Atlantic Council

GLOBAL BUSINESS
& ECONOMICS PROGRAM

EuroGrowth **Initiative**

CHARTING THE FUTURE NOW

European Economic Growth and Its Importance to American Prosperity

A report from the **EuroGrowth Task Force**

With an introduction by
José Manuel Barroso and Stuart E. Eizenstat

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ISBN: 978-1-61977-432-2

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March 2017

The Atlantic Council is a nonpartisan organization that promotes constructive US leadership and engagement in international affairs based on the central role of the Atlantic community in meeting today's global challenges.

ACKNOWLEDGEMENTS

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ABOUT THE EUROGROWTH INITIATIVE

The Atlantic Council EuroGrowth Initiative was established in March 2016 to stimulate thinking on how the current challenges of the European economy can be transformed into opportunities to achieve a more sustainable growth path. In its first year, the Initiative published five papers, hosted six European commissioners, finance ministers, central bank governors, and leading European experts to identify practical solutions. The initiative aims to energize key stakeholders on both sides of the Atlantic to design the right approaches for growth, taking into consideration the unique European institutional setting.

The initiative is made possible through the generous support of Beretta, the European Investment Bank, JPMorgan Chase & Co., Moody's Investors Service, Pirelli Tire North America, United Parcel Service, Ambassador C. Boyden Gray, and Ambassador Stuart Eizenstat.

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Introduction by José Manuel Barroso and Stuart E. Eizenstat

Short-term responses to populist concerns, medium-term deliverables, and a long-term plan for better integration.

This Task Force report is unique. We have gathered experts from both sides of the Atlantic in a year-long detailed study of how Europe can restore confidence through higher economic growth.

Europe's current sluggish economic performance can be explained by a number of factors, some of which require action at the national level, and others that can best be achieved by the member states working together at the European Union (EU) level: inflexible labor markets; lack of innovation and culture of risk-taking; capital markets that lack the depth, breadth, and flexibility to provide funds to start-ups and small- and medium-size enterprises (SMEs), and that rely too heavily upon commercial bank debt financing; low levels of public investment; over-regulation.

The report, looking mainly at what the EU as a whole can do, recommends short-, medium-, and long-term actions, with a sense of urgency, reflecting our view that the European project is threatened by recent developments internally and externally. The result of the Brexit referendum in June 2016 has raised fundamental questions about the durability and future of the European construction. Other developments are also raising questions about the long-term viability of the vision articulated by Jean Monnet and Robert Schuman in the 1950s.

The first blow was the outbreak of the eurozone debt crisis in 2010. Later, the refugee crisis, which affects most European countries, tested solidarity between EU members. As economic and political crises raged across Europe, nationalist and populist movements rose to prominence in many member states and produced unpredictable consequences and clear pressures to perform better on EU leaders. The results of the 2016 US presidential elections have left no doubt that the whole Transatlantic partnership will go through a massive, soul-searching period.

Since the start of the convergence process in 1992, the EU's economy has grown by approximately one percentage point less per year when compared with the United States. While there are multiple reasons behind the lack of growth, many European citizens now associate economic integration and the common currency with comparatively worse economic outcomes. Euroskeptic parties are gaining strength in many member states, and local populations in some countries now favor national, not EU-wide, solutions.

Relatively favorable economic conditions including lower oil prices, quantitative easing by the European Central Bank, a depreciating euro, and slightly positive world growth projections, allowed the EU to grow at a decent rate in 2016, indeed above that of the US, and likely in 2017. But economic headlines are still dominated by debt crises, bank bailouts, unemployment, stagnant growth, and low inflation, all of which threaten to undermine long-term investment, entrepreneurial spirit, innovation, and market confidence.

Europe also wrestles with a tempest of geopolitical tensions. Notably, the Russia-Ukraine conflict to the east and severe turmoil in the Middle East that has resulted in a migrant crisis and terror attacks, underscore the fragility of Europe's economy and will continue to do so for the foreseeable future.

This report wishes to communicate strongly five messages that are key to improving growth in Europe and for the continuation of its close partnership with the United States. The agreement around these five messages is time sensitive and critical.

1. The Time For Action Is Now. Brexit Shows That Europe Needs To Provide Responses to Legitimate Concerns.

Europe is at the precipice of a dangerous future. European youth unemployment currently sits above 20 percent, which may consign over four million youth to unemployment over the next decade if it is not reversed, and may eventually create a generation defined by political extremism on both the left and right. Meanwhile, Europe's population is aging: current demographic trends project the European Union to move from four to two working-age persons per retiree between 2015 and 2060, putting significant pressure on pension and healthcare systems.

Moreover, lack of confidence, regulatory barriers, and a mediocre innovation record restrict future high-tech growth. If the worst-case scenarios become reality, Europe risks not only losing its still considerable influence on the global economy, but also its role as a global actor. We cannot resign ourselves to another twenty years of low growth in Europe. Bold action is needed now.

The Brexit vote of last June is a wake-up call. British citizens saw Europe as a burden without being able to fully appreciate the benefits that come with membership in the EU. In a context of low growth, the pressure stemming from increasing immigration made articulating a positive message on Europe to British citizens a difficult task, which triggered the vote to exit from the Union. For the first time ever, the Union is not growing in size but is expected to shrink.

The upcoming wave of general elections in the four largest founders of the Union that will take place in 2017—Germany, France, the Netherlands, and likely Italy—have the potential to change the landscape of Europe and increase the voice of Euroskeptics. Populism has found fertile ground in Europe in large part because of the lack of growth, carrying protectionism and economic nationalism. However, the EU leadership has not yet been able to put a reasonable alternative on the table.

Before other countries are tempted by the idea of exiting the European Union, European leaders must create the conditions for more economic growth as well as show that they can deliver solid solutions to challenges like migration and terrorism. Growth will restore confidence and affection toward the European project, which has secured peace in the area since the end of World War II, and has helped countries to develop economically and socially. One only needs to recall Spain and Portugal under their dictatorships, the poverty of Ireland in the 1970s, and the misery of the former Soviet Union republics under communism, to be aware how much these countries have gained from joining the Union. The United Kingdom (UK), too, reaped benefits from joining the Union: while it is difficult to disentangle the merits of the accession from the profound changes carried out by Margaret Thatcher, it is a fact that UK gross domestic product (GDP) per capita was 15 percent below the Union's average before the accession in 1973; it is now 37 percent above.

2. Stronger economic growth in Europe is of enormous importance to the United States. US investments, trade, and financial flows with Europe are far larger than with any other part of the world. The US needs a reliable European partner.

Greater European economic growth will not only benefit EU citizens, but it will also strengthen the United States for at least three reasons. First, US companies have invested massively in Europe over the last sixty years: as of 2015, US stocks of foreign direct investment (FDI) in the European Union were $2.67 trillion versus less than $75 billion in China. US companies and investors stand to gain much more from a one or two percent increase in EU growth over the long term; a small increase in European growth makes a big difference for the profits of American corporations, small and large. Let us add the portfolio investment figures, too. And add that the EU functions already in many ways as a single marketplace. The goal should be to eliminate barriers to growth in that marketplace.

Second, many current geopolitical crises are occurring in regions surrounding Europe; the stability of the world for years to come relies on the resolution of these crises. Europe needs to be a frontline leader managing these crises and finding solutions to them; however, without sustainable economic growth, European leaders will not likely have the necessary political capital to address the external geopolitical crisis, and will rather be focused on national, internal affairs. Moreover, the financial resources to be devoted to NATO and international missions will inevitably shrink if there are insufficient resources due to long-term low economic growth, making it difficult to reach the 2 percent of GDP spending on defense agreed by the NATO alliance. If Europe cannot deliver on its commitments to defense and peacekeeping, it will be hard for the United States not to take the lead or for the overall level of security to fall.

A third reason is global economic governance. In the 1960s, the United States alone accounted for around 40 percent of world GDP and could easily provide guidance and leadership on most transnational economic affairs. Now, the United States represents around 20 percent of world GDP and needs a reliable partner, sufficiently large in size, to continue to lead. Moreover, in the last thirty years the world has become more interconnected through trade and the financial markets: the great recession showed that an event that takes place in New York (the failure of a bank) or on a relatively tiny island in the Mediterranean (Cyprus)

"This is a crucial year for the European Union. It is time to show European citizens that there is leadership—both at the national and the EU level—able to concretely deliver solutions to create the right conditions for more jobs. . ."

can have negative global ramifications in a few days or even hours.

We believe Europe possesses important strengths and, despite such high strategic stakes, a window of opportunity exists to ensure a stronger Europe in the future. Macroeconomic conditions, and efforts to strengthen European institutions through the creation of the Banking Union and the revised Stability and Growth Pact (SGP) all point in the right direction. Europe still presents a greater investment value when compared to more attention-grabbing investments in China, particularly over the long term.

There is not a silver bullet that will trigger growth but with the right push, the European Union can turn a corner. We therefore propose a three-pronged strategy:

a) Provide short-term responses that will help to counter populist forces during 2017, such as a one-time increase in public investment to take advantage of historically low interest rates; begin the negotiations on a restyled EU-US economic agreement; restore free movement of people in the Schengen areas, while making Frontex and the new European Coast Guard operational to control illegal immigration; and manage wisely the challenge of Brexit.

b) Deliver a number of concrete outcomes that can deepen the internal market in digital and other services, capital, banking, and energy in the next twenty-four months.

c) Launch an ambitious long-term plan for more integration, starting from the European Union's founding countries.

3. 2017 is a pivotal year for the restoration of confidence. Given the window of opportunity provided by low lending costs, a tailor made, one-off expansion of public investment can be explored.

This is a crucial year for the European Union. It is time to show European citizens that there is leadership—both at the national and the EU level—able to concretely deliver solutions to create the right conditions for more jobs and to handle the complexity of our times. Successful results on a number of key issues, such as a functioning system for countering terrorist threats and managing the refugee and migration situation, Brexit negotiations, managing relations with the new US administration including a new transatlantic economic project, and astutely managing challenges from Russia can increase the confidence of European citizens in Europe.

European citizens also need more direct action on the economic front in the short term. We do not want national public budgets to become unsustainable, and we do not advocate for additional structural spending. At least in countries with already high public debt. Rather, low lending costs currently provide a window of opportunity for an extraordinary, one-off injection of public investment in 2017-2018 for countries with sound public budgets, as well as an enhancement of the so-called Juncker Plan. The celebration of the sixtieth anniversary of the Treaty of Rome in late March at the Conference of Rome might be the right occasion to announce such a plan. For 2017, the report recommends the following:

› *Keep the efforts to deepen and expand the transatlantic marketplace alive, setting the stage for a new Transatlantic Economic Agreement, on the basis of what already has been achieved under the Transatlantic Trade and Investment Partnership (TTIP) negotiations, but eliminating some of the most divisive issues;*

› *Negotiate Brexit wisely, having the next twenty years in mind;*

› *Restore full freedom of movement across Europe (the so-called Schengen area);*

› *Use wisely the current window of opportunity provided by low interest rates.*

› *The current and proposed expansion of the "Juncker Investment Plan for Europe," targeting EUR 500 billion additional investment by 2020 should be pursued with the greatest commitment in collaboration with the European Investment*

Bank (EIB); other partner institutions; private sector investors; and member states.

4. Europe must focus on projects that can be completed in the next twenty-four months: a more integrated internal market with more capital, freer service market, fewer digital barriers, and simple yet effective regulation.

European leaders have already agreed on a number of projects that can have a positive impact on long-term growth: they aim at reducing barriers and deepening the internal market, creating more competition, spurring innovation and growth. Even if these projects are not highly visible, we consider them vital to creating the right conditions for stronger growth. Among the many European projects in the pipeline, we suggest focusing on those that are already advanced in the political and technical process. Over the next twenty-four months we recommend to:

› *Create the conditions necessary to stimulate more innovation, such as more support for research and development, private venture capital markets, and the regulatory framework to foster creativity;*

› *Complete the internal market for services with less digital barriers and finalize the European Energy Union;*

› *Attract more capital and investment by delivering the Capital Market Union;*

› *Unleash the economy with more simple and cost-effective business regulation.*

› *EU member states must play their parts by liberalizing areas still under their jurisdiction such as labor markets, which remain too rigid to promote job growth in many member states.*

5. Abandon the concept of a "two-speed Europe" and work for a Europe of "concentric circles." The largest founding EU countries, and others able to do so, need to take the lead and propose an ambitious plan that can produce greater fiscal cooperation and integration.

While managing the short term and focusing on deliverables in the medium term, Europe must start designing its future by exploring measures aimed at revamping and strengthening the European Union, so as to address its existential challenges from populist and nationalistic movements across the continent. If adequate leadership emerges, it is time for deeper integration and enhanced EU institutions. Alternatively, EU leaders have to continue to find smaller steps to deal with challenges.

Brexit has already set the stage by showing that twenty-eight countries are too different to simply assume that they will be willing and able to march in the same direction, at the same time. With strong leadership, the future of Europe can be conceived as groups of nations organized in concentric circles, with an inner ring composed of deeply integrated nations utilizing a common currency, common public debt (in part), a common fiscal authority, and external circles with different degrees of integration. The natural candidates to be part of the inner circle are, at least, the largest founding countries of the European Union that have already joined the euro: Germany, France, and Italy. The report recommends to:

› *Prepare the technical ground of the issuance of common debt (Eurobonds) to finance infrastructure, human capital, and research and development (R&D);*

› *Reach a political agreement to expand the EU budget for countercyclical purposes;*

› *Explore under which conditions some countries can increase fiscal integration and establish a European Fiscal Authority to manage the enlarged budget and the Eurobonds, while having the responsibility to impose remedies when national budgets are out of control.*

A European Union that is economically stable, embraces innovation and technology, attracts foreign capital, and encourages investment is crucial to its ability to play a key role in the world. Only a strategy with support from both sides of the Atlantic will make it possible to successfully foster growth. Failing to act now will result in a Europe that is too discordant internally to be an effective partner and ally to the United States. However, by working together toward long-term growth and prosperity, Europe will remain a global leader and critical partner in future challenges, whether in internal security, international defense, or global economic governance.

José Manuel Barroso | Stuart E. Eizenstat

CHAPTER 1

Why European Growth is Relevant for the United States

"We believe that a united Europe will be capable of playing a greater role in the common defense, of responding more generously to the needs of poorer nations, of joining with the United States and others in lowering trade barriers, resolving problems of commerce, commodities, and currency, and developing coordinated policies in all economic, political, and diplomatic areas."

President Kennedy at Independence Hall, July 4, 1962

1.1 Summary and main recommendations

Since the end of the Second World War, European Union countries have been the closest allies of the United States. Friendship, business relations, and migration flows have much deeper roots and go back to the birth of the nation. More than two hundred years of trade and exchange of ideas have created what are today the largest economies in the world. The United States and the twenty-eight countries of the European Union (EU) together represent 11.2 percent of world population, but almost half (46.5 percent) of the world's output, 43 percent of world merchandise exports, and 56 percent of the world stock of foreign direct investment.[1]

Addressing the US Chamber of Commerce in 2013, International Monetary Fund (IMF) Managing Director Christine Lagarde said, "Considering that 20 percent of U.S. exports are destined for Europe, and that more than half of U.S. overseas assets are held in Europe, you clearly have a large stake in the recovery there... President Taft, who helped establish the Chamber, captured this when he said: *'I am in favor of helping the prosperity of all countries because, when we are all prosperous, the trade with each becomes more valuable to the other.'* What was true in President Taft's day is even more true in today's interconnected world: a strong U.S. economy and a strong global economy are two sides of the same coin."[2]

1 United Nations Conference on Trade and Development (UNCTAD), "World Investment Report 2015," last accessed February 22, 2017, http://unctad.org/en/pages/PublicationWebflyer.aspx?publicationid=1245.

2 Christine Lagarde, "The Interconnected Global Economy: Challenges and Opportunities for the United States—and the World," speech delivered at the US Chamber of Commerce, September 19, 2013, http://www.imf.org/en/News/Articles/2015/09/28/04/53/sp091913.

What happens in EU countries is crucial for the United States for at least three reasons:

- First, economic ties are so close in trade and investment that a small increase of EU GDP immediately has positive spillover effects on corporate profits, portfolio investment, US exports, and, ultimately, on US jobs.
- Second, the EU and the United States share the responsibility to address the most relevant challenges of our times, namely terrorism and interstate conflicts, most of which are concentrated in, or emanate from, countries that are neighbors to the EU's outer borders. An economically weak Europe will not be able to help the United States, and ultimately the world will be less secure.
- Third, the EU and the United States share responsibility for global economic governance. Following thirty years of globalization, the highly interconnected world economy needs guidance and coordination in a number of key areas such as financial markets and trade. Given the size of the two economic areas, and the shared common vision on the economic fundamentals, only the United States and the EU can play this role.

As long as the economies in Europe and the United States were robust and growing rapidly, the protectionists' voices engendered only a modest response. Today, however, these voices have grown much louder, and populist promoters of protectionism have gained political power in both Europe and the United States (see section 2.3). The preservation and enhancement of the European-American economic linkages depend on the adoption of pro-growth policies that will lift the EU countries out of the slow growth environment that they have been mired for the past twenty-five years.

The EuroGrowth Task Force considers that more economic growth in Europe is in the interest of the American people. Stronger growth in Europe means:

- ✓ *more profits for US companies that invested in the old continent;*
- ✓ *more stable jobs for American companies that are dependent on trade;*
- ✓ *more resources to be devoted to common security against the threats of non-state actors;*
- ✓ *stronger global economic governance to put forward common values.*

Table 1. Global Connectedness

World Rank	Country
1	Singapore
2	Netherlands
3	United States
4	Germany
5	Ireland
6	United Kingdom
7	China
8	France
9	Belgium
10	Saudi Arabia

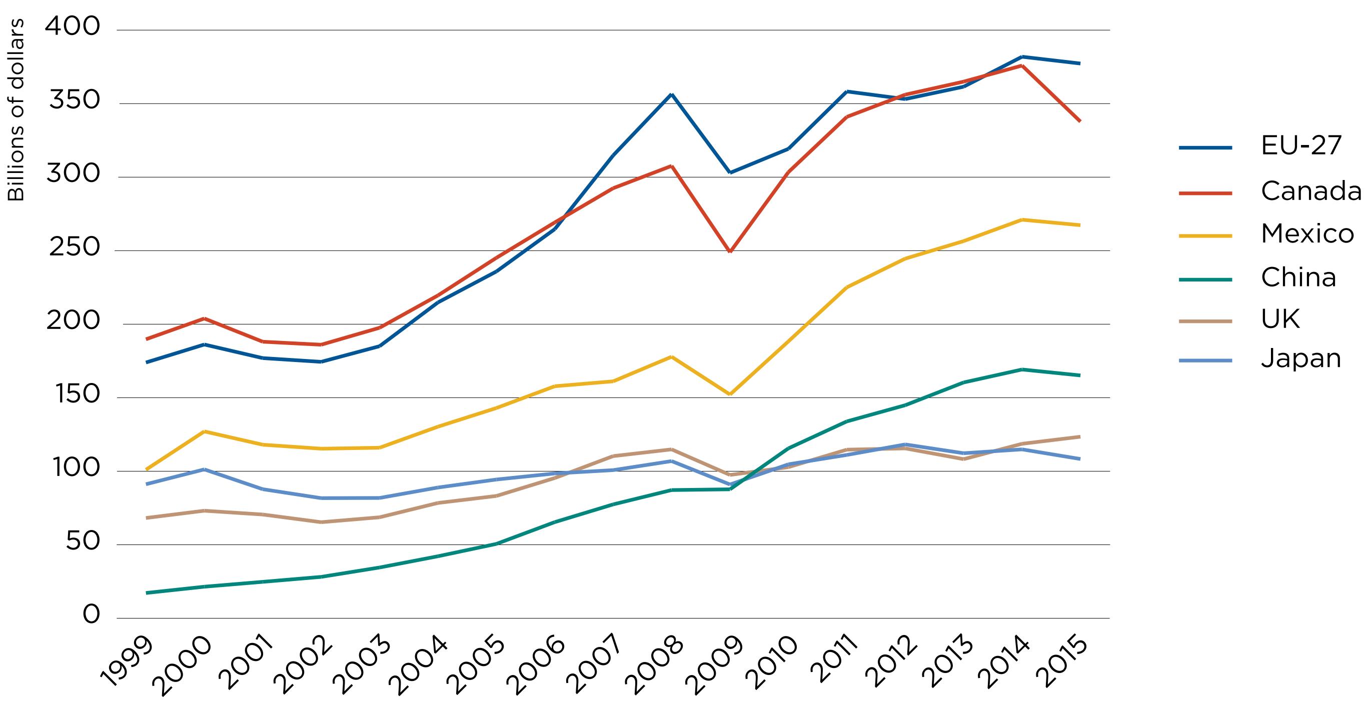
Source: McKinsey Global Institute.

1.2 Strong economic ties

The two economies are not just the largest in the world, they are also among the most interconnected. According to the McKinsey Global Institute connectedness score, the United States ranks third, and six EU countries rank among the top ten when one considers five indicators of economic interconnectedness: flows of goods, services, finance, people, and data (see table 1).[3] Such openness provides both opportunities and challenges to the US and EU economies. While it provides avenues for expansion, it also leaves them vulnerable to external shocks: the flows of migrants (either refugees or

3 McKinsey Global Institute, "Digital Globalization: The New Era of Global Flows," March 2016, 127-129. A higher score signals an elevated level of global flows.

Figure 1. Exports of goods and services from the United States to its largest trading partners



Source: Bureau of Economic Analysis.

economic migrants) to the EU following the Syrian and Libyan civil wars have been unprecedented, the GDP loss by the United States in 2009 was, by far, the largest since World War II; the way the financial crisis spread from the United States toward the rest of the world is a testimony to the interconnectedness of its financial markets, all show opportunities but also the challenges of openness.

The size and openness of the EU and US economies are reflected in their bilateral trade and investment relations. The transatlantic market is by far the largest in the world for trade, foreign direct investment, and financial flows.

Trade in goods and services between the EU and the United States is quite substantial (figure 1). Indeed, the EU is the largest recipient of US exports of goods and services, and the second largest source of US imports. Despite the significant increase of exports to China, this market is still less than one-third of the EU market. Extrapolating from the average growth rate of US exports to China and to the EU during the period 2010-2015, China will become a larger market for the United States than the EU, but not before 2040.

Given the extent of exports to the EU, an increase in EU aggregate demand will impact US exports: according to Bems, Johnson, and Yi, a 1 percent increase for services demand in the core, western EU countries (EU-15) will increase US total exports of services by 0.12 percent; a similar increase for durable goods, will increase exports by 0.09 percent.[4]

Supply chains paint an even more vivid picture of the inter-reliance of the EU and the United States.

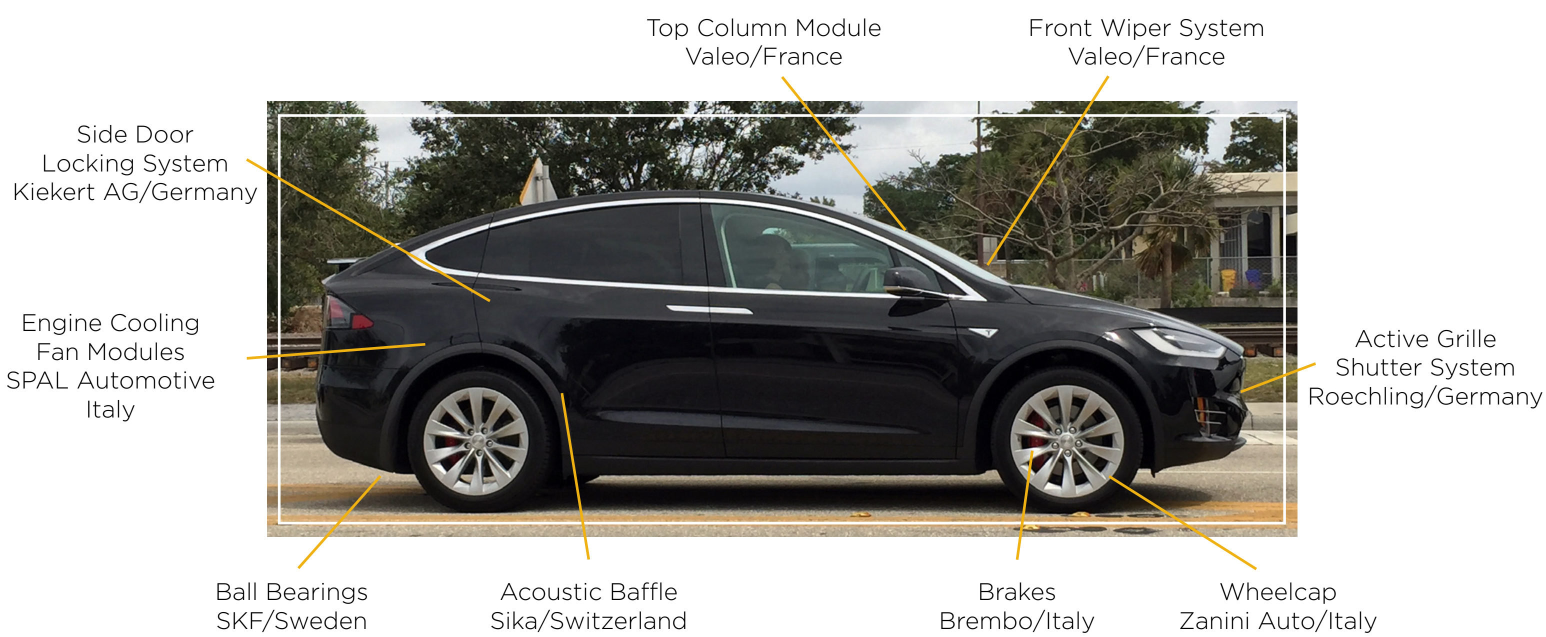
Tesla Motors, which produces its cars in the United States, provides one case study. The 2016 Tesla Model X embeds forty-six components produced by thirty-six different companies headquartered in twelve countries (some of them are shown on figure 2). The United States houses the most companies, with fourteen suppliers, but fifteen of the other twenty-two suppliers are headquartered in Europe. So, Tesla and its European suppliers are engaged in mutually beneficial trade. And Tesla is only one example.

In fact, according to the Economic Report of the President, almost half of US imports are intermediary goods in the production process.[5] A stronger European

4 Rudolfs Bems, Robert C. Johnson, and Kei-Mu Yi, "Demand Spillovers and the Collapse of Trade in Global Recession," IMF Working Paper n. 142, June 2010, https://www.imf.org/external/pubs/ft/wp/2010/wp10142.pdf.

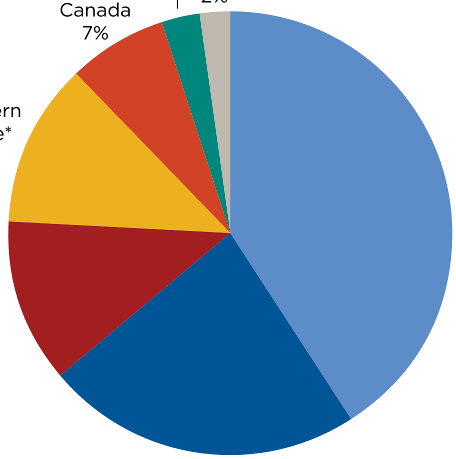
5 Government Publishing Office, "Economic Report of the President Transmitted to the Congress," February 2016, 212,

Figure 2. The Global Supply Chain of Tesla Model X



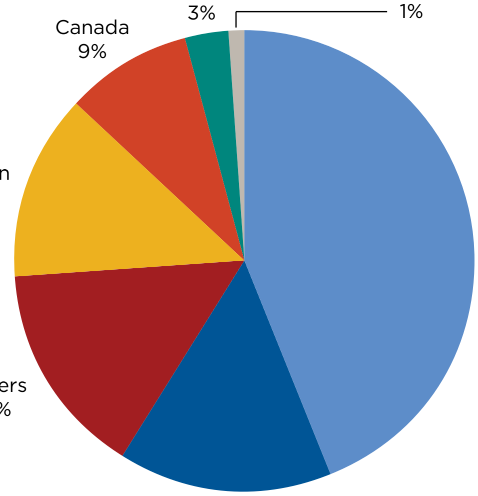
Source: Supply Business/Wikimedia Commons.

Figure 3a. US FDI Investment abroad on a historical-cost basis, 2015



Source: Bureau of Economic Analysis.
* Includes Bermuda, Barbados, United Kingdom islands (Caribbean), Netherlands Antilles, etc.

Figure 3b. FDI in the United States on a historical-cost basis, 2015



Source: Bureau of Economic Analysis.

economy can provide more options for inputs with high technological content and sometimes lower prices, reducing the cost of production in the United States and benefiting the US economy.

US trade with the European Union encourages technological progress, stimulates competition and innovation, and allows each side of the Atlantic to benefit from comparative advantages. It also has a direct, immediate positive impact on American jobs. According to a report by Trade Partnership Worldwide published in January 2016, 6.9 million US jobs are directly dependent on trade with Europe.[6] A stronger European economy and a greater volume of trade would only increase that number.

Trade is only one component of the strong economic ties; the stock of foreign direct investments (FDI) between the EU and the United States tells much of the same story as do the trade flows (figure 3). The cumulative stock of foreign investment by American corporations in EU member states excluding the UK (EU-27) represents 41 percent of all accumulated investment abroad, almost 2.5 trillion dollars at the end of 2015.

As is clear from the chart, China is a mere 3 percent and even neighboring regions such as Canada or Latin America do not have comparable figures with those of the EU. A major recipient of US investment is the United Kingdom with almost 600 billion dollars accumulated over the years, but, even after Brexit, the EU-27 member states will remain by far the largest recipient of US investment.

At the same time, EU-27 countries invest massively in the United States and account for 44 percent of total foreign investment. The inflow of European direct investment enhances the US economy, in particular in manufacturing, where EU companies often have enhanced labor skills and know-how. Not surprisingly, EU-28 countries account for 68.3 percent of cumulative FDI in manufacturing, a sector President Trump has identified as central to his economic goals.

Financial inflows, as well as imports, make the country stronger and better equipped for international competition. As Alfaro et. al. point out, "FDI has several positive effects which include productivity gains, technology transfers, the introduction of new processes to the domestic market, managerial skills and know-how, employee training, international production networks, and access to markets."[7]

https://www.gpo.gov/fdsys/pkg/ERP-2016/pdf/ERP-2016.pdf.

6 Trade Partnership Worldwide, LLC, "Trade and American Jobs: The Impact of Trade on U.S. and State-Level Employment: 2016 Update," January 2016, 11, http://businessroundtable.org/sites/default/files/reports/Trade%20and%20American%202016%20FINAL.pdf.

7 Laura Alfaro, Areendan Chanda, Sebnem Kalemni-Ozcan, and Selin Sayek, "FDI and Economic Growth: The Role of Local Financial Markets," *Journal of International Economics*, February 2003, http://econweb.umd.edu/~kalemli/jiefinal.pdf.

At a time when the new US administration envisages a return of the traditional manufacturing industry to the country, the importance of EU companies in achieving this result is relevant, and strong and sustainable growth for the EU economy is a precondition to continued investment in the United States for European companies.

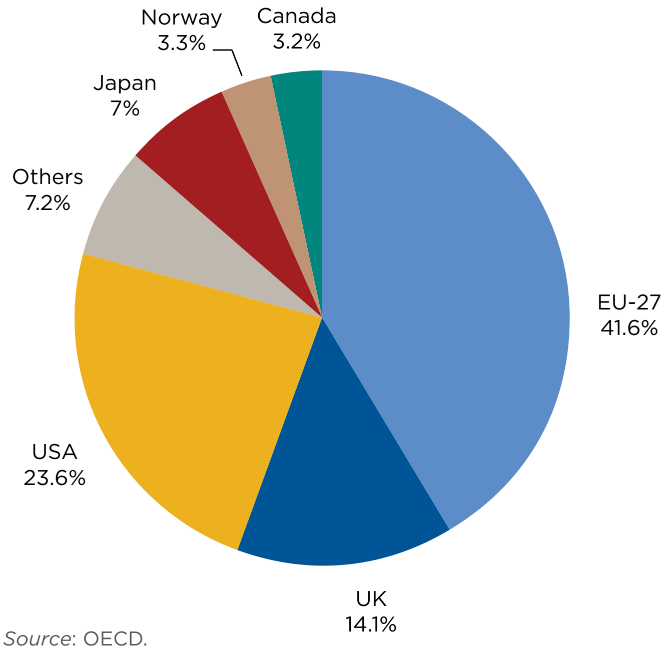
1.3 Factoring in geopolitical and geo-economic concerns

The European Union is deeply involved with some of the most pressing geopolitical crises on the world's agenda and is a key player for problems in neighboring regions. The EU and its member states are essential partners for the United States in tackling many of these international problems. While the European Union still does not have the agility of a nation-state in grappling with foreign and security policy, the creation of a High Representative and accompanying institutional changes have expanded the role that it plays. At the same time, the EU and its member states are a vital source of assistance funds to meet humanitarian and development needs in crises around the world. Access to EU markets is also a major point of attraction for many developing countries and neighbors, while EU membership remains an attractive goal for others on a track to accession.[8] This interest in closer ties with Europe provides the EU with leverage for encouraging reform and good performance in those countries, and the EU can target assistance to support such reforms. Given the shared perspectives between the EU and the United States, these actions are largely consistent with and reinforce US foreign policy objectives, programs, and actions.

In order to continue contributing such valuable international development, financial, and technical assistance, the EU and member states need to maintain and grow the EU's own economy. Such growth will provide the financial basis for strong aid programs and for popular support to continue to aid less-developed countries.

The EU and its member states have developed a range of assistance tools to help countries around the world. In the past several years, much attention has been focused on refugee and migration issues from Syria, Afghanistan, Somalia, South Sudan, and elsewhere to the EU. The EU has dedicated billions of dollars and much political effort to trying to meet the humanitarian needs of the migrants and agree on

Figure 4. Top Official Development Assistance Donors, 2015



Source: OECD.

more efficient and effective means for dealing with the refugee inflows inside the EU and before they reach EU borders. For example, this effort to stem the flow of refugees has included promises of 3 billion dollars of assistance to Turkey to help shelter those fleeing Syria, and additionally has member states and EU institutions grappling with how best to assure border security and to coordinate the handling of refugees already inside the Union.[9] In the case of Afghanistan, the EU linked its substantial pledges of future aid to an agreement by Afghanistan to accept the return of Afghan migrants who had reached the EU.

The EU is a major player and development aid partner in nearly every corner of the world.[10] Combined, the EU and its members provided over 87 billion dollars in official development assistance in 2015 according to the Organization for Economic Co-operation and Development (OECD)—that is 55.7 percent of the total. The comparable number for the United States was $31 billion or 23.6 percent of the OECD total.[11] The EU institutions, separate from EU member states, dedicated $15.56 billion to development aid in 2015, and this still ranks the EU in the top handful of aid contributors.[12] Turkey, India, Afghanistan, Morocco,

8 Delegation of the European Union to the United States, "Fact Sheet on EU-Ukraine Relations," accessed on February 17, 2017, http://www.euintheus.org/press-media/factsheet-on-eu-ukraine-relations.

9 Ibid.

10 European Commission, "EU Aid Explorer, Donor/Beneficiaries," 2015, https://euaidexplorer.ec.europa.eu/DevelopmentAtlas.do.

11 OECD, "Financing for Sustainable Development," last accessed February 20, 2017, http://www.oecd.org/dac/financing-sustainable-development/.

12 European Commission, EU Institutions provided $15.56bn of

Syria, China, Ethiopia, South Africa, Pakistan, and Colombia are the top EU aid recipients and give a sense of the breadth of impact assistance from the EU has. The EU itself also provides a means to better coordinate EU member state assistance through coordination in Brussels and on the ground around the world. For example, the EU and member states development teams jointly programming aid in about forty countries. Not surprisingly, the representatives from EU institution are very influential players and partners among the world's development agencies, helping to identify best practices as well as coordinating with other donors and host governments in designing aid and development programs in recipient countries.

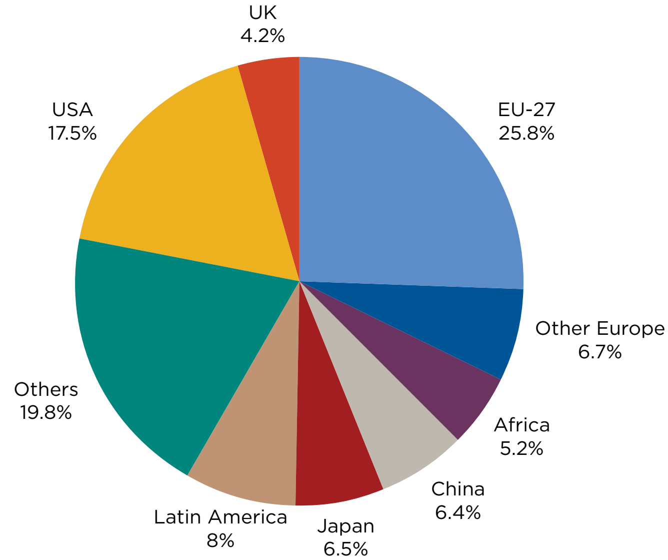
On the diplomatic front, the EU has taken major strides since creating a High Representative of the Union for Foreign Affairs and Security Policy in 2009 and creating a European External Action Service in 2011 to support the High Representative. These steps have allowed the EU to play a larger role in key international issues of critical importance to Europe and the US, including, for example, nuclear diplomacy with Iran or efforts to deal with the Syrian civil war.

However, the EU's High Representative still must share the stage with a number of member-state ministers and lacks the security and military tools that many member states have or that are handled by NATO, its neighbor in Brussels. The complicated institutional make-up of the EU also makes it very difficult for the EU to reach decisions with the speed of a nation-state, as, for example, in placing sanctions on another country. It also becomes very difficult when member-state and EU competencies cross or leave gaps as we have seen in the last two years as Europe has struggled to counter ISIS-supported terrorism or to deal with refugee flows from Africa, Syria, and Afghanistan. Despite the shortcomings in EU foreign policy, the EU is still a much stronger foreign policy partner for the United States today than it was in the past. The United States greatly benefits from the fact that the EU is contributing significantly via a range of programs, funds, and policies with significant regional impact, from its "neighborhood" policies for its southern and eastern neighbors to its humanitarian assistance, its aid for the least-developed countries, and its sizable programs in priority countries like Afghanistan.[13]

development aid in 2015, last accessed on February 20, 2017, https://euaidexplorer.ec.europa.eu/.

13 European Commission, "Welcome Page," https://euaidexplorer.ec.europa.eu/MainHomePageAction.do.

Figure 5. Quota shares in the International Monetary Fund (IMF)



Source: IMF.

There is little question that the EU remains a vital international partner for the United States. If the EU was not able to contribute significant assistance resources to dealing with major humanitarian crises, dealing with the fall out of conflicts and terror, helping bolster the prospects for peace or helping key countries like Ukraine, a much greater burden would fall on the United States and others.

1.4 Economic Governance

The European Union and the United States play an important role in global economic governance. Since the creation of the Bretton Woods institutions (the IMF and the World Bank) at the end of WWII, the Atlantic Alliance has cooperated closely in advancing the common principles of liberal democracies, free trade, transparency, and accountability. Economic relations are complex, and financial markets heavily interconnected; in such a context, global economic governance is more relevant than ever to preserve financial stability and economic prosperity across the world.

The United Sates and the European countries currently represent the most important blocks in the IMF and the World Bank, which together can promote policies that encourage the adoption of fundamental market principles. They have almost 45 percent of the votes in the IMF and 44 percent of the votes in the World Bank. Four out of seven G7 countries are European. Among the twenty members of the G20 there are four EU countries (Germany, France, UK, and Italy) plus the European Union as such. Among the twenty-five members of the Financial Stability Board, there are six EU countries (the four already in the G20 plus Spain and the Netherlands), as well as the European Union. So, undoubtedly, the EU together with the United States play a leading role in global economic governance, which means the possibility to set the agenda and to promote their common values.

The role in these fora is based on economic size: the larger the country, the more important its role is. For instance, the IMF and the World Bank are quota-based institutions, where the quotas are calculated through formulas where the size of the GDP plays a key role.[14] But European countries' share of world GDP is shrinking, and therefore they are losing power in the above-mentioned organizations. With the recent reform of the IMF ratified in 2015, European countries agreed to reduce the number of executive directors sitting on the board from eight to six in order to give more voice and space to emerging economies; China doubled its quota from the previous setting. While this trend is inevitable and should be consider a positive development, there is no alternative to EU-US leadership: The United States does not have other reliable partners that are the size of the EU and with which they share a broad common view on many aspects related to trade, financial regulation, financial assistance in third countries, fiscal policy, etc.

Less known are several bilateral mechanisms that the EU and the United States have established over the past twenty years or so to foster transatlantic cooperation. Examples are:

› The Transatlantic Economic Council, to advance EU-US economic integration, with emphasis in regulatory convergence;

› The EU-US Energy Council, to address current challenges of energy security, sustainability, and climate change;

› The Transatlantic Business Dialogue, to establish a barrier-free transatlantic market;

› The Transatlantic Consumer Dialogue, to champion the consumer perspective in the EU-US economic decision making; and

› The Transatlantic Legislators' Dialogue, which centers around biannual meetings of the European Parliament with US congressional delegations and aims at enhancing cooperation on several common concerns, from growth of jobs to energy, security, and defense.[15]

The above examples of close economic collaboration between the EU and the United States demonstrate that the combined power of the two sides of the Atlantic Alliance remains unmatched and is unlikely to be challenged by any rising competitor in the foreseeable future. For Europe to continue to play its part, however, it is necessary that the EU successfully manage its current and emerging challenges.

The best way is for Europe to repair its unity, demonstrate leadership, and generate prosperity. As discussed in subsequent chapters, European leaders must move quickly to resolve the euro crisis and strengthen their economies through bold steps toward liberalizing their domestic markets and providing an investment boost that could break the unemployment stalemate. Whether achieving these economic goals, resolving the refugee crisis, or better confronting terrorist threats, the European countries must speak with one voice, even more so as the Trump administration appears to dislike multilateral institutions. The NATO summit in Brussels planned for May 2017, the next EU-US summit, as well as Italy's G7 and Germany's G20 presidencies in 2017 will provide opportunities for the Europeans to set the "terms of engagement" with the new US administration for the next four years. Europe remains America's closest ally and preserving the governance gains of the past seventy years is the best guarantee for continuing the liberal international order.

14 IMF, "Fact Sheet: Quotas," September 26, 2016, https://www.imf.org/en/About/Factsheets/Sheets/2016/07/14/12/21/IMF-Quotas for the variables that enter in the quota formula of the IMF.

15 Most of these dialogues were created with the leadership of then-US ambassadors to the EU Stuart E. Eizenstat and C. Boyden Gray, members of the EuroGrowth Task Force.

CHAPTER 2

Deal with the Short Term

"The remedy seems to lie in breaking the vicious circle and restoring the confidence of the people of Europe in the economic future of their own countries and of Europe as a whole."

George Marshall speech on the Marshall Plan in Harvard, Cambridge (MA), June 5, 1947

2.1 Summary and main recommendations

The next twelve months will set the stage for the sustainability of the European project. A number of events, policy options, and decisions will take place: they can point in the right direction for a more comprehensive and sustainable growth or, alternatively, suggest the inability of the European leadership to provide vision and guidance. In the former scenario, citizens will still see a reason to stick together, while the latter could lead to the resurgence of economic nationalism that may weaken the European economy over time.

The start of the negotiations for the United Kingdom (UK) to leave the EU in March, the Dutch elections in March, the French elections in April-May, the German elections in September, and the likely Italian elections during the second part of 2017 are five major political events that can change the landscape.

The willingness and ability of the European Central Bank to continue the non-conventional monetary policy designed to keep interest rates low and smooth the rollover of public debt for highly indebted countries might be reconsidered if the inflation rate in Germany gets above 2 percent.

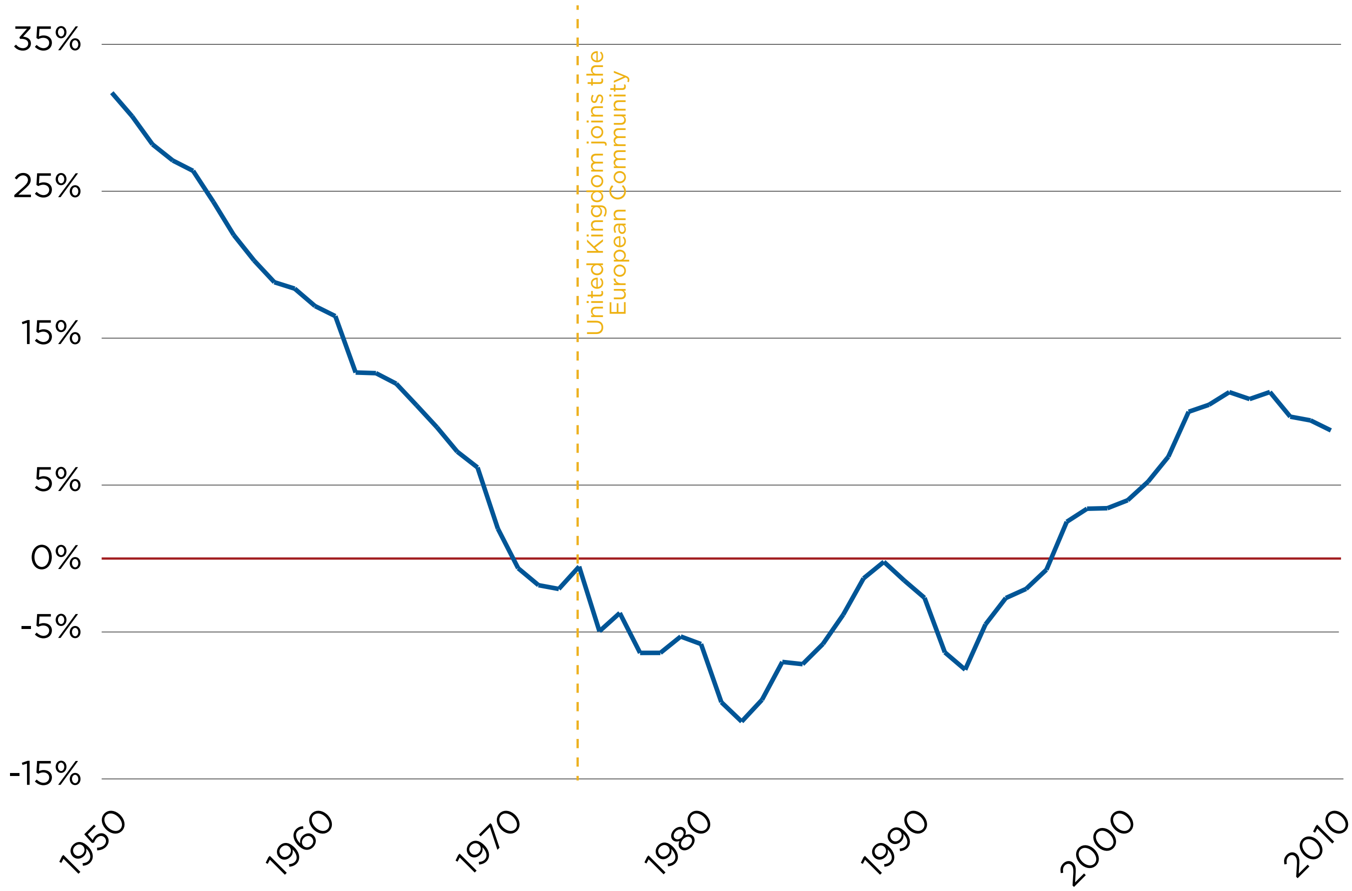
The refugee surge and the lack of a strong, coordinated migration policy, as well as any terrorist acts tied to recent migrants, exacerbates tensions between inner countries and those that represent the external border of the EU. The former tend to believe that external borders are not secured, and therefore question the free movement of people, one of the four topical freedoms and cornerstones of the EU. The latter sense a lack of solidarity and consider that the burden—both financial and political—is not equally shared.

Trade and openness are at risk, too. Under the new US administration of President Donald Trump and given the hostility in some EU countries, the future of the ambitious Transatlantic Trade and Investment Partnership (TTIP) is at stake. It is a complex framework that would involve regulatory changes and rules harmonization, and the timing set by the EU Commission and the Obama Administration was too short to resolve all of the complexities behind the required changes on both sides of the Atlantic. But this does not mean that the ambitious project to develop a new phase of transatlantic connectivity should be abandoned. Rather, it is important to continue the work at a technical level and prepare the ground for a final agreement to take transatlantic commerce forward when the appropriate conditions materialize. TTIP must be renamed and those controversial issues where negotiators are not able to move forward abandoned for now. The best model would appear to be an open agreement in which issues can be solved over time within an agreed framework. This will allow continued deepening of economic relations while adapting to the practices and needs of economies on both sides of the Atlantic.

For the short term, our main recommendations are:

- ✓ *Once the Brexit timing is confirmed, negotiations should take place through a transparent process and with a long-term perspective. The UK and EU need each other to promote common values and to continue to play key roles in global governance.*
- ✓ *Identify circumstances under which the window of opportunity of low interest rates can be used for an extraordinary public investment plan.*
- ✓ *Increase human and financial resources to tackle the refugee crisis and build a binding policy for all member states to share the political and economic burden, while strengthening anti-terror coordination among members.*
- ✓ *Preserve the goal of deepening and widening the transatlantic marketplace and build on the work done so far with TTIP for a new version of the agreement.*

Figure 6. Percentage difference between the UK's GDP per capita and EU founding members EU-5's (excludes Luxembourg) between 1950 and 2011 (in percentage)



Source: Penn World Tables 8.0.

2.2 Negotiate Brexit wisely

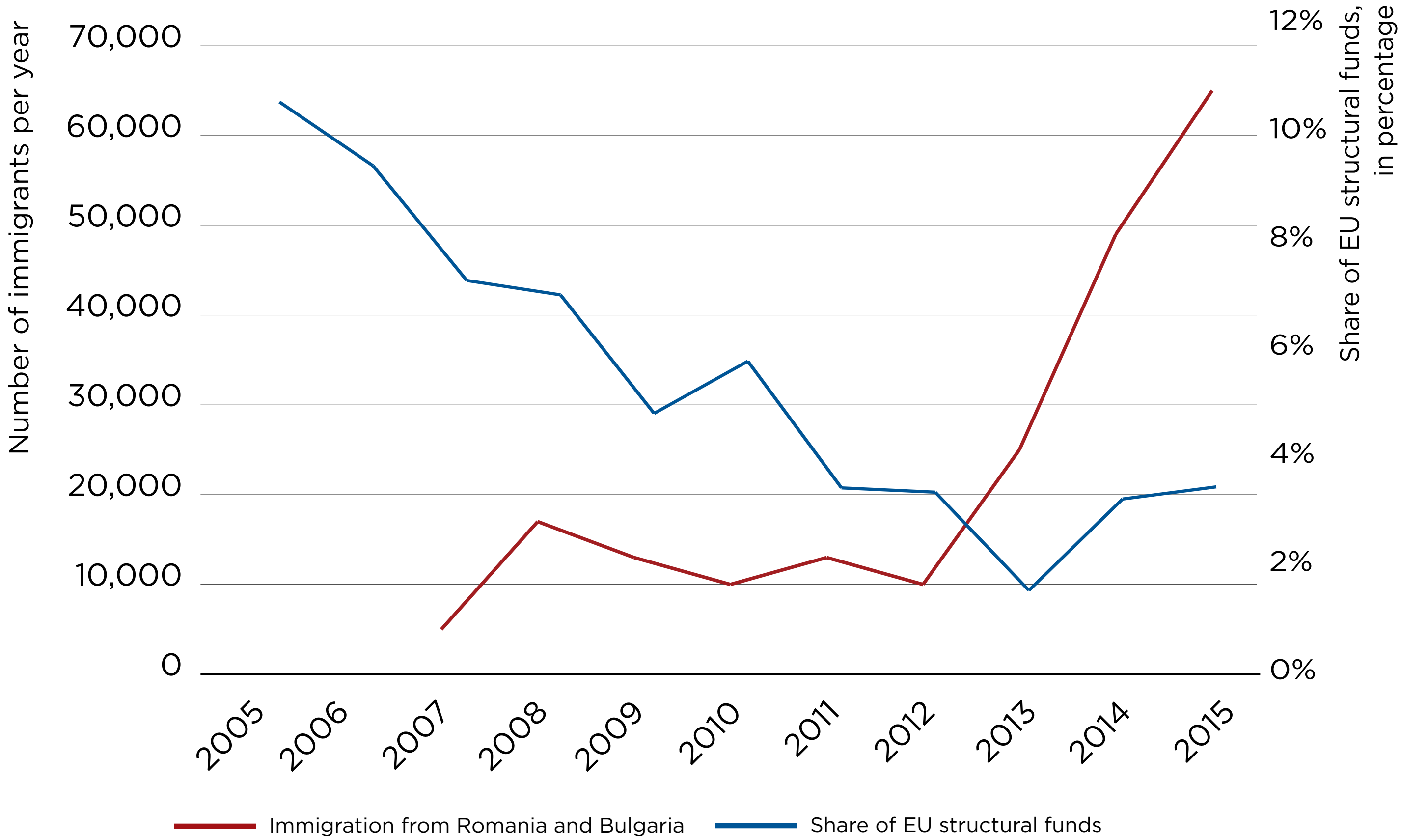
The United Kingdom benefited greatly from joining the European Community in 1973: as Campos and Corricelli point out, the accession contributed to the stabilization of the ratio of the UK's per capita GDP to the average of the six EU founders, after a steady decline of this ratio from 1945 to 1972 (figure 6).[16] At the same time, the UK benefited from special clauses and treatments. First and foremost, the 1992 Treaty of Maastricht, which created the European Union and paved the way for the euro, allowed the UK not to participate in the third stage of the Union, i.e., the creation of the European Central Bank and of the single currency.[17] Second, in 1984 Prime Minister Margaret Thatcher obtained a special formula to calculate the UK contribution to the European budget, through a rebate by 66 percent of the difference between its contribution and what it receives back from the budget. The burden of this rebate is mainly borne by France, Italy, and Spain: although the UK is the third largest economy in the Union, it is only the fourth net contributor after Germany, France, and Italy. A third area of preferential treatment for the UK was the Schengen Agreement, which abolished the border controls between member states. The UK did not sign the agreement that was incorporated in the Treaty of Amsterdam in 1997, allowing the country to maintain customs with the rest of the EU.

Such exemptions from the normal obligations of other member states kept the anti-EU sentiment at bay, until the enlargement to Eastern Europe began to unfold. These countries had a much lower GDP per capita than the rest of Europe and, as a result, two major flows took place. On the one hand, transfers from the EU budget shifted massively to these countries in the

16 Nauro F. Campos and Fabrizio Coricelli, "To Brexit or to Remain? That is the Question," Atlantic Council, June 6, 2016, http://www.atlanticcouncil.org/publications/reports/to-brexit-or-to-bremain-that-is-the-question.

17 The first stage, which liberalized capital movement, began on January 1, 1990; the second stage provided convergence criteria for economic policies and began on January 1, 1994.

Figure 7. UK's share of EU structural funds and immigration from EU2 (Romania and Bulgaria)



Source: European Commission and Migration Watch UK.

form of structural funds to help their economies catch up with the rest of the union. Consequently, the UK share of structural funds dropped from 10.5 percent in 2005 to less than 1 percent in 2013 (with a slight rebound in the most recent years).

On the other hand, the free movement of citizens granted after accession caused large flows of migrants from the ten eastern countries to the rest of Europe. In the UK, this phenomenon became pressing only in recent years and mirrored immigration from two specific countries: Romania and Bulgaria. As figure 7 indicates, the number of annual immigrants from these two countries went up from 5,000 in 2007 to 65,000 in 2015 creating a sense of urgency for blocking further immigration to the isles.

Migration trends and the reversal of EU funds flow at the expense of the UK caused an internal debate that prompted then Prime Minister David Cameron to make a last effort to convince UK citizens about the benefits of the Union. In February 2016, he negotiated and secured a new agreement for the United Kingdom's relationship with the European Union. Following the deal, he announced a referendum for June 23 on whether or not the United Kingdom should remain in the European Union. In an unexpected outcome, UK voters chose, by 52 to 48 percent, to leave the EU, forty-three years after their accession in 1973. The day following the referendum, David Cameron announced his resignation, paving the way for Theresa May to take over as prime minister on July 13, 2016.

2.2.1 The timeline

In October 2016, Prime Minister May said that Article 50 would be triggered by the end of March 2017. By doing so, the UK would initiate the legal process laid out in the Lisbon Treaty, through which the UK would formally negotiate its exit from the EU. Once this happens, the UK and its counterparts would have two years to secure a complete withdrawal arrangement (for which approval from at least twenty countries with 65 percent of the population is needed) or agree to extend the negotiations (for which unanimous approval is needed). If the UK and the other twenty-seven member states are unable to reach a consensus

From Our Task Force Members

Ms. Courtney Geduldig
Executive Vice President, Public Affairs
S&P Global

How risky is it to have a number of years of uncertainty on whether London will remain the European financial hub?

This will depend on how much clarity can be provided during the negotiations as to what Brexit will really entail for financial services providers. Following the Brexit vote, S&P Global Ratings lowered the sovereign rating of the UK by two notches to "AA" from "AAA" with negative outlook partly based on our assessment of the economic and political risks involved. The downgrade reflected our view that the "Leave" result would weaken the predictability, stability, and effectiveness of policy making in the UK and also affect its economy, GDP growth, and fiscal and external balances.

In the opinion of our analysts at S&P Global Ratings, Brexit presents a significant risk to the UK's track record of strong economic performance and to its large financial sector, in particular. Complex and protracted negotiations between the UK and the EU could put pressure on the UK's financial services sector, which is a major contributor to UK employment and public receipts. In particular, it is not clear if the EU will permit the UK access to the single market on existing tariff-free terms, or impose tariffs on UK products. Further arrangements regarding the export of services, including by the UK's important financial services industry, are also unclear, due to the current regulatory uncertainty with regard to maintaining full access post-Brexit.

Our S&P Global Ratings analysts also noted that about two-thirds of all FDI into the UK represents investment in the financial services sector, and most of this is channeled into London. According to S&P Global Ratings, the UK financial system, measured by total assets, stands at about 4.5 times GDP and foreign banks comprise half of UK banking assets on a residency basis. Foreign branches account for about 30 percent of total UK resident banking assets. Brexit could lead financial firms, especially foreign ones, to favor other destinations when making investment decisions. However, this will all depend on the trajectory and outcome of the negotiation. One thing is clear: uncertainty will tend to increase risk.

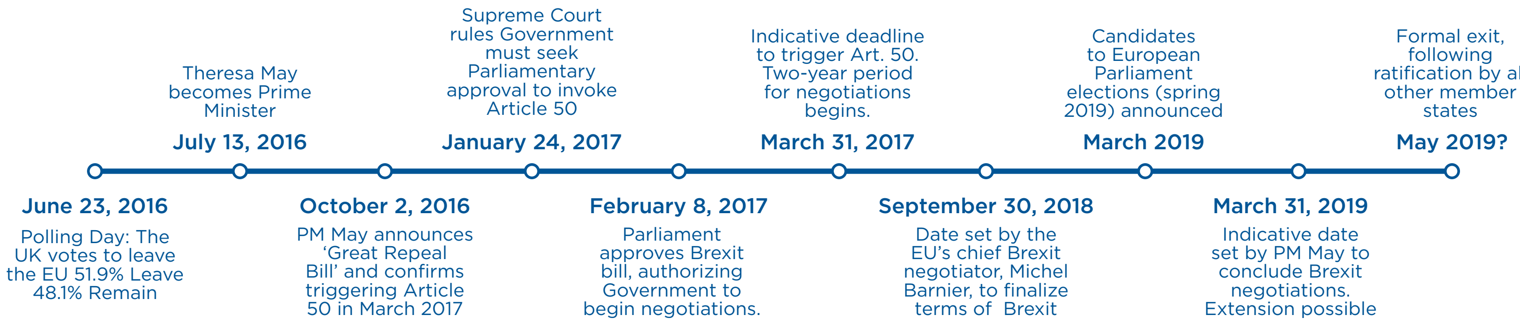
How can Europe potentially benefit from Brexit?

Navigating Brexit will be a challenge for all parties. Many have recognized that the result of the Brexit vote also represented a wake-up call for the rest of the EU. How policy makers choose to respond to and manage this particular challenge, especially in a year of elections in key remaining member states, will shape whether it can be transformed into a longer term positive pivot for Europe. After the Brexit result the president of the Council, Donald Tusk, initially called for a "serious and realistic reflection on the future of Europe," which seems appropriate but also spells out the potential disruptive nature of Brexit to the wider European Union. He, as well as President Juncker, also made clear that the danger of "disintegration" as well as "differences and disagreements" were obstacles that should be overcome as a priority.

As such, it is possible that Brexit could present a strategic opportunity for the remaining twenty-seven member states to re-consolidate the European Union and give renewed momentum to further, and perhaps complete, a number of important integration projects. The Economic and Monetary Union, for example, is a cornerstone of the future of the eurozone and steps are already under way to complete it as prescribed by the Five President's Report. Brexit may present an opportunity for further steps.

Equally, the Capital Markets Union project could now be accelerated to ensure that the remaining EU member states will have access to deeper and more liquid financial markets should the key financial hub of the City of London no longer be part of the EU. This would be in step with the planned renewal of the European Fund for Strategic Investment (EFSI) which looks to stimulate jobs, growth, and infrastructure funding.

Figure 8. Brexit timeline



Source: Atlantic Council.

in this timeframe, withdrawal would become effective without an agreement, and all EU treaties would cease to apply to the UK.

It is important to note, however, that it would be highly problematic if Article 50 were triggered later than currently scheduled, as the two-year deadline for the negotiations would fall after the European Parliamentary elections in May 2019. Failure to complete negotiations by then could have serious implications for the composition of the European Parliament and the Brexit negotiations, especially if British candidates were able to run for election.

2.2.2 What Brexit means for Europe. . .

For the first time after sixty years, the European Union will be reduced in size, economic power, and likely political relevance. The story of the Union had been one of increasing influence: from the six founding countries in 1957 onward, the Union experienced several enlargements to the west (UK and Ireland in 1973), to the southwest (Portugal and Spain in 1986), to the north (Sweden and Finland in 1995), and to the east (ten former Soviet Union Republics in 2004). Every enlargement meant additional political power and economic strength (see figure 9).[18] The Brexit would reduce the EU's share in world GDP to 18.1 percent from around 22 percent.[19] The loss of those four percentage points reflects three important aspects of Britain's contribution to the EU, which are discussed in turn.

The UK as a financial center

The UK represents the largest financial market in the EU: the capitalization of the London Stock Exchange Group is 3.15 billion euros, compared with 1.52 billion euros of Frankfurt, the second largest in the area.[20] Regarding London as a financial hub, Simeon Djankov underlines that it is very unlikely that London will lose its role for at least three reasons: [21]

- The preeminence of the British court system in upholding the rule of law, including the protection of creditor and shareholder rights.
- The superiority of the UK's university education in economics and finance over its continental counterparts.
- The UK's tax and employment regulation that is conducive to the industry's health and profits.

The UK has one of the friendliest business environment for financial services according to the ranking prepared by the World Bank for its *Doing Business* report, and it has attracted a lot of talent from both its top-ranked universities and from abroad. It is very difficult to imagine better conditions for financial markets than those now available in London. Nevertheless, some unavoidable disruption will occur, as activities currently in London would have to move elsewhere to comply with EU regulations once the UK leaves the Union. And, certainly, some key EU players will want to make an effort to expand their financial market roles at the expense of London. This will

18 The reader may notice discrepancies between data cited in the text and those represented in figure 9. The authors acknowledge these discrepancies, which are the result of the use of different data sources, necessitated by a lack of official data for the historical time period covered in figure 9.

19 IMF, "World Economic Outlook," October 2016, http://www.imf.org/external/pubs/ft/weo/2016/02/; European Commission, "Annual Macro-economic database AMECO," https://ec.europa.eu/info/business-economy-euro/indicators-statistics/economic-databases/macro-economic-database-ameco_en.

20 World Federation of Exchanges, "Market Capitalization Report," November 2016. https://www.world-exchanges.org/home/index.php/statistics/monthly-reports.

21 Simeon Djankov, "Why London won't lose its crown as Europe's financial capital," The National Business Review, Spetember 1, 2016, https://www.nbr.co.nz/article/why-london-wont-lose-its-crown-europes-financial-capital-193719

be a complex set of maneuvers that will impact transatlantic and multilateral efforts to keep financial regulations working in sync.

International Trade

Being an open economy, the UK has contributed significantly to EU trade with the rest of the world. Considering only extra-EU trade, the UK accounts for 12.9 percent of EU goods, and 23.3 percent of services.[22] For most EU countries, the UK represents one of the main trading partners because the internal market allowed over time to develop a comprehensive EU supply chain where products are the result of complex movements across the EU of intermediate goods that end up as UK goods. Also, services provided by UK financial institutions as insurance allow EU goods to be delivered outside the borders of the Union.

The contribution of the UK to the EU budget

In 2016, the common EU budget amounted to €155 billion, roughly 1 percent of EU GDP. Even though the UK benefits from a rebate that reduces its contribution to the common budget, it is still a net contributor by about 7 billion euros, of which 4 billion goes to the common agriculture policy.

2.2.3 . . .and for the United Kingdom

What will be the consequences of Brexit for the United Kingdom over the medium and long term will depend on the terms on which the Brexit is executed. Politically, the issue is whether the United Kingdom will give priority to the single market and its benefits, at the expense of accepting some limitations on control of its borders and its laws, plus contributing to the EU budget: this would be the soft option. Under the hard option, the UK would give priority to total control of its borders, legal system, and economy at the expense of losing the single market. It is worth noting that even Switzerland, which currently has the most distant relationship with the EU, still must accept free movement and many EU regulations, while also contributing to the EU budget. If the UK wishes to avoid such obligations at all costs, a hard Brexit would be the only option. Table 2 indicates the implications for the UK of possible Brexit scenarios.

The most daunting challenges facing the UK government under a hard Brexit scenario are not those related to the Article 50 negotiations and its two-year deadline; it's the post-Brexit economic and political landscape that the United Kingdom will have to face along with the steps to address the new reality. In particular, Britain would have to negotiate and complete new individual deals as a substitute for the lost membership in the EU. These range from the current free-trade pacts of the EU with fifty-three countries to trade arrangements with the United States, or to China, India, and Australia that currently have no deals with the EU. Moreover, Britain would have to renegotiate its full membership with the World Trade Organization (WTO), to which it now belongs via the EU. Negotiations with the WTO are usually painfully slow. Finally, aside from the strictly economic aspects of a hard Brexit scenario, Britain will need to resume cooperation with its EU partners through new (if not different) commitments in security, foreign policy, and counter-terrorism. Even if there are no substantive disagreements on these issues, just the formal negotiating process will take a long time to complete.

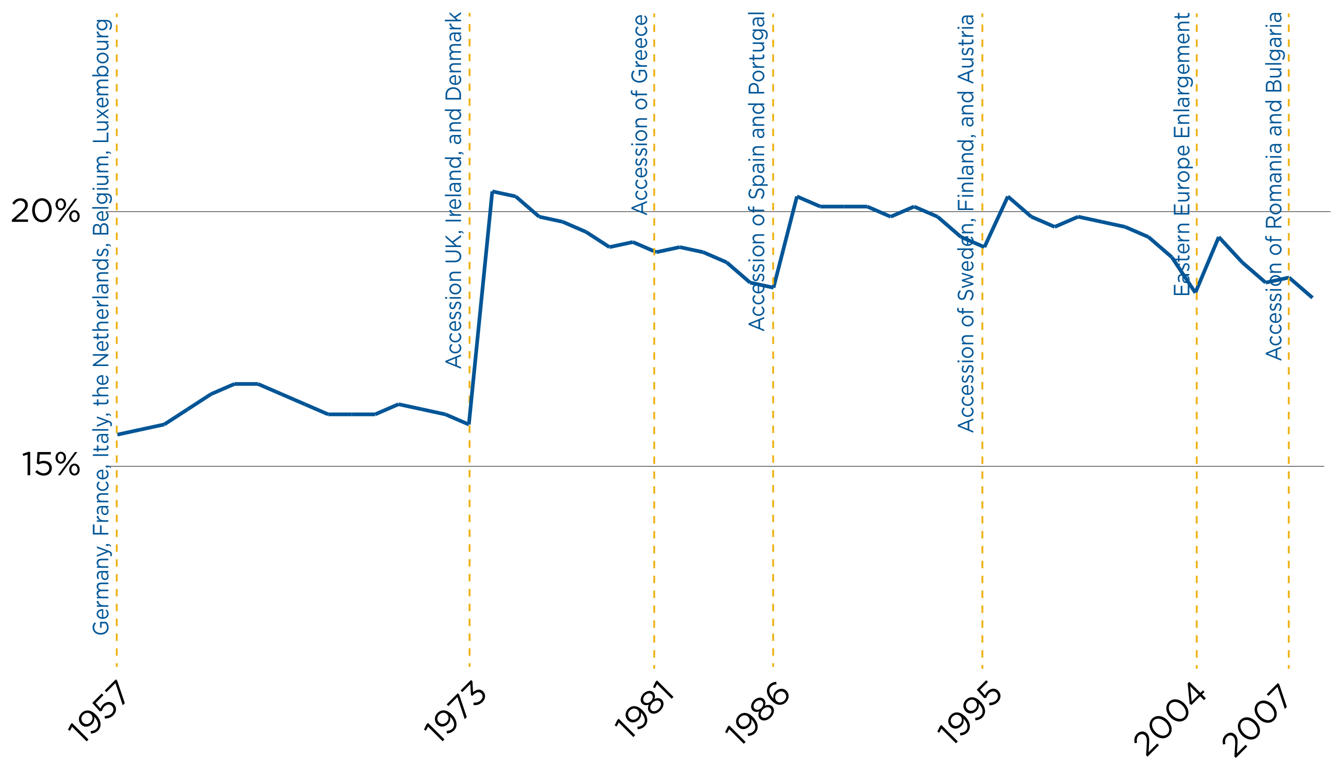
"The European Union will have the difficult task of balancing a hard agreement that would ward off temptations by other members to leave in the future, against a milder position that would allow the UK's strength to benefit the remaining twenty-seven countries."

The consequences of the UK's decision to leave the EU are far from clear, both for the country itself and for the European Union, if only because the institutional process toward the exit has not been tried before.[23] Over the next two years, the UK will fight for maintaining some privilege in accessing the EU internal market, and the uncertainty surrounding the negotiations might affect its economic performance. The European Union will have the difficult task of balancing a hard agreement that would ward off temptations by other members to leave in the future,

22 See Eurostat http://ec.europa.eu/eurostat/data/database.

23 There are only two precedents of a territory leaving the European Community: Algeria in 1962, following independence from France, and Greenland in 1985, following a referendum in 1982 and the special status with Denmark starting from 1979. Greenland relations are regulated by the Greenland Treaty.

Figure 9. EU GDP as a share of world GDP



Source: The Maddison-Project.

against a milder position that would allow the UK's strength to benefit the remaining twenty-seven countries.

Negotiations should also help in overcoming some of the reasons that created the negative attitude toward Europe. Understanding how and why British citizens voted for leaving the European Union is pivotal for producing a good outcome that can endure over the long term. The EU must consider Brexit as a step in building a new institutional setting, where the final outcome of the negotiations with the UK can represent a future model of cooperation with countries in the east, such as Ukraine or Turkey. At the end of the day, the EU needs the UK and vice versa. If the continent wants to continue to play a role in the world, where big and powerful actors are rising, a way of cooperation between the two is not only desirable, but necessary.

We consider it essential to develop a strategy that takes into account the mutual benefits, while preserving the advantages of the internal market to the members of the Union. Looking ahead, the most pressing challenges are the role of London as a financial hub and the format of a trade partnership with the rest of the EU.

As part of the Brexit negotiations, the UK and the EU should agree to keep the contribution to the EU budget until the end of the current Multiannual Financial Framework, in 2020. According to estimates provided by the House of Commons (2016), the total contribution for the remaining period of the Multiannual Financial Frameworks after rebate and refunds amounts to around 67 billion euros of which 43 billion euros is net contribution.[24] Maintaining the current framework would avoid reallocation of the contributions and especially the interruption of programs financed by the EU budget and currently ongoing in the UK. It would also prevent putting on the table a confrontational issue in the forthcoming negotiations. But at the same time, it is urgent to set immediately the stage for the rules that will define the contribution to the EU budget for the remaining twenty-seven countries once Brexit materializes. According to Nuñez Ferrer and Rinaldi, if the UK reduces to zero its contribution to the EU budget, the small- and medium-sized countries of the EU will be negatively affected most, because their contribution in relative terms will increase significantly.[25]

24 Matthew Keep, "A guide to the EU budget," House of Commons Library Briefing Paper n. 06455, http://researchbriefings.parliament.uk/ResearchBriefing/Summary/SN06455.

25 Jorge Núñez Ferrer and David Rinaldi, "The Impact of Brexit

Table 2. Possible Brexit scenarios

	No Brexit	Soft Brexit			Hard Brexit		Theresa May's exit
	Full EU Membership	EEA (Norway)	EFTA (Switzerland)	Customs Union (Turkey)	FTA (Canada)	WTO Rules	Free Trade Agreement with EU
Acces to Single Market?	Yes	Yes	Partial	No	No	No	No
Free labor mobility?	Yes	Yes	Yes	No	No	No	No
Duty free trade in goods	Yes	Yes	Yes	Yes	Yes	No	Yes
Participates in Single Market rulemaking?	Yes	No	No	No	No	No	No
Market access for services	Yes	Yes	Partial	No	Partial	No	Yes
Free to negotiate bilateral trade agreements with non-EU countries?	No	Yes	Yes	No	Yes	Yes	Yes
Contributes to EU Budget?	Yes	Yes, but reduced	Yes, but reduced	No	No	No	No
Part of Common Agricultural Policy?	Yes	No	No	No	No	No	No

Source: Atlantic Council.

In conclusion, building good economic cooperation between the EU and the UK is vital for Europe. But Brexit goes beyond the short-term economic implications, because it can set the stage for a different model of European integration. In chapter 4, we argue that Europe should move toward a setting of concentric circles, where an outer circle represents other key economic and strategic allies in Europe: defining the way the UK will deal with the EU is therefore not only important for bilateral relations but also for the future governance of the continent.[26]

2.3 Survive the electoral cycle in the Netherlands, France, Germany, and Italy

European leaders enter 2017 knowing that they have a sizeable group of voters skeptical of globalization and

on the EU Budget: A Non-Catastrophic Event," Centre for European Policy Studies, n. 347, September 2016, https://www.ceps.eu/system/files/Impact%20of%20Brexit%20on%20EU%20budget.pdf. Austria will increase its contribution by 15.5 percent, Cyprus and Malta by 11.1 percent, Denmark by 10.7 percent. If instead the UK receives a similar status a Norway in the European Economic Area (EEA), the loss of contribution will be halved.

26 Jean Pisany-Ferry, Norbert Röttgen, André Sapir, Paul Tucker and Guntram B. Wolff, "Europe after Brexit: A Proposal for a Continental Partnership," Bruegel, August 2016, http://bruegel.org/wp-content/uploads/2016/08/EU-UK-20160829-final-1.pdf. The authors propose a "continental partnership" between the UK and EU-27 with the UK having a role in inter-governmental decisions, contributing to the EU budget under a regime of controlled labor mobility.

From Our Task Force Members

Sir David Manning*

Former British Ambassador to the United States

What do you think needs to be done ahead of the triggering of Article 50 on both the European side as well as the British/national levels, to prevent a long period of market insecurity that could harm investment into both Europe and the UK?

We need early confidence-building measures in the form of statements from Prime Minister May, her European counterparts, and the European Commission, that are designed to reassure markets and investors about the good intentions of both sides. The British Prime Minister needs to recognize publicly that, while the two-year period provided by Article 50 may be enough to conclude exit negotiations, it is very unlikely to be adequate for the negotiation of the new trade agreement that will have to be reached between the UK and the EU. There will therefore almost certainly have to be transitional arrangements after 2019 governing UK/EU relations until a final trade agreement is reached and has been endorsed by the UK and the other current EU member states. Mrs May has said that she wants the easiest possible access for UK goods and services to the Single Market through a new trade agreement: the question is how she will secure this while at the same time insisting on leaving the Single Market. These assurances will need to be matched by an encouraging welcome from EU leaders if the UK is to minimize the risk of a collapse of confidence leading to the departure of financial institutions from the City of London and a decline in inward investment.

What new form of alliance do you see for Europe and the United Kingdom? What kind of institutional setting do you envision?

It is impossible to predict at this early and confused stage what sort of institutional arrangements or alliances will emerge between the UK and EU from the Brexit negotiations. Personally, I hope that we shall maintain the closest possible links, with the UK cooperating closely with the EU on foreign, defence, and security policy, the environment, and wherever possible on the economic and social agenda. The UK should be in the business of adjusting its close relations with its European neighbors not severing them. But much will depend on the good will of both sides. Will the Brexit negotiations be conducted in a way, and in a spirit, designed to preserve the maximum degree of co-operation; or will they, instead, prove acrimonious and result in a minimalist "hard Brexit"?

What is the process, what are the institutional mechanisms for the Brexit? What institutional challenges could you anticipate?

The negotiations will be led by David Davis, minister for Brexit, on the British side and by Michel Barnier, the chief negotiator for the EU. There are no tried and tested procedures for managing a country's withdrawal from the EU, something that has never happened before. We are making it up as we go along, which adds to the confusion and controversy. The challenges are huge and complex: we need mechanisms to negotiate and manage the UK's withdrawal; and probably, separately, to negotiate transitional arrangements pending the conclusion of a final trade agreement between the UK and EU. Creativity, patience, and stamina are going to be essential if the Brexit process is to be managed amicably and constructively, and with minimum disruption and damage both to the UK and the EU.

* Disclaimer: The following reflects Sir David Manning's own personal views exclusively and are not endorsed by any other institution.

"multiculturalism," critical of European Commission and Council leadership performance, angry over a slow recovery, and fearful of continued inflows of immigrants and of terrorist incidents. They have seen a rapid rise of votes for far right parties in recent years including in the European Parliament. Concerns are high as voters head to the polls in the Netherlands, France, Germany, and possibly Italy.

This follows on a big set of challenges in 2016: the UK decision to leave the EU; the massive surge in illegal immigrants; the continued tepid economic recovery in parts of the EU; the US election of Donald J. Trump, who praised the Brexit movement and criticized the EU and Germany; continued terrorist attacks across Europe; rebellion against EU trade deals with the United States, Ukraine, and Canada. On the positive side, Europe emerged from 2016 with a modest economic recovery and world growth projections headed in a positive direction. Economies were not knocked off track by the Brexit vote. Austrian presidential elections in December ended the year with victory by a pro-European candidate over his anti-EU, Freedom Party opponent. The EU trade deal with Canada was ultimately approved, after last minute maneuvers by the Wallonian regional parliament of Belgium. EU leadership continued to muddle through, even if only giving the impression of moving from crisis to crisis.

The Netherlands holds national elections on March 15. Well-known Euroskeptic Geert Wilders, head of the Party for Freedom (PVV), appears set to win a large number of delegates in parliament. Wilders has called for a referendum on Dutch EU membership and for a ban on Muslim immigrants. Next, France goes to the polls for presidential elections in two rounds in April and May, to be followed by parliamentary elections. Marine Le Pen, head of France's National Front, has pledged to renegotiate terms of France's EU membership and hold a referendum on EU membership, in addition to pursuing her nationalist and anti-immigrant platform. Barring a big surge in National Front votes beyond its historic highs, France should not emerge from the second round with a blatantly anti-EU leader.

Germany scheduled a general election for September 24. The two traditional parties (Chancellor Angela Merkel's Christian Democratic-Christian Social Union coalition and Martin Schulz's Social Democrats) have the largest consensus. However, people will be looking closely to see how much of a protest vote emerges through the far-right, anti-EU Alternative for Germany. It currently sits in ten of sixteen state legislatures, with its presence growing impressively since it emerged in 2013.

It is unclear if Italy will vote in 2017 or early 2018, but analysts argue anti-establishment parties, led by the Five-Star Movement and the Euroskeptic, anti-immigrant Northern League and Brothers of Italy, could have a large number of seats in parliament once elections will be called.

"European leaders enter 2017 knowing that they have a sizeable group of voters skeptical of globalization and "multiculturalism," critical of European Commission and Council leadership performance, angry over a slow recovery, and fearful of continued inflows of immigrants and of terrorist incidents."

Many commentators argue that, whether any of the Euroskeptic parties wins big or not, they are already having, and will continue to have, influence. In some cases, the discontent might push EU leaders to give the Union better ways to handle problems, such as in agreeing for new EU trade defense tools. In other cases, it may paralyze the process. In the US-EU TTIP negotiations, for example, EU officials and leaders lost control of the debate in several member states. One of the key issues to watch, in this sense, is the handling of immigrant flows. EU leaders are struggling to stay ahead of popular outcries. If that debate were to shift to restrictions on internal EU flows of labor as happened in the UK during the Brexit campaign, the issue could become even more divisive, because the Central European EU members tend to be most in favor of free internal EU migration of labor and most opposed to external migrant inflows.

Given the multifaceted nature of issues and pressures, it is not clear how willing or able EU leaders will be this year to take big decisions, for example to move ahead with fiscal, financial, and other structural reforms. Will they be too timid, too nervous, fearing reactions at home to something perceived to be expanding EU reach? Or, on the other hand, could this situation

From Our Task Force Members

H.E. Gordon Bajnai
Group Chief Operating Officer, Meridiam
Former Prime Minister of Hungary

Are there any lessons that you can transfer from your experience stabilizing the Hungarian economy to the European level in the short term and in the medium term?

The first lesson I have learned from my country's crisis is that whenever you get into a crisis the first thing you do is you look into the mirror and ask yourself how have I gotten into this situation? However, since Europe is not a country, solutions in a diverse union are much more complex. Europe's current overall management problem is that there are always high expectations and low execution. Using the Hungarian crisis management example, it is better to manage public expectations down and outperform those expectations. The underlying reason for Europe's crisis is its half-hearted, half-considered, and half-finished integration.

Finding optimal solutions is hard because, politically, it is always easier to choose the popular parts of an issue without adding the difficult parts. A good European example would be having a common currency like the euro without a common fiscal policy and a common banking system. While it is easy to agree to a joint monetary policy, it is very difficult to agree to a joint fiscal policy because it is about how much money I take from your pocket and put into someone else's pocket. This is the heart of politics at every national parliament and if this competence is raised to the federal level, there is a lack of proper democratic legitimacy there. Not to mention that most politicians at national level would be counter-interested about giving up this competence.

However, to keep the Euro sustainable there should to be some form of a redistribution all around Europe, a partial transfer union, as well as a more complete banking union. This, though, is only manageable politically if proper guarantees are secured for the net contributors, that they are not going to sign a blank check again—while giving a clear timeline and assurance for the countries in trouble that they are not expected to walk into a tunnel without a light at the end.

The answer to Europe's current problems is more integration, not less, for which this grand political bargain is missing support yet. However, with the current uncertainty surrounding Brexit, the new US administration, Italy's banking crisis, and the elections in Germany and France, there might enough political momentum and strategic urgency for the eurozone to come together and find a common solution. One solution could be for the core countries of the eurozone to go for a closer Union, something like a Europe of concentric circles and allowing the others to take their time.

What do you think can be done at the national or at the European level, or both, to prevent an increase in populism and anti-EU sentiment especially because we can expect this to increase once Brexit negotiations start and all that momentum starts again?

While Brexit is of major interest to populists, it is not a driver of populism per se. Populism is an answer, a reaction, to the dissatisfaction of the middle class; revolutions are not made by those who are poor, but by those who get disappointed. The middle classes in all developed economies got disappointed in the elites—the political and economic elites who did not protect them from the destabilization or even loss of their social status, their identity and security. One should keep in mind that there are different forms of populism: Populism in the UK constitutes itself in the form of "pro-Brexitism," with the UK rebelling against exactly those Eastern European migrants whose countries are most vocally rebelling against migrants from outside the EU.

Populism has to be tackled at both the national and the European level. However, the problem is that the European Union currently constitutes more of a target of populist politics rather than being an actor in politics. Populists are using and intentionally creating artificial enemies. A pro-European centrist's answer to this is to identify and single out the real enemies and competitors, in the face of which a common European identity could develop. If you identify who your real competitors and, in some cases, enemies are then it is easier to come together and find answers but that requires a responsible political elite and both economic and social stability and security for the middle classes—especially the lower middle classes. European identity will however never replace national identity, as the national identities in Europe are very strong—they have to be kept, recognized, tamed, and harmonized with the broader common European identity and interest.

Where do you see the right balance between not creating incentives for others to leave the union, but at the same time not alienating one of Europe's oldest allies, the United Kingdom?

In the short term, there are strong incentives on both sides of the negotiating table to escalate the situation, with three motivations that prevail over more peaceful, conciliatory solutions: in the UK, the real negative impact of Brexit has not started yet, as Brexit has not commenced in practice. On the EU side, there is a strong incentive to find and have an "easy-to-use" enemy for electoral profiteering in Europe. In addition, there is also a strong economic interest for Europe to attract the "financial services center" role over to the continent. Thirdly, there is just the common rationale to set an example that those who leave the European Union will have to be worse off than those who stay in.

For the nations of Europe, the EU is Noah's Arc in the flood of globalization and they need to stay on board to survive.

However, from a strategic, security, and economic point of view, it makes sense to remain close allies. There is much more in common values, interests, challenges, and enemies than what keeps us apart. It is time for those in charge to work on making it a soft Brexit and a strong new alliance.

lead to taking very hardline positions, for example, in Brexit negotiations, lest a "good" agreement for the UK encourage other member states to seek a break with the Union?

This situation raises questions about whether the EU decision-making process is too complicated to let the Union manage the range of tough issues on the table. Clearly, 2017 will be a year full of challenges for the European Union. There is political space for creative leadership by EU and national officials evident in the strong majorities of Europeans supporting more European-level solutions to priority problems. The new skeptical tone from the United States and the continued aggressive behavior from Russia could give European leaders a way to rally more support for pan-EU initiatives. Whether the current EU leaders are able or willing to take up those openings remains to be seen.

2.4 Use current window of opportunity to boost public investment

Since 2009, public investment in the European Union has declined substantially. To ensure the sustainability of public finances and to reassure financial markets of their ability to rollover massive amounts of public debt, member states searched to find ways to limit the increase of public debt to GDP ratios. Throughout the financial crisis, the easiest and fastest strategy for most countries has been to cut public investment: between 2009 and 2013, the public investment level of the EU-28 dropped by 55 billion euros (-12 percent since its peak in 2009). In 2016, the aggregate level of public investment in the area was estimated to be 415 billion euros, still 40 billion less than its peak.[27]

Despite the need to revisit public investment, very few European countries foresee an increase during 2017: among the five biggest economies of the eurozone—Germany, France, Italy, Spain, and the Netherlands—only Italy plans a slight increase of public investment as a share of GDP. Public investment levels are forecast to remain unchanged in Germany, Spain, and France and are slated to decrease in the Netherlands.[28]

Budget constraints are still there, and EU countries cannot put at risk debt sustainability. In the medium term, the Capital Market Union will allow additional inflows of private resources to finance economic growth (see section 3.3). In the long run, we advocate for a more active role at EU level through Eurobonds for growth (see section 4.4). The so-called Juncker Plan for investment is playing a key role to boost private investment in infrastructure for high risk projects but, despite the positive outcomes so far, the impact on jobs and growth is still limited. Given the urgency of providing concrete answers, in the

27 European Commission, "Annual Macro-economic database AMECO," https://ec.europa.eu/info/business-economy-euro/indicators-statistics/economic-databases/macro-economic-database-ameco_en.

28 European commission, "Annual draft budgetary plans of euro-area countries," October 2016, https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/annual-draft-budgetary-plans-dbps-euro-area-countries_en.

current environment of slow growth and historically low interest rates, more can be done.

Under agreed circumstances, European nations make use of the window of opportunity provided by the accommodative monetary policy pursued by the European Central Bank to foster a more robust attitude toward well targeted public investment.

In doing so, countries should take into account the available fiscal space and the supply effects of increased investment expenditures. The International Monetary Fund shows that a 1 percent increase in public spending in infrastructure increases output by 0.4 percent in the same year as a demand effect, and by 1.5 percent four years later, as a supply effect.[29]

29 IMF, "World Economic Outlook," October 2014, http://www.imf.org/external/pubs/ft/weo/2014/02/.

Table 3. Potential additional public investment in 2017-2018 with a flexible interpretation of the Stability and Growth Pact's "investment clause"

	GDP (2016, billion euros)	Deficit to GDP (2016)	Deficit to GDP (2017)	Deficit to GDP (2018)	Additional public investment (billion euros)
European Union	14,774.20	-2	-	-	84.8
Belgium	420.8	-3	no space	no space	0
Bulgaria	46.6	-0.35	-0.85	-1.35	0.5
Czech Republic	172.7	-0.2	-0.7	-1.2	1.7
Denmark	271.1	-0.9	-1.4	-1.9	2.7
Germany	3,139.30	0.6	0.1	-0.4	31.4
Estonia	21.2	0.5	0	-0.5	0.2
Ireland	265.1	-0.9	-1.4	-1.9	2.7
Greece	174.8	-2.5	-3	no space	0.9
Spain	1,118	-4.6	no space	no space	0
France	2,226.50	-3.3	no space	no space	0
Croatia	45.6	-2.1	-2.6	-3.1	0.5
Italy	1,669.80	-2.4	-2.9	-3.4	16.7
Cyprus	17.9	-0.3	-0.8	-1.3	0.2
Latvia	25	-0.8	-1.3	-1.8	0.3
Lithuania	38.6	-0.5	-1	-1.5	0.4
Luxembourg	54	1.3	0.8	0.3	0.5
Hungary	114.4	-1.5	-2	-2.5	1.1
Malta	9.3	-0.7	-1.2	-1.7	0.1
Netherlands	689.6	-0.8	-1.3	-1.8	6.9
Austria	351.5	-1.5	-2	-2.5	3.5
Poland	428.4	-2.4	-2.9	-3.4	4.3
Portugal	184.4	-0.27	-3.2	no space	0.9
Romania	170.2	-2.8	-3.3	no space	0.9
Slovenia	40	-2.4	-2.9	-3.4	0.4
Slovakia	81.2	-2.2	-2.7	-3.2	0.8
Finland	213.1	-2.4	-2.9	-3.4	2.1
Sweden	467.4	0	-0.5	-1	4.7
United Kingdom	2,317.40	-3.5	no space	no space	0

Source: Atlantic Council calculations based on European Commission AMECO database.
"No space" indicates a country does not have enough fiscal space to allow additional public investment.

Given the low borrowing cost, this will likely bring down public debt as a share of GDP. To maximize the positive effects on potential output over the long run, it is imperative that the assessment of the projects is based on the indirect impact of the investment on jobs and growth over time rather than simply its direct, short-term effect on aggregate demand. The quality of the investment, too, is of the utmost importance.

Given the limited capacity for public investment projects at the EU level, such an effort should be conducted through the national budgets of member states. Thus far, the leeway for additional investment spending has been rather limited, given the current interpretation of the fiscal rules.

The existing EU budgetary framework makes sense during a period of "normal" economic growth and surely contributed to keep deficits under control for the vast majority of EU member states; however, Europe currently finds itself in an exceptional juncture. There is high growth potential in both the short and the long term, there is a need to boost economic confidence and, above all, borrowing costs are so low that any investment practically pays for itself in a few years. The bureaucratic restraints currently placed on member nations by the European Commission, with the goal of ensuring fiscal responsibility, have become a straightjacket. While it is meaningful to limit this maneuvering space to member states with a deficit below 3 percent of GDP, it might be less relevant to exclude those with a debt above 60 percent of GDP, given the low current borrowing costs.

Something for consideration could be a one-off, temporary expansion of public investment for 2017-2018 through a smart interpretation of the Stability and Growth Pact, while preserving the corrective arm of the Pact itself, i.e., by allowing additional investment only for countries with a deficit to GDP ratio below 3 percent. Given the current budgetary figures, table 3 assumes that in 2017, all countries with a deficit to GDP ratio below 3 percent are granted an additional one-off increase of 0.5 percent of GDP in additional investment. For 2018, the table assumes that those countries still below the 3 percent limit after the one-off additional increase in public investment, can have an additional 0.5 percent of GDP increase. The cumulative effect in 2017-2018 will be a one-off boost of public investment of around 84.3 billion euros (0.6 percent of the EU GDP).

This approach will have a number of benefits: first, it will stimulate the economy in the short term, while creating the conditions for stronger growth over the long term. Secondly, it will assist the European Central Bank (ECB) in reaching its target of an inflation rate at or below 2 percent due to higher aggregate demand. Lastly, it will restore the confidence of European citizens in the ability of the EU to provide policies that directly create jobs and growth. It will also complement and reinforce the so-called Juncker plan for investment (see section 3.3), which essentially seeks to mobilize private investment.

This recommendation should not be interpreted as a call to abandon fiscal restraint; on the contrary, the proposed policy should be interpreted as a one-off measure and not as a permanent feature of member states' fiscal policy. Otherwise, it might have the opposite effect, namely it might reduce confidence in the capacity of EU countries (especially those with high public debt to GDP ratios) to keep their debt levels under control. At the same time, it can be a balanced option between those advocating for more austerity (e.g., Germany) and those instead asking for more relaxed public budgets.

2.5 Addressing the migration challenges

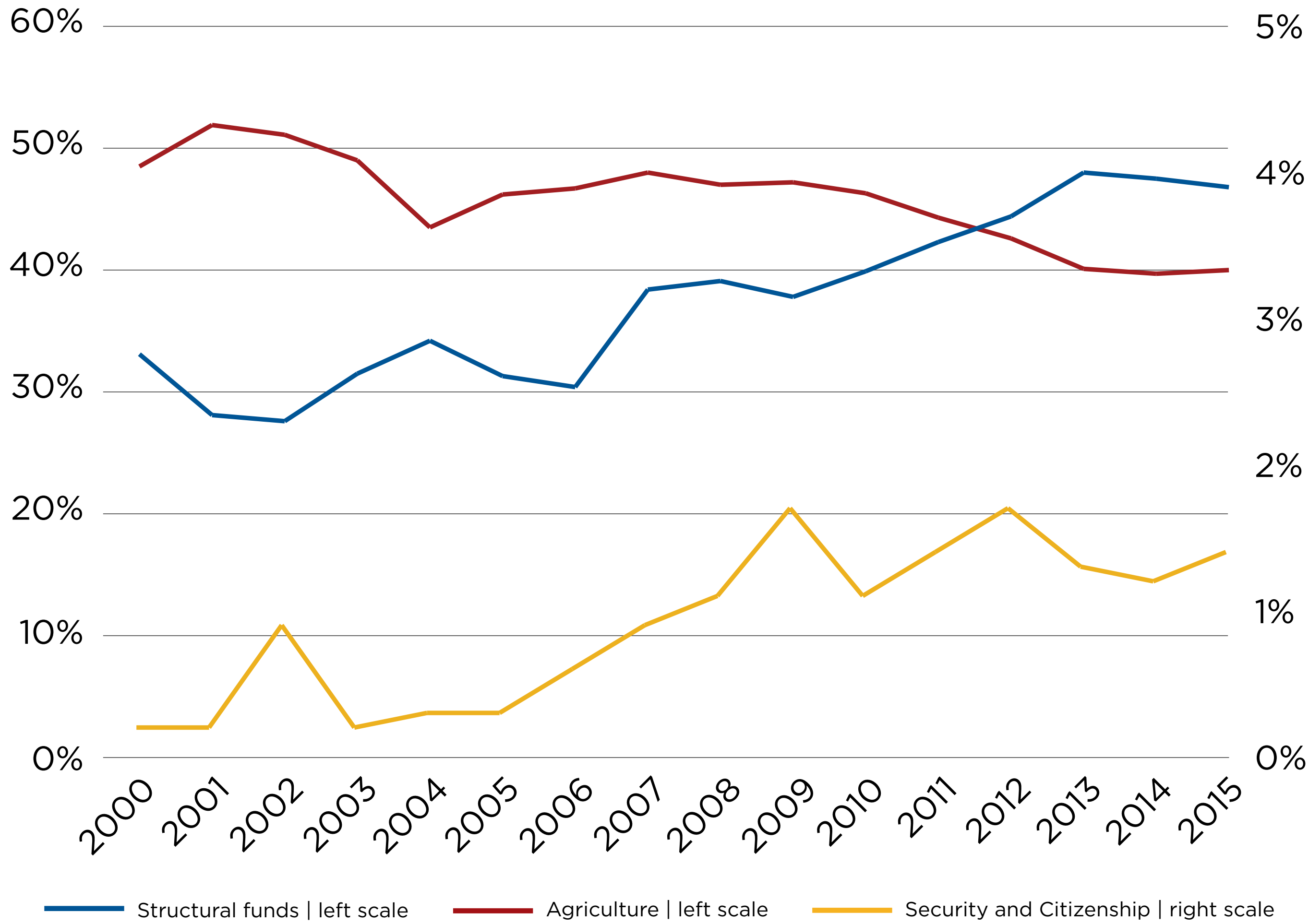
In recent years, the refugee crisis that advanced across Europe in 2014 has shown that these disruptive events

Table 4. Number of illegal migrants entering the EU

Main port of entry into the EU	2009	2010	2011	2012	2013	2014	2015	2016*
Canary Islands	2,250	200	340	170	250	275	874	-
Spain	6,650	5,000	8,450	6,400	6,800	7,840	7,164	-
Italy	11,807	7,288	69,559	20,672	45,000	170,760	153,946	181,000
Hungary	3,090	2,370	4,650	6,390	19,950	43,360	764,038	-
Greece	80,000	91,000	62,300	42,700	33,500	59,670	894,318	182,500
Slovak Republic	1,050	1,050	1,050	1,600	1,300	1,270	1,920	-
Total	**104,847**	**106,908**	**146,349**	**77,932**	**106,800**	**283,175**	**1,822,260**	**-**

Source: Frontex.
*Preliminary data.

Figure 10. EU budget composition (in percentages)



Source: European Commission.

are rarely caused by internal and endogenous factors; rather, they emerge as the consequence of exogenous factors such as wars.

The numbers are huge as shown in table 4: illegal immigration jumped from 107,000 in 2013 to more than 1.8 million in 2015, almost double the number Europe experienced in the early nineties in the wake of the dissolution of Yugoslavia and the flows of refugees from Albania to Italy and Greece. The sheer size of the inflow lies behind the difficulties the EU experienced in controlling its border and managing the crisis. Moreover, the uneven distribution of refugee arrivals created tension among member states, between the nations forming the external borders of the European Union, which asked for more cooperation and financial resources to handle the crisis while directly bearing the burden as refugees arrived in the EU, and others that accused the former of not being able to control their borders.

The migration challenges of the last few years have been so demanding and difficult that several EU member states and associated countries have reinstated interim border controls at internal frontiers between nations within the Schengen area. The decision to temporarily reintroduce border controls, as specified in Article 25 et seq. of the Schengen Borders Code, was taken as a measure to address the serious threat to public policy and internal security posed by weak external border control, mainly on the frontier between Turkey and Greece. Until the outbreak of the refugee crisis, temporary border controls were only introduced for a limited number of days on the occasion of special events such as NATO Summits, G7 summits, and large sporting events.[30]

30 Council of the European Union, "Implementing Decision setting out a Recommendation for prolonging temporary internal border control in exceptional circumstances putting the overall functioning of the Schengen area at risk," November 11, 2016, http://data.consilium.europa.eu/doc/document/ST-14115-2016-INIT/en/pdf.

From Our Task Force Members

Ms. Laura Lane
President of Global Public Affairs
United Parcel Service (UPS)

In 2015, over 1 million people—refugees, displaced persons, and other migrants—made their way to the EU, either escaping conflict in their country or in search of better economic prospects. While the numbers show a decreasing trend, by June 2016, around 156,000 people reached Europe. You have been visiting refugee camps in Germany in person and UPS has been very active in trying to help refugees in Europe. How do you evaluate the immediate policy responses to the refugee crisis and its aftermath? What do you think has been working, what more could be done? Do you envision a bigger role for the private sector in tackling the challenges that the refugee crisis poses?

As someone who early in my career was a firsthand witness to genocide and the refugee crisis in Rwanda, providing humanitarian assistance in the current refugee crisis is something that I see as vitally important, and why I am so proud that UPS is heavily involved in helping to mitigate the current crisis. With lives on the line and nearly all of the world affected by the current situation in the Middle East and Europe, now is the time to take a hard look at how governments address the issues surrounding global migration. Specifically, we need to find ways to make government actions more effective by encouraging greater partnership with corporations and humanitarian organizations in order to promote peace, advance freedom, and protect fundamental human rights.

In this regard, companies, including UPS, have valuable skills and resources that can be brought to bear. Since 2012, in fact, the UPS Foundation has partnered with United Nations agencies and non-governmental organizations (NGOs) in providing aid in response to the Syrian refugee crisis in the Middle East and now in Europe. The scope of the aid has included a combination of donated supply chain and logistics services, transportation, human capital expertise and financial contributions. Our company also serves as the UN High Commission for Refugees' Emergency Standby Partner in helping the organization provide its multi-faceted portfolio of aid to assist in maintaining the health, welfare, and dignity of its beneficiaries and the communities responding to this crisis. Our hope at UPS is that we can join others in doing more to help address the current crisis, using our logistical strength to provide compassionate relief while governments work through diplomatic and military means to re-establish peace and security. Addressing the logistical, political and bureaucratic challenges in this crisis is a daunting task, but well worth the effort in aiding those who share our common humanity.

Due to a lot of uncertainty around the next administration's priorities in trade, TTIP negotiations have been put on hold for the time being. How do you see the chances of the negotiations going forward at a later stage? What could be done in the meantime—do you think it would be wise to try and negotiate the different parts of TTIP separately? What can private companies do to further transatlantic trade and investment if TTIP fails?

The US-EU trade and investment relationship is the largest in the world. A stronger partnership in trade and investment between the US and the EU will bring enormous benefits for US and European exporters alike, particularly if customs modernization is pursued jointly. However, while UPS believes the underlying rationale for a transatlantic trade and investment deal remains strong, the outlook for TTIP remains unclear with the current political transition in the United States, upcoming elections in France and Germany, a heightened anti-trade environment in both the US and Europe, and challenges to EU approval of mixed trade agreements like TTIP given multiple veto opportunities for each of the EU's national and regional parliaments.

While we are in this period of transition, we intend to continue to pursue key elements of the US-EU trade agenda. Three critical areas in the transatlantic trade relationship that UPS is trying to advance are customs modernization and trade facilitation, regulatory cooperation and coherence, and creating a level playing field for service providers, particularly when state-owned or state-supported postal entities also provide the same services. UPS will continue to make the case for the value of joint US-EU efforts in these areas as a means for transatlantic competitiveness. We believe, for example, that trade facilitation initiatives focused on helping small- and medium-sized companies better capitalize on trade opportunities would be of great benefit to both the US and EU economies. Private companies need to educate their workers and the general public on the importance and benefits of global trade, but also advance improved workforce training programs to better engage the twenty-first century economy.

The risk Europe is facing is that a temporary measure, taken to handle exceptional circumstances, may become a permanent feature limiting the free movement of people within the EU. This has relevant economic costs for Europe: according to the European Commission, "full reestablishment of border controls to monitor the movement of people within the Schengen area would generate immediate direct costs for the EU economy in a range between €5 and €18 billion annually."[31] Trade will suffer, in part due to rising transportation costs, hampering sectors with low margins and comparatively higher transportation expenses. Cross border workers, who number around 1.7 million individuals located across the European Union, will face increased expenses in terms of time and fees—a significant restriction on the free movement of citizens and labor.

The full restoration of the Schengen area as a passport and border control free travel area in 2017 can be achieved through the implementation of several measures that will reinforce external borders, increase burden sharing across participating countries, and provide an ameliorated framework for the integration of refugees in the European labor market.

> "The risk Europe is facing is that a temporary measure, taken to handle exceptional circumstances, may become a permanent feature limiting the free movement of people within the EU."

There are least two reasons why 2017 can be the year in which these issues are rectified and Schengen returns to functioning normally within Europe. First, the number of illegal immigrants entering the Schengen area declined significantly in 2016 (in particular the number of illegal migrants entering through Greece and Hungary has fallen substantially); levels are still high in historical terms, but much lower than in 2015 (table 4). This development could encourage European decision makers to transition from responding to an acute crisis to establishing a more systematic and structural approach in relocating and repatriating immigrants.

Second, several important political decisions have already been taken that would facilitate a quick adoption of measures to handle the refugee crisis while simultaneously reaffirming Schengen. The communication from the European Commission, "*Back to Schengen—A Road Map,*" released in March 2016, detailed plans to reinforce the external border, provide assistance to Greece while proposing a coherent approach for border controls. The European Border and Coast Guard Regulation (Frontex) entered into force in October 2016; member states are expected to contribute human resources and financial support. If fully implemented, this policy will reinforce the external borders through a coordinated and EU-wide policy, moving from an approach in which the burden was mainly or solely placed on a single country (Italy, Greece, or Hungary) to a greater shared responsibility on the part of EU members.

The decisions on the relocation of asylum-seekers were made in September 2015, and the legal framework is already in place; however, progress is very limited thus far. According to the agreement forged between EU leaders (at the level of heads of states and prime ministers), 160,000 asylum-seekers will be relocated from frontline EU member states but, according to the UN refugee Agency, UNHCR, less than 6,000 asylum-seekers have been relocated as of October 2016, 4 percent of the original target. It will be difficult to reach the target of 160,000 relocations by September 2017, and EU member states should be ready to earmark more transfers from the EU budget to compensate countries that will continue to host asylum-seekers until their eventual relocation.

Countering terrorism whether homegrown or imported is a vital related area of action for the EU. Eurobarometer polling indicates a strong desire for the EU to improve collective handling of these threats through better coordination among intelligence, police, and judicial services across member states. The European Commission has proposed a series of steps to move toward a Security Union, but this is still an area of important unfinished business for the EU.[32]

31 European Commission, "Back to Schengen – A Roadmap," March 4, 2016, https://ec.europa.eu/home-affairs/sites/homeaffairs/files/what-we-do/policies/borders-and-visas/schengen/docs/communication-back-to-schengen-roadmap_en.pdf.

32 European Commission, "European Agenda on Security: Paving the way towards a Security Union," April 20, 2016, http://europa.eu/rapid/press-release_IP-16-1445_en.htm.

2.6 Keeping the spirit and substance of TTIP alive—by any name!

The new US administration has spoken loudly and clearly about its skepticism regarding multilateral trade agreements. It apparently intends to prioritize bilateral agreements that will allow it to take advantage of the strength of the largest economy in the negotiations, i.e. the strength of the United States. The administration is also signaling strong skepticism about the principles of openness that greatly benefited the vast majority of countries participating in the global economy.

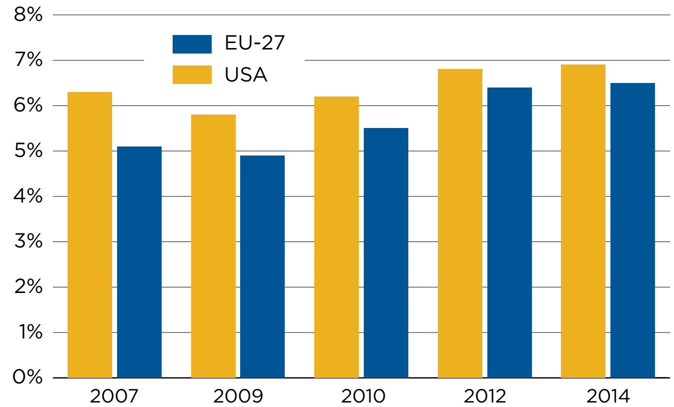
In this political environment, the TTIP as it was originally conceived will not likely survive. But, it will be a mistake that future generations of Europeans and Americans will pay for if leaders of the two side of the Atlantic do not pave the way for an agreement to take the transatlantic economic relationship forward in the future. Talks should thus be kept alive and future options open.

As a practical step, the EU and the US can enhance the role of the Transatlantic Economic Council (TEC), created at the end of the 1990s with the scope of eliminating unnecessary regulatory barriers. Gray points out: "Reinvigorating the TEC with high-level leadership and inviting European regulators to participate in negotiated rulemakings are both developments that could be integrated into a successful TTIP."[33] Keeping the dialogue open will allow a better understanding of the benefits of a free trade agreement.

The economic arguments for free trade arrangements are overwhelming. Beside the economic benefits that flow from it, free trade creates channels of communication that promote the exchange of ideas, cultural understanding, and international cooperation in solving global issues. In the words of Frédéric Bastiat, a nineteenth century French economist, "When goods do not cross borders, soldiers will."

Isolationism and protectionism, on the other hand, favor concentrated interests at the expense of the diffuse interests of everyone else. The cost of subsidizing those who are "protected" by nationalist economic policies accrue to taxpayers and consumers. History demonstrates that protectionist measures may indeed provide temporary—if costly—employment protection in some areas but, eventually, the price-distorting, artificial barriers they create succumb to the market forces that inexorably dominate trade flows over the long term.

Figure 11. Openness of EU and US economies. Transatlantic trade in goods and services a share of GDP



Source: Eurostat, World Bank.

The United States had a disastrous experience with protectionism in the 1930s when the Smoot-Hawley Act introduced tariffs in an attempt to shift demand to domestic producers in the midst of plummeting employment. The ensuing retaliatory trade war plunged the world's commercial exchange in a rapidly shrinking spiral that severely compounded the Great Depression. Following the end of World War II, the United States and twenty-two other countries came together to design a system that would lower tariffs, facilitate trade, and prevent a repeat of such policy mistakes by designing the General Agreement on Tariffs and Trade (GATT).

Since then, multilateral and bilateral agreements helped global trade to grow rapidly: from 1960 to the onset of the global financial crisis in 2007, it went from 25 percent to 60 percent of world GDP. Of the many structural shifts that changed the landscape of globalization in the last quarter century, none was bigger than the speed of China's rise. Its share of world manufacturing exports soared from 2 percent in 1991 to 19 percent by 2013—with a material acceleration since its accession to the WTO in 2001—turning the country into America's single largest trading partner. This rise of China and the associated rearrangement of entire supply chains, exposed weaknesses in the American and European economies with wages and employment in certain sectors suffering disproportionately. The change negatively affected large pockets of the middle and working classes in those sectors and the adjustment has been very slow.

33 C. Boyden Gray, "Upgrading Existing Regulatory Mechanism for Transatlantic Regulatory Cooperation," *Law and Contemporary Problems* (Vol. 78:31, No. 4, 2015), http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=4739&context=lcp.

EU-US Trade Agreement—Future Scenarios for the Short and Long Term

OPTIONS FOR THE SHORT TERM

1) Focus on regulatory cooperation outside the TTIP framework

In 2013, at the start of TTIP negotiations, nine sectors were identified for possible closer regulatory cooperation: automobiles, pharmaceuticals, chemicals, cosmetics, information and communications technology, pesticides, engineering, medical devices, and textiles.[1] Considerable progress was made in the fifteenth round of negotiations in late 2016 on the regulatory pillar, both in terms of horizontal disciplines and within sectors. Progress was also made on regulatory cooperation, technical barriers to trade (TBT), good regulatory practices with sectoral progress in regulatory compatibility for the pharmaceutical, auto, and medical devices sectors.[2] Enhanced transatlantic regulatory cooperation, both in terms of horizontal disciplines as well as on specific sectors, even outside the TTIP framework, would be a viable short- to medium-term solution that would be beneficial for consumers, SMEs, research capabilities, and efficiency of regulations. This is feasible especially in the case of pharmaceuticals, because the existing Mutual Recognition Agreement constitutes an adequate legal basis for future updates outside of the TTIP framework.[3]

2) Reinvigorating the Transatlantic Economic Council

One mechanism for achieving enhanced horizontal and sectoral regulatory cooperation would be a reinvigorated Transatlantic Economic Council (TEC). Founded after the US-EU Summit in Washington in 2007, the TEC had, until the start of TTIP negotiations in 2013, been the primary plenary forum for economic dialogue between the United States and the European Union to further economic partnership objectives and harmonize regulations.[4] It has since continued working on a technical level, but ceded its status of primary forum to TTIP negotiating parties. Reinvigorating the TEC would allow progress to be made on several key issues until TTIP negotiations are officially relaunched.

For this to be a viable solution, the TEC would need to be revised to include closer agency involvement, as has been the case with TTIP, to be able to move from being a primarily technical forum to an implementing one.

3) EU leadership in trade

While the Trump administration is reassessing its trade priorities, the EU could reassert its leadership position in international trade: ratifying trade agreements with Canada (CETA) and Vietnam, as well as pursuing bilateral trade deals with Japan and Mexico will allow the EU to remain at the forefront of international trade. In addition, the EU should take the innovative suggestions that it put forward in TTIP negotiations, i.e. an SME chapter or a reconfigured model of Investor State Dispute Settlement (a neutral, international arbitration procedure), and include it in all its future trade negotiations. This proactive strategy would allow the EU to continue to be an agenda and standard setter in international trade.[5]

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1 European Commission, "Final press conference of the TTIP 15th round of negotiations," October 7, 2016, http://trade.ec.europa.eu/doclib/press/index.cfm?id=1553.

2 Michael McKeon, "TTIP Negotiators Make Small Gains, No Major Breakthroughs in Final Round before US Elections," Bertelsmann Foundation, October 2016, http://www.bfna.org/publication/bbrief-ttip-negotiators-make-small-gains-no-major-breakthroughs-in-final-round-before-us.

3 Transatlantic Trade & Investment Partnership Advisory Group, Meeting Report, November 2016, http://trade.ec.europa.eu/doclib/docs/2016/november/tradoc_155087.pdf.

4 European Commission, "Transatlantic Economic Council: Cooperation on Innovation for Growth," November 30, 2016, http://trade.ec.europa.eu/doclib/press/index.cfm?id=1591.

5 European Commission, "Transatlantic Trade & Investment Partnership Advisory Group Meeting report," November 22, 2016, http://trade.ec.europa.eu/doclib/docs/2016/november/tradoc_155087.pdf.

OPTIONS FOR THE LONG TERM

Despite the Trump administration's preference for bilateral deals, this is not an option for the future of US-EU relations. Since trade policy is an exclusive power of the EU, the EU, not individual member states, negotiate trade agreements.

1) Rebranding TTIP: Introducing the Transatlantic Jobs & Growth Pact

TTIP negotiations could be relaunched under a different name and possibly new structure in the future. This would allow the Trump administration to present the deal as a "new and improved" version, distancing itself from the impression that it is merely putting the finishing touches on a deal negotiated by the Obama administration.

Such an approach could mean an initial setback for negotiations, but it could also be advantageous for the European partners as it would give them the chance to improve communication with their publics at home.[6] One way to rebrand and restructure TTIP would be to shift away from an emphasis on tariffs and regulatory convergence and toward a rhetoric and strategy focused on jobs and growth. This would be in line with the Trump administration's priorities and make the benefits of transatlantic cooperation more apparent to the average consumer on both sides of the Atlantic.

2) A "living" agreement

Given the progress made in some areas and the difficulties in coming to an agreement in other sectors, one could envision a "living" agreement with multiple phases. However, if negotiators only focus on the areas where there has already been significant progress, and set aside contentious issues such as ISDS and geographical indications (products that have a specific geographical origin and have qualities inherent to this specific origin), it will likely result in diminished political will for a "phase two," tackling the more contentious subjects of the negotiations in the years to come. In addition, it would take away bargaining chips for both sides as some issues that would be part of "phase one" would initially be linked to concessions elsewhere in the agreement.[7]

3) TTIP light: tariffs only

This option would leave out all regulatory convergence efforts and simply focus on cutting remaining tariffs between the United States and the EU. However, tariffs between the two blocs are already low and the main innovation of TTIP was cutting regulatory barriers. Given the Trump administration's priorities of cutting down tariffs for the United States, this option seems feasible from a US standpoint.

However, several European leaders have repeatedly said that they would not agree to a "TTIP light." Ultimately, all twenty-eight EU member states would have to agree to any form of TTIP. For that to happen, a final agreement would have to benefit all of the member states. A TTIP that focuses only on removing tariff barriers would not deliver the benefits all member states had initially envisioned and would not be politically viable.[8]

6 Tereza Novotna, "Will Donald Trump shoot down TTIP or rebrand it as the 'Trump Trade and Investment Partnership'?," LSE, September 2017, http://blogs.lse.ac.uk/usappblog/2017/01/19/will-donald-trump-shoot-down-ttip-or-rebrand-it-as-the-trump-trade-and-investment-partnership/#Author.

7 Christian Oliver, Hans von Der Burchard and Alberto Mucci, "TTIP Lite, less filling — but tastes great?," *POLITICO*, Last updated September 16, 2016, http://www.politico.eu/article/us-officials-float-plan-to-rescue-ttip-step-by-step-transatlantic-trade-and-investment-partnership-obama/.

8 Brett Fortnam, "Future of TTIP in flux as Trump has said little on trade with Europe," *Inside U.S. Trade*, November 9, 2016, in Trans-Atlantic Business Council, "TABC Comments on the Future of TTIP," November 10, 2016, http://www.transatlanticbusiness.org/news/tabc-comments-on-the-future-of-ttip/.

The mounting reaction came into the open in the 2016 US presidential race and the United Kingdom referendum. The new reality calls for a rethinking of the TTIP, without abandoning the valuable objectives and shared interests that powered it and points of agreement reached. Key features remain, in fact, valid also in the new political landscape.

First and foremost, any agreement with EU countries must be a multilateral agreement: EU member states cannot negotiate any bilateral agreement, and in fact all the competences are concentrated in Brussels that negotiate under a mandate of the member states. This rule is valid for the UK too until it leaves the Union.

Second, free trade is a powerful and valuable reality for the two sides of the Atlantic, since tariffs are only around 3 percent on average. TTIP aimed to take further steps, for example helping mainly small businesses to trade through a reduction of non-tariffs barriers, regulation in services, public procurement, geographical indications, and investor protection.

An agreement will also facilitate the ever more important cross-border e-commerce by reducing barriers to digital trade while finding the right balance between the free flow of information and privacy issues. A US-EU Free Trade Agreement can serve as a new model for the next phase of international commerce by becoming the reference treaty for international best practices in a rules-based economic partnership, focused on establishing global minimum standards and harmonizing approaches.

An agreement would provide a sizeable and yet untapped economic stimulus: because of the size of transatlantic commerce even a small percentage increase in the $5.5 trillion in commerce exchanged every year between the transatlantic markets would be a meaningful inducement to growth in both the United States and the EU. Moreover, the benefits of a new transatlantic agreement would go beyond the European Union and the United States. Both trading partners hold a significant number of bilateral treaties and a new US-EU agreement on trade, investment, and related issues would create a geographically expanded platform for third countries. Furthermore, adherence to best practices in standards, norms, and streamlined regulations would encourage greater foreign investment flows to those countries.

The recent political developments in the United States and the UK, as well as the uncertainty about election outcomes in major European countries in 2017, suggest that a new transatlantic deal should be based on the original objectives that fueled the TTIP talks.

Indeed, the United States and EU should consider a new name for the agreement to be negotiated, reflecting these changed circumstances. While much smaller, the recently approved Comprehensive Economic and Trade Agreement (CETA) between Canada and the EU could serve as a relevant example for renewed negotiations between the EU and the United States. Moreover, it is now possible that a bilateral agreement between the United States and the UK might precede the TTIP, giving examples of how some complex issues might be addressed. These developments can form the benchmarks for a new beginning in the US-EU negotiations.

CHAPTER 3

Deliverables in the Next Twenty-Four Months

Toward a Fully Integrated Internal Market

"The difficulty lies not so much in developing new ideas as in escaping from old ones."

John Maynard Keynes, *The General Theory of Employment, Interest and Money*, 1936

3.1. Summary and main recommendations

After Jean-Claude Juncker was elected president of the current European Commission in July 2014, he presented his program to the European Parliament. He called his political guidelines for the next European Commission: "A New Start for Europe: My Agenda for Jobs, Growth, Fairness and Democratic Change."[34] This program singles out ten priorities, of which five aim at higher economic growth:

› New Boost for Jobs, Growth, and Investment,

› Connected Digital Single Market,

› Resilient Energy Union with a Forward-Looking Climate Change Policy,

› Deeper and Fairer Internal Market with a Strengthened Industrial Base, and

› Toward a New Policy on Migration.

Growth will not materialize if member states do not make their economies more competitive vis-a-vis the rest of the world, i.e. more innovative. Most of the policies need to be implemented at the national level, and indeed there are countries within the EU that are at the forefront of competitiveness. However, the EU as a whole has the responsibility to set the stage for allowing member states to put forward the necessary country-specific reforms and to implement EU-wide reforms to complete the internal market.[35]

The EuroGrowth Task Force recommends:

✓ *Keep harmonizing capital markets and focus on venture financing of high growth firms.*

✓ *Reduce digital barriers through secure and affordable system of cross-border online payments and a trusted resolution mechanism.*

✓ *Expand the Services Directive and reinforce its implementation by the European Commission and the Court of Justice.*

✓ *Favor a greater diversification of energy supply through the Energy Union*

3.2. The innovation challenge

In 2015, the magazine *Forbes* claimed that only eleven of the world's one hundred most-innovative companies were located in Europe.[36] European companies are leaders in many niche industries, but they are generally lagging behind in innovation capacity, mainly because their size remains small. A telling example is that in the 1990s, Finnish Nokia and Swedish Ericsson defeated American Motorola in competition in the mobile phone industry, but today Apple and Samsung rule the world with their smartphones. The Italian Olivetti produced and commercialized the first desktop computer, but by the end of 1990s went out of the market.

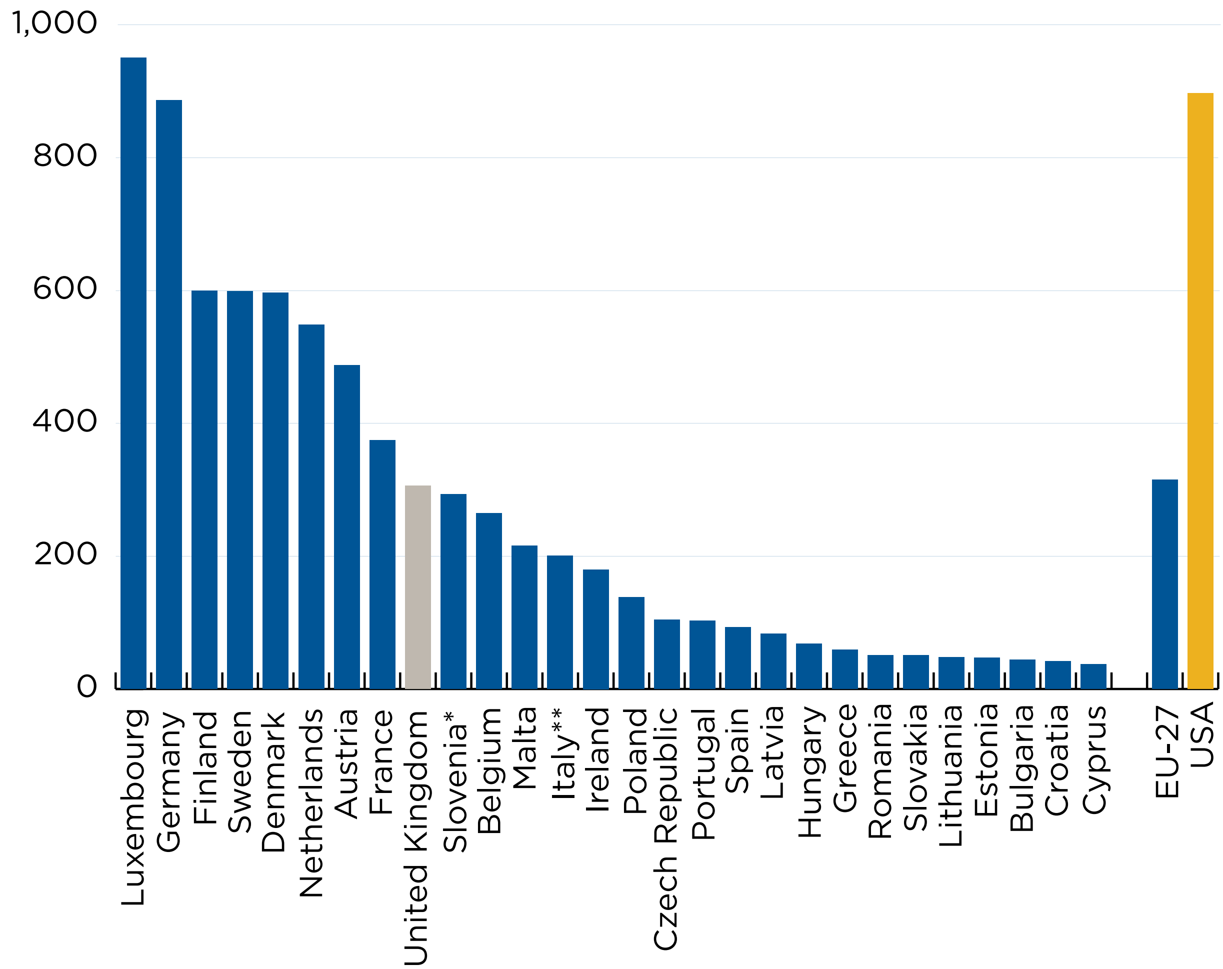
The most objective measure of innovation is patents registered per capita. The World Intellectual Property Organization (WIPO) measures patent applications by country (figure 12). The United States average is far

34 Jean-Claude Juncker, "A New Start for Europe: My Agenda for Jobs, Growth, Fairness and Democratic Change," July 15, 2014, http://ec.europa.eu/priorities/sites/beta-political/files/juncker-political-guidelines-speech_en_0.pdf.

35 Some parts of this chapter draw on Task Force member Anders Aslund and Simeon Djankov, *Europe's Growth Challenge* (New York: Oxford University Press, 2017),

36 See http://www.forbes.com/innovative-companies/list/#tab:rank.

Figure 12. Patent applications per million population



Source: WIPO database for patent data. *Data from 2011. **Data from 2014.

above the European level and only Luxembourg ranks above the United States.

The reasons for Europe's lower innovative capacity are many and complex. Needless to say, no silver bullet exists to remedy the problem. Many conditions need to be improved. Innovations require a better ecosystem for research and development (R&D) with a critical mass of many factors: top-class universities, public financing for research, risk-prone private venture capital, freedom of thinking, freedom from excessive regulation and cumbersome taxation, and freedom of movement of qualified workers.[37]

Also, an innovation hub needs access to a large market to allow successful enterprises to expand fast. Such is the American market. On the other hand, for a software startup Europe still consists of twenty-eight separate national markets.

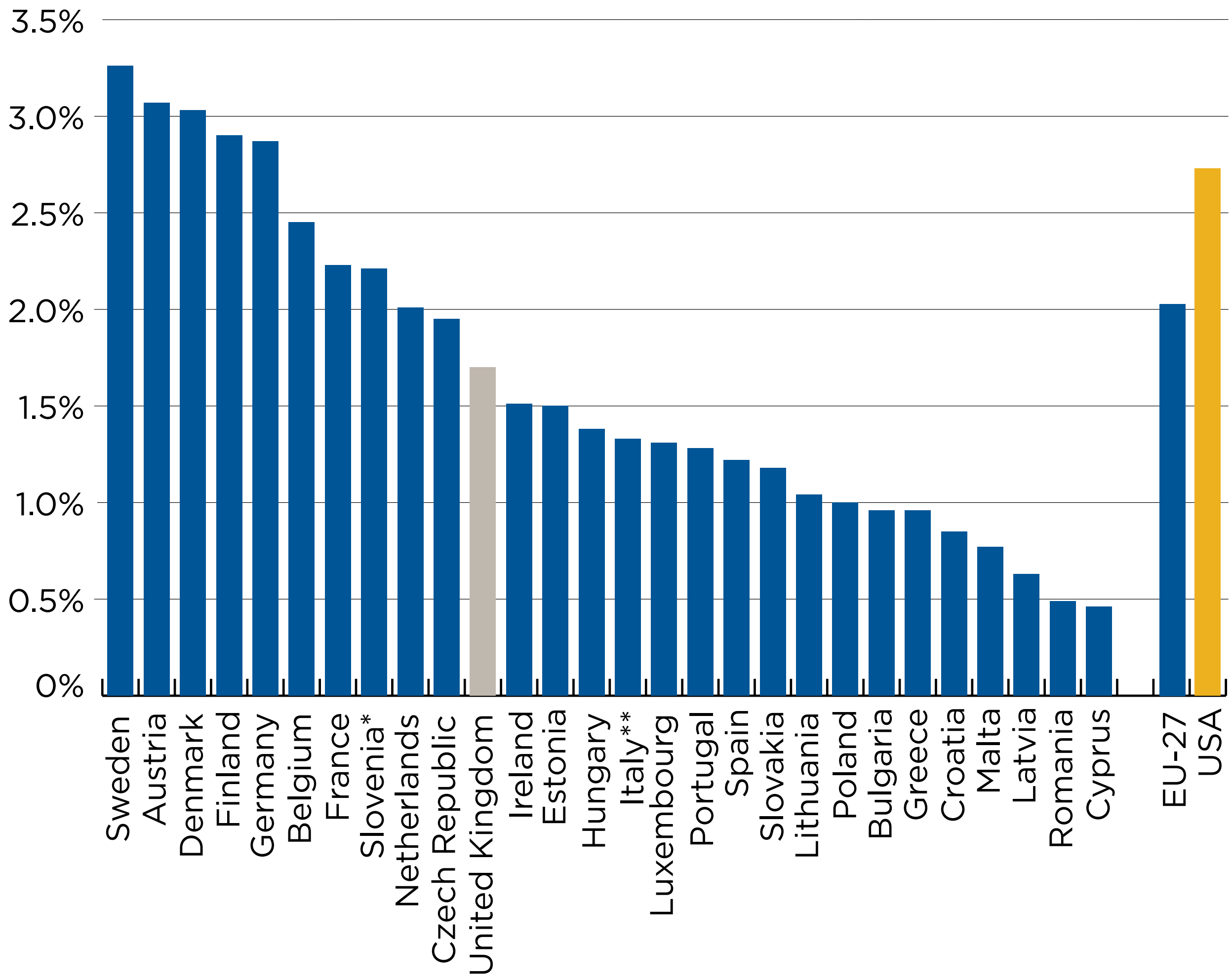
Spending is only one variable, but tells much about the low attitude to innovation in the EU as a whole. The EU has adopted 3 percent of GDP as a goal for public and private spending in R&D, but on average EU members spent only 1.8 percent of GDP in 2014. By contrast, South Korea devoted 4.2 percent of GDP to R&D, Japan 3.5 percent, and the United States 2.8 percent.[38] Europe cannot catch up if it does not increase its R&D spending substantially. To be effective, it should occur in a suitable balance of private and public spending, which is typically one-third public spending and two-thirds private outlays in the innovative countries.

Regulation is another concern. Several European countries—France, Bulgaria, and the Czech

37 Antoine van Agtmael and Fred Bakker, *The Smartest Places on Earth: Why Rustbelts are the Emerging Hotspots of Global Innovation* (New York: Public Affairs, 2016).

38 Eurostat, "Statistics Explained: R&D Expenditure," data extracted February 2017, http://ec.europa.eu/eurostat/statistics-explained/index.php/R_%26_D_expenditure.

Figure 13. R&D spending, as percentage of GDP, 2015



Source: Eurostat. *Data from 2014. **Data from 2013.

Republic—have prohibited shale gas exploration without prior scientific evaluation. Many EU members are fighting against the current redefinition of the limits of enterprises in the new sharing economy, notably Uber and Airbnb. The same is true for genetically modified foods and various biogenetic areas.

Regulation is necessary in modern economies, but it should be based on scientific analysis when the scope is to protect the health of citizens, and it should be limited to cases with a clear need for protecting consumers or addressing market failures. It also needs to be reviewed after it is in place to see whether it is having beneficial effects overall. Otherwise, regulation creates bureaucracy and hampers economic growth.

EU member states have the responsibility for most of these policies. However, the EU as a whole can favor innovation through more efficient capital markets, reducing digital barriers, completing the energy union, improving services regulation.

3.3. More capital

European Union continental countries require a greater diversity and substantial expansion of risk bearing financial instruments to complement existing banking and investment resources. With limited fiscal space in most European countries as a legacy of the great recession, and a banking system that provided too much for too long with too little control on loans, it is time to develop alternative tools.

On private financing, the size of EU venture capital is 4.45 times smaller than that of the United States, while the two economies are broadly the same size. Private equity is 2.4 times smaller and in most cases is not growth-oriented capital, but a buyout process

From Our Task Force Members

Mr. Neil R. Brown*
Director
KKR Global Institute

As the Director of Policy and Research of the KKR Global Institute, you are constantly traveling to many different economies to evaluate market developments and growth prospects. Entrepreneurship and innovation are considered key to fostering sustainable economic growth in any country. From your experience identifying best practices in fast growing economies, what can Europe learn from these economies to boost entrepreneurship and innovation?

Keep in mind that innovation and entrepreneurship are not the same concepts. At its core, innovation is about technological or process improvements that, once adopted, will collectively make an economy more productive. Those ensuing productivity gains are essential in Europe to offset declining demographics. However, innovation alone will tend to displace jobs if those technologies and processes are not also used to create new businesses. That is why entrepreneurs are vital. Entrepreneurs identify opportunities in market failures or gaps and grow businesses around them, creating jobs in the process. The most dynamic economies in the world blend innovation and entrepreneurship.

There is no one-size-fits-all formula for success. Europe is a diverse place with countries at quite different stages of economic and institutional development, so it is natural that the EU and its member states look for diverse models for successful economic outcomes. Georgia, for example, set up "one stop shops" to ease regulatory burdens on businesses in areas such as customs clearances and new business licenses. I like that example because western European regulatory burden is well-known to be a special challenge for small business, and that creates a high barrier to entry for entrepreneurs. Start-ups have very limited manpower and money, so policy should encourage them to spend both of those vital resources on originating ideas and building businesses around those ideas, rather than managing regulatory bureaucracy.

No country has a monopoly on good ideas. The European Union should be open to ideas from developed and emerging economies alike, choosing models based on the particular challenge that needs to be solved. Many European states have many component pieces for entrepreneurial edge, but the whole is less than the sum of the parts. Innovation and entrepreneurship feed off a local ecosystem of market needs and strengths, from education to finance. Israel is a great example. The government invests heavily in Israelis' technical education due to market isolation and for security reasons. That creates a cadre of highly-capable individuals in areas like IT, agriculture, and water and world-class universities. Government seeded both finance (VC) vehicles and companies directly to help jump-start the industry in the 1990s. Now, the ecosystem feeds on itself as young Israelis see entrepreneurship as a highly attractive area and there is a good availability of early stage private capital. The result is a country that punches well above its weight on the global economic stage in the tech start-up area.

What lessons can Europe learn from the United States to reignite a culture of entrepreneurship in Europe and create a better environment for aspiring entrepreneurs?

I like that you said "reignite" because, historically, Europe has produced some of the most innovative industrial companies in the world. Europe today also has a lot of entrepreneurs in the form of small shop owners that provide important services to their communities. In that respect, Europe has largely done better than the United States in supporting a culture of small business. However, Europe has more recently under-performed in producing new fast-growing companies. In the United States, those companies frequently rely on an underlying innovative technology. Europe's lag in that is not for lack of education, creative thinkers, or hard workers—just look at the impressive number of Europeans succeeding in Silicon Valley.

In the United States, the entrepreneurship culture embraces failure. Entrepreneurs anywhere love market failures. Finding a better way to do something, or even avoid doing that thing altogether, and then building a business around that idea it is the hallmark of an entrepreneur. More uniquely though, Americans look favorably upon professional failure in pursuit of new ventures. We encourage individuals that take a risk to try a new idea, fall short, and get up to try again. Professional failure is not something that is shameful or a demerit on one's CV. Entrepreneurship is inherently risky, and the willingness to take on that risk is as much a social decision as it is an economic decision.

Culture is both the most critical component to encouraging entrepreneurship and the most elusive element for government to support. But, government can help both in soft ways, like publicly celebrating entrepreneurs and seeding business incubators associated with universities, and in more concrete ways like easing bankruptcy rules. I already mentioned the Israeli example. I also like an emerging example in Switzerland. Switzerland is already a rich country with even richer technical capacity, but it lags in reaching its potential for fast-growing tech companies. Through an initiative called digital Switzerland, federal and canton governments, corporates, and universities are working together to establish Switzerland as a tech-hub in the heart of Europe. Coordinated initiatives target to areas like attracting more international capital, regulatory/tax incentives, hands-on help by corporates, and a better hand-off from universities into the private economy.

The European Commission has introduced a "Entrepreneurship 2020 Action Plan." In addition to creating a "culture of entrepreneurship," what do you consider vital to foster entrepreneurship in Europe?

Of course, culture alone is not enough to get the step-change in entrepreneurial activity envisioned by the EU. Entrepreneurs need access to capital to scale their businesses beyond the venture stage. Conservative investors like pension funds typically see such investments as too risky. Investors with higher risk appetite, looking for higher yields, can be reluctant to invest behind scaling SMEs because they don't see the market opportunity with sluggish European growth, creating a negative loop. Lack of growth capital pushes European start-ups to strive for revenue before scale, so we naturally see slower growing businesses in Europe. Incidentally, this is an area where Brexit gives me some concern because London is by far in the lead in Europe as the home to private growth capital.

The EU's action plan has useful vision, and the fruition of that vision will depend on substantive actions taken in its pursuit. That requires improving current regulatory concerns—I mentioned bankruptcy and would also note the need for more flexible labor laws.

The EU also needs to look at what's next though because innovation and entrepreneurship are always about change. I'd encourage them to think carefully about the relationship between the digital policy agenda and entrepreneurship. European nations successfully led industrialization and have built successful service sectors, but the current wave of change is around digitalization. IT has already transformed communications and finance, and now it is doing the same in manufacturing, services, and retail. That means that entrepreneurial small- and mid-sized companies will be even more important for job creation as automation displaces workers. But, it also creates an opportunity for new companies. Economy-wide digitalization will spur creation of a new generation of tech-enabled giants enabled by big data and processing power. Europe can't afford to miss that tech wave.

* Disclaimer: This interview expresses the personal views of the author and not necessarily those of KKR.

that does not add much to the long-term prospect of a firm. The bond market is 1.44 time smaller, and only big companies have access to it.[39]

All in all, 80 percent of finance comes from the traditional banking system, the opposite of what happens in the United States. This model has worked so far because a widely dispersed system of local banks was able to make loans on the basis of proximity to the client, often a small business with a local market. Following the higher capital and regulatory requirements as a consequence of the financial crisis, along with the large number of non-performing loans, in most European countries credit shrank and this model is no longer viable.

39 BlackRock, "Addressing Market Liquidity: A broader perspective on today's Euro corporate bond market," August 2016, https://www.blackrock.com/corporate/en-sg/literature/whitepaper/viewpoint-liquidity-bond-markets-broader-perspective-february-2016.pdf; Pitchbook, 2016 "Annual European PE Breakdown," https://pitchbook.com/news/reports/2016-annual-european-pe-breakdown.

A broader and more diversified financial system is necessary to finance economic growth in European countries, but currently markets are fragmented with different rules on private equity, venture capital, initial public offerings (IPOs), etc. An internal capital market can ease investment and allow firms to become stronger and bigger, ultimately creating jobs. The Capital Market Union (CMU) is a process that can deliver short-term goals while pursuing long-term comprehensive harmonization.[40]

On public financing, public budgets used to finance public infrastructure extensively in the past, and state-owned enterprises accounted for a significant portion of investment. During the crisis, most countries cut public investment dramatically to reduce the large fiscal deficits caused by the drop in economic activity. The European Fund for Strategic Investment (EFSI) is a tool that can boost investment in infrastructure and innovation, by risk sharing and leveraging EU facilities over and above the national budgets.

3.3.1 The Capital Market Union

Although the title of the EU initiative invites parallels with the EU's banking union, the CMU is instead a long-term structural reform process—thirty-three measures focusing on twenty different objectives in six capital market areas—aimed at integrating national capital markets and unlocking cross-border investments in the European Union (table 5). Both a long-term view and short-term deliverables are necessary.

> *1. Maintain the long-term view: keep harmonizing capital markets, regulation, and supervision, while introducing politically difficult reforms.*
>
> The harmonization of capital markets is a constant, long-term process and aims at transforming fragmented national markets into a single capital market comparable in depth and efficiency to that of the United States. At the same time, it is imperative to instill a sense of urgency given that the politics of EU's harmonization is always slow and difficult.

The progress risks to be slow on some notoriously difficult agendas, such as harmonization of national insolvency laws or cross-border differences in tax treatments of different financial products. These represent fundamental obstacles to capital market integration, but are difficult to reform as these differences are deeply-rooted in national legal systems and considered as pillars of sovereignty. However, it is important to maintain steady progress in identifying and harmonizing the less sensitive aspects of the national tax and insolvency regimes.

One difficult area where the EU achieved major progress in the last decade was harmonization of accounting standards based on International Financial Reporting Standards (IFRS). However, these rules are still too complex and costly for the small and medium enterprises (SMEs) that are at the center of the CMU initiative. Accepting a simplified IFRS version for SMEs would provide the EU with a single reporting language, which would certainly ease cross-border capital market integration.

2. Upgrade to CMU 2.0: introduce a single European supervisor and allow for national specialization.

Brexit may encourage the European Commission to upgrade the CMU at its mid-term review this year. The UK was the member state most vehemently opposing steps toward supra-nationalization, i.e., shifting supervisory responsibilities from national authorities to the European Securities and Markets Authority (ESMA) and its related European Supervisory Authorities (ESAs). Such an upgrade would provide a breakthrough element that is currently missing and that would correspond to the introduction of the Single Supervisory Mechanism for the banking union. More importantly, unified supranational supervision relying on a single database, multinational teams, and a single centralized authority could overcome the fragmentation arising from different implementation of harmonized rules by national supervisory authorities.

An inevitable consequence of integrated capital markets is specialization of certain activities in financial centers. Some member states will have

40 For an overview on the progresses and challenges of the Capital Market Union see Nicolas Veron, and Guntram B. Wolff, "Capital Markets Union: A Vision for the Long Term," Bruegel, April 23 2016, http://bruegel.org/2015/04/capital-markets-union-a-vision-for-the-long-term/; Karel Lannoo, "Eliminating the cost of non-Europe in capital markets," Centre for European Policy Studies, https://www.ceps.eu/system/files/No32%20KL%20Upgrade%20CMU.pdf; Orçun Kaya "Capital Markets Union: An ambitious goal, but few quick wins," EU monitor, Deutsche Bank Research, November 2, 2016, https://www.dbresearch.com/PROD/DBR_INTERNET_EN-PROD/PROD0000000000371611/Capital_Markets_Union%3A_An_ambitious_goal,_but_few_.pdf; Zdenek Kudrna, "The EU'S Capital Markets Union: The Next Step in Gradual Integration" Atlantic Council, November 2, 2016, http://www.atlanticcouncil.org/publications/reports/the-eu-s-capital-markets-union; and European Commission, "Action Plan on Building Capital Markets Union: Overview of progress achieved and next steps," September 30, 2015, http://ec.europa.eu/finance/capital-markets-union/index_en.htm.

Table 5. Capital Markets Union (CMU) progress

Headline	Focus on	Action	Outcome	Progress
Financing for innovation	Support venture capital and equity financing	Pan-European venture capital fund-of-funds	+ €	
		Revise legislation on EU venture capital/social entrepreneurship funds	§	
		Tax incentives for venture capital and business angels		
	Information barriers to SME investment	Strengthen feedback given by banks declining SME credit		
		Map best SME-supporting practices across the EU		
		Develop Pan-European information systems		
	Innovative forms of corporate financing	Report on crowdfunding		
		Develop EU framework of loan origination by funds		
Raising capital	Strengthen access to public markets	Proposal to modernize the Prospectus Directive	§	
		Reduce barriers to SME entry to public markets		
		Review EU corporate bond markets (liquidity)		
	Support equity financing	Address debt-equity bias in national tax systems		
Investing for long term	Support infrastructure investment	Adjust insurance rules for infrastructure investments		
		Adjust bank capital rules for infrastructure investments		
	EU financial services rulebook	Review cumulative impact of the financial reform		
Retail and institutional investment	Choice and competition in retail	Proposal on retail financial services and insurance		
	Retail investors protection	EU retail investment product markets assessment		
	Support saving for retirement	Assess the case for European personal pensions		
	Institutional investors and fund managers	Assess prudential treatment of private equity in insurance		
		Assess barriers to the cross-border distribution of funds		
Leveraging banking capacity	Strengthen local financing networks	Possibility for the national authorization of credit unions	§	
	Build EU securitization markets	Simple, transparent and standardized securitizations	§	
	Bank financing	EU framework for covered bonds for SME loans		

Cross-border investing	Barriers to cross-border investment	Report on barriers to the free movement of capital		
	Cross-border market infrastructure	Securities rules/third-party effects of claims' assignment		
		Removing barriers to cross-border clearing & settlement		
	Convergence of insolvency	Insolvency law proceedings	§	
	Cross-border tax barriers	Rules for relief-at-source from withholding taxes		
		Tax obstacles to cross-border pension/insurance investment		
	Supervisory convergence and capacity	Supervisory convergence for the single market for capital		
		European Supervisory Authorities funding and governance		
		Assist to Members to support capital markets' capacity	§	
	Capacity to preserve financial stability	Review of the EU macroprudential framework	§	

Legend: Progress to date: red = initiative is yet to start, typically after completion of related activity; yellow = initiative has started and there are clear next steps planned; green = initiative has been completed and no further follow-up is planned. Expected outcome: § = legal change; = report (no n-binding recommendations, soft law or research); € = seed capital.

to accept that their firms and investors will go for capital and investment opportunities to other countries that are better equipped to become financial centers due to their size, location, language, legal tradition, education, or any other relevant comparative advantage. National governments should not strive to replicate every aspect of capital markets in every EU country and should give up a gate-keeping role.

3. Secure the shorter-term benefits: revive securitization with the Simple, Transparent, and Standardized (STS) rules and focus on venture financing of high-growth firms

The EU securitization market was sound even during the crisis, and default rates were negligible compared with the United States. Yet, between 2008 and 2014 mortgage-backed securities in the EU declined by 41 percent, asset-backed securities by 19 percent, which is about double the decline in the United States. Since many of these securities turned toxic due to the extravagant complexity of their structure, the revival is led by new global rules that emphasize simplicity, transparency, and comparability.[41] The EU is introducing this change under the label of STS securitization, the precise parameters of which are currently being negotiated; it is expected to become law in 2017. The new framework is being complemented by recalibration of prudential rules for banks and insurance companies that will ease the regulatory treatment and corresponding capital requirements for STS-compliant securitized products. This could deliver material economic benefits in the next few years, especially when the European Central Bank starts to reduce its liquidity injections and interest rates consequently increase, as the revival of securitization may allow commercial banks to free up their balance sheets and allow further lending.

3.3.2. The European Fund for Strategic Investment (EFSI)

A complement to the Capital Market Union is the EFSI, an EU initiative launched jointly by the European Investment Bank Group (EIB) and the European Commission to help overcome the current investment gap in the European Union by mobilizing private financing for strategic investments. At the end of 2016, after a year and a half of operations, the EFSI had mobilized potentially more than 160 billion euros of investment on the basis of projects approved by

41 Basel Committee on Banking Supervision and the International Organization of Securities Commissions, "Margin requirements for non-centrally cleared derivatives," March 2015, http://www.bis.org/bcbs/publ/d317.htm.

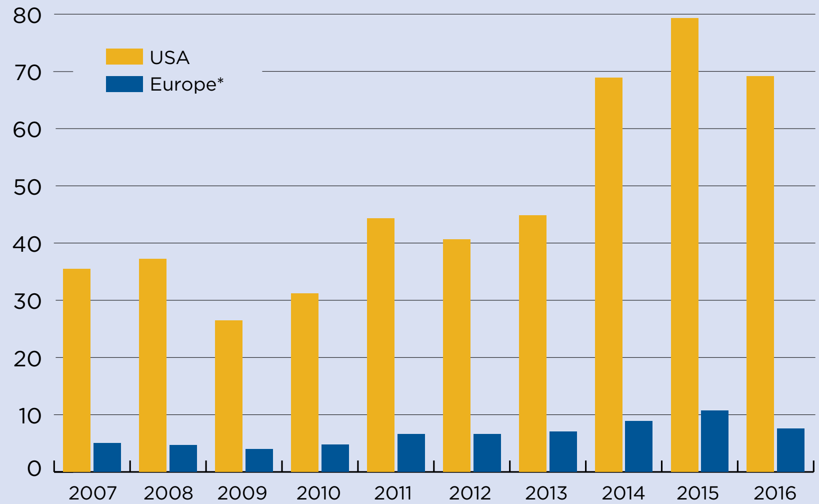
Venture Capital in Europe: State of Play

This box outlines why European venture capital (VC) falls far short compared to the United States, discusses positive signs for VC in Europe, and describes efforts and reforms currently underway to develop a dynamic European equity market that fosters growth by financing the most innovative ideas.

Weaknesses

European VC suffers from fragmentation, undersized funds, lack of private capital, excessive and unfavorable regulations, dependence on public investment, and an often risk-averse culture. These factors stymieing VC in Europe are all interconnected and mutually reinforcing.

Figure 14. Venture capital deal value (in billions of dollars)



Source: Pitchbook Europe.
*Includes EU member states, other european countries. Excludes UK.

The European Union is still not one large VC market; instead the EU is made up of twenty-eight markets with different regulatory regimes. To market their funds across different EU member states, many VC fund managers have to pay a fee and register their funds in each EU country.[1] National corporate tax systems throughout the EU actively discourage equity financing and incentivize debt financing instead. For funds operating across EU borders, double taxation remains a serious obstacle.[2] EU-wide regulations, such as Basel III and Solvency II, impede equity investments by banks and large insurance companies.[3] As a result of this fragmented VC market, today's typical European VC fund only operates in one EU member state and is much smaller than its US competitors.[4]

The European VC funds' smaller size and scope make the funds a less attractive investment target for large international institutional investors such as sovereign wealth and pension funds. The lack of capital, especially private funding, has made European VC funds dependent on government financing. European governments provide more than 30 percent of the total VC investment in Europe.[5] In addition, Europe's entrepreneurial culture still does not promote the same risk-taking attitude generally considered vital for the success of American VC hubs.

Positive Signs

Despite the complex set of obstacles European VC is facing, there are many reasons to be optimistic about the future of the VC industry in Europe.

Europe already meets many of the conditions necessary for a successful VC and start-up environment. The continent's excellent research universities are producing world-class scientists, engineers, and programmers

1 European Commission, "Capital Markets Union: New Rules to Support Investment in Venture Capital and Social Enterprises," July 14, 2016, http://europa.eu/rapid/press-release_IP-16-2481_en.htm.

2 European Commission, "Commission Proposes Major Corporate Tax Reform for the EU," October 2016 http://europa.eu/rapid/press-release_IP-16-3471_en.htm.

3 Boston Consulting Group, "The State of European Venture Capital," BCG Perspectives, https://www.bcgperspectives.com/content/articles/alliances-joint-ventures-growth-state-of-european-venture-capital/?chapter=3.

4 European Commission, "Commission and EIF Seek Pan-European Venture Capital Fund-of-Funds Managers," November 8, 2016, http://ec.europa.eu/research/index.cfm?pg=newsalert&year=2016&na=na-081116.

5 Ibid.

capable of building companies to rival their Silicon Valley competitors.[6] Europe's consumer market is bigger than the American one.[7]

Europe's VC and entrepreneurial landscape is maturing, illustrated by the rise of major VC hubs such as London, Berlin, Paris, and Stockholm. European entrepreneurs are increasingly returning home, after gaining invaluable expertise in the United States. This expertise from Silicon Valley will also be vital for the next generation of European founders.

In 2016, European VC funds raised €8.8 billion, the highest total in over a decade.[8] An increasing number of US investors are participating in European VC deals. In 2016, US investors took part in 63.8 percent of all European VC deals.[9]

Possible Solutions

To address the European VC market's fragmentation, its undersized funds, the lack of private capital, and the dependence on public funding, VC industry insiders and experts have long championed the idea of establishing a pan-European VC fund-of-funds (FoF). The rationale behind a European FoF is to create a very large fund that attracts more private institutional investors, such as pension and sovereign wealth funds, from Europe and the rest of the world. An FoF could boost the size of VC funds across Europe and unlock cross-border investment.[10] To overcome the dependence on public funding, governments must only act as first movers to catalyze financing by private investors.[11] To be sure, a European FoF would only be an interim solution until the VC ecosystem is self-sufficient

Responding to expert advice, the European Commission has announced that it will launch an FoF with an initial investment of up to €400 million.[12] The EU investment is limited to make up no more than 25 percent of the FoF with the remaining 75 percent coming from private investors. Simply put, if the EU were to contribute €400 million, the FoF would reach a total of at least €1.6 billion.

In addition to the pan-European VC fund-of-funds, EU member states are working to provide smarter government support that focuses on cross-border investments.[13] In December 2016, France and Germany created a joint €1 billion fund specifically targeted to help start-ups scale-up their operations more efficiently and quickly to be able to compete with their better funded US counterparts.

As part of the its Capital Markets Union Action Plan, the European Commission is addressing some of the problems outlined above. The Commission is reforming its European Venture Capital Funds (EuVECA) and European Social Entrepreneurship Funds (EuSEF) regulations that enable VC managers to market their funds across the EU.[14] First, to make cross-border marketing cheaper, VC managers will not have to pay fees to register their funds in each EU member state anymore. Second, VC funds of all sizes can now take advantage of the EuVECA and EuSEF labels to market their funds. Third, VC managers can now invest in a much broader

6 Gail Edmondson, "Money, Money, Money: Europe Has the Science but Lacks Venture Financing to Create Technology Champions," Science Business, November 14, 2013, http://sciencebusiness.net/news/76334/Money-money-money-Europe-has-the-science-but-lacks-venture-financing-to-create-technology-champions.

7 Matthias Verbergt, "New Hotbed for Tech Startups: Europe," Wall Street Journal, January 28, 2017, https://www.wsj.com/articles/new-hotbed-for-tech-startups-europe-1485604802.

8 Ibid.

9 Ibid.

10 PitchBook, "3Q 2016 European Venture Industry Report," October 17, 2017, http://pitchbook.com/news/reports/3q-2016-european-venture-industry-report.

11 Boston Consulting Group, "The State of European Venture Capital," October 15, 2015, https://www.bcgperspectives.com/content/articles/alliances-joint-ventures-growth-state-of-european-venture-capital/.

12 European Commission, "Commission and EIF Seek Pan-European Venture Capital Fund-of-Funds Managers," November 8, 2016, http://ec.europa.eu/research/index.cfm?pg=newsalert&year=2016&na=na-081116.

13 KPMG Enterprise, "Venture Pulse 4Q 2016 - Global Analysis of Venture Funding," January 12, 2017, https://assets.kpmg.com/content/dam/kpmg/xx/pdf/2017/01/venture-pulse-q4-2016-report.pdf.

14 European Commission, "Capital Markets Union: New Rules to Support Investment in Venture Capital and Social Enterprises," July 2016, http://europa.eu/rapid/press-release_IP-16-2481_en.htm.

spectrum of companies. The EU is also reforming its corporate tax policy to reduce the "debt-equity bias" and, in turn, stimulate demand for market financing.[15]

European Investment Fund (EIF), the subsidiary of the European Investment Bank that specializes in Venture Capital, Private Equity, and SME Financing, has established a successful European network of VC partners. By the end of 2015, the EIF had 9.9 billion euros committed to venture capital and private equity in Europe. As of the end of 2014, the fund directly contributed about 12 percent of all venture money raised in Europe and funds that had the EIF as a key limited partner were responsible for about 45 percent of all European venture money raised. Between 2011 and 2015, the EIF committed 2.3 billion euros to some 144 UK-based venture firms, which amounts to about 37 percent of all venture funding raised in the UK during those years.[16]

15 European Commission, "Commission Proposes Major Corporate Tax Reform for the EU," October 25 2016, http://europa.eu/rapid/press-release_IP-16-3471_en.htm.

16 European Investment Fund, "EIF in the United Kingdom," February 2016, http://www.eif.org/news_centre/publications/country-fact-sheets/EIF_Fact-sheet_UK.pdf.

the EIB Board and the EFSI Investment Committee. These 160 billion euros are supported by 30 billion euros of EIB group financing backed by the EFSI. Thus far, approximately two-thirds of total investment mobilized by EFSI derives from the private sector.

The key element of this initiative is additionality, which lies in the increased capacity given to the EIB to take higher risks when supporting projects. While the EIB Group has been supporting higher risk (i.e., Special Activity-type) projects for a long time, EFSI provides EIB with additional risk-bearing capacity to drastically increase the scale of these operations (circa +400 percent), in number, amount, and complexity to help accelerate and increase investment in Europe.

The EIB is also multiplying its support to innovative companies, or to infrastructure projects such as off-shore wind parks. The EIB was supporting such activities in the past, but not with the same volume. Without EFSI, the EIB would have quickly reached its risk capacity limits and would have only financed a very limited number of those projects. With the support of EFSI, the EIB can support a larger number of these risky "Special Activity" projects, which are deemed additional by the EFSI Regulation.

The special activity feature of an operation is mostly related to the riskiness of the underlying project. In other words, a senior lending position does not automatically imply a low-risk level. Likewise, a junior position does not automatically imply a high risk, notably if the company/project is of a strong investment grade nature. Therefore, EFSI pushes the EIB to look for riskier projects, with the possibility to support projects with sub-investment grade ratings. In order to attract private investors, the EIB is, where possible, using EFSI to be in a subordinated position to cover part of the risks (for instance by taking a riskier part of the operations or by providing longer maturities than the other investors) and facilitates/crowds in private sector investments.

All in all, if the process of the Capital Market Union is speeded up and the EFSI fully exploited, EU countries could become the most attractive places to invest in companies, especially SMEs. There are thousands of companies that are world leaders in their niches and are fully integrated in the global supply chain, but do not have a strong and balanced financial position that allows them to fully benefit from their strengths. With more and diversified sources for capital, these companies can also gain additional competences to penetrate new markets.

3.4. Fewer digital barriers

Suddenly, a great new market for digital services has erupted. The focus is on online trade, but since the EU's single market does not apply to this new market, it has been fragmented into twenty-eight national markets. Travelers in Europe need to buy a Netflix license for each country they visit, and delivery services for online trade are seriously disrupted.

The European Parliamentary Research Service has assessed the cost of the absence of an EU digital single market for 2015–19 at €415 billion or 3 percent of EU GDP per year.[42] This amount will rise with the quick expansion of digital services. This European drawback also impedes all kinds of innovations.

The beneficiaries of this fragmentation of the European digital market are the sellers of telecommunications services, who reap monopoly rents. The longer these

42 European Parliamentary Research Service, "Mapping the Cost of Non-Europe, 2014-19" April 2015, http://www.europarl.europa.eu/thinktank/en/document.html?reference=EPRS_STU(2015)536364.

From Our Task Force Members

Mr. Thomas Barrett
Permanent Representative of the European Investment Bank
and Minister of the European Union Delegation to the United States

In a nutshell, what's the purpose of EFSI?

Increasing investment in Europe through smart use of public resources is the core of the European Fund for Strategic Investments that is being implemented to boost the European economy and to improve the investment levels that prevailed prior to the Great Recession. As Europe needs substantially more private investment, the European Commission and the European Investment Bank created EFSI to accelerate additional capital investment of up to EUR 315 billion between 2015 and 2018. Investment commitments to date are firmly on track to reach the target of EUR 315 billion by 2018; as a result, an increased target of EUR 500 billion by 2020 is now proposed.

How does EFSI fit into the Investment Plan for Europe?

EFSI is the core Pillar of the Investment Plan for Europe. Its objective is to increase strategic private and public investment which will accelerate economic growth throughout the entire twenty-eight countries of the EU. The priority sectors for investment are transport, energy and digital infrastructure; education; health; innovation, research and development; information and communications technology; also investments in the expansion of renewable energy and resource efficiency; environmental, urban and social projects; as well as finance for small and midcap companies.

This EFSI initiative is supported by the European Investment Advisory Hub, the Second Pillar of the Investment Plan. The hub provides advisory services notably for financial institutions and in support of public policy programs. The Advisory Hub is critical to the success of the overall program, as it is required to accelerate the development of project pipelines, as the current pipeline of mature and bankable projects appears rather weak.

The Third Pillar of the Investment Plan for Europe is the implementation of structural reforms to benefit member states by improving the business and investment climate though regulatory reform and improved policy implementation. Although EFSI will facilitate the financing of riskier projects, further improvements to the business and economic environment throughout Europe are also crucial. The European Commission's priority initiatives, agreed with the EU member states, are to expand access to and deepen the Single Market such as the Capital Market Union, the Digital Single Market, and the Energy Union.

What Type of Risk is the EIB covering with EFSI?

Under EFSI, the EIB has developed various new products for use of the additional EFSI risk-bearing capacity appropriate to higher risk investments. These include subordinated debt, equity, and equity-type risk sharing in order to address the increased demand for equity and risk-based financing. EIB has reviewed its credit risk policy as well as eligibility conditions to allow for increased flexibility.

In order to catalyze private investment, the EIB is, where possible, using EFSI in a subordinated position in order to cover part of the risks, for instance by taking a riskier part of the operations or by providing longer maturities than the other investors.

EIB is currently designing and implementing new risk-sharing instruments for cooperation, for instance, with national promotional banks. It is also extending its use of EU budgetary funds by blending with EIB's own resources to establish revolving funds or to lower the cost of finance. This is a particularly important innovative approach to using public finance and budgetary resources in support of economically viable investments with private sector participation.

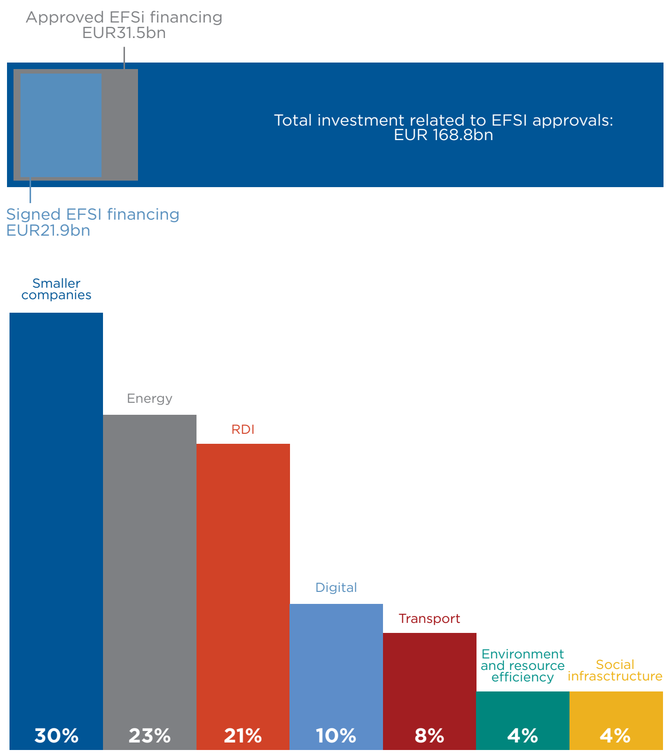
Market failures are often structural. While economic shocks and cyclical developments can create additional frictions that further aggravate some market-failures and hamper the capability of the financial markets to efficiently allocate finance to investment, the Great Recession has highlighted additional areas here investment gaps persist because the risk absorption capacity of the financial sector has become unduly constrained.

Private financiers are incapable or unwilling to support riskier activities or the high premium that would be required to remunerate for this risk makes the financial costs of the operations too high for the project to be financially viable, while its economic impact for the society is positive.

Overall, these market failures and distortions result in limited risk finance to economically viable investment projects and smaller companies, especially innovative SMEs and companies in their early stages These are the type of investment situations, which EFSI was meant to address since it allows the EIB to step up its efforts by engaging in greater volumes of higher risk operations than it would do otherwise.

In addition, at a structural and strategic level, the EU has, in line with global efforts, overhauled regulation and supervision to restore financial stability and market confidence. These reforms are making the European financial system more stable and resilient and improving the conditions for investment and economic growth.

Figure 15. The EFSI



Source: European Investment Bank.

rents are allowed to persist, the more they will grow, and the stronger the resistance to a deregulation of the digital market will become from these narrow but strong, vested interests. Therefore, an early unification of the European digital market is vital. Since this is trade policy, it is subject to EU jurisdiction. Indeed, the formation of a single European digital market is one of the priorities of the current commission.

Fewer digital barriers mean a number of actions including the simplification of licensing, the creation of an efficient framework for European copyright, the establishment of a secure and affordable system for cross-border online payments, and a resolution mechanism for cross-border online transactions.

3.5. Fewer, and better, services regulations

All modern economies are dominated by services, and so is the case with the European economy. The share of services in GDP averages over 70 percent, ranging from 87 percent in Luxembourg to 52 percent in Romania. Even so, the services trade is limited, amounting to a mere 28 percent of total EU mutual trade, in stark contrast to the ubiquitous trade in goods.[43]

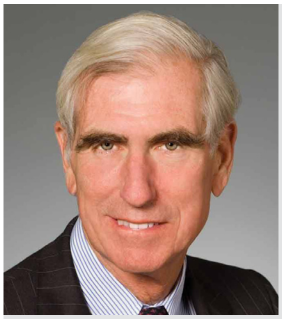
We would expect services trade to be much more limited than trade in goods because many services are inherently local, such as a haircut, but a major reason for this very small trade volume is that protectionism persists in the services trade through differing national regulations.

The EU has been surprisingly slow in its attempts to open up services trade. Only in 2006 did it adopt the Services Directive, which was the first attempt to do away with hindrances in the services trade. It aimed at facilitating companies from EU member countries to set up shop in another EU country, and it insisted that all EU countries should establish one-stop licensing, so that a company moving into another market would not suffer from excessive bureaucracy.

Nevertheless, the Services Directive suffers from many shortcomings. It does exclude many services, notably financial services, transportation, postal services, telecommunications, healthcare, and water supply. It also contains many loopholes, and its vagueness has invited member countries to disregard it. It needs to

43 European Commission, Eurostat database page, last accessed February 21, 2017, http://ec.europa.eu/eurostat/data/database.

From Our Task Force Members



The Hon. C. Boyden Gray
Former US ambassador to the European Union
Founding partner, Boyden Gray & Associates, PLLC

You served as the White House Counsel to President George H.W. Bush. In this capacity, you worked with the Presidential Task Force on Regulatory Relief. What is the most important lesson from your work on the president's task force for policy makers aiming to enact better regulation in the European Union?

The most important lesson I learned to enact better regulation is to have the highest ranking official possible to head the reform effort. I say that because many of the problems arise out of simple bureaucratic turf concerns, and it takes the boss to break it down. So, I do not think you need the president of the European Commission or the US president to be involved, but you do need the vice-president (in the case of the United States) or someone who is very high ranking in the European Commission. One name that comes to mind on the European side is Alexander Italianer (currently serves as the European Commission's secretary-general). I worked with him repeatedly during my time serving as the US ambassador to the EU. He is very knowledgeable about regulatory reform, having chaired the European Commission's Group of High-Level National Regulatory Experts in the past. Someone with his stature and knowledge could push for more effective regulatory reforms at the EU level. The experience in America has been that when the vice-president takes it over, it works. When you do not have the VP ensconced inside the West Wing, it does not work because the bureaucrats just do not respond. And you cannot have someone trying to run the show, who is the same bureaucratic level as the people he is trying to order around. In other words, you cannot have the director of OMB (Office of Management and Budget), as an example, by himself trying to get a fellow cabinet member to do something. If he can call on the vice president as back-up, then he can get something done. Vice President Bush (George H.W. Bush was US Vice President from 1981-89) served as chairman of the Task Force on Regulatory Relief at the beginning of the Reagan years, which was very successful and Vice President Bush was, of course, a business man in the first half of his life and understood regulation extremely well and was qualified and knowledgeable to lead the task force. But having him there to call on to break the tie and to get some action was absolutely essential.

After becoming president of the European Commission in 2014, Jean-Claude Juncker famously said: "I want a European Union that is bigger and more ambitious on big things, and smaller and more modest on small things." What would you add to this statement?

The premise of the question is misleading because it is not the government that will be the driver of new job creation. The main driver will always be the private sector. So, one thing I would add is that the EU needs to foster a stronger private sector response to the challenges to European growth. For example, the major source of capital in the EU are banks. In the United States, we have multiple sources of financing: there is venture capital, equity funds, hedge funds, and many corporations issue their own commercial paper without having to deal with banks. The United States has a very robust and liquid capital market, and that is something Europe really needs to move towards. Europe has to get rid of its inhibitions, get rid of the rules that make it hard for the private sector to create more growth and jobs. There are quite a few rules and regulations that, for instance, hurt financing for start-ups, which is where the jobs are created, and these rules need to be studied and eliminated. That is what I would say.

International regulatory cooperation is a key component to cutting red tape, improving the ease of doing business, and fostering economic growth. What specific steps should the EU and the United States take to improve their regulatory cooperation, and in turn boost transatlantic commerce and prosperity on both sides of the Atlantic?

There are three important steps that the EU and United States should take. First, as mentioned in question one, it is vital to raise the level of political accountability and attention for EU-US regulatory cooperation. This is achieved by getting a very high official at the level of the US vice president on both the EU and US side into the game. In turn, the vice president can drive the agenda, which was done successfully in this country under Reagan. There are studies that back this up. Bertelsmann did a study in conjunction with Johns Hopkins University that made the same observation that you have to elevate the political accountability to the highest possible level on both sides to achieve significant progress. As a second step, the United States and the EU have to include all sectors of the economy into negotiations about regulatory cooperation. For example, financial services and energy are currently not included in the TTIP negotiations. Both financial services and energy are key drivers of economic growth on both sides of the Atlantic, they are not the only ones but they are certainly indispensable. Thus, they have to be included in any transatlantic discussions about regulatory cooperation. I think the third step is to reach to out to every interest group, the business community, NGOs, environmentalists, and academia to make negotiations of regulatory cooperation as public and as inclusive as you can and achieve public buy-in. Ask the public, as generally and specific as you can, for help, ideas, and suggestions to make the process more publicly transparent. Those are the three steps I would take.

be strengthened and member countries need to opt for greater deregulation for their own welfare.

The gains from liberalizing the services trade could be as substantial as those from the liberalization of the digital market. Various studies have assessed that a proper opening of the EU services trade could add €330 billion or 2.4 percent of EU GDP for 2014-19.[44]

The obstacles to services trade are many, but a handful of measures can be easily undertaken, from a technical point of view, to facilitate greater services trade. Three examples, discussed below, are the regulation of retail trade, the regulation of professions, and formal requirements.

After the severe Swedish financial crisis in the early 1990s, the Swedish economy took off thanks to great productivity growth in the private sector. This was particularly true of retail trade, banking, and the food industry, which went through a far-reaching deregulation and opening to foreign competition. The construction sector and the public service sector, by contrast, remained highly regulated and showed minimal productivity growth.[45] This experience offers two conclusions. One is that other European countries can adopt the practices that worked in Sweden and other countries. The other is that those sectors that were not reformed, notably public services and construction, should adopt the deregulation that worked so well in the retail trade sector. Domestic and international deregulation usually go together.

A peculiar remnant of the medieval guild system is the far-reaching licensing of professions. In many cases, certain professional qualifications need to be verified, such as in medicine, law, and academia, but that is no longer true of most craftsmen. No fewer than eight hundred professions in the European service sector are subject to government licensing and regulations. One-quarter of these are only regulated by one single country. Old guild restrictions are stalling trade in construction services and keep the European construction industry inefficient. The regulation of far more professions than is currently justified amounts to maintaining local monopolies, blocking new entries, and increasing costs for consumers. Some professional organizations are so strong that they can maintain their monopolies against both the European Commission and national governments. Two stark examples are the problems that Uber and Airbnb face in Europe.

Another concern is that public procurement for services is open only to a limited extent to competition. From 2006-2010, only 3.4 percent of all public-sector contracts in services across the EU were given to foreign bidders, indicating a nearly complete protectionism.[46] Manifold obstacles exist.

Shopping used to be highly regulated with restrictions on foreign competition, shop hours, and zoning. Many countries in Europe have eased these restrictions. They have liberalized shop hours, and numerous European discount shops have broken through zoning regulations. Still, large countries maintain strict restrictions in the face of pressure from powerful interest groups such as small neighborhood shops, local interests, trade unions, and churches.

Naturally, all the impediments to trade and efficiency in the service sector cannot be abolished within the next twenty-four months, but much can be done both by the European Commission and national governments.

First, the Services Directive needs to be expanded in its reach, and its implementation should be reinforced by the European Commission and the European Court of

44 European Parliamentary Research Service, "Mapping the Cost of Non-Europe, 2014-19" April 2015, http://www.europarl.europa.eu/thinktank/en/document.html?reference=EPRS_STU(2015)536364.

45 McKinsey Global Institute, "Sweden's Economic Performance: Recent Developments, Current Priorities," McKinsey & Company, May 2006, 10-11, http://www.mckinsey.com/global-themes/europe/economic-performance-of-sweden.

46 PricewaterhouseCoopers, London Economics, and Ecorys, "Public Procurement in Europe: Cost and Effectiveness," March 2011, http://ec.europa.eu/internal_market/publicprocurement/docs/modernising_rules/cost-effectiveness_en.pdf.

Mr. Stefano Itri
Vice President BDT Sales
Beretta USA Corp

You work for a family-owned business with production facilities in Europe, the United States, and Asia that sells its products all over the world. Small-medium enterprises (SMEs) that export their products are usually more competitive than counterparts that operate only domestically. What is your advice for European SMEs that strive to do business internationally and become more competitive in the process?

In the process of seeking growth, small and medium businesses should avoid focusing only on the internal market. Often I see companies that generate a good revenue by keeping a conservative approach, and they tend to develop a fear of approaching new markets. This in the long term can produce a negative effect. An example is all the small/medium companies in Italy that provide unique products, very well-known and respected all around the world, that have been incapable of finding their own way for growth and that have been acquired by foreign large groups, that have provided those instruments to be more competitive worldwide. If I have to choose the number one advice, it would be to challenge your own organization to constantly find new markets and opportunities. In the last fifteen years, the tools at our disposal have totally changed, giving us the opportunity to be faster and more effective around the globe. The real challenge is to study the market, go out there and capture those opportunities with a pragmatic approach. Beretta's experience is an example of this. With a wise vision of the future, the Beretta family invested in the US and has, over the years, expanded its direct physical presence in eight different states within the United States, with over 600 employees generating around half of the total sales of the group between the domestic market and exports.

Before coming to the United States you worked for Beretta in countries across Europe. What can Europe learn from the United States in terms of creating a business friendly environment and cutting red tape?

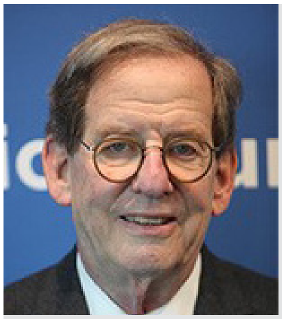
I work for a company that, among the other technologies, develops high precision mechanics. Some European countries such as Italy or Germany (only to make two examples) have an incredible capacity and know-how in doing this. On the other hand, the United States has the most advanced technological infrastructure. I see an incredible potential in such partnerships to develop Industry 4.0 that works better, more efficiently, and creates growth. We in Beretta are very focused on making this upgrade of the manufacturing facilities: we see every day how European and US plants benefit from this kind of exchange and partnership.

From your company's perspective, which operates in the EU and the United States, what reforms and policy proposals need to be implemented in the EU and the United States to increase the ease of doing inter- and intra-business transactions across the Atlantic?

Selling defense systems is a highly regulated business, as it should be, and there is a lot of preparation work to be done before confirming any contract with our customers and before shipping the products abroad. We interact with government authorities constantly to define the most effective approach to the market. Beretta Defense Technology (BDT), which operates with government's sales worldwide, is composed of four different companies, all belonging to Beretta Holding, to provide firearms, optics, and eOptics (laser devices and night vision) located in the EU and United States.

As a multicultural group of companies, it is evident to us that Europe and United States share similar values, both seek peace and prosperity and are trusted partners in respect of human rights and freedom. They also share the same defense policies that are well represented in NATO. For these reasons, it does not make sense to keep complicated and convoluted procedures to control the exchange of shooting sports and defense materials between the two markets. Simpler and faster processes, that anyway guarantee traceability and safety, can be implemented thus dramatically improving the competitiveness and effectiveness of these industries against the emerging players from other areas of the globe. This is a strategic market to keep in European and American control to maintain geopolitical influence.

From Our Task Force Members



The Hon. Richard L. Morningstar
Former US Ambassador to the European Union
Founding Director and Chairman, Global Energy Center, Atlantic Council

The European Commission aims to establish an Energy Union to provide secure, sustainable, competitive, affordable energy for every European. What is the biggest obstacle to the completion of the EU's Energy Union?

The obstacles are a combination of things. First, solidarity: many countries have their own energy policies and sometimes are not keen to cooperate. Second, infrastructure: there is a need for major interconnections, which require significant funding and convergence of opinion across the EU as to what needs to be done. And finally, significant differences of opinion among countries as to views of diversification; such lack of agreement could inhibit reducing dependence on Russia for natural gas.

What would be the greatest shared benefit of the Energy Union in your opinion?

The greatest shared benefit of the Energy Union would be an integrated energy market with a free flow of energy between various regions in Europe that would create greater diversification of energy, in terms of fuel types, supply source countries, and transmission routes. This would increase competition in the energy market and lessen dependence on imports on a single supplier, i.e. Russia, in certain parts of Europe.

Shale oil & gas exploration experienced a boom in the United States and helped the country to become more energy independent. Do you think shale projects can overcome the political opposition in Europe to contribute to a more energy independent Europe?

There are many issues regarding shale development in Europe, including political opposition to developing that resource mainly due to environmental concerns. But even apart from such opposition, shale resources have proven to be more difficult to develop in Europe compared to the United States for a few reasons. The main reason is the quality of the shale geology in Europe is much poorer. In addition, across much of Europe, landowners do not own the mineral rights below their property. This reduces the incentive to explore and develop the resources below the surface.

Falling prices for renewables, and the shale oil and gas boom are disrupting the global energy markets. How could the EU use the Energy Union to take advantage of these current trends to fulfill its mission to provide secure, sustainable, competitive, and affordable energy for every European?

Europe's major energy challenge springs from the fact it is a net energy importer. The Energy Union strategy, by creating a common energy market across the EU and increasing energy efficiency and deployment of renewables across the EU, will allow the EU to reduce costs and increase sources of supply.

Justice. In particular, the EU authorities need to demand an opening up of public procurement of services.

Second, the number of regulated professions needs to be reduced sharply, to which both the European Commission and national governments can contribute.

Third, EU deregulation should focus on the retail trade sector because the situation varies greatly between various EU countries, and the proven benefits in those countries that have opted for liberalization have been ample.

Fourth, the European Commission needs to take the lead on facilitating the new sharing economy rather than allowing national governments to prohibit it.

The current European Commission has rightly declared the facilitation of services trade as one of its top priorities. This can and should be completed soon.

3.6 Complete the European energy union

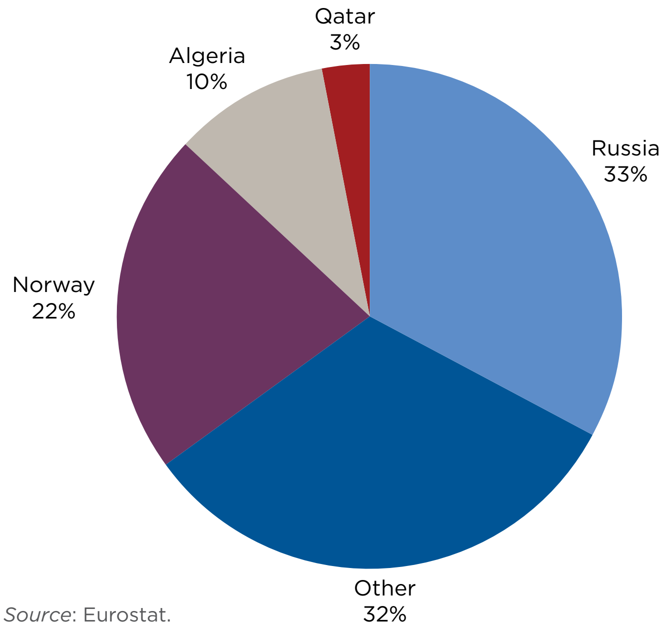
Europe is highly dependent on imports of energy. It imports around 53 percent of the energy it consumes, and until 2014 energy accounted for one-quarter of Europe's total imports, costing €400 billion a year.[47]

Ever since the formation of the European Coal and Steel Union in 1951, energy has played a major role in European integration. The current European Commission has made the creation of an energy union one of its foremost goals. The policy has five aims: to secure supplies of all types of energy (oil, gas, electricity), to develop an integrated and competitive energy market, to promote energy efficiency, to reduce carbon emissions, and to support innovation in the European energy sector.[48] The energy union is an evolution of the EU's 2009 third energy package that aimed at the developing a single energy market.

Security of energy supplies became an urgent objective after Russia's state corporation Gazprom cut its gas transit through Ukraine in January 2006 and 2009, impacting gas supplies to sixteen European countries. Some of these countries, notably Bulgaria, had no alternative gas supplies, significant storage facilities, or interconnectors. The European effort to bolster energy security has been manifold. A large number of interconnectors have been built or upgraded so that gas can be delivered from many sources; reverse-flow capabilities have been added to allow gas to flow in more than one direction. In Central Europe, substantial gas storages have been developed, and Lithuania and Poland have invested in liquefied natural gas (LNG) terminals.[49] The risk of any country being left without gas supplies for any significant period of time has been sharply reduced.

Another European concern is the high cost of its energy in Europe. The European Commission pointed out that "[w]holesale electricity prices in Europe are 30 percent higher, and wholesale gas prices over 100 percent higher than in the US."[50] After this statement was made, European natural gas prices have fallen sharply, as a result of the proliferation of LNG but not as much as much as in the United States, where natural gas prices are about half of the European prices (not including the high European energy taxes).

Figure 16. EU natural gas imports, 2015



Source: Eurostat.

The energy union follows the principles of the third energy package, which aimed to make a single internal EU market in the electricity and gas sectors. The main policy tools to achieve this were the unbundling of vertically integrated utilities and gas companies, third-party access to transmission infrastructure, the banning of destination clauses, and the creation of an EU-wide regulatory coordinator. Unbundling was particularly significant in liberalizing energy in Europe. Breaking conglomerates into separate entities responsible for gas production and power generation, transmission services, and distribution to consumers in the power and gas sectors has helped to increase competition and consumer choice. But these policies face resistance in many European countries by large "national champions" who want to maintain their dominance in these sectors. Their defense is that economies of scale are great in energy trade, which is correct. These large energy companies often cooperate with Gazprom, which owns pipelines and storage in many European countries.

When it comes to decarbonizing Europe's economy, energy efficiency and the reduction of greenhouse gas emissions go together. In this area, the EU has been highly successful. From 1990–2013, it reduced its emissions by 19 percent, although the EU's GDP grew by 45 percent.[51] This is in line with the commitments

47 European Commission, "European Union trade in the World," June 2015, http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc_122532.pdf.

48 European Commission, "Energy Union Package: A Framework Strategy for a Resilient Energy Union with a Forward-Looking Climate Change Policy," February 25, 2015, 4. http://eur-lex.europa.eu/resource.html?uri=cellar:1bd46c90-bdd4-11e4-bbe1-01aa75ed71a1.0001.03/DOC_1&format=PDF.

49 E.On, "Largest gas storage facility in Central and Eastern Europe completed," https://www.eon-hungaria.com/cmsfinel/7b/f5/gazaram2009winter.pdf.

50 European Commission, "Energy Union: Secure, Sustainable, Competitive, Affordable Energy for Every European," February 25, 2015, http://europa.eu/rapid/press-release_IP-15-4497_en.htm.

51 European Commission, "Energy Union," 6-7.

that the EU made at the UN climate conference in Kyoto in 1997, where it promised to reduce its greenhouse gas emission 20 percent from the 1990 level by 2020. The EU adopted an ambitious "cap and trade" scheme, but it has had only mixed success to date. The European Emission Trading System (ETS) covers more than 11,000 power stations, industrial plants, and airlines but only 45 percent of the EU's greenhouse gas emissions.[52]

Furthermore, there are many problems with the trade in pollution permits. As evident from the figures, a large number of polluters are exempted. The price of emission permits has vacillated sharply and eventually collapsed. As a result, the ETS has, to date, been unable to provide a market signal to drive carbon reductions in the EU economy. Most economists prefer carbon taxes over cap and trade because a carbon tax is more transparent and predictable, offering fewer loopholes, and its transaction costs are lower. Many EU countries have carbon taxes, and energy taxes are generally very high in Europe. In 2015, energy taxes collected 2.3 percent of the EU's GDP.[53] The EU is committed to continue with cap and trade, but some member states continue carbon taxes, which are likely to be more adequate.[54] The EU institutions are currently developing reforms to the ETS, which will be essential to bring coherence to the EU's various policies to reduce emissions, increase efficiency, and expand the use of renewable energy.

Europe is doing well in energy saving, and it is also leading in energy supply technology in areas such as renewables. Now, the crucial issue for the EU is the marketization of the energy trade. The European Commission is facing two tests, both posed by Gazprom. The first is a competition case that was raised by the European Commission in August 2012 and has not been completed as yet. Gazprom is accused of imposing territorial restrictions in its supply agreements with several member states, prohibiting the re-export of gas. These restrictions can lead to higher prices and unfair pricing policy.

The other EU test case is Nord Stream 2, the proposed second pipeline from St. Petersburg to Germany through the Baltic Sea. The aim of the energy union is to diversify both transportation routes and supplies, but Nord Stream 2 would concentrate 90 percent of Russia's gas supplies to Europe in one single pipeline.

3.7 Europe matters, but member states need to do their homework

A firm commitment on EU-wide projects is instrumental to unleash the European economy and create the conditions for stronger growth. However, this is a necessary, but not sufficient criterion. Each member state must deliver country-specific reform to ease private business. Areas such as immigration policies or labor market policies remain firmly in the hands of individual member states.

The World Bank's annual *Doing Business* report contains information on the ease of doing business in 190 countries worldwide.[55] Considered the authoritative measure of ease of doing business, the World Bank publication takes into account ten different factors: the ease of starting a business, dealing with construction permits, getting electricity, registering property, getting credit, protecting minority investors, paying taxes, trading across borders, enforcing contracts, and resolving insolvency.

As figure 17 shows, there is a strong, positive relationship between higher ease of doing business scores and higher GDP per capita. Look at Germany as a case study. In the *Doing Business 2017* report, Germany ranked seventeenth in the world. However, there are areas where it can improve.

The worst performance for Germany is in starting a business, ranking 114 out of 190 countries. According to data collected by the World Bank, starting a business in the European industrial powerhouse requires nine procedures, takes 10.5 days, and costs 1.9 percent of income per capita. For comparison, starting a business in New Zealand requires one procedure, takes less than a day, and costs only 0.3 percent of income per capita. If Germany were to move toward best practices (i.e., supply-side reforms), it could realize immense economic gains.

By improving its two weakest factors—ease of starting a business and registering property—enough to move its Doing Business score from 80 to 85, Germany's GDP per capita would be expected to eventually move from $42,320 to $52,755—a $10,435 increase. If it managed to improve its score a further five points to reach 90,

52 European Commission, "The EU Emissions Trading System," http://ec.europa.eu/clima/policies/ets/index_en.htm.

53 European Commission, Eurostat, "Database," last accessed February 21, 2017, http://ec.europa.eu/eurostat/data/database.

54 These include Denmark, Finland, Ireland, the Netherlands, Slovenia, Sweden, and the United Kingdom. Carbon Tax Center, "Where Carbon is Taxed," last accessed February 21, 2017, https://www.carbontax.org/where-carbon-is-taxed/.

55 World Bank, "Doing Business 2017: Equal Opportunity for All: Comparing Business Regulation for Domestic Firms in 190 Economies," 2017, http://www.doingbusiness.org/~/media/WBG/DoingBusiness/Documents/Annual-Reports/English/DB17-Report.pdf.

the German GDP per capita should increase another $15,038 to $67,793 eventually.[56]

The previous example shows the potential for gain in the EU as a whole from countries moving toward best practices. Rounding out the big three, France and Italy represent two more clear examples of this opportunity for economic strengthening.

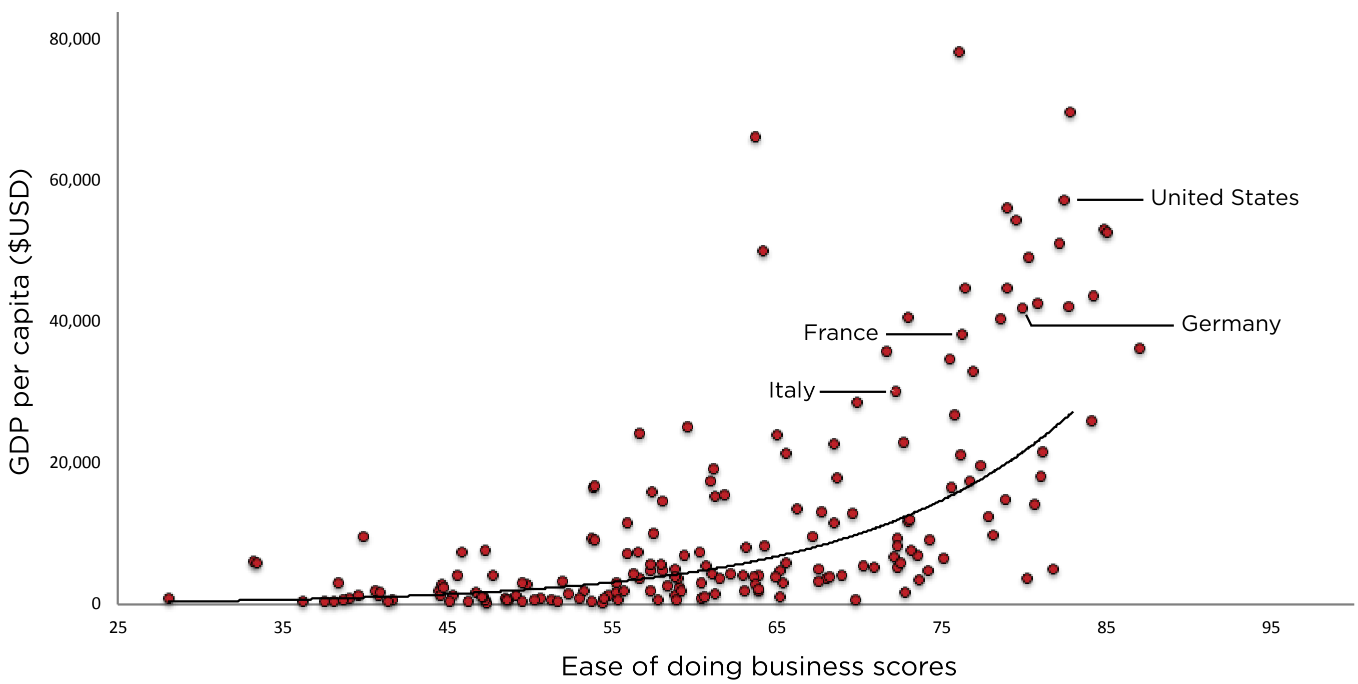
With a Doing Business score of seventy-six, which ranks twenty-ninth worldwide, France has even more opportunity to pick the low-hanging fruit and move toward the frontier. For registering property, France received a score of sixty-one, one hundredth in the world. Registering property in France requires eight procedures taking sixty-four days at 7.3 percent of property value. The average for OECD high-income countries is 4.7 procedures taking 22.4 days at 4.2 percent of property value. Procedures include obtaining mandatory environmental reports (fifteen–thirty days), obtaining a waiver of preemption rights from the municipality (twenty days), and applying for the publication of the deed of sale and obtaining stamped documents (forty-one days). In New Zealand, which exercises best practices for registering property, it requires just two procedures taking one day: obtaining a land information memorandum and registering the title through Land Information New Zealand. In 2016, France actually moved away from best practices—making the transfer of property more expensive by increasing the property transfer tax rate and introducing additional taxes for businesses in Paris, which lowered France's Doing Business score.

If France improved its Doing Business score five points to 81, French GDP per capita would be expected to rise from $38,172 to $45,672, an eventual $7,500 gain. Similarly, for Italy a five-point increase from 72 to 77 should eventually realize a $5,277 increase in GDP per capita, up from $30,231 to $35,508.

All in all, the EU as a "nation" would fare both in ease of doing business scores and world ranks for each of the categories (figure 18). The spider (or radar) charts can be viewed as radial bar charts or spoked wheels, where each spoke is its own category. The closer to the outer edge a category is, the better. The outer edge represents best practices. From this, it's clear that the EU is fairly middle-of-the-road, with consistent forty–sixty world ranks. The European Union has plenty of room to improve, and the guidelines are available to assist it in doing so.

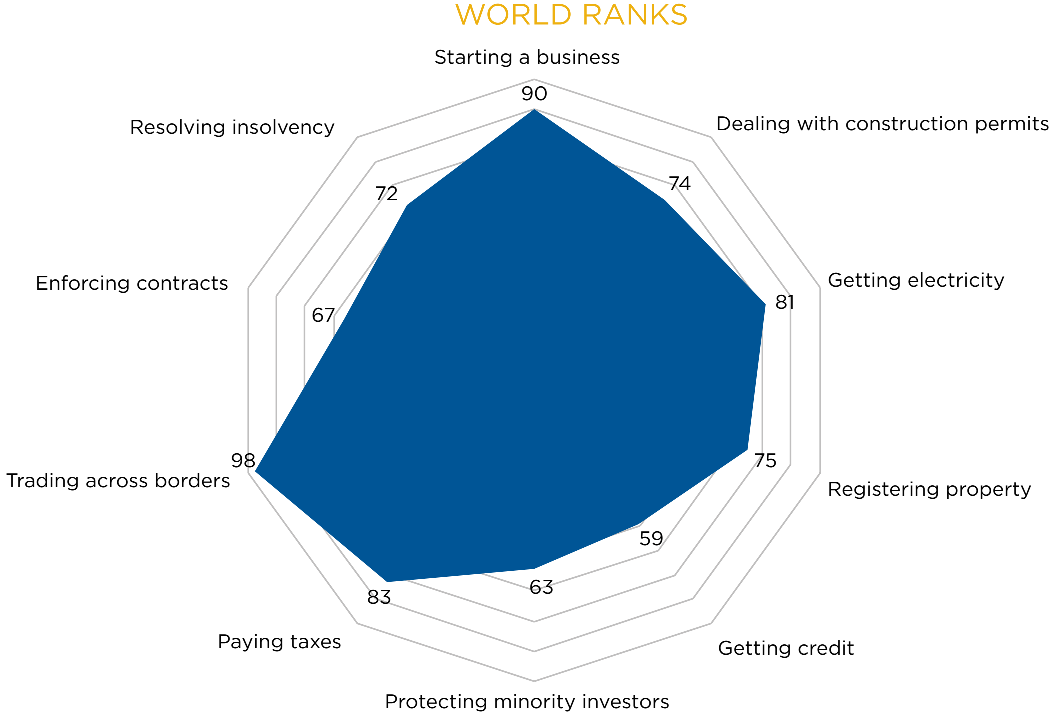
56 Estimation provided by Professor Steve Hanke.

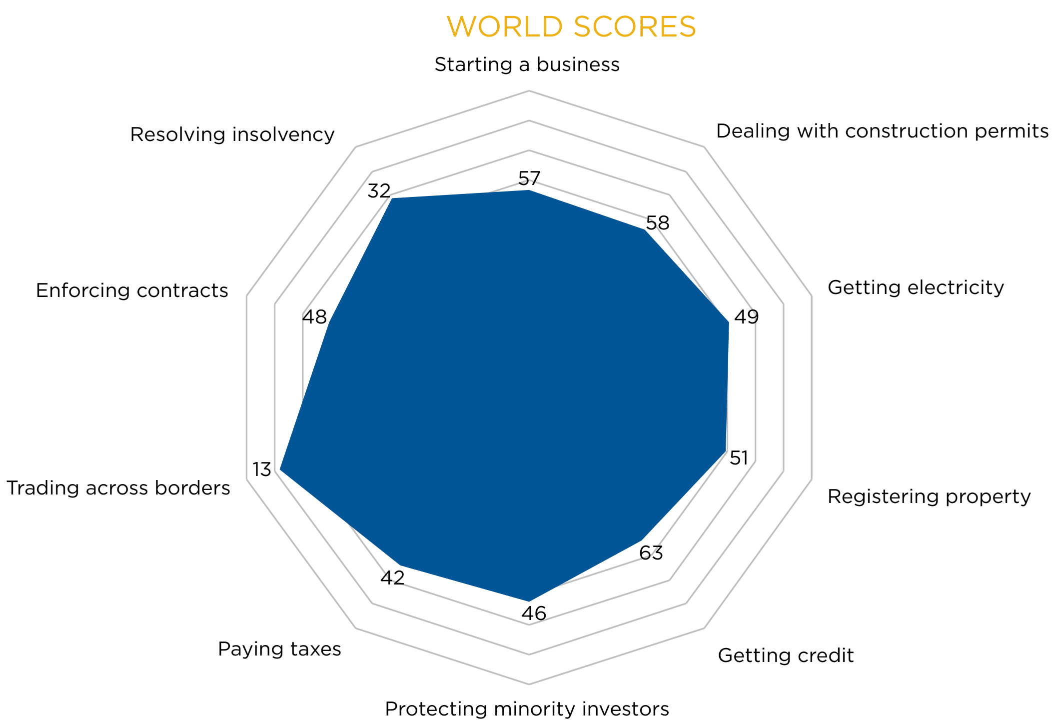
Figure 17. GDP per capita vs ease of doing business scores, 2016



Source: World Bank.

Figure 18. EU-27 business environment if it were a country.





Source: World Bank.

CHAPTER 4

Charting the Future: EU Economic Governance by 2022

"The future cannot be predicted, but futures can be invented"

Dennis Gabor, Nobel Prize in Physics, *Inventing the Future*, 1964

4.1 Summary and main recommendations

The European Union project of Economic and Social Cohesion is threatened by recent developments internally and externally. It must now respond effectively if it is to continue to succeed. The Brexit referendum in June 2016 was a direct assault against the unity of the European Union, but other indirect developments have also raised questions about the long-term viability of the vision articulated by Jean Monnet and Robert Schuman in the 1950s. The first recent challenge was the outbreak of the eurozone debt crisis in 2010, which is still ongoing in one country (Greece) and has kept other countries on a watch list (Ireland, Portugal, and Cyprus). The debt crisis led to severe adjustment programs and revealed that countries in the periphery had gradually lost their comparative advantage in many export sectors. The sense of malaise has been aggravated by the refugee crisis, which added a nationalist dimension. The outcome of the 2016 US presidential election has raised doubts about the whole Atlantic Alliance. Europeans are concerned about low economic growth and rising income disparities, which many blame on globalization.

A secular transfer of income and wealth has occurred from the western world to the Far East, since the opening of the United States to China in 1972. To take China as the primary example, the *Economist* reports that since 1978, more than 700 million people have been lifted out of poverty, and today, the Chinese middle class numbers about 225 million, compared with only 5 million in 2000![57] Between 1999 and 2014, per capita income in China increased thirteen-fold in real terms, whereas globally it less than tripled. These staggering statistics may explain the new negative western attitude to globalization.

Jean-Claude Juncker, the president of the European Commission, has said, "We all know what to do, but we don't know how to get reelected after we've done it."[58] This is not quite true, because no generally agreed reform agenda exists, and governments that have pursued vigorous reforms have been reelected far more often than those that have not. What is true is that the European Project is endangered and a major cause is too little economic growth. The strongest countries of the Union need to take bold steps to salvage the European Project and return prosperity to the peoples of Europe.

After the Brexit vote, the remaining EU members held an informal summit in Bratislava in September 2016. It aimed at reassuring the remaining EU members that disintegration should not be a concern, but it also raised questions about differences among member countries regarding immigration and economic policies. As the *Telegraph* put it, "…attempts to choreograph a picture of unity against the backdrop of Bratislava's chocolate-box castle, descended into a full-blown European farce."[59] Even for the most optimistic observers, the future of the EU appears uncertain and the European governance structure requires serious reconsideration.

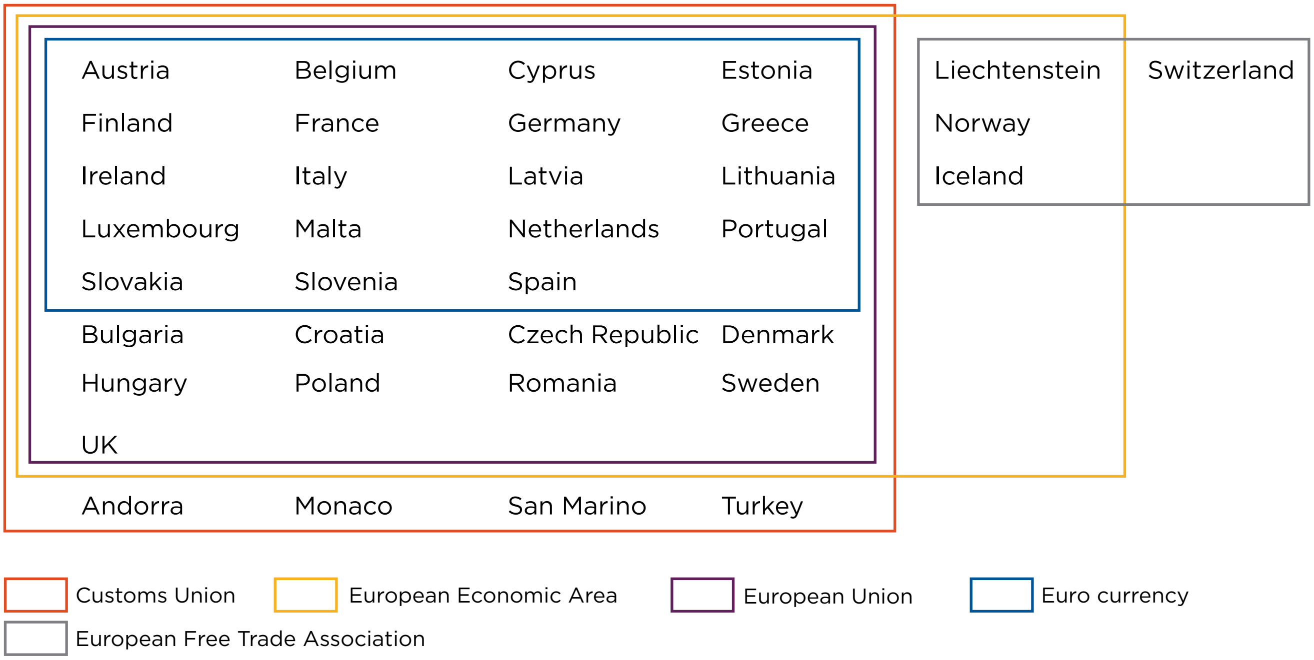
There are several possible directions in revamping and strengthening the European Union to help it address its existential challenges from populist and nationalistic

57 *Economist,* "The new class war," July 9, 2016, http://www.economist.com/news/special-report/21701653-chinas-middle-class-larger-richer-and-more-vocal-ever-threatens.

58 John Lanchester, "The Failure of the Euro," *New Yorker*, October 24, 2016, http://www.newyorker.com/magazine/2016/10/24/the-failure-of-the-euro.

59 Peter Foster, "Bratislava summit: Europe's 'united front' proves fragile," *Telegraph*, September 16, 2016, http://www.telegraph.co.uk/news/2016/09/16/eu-bratislava-summit-donald-tusk-calls-for-sober-and-brutally-ho1/.

Figure 19. European Geometry



Source: European Commission.

movements across the continent. What is discussed here is neither original nor cast in stone, and many of the suggested approaches have been analyzed and debated by academics and policy makers. These are long-term proposals, which will take many years to materialize. In fact, one might argue that the current EU leaders and institutions need to demonstrate that they can manage current crises before they are able to tackle fundamental governance reforms in the future. At the same time, history has shown that rallying around bigger ideas has helped the EU make progress in the past.

With these caveats in mind, we recommend to explore options and political consensus to:

› *expand the scope and the size of the EU budget;*

› *create a European Fiscal Authority among member states that are ready for stronger integration; and*

› *allow the issuances of Eurobonds for growth to finance infrastructure, human capital, and R&D in those countries that agree on the European Fiscal Authority.*

We are fully aware of the challenges, political, legal, and technical for such radical changes in the EU's economic governance. However, these changes are essential steps toward a stronger and more stable Europe and a concrete response against populism.

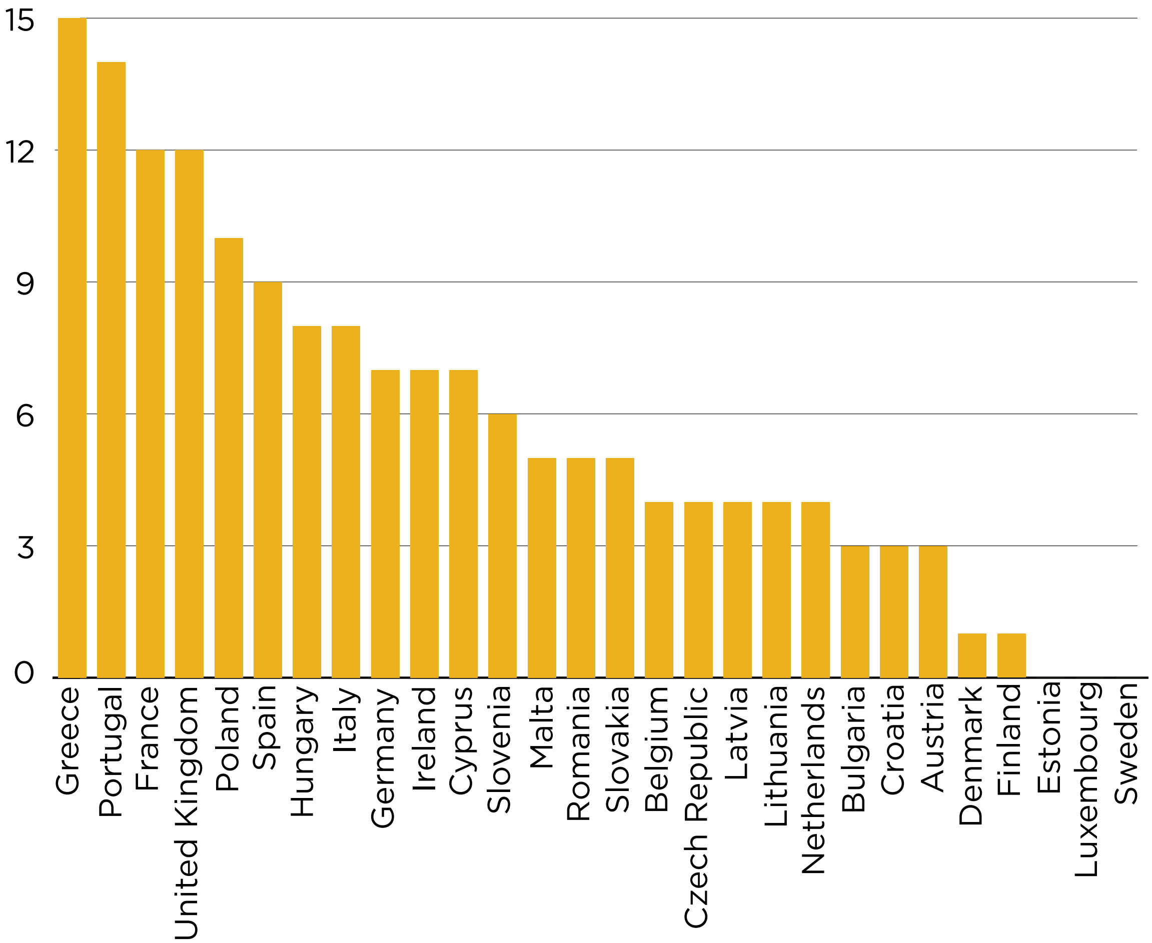
4.2 Past reforms and current structure

The diversity of European countries is not limited only to different cultures and languages, as is often recalled and emphasized; it is also the consequence of the European structures themselves that generations of politicians have imposed on various countries in the name of "integration" and "convergence" (figure 19).

One of the areas where there is still a lot of debate is economic governance, and in particular how to cope with an institutional setting where member states still have full responsibility on fiscal policy. Many attempts have been made to improve the fiscal discipline and financial integration of EU members. Since the Maastricht Treaty was adopted in 1992 and the Stability and Growth Pact introduced in 1998, the main changes to the fiscal framework were the 2005 reforms, the 2011 Six Pack, the 2012 Fiscal Compact, and the 2013 Two Pack (see box "History of the Stability and Growth Pact).[60] Despite good intentions, these ad hoc improvements have led many analysts to complain that the present system of fiscal relations is opaque, cumbersome, and ineffective. It is also seen as too flexible, providing ample scope for exceptions from the rules, and establishing precedents for further bending of the rules.

60 For a description of these reforms, see Michal Andrle, John Bluedorn, Luc Eyraud, Tidiane Kinda, Petya Koeva Brooks, Gerd Schwartz, and Anke Weber, "Reforming Fiscal Governance in the European Union," IMF Staff Discussion Note, May 2015, https://www.imf.org/external/pubs/ft/sdn/2015/sdn1509.pdf.

Figure 20. Number of years with a deficit to GDP ratio greater than 3% (since 2001)



Source: World Economic Outlook.

Counting since 2001: Greece, Portugal, France, UK, Spain, Italy, Germany, Ireland, Belgium, the Netherlands, Austria, Denmark, Finland, Luxembourg, Sweden.
Counting since 2004: Poland, Hungary, Cyprus, Slovenia, Malta, Slovakia, Czech Republic, Latvia, Lithuania, Estonia
Counting since 2007: Romania, Bulgaria
Counting since 2013: Croatia

As a result of opaque and flexible rules, the track record of respecting the 3 percent requirement in the deficit to GDP ratio has been poor. Since the introduction of the euro in 1999, only five countries of the European Union have respected the requirement most of the time, while some others such as France and the United Kingdom have had a deficit to GDP ratio above the threshold for at least ten years (table 6).

It is time to explore options that go beyond the step by step approach and try to figure out whether there is a consensus, at least among a subset of EU nations, for more Europe. As underlined by Buti and Pichelmann, EU institutions have been a popular "punch bag" for populist and anti-euro movements.[61] A reason lies behind the lack of instruments to counterbalance the effects of globalization on the losers. While it looks unpopular nowadays to advocate for more Europe, it seems that this can be a way to provide concrete responses.

4.3. Principles of fiscal federalism: United States vs. Europe

A key area of integration is fiscal policy. Fiscal federalism is a set of laws, rules, and regulations that

61 Marco Buti and Karl Pichelmann, "European integration and populism: Addressing Dahrendorf's quandary," *VOX*, February 22, 2017, http://voxeu.org/article/european-integration-and-populism-addressing-dahrendorfs-quandary.

From Our Task Force Members

H.E. Andrius Kubilius
Former Prime Minister of Lithuania (1999-2000, 2008-2012)

Under the leadership of President Juncker, the European Commission is pursuing a better regulation agenda, which is guided by the principles of subsidiarity and proportionality, to improve EU policies and laws. From your experiences as the former Prime Minister of Lithuania, what should be the most important goal of the EU's better regulation agenda?

"Better regulation agenda" is always among the top priorities of all the governments and bureaucracies. Unfortunately, these priorities often fall short of realization. This is typically because countries tend to use the excuse of subsidiarity and proportionality. The EU could be much more effective in this regard, but for this it must become a real priority, implemented through three divergent approaches:

a. A "top-down," not only a "bottom-up" approach is needed: there are good examples how some member states have made substantial progress in the Doing Business ranking, while others are still lagging behind. The Commission should look for new legal instruments to encourage member states to follow the best practices already implemented in other countries.

b. There are still a lot of challenges for a fully-fledged and truly operative single market, which would not be hindered by bureaucratic obstacles along national borders: realization of the Single Digital Market agenda should thus be one of the crucial priorities at the EU level.

c. The Commission should look for opportunities of putting the whole EU onto the "Doing Business" ranking. This is needed in order to be able to compare the EU with its major global competitors: the United States and China. At the same time, this would create a possibility to benchmark the EU as a single economic entity against its peers.

The Brexit referendum and rising nationalism across Europe are symptoms of the EU's unpopularity among many of its citizens. How can the EU reform both its policy making and messaging, so that ordinary citizens can better understand how the EU improves their livelihoods?

Rising nationalism across Europe and increasing unpopularity of the EU among its citizens has the same roots as rising radicalism and populism all around the Western Community, as reflected by different elections and referendums: in the United States, United Kingdom, the Netherlands, and elsewhere.

Those roots are basically of economic and social origins: slow economic growth, flat or decreasing incomes, shrinking middle class, and a permanent segregation of those who "have" and those who "have not." Adding to this, one may witness ordinary people losing trust in the so-called "American dream"—more and more people are angry, frustrated and looking for whom to blame for their misfortunes. This makes a growing segment of the society keen on supporting populist, radical, and nationalistic ideas. These systemic problems are well reflected in two recent influential academic books: *Coming Apart: The State of White America, 1960—2010* by Ch. Murray and *Our Kids: The American Dream in Crisis* by R. Putnam.

The increasing unpopularity of the EU and the rise of nationalism across Europe can be tackled only by bringing back economic growth to all the regions and countries of the EU and by finding new ways of how to overcome social divisions within the framework of the liberal market economy.

What can the EU member states do to increase the efficiency and impact of EU policies and laws?

The impact of the EU is, first of all, limited by the amount of resources pooled in the EU budget and later used for the implementation of its common policies. Many people are expecting some sort of policy miracle from the EU, but they do not seem to realize that financial resources available for supranational EU initiatives amount to only around 1 percent of EU GDP.

This difference between "high expectations" and "low resources" is one of the critical problems the EU is facing today. It can be resolved only by taking brave political steps and by agreeing to boost resources devoted to the EU common budget. Of course, in order to achieve such a result, we must have brave political leadership at both EU and national levels.

History of the Stability and Growth Pact (SGP)

2015: SGP Flexibility

The Commission issues guidance on how it will apply the SGP rules to strengthen the link between structural reforms, investment, and fiscal responsibility in support of jobs and growth.[1]

2014: SGP review

A review of the "Six Pack" and "Two Pack" rules, which was called for in the legislation, determined that the legislation had contributed to the progress of fiscal consolidation in the EU.[2] The review highlighted some strengths as well as possible areas for improvement, which will be discussed with the European Parliament and member states.

2013:

(a) Fiscal Compact

The importance of the budgetary targets set by the SGP's preventive arm (the medium-term objectives), are strengthened by a law known as the "Fiscal Compact,"[3] which is part of an inter-governmental treaty known as the Treaty on Stability, Coordination and Governance (TSCG).

(b) Two Pack

Adherence to the SGP is further strengthened by new laws, known as the "Two Pack," which reinforces economic coordination between member states and introduces new monitoring tools. Further details on the implementation of the Two Pack provisions are laid down in "Code of Conduct" (last revised in November 2014).

- Regulation No 472/2013[4]
- Regulation No 473/2013[5]

2011: Six Pack

The SGP is made more comprehensive and predictable with a major enhancement of the EU's economic governance rules through a collection of new laws, known as the "Six Pack." The monitoring of both budgetary and economic policies is organized under the European Semester and further details on the implementation of the SGP's rules are laid down in a "Code of Conduct" (last revised in September 2012).

2005: SGP amendment

EU lawmakers amend the SGP to allow it to better consider individual national circumstances and to add more economic rationale to the rules to be complied with.

- Surveillance and coordination are strengthened.[6]

1 European Commission, "Stability and Growth Pact," last accessed February 21, 2017, https://ec.europa.eu/info/node/4287/.
2 Ibid.
3 EU Laws and Publications (EUR-Lex), "Requirements for Euro area countries' budgets," last accessed February 21, 2017, http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1412158671390&uri=URISERV:ec0021.
4 EU Laws and Publications (EUR-Lex), "Regulation (Eu) No 472/2013 Of The European Parliament And Of The Council," May 21, 2013, http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:32013R0472.
5 Ibid.
6 EUR-Lex, "Council Regulation (EC) No 1055/2005," June 27, 2005, http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1412159031745&uri=CELEX:32005R1055.

- The excessive deficit is clarified and made faster.[7]

1999: Corrective rules

The SGP's corrective rules enter into force.[8]

1998: Preventive rules

The SGP's preventive rules enter into force.[9]

1997: Stability and Growth Pact

EU member states agree to strengthen the monitoring and coordination of national fiscal and economic policies to enforce the deficit and debt limits established by the Maastricht Treaty. The Stability and Growth Pact is born.[10]

1992: Maastricht Treaty signed

EU member states sign the Maastricht Treaty, paving the way for the creation of the euro as the common currency of the EU.[11] The most widely quoted parts of the treaty are the limits of government deficits to 3 percent of GDP and of public debt levels to 60 percent of GDP, so as to enable countries to share a single currency.

7 EUR-Lex, "Council Regulation (EC) No 1056/2005," June 27, 2005, http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1412159031745&uri=CELEX:32005R1056.

8 EUR-Lex, "Council Regulation (EC) No 1467/97," July 7, 1997, http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1412158400303&uri=CELEX:31997R1467.

9 Ibid.

10 EUR-Lex, "Resolution of the Amsterdam European Council on the stability and growth pact," June 17, 1997, http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1412156825485&uri=URISERV:l25021.

11 EUR-Lex, "Treaty of Maastricht on European Union,' (Summary), last accessed February 21, 2017, http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1412156972092&uri=URISERV:xy0026.

lay out a normative framework for the assignment of functions to different levels of government with the appropriate fiscal instruments. An initial question is which level of government should be responsible for the three traditional objectives of fiscal policy pointed out by Musgrave: macroeconomic stabilization, income redistribution, and resource allocation.[62] An additional issue is risk sharing, which, unlike stabilization (i.e., countercyclical fiscal policies when the whole federation is affected by an external shock), might reflect temporary transfers to specific regions that have been hit by a shock.

The provision of common public goods (defense, foreign relations, countrywide justice, and security, as well as key communication and transportation systems) should be in the hands of the federal government. Since the late nineteenth century in Europe (mainly upon the introduction of a national social insurance in Germany) and certainly since the New Deal in the United States in the 1930s, the federal government has also assumed redistributive functions. With the Keynesian revolution and its stabilization policies, the growth of central governments was significant throughout the twentieth century until 1980.[63] In the United States, for example, the 1929 federal government budget was 2.5 percent of GDP; by 1939, it had quadrupled to 10 percent of GDP.[64]

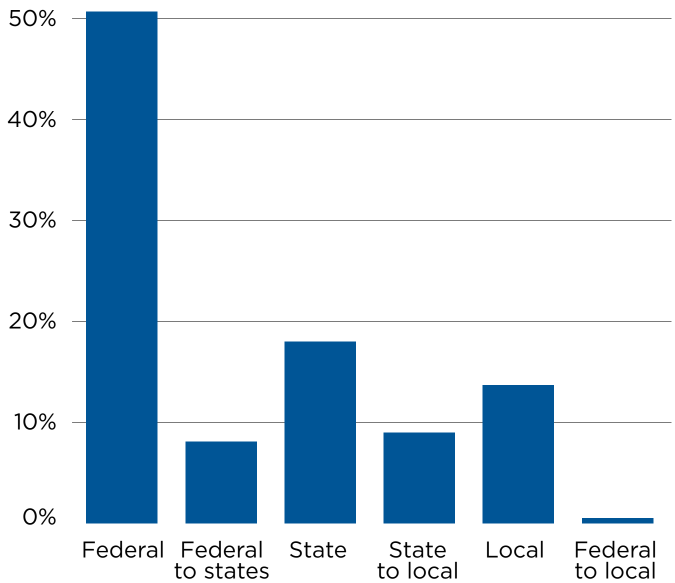
The differences in the present respective frameworks between the United States and the EU are striking. In 2016, the US federal budget is estimated at about 22 percent of GDP, whereas the EU budget is only 1 percent of the Union's GDP, three-fourths of which is redistributed to member states through structural funds. Equally important, the distribution of revenues between the federal (central) government and the subnational governments is the reverse on the two

62 Richard A. Musgrave, "The Voluntary Exchange Theory of Public Economy," February 1, 1939, *Quarterly Journal of Economics* (53 (2): 213-237. DOI: https://doi.org/10.2307/1882886.

63 Vito Tanzi and Ludger Schuknecht, *Public Spending in the 20th Century* (Cambridge, UK: Cambridge University Press, 2000).

64 Carlo Cottarelli, "Presentation for ECB-IMF Conference," Frankfurt, December 13, 2012, https://www.ecb.europa.eu/events/pdf/conferences/ref_eu/Cottarelli_ppt.pdf?b825755bde4ed76ae3e7b6b7997a4b55.

Figure 21. Federal, state, and local government receipts and transfers in the United States, 2013



Source: World Economic Outlook.

sides of the Atlantic: the figure below shows the distribution of revenue collected by the federal and subnational governments in the United States.

The US federal government collects nearly 51 percent of total taxes directly and transfers 8.6 percent of its revenues to state and local governments. The situation in the EU is the opposite: the EU central budget is financed by member states by about 1 percent of their GDP and accounts for only 2 percent of general government spending, and transfers from national governments to the central EU budget range from 0.5 percent to 3.5 percent of the members' income. Thus, fiscal redistribution is much larger in the United States than in the EU.

The limited role of the central EU budget reflects that it was not designed as a federation budget of a political union (common defense, common foreign affairs) or to carry out other traditional economic roles such as macroeconomic stabilization, risk sharing, or harmonization of spending policies.

The long road to a European fiscal union (and eventually political union) should begin with the transformation of the current EU budget to a budget resembling a traditional federation, under the control of a single authority. Other related issues are the completion of the banking union and the interaction between the fiscal union and the monetary union. These topics are analyzed in turn below.[65]

4.4. Toward more fiscal integration

The Maastricht Treaty did not incorporate any fiscal union, except in the very narrow sense of "fiscal discipline." Moreover, the creation of the eurozone also did not envisage any common budget, except for the lending capacity of the European Stability Mechanism (ESM), which was created after the eurozone debt crisis; its capacity in 2016 was €500 billion, equivalent to 10 percent of euro area member combined budgets. But the ESM (like its predecessor, the European Financial Stability Fund) is a stock rather than an annual flow and not a substitute for a euro area budget; it is a mutual assistance scheme that does not involve delegation of competencies to the center.[66]

In June 2015, the Five Presidents' Report proposed the creation of a "common fiscal stabilization function to better deal with shocks that cannot be managed at the national level alone," but it stopped short of recommending specific steps toward the creation of a true fiscal union.[67] It only recommended the establishment of a European Fiscal Board.[68]

The question is what type of a fiscal union would best improve the functioning of the monetary union and how far-reaching should it be. A viable and effective fiscal union should comprise three fundamental steps: first, the expansion of the European budget; second, the creation of a European Fiscal Authority; and third, the issuance of common debt. All of these proposals had been on the agenda of European policy debates for many years, but resurfaced with enhanced vigor and coordination since the eruption of the eurozone crisis in 2010.

65 Many, but not all, of our proposals parallel recommendations that are included in Stephen Pickford, Federico Steinberg and Miguel Otero-Iglesias, "How to Fix the Euro. Strengthening Economic Governance in Europe" Chatham House, Elcano Royal Institute, and AREL, March 2014, http://www.realinstitutoelcano.org/wps/portal/rielcano_en/contenido?WCM_GLOBAL_CONTEXT=/elcano/elcano_in/zonas_in/international+economy/pickford-steinberg-oteroiglesias-how-to-fix-the-euro. This is one of the most comprehensive, analytically rigorous and procedurally specific reports on reforming economic governance in Europe.

66 Agnès Bénassy-Quéré, Xavier Ragot, and Guntram B. Wolff, "Which Fiscal Union for the Euro Area?," Bruegel Policy, February 2016, http://bruegel.org/2016/02/which-fiscal-union-for-the-euro-area/.

67 European Commission, "Completing Europe's Economic and Monetary Union," June 2015, https://ec.europa.eu/commission/sites/beta-political/files/5-presidents-report_en.pdf.

68 European Commission, "Completing Europe's Economic and Monetary Union," 14.

The current Union budget is tiny compared to other fiscal federations. The purpose of an expanded central budget administered by a supranational authority would be to establish a common fiscal framework with a view to conducting stabilization and growth-promoting policies that are currently under the jurisdiction of national budgets, while maintaining financial stability. In three resolutions published in February 2017, the European Parliament proposed the creation of a euro-area budget with increased fiscal capacity, based on the ESM. Furthermore, one resolution advocated the evolution of the ESM into a European Monetary Fund, "with adequate lending and borrowing capacities and a clearly defined mandate to absorb economic shocks."[69]

In addition to the strictly countercyclical objectives, others (Cottarelli, for example) argue that a large central budget is important for the long-term working of a monetary union, because it promotes convergence and harmonization of economic policies through four channels:

a) Convergence of product and factor markets (common Corporate Income Tax, unemployment subsidies, pension systems);

b) Fiscal discipline;

c) The center, not the periphery, would run higher deficits during downturns, and

d) The center (related to the above) would be responsible for running countercyclical policies and it would be easier for it to borrow and thus be more effective.[70]

A major question is not only the functions but also the size of the new central budget. Although this is a difficult issue, the 1977 MacDougall report on the role of public finance in European integration suggested a central budget equivalent to 5–7 percent of the members' combined GDP, or 7.5 percent to 10 percent if a large portion of defense expenditures currently under national budgets are included.[71] The latter range should be seen in light of President Juncker's suggestion in September 2016, for the creation of a European Army,[72] but also mindful of US President Trump's comments both during and after the election campaign of 2016, about burden sharing among NATO allies.

The expansion of the EU budget must be handled with care, avoiding an increase of the tax burden on EU citizens. The present level of tax burden among national economies does not allow for major additional taxes at the supranational level. Only a small part of the new expanded budget could be financed with a few, well-targeted, area-wide taxes, notably environmental and energy taxes. For the rest, the financing would have to come through increased transfers from the member countries, compensated by lower spending at the national level. The European national budgets would continue to exist, and most revenues and expenditures would be administered at the national level; overall taxation would not increase. The European economies would simply contribute a larger share of their own national budgets to the enlarged European budget. Such a process should be designed so as to avoid a recurrent transfer of resources from North to South, which has been the principal moral hazard argument by those who wish to dissociate the concept of a currency union from the prospect of a transfer union.

Yet, with a current Union budget of 1 percent of GDP, any proposal to raise the size of the common central budget beyond 5 percent is likely to face political resistance. To overcome such a potential difficulty, one can assume to add to the current functions of the EU budget some additional redistribution capacity, in particular during downturns. This can be achieved with the transfer of some functions from member states to the common budget and the relative resources, for around two more points of GDP so that the budget can become something around 3 per cent of GDP. Additionally, countries can pledge additional contributions up to a given limit, say around 2 percent of GDP, as the need arises. Such a scheme should be acceptable if the pledged contributions become "callable" only in case of countercyclical or risk-sharing measures that require immediate implementation. Clearly, moving forward a common defense will require additional contribution to the central budget.

A second fundamental step toward a viable fiscal union is the creation of a European Fiscal Authority

69 European Parliament press release, "Parliament sets out its vision for the future of Europe," February 16, 2017, http://www.europarl.europa.eu/news/en/news-room/20170210IPR61812/parliament-sets-out-its-vision-for-the-future-of-europe.

70 Carlo Cottarelli, "A European fiscal union: the case for a larger central budget," *Journal of Analytical and Institutional Economics*, February 19, 2016, http://link.springer.com/article/10.1007/s40888-016-0026-2.

71 Commission of the European Communities, "Report of the Study Group on the role of Public Finance in European Integration," Brussels, April 1977, http://www.cvce.eu/content/publication/2012/5/31/c475e949-ed28-490b-81ae-a33ce9860d09/publishable_en.pdf

72 Jean Claude Juncker, "State of the Union Address," speech delivered at the European Parliament, September 16, 2016, http://europa.eu/rapid/press-release_IP-16-3042_en.htm.

(EFA).[73] This has been a long-standing proposal among important European policy makers for many years. In fact, as far back as 2012, The German Finance Minister Wolfgang Schäuble, had accepted the possibility of a "European Minister of Finance" with the power to monitor debt levels and veto member states' budgets.[74] A year earlier, a similar proposal had been advanced from former ECB President Jean-Claude Trichet.[75] Those were proposals with a specific mandate for a "European Minister of Finance" arising from the eurozone crisis. More recently, and more akin to the proposals in this chapter, are recommendations from Emmanuel Macron, the former French Minister of the Economy and currently one of leading candidates in the French Presidential elections, who stated that such a position should be "not just a euro area finance minister, but someone who allocates funding for investments or has a say in labor market policy."[76] Perhaps the most surprising proponents of a European Fiscal Authority are three central bankers: Jens Weidmann, president of the Deutsche Bundesbank, François Villeroy de Galhau, governor of Banque de France, Mr. Benoit Coeuré, a member of the ECB's Executive Board, reportedly with the support of ECB President Mario Draghi.[77] The central bankers clearly stated that a common fiscal authority would "foster confidence" and it would be "the biggest step in integration since the introduction of the euro."

But what would be the motivation for a European country to give up part of its sovereignty in favor of the European project? There are several reasons for this trade-off: economic stability, economic prosperity, and maybe even national defense. By being a member of the EFA, a country would be assured of the smooth functioning of its financial sector and its capital markets; it would also have access to resources managed by the EFA for stabilization purposes, allowing it to manage asymmetrical economic shocks without increasing its public budget. Being part of the EFA would allow the country to benefit from the emission of common debt for growth purposes, adding an important tool to the growth strategy. And maybe, the EFA countries would be the forefront in a common defense.

During a period when the issue of burden sharing for NATO expenses has returned to the forefront of the new US administration agenda, the EU may well want to show greater willingness to deploy military power, especially in geographical areas that the United States might not consider of vital interest. EFA countries would lead the development of a collective security architecture, which, on the one hand would realize the ambitions of the EU Global Strategy, and on the other would allow them to become more capable US allies in military terms.

This new authority should in principle be joined by all eurozone member states. However, one can imagine that only an initial subset of countries might decide to opt for more integration. While this solution would not be optimal, it cannot be acceptable that EU integration does not move forward at all due to the opposition of some countries: those that are willing to integrate more extensively, should also be allowed to.

By giving up part of their financial and decision-making sovereignty in favor of a supranational entity, the EFA countries would foster the creation of a more powerful fiscal tool, which might enhance the prospects for sustainable growth in the EU.

Among the functions of this Authority, the most relevant would be:

- The responsibility for the issuance of common debt (Eurobonds);

  The EFA should have the authority to issue common debt under a strict mandate on the size and the scope of that debt. The euro area sovereign debt crisis revived the debate on the common issuance of sovereign bonds in the eurozone and some policy makers and experts have seen them as a solution to the crisis. Although this proposal was put forward by the European Commission in 2011, and was backed by French President Francois Hollande in 2012 and various eurozone ministers in later years, the issue has remained controversial.[78] In February 2012, the

73 Alternative names could be "European Minister of Finance" or "European Treasury."

74 Interview with Finance Minister Schäuble, *Der Spiegel*, June 25, 2012, http://www.spiegel.de/international/europe/finance-minister-schaeuble-euro-crisis-means-eu-structures-must-change-a-840640-2.html.

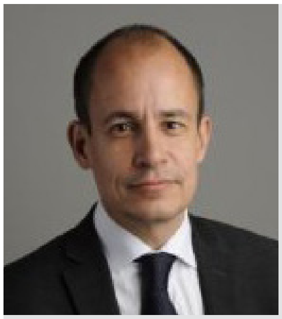
75 Christian Vits and Ghabi Thesing, "Trichet Calls for Euro Finance Ministry as Crisis Deepens," *Bloomberg Business*, June 2, 2011, https://www.bloomberg.com/news/articles/2011-06-02/trichet-proposes-euro-area-finance-ministry-to-coordinate-fiscal-policies.

76 Interview with Emmanuel Macron, *Süddeutsche Zeitung*, August 31, 2015, http://www.sueddeutsche.de/politik/emmanuel-macron-im-interview-wir-wollen-eine-neugruendung-europas-1.2628139.

77 Jens Weidmann, "A central banker's take on improving the euro area's stability," speech delivered at Banco de Portugal, December 10, 2015, http://www.bundesbank.de/Redaktion/EN/Reden/2015/2015_12_10_weidmann.html; François Villeroy de Galhau, speech delivered at Paris Europlace International Financial Forum, Tokyo, May 12, 2016; and "EZB-Präsident: Draghi unterstütz angeblich Forderuung nach Eurofinanzminister," *Spiegel Online*, August 28, 2015, http://www.spiegel.de/wirtschaft/soziales/eurozone-ezb-chef-mario-draghi-fordert-angeblich-euro-finanzminister-a-1050274.html.

78 European Commission, "Green Paper on the feasibility of

From Our Task Force Members



Mr. Bart Oosterveld
Managing Director—Chief Credit Officer, Americas
Moody's Investors Service

How do you see the prospects for progress on further fiscal integration in the European Union?

Overall, we see the prospects for further political and fiscal integration in the EU as reduced and subject to rising political risk. Our recent outlook on the euro area highlights this risk. Political and policy risks associated with the emergence of anti-consensus parties could hamper reform efforts, and/or generate upward pressure on funding costs. Regardless whether any fringe parties actually win an election or gain meaningful influence in a euro area country, the underlying political trends that shaped the emergence of these parties could hamper the passing and implementation of current and future economic and fiscal reforms, both at the national and European level. For example, in countries in which such parties are able to create the perception that national governments are pursuing structural economic and fiscal reform in an effort to meet EU targets and placate critics at the EU level, anti-EU sentiment has typically expressed itself in part through opposition to reform.

What kind of institutional enhancements would support further fiscal integration in the European Union?

Progress toward a strong banking Union, centralized management of deficits and debts, strong and enforced debt and deficit criteria would all be supportive of fiscal integration. We have highlighted the risks to this type of progress in several recent publications. At the European level, challenges to incumbent governments would make it harder to agree common solutions to shared problems, such as the migrant crisis. The high visibility of disagreements at the EU level can further entrench domestic "anti-EU"—and hence anti-reform—sentiment. In our view, these political trends are likely to curtail further meaningful progress on economic and financial matters at either level, including the completion of the Banking Union by the EU. The EU's decision-making processes have already been revealed to be weak, fueling calls for an increased de-centralization of powers to national governments (as opposed to centralization of powers in Brussels).

European Parliament issued a resolution calling for further work from the European Commission on the features of such bonds.

Instead of moving forward on a "mutualization" of public debt, the scope of Eurobonds should be limited to finance infrastructures, R&D, and human capital.

In terms of size, a newly issued EU public debt that remains within the range of 3 to 5 percent of the participant countries' GDP can significantly boost productive expenditures. However, the relatively limited size of the new debt to GDP ratio will not jeopardize the issuance of public debt by single member states, and will not put at risk the rating of either the common debt or single countries' debt.

Moreover, it is likely that the Eurobonds will receive the highest credit rating. From a technical point of view, the question is who will play the role of the debt agency for this core group of countries. Two candidates can be explored: the European Investment Bank or the European Stability Mechanism, but not the European Central Bank. The ECB must continue to be a strictly monetary institution involved in liquidity management and inflation control, but whose mandate should eventually include the promotion of growth and employment, much like the US Federal Reserve. The ESM has the advantage of having been created by an intergovernmental agreement, so its mandate and scope can be enlarged through the same process. It also has played already the role of treasurer on behalf of member states financing countries under a financial assistance program and has the technical expertise in place for extending its issuance program.

- The responsibility to manage part of the common budget for stabilization purposes.

The Five Presidents' Report set "an appropriate fiscal stance at the level of the euro area as whole" as a target for the next step of European integration. This function could be played by the EFA through the common budget, by applying countercyclical policies at a supranational level.

introducing Stability Bonds," Brussels, November 23 2011, http://ec.europa.eu/europe2020/pdf/green_paper_en.pdf.

Within a currency union, the centralization of fiscal policy decisions would reduce the risk that national governments might take unsustainable fiscal decisions. More importantly, however, during cyclical downturns it would be the center, and not the periphery, that would run higher deficits, which, as explained above, would be easier to finance through the issuance of Eurobonds. In the longer term, a common macroeconomic stabilization function is better equipped to address shocks that are too hard to manage at the national level alone.

- The power to enforce additional measures such as the introduction of taxes or spending cuts at member state's level when there is a significant deviation from fiscal targets is not justified by cyclical conditions.

  In order to overcome misbehavior and to enhance fiscal discipline at the national level, member states participating in the EFA and therefore benefiting from a common budget for countercyclical policies and Eurobonds should accept that the EFA can impose corrective measures to safeguard the common resources. The circumstances under which EFA could intervene should be spelled out clearly and embedded in a set of fiscal rules with a relative high degree of automaticity.

Such an Authority will be the natural complement of a European Central Bank and of the banking union. The latter was conceived as a three-pillar approach: (a) shifting bank supervision from a national to the European level, (b) establishing a single framework for bank crisis management, and (c) introducing a common system for deposit protection. Of the three legs envisaged in 2012, progress has been made only with the first one, the Single Supervisory Mechanism (SSM), which seems to be working as intended. The second leg, the Single Resolution Mechanism (SRM), is in place, but a potential problem is the size of the fiscal backstop; its relationship with the ESM must be further explored, with a view to using it as a backstop for the Single Resolution Fund. Nevertheless, total resources would still be inadequate given the size of the banking sector, which was estimated at €30 trillion in 2013. However, no real progress has been made to date with the third pillar, namely the deposit insurance scheme. The delay in the implementation of the deposit insurance scheme has been caused by a disagreement about the sequencing of risk sharing: the stronger economies oppose moves toward risk sharing before the weaker countries in the periphery have cleaned up their banking sectors (mainly by tackling the issue of non-performing loans). Only then would richer countries agree to the establishment of a common fund to shield depositors from future failures.

4.5. Toward concentric circles

Not all EU countries would necessarily agree on a common fiscal authority or the issuance of common debt. After much progress by the European Union over the last sixty years, it is time to accept that member states can prefer different institutional settings. This is not a failure of the European project. Rather, it takes into consideration that national identities are strong and will remain strong, and that preferences in terms of integration can differ. This cannot stop the integration process among those countries that believe in it, and a new institutional setting might emerge.

There will likely be three tiers within the Union: the first tier will be the EFA countries, which by definition will use the Euro. Germany, France, and Italy, as the largest eurozone economies and founders of the Union must be at the forefront of this next, big step. The second tier will be represented by those euro countries that, while being in the euro, would be reluctant to join the common fiscal authority or agree on the issuance of common debt, at least initially. The third tier will be the EU countries that have not adopted the euro yet. One might also imagine a fourth circle where countries with a special relationship to the EU, such as the UK after Brexit, will be included.

All this requires vision, and a sufficient number of years to deal with the many technical and legal issues that such a design would entail. Major legal issues concern how countries with the same currency can coexist under two different levels of integration; the role of national parliaments when the EFA imposes additional, corrective measures; the relationship between the EFA and the European Commission; the agency in charge of issuing Eurobonds; the decision-making process for the EFA to use the budget for stabilization purposes; and how countries would enter, and exit, from the EFA. In fact, some analysts worry that a stronger fiscal union could imply a "permanent" one-way redistribution and moral hazard. Therefore, they propose a clearly defined exit option as a guarantee against involuntary redistribution.[79]

The objective for a full-fledged economic union should follow the completion of the monetary union and the introduction of a fiscal union. The diversity of European economies calls for extensive structural

79 Shafik Hebous and Alfons Weichenrieder, "Towards a Fiscal Union? On the Acceptability of a Fiscal Transfer System in Eurozone," SAFE, White Paper, July 28, 2015, http://econpapers.repec.org/paper/zbwsafewh/28.htm.

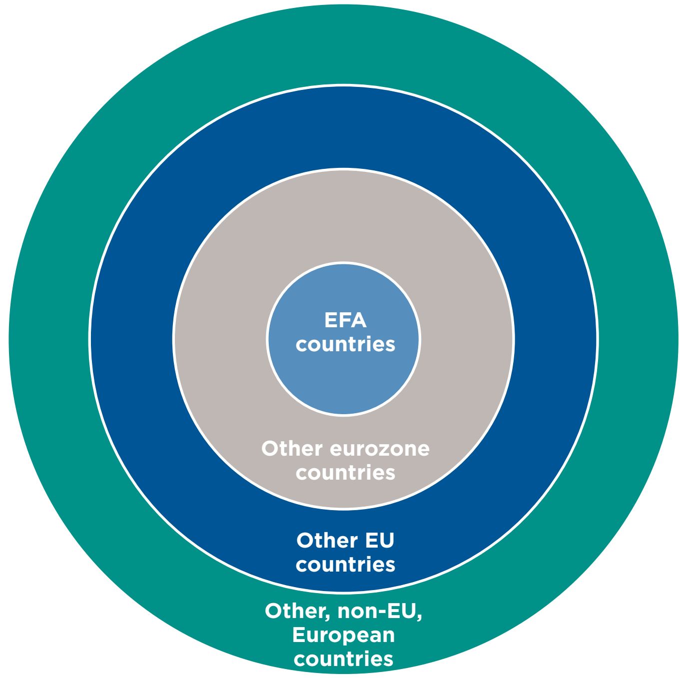
reforms that would allow euro area countries to live within the discipline imposed by the single currency and eventually allow all countries to join the eurozone. The project would establish minimum common standards for major economic sectors, such as labor market, pension systems, taxation, transparency in public administration, tax evasion, etc. Convergence could be achieved through a proposal by the Jacques Delors Institute, which calls for the provision of some extra EU funding earmarked for public governance reforms to any government agreeing to create a task force that would help shepherd such reforms in the country.[80]

Ultimately, all steps toward harmonization and integration imply a profound transfer of sovereignty from member states to European institutions, with many important decisions to be made at a level that most European citizens perceive as too remote. The challenge for the strongest countries would be to demonstrate that integration is not a zero-sum game, and that in case of unavoidable adjustments the burden will be shared fairly among all members of the Union. Flexibility should be the name of the game.

These steps will require fundamental and lengthy reforms that go beyond economic and financial policies and will cover all aspects of a modern society such as energy, security, defense and, of course, a system of transnational democracy. In light of Brexit, the rise of nationalist parties, and the anti-globalization movements, these objectives appear remote today. With the right mix of leaders willing to offer EU citizens a long-term vision of prosperity

80 Eulalia Rubio, "Promoting Structural Reforms in The Euro Area: What for and how?," Notre Europe – Jacques Delors Institute, Policy Paper 119, October 14, 2014, http://www.notre-europe.eu/media/structuralreformseuroarea-rubio-ne-jdi-oct14.pdf?pdf=ok.

Figure 22. Concentric Circles



and security based on concrete achievements, these could find a stronger base of support. While this order of events is appropriate, Brexit has raised the stakes for completing and strengthening the banking union. The last step should be completed expeditiously, buttressed by a common fiscal backstop, and with incentives to progressively diversify banks' exposures to sovereign risks.[81]

81 Agnès Bénassy-Quéré, Xavier Ragot, and Guntram B. Wolff, "Which Fiscal Union for the Euro Area?," Bruegel Policy, February 2016, http://bruegel.org/2016/02/which-fiscal-union-for-the-euro-area/.

CONCLUSIONS

A Check List for the European Union

This report depicts a road map for the short, medium, and long term to make Europe economically stronger in order to address the challenges of our times. The *EuroGrowth Task Force* will monitor progress and will continue to galvanize an EU-US community on the need for faster and deeper implementation of a number of measures and initiatives that can create the right environment for attracting talent and investments, and restore confidence in the European project.

By the end of 2017			
Restore free movement of people in the Schengen areas, make Frontex and the European coast guard fully operational with contributions by all member states and with sanction mechanisms for those that do not contribute, enhance counter-terror work			
Start negotiations of an EU-US economic agreement.			
Present a clear timeline for Brexit negotiations that avoid carrying into the next European Parliament elections in June 2019 to avoid uncertainty about British participation.			
Allow a one-off increase in public investment			
By the end of the European Commission mandate (2019)			
Make online transactions across border efficient and secure.			
Fix the building blocks of the Capital Market Union: introduce the European supervisor on capital markets, launch the Pan-European venture capital fund-of-funds, and reduce barriers to small and medium enterprises' entry to public markets.			
Speed up the internal services market, reducing unnecessary regulations.			
Complete the energy union, increasing competition.			
By 2022			
Launch Eurobonds for growth.			
Establish a European Fiscal Authority.			
Rethink and expand the EU budget.			
Set up a new institutional framework to favor additional integration among a core group of countries.			

Atlantic Council Board of Directors

"In a turbulent world, there is a serious need for insightful examination of complex problems and the provision of effective solutions; the Atlantic Council report delivers both."

David Abney
Chairman & CEO, UPS

"The EuroGrowth Task Force Report chaired by Jose Manuel Barroso and Stuart Eizenstat is extremely important and timely. It successfully addresses the main challenges that face the European economy, and it outlines a concrete and well-reasoned set of policies for achieving sustainable economic growth. It should be highly welcomed by policy makers, and by political and economic analysts. It should provide the basis for a far reaching blueprint for European Policy."

Jacob A. Frenkel
Chairman, JPMorgan Chase International, Chairman, Board of Trustees of the Group of Thirty (G30) and Former Governor, Bank of Israel

"The report is remarkable. It provides a refreshing view on the main European issue: i.e. how to unlock its economy and rekindle growth.

The background is based on well-documented data. The diagnostic is clear and uncompromising. The authors propose pragmatic and staged reforms for a better future to a still divided Union.

The concept of 'concentric circles' is appealing.

Lastly, this document stresses how much a stronger and more stable Europe is important for the US and the world at large."

Jacques de Larosière
Former Managing Director of the International Monetary Fund (1978-1987), former Governor of Banque de France (1987-1993), former President of the European Bank for Reconstruction and Development (1993-1998)