

Europe's economic
priorities 2010-2015

Memos to the new Commission

Edited by
André Sapir

Contributions from:

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BRUEGEL MEMOS TO THE NEW COMMISSION
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Foreword

THERE IS NOW A DISTINCT POSSIBILITY that this crisis will be remembered as the occasion when Europe irretrievably lost ground, both economically and politically.

Economically, there is a risk that, by compounding lingering demographic and economic problems, the crisis will result in a spiral of near-stagnation, rising public debt and declining innovation performance.

Politically, the European Union is at risk of being blamed for having fostered a liberalisation agenda in the past rather than being praised for having promoted a coordinated response to the crisis when it struck.

Although Europe should be part of the answer to current economic woes, there is currently no appetite for bold European initiatives.

For these reasons, the next European Commission will have an exceptionally difficult task. At a time of retreat into the national sphere and disenchantment with the EU, it will need to fight in defence of commonly agreed rules, to propose new solutions, to redefine the European narrative, and to make the EU an effective player in a fast-transforming world. If the Commission succeeds, it may turn the crisis into an opportunity. If it fails, the EU may become less relevant.

The stakes are therefore high, and priorities will need to be set from day one. This is why Bruegel has decided to contribute to the debate on priorities and to prepare a series of open memos for the attention of the new Commission.

Our memos are intended to be strategic. They do not spell out the whole agenda awaiting the commissioners but succinctly describe the state of affairs, outline the key challenges and propose key priorities. Also, the twelve memos in this volume do not cover the whole range of policies, but focus on the most important economic questions at the EU level.

It is impossible to boil down the findings of the memos to a few bullet points. However two common themes emerge.

The first theme is the need for balance between the focus on tackling the crisis and holding a firm line on long-term challenges, which in turn have a domestic and an external dimension. Internally, the Commission must tackle head on the growing economic and social tensions between individual member states. Externally, it must ensure that Europe is a coherent rather than a fragmented actor both globally and regionally in its own backyard.

The second theme is that the times call for courage. More than its predecessors, the next Commission will be faced with the need to ward off economic nationalism and put critical

choices straight to the member states and the citizens of Europe. The risk of economic, social and political relapse is just too high for a low-profile strategy to be an acceptable one.

The memos have all been written by Bruegel scholars and their preparation has been coordinated by Senior Fellow André Sapir. As for every Bruegel publication, each of them reflects the views of its author(s), and there has been no intention to write a 'Bruegel programme'. But the memos have been discussed extensively within the team and therefore provide a reasonably coherent picture of what needs to be done.

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

Jean Pisani-Ferry and André Sapir
Brussels, September 2009

The President

To: The President of the European Commission
From: Jean Pisani-Ferry and André Sapir
Subject: Priorities for your term of office
Date: 1 September 2009

For a quarter of a century each European Commission has been defined by a paramount achievement, often in connection with a major treaty change: the first Delors Commission is remembered for the single market; the second for the Maastricht Treaty; the Santer Commission for the launch of the euro; the Prodi Commission for the big enlargement to the East; and the 2004-2009 Barroso Commission will, it is to be hoped, go down in history for taking the initiative on climate change and getting the Lisbon Treaty ratified.

Each of these attainments was a step forward for Europe. Should the next Commission set itself, and propose to the peoples of Europe, a similar goal? Or should it rather accept that it will be fighting mainly to preserve past achievements and set itself the goal of limiting the slippage? This is the main question you should ask yourself while preparing for the next five years.

Challenges

IN THINKING ABOUT THE AGENDA FOR THE NEXT FIVE YEARS it is appropriate to depart for a moment from current discussions and assess what Europe's priorities were before the crisis. Its main challenges were essentially long term. They concerned a number of tectonic changes that started at the end of last century and which are likely to have a profound impact on the twenty-first century: globalisation and the (re)emergence of China and India as leading economic and political powers; the erosion of Europe's traditional comparative advantage in human capital and the need to foster the development of a knowledge-based economy; the ageing population and its consequences for European societies and public finances; the return of mass migration; energy security; and the need to take decisive measures to fight climate change. At regional level, the challenges for a largely reunified Europe were to carry through enlargement and redefine its relationship with its neighbours. At global level, it was to behave as the soft but effective power it claimed to be.

These were daunting challenges, but mostly ones that naturally called for a common European response and were perceived as such by public opinion. To take only a few examples, there was no need to be a federalist to accept that climate change and mass migration had to be tackled at European level, or even that only the EU could weigh enough in international negotiations with the new giants. The EU's slow-moving governance apparatus also provided an appropriate basis for balancing the inevitable short-termism of elected governments and the need to respond to long-term challenges.

Over the past ten years the EU has started to provide structural responses to these challenges. Enlargement has been a major achievement. On some fronts (the knowledge society, migration or climate change) the jury is still out, as commitments need to be followed by acts, but at least the agenda has been clearly set. On others (ageing, energy security, neighbourhood, external representation), there has barely been any move to date, but at least the questions have been raised.

In brief, prior to the crisis Europe had a clear agenda, some progress had been made towards defining and implementing it, and much more was still needed. There was also a clear strategy for the Commission president: to focus on the challenges one by one, seize the intellectual high ground, set out the risks, outline policy responses, and build coalitions for common European solutions. At a time when there was palpably little appetite for major institutional initiatives, this was a practical, results-oriented approach very much in the spirit of the famous 'small steps' method.

The crisis has brought six major changes in this landscape:

- **First**, it is making the long-term challenges faced by Europe even more acute. At global level, convergence between emerging and advanced countries will doubtless accelerate as the negative growth impact of the restructuring of the financial sector is likely to be felt more in the latter than in the former (which can still rely for a while on traditional sources of growth based on imitation). This will affect the global power balance – in fact it has been redefined already – but also strengthen the need for structural adjustment in Europe, especially in the old member states. Simultaneously, public debt in these countries is set to increase significantly, precisely at a moment when the effect of ageing on public finances is starting to set in as baby-boomers retire. This will compound pressures linked to globalisation and have serious implications for Europe's social models at a time when they are already strained by the return of mass unemployment.
- **Second**, the crisis is calling into question one of the EU's recent successes. The growth model of several of the new member states, which relied on massive capital inflows, suddenly looks problematic. The potential for catching up remains generally good but the path towards it is much less assured and those of the new member states who financed present consumption with foreign savings will need to reassess their

economic strategy fundamentally. IMF intervention within the EU for the first time in three decades highlights the seriousness of the situation and Europe's limited ability to address its own difficulties. In some of the new member states, the dramatic revision of growth prospects may even end up shaking the existing consensus in favour of European integration.

- **Third**, extensive state intervention to assist sectors in distress is creating tensions between the logic of European economic integration and the logic of national political accountability. Governments that strive to prevent financial or corporate bankruptcies are accountable to their citizens for the use of public funds and insist that they be used domestically, but this is in contradiction with the very principles of EU integration. The integrity of the single market is, and is likely to continue, being threatened by sectoral state support schemes during the crisis. The most glaring problem lies in the banking sector, which has become heavily dependent on national budgetary support that is often accompanied by trade-distorting measures. But the problem also lies outside the financial sector. It is most acute in the automobile sector, where national intervention is designed to preserve national jobs, often at the expense of jobs elsewhere in Europe, but it could spread to other sectors.
- **Fourth**, the crisis is exposing fault lines in the current European governance system. To start with, policy integration in the financial sector lags behind market integration and it has become evident that the coexistence of pan-European banks and purely national supervision is unsustainable. As the Turner Review commissioned by the UK government puts it, 'sounder arrangements require either increased national powers, implying a less open single market, or a greater degree of European integration'. The problem is being addressed through enhanced coordination, but a sticking-plaster solution won't suffice. A related fault line is that of crisis management: at the height of the financial crisis in October 2008, the EU was able to get its act together but this was largely done outside the institutional framework. What this episode exposed was that the EU has an elaborate crisis-prevention system but no built-in crisis-management capability. It is no accident that the ECB is the only EU institution to emerge strengthened from the crisis so far: it is a full-fledged, unrivalled decision-maker in its field. The dilemma the EU faces is that the crisis has highlighted a need for further reform of its economic governance, involving more policy centralisation in some fields, while there is in fact no appetite for such reforms, let alone for devolving more powers to Brussels.
- **Fifth**, the crisis risks calling into question the very legitimacy of the European Union. Over the past twenty years EU integration has mostly been associated with liberalisation (although perceptions differ from country to country). Yet the crisis is widely (and rightly) perceived as a major failure of financial liberalisation, responses to which cannot consist of mere tinkering with regulation. The situation calls instead for a major redefinition of the relative roles of governments and markets, certainly in financial markets and perhaps even in other areas. This begs the question as to whether such increased public intervention will take place at the member-state or EU (or even global) level. Ultimately the issue is, therefore, whether the potential backlash against liberalisation will produce a collateral backlash against the EU. Indeed a backlash against the market could indeed easily turn into a backlash against the very bedrock of European economic integration, the single market. Or will the EU be part of the redefinition of the relative roles of states and markets? This question leads in turn to the issue of governance reform, and the response that is provided to this question could have considerable consequences for the EU itself.
- **Sixth**, a remarkable feature of the reaction to the crisis so far is that the international community has responded to it with a strengthening of

global governance. This has helped maintain the integrity of international economic relations while alleviating the effects of the shock in the hardest-hit countries. The EU, which sees itself as a natural champion and a laboratory of global governance, strongly supports the process initiated with the first two G20 summits. Yet assuming this spirit of global coordination proves durable, it will not be without difficulty for the EU, which is only partially equipped for acting as an effective global player and more than often behaves as a 'fragmented power'. A

lasting revival of global governance – and the redistribution of global institutional power this would necessarily imply – would expose the weaknesses of European external representation and governance and could become a double-edged sword. For the larger member states, coordination at G20 level could become a substitute for coordination at EU level. Whether the EU ends up as a player or a taker in the global governance game may have crucial implications for its future.

You will have to redefine the EU narrative. Citizens need to know what is the *raison d'être* of the EU. The outgoing Commission has not been successful in demonstrating what the EU stands for.

A strategy

YOUR FIRST TASK will be to deal with the consequences of the crisis through a series of initiatives. First, as guardian of the treaty your Commission has a duty to police the existing EU rules. This means combating infringements to competition rules and the single market, and implementing the Stability and Growth Pact to trigger the necessary budgetary adjustments. Second, the new Commission will also have to see through the on-going legislative process introducing the new framework for EU financial supervision. Third, your Commission will have to work closely with our foreign partners to fulfil the promise of world leaders meeting in L'Aquila in July to complete the Doha Development Round in 2010, which remains our best insurance policy against the risks of protectionist responses to the economic and social consequences of the crisis. Your other priority task for the next few months will be to deliver on the EU's commitments on climate change control and to secure similarly ambitious promises from our foreign partners so as to ensure the success of the UN Climate Change Conference to be held in Copenhagen at the end of this year.

But demanding though these tasks will be, you cannot afford to confine yourself to planning for the next few months. The challenges we have described above clearly suggest that the stakes for Europe in the next few years will be high and that they call for a transformational agenda. Lack of ambition for Europe would in effect not appease, but rather vindicate, the anti-European forces that have emerged in recent years, and entail the risk of jeopardising the European project itself.

Yet, at the same time, it must be recognised that no one is contemplating a major institutional initiative, let alone a new treaty change, so whatever will be done needs to take place essentially within the framework of the Lisbon Treaty – assuming it is ratified by the time the new Commission takes office.

The solution to this dilemma lies primarily in leadership. The duty of your Commission will be to define the challenges, set out the choices and

propose the common responses Europe needs. At a time when each and every head of state and government will be overwhelmed by domestic problems, you cannot expect them to come up with ideas and initiatives for the collective good. Their consensus is unlikely to provide useful guidance. Boldness will be needed and it is unlikely to come from them. It will need to come from you and your Commission colleagues. You should therefore be ready to fight for ideas and take necessary risks.

You will have to redefine the EU narrative in a transformed context. Citizens need to know what is the *raison d'être* of the EU, ie what it is about and what it stands for. The outgoing Commission has had some success in defining what the EU is about: with its initiatives on climate, energy and migration it has been able to recast Europe's role in an age of globalisation. On the other hand, it has not been successful in demonstrating what the EU stands for: it had to backtrack on the services directive, proved inconsistent on financial liberalisation and was unable to define what a renewed European social agenda might consist of. As the old alliance of convenience between free marketeers and federalists has largely run out of steam, a new compromise needs to be found that allows citizens of various cultural and political backgrounds to identify with Europe. Ideas have been proposed, such as Mario Monti's call for a new balance between liberalisation and redistribution. You will need to find the words that capture the idea you intend to recommend but, more importantly, you will need to reach out to member states, the European Parliament and civil society to build consensus on and elicit support for your proposals.

Leadership will also be needed to put in place a coherent post-crisis economic strategy. No matter how serious the immediate problems, the Commission will need to focus its action and that of national governments on the long-term challenges. This will imply pressing national governments to avoid immediate moves that jeopardise common longer-term goals, but also defining and implementing measures that will strengthen growth potential and avoid the stagnation trap that

threatens Europe's future. To this end short-term responses need to be consistent with long-term goals. This is not the case at present with, on the one hand, a series of immediate, short-term initiatives and, on the other hand, a Lisbon Strategy which is losing the little traction it once had.

You should take the initiative and propose to define and implement for the next five years an economic revival package consisting of:

- A programme to restore the sustainability of public finances;
- A blueprint for recovery in the new member states and for euro-area enlargement;
- A plan for exit from exceptional crisis-management action;
- A European Growth and Employment Programme.

The details of the first two proposals are presented in the memo to the Commissioner for Economic and Monetary Affairs, so we focus here on the last two.

The exit from exceptional crisis-management measures involves many technical dimensions that are better dealt with by specialists. But there is one dimension that you should concentrate on: the extent to which these policies need to be coordinated. In banking, the loose character of coordination has been highlighted by the absence of a European process of triage involving consistent balance-sheet assessment and stress-testing, which puts the single market at risk. You should emphasise that while member states remain responsible for providing financial support there is a need for a common solution to Europe's banking problems. Similarly, unless the Commission takes the initiative in helping to restructure an automotive sector suffering from overcapacity (owing not only to new competitors but also to rising oil prices and concerns about climate change), national intervention could severely damage the single market. In both cases exceptional measures do not require permanent transfers of sovereignty, but rather an explicitly temporary common response.

The crisis risks significantly and permanently reducing the EU's potential output. There is also a serious danger of a reduction in long-run potential growth rates, as the crisis is likely to result in a more restrictive financial regime less conducive to innovation. Together with weakening demographic conditions and the higher tax rates implied by the deterioration of public finances, such developments would turn Europe into a permanently low-growth area incapable of attracting, or even retaining, the most productive personnel and companies.

Countering these dampening forces will require a new European Growth and Employment Programme – as such, the successor of the Lisbon Strategy – which could rely on some of the features of the Lisbon agenda, in particular the lynchpin role of a competitive single market for boosting productivity growth and of well-functioning labour markets and social conditions for improving employment performance. In addition, and in contrast to Lisbon, the new programme would need refocusing and a stronger EU component in selected fields. Candidates include: financial markets, which were neglected in the Lisbon Strategy and remain an essential catalyst for investment and innovation; the knowledge triangle, and in particular higher education, where Europe can build on the success of the Bologna process and take initiatives in line with the European Research Area concept enshrined in the Lisbon Treaty; and green growth, where the EU needs to make its climate commitments the basis for a sustainable economic development strategy.

In designing the new European Growth and Employment Programme for the period after 2010, you will be confronted with one major difficulty. You will not have any new money to rely on since government finances are stretched to the extreme. Luckily, you will have an opportunity to improve the EU budget: in 2005, the European Council agreed on the principle of carrying out an in-depth budget review. This review initially planned for 2008/2009 has been postponed until after the entry into force of the Lisbon Treaty. You should conduct this review as soon as you take office and put forward without

delay proposals for an immediate revision of the EU budget. The new economic situation calls for new spending priorities. Postponing changes until the start of the next programming period in 2014 would be a sign of misplaced inflexibility. Consistent with the European Growth and Employment Programme you should therefore propose a revision of the EU budget effective in 2011.

Last but not least your economic strategy must continue building on the efforts of the Barroso Commission to shape globalisation. The emergence of new global powers requires a rethink of global governance to ensure that all the essential players have a stake in the process and are effectively engaged in it. This concerns not only traditional areas and institutions such trade and the WTO or international finance and the IMF, but also new areas such as climate change. The combination of a global crisis-inspired spirit of cooperation and of a US administration that is sympathetic to multilateralism offers a rare opportunity for progress. To play its role, the EU should first overcome its 'fragmented-power' syndrome and reform its internal governance in order to speak more effectively in international economic forums. A situation in which the EU has a seat at the G20

but is not considered a legitimate voice by its own members is untenable. There are means to improve upon the present situation even in the absence of governance reform. For instance, the participating EU countries could speak with one voice within the G20 by delegating to one of them the responsibility for presenting the European position on a particular topic. Second, the EU should stop playing rearguard games and spell out its conditions for accepting a significant *diminutio capitis* in international forums.

Although the global agenda should be one of your priorities during the months and years ahead, it should not lead you to forget that Europe also has crucial regional responsibilities. Our neighbourhood is potentially highly volatile and requires more focused attention on our part, especially in view of the destabilising repercussions of the crisis. Despite some recent progress, the EU's neighbourhood policy remains unfit for purpose. This partly reflects an uncertain or ambiguous stance towards enlargement, partly the fact that two important pillars of our interaction with neighbouring countries – energy security and migration – remain largely outside the scope of effective common EU action. These shortcomings will need to be remedied.

Organisation of the Commission

DESIGNING SUCH A STRATEGY will require leadership on your part. Setting it in motion will furthermore require turning the Commission into a more effective actor, better equipped to deal with major evolving challenges. This means becoming more of a 'policy Commission' and less of a 'process Commission'. Changing the mix between the two will necessitate reforms in three areas.

The first concerns the portfolios and the role of commissioners. In order to exercise leadership in key areas, a certain number of new posts should be created:

- **Commissioner for Economic and Financial Affairs.** The previous arrangement whereby responsibility for economic and financial affairs was split between two commissioners has been detrimental to both the Commission and the EU during the economic and financial crisis. It weakens the Commission internally, vis-à-vis finance ministers, and externally, in international forums. Correcting this situation should be a priority.
- **Commissioner for Internal Market and Industrial Affairs.** With the merger of economic and financial affairs, the commissioner in charge of the internal market will be deprived of one of his/her main responsibilities. At the same time, the commissioner in charge of industrial affairs, or more recently enterprise, has lacked proper policy tools. It is proposed, therefore, to go back to the situation that prevailed until the early 1990s and to merge internal market and industrial affairs. This will be especially important at a time when industrial restructuring is again high on the European agenda.
- **Commissioner for Climate Change Policy.** Creating this new post will send a strong signal that climate-change policy will be a key priority of the new Commission and of the EU, not only in Copenhagen this December but also in the years ahead.
- **Commissioner for the Knowledge Economy.** Creating this new post will underscore the fact that making Europe a knowledge economy remains a vital priority of the new Commission. The knowledge commissioner should have responsibility for the three sides of the knowledge triangle: higher education, research and innovation.
- **Commissioner for Enlargement and Neighbourhood Policy.** For its own economic and political stability, the EU needs to pay much more attention to its neighbours. Having one commissioner in charge of enlargement and neighbourhood policy will be an important step in seeking to devise coherent policies towards these countries.

In addition, the entry into force of the Lisbon Treaty and the creation of a new Commission Vice-President for Foreign Affairs and Security Policy will be an opportunity to rethink the organisation of the entire Commission, and not just in the foreign policy area. Having one commissioner per member state is positive for the Commission's legitimacy, especially in its legislative role. However with 27 member states, and soon more, it means having too many commissioners in relation to the actual responsibilities of the Commission. The time may have come, therefore, to reflect on the value of introducing two levels of commissioners, just as

Turning the Commission into a more effective actor means becoming more of a 'policy Commission' and less of a 'process Commission'.
Changing the mix between the two will necessitate reforms.

most governments have ministers and secretaries of state. Regardless of whether such an approach is deemed feasible or desirable, the Commission must find a way to act as a college that takes the time, despite its size, to deliberate on important policy choices. This is a *sine qua non* for the Commission to act as a policy- rather than a process-driven institution and to exercise leadership.

The second area of reform concerns civil servants.

There is obviously plenty of talent within the Commission, but it cannot ignore the immense pool of talent that exists in other institutions within or outside Europe. Except after an enlargement, the Commission – contrary to, for instance, the European Central Bank or the European Investment Bank – rarely opens its top positions (director-general, deputy director-general or director) to persons working elsewhere. The Commission needs to find a better way to tap the best human

resources possible.

Thirdly, the Commission needs more and better evaluation of its regulatory and budgetary measures.

Some progress has been made with the creation in 2006 of the Impact Assessment Board, which evaluates the potential economic, social and environmental impact of new regulations prior to adoption of proposals by the Commission. There is, however, no comparable effort to evaluate policies that are already in place, whether they involve budgetary expenditure or not. This lack of ex-post evaluation is a major drawback of EU action which needs to be corrected. This need is likely to be reinforced by demands from the European Parliament, which will have greater budgetary powers under the Lisbon Treaty, to hold the Commission to account for EU budgetary expenditure. An independent European Evaluation Office should therefore be created.

Economic and monetary affairs

To: The Commissioner for Economic and Monetary Affairs

From: Jürgen von Hagen and Jean Pisani-Ferry

Subject: Priorities for your term of office

Date: 1 September 2009

State of affairs

BY THE TIME YOU TAKE OFFICE IN EARLY 2010 the EU economy is likely to be in the early stages of recovery. But you will inherit:

- A weak economy whose recovery is still hampered by the state of its banks;
- The return of mass unemployment, with unemployment rates above 10 percent of the labour force and in the 15-20 percent region in several cases, and no prospect of improvement in the short term;
- Industrial production shortfalls of a magnitude not seen since the Great Depression, as output in several member states is likely to be more than 10 percent lower than expected before the crisis. These shortfalls may only be partially recoverable in the foreseeable future, as withdrawals from the labour force, cuts in investment and innovation spending, and the inability of the financial system to support profitable firms and allocate capital to the most productive use may have severely lowered the production potential;
- A depression-deep crisis in parts of central and eastern Europe (with output in the Baltic countries 20 or 30 percent below the level expected before the crisis and several countries in the region, including EU member states, under IMF programmes);
- A profound deterioration of public finances, virtually all EU member states officially considered as having 'excessive deficits', general government deficits in excess of 10 percent of GDP in several countries, and an increase in the average public debt ratio by 20-30 percentage points, in some cases much more. Persistent deficits in some countries are likely to lead to a serious threat to the sustainability of public finances.

You will also be confronted with increased divergences between countries as some suffer much more from the crisis than others and, as a consequence, risks of divergent political and policy developments. In the euro area, some countries may face problems with financing their public expenditure and rolling over their public debts as

markets will question the sustainability of public finances. In any case, there will be tensions between countries running surpluses and countries running deficits on their current accounts, with no consensus on what is the desirable adjustment process. In the new member states, acute crises will heighten doubts about the viability of the growth and convergence models of some of the former star performers.

From a political and policy standpoint, the crisis has undermined public confidence in open and competitive markets and this will reduce public support for the single European market and the structural reforms you certainly intend to push for. Necessary or at least legitimate government intervention to rescue private banks and companies may have degenerated into a pervasive appetite for state aid and a distrust of competition, with the result that your colleague in charge of competition policy, but also the whole Commission, will be on the defensive. You should be prepared to face creeping fragmentation of the European economy as a consequence of growing divergences among member states, possibly involving conflict over the desirable direction of economic policy, and a return of economic nationalism.

In the best possible scenario, the next five years will be devoted to, and marred by, the process of adjusting to the shock and by the end of your mandate you will only be able claim that the major part of the adjustment has been completed.

You must furthermore be aware that confidence in the effectiveness of the EU economic policy system has been severely hurt by the crisis. Thanks to its immediate response to the liquidity crisis and its large-scale continuing support to the banking system, the European Central Bank (ECB) is emerging strengthened from the crisis. Assuming that the immediate threat to financial stability is over and that the large amounts of liquidity injected into the financial system in recent months can be mopped up without resulting in increased inflation, the ECB will have gained both legitimacy and a reputation for effectiveness. The same cannot be

said, however, of the other components of the euro-policy system. By controlling public deficits, the policy framework was intended prevent crises from occurring but it has in effect contributed to distracting attention from instabilities looming in the private sector. Efforts to make public finances in the member states more resilient to economic and financial crises and to build the basis for common action in times of crisis have also been insufficient.

You are going to be in charge of managing procedures, such as the Stability and Growth Pact, which have suffered from considerable loss of credibility. You will shortly be requested to report on the enlargement of the euro area on the basis of two criteria, one of which (inflation) will tell you that virtually all countries are able to join and the other one (deficits) that virtually all countries are unfit to join. You will be supposed to rely on, and provide input to, an institution – the Eurogroup – that was established to deal with the unexpected but which has not been able to take any meaningful initiative when the unexpected occurred. The Commission itself has lost its shine because it has failed to seize the initiative at the crucial moment and has not proven to be an effective crisis manager. So, a key choice for you and your colleagues is whether to focus on policy action, at the cost of relying on impaired policy instruments, or to propose policy reforms, at the cost of being distracted from action at a time when it will be urgent.

There is finally a field where you may have to take the initiative for institutional rather than purely economic reasons. Global economic governance is changing fast as a consequence of the recognition that (a) the crisis calls for global solutions and (b) the time has come to give voice and power to the largest emerging and developing economies. No one knows whether the G20 will become an effective institution for global economic management or be a mere forum for dialogue. But significant reforms are possible, because the current US administration is more sympathetic to multilateralism than the preceding one. This raises the question of Europe's ability to define and play its role at the global level, and therefore of the voice and representation of the EU and the member states. The rest of the world is increasingly irritated by Europe's permanent squabbling over chairs in international forums and the Commission advocating consolidation. The reality is that in recent years Europe has not moved towards this, but rather away from it. Now that the role of the G20 has been expanded, the larger EU member states are less keen than ever to concede power and voice and it is true that, throughout the crisis, the EU as an entity has not been able to engage in a meaningful way in international economic and financial discussions. Together with the president, it will be your role to take initiatives and make proposals for reforms in this area, and this will be facilitated by the entry into force of the Lisbon Treaty.

In the best possible scenario, the next five years will be devoted to the process of adjusting to the shock. Confidence in the EU economic policy system has been severely hurt by the crisis.

A strategy

AGAINST THIS BACKGROUND you cannot afford to be merely a servant of outdated procedures, and you cannot afford either to be the advocate of institutional reforms at a time when everyone's attention is (rightly) focused on results. What you can do, however, is to make use of a situation that calls for close consultation and coordination to redefine the role of the Commission and regain authority. To this end, you should devise and propose a strategy centred on economic priorities for the EU and make sure that it can be carried out within the existing institutional framework, while creating opportunities for later changes in governance.

The six pillars of the strategy should be:

a) An exit plan

When the crisis hit, exceptional measures were taken to prevent a collapse of the financial system, avoid a generalised credit crunch, limit the depth of the recession, avert bankruptcy contagion, and contain damage to labour markets. Most of these necessary measures took policymakers into the very territory they were previously cautious not to venture into: massive expansion of central bank liquidity, extraordinary deficits and pervasive state aid, to name only the main measures. As the situation stabilises and the contours of the recovery emerge, the question will increasingly be about when and how policy can exit the crisis-management mode and return to normality.

Eagerness to exit from exceptional crisis management is natural – and welcome. The sooner a normal policy framework can be restored, the better. But a generalised rush to exit combining the mopping up of liquidity, interest rate increases, vigorous budgetary adjustment and the withdrawal of government guarantees would be a recipe for a double-dip recession. Exit is bound to be gradual and because crisis management policies are interdependent, a proper sequencing of normalisation action by governments, the Commission and central banks is essential for

success. Coordination across countries will also matter, especially about governments' withdrawal of exceptional bank support, but also on the budgetary side. Your first priorities should therefore be to establish a temporary consultation mechanism so that exit decisions are coordinated among the various players, and to propose an exit plan that allows a return to the normal state of affairs while providing the necessary conditions for a strengthening of the recovery. This coordination effort does not need to result in permanent arrangements. In fact, it is likely to be better accepted if explicitly provisional.

b) A European growth programme for the next five years

Beyond the immediate measures, Europe needs longer-term initiatives to reignite growth and employment. These must involve EU action in fields such as capital markets and climate change, national initiatives in areas where member states have the leading role, such as in certain product markets and certainly labour markets, and joint initiatives in fields like higher education, research, and innovation. You are not in direct control of any of these instruments so we will not describe the necessary action in detail here (they are presented in the memo to the President). But we wish to insist on one point: you cannot abandon the design of the growth strategy to your colleagues in charge of specific instruments or sectors or to the necessarily political supervision of the president. The responsibility of the Commissioner for Economic and Monetary Affairs is not only to manage the specific instruments he or she is in charge of – such as the Stability and Growth Pact – but, equally importantly, to be the relentless advocate of economic efficiency and coherence within the Commission. Your role will be to devise and propose the economic underpinnings of a new programme for 2010-2015, linking the immediate crisis management measures with the longer-term priorities. This is an essential role: the situation is too serious for Europe to succumb again to the temptation to pursue pork-barrel economics.

c) A European sustainability programme for the next five years

Virtually all EU member states need to design and start implementing budgetary adjustment programmes to trim and eventually eliminate their deficits, with a view to stabilising and later reducing their public-debt ratios. Given the magnitude of the deficits and the need to avoid withdrawing the stimulus prematurely, a five-year horizon is appropriate for programming the adjustment. Within this timeframe budgetary adjustment needs to involve (in variable proportions depending on the country) expenditure cuts, tax increases and pension reforms that improve the long-term sustainability of public finances. In several countries institutional reforms are also needed in order to enhance the credibility of commitments to budgetary discipline.

To trigger this process, the procedures of the Stability and Growth Pact (SGP) will be of limited help. They were designed to single out and punish individual sinners, not the entire EU. And they are of questionable value, as a narrow focus on deficits blinded your predecessor to vulnerabilities in countries whose fiscal performance relied on the financial health of shaky banks. You cannot afford to start by opening the Pandora's box of SGP reform, so you will have to tinker with this damaged instrument. But you will have a new ally: market discipline. In the crisis markets have differentiated much more forcefully between sovereign debtors of different perceived quality than before and, even if spreads have narrowed, the memory of this episode remains. Furthermore, rating agencies have started to downgrade several states. So while EU sanctions remain an elusive threat, funding crises have become a real one. This increases the value of EU 'labelling' of national budgets and can be a powerful incentive for governments, provided you play the game skilfully. Clearly, for you to put market discipline on your side, you will need to avoid making open-ended commitments of unconditional financial support to all euro-area countries.

What you have to do is first to build consensus on

the desirable pace of the budgetary adjustment. Together with the president, you should propose a European Sustainability Programme for adoption by the European Council, as a companion the European Growth Programme.

The European Sustainability Programme should make use of the provisions of the SGP which provide a margin for a more sensible approach to budgetary discipline:

- First, it should define country-by-country deficit objectives for 2015 that take into account both the level of public debt and implicit liabilities, including those arising from unfunded pension liabilities. If countries reduce their implicit liabilities, for example through pension reforms, this should be taken into account in a revision of the budget-deficit objective.
- Second, it should include a commitment by each member government to present to its parliament by September 2010 a medium-term budgetary programme that sets out the measures proposed in order to achieve the budgetary objective.
- Third, it should call on member states to reform their policy institutions and rules, with a view to enhancing budgetary credibility and creating the conditions for a decentralisation of fiscal discipline. Incentives for decentralised discipline should be adopted so that countries with more credible institutions or effective rules, and a stronger record, are given more flexibility in the short run.

d) A framework for coordination within the euro area

One of the main lessons from the crisis is that the old mechanisms for coordination among the finance ministers, especially of the Eurogroup, have not worked well. This concerns both the reaction to the financial crisis when it became visible on the horizon during the autumn of 2007 and the spring of 2008 and especially when it hit in September of

2008, and the reaction to the severe economic downturn that followed. In the past, crises have regularly been opportunities for European integration to develop in new directions and to improve the EU's institutional structure. An important challenge for you and the Commission more generally will be to muster sufficient leadership to seize this opportunity to strengthen the EU's governance.

During the first ten years of the euro, divergences within monetary union were left unattended as long as they did not originate in divergent budgetary positions. This was not because of a lack of mandate or instruments – after all the EU adopts annual country-specific Economic Policy Guidelines and can if needed issue recommendations – but the assumption was too often that instability can only result from fiscal irresponsibility. Yet the two euro-area countries where a bubble burst and domestic demand collapsed in 2008-2009 were both paragons of fiscal rectitude. This is a clear indication that the existing framework for surveillance and coordination is inadequate (as in fact recognised early on in the Euro@10 report presented by your predecessor in spring 2008).

Looking forward, you need to propose to the Eurogroup new benchmarks for the surveillance of national policies. Here you cannot rely on the existing framework, which barely exists, but must think afresh. The most promising avenue is to select a set of indicators (including the external balance and relative competitiveness) and to use them as a systematic basis for macroeconomic surveillance. You should state your intention fully to play your role, which implies preparing country-specific surveillance reports whenever you perceive a risk to macroeconomic sustainability and making proposals for the use of country-by-country recommendations under Article 99 of the treaty. However you should be aware that this will imply having a view on the situation of surplus as well as deficit countries. Even-handedness is essential to the credibility of macroeconomic surveillance.

However, even the best surveillance framework will not banish crises. We now know how damaging they can be and we have even learnt that crises within the euro area are possible. As already observed, a funding crisis affecting a member state of the euro area has to be regarded as a possibility and the EU must draw up contingency plans for such situations. Yet a lesson from recent months is that the EU is not equipped with crisis-management capabilities.

You should therefore prepare a proposal on how to coordinate crisis response at EU level. This need not imply additional treaty instruments but a political agreement on how the existing tools, such as Article 100 of the treaty, should be used when an urgent response is called for.

e) A blueprint for recovery in the new member states and euro-area enlargement

Several of the new member states have been hit very hard by the crisis and you should be prepared for the unexpected. It is to be hoped – but it is by no means certain – that the intensity of the crisis will have abated somewhat and instead of managing further crises you will be able to concentrate on supporting the recovery. But even on this optimistic assumption your task will not be an easy one. There is a clear risk that the successful growth model that allowed rapid catching-up in the region will not survive the crisis and that some of the new member states will experience relative stagnation. You should therefore assess the obstacles to growth and propose a blueprint for recovery in the new member states.

An issue of major importance in this respect is euro membership. The euro area members, the ECB and the Commission have argued so far that euro entry should be decided country-by-country on the basis of the criteria set out in the early 1990s for the formation of monetary union in 1999. But this makes less and less sense. First, the country-by-country approach ignores regional spillovers. As Slovakia has experienced, a country's fate in the euro area depends to a great extent on the

monetary strategy of its competitors. Second, the criteria made little sense in normal times but they have now become wholly inappropriate. When two criteria designed to be mutually consistent – inflation and deficits – convey opposing messages, it is likely to be because there is a problem with the criteria.

So your economic brief is clear: you should break with the formalistic approach and make an economic assessment of the costs and benefits of euro membership on the basis of both the immediate benefits of joining and the longer-term sustainability issues, and taking into account the regional dimension. You should assess at what exchange-rate level potential members should join and what should be the preconditions, including in some cases as regards the restructuring of private hard-currency debts. This assessment should be discussed with candidates and euro-area members and serve as a basis for a renewed euro-area enlargement strategy. To countries wishing to join the euro, a path to membership should be offered, with clear, economically meaningful benchmarks instead of a-temporal, nowadays largely irrelevant criteria. Countries preferring to postpone euro entry should be free to do so. Looking beyond the EU borders, monetary cooperation should be offered to neighbouring countries.

To restore some economic logic to a process where a legalistic approach has been allowed to dominate (in large part because it offered a convenient excuse for procrastination) will not be easy. But you should remind everyone that the criteria for joining the euro were introduced in order to ensure that economic logic prevails over political logic, not that legal logic prevails over economic logic.

f) A path towards common external representation

For decades now the Commission has, rightly, argued that the EU is a much more effective player in the trade field, where it speaks with the one voice of the commissioner for trade, than in the macroeconomic or the financial fields, where it speaks with several voices. For decades it has insisted that trade policy therefore provides a template for the management of external economic relations and that it should be replicated in other fields. But it has not had any significant success in bringing this about.

The reasons for this state of affairs are many. One is that topics discussed at the G20 or at the IMF board meetings only partially belong to the EU's remit. Another is that IMF constituencies include EU as well as non-EU countries, so there cannot be an EU voice as there are no EU seats. A third reason is that the Commission's contribution to international affairs has never been exceptional. But by far the most important reason is that the larger member states are willing to use any pretext to hang on the power they have. The creation of the G20 has made them less keen than ever on changes in their external representation. Why, after all, should large European countries refrain from speaking with their own voice when Argentina and Australia have a seat at the G20?

If you do not engage battle on this point, you may soon observe that individual representation of major member states in global discussions may lead them to attempt to bypass the EU level – thereby undermining the single market and intra-EU coordination. The consequences for the EU could

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be severe and they would probably not be limited to the macro-financial field. Eventually, even integrated areas such as external trade could be affected. But revolution is unlikely and you must define a realistic path.

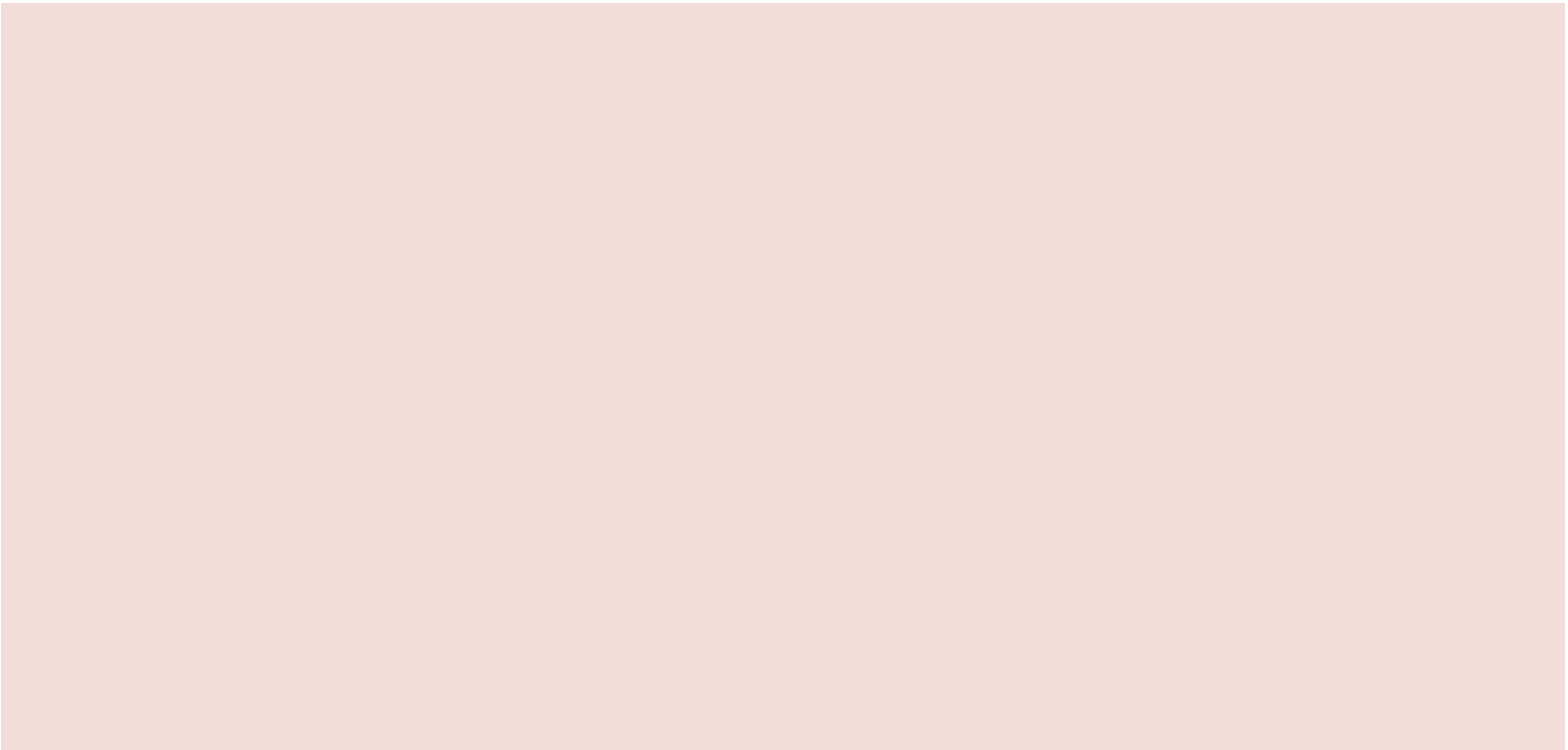
One way out could be to start by restructuring IMF constituencies in a way that ensures there is a subset of euro-area constituencies and a subset of non-euro EU constituencies. This would at least facilitate coordination and adoption of common positions, facilitating the task of the Commission and paving the way for future 'folding in' of representation into two constituencies.

Another initiative you should take is to outline a regional economic strategy for the euro area. The euro is not a rival to the US dollar but it is a very

successful regional currency, and a clear and necessary step towards a global role is for the euro to start by playing a meaningful regional role.

Crises are times for institutional reform and improvement. Most major steps forward in EU integration have come in response to political and economic crisis – for example the euro emerged from the inflationary traumas of the 1970s and the 1980s. When your predecessors called for coordination of national policies, their message often fell on deaf ears. To be sure, national policymakers are currently driven by political constraints and imperatives, but they also realise that boosting policy coordination is indispensable in the face of doubts about the viability of the euro. Now is the time to exert leadership and improve the framework for Economic and Monetary Union.

Crises are times for institutional reform. To be sure, national policy-makers are currently driven by political constraints and imperatives, but they also realise that boosting policy coordination is indispensable.



Financial services

To: The Commissioner for Financial Services
From: Nicolas Véron
Subject: Priorities for your term of office
Date: 1 September 2009

State of affairs

FINANCIAL SERVICES IS ONE OF THOSE AREAS for which the European Union can be both proud of its past achievements and humbled by the magnitude of its task. This would be the case even if the crisis had not erupted, but the current environment means that your portfolio has become one of the most exposed of the entire Commission. You are likely to be remembered either for major shortcomings and failures, or for major breakthroughs.

Over the past ten years, the Commission's efforts in your area of responsibility have been focused on one dominant goal: financial integration. The aim has been to forcefully eliminate barriers to the emergence of a single financial market. This effort has mainly centred on three major policies, the first two of which have been pioneered by other parts of the Commission: Economic and Monetary Union (EMU); competition policy, which has considerably reduced the scope for national banking protectionism under the cover of prudential supervision, starting with the landmark case of Champalimad in Portugal (1999); and the Financial Services Action Plan, an ambitious legislative programme adopted in May 1999 and mostly implemented during the following Commission term (1999-2004). These three policies have been conducted simultaneously with two major related developments, namely the introduction of the so-called Lamfalussy process for financial regulation and the adoption of International Financial Reporting Standards (IFRS).

There were good reasons to devote so much energy to financial integration. By enabling better

allocation of capital, it enhances Europe's growth potential. Furthermore, it contributes to the sustainability of EMU as it is a powerful driver of economic convergence; conversely, a monetary union with fragmented capital markets is likely to be subject to significant internal economic disparities which may threaten its very existence. An additional benefit, which was perhaps not explicitly sought, is that a financially integrated EU is a much heftier player on global financial markets than the sum of fragmented national systems could be, thus enhancing the EU's influence in international regulatory choices. A remarkable illustration of this was the extent to which other nations adopted IFRS once the EU had endorsed them.

Although economic impact is fiendishly difficult to measure, financial integration has indeed remodelled Europe's financial landscape in powerful ways. It has reinforced London as a major international financial hub, as many wholesale activities of continental financial firms have tended to migrate there: thanks to this the EU has the (by several measures) leading global financial centre on its territory. It has contributed to the strong catch-up growth of central and eastern European countries, which was largely fuelled by credit channelled through local subsidiaries of banking groups headquartered in the 'older' member states. It has generally fostered better financial services throughout the EU by raising the competitive pressure on incumbents, even though this effect has been unevenly spread as situations vary widely from one member state to another.

Challenges

IN SPITE OF PAST SUCCESSES, the challenges would have been daunting even if there had been no crisis; with the crisis, they are colossal. The current risks include major cross-border banking failures which could spiral out of control for lack of an appropriate crisis-management framework and may threaten the very fabric of the EU; an unravelling of global and intra-EU financial integration; and ill thought-out regulatory moves (or absence of necessary regulatory action) that would hamper Europe's growth potential. It would be foolish and utterly irresponsible to count on luck to prevent these risks from materialising, with all the catastrophic consequences they would have.

The core challenge is that your predecessors have made great and hard-to-reverse steps towards a single EU financial system but have failed to create the public institutions that would make such a system sustainable. During the decade to 2007, whether driven by ideology or captured by special interests or both, many observers and policymakers have complacently adhered to the view that the financial system would essentially take care of itself, and that the design and effectiveness of regulation and supervision were somewhat second-order issues. The crisis illustrates how misguided this view – in some cases inspired by free-market fundamentalist ideology – has been. The difficulty is that you cannot simultaneously have financial integration, full national financial policy sovereignty and effective supervision. Now, the third of these three dimensions can no longer be neglected, and as a consequence the EU finds itself in a trap from which there are only two possible exits: either market fragmentation, which would make everyone poorer; or institutional build-up, which is the far better option from an economic standpoint, even if fraught with technical and political pitfalls.

Conversely, you should be aware of the obverse risk of excessive or poorly conceived regulation, which would place a drag on Europe's competitiveness and reduce our growth potential. Well before the crisis, Europe had suffered from obstacles to the development of those financial services that are

most needed by high-growth firms which rely extensively on external funding, such as growth equity investment, subordinated and mezzanine debt and high-yield bonds. As a result, Europe (like Japan) has demonstrated minimal ability in the past few decades to nurture 'new champions', companies that grow from nothing to global leaders while creating a large number of jobs in the process – which, by contrast, are numerous in both the United States and emerging economies. Ill thought-through reactions to the crisis risk reinforcing such obstacles. Reducing them involves more competition in some financial services segments; better tailored tax, securities and prudential regulation; and reform and partial harmonisation of antiquated insolvency legislation. Good financial regulation is a delicate line to tread, and you will need a fine combination of market savvy and assertiveness on behalf of the public interest.

You will have to act simultaneously on a short- and a long-term agenda. On the short-term side, you are confronted with the sorry situation of Europe's banking sector, in which the need for comprehensive recapitalisation and restructuring has so far largely been met by policy paralysis. Beyond the immediate sticking-plaster solutions applied by member states since October 2008, a centralised system-wide approach is necessary to fix this banking crisis, and 'system-wide' here means EU-wide, or at least on a scale covering the main continental European countries (as the British and Scandinavian banking systems can arguably be considered autonomous with regard to the rest of the EU). In spite of all the criticism they have given rise to, the US 'stress tests', whose results were published in May 2009, have tentatively addressed this challenge. Continental Europe has done nothing equivalent. Europe-wide bank triage is necessary to provide transparency and trigger the indispensable restructuring of those multinational financial groups which may not survive on a stand-alone basis.

Furthermore, depending on the severity of the crisis-related future developments, the credit needs of Europe's companies and households may

not adequately be met in the short term by commercially run financial intermediaries, which could in some scenarios lead to a significant (though, it is to be hoped, temporary) build-up of public-sector credit providers to the economy. In such a case, innovative solutions will be needed from the EU institutions to prevent massive distortions in the European economy.

On a longer-term basis, you will need to work on all four dimensions of a sound EU financial services policy:

- **Financial stability** has understandably become the priority concern. Here the needs are effective supervision, protection of retail deposits and a capacity to manage future crises and let failed firms exit the marketplace in any orderly way. In an integrated financial system, these cannot be properly addressed with the current institutional fragmentation.
- **Financial efficiency** should be improved to enhance Europe's growth potential. It requires significant progress in the EU financial system's ability to provide external capital, which could be channelled from Europeans' ample savings to those actors who need it most, including fast-growth companies.
- **Financial fairness** should be pursued through adequate protection of the weaker players in the system, which depending on the issues may include consumers, investors and actual or potential competitors to powerful established players. The Commission has a number of instruments at its disposal to act in this area and you should advocate their robust use to meet the challenges created or reinforced by the crisis.
- Finally, **financial integration** must not be abandoned but, on the contrary, defended and promoted. It requires not only harmonisation of rules and regulations, but also consistent compliance and implementation, which is impossible without effective enforcement mechanisms. Better mechanisms are needed to meet this challenge.

You will have to deal with short-term crisis management. Simultaneously, you will face the indispensable reform of the EU financial regulatory and supervisory architecture.

Recommendations

TO MEET THESE MONUMENTAL CHALLENGES, you will need considerable doggedness and focus, and a stronger sense of direction and priorities than has been displayed in recent years as regards your portfolio. As the crisis creates more pressure for politicised, knee-jerk decisions, clarity of purpose is necessary not only to guide your own initiatives but also to be able to prevent ill-advised policy moves at a time when the desire to find and punish culprits can be high in the public consciousness.

Simultaneously, you should not sacrifice but rather reinforce the quality of the policy process. Though it has occasionally been used by some players to delay necessary policies, better regulation is a sound objective and should be defended against the temptation to skip thoughtful design, impact analysis and consultation of stakeholders in the name of expediency.

You will have to deal with short-term crisis management, which is *de facto* a shared responsibility between the national and EU level, and regulatory reform, which is mainly an EU-level responsibility but must be closely coordinated with other jurisdictions such as the US and international groupings such as the G20 and Financial Stability Board. Simultaneously, you will face a specifically European task, namely the indispensable reform of the EU financial regulatory and supervisory architecture. It will not be easy, even though the conclusions of the EU summit of 18-19 June provide a basis for progress.

To succeed in a demanding environment, you will need to go back to basics. First, you should publish, say in the first half of 2010, **a clear vision for the financial system Europe needs** – how stable, how efficient, how fair and how integrated it should be, reflecting the four dimensions described in the previous section. You should work hard to build a consensus for this vision among member states and the public. This will be a crucial step to allow you subsequently to set out the means to achieve the desired ends. Clarity of vision will help you not to be overwhelmed by turf fights and special-interest considerations, which weigh particularly

heavily in this policy area. You may not want to take a stance on all aspects early on, in the same way that the US president's plan for financial reform announced on 17 June leaves many key aspects open to further elaboration. But you need to articulate the key parameters that will then drive decisions on specific issues. Do not confuse haste with speed. As in high-end manufacturing, mistakes are better corrected or averted during the early design phase; otherwise, they will result in much longer delays and costs, or ruin the project altogether. Move swiftly, but make sure your vision is comprehensive and shared by a critical mass of constituents.

Then, basing yourself both on this vision and on the principles at the core of the European Union, you should devote the next six months to a comprehensive **Subsidiarity review**, to be carried out by the Commission's services under your leadership.

In this review, you should examine the key financial services policy areas, including financial stability and prudential oversight, protection of investors and consumers, market integrity, and financial disclosure. The review should be based not just on the usual routine of publishing drafts and collecting spontaneous feedback, which engages only the most dedicated special-interest groups, but on active consultation of those stakeholders whose welfare and input you care most about.

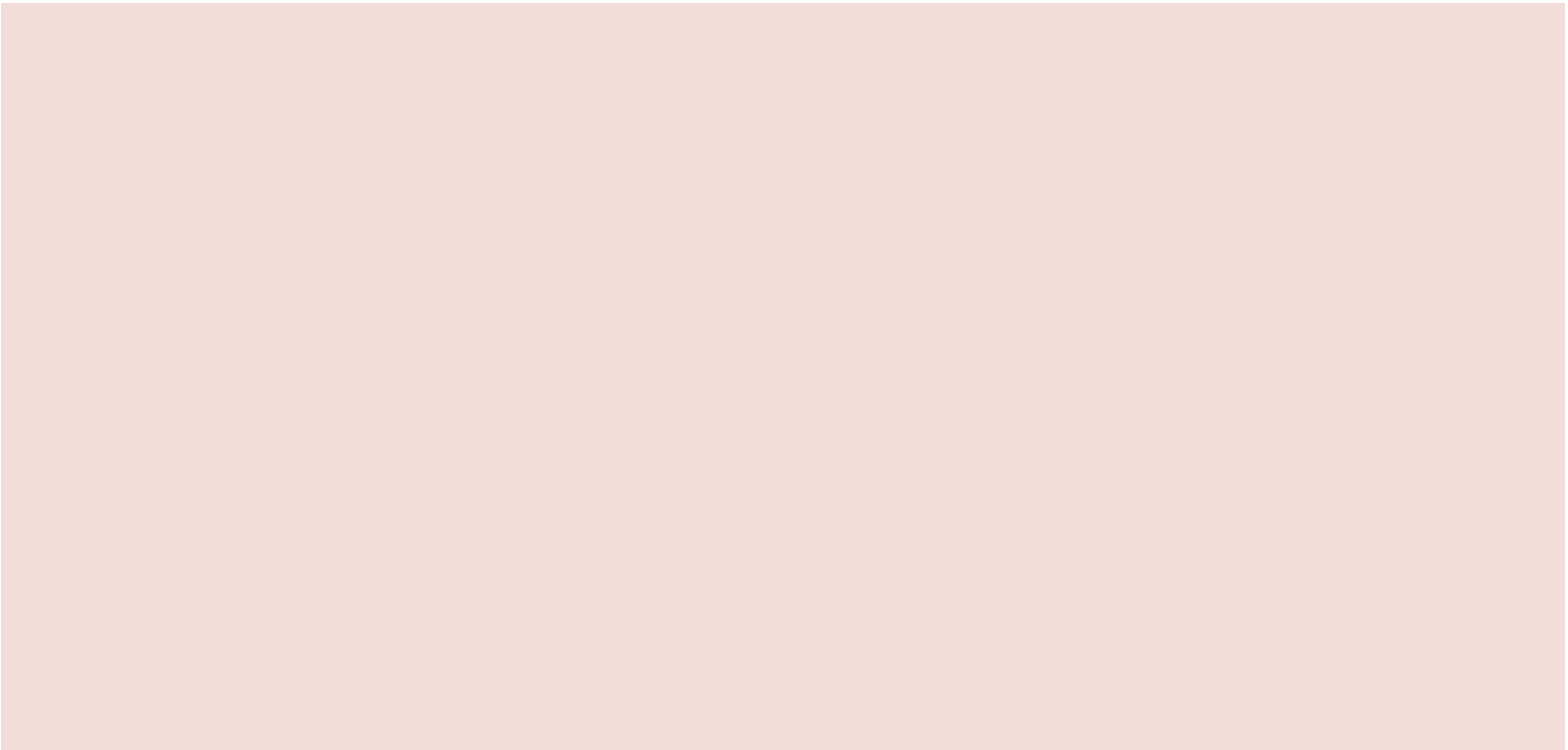
This process should determine which tasks the EU should give back to member states, which ones it should take over from them, and which new bodies – not new layers of committees, but decision-making authorities – may be required credibly to carry them out. This will be the basis for the requisite overhaul of EU supervisory and regulatory architecture. Separating this exercise from the prior establishment of your vision for Europe's financial system will help you to focus the debate on substance and not be deflected by vested interests or defence of the status quo. The question will not be whether your approach is 'evolutionary' or 'revolutionary'. It will be whether it meets the

requirements of a sustainable EU financial system, or not.

In parallel, you will be confronted with the difficult questions of crisis management and of the very purpose and key tenets of financial regulation, such as the nature and instruments of macro-prudential policies, the role and definition of capital requirements, the compatibility of different financial-service segments in the same financial group and the extent of risk disclosures by financial-market participants. On these fundamental issues you should seek synergies with the US policy-elaboration process, which is generally faster and more in-depth than the

European equivalents, in liaison with your correspondents in member states' national authorities, especially those which participate in G20 meetings or key bodies hosted by the Bank for International Settlements.

Your tasks will inter alia entail a hefty legislative programme. Aspects of it will be unprecedented at EU level, such as on company law with the introduction of a consistent insolvency regime for systemically important financial-services firms. Partnership with the newly elected European Parliament should be, more perhaps than for any of your predecessors, a core tenet of your ambitions.



Competition

To: The Commissioner for Competition Policy
From: Lars-Hendrik Röller
Subject: Priorities for your term of office
Date: 1 September 2009

State of affairs

EUROPEAN UNION COMPETITION POLICY is one of the success stories of Europe. The main reason for this success is the fact that member states have delegated substantial powers in the fields of merger control, antitrust and state aid to the European Commission. As a result, competition policy has developed into a powerful instrument for enforcing a set of consistent rules across Europe. The impact and significance of EU competition policy can be divided into two areas. The first is the internal dimension: providing a consistent set of rules through a one-stop shop, coherent implementation of competition law, as well as by spreading the competition culture across Europe, including to the new member states. The second - and increasingly important over the last few years - is the external dimension: Europe speaks with one voice on competition matters to third countries, such as the US and China. Indeed Europe has had a significant impact on the new competition policy regime in China.

In the last few years, Europe has undertaken a substantial number of initiatives and reforms. Key policy reforms have been adopted in the area of merger control, where a new test for deciding on

anticompetitive mergers was introduced in 2004. In addition, the role of 'efficiencies' in merger control has been clarified and encouraged. Cartel enforcement has been one of the priorities of your predecessors. Record fines have been imposed, not only in cartel cases but also in cases of abuse of dominant position such as Microsoft and Intel. As a result of these enforcement activities, many European companies have launched comprehensive - as well as expensive - compliance programmes in order to prevent future fines. Finally, the area of state aid control has undergone reform as well. The state aid action plan introduced the so-called 'balancing test', by which the positive (rectifying market failure) and negative effects (distortions of competition) of state aid measures are weighed against each other.

All these developments in EU competition policy are generally very positive. As a result, Europe has been at the forefront of competition policy, and some even refer to it as the world's leading jurisdiction in antitrust matters. However, there are major policy challenges ahead that need to be addressed in order to keep the success story going.

Challenges

THE FIRST AND MOST IMPORTANT CHALLENGE is to keep the rules of competition policy intact in times of economic crisis. There are no grounds for compromise on competition policy principles, as the current rules are well equipped to deal with the financial and economic crisis. One of your main challenges is thus to avoid 'throwing the baby out with the bathwater' and to keep markets fair and open.

This applies in particular to the area of state aid. The financial and economic crisis has increased the political demand for state aid, not only in banking and finance but also increasingly in all sectors of the economy. State aid has always been an area of competition policy where political pressures are significantly higher than elsewhere. And such pressures are intensifying as the crisis percolates through to the real economy and the labour market. Competition policy therefore needs to be firmly enforced – in particular in the area of state aid – so that markets continue to be open and transparent. This is a **first** key challenge for you and for the new College as a whole.

Moreover, the area of state aid constitutes an opportunity for you and the new Commission: to be assertive and show that Europe has an important role to play in boosting the future economic strength of our industrial base. This is crucial for future economic performance, including for our welfare states. Getting the right industrial policy for Europe is key, getting it wrong will guarantee Europe's industrial decline for years to come. We should not sacrifice the long-term growth prospects of all member states for short-run national interests. We need a strong Commission in the area of state aid, and in the area of industrial policy in general.

One of the more significant trends in EU competition policy has been the increased use of economics. Under the so-called 'more economic approach', a more effects-based analysis has been emphasised, that is, cases are analyzed and

decisions taken in light of their effects on markets and, in particular, on consumers. Your **second** policy challenge is to move this process forward and focus on markets and consumer benefit – the so-called 'consumer surplus standard' – in order to preserve competition and not competitors. This is especially important in times of economic crisis.

A **third** challenge concerns merger control. The purpose of mergers is to create efficiencies. Despite this, efficiencies have not played a major role in EU merger evaluation to date. This is disappointing if one believes that there are mergers which bring significant efficiencies, while others produce virtually no efficiencies at all. Moreover the current approach emphasises static efficiencies, not dynamic efficiencies, such as innovation and fixed costs savings. Given the economic importance of dynamic efficiencies, it may be time to be more explicit about what kind of *dynamic* efficiencies is acceptable.

A **fourth** challenge relates to how the Commission approaches 'market definition'. Although market definition is primarily used as a screening device, it is nevertheless a very important aspect of the practice of competition policy. Market definition in antitrust and merger control currently emphasises demand-side substitutability. This contrasts with the business view of markets, which puts more emphasis on the supply side (ie. on competitors). Since many industries are characterised by increasing international competition on the supply side, while the demand side remains national or regional (for example retail electricity markets), this leads to some frustration between market definition in antitrust cases as compared to market definition by the business world. By not taking supply-side factors fully into account at the market-definition stage, the current approach leads to an overly restrictive market definition, and thus to a screening bias. It follows that either market definition should be de-emphasised as a screening device*, or that supply-side factors should be

* The two new chief economists at the FTC and DOJ, Carl Shapiro and Jo Farrell have recently suggested complementary screens to market definition.

emphasised more in defining relevant antitrust markets.

A **fifth** challenge is to address the interface between competition policy and direct regulatory intervention in protecting consumers. Horizontal antitrust laws are often complemented by sector-specific (often national) regulation. Numerous other regulations – consumer protection and safety, environment, high prices – can also be addressed by competition policy instruments. Even though many of the regulatory policy measures have different first-level objectives, sometimes they even have the same (or a very similar) objective, such as consumer protection rules and competition policy, which both address consumer benefit. In either case more policy coordination is urgently needed.

A **sixth** and final policy challenge is to work towards effective global governance in competition. More of the emerging economic powers (such as China and India) need to be fully integrated into a global competition architecture. Providing an international forum and expanding bilateral relationships creates a much-needed governance structure in a world where competition-related issues are increasingly raised at the international level. It is important to maintain a level playing field globally. With the change-over in the White House, new US antitrust leadership is beginning to take charge. An early indication of this is that US agencies will take a tougher stance in areas such as mergers and monopolisation. Developing and strengthening the key relationship between the EU and the US should be one of your priorities.

You must enforce state aid rules in times of economic crisis. The state aid system is one of the major accomplishments of European integration and will ensure that we will achieve growth in the future.

Recommendations

1. Enforce state aid rules in times of economic crisis

The first and most important challenge. Keep the state aid system intact. This is one of the major accomplishments of European integration and will ensure that we will achieve growth in the future.

2. Keep a consumer orientation in competition policy

Consumer orientation focuses analysis on the market and not on competitors. Much needed investment, efficiencies and innovation should be taken into account and encouraged insofar as they benefit consumers.

3. Strengthen the role of efficiencies in merger control

Increase the role of efficiencies when approving or blocking mergers and clarify which dynamic efficiencies are acceptable.

4. Strengthen supply-side factors in defining relevant antitrust markets

Take proper account of the internationalisation of competition when defining markets. Put more emphasis on supply-side factors in defining relevant antitrust markets or downgrade market definition as an antitrust screening device.

5. Protect consumers through effective competition, rather than by direct regulatory intervention

Increase coordination of competition policy measures with those in other policy areas.

6. Broaden and deepen global ties with competition regulators

Promote ties with emerging countries with a view to strengthening competition codes and deepen cooperation with the competition authorities of developed countries, especially the US.

Single market

To: The Commissioner for the Single Market
From: Carlo Altomonte
Subject: Priorities for your term of office
Date: 1 September 2009

State of affairs

AS COMMISSIONER FOR THE SINGLE MARKET, you will be in charge of one of the key pillars of the process of EU integration, together with the single currency. A competitive and truly integrated single market is also our best asset in promoting European productivity and growth in an environment characterised by changing global trends and technological advance.

Politically, the EU single market was completed at the end of 1992, with the aim of eliminating the remaining barriers to free circulation among member countries. However, the process has to be considered as a dynamic one: technological, political and economic developments imply the creation of new potential barriers, and thus the need for constant adaptation of the EU legislative framework in order to guarantee within the member states the four so-called 'fundamental freedoms' (free movement of goods, services, capital and people), all core objectives of the EU Treaty.

Given a market of 500 million people, 27 countries, a GDP of about €13,000 billion and a clear treaty-defined mission, it is hardly surprising that your portfolio is among the most sought-after by incoming commissioners. The EU market, if properly policed through the crisis, has the potential to be the springboard for healthy EU-based businesses to overcome the immediate shock of the crisis, and sustain the long-run growth of the EU economy. By the same token, a friction-free single market can only become more attractive for non-EU firms to sell into, and is already causing foreign manufacturing companies to follow European production standards even on non-EU markets. As 'the world's regulator', as one commentator recently put it, you are thus not going

to be focused exclusively on the single market *per se*. Your job has indeed a major and growing global dimension.

What is more, the Commission has managed to retain its exclusive right of legislative initiative under the Lisbon Treaty, which is arguably the sharpest political weapon in the Commission's armoury. In your portfolio in particular, with a relatively large amount of legislative activity, your right to propose – or not the propose – new rules gives you a certain amount of leverage with member states, along with the power to pursue governments through the infringement procedure.

But the crisis, and its effect on political sentiment in member states, has the potential to bring uncertainty and even chaos to the single market if not handled skilfully. The crisis is undermining trust in competitive markets in general, and throttling support for the single market in particular. While it is unquestionably right that the Commission should fully exploit single-market and competition rules in order to help vital parts of our economies to cushion the shock of the crisis, we have already seen behaviour by individual EU governments, mirroring the actions of other governments globally, keen to defend shorter-term domestic sectional interests by locking up value chains at home at the expense of other member states. Such behaviour, while politically understandable in the short term, is economically inefficient in the long term, if not potentially disruptive for the single market.

Moreover, crisis or no crisis, there are currently well over 1000 single-market infringement cases outstanding against member states, either because

You inherit a policy under serious threat of unravelling; you also inherit a portfolio in which the Commission's status has subtly shifted from being a big fish in a little pond to being a smaller fish in a big pond.

governments have failed to implement agreed rules correctly, or failed to implement them at all.

Not only do you inherit a policy under serious threat of unravelling, you also inherit a portfolio in which the Commission's status has subtly shifted from being a big fish in a little pool to being a somewhat smaller fish in a big pool. While the Commission has historically been the undisputed master of harmonising negotiations in narrowly defined technical areas, the EU – and therefore the Commission – now penetrates ever deeper into large swathes of the goods and services markets of member states (think of the across-the-board

services directive, discussed below, the current debate over financial services, dealt with in another memo, or the already implemented regulation of company law and network industries). The less well-known but equally important case-law of the European Court of Justice relating to the single market via infringement or competition procedures contributes and adds to the picture. These areas are very high-stake games for national economies which, as a result, can put you on the back foot with member states, unless you manage to capture and exploit the intellectual and political high ground in this complex arena, and are seen to do this early in your tenure.

Challenges

1. Upholding existing law

Without doubt, the crisis has confronted you with the biggest test ever of the cohesion of the EU's single market. It was always going to be difficult for the Commission to establish and maintain order in 27 (soon more) different jurisdictions. But the crisis is a wake-up call to those complacent enough to believe that compliance with the 'acquis' can be taken for granted. The biggest test you face in the present economic and political climate – whether you work under the Nice Treaty or the Lisbon Treaty – will be to uphold existing single market rules and to prevent backsliding by individual member states, which may attempt to switch part of the burden of change to the businesses, workers and consumers of other member states.

With administrative resources within the Commission unlikely to increase appreciably and the infringement procedure painfully slow and blunt, you will need to enlist the support – and the 'eyes' – of all stakeholders, notably the European Parliament, business, consumers and the media, in defending what is arguably the EU's chief defining policy. Otherwise there is a risk that the Commission could become too focused on tackling day-to-day infringement complaints and fail to spot or give priority to bigger-picture market failures. The Commission's current sector reviews partly meet this need, but a more urgent and political approach is required.

2. A revamped single-market strategy

At the same time as rigorously defending – and being seen to defend – a level playing field throughout the EU, you will be expected by many to come up with a revamped single-market strategy, in other words the next new 'big idea' which captures the imagination of all stakeholders.

'Business as usual' and being a good watchdog, however vital, will be a hard sell as a slogan for your term. You need instead to provide a comprehensive response to the heterogeneity currently characterising regulation of the single market:

certain areas are considered to be over-regulated or badly regulated; others lack effective implementation of the existing rules; still other areas might require further regulation. However, the twin push to prevent single market fragmentation and to come up with a new all-embracing project for the single market with across-the-board appeal will be a difficult nut to crack. This memo does not nail down what specific areas your strategy should tackle (it seeks to provide food for thought), but you should devote time to reflecting on a simple and comprehensive message which encapsulates your ambitions for the five-year period. This will not be straightforward, not least because of current cynicism about the benefits of open markets and about the ability of government at any level to shape markets for the general good.

3. Driving through the services directive on the ground

You may be surprised to see the services directive as a priority for your term of office, as it has already been adopted and will enter into force this December. However, the challenges awaiting the member states – and hence the Commission – in implementing this new set of rules fully and properly should not be underestimated. This directive is a key plank in the EU's economic policy, currently known as the Lisbon Strategy, and will doubtless remain central to the new post-2010 strategy still to be hammered out. The new economic agenda is likely to spotlight as one of its priorities the improvement of the business environment throughout Europe, including for the services covered by single-market rules, which according to Commission estimates make up around 57 percent of EU GDP.

But the directive is perhaps the most challenging piece of legislation member states have ever been confronted with in terms of implementation into national law. It is a heroic 'residual directive' which not only seeks to regulate business conditions in all services sectors not already tackled by the EU, but also aims more generally to change member states' behaviour towards behind-the-border

obstacles to provision of any and all services. In one sense it is revolutionary, as it provides for member states to mutually evaluate, or peer-review, each others' rules, whereby the Commission in a sense 'outsources' single-market surveillance to member states collectively (though under the Commission's ultimate control).

Furthermore, the directive requires member states to encourage action by private parties (for example consumers' associations) where disputes arise, which also goes in the direction of 'outsourcing' surveillance and thus to harnessing multiple stakeholders to the cause of a single market which works 'on the ground'.

Needless to say, you will inevitably be faced with delays and procrastination by member states which will not have fulfilled all the legal and practical requirements of the directive by the end of this year. In light of the vital importance of the services sector for the EU's economies, and given the probable reluctance of member states to open up their services markets at a time of crisis, your third challenge will thus be to hold a firm line and make sure that businesses – especially SMEs – and consumers can benefit from an obstacle-free single market for services as swiftly as possible.

4. Push EU global regulatory standard-setting

To a certain extent, the EU already attracts the world's businesses to adopt its standards by virtue of its size alone. Indeed US companies, for example, have already started to switch production to EU chemicals standards as a result of the EU's REACH legislation (registration, evaluation and authorisation of chemicals). But there is no room for let-up. If foreign businesses are faced with a fractured or fragmenting single market, they may start to doubt the added value of aligning product standards on the EU. Moreover, the performance and credibility of the single market will continue to be a key factor driving Europe's clout in international rule- and standard-setting bodies, not to mention in the Commission's negotiations with individual third countries. In addition to vigorously defending the single market, you can boost the EU's external regulatory reach by broadening and deepening regulatory dialogue with third countries – certainly with the US and Japan, but also with the major emerging and developing countries. Failure to keep the dialogue channel open, and to expand it strategically in the best interests of European businesses, would send the political message that the EU is rocking back on its heels and that it does not have faith in its own ability constantly to refine and manage the single market properly.

Recommendations

1. Upholding existing law

Upholding the existing rules is the single most important task, especially in the current economic and political circumstances. It is therefore proposed to:

- Keep under constant review and evaluate any new provisions which member states implement as a result of the crisis and strictly apply existing single-market rules, strengthening the existing instrument of the single-market scoreboard, and if possible achieving a 'quick win' early in your term in order to establish your credentials;
- Make it clear from the outset that you encourage surveillance input from other single-market stakeholders, and look into the possibilities of formalising this cooperation.

2. A 2015 roadmap for the single market

Business as usual is not, on its own, a strategy for your term of office. It is therefore proposed to:

- Invest time and effort in framing a narrative which encapsulates the focus of your term. Your strategy should be comprehensive and clear at the outset to all stakeholders, thoroughly describing your priorities, the regulatory areas you wish to change or develop, those where action should be left to the member states, and your long-term horizon. The 1992 message was simple, powerful and galvanising, although it was and is clear that the single market is an ongoing project. As a suggestion, your approach might refer to the global role of Europe and its single market, for example as a force for good in terms of global environmental and consumer protection.

3. A truly integrated market for services in Europe

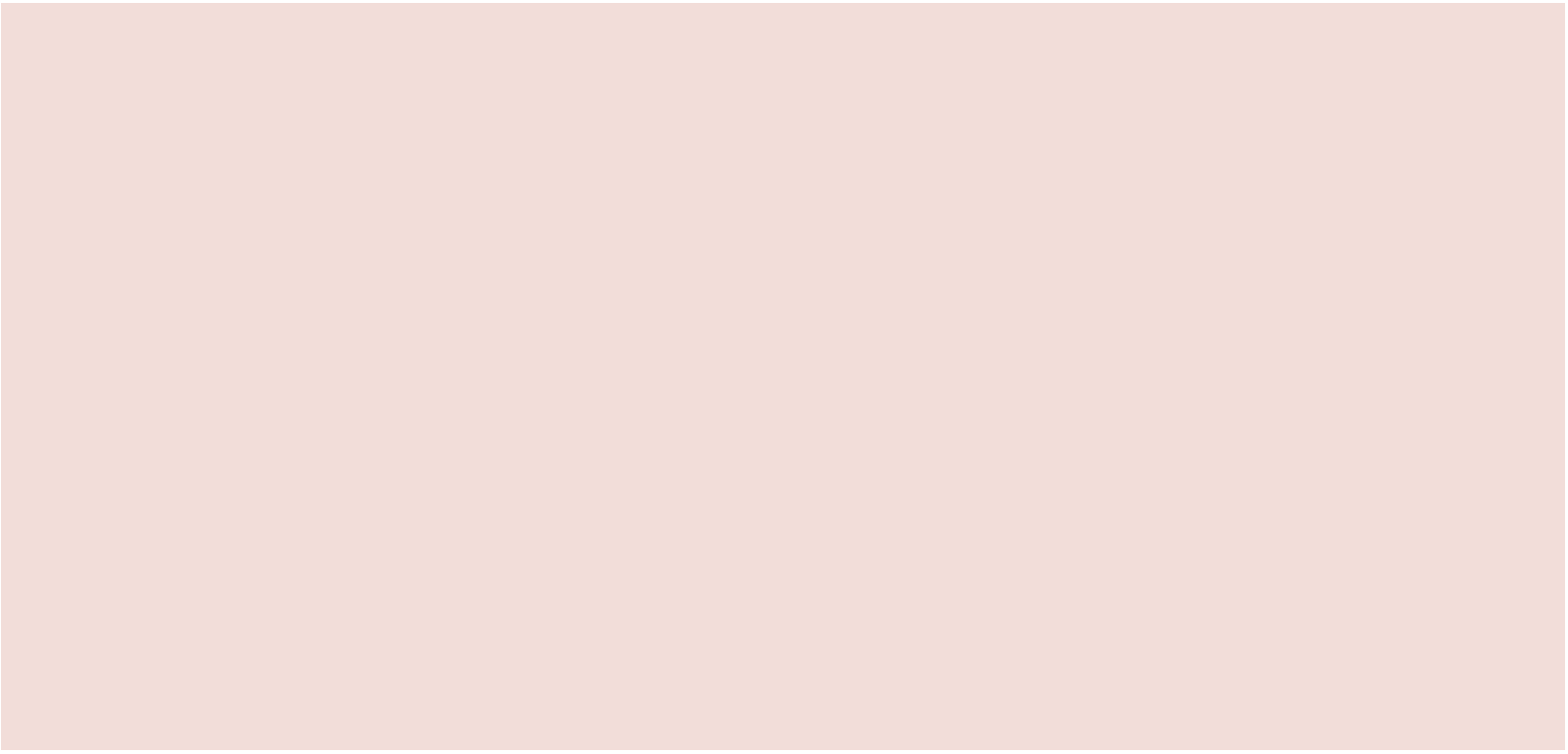
A number of member states, possibly many, are unlikely to have all the rules in place by the end of this year, which will deprive businesses, especially SMEs, and consumers of the benefits of a border-free services market. It is therefore proposed to:

- Adopt a clear strategy towards member states which have not put the new rules in place by the agreed date. Help those with genuine problems, while giving them a strict timetable to comply. Come down hard and swiftly on those who are failing to cooperate. Envisage a mid-term review of the services directive during your mandate.

4. The EU as the global regulatory standard-setter

The EU's success as a global standard-setter relies primarily on the single market remaining intact under the current pressure and on accommodating the changes driven by the increasing importance of services. But the EU also needs a coordinated approach across its institutions, and across Commission departments, a common external 'face' to defend, explain and promote the single market to third country governments and businesses. It is therefore proposed to:

- Coordinate European stakeholders' efforts to define a global regulatory standard-setting approach for the EU;
- Use the EU's external standard-setting power as an additional argument to convince EU governments to play ball and respect single-market rules, and to get EU businesses with export interests to help you police it;
- Expand the regulatory dialogue with third countries and international institutions.



Enterprise and industry

To: The Commissioner for Enterprise and
Industry Policy

From: André Sapir and Nicolas Véron

Subject: Priorities for your term of office

Date: 1 September 2009

State of affairs

THE CONCEPT OF 'INDUSTRIAL POLICY' was the subject of repeated controversies for many years in the European Union. It pitted the advocates of 'horizontal' measures that support economic activities such as innovation against those in favour of 'vertical' measures targeting specific sectors. Since the early 1990s the consensus at EU level has been that the main role of EU industrial policy is to provide the right framework conditions for business. This view corresponded to the perception that the main challenge for European industry was to adapt to a global economic context characterised by rapid technological change and the emergence of new competitors, fortunately at a time of fast-growing world markets. After having successfully caught up with the US in the first few decades following the second world war, European industry had to succeed at the frontier of innovation and business transformation, an environment which, in contrast to the earlier catching-up process, provided little scope for state-led steering of the economy as a whole. In response to this challenge, the core of EU industrial policy in the past two decades has been, first, the single

market programme and then the Lisbon programme, which both aimed at improving competitiveness in a 'horizontal', non sector-specific manner.

At the beginning of the 1990s, the commissioner in charge of industrial affairs was also responsible for the single market, which gave him great influence in the shaping of EU industrial policy. From 1994 on, however, this link was severed, depriving the industrial affairs commissioner of key policy tools. The launch of the Lisbon programme in 2000 has only accentuated this trend: although your immediate predecessor was nominally in charge of it, the reality was that he had little impact on the framework conditions for business since most of the associated policies – on the single market, competition, trade, research, higher education, social and macroeconomic affairs – were under the direct responsibility of other commissioners. Hence your predecessor found himself in the odd position of being nominally in charge of industrial policy without having much actual say on its design and implementation.

It would be a mistake to see your portfolio as the irrelevant legacy of a bygone era. The response to some of the challenges created by the global crisis falls naturally under your responsibility.

Challenges

IN SPITE OF THE TREND over the last two decades, it would be a mistake to see your portfolio as the somewhat irrelevant legacy of a bygone era. The reason is that the response to some of the new challenges created by the global crisis falls naturally under your responsibility given the division of labour within the Commission. Specifically, you will be seen as partly responsible for the management of the immediate effects of falling demand and constrained credit in manufacturing and non-financial services, a responsibility that should form the basis of your policy priorities.

European industry is in dire straits, with production falling at record speed. Between May 2008 and May 2009, industrial production in the EU27 has declined by 15.9 percent. The fall has been particularly severe in intermediate goods (22.5 percent), capital goods (21.2 percent) and consumer durables (17.2 percent). In some sectors, like automobiles, production is down by nearly 30 percent. Moreover, a number of industry segments are going to hit a wall of refinancing needs over the coming months and years. Even assuming that the worst of the financial crisis is behind us, massive economic damage and restructuring can be expected in large swathes of Europe's industrial base.

In this gloomy environment, you will face three crucial, interlinked challenges.

The **first** challenge is to avoid the 'zombification' of Europe's economy. There will be huge temptation for governments to encourage or force banks to provide credit to businesses which are not viable in their current form, to prevent those businesses from restructuring if that means significant numbers of redundancies, and frantically to repress the spreading of related bad news even if it

is entirely accurate. Such action would turn banks into 'zombie banks', *de facto* insolvent but unwilling to recognise it and protected by national authorities, and would simultaneously turn non-financial companies into 'zombie companies', unviable but pretending to continue their operations as before the crisis. We know from experience, especially Japan's, that this would put a significant drag on Europe's mid-term growth.

The **second** challenge is to ensure that the legitimate concern of dampening the shock of adjustment does not overshadow the focus on competitiveness which, as previously mentioned, has appropriately defined the EU's industrial policy over the past two decades. In times like these, the minds of policymakers and business leaders are focused on survival and adaptation rather than innovation and competitiveness. But the two are by no means contradictory. Specifically, the credit crunch may have a disproportionate effect in constraining innovation, research and development in hard-pressed companies.

The **third** challenge is to ensure that the policy responses to the crisis do not weaken European economic integration. Large industrial companies, like cross-border banks, tend in the words of the well-known quote to be 'international in life, but national in death'. Indeed, given that the EU institutions have no fiscal discretion, it is most often to national governments that they have turned for help during the crisis. There is a distinct risk that government action will lead to the fragmentation of Europe's single market, which ranks among the EU's most valuable but also most fragile assets.

These three challenges lead to three recommendations.

Recommendations

FIRST, YOU SHOULD STRIVE TIRELESSLY to educate the European public and fellow policymakers about the risk of ‘zombification’ and the need to accept restructuring in order to enable the EU economy eventually to rebound, taking into account the lessons of Japan’s ‘lost decade’ and the massive misallocation of capital that characterised it. At the same time, you should add your voice to those demanding better social protection for affected workers. Refusing to create zombie firms which protect existing jobs when there is no longer sufficient demand for their output should not be synonymous with a refusal to protect workers.

Second, you should defend the vision of a European Union that builds leadership in frontier innovation (whether technological, green or otherwise) and breeds world-class new companies, because that is the only vision that can maintain the prosperity of Europe’s citizens in a rapidly changing globalised economy. Your vision of industrial policy should not aim at the creation of ‘European champions’, an approach that, more often than not, has led to waste or failure, but should rather be designed to create the right framework conditions for success, as the Commission has sought to do over the past two decades.

Third, we suggest that you depart from your predecessors’ hands-off approach to industrial policy during the past 20 years, and **make the restructuring of industries severely damaged by the crisis the main focus of your term**. This is a temporary task, and it does not answer the long-term question of your portfolio’s relevance in normal times, which the memo to the president suggests merging with the internal market portfolio. But it is crucial, because we fear that existing policy tools such as competition policy and single-market policy will not suffice to meet the challenges given the magnitude of the economic shock. EU-wide strategic direction is needed for the scale of industrial restructuring that now seems due, and neither these two policies nor national governments can provide it.

In dealing with this task, you may wish to look

closely at the experience of Etienne Davignon, your predecessor in the late 1970s and early 1980s when national governments’ support of troubled sectors threatened what was then the common market. The ‘Davignon Plan’ implemented in the 1980s was a response by the European Commission to measures introduced by governments in support of their national steel industry that were suffering from chronic overcapacity due to changing market conditions. Rather than seeking to eliminate state aid, it chose to accept it in exchange for coordinated restructuring plans that drastically reduced production capacity.

A similar approach could now be used specifically in the automotive sector, which also suffers from structural overcapacity as a result of changing market conditions (including competition from new EU countries, rising oil prices and concerns about climate change) and has been badly hit by the crisis. Granted, the powers of the Commission in the automotive sector are not at all what they were in the steel sector under the European Coal and Steel Community framework, and the two industries are anyway very different. Yet Davignon’s approach of joint action by the member states, spearheaded by the Commission, could usefully be replicated today in a sector sorely in need of restructuring needs and plagued by national state aid.

In terms of policy action, we recommend that you **initiate the formation of industry-specific EU task forces** that would help you in coordinating national governments’ moves and suggesting relevant EU decisions. Such task forces would report to you and would not wield policy instruments of their own but, if well designed and managed, could play a powerful role in providing shared understanding of industry dynamics and in being a catalyst for joint action in situations where a fragmentation of policy initiatives is leading to demonstrably inefficient outcomes.

At the moment, we think only the automotive industry would be concerned, but other cases may be considered during your term as the

consequences of the crisis unfold. We suggest that you consider the banking and financial industry as outside your scope of action because of its specificities as being both a cause of, and a solution to, the crisis. Otherwise, any manufacturing or non-financial services sector may be concerned, provided the extent of difficulties justifies intervention at EU rather than national or local level.

The EU task forces should be sufficiently skilled, focused and empowered to make an impact. First, skills: you should maximise flexibility as to their staffing, including task force chairs, by both public officials (including from member states) and individuals with private-sector experience. In spite of the many talents currently present in your department, they cannot be up to the challenge of steering the transformation of entire industries without significant external (and temporary) help. Second, focus: you should give any EU task force a clear mandate and protect them from being constantly distracted by requests from this or that member state or constituent on issues of minor importance. Third, empowerment: you should seek member states' explicit endorsement of task force formation and mandates, accept significant operational delegation of initiative to task force

chairs and staff, and build the corresponding channels of accountability, not only to EU institutions and member states but also to national parliaments. To have impact, the task forces will need to build a public profile and legitimacy, even though they will ultimately report to you.

Such EU task forces can provide you and your Commission colleagues with the indispensable direction and consistency that is needed for other policymakers at national and EU level to make the right decisions. Their creation and operation will not be consensual but correspond to a need that is already acknowledged by many stakeholders. They should not be seen as a substitute for EU policies such as those on competition or the internal market, but rather as an indispensable complement given the pressures created by the crisis. Coordination with state aid policy will be especially crucial. Although the goal would be to rein in state aid, special arrangements for state aid review could be introduced in specific sectors if their restructuring plans were deemed appropriate for this by the EU task force. Altogether, it is an ironic but unmistakable reversal of pre-crisis times that an active industrial strategy now needs to be conducted, by you, to ensure that the single market is adequately defended.

It is an ironic but unmistakable reversal of pre-crisis times that an active industrial strategy now needs to be conducted, to ensure that the single market is adequately defended.

Knowledge edge

To: The Commissioner for Knowledge
From: Bruno van Pottelsberghe
Subject: Priorities for your term of office
Date: 1 September 2009

State of affairs

CURRENT SITUATION: A 30 PERCENT 'KNOWLEDGE OUTPUT GAP' WITH THE US

With nearly 500 million inhabitants the European Union is an important player in the global research landscape. An important, but ailing one!

In the early 2000s the EU member states agreed that Europe was to become the 'world's most competitive and dynamic knowledge-based economy by 2010'. Their ambitious self-set Lisbon agenda included a precise target: three percent of GDP was to be devoted to research and development (R&D) activities by 2010, one third of which was to be funded by the public sector. Nearly ten years later the evidence tends to show that at most limited progress has been achieved, but nothing significant compared with the original objective. In terms of ultimate 'output' of innovative activities and competitiveness, the EU's productivity performance (GDP per capita) remains at 70 percent of the US level. Knowledge generation (total R&D spending as a share of GDP) has been characterised by a similarly poor relative performance. The US is close to the three-percent target (about 2.7 percent), whereas the EU has for about 20 years managed an R&D intensity hovering below two percent, with no sign of movement towards its Lisbon target. And a key vector of knowledge dissemination and accessibility – ICT investment as a percentage of GDP – is performing just as poorly. Likewise, the ability of Europe to attract foreign brains is much less effective than that of the US. This is worrying for the sustainability of European economic growth, because innovation and information technologies are key drivers of long-term growth.

Knowledge policy is far from being an exclusive competence of the EU. Research is mainly funded by an independent business sector and by the public sector of individual member states, and often by regional authorities with no or very little coordination. The EU's own Framework Programmes account for about five percent of total public funding for civilian research activities in Europe: a significant amount compared to the size of the

overall EU budget but small when compared to total spending on research activities. For the record, the EU's 7th Framework Programme (2007-2011) has a budget of more than €50.5 billion, of which 64 percent goes to collaborative research, 15 percent to frontier research through the ERC (European Research Council), and the rest to research mobility, infrastructure and the EU's Joint Research Centres. Despite identifiable progress in recent years, the lion's share of this funding – collaborative R&D – is still subject to three main criticisms: the burden of red tape, cumbersome conditions governing the geographical spread of partnering institutions, and an opaque fund-allocation mechanism which is influenced by national insistence on getting their money back from the EU budget. The inevitable consequence is a drop-off in business-sector participation.

But knowledge generation is more effective when funnelled through higher education policy and training. Here again, Europe's overall higher education expenditure (1.3 percent of GDP) is much lower than in the US (2.9 percent). Besides, Europe's national education systems are still highly disparate, despite progress in coordinating systems under the Bologna Agreement. The weaknesses of European education systems lie in a lack of transparency, different governance systems across countries, network-based competition for promotion of senior academic staff (as opposed to excellence-based competition); tenured positions frequently reserved for national or internal staff; a lack of managerial autonomy in several countries; a lack of funding to ensure a minimum level of quality, and administrative and legal obstacles to intra-EU mobility (transferability of social security and/or research funding). These shortcomings have had two negative consequences: very poor research performance according to international rankings, and a relative lack of attractiveness of European universities for students originating from Asian and other emerging and developing countries.

The work of the research commissioner over the past few years has increasingly focused on putting

in place a European Research Area (ERA) that would by 2020 span geographical, sectoral and institutional boundaries. Its ultimate objective is to 'extend the single European market to the world of research and technological development, ensuring open and transparent trade in scientific and technological skills, ideas and know-how'. In other words, besides funding tools for projects ranging from basic to applied research, the Commission is aiming to improve coordination within the EU and offers a platform for best practice in science and technology policy. The Commission's Green Paper on the European Research Area: New Perspectives adopted in early 2007 identified six fields for action, namely: realising a single labour market for researchers; developing world-class research

infrastructure; strengthening research institutions; sharing knowledge; optimising research programmes and priorities; and opening R&D activity to the world through international science and technology cooperation.

From a very specific, well-defined and probably too restrictive objective set in the early 2000s (the three-percent R&D intensity target), the operational objective has now switched towards a more glamorous – though unverifiable – target, namely the ERA. The advantage of this second approach is that failure is difficult to establish in objective terms: indicators can always be computed to illustrate success in one dimension of the ERA or the other.

The weaknesses of European education systems have had negative consequences: very poor research performance, and a relative lack of attractiveness for students from emerging and developing countries.

Challenges

YOUR MAIN CHALLENGES ARE THREEFOLD: i) fielding the likely reaction to failure to meet the Lisbon spending target; ii) improving the effectiveness of EU funding and its accessibility for the business sector; iii) contributing to the development of the ERA and the creation of a single market for knowledge.

Your challenges are accentuated by the limited amount of resources and hard-law leverage at your disposal: budgets and regulatory tools are mostly controlled by member states or their regions.

The first challenge concerns the likely decision of the Council to uphold the **three-percent R&D intensity target**. This is potentially hard to achieve, as very little momentum for this is observable at EU level. However, the target has the advantage of being simple (hence easy to communicate) and well defined. But while the creation of new knowledge is mostly driven by high-quality research institutions and R&D funding, its dissemination is essentially driven by higher-education expenditures. Having a two-dimensional target for generation and dissemination of knowledge would give countries more freedom to select their own priority within the spectrum of knowledge policy.

The second challenge is to improve the **effectiveness and attractiveness of EU public funding of research**, ie. to maximise its likelihood of succeeding, its socio-economic impact and its stimulating effect on business R&D. Chances of success and tangible socio-economic impact depend on selecting the most appropriate projects and on competent researchers. This, in turn, depends on the ability to attract competitive institutions with efficient research departments.

The challenge for the EU's Framework Programmes and other research funding projects is therefore to make them more user-friendly and open.

The third challenge is to contribute to the **creation of a single market for knowledge in Europe**. This objective requires the implementation of many structural changes in individual member state. First, there is a need for highly qualified researchers to fuel new research activities, which would call for both improved mobility of European researchers within the EU and easier access for non-EU brains and talent. Better-trained researchers are also needed through improved tertiary education systems. An effective European Research Area should also reduce duplication of research activities. There is currently only a very small degree of coordination within the EU of resource allocation for basic and applied research implemented by public institutions. Most regional policies include 'fashionable' objectives such as nano- and biotechnology, or life sciences. Whereas some research duplication can be good in order to maximise the probability of discovery, excessive duplication reduces funding for new and promising scientific and technological areas. The European Space Agency (ESA) is one example of EU-wide coordination of research activities. The governance of the ERC could also become a benchmark for other European research programmes. Its bottom-up approach, relative independence and high-quality project selection process has nurtured a strong degree of confidence. Unfortunately most national or regional government-sponsored programmes are not coordinated, which leads to wasteful duplication. Here the challenge is considerable, as local governments will tend to resist the dictates of a centralised institution.

An effective European Research Area should reduce duplication of research. There is currently only a very small degree of coordination within the EU of resource allocation for basic and applied research.

Recommendations

1. Negotiate with the Council on new spending targets to be achieved by the EU: an aggregate knowledge spend of five percent of GDP to be achieved by 2014

Two types of expenditure are at the root of sustainable growth: education and research. The sum of R&D intensity and higher-education expenditure as a share of GDP should increase from the current 3.2 percent (against 5.6 percent in the US) to five percent by the year 2014. This new 'knowledge-intensity' target approach would provide much-needed and welcome room for manoeuvre for member states, given their differing industrial specialisations and levels of economic development. Countries that are highly specialised in service industries would focus on fostering higher education, whereas other countries might choose to reinforce research activities. The common denominator here is knowledge generation and dissemination.

2. Improve the size, effectiveness and attractiveness of the research funding distributed under the EU's Framework Programmes (starting with the new FP8).

The EU's Framework Programmes are essential for attaining critical mass in many fields of scientific research, attracting business funding and facilitating multidisciplinary. By 2011 the content, design and tools of FP8 will have to be defined, in addition to the size of its budget. As compared to FP7, you should work to improve the attractiveness of framework programmes for both the business and academic sectors, for instance by seeking to adopt key parts of the ERC governance model for the FPs:

- Improved transparency, and a move away from the 'money-back' logic of member states;
- A bottom-up approach, with a high-quality and independent selection process;
- Simpler and lighter administrative procedures;
- A smaller set of more straightforward funding channels, with more flexibility and freedom and stronger management autonomy.

3. Achieve identifiable progress towards the ERA through excellence-based policies and by supporting other commissioners' targets.

The creation of a single market for knowledge generation and dissemination requires material progress in many fields which are not under your direct control. Four specific policies could substantially contribute to the ERA, of which three may not fall under your portfolio but should receive your active support:

- Creation of an 'excellence initiative' for higher-education institutions, through which a new European test would be created to identify excellent students and the best 'learning' institutions;
- Policies aiming at attracting and keeping foreign talent, in particular by means of an improved 'EU Blue Card' for non-EU labour (with better portability and a longer period of validity), and possibly an 'EU Blue Diploma';
- Effective and simplified mobility for researchers and scientists within Europe, in particular by providing a retirement pension scheme valid throughout the EU to talented researchers or professors;
- Creation of a single market for technology through the adoption of the Community patent.

Climate Change

To: The Commissioner for Climate Change
From: Reinhilde Veugelers
Subject: Priorities for your term of office
Date: 1 September 2009

Challenges

THIS MEMO IS DRAFTED on the assumption that the new Commission will have a dedicated climate change commissioner. This would not only signal the importance attached by the Commission and its president to climate change, but would also render policymaking more effective, as I will argue further in the note.

First, you will have myriad objectives – a veritable ‘Medusa’s’ head of challenges – to consider. Beyond fighting global warming, you will also be confronted with energy efficiency, energy security and pure-play political concerns (not dealt with in these memos), and last but not least economic and societal concerns related to growth and jobs. These objectives do not necessarily all align and may even be at variance with each other.

Second, the climate change challenge is characterised by high and skewed uncertainty. First, there is uncertainty regarding the size of the problem. This starts with a lack of consensus on how big the change in climate is and is going to be. In this discussion, the change in (land and sea) temperature is the focal point of attention and carbon dioxide emissions are the central causal factor considered. Model predictions of these parameters produce wide confidence intervals, with an (albeit small) probability of extreme disasters to deal with. The tendency emerging from the more recent models is to predict bigger effects than those used previously*. A second source of uncertainty is the effect of global warming on overall economic welfare and societal well-being and its distribution across countries, groups within countries and generations. Also tricky is the valuation of losses not measured in the market

place, such as the disruption of societies and political instability.

In addition, you have a wide set of possible policy instruments (including taxes, subsidies, public investment, regulation, standards and permits), all of which you will need to use, but with many unknowns in terms of their effectiveness, efficiency and equity.

What is more, the current crisis will not make your life easier. Although it may provide a short windfall benefit in the form of lower CO₂ emissions, at the same time it temporarily weakens the power of fossil fuel price rises to incentivise climate change action. The financial crisis also affects the provision of finance for green investments, private as well as public. And the crisis makes it politically much more difficult to even broach the question of a carbon tax, although it might all things considered be among the better policy instruments to use.

But to end the challenges section of this memo on a positive note, you will enjoy increasing recognition and support for the climate change agenda, not only from the public at large, but also from the corporate sector in the EU and among the EU’s main partners such as the US and China. The UN Climate Change Conference in Copenhagen in December 2009 will provide much momentum to the public debate. But a higher level of public support and awareness of climate change issues does not guarantee a common stance among the participating governments on how (urgently) the problem needs to be tackled, thus dampening Copenhagen’s chances of substantive immediate success.

* The prediction errors have been mostly on the effect of CO₂ in the atmosphere on climate variables, less so on the CO₂ emissions themselves. Recent data show that the rise in the global mean surface temperature (land and ocean combined) was in 2006 already 0.3°C higher compared to the trend line value in 1990, which was the base year of the Intergovernmental Panel on Climate Change (IPCC) scenarios. This value is in the upper part of the range projected by the IPCC.

What is needed?

WITH COPENHAGEN NOT LIKELY to bring a major paradigm shift in global climate-change policies, most of the pre-Copenhagen discussions will continue to run thereafter: the post-Copenhagen agenda you will inherit when taking office will most probably not look that much different from today's agenda.

Your experts will probably tell you that your agenda will basically be taken up, and achieved, by implementing the EU's '20/20/20' climate-change plan. But the recent updates based on the currently available scientific evidence (amongst others Rahmstorf, the recent PEW Climate Organisation conclusions), make clear that the EU targets, even if successfully implemented, will be insufficient. In addition, it is now also clear that currently available technologies, and the current speed of progress in new technologies, will not be up to addressing the challenges. We will need to foster paradigm shifts and new breakthrough innovations ('backstop technologies'). And finally, although international coordination has been improving since Kyoto and, it is hoped, will continue to improve after Copenhagen, the global governance of climate-change is unfit for purpose.

In tackling the climate-change challenges we are faced with, we need a policy strategy that is much more pro-growth than what we have seen so far. Taking a more pro-growth perspective implies seeing climate change as an opportunity – even now, and perhaps especially now – as we can use the crisis as 'creative-destruction momentum' for change and as a lever to put the EU economy on a sustainable post-recovery growth path. Such a pro-growth approach would help to give 'push-back' to the many who see the climate-change agenda as a cost that needs to be contained.

Taking a pro-growth perspective does not mean ignoring the costs of fighting climate change, nor naively thinking that climate-change action will create a massive number of green jobs and steep future growth. It implies seeing the cost-benefit trade-offs in a new perspective.

First, on the benefit side, the growth we should be aiming for is sustainable growth, properly taking into account the quality of our environment. This implies using a different metric than the traditional GDP calculations we are using now to assess the costs and benefits.

Second, whether more or less sustainable growth will be created depends on which benchmark is used. The proper benchmark to weigh policy actions is how the world would look in the absence of action: ie. more polluted, warmer, unhealthy and with more people dislocated. The benchmark of no action is unfortunately not the extrapolation of 'business as usual'. There is a cost to non-action that needs to be factored in. Unfortunately, in view of the many uncertainties inherent in climate change as discussed above, it is difficult to be precise about the cost of inaction*. But it is not because they are uncertain or difficult to value that we should ignore these costs. When due regard is given to downside risks, the cost of inaction is any case very high. Relative to this benchmark, the cost of fighting climate change is likely to be much lower, at least if sensible policies are enacted globally†. Together with a factoring-in of the quality of growth on the benefits side, these arguments make a pro-growth perspective easier to defend vis-à-vis the cost-containment advocates. But not easier to implement, given the big 'if' related to the feasibility of sensible, globally enacted pro-growth policies.

* As discussed, the cost of doing nothing depends on, first, how fast greenhouse gases will build up in the atmosphere if 'business as usual' is allowed to continue; second, what impact that build-up will have on climatic conditions around the world; and, third, what the impact of the ensuing climate change will be and how we value that impact.

† The Stern Review estimates the cost to be around one percent of GDP forever in order to stabilise greenhouse gas emission to 550ppm CO₂e, thus avoiding a loss of five to 20 percent of GDP forever

Some principles for a pro-growth climate-change policy:

1. A more pivotal role for the development of new technologies

Technologies include those for mitigation (low- or no-carbon technologies such as biofuels, renewables, solar, wind, nuclear), carbon capture and storage, energy efficiency) as well as for adapting to climate change.

A Green Technology Policy should operate in three different areas:

- Improving the dissemination of existing technologies;
- Developing/scaling up near-commercial technologies in the pipeline;
- Creating new breakthrough innovations (backstop technologies).

Most of the policy attention regarding green innovation is directed to the first two areas. All too often green innovation is promoted through industry policy-type intervention, supporting particular technologies through subsidies or tax incentives, often at the expense of others. Given the notoriously bad record of governments in picking winning technologies, and especially in green innovation where technological and market uncertainties still abound, a more horizontal policy approach establishing more general framework conditions, and supporting a portfolio of technologies, is more advisable.

But particularly the third area – breakthrough innovation – requires more policy attention. The climate-change debate as it relates to technology should move beyond assessing the short-term impact and adoption of currently available or near-commercial technologies and look more at the potential for developing major breakthrough innovations, often emerging from non-incumbent players. Market failures are the highest in this area and it therefore requires extra policy attention. While these innovations will only be coming

onstream and helping growth and jobs in the longer term, the foundations of these paradigm shifts need to be built now. Particularly in the area of energy storage, battery technologies need to be nurtured.

2. The need to be much more market-based

Through a strong policy framework which provides the requisite economic incentives for consumers and producers to invest and adopt climate change-friendly technologies, governments should harness the power of markets to find an effective response to the climate-change challenge. In order to have innovative markets and entrepreneurship working to combat climate change, that policy framework must be credible, and predictable:

- A price for carbon that is sufficiently high and predictable to serve as an incentive for carbon-saving investments is obtained in the most straightforward way through a carbon tax. This is why the carbon tax instrument is usually preferred by economists. Although the cap-and-trade system in your portfolio can also do the trick, this nevertheless requires a lot of information and expertise to get the emission-allocation process right, creating more room for error and exposure to political pressure. Nevertheless, given that current political momentum is in favour of cap-and-trade rather than a carbon tax – not least because of perennial national sensitivities about any EU intervention in the tax domain – you need to make the cap-and-trade system as pro-growth as possible. This requires regularly evaluating its effects and adapting when necessary. This evaluation should go beyond measuring the short-term reduction in CO₂ emissions and also consider whether it provides, through a sufficiently high and predictable carbon price, an adequate incentive to generate the necessary investment in innovation for the future.
- Myriad government regulations shape incentives for green investments, some of them stimulating, others impeding, progress. Many of

them originate in member states, but some come from the EU level. A green dynamic efficiency perspective should be incorporated when reassessing existing regulations and when designing new regulations.

- Competition for the net returns to green investments is perhaps the strongest incentive for firms to invest in green technologies, calling for a green dynamic efficiency perspective in competition policy.

3. The need for a global policy perspective

In view of the large and global nature of the problem, public and private resources will need to be mobilised to generate new ideas for fighting climate change wherever they are located. And when new ideas are developed they should be disseminated to users, wherever they are located. This implies a global, or at least a globally coordinated, policy response.

Although the effects of climate change are unevenly distributed across the globe (with the developing countries affected most), climate change is a challenge faced all over the world. This does not necessarily imply that all parties agree on how to tackle it. With the US finally showing more openness, particularly tricky is the position of large emerging powers such as China and India, which may

be reluctant to shoulder a share in any globally set CO₂ targets commensurate with their current and future emission levels, focusing rather on their past emission levels.

Should negotiators consider a border tax or other adjustments for products from those countries failing to agree adequately to reduce their CO₂ levels? Or should they be less ambitious as to their own targets when others fail? While credible non-compliance measures must form part of any good agreement, it is on balance best to avoid having to revert to such penalties as much as possible by reaching an equitable overall agreement in the first place that takes into account the specific capabilities and constraints of all players involved. This means taking into account that countries like China and India may have big CO₂ flows, but still have a smaller stock of CO₂ emissions than big players. It also means taking into account that they still have insufficient means to absorb the latest technologies (although they have a large – potential – pool of scientific and technological brains to develop new ideas for fighting climate change and to bring them to market more cheaply). In approaching the competitiveness debate, it will pay to avoid an excessively short-term, local-champion protectionist approach and to bear in mind that longer-term competitiveness will involve globally agreed and sustainable solutions.

In the competitiveness debate, it will pay to avoid a short-term, protectionist approach and to bear in mind that longer-term competitiveness will involve globally agreed and sustainable solutions.

Recommendations

A **PRO-GROWTH APPROACH** does not require a complete overhaul of past EU policies. Pro-growth principles are already discernable in the existing EU 20/20/20 plan. But they were sub-optimally developed. A more serious pro-growth approach to climate change, better able to deal with the challenges we are facing, requires a change in current EU policymaking. It calls for an EU 20/20/20 Mark II.

Your new, dedicated post as a commissioner for climate change is a necessary condition for the success of Mark II. A pro-growth approach requires more intensive coordination across policy areas (energy, environment, competition, internal market, research, trade, budget...). By being in effect a European climate-change czar, you will have a mandate to cross-cut the various departments, mobilising and coordinating with your fellow commissioners and other stakeholders.

A dedicated commissioner is a necessary, but not sufficient, condition for Mark II. It also requires the enactment of sensible, pro-growth policies. In choosing the policy action in which you will invest, you need to think carefully where policymaking adds the most value to – and can complement – action at member-state level.

Bearing in mind this subsidiarity rationale, your policy action should concentrate on:

1. Improving the incentivising effect of the European cap-and-trade system (ECTS)

As the ECTS is now the established route in the EU to pricing carbon, you need to ensure that it is an effective, incentivising, pro-growth climate-change instrument. To this end, the procedure for issuing permits should be delegated to a newly set-up independent agency, a kind of ECCB (European Climate Change Bank). This independent executive agency should be able to provide highly qualified and independent expertise in order to translate

clearly set targets into permit schemes. This should give the ECTS a better chance of generating a sufficiently high and predictable carbon price.

2. Taking a leading role in international coordination of climate-change action

Relying on its experience of governing intra-EU coordination of member states, the EU should take a leading role in international negotiations on climate change by:

- Developing a roadmap for an international cap-and-trade system, or at least international linkage of the cap-and-trade systems of major players, in particular the US. This would include removing barriers to trading permits across different systems;
- Developing an efficient as well as equitable financing scheme for climate-change action by less-developed countries, given that the current Clean Development Mechanism is clearly insufficient:
 - You should propose a transfer of funds to cash-constrained developing countries for developing or acquiring green technologies;
 - As an alternative to providing these countries with funds for acquiring green technology, you could also consider providing green technologies to them at subsidised prices;
 - Countries should contribute to this fund on the basis of stocks of past emissions, a criterion* which would address the concerns raised by fast-growing countries.

3. Stimulating breakthrough new technologies

The role of the EU in green technology is particularly important in:

- Public funding of green basic R&D through the EU's R&D Framework Programmes and other funding;
- Coordinating green research with international

* The starting year for calculating these stocks should be an agreed date at which awareness of the climate-change challenge became apparent.

- (non-EU) partners;
- Providing a large, integrated EU output market for green investments;
 - Coordinating clear and time-consistent green regulation, standard- setting and public procurement.

I would like to close with a few very specific suggestions. These could be your 'quick wins', clearly marking your arrival in office and showing your commitment and resolve to take the climate-change agenda beyond rhetoric:

- **A green 'YICs' programme:** The programme would fund project proposals from young innovative companies (YICs) to help bring to market highly innovative and pathbreaking ideas for climate change;
- **The European Commission as green leader:** the European Commission should set a good example with its own green procurement. To name but a few ideas: the car pool of the commissioners should include hybrids, electric cars; its building procurement should reflect the principles set out in its own Sustainable Construction Lead Market Initiative.

Pro-growth principles are discernable in the EU 20/20/20 plan. But they were sub-optimally developed. A more serious pro-growth approach to climate change calls for an EU 20/20/20 Mark II.

Employment, social affairs and equal opportunities

To: The Commissioner for Employment, Social Affairs and Equal Opportunities

From: Jakob von Weizsäcker

Subject: Priorities for your term of office

Date: 1 September 2009

State of affairs

AS A CONSEQUENCE of the current economic crisis, unemployment rates in most EU countries are set to soar to double-digit rates in 2010 and the return to pre-crisis levels of unemployment is likely to take several years. This will put considerable strain on the social fabric of societies throughout Europe. This strain will be increased by ideological disorientation. Socialism has failed for good. Confidence in capitalism has also suffered as a result of the crisis. Globalisation is no longer viewed as utterly inevitable but as a surprisingly fragile construct which needs to be organised and regulated better.

Calls to strengthen the social dimension of Europe and of globalisation will intensify. A TNS opinion survey in the run-up to the 2009 European Parliament elections identified unemployment as the top concern for 57 percent of Europeans, followed by economic growth (45 percent), insecurity (32 percent) and the future of pensions (31 percent), well ahead of other broad concerns such as climate change, terrorism or inflation. Yet there is no obvious common European or global

vision on which to build. Despite full awareness by all participants of the major labour-market impact of the crisis by 2010, the main messages that emerged from the recent employment summit did not add to the minimal consensus on employment policy of which member states and social partners were capable before the crisis.

Finding common ground at the European level may well become even harder because the speed at which member states will recover from the crisis is likely to vary considerably more between countries than did the timing of the initial economic shock of the crisis. Furthermore, there is a risk that currency devaluations and sector-specific support measures designed to save jobs in one country at the expense of another country might poison relations within the EU and between the EU and other economies.

In summary, the new employment commissioner will be confronted with increased demand for a social Europe but an environment that may make it even more difficult to deliver than today.

The new employment commissioner will be confronted with increased demand for a social Europe but an environment that may make it even more difficult to deliver than today.

Policy tools

THE EMPLOYMENT COMMISSIONER has essentially three distinct toolsets at his disposal to shape policy. The first toolset consists of executive powers and powers of legislative initiative. However, compared to policy areas such as competition, trade and the single market, the scope for action in the area of employment and social protection is much more limited. The main reason for this is that member states have jealously guarded their national sovereignty in social matters, and this is set to remain the case even if the Lisbon Treaty is finally adopted. As a result, ambitious and successful EU legislative initiatives have been rare in recent years, apart from those linked to internal mobility within the EU or the largely generic non-discrimination agenda.

The second tool is spending power. You have the third-highest budget within the European Commission, amounting to €11.5 billion in 2008 (or almost 10 percent of the EU's annual budget). Only the commissioners for agriculture (€57.7 billion) and for regional policy (€40.0 billion) had bigger budgets in 2008. Concerning your budget, almost all expenditures relate to the European Social Fund (ESF), the oldest of the EU's structural funds going back all the way to 1957 and the Treaty

of Rome. Unfortunately, the track record of the ESF is mixed and the incentives for either the Commissioner or member states properly to evaluate the impact of ESF spending are weak. But significant changes to the way in which the ESF operates are hard to achieve. The reason is that there are powerful stakeholders broadly in favour of the status quo – in particular the poorer countries and regions in the EU and the social partners. These stakeholders will watch closely over any attempts to change the system, worrying about the adverse consequences such changes could entail with respect to the allocation of funds and their effective control.

Third, there is the instrument of thought leadership – the commissioner can initiate debates – and the power of persuasion. This third instrument will prove to be critical in helping to unlock the two other instruments mentioned above. But this will not be easy as long as Council debates on employment policy are 'remote-controlled' by bodies such as the Employment Committee, in which member states 'script' the Council meetings, in the process choking off free-range political debate at ministerial level.

The flexicurity challenge

HELPING TO END this political stalemate at the European level well before unemployment in the EU is likely to peak in 2010 is a critical challenge for you and the new Commission. The stakes are high because the situation on European labour markets – and in EU treasuries – in 2010 may readily destroy the most important conceptual pillar of European employment policy beyond pure regional policy: the notion of flexicurity.

Flexicurity will come under pressure on two fronts. First, the returns to labour market flexibility will be unusually low in 2010. The simple reason is that the rise in unemployment will be attributable primarily to a macro shock that sends essentially all sectors into decline, with hardly anybody willing to hire. Therefore, the main upside of flexibility, namely that it enables swift reallocation of workers from sectors in decline to sectors on the rise, risks being largely irrelevant until the economy picks up again. In the short run, flexibility will merely mean that people lose their jobs more quickly. Second, some of the more flexible economies like the US, the UK and Ireland have been hit particularly severely by the crisis. Taken together, this is likely to lead to a situation where, empirically, the increase in unemployment as a result of the crisis will be greater in countries with more flexible labour markets.

But this is only half the story. Not only will the benefits of flexibility be called into question by a public whose trust in conventional economic wisdom has been weakened by the crisis, the promise of security to cushion the adverse effects of greater flexibility will also rapidly lose credibility in view of rapidly mounting public debt, severely curtailing the ability of governments to offer more substantial support and economic security to those who lose their jobs. In particular, countries such as the UK and Ireland which are going through a period of severe fiscal stress and have low levels of protection may find it difficult to sustain – let alone increase – their level of protection. Overall, there is a risk that flexicurity will come to be regarded as a fair-weather arrangement unable to withstand the current stress test.

Only once the economy recovers will the substantial benefits of flexibility in the labour market once again become apparent. The reason is that, when the recovery starts, typically certain companies and sectors will expand while others will continue to stagnate or even shrink. The speed and extent of recovery will therefore depend crucially on the ease with which workers can be reallocated to the expanding sectors. If instead workers are tied up in government-subsidised sectors in decline, or have left the workforce altogether through early retirement schemes, growth risks being stifled.

In light of these likely developments, you will be confronted immediately you take office with perhaps the most important strategic decision of your tenure: whether actively to promote an ambitious flexicurity agenda against the odds outline above. Or whether to shift emphasis and attempt to develop a less controversial agenda based on longer-term challenges such as ageing and migration that also have a crisis dimension. Before taking the decision, you should explore with member states to what extent they would be prepared to support greater EU involvement in the flexicurity agenda. There are at least two reasons why member states could find this attractive.

First, they may have an interest in creating a link between, on the one hand, social and employment policies and, on the other, the much-needed EU-level agreement on a return to fiscal sustainability within the framework of the Stability and Growth Pact. Specifically, they may wish to see flexicurity-type arrangements rewarded by interpreting a higher percentage of post-crisis unemployment as cyclical rather than structural, thus allowing for a larger portion of their deficit also to be deemed cyclical rather than structural. You should explore this question with your colleague responsible for economic and financial affairs upon assuming office.

Second, member states may find a European agreement in support of flexicurity helpful not only to sustain social security-related fiscal expenditures in the crisis despite fiscal pressure

but also politically to anchor labour-market flexibility. This could be helpful for national governments because they know that, once growth returns, the rewards of flexibility in terms of job creation are likely to return more rapidly than political support for such flexibility.

Such an intensified flexicurity agenda would have carefully to balance the flexibility and security elements. In addition, it would have to be sufficiently versatile to be meaningful within the great variety of social models present in Europe today. It would certainly have to be backed up not only by the open method of coordination but also by supporting reforms of the ESF and significant legislative action to achieve credibility and bite.

On the security side, a focus on minimum work

income – also sometimes called workfare – could be an attractive alternative to approaches focused on the contentious issue of the minimum wage. The minimum work income would of course be defined and financed at the national level. Technically, it would be achieved by national governments topping up the market wage of low-paid workers. These benefits would then be withdrawn gradually as incomes rise. While the mechanics of such schemes will always have to be tailored to the institutional characteristics of national welfare states, the creation of a common framework and a joint social commitment at the European level could go a long way towards balancing the efficiency and equity objectives of the flexicurity agenda in a climate of post-crisis mass unemployment.

EU unemployment is likely to peak in 2010. The situation on European labour markets may destroy the most important conceptual pillar of European employment policy: the notion of flexicurity.

An alternative focus

IT IS ENTIRELY POSSIBLE that an ambitious flexicurity agenda as previously described will receive insufficient support from member states, not least due to the different speeds of post-crisis recovery and the differences in outlook that this may entail. In this case, you should explicitly note that member states have, for the time being, made the conscious choice to deal with the upcoming unemployment challenge predominantly at the national level without substantive EU involvement. The alternative course of action is to pursue an agenda which would be somewhat lower key. It should focus on two areas that have a pressing crisis dimension while also being decisive for the longer-term future of the EU: **ageing and migration**.

Ageing and retirement: Politically, it will be almost unavoidable that some countries use early-retirement schemes to buffer the labour-market impact of the crisis. However, this would not only hamper the prospect of an economic rebound after the crisis. It would also add substantially to the problem of fiscal sustainability when debt levels are already soaring. Therefore, it is essential that you collaborate closely with your colleague in charge of economic and financial affairs to develop EU-level arrangements which recognise the contribution to fiscal sustainability of increases in the effective retirement age and which, conversely, impose tighter demands for fiscal consolidation on countries that once again fall into the early-retirement trap. You will have a critical role to play in this initiative, developing best-practice arrangements for re-integration of older workers into the labour market once the economy picks up again.

Migration: To emerge from the current phase of

'destructive destruction' in the economy, European economies need to move to Schumpeterian 'creative destruction', where some dynamic sectors start to pick up the slack. Regaining the path to growth would be helped in no small measure if the EU could attract significantly more creative and entrepreneurial talent from abroad. Unfortunately, Europe is traditionally no leader in the global competition for talent. To better position the EU, you should strive to convert the EU's Blue Card from being merely a symbolic achievement to being a real success story on the ground. This would, in particular, require the Blue Card to become truly portable within the EU, and to offer a much more secure prospect of long-term residence than at present. Thus, the agenda for 'mobility partnerships' with the EU's neighbourhood should be significantly broadened: they should no longer be narrow repatriation exercises but should include a broader 'skill-mixing' agenda. Given the rise in unemployment, the migration agenda will have to be implemented against the backdrop of a 'heads-you-win-tails-I-lose' fallacy: migrants will be accused of taking jobs from natives if they keep their jobs and they will be accused of living off [native] taxpayers' money if they lose their jobs. You will have forcefully to address this fallacy.

Mobility: As the remaining transitional arrangements imposed on the new member states for the free movement of workers within the EU expire, the issue of portability of social entitlements should once again be at the centre of EU efforts to build an effective EU labour market. Traditionally, the approach has been to make pre-existing national social insurance schemes portable to the extent that this is feasible. This approach has now largely run its course, encountering increasing

It will be almost unavoidable that some countries use early-retirement schemes to buffer the labour-market impact of the crisis, hampering the prospect of a rebound and adding to the fiscal sustainability problem.

difficulties as there are many aspects of national schemes that may intrinsically resist portability, such as maximum or minimum pension rules or certain features of health or long-term care insurance. Therefore, a new and somewhat more invasive agenda will be needed that creates strong incentives for member states increasingly to replace characteristics of the welfare state that resist portability.

ESF: Only in case an ambitious flexicurity agenda were to be pursued might the ESF be needed as a sizeable bargaining chip. In the lower-key scenario, it would instead be recommended to decentralise

decision-making on the use of ESF funds much more, while centralising the monitoring and evaluation functions somewhat more. Specifically, ESF spending could move increasingly towards block grants, thereby leaving the geographic distribution of the funds largely untouched while paying heed to the subsidiarity principle. However, such a move should be complemented by a much stronger monitoring and evaluation role for the Commission. Such credible ex-post controls would not only help with joint learning on what works well and what does not. It would also create much better incentives for member states to spend EU taxpayers' money wisely.

Enlargement and neighbourhood policy

To: The Commissioner for Enlargement and
Neighbourhood Policy

From: Zsolt Darvas

Subject: Priorities for your term of office

Date: 1 September 2009

State of affairs

EUROPE CAN BE VERY PROUD of the completed fifth enlargement round. It has not just unified most of historically divided Europe, promoted democracy, the rule of law, protection of human rights, market-oriented reforms and helped to preserve security and stability in Europe, but it has also brought higher GDP, boosted the competitiveness of the whole EU and enhanced the role of the EU as a global player. Most of the initial fears surrounding the eastern enlargement have not materialised – in particular, although mobility from East to West was sizeable, there has been no mass exodus, and European institutions have continued to function reasonably smoothly. However, beyond the current borders of the EU, significant tensions and risks persist. Some have indeed emerged more recently.

Apart from Croatia, countries in south-eastern Europe that have either candidate or potential candidate status are caught between slow domestic progress and mixed signals arriving from the EU. Talks with Turkey are practically frozen. Deterioration in its EU prospects has led to a deceleration in the reform effort and also to a change in public opinion. For example, according to a Eurobarometer survey 71 percent of Turks thought that membership of the EU would be good for their country in the spring of 2004, but this support had declined to 42 percent by the autumn of 2008. Influential political leaders in some EU countries have become mired in a sterile public demonstration of 'enlargement fatigue'. The voice of other member states and of the Commission reaffirming that it is progress that matters is less audible. The results of the June 2009 European elections were also taken to imply that the

prospects of further enlargement after Croatia and perhaps Iceland are fading.

The progress of countries at the EU's eastern border, at least those that have decade-long dreams of moving closer to the EU, is also stalled by enlargement fatigue, despite efforts from the EU side such as the Eastern Partnerships (EaP). These countries have a long way to go to shed their remaining Soviet economic and political legacies and also to resolve conflicts. Their situation is certainly complicated by the foreign policy objectives of Russia, a country that does not share all Europe's values but is keen on maintaining and recovering its influence in the region.

With the arrival of the crisis in south-eastern and eastern Europe from the West in the autumn of 2008, the short-term risk of rising poverty and the long-term risk of permanently reduced growth prospects have emerged. Economic damage to these neighbours will have serious repercussions for the EU in the form of instability at its borders and illegal migration.

Neighbours on the southern rim of the Mediterranean are generally characterised by unresolved conflicts, authoritarian regimes, terrorist risk, slow progress even in non-political areas such as improving regulatory quality. Alleviation of these problems should be high on your agenda, and the new 'Barcelona Process: Union for the Mediterranean' (BP-UfM)' initiative should not be allowed to lapse into being a second Euro-Mediterranean Partnership, whose performance has been disappointing.

Neighbours on the southern rim of the Mediterranean are characterised by unresolved conflicts, authoritarian regimes and terrorist risk. Alleviation of these problems should be high on your agenda.

Challenges

YOU WILL FACE TWO PRINCIPAL CHALLENGES regarding the whole EU neighbourhood, whether the countries are prospective EU member states or not. The first challenge is more of an economic one and is related to the eastern and south-eastern neighbours, while the second one is more political and has a bearing on the whole neighbourhood:

1. How to help neighbouring countries to cope with the crisis and return to a sound economic growth path after the crisis, so as to save Europe from the increased risk of instability at its borders and a potential flood of illegal migrants;

2. How to help them to maintain their political orientation towards the EU in order to promote the adoption of EU norms and the sharing of EU values.

To provide a starting point for addressing these issues, the table below provides a brief comparison of EU and neighbourhood countries in terms of some general indicators, some indicators related to the EU's Copenhagen criteria, and some indicators related to the crisis.

In terms of the indicators related to the Copenhagen

Some key characteristics of EU and neighbourhood countries

	EU15	NMS12	Croatia	Macedonia, FYR	Turkey	Iceland	West Balkan-4	EaP-6	Med-10
Population (millions), 2007	391.1	103.2	4.4	2.0	73.9	0.3	14.9	75.8	187.3
GDP/capita at Purchasing Power Standards, forecast for 2010*	100	54	56	28	38	108	28	23	21
Democracy, 2007*	100	96	92	92	82	102	90	54	15
Voice and accountability, 2007*	100	86	77	69	59	104	68	51	35
Rule of law, 2007*	100	73	67	54	66	115	52	47	61
Lack of corruption, 2008*	100	65	63	51	65	127	48	35	46
Economic Freedom index, 2007*	100	93	85	86	85	104	84	78	84
Cumulative GDP growth from 2000-2008 (percent)	16.1	47.4	42.9	23.9	41.3	36.4	53.2	93.1	43.9
Forecast of cumulative GDP growth from 2008-2010 (percent)	-4.1	-3.2	-3.3	-1.0	-3.7	-10.8	-1.3	-3.1	6.6
Lack of vulnerability to political and social unrest, 2009*	100	74	46	46	31	94	47	50	64

* EU15=100

Note: EU15: The 15 EU member states before 2004. NMS12: The 12 member states which joined the EU in 2004 and 2007. West Balkan-4: Albania, Bosnia/Herzegovina, Montenegro and Serbia. EaP6: Armenia, Azerbaijan, Belarus, Georgia, Moldova, Ukraine. Med10: Algeria, Egypt, Israel, Jordan, Lebanon, Libya, Morocco, Occupied Palestinian Territory, Syria, Tunisia.

Population refers to total population of the respective country group. All other figures are weighted averages (using population weightings). All institutional/governance indicators were rescaled so that a higher figure indicates a better score and are expressed as EU15=100; GDP per capita is also expressed as EU15=100. Due to different methodologies behind the various indicators, scores across indicators are not necessarily comparable, eg a 50-percent score relative to EU15 on one indicator may give rise to a different interpretation than the same score on another indicator.

Source: Bruegel calculations based on data from Eurostat, Integrated Network for Societal Conflict Research, Freedom House, Economic Freedom Network, Transparency International, World Bank, Economic Intelligence Unit, the April 2009 forecasts of the European Commission's DG ECFIN, and the IMF.

criteria, Iceland clearly stands out, Croatia ranks close to the average of the 12 new member states, but other countries have larger gaps. Statistical evidence also supports the case that institutional/governance indicators are very persistent over time and hence countries ranking low have a long way to go to close the gap with EU member countries.

The table also highlights that pre-crisis economic prosperity was indeed remarkable for the whole neighbourhood area, but that the crisis has marked a significant break with this trend in the eastern and south-eastern neighbours. It is no solace that the fall in GDP from 2008 to 2010 is expected to be slightly less on average than in EU15. The conclusion that there is no need to be more concerned than about EU15 would be wrong:

1. Neighbourhood countries are poorer and hence the same percentage fall in income represents a more serious threat to poverty than in EU15;
2. Group averages hide huge country-specific differences. Any 'weak link' can have destabilising effects on its neighbours as well;
3. Neighbourhood countries are more vulnerable to social and political unrest than western Europe. This can block important reforms and, combined with increasing poverty and anti-globalisation sentiment, can result in greater popular support for anti-western political parties.
4. It should be acknowledged that the process of integration with the EU itself also contributed to the severity of the crisis. Pre-crisis capital inflows, while beneficial to growth, also boosted unsustainable credit and housing booms and rising current-account deficits in many neighbouring countries.

In the past decades the EU has provided an anchor for transition countries and influenced to a considerable extent the design of their economic and political institutions. The sudden realisation that, in situations of stress, capital flows diminish, trade collapses, protectionist policy rears its head, migration inflows reverse and remittances dwindle are major shocks that could lead to a rethink of past

policy choices and undermine support for the market economy and EU orientation.

In Latin America, following a period of market-oriented reforms along the lines of the 'Washington Consensus' that emerged in the late 1980s and early 1990s, globalisation and pro-market policies became increasingly unpopular in many countries and some of the pro-market reforms were reversed. The economic literature concludes that the main reason for this turnaround was that crises that affected Latin America in the late 1990s and first half of the 2000s were extremely costly and voters associated these crisis episodes with market-oriented reforms and the opening up their economies. The risk that the current crisis will have a similar effect on some EU neighbourhood countries is non-negligible.

It is against this background that you should ask the question whether the available tools and their current use are sufficient to address the key challenges. The symptoms and risks discussed so far suggest that action should be sincere and bold.

Your political margin for manoeuvre will be very limited. Member states are struggling with internal problems, and enlargement and neighbourhood policies have always been among the most sensitive issues. As some new initiatives, such as the BP-UfM and the EaP have been launched recently, both the need and the appetite for any brand new scheme may be very limited. EU public opinion generally reflects enlargement fatigue, and the EU's popularity has taken a hit among the citizens of neighbourhood countries.

Under these circumstances you should and can play the role of a strategic thinker, a strong leader in driving neighbourhood issues forward, an effective communicator and an honest broker among EU institutions, member states and neighbourhood countries. You cannot afford to remain trapped by current political realities and not look forward.

You should find better ways to promote positive incentives to break the vicious circle of

enlargement fatigue in the West, reform fatigue in the East, and the resulting drop in prosperity at the EU borders. The policy options available for dealing with eastern and the south-eastern Europe on the one hand and with the southern Mediterranean rim on the other differ, in part because of the crisis and in part because of geography.

For the crisis-troubled eastern neighbours, a vital short-term option is to revive the EU's macro-financial assistance instrument to third countries. The loans disbursed under this facility have declined to a few million euros over the last few years. In contrast, the EU swiftly increased the limit of the balance-of-payments facility for non-euro area member states from €12 billion to €50 billion recently. There is no doubt that EU member states should be given priority, but the relatively paltry facility for third countries sends the wrong message to the neighbourhood. The respectable US\$100 billion European boost to the IMF resources does not alleviate the need for a substantial increase in this facility, because direct support from the EU would also have a strong signalling effect. In the neighbourhood countries under the IMF programme there is more talk about the IMF than about the EU, which must be changed, since the EU's stand during the crisis will have far-reaching consequences for the relations of the EU with partner countries. Within the EU, the difference between extending a loan and granting aid should be clearly communicated.

Regarding medium-term policies, there are basically three options, of which the last one applies only to European neighbours deemed to be part of geographical Europe.

The easiest option is to go ahead with the current instruments along the lines of the European Neighbourhood Policy, the pre-accession strategy and the enlargement process, with some fine-tuning. These policy areas have many very positive initiatives, such as the deep and comprehensive free-trade area (DCFTA) envisaged in the recent EaP, though this was set as a distant goal for most of the countries in exchange for exhaustive reforms. For other fundamental EU freedoms, the initiatives were strongly constrained by current political realities. For example, in terms of mobility the EaP policy paper explicitly uses the phrase 'long-term goal' for full visa liberalisation and not just the notion of strict conditionality, and also relegates migration issues to the general framework of the EU's 'Global Approach to Migration'. Similarly, enlargement documents for currently recognised candidates suggest, as the Commission itself has noted, that the process is proceeding like a 'local train'.

The key question is whether the current initiatives, coupled with the various formal and informal messages from the EU side about the slowness of the process, provide sufficient incentives for neighbourhood countries to take the hard and painful road of reform. The recent EaP, for example, was received by one country concerned as 'good but not good enough', another regarded it as 'modest', while a third expressed its gratitude but made it clear that it will not change its attitude and can proceed to pursue its own objectives even without the EU.

Perceptions are important. If politicians and citizens in the neighbourhood do not regard the EU as attractive enough, there is a serious risk that the

You should find better ways to promote positive incentives to break the vicious circle of enlargement fatigue in the West, reform fatigue in the East, and the resulting drop in prosperity at the EU borders.

warning signs discussed so far will persist and that a Latin-American scenario could emerge, ultimately leading to less prosperity, security and stability at the borders of the EU, with all the associated consequences.

A second option for you, therefore, is to promote and lead a discussion to extend the scope of all regional neighbourhood policies to include all four EU freedoms, applying strict conditionality, without any timescale or advance commitment, but nevertheless offering a clear prospect of success. First steps in this direction could be to set more ambitious targets for visa liberalisation, as it would instantly improve the image of the EU in the neighbourhood, and to ensure the intra-EU portability of the Blue Card, also providing for the possibility of longer-term residence (see Jakob von Weizsäcker's suggestions to the new EU Commissioner for Employment, Social Affairs and Equal Opportunities). For the currently recognised candidates, speeding up the EU-entry procedure should be high on the agenda, but again applying strict conditionality, without any particular timescale or upfront commitment but with clear prospects if conditions are met.

A third option for you would be a radical rethink of attitudes to neighbourhood countries: promoting and leading a discussion on abolishing the dividing line between 'potential candidate' and 'other' European neighbourhood countries. Again, this approach need not involve any upfront commitment, or even any active encouragement, but should imply a clear prospect of EU entry subject to the conditions set being met.

The EU has always been keen on applying a rule-based equal-treatment principle in its other policy areas. The dividing line between potential candidate and other European countries suggests that enlargement is an exception to this rule, despite the fact that Article 49 of the EU Treaty states that 'Any European State which respects the principles set out in Article 6(1) may apply to become a member of the Union'. The discrimination between potential candidates and other countries sends a very strong message to the people of most of the neighbourhood countries that they should give up any hope of EU accession in the long term even if they succeed in meeting all relevant criteria, irrespective of what is written in the treaty.

Promoting and leading a fact-based discussion on this issue would be a worthy initiative. The discussion should stress that meeting the accession criteria is a job which lies mostly with the applicant country itself and that all applicant countries (apart from Croatia and perhaps Iceland) have a long, hard road to go in order to meet the criteria. The discussion should also explore the potential beneficial effects of abolishing the current difference in status between neighbourhood countries and what these beneficial effects would imply for the EU.

Any of the three options, but especially the second and the third, should be accompanied by an institutional change within the Commission: unification of the enlargement and neighbourhood policies not only under a single commissioner but also under a single Directorate-General. This change is dictated by professional and political considerations and by reasons of efficiency.

Recommendations

FIRST, YOU SHOULD PROPOSE a substantial extension of, and active use of, the macro-financial assistance instrument to third countries.

Second, you should keep the reform momentum going – or rekindle it – in all EU neighbourhood countries by:

- Leading a comprehensive and strategic joint review of both enlargement and neighbourhood policies, including the possible extension (subject to proper conditionality) of all four EU fundamental freedoms to neighbourhood countries and a re-examination of the issue of the EU's integration capacity;
- Applying the enlargement criteria to any and all applicants in a transparent, tough but objective way with the same standards as in the past, while also making it clear to candidates that the

prospects for, and timing of, EU entry depend exclusively on their own preparedness for accession;

- Communicating more effectively and providing more information about past and prospective enlargements and neighbourhood issues to the citizens of both the EU and neighbourhood countries;
- Pushing the EU, not just the Commission, to speak with one voice on enlargement and neighbourhood issues, or at least to avoid contradictions by adhering to a *sprachregelung* acceptable to all.

Third, enlargement and neighbourhood policies should be combined within a single Directorate-General.

Discrimination between potential candidates and other countries sends a very strong message to the neighbourhood countries that they should give up any hope of EU accession.

Tea

To: The Commissioner for Trade
From: André Sapir
Subject: Priorities for your term of office
Date: 1 September 2009

State of affairs

BETWEEN 1998 AND 2008 the volume of world trade grew at an average annual rate of nearly six percent, twice as fast as world GDP. In 2009 the collapse of global demand brought about by the economic and financial crisis will, according to the WTO, result in a decline in world trade of 10 percent, the largest such contraction since World War Two. The decline will be especially severe in developed countries, including in the EU, with exports falling by more than 10 percent. In developing countries exports will contract by three to four percent.

This dramatic turn of events raises two questions for the multilateral trading system and for the European Union, the largest trading bloc in the world with an overall (export plus import) share in world trade (in goods and services) of nearly 20 percent in 2008, well ahead of the US (15 percent) in second place and China (10 percent) in third*.

The first question concerns the future of the Doha Development Agenda (DDA), originally launched in November 2001, which in June 2009 became the longest running GATT/WTO trade round. Will the crisis help to accelerate the pace of negotiations, or will it instead make a deal impossible to achieve in the immediate future? A broader question concerns the very future of the WTO and the multilateral trading system, a matter which goes much further than the fate of the Doha Round.

The second question deals with the position of the European Union on a number of issues crucial both for us and for the multilateral trading system, of which we are an avowed and staunch supporter. Two issues stand out: trade and climate change, and preferential trade agreements.

* All the figures in this memo exclude intra-EU (27) trade.

Challenges

YOUR FIRST CHALLENGE will obviously be the economic and financial crisis. Even if growth restarts in 2010, next year is likely to see record unemployment in Europe and elsewhere, which will bring mounting protectionist pressures. This will be a testing time for our trade policy and for the multilateral trading system.

The next three challenges to Europe's trade policy relate to three issues likely to shape the future of the multilateral trading system.

Your **second challenge** is the role of emerging and other developing countries, which form the majority of WTO members and have also become important players. Back in 1995, when the WTO was created, the four leading exporters of goods were still the so-called 'Quad countries' of Canada, the EU, Japan and the US, which together accounted for 52 percent of world trade. By 2008, their share was barely 37 percent, whereas the share of the 'BRICs' (Brazil, Russia, India and China) had increased from eight to 18 percent.

During the 1999 Seattle WTO Ministerial Conference, one of your predecessors, Pascal Lamy, famously declared that the WTO was 'medieval'. He was right. The Quad, that cosy club of old powers, basically set the agenda of the World Trade Organisation, as it had done for many years with its predecessor, the GATT. But what Lamy was describing was in fact an ancient regime about to change. In 2001, China became a member of the WTO, and by the time of the 2003 Cancun WTO Ministerial Conference, it had joined forces with Brazil, India, and South Africa to create a powerful coalition of twenty emerging trading countries, which together account for about the same share of world trade as the European Union.

The WTO basically works by consensus. This makes negotiations among its increasing number and variety of members highly problematic. Prior to the Uruguay Round, there were two ways of dealing with the diversity of interests among members. One was to grant 'special and differential treatment' (S&D) to developing countries, which essentially

allows them to make fewer concessions, if any, in exchange for trade benefits than other countries. The second was to allow any country to remain outside certain specific agreements. The Uruguay Round sought to reduce these two flexibilities. First, it introduced a distinction between developing and least-developed countries in the application of S&D measures aimed at increasing the participation of emerging countries in the trade bargaining process. Second, it established, at the EU's insistence, the notion of a 'single undertaking', whereby members of the WTO would be required to accept the results of a trade round as a package. One of the results of this provision was to force developing countries to become members of the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) despite their reluctance to do so, a situation only partly alleviated by the presence of S&D clauses.

The TRIPS arm-twisting episode still leaves a bitter taste in the mouth of developing countries, a feeling intensified in the late 1990s when the EU and the US separately attempted to extend the 'trade-and-IPR-rules' linkage concept to rules on labour, environment, investment and competition. Efforts to include 'trade and labour' on the agenda of the future trade round discussed in Seattle was, in fact, the main reason why developing countries torpedoed the 1999 conference. Launching the Doha Round two years later entailed labelling it a 'Development Agenda', although one never clearly defined.

These clashes between industrialised and developing countries need to be borne in mind in tackling your **third challenge**: the role of trade rules in the post-Kyoto global climate change regime. Climate change is an issue where the environmental objectives are fundamental, but where the trade-offs with other objectives are perceived differently across countries, in particular (but not only) between industrialised and developing countries. Different approaches to resolving the tensions between environmental and competitiveness concerns are likely to lead governments to consider programmes that support

local industries at the expense of foreign suppliers through border taxes or other instruments. Several countries, including the EU, have for several years been discussing trade measures against 'dirty' imports, which might even be WTO-legal under GATT Article XX, which allows countries to take measures to protect 'human, animal or plant life or health'. No such measure has yet been taken, but their use in the future could lead to trade wars and unravel the multilateral trading system, unless they were embedded in new multilateral obligations. Much will depend, however, of the capacity of countries to reach a scientifically-credible and equitable deal at the Copenhagen summit later this year.

The **fourth challenge** relates to the proliferation of preferential trade agreements (PTAs) and the risk of fragmenting the multilateral trading system into regional blocs.

The EU only applies the full 'most-favoured-nation' (MFN) tariff to nine countries (Australia, Canada, Hong Kong, Japan, Korea, New Zealand, Singapore, Taiwan and the US). All other countries receive either unilateral or reciprocal preferential treatment. The unilateral regime is available to nearly all developing countries through the EU's Generalised System of Preferences (GSP). The reciprocal regime covers the EU's preferential trade agreements (PTAs), which provide free trade in non-agricultural goods, and limited liberalisation of trade in agricultural products. Some agreements also cover trade in services. The EU has PTAs with nearly all European countries and with a number of non-European partners (ACP countries, Chile, Mexico, Mediterranean countries, South Africa). It has also launched PTA negotiations with several regional groupings (ASEAN, Central America, Gulf

Cooperation Council, MERCOSUR) and individual countries (Canada, India, Korea, Ukraine).

All the EU PTAs include subject-matter already covered by the existing WTO Agreement, and generally involve commitments going beyond multilateral obligations, such as lower-than-MFN tariffs, especially in non-agricultural goods. In contrast to US PTAs, however, only few EU PTAs cover trade in services. Many recent EU PTAs, and all those currently being negotiated, also include a number of regulatory matters that are outside the WTO Agreements altogether, such as competition and investment norms.

It is not only the EU which is crafting a network of PTAs. The United States, Japan, China and every other WTO country are engaged in similar activities. The result is not only a welcome process of trade liberalisation but also the creation of a vast 'spaghetti bowl' of discriminatory rules and regulations, which tend to work in favour of large 'hubs' such as the EU, the US or China and against the interests of smaller, often developing, trading nations. The discriminatory dimension of such agreements is further reinforced by the fact that many recent PTAs include subject-matter not currently covered by the WTO Agreements.

Besides the crisis and the three challenges to the future of the multilateral trading system, the EU's trade policy confronts a **fifth challenge** which concerns its domestic organisation. Almost by definition, trade policy is highly distortive and subject to strong interest-group pressures. Trade-protection measures bring benefits to some domestic interests and costs to others. Typically, benefits accrue to a small group of well-organised

The aggregation across interest groups of the costs and benefits of EU trade policy has been entirely in the hands of the Commission and the Council, conducted through a process that often lacks transparency.

producers, while costs are borne by a large group of poorly organised consumers. What makes this by and large politically feasible is that each producer accrues a large gain, while each consumer bears only a small cost. Moreover consumers may not even be aware of the cost they bear, unless they are themselves producers or distributors, who also tend to be well organised. This explains why final consumer goods such as food or apparel and clothing tend to be much more protected than intermediate products.

So far, the aggregation across interest groups of the various costs and benefits associated with EU trade

policy has been entirely in the hands of the Commission and the Council, conducted through a process that often lacks transparency, with votes in the Council generally kept confidential. With the Lisbon Treaty, the European Parliament will gain substantial power in the field of trade policy, including in its ability to shape regulations defining the framework for implementing EU trade-policy measures. This is likely to have two impacts on EU trade policy: greater transparency and greater special-interest activity.

These five challenges translate into five recommendations.

Recommendations

FIRST, YOU WILL HAVE TO WORK hard with your foreign partners in stemming the rise of protectionism in the face of mounting economic difficulties and in accelerating the pace of the Doha Round negotiations with a view to reaching a final agreement in 2010. Success in the DDA is our best insurance policy against a rise in protectionism that could otherwise emerge from high unemployment and sizeable changes in exchange rates. Concluding the DDA will help the EU to reduce its trade protection in agriculture, which remains very high. In return, the EU will be able to improve its access to foreign markets in non-agricultural goods and services, which together account for 95 percent of EU exports*.

Second, you should assume that the DDA will be the last traditional trade round. Even if trade liberalisation continues after the Doha Round, it is unlikely to take place through the kind of multilateral negotiations we have been witnessing for the past eight years. If the WTO were to lose this role, could it find a new one besides being a tribunal for trade-dispute settlement? You should therefore immediately establish a high-level group tasked with preparing a report on the EU's vision for the role and the functioning of the WTO post-Doha.

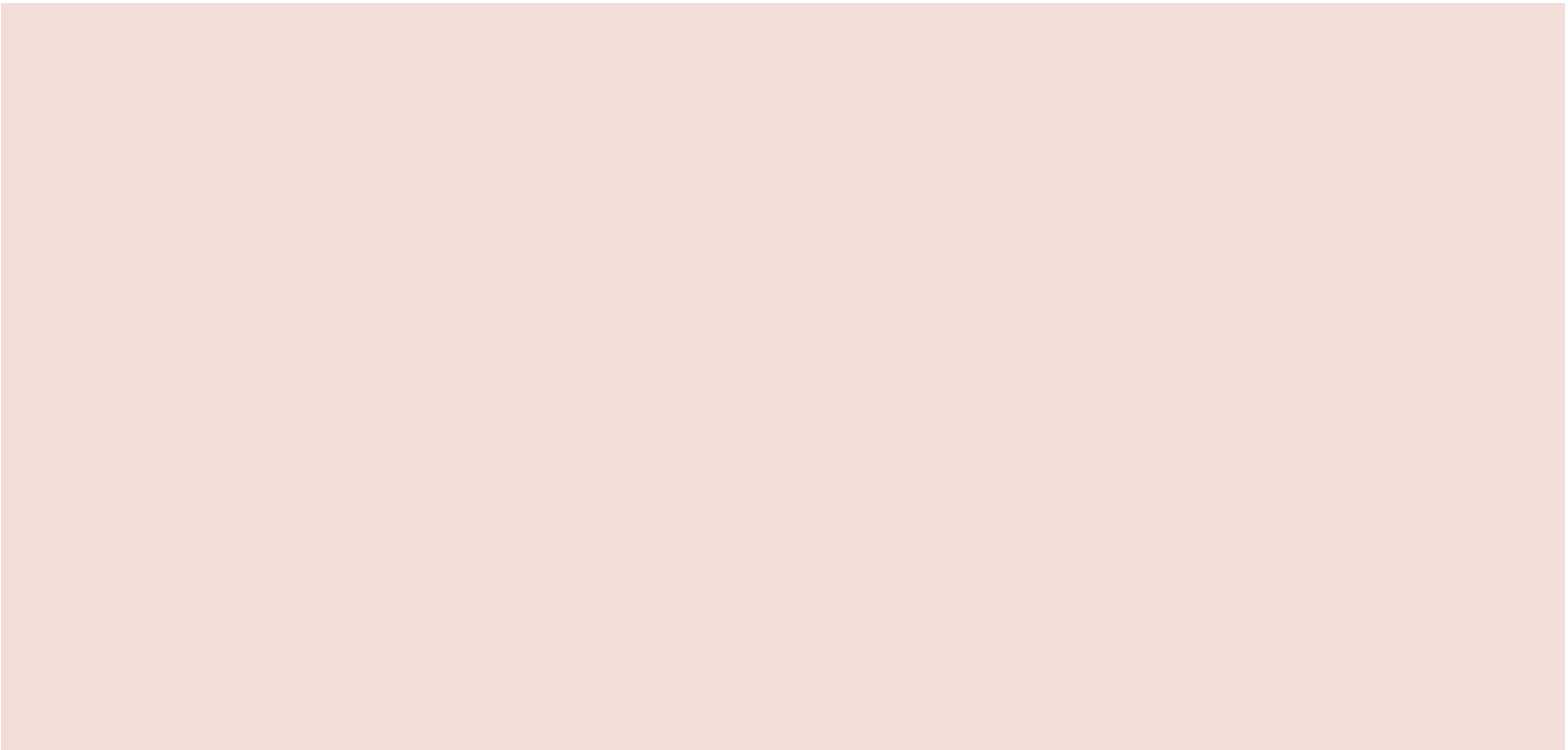
Third, a new legislative package on climate policy will be a priority for the new Commission. It may include trade-restrictive measures, or the threat thereof, against countries refusing to take binding climate-policy action. It would be a mistake, however, to introduce such measures unilaterally, or simply in conjunction with the US and other industrial countries, which would be aimed at developing countries. Instead, you should work with your G20 partners in developing multilateral trade disciplines along the lines of the recently proposed Code of Good WTO Practice on Greenhouse Gas Emissions Control. This will be a subject where you will have to negotiate not only with your foreign

partners, but also with our member states and with your colleagues within the Commission, and above all the commissioner responsible for climate change policy, and obviously the president.

Fourth, one reason why the WTO may lose its trade-liberalisation role after Doha is the rise of PTAs, to which the EU largely contributes. You should be aware that our current strategy on preferential trade agreements brings both short-term benefits and long-term costs. The benefits come in the form of mercantilist gains: improved market access and the opportunity to export EU regulatory norms to trading partners. The costs of 'competitive regionalism' are a weakening of the WTO system and the risk of fragmenting the world into competing trade blocs. This calls for a rethink of EU policy that your high-level group should reflect upon. We should probably consider how we can work with other major trading partners in developing new multilateral guidelines to better control the perverse effects of free-trade areas than is the case under existing WTO rules.

Fifth, you will have to work more closely than your predecessors with the European Parliament, which will probably push for greater transparency in our internal EU trade policy process. You should strongly support such an effort. You should also seek to establish with Parliament a common vision of what EU trade policy aims to achieve and how. Trade policy is an important instrument for our competitiveness. Freer trade and open markets are essential ingredients for Europe's prosperity. Keeping global markets open will require a continuous, strong commitment towards the multilateral trading system on our part. Given that vast the majority of WTO members are developing countries, it will also dictate that EU trade and development policies become more complementary and, indeed, mutually enhancing and supportive.

* In 2007 non-agricultural goods accounted for 67 percent of exports, compared to 28 percent for services and only five percent for agricultural goods.



Development

To: The Commissioner for Development
From: Indhira Santos
Subject: Priorities for your term of office
Date: 1 September 2009

State of affairs

PROGRESS MADE IN THE LAST DECADE to reduce global poverty and improve standards of living has been remarkable. The share of people living in extreme poverty has fallen from 42 percent in 1990 to 25 percent in 2005. But achievement of the Millennium Development Goals (MDGs) by 2015 – a big milestone for the next Commission and the international community – looks unlikely in the poorest countries. Moreover, the economic and food crises have shown that gains can be fragile. There is, therefore, a long way to go in the fight against poverty.

The EU bears major responsibility in this task as a key player in international development, providing over half of all official development assistance worldwide. The good news is that the EU is one of the few actors with the necessary clout to affect the development agenda related not only to poverty, but also to climate change and global health. Involvement of the EU in development policy has, moreover, broad support among EU citizens and a strong economic rationale. The bad news is, however, that the governance and implementation of EU development policy remains highly fragmented: the responsibility for this policy area is shared between the Commission and member states, resulting in 28 development policies. The Commission, as a result, plays a dual role as a development actor itself – managing 20 percent of EU aid in 2006 – and as the coordinator of member states' action in this field.

But complexity is not limited to the question of shared competency. The task of aid agencies is further complicated by the co-existence of multiple objectives and weak performance assessment. The presence of many donors within and outside the EU and a broken accountability loop between providers and beneficiaries make these challenges even more daunting. To increase the effectiveness of EU development policy, these issues must be (at least partly) resolved.

Further difficulties arise from the ongoing changes in the global economic order. The impressive

performance of developing countries in the last decade, with average annual growth of six percent, has brought their share of world GDP from 37 percent in 1999 to 45 percent in 2008. For Europe, this means that developing countries are both consumers and competitors, a source of unskilled and skilled immigrants, partners in global issues and contenders for global influence.

The fates of the developed and the developing world are as intertwined as ever. Development policy is embedded in a broader foreign policy framework. The links between trade, immigration and development policy have long been acknowledged, but the future promises even stronger interaction with other areas such as international security. The Lisbon Treaty explicitly provides for the establishment of a new High Representative of the Union for Foreign Affairs and Security Policy, who should play an important role in coordinating the different aspects of EU political and economic foreign policy.

In this environment, both the Commission and EU member states have recently made a considerable effort to improve development assistance, particularly by enhancing 'ownership' on the part of recipients and harmonising policies, objectives and procedures. The MDGs, the Paris Declaration on Aid Effectiveness and, most recently, the Accra Agenda for Action have changed international development cooperation, challenging donors and partner countries to find more effective ways of working together. Similarly, a series of recent EU initiatives, including the 2005 European Consensus on Development, have added to the reform wave.

These are steps in the right direction and you should continue these efforts. However, they will not suffice. The economic crisis, a fragmented institutional environment, unmet aid commitments and the rise of new economic powers will shape the landscape of development policy in the EU over the next five years. Addressing these issues matters greatly for improving the value of aid and the effectiveness of EU development policy.

Challenges

FIVE MAIN CHALLENGES in your job as Development Commissioner stand out.

First challenge: assisting the poorest countries during the crisis and beyond. The UN's aid target of 0.7 percent of rich-country GNI remains distant, with EU countries currently achieving 0.4 percent on average. Only Sweden, Norway, Denmark, Luxembourg and the Netherlands have reached the target. Meeting aid commitments will become even harder once one-off measures (such as debt relief) – accounting for much of the increase in ODA in recent years – have run their course.

The world economy is in recession. Poor countries are experiencing a fall in exports, remittances and capital flows while their own resources do not allow for fiscal expansion. Last year's food crisis already threw millions into extreme poverty and the World Bank estimates that the economic crisis will add 50 to 90 million poor in developing countries. Yet the response of the international community has been timid. According to Eurodad, out of the \$1.1 trillion in extra money for the international financial institutions (IFIs) agreed by the G20, only \$50 billion would go to the poorest countries.

At the UN Conference on Financing for Development in November 2008, donors underlined the need to meet aid commitments, even in the midst of the economic slowdown. Whether these promises will be kept is still an open question, but previous experience does not provide much hope. In the early 1990s, aid from Finland, Norway, Sweden and Japan dropped between ten and 62 percent in the aftermath of financial crises. This time, Ireland became the first major European country to announce a cut in its aid budget. In a crisis, maintaining aid levels is a critical challenge – one that is likely to remain during the expected slow recovery. Resisting pressure to limit aid budgets will consume considerable political capital, but the case for international aid as a policy in the self-interest of Europe will need to be made more audibly than ever. This should be a priority task for the Commission – making sure that its own commitments and those of member states are

respected. Moreover, it should use its weight in international organisations to argue the case strongly for prioritising assistance to the poorest countries in crisis-related initiatives.

A second challenge is to make EU development policy more efficient. As an aid agency and donor, the Commission should have significant advantages: in ensuring cohesion of EU policies, in achieving economies of scale in development programmes, in putting forward a development policy that is freer from commercial, political and historical considerations and in adopting a more regional and global approach to development. Yet its influence in setting the development agenda is limited. Fulfilling its potential role as leader in this field requires steps to be taken in two areas: i) improving coherence with member states' development policies and coordination of EU actions; and ii) exploiting the Commission's comparative advantage in development aid.

Fostering coordination in terms of delivery and implementation of development policy remains a key challenge. Although important steps have been taken towards this objective, more progress is needed. Pooling resources under specific objectives shared in the EU would help in simplifying aid modalities and maximising economies of scale in the collection of funds, monitoring and policy discussions. While maintaining shared competency in development policy, the Commission and member states should strive for more efficient use of resources which would generate the necessary synergies among the different instruments, policies and budgets. The objective is to benefit from member states' differing comparative advantage in development assistance, reduce fragmentation of EU development policies and minimise the burden on recipient countries of multiple and different negotiations and rules.

Of course, playing the role of coordinator of EU development policies and being a donor itself, the Commission should find its niche. The Commission, given its own experience with structural policies in the EU as well as its positioning as the largest donor

worldwide, is in a unique position to follow a more regional approach to development. This is particularly needed in Africa, where internal bottlenecks - especially in infrastructure - make it difficult to exploit the potential gains from further integration on the continent. One example of positive cooperation is the West African Power Pool, in which 14 governments seek to maximise the supply of electricity at a regional level.

A word of caution is needed here. Issues related to global public goods – although inherent to development – should be treated separately from local and regional development assistance programmes, since there is a risk that focusing more attention on them will lead to a decrease in traditional aid where a larger share of the benefits accrue to recipient countries. As for global public goods, such as those related to climate change, some environmental projects, infectious diseases and security, the EU should push for a truly global approach, empowering international institutions such as the World Bank to play a larger role.

A third related challenge involves building and exercising intellectual leadership in international development. Today, the World Bank enjoys a near-monopoly in intellectual debate on development, even though the Commission is well placed to put forward innovative ideas in this field and to strengthen the link between development research and policymaking. The new European Development Report – focusing this year on failed states – is a step in the right direction. It is designed to be an annual research-led review of development issues and a European counterpart to other major global flagship reports. However, it is not really a publication of the Commission but rather a report outsourced to a team of researchers. As such, it does not put forward the thoughts of Europe on development issues, and thus the vacancy for a rival powerhouse to the World Bank remains unfilled.

The fourth test of your tenure is the need for enhanced accountability of both donors and recipients if the EU is to play a bigger and more

effective role and aid budgets are to be boosted to levels commensurate with commitments. This is a task in which others, while making progress, have failed. Today, there is almost a complete lack of independent evaluation of aid, leaving aid agencies – including the Commission – unaware of programme impact and unaccountable to the public. Given the lack of clear incentives to carry out project evaluation on the part of donors, recipient countries and implementing agencies, and bearing in mind the cost of carrying out evaluation, it is necessary to set up an independent third party for this task. Global efforts in this direction already exist, including the International Initiative for Impact Evaluation. These are meant not only to improve the legitimacy of development programmes at home but also to obtain valuable insights for future policy. A more comprehensive approach to development policy evaluation at the European level is, therefore, urgently needed.

A fifth challenge concerns the changing landscape in international development as new players come onto the scene. For many decades, the US and the EU have acted as a duopoly in the development arena. However, the improved economic performance of China and Middle Eastern countries in particular, and renewed interest in ensuring access to natural resources, means that competition in international development – as in trade or investment – is intensifying. The newcomers' role as donors, investors and key trade partners for the poorest countries is potentially beneficial but inevitably raises questions about competing interests and about governance and standards. The main challenge is, therefore, to incorporate these new powers into donors' discussions and into international initiatives in this field.

These five challenges map into five policy recommendations.

Recommendations

1. AS A FIRST TASK, your efforts should be directed towards strengthening support for least-developed countries during the crisis and beyond. Aid targets of 0.56 percent of GNI in 2010 and 0.7 percent by 2015 should be met and disbursements of provisioned funds blocked by procedural requirements accelerated.

2. For the Commission to improve efficiency in EU development policy, a two-pillar strategy is proposed:

Pillar I: Fostering synergies through EU Development Initiatives. Moving forward, donor harmonisation can be improved by creating EU Development Initiatives, both by country and by sector, in which member states pool their available development funds in support of large sector programmes – such as for education or health – in particular countries. These initiatives could first be explored through pilot programmes. The pooled resources can be managed by the Commission and initiatives headed by a particular member state or group of member states or the Commission itself and modeled on existing ‘global’ programmes such as the Global Fund to Fight AIDS, TB and Malaria and the Fast Track Program for basic education.

Pillar II: Increasing focus on regional public goods. Within the EU Development Initiatives, the Commission should focus on funding regional public goods, especially in Africa. Transnational infrastructure projects, including roads but also social investments such as health centres in border regions, can advance economic and social integration in Africa where markets are still largely fragmented. This can be done in two steps: i) the Commission can establish common reporting requirements for the EU bilateral donors on their support of regional projects, which could then be used to assess the strengths and weaknesses of regional initiatives; and ii) in addition to the Commission, individual member states or groups of member states can put special emphasis on strengthening regional

programmes, as the UK and France often do, for example, in sub-Saharan Africa.

3. For the Commission to realise its full potential as a development actor, it needs to strengthen its intellectual credentials. It clearly has the potential to become an intellectual powerhouse in international development and a ‘knowledge agency’. A proper research department in the Commission’s Directorate-General for Development should be established, with the objective of developing an in-house European development paradigm and spreading best practice in development policy. In particular, you should create a position of Chief Development Economist in charge of heading this effort.

4. Improved governance and accountability of development assistance should remain a key objective for the EU and the Commission. Together with more aid, critical impact assessments need to be carried out. It is recommended that the Commission set up an evaluation office within DG Development – the EU Development Evaluation Group – to: i) pool a fixed proportion of member states’ annual aid disbursements (0.05 to 0.1 percent, for example) to form an EU Independent Evaluation Fund from which to contract out a small number of evaluations every year; and ii) draw upon these evaluations to formulate specific recommendations and guidelines, giving priority to broad public reporting and debate.

5. Finally, the Commission should play an active role in integrating China and other growing economies into the donor world. In particular, the Commission can take the lead in trying to agree on a set of common global standards for development assistance to ensure that aid works for the long-term benefit of poor countries’ citizens. It should take the initiative, therefore, in developing a code of conduct for donor countries, specifying criteria for assistance disbursements and best practice in development policy.

About Bruegel

Bruegel is a European think tank devoted to international economics. It started operations in Brussels in 2005 as a Belgian non-profit international organisation supported by European governments and leading corporations. Bruegel seeks to contribute to the quality of economic policymaking in Europe through open, facts-based and policy-relevant research, analysis and discussion.

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Europe's economic priorities 2010-2015

Memos to the new Commission

With the worst crisis in the European Union's history, a return to economic nationalism and increasing cynicism about the power of government at any level to be a force for the general good, the stakes for the next European Commission are arguably higher than for any of its predecessors. To succeed, it will have to set priorities right from day one. But faced with a plethora of comment, analysis and advice even before the new commissioners assume office, what key priorities should they focus on?

As a contribution to sharpening this debate, Bruegel has decided to prepare a set of open memoranda for the attention of the new Commission. One is addressed to the president and eleven to individual commissioners in charge of the most important economic policies at the EU level. These memos are intended to be strategic. They do not spell out the whole agenda awaiting the new Commission but describe succinctly the state of affairs, outline the key challenges, and propose selected priorities.



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