidies in non-EU jurisdictions. For now, these rules remain in place until end-2025.

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9 Not yet ratified by the Council of the EU at time of writing.

Challenges

As the commissioner responsible for the internal market and the EU's industrial strategy, you face two main challenges.

The first is to deepen the single market (outside financial services, capital markets and energy, which are handled by some of your colleagues) when everything seems to have been tried – including improvements in single market governance and enforcement. More than three decades after date foreseen for the completion of the single market, it might be assumed that efforts to achieve this goal have reached their limits, perhaps because of deep differences in national preferences and cultures and the related wish of member states to maintain some control over regulation.

Single market governance focused on information, monitoring and implementation remains essential and can be improved

You should not accept this assumption. However, making headway will likely require a more ambitious strategy. Single market governance focused on information, monitoring and implementation remains essential and can be further improved. But in addition, it is essential to choose a few projects that push forward the EU legislative boundary. Outside the digital area, this approach has not been pursued since the 2006 Services Directive (Directive 2006/123/EC), and for obvious reasons: it is politically very difficult.

You must therefore choose your priorities wisely. Fortunately, political momentum for single market advancements has been building, as have some concrete ideas (for example, Letta, 2024). Beyond choosing wisely, you will need to ensure that you have the right implementation tools at your disposal. These includes analytical and administrative capacity to prioritise, monitor, and evaluate, and also control over the use of funds for relevant programmes.

Your second challenge is whether and how to pursue industrial policy targeted to specific industries, technologies and value chains deemed of special economic or strategic importance. Industrial policy of this type can be justified by societal objectives such as the green transition, which requires directed technical change. It could also be justified by economic security – to maintain or create EU production capacity and industrial know-how to reduce dependence on third countries, particularly those that might seek to exploit such depencence.

Targeted industrial policies are fraught with risk

But targeted industrial policies are fraught with risk. Industrial subsidies provided by national governments harm competition and fragment the single market. Policies to protect incumbents can backfire – even when applied at the EU level – by contributing to the erosion of the rules-based trading system that the EU depends on for growth and industrial competitiveness, and by reducing market entry and hence business dynamism. Finally, as is clear from the examples of both the US and China, large-scale industrial subsidies pose significant fiscal risks and divert resources from other essential public investment or from rearming the EU in the face of new military threats.

In principle, the solution to this dilemma is well known: pursue industrial policy that promotes competition, respects multilateral trade rules, is open to new technology (subject to serving broad societal objectives such as the green transition and security) and spends targeted resources at the EU level rather than through state aid. But implementing this solution in practice is very difficult. One reason is money: the EU budget is only a fraction of total public spending by the EU and its member states. For example, the Horizon Europe budget for research only covers about 7 percent of total EU public research spending on clean tech. Another reason is the need to create strong governance to ensure that industrial policy is effective and strengthens the single market.

Recommendations

Strategies to improve the single market can be grouped into three categories: EU-level legislative changes in core areas, particularly services and movement of people, where well-documented barriers remain; better implementation and information; and coordination of member-state policies and spending in key sectors for which efficiency gains appear particularly high, such as capital markets, energy markets, or public R&D.

The recommendations in this memo focus on the first two areas, followed by recommendations for smart, EU-level industrial policies that meet the conditions described at the end of the challenges section.

Stronger single market governance

Create a Single Market 2.0 programme (SMP 2.0) to prioritise, develop and implement ideas for single market reform, led by a dedicated Director General and backed by a monitoring, analysis and evaluation taskforce

Stronger governance is needed for two reasons. First, lack of prioritisation. There is an abundance of ideas to improve the single market, but most are costly, and it is often unclear which ideas are worth the political cost. Second, inconsistent evaluation of single market policies and reforms. Single Market 2.0 should set clear performance indicators related not just to process, but to the desired effects of the programme. Your monitoring, analysis and evaluation taskforce should provide you with the evidence base for your policies, identifying the most critical bottlenecks and the actions that can address them. The taskforce should develop tools to assess the impact of single market policy on the performance indicators, which should encompass innovation, corporate investments, productivity growth, competitiveness, sustainability and cohesion.

Ensure that you have the authority to allocate EU funds for specific programmes that are essential for the single market

An example of a programme at the core of the single market is the Connecting Europe Facility (CEF), the EU fund established in 2014 for investment in infrastructure projects that connect EU countries, funded by grants, financial guarantees and project bonds for transport, energy, digital and telecommunication projects. But rather than being run by your services, CEF is run by the Climate, Infrastructure and Environment Executive Agency. Its budget for 2021-2027 is €33.7 billion, of which about 80 percent goes to transport. As connectivity projects are perhaps the most tangible initiatives for the single market, CEF should be scaled up and be brought under your responsibility, so that you can select the projects, run as public-private partnerships, that are most needed for deepening the single market.

Expand capacity building and support for national administrations implementing single market legislation

Lacking technical and administrative capacity in member states continues to be a major barrier to single market implementation

Notwithstanding significant efforts to improve coordination and information exchange, lacking technical and administrative capacity in member states continues to be a major barrier to single market implementation. You should ask the Single Market Enforcement Task-Force, for example, to develop proposals on how member state administrative capacity can be improved and aligned. The initiative could be extended to foster capacity in member states' procurement processes, with several countries struggling to place greater weight on qualitative criteria because of administrative constraints and corruption fears. Another important area for efficiencies would be the streamlining of permitting procedures, particularly in clean energy, clean tech and infrastructure.

A new push to break down single market barriers

As part of SMP 2.0, design and pass a legislative package to eliminate sector-specific regulatory barriers to services trade

Sector-specific regulatory barriers continue to impede services trade, notwithstanding many years of efforts to reduce these barriers through better implementation of the 2006 Services Directive. Building on plentiful existing analyses, your services should identify the regulations with the highest economic costs and design a legislative plan akin to the 1985 Commission White Paper (European Commission, 1985). The aim should be to eliminate most of these barriers by the end of your mandate. The endorsement of this plan by the Council and its subsequent implementation should be one of your top priorities.

Design and implement a '28th regime' for companies

A 28th regime refers to a European regulatory regime that would exist in parallel with national regimes and could be used by any company in the EU (Letta, 2024). As a new design, it could be made more business friendly than some existing regimes. Most importantly, it would apply throughout the entire EU, facilitating operations across member states.

The introduction of a 28th regime could complement a legislative programme to eliminate the remaining regulatory barriers for services. In particular, the 28th regime should encompass the regulation of liberal professions such as accountants and architects – areas in which harmonisation of national regulation has been difficult. It could initially only cover product and services-market regulation. An extension to labour-market regulation, such as rules on severance pay and hiring, should be explored. This would require ensuring consistency with representation of workers in national unions to avoid a dual labour market.

Improve the recognition of professional qualifications and transferability of social security entitlements

Recognition by EU countries of professional qualifications obtained in other EU countries remains incomplete

In spite of the 2005 Professional Qualifications Directive (Directive 2005/36/EC), recognition by EU countries of professional qualifications obtained in other EU countries remains incomplete because of exemptions, and can be slow as a result of cumbersome administrative procedures (Dahlberg *et al*, 2020). Eliminating these exemptions and introducing automatic recognition may require new EU-level legislation. A 'European Degree' as proposed by Letta (2024) would help the next generation of labour-market entrants. Progress should also be made in the coordination and transferability of social-security entitlements and in improving the interoperability of social-security systems. Digital tools such as the European Social Security Pass can help.

Developing single market-friendly industrial policy instruments

Turn IPCEIs into the main tool of a truly European industrial policy, by simplifying and strengthening their governance and using the EU budget to top-up national funding

Important Projects of Common European Interest (IPCEIs) are cross-border collaborations between firms that benefit from subsidies from at least four member states, are deemed to serve EU objectives (such as sustainable growth) and meet an extensive set of additional criteria. Unlike most other forms of state aid, these projects are allowed under prevailing state aid rules, and have become an important tool for public-private collaboration at EU level. However, they remain thin on EU-wide spillovers, are often bureaucratically heavy and end up supporting mostly large incumbent firms that have the ability and experience to propose and manage such complex projects. Furthermore, good IPCEIs might be missed because the members states that might support them do not have sufficiently deep pockets.

IPCEI procedures should be simplified and accelerated and should take a value-chain approach

To address these problems, IPCEI procedures should be simplified and accelerated and should take a value-chain approach. IPCEIs with significant EU-wide spillovers beyond the participating countries should be topped-up by EU funding. IPCEI governance must change accordingly, to ensure adequate selection, monitoring and evaluation of IPCEIs, particulary those that benefit from EU funding.

Expand the EU-level 'Auctions as a Service' approach to support innovative low-carbon projects

The Auctions as a Service scheme to support the production of renewable hydrogen under the Innovation Fund[10] allows EU countries to contribute their own financial resources to top up the budget of an EU-wide auction in exchange for a guarantee that the funds will support domestic projects. While this approach falls short of maximising European economic efficiency (as funds are earmarked on a national basis), it is a great improvement on member state-level industrial policy, as it (1) offers a single EU-wide design of the allocation criteria; (2) reduces administrative and bureaucratic work (by avoiding duplication of work across member states and labourious applications for approval under state-aid rules); (3) frees up EU funds to support companies that perform well in the auction but lack a national sponsor. By demonstrating how EU funds can be used for industrial policy that complements that of member states, it could also constitute a stepping stone toward eventually enlarging the EU pot.

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10 See European Commission, 'Competitive bidding,' undated, https://climate.ec.europa.eu/eu-action/eu-funding-climate-action/innovation-fund/competitive-bidding_en.

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Memo to the commissioner responsible for financial services

Silvia Merler and Nicolas Véron

As a result of the extensive regulatory activity triggered by the Great Financial Crisis and the euro-area crisis, the area of financial services has seen a clear shift towards broad-based acceptance of primarily EU-level regulation and, to a lesser extent, also supervision. This shift remains unfinished, however. The two main areas in which greater EU integration is both necessary and achievable in the near term are banking crisis intervention and capital markets supervision. In the newer area of sustainable finance, where EU regulatory activity has been massive over the past five-year term, gaps exist that could limit the effectiveness of the framework in leveraging the power of finance behind the EU's climate goals.

You should address these issues forcefully, striving for consistency across the whole landscape of EU financial regulation including sustainable finance, and not giving up on completing the banking union.

Integrate capital markets supervision at EU level

Push sustainable finance in pursuit of climate goals

Don't neglect banking union

State of affairs

Financial services is one of few policy areas for which the centre of gravity of decision-making is now closer to the EU than the national level

Your portfolio, corresponding to the scope of activity of DG FISMA (labelled in the last two terms as 'financial stability, financial services and capital markets union'), is among the most impactful of the entire Commission. This is because financial services is one of few policy areas for which the centre of gravity of decision-making is by now closer to the European Union than to national level, and the political momentum points towards still greater EU-level integration.

This state of affairs is relatively new. At the close of the twentieth century, financial services policy was still overwhelmingly a national prerogative. The path towards policy integration has been punctuated by a series of developments, including the single currency and your predecessor Mario Monti's Financial Services Action Plan in 1999, the crisis-induced commitment to a single rulebook in 2009, and the watershed decision in mid-2012 to entrust the European Central Bank (ECB) with European banking supervision, soon followed by the establishment of a less solid but nevertheless significant crisis management component centred on the newly established Single Resolution Board (SRB).

Further steps included the spin-off of your portfolio from the previously sprawling DG MARKT in 2014, the Brexit vote of June 2016, which resulted in the departure from the EU of the country with the staunchest attachment to autonomous national financial services policy implementation, and the decision in 2021 to create an EU agency for anti-money laundering and countering terrorist financing (AMLA). Taken together, these milestones have created a landscape in which you have significant policy initiative, even though you must also take into account the parallel activity of EU institutions and agencies that you do not fully control. The latter include, most prominently, the ECB in Frankfurt, the SRB in Brussels, AMLA in Frankfurt and the European Securities and Markets Authority (ESMA) in Paris. Complementing this increasingly crowded landscape are the European Banking Authority (EBA) in Paris, the European Insurance and Occupational Pensions Authority (EIOPA) and European Systemic Risk Board (ESRB) in Frankfurt, and the European Stability Mechanism (ESM) in Luxembourg, which may intervene in certain financial crisis scenarios and has accordingly developed its own capacity

To be sure, member states still have independent roles in many aspects of financial services policy. What has been pooled at EU level has largely depended on contingent circumstances, particularly during the decade-long systemic financial crisis from 2007 to 2017, which greatly accelerated the shift towards EU-level empowerment. For example, it was commonly accepted wisdom throughout the 2000s that the European integration of supervision of wholesale markets would happen, if at all, before supervision of retail banking prudential supervision – but the opposite occurred in the turmoil of the euro-area crisis.

Consequently, the current division of labour by no means reflects a rational application of the subsidiarity principle, under which the policy challenges handled at EU level would be those with most EU-level or even global significance. If that were the case, globally systemic market infrastructures based in the EU, including Clearstream and Eurex Clearing, Euroclear, LCH SA and SWIFT, would be supervised at EU level. This example is only one of several cases in which the status quo deviates from subsidiarity by erring on the side of excessive policy decentralisation. Conversely, we do not presently identify cases of excessive supervisory concentration. In other words, applying the subsidiarity principle in financial services, at this point, means further supervisory integration at EU level. A time will probably come when some financial supervisory tasks should be delegated back from the European to the national level, as happened in competition policy in the early 2000s, but in our assessment, that time has not come yet.

Brexit's early impact on financial firms' legal organisation and geographical footprint continues to unfurl

Several more recent developments also affect your portfolio. The COVID-19 pandemic, contrary to initial expectations that it might trigger a wave of bankruptcies, has not left a structural mark on the European financial system. By contrast, Brexit represented a major if orderly transformation when the United Kingdom left the internal market on 31 December 2020. Its early impact on financial firms' legal organisation and geographical footprint continues to unfurl. The EU has adopted a pioneering approach to regulating the recourse to critical technology providers such as cloud services vendors, through the Digital Operational Resilience Act (Regulation

(EU) 2022/2554), enacted in December 2022. It has initiated a project of introducing a digital euro in close partnership with the ECB.

Russia's full-scale invasion of Ukraine in February 2022 has made financial and trade sanctions more relevant than ever. While the High Representative for Foreign Affairs and Security plays a key role in preparing the Council's sanctions decisions, DG FISMA has provided much of the policy expertise in this area. More generally, the rise of geopolitical confrontation is a major development in the landscape of risks that may affect financial stability in Europe.

Meanwhile, the EU has an ambitious goal of making Europe the first climate-neutral continent by 2050, and of ensuring that all sectors are able to finance their transitions towards a net-zero economic model "*regardless of their starting point*" (European Commission, 2021). According to the Commission, additional investment of about €620 billion will be needed annually to meet the objectives of the Green Deal, of which the greatest part needs to come from private-sector funding. The EU sustainable finance framework – which is part of your remit – will play a major role in reaching these goals.

Challenges

Banks appear to be sound, at least in the euro area, where European banking supervision appears to have been effective

The current condition of the EU financial sector appears stable, more so than in 2019, 2014 or 2009. Banks appear to be generally sound, at least in the euro area, where European banking supervision appears to have been effective so far.

In that context, the dominant challenge, for you as for your immediate predecessors, is the mismatch between European-level risks and capabilities – in other words the unfinished nature of the transition from a mainly national to a mainly European financial services policy framework. The combination of EU-wide market integration with national policy responsibility often results in harmful incentives for the relevant authorities. The resulting failures, respectively in the prudential supervision of banks and in AML supervision, have been addressed with European banking supervision and AMLA. They still exist in other areas of financial sector policy.

The incompleteness of the banking union remains the major shortcoming of the EU financial services policy framework

Because the banking sector is so central in the EU financial system, the incompleteness of the banking union remains the major shortcoming of the EU financial services policy framework. That incompleteness perpetuates a structural vulnerability of the euro area and entails continued fragmentation of the banking sector along national lines, since national authorities implement ringfencing measures under the guise of their lingering authority over the banking sector. The aim of banking union, as stated at the outset, was the "*imperative to break the vicious circle between banks and sovereigns*" that came close to breaking up the euro area (Euro Area Summit Statement of 29 June 2012). European banking supervision has mitigated the bank-sovereign nexus by making bank failures less likely, but it has not broken it. Bank-sovereign linkages include, on the one hand, financial exposures of banks to national sovereigns (mostly their home country), and, on the other hand, contingent liabilities of national sovereigns in relation to banking crises, such as national deposit insurance and the possibility of other forms of national funding of bank crisis management.

Several interrelated initiatives have been identified as needed to complete the banking union: the pooling at European level of deposit insurance, liquidity in resolution and a quasi-fiscal backstop for the SRB's Single Resolution Fund (SRF); a regulatory limitation on banks' concentrated domestic sovereign exposures; and, once a credible safety net is established at European level to address systemic banking crises, effective constraints on the ability of national sovereigns to bail-out 'their' banks. While the latter component is a matter for your colleague in charge of competition policy (who will need to revise and tighten the 2013 'Banking Communication' on state aid control in the banking sector), other aspects fall within your remit and have been discussed at length but without result since 2015. Despite the Commission President's commitment in 2019 to deliver at least on European deposit insurance and SRF backstop, nothing has been achieved in that area since the historic initial round of banking union legislation in 2012-2014, championed by your predecessor Michel Barnier. EU leaders have decided to allow the European Stability Mechanism to play the role of backstop to the SRF, but this is not yet implemented because Italy has not ratified the ESM treaty.

Meanwhile, European capital markets remain underdeveloped and fragmented along national lines, despite the European Commission's proclaimed promotion of a capital markets union (CMU). To fulfil the CMU vision, public policy has a major role to play, given the extent of regulation and supervision of numerous segments of the capital markets complex. Since Jean-Claude Juncker coined the CMU term in July 2014, initiatives have been of two types: either incremental EU financial regulatory changes that have stopped well short of transformational, even when they have been well-grounded (eg the European Single Access Point for corporate financial information and the so-called consolidated tape of market transactions, both to be implemented in the coming years), or attempts to foster changes in structural areas that go beyond your portfolio – such as in taxation, insolvency law, pension finance and housing finance – which have achieved little to nothing because these areas remain the near-exclusive and jealously guarded preserve of member states.

The EU has pioneered legislation including the EU Taxonomy for Sustainable Activity (Regulation (EU) 2020/852) and the Sustainable Finance Disclosure Regulation (SFDR, Regulation (EU) 2019/2088), but gaps remain in the sustainable finance framework that could hinder its effectiveness in leveraging private finance for the net-zero transition.

The definition of 'sustainable investment' is broad and non-prescriptive, leaving the assessment entirely to financial-market participants

First, the SFDR definition of "*sustainable investment*" is broad and non-prescriptive, leaving the assessment entirely to financial-market participants. While flexibility is warranted to cater for different approaches to sustainable investment – especially for socially-focused investments, in the absence of a social taxonomy – the lack of minimum requirements creates a risk of greenwashing and reduces the comparability of SFDR disclosures for the consumers of investment products.

Second, while the Taxonomy defines very clearly what should be considered 'green', the concept of transition finance is not equally well defined in EU legislation. The Transition Finance Recommendation (2023) includes a list of investment types that are considered by the Commission to constitute "*transition finance*", but it is unclear whether all of these qualify as "sustainable investment" under the SFDR, and under which conditions.

Recommendations

Consistency

Your primary duty is to advance the transition to a consistent EU system of financial regulation, and especially supervision, that would align with the subsidiarity principle. Capital markets supervision offers the most immediate opportunity for progress and would finally give substance to the CMU project. The ECB President (Lagarde, 2023) and your predecessor[11] have created momentum through clearly-worded calls for supervisory integration, as have leaders from some member states.

European Securities and Markets Authority reform

Start with in-depth reform of ESMA to make it an effective financial supervisor, which it arguably cannot be under its current design

Start with in-depth reform of ESMA to make it an effective financial supervisor, which it arguably cannot be under its current design. The model to follow is the governance and financing template of AMLA, itself based on lessons learned from previous experience. This means a compact executive decision-making board and funding by an *ad-hoc* levy on supervised entities under scrutiny of the European Parliament. To allow greater connectivity with market participants, the reconstructed ESMA should establish offices in the EU's major financial centres, if not in every member state; some of these offices may also host teams that lead supervision of specific market segments, thus alleviating concerns about excessive geographical centralisation in Paris. In parallel or following ESMA reform, but not before, you should work to significantly broaden ESMA's scope of direct supervision, including relevant critical financial infrastructure (in appropriate interaction with the ECB), audit firms and accounting enforcement.

Don't give up on banking union

You should not give up on the aim of completing the banking union and should learn from the shortcomings of previous attempts in that area. Specifically, you should address the challenge of banks'

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11 Mairead McGuinness, 'Vested interests must not block the EU's capital markets union,' *Financial Times*, 19 March 2024, https://www.ft.com/content/f1270cc3-eb3d-4e8b-a2d7-264aeab51c6d.

concentrated domestic sovereign exposures and make it explicitly part of the banking union agenda. And you should reset the discussion about European deposit insurance, with a new blueprint for a European deposit guarantee scheme that would be better articulated with the resolution mechanism than the 2015 proposal, in line with the Commission's 2023 proposed legislation on Crisis Management and Deposit Insurance. (You will also coin a new acronym for that, since EDIS now means the European Defence Industrial Strategy).

Other areas are ripe for further pooling of decision-making authority at the European level in line with the subsidiarity principle. They include the prudential supervision of EU-significant insurers, financial sanctions implementation, macroprudential policy and financial consumer protection. Given political sensitivities and the opportunity of progress on the CMU front, however, you should not frontload these areas. Rather, be opportunistic in case exogenous developments create openings for new initiatives. You should also devote appropriate resources to ensure the successful inception and early development of AMLA.

Accept limitations

There are only limited opportunities for breakthroughs in structural areas that are critical to the CMU agenda

We see only limited opportunity for breakthroughs in the above-mentioned structural areas that are critical to the CMU agenda but are beyond what we see as the current scope for major EU-led change. These areas include taxation (especially of investments), insolvency law, pension finance and housing finance. In these areas, you should establish a robust approach of purposeful mapping and benchmarking of national practices and reform, and possibly consider ambitious harmonisation initiatives at a later stage. In order to ensure independence and resilience from national political pressures, this could take the form of a separate monitoring organisation funded by the Commission but not directly governed by it. Such an approach would allow you to avoid obfuscation and distraction from the effort towards supervisory integration.

Sustainable finance framework

To develop sustainable finance, you should streamline the EU framework to make it more effective. First, the SFDR definition of "*sustainable investment*" should be clarified, introducing minimum exclusions requirements for an investment to be considered sustainable. The set of minimum exclusions proposed by the Commission in 2020 for the so-called EU Paris-aligned Benchmarks would constitute a natural reference. In this, you should specifically form a view on how investment in the defence sector should be treated, to reconcile with changed geopolitical conditions.

The definition of "*transition finance*" in the EU legal framework should similarly be clarified, including how different types of transition finance should be evaluated when assessing their eligibility as sustainable investment under SFDR. At present, investment in economic activities that are aligned with the Taxonomy automatically qualify as sustainable investment under SFDR, but it is much less clear whether and how general debt or equity funding to transitioning issuers may also qualify. As transition plans become more common across EU companies in the coming years, they should be used as the basis for that assessment. Relatedly, you should pursue the development of a standard for sustainability-linked bonds and other types of target-based transition finance, including common key performance indicators, criteria to ensure ambition in target-setting and a methodology to evaluate the credibility of plans.

As transition plans become more common across EU companies, they should be used as the basis for sustainability assessment

ESG ratings review

You should also push for a review of the proposed ESG (environmental, social and governance) Ratings Regulation to require ratings sold in the EU to incorporate a double materiality approach and to include an assessment of entities' transition plans. The European Sustainability Reporting Standards developed on the basis of the 2022 Corporate Sustainability Reporting Directive (2022/2464/EU) constitute the cornerstone of climate transition plans for large or listed companies and embed a double materiality approach. A similar approach should be required for the entities that evaluate the credibility and ambitions of those same companies' transition plans, as well as their sustainability credentials.

Evaluate EU-UK financial linkages

The transition from Brexit is still unfolding. You should work at identifying any linkages between the EU financial system and the UK market in which the balance of efficiency gains and systemic vulnerabilities would not be beneficial for the EU. This concern is justified by the extraordinary dependency of the EU on London as an offshore financial centre, which is unprecedented and unparalleled among major jurisdictions. In this, you should resist protectionist impulses while being clear-eyed about genuine potential drivers of systemic risk, a difficult balance to maintain. Such analysis should guide you for the decision on whether to renew the equivalence recognition of UK clearing services, which expires in mid-2025.

Bring the digital euro to fruition

On the digital euro, you should bring your predecessor's proposal to fruition, ensuring that the project makes a positive contribution to the performance and resilience of the EU payments infrastructure – even though this is only an enabling framework for concrete decisions which will ultimately be made by the ECB.

International standard-setting and coordination

Finally, you should work to preserve and strengthen the global infrastructure for financial standard-setting and policy coordination, in line with the EU's strategic interest in a functioning open and rules-based international system. For that, you should improve the EU's own compliance with international financial standards, particularly those of the Basel Committee on Banking Supervision, with which the EU has been assessed as the least compliant of all the world's jurisdictions represented in the Committee. You should also identify ways to encourage EU countries to accept the rebalancing of bodies such as the Basel Committee and the Financial Stability Board, in which an excessive aggregate number of representatives from the EU undermines global reputation and buy-in from third-party jurisdictions. Specifically, since supervisory policy in the euro area is now under a single framework, the ECB alone could appropriately represent all euro-area countries in the Basel Committee, with the Commission and EBA retaining observer status.

You should improve the EU's own compliance with international financial standards, particularly those of the Basel Committee

Due disclosures: Silvia Merler works at Algebris Investments, an asset management firm subject to EU sustainability disclosure requirements. Nicolas Véron is an independent non-executive director of DTCC Derivatives Repository Ireland, a trade repository supervised by ESMA.

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Memo to the commissioner responsible for competition

Fiona Scott Morton

You face challenges of filling gaps in competition enforcement (including small mergers of innovative firms, for example), applying state aid to advance competition and enable European firms to grow, and enforcing new rules for digital gatekeepers embodied in the Digital Markets Act (DMA). Your priorities should be continued vigorous competition enforcement to maintain existing competitive markets, redesigning state aid to serve as a procompetitive industrial policy that creates new markets and fixes broken ones, and regulation of monopolised markets to deliver competitive outcomes to society (not least through the DMA).

Coordinating with other jurisdictions on regulation of digital platforms will also be crucial. In this context you must resist platforms' divide-and-rule strategies, benefitting from European Union leadership in this area.

Continue vigorous competition enforcement

Deploy state aid as procompetitive industrial policy

Regulate monopolised markets to benefit society

State of play

Under your predecessor, European competition enforcement was overhauled and made more rigorous

Competition enforcement

Under your predecessor, European competition enforcement was overhauled and made more rigorous. Reforms include new guidance, more aggressive use of existing powers and changes to the law to create new powers for the competition directorate-general (DG COMP).

Revised EU Horizontal Guidelines cover modern topics such as allowable R&D cooperation and pricing algorithms. The so-called ECN+ Directive (European Competition Network, Directive (EU) 2019/1) makes national competition authorities more effective enforcers. The Market Definition Notice was revised to enable better enforcement in digital markets, such as on content on multisided platforms and digital ecosystems. The Commission published the revised Vertical Block Exemption Regulation (Regulation (EU) 2022/720) and Vertical Guidelines that cover in a modern way digital sales topics including online sales restrictions, resale price maintenance, non-competes and agency agreements. The adoption of a new Article 22 of the Merger Regulation (Regulation (EC) No 139/2004) fills a gap by allowing the Commission to review small transactions it might otherwise miss[12]. The Foreign Subsidies Regulation (Regulation (EU) 2022/2560) applies the state aid rules applied to EU countries to foreign states, providing a tool to create a level playing field for European companies. And finally, the Digital Markets Act (DMA, Regulation (EU) 2022/1925) is a landmark law that allows the Commission to create and protect contestability in digital markets.

Enforcement using existing tools intensified under your predecessor. In 2019, Commissioner Vestager used the 'interim measures' tool for the first time in 18 years to prevent irreparable

12 See European Commission, 'Guidance on the application of the referral mechanism set out in Article 22 of the Merger Regulation to certain categories of cases', https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52021XC0331%2801%29#n-tr1-C_2021113EN.01000101-E0001.

The Commission has become stricter on digital mergers, with several acquisitions blocked or abandoned

harm[13]. Over the last five years the Commission has continued strong enforcement of 'standard' cases in areas including telecoms, pharma and banking, supported by court opinions.

Digital enforcement has increased significantly. The Commission has brought (and in some instances concluded) a number of important digital platform antitrust cases, including against Apple, Amazon, Google and Meta. The Commission has also become stricter on digital mergers, with several acquisitions blocked or abandoned. An unusually large amount of state aid was disbursed over the last five years because of COVID-19, the energy crisis and the green transition.

The courts were not entirely friendly to competition enforcement in Europe during the previous mandate. The Commission lost state aid tax cases and suffered significant setbacks in antitrust. In Qualcomm, the court rejected the Commission's analysis of anticompetitive effects and criticised its procedures, demonstrating the supremacy of process over substance that hinders the Commission's ability to protect consumers from market power[14]. The Intel case showed that judicial outcomes can turn on details of how and whether particular economic analyses were carried out, making enforcement more expensive and risky for the Commission[15].

Regulation of digital markets

Though the Commission obtained commitments and remedies in several big-tech competition cases, these did not lead to more competition. Rather the monopolists maintained their market positions. The DMA was passed after it became clear that competition law was not a strong enough tool to deliver competition in digital markets. The Commission moved swiftly along an analytical path from opening investigations, bringing

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13 See European Commission press release of 16 October 2019, 'Antitrust: Commission imposes interim measures on Broadcom in TV and modem chipset markets,' https://ec.europa.eu/commission/presscorner/detail/en/ip_19_6109.

14 Luca Bertuzzi, 'EU court dismisses Commission's €1 billion antitrust fine against Qualcomm,' *Euractiv*, 15 June 2022, https://www.euractiv.com/section/digital/news/eu-court-dismisses-commissions-e1-billion-antitrust-fine-against-qualcomm/.

15 See General Court of the European Union press release of 26 January 2022, 'The General Court annuls in part the Commission decision imposing a fine of €1.06 billion on Intel,' https://curia.europa.eu/jcms/upload/docs/application/pdf/2022-01/cp220016en.pdf.

cases, launching a debate on digital policy (eg Crémer *et al*, 2019), drafting the DMA, passing the law despite lobbying from big tech and then beginning enforcement in March 2024.

Challenges

Gaps in competition enforcement

Gaps exist in competition enforcement that cannot be filled with existing tools

Gaps exist in competition enforcement that cannot be filled with existing tools. Tacit collusion, for example, may be easier to create in the high inflation environment of recent years, but there is no good EU-level tool that can be used to tackle the practice. Consumers with behavioral biases such as excess inertia or responsiveness to defaults may not be able to discipline competition because they do not choose the most competitive product. Again, there is no obvious tool for a competition enforcer to use to reform these markets so that consumers are not exploited.

Controlling mergers between innovative or disruptive startups and dominant incumbents has become critical because often a dominant firm has an incentive to end the innovation competition between the merging parties. When these innovative firms could be competitively significant at EU level, it is crucial that the Commission has an accepted and settled way to obtain jurisdiction over them. Advance notice allows the regulator to keep up with a dominant firm that can quickly identify disruptive competitors and buy them.

More competition, to the benefit of European consumers, often comes from trade that results in regional or global markets. However, ensuring that trade does not unfairly harm European firms is a challenge. Competition can be harmed by illegal subsidies to foreign firms, and these must be distinguished from efficiency.

Competitiveness

Scale is an important factor in commercial success in many sectors. The importance of scale for success has grown and is forecast to continue to grow with advances in digital technology. For

European firms to succeed, they must be able to get bigger within a functioning single market for inputs, outputs, labour and capital. When the necessary firm scale is large relative to the EU market, there can appear to be a conflict between sustaining competition between multiple European firms and achieving full economies of scale that similar firms located in bigger markets may achieve.

Merger control is perceived as being inconsistent with development of European 'national champions'

Merger control is perceived by some as being inconsistent with development of European 'national champions'. The argument is that, for example, perhaps a combination of two medium-sized European firms can create a large European firm that will then compete with a large Chinese or American firm on a global scale, and this will bring benefits to Europe that the two medium-sized firms could not.

Managing state aid so that, beyond being neutral, it enhances competition, is a challenge. Political pressure to use state aid in a harmful way, such as the creation of national champions, rather than using it to mitigate externalities that prevent entry and competition, is significant.

DMA enforcement

The first moment of DMA compliance and compliance reports arrived in March 2024, but many challenges remain. For example, it is clear that some gatekeepers are not complying. If enforcement of the law does not compel compliance quickly the law will be perceived by consumers as lowering the quality of their digital experience while delivering no benefits. Business users will become disillusioned about their ability to access consumers freely through the gatekeepers and business user investment and innovation will decline.

Europe cannot be the world's regulator if its regulations do not change behaviour in a reasonable time period. An unsuccessful DMA will also raise the question of whether digital platforms are too big and powerful to be regulated. This risk is a significant threat to the rule of law in Europe. Furthermore, because these digital gatekeepers are global in scope, whatever happens in Europe will have impacts around the world. This creates a challenge for you of coordinating with competition enforcers and regulators in other jurisdictions.

Recommendations

Redesigning state aid rules to favour procompetitive industrial policy will create competitive markets

You must continue vigorous competition policy; this maintains and strengthens markets that are already fairly competitive. Redesigning state aid rules to favour procompetitive industrial policy will create competitive markets where there were none, or where the market functioned poorly because of significant externalities that can be fixed with a public intervention. And you must regulate monopolised markets; this improves the performance of monopoly markets so that they serve consumers with better price, quality and innovation.

Continue vigorous competition enforcement

Current competition enforcement does not stop European firms from growing and getting large through any procompetitive strategy, including mergers. Antitrust cases to date (outside energy) have overwhelmingly been focused on non-EU firms such as Intel and Google, while modern merger enforcement does not prevent the growth of large European firms that can succeed in the global economy.

EU merger rules prohibit mergers when they may lessen competition inside the EU, and that analysis centres on the substitutes available to EU consumers. If the market is not larger than Europe and there is no competition coming in from outside the EU, then a merger of significant EU rivals may well harm competition. The resulting monopoly prices and monopoly quality will not help this firm gain share should it choose to compete outside Europe. Vigorous competition at home creates the capabilities and efficiency that allow a firm to succeed globally, as shown by many globally successful European firms today.

If there is global competition in the market and competitors can and do import into the EU, then an analysis of competition will likely confirm that a merger of two local firms does not lessen competition in Europe. If so, European market shares will not be used in analysis, and the merger will not be blocked.

It may be that competition in the EU occurs between local firms today, but future expected competition will come from growth and entry of Chinese firms, and the European firms are merging because they anticipate this problem. If the regulator has evidence that entry by foreign firms with scale advantages is happening or is imminent, this may render an EU merger harmless. If the foreign entrant is 'competitive' because it is receiving illegal subsidies, this is a serious problem, but not one that merger control is set up to solve. Rather, implementation of the Foreign Subsidies Regulation and procedures to block or impose countervailing tariffs need to be fast and effective.

Procedures to block or impose countervailing tariffs need to be fast and effective

Adapt competition enforcement to reflect new concerns

The Commission must vigorously protect competition on the basis of innovation, not only price and quality, which requires explaining that risks to competition in future innovation are inevitably uncertain. For example, we cannot know for sure what innovation might occur in the but-for world and it is difficult to identify harmful transactions ex ante. The Commission must ensure there is a strategy to review small acquisitions that nonetheless have a large impact on innovation and competition must be created

You should advocate for the creation of a new tool that allows you to protect competition more effectively in several weak areas. One of these areas is tacit collusion, which usually is not a violation of existing laws. A tool that allows the authority to investigate and disrupt tacit collusion would restore competition. Another problematic area is (the many) markets that do not work well because of consumers' behavioural biases. A tool permitting you to identify and propose procompetitive solutions where consumers are being exploited would improve competition in those markets. European enforcers may be able to learn about successful solutions from competition authorities in the process of obtaining these capabilities such as those in Iceland, Germany and the Netherlands.

Lost resilience is a possible harm from a merger

For example, a pandemic that causes Europeans to lose access to certain kinds of chips or medications could be costly. If, for example, merging parties become efficient by consolidating their supply chains on one supplier of a raw ingredient, this may lead to a shortage of the product when there is a pandemic, flood or war. Consumers may be harmed by the merger over time as these adverse shocks manifest themselves, even if costs are lower initially. The Commission could consider using existing merger review to guard against this kind of harm to competition.

Ensure that industrial policy is procompetitive

State aid has been large under the Temporary Frameworks made necessary by COVID-19 and the energy crisis but, perhaps because that aid was a response to emergencies, lacked an overarching strategy. A procompetitive industrial policy designed to improve important market failures provides the framework for more effective state aid.

There is no inherent intellectual conflict between competition and industrial policy. Rather, procompetitive industrial policy makes broken or poorly performing markets exist, become competitive and deliver good outcomes for consumers. It is very easy to waste resources on industrial policy that is poorly designed. But significant externalities such as unpriced harms to the climate, the need for coordination among private actors, the need for critical infrastructure and the lack of scale in the internal market are preventing some large and valuable markets from operating efficiently in Europe. A policy that is targeted at a specific externality and solves it will improve productivity, output, jobs and competition. The targeted policy could be a subsidy to entrants, to training, for infrastructure, or as simple as the adoption of a standard.

It is very easy to waste resources on industrial policy that is poorly designed

Procompetitive industrial policy has two steps. The first is the identification of the externality and the incentive, investment, or coordination that will fix it. The design of the regulatory mechanism should ensure that the agents with information (eg firms or national regulators) put forward productive projects and clever solutions. Second, the policy must include a mechanism to attract the right entrants, set up a method (like an auction) to discover the right prices and create market rules that foster competition and generate ongoing innovation. The agency that supervises the industrial policy must monitor the policy over time, evaluate outcomes and adjust it as necessary. Any policy that receives public support should be designed to support more scale through deepening of the single market. And to this end the subsidies should be EU funds. These funds can subsidise a member state's firms' investments, infrastructure or coordination, on the condition that that country has harmonised its regulations and made the required reforms. You must carefully review such a policy because cooperation between firms in an industry can quickly devolve into a mechanism to shut out innovation and disruptive entrants. If DG COMP concludes the project is procompetitive, it is more likely to increase output, innovation and competition.

Better studies

There are many externalities in Europe and it is unlikely that DG COMP has the information or resources to identify and fix them all. A programme might allow for a member state, one of its regulatory bodies or an EU agency to carry out the study that identifies the externality causing the problem and determine the policy necessary to mitigate it. You should then review the plan to ensure that it improves the functioning of one or more markets and strengthens competition.

An example is the harmonisation of spectrum management across member states. With such harmonisation, telecom firms could operate in many member states and achieve large economies of scale (today it is a problem that they cannot, as described by Letta, 2024). Scale for many European industries can be achieved, and therefore competition intensified, with a programme that induces national regulators to change rules to permit efficient cross-border operations. Critically, this is a solution that does not involve mergers within member states – which creates countervailing problems of market power, higher prices, lower quality and less innovation – but rather makes it easy and productive to merge across member state lines.

Competition can be intensified with a programme that induces national regulators to change rules to permit efficient cross-border operations

The externality may be mitigated through the use of existing law or it may require the application of new tools. You can advocate a solution to these externalities that creates a longer-lived entity in that case, one with its own programme, a source of EU funds and ongoing oversight (in addition to DG COMP). Such a structure would allow approved programmes to access EU funds and expand the single market. However, any subsidies to firms must be conditional on the member states that are home to those firms carrying out the reforms the project requires (eg a change in regulation, adoption of a standard or opening of a market). A similar programme exists already in the form of Important Projects of Common European Interest (IPCEI), which could be expanded to include simpler and non-frontier projects.

DMA enforcement is critical

Regulation limits harms from already monopolised markets. The DMA is now fully in force. If core platform services comply with its rules, then business users in the EU will have many more opportunities for innovation. Entry into app stores, digital wallets, messaging, gaming, entertainment content and more will be technically easier, while business users will be protected from discrimination and expropriation.

However, enforcement of the law must be vigorous and swift. Big tech can be expected to deploy substantial legal, economic and lobbying resources, so you will need to have backbone in this process or the regulation will be ineffective. The Commission has already begun noncompliance proceedings against Apple, Google and Meta. The DMA unit will need to spend enforcement resources on this stage of the law which is expected to last through the bulk of your mandate because of the slow speed of the courts. In some cases, you have two tools to achieve improvements within one market – an Article 102 investigation and the relevant portions of the DMA. You have the possibility to coordinate enforcement to achieve maximum contestability at maximum speed and minimum resource cost.

Big tech can be expected to deploy substantial legal, economic and lobbying resources, so you will need to have backbone

Coordinate with other jurisdictions concerning regulation of digital platforms

This may be the most delicate and important topic of your mandate. Many other jurisdictions are also interested in, or are in the process of, adopting regulations that seek to create more competition in digital markets. Because the platforms themselves are global, one can expect those that are most threatened by regulation to have global strategies of playing one jurisdiction off against another. Governments need to play this same game, advance their interests in a coordinated fashion and work together to resist corporate lobbying. Because Europe has moved first, it has the ability to provide advice and leadership to others. There are opportunities for regulatory progress given that many other states share Europe's goals, even if their legal systems and timings are different. The stakes are high and the game will be tricky.

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Memo to the commissioner responsible for research and innovation

Reinhilde Veugelers

Various indicators show the European Union continuing and even increasing to lag behind the United States and China on research and innovation, mostly for R&D carried out by companies. You must use the main instrument at your disposal – the Framework Programme for research – to push for improvements in the EU position, while bearing in mind that most EU public R&D spending comes from the budgets of member states.

In reforming the EU research programme and its components you should be guided be an assessment of the effects of any EU research spending in terms of redressing the EU's current R&D performance deficits, learning from what has worked best in the past, while not being shy to pilot new instruments, including an EU mission-oriented advanced research projects agency. You should show more clearly how EU countries are benefitting from EU research support, while remaining internationally open.

Implement effects-based Framework Programme reform

Develop a truly directed, mission-oriented perspective

Foster partnerships based on excellence

State of affairs

EU spending on research and development hovers at around 2 percent of GDP, while the US spends increasingly more

The recent performance of the European Union's research and innovation system compared to the United States and China mostly delivers an alarming wake-up call. EU spending on research and development hovers at around 2 percent of GDP, while the US spends increasingly more, meaning the gap is widening rather than shrinking (the US share was 3.5 percent/GDP in 2022). Meanwhile China has overtaken the EU on this indicator, with a 2.4 percent share in 2022. Within the EU, there has been very slow convergence: the bottom five EU countries in 2022 spent only 31 percent of the EU average GDP share, though this was up from 28 percent in 2015.

Public funding of R&D in the EU is provided mostly at national level. While this memo focuses on EU publicly funded R&D as your main instrument, it is important to note that the EU research spending deficit compared to the US is not down to public funding. Rather, the business sector is responsible for the persistent and growing EU R&D deficit relative to the US. Government-financed R&D was 0.66 percent of GDP in the EU in 2022 and 0.6 percent in the US, but the shares of GDP for business-financed R&D were 1.22 percent and 2.4 percent respectively[16]. This business R&D deficit has been long-standing (in 2015 the respective EU and US numbers were 1.12 percent and 1.76 percent), but the EU has not been able to reduce it.

In terms of high-quality science as measured by top-cited publications, however, the EU-US gap is shrinking. But China has taken the lead, with a 25 percent share of the world's top 1 percent most-cited publications in 2022, compared to 22 percent for the US and 19 percent for the EU. If the United Kingdom and Switzerland are included, 'Europe' with a 26 percent share has increased its lead over the US and still, though marginally, outdoes China.

The EU's lag in patent performance over the US has reduced somewhat over time. The EU share of patent applications filed under the Patent Cooperation Treaty was 19 percent compared to 22 percent for the US. But again, China is fast rising, with a 26

16 For China, the shares of GDP in 2022 were 0.46 percent for government-financed R&D, and 1.9 percent for business-financed R&D.

percent share compared to 14 percent in 2015 (when the EU27 and US shares were 24 percent and 28 percent respectively).

The EU still leads the US in AI-related scientific publications, but has been overtaken by China

In AI, a major battleground general-purpose technology, the EU still leads the US in AI-related scientific publications, but has been overtaken by China. On AI-related patents, however, the EU is a dwarf. The AI patent race is between the US and China, with China winning.

Finally, the position of EU firms in the ranking of the 2500 largest R&D spending companies worldwide illustrates the EU's lagging business R&D performance. In 2022, EU companies held only 15 percent of these slots, less than half the US number. As US firms on average are highly R&D intensive, the lead of the US over the EU is even bigger in terms of scale of R&D spending. Meanwhile, China's share of the top 2500 firms was the same as the EU27 in 2017, but almost double the EU27 share in 2022.

The continued and increasing dominance of the US over the EU and the catching-up of China is very much driven by sectoral composition. The most strongly growing sector in innovation terms is information and communication technologies (defined broadly as electronics, hardware and software, and ICT services). Alphabet, Meta, Microsoft and Apple – all US companies of course – were the world's top four R&D spenders in 2022, followed by China's Huawei in fifth place. EU firms are virtually absent from the top ICT R&D spenders. Health is the second most important sector in the innovation landscape, but the EU firms in this sector are on average only mildly less R&D-intensive than their US counterparts.

One sector dominated by EU firms is automotive. The strong concentration in this medium-tech sector contributes to the EU's significantly lower overall corporate R&D intensity (referred to as the "*EU mid-tech trap*"; Fuest *et al*, 2024). But even in the automotive sector, EU firms are increasingly challenged by the new wave of interconnected, autonomous and electric cars from China and the US. In 2022, China's BYD recorded the highest year-on-year R&D growth rate in this sector (80 percent).

Table 1: Sectoral R&D intensity, 2022

	Share of region in sector total R&D (%)			Region's R&D to sales ratio			Region's share of top 10% R&D-spending firms per sector*		
	ICT	Health	Cars	ICT	Health	Cars	ICT	Health	Cars
China	18	6	13	7.7	7.6	5.2	18	3	12
US	55	52	19	12.3	13.1	5.1	49	53	18
EU	9	17	42	7.2	11.6	5.5	7	19	41

Source: Bruegel based on 2023 EU Industrial R&D Investment Scoreboard. Note: * refers to top 10% firms per sector from the 2023 EU Industrial R&D Investment Scoreboard.

Correlated with the EU's persistently lagging business innovation performance are the differences between the EU and the US (and China) in the incumbency of their leading R&D spending firms. This is most striking in ICT: the sector top five are well-established but all still relatively young stars (Alphabet, Meta, Microsoft, Apple and Huawei), while stellar growers like Nvidia, established in 1993, was already ranked 26 in 2022. The EU firms with the highest R&D spend in ICT are incumbents SAP followed by Nokia and Ericsson. Relatively young star ASML (established in 1984) ranks 36. In cars, all EU leading firms are incumbents, while Tesla is the US's highest R&D spender in this sector and BYD is China's second largest R&D spender. The same issue of vintages prevails in the health sector. Of the 31 US health firms in the top 10 percent of R&D spenders, 11 are new (including Gilead, Amgen, Novavax and, more recently, Moderna). In contrast the EU has only one new health firm, BioNTech, among its largest R&D spending companies.

Challenges

Failure to redress the EU's growing business corporate R&D deficit

The EU's increasingly lagging performance in R&D spending is not explained by public funding levels or even science, but by its business sector R&D. While Europe has pockets of great science, it typically succeeds less in turning them into innovative corporate successes. Compared to the US, and more recently China – which hosts most of the new corporate R&D leaders, especially in digital and innovative digital/AI using sectors – the EU corporate R&D system generates both fewer new leading innovators and fewer dynamic incumbent leaders. This has been a long-diagnosed challenge for the EU, which policy does not seem able to address. The EU's business innovation shortfall has become even more critical in the fast-changing and highly competitive global AI-powered innovation environment.

The EU's business innovation shortfall has become even more critical in the AI-powered environment

A less open global innovation environment

The global innovation scene is increasingly characterised by a race between the US and China for technology sovereignty and dominance, protected by domestic fences. This challenges the EU's traditionally open-to-the-world approach to R&D, with the EU struggling to adopt a strategy of "*as open as possible, as closed as necessary*" (European Commission, 2021).

Addressing innovation gaps with a limited instrument: the EU's Framework Programme budget

While the challenges for EU's innovation system are sizeable, structural and urgent, your powers to address them are modest. Your main tool is the portion of the EU budget that goes to research, its Framework Programme (FP). While public funding is not responsible for the EU lagging behind the US on innovation, it could nevertheless help to address its business innovation gaps – but only if flanked by policies that improve framework conditions for private investment in research and innovation. Unfortunately, the latter are outside your remit. And the budget instrument with which you can work, albeit sizable (€100 billion in the current seven-year budget), represents only a small share of the total public budget for R&D spent by EU countries. The power of EU research spending should thus be seen in terms of what extra value added it can bring alongside member-state spending to alleviate the innovation gap, and policies to improve framework conditions.

The next FP will start during your mandate. Discussion have started already, mostly about the size of the budget, with stakeholders demanding a massive expansion. Less discussed is how to use the next budget to address the EU's major challenge: narrowing the business innovation gap.

Lack of intra-EU cohesion

In light of evidence indicating weak or no convergence in R&D performance across member states, the question is how to reconcile broader participation in the FP with excellence-based selection (which remains crucial if the FP is to improve innovation performance). There is also no consensus between EU countries on whether and how to support R&D through EU-level instruments, or through coordination of national instruments.

Recommendations

Implement regulation in an innovation-friendly way

Most of the focus of your term will be on the size and content of the next Framework Programme budget

Most of the focus of your term will be on the size and content of the next FP budget. Rather than being guided by the usual stakeholder consultations, which typically lead to path-dependent calls for more money for an at best marginally changed FP, you should seek agreement based on evidence of the FP's effects. The main weaknesses that the next FP must address are Europe's weak science-industry connectivity and the lack of new players able to grow to sufficient scale for world innovation leadership and/or to challenge incumbents. The key performance indicator you should use is therefore the contribution of the portfolio of FP instruments to nurture the next scientific and technology ideas that will boost business innovation.

Taking an effects-based approach requires *ex-ante* and *ex-post* micro and macro assessments of the long- and short-run impacts of the FP portfolio and its instruments. This requires a permanent in-house monitoring and evaluation capacity, which should open source its data and methodologies so that external expertise can validate and complement internal analysis. In its evaluation of the previous FP, published in January 2024, your services used macro-econometric exercises to come up with a 1:5 multiplier for the direct and indirect economic effects from each FP euro spent. This is a generous assessment, which could do with more independent robustness analysis. Also needed is more hard evidence on the direct and indirect benefits of the instruments in the FP portfolio.

Programmes that fail to show unique value, and that do not pass the test of *ex-post* evaluation of their effectiveness and proportionality, should be subject to the sunset clause, creating budgetary space for new programmes.

Empower the FP instrument: innovation effectiveness

The EU's entrepreneurs face obstacles in bringing their ideas to commercial fruition, particularly in finding risk finance

The EU's entrepreneurs, particularly first-time and radical innovators, aspiring to be the new world leaders and/or to challenge incumbent leaders, face obstacles in bringing their ideas to commercial fruition, particularly in finding risk finance. Public funding support could help to address this barrier.

The FP's Open Innovation pillar and its new instrument, the European Innovation Council (EIC), are a small (less than 10 percent of the total FP budget), step forward towards addressing this issue. As various support schemes already exist both in member states and at EU level (for example, the European Investment Fund), the question is what unique value the EIC can bring to the public funding landscape. Unfortunately, it is too early for hard evidence of its success. But you can justify the value added of the EIC over other instruments by referring to its potential to be an EU-level quality label. Being an EIC grantee could and should become valuable certification to secure other funding.

For this, it is critical that you install an EIC governance model like the European Research Council (ERC)

Based on an autonomous council composed of recognised technology leaders, who can design the programme and select the evaluators. The potential for EIC value added is more obvious for high-risk proposals in their early stages of financing, when certification is much more critical; it is less clear for later accelerator phases of financing. You should therefore prioritise the early-stage pathfinder EIC instrument over its accelerator instrument. Like the ERC, the EIC should be based fully on bottom-up proposals from entrepreneurs, and not confined to specific top-down selected areas or other requirements such as collaboration.

The Open Science pillar, currently about 30 percent of the FP budget, is perhaps the pillar that might be least on your radar, given the EU's overall performance on scientific excellence. The ERC, relying on bottom-up proposals selected based on excellence only and with an autonomous and independent scientific council, has become a success story, as shown by EU's position at the world scientific frontier.

Particular attention should be paid to the Marie Skłodowska Curie Actions (MSCA), currently mostly dedicated to doctoral training. Researcher mobility is a critical pathway for knowledge networks, collaboration and connectivity. Yet, only a small part of the current MSCA budget, itself already relatively small, is spent on individual fellowships for mobility. Sending more EU researchers from academia to industry across borders will help bridge the EU's gap between science and the commercialisation of innovative ideas. It would help address the skills shortfalls that are identified by start-ups as a constraint in scaling up, and by companies as a major constraint in adopting new digital technologies. More targeting of MSCA mobility fellowships to specific missions would help improve the knowledge spillovers in key areas, such as AI. Enabling researchers to move from lagging countries to excellent research destinations, and to subsequently return or connect, will help in intra-EU convergence. In addition, mobility fellowships to and from non-EU countries are important to deliver on the EU's commitment to international openness. Any expansion of the MSCA programme should of course always be tied to evaluation of its intended impact.

Sending more EU researchers from academia to industry across borders will help bridge the EU's gap between science and the commercialisation of innovative ideas

Empower the FP instrument: mission-directed

Global challenges such as climate change may demand more EU-level support and directedness. Tackling global challenges is what the biggest part of the current FP, Pillar II, is about. Pillar II should seek to stimulate intra-EU collaboration between science and industry in strategic technology areas (health, digital/AI, clean tech, quantum) and address the EU's weakness in connecting these dots at EU scale. Pillar II should be about bottom-up proposals for cross-border collaboration, selected on the basis of excellence and their impact in terms of tackling challenges. Specific calls, which are often only suitable for incumbents, should be avoided.

Still underdeveloped in FP is a truly directed, mission-oriented perspective. Funding calls directed to new strategic fields, including hydrogen, AI, quantum computing and semiconductors, have been on the rise, but are too ad hoc. The new 'Missions' initiative in the current FP lacks a well-designed governance structure (Tagliapietra and Veugelers, 2023). The EU still lacks a mission-oriented advanced research projects agency (ARPA) supporting high risk/high gain projects using a goals-oriented, top-down approach (Pinkus *et al*, 2024). You should therefore consider creating an EU ARPA in the form of an independent agency with a mandate to fund precisely defined missions related to EU policy priorities. An ARPA-style approach requires sufficient funding – part of which could originate in the reallocation of existing budgets – to allow it to make multiple bets as part of a portfolio approach. (Sufficient does not mean enormous; for example, the budget of the US Defense Advanced Research Projects Agency is about $4 billion). Equally important is to design it properly, most notably, granting it autonomy and organisational flexibility, to recruit and accommodate the venture capital entrepreneur type of policy officers. Calls must have clear quantifiable goals and trackable metrics, so that policy officers can be given elevated levels of autonomy, together with clear accountability.

The EU still lacks a mission-oriented advanced research projects agency supporting high risk/high gain projects

Improve cohesion

The cohesion objective cannot be merged with the critical excellence objective of the FP. This dichotomy can only be solved by using multiple focused instruments. The Widening Participation and Spreading Excellence actions, introduced in the current FP, are targeted at supporting member states and regions in improving their capacities to adopt and adapt to new technologies. Focusing this instrument on widening will allow the other parts of the FP to remain focused on excellence. You only need to monitor whether the Widening Participation and Spreading Excellence actions complement other EU and national-level instruments to effectively unleash the innovation capacity of lagging countries and regions.

To shift the 'what's in it for me?' mentality of member states in the direction of a positive-sum, subsidiarity-consistent instrument, you should use your monitoring and evaluation capacity to document the direct and indirect gains for each EU country from

FP instruments, and how this depends on complementary national policies.

Stay open to the world

Science and innovation thrive on the international flow of ideas and cooperation. Even in a world of global retrenchment, it is important for the EU to remain open, certainly on science. It is important that the EU remains connected to the other global centres of science excellence. Past and current framework programmes have not been very successful in establishing links with the best science countries. Selection on the basis of excellence should become the priority for agreements with third countries, with the US and China being among the highest priorities, even if they are becoming less open, along with the UK and Switzerland.

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Memo to the commissioner responsible for digital affairs

Bertin Martens

You should pursue two main objectives: first, seek to narrow the digital investment and uptake gap between the United States and the EU; second, aim to better leverage data as a true economic production factor, alongside labour and capital. Both are critical to boost productivity growth in increasingly data-driven industries.

You should push for innovation-friendly implementation of recent regulation, taking advantage, for example, of flexibility given by the Artificial Intelligence Act, and identify areas in which very large EU platforms could be established. Simplification can be pursued when the general data protection regulation comes up for review, and a balance between the benefits of generative AI and copyright protection needs to be struck. Data governance can be improved, with the European Health Data Space as a model. Your objective should be to maximise the societal and innovation value of data pools, over and above the private value of the data.

Focus on digital investment and productivity

Push for innovation-friendly implementation

Maximise the societal value of data

State of affairs

European Union productivity growth continues to lag behind the United States partly because of weak EU investment in, and uptake of, digital technologies. US R&D spending on ICT software, hardware and services exceeds EU spending by an order of magnitude. The US ICT capital stock grew at about twice the EU rate over the last two decades. US labour productivity growth in the ICT sector (2000-2021) is four times higher than in the EU (Pinkus *et al*, 2024).

Part of the reason for this gap is that the US is home to the world's largest tech companies, which account for the bulk of US ICT R&D. Their market power enables them to hoover up much ICT spending by consumers and businesses worldwide, and to re-invest it in their own R&D priorities. Moreover, their market capitalisation and financial means enable them to integrate innovative start-ups into their ecosystem – including European ones.

Collaboration with the big US tech companies is often the most promising growth strategy for EU ICT start-ups

EU ICT firms, meanwhile, are innovative in terms of producing patentable research, but face obstacles in scaling-up that research into viable business models. Barriers include weak EU private equity and venture capital markets and insufficient access to established business channels to expand sales. Collaboration with the big US tech companies is often the most promising growth strategy for EU ICT start-ups.

As the EU is not home to major tech firms, it misses out on the large private R&D budgets they generate and the market reach they can leverage. The EU is also not in a position to compensate for low private R&D and investment through government funding. Instead, the EU has focused on reigning in the market power of very large digital platforms and re-distributing their intermediation rents and data stocks to smaller firms and consumers. The Digital Markets Act (DMA, Regulation (EU) 2022/1925) imposes a series of competition policy measures on very large and mostly US-based 'gatekeeper' platforms to reduce market power and facilitate market entry. The Digital Services Act (DSA, Regulation (EU) 2022/2065) targets very large online social media and other intermediary platforms with responsibility rules to reduce illegal and inappropriate content.

The EU has also launched a plethora of data regulations to open up access to data and facilitate competition in data-driven services markets, including data access rights in the Data Act (Regulation (EU) 2023/2854), the DMA and specific sectoral data regulations. These seek to bring more competition into data markets and data-driven services markets. At the same time, they create the risk of multiple and partly overlapping regulations, with provisions that are not always consistently defined or applied across sectors and regulatory instruments. Regulatory complexity and compliance are becoming a costly burden on firms (Demirer *et al*, 2024). The General Data Protection Regulation (GDPR, Regulation (EU) 2016/679), a cornerstone of EU data regulation, has been enforced less rigorously than it could have been. Since managing consent is economically costly for firms and for consumers, this is holding up effective implementation.

The EU Artificial Intelligence Act takes a precautionary stance to set product safety standards, including for the latest generation of general purpose AI models that have widely varying applications. General fundamental rights considerations have replaced specific technical safety standards. The Act marks the start of a long regulatory process in which many implementation rules and compliance mechanisms remain to be defined. It focuses on self-standing AI models rather than on rapidly developing ecosystems of AI-driven services.

There is increasing data-regime competition between the EU, US and China

There is increasing data-regime competition between the EU, US and China (Bradford, 2023): the design of data regulation matters for competitiveness across the economy. The US takes a *laissez-faire* approach with little regulatory intervention. It counts on homegrown big and small tech firms to take a competitive lead and increase productivity across the economy – so far very successfully. It has opted for a lighter and more flexible approach to regulation of digital competition, data access and AI. China has made some heavy-handed interventions in its domestic big tech industry. However, much of its regulation seeks to promote digital innovation and investment, for example in AI. Whether the EU will remain an attractive location for AI model and services developers will depend on the evolution of compliance costs.

Over the last few years, the EU Digital Single Market has somewhat faded into the policy background. In the past, the EU put considerable effort into reducing regulatory barriers in the single market as a way to stimulate digital services. The EU Geo-blocking Regulation (Regulation (EU) 2018/302) had some success in promoting online cross-border trade, except for copyright-protected media products, which remain locked up in national markets that are not competitive in an era of global media giants and streaming platforms. However, most remaining obstacles are not specific to digital services; they mirror border costs in offline services, such as product safety and consumer protection legislation, or the absence of a single payment system. Increasing scale through the Digital Single Market may have run out of steam as a driver of digital productivity growth. Weak private financing of R&D and investment, and access to large digital ecosystems, may be more important constraints.

On the digital hardware side, the EU is vulnerable at times of geopolitical tension

On the digital hardware side, the EU is vulnerable at times of geopolitical tension. While hardware supply chains were until recently rather diversified, the arrival of large AI models has exposed dependency on very few advanced chip producers and big data centres. Regulatory intervention in chip production and critical raw materials supply chains seeks to address these risks. Increased cybersecurity risks require not only more awareness and investment by firms; they also require closer cooperation with cloud and software providers in a networked security strategy.

Challenges

You should pursue two main objectives: first, seek to narrow the digital investment and uptake gap between the US and the EU; second, aim to better leverage data as a true economic production factor, alongside labour and capital. Both are critical to boost productivity growth in increasingly data-driven industries.

Narrowing the digital investment and uptake gap

You will need to continue working on the slow-grinding process of reducing barriers in the Digital Single Market to increase the scale of EU markets, though this may not generate significant leaps in productivity. But increasing market scale is in itself not a sufficient condition for the successful uptake of digital technology. A complementary challenge is market deepening. Even if the DMA is successful in reducing monopolistic profit margins of US-based gatekeeper platforms, and channelling some of that surplus back to European consumers and businesses, there is no guarantee that this re-direction will result in an increase in EU private investment in digital R&D and firms. This requires flanking measures to stimulate the development of private equity and venture capital markets in the EU to provide private financial resources for R&D and start-ups.

Public R&D and investment funds alone cannot bridge the digital investment gap with the US. Accelerating the uptake of digital technology in EU firms and services requires investment in digital ecosystems that link many types of services. For the time being, EU consumers and businesses still depend on network effects around rapidly evolving and expanding digital ecosystems that work off US-based platforms. Trying to weaken these network effects without alternative sources would only reduce welfare for EU citizens. Instead, investment is required to build alternative and competing EU ecosystems, for example around a single payments platform, identity platforms, industrial data pools or new AI-driven ecosystems.

Leveraging data as an economic production factor

Your first challenge in this area is to reduce regulatory fragmentation among the large number of data regulations

Your first challenge in this area is to reduce regulatory fragmentation among the large number of data regulations where rules intersect, overlap and sometimes lack coherence, and may impose heavy compliance costs on firms. The scope of personal and business data that can be accessed and ported to third parties varies across regulatory instruments, from raw data, to interaction data and to processed data. Data-sharing obligations for very large gatekeeper platforms in the DMA are especially challenging because of the technical complexity and large volumes of data involved. This raises the question why so many regulations are needed: why not just one, or a few, horizontal regulations that cover many conceivable situations? Are the nature and types of market failures in each situation so different that they justify separate regulations?

Another challenge is high GDPR compliance costs for firms and consumers. This results in reduced investment in innovative consumer services applications. Consumers have no meaningful instruments to exercise their sovereign decisions over personal data. Dumb clicking on irritating pop-up consent notices does not amount to meaningfully informed consent. The costs of the GDPR to firms and consumers should be reduced. Consumer benefits should be made more explicit and transparent.

An important emerging challenge is the tension between the benefits of data-access rights and the protection of prior private rights, including consumer privacy and trade secrets for firms. Policymakers need to reflect on the extent to which private rights can be allowed to undercut the wider societal benefits of data access. Anti-competitive provisions in the Data Act create new obstacles in data markets. Allowing data holders to exclusively license data and charge monopolistic prices for data transfers constitutes a return to the fraught concept of exclusive data ownership. These provisions reduce digital innovation and prevent the realisation of the wider societal value of data.

Creating data-access rights is a necessary but often not sufficient condition for the emergence of efficient data markets. Data exchanges can only happen in the presence of a physical and institutional infrastructure that facilitates exchange. The Data Governance Act (Regulation (EU) 2022/868) has taken a first step to create trustworthy intermediary institutions to facilitate data exchanges. The Commission's announced industrial data pooling initiatives also require viable intermediary institutions to manage data contributions and use rights (European Commission, 2020).

The EU AI Act is only a first step in AI regulation, with many guidelines and implementing acts still to be drafted

The EU AI Act is only a first step in AI regulation, with many guidelines and implementing acts still to be drafted by the Commission's newly-created AI Office. This can still steer the Act in different directions and change the relative weights of precaution and innovation measures, spurring or slowing down innovation. The Commission will have to ensure that protecting user safety does not slow AI-driven innovation and instead enables European AI developers and deployers to remain competitive on the global AI market. The emergence of generative AI models has upset the balance between the need for copyright protection on AI training inputs and the potential for AI-driven innovation in creative industries and in the wider economy.

Recommendations

To narrow the productivity gap with the US, you should opt resolutely for a strong pro-innovation approach to the digital transition, while not losing sight of precautionary measures to mitigate negative impacts. Competition, redistribution and precautionary policy measures are necessary and need to be pursued vigorously in a world that is increasingly dominated by a few very large tech companies, which direct R&D and investment towards their own private interests. However, such policy measures need to be accompanied by innovation and private-investment-stimulating measures to accelerate productivity growth.

Innovation-friendly implementation of recent regulation

You can build on existing and recently introduced digital regulations and ensure that they are implemented in an innovation-promoting and productivity-stimulating way. There is scope and room for adjustment in the implementation of the DMA, the AI Act and several data regulations and policy initiatives, to steer digital data and services markets in a pro-innovation direction. You should resist further fragmentation in the data-regulation landscape and seek to harmonise rules across regulations, in particular with regard to types of data and conditions under which it can be accessed and ported.

There is still room in the implementation of the Data Act to reduce anti-competitive restrictions on the use of shared data

There is still room in the implementation of the Data Act to reduce anti-competitive restrictions on the use of shared data and tone down monopolistic pricing of third-party data transfers through the FRAND (fair, reasonable and non-discriminatory) provisions. Data-sharing obligations for gatekeeper platforms in the DMA should be implemented in a way that facilitates access to business network interaction data, rather than being restricted to 'own' data. If not, incumbents will retain an information advantage over competitors. Sharing networked data will weaken the welfare-reducing side of network effects and strengthen their welfare-enhancing impact.

Create infrastructural EU platforms

While the EU is currently not home to very large online platforms, it may seek to create such platforms in still unexplored domains. A digital euro could finally create a single payments platform in the EU. This will facilitate cross-border payments and may also become a launch platform for a variety of innovative financial and other services. An EU-wide identity platform could provide a secure and neutral log-in system to access many consumer services. Just as today's big tech platforms started by attracting many users to a single application and then leveraging that user base into many other complementary applications, large infrastructural EU platforms could become portals to access many services and benefit from welfare-enhancing network effects, while avoiding monopolisation by a single firm.

An EU-wide identity platform could provide a secure and neutral log-in system to access many consumer services

Improve data governance

To leverage data as a production factor, the creation of efficient data sharing and pooling institutions is necessary. You should push ahead with data-pooling initiatives launched by your predecessor. The European Health Data Space has a very well-designed set of governance rules that could be a blueprint for ongoing initiatives in other sectors. Your objective should be to maximise the societal and innovation value of data pools, over and above the private value of the data. Data market failures will occur because of the gap between private and social value, and that will require further regulatory intervention. You should promote the use of better data-protection technologies, such as federated machine learning, which can protect private rights while still enabling the extraction of socially valuable benefits from the data. Data pools could also become an attractive launching platform for firms that provide data-driven services. Circumstances may vary across sectors and may require specifically designed data-governance regimes and intermediaries.

Standardise GDPR consent notices

You could use the review of the GDPR not only to streamline complaint procedures but also to reduce transaction costs related to costly, cumbersome and not easy-to-understand GDPR consent notices and make it easier for data subjects to meaningfully exercise their data rights. The introduction of standardised and machine-readable consent notices would facilitate personal information and consent management systems with AI-powered personal assistants. This would considerably reduce transaction costs and risks for data subjects, compared to current 'manual' personal information management applications that are too costly to scale up.

Use guidelines and implementing acts for the AI act to maximum effect

Dozens of guidelines and implementing acts for the AI Act still need to be designed by the new AI Office. This creates an opportunity to keep the AI Act in tune with the rapidly evolving landscape for AI technologies and complex business models. While the AI Act focuses on self-standing models, implementation should take into account AI-driven ecosystems that seek closer collaboration between incumbent services firms and providers of AI models. The dividing lines between AI model developers, deployers and users, and their respective responsibilities, should be clarified in guidelines. Implementation guidelines should avoid excessively precautionary measures and facilitate innovation by keeping market entry and compliance costs low.

Implementation guidelines should avoid excessively precautionary measures

Reduce the scope of copyright protection for AI

Generative AI technology has shifted the balance between exclusive copyright as an incentive to produce innovative artwork and the wider societal innovation benefits. Generative AI technology has reduced the cost of producing creative content and induced positive spillover effects beyond the media sector to the rest of the economy. To sustain these benefits and maintain vigorous competition in AI model development, the widest possible access to training data is required. This may require a revision of the opt-out clause in the EU Copyright Directive (Directive (EU) 2019/79), or at least pro-innovation design of the implementation guidelines for this clause under the AI Act.

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Memo to the commissioner responsible for employment and social rights

Duygu Güner and David Pinkus

Social and labour market policies in the European Union are primarily the responsibility of member states, leading to varying approaches. Your job is to foster positive convergence through legislation, financial and technical support, and coordination of best practices. Despite considerable progress, the EU has yet to meet the 2030 targets for employment rates, adult training and poverty reduction.

The major social policy challenge you will face include transforming labour markets, skills and labour shortages, balancing pension sustainability with adequacy and meeting the increasing demand for long-term care. To address these issues, you must collaborate with member states to improve labour market conditions for all workers, support the reform of pension systems, support measures to increase the supply of long-term care, fund research into healthy ageing and enhance data collection for better policymaking.

Focus on wages, working conditions and technology

Assess pension, healthcare and longterm care policy

Push for better data and develop best practices

State of affairs

Social and labour market policies are mostly member-state competencies. While labour market policies and the structure of social security systems vary considerably in different EU countries, the EU strives to promote positive convergence through different tools. First, it can legislate on matters that impact labour and social policies, such as the protection of workers' rights and non-discrimination. Second, it can set high-level targets and monitor implementation through mechanisms including the European Semester. Third, it can provide technical and financial support to reform and investment efforts. Finally, it can play an important role in coordination and in collecting best practices.

Since its adoption in 2017, the European Pillar of Social Rights (the 'Pillar') has guided EU social policy. In 2021, the Pillar Action Plan reinforced the EU's commitment to its objectives by setting targets for 2030, focusing on improving quality of life and living standards, reducing socioeconomic disparities, promoting social justice and combatting social exclusion and discrimination.

EU citizens generally support social policy at EU level. According to the 2020 Eurobarometer wave, 88 percent of European citizens consider a social Europe personally important, and 60 percent are aware of at least one recent key EU initiative aimed at improving working and living conditions. However, the EU still has a long way to go to achieve the three main 2030 targets – on the employment rate, adult training and poverty – set by the Pillar Action Plan. As of 2023, the EU employment rate was 75.3 percent, falling short of the 78 percent target, requiring the creation of nearly 7 million new jobs. Adult training participation was stagnant at 46 percent, below the 60 percent target. Finally, the objective of reducing the number of individuals at risk of poverty or social exclusion by 15 million is far from realistic, given that the EU only saw a reduction of 266,000 from 2021 to 2022.

The EU still has a long way to go to achieve the three main 2030 targets on the employment rate, adult training and poverty

Changing labour markets

Labour markets have been significantly impacted by emerging technologies, demographic shifts and climate change. Emerging digital technologies have reshaped the world of work by introducing new forms of employment, such as platform work, and altering the task composition of jobs. In recent years, the green and digital transitions have sped up this transformation by drastically changing the skills required in the labour market, leading to a significant mismatch between skill supply and demand.

The EU has responded to the changing world of work through targeted funding and legislation including the 2019 Work-life Balance Directive (Directive (EU) 2019/1158) and the Directive on Transparent and Predictable Working Conditions (Directive (EU) 2019/1152). Until early 2020, EU countries made significant social progress partly due to EU-level measures that supported the design and implementation of social policies at national level. Unemployment rates, which peaked in 2013 post-Global Financial Crisis, declined steadily. Increased labour income and social transfers boosted household disposable income and reduced at-risk poverty rates. However, progress has been challenged by COVID-19 and the energy crisis.

Despite the rapid mobilisation of massive EU funds, the pandemic ended a six-year continuous employment growth cycle

In the first half of 2020, the pandemic caused a deep recession and, despite the rapid mobilisation of massive EU funds, ended a six-year continuous employment growth cycle. The pandemic also contributed to the widening skills gap by accelerating the digitalisation of both public and private sector activities. Following the pandemic, the energy price spike in 2022 led to a surge in inflation and caused a cost-of-living crisis, which exacerbated inequalities.

Navigating structural transformations and mitigating the adverse impacts of transitory shocks, your predecessor implemented significant EU social policy measures including the SURE instrument to safeguard employment (2020), the Directive on Adequate Minimum Wages (Directive (EU) 2022/2041) and the Platform Work Directive (2024). Your predecessors also mobilised various funding instruments to support EU social policy measures, with the European Social Fund Plus (ESF+) serving as the primary funding source.

An ageing population and shrinking workforce

EU labour markets are changing against the backdrop of ageing populations. The number of working-age individuals peaked at 270 million in 2010 and has since been steadily decreasing, reaching 262.4 million in 2022. The significant influx of refugees (about 3.2 million in 2022) has temporarily alleviated the impact of the declining working-age population, but these arrivals do not provide a long-term structural solution and the downward trend will resume. The retirement of older workers is already exacerbating labour shortages, particularly in industries with subpar working conditions.

A shifting age structure will have major implications for social security systems, notably pensions and long-term care

A shifting age structure will have major implications for social security systems, notably pensions and long-term care (LTC) – citizens need both for welfare in old age. Pension and LTC policy are national responsibilities. Nevertheless, you have some tools at your disposal to foster positive convergence among countries, as reflected in the communication on demographic change (European Commission, 2023a). Pension and LTC issues also feature in some countries' legally non-binding European Pillar of Social Rights action plans.

The structure and coverage of pension and LTC systems are very different in various EU countries, resulting from their distinct preferences and histories. However, the Commission can identify best practices, benchmark national systems and advise governments on their reform efforts. The EU also provides financial support in these policy areas. The 2021-2027 ESF+ programming period includes €6.7 billion for healthcare and LTC. Furthermore, pensions and LTC policies feature in some countries' post-pandemic Recovery and Resilience Plans.

The Commission supports member states on pensions with monitoring and analytical activities, such as the projection of future ageing expenses. It monitors the financial sustainability of pension systems under the Stability and Growth Pact and the European Semester. More recently, your predecessor put more emphasis on pension adequacy. Furthermore, Commission initiatives not directly targeted at the pension sector impact pension matters. The Pay Transparency Directive (Directive (EU) 2023/970) and its enforcement should help close the substantial gender pension gap that still exists in the EU. The Work-life Balance Directive should also help in this respect.

While pensions are a longstanding issue for the Commission, The pandemic showed that the long-term care sector is already under strain in many EU countries

LTC has received increased attention more recently. The pandemic showed that this sector is already under strain in many EU countries. A significantly larger share of elderly people in the population will lead to rising demand for LTC. Your predecessor published the European Care Strategy in September 2022 (European Commission, 2022) to promote access to high-quality LTC services and to improve the situation for those needing care and those providing it. The Council subsequently adopted a recommendation in December 2022. The Strategy notably establishes an information and knowledge exchange mechanism through national coordinators, which is very welcome. Furthermore, the Commission has been supporting member states in implementing structural reforms in health, social care and LTC through a 2023 Flagship Technical Support Instrument (TSI), and a proposed 2025 Flagship TSI on Demographic Change[17].

Challenges

Your main challenge will be to assist the EU labour market in managing the impact of technological change, the green and digital transitions and the demographic shifts, while ensuring inclusivity and maintaining the stability of the social security systems in the long-term. Achieving the EU's strategic objectives will only be possible if labour markets and social security systems are concurrently reformed.

Skills shortages

Shortages of skills, whether basic or advanced, pose recruitment challenges for all companies, especially SMEs. While most companies struggle with skills shortages, many workers report that their skills are underutilised. Skills shortages (and skills mismatches) hinder technology adoption and EU competitiveness, and also slow down the green transition.

17 See European Commission, 'Flagship Technical Support Projects', undated, https://reform-support.ec.europa.eu/our-projects/flagship-technical-support-projects_en.

The difficulty of activating underrepresented groups

A significant number of individuals aged 20 to 64 (53 million, 20 percent), are not in the labour force. Among them, only one in six express a readiness to work. Almost 40 percent of these inactive individuals are aged 55 to 64, with women constituting up to 63 percent. The vast majority have at most a high school level qualification (83 percent). Activating these underrepresented groups is a main policy area identified in the March 2024 action plan for tackling skills and labour shortages (European Commission, 2024). Yet, a comprehensive understanding of the reasons for low labour force participation among these underrepresented groups is lacking.

Persistently low training participation

Despite the importance of reskilling and upskilling in a changing labour market, training participation remains low

Despite the importance of reskilling and upskilling in a changing labour market, training participation remains low: only 46 percent of adults participate in training with only 10 percent of survey participants citing access barriers, according to Eurostat. Low training participation is primarily due to a lack of anticipation of the need for reskilling/upskilling (32.2 percent). This pattern has persisted for decades, but the underlying reasons remain poorly understood.

Risks of skilled third-country migration

Policies easing skilled migration from non-EU countries carry inherent risks. First, influxes of skilled migrants may discourage domestic skills development if skilled migration proves to be cost-effective. Additionally, third-country labour migration may introduce new challenges in ensuring proper working conditions. Social dialogue plays a crucial role in maintaining adequate working conditions, but migrant workers often lack access to these networks, making them more vulnerable to substandard working conditions arising from language barriers, subcontracting, social security fraud, undeclared work and inspection difficulties. Similar instances have already been observed with third-country haulage drivers working within the EU borders.

Tension between financial sustainability and adequacy of pensions

The demographic transition will increase the financial burden on pension systems, particularly pay-as-you-go systems, which are still the dominant form of pension provision across the EU. The EU-wide old-age dependency ratio, or the number of people aged over 64 relative to the working-age population, stood at 36 percent in 2022. The ratio is projected to increase to 55 percent in 2050 and 65 percent in 2100.

Without reform, population ageing might result in soaring pension liabilities that jeopardise fiscal sustainability

Without reform, population ageing might result in soaring pension liabilities that jeopardise fiscal sustainability. Your challenge is to advise countries in their reform efforts with a view to improving financial sustainability of pension systems while ensuring pension adequacy, especially for the vulnerable. Notably, a substantial gender pension gap persists in the EU, despite past policy action.

Insufficient long-term care supply

Elderly citizens need adequate income in old age and also access to the services they need. Countries must prepare for a significant increase in demand for care services. The care sector needs to be made more attractive to workers, and investments in equipment and infrastructure are needed. Insufficient preparation of LTC systems would be particularly harmful for women, who supply the majority of informal care in Europe.

Utilising emerging technologies while mitigating the risks

Emerging technologies including machine learning and artificial intelligence have the potential to create jobs, optimising labour allocation and increasing productivity. However, their overall impact on labour markets remains uncertain and will largely depend on the regulatory framework and how the workforce adapts to changing skills demand. These technologies also raise various concerns, including but not limited to job security, wage polarisation and working conditions. Misuse of emerging technologies poses several risks to workers, such as algorithmic bias in recruitment, promotions and workplace evaluations, or algorithmic management and surveillance prioritising efficiency over worker wellbeing.

Despite these challenges, emerging technologies also offer numerous opportunities. Innovative job design can increase labour force participation among individuals with physical or cognitive limitations, and flexible work arrangements can help balance work with personal responsibilities. Technology-based training initiatives can boost training participation, and advancements can reduce labour requirements in shortage occupations and industries by automating routine tasks. However, implementing these technologies often requires significant investment in R&D and infrastructure. While the private sector already invests heavily in technology design, commercial interests do not always align with the public interest and the EU's strategic priorities. Hence, the EU's presence in technology design is of crucial importance.

Recommendations

Address skills and labour shortages: wages, working conditions and technology

You should monitor carefully the implementation of the Directive on Adequate Minimum Wages in the EU, particularly in shortage occupations where wages often lag behind jobs not affected by shortages. Active labour market policies, such as employment/wage subsidies, could bridge the gap between market and reservation wages, thereby alleviating labour shortages. An EU instrument allocating funds (grants and/or loans) to partially offset governments' revenue losses would enhance the attractiveness of such active labour market policies at member-state level. You should explore the potential employment impact of increased wages in shortage occupations, and provide an assessment of mobilising the ESF+ to promote better wages in these occupations.

Maintain the focus on improving working conditions

There is an urgent need for a directive to improve working conditions in shortage occupations to attract more workers into these occupations, especially in sectors that will face increased future demand, such as LTC. You should ensure that the welfare of formal and informal carers is reflected in the implementation of the Work-life Balance Directive, for example through the 2025 TSI on demographic change. Working with the commissioner responsible for home affairs and the European Labour Authority, you should also ensure that decent working conditions extend to third-country migrant workers.

Support the use of emerging technologies by assisting with the regulatory framework and providing funding

The Platform Work Directive regulates algorithmic management for platform workers; however, algorithmic management extends beyond platforms. Therefore, you should facilitate discussions about expanding these rules to cover all workers. You should also ensure that the EU can leverage the opportunities offered by emerging technologies. To support innovative ideas that utilise technology to enhance employment access of underrepresented groups and to reduce labour demand in current and future shortage occupations, you should mobilise EU funds through specific calls for proposals under the EU Programme for Employment and Social Innovation or innovation actions under Horizon Europe.

Improve labour market support for older workers

You should facilitate structural reforms and activation strategies for older people (aged 54 to 65) across the EU, to help them navigate changing labour markets. By preparing a proposal for council recommendations on addressing employment challenges faced by older workers, you can promote the development of an EU instrument that would help older workers remain active and engaged in the workforce for longer. Such an instrument would not only prevent widening labour shortages in already constrained occupations, but also has the potential to increase the effective retirement age beyond the statutory retirement age, thereby reducing the pressure on pension systems.

You should facilitate structural reforms and activation strategies for older people, to help them navigate changing labour markets

Integrate the assessment of pension, healthcare and LTC policy

You can play an important role in establishing a strategic, long-term vision for social policy and in helping member states achieve it. You are well-placed to make a holistic assessment of social security provision in old age, encompassing pensions, healthcare and LTC. Financial sustainability of these systems should be evaluated alongside adequacy of services. Low-cost access to high-quality LTC for the elderly could, for example, justify a lower pension level.

The European Care Strategy (European Commission, 2022) provides an important platform for exchange and identification of best practices. However, policymaking would benefit from a more holistic view of old-age welfare. You can play an important role in fostering such an approach together with other commissioners, particularly for economic and financial affairs. Such an effort should include data exchange and analytical work on a country-by-country basis, given the range of pension and LTC systems across countries and differences in the rapidity of population ageing. With a sound set of best practices in hand, EU countries can decide which actions are most appropriate for their circumstances.

More funded pensions would help develop the base of institutional investors in the EU and provide capital for long-term projects

The impact of social security reforms on the larger economy should also be analysed and taken into account. More funded pensions would notably help develop the base of institutional investors in the EU and provide capital for long-term projects, contribute to the deepening of capital markets and support investment in the EU more generally.

Increase long-term care supply

You should continue the coordination efforts regarding best practices in LTC policies within the European Care Strategy. Particular focus should be put on effective policies to increase the supply of LTC, in terms of both personnel and physical assets (facilities and equipment).

You and your colleagues should promote investment in care services and infrastructure in two ways. First, you can investigate which investments have proven effective across member states in the context of the European Care Strategy. Second, the Commission can provide financial support, for example through an expanded ESF+.

You should work to maximise use of the findings of the European Care Strategy in the 2025 TSI on demographic change. The TSI should notably carefully examine the impact of reform proposals on women and gender equality.

Fund research into healthy ageing

EU funds should be used to finance research in support of healthy ageing

EU funds should be used to finance research in support of healthy ageing. This will be the most effective measure to contain the pressure on LTC systems in the future. Priorities should include technology to detect cognitive diseases early and medicines to treat them. Given the projected surge in the elderly population, it will be important to reduce LTC needs to minimise the pressure on public health systems. The EU can help identify and finance promising research projects in this area. Such projects could be prioritised under Horizon Europe and EU4Health.

Develop adequate data

You should designate a specific portion of the funds given to member states as direct grants under the Programme for Employment and Social Innovation for the Labour Force Survey to be utilised to uncover the underlying factors influencing individuals' attitudes towards work. Based on better data, EU countries should be supported in the design of targeted interventions to address long-lasting issues such as weak labour market attachment of certain socioeconomic groups and low participation in job-related training.

Data on long-term care also remains scarce, especially on informal care, limiting policy planning. You should also promote harmonised data collection across member states on pensions and LTC. Connecting national data systems would not only be useful for policy planning but can also impact citizens' lives directly. For example, the full establishment of a cross-border pension database would promote labour mobility. Such efforts should be intensified in collaboration with other commission services that would benefit from better data.

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Memo to the commissioner responsible for health

Anne Bucher

Health policy in the European Union is in a stronger situation in the wake of the COVID-19 crisis and the adoption of legislation intended to ensure greater resilience and underpin the response to the next pandemic. In this context, you face challenges of ensuring that health security stays prominent on the agenda, while furthering the reform of EU pharma legislation and doing more on non-communicable diseases, including cancers, cardiovascular disease, diabetes and Alzheimer's.

You should push for greater resources for the Health Emergency Response Authority, pursue an integrated 'one health' approach that takes into account the linkages between human health, animal health and ecosystems, do more to make the EU attractive for highly innovative pharma and seek to extend the Health Union project to non-communicable diseases.

Maintain health policy as a high priority

Boost EU attractiveness for innovative pharma

Extend the Health Union to non-communicable diseases

State of affairs

Your predecessor's term was dominated by the management of the COVID-19 crisis, its global and European aspects and its legacy. As early as November 2020, the European Union started to reflect the lessons of the crisis in a 'Health Union' package, finalised in 2022 and intended to make the health security framework more resilient.

Although the Health Union was conceived as response to COVID-19, its perimeter is much larger. It includes initiatives on pharmaceutical markets, health data and non-communicable diseases (cancer and mental health), and a global health strategy.

During your term, decisions will have to be made on the ambitions for Health Union, whether to implement and consolidate the pipeline of ongoing initiatives, or whether to boost the project further with new proposals for a more integrated European health policy[18].

Better prevent and manage health crises

COVID-19 reminded the world of pandemic risks and made European citizens aware of the role of the EU as a partner to manage health crises. The EU did well to guarantee the integrity of the internal market and adopt emergency measures to protect the economy. Citizens will remember the joint purchase of vaccines, which allowed the EU to vaccinate 70 percent of the population by the end of 2021, just one year after the market launch of new vaccines. Access to vaccines and the common digital COVID-19 certificate were critical to exit the pandemic and end restrictions on social and economic life.

Access to vaccines and the digital COVID-19 certificate were critical to exit the pandemic

Vaccine purchases were successful exceptional crisis responses. But the EU cooperation framework for health security was less effective than expected in providing a coordinated response to COVID-19. National priorities and conditions determined member states' responses to the pandemic. The EU took stock of the weaknesses in coordination and adopted the Health Union package to strengthen the existing mechanisms.

18 In the absence of Treaty change, this is limited to supporting cooperation between EU countries on public health and cross-border health threats, and organising markets for medicines, medical devices, blood, tissues and organs. EU policy must respect the exclusive competence of member states for health policy and healthcare services.

The most significant change under the Health Union was the creation of the Health Emergency Response Authority

The most significant change under the Health Union was the creation of the Health Emergency Response Authority (HERA) in 2021 as a Commission directorate general. HERA was set up as a European counterpart to the United States' BARDA (Biomedical Research and Development Authority), which oversees development and purchasing of medical countermeasures (vaccines, therapeutics and diagnostics) for health crises. HERA has already a track record in setting up schemes for vaccine production (EUFABLAB), clinical trial platforms for crisis medicines and vaccines (VACCELERATE) and joint purchases. It is being evaluated and you will have to decide its future.

Reform of the pharma legislation

The COVID-19 crisis has been enlightening in terms of the capacity and limitations of pharmaceutical markets to respond to needs in crisis. The development of innovative mRNA vaccines within less than a year was an unprecedented scientific success. The ability to ramp up vaccine production within half a year was a sign of a dynamic ecosystem. At the same time, health systems suffered shortages of basic medicines.

The COVID-19 experience shaped the far-reaching pharma reform proposed by the Commission in 2023. This reform includes framework legislation and specific regulations, such as for orphan or paediatric medicines. It also extended the mandate of the European Medicine Agency (EMA) to include monitoring for medicine shortages. Access, affordability, availability of medicines, innovation and the environmental impact of the industry are at the heart of the reform. Medicine shortages, which have become chronic and affect a large part of the market are considered of utmost priority, making temporary measures necessary pending adoption of the legislation. Immediate measures have been put in place: a new alliance with all partners, regulators and industry to secure value chains; the adoption of a list of critical medicines; and monitoring of national and European markets by national medicine agencies and the EMA. Negotiations on the pharma reform; the European Parliament adopted its position on the package in April 2024.

The European Health Data Space

The EU has been very effective in using its political leverage to speed up the digital transformation of health

The EU has been very effective in using its political leverage to speed up the digital transformation of health. The healthcare sector has not been an early adopter of digital technologies. But the EU made health a priority sector for the new wave of innovation brought by artificial intelligence: the European Health Data Space Regulation (EHDS), finalised in spring 2024, is the first sectoral application of the EU data strategy. It is an ambitious law that puts in place a European framework for patients' electronic health records, access to them by patients and professionals and their use for research and policy purposes. However, implementation will pose significant challenges: supporting the development of markets for interoperable IT solutions for patient data; upgrading the European platform, MyHealth@EU, an infrastructure for cross-border exchanges of patient records; coordinating the network of bodies for access to health data that member states will have to set up.

Global health

The EU has been active on the global stage during and since the pandemic. The EU was an early promoter of a World Health Organisation pandemic treaty, and a major contributor to the new international Pandemic Fund. It is also an important actor and investor in global health through the Neighbourhood, Development, and International Cooperation Instrument (NDICI). The EU has all the assets to play an even bigger role in global health and the Global Health Strategy (2022) identified new partnerships and contributions to global initiatives such as research, environmental health and pandemic prevention.

Other health initiatives

Several other initiatives, not less important than those above, fall within the scope of more traditional EU intervention in health: cooperation between EU countries, exchange of best practices and funding from the EU4Health programme. This includes the Europe's Beating Cancer Plan (2022), which could be prolonged, the comprehensive approach to mental health initiative (2023), which is to be implemented, rare diseases and the European

Reference Networks (ERNs), which are 24 specialised networks covering different rare diseases involving 300 university hospitals, set up in 2017. They share knowledge and provide telemedicine services for rare diseases. They could be considered as prototypes of EU cooperation between healthcare facilities. The ERNs are being evaluated and you will decide on their consolidation and expansion.

Challenges

You will have much to do to deliver on the post-COVID-19 agenda

You will have much to do to deliver on and implement the post-COVID-19 agenda. However, you may face the risk of a decline in interest in European health policy, which has never been a priority for national governments and might attract little support from a less pro-EU European Parliament. Choosing your priorities and political battles carefully will be key for success in consolidating progress and avoiding setbacks.

Keep health security on the agenda

Pandemics are prone to 'panic and neglect' cycles and the negotiations on the Health Union package have shown that member states are lukewarm about more coordination at EU level for pandemic prevention and response.

Your first challenge will be to develop and maintain very good and open cooperation between different layers: cooperation between EU countries in the Health Security Committee, interaction with the WHO and the global health community, cooperation between EU agencies (the European Centre for Disease Prevention and Control, HERA, EMA, the European Food Safety Authority, the European Environment Agency). Such partnerships are indispensable to take into account the linkages between human health, animal health and ecosystems in an integrated 'one health' approach. Over the last five years, there have been several political commitments for countries to cooperate, but the framework remains fragmented, untested and not yet crisis-proof.

Your second health-security challenge will be to make a success of the new authority, HERA. HERA has limited resources and draws on a few funding programmes which are not fit for high-risk investment in development and production of innovative medical products for use in crises. HERA is also increasingly involved in the initiatives on medicine shortages. The previous Commission outlined a roadmap on strategic autonomy for medicines. You will likely benefit in this respect from consensus among and support from member states, and probably industry, to implement it. But there is a risk that HERA's limited resources reduce its ability to focus on crises.

Better functioning pharma markets

The first part of your mandate will focus on finalising the pharma reform and reversing the trend of chronic medicine shortages in the EU. The debates on the reform package are likely to remain highly contentious and it will not be easy to finalise a balanced package of obligations and incentives for the pharmaceutical industry.

Pharma reform should preserve an innovation-friendly environment for industry

The reform should preserve an innovation-friendly environment for industry. The pharma sector is very research-intensive, and the failure rate of research is high. With more complex treatments and diseases to address, the R&D costs per medicine have been increasing (Simoens and Huys, 2021) and the business model has moved from a model of blockbusters to a model of 'niche-busters,' with higher prices and less scientific certainty on medical effectiveness. Measured by the increasing share of medicines addressing unmet needs in market authorisations (Bouwman *et al*, 2024), the trends point to a continuous increase in innovation. The pharma industry exhibits a stable profitability rate, higher than in most other sectors.

However, there is a need to tackle several unfavourable trends. Some markets, mainly in small or less-developed member states, remain underserved because industry does not consider them profitable. Mismatches between supply and demand persist with unmet needs (antibiotics; very rare diseases) or marketing of medicines with low added value. Industry sees EU markets as less and less attractive because of the oligopsony structure, with public authorities or social insurance funds negotiating prices and sales volumes. Overall, the EU pharma industry has lost ground over the years compared to international competitors. The production of active pharmaceutical ingredients (APIs) has moved outside the EU to benefit from lower production costs in India or China. With a market share of 24 percent of API production in 2015, Europe is specialised in the high-end segment of the market. However, China and India outperformed Europe over the last 20 years and it is estimated that two thirds of API quality certificates are held by Indian and Chinese manufacturers (European Commission, 2021). Meanwhile, the US has become increasingly more attractive for innovative medical research thanks to a dynamic biotech ecosystem and a more favourable regulatory and market environment, offering a large market with much higher prices than in the EU. Europe accounted for 19.3 percent of global clinical trials activity in 2020, a decrease of 6.3 percent, compared with a 25.6 percent average over the previous decade (EFPIA, 2022).

The pharma reform is timely. It is encouraging more competition through earlier entry of generics. It is offering longer regulatory protection for medicines responding to unmet needs, and launched on the 27 member states' markets, and a transferable exclusivity voucher for new antibiotics. The negotiation will challenge this new balance of incentives.

Getting more done on non-communicable diseases

The EU's legitimacy is weaker for actions in areas such as non-communicable diseases, health systems and health inequality

The EU has been playing an increasingly strategic role in health security and in regulation of medical products. But its legitimacy is weaker for actions in other areas, such as non-communicable diseases, health systems and health inequality. EU action in these fields is constrained by the competences set out in the Treaty. But at the same time there is strong political pressure for action from civil society, including patients' organisations and health professional associations. In these areas, the track record of the EU is characterised by fragmented and discontinuous actions, with uneven support from member states.

The EU4Health programme is a useful tool to support the various health policy initiatives. But there is a need to streamline actions to create a critical mass of interventions and make them visible. Rare diseases, chronic diseases, ageing, mental health and environmental health are the areas that need strategic steering.

The launch of the Health Union project has created expectations and you cannot start your mandate without clear views on its development, and whether and how you want to contribute to its consolidation in these areas.

Recommendations

The success of your mandate will be measured by the successful delivery of the existing pipeline of policy initiatives and your ability to set the EU Health Union on a credible path.

Two 'must-dos' for health security

The immediate task you will be faced with will be to put HERA on a sound footing

The immediate task you will be faced with will be to put HERA on a sound footing. Currently, HERA is being evaluated. It has limited resources relative to its responsibilities and there are overlaps in risk evaluation and management with the European Centre for Disease Prevention and Control (ECDC) for major threats, and with EMA for medicine shortages. In the current set up, HERA is not designed and resourced to support large-scale investment in research and development for counter-medical measures. HERA could host such a function, which could take the form of a European public infrastructure for pharmaceutical research and development. But it would need an adequate budget. The first recommendation is that at constant resources and mandate, HERA might be better off if merged with the ECDC. This would bring the advantage of operating as an agency without creating a new one, and it could build synergy with ECDC on risk assessment and preparedness measures.

A 'one health' approach'

The post-COVID-19 period has been rich in creating plans and partnerships at European and international levels. Emerging zoonotic pathogens and antimicrobial resistance are major threats to the EU, and require a 'one health' approach to national and international cooperation. The EU is well positioned, with competence in animal health and environment. It is also supported by a network of independent scientific agencies that have records of cooperation with national counterparts. The second recommendation on health security is an ambitious 'one health' programme with enhanced member-state coordination, stronger mandates for EFSA and the EEA and direct involvement of EU representatives in global governance structures, in particular after the adoption of the pandemic Treaty.

Make the EU attractive for highly innovative pharma

The ongoing initiatives on pharmaceutical markets, though legitimate, fail to address the structural problem of loss of competitiveness of industry, and the widening gap with the US on innovative medicines. This requires a more forceful policy response focused on cutting-edge innovation. You should consider a package of measures along the whole value chain, from research to price setting. This would combine:

Consider a package of measures along the whole value chain, from research to price setting

Setting up an ARPA for Health

Currently, research efforts at EU level are too fragmented (ECDC, HERA, Horizon Europe, EU4Health, European institute of Technology, Innovative Health Initiative) and fail to concentrate resources on the most consensual priorities, such as research for new antibiotics. The EU needs a strong public institution for medical research with resources for top-down priorities and high risk projects – an ARPA (advanced research projects agency) for Health.

Reviewing regulatory bottlenecks to innovation

Highly innovative biological medicines fall within the framework of Advanced Therapies and Medicinal Products (ATMP). These specific rules were not part of the pharma package and with rapid scientific developments in this segment, it is time to check whether the legislation is fit for purpose and implemented consistently across EU countries. Moreover, the pharma reform has left the clinical trial legislation untouched. Clinical trials are authorised by national regulators, which makes clinical research costly and creates unnecessary delays and bottlenecks. A centralised clinical trial protocol under the responsibility of EMA would create a regulatory environment such as that which firms face in the US, and would enhance clinical research in the EU.

Initiatives on new price and reimbursement models

Although the market for medicines is well integrated with central market authorisation delivered by EMA, prices and reimbursement decisions remain national. Such fragmentation is particularly penalising for innovative medicines that target small populations, often with limited clinical data on their effectiveness, and which come to the markets with high prices. Radical innovation requires new pricing and reimbursement models, such as pay-for-performance and annuity models. Member states should set up pilot schemes for new financing models. The new Health Technology Assessment framework, the group of National Competent Authorities on Pricing & Reimbursement and public healthcare payers should examine this possibility as a priority, and EU countries could launch joint public procurement for such cases.

A Health Union for non-communicable diseases

Your ambition should be to develop a Health Union project, with clear benefits for citizens

Your ambition should be to develop a Health Union project, which delivers clear benefits to the European citizen. The current initiatives on rare diseases, cancer and mental health deserve to be continued. But you should extend the 'Health Union' project to non-communicable diseases (NCDs) at large, since they generate the heaviest burden for health systems, are significantly affected by the way public health is addressed in EU policies and are at the heart of health inequalities.

The EU would gain from mutualising research and epidemiology for NCDs. The move towards a comprehensive European epidemiology should be a long-term goal and could rely on research funding and the experience of ECDC. The first step in this direction is to extend the ECDC mandate to NCDs, building on the ECDC cooperation with national public health institutes and fully aligning ECDC with the role of organisations outside the EU, such as the WHO.

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Memo to the commissioner responsible for migration

Jacob Funk Kirkegaard

The European Union's population is ageing and legal migration avenues must be expanded, while addressing concerns about irregular migration into Europe. EU countries retain control over most migration-related regulation, leading to highly diverging national utilisation of residency permits. Issuance of employment-based residency permits has been rising, while in the spring of 2024 the EU agreed a new Pact on Migration and Asylum, resulting in a fundamental reform of the EU approach to border control and asylum management. Immigration remains a politically potent topic and newly agreed common rules to better distribute the burden of irregular migration among all EU countries will prove especially controversial.

You must push reforms to the mandatory solidarity mechanism and to how migration is integrated into EU partnerships with third countries (Team Europe Initiatives), while greatly expanding the scope of the Blue Card, the only common EU-level entry/residence/work permit.

Improve the functioning of the solidarity mechanism

Promote transparency of third-country migration deals

Think bigger on the EU Blue Card

State of affairs

No political issue continues to fuse economic importance and political explosiveness in Europe like immigration

No political issue continues to fuse economic importance and political explosiveness in Europe like immigration. And probably none exposes more brutally the shortcomings of the European Union's distributed sovereignty model. Political families in the European Parliament that are generally sceptical of more immigration to the EU gained seats in the 2024 election, but unaffected by politics, the EU's demographic transition is accelerating.

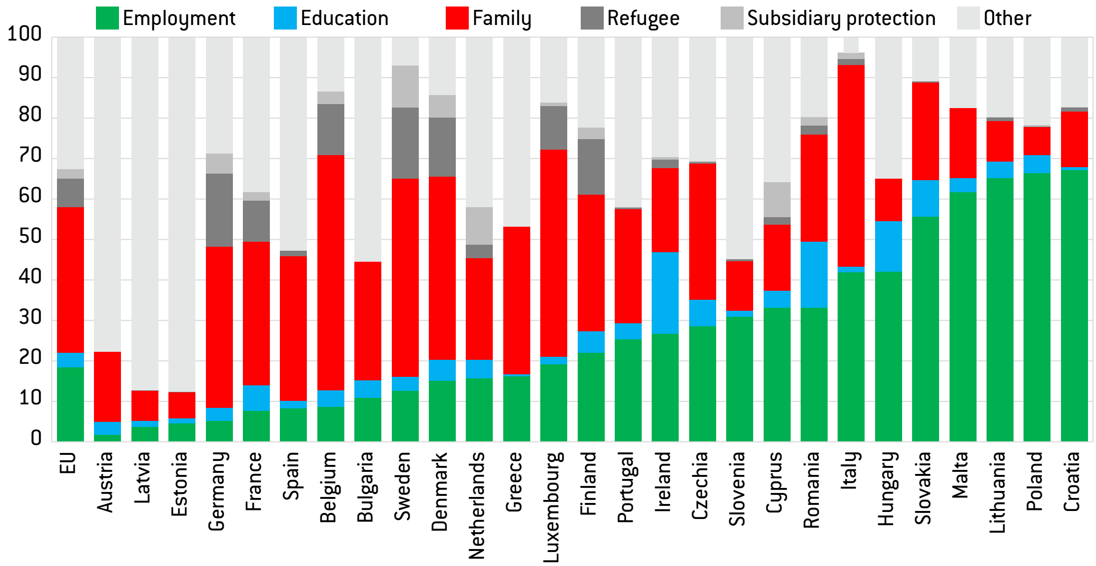
EU total population growth has since the late 1990s been attributable to net migration. As natural population decline accelerates, it is more urgent for EU countries to at least maintain immigration levels at recent historical levels to mitigate the economic and social effects of ageing. Population forecasts already assume this. Eurostat's baseline 2023 population forecast shows the EU's working-age population (aged 15-64) declining by 7 percent or almost 20 million by 2040. This baseline's assumption of net inward migration of roughly 19 million – or more than 1 million annually – is in line with the annual average in the twenty-first century. Without migration, Eurostat estimates that the EU workforce will decline by a whopping 35 million – a 13 percent decrease – by 2040. Global population forecasts moreover suggest that while some individual Asian countries will see faster working-age population declines, only the EU will experience a declining regional workforce in the coming decade.

Legal inward migration, statistically captured through the issuance of residency permits, is split into four main channels: for employment, education, family (reunification) and 'other reasons' (including all asylum and refugee status related categories). In addition to those four legal channels, illegal migration to the EU is occasionally integrated into legal migration through national legalisation drives, granting residency to some illegal migrants.

Legal reality holds that most immigration policy decision-making power, a core manifestation of statehood, continues to reside with EU countries. National capitals decide almost all matters related to legal migration via all four channels. The EU's aggregate legal immigration policy is consequently a spaghetti bowl of incongruent national rules.

Issuance of residency permits to non-EU nationals varies greatly by member state and category. Figure 1 shows this dramatic variation. Approximately a fifth of the EU 'residency permit stock', amounting to 22.3 million valid permits, is attributable to employment and education. Just over one third are issued for family reasons, with the remainder issued to refugees, people under subsidiary protection and for other reasons[19]. In Croatia and Poland, employment-based residency permits dominate, while in Austria almost 90 percent are refugee or protection related. In Belgium almost 60 percent are issued for family reasons.

Figure 1: Valid residency permits, EU and member states, by reason for issuance, % of total valid permits, end 2021



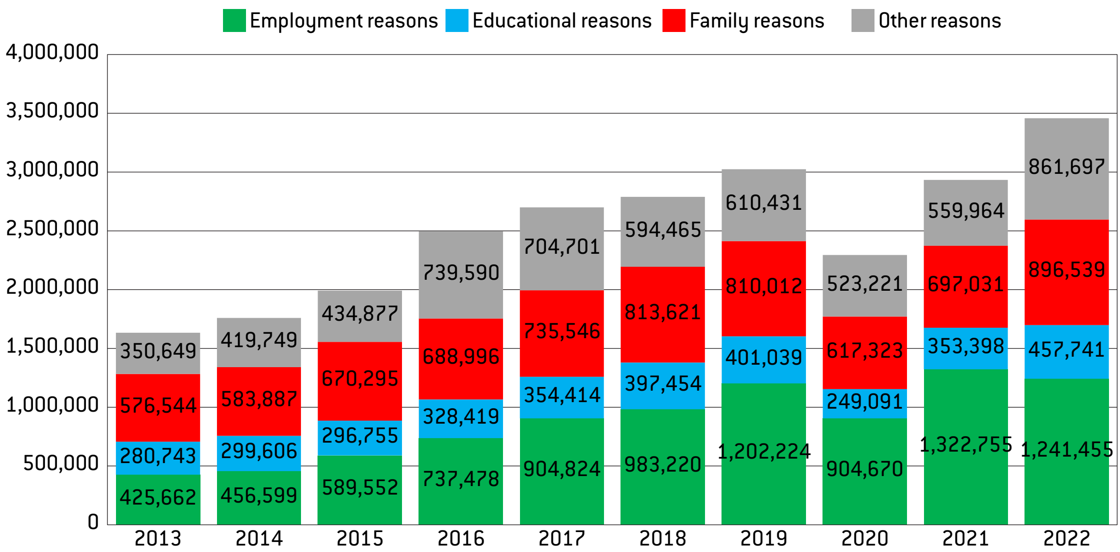
Source: Eurostat.

Meanwhile, significant shifts are happening in the annual issuance of new residency permits. Ignoring the 2020-2021 pandemic dip, issuance of first residency permits in the EU has doubled since 2013. An increase in refugee/humanitarian reasons is visible after 2015, but in the aggregate most of the increase is

19 Other reasons include humanitarian reasons related to residence permits issued under national law, different from refugee status or subsidiary protection (as defined in EU law), unaccompanied minors or victims of human trafficking.

attributable to a tripling of employment-based permits. Since the late 2010s, the new issuance of EU27 residency permits has been split roughly evenly between employment/education reasons and family/humanitarian reasons (Figure 2).

Figure 2: First residency permits issued annually by reason for issuance, EU27, 2013-2022



Source: Eurostat.

While the pandemic lockdowns showed the importance of keeping the EU's internal borders open, the principal border control challenge in relation to migration has been transferred to the EU's external border and transformed from a national to an EU-level policy issue. The ongoing expansion of the European Border and Coast Guard Agency to 2,500 border guards deployed in 2023 to assist national enforcement agencies represents this increasingly shared responsibility. Common external border control in the EU must genuinely alleviate migration-related political and economic stresses in individual countries and see the harmonisation of rules governing legal and irregular migration across the external border.

Progress has been made on integrating rules governing one of the main channels of migration into the EU – namely aspects of asylum regulation (and indirectly irregular migration). A major milestone was reached with the spring 2024 final approval of the EU Pact on Migration and Asylum (PMA). This introduces new common rules aiming at a more integrated EU institutional structure for external border control and asylum management. New identification processes and a new asylum and migration database will be introduced, including common mandatory screening procedures at the EU external border and a more streamlined returns policy.

The controversial Dublin Procedure for determining which EU country is responsible for processing an asylum application has been overhauled and additional operational and financial support from the EU budget is provided to frontline states. The PMA further includes a mandatory solidarity framework for frontline member states under migratory pressure, into which other member states must pledge commitments to receive relocated asylum seekers, financial resources or other types of operational support. Finally, the PMA includes new EU crisis protocols to neutralise the effects of sudden migration crises, also if provoked deliberately by third countries.

Ensuring the timely transposition and initial implementation of the PMA and the setting up of a series of new EU-level institutions mandated by the PMA will be among the major tasks for your mandate.

Challenges

Overall, the EU's legal immigration system is both attractive and working well, something you must help preserve

Overall, the EU's legal immigration system is both attractive and working well, something you must help preserve. Scaling the EU's legal immigration system up further in the face of accelerating ageing and rising public concerns about irregular migration will be challenging. However, failure to do so will result in fewer people employed, lower economic growth, lower government revenues and additional pressure on most aspects of Europe's social market economy. The choice is clear.

The survival of national governments, too, depends increasingly on whether pragmatic migration solutions can be found at EU level. You must remain focused on balancing the economic need for more workers in an ageing Europe with the need to maintain voters' trust that migration is managed adequately.

Your main role will not be to propose new grand immigration designs, but the implementation and incremental improvement of existing legislation

At the same time, however, the prolonged process and political difficulty in passing the PMA in 2024, combined with the numerous other political priorities for you and your colleagues, will in all probability exhaust the political impetus for major new EU-level legislative initiatives on immigration during your term. Your main role will not be to propose new grand immigration designs, but the implementation and incremental improvement of existing and recently enacted EU immigration legislation.

A particular challenge will be the implementation of increased solidarity among EU countries as part of the PMA's Solidarity Pool, the EU's new mechanism to ensure fairer (re)distribution among all members of the burden from irregular migration currently borne overwhelmingly by frontline border states. The pool must annually consist of a minimum of 30,000 relocations (ie pledges from other member countries to accept this number of asylum seekers from a frontline state) and €600 million in financial contributions[20]. The Commission may set a higher annual number for relocations and financial contributions, but as set out in EU Asylum and Migration Management Regulation (AMMR, Regulation (EU) 2024/1351) Article 12, paragraph 3 "*In order to preserve the equal value of the different types of solidarity measures, the ratio between the numbers* [of relocations and financial contributions] ...*shall be maintained*." For this to remain true, it must hold that for each additional relocation, financial contributions must rise by €20,000 per asylum seeker, making this the imputed 'financial cost' of a relocation in the Solidarity Pool. This equals twice the support level – €10,000/asylum seeker relocated as part of the Solidarity Pool – offered directly from the EU budget.

The Commission may lastly, per Article 56, paragraph 2 of the AMMR, include "*alternative solidarity measures*" in the Solidarity Pool. These must be "*in the field of migration, reception, asylum,*

20 Financial contributions are, per Regulation (EU) 2024/1351 Article 56, paragraph 2, money "*provided by Member States primarily aiming at actions in Member States related to the area of migration, reception, asylum, pre-departure reintegration, border management and operational support*". The money is contributed to the EU budget as regular externally assigned revenue (Article 64, paragraph 1) and then subsequently disbursed by the Commission to the member state under migratory pressure.

return and reintegration and border management, focusing on operational support, capacity building, services, staff support, facilities and technical equipment" and must "*be based on a specific request of the benefitting Member State*". The share of each contributing member state to the Solidarity Pool is set by the share of its population (50 percent) and GDP (50 percent) in total EU population and GDP, establishing that in principle each EU member state should contribute both accepted relocations and money.

The details of the Solidarity Pool are highly complex, reflecting its controversial subject and the hard-fought compromise behind it

Evidently, the details of the Solidarity Pool are highly complex, reflecting its politically controversial subject and the hard-fought compromise behind it. Indeed, details of its precise annually agreed contents are to be kept confidential, from when the Commission makes its initial recommendation for the Pool's content for the year to when the Council approves the implementing act.

A number of EU countries find it extraordinarily difficult to politically accept any relocated asylum seekers as part of the new Solidarity Mechanism. Poland's Prime Minister Donald Tusk has already vowed to "*find ways so that even if the migration pact comes into force in roughly unchanged form, we will protect Poland against the relocation mechanism*"[21]. Successful implementation of the PMA requires this political reality to be confronted.

Recommendations

You should seek to improve the EU's immigration framework touching on two of the main channels of immigration – refugee and asylum and employment-based migration flows. Reforms should be made to the mandatory solidarity mechanism (Regulation (EU) 2024/1351), to how migration is integrated into EU partnerships with third countries, and to the functioning of the Blue Card, the only (sort of) common EU-level entry/residence/work permit.

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21 *Reuters*, 'Poland won't accept migrant relocation mechanism, PM says', 10 April 2024, https://www.reuters.com/world/europe/poland-wont-accept-migrant-relocation-mechanism-pm-says-2024-04-10/.

Improve the functioning of the solidarity mechanism

Probably the most controversial aspects of the PMA, the solidarity mechanism, establishes an annual 'Solidarity Pool.'

To ensure that the solidarity mechanism works as smoothly as possible, you should accommodate inevitable political demands by member states to accept zero relocations. However, reducing their shares of relocations from the Solidarity Pool below the level implied by their populations and GDP shares must come at a significant additional financial cost.

Replacing genuine solidarity with money is not optimal, but is the most attractive second-best policy option for the EU

The additional financial contributions by such member states should not be €20,000, but €100,000 per 'avoided asylum seeker,' scaled to the current year GDP per capita of the country relative to the EU average. This will ensure that countries that are politically reluctant to share the burden of relocations, adequately compensate affected frontline states financially for their renouncement of agreed EU solidarity. Replacing genuine solidarity with money is not optimal, but is the most attractive second-best policy option for the EU.

Improve transparency and accountability of Team Europe Initiatives

The previous Commission moved to embed migration into the EU's comprehensive partnerships with neighbouring countries and sought to "*shift to a more pragmatic and assertive way of ensuring our own* [migration-related] *interests are reflected in the partnerships we maintain, not shying away from using leverages, both positive and negative*" (European Commission, 2024). Such 'negative leverage' includes the EU removing visas and trade access under the General System of Preferences from third countries unwilling to accept the return of their nationals who are denied entry to the EU. Positive incentives include expanded trade access and legal migration options, Global Gateway investments and additional development aid.

The so-called Team Europe Initiatives, spearheaded by the Commission President and interested member state leaders, in principle cover all four channels of migration (and illegal migration). Migration related agreements have to date been signed with Tunisia (July 2023), Mauritania (February 2024), Egypt

(March 2024) and Lebanon (May 2024), expanding on the earlier migration-related agreements with Libya (October 2015) and Turkey (March 2016). Announced Team Europe 'deals' generally include significant EU financial support for the country, in return for economic and financial reforms and assistance in combatting human trafficking and smuggling, and improved conditions for safe, voluntary and dignified returns of rejected asylum seekers and other migrants – figuratively a 'wall of cash' to protect the EU's external borders.

Given how the EU's immediate neighbourhood is currently governed, it is unrealistic to expect human rights, press freedom and other political-reform requirements to feature in Team Europe Initiatives. Yet you must improve the longer-term legitimacy of these arrangements.

Ensure regular public accountability for the financial flows to these regimes, including European Parliament scrutiny of EU budget related aspects

MEPs should be able as part of this process to also evaluate the indirect effects of such agreements on relevant human rights, press freedom and other political issues in partner countries. You should present regular biannual reports covering cash disbursements to and *quid pro quo* reform progress in partner countries to the public and the European Parliament. Migration-related aspects of these bilateral relationships should be part of highlighted sections of the Commission's forthcoming PMA mandated annual reporting on migration issues.

Think bigger on the EU Blue Card

The EU needs more workers, but member states continue to utilise employment-based national residency permits at greatly varying frequencies

The EU needs to attract more workers, but member states continue to utilise employment-based national residency permits at greatly varying frequencies. Malta and Cyprus issue most national employment-based residency permits. In richer EU members, free movement of labour from elsewhere in the EU can to a great degree substitute for inflows from outside the EU, but this is not relevant for the EU as a whole. The highly divergent use of national employment-based residency permits suggests policy space for a common EU initiative expanding the EU Blue Card.

The Blue Card has not been successful in attracting materially more skilled workers to all of the EU. This is highlighted by it accounting for just a fraction of the roughly 1.2 million national employment-based first residency permits issued by member states in 2022. The approximately 82,000 Blue Cards in 2022 can be more accurately described as an extra access channel to the German labour market, given that about 85 percent of Blue Cards have over the recent decade been first issued by Germany.

The reformed Blue Card Directive (Directive (EU) 2021/1883) entered into force in November 2021 and was supposed to be implemented in all member states by November 2023, though not all met this deadline. The reformed Blue Card rules include more flexible entry and residency criteria, lower minimum salary thresholds and facilitation of cross-border moves in the EU and family reunifications. In April 2024, the Council further adopted a reform of the Single Permit Directive, aiming, like the Blue Card reform, to make the rules more attractive to skilled workers from third countries. Among other changes, the application procedure has now been cut to a maximum duration of three months, and short stints of unemployment no longer mean the loss of residency.

Given the scale of the future labour challenge facing the EU, you must think bigger with the Blue Card

These reforms evidently go in the right direction towards creating more attractive arrangements for third-country nationals at EU level. Yet, given the scale of the future labour challenge facing the EU, you must think bigger with the Blue Card.

Include students

There are currently over 1 million students in tertiary education from non-EU countries enrolled at educational institutions in the EU.

Not all will graduate, but you should propose that the relevant member state offer those who do an automatic EU Blue Card, giving the option of staying and working in the EU. Functionally, the degree earned in the EU could substitute for an employment contract and grant EU residency for up to one year after graduation. And such offers should not be limited to just tertiary education graduates, but should include graduates from secondary educational institutions or other relevant professional training. If labour shortages in specific industries or sectors – say agriculture or long-term care – are found in enough member states to cross the minimum ‘enhanced cooperation’ threshold of nine members, why not seek to alleviate such cross-border labour shortages by making more Blue Cards available?

Currently Blue Cards are valid for between one and four years and are potentially renewable once. You should seek to ensure that third-country workers, who have exhausted their Blue Card stays, but otherwise satisfy all relevant criteria, have options available to them to remain resident and employed in the EU. Better and preferably explicit links between the Blue Card system and member-state provisions for permanent residency must be created, making the Blue Card a potential stepping stone to permanent employment-based residency in the EU.

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Memo to the commissioner responsible for energy

Simone Tagliapietra and Georg Zachmann

The great momentum in Europe's energy transition must continue during your mandate. Electrification is the primary tool for reaching climate targets. Fortunately, you take office against a backdrop of huge global innovation and cost reduction in clean technologies. Your first challenge will be to ensure security of energy supply as electrification raises questions about infrastructure and cyber-security risks. You will also need to deploy efficient frameworks, including a European fund, to ensure the necessary green investments are made, particularly in European electricity grids.

You should work with national capitals to eliminate remaining energy imports from Russia. You should lead negotiations on the 2040 climate targets, which would see EU emissions falling by 90 percent compared to 1990. Finally, you should propose a European Energy Agency to deliver the better data policymakers and investors need to better understand Europe's energy transition.

Resolve electrification infrastructure issues

Promote investment, especially in grids

Exit the energy trade with Russia

State of affairs

Contrary to what in 2019 was expected to be an unexciting implementation mandate, your predecessor had to manage the most turbulent period ever for the European energy portfolio. First, the pandemic slashed energy demand and derailed investment plans. Then Russia invaded Ukraine. Europe had to replace Russia as its dominant energy supplier – no small feat considering that in 2021 Russia provided about 40 percent of the natural gas, half of the coal and a quarter of the oil imported into the EU. Simultaneously there were large nuclear power shortfalls and a once-in-a-century-drought.

The embargo on imports of coal, oil and oil products from Russia will remain in place for the foreseeable future, and gas imports from Russia via pipeline will remain drastically limited. The emergency reconfiguration of Europe's energy imports is thus set to solidify. Given the geopolitical context, remaining direct and indirect imports of Russian fossil fuels – in particular liquified natural gas (LNG) – and nuclear fuels could end at any time.

Skyrocketing gas prices propelled inflation and led to a fall in gas demand of 19 percent between 2019 and 2023, while electricity demand fell by 7 percent. Thanks to broadly coordinated national policies and the power of the internal market, the acute energy crisis came to an end. Gas storages are filled well, electricity and gas wholesale prices have returned to 2021 levels and electricity demand has stopped declining. But several remaining challenges and emerging cracks still need to be addressed.

The transformation of Europe's energy sector – which is expected to decarbonise fully by 2040 – is far from guaranteed

The transformation of Europe's energy sector – which is expected to decarbonise fully by 2040 – is far from guaranteed. Meeting the next milestone – the 2030 targets – is only six years away. It requires almost doubling the share of renewable energy in final consumption (in 2022 it was 22.5 percent, while it needs to reach 42.5 percent in 2030). This is a very tall order: some EU countries do not want to commit to the national efforts that will be needed.

Meanwhile, energy efficiency targets will require a reduction of more than a fifth in primary energy compared to 2022. This is not going to be easy either, but high energy prices and electrification of transport and heating can help. However, this electrification will bring with it a need for huge investments in electricity generation and grids. Obligations such as the phase-out of new internal combustion engine cars by 2035, and targets such as increasing hydrogen consumption to 20 million tonnes by 2030, will also require substantial investment. Overall, Europe is on the brink of a massive green-energy investment wave. The EU will have to spend about 3 percent of annual GDP on energy-related investments (excluding transport), versus 1.7 percent in the 2011-2020 period.

Electrification will be at the centre of Europe's energy transition. The European Commission (2024) expects electricity to account for more than 62 percent of final energy consumption by 2050, up from a projected 33 percent in 2030. Hence, investment in the electricity system will be a core driver of energy costs. Fine-tuned rules are needed to enable markets to develop and run a continental electricity system efficiently – such coordination is currently not in place. Cross-border networks are too limited, some power plant dispatch is still inefficient and, most importantly, there is little-to-no regional coordination of national power system development. Coordination means investment in clean-energy generation and storage as well as the use of demand side flexibility. Europe's Energy Union must increasingly become an Electricity Union (Zachmann *et al*, 2024).

Cross-border networks are too limited, some power plant dispatch is still inefficient and there is little-to-no regional coordination

The energy transition will reduce energy costs in regions with abundant access to cheap clean electricity – known as the renewables-pull effect (Samadi *et al*, 2023). Previously favourable factors for energy-intensive industry location decisions, such as access to coal and gas, will quickly lose their relevance. The threats (or opportunities) arising from relocation of sectors within countries, within Europe and globally, creates dangerous political incentives to use energy-policy tools to shape energy prices for industrial users.

While the European energy system demonstrated its resilience to price shocks, costly national support schemes were required to partially buffer consumers from the most negative consequences. Structurally increasing the share of energy costs in household expenditures (currently between 11 percent in 2020 and 13 percent in 2022) remains politically very difficult.

Internationally, decoupling from Russia is likely to prove permanent. Over the course of the next two decades, EU energy imports are expected to decrease substantially (from 800 Mt of oil and gas in 2021 to 300 Mt in 2050). In the meantime, the United States is set to assume a very important role in LNG exports to the EU. The EU will need to also prepare the energy dimension of enlargement – especially to Ukraine.

The global roll-out of clean technologies and continued investment into R&D gift the EU with continuing cost reductions

The good news is that the global roll-out of clean technologies and continued investment into research and development gift the EU with continuing cost reductions (Claeys *et al*, 2024). Solar PV deployment has continued to accelerate, with global capacity additions in 2024 expected to be nearly triple their 2019 levels, while onshore and offshore wind capacity is still growing rapidly. Since 2019, the cost of batteries for use in stationary storage and electric vehicles has dropped drastically. Continued technical improvements in efficiency and capabilities thanks to deployment of these clean technologies are an enormous and transformative help. Some highly acclaimed technologies such as small modular reactors and hydrogen electrolysis, have not yet seen their commercial breakthroughs, while geothermal and district heating are coming back into fashion. Your mandate will likely feature many fascinating and some unexpected technological developments, including occasional disappointments. Most of those will, however, be more relevant for the 2050 planning horizon than the deployment plans during your mandate.

Challenges

Ensuring energy security will remain a crucial challenge during your mandate – but in a very different way from that of your predecessor. While LNG supply still needs to be closely monitored, and energy imports from Russian will remain an issue for you, both issues are likely becoming less systemic, and more regionalised, risks. This should give time to work on strategic solutions that ensure gas import resilience (including hydrogen) and a framework for dealing with Russian imports.

An energy system that involves more interconnections and more digitalisation is potentially more vulnerable to systemic physical and cyber risks. Adequately tackling this will require cross-border coordination of defence and interior security. It will also require coordination on the energy side to ensure resilience of highly meshed systems.

Deploying efficient frameworks to ensure the delivery of the required clean-energy investment volumes will be the key indicator of your success. Thereby, public budgets can at best play a catalytic role – the bulk of the investments will have to come from private sources. Meeting this investment challenge will made more difficult by higher interest rates. Moreover, skill shortages and some value-chain issues increase the cost of the hardware. To ensure a managed, cost-efficient transition, Europe must synchronise electricity supply and demand growth. If heat pumps and electric vehicles are deployed too slowly, Europeans will have to pay for underutilised renewables. If too little is invested in electricity generation and storage, European consumers might run into very expensive scarcity. If grid capacity is too low, even perfect synchronisation of demand and generation will not help. Getting to a coordination framework between actors and between countries, each with strong interests and preferences, is going to be a daunting task.

To ensure a managed, cost-efficient transition, Europe must synchronise electricity supply and demand growth

Similarly, it will be important to promote the best feasible pathway to achive decarbonisation targets. A balance needs to be struck between reducing final energy demand and promoting electrification. Relying solely on the efficiency gains from electrification – notably through heat-pumps for heating and EVs for transport – risks putting an extraordinary burden on the electricity grid in periods of low renewable-energy generation. On the other hand, it will not be easy to ensure that efficiency is properly accounted for in all investments, while not discouraging electrification.

A related challenge is to find a suitable way of sharing the cost of the energy system. Increasingly, the electricity system will be central in the energy system. The shift of tariffs and taxes from oil, gas and coal toward one major energy carrier – electricity – leads to new distributional challenges. Should the costs of electricity transmission be borne by taxpayers, should current renewable investments be paid for by future consumers, how much profit and risk should be left for private investors, and should households subsidise the bills for industry? In the transition, the current settings of market design, network tariffication, taxation, levies and subsidies, and an extended carbon price that directly affects household budgets, will lead to very different distributional results, both within and between countries. Finding new guidelines that provide good incentives for efficient operation and investment – but that are also fair – is going to be a crucial challenge.

Investors will only invest in the 'right' technology mix if the expected returns correspond to the desirability of these investments. Expected market prices would be an efficient driver, but future prices depend on current and future policy choices. And those policy choices will depend on current and future technology preferences. If uncertainties are high, the EU runs the risk of under-investment in sustainable solutions and over-investment in technologies with high degrees of optionality/self-hedging (eg fossil-fuel plants). To address this, public institutions need to provide credible guidance on which investments they will value at which point in time. Such guidance would imply which investments should not be devalued by future policy choices. The challenge will be to balance flexibility with credibility.

A crucial challenge for you will be to define the policy architecture to meet Europe's climate targets after 2030

A crucial challenge for you will be to define the policy architecture to meet Europe's climate targets after 2030. You will have to propose successors to the 2030 renewables (42.5 percent), energy efficiency (-40 percent) and interconnection (10 percent) targets, and whether/how those will be allocated to member states. You will thus have to decide: 1) how targets are defined, eg should energy efficiency targets be measured in terms of primary energy or should they rather be set on final energy, or useful energy? 2) which targets are set, eg is an energy efficiency target still needed when renewable electricity is regularly abundant, or should there be an electrification target? 3) what level of renewables to target; 4) how will those targets be differentiated across member states; and 5) how national targets can be enforced. An overly restrictive setting will not be credible, while a too-loose setting will not provide guidance. Issues like the treatment of nuclear power, which is seen as a silver bullet by some countries and a dead-end by others, will create an additional complication.

Energy-policy choices will become increasingly political over

It will be of paramount importance to anchor policy in reliable and transparent data

the next few years. It will be of paramount importance to anchor policy in reliable and transparent data. Without good data, Europe's green transition will be harder to achieve. Good data and publiclyavailable information are needed to assess the impact of planned policies, to evaluate current frameworks and to plan infrastructure, to assess national and regional plans and to identify priorities. In the absence of good public data, special interests find it much easier to lobby for suboptimal approaches. The EU has a substantial problem in this respect, as energy data is not available currently in a timely way or at the level of granularity, reliability and consistency needed for informed policymaking. To inform and guide the EU energy transition in a transparent, consistent and authoritative way, you will have to respond to this challenge.

Recommendations

Prepare to become 'Fit for 90'

Efficient European coordination of investments and policies also requires well-defined and accepted targets for 2040, by when net emissions should be 90 percent below 1990 levels. The 2020 and 2030 targets on energy efficiency and renewables provided guidance, but ensuring that all member states contribute their fair share has proved an impossible exercise. Applying the same approach to the 2040 climate targets would imply highly intrusive energy-efficiency and renewables targets. One way out could be to have targets that are more in line with expected decarbonisation pathways – in effect using 'clean electrification targets'. A more radical shift would be to replace gross targets by requiring National Energy and Climate Plans to show planned investments to achieve domestic mitigation in line with the climate ambition.

Coordinate member-state investments in clean electrification

Implementing incentives for efficient investment in the large-scale electrification of Europe by 2040 is your most important task. This will require a broadly consistent vision of the future electricity system that no member state fundamentally disagrees with. The task is to synchronise the increase in clean-electricity generation with the investments in the enabling infrastructure (including storage, networks, and back-up), and the switch from fossil fuels to electricity in major demand sectors. Such coordination across borders requires transparent and inclusive planning, and efficient markets and conducive pricing (with the right taxation and subsidies). European and national investment incentives can then be evaluated against their contribution to this effort.

For example, national and European network development plans should be scrutinised by the corresponding regulators to assess whether they constrain the desired transition. For investments in renewables and flexibilities/back-up you should encourage member states to engage in joint mechanisms for supporting investments. If this is not possible, you will have to, at least, put effective guardrails on national investment incentives. Otherwise, disproportionate investment incentives for one technology in one country can trigger a subsidy race in all neighbouring countries – to the detriment of consumers and taxpayers. For the demand-side, you will need to promote both efficiency investments – aimed at reducing final energy demand – and technologies creating flexibility in the power system for short-term (via heat-pumps and electric vehicles) and seasonal variations (via industry). New instruments can be designed to reward energy efficiency gains, while cross-country public transport should be made more cost competitive against flying and private mobility. You will also need to ensure that all consumers are incentivised to dynamically respond to system conditions to reduce the overall system costs.

Launch an EU Grids Fund

You should work with other commissioners on a European fund to invest in electricity grids

You should work with other relevant commissioners on a European fund to invest in electricity grids. This would have two main merits: first, it would enable faster deployment of much-needed grid infrastructure, the systemic benefits of which largely exceed the willingness-to-pay of those consumers that normally have to pay for it. Second, it would put some of the grid cost on future taxpayers and thereby allow faster electrification today and hence greater benefits also for those future consumers. As a matter not only of affordability and social fairness, but also to encourage fast electrification and decarbonisation, you need to ensure that, on aggregate, electricity is a cheaper form of energy than fossil fuels. Energy taxation and the carbon trading are important levers, but the sharing of network costs between current and future ratepayers and taxpayers will also be essential. At the same time, containing cost will require maintaining good incentives for investments and reducing electricity consumption, especially in times of scarcity.

Go the last mile on Russian energy

Europe must not become dependent again on Russian energy

Europe must not become dependent again on Russian energy. In the near term, sectoral (eg nuclear) and regional vulnerabilities will be exploited by Russia to pursue tactics that ultimately aim at undermining the European project. The risk that individual member states are tempted by 'energy gifts' from Russia is undermining solidarity and investments in alternative supplies. Moreover, any imports from Russia help Russia finance its war on Ukraine. You should develop an EU strategy to jointly manage remaining energy trade with Russia. Any decision to reopen energy trade with Russia should be an EU decision. With the transit contract between Naftogaz and Gazprom in Ukraine to expire at the end of 2024, and the upcoming wave of new LNG liquefaction capacity from the US and Qatar, the favourable moment to renegotiate the contractual terms of energy trade with Russia is now. A European buyers cartel would strengthen political leverage in any negotiations with Russia. At the same time, you should prepare a tightening of energy sanctions. Europe still buys gas via ship and pipeline, nuclear fuel and pipeline oil worth €30 billion per year from Russia, and does not enforce rules that would constrain Russian oil and oil product exports. The missiles and shells Russia can buy with these revenues drastically increase the cost of European battlefield support for Ukraine.

Strike a grand bargain on EU security of supply

To overcome the stalemate between individual member states' interests – Czechia and others in buying Russian pipeline oil; Spain, France and Belgium in LNG; Slovakia, Austria and Hungary in pipeline gas; France and others in nuclear fuel – a grand bargain is needed that fairly shares the cost across all member states. For this, you need to engineer tangible solidarity solutions for the vulnerable countries. In the short-term one area sticks out. To give Ukraine a free hand in negotiations over a new gas transit contract with Russia (the current one expires at the end of 2024), you should moderate a discussion on the use of intra-European gas-transit infrastructure to properly supply Austria, Hungary, Slovakia and Ukraine from the west, in case no settlement with Russia is reached. In these negotiations, you should push for the transit agreement not to be renewed.

Create a European Energy Agency

Early warnings of demand-supply gaps will help underpin policy initiatives and improve guidance for investments

Such an agency would make your work easier by providing timely data and modelling to everyone and thus improving the quality of the European energy policy debate (Tagliapietra *et al*, 2023). Obtaining early warnings of demand-supply gaps will help underpin policy initiatives and improve guidance for investments. The loss of political control over results from the currently used proprietary black-box models will be outweighed by the gains in credibility of an open approach, easing negotiations with co-legislators, and ensuring a more transparent policy-making process.

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Memo to the commissioner responsible for climate policy

Simone Tagliapietra and Georg Zachmann

The European Union has set ambitious climate targets and, to reach them, has rolled-out a wave of legislation. But despite this momentum, the pace of decarbonisation has not been fast enough. Your overriding challenge for the next five years is to accelerate EU decarbonisation in sectors such as buildings and transport, while addressing the social impacts of climate policy. Whether green industrialisation can be fostered and an effective green social contract can be put in place will make or break the European Green Deal.

You must then lay the foundations for a 'Fit for 90' package, tackling emissions in agriculture and land use, among other difficult policy questions. A new governance framework for climate adaptation must be developed as climate impacts increase. Finally, it will be important to scale-up the EU's green global reach, strengthening diplomacy, ramping-up climate finance and pushing new green industrialisation partnerships.

Firm-up 2040 emissions reduction plans

Establish a green social contract and focus on adaptation

Extend the EU's green global reach

State of affairs

The European Union has set binding climate targets for 2030 and 2050 and, to reach them, has rolled-out a wave of legislation. A three-pillar governance structure has been developed to ensure the implementation of the European Green Deal plan for climate neutrality: emissions trading (ETS) to coordinate decarbonisation also in most sectors (including buildings and transportation from 2027 under the so-called ETS2); National Energy and Climate Plans to coordinate decarbonisation in the remaining sectors and to somewhat coordinate energy policy; and EU financial support to address the social and distributional implications of EU climate policy (Pisani-Ferry *et al*, 2023).

The EU has taken the first step towards the adoption of a 2040 climate target, recommending a 90 percent reduction relative to 1990

The EU has also taken the first step towards the adoption of a 2040 climate target, recommending a 90 percent reduction relative to 1990. This represents the starting point for the EU to update its emissions pledge – the Nationally Determined Contribution (NDC) at the important United Nations climate conference (COP30) in Brazil in 2025.

But despite the targets and the EU's decoupling of GDP growth from emissions since about 2010, the pace of decarbonisation has not been fast enough. The 2030 target is in jeopardy. Over the last decade, most greenhouse gas emissions reductions in the EU happened in sectors covered by the ETS, most notably in the power sector. In non-ETS sectors, including transport and buildings, emissions reductions have been relatively small. Agriculture has remained almost untouched.

Notwithstanding this, the European Green Deal has faced popular and political resistance. The 2024 European elections underlined the mounting discontent about ambitious climate action, with groups –in the European Parliament that are sceptical about the Green Deal gaining momentum, while the Greens lost seats.

Meanwhile, climate impacts are increasing. Europe is the fastest-warming continent. Extreme heat, once relatively rare, is becoming more frequent, while precipitation patterns are changing. Downpours and catastrophic floods are increasing in frequency and severity. At the same time, southern Europe can expect declines in rainfall and more severe droughts. Current water, energy, buildings and agriculture infrastructure is not adapted to the changing climate, exacerbating the economic and human cost of extreme events. Unless the EU takes much stronger action in climate adaptation (eg floodproof zoning), an unfortunate sequence of such events could undermine financial and economic stability.

Rising global emissions while the EU's share is quickly declining also poses a challenge for the justification for domestic climate policies. However, as a global leader, the EU encourages, facilitates and catalyses global decarbonisation. Hence, a key criterion for domestic climate policies should be how they contribute to decarbonisation elsewhere. Innovation in technology and policy instruments, climate diplomacy, climate finance and trade policy will need to be combined in a broadly consistent strategy.

The EU has played a major role in supporting the Paris process to keep global warming within two degrees Celsius above pre-industrial levels. This has included teaming up with the United States on important pledges from methane to renewables and energy efficiency. The EU and its member states have continued lead on climate finance, and have initiated with other G7 partners new initiatives such as the Just Energy Transition Partnerships (JETPs). However, it has become clear that the EU needs to reinforce its climate diplomacy and international partnerships to contribute in a more effective manner to global decarbonisation and fairness.

The EU needs to reinforce its climate diplomacy and international partnerships to contribute more effectively to global decarbonisation

This notably calls for more and more targeted climate finance, which is at the centre of global climate fairness conversations and is the cornerstone of the Paris Agreement's main principle of common but differentiated responsibilities. It also calls for new measures on carbon pricing and international taxation for development and climate policy, new green industrial partnerships with emerging and developing economies and new plurilateral agreements on green subsidies and tariffs. This is the crossroads where climate policy meets development, foreign and industrial policy.

Challenges

The overriding challenge is to accelerate EU decarbonisation

To meet the 2030 55 percent emissions reduction target, ETS sector emissions must drop by 35 percent compared to 2022, while emissions from buildings and transport should be reduced four times faster than in the past decade. To get there, multiple problems must be tackled.

Increasing marginal cost of abatement

Decarbonisation will move in the coming years into sectors where the cost of abatement is higher and will increasingly require green investment

Decarbonisation will move in the coming years into sectors where the cost of abatement is higher and will increasingly require green investment. For example, larger shares of renewables in the system require more investment in grids and flexibility solutions such as batteries. Electric vehicles require charging infrastructure. Buildings must be retrofitted. Industrial processes must electrify, and green hydrogen production must grow. The EU needs to keep contributing to this, even when post-pandemic recovery funding from NextGenerationEU (NGEU) phases down.

EU climate governance is not 'fit for 55'

The three-pillar governance structure described above is insufficient to sustain the deep decarbonisation trajectory the EU will face in the coming years. The EU has limited tools to push governments to implement the energy and climate strategy they have agreed to at EU level. This is particularly true for the 2030 targets, which are not binding at national level, unlike the 2020 targets.

Distributional implications between countries

The distribution of the costs of decarbonisation between EU countries will change as decarbonisation moves towards harder-to-abate sectors. While power-sector decarbonisation primarily hits coal-based countries in the east, buildings and transport sector decarbonisation will also hit core countries. A more specific issue relates to the ETS. Carbon prices impact different EU countries differently, because of their differing starting conditions. This cannot be resolved through the initial allocation of ETS allowances as the distribution of decarbonisation costs between countries is uncertain and varies over time.

Distributional implications within countries

The burden of complying with new regulations will be high for low-income households, but also for middle-income households

Decarbonisation will affect households unequally: the burden of complying with the new regulations by set deadlines (for example, the phase-out of combustion-engine cars by 2035) will be high for low-income households of course, but also for middle-income households, for which renovating property or buying an electric car could require investment of about a year's income. Policies that have the effect of requiring these investments could easily trigger political backlash if they are not properly designed and explained.

Higher cost of capital

Many of the needed clean technologies are characterised by high capital expenditures and low operating expenses. This is true for renewable energy sources including wind and solar, but also for electric vehicles. The response of central banks to the 2021-22 inflation shock has increased real interest rates across Europe, making financing for both households and private companies more expensive. If higher interest rates persist, investment in key clean-technologies may be dragged down.

EU fiscal constraints

The public investment needed for decarbonisation is harder to find if fiscal space is constrained – and increasingly focused on other areas, such as defence. The new EU fiscal rules might be too restrictive when it comes to climate policy (Zettelmeyer *et al*, 2023).

Reconciling the climate agenda with industrial competitiveness

There are widespread fears that climate action predominantly based on carbon pricing and regulation will hurt EU industrial competitiveness. Ensuring decarbonisation is compatible with industrial competitiveness is critical for the political sustainability of climate policy.

More pressing priorities

The Russian war of aggression against Ukraine has put national security at the top of policymakers' agendas and the cost of living at the forefront of citizens' concerns. This may have contributed to the loss of support in the 2024 European elections for green and liberal parties that were pushing the Green Deal. In addition, maintaining the political and social momentum on climate action will inevitably become more challenging as the transition moves from plans to actions that require sacrifices from households and companies.

Maintaining the political and social momentum on climate action will inevitably become more challenging

Climate adaptation

While adapting to climate change certainly is mostly a matter of regional and local action, there are several reasons why the EU should play a greater role. These involve scale advantages, territorial spillovers and impacts that relate specifically to the EU's other competences, such as ensuring the functioning of the single market. Emergency response to major climate-related disasters is a very practical example where scale can make a difference. National response capacities can easily be overwhelmed by large-scale floods or forest fires. Since time is often of the essence, pooling resources for fast and decisive interventions can prevent substantial damages and loss of life.

Prepare to become 'fit for 90'

You will have to oversee the approval of the 2040 climate target and start preparing the next wave of legislation for the post-2030 period. This also includes very difficult questions such as whether to start preparations for an ETS3 for agriculture, and how to incentivise negative emissions.

Green global reach

The EU needs a new climate diplomacy and partnerships plan aimed at supporting global decarbonisation while addressing increasingly pressing competitiveness and security concerns. Developing this external dimension is challenging, as plenty of trade-offs exist between the various policy objectives, such as the interplay between decarbonisation, competitiveness and security, and how to allocate limited fiscal resources to domestic decarbonisation and international climate finance.

Recommendations

Boost green industrialisation and establish a green social contract

The previous Commission promoted the European Green Deal as Europe's new growth agenda. However, the socio-economic aspect remains a weakness of the initiative, creating the risk of a serious political backlash against green policies in the coming years if not adequately addressed. Addressing this backlash convincingly will be essential to ensure the implementation of the legislation to meet the 2030 emissions target.

Green industrialisation

The transition is an historic occasion to innovate and create new markets, starting with clean technologies

One challenge facing Europe is how to pursue the green transition while preserving – and ideally boosting – industrial competitiveness. Climate policy represents a burden to certain European industries, as it implies higher costs for them compared to their international competitors. However, the transition is also an historic occasion to innovate and create new markets, starting with clean technologies.

On this front, limited progress has been achieved so far. It will be crucially important for you to work with the commissioner responsible for internal market and competitiveness to create a strong and innovation-driven EU green industrial policy. This entails working on both horizontal (single-market deepening) and vertical (targeted interventions, such as smart subsidies for innovative clean technologies) actions. You have an opportunity to further develop the Innovation Fund as the EU's main instrument to support clean-tech demonstration.

Green social contract

Climate action should not increase inequality. Seeking the political support of coal-intensive eastern European countries and learning from the French experience with the gilets jaunes, the European Green Deal has been profoundly shaped by distributional considerations. The Just Transition Fund was the first flagship initiative to be adopted under the Green Deal, while the Social Climate Fund has been created alongside the ETS2, as the best economic literature on carbon dividends would prescribe. However, the creation of these funds is insufficient to address the profound distributional implications of climate policies.

To do better, you will need to: 1) work with other relevant commissioners to streamline and simplify EU funding instruments – from the under-utilised Just Transition Fund to Regional and Cohesion funds – to accompany the transformation of coal and carbon-intensive regions; 2) guide an efficient utilisation of the Social Climate Fund, with actions targeted in a way to maximise impacts on both emissions reductions and social fairness; 3) push for a comprehensive rethink of the sustainable agriculture agenda and of the Common Agriculture Policy, in view of the next EU budget (Multiannual Financial Framework, MFF) cycle, with the aim of supporting small-scale farmers and requiring more effort from the agri-food industry instead. This should lead to a 'Rural Green Deal' that further contributes to the political sustainability of the initiative.

Green investment plan

You should work with colleagues on the creation of a new EU Green Investment Plan

You should work with colleagues on the creation of a new EU Green Investment Plan to maintain the current level of EU grants after the end of NGEU in a way that will strengthen EU climate governance. EU funds should support projects that, overall, allow for more efficient decarbonisation, such as investment in electricity grids.

Lay the foundations for 'Fit for 90'

The 'Fit for 55' package created ETS2 for buildings and road transport. After its entry into operation, most economic sectors will be covered by a carbon-pricing mechanism, with the notable exception of agriculture and land-use, land-use change and forestry (LULUCF)[22]. As all sectors must contribute to the 2050 climate-neutrality objective – and to negative emissions thereafter – this gap should be addressed by a future Fit for 90 package. Applying a carbon-pricing mechanism to the agriculture and LULUCF

22 Other sectors not covered by a carbon pricing mechanism will be: international aviation and maritime; non-CO2 emissions from energy production, transport and combustion; and some smaller sectors including waste landfilling and wastewater treatment.

sectors would provide a clear financial incentive for farmers and forest managers to reduce emissions and increase removals, and for consumers to reduce the consumption of emission-intensive agricultural products. But this will be politically very challenging and will require attentive calibration and communication.

Meanwhile, there is a need to start a serious reflection on the 'ETS endgame'. By 2039, carbon allowances will no longer be created. As a result, 15 years from now, utilities and energy-intensive industries will only be able to use carbon allowances they have previously banked or bought from other market participants. This raises important questions about if and how the market will work, and what the options should be to face this new scenario. To provide visibility to all players covered by the ETS, and to ensure a conducive investment environment for decarbonisation, it will be important to provide early answers to this looming question.

Develop EU climate adaptation policy

Develop a new governance framework to structure EU-member state cooperation on climate adaptation

The Commission should be responsible for helping to generate, collect and spread scientific knowledge

With the aim of facilitating the exchange of information between different governance levels and introducing verifiable targets to guide action. The Commission should be responsible for helping to generate, collect and spread scientific knowledge (such as satellite imagery and model simulations), and for providing a platform through which national and sub-national governments can share ideas, experiences and adaptation practices in a structured way.

You should also take additional steps to mainstream adaptation in other policy areas, starting with the Common Agriculture Policy. The Commission should help countries establish national adaptation plans with clear targets, consistent with those of neighbouring countries. This would be a step beyond than what is required by the European Climate Law. You should require the inclusion of strategic interventions that have EU-wide relevance, such as for the protection of key infrastructure. National adaptation plans should serve as a guide for local government action. This framework is meant to be flexible and cooperative rather than overly rigid and hierarchical. However, agreed adaptation plans should be formal and linked to a new EU climate-disaster insurance instrument.

Work to create a new EU climate-disaster insurance mechanism to tackle the impacts of climate change

You should work with the commissioner responsible for regional policy to create a new EU climate-disaster insurance mechanism to tackle the increasing impacts of climate change. EU countries are all exposed to various climate impacts, creating a rationale for all to be insured against catastrophic impacts that will occur at different times across the continent, while of course accepting that they are unlikely to be willing to accept large and structural fiscal transfers to compensate for long-term climate-induced damages. The European Solidarity Fund can be a good starting point for this new initiative. It could be scaled-up to cover an agreed set of costs that are expected to arise from climate damages, also to soften the fiscal blow for affected countries. Access to the fund might be made partly conditional on development and implementation of solid national adaptation plans.

Scale-up the EU's green global reach

Re-orient green diplomacy from targets to implementation

Targets agreed at UN climate summits are impactful to the extent that they are implemented. For this, it is first of all important to have dedicated secretariats to ensure monitoring and promote coordination on a continued basis. The Climate and Clean Air Coalition is the secretariat for the Global Methane Pledge, but a secretariat is also needed for the Global Renewable Energy and Energy Efficiency Pledge. This will be important for promoting bottom-up initiatives for global climate action, and engaging the private sector and cities.

Ramp-up international climate finance

Financial commitments provided by advanced countries must be increased substantially. One way to do this could be through JETPs, which should be given larger financing and expanded to cover other large emitting emerging and developing economies (EMDEs), including Colombia, Kazakhstan, Nigeria, Mexico, Thailand and India. The benefits for the EU and G7 of scaling up climate finance largely outweigh the fiscal costs, but doing so is fraught with political-economy challenges. A minimal requirement for overcoming these challenges is demanding more detail in the conditions that would trigger the release of funding, and a governance structure to monitor that conditions are met (Bolton *et al*, 2024).

New carbon pricing and international green taxation diplomacy
Implementation of the carbon border adjustment mechanism (CBAM), intended to equalise carbon costs of certain domestic and imported good, will test the EU's capability to deliver and manage international repercussions. But there should be no backwards step on CBAM. Taken seriously at global level, it illustrates the important role of the EU market. The implementation should focus on maximising incentives for decarbonisation - implying resolve on principles and flexibility on details. In this context it is important to ramp-up CBAM diplomacy in partner countries and assess possible targeted interventions to offset its impacts for the poorest countries.

Push for international taxation for development and climate action
Levies on heavy fuel oil and kerosene used in international aviation and shipping would help provide much needed capital to boost loss and damage and adaptation funding in developing countries.

New green industrialisation partnerships and guardrails
You should promote bilateral green industrial partnerships with EMDEs. The EU should focus on engaging with EMDEs in moving up the supply chain, from extraction to refining for example. EU governments will not be able to intervene directly, but can, for instance, support guaranteed offtake agreements (in which buyers commit to purchase a volume of product, to help secure loans for infrastructure and other high-cost projects). You should also work with commissioner for trade to promote plurilateral agreements on green subsidies and tariffs – green trade wars would hold back global decarbonisation. You should reach out to the US and China to build green subsidy and tariff guardrails. A three-way agreement could be pursued, that would then be expanded to others, or the World Trade Organisation.

The EU should focus on engaging with EMDEs in moving up the supply chain, from extraction to refining

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Memo to the commissioner responsible for environment policy

Heather Grabbe

The link between economic sustainability and the environment should be obvious, but in practice environmental policy continues to face pushback because of short-term economic concerns, and failure to account for the longer-term costs of environmental degradation. You will have to plan for this pushback in promoting policy in crucial areas including safeguarding biodiversity, water security, resource efficiency and pollution reduction.

Your best strategy may be to create stronger links between the environment and the EU's major policy goals – especially economic security and competitiveness – and to show how environmental policies are enablers of other policies. Improving environmental metrics will be important to make the case.

Propose a green economic security strategy

Develop detailed sustainable competitiveness policies

Foster long-term thinking, especially on agriculture

State of affairs

The environment portfolio lingered for many years in the shadow of others as political leaders prioritised economic policies. Since 2019 however, the European Green Deal has brought more attention and resources to environmental policymaking. A more robust legislative framework has resulted for biodiversity protection, incentives and regulation to bring more resource circularity into the European economy, and some reductions in pollution. However, progress on the environment has been modest compared to the decarbonisation of energy systems, for which the transition has accelerated since Putin's 2022 invasion of Ukraine.

Biodiversity and functioning ecosystems provide essentials for life including fresh water, soil fertility and pollination. Economic systems do not account for these 'ecosystem services' as having monetary value, yet economic activity cannot happen without them, and many of them cannot be substituted by human-made technology. They are still largely discounted as invisible and silent externalities, rather than as assets that have value and carry depreciation costs. Annual species loss from land-use change will exceed the international target by 35 times in 2024 (UNEP, 2024).

Annual species loss from land-use change will exceed the international target by 35 times in 2024

In addition, there are close links between decarbonisation and healthy environments. Energy accounts for about three-quarters of greenhouse-gas emissions, but nearly a fifth comes from agriculture and could be reduced by more sustainable practices. Climate change meanwhile puts more pressure on nature, as plants, animals and other forms of life struggle to adapt to sudden temperature rises, changing rainfall patterns and extreme weather. Europe is already warming at twice the global average (C3S and WMO, 2024), resulting in water stress, storms and wildfires that will recur every summer.

Many of these environmental impacts have already severely transgressed planetary boundaries, creating a high risk to the natural systems that have maintained the stable and favourable conditions in which human civilisations have developed. Although climate policy is the responsibility of your fellow commissioner, most of the other planetary boundaries (from water to biodiversity) are in your portfolio. Different forms of environmental damage

Even if carbon emissions stop, the predominant linear 'take-make-waste' economic model is causing over-extraction from nature

– on land, in the seas, in the ice-caps and in the atmosphere – have non-linear interactions, meaning that larger risks are building up from the aggregate effects of ecosystem degradation. This will have damaging and volatile impacts on economies. Even if carbon emissions stop, the predominant linear 'take-make-waste' economic model is causing over-extraction from nature that damages biodiversity, water cycles and other essentials for human life and health.

Your predecessor made significant progress in areas including the circular economy (sustainable products, right to repair), nature restoration and a biodiversity strategy for 2030, material consumption and waste targets, and pollution reduction. Your focus will be on implementation of these policy frameworks in a difficult political environment, while introducing new measures on water security (including oceans), the circular single market, and chemicals. You must also build environmental risks and benefits into other policies.

Challenges

Your biggest challenge is the "*tragedy of the horizon*"

The tragedy of the horizon is the deeply embedded human tendency to discount the costs and benefits of distant events (Carney, 2015). The reality that human activity cannot survive without nature is quickly forgotten in policy debates about priorities that have a time-horizon of just one to five years.

To overcome the tragedy of the horizon, you will need to do a lot of outreach, both on the framing of existing measures to make sure they get implemented at national level, and in the form of political communication on why environmental measures go hand-in-hand with long-term economic and security goals. This is a daunting task. Therefore, you would do well to link your portfolio to the EU's major policy objectives, because that is where the power, money and political attention lie.

Political pushback and 'greenhushing'

You face a risk that environmental goals will be eclipsed by other priorities, including defence procurement and fears of de-industrialisation. Moreover, the Commission is tempted make the environment portfolio less visible to try to prevent pushback by keeping it below the political radar

This might work in the short term but it will not build support for EU measures and it keeps environmental risks out of the public eye. To sustain implementation of EU-level policies and laws, you need to explain the scientific realities over and over. This is important for the environment, but also for the economy, given the investments already made in sustainable products, services and technology by both the private and public sectors. After the difficulty and delay in the adoption of the Nature Restoration Law[23], it will be hard to get attention for the other elements of the Biodiversity Strategy for 2030, such as the Soil Monitoring Law and the EU forest monitoring framework.

Environmental stresses and disasters could have a perverse impact on politics; voters may turn inwards

The increasingly obvious physical effects of nature degradation will reinforce your case, but environmental stresses and disasters could have a perverse impact on politics. Voters may turn inwards, encouraged by populists who argue that their interests are threatened by moves away from the linear, brown economy. Instead of favouring systemic solutions, people may seek to hold on to what resources and assets they have. To widen mental horizons and combat disinformation, you will need to work with a wide range of politicians across many parties.

The impact of water stress and climate change on nature

Biodiversity loss is likely to increase over the next years because of the stresses of climate change. Water stress will also worsen as evaporation increases because of higher temperatures and rainfall decreases around the Mediterranean basin. Elsewhere in the EU, extreme rains and floods are becoming more frequent, endangering lives and leading to heavy economic losses, releases of pollutants and harms to biodiversity.

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23 Finally approved in June 2024; see Council of the EU, 'Environment Council, 17 June 2024, main results,' https://www.consilium.europa.eu/en/meetings/env/2024/06/17/.

The economic and human costs of pollution

Air pollution kills 300,000 Europeans per year

Air pollution kills 300,000 Europeans per year according to the European Environment Agency, while reducing worker productivity, agricultural yields and carbon sequestration by plants – and there is clear evidence that productivity improves when air pollution declines (Dechezleprêtre *et al*, 2019). Water pollution and soil degradation also reduce agricultural productivity over time. Full implementation of EU environmental laws could save tens of billions of euros every year in health and other costs, so going slow on implementation is costly.

Agriculture and nature

Pushback by the agro-chemical industry against green measures is likely to continue for as long as the EU continues to subsidise large-scale, industrial farming. The next major opportunity to re-think agricultural policy will come with the negotiations for the next EU budget (multiannual financial framework, MFF). Agricultural sustainability measures will be vital to reduce emissions, but also to maintain biodiversity and reduce water and air pollution from nitrates and fertiliser use. However, the Common Agricultural Policy is arguably the EU's most reform-resistant policy.

Transition to a circular economy

The focus of the EU's circular economy strategy has broadened from waste management – recycling and end-of-life disposal – to a wider economic paradigm that includes product design and empowering consumers to choose more sustainable options. Much greater gains can be made by designing products and buildings at the start of life for durability, resource efficiency and ease of re-purposing and re-use.

However, achieving EU goals relies on countries adopting their own circular-economy strategies, most of which remain generic, without binding measures or solid timeframes (EEA, 2024). Better governance through accountability and enforcement will be needed to decouple economic growth from resource use and to meet goals such as halving residual municipal waste within a decade.

Lack of metrics for cost-benefit calculations

There is still no widespread understanding of the near-term or longer horizon risks posed by losing the services that nature provides for free

The costs of environmental policies are widely discussed and calculated in terms of trade and competitiveness, but the costs of pollution and waste are not subject to the same denominators and are often not included in cost-benefit calculations. There is still no widespread understanding of the near-term or longer horizon risks posed by losing the services that nature provides for free, and few metrics are available for valuing those services in monetary terms. Calculations of the effect of lessening the pressure on nature appear only rarely in economic thinking, for example by applying concepts such as sufficiency or *sobriété* to reduce the rate of extraction from nature through demand reduction, greater resource efficiency and a circular economy.

The value of biodiversity is particularly difficult to measure. It consists of many elements that are not amenable to quantitative indicators, being silent and invisible, and the quality of the integral system is more important than the individual elements.

A further area where metrics need development is avoided costs and negative impacts. Nature plays a major role in reducing emissions and avoiding disasters, but these contributions rarely appear in financial and economic systems. These accounting challenges have long caused environmental objectives to lose out in the competition for investment – even with other aspects of the green transition. For example, risk assessments suggest that biodiversity collapse is a more immediate threat than sea-level rise, but the potential costs – such as the economic impact of key pollinators becoming extinct – is little discussed in policy debates.

Green global reach

The negative reaction of EU trade partners to the Deforestation Regulation (Regulation (EU) 2023/1115) shows how the global impact of EU environmental measures can cause tension. To prevent similar shocks, you need to start diplomatic outreach on other environment measures early. But external impact assessment – which is one of the proposed solutions – could stall progress in Europe, so you will have to find a balance.

Recommendations

You should create stronger links between the environment and the EU's major policy goals

You should create stronger links between the environment and the EU's major policy goals, most notably economic security, strategic autonomy, competitiveness and financial system stability. Environmental policies are enablers of other policies, as well as safeguards of the intrinsic value of nature.

Propose a strategy for green economic security

The fastest way for the EU to achieve de-risking from toxic dependencies on imported raw materials and products is to reduce the need for those imports by moving to a circular economy. This does not mean that the EU should become a self-sufficient economy or introduce protectionist policies, but rather that it should prioritise the elimination of wasteful use of materials and energy in both production and consumption, keeping products in use for longer and getting the most value from materials by recovering and repurposing them. The demand side of the green transition has received little attention, with most focus on the supply side – seeking alternative sources of energy, materials and manufactures. But there is great potential to reduce demand by incentivising resource efficiency and optimising provisioning systems (UNEP, 2024).

A more circular economy would be more secure and resilient when shocks come, as shown by the fragility of long global supply chains during the COVID-19 epidemic. Development of a circular economy is important for de-risking in preparation for future emergencies.

Develop detailed policies for sustainable competitiveness

Competitiveness tops the EU's economic priorities and environmental objectives are often portrayed as being in opposition to it. You need to make the case for synergy, particularly in relation to the circular single market.

By increasing efficiency in production of goods and how long they are used for, the EU could achieve greater productivity, which will enhance the competitiveness of EU firms. Europe is poor in energy but rich in human capital and world-class in creating regulations that often set global norms. Other countries are also moving towards encouraging circularity because of the rising costs of managing waste, and many European companies have solutions and technology to export.

Focus on the Circular Economy Act

You can make a major contribution by developing the policy framework to enhance Europe's comparative advantage in producing the most energy and resource-efficient products and services. Commission President von der Leyen has committed to a new Circular Economy Act, helping to create market demand for secondary materials and a single market for waste, notably in relation to critical raw materials, with the aim of a creating more sustainable pattern of production and consumption and retaining the value of resources in the economy for longer. This Act should be a centrepiece of your mandate.

The EU sets global norms for eco-design, repairability, durability and recyclability through its rules on sustainable products, soon to be enhanced by the rollout of digital product passports. If the move to circularity stimulates innovation to make products that are more durable and resource-efficient, it will create lead markets and European companies will have the edge in designing products that meet the highest global standards, and in building supply chains for recyclates and recycled materials.

Work with central banks and regulators to reduce environmental risks to financial stability

If ecosystems continue to be degraded, crises such as water shortages or collapse of pollination will occur, with drastic and long-lasting effects

If ecosystems continue to be degraded, crises such as water shortages or collapse of pollination will occur, with drastic and long-lasting effects on business continuity and wider society. The risks of environmental degradation need to be built into prudential supervision of the financial sector, given that three-quarters of euro-area bank loans are to companies that are highly dependent on at least one ecosystem service.

These risks are important to central banks because they can cause supply-chain disruptions that affect prices and ultimately inflation. However, central banks, financial regulators and credit agencies cannot introduce policies and laws that would reduce these risks. Your role will be important in guiding the creation of new policy frameworks for valuing nature to complement the risk-based approaches of your colleagues responsible for economic portfolios.

Establish climate adaptation planning

President von der Leyen has proposed a European Climate Adaptation Plan to support countries notably on preparedness and planning and to ensure regular science-based risk assessments, including a new European Water Resilience Strategy.

For this, a cross-portfolio approach will be needed, working with your colleagues with responsibilities for the Mediterranean, climate and humanitarian response. Your role will be to look for solutions that work with nature rather than against it. For example, transfer of water from one place to another causes harm to ecosystems. Pressure could come for emergency measures that cause longer-term harm, such as flood protection walls that destroy more nature or uncontrolled proliferation of private wells. You need to put forward green infrastructure solutions, such as restored wetlands and tree cover.

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Foster long-term thinking for the next generations

The voices of those who benefit from the current economic system are loud, and many are well organised. However, the people and companies who will lose from environmental degradation in the future are often unaware of the severity of future impacts, or cannot speak up because they are not yet born. You should work to highlight the enormous costs of unsustainable activities on future generations, and the benefits to them of moving to sustainability now.

A particularly important constituency for this long-term thinking is farmers. In some EU countries, certain soils have a remaining lifespan of less than 100 years for food production. The range of farmers' views on future agricultural policy is under-researched. You should start dialogues with a range of different farming communities to design policies and incentive structures to ensure the long-term productivity of soil and water, in order to foster a debate about how to ensure that the value of farmland is maintained for farmers' children and grandchildren. That would create a different frame for discussion of Common Agricultural Policy reform over the next few years.

Improve environmental metrics

You need to take natural capital accounting to the next level by including monetary accounts for ecosystem services

The case for environmental measures will be much more powerful if you are able to improve methods of measurement and means of showing the value of nature, as well as the risks of losing it. Cost-benefit calculations for circularity measures, such as eco-design, would help to motivate deeper and faster implementation. More precise measurement of hidden inefficiencies would show the value of greater resource efficiency. For example, in the area of 'waste as resources,' estimates of the value of bio-waste when turned into a high-quality fertiliser and soil improver, as well as biogas (a renewable fuel), would help to encourage collection of all discarded organic material. You need to take natural capital accounting to the next level by including monetary accounts for ecosystem services.

Green external policies

Other commissioners responsible for various aspects of external relations will need help to integrate environmental objectives more systematically into their priorities, focusing on energy security and independence, resilience in the face of climate-related disasters, and the value of ecosystem services – starting with the Mediterranean and enlargement countries.

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Memo to the commissioner responsible for economic and financial affairs

Zsolt Darvas, Maria Demertzis and Stavros Zenios

The European Union withstood multiple economic shocks during the last five years but the productivity gap between the EU and other parts of the world is persistent. Your tasks include management of some of the structural factors that can help close this gap. You have three main challenges for the next five years: ensure credible implementation of the new EU fiscal rules, encourage the reduction of current account surpluses if they reflect a savings/investment imbalance and encourage the implementation of country-specific recommendations.

You will need to maximise the value of the money that the EU invests, enforce implementation of rules and structural reforms and help prepare negotiations for the next Multiannual Financial Framework, in order to achieve the EU's strategic objectives.

Implement fiscal rules rigorously

Promote reform and deployment of excess savings

Focus the EU budget on investment

State of affairs

Economic outlook

Inflation in the euro area has declined continuously since its late-2022 peak. It is now forecast by the European Central Bank to be close to its 2 percent target, in both 2024 and 2025. However, inflation differentials persist within the euro area, leading to shifts in competitiveness that may require differentiated economic policy interventions. The scope for ECB interest rate cuts – and thus reductions in private-sector nominal borrowing costs, which were at a 15-year high before the start of the monetary easing phase – remains uncertain. Economic growth remains weak, as your services expect the EU economy to grow only 1 percent in 2024.

Unprecedented fiscal support provided during the pandemic and energy crisis is paying off

Unprecedented fiscal support provided during both the pandemic and the energy crisis is nevertheless paying off. The labour market is strong across the EU and inequality is contained. It remains to be seen whether there will be delayed effects on income inequality as fiscal support is withdrawn.

EU productivity lags the United States, but there is significant variance within the EU. Measured as GDP at purchasing power parity per hours worked, the gap compared to the US productivity level is modest in most western and northern EU countries, including Germany (7 percent below the US in 2023) and France (10 percent below the US in 2023).

The Recovery and Resilience Facility (RRF)

The start of your term coincides with the halfway point of implementation of the NextGenerationEU instrument and its centrepiece, the RRF. Disbursement of RRF funds at time of writing had reached about 40 percent of the total grants facility and 27 percent of the loan facility. However, by July 2024, EU countries had met only 20 percent of the milestones and targets in their national recovery and resilience plans. This raises the question of whether the initial timeline for accomplishments linked to RRF money was too ambitious.

European Semester

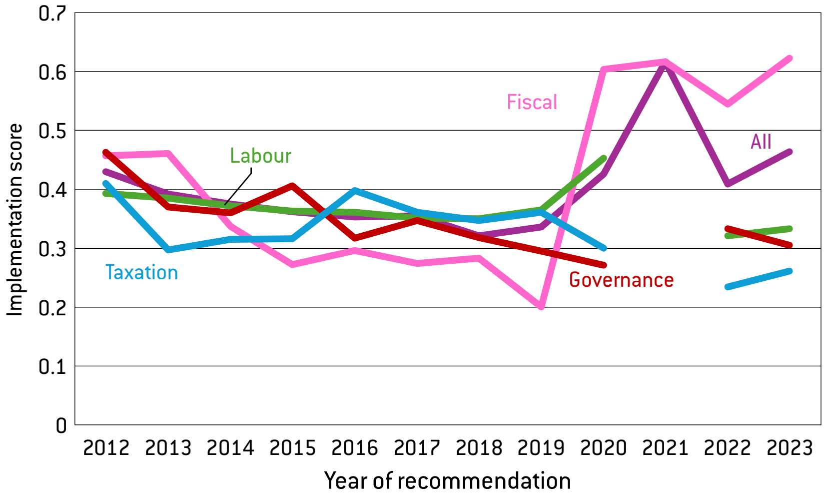
Within the European Semester, the coordination of fiscal policies has entered a new phase with the entry into force in April 2024 of an updated fiscal framework. During your term, the new rules will be implemented for the first time. The new framework requires technically complex debt-sustainability analysis, leaves room for interpretation and is likely to constrain needed public investment.

Macroeconomic imbalances persist in eight euro-area countries, with three experiencing excessive or potentially excessive imbalances. For six countries, no imbalances are identified and their vulnerabilities are presently contained. Sovereign debt levels have come down significantly since the pandemic, but are still high, comparable to levels seen in the aftermath of the euro crisis. The EU is re-experiencing current account surpluses, more than 2.5 percent of GDP (expected for 2025) relative to the rest of the world, while Denmark, Germany, Ireland, and the Netherlands will have surpluses in 2024 of between 6 percent and 10 percent of GDP. These excess savings are inconsistent with the large investment gaps the EU faces.

The implementation record of country-specific recommendations in some challenging areas did not improve

The overall implementation record of country-specific recommendations (CSRs) improved somewhat during the pandemic, partly because fiscal recommendations were given more prominence and some of those recommendations required measures countries were implementing anyway in addressing the adverse impacts of the pandemic. In some more challenging areas, including governance, labour-market and taxation reform, there was no improvement (Figure 1).

Figure 1: Implementation of European Semester country-specific recommendations



Source: Bruegel based on the European Commission CSR database. Note: scores assigned by the Commission: fully implemented = 1; substantial progress= 0.75; partial progress = 0.5; limited progress = 0.25; no progress = 0. Average across all countries for evaluated CSRs. Implementation after one year is reported. There were only fiscal CSRs in 2021. Governance is composed of civil justice, corruption, justice system, public administration, public procurement and concessions, quality of law-making, shadow economy and corruption, and state-owned enterprises.

Your services also monitor the €3 billion in macro-financial assistance (MFA) to ten candidate and neighbouring countries. Several of these countries are in geopolitically high-risk environments. Ukraine was recently granted a €50 billion Ukraine Facility from the EU. The ongoing conflict can make it difficult to implement many of the preconditions of the MFA and the Ukraine Facility. These programmes have an important role in the EU's enlargement strategy.

Challenges

You will face at least three major challenges:

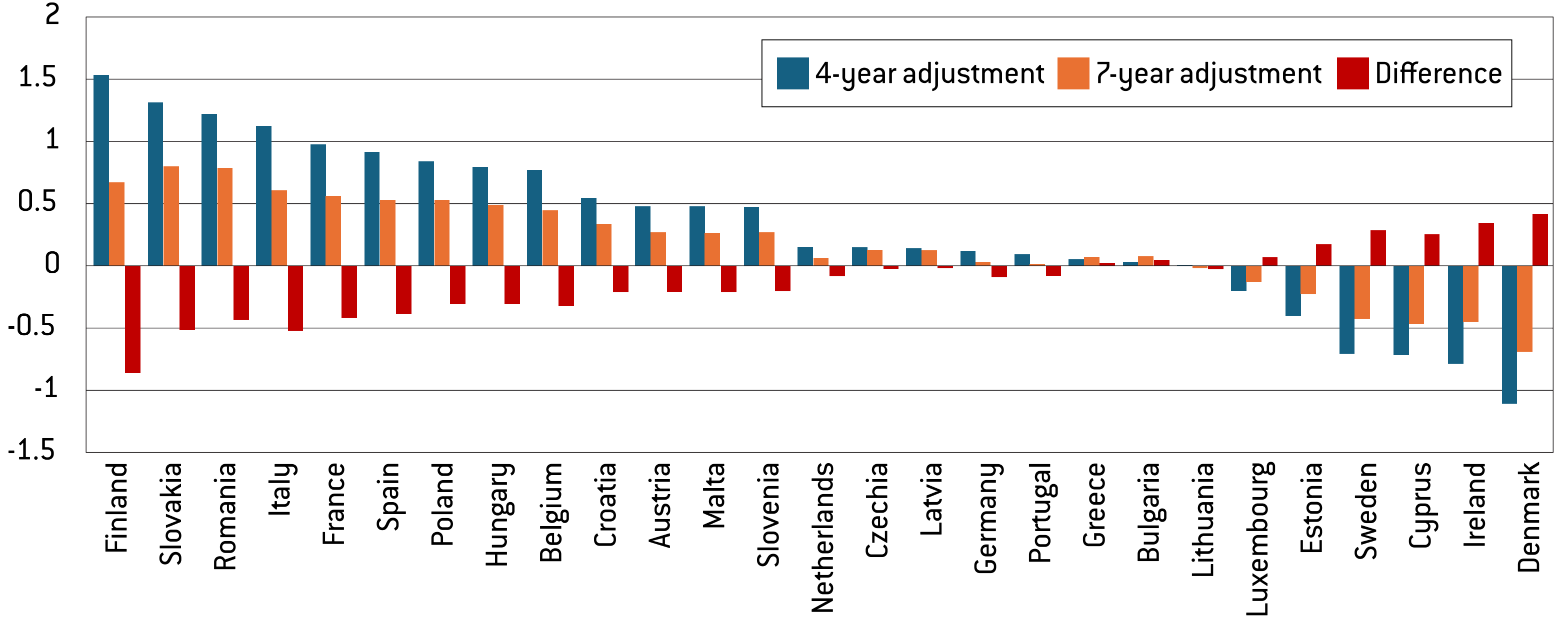
Ensuring credible implementation of the new fiscal rules

The credibility of the new fiscal governance framework must be established from the outset. Your predecessor set out fiscal "*reference trajectories*", against which countries will formulate their medium-term fiscal-structural plans and submit them in late 2024. You will need to evaluate the plans, and make recommendations on the adjustment paths of the eight countries with excessive deficits. Under the new rules, your room for discretion is limited but not eliminated. For example, you will be called on to propose whether the standard four-year adjustment period can be extended to seven years. This can have a major impact on annual fiscal adjustments (Figure 2) but can only be granted if countries propose investments and/or reforms which "*as a general rule taken altogether*" are growth-enhancing, supportive of fiscal sustainability, in line with common EU priorities, address European Semester CSRs and result in sufficient national investments. Your challenge will be to exercise this discretion in a way that preserves both the intent of the new rules and country ownership.

Complicating the smooth implementation of new fiscal rules, demands on fiscal policy may continue to grow

Complicating the framework's smooth implementation, demands on fiscal policy may continue to grow. The policy environment is highly uncertain (geopolitics, military, trade, fragmentation, elections outcomes), potentially requiring unexpected intervention. But equally importantly, EU countries collectively face an annual investment gap of at least €356 billion for the climate transition and €125 billion for the digital transition, for a total of €481 billion up to 2030. The gap is much larger if greater defence needs, the reconstruction of Ukraine and the health union are factored in. Closing this gap will require the efficient use of public resources and mobilising of private investment. Few countries currently have the fiscal space to meet these investment needs, and some challenges, such as climate damage and adaptation, could further restrict the available fiscal space. The new framework will constrain the increase in investments (Darvas *et al*, 2024). It will be a challenge for all policymakers to find the fiscal space to fill this gap.

Figure 2: Annual average fiscal adjustment requirements under the new fiscal framework (average annual change in the structural primary balance, % of GDP)



Source: Bruegel based on June 2024 AMECO dataset for macro variables, June 2024 market expectations for interest rates and inflation rates. Note: the European Commission's methodology was used. A positive number for the four and seven-year adjustments indicates that the country must increase its structural primary balance. Difference = the gap between the four-year and the seven-year average annual adjustment requirements. The six countries on the right side have either debt levels well below 60 percent of GDP (Denmark, Estonia, Ireland, Luxembourg, and Sweden), and/or large primary surpluses (Cyprus and Denmark), implying that these countries could implement fiscal expansions (ie reducing the structural primary balance) under the new fiscal framework.

Despite large investment gaps, the EU continues to send a large part of its savings outside its borders

Current account surpluses coexist with investment gaps

Despite large investment gaps, the EU continues to send a large part of its savings outside its borders. A 2.5 percent of GDP current account surplus forecast for 2025 represents about €450 billion. If the EU could use these excess savings, it could cover its climate and digital investment gaps almost in full. Solving this enormous inconsistency is both urgent and complex. You and all EU and national policymakers must identify the factors that hold investments back and provide incentives for investors to stay in Europe. The fragmented nature of the EU's single market, regulatory obstacles and imperfections of Europe's capital markets union are likely contributing factors, so you should work with other commissioners to remedy these issues. You will be required to contribute to setting EU strategic priorities and to designing an EU growth strategy. To this end, you must work closely with commissioners responsible for climate, energy, finance, digital economy, competition, research, single market and the EU budget.

You will also be required to identify sources of finance. Beyond national fiscal resources, the EU must look for other options. How can the right incentives be provided to keep savings in the EU and contribute to closing the gap? How can the EU budget be reformed, and/or national budgets coordinated, to provide for more efficient spending on projects that have EU value added? How can institutions, including the European Investment Bank and the European Stability Mechanism, be reformed and/or repurposed to engineer better financial inducements that will stimulate the private sector to play a more significant role? These are questions the next leadership team will have to address, and you will have to play an active role in answering them.

Improving country-specific recommendations (CSRs) implementation in the second half of the RRF

Your challenge will be to improve the implementation of CSRs that require structural reforms and fiscal recommendations that require difficult fiscal consolidation.

Country-level reforms are crucial for promoting member state competitiveness and resilience. Failing to reform, therefore, is an obstacle to EU economic progress. But there is another reason why the poor CSR implementation record is a challenge for your portfolio: it jeopardises the success of NextGenerationEU. Addressing CSRs was a requirement for the approval of national recovery and resilience plans (NRRPs), but assessments vary of how well NRRPs have incorporated the relevant CSRs, while governance, labour market and taxation reforms have been implemented poorly (Figure 1).

As you enter the second half of the lifetime of the RRF programme, your challenge will be to assess NRRP implementation objectively and nudge member states towards a successful close. The evidence so far points to delays, which will require an acceleration of implementation. A further problem is that exceptionally high inflation in the first two years after Russia's full-scale invasion of Ukraine has meant that costs associated with the implementation of projects have increased compared to initial plans. Under current provisions, national budgets bear the unforeseen burden of inflation-related costs. Depending on their fiscal space, this will be felt differently by different member states and may pose material risks to the success of national programmes.

Recommendations

You should push for changes to economic policies at national and EU levels to enhance economic sustainability, competitiveness and inclusiveness. Your tools to achieve these goals include the new fiscal framework, overseeing the macroeconomic imbalance toolkit, setting the right CSRs in the European Semester, steering discussions and seeking agreements within the Commission and with member states.

Raise investment in the next five years and beyond

The EU must find new ways to finance its investment gaps

In the next five years, the EU must find new ways to finance its investment gaps. Both public and private investment should be increased, and the public portion should include both nationally-funded and EU-funded components. You will have a central role in reconsidering the EU's investment-supporting instruments.

Ensure that InvestEU maximises EU value-added

Among existing EU tools, you should ensure that the projects supported in the remaining lifetime of the InvestEU programme (which uses €26.2 billion in EU budget guarantees to mobilise €372 billion in private investment from 2021 to 2027) have EU value-added and are in line with EU strategic priorities. You should also support EU countries in completing all planned investments in their national recovery and resilience plans by 2026, the RRF expiry date.

Use the CSRs and single market measures to help reduce current account surpluses

As part of the Macroeconomic Imbalances Procedure, you monitor current account developments yearly and aim to identify the reasons for such high inconsistencies between savings and investments in the EU. It will be crucial for the CSRs, the tool at your disposal, to focus on actionable policies that can make a material difference for the countries concerned.

Deficiencies in the functioning of the EU single market also likely inhibit the within-EU utilisation of European savings. Your colleague responsible for financial services will be working towards creating better conditions that will enable wider and deeper capital markets in the EU. Other parts of the Commission will attempt to improve the functioning of the single market by removing regulatory or other obstacles. You should work with these and other commissioners to detect the factors that drive investments outside Europe and remedy those deficiencies.

You should work with other commissioners to detect the factors that drive investments outside Europe and remedy those deficiencies

Promote private investments via an expanded role for the EIB and possibly the ESM

You must rethink whether financial institutions, including the EIB and the ESM, can also do more to attract private capital. While the EIB has increased its gearing ratio to expand its activities, the question is whether they can be reformed or possibly repurposed in this regard. This raises the issue of participation in more risky projects as a way of helping companies enter areas they would otherwise not pursue. It also raises the question of whether and how should the EIB increase its leverage ratio.

Similarly, the role of the ESM as an institution can also be rethought. There have been many discussions on ESM reform and there are ideas on how to use its firepower during calm times to help with, for example, finishing the banking union by providing a deposit guarantee (Tordoir, 2022). This would help increase the EU's resilience. On the other hand, one could go further and ask whether there is more that can be done to repurpose the ESM's €400 billion firepower, in the context of closing the investment gap when there is no EU country in distress.

Repurpose the EU budget within and beyond the Multiannual Financial Framework (MFF) to target investments

The next EU budgetary cycle will start in 2028 and there will be considerable pressure for more EU funding than the MFF has provided until now. You should contribute to the discussions on financing EU projects within and beyond the MMF, in two ways:

There is a rationale for closing some of the climate investment gap via the EU budget

- **Climate fund**
  Climate is a global, and also an European, public good. There is a rationale for closing some of the climate investment gap via the EU budget. Since increased climate spending will be needed for decades, the best option would be to increase the size of the MFF to create a new dedicated climate fund within it. Failing that, you should foster an agreement on a temporary (eg five-year), debt-financed new EU climate fund outside the MFF. The fund could provide grants and concessional loans directly to applicant companies (ie not pre-allocated to countries). Such grants and loans could be provided on a competitive basis. If the cross-country allocation is not directly related to national contributions to the fund, as was the case with RRF grants, then these allocations would not be counted as national debt and thus would not be constrained by the EU fiscal rules (Darvas, 2022). At the same time, you should progress with the new own resources debate as a way of securing means to finance the interest and repayment of such borrowing.
- **European Strategic Investment fund**
  A follow-up instrument for InvestEU should be created at a much larger scale within the MFF. We recommend the creation of a European strategic investment fund to pursue long-term

objectives consistently. The EU must pursue a structural approach to defining and financing its long-term strategic objectives. Currently, there is a lack of continuity in how the EU pursues investments. Programmes are finite and sporadic, with different funding sources and overlapping objectives. A new European strategic investments (ESIs) fund could come initially from a partly repurposed EU budget. Projects should be evaluated on how well they provide added value to the EU and contribute to its strategic objectives.

Operationalise the new fiscal monitoring procedures: evaluate how reforms contribute to growth and fiscal sustainability

You must develop an appropriate methodology to assess quantitatively proposed reforms and investments

You will need to assess national medium-term fiscal-structural plans, not only qualitatively but also quantitatively. To this end, you must develop an appropriate methodology and incorporate it into the EU's commonly agreed potential output projection methodologies. Except for labour-market reforms and measures related to the fiscal costs of ageing, the European Commission does not have a methodology that helps quantify the impact of reforms and investment on growth and fiscal sustainability. In particular, the Commission's forecasting methods do not capture the impact of reforms and investment on total factor productivity and the capital stock, unless these are expected to be felt in the first two years of the forecast; even in this case, these impacts are assumed to fade away (Darvas *et al*, 2024).

EU countries' fiscal plans can deviate from the Commission's reference trajectory if they provide "*sound and data-driven economic arguments explaining the difference*". Planned reforms and investments recognised to support growth sustainably would be an excellent justification for such deviations. Thus, the Commission must evaluate whether the trade-off between fiscal adjustment and the reforms assumed in a medium-term fiscal-structural plan is quantitatively reasonable. Having an accepted tool to do that will contribute to the credibility of your decisions.

Apply the excessive deficit procedure consistently

You will also have the scope to steer adjustment requirements for the eight excessive deficit countries. There is some ambiguity in the EDP regulation (Council Regulation (EU) 2024/1264), which creates a risk that the EDP will become a shelter for lower fiscal adjustment than what is required when the country is not subject to an EDP (Pench, 2024). You should make sure that debt sustainability, the primary objective of the new fiscal framework, is also required from EDP countries. Otherwise, the new fiscal framework will lose its traction right from the start.

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Memo to the commissioner responsible for tax policy

Pascal Saint-Amans

European Union tax policy faces stringent limitations because taxation lies at the core of national sovereignty. There are many examples of EU tax proposals that have either failed or are likely to fail. Nevertheless, backsliding on tax harmonisation in a less-favourable international context needs to be countered, and taxes can play a role in finding new resources for the EU budget. Priorities include tax simplification, taxation of high net worth individuals and digital nomads, and better taxation of capital income. You must also plan for the potential failure of Pillar 1 of the global tax deal, think more broadly on EU budget resources and reset the EU-Africa tax relationship.

Address undertaxed bases and tax competition

Promote simplification

Engage on Pillar 1 and digital services taxes

State of affairs

Tax policy at European Union level faces stringent legal and political limitations. This reflects the fact that taxation lies at the core of national sovereignty and consent to taxes is a core constitutional principle in all EU countries. Their tax profiles vary widely, with tax-to-GDP ratios ranging from 21 percent (Ireland) to 48 percent (France), with an EU average around 40 percent.

There is some basis for EU harmonisation of value-added taxes and excise duties (Treaty on the Functioning of the EU, Article 113), but no unambiguous basis for direct taxation such as income or wealth taxes (Article 115 TFEU provides only for an indirect basis, to "*limit distortions in the internal market*"). All tax decisions require unanimity.

Unanimity requirements and different member-state tax policies have made harmonisation very difficult

Some harmonisation has been agreed in the field of indirect taxes, notably on the definition of the base, and procedures and limitations in EU countries' freedom to fix rates (for example VAT and energy taxes). But over the past decade, the tax policy debate in the EU has focussed primarily on direct taxation, particularly corporate income tax (CIT), which is most likely to distort competition within the internal market. The combination of unanimity requirements and very different member-state level tax policies has made harmonisation very difficult. Low corporate income taxes in small open economies have historically coexisted with much higher tax pressure on companies in larger economies. This is true for CIT rates (10 percent in Bulgaria, 12.5 percent in Ireland compared to 25 percent in France and Germany) but even more so for the tax base.

Some progress was made during the 1990s and early 2000s in limiting withholding taxes on some intra-group cross-border flows within the internal market, with the Parent-Subsidiary Directive on dividends (2011/96/EU), the Interest and Royalty Directive (2003/49/EC) and the Merger Directive on taxation applicable to cross-border mergers and acquisitions (2009/133/EC). Despite calls to harmonise corporate income tax (European Commission, 1992), which later led to the Commission proposal for a common consolidated corporate tax base, no real progress was made on the legislative front until the early 2010s. Instead, beginning in the 1990s, some harmonisation was imposed by the European Court of Justice, which ruled that, while taxing non-residents differently from residents was allowed in principle, it should not constitute hidden discrimination based on nationality[24]. This improved the consistency of domestic tax regimes, but EU countries remained unable to agree on common rules.

Since the 2008 global financial crisis however, the EU has made unprecedented progress on the back of global efforts, brokered by the Organisation for Economic Co-operation and Development, to reduce tax evasion and avoidance. Since 2015, the EU has implemented eight directives on administrative cooperation between tax authorities to fight tax evasion, and two anti-tax avoidance directives (ATAD) to limit profit shifting and corporate tax avoidance. The latter involved anti-abuse measures including controlled foreign company taxes and limitations on the deduction of interest payments.

On the procedural side, the EU adopted a dispute resolution directive in 2017 (Directive (EU) 2017/1852), increasing the scope and availability of tax certainty to taxpayers in the EU. The most recent and meaningful addition to the rulebook is the implementation of a global minimum tax, part of on the OECD's two-pillar solution agreed in October 2021, which will guarantee that multinationals pay at least 15 percent on their profits. In less than 15 years, bank secrecy has largely ended, with exchange of information on request and automatic exchange of information, and base erosion and profit shifting (BEPS) have been tackled seriously. The EU was the first adopter of the minimum tax. An essential condition that allowed the EU to overcome the unanimity requirements in these cases was member-state interest in the global agreements that preceded them, which were viewed as critical to level the international playing field.

In less than fifteen years, bank secrecy has largely ended

Despite the Commission's efforts, the EU has only rarely gone beyond OECD standards. Examples include country-by-country reports, which multinationals will have to publish from 2025[25], and the adoption by the EU Code of Conduct group of a list of non-cooperative jurisdictions that is more stringent than the OECD, but

24 This was referred to as 'negative harmonisation.' EU countries complained that these decisions were undermining the consistency their tax systems, but the Court responded that domestic tax systems could not contradict the EU Treaty and that it was not responsible for the inability of member states to agree common rules.

25 Pushed by the European Parliament, this was considered a non-tax issue and was adopted with a qualified majority.

has also raised some diplomatic issues. The ATAD Directives also went beyond the OECD by introducing so-called 'general anti-abuse rules' and an exit tax.

Member states have been lukewarm on the European Commission's efforts to leverage this progress. Your predecessors tabled several proposals which have either failed or are likely to fail – a 2018 proposal to establish a digital service tax, for example. In 2023, the Commission tabled a draft directive to reboot the common consolidated corporate tax base into BEFIT (Business in Europe: Framework for Income Taxation). BEFIT is stalling as member states remain reluctant to give up control in this area. Even a draft directive on transfer pricing, proposed at the same time as BEFIT[26], which would just translate agreed OECD rules into EU legislation to bridge a gap revealed in some state-aid cases, faces some challenges. It would result in EU countries transferring their international tax competence to the Commission, which they are reluctant to do. A few other proposals on fighting tax evasion and avoidance have not progressed (eg preventing the misuse of shell entities for tax purposes – UNSHELL – or securing the activity framework of enablers – SAFE). Overall, it seems clear that EU countries do not want to transfer tax competences to the Commission and the control of the EU Court of Justice.

You will have to handle the sensitive and important debate on own resources for the EU budget

Finally, you will have to handle the sensitive and important debate on 'own resources' to meet the growing demands on the EU budget. In December 2021, the Commission proposed three new own resources: 15 percent of the revenues from the EU emissions trading system (ETS); 75 percent of of the revenues from the new carbon border adjustment mechanism (CBAM), and a 15 percent share of the revenue expected from the application of the OECD agreement on the taxation of the residual profits of large multinationals (Box 1). In June 2023, in an update to the plan, the Commission proposed increasing the ETS contribution rate to 30 percent and suggested a new statistically based own resource on a proxy for corporate profits.

These proposals have failed to trigger much discussion among

26 Also at the same time as the BEFIT proposal, the Commission proposed a head-office tax system for small and medium companies, under which those companies would deal with only one tax administration.

EU countries, despite a call for them "*to accelerate the negotiations*", aiming at a unanimous decision by 1 July 2025 and the introduction of the new own resources in January 2026. Addressing this will be one of your priority issue, shared with the commissioner in charge of the budget.

Challenges

You have six main challenges to navigate. They also represent opportunities.

Avoiding backsliding on tax harmonisation in a less-favourable international context

The momentum for harmonising taxation and eliminating loopholes, driven by the G20 and deployed at the OECD, which has allowed the EU to adopt an unprecedented number of directives, is receding. The G20 is in crisis and geopolitical fragmentation makes new initiatives less likely. The OECD has broadly delivered on fighting tax fraud and evasion and new projects are unlikely to get enough international support. With the US failing to implement its international tax commitments, the G7 is unlikely to fill the gap.

Indeed, an EU-US conflict over tax policy appears likely. Starting in 2025, the EU will start collecting the minimum 15 percent on US companies that operate in Europe but have profits in third countries that tax them at less than 15 percent. Furthermore, the likely failure of Pillar 1 of the OECD's two-pillar agreement may lead to an EU digital services tax, which would hit mostly US companies (Box 1).

Box 1: US-EU tax tensions

The US Congress has not, at time of writing, adopted the global minimum tax and it is unclear whether the next administration will be more successful. This is a source of tension with the EU, as the minimum tax includes an interlocking mechanism by which, if a country does not collect the tax from its own multinationals, other countries may do so. Starting in 2025, EU countries will start collecting the minimum 15 percent from US companies that operate in Europe but book profits in third jurisdictions where they are taxed below 15 percent (such as Bermuda or the Cayman Islands). This is in line with rules, but a Republican majority in the US might threaten the EU with trade sanctions for doing so (not understanding that it would require an unlikely unanimity to change the EU directive).

Pillar 1 is unlikely to succeed

In addition, and more importantly, Pillar 1 is unlikely to succeed. It would reallocate to market jurisdictions some of the profits of the world's largest (above €20 billion in revenues) and most profitable (above 10 percent profitability on sales) companies. A quarter of their rent (defined as exceeding 10 percent profitability) would be allocated to market jurisdictions based on a revenue key, whether or not the company has a physical presence in that jurisdiction.

Pillar 1 largely responds to the call by some EU countries to tax digital transactions in the countries where customers are located. The removal of digital services taxes in countries including France, Italy and Spain was conditional on the implementation of Pillar 1, and EU countries have agreed that without implementation of Pillar 1, a European digital services tax will be implemented. Pillar 1 requires a multilateral convention that has not yet been approved or signed. Even if it is, it is unlikely to be ratified, since this would require a two-thirds majority in the US Senate. The issue of the taxation of tech companies will therefore remain unresolved, implying tensions between the EU and US in the next five years.

Making taxation more growth-friendly

Europe is perceived as an aggressive regulatory environment, including on taxation. The past decade of strengthening tax cooperation, closing loopholes, putting in place anti-abuse measures and increasing tax revenues was long overdue. However, pro-growth measures have been missing, including in VAT where an upgrade of rules – VAT in the digital age – is perceived as adding another layer of compliance cost by innovative companies.

The Commission attempts to introduce business friendly measures have not been successful. A draft directive expediting withholding tax relief has been watered down by member countries even though it would remove obstacles to financial flows within the EU[27]. Tax administrations' fears of fraud are a serious obstacle to progress that would make the EU financial market more attractive. A Commission proposal to equalise tax treatment of equity and debt has also been ignored. Moving from the current 'anti-abuse agenda' to a pro-growth agenda will hence be challenging.

Pushing for EU-level decisions on individual taxation

Digital mobility has facilitated the emergence of 'digital nomads' for whom traditional definitions of tax jurisdiction are no longer fit for purpose

You should do this when it is more efficient than decisions at the national level. Digital mobility, particularly post-COVID-19, has facilitated the emergence of 'digital nomads' for whom traditional definitions of residence or tax jurisdiction are no longer fit for purpose. The resulting tax uncertainty for both individuals and companies (do companies have a permanent establishment in a country because some of their employees telework from there?) can be an obstacle for growth and should be addressed. The unprecedented level of income inequality between individuals also calls for action (Alstadsæter *et al*, 2023). Addressing these personal tax issues at EU level is both a challenge and an opportunity to reboot the EU tax agenda in a balanced manner.

Reinvigorating the EU's relationship on tax matters with developing countries, particularly in Africa

The role of the OECD in setting the international tax agenda is being contested by large emerging and developing countries. Following a campaign by African countries, the United Nations has established an intergovernmental group to develop terms of reference for a new international tax framework. This work is likely to challenge the OECD leadership on these issues. The EU has been

27 EU finance ministers agreed the rule in May 2024, but added exemptions that would mean some countries can opt out. The draft directive was aimed at tackling a situation in which relief procedures to eliminate double taxation are not harmonised, are still based on paperwork in some countries and waste time and money for investors. See Council of the EU press release of 14 May 2024, 'Taxation: Council agrees on new rules for withholding tax procedures (FASTER)', https://www.consilium.europa.eu/en/press/press-releases/2024/05/14/taxation-council-agrees-on-new-rules-for-withholding-tax-procedures-faster/.

outvoted on this issue at the UN and is criticised for not supporting developing countries. One of the reasons for the bitterness of developing countries is that the EU imposed 'good governance' principles (adoption of OECD standards on transparency and on BEPS) on many African countries which were not tax havens and no threat to the level playing field. CBAM, though not technically a tax issue, has just worsened the relationship.

Given the critical role of these countries as EU partners and the importance of domestic resource mobilisation in sustainable development, the EU should restore its reputation and influence with the Global South. The debate on innovative sources of financing for the energy transition may provide the EU with an opportunity to support the South[28].

Pushing for taxation decisions based on qualified majority rather than unanimity, taking advantage of likely EU enlargement

The more countries that join the EU, the more difficult it will be to agree tax rules unanimously

The more countries that join the EU, the more difficult it will be to agree tax rules unanimously. The history of enlargement has not facilitated a good tax dynamic, with low-tax countries joining the Union (Malta and Cyprus most recently). Eastern European countries have also challenged the group dynamic, even when rules had been agreed at OECD level (Poland and Hungary delayed by a year the adoption by the EU of the minimum tax, though they approved it at the OECD). Welcoming a cohort of new countries, with relatively low tax-to-GDP ratios, may increase the risk that progress on taxation becomes more difficult if not impossible. But changing the decision-making rule is not trivial, nor is it a technical issue. It raises the question of the nature of the institution, with a move to qualified majorities meaning a move to a federal system. As such, it is unlikely to resonate positively with the membership in the current political circumstances.

Negotiating a successful compromise on own resources

You will need to do this taking into account tensions between

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28 The Commission is a member of the International Tax Taskforce, established at the COP28 climate summit at the end of 2023. The taskforce's goal is to find new sources of development and climate finance. See https://internationaltaxtaskforce.org/about.

frugal states and those supporting more action from the EU. On the proposals tabled by your predecessors, there will be a debate on who bears the cost. The currently open own resources proposals would tend to rebalance the burden from Eastern European countries (more impacted by the ETS) to larger member countries and small open economies including Ireland and Luxembourg, which would be most impacted by the proposed own resource based on a proxy for corporate profits.

Recommendations

Address tax competition for high net worth individuals and digital nomads

You should explore the possibility of establishing a code of conduct on personal income taxation

For this purpose, you should explore the possibility of establishing a code of conduct on personal income taxation. This would allow for a soft form of cooperation to take shape at EU level and would create a basis for discussing common approaches. There should be a recurrent opportunity for EU countries to inform the others on their personal income tax systems, allow for a review process to identify the most harmful schemes, and discuss common standards that could be agreed. The EU has already had good experiences with the Code of Conduct Group on Business Taxation, which should be taken as the template for personal income taxation.

Explore better taxation of capital income

For instance, political momentum exists for a new individual capital gains tax, which should however be ideally harmonised at EU level. The personal income tax base is currently not fully aligned across EU countries, distorting the allocation of capital in the EU. Triggering a debate on the principle of capital gains taxation within the EU could also provide the EU with a global leadership role on this issue.

Push for tax simplification as a priority

This should include more effort to achieve a Capital Market Union, with the possibility of introducing common tax incentives for pension savings. Following through on existing pro-growth proposals, such as on withholding tax relief (see footnote 4), should also be a priority. And in line with the implementation of the global minimum tax, a comprehensive review of the ATAD anti-abuse rules might be necessary, to avoid duplication of administrative burdens related to the global minimum tax and other anti-abuse rules, if the rules end up having the roughly the same impact.

Engage with the US and seek an alternative solution if Pillar 1 fails

Digital service taxes are distortive and will ultimately be passed on to consumers

Digital service taxes are distortive and will ultimately be passed on to consumers, making them a 'European tax on the Europeans' rather than a tax on the American tech giants. In case of a roadblock in the negotiation, a very large base and low-rate tax could be a way out, in consultation with the US.

Promote the taxation of international bases that are currently untaxed

You should explore how aviation taxation could be strengthened internationally and take the lead to establish the necessary forum on taxing carbon emissions from the shipping industry, which so far has been out of scope of any international agreement. You could also explore progressive carbon taxation as a way to increase the legitimacy and acceptance of those measures among the broader public.

Leverage the need for new own resources for the EU budget to build EU external tax borders

This would both strengthen the EU's capacity to raise revenue and increase coherence in the tax system. The ETS and CBAM should be revisited and enriched. Pigouvian taxes, that aim to raise revenue while penalising bad behaviour, should be explored.

Reset the EU's tax relationship with Africa

This can be done by reducing the scope of countries that are assessed for compliance with OECD and EU tax transparency and anti-evasion standards. This is currently much too broad and includes countries merely because they have economic links with the EU or because they are aid recipients, even if they are not tax havens, like most African countries. The current metrics determining scope should be replaced by a risk-based approach, resulting in the removal from the assessment of most developing countries, particularly African countries. Prioritising concrete counter-measures against illicit financial flows, through a dialogue with the African Union, would help restore the relationship.

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Memo to the commissioner responsible for the European Union budget

Marco Buti, Zsolt Darvas and Armin Steinbach

You take over responsibility for the European Union budget at a time of climate emergency, a war near the EU's border, heightened security risks, increased global protectionism, slow productivity growth and a weak European economic outlook. Demands for new EU spending are mounting.

While opinion polls suggest significant alignment among EU citizens on what the EU's priorities should be but member countries remain divided over the size of the EU budget and how to finance it. Old questions about the value added of traditional EU policies continue to resurface. Following the mid-term reviews of the 2021-2027 Multiannual Financial Framework (MFF) and the 2021-2026 Recovery and Resilience Facility, the proposal for the next MFF starting in 2028 should be prepared soon.

Propose substantial budget reform by mid 2025

Focus on funding for European public goods

Push to unblock decision-making

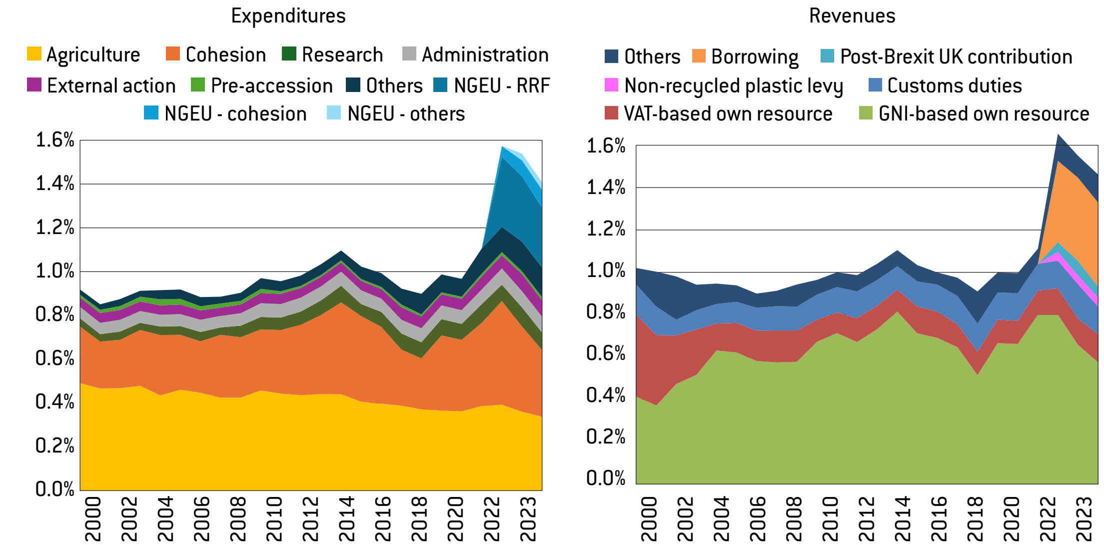
State of affairs

EU budget spending

Since the mid-1980s, EU budget spending has amounted to about 1 percent of EU GDP. The EU's main pandemic response was an unprecedented debt-financed instrument, NextGenerationEU (NGEU). Its announcement had a stabilising effect by convincing market participants about EU-wide solidarity in supporting vulnerable countries, even if disbursement of NGEU money was slow.

On average, NGEU provides spending power of an additional 0.4 percent of GDP from 2021 to 2026 (Figure 1, Panel A), beyond preferential loans. Its largest component, the Recovery and Resilience Facility (RRF) supports six main objectives – most notably the climate and digital transitions – with an indicator-based funding model (as opposed to the traditional cost-based funding model and the performance-based funding model, even if the Commission claims that the instrument is performance-based; Darvas *et al*, 2023). The other components of NGEU top up existing cohesion, agricultural, research and investment funds.

Figure 1: Implementation of the EU's annual budgets, % GNI, 2000-2023



Source: Bruegel based on European Commission data and adopted EU annual budgets. Note: Agriculture includes fisheries. 'NGEU - cohesion' is the top-up to the European Regional Development Fund (ERDF) and European Social Fund (ESF). 'NGEU-others' is composed of top-ups to Horizon Europe, InvestEU, the European Agricultural Fund for Rural Development (EAFRD), the Just Transition Fund (JTF) and the Union Civil Protection Mechanism (RescEU).

The EU has for a long time been adjusting the MFF at the margin and has tried to incorporate recent priorities via budgetary mainstreaming

For political, institutional and legal reasons, the EU has for a long time been adjusting the MFF at the margin, without radical changes to its size, composition and contribution to stabilisation (except for NGEU). Instead, European leaders have tried to incorporate recent priorities via budgetary mainstreaming, including cross-cutting policy goals (climate, biodiversity, gender), in all phases of the budget cycle.

EU budget revenues

EU countries unanimously agree on so-called 'own resources' (EU budget revenues, Figure 1, Panel B) to finance the MFF. In the 2021-2027 MFF, the expenditure ceiling is 1.1 percent of gross national income, while the own-resources ceiling is 1.4 percent of GNI (apart from NGEU debt service). Except for the GNI-based revenue, which acts as a balancing item, the other largest revenues, including customs duties, a value-added tax own resource and a non-recycled plastic packaging waste levy, are determined by the underlying revenue base and specific formulas. The plastic waste levy, while not increasing overall budget revenues (since the balancing GNI-based contributions are reduced correspondingly), incentivises country-level recycling policies, an important side effect.

To repay NGEU debt, the own resources decision secured an additional annual revenue stream of 0.6 percent of GNI up to 2058. This can only be called on to pay the interest and debt amortisation of NGEU debt. This commitment was about ten times the expected debt service costs when NGEU was approved in 2021, and is still several times more now, after interest rates increased.

Your predecessor proposed several possible other EU budget revenues, based on the EU's carbon border adjustment mechanism (CBAM), the emissions trading system (ETS), national accounts data on corporate profits and the re-allocation of taxing rights under Pillar One of global tax reform agreement, brokered with 138 countries by the Organisation for Economic Co-operation and Development.

Dwindling market enthusiasm for EU debt

Since the start of monetary tightening, interest rates on EU bonds have increased relative to national debt. Technical reasons for this increase were addressed by the issuance since January 2023 of single branded EU bonds rather than separately labelled bonds. But there is a deeper reason: investors do not see the EU as a permanent player in the bond market, since EU leaders emphasise the temporary nature of EU bond issuance and the priority of debt repayment. This contributes to the negative market perception, which in turn feeds the scepticism of reluctant member states about further EU debt issuances.

Negative market perception about EU debt is fuelled by the emphasis on the temporary nature of EU bond issuance

Challenges

You will face two major challenges, which will be aggravated by the forthcoming EU enlargement.

Increasing tension between strategic goals and the budget's size and allocation

You must decide whether to accept the inevitability of a small (close to 1 percent of GDP) budget, or to make an ambitious attempt to reconcile new priorities with the budget's size. In the past, budget adaptation has been implemented in an *ad-hoc* fashion, rather than built into the system. Your challenge will be to decide whether to seek root-and-branch MFF reform, or to adjust it at the margins and pursue the new political priorities outside the MFF.

Your next challenge will be to reconcile budget composition and EU priorities. EU budget discussions focus increasingly on European public goods (EPGs). These can be defined as goods not supplied at an adequate level without public intervention, and which should be provided at the EU level to internalise externalities and reap the benefits of scale, while ensuring that local preferences are taken into account.

Some elements of the two largest EU budget spending items are not in line with the evolving goals of the EU.

Article 39 of the Treaty on the Functioning of the European Union (TFEU) defines five objectives for the Common Agricultural Policy (CAP): agricultural productivity, income support, market stabilisation, food supply and reasonable food prices. Horizontal mainstreaming introduced additional climate and biodiversity goals. While market stabilisation and food supply could classify as public goods, direct transfers to farmers – the CAP's largest component – pursue re-distributional purposes and do not amount to an EPG that should be funded by the EU. Yet direct transfers are paid solely by the EU budget without national co-financing, even if there is no such requirement in the Treaty, while the CAP's rural development component is co-financed. Consequently, the CAP is oversized. Moreover, the European Court of Auditors found the CAP's 'greening' policies to be likely ineffective at reducing the climate impact of agriculture in Europe.

Likewise, cohesion policy has a Treaty-based justification (Article 174 TFEU), but does not always meet the definition of an EPG, to the extent that most cohesion projects do not involve externalities and scale benefits. Moreover, its effectiveness can be improved, and it is essential to tackle corruption to avoid improper use of funds in some member states. It needs to be seen whether the new toolbox addressing rule- of-law deficiencies can reduce the scope for misuse of EU fund.

Several European public goods have been underrepresented in the EU budget

Other EPGs have been underrepresented in the EU budget. Research funding is a good example of a successful EPG. It's share in the MFF has only marginally increased from 6.9 percent on average in the 2010s to 7.8 percent in 2022. Potential EPGs include European strategic investments, single market measures, the European space programme, migration and border management, and security and defence, which take low shares of EU spending. External action – accounting for about 8 percent of the MMF – is another crucial category reflecting the EU's responsibility to support less-developed nations.

Finally, the MFF is not designed for cyclical stabilisation, partly because of its small size and reflecting moral hazard concerns (which, however, could be addressed). While NGEU had a positive announcement effect, its deployment was slow. A major challenge for you is to devise a much faster mechanism for such a large shock.

The difficulty in agreeing on genuine own resources

Traditionally, in the EU, spending has driven revenue: the size of expenditures was fixed at close to 1 percent of GDP and revenues

The 'culture of net balances' is wrongheaded, since it disregards the economic impact of the EU budget

were decided accordingly, based on unanimity of EU countries. This procedure reflects provisions in the EU Treaties, which maintain the taxing right as an exclusive national prerogative. Since GNI-based national contributions predominantly fund the EU budget, a 'culture of net balances' has limited the scope for budget expansion: politicians often focus on how much their country gets from and pays into the EU budget. As a result, net payers have blocked attempts to increase the size of the budget, fearing that their taxpayers would finance even more expenditures elsewhere in the EU. This viewpoint is wrongheaded, since it disregards the economic impact of the EU budget. Your challenge will be to fight against it.

Arguably, new own resource to replace GNI-based contributions represents an opportunity cost to member states' budgets, to the extent that those revenues would go to the EU budget instead of national budgets. Thus, your challenge will be to explore new own resources that are acceptable to EU countries, minimise net balance considerations and bring about behavioural change or other additional benefits. For example, taxing emissions is good for the environment, while EU-level corporate taxation – especially if based on harmonised tax bases – could benefit the single market by reducing undue tax competition, and could also be the basis for a centralised industrial policy (via reduced tax rates for preferred industries).

Enlargement

The budgetary challenges for the EU will become even more difficult in an enlarged EU of 35 or more members. First, as the new entrants will all be net beneficiaries, at unchanged policies, significant resources will have to be directed to those countries. Second, under the current unanimity requirement for the approval of the MMF, there is the risk of decision-making paralysis. Your challenge will be to find remedies to these concerns.

Recommendations

You should make a comprehensive reform proposal by June 2025, otherwise it will be difficult to add substantial new elements later. The proposal should incorporate the following changes:

Propose an increase in MFF expenditure

A budget worth 1 percent of GNI is insufficient

To deliver the EU's ambitious priorities and to include the EPG component of NGEU in the MFF, a budget worth 1 percent of GNI is insufficient. A dramatic increase is politically unrealistic, but nevertheless you should make an ambitious proposal to the European Council: increase the current 1.1 percent of GDP MFF by 20 percent of the estimated investment needs of the twin transition, ie 0.7 percent of GDP, and by a new flexibility reserve of 0.2 percent of GDP. This would increase the size of the MFF to 2 percent of GNI.

Embrace a European public goods approach

Such a larger budget should embrace a European public goods approach. It should focus on areas where the EU can bring real added value. EPGs can be classified into 'genuine' EPGs delivered and financed at EU level, and projects pursuing EU priorities financed at the EU level, but for which delivery takes place at national level.

In the first category, projects tackling EU challenges at EU level should in principle be politically less contentious than other forms of EU spending, because they weaken the 'net balance' narrative and do not carry the risk of moving to a 'transfers union'. Hence, the production of genuine EPGs should reduce the tensions between so-called 'creditor' and 'debtor' countries.

Examples of EPGs include common digital infrastructure, cross-border green energy projects, common purchasing of critical raw materials, border management, handling of migration inflows, procurement of vaccines, economic security and defence. These correspond broadly to the European priorities identified in the informal European Council in Versailles in March 2022.

Revamp programmes to deliver EPGs

A pragmatic idea to enable the delivery of EPGs would be to rely on current EU programmes, revamping and refocusing them on cross-country projects. Some parts of NGEU, the Connecting Europe Facility, InvestEU, Horizon Europe and REPowerEU could support common initiatives at EU level. European initiatives are also the core of the Innovation Fund. Moreover, if reformed to allow financing via EU resources and devoted to EU-wide interventions, the Important Projects of Common European Interest (IPCEI) would offer a useful tool for a reformed EU industrial policy. EU countries could put forward transnational projects benefitting from common financing if they comply with EU fiscal rules (Bakker *et al*, 2024).

Reform cohesion policy and the CAP

Limiting the scope of cohesion policy and the CAP to the pursuit of EPGs, and increasing their effectiveness, are fundamental

Limiting the scope of cohesion policy and the CAP to the pursuit of EPGs, and increasing their effectiveness, are fundamental for an EU budget that aims to provide the greatest value added. A rethinking could build on the experience with the RRF. Two innovative aspects of the RRF are its focus on reforms and investments in exchange for financial support, and its indicators-based approach, which, however, should be upgraded to a performance-based instrument.

Significant elements of the CAP do not pursue EPGs, but reflect national public goods or other policy preferences. You should therefore seek to introduce 50 percent national co-financing of direct payments in the next MFF. In addition to freeing-up one-sixth of the MFF funds for the provision of EPGs, this would reduce the cost of enlargement via the EU budget by one-fifth. Fundamental CAP reform should also involve the gradual replacement of decoupled direct payments with coupled direct payments linked to environmental protection. In the past, coupled direct payments were linked to the production of specific products – and it was wise to eliminate such payment conditions to avoid the overproduction of certain products and to allow farmers to respond to market demand. In the future, payment conditions should be based on environmental protection and progress in reducing harmful emissions.

There could be more flexibility by reducing the number of different headings in the MFF, which would mean a smaller number of categories to which funds are bound.

Ensure rapid mobilisation of emergency funds

You should be prepared to adopt further temporary instruments outside the MFF (beyond the 2 percent limit) on a suitable legal basis (not necessarily limited to Article 122 TFEU), under exceptional circumstances. It will be essential to put in place a procedure that secures fast mobilisation and implementation of emergency funds. Borrowing seems to be an ideal source of financing for an emergency instrument, similarly to NGEU, within the legal limits (Grund and Steinbach, 2023). More generally, there is an economic rationale to finance investments that produce future returns by issuing debt. Introducing debt revenues as own resources would be an unprecedented, but legally feasible way. The EU's regular presence on bond markets would improve market perception of EU debt.

It will be essential to put in place a procedure that secures fast mobilisation and implementation of emergency funds

Promote a new instrument for defence spending

In responding to the mounting external security threats, defence is a quintessentially European public good, though most of its delivery occurs at national level. Since there is an urgency to increase EU countries' defence capabilities, while EU fiscal rules constrain the fiscal space, we recommend the prompt roll-out of an exceptional and temporary debt-financed EU instrument to boost such capabilities. The cross-country distribution of defence investment should follow an efficiency logic, though its results would benefit the whole EU.

Develop genuine own resources

You should break the net-balance perspective by funding the EU budget with 'genuine' own resources, which should be those taxes and levies for which the EU holds the exclusive or shared competence under the current Treaty framework. This includes customs duties and ETS and CBAM revenues. All of these revenues – not just 75 percent as currently applied to customs duties – should be channelled to the EU (excepting a small collection cost). Second, you should also explore to what extent the tax revenues to be collected as a result of implementing the OECD Pillar 2 agreement establishing a 15 percent global minimum tax (Directive (EU) 2022/2523) could accrue to the EU. Under these rules, jurisdictions where a multinational company sells its goods or services may have a right to collect top-up taxes in case the minimum is not collected elsewhere. Since there is good reason for this right to tax to be attached to the EU single market, you should claim these revenues as genuine resources (Saint-Amans, 2024). Among various new revenue options, you should put most of your political capital into those that offer the largest EU budget revenues.

You should also continue the work of the previous Commission on fostering various kinds of own resources that could exert positive externalities, including environment protection, limiting undue tax competition and providing a base for an EU-wide industrial policy.

Move to qualified majority voting

The decision-making procedures related to the EU budget must be overhauled

The decision-making procedures related to the EU budget must be overhauled. This is important also to cope with the consequences of enlargement. You should use the legal leeway under the Treaties to move the adoption of the MFF from unanimity to majority voting, to avoid the risk of decision-making paralysis. Specifically, the passerelle clause under Article 312(2) TFEU could be used, under which the European Council may unanimously authorise the Council to adopt the MFF Regulation by qualified majority voting (QMV). This would mean that spending ceilings under the MFF would also be adopted by QMV and MFF adoption would be aligned more with the annual budget procedure.

In the delivery of EPGs, vertical coordination will have to be ensured between the EU budget and the implementation of the new EU fiscal framework, agreed in April 2024. Hence, you need to work closely with the commissioner responsible for economic and financial affairs. Also, the Commission's organisation must be revamped to allow efficient delivery of EPGs.

It would also be appropriate to move from seven-year to five-year planning periods to align with the European political cycle. As priorities may shift substantially, it would appear opportune to strengthen the mid-term review which, so far, has been a rather minimalist exercise.

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The policymakers who will lead the European Union until 2029 take office at a time of heightened instability. The previous five years were marked by a series of shocks, to which the EU adapted admirably in many cases, but which have left the EU in a bruised state. Meanwhile, the wider world has become more threatening and fragmented. The challenges for the European Commission and other EU institutions are formidable.

The priorities are to continue to support Ukraine while implementing measures to reinvigorate EU growth. The 2030 climate targets must be met and the ground laid for meeting the 2040 goals, while securing faster emissions reductions beyond the EU's borders. Social cohesion needs to be restored to head off threats to the EU model. More needs to be done to improve EU external security. On top of all of this, a serious effort must be made to improve EU governance without creating further division.

This comprehensive set of Bruegel memos assesses the state of affairs and the main challenges for the next five years, and provides economic policy recommendations to help guide the EU towards its goals.

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