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Overcome divisions and confront threats: Memo to the new Presidents of the European Commission, Council and Parliament

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Executive summary

IN THE LAST five years, the European Union managed to find its way through a series of major shocks, including the pandemic and the 2022 surge in energy prices. The response was in many ways remarkable, including unprecedented EU borrowing to fund the NextGenerationEU economic recovery programme and a coordinated reduction in energy demand. However, these crises have left the EU in a bruised state.

THE PANDEMIC RECESSION and energy-support measures have squeezed fiscal space. Higher energy prices have persisted and EU industrial competitiveness has been eroded. The productivity and *per-capita* income gap with the United States has widened. Meanwhile, the world around the EU has become more threatening and fragmented. The military situation in Ukraine remains precarious. China has become both more authoritarian and more assertive. The US shift toward protectionism has become entrenched. There is less consensus for measures to combat climate change.

IN THE FACE of all this, the challenges confronting you are substantial. In the next five years, you must continue to support Ukraine while implementing measures to reinvigorate EU growth, meet the 2030 climate targets and lay the ground for meeting the 2040 goals, and secure faster emissions reductions beyond the EU's borders. Social cohesion needs to be restored to head off threats to the EU model. More needs to be done to improve EU external security.

PROMOTING GROWTH AND enhancing cohesion will entail further deepening of the single market in areas with the highest growth impact, doing more to support innovation and defending competition, openness and multilateralism. Safeguarding the European Green Deal means boosting green industrialisation and fair burden-sharing, while scaling up international climate finance. Strengthening security requires continued support for Ukraine and the addressing of economic security risks. Underpinning all of this, a serious effort must be made to improve EU governance – and it must be done without creating further division.

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1 State of affairs

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

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

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

The world around the EU has become more threatening and fragmented

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

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

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

The EU passed several landmark laws in the previous cycle. These include the Recovery and Resiliency Facility financed by common borrowing (February 2021), the European Climate Law (June 2021) and a set of digital laws (the Digital Markets Act and Digital Services Act in 2022; the Artificial Intelligence Act in 2023). Economic security took centre stage (the

European Chips Act, Critical Raw Materials Act and Anti-Coercion Instrument in 2023; the 2024 Cyber Resilience Act). The 2024 Migration and Asylum package and the 2024 revamp of the European fiscal rules represented hard-fought compromises and are for the most part improvements.

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

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

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

2 Challenges

Provide effective support to Ukraine

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

Invigorate growth

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

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

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

Accelerate climate action outside the EU's borders

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

Restore social cohesion

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

Improve the EU's external security

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

Improve EU governance

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

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

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

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

3 Recommendations

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

Promoting growth and enhancing cohesion

1 Deepen the single market in the areas of highest growth impact

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

2 Curb regulatory excess and make EU regulation more growth-friendly.

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

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

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

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

4 Focus the EU budget on EU public goods

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

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

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

6 Defend competition, openness and multilateralism

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

Safeguarding the Green Deal and extending its global reach

7 Boost green industrialisation and establish a green social contract

Green deal goals will have medium-term costs for European industrial competitiveness, particularly after the loss of free ETS allowances and, later, when ETS2 applies. This should be addressed by strengthening the EU's comparative advantage in clean tech through instruments such as the mission-oriented innovation support proposed in recommendation 3. A further obstacle to meeting Green Deal goals is the disproportionate burden of carbon pricing and regulation borne by vulnerable groups. To address this, the existing Just Transition Fund and Social Climate Fund must be better targeted to help those with lower incomes adjust to the energy transition, while the Common Agricultural Policy should be transformed into a 'Rural Green Deal' supporting farmers.

8 Scale-up international climate finance

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

Strengthening the EU's security

9 Support Ukraine and strengthen EU defence autonomy

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

10 Address economic security blind spots

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

11 Reset the relationship with the UK

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

Reforming EU decision-making

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

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

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

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