

# WORLD COMMENTARY REVIEW

EU ePub  
Autumn 2020

FINANCING THE EU. CLEMENS  
FUEST AND JEAN PISANI-  
FERRY CONSIDER THE LATEST  
EU BUDGET

BENJAMIN ZEEB BELIEVES  
THAT EUROPE NEEDS A  
PLAN B TO THRIVE POST-  
PANDEMIC

THE CJEU HAS RULED  
THAT THE EU-US PRIVACY  
SHIELD IS INVALID. JOSHUA  
MELTZER EXAMINES

THE GLOBAL TRADE AND FINANCE PLATFORM

# CONTENTS

## *To thrive in the post-COVID world, Europe needs a Plan B*

Benjamin Zeeb considers the EU's COVID-19 rescue package and argues that government by consensus rather than majority is not the right method in times of crisis

## *Freedom during the COVID-19 crisis*

Fleur de Beaufort and Patrick van Schie consider the measures taken to combat the pandemic and how state intervention can be reigned back

## *Building the world we want to live in*

Ursula von der Leyen presents her vision for a Europe that emerges stronger from the pandemic and leads the way towards a new vitality in a world of fragility

## *The impact of GDPR on data flows and national security*

The CJEU has ruled that the EU-US Privacy Shield is invalid. Joshua Meltzer considers the impact and suggests ways forward

## *New challenges to transfers of personal data*

Scott Marcus considers the recent CJEU judgement and the impact on data transfers between the European Union and the United States

# CONTENTS

## *Europe needs a fully-fledged CMU*

The coronavirus crisis makes progress on CMU even more important. Luis de Guindos, Fabio Panetta and Isabel Schnabel outline priority areas for reform to foster European capital markets

## *Financing the EU: new context, new responses*

Clemens Fuest and Jean Pisani-Ferry consider the EU budget, which has to be reassessed in light of the Next Generation EU programme

## *The challenge of climate finance*

Alexander Lehman and Mark Plant discuss low-carbon transition challenges and consider the EU agenda for coordinating with emerging markets

## *Deeper recession, wider divergences*

Maarten Verwey and Björn Döhring consider the Commission's Summer 2020 interim forecast, and argue that a rapid response at the EU level is needed to minimise hysteresis

## *Is the market prepared?*

The SCA deadline is nearing. Marius Galdikas says the need to adapt will be a watershed moment for businesses

# To thrive in the post-COVID world, Europe needs a Plan B

Benjamin Zeeb considers the EU's COVID-19 rescue package and argues that government by consensus rather than majority is not the right method in times of crisis

**H**ailed as a bold move and new chapter in the EU's development, the COVID-19 rescue package still follows a logic that is doomed to failure. On 5 August 1943, Jean Monnet declared: *"There will be no peace in Europe, if the states are reconstituted on the basis of national sovereignty... The countries of Europe are too small to guarantee their peoples the necessary prosperity and social development. The European states must constitute themselves into a federation..."*

But after the European Defence Community failed in 1954, Monnet took on a more practical approach, aiming to gradually integrate bits and pieces of national sovereignty until little was left for the state to decide over. Some in Brussels and Europe's capitals have taken this workaround as gospel and to this day misunderstand its intention.

The Methode Monnet was always intended to be directed at a final state of European federalization. It was never intended to be an endless process of baby steps aimed at an 'ever closer union' whose realization is projected into some distant past.

Europe paradoxically has come to fully endorse Monnet's Method, without approving its goal. Like a race car driver that is fundamentally and on principle opposed to reaching the finishing line, Brussels continues to make mockery of the man it holds in such high esteem.

This same mechanism is on display in the handling of Europe's latest crisis, one that once again requires the entire continent to act, when only few are capable and even fewer willing to do so.

Yes, a common debt is a step in the right direction, but what we are witnessing now is a far cry from the Hamiltonian moment required. Government by consensus rather than majority was never a great idea. In times of crisis it can prove fatal.

It is this lack of clarity and focus, this intellectual weakness, more so than any pandemic, that presents the largest danger to the European idea and by extension its citizenry. It could not come at a more critical time.

Across Europe, advocates of liberal democracy, rule of law, equality, solidarity, and free civil society have been pushed in a defensive position. The very same individuals and organisations who had traditionally been engaged in the drive to move the continent forward are finding themselves in the trenches of a hard-fought political, cultural, and ideological clash.

Rather than moving ahead, so it seems, in many European countries the order of the day has moved to defending what has been achieved in previous decades, by previous generations.

*If one wants to Europeanize executive power, this means that democratic process needs to be Europeanized as well*

The classical divides between left and right, conservatism and progressivism, individualism and solidarity no longer apply. It is not only historians who are increasingly listening for the echoes of the 1920s and 30s in the speech, policies and demeanour of illiberal governments and movements around Europe.

Are we paranoid or is a second coming at hand? What if it is true that - in the words of William Butler Yeats - things are falling apart, the centre cannot hold, and a new rough beast is slouching towards Bethlehem to be born? Isn't it our responsibility then to try and kill it before it reaches its destination?

In this critical moment Europeans cannot leave politics to politicians alone. What is required is a strong civil society. This includes business and requires industry leaders to rediscover their sense of responsibility for the shared security and health of the continent.

What is happening here, too slow for many to catch on, has already happened elsewhere. And happened after business elites had failed to respond adequately to a moment in history that required more than just economic savvy.

The very same night that Donald J Trump was elected the 45<sup>th</sup> president of the United States, early trading on stock exchanges around the world saw prices plummet. The investor Carl Icahn, who was worth an approximate 20 billion dollars at the time, and a Trump supporter from the very beginning, left the election party before midnight. He went on a big shopping tour.

Unfortunately, he was only able to mobilize about one billion dollars on the quick, Icahn told the New York station Bloomberg TV later. Icahn, who would later become Trump's special advisor for economic reform, put everything

he was able to scrape together into US stocks - and he turned out to be right. A year later, the S&P 500 had risen by almost a quarter.

One year later, the markets had learned their lesson. When the authoritarian right-wing populist Bolsonaro won the elections in Brazil last October, investors responded to the news with display of financial fireworks. What does this tell us about our economic culture?

At first glance it is not surprising that many business representatives shrug off the fact that Salvini is meeting with the PiS government in Poland, that Steve Bannon together with Gloria von Thurn und Taxis was mobilizing the conservative clergy against Pope Benedict, before being charged for fraudulent activities, or for that matter, that Cambridge Analytica, the dubious company that helped to win Trump the 2016 election, is also in contact with the heads of the Brexit campaign.

Populists, it seems, are good for business. But European industry, and Germans in particular, should be aware that an alternative to the post-war order is being created here. In this world, there is no room for the German business model.

All this requires a new radicalism in the strive for European unity that goes far beyond the tedious processes of the Methode Monnet.

The recent history of the European Union has shown that its members are extremely reluctant to cede sovereignty to the continental bureaucracy and until the creation of the Troika there was no governmental structure to be found anywhere in Europe that would have been worth the trouble for European federalists to even consider taking over.

Historically, nearly all political entities in Europe and elsewhere that successfully changed from authoritarian regimes or monarchies to democratically legitimated nation states achieved this by some sort of internal or external revolution.

Basically either the people took away political authority from those who had ruled them (as in France or in the US), or political authority was given to them by the victors following a conflict (as with Germany).

In nearly all cases, however, centralization had already occurred beforehand. It is hard to find cases in which stable democratic states have been established within a territory not previously consolidated.

However, European history also shows that suspending democracy, even for the briefest of moments is not a very good idea. Already Europeans don't trust the European institutions with the management of the rather mundane duties they are tasked with today.

How could we expect them to trust them with managing the fate of an entire continent? At times European elite's utterances seem to reveal the desire for a new kind of philosopher king that captures the minds of everybody walking the halls of the Berlaymont in Brussels.

Suspending national democracy is not an option until there are institutions in place and ready to take over as a functional equivalent. We cannot allow the state to crumble before we have a very clear gameplan for what comes next.

What we must push for instead is a one single and well-prepared moment of parliamentary fusion, that ensures continued representation and guarantees that democratic accountability remains in place.

This will necessitate something many dread, an element of direct democracy. Simultaneous referenda in all member states and regions of the eurozone that will determine whether or not a country or region joins the new federal Union. The new Union will then be constituted the very same moment in which two or more entities decide to join it.

A European Union that continues to rely on structures that are built from the top down, whether this affects all members at once or only a handful at a time, especially if it doesn't grant citizens the power to collectively decide on varying policy ideas, will never be stable.

If one wants to Europeanize executive power, this means that democratic process needs to be Europeanized as well. In the end, whether or not a state's citizenry is willing to make this change, should be where the line is drawn. ■

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The background of the slide features a warm, orange-to-brown gradient, suggesting a sunset or sunrise. In the foreground, there are dark silhouettes of hands. One hand is raised, reaching up to break through a chain of links. Another hand is visible in the lower left, also appearing to be part of the struggle against the chains. The overall mood is one of liberation and defiance.

# Freedom during the COVID-19 crisis

Fleur de Beaufort and Patrick van Schie consider the measures taken to combat the pandemic and how state intervention can be reigned back

**T**he world has been in the grip of the COVID-19 outbreak since early 2020. While initially, many aspects of the virus were still shrouded in uncertainty – with governments unable to make a sound assessment of its impact – by March, it had become clear that the world was facing a full-blown crisis.

Intensive care units rapidly filled up with patients and the medical care sector was overloaded with cases. Citizens started stockpiling en masse, and on 11 March the WHO officially characterised the COVID-19 outbreak as a pandemic.

Governments had to hastily determine which measures they needed to take to mitigate the crisis. And as the Dutch Prime Minister Mark Rutte reminded the press, they had to base their decisions on a very limited understanding of what they were actually up against. 'A veritable struggle,' as Rutte put it, that led to 'diabolical dilemmas'.

Around the world, it quickly became clear that it would be necessary to restrict people's freedom of movement in an effort to rein in the pandemic. At first, fear of the unknown virus and the mounting number of infections created widespread public support for all the emergency measures.

However, in the period that followed, we also saw new scope for reflection and criticism. Particularly now that in many countries, what has become known as 'the first wave' seems to have abated – and the associated, nation-wide panic with it – the adopted containment measures are the subject of heated debate. And almost everywhere, we can see certain groups resisting any form of intervention whatsoever.

Over the past months, different governments have also decided on radically different forms of 'crisis management'. Some governments opted for a total lockdown, during which almost every civic freedom was initially restricted in some way and citizens found in breach of regulations could count on hefty fines.

Schools and universities had to close their doors, working from home – wherever possible – became the standard, and citizens were generally expected to stay indoors as much as possible. Physical contact was kept to a bare minimum by government order, and in certain locations – nursing homes and care homes, for example – banned altogether.

The only stores allowed to stay open were those selling essential products – supermarkets, for instance. Many countries in Southern Europe adopted a total lockdown, but in Asia too, governments didn't hesitate to take the crisis as an opportunity to further strengthen their hold.

Other countries, in contrast, adopted a far less rigorous response. In some cases, in any case initially, this was due to the government underestimating the gravity of the situation – as witnessed in the US and Brazil.

*One thing's for sure: sooner or later, our citizens – as taxpayers – will be footing the bill for all the funds currently being doled out – seemingly free of charge*

In other cases – Sweden for example – the government consciously decided to let things run their course. While Sweden's citizens were advised to work from home wherever possible and keep travel to a minimum, its schools, hospitality venues and shops remained open. The Scandinavian country only prohibited gatherings of over 50 people, and care homes were also closed to the public.

During a press conference the Swedish Prime Minister Stefan Löfven announced that he trusted people to be responsible in their decisions. These were times, according to Löfven, when people not only needed to make sacrifices in their own interest but also for others' sake.

The Swedish government did not deem it necessary to legally enforce these sacrifices, pointing to people's personal responsibility to do the right thing.

In the meantime, the Dutch government had implemented what was known as an 'intelligent lockdown'. While this encompassed a large number of measures – a number of which were also enforced via emergency ordinances – the country consciously wasn't put into total lockdown.

Shops, for example, remained open and people working in essential occupations were allowed to drop off their children at school or childcare – albeit in limited numbers. And citizens could still relax in the outdoors – provided they continued to socially distance.

In the Netherlands too, the authorities appealed to citizens' sense of personal responsibility, although in terms of enforcement they wielded a bigger stick than their colleagues in Sweden.

Public support for the official COVID-19 policy tends to fluctuate according to the current crisis situation. In the Netherlands, for example, the government's measures initially enjoyed widespread support – in early March, many people even felt that the government could be more incisive in its response. Were we doing enough to prevent the virus from spreading? Or should we follow the example of our neighbours to the south and adopt far stricter measures?

As the country gradually brought the outbreak under control and the economic consequences of the intelligent lockdown came into sharper focus, public confidence in the government's performance as crisis manager diminished.

Reflecting on and criticising the government's handling of the corona crisis, people frequently draw comparisons with other countries. Opponents of far-reaching government intervention consistently point to Sweden as an example of how it should be done, while the media keep close tabs on this country's infection rate and death total.

A big risk of looking abroad for answers is that in many ways it amounts to comparing apples and oranges. After all, taken by themselves the COVID-19 data only tell part of the story. Other factors that play a key role in this context are the state of healthcare in the country in question (available care and, above all, IC capacity), population density, national character, etc. Aspects like these make drawing a direct comparison very difficult.

European liberals show a preference for the Swedish approach on ideological grounds. After all, citizens' individual freedoms and personal responsibility are two core values for this movement. At the same time, liberals also acknowledge the 'harm principle' as articulated by John Stuart Mill.

Over 150 years ago, the British philosopher worded this principle as follows in his work *On Liberty*: 'The only purpose for which power can be rightfully exercised over any member of a civilised community, against his will, is to prevent harm to others.'

In line with this principle, Rutte reminded the public during a press conference that one individual's freedom should not come at the expense of the other's health. In the present COVID crisis, this seems to open the door for a possible total lockdown.

After all, until we have developed a vaccine or effective treatment the potential risk of infection is such that people will continue to pose a threat to each other almost by definition. But is this actually the case? Since individual freedom is never entirely without risk, one could also make any number of other considerations.

For those who attach strong importance to individual freedom, restricting said freedom is not a step taken lightly – even during a pandemic. After all, as far as the concrete risk of infection is concerned, citizens do not all threaten their neighbours to the same degree.

A lot of people aren't infected with the virus – meaning they don't pose a threat to others. And among those who do contract it, quite a few don't suffer serious symptoms.

Moreover, greater freedom of movement for everyone does not preclude different considerations at the individual level. Anyone can decide for themselves whether they prefer to avoid large gatherings or physical contact with too many other people – or skip their annual holiday, for example.

Members of the various high-risk groups in particular will probably make different decisions than eg. young people, who feel more or less immune to this threat.

In organised societies, authorities are taking a variety of measures to minimise risks – health-related and otherwise – not least because of the impossibility of collectively bearing the possible consequences of inaction. It is vital to find the right balance in these endeavours.

Considering the number of people killed or injured in traffic accidents every year, those seeking an entirely risk-free society would be best served by far-reaching, government-imposed restrictions on road traffic. Nevertheless, no one would deem such a proposal realistic.

However, almost everyone accepts the legal requirement to wear a seat belt – a prescription that prevents numerous casualties – although this takes away the individual's freedom to make this particular risk assessment. In other words, it needs to be consistently evaluated which measures aimed at minimising a risk can still be considered proportionate.

An uncontrolled outbreak would put such pressure on the country's IC capacity that liberals will also agree to some measure of government intervention. However, the eagerness with which certain governments are seizing more power at the expense of individual freedom is unacceptable to liberals. After all, in times of crisis, individual freedom and people's individual responsibility remain as important as ever.

In the fight against COVID-19, an array of measures that reduce risk could be considered – isolating infected people, for example, protecting vulnerable groups who agree to this step, a temporary ban on large-scale public events like

festivals or unnecessary travel abroad – while better safeguarding citizens' individual freedom. A freedom – and this we all understand – that will always entail some risk or other.

At first glance, this careful navigating between one person's individual freedom and risks to the other's health seems a temporary phenomenon. As soon as an effective vaccine or antiviral drug has become widely available, these deliberations will no longer be necessary.

We can return from the 'new normal' – as virologists and politicians have dubbed the current, rather inconvenient and unpleasant arrangements – to the one-and-only 'real' normal. At least, that's what you'd expect...

However, in the present public debate, quite a few people believe that we won't be going back to the way things were – or shouldn't. To start, there are those who believe that our behaviour will be structurally changed by our present forms of interaction.

This ranges from the idea that we will no longer greet each other in the same way – no more shaking hands, let alone kissing – to changes to our travel behaviour. In this outlook, we will be taking far fewer flights than we used to, for instance, which – as an added bonus – contributes to our efforts to combat the 'climate problem'.

From a historical perspective it does not seem very likely that human interaction will be structurally changed by the present crisis. After all, after previous pandemics like the plague or (as recently as the 20<sup>th</sup> century) the Spanish flu, people didn't keep more distance between them or seek each other out less often either. Human beings are highly social creatures who need to interact with others and who receive positive stimuli from these experiences.

Indeed, we can see in the present crisis how difficult it is for people – even with the threat of the virus still looming large – to keep the requisite distance. And this past summer, we saw how masses of well-to-do Europeans took a holiday abroad, viewing this as an inalienable ‘right’ – crisis or no crisis. Think what we like of such behaviour, the fact remains that human nature is unlikely to be changed by temporary threats like the COVID crisis.

What we could see happening is that working from home becomes a more common practice in occupations that allow for this. It will be necessary in that case to ensure that one still meets colleagues, clients, course participant and other work-related contacts face to face with some regularity.

It has become clear from the numerous Zoom sessions held over the past few months that while digital communication tools can be handy, they are also somewhat restricted. We will still have to meet each other in person every now and then. But it doesn’t have to be every workday.

Now that it has become clear that employees can do a lot of work from home, we no longer have to submit to the ‘daily grind’ of commuting to and from the office five days a week. In this case, a change of behaviour is quite plausible because daily commutes were already considered inconvenient, due to wasted time and annoying congestion, for example.

From the very start of the COVID-19 crisis, there were also calls to grasp this pandemic as an opportunity to fundamentally change our way of life. For example, the outbreak was said to highlight the crisis that capitalism itself was going through. Or – under the motto ‘never waste a good crisis’ – it was seen as an opportunity to make thorough work of the ‘climate problem’.

As was clear from the speed with which they were presented, these conclusions were hardly supported by a solid underlying analysis. Indeed, this call did not stem from a logical scientific inquiry into the issues at hand, but was made by a group of 'true believers' – be it in Socialism or in man's need to pay obeisance to the 'climate gods' – who latched onto the pandemic as a way to politically capitalise on their 'vindication'.

Was the pandemic caused by capitalism? Well, it actually originated in the world's foremost Communist dictatorship: the People's Republic of China. And that particular system also made things worse by attempting to cover up the outbreak for several weeks, and punishing whistle-blowers rather than giving them a fair hearing.

Is a Communist country like the PRC better able to combat the virus than a capitalist one? Well, in this respect, free China – Taiwan – has definitely outperformed its unfree counterpart on the mainland.

Nor could one say that free countries with stronger government intervention have done a better job. In Europe, countries like Italy, France and Great Britain with a nationalised system of healthcare have done worse than countries with a more mixed system.

This is not to suggest that there is a causal relationship as such, but simply that anyone who states that we will need to step up government involvement if we intend to weather the future will have to provide substantial evidence in support of this claim. For the moment, the opposite view seems to hold.

Nevertheless, one of the few structural changes that have come out of the COVID-19 pandemic seems to be increased state intervention in our economy. Across the planet, governments have come to the aid of citizens and companies with support measures large and small.

During major crises, governments need to offer temporary emergency aid. But at the same time, we have also seen how in the aftermath of the two major crises of the 20<sup>th</sup> century – the two world wars – it became next to impossible to once again dial back this extra state intervention.

While this will be applauded by some – the Socialist faithful, for instance – we fear that once we have overcome this pandemic, our societies will be continue to groan for far too long under governments that believe they can ‘steer’ and stimulate our economy.

One thing’s for sure: sooner or later, our citizens – as taxpayers – will be footing the bill for all the funds currently being doled out – seemingly free of charge. ■

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# Building the world we want to live in

Ursula von der Leyen presents her vision for a Europe that emerges stronger from the pandemic and leads the way towards a new vitality in a world of fragility

**O**ne of the most courageous minds of our times, Andrei Sakharov – a man so admired by this House - always spoke of his unshakeable belief in the hidden strength of the human spirit. In these last six months, Europeans have shown how strong that human spirit really is.

We saw it in the care workers who moved into nursing homes to look after the ill and the elderly. In the doctors and nurses who became family members for those in their last breath. In the front-line workers who worked day after night, week after week, who took risks so most of us didn't have to. We are inspired by their empathy, bravery and sense of duty – and I want to start this speech by paying tribute to them all. Their stories also reveal a lot about the state of our world and the state of our Union.

They show the power of humanity and the sense of mourning which will live long in our society. And they expose to us the fragility all around us. A virus a thousand times smaller than a grain of sand exposed how delicate life can be. It laid bare the strains on our health systems and the limits of a model that values wealth above wellbeing.

It brought into sharper focus the planetary fragility that we see every day through melting glaciers, burning forests and now through global pandemics. It changed the very way we behave and communicate – keeping our arms at length, our faces behind masks.

It showed us just how fragile our community of values really is – and how quickly it can be called into question around the world and even here in our Union.

But people want to move out of this corona world, out of this fragility, out of uncertainty. They are ready for change and they are ready to move on. And this is the moment for Europe.

The moment for Europe to lead the way from this fragility towards a new vitality. And this is what I want to talk about today.

I say this because in the last months we have rediscovered the value of what we hold in common. As individuals, we have all sacrificed a piece of our personal liberty for the safety of others. And as a Union, we all shared a part of our sovereignty for the common good.

We turned fear and division between Member States into confidence in our Union. We showed what is possible when we trust each other and trust our European institutions. And with all of that, we choose to not only repair and recover for the here and now, but to shape a better way of living for the world of tomorrow.

*For me, it is crystal clear – we need to build a stronger European Health Union. And to start making this a reality, we must now draw the first lessons from the health crisis*

This is NextGenerationEU. This is our opportunity to make change happen by design – not by disaster or by diktat from others in the world. To emerge stronger by creating opportunities for the world of tomorrow and not just building contingencies for the world of yesterday.

We have everything we need to make this happen. We have shaken off the old excuses and home comforts that have always held us back. We have the vision, we have the plan, we have the investment. It is now time to get to work.

I have sent a Letter of Intent to President Sassoli and Chancellor Merkel – on behalf of the German Presidency - outlining the Commission's plans for the year ahead. I will not present every initiative, but I want to touch on what our Union must focus on in the next twelve months.

### **Pulling through together: making good on Europe's promise**

The people of Europe are still suffering. It is a period of profound anxiety for millions who are concerned about the health of their families, the future of their jobs or simply just getting through until the end of the month.

The pandemic – and the uncertainty that goes with it – is not over. And the recovery is still in its early stage. So our first priority is to pull each other through this. To be there for those that need it. And thanks to our unique social market economy, Europe can do just that.

It is above all a human economy that protects us against the great risks of life - illness, ill-fortune, unemployment or poverty. It offers stability and helps us better absorb shocks. It creates opportunity and prosperity by promoting innovation, growth and fair competition.

Never before has that enduring promise of protection, stability and opportunity been more important than it is today. Allow me to explain why.

First, Europe must continue to protect lives and livelihoods. This is all the more important in the middle of a pandemic that shows no signs of running out of steam or intensity.

We know how quickly numbers can spiral out of control. So we must continue to handle this pandemic with extreme care, responsibility and unity.

In the last six months, our health systems and workers have produced miracles. Every country has worked to do its best for its citizens. And Europe has done more together than ever before.

When member states closed borders, we created green lanes for goods. When more than 600,000 European citizens were stranded all over the world, the EU brought them home. When some countries introduced export bans for critical medical goods, we stopped that and ensured that critical medical supply could go where it was needed.

We worked with European industry to increase the production of masks, gloves, tests and ventilators. Our Civil Protection Mechanism ensured that doctors from Romania could treat patients in Italy or that Latvia could send masks to its Baltic neighbours. And we achieved this without having full competences.

For me, it is crystal clear – we need to build a stronger European Health Union. And to start making this a reality, we must now draw the first lessons from the health crisis.

We need to make our new EU4Health programme future proof. This is why I had proposed to increase funding and I am grateful that this Parliament is ready to fight for more funding and remedy the cuts made by the European Council.

And we need to strengthen our crisis preparedness and management of cross-border health threats. As a first step, we will propose to reinforce and empower the European Medicines Agency and ECDC – our centre for disease prevention and control.

As a second step, we will build a European BARDA – an agency for biomedical advanced research and development. This new agency will support our capacity and readiness to respond to cross-border threats and emergencies – whether of natural or deliberate origin. We need strategic stockpiling to address supply chain dependencies, notably for pharmaceutical products.

As a third step, it is clearer than ever that we must discuss the question of health competences. And I think this is a noble and urgent task for the Conference on the Future of Europe.

And because this was a global crisis, we need to learn the global lessons. This is why, along with Prime Minister Conte and the Italian G20 Presidency, I will convene a Global Health Summit next year in Italy. This will show Europeans that our Union is there to protect all.

And this is exactly what we have done when it comes to workers. When I took office, I vowed to create an instrument to protect workers and businesses from external shocks. Because I knew from my experience as a Minister for Labour and Social Affairs that these schemes work. They keep people in jobs, skills in companies and SMEs in business. These SMEs are the motor of our economy and will be the engine of our recovery.

This is why the Commission created the SURE programme. And I want to thank this House for working on it in record time. If Europe has so far avoided mass unemployment seen elsewhere, it is thanks in large part to the fact that around 40 million people applied for short-time work schemes.

This speed and unity of purpose means that 16 countries will soon receive almost €90 billion from SURE to support workers and companies. From Lithuania to Spain, it will give peace of mind to families who need that income to put food on the table or to pay the rent. And it will help protect millions of jobs, incomes and companies right across our Union.

This is real European solidarity in action. And it reflects the fact that in our Union the dignity of work must be sacred. But the truth is that for too many people, work no longer pays.

Dumping wages destroys the dignity of work, penalises the entrepreneur who pays decent wages and distorts fair competition in the Single Market. This is why the Commission will put forward a legal proposal to support member states to set up a framework for minimum wages. Everyone must have access to minimum wages either through collective agreements or through statutory minimum wages.

I am a strong advocate of collective bargaining and the proposal will fully respect national competencies and traditions. We have seen in many member states how a well-negotiated minimum wage secures jobs and creates fairness – both for workers and for the companies who really value them. Minimum wages work – and it is time that work paid.

The second promise of the social market economy is that of stability. The European Union and its member states responded to an unprecedented crisis with an unprecedented response. By showing it was united and up to the task, Europe provided the stability our economies needed.

The Commission immediately triggered the general escape clause for the first time in our history. We flexibilised our European funds and state aid rules, authorising more than €3 trillion in support to companies and industry: from fishermen in Croatia and farmers in Greece, to SMEs in Italy and freelancers in Denmark.

The European Central Bank took decisive action through its PEPP programme. The Commission proposed NextGenerationEU and a revamped budget in record time. It combines investment with much needed reforms. The Council endorsed it in record time. This House is working towards voting on it with maximum speed.

For the first time – and for exceptional times - Europe has put in place its own common tools to complement national fiscal stabilisers. This is a remarkable moment of unity for our Union. This is an achievement that we should take collective pride in.

Now is the time to hold our course. We have all seen the forecasts. We can expect our economies to start moving again after a 12% drop in GDP in the second quarter. But as the virus lingers so does the uncertainty – here in Europe and around the world. So this is definitely not the time to withdraw support.

Our economies need continued policy support and a delicate balance will need to be struck between providing financial support and ensuring fiscal sustainability. In the longer-term there is no greater way to stability and competitiveness than through a stronger Economic and Monetary Union. Confidence in the euro has never been stronger.

The historic agreement on NextGenerationEU shows the political backing that it has. We must now use this opportunity to make structural reforms in our economies and complete the Capital Markets Union and the Banking Union.

Deep and liquid capital markets are essential to give businesses access to the finance they need to grow and invest in recovery and in the future. And they are also a pre-requisite to further strengthen the international role of the euro. So let's get to work and finally complete this generational project.

The third enduring promise is the promise of opportunity. The pandemic reminded us of many things we may have forgotten or taken for granted. We were reminded how linked our economies are and how crucial a fully functioning Single Market is to our prosperity and the way we do things.

The Single Market is all about opportunity - for a consumer to get value for money, a company to sell anywhere in Europe and for industry to drive its global competitiveness. And for all of us, it is about the opportunity to make the most of the freedoms we cherish as Europeans.

It gives our companies the scale they need to prosper and is a safe haven for them in times of trouble. We rely on it every day to make our lives easier – and it is critical for managing the crisis and recovering our strength. Let's give it a boost.

We must tear down the barriers of the Single Market. We must cut red tape. We must step up implementation and enforcement. And we must restore the four freedoms – in full and as fast as possible.

The linchpin of this is a fully functioning Schengen area of free movement. We will work with Parliament and member states to bring this high up our political agenda and we will propose a new strategy for the future of Schengen.

Based on this strong internal market, the European industry has long powered our economy, providing a stable living for millions and creating the social hubs around which our communities are built.

We presented our new industry strategy in March to ensure industry could lead the twin green and digital transition. The last six months have only accelerated that transformation – at a time when the global competitive landscape is fundamentally changing. This is why we will update our industry strategy in the first half of next year and adapt our competition framework which should also keep pace.

### **Propelling Europe forward: building the world we want to live in**

All of this will ensure Europe gets back to its feet. But as we pull through together, we must also propel ourselves forwards to the world of tomorrow.

There is no more urgent need for acceleration than when it comes to the future of our fragile planet. While much of the world's activity froze during lockdowns and shutdowns, the planet continued to get dangerously hotter.

We see it all around us: from homes evacuated due to glacier collapse on the Mont Blanc, to fires burning through Oregon, to crops destroyed in Romania by the most severe drought in decades.

But we also saw nature come back into our lives. We longed for green spaces and cleaner air for our mental health and our physical wellbeing. We know change is needed – and we also know it is possible.

The European Green Deal is our blueprint to make that transformation. At the heart of it is our mission to become the first climate-neutral continent by 2050.

But we will not get there with the status quo – we need to go faster and do things better. We looked in-depth at every sector to see how fast we could go and how to do it in a responsible, evidence-based way. We held a wide public consultation and conducted an extensive impact assessment.

On this basis, the European Commission is proposing to increase the 2030 target for emission reduction to at least 55%. I recognise that this increase from 40 to 55 is too much for some, and not enough for others.

But our impact assessment clearly shows that our economy and industry can manage this. And they want it too. Recently 170 business leaders and investors – from SME's to some of the world's biggest companies - wrote to me calling on Europe to set a target of at least 55%.

Our impact assessment clearly shows that meeting this target would put the EU firmly on track for climate neutrality by 2050 and for meeting our Paris Agreement obligations. And if others follow our lead, the world will be able to keep warming below 1.5 degrees Celsius.

I am fully aware that many of our partners are far away from that – and I will come back to the Carbon Border Adjustment Mechanism later. But for us, the 2030 target is ambitious, achievable, and beneficial for Europe.

We can do it. We have already shown we can do it. While emissions dropped 25% since 1990, our economy grew by more than 60%. The difference is we now have more technology, more expertise and more investment. And we are already embarking towards a circular economy with carbon neutral production.

We have more young people pushing for change. We have more proof that what is good for the climate is good for business and is good for us all. And we have a solemn promise to leave no one behind in this transformation.

With our Just Transition Fund we will support the regions that have a bigger and more costly change to make. We have it all. Now it's our responsibility to implement it all and make it happen.

Meeting this new target will reduce our energy import dependency, create millions of extra jobs and more than halve air pollution. To get there, we must start now.

By next summer, we will revise all of our climate and energy legislation to make it 'fit for 55'. We will enhance emission trading, boost renewable energy, improve energy efficiency, reform energy taxation.

But the mission of the European Green Deal involves much more than cutting emissions. It is about making systemic modernisation across our economy, society and industry. It is about building a stronger world to live in.

Our current levels of consumption of raw materials, energy, water, food and land use are not sustainable. We need to change how we treat nature, how we produce and consume, live and work, eat and heat, travel and transport.

So we will tackle everything from hazardous chemicals to deforestation to pollution. This is a plan for a true recovery. It is an investment plan for Europe. And this is where NextGenerationEU will make a real difference.

Firstly, 37% of NextGenerationEU will be spent directly on our European Green Deal objectives. And I will ensure that it also takes green financing to the next level. We are world leaders in green finance and the largest issuer of green bonds worldwide. We are leading the way in developing a reliable EU Green Bond Standard.

And I can announce that we will set a target of 30% of NextGenerationEU's €750 billion to be raised through green bonds.

Secondly, NextGenerationEU should invest in lighthouse European projects with the biggest impact: hydrogen, renovation and 1 million electric charging points. Allow me to explain how this could work.

This summer in Sweden a unique fossil-free steel pilot began test operations. It will replace coal with hydrogen to produce clean steel. This shows the potential of hydrogen to support our industry with a new, clean, licence to operate. I want NextGenerationEU to create new European Hydrogen Valleys to modernise our industries, power our vehicles and bring new life to rural areas.

The second example are the buildings we live and work in. Our buildings generate 40% of our emissions. They need to become less wasteful, less expensive and more sustainable. And we know that the construction sector can even be turned from a carbon source into a carbon sink, if organic building materials like wood and smart technologies like AI are applied.

I want NextGenerationEU to kickstart a European renovation wave and make our Union a leader in the circular economy. But this is not just an environmental or economic project: it needs to be a new cultural project for Europe.

Every movement has its own look and feel. And we need to give our systemic change its own distinct aesthetic – to match style with sustainability. This is why we will set up a new European Bauhaus – a co-creation space where architects, artists, students, engineers, designers work together to make that happen.

This is NextGenerationEU. This is shaping the world we want to live in. A world served by an economy that cuts emissions, boosts competitiveness, reduces energy poverty, creates rewarding jobs and improves quality of life. A world where we use digital technologies to build a healthier, greener society.

This can only be achieved if we all do it together and I will insist that recovery plans don't just bring us out the crisis but also help us propel Europe forward to the world of tomorrow.

Imagine for a moment life in this pandemic without digital in our lives. From staying in quarantine – isolated from family and community and cut off from the world of work – to major supply problems. It is in fact not so hard to imagine that this was the case 100 years ago during the last major pandemic.

A century later, modern technology has allowed young people to learn remotely and millions to work from home. They enabled companies to sell their products, factories to keep running and government to deliver crucial public services from afar. We saw years' worth of digital innovation and transformation in the space of a few weeks.

We are reaching the limits of the things we can do in an analogue way. And this great acceleration is just beginning. We must make this Europe's Digital Decade.

We need a common plan for digital Europe with clearly defined goals for 2030, such as for connectivity, skills and digital public services. And we need to follow clear principles: the right to privacy and connectivity, freedom of speech, free flow of data and cybersecurity.

But Europe must now lead the way on digital – or it will have to follow the way of others, who are setting these standards for us. This is why we must move fast. There are three areas on which I believe we need to focus.

First, data. On personalized data - business to consumer - Europe has been too slow and is now dependent on others. This cannot happen with industrial data. And here the good news is that Europe is in the lead – we have the technology, and crucially we have the industry.

But the race is not yet won. The amount of industrial data in the world will quadruple in the next five years - and so will the opportunities that come with it. We have to give our companies, SMEs, startups and researchers the opportunity to draw on their full potential. And industrial data is worth its weight in gold when it comes to developing new products and services.

But the reality is that 80% of industrial data is still collected and never used. This is pure waste. A real data economy, on the other hand, would be a powerful engine for innovation and new jobs. And this is why we need to secure this data for Europe and make it widely accessible.

We need common data spaces - for example, in the energy or healthcare sectors. This will support innovation ecosystems in which universities, companies and researchers can access and collaborate on data. And it is why we will build a European cloud as part of NextGenerationEU - based on GaiaX.

The second area we need to focus on is technology - and in particular artificial intelligence. Whether it's precision farming in agriculture, more accurate medical diagnosis or safe autonomous driving - artificial intelligence will open up new worlds for us. But this world also needs rules.

We want a set of rules that puts people at the centre. Algorithms must not be a black box and there must be clear rules if something goes wrong. The Commission will propose a law to this effect next year.

This includes control over our personal data which still have far too rarely today. Every time an App or website asks us to create a new digital identity or to easily log on via a big platform, we have no idea what happens to our data in reality. That is why the Commission will soon propose a secure European e-identity.

One that we trust and that any citizen can use anywhere in Europe to do anything from paying your taxes to renting a bicycle. A technology where we can control ourselves what data and how data is used.

The third point is the infrastructure. Data connections must keep pace with the rapid speed of change. If we are striving for a Europe of equal opportunities, it is unacceptable that 40% of people in rural areas still do not have access to fast broadband connections.

These connections are now the prerequisite for home working, home learning, online shopping and, increasingly by the day, for new important services. Without broadband connections, it is now barely possible to build or run a business effectively.

This is a huge opportunity and the prerequisite for revitalising rural areas. Only then can they fully exploit their potential and attract more people and investment.

The investment boost through NextGenerationEU is a unique chance to drive expansion to every village. This is why we want to focus our investments on secure connectivity, on the expansion of 5G, 6G and fibre.

NextGenerationEU is also a unique opportunity to develop a more coherent European approach to connectivity and digital infrastructure deployment.

None of this is an end in itself - it is about Europe's digital sovereignty, on a small and large scale. In this spirit, I am pleased to announce an investment of €8 billion in the next generation of supercomputers - cutting-edge technology made in Europe.

And we want the European industry to develop our own next-generation microprocessor that will allow us to use the increasing data volumes energy-efficient and securely. This is what Europe's Digital Decade is all about!

If Europe is to move forward and move fast, we must let go of our hesitations. This is about giving Europe more control over its future. We have everything it takes to bring it to life. And the private sector is desperately waiting for this too.

There has never been a better time to invest in European tech companies with new digital hubs growing everywhere from Sofia to Lisbon to Katowice. We have the people, the ideas and the strength as a Union to succeed. And this is why we will invest 20% of NextGenerationEU on digital. We want to lead the way, the European way, to the Digital Age: based on our values, our strength, our global ambitions.

### **A vital Europe in a fragile world**

Europe is determined to use this transition to build the world we want to live in. And that of course extends well beyond our borders. The pandemic has simultaneously shown both the fragility of the global system and the importance of cooperation to tackle collective challenges.

In the face of the crisis, some around the world choose to retreat into isolation. Others actively destabilise the system. Europe chooses to reach out. Our leadership is not about self-serving propaganda. It is not about Europe First. It is about being the first to seriously answer the call when it matters.

In the pandemic, European planes delivering thousands of tonnes of protective equipment landed everywhere from Sudan to Afghanistan, Somalia to Venezuela. None of us will be safe until all of us are safe – wherever we live, whatever we have. An accessible, affordable and safe vaccine is the world's most promising way to do that.

At the beginning of the pandemic, there was no funding, no global framework for a COVID vaccine – just the rush to be the first to get one. This is the moment the EU stepped up to lead the global response. With civil society, the G20, WHO and others we brought more than 40 countries together to raise €16 billion to finance research on vaccines, tests and treatments for the whole world. This is the EU's unmatched convening power in action.

But it is not enough to find a vaccine. We need to make sure that European citizens and those around the world have access to it. The EU has joined the COVAX global facility and contributed €400 million to help ensure that safe vaccines are available not only for those who can afford it – but for everyone who needs it. Vaccine nationalism puts lives at risk. Vaccine cooperation saves them.

We are firm believers in the strength and value of cooperating in international bodies. It is with a strong United Nations that we can find long-term solutions for crises like Libya or Syria.

It is with a strong World Health Organisation that we can better prepare and respond to global pandemics or local outbreaks – be it Corona or Ebola.

And it is with a strong World Trade Organization that we can ensure fair competition for all.

But the truth is also that the need to revitalise and reform the multilateral system has never been so urgent. Our global system has grown into a creeping paralysis. Major powers are either pulling out of institutions or taking them

hostage for their own interests. Neither road will lead us anywhere. Yes, we want change. But change by design – not by destruction.

And this is why I want the EU to lead reforms of the WTO and WHO so they are fit for today's world. But we know that multilateral reforms take time and in the meantime the world will not stop. Without any doubt, there is a clear need for Europe to take clear positions and quick actions on global affairs.

The latest EU-China leaders meeting has taken place. The relationship between the European Union and China is simultaneously one of the most strategically important and one of the most challenging we have.

From the outset I have said China is a negotiating partner, an economic competitor and a systemic rival. We have interests in common on issues such as climate change – and China has shown it is willing to engage through a high-level dialogue. But we expect China to live up to its commitments in the Paris Agreement and lead by example.

There is still hard work to do on fair market access for European companies, reciprocity and overcapacity. We continue to have an unbalanced trade and investment partnership.

And there is no doubt that we promote very different systems of governance and society. We believe in the universal value of democracy and the rights of the individual. Europe is not without issues – think for example of anti-semitism. But we discuss them publicly.

Criticism and opposition are not only accepted but are legally protected. So we must always call out human rights abuses whenever and wherever they occur – be it on Hong Kong or with the Uyghurs.

But what holds us back? Why are even simple statements on EU values delayed, watered down or held hostage for other motives? When member states say Europe is too slow, I say to them be courageous and finally move to qualified majority voting – at least on human rights and sanctions implementation.

This House has called many times for a European Magnitsky Act – and I can announce that we will now come forward with a proposal. We need to complete our toolbox.

Be it in Hong Kong, Moscow or Minsk, Europe must take a clear and swift position. I want to say it loud and clear: the European Union is on the side of the people of Belarus. We have all been moved by the immense courage of those peacefully gathering in Independence Square or taking part in the fearless women's march.

The elections that brought them into the street were neither free nor fair. And the brutal response by the government ever since has been shameful. The people of Belarus must be free to decide their own future for themselves. They are not pieces on someone else's chess board.

To those that advocate closer ties with Russia, I say that the poisoning of Alexei Navalny with an advanced chemical agent is not a one off. We have seen the pattern in Georgia and Ukraine, Syria and Salisbury – and in election meddling around the world. This pattern is not changing – and no pipeline will change that.

Turkey is and will always be an important neighbour. But while we are close together on the map, the distance between us appears to be growing. Yes, Turkey is in a troubled neighbourhood. And yes, it is hosting millions of refugees, for which we support them with considerable funding. But none of this is justification for attempts to intimidate its neighbours.

Our member states, Cyprus and Greece, can always count on Europe's full solidarity on protecting their legitimate sovereignty rights. De-escalation in the Eastern Mediterranean is in our mutual interest. The return of exploratory vessels to Turkish ports in the past few days is a positive step in this direction.

This is necessary to create the much-needed space for dialogue. Refraining from unilateral actions and resuming talks in genuine good faith is the only path forward. The only path to stability and lasting solutions.

As well as responding more assertively to global events, Europe must deepen and refine its partnerships with its friends and allies. And this starts with revitalising our most enduring of partnerships.

We might not always agree with recent decisions by the White House. But we will always cherish the transatlantic alliance – based on shared values and history, and an unbreakable bond between our people. So whatever may happen later this year, we are ready to build a new transatlantic agenda. To strengthen our bilateral partnership – be it on trade, tech or taxation.

And we are ready to work together on reforming the international system we built together, jointly with like-minded partners. For our own interests and the interest of the common good. We need new beginnings with old friends – on both of sides of the Atlantic and on both sides of the Channel.

The scenes in this very room when we held hands and said goodbye with Auld Lang Syne spoke a thousand words. They showed an affection for the British people that will never fade. But with every day that passes the chances of a timely agreement do start to fade. Negotiations are always difficult. We are used to that.

And the Commission has the best and most experienced negotiator, Michel Barnier, to navigate us through. But talks have not progressed as we would have wished. And that leaves us very little time. As ever, this House will be the first to know and will have the last say. And I can assure you we will continue to update you throughout, just as we did with the Withdrawal Agreement.

That agreement took three years to negotiate and we worked relentlessly on it. Line by line, word by word. And together we succeeded. The result guarantees our citizens' rights, financial interests, the integrity of the Single Market – and crucially the Good Friday Agreement.

The EU and the UK jointly agreed it was the best and only way for ensuring peace on the island of Ireland. And we will never backtrack on that. This agreement has been ratified by this House and the House of Commons. It cannot be unilaterally changed, disregarded or dis-applied. This a matter of law, trust and good faith.

And that is not just me saying it – I remind you of the words of Margaret Thatcher:

*“Britain does not break Treaties. It would be bad for Britain, bad for relations with the rest of the world, and bad for any future Treaty on trade.”*

This was true then, and it is true today. Trust is the foundation of any strong partnership. And Europe will always be ready to build strong partnerships with our closest neighbours.

That starts with the Western Balkans. The decision six months ago to open accession negotiations with Albania and North Macedonia was truly historic. Indeed, the future of the whole region lies in the EU. We share the same history, we share the same destiny.

The Western Balkans are part of Europe - and not just a stopover on the Silk Road. We will soon present an economic recovery package for the Western Balkans focusing on a number of regional investment initiatives. And we will also be there for the Eastern Partnership countries and our partners in the southern neighbourhood – to help create jobs and kickstart their economies.

When I came into office, I chose for the very first trip outside the European Union, to visit the African Union, and it was a natural choice. It was a natural choice and it was a clear message, because we are not just neighbours, we are natural partners. Three months later, I returned with my entire College to set our priorities for our new strategy with Africa. It is a partnership of equals, where both sides share opportunities and responsibilities.

Africa will be a key partner in building the world we want to live in – whether on climate, digital or trade.

We will continue to believe in open and fair trade across the world. Not as an end in itself – but as a way to deliver prosperity at home and promote our values and standards. More than 600,000 jobs in Europe are tied to trade with Japan. And our recent agreement with Vietnam alone helped secure historic labour rights for millions of workers in the country.

We will use our diplomatic strength and economic clout to broker agreements that make a difference – such as designating maritime protected areas in the Antarctica. This would be one of the biggest acts of environmental protection in history.

We will form high ambition coalitions on issues such as digital ethics or fighting deforestation – and develop partnerships with all like-minded partners – from Asian democracies to Australia, Africa, the Americas and anyone else who wants to join.

We will work for just globalisation. But we cannot take this for granted. We must insist on fairness and a level playing field. And Europe will move forward – alone or with partners that want to join.

We are for example working on a Carbon Border Adjustment Mechanism. Carbon must have its price – because nature cannot pay the price anymore. This Carbon Border Adjustment Mechanism should motivate foreign producers and EU importers to reduce their carbon emissions, while ensuring that we level the playing field in a WTO-compatible way.

The same principle applies to digital taxation. We will spare no effort to reach agreement in the framework of OECD and G20. But let there be no doubt: should an agreement fall short of a fair tax system that provides long-term sustainable revenues, Europe will come forward with a proposal early next year. I want Europe to be a global advocate for fairness.

### **A new vitality for Europe**

If Europe is to play this vital role in the world – it must also create a new vitality internally. And to move forward we must now overcome the differences that have held us back.

The historic agreement on NextGenerationEU shows that it can be done. The speed with which we took decisions on fiscal rules, state aid or for SURE – all this shows it can be done. So let's do it.

Migration is an issue that has been discussed long enough. Migration has always been a fact for Europe – and it will always be. Throughout centuries, it has defined our societies, enriched our cultures and shaped many of our lives. And this will always be the case.

As we all know, the 2015 migration crisis caused many deep divisions between member states – with some of those scars still healing today. A lot has been done since. But a lot is still missing. If we are all ready to make compromises – without compromising on our principles – we can find that solution.

The Commission's New Pact on Migration will take a human and humane approach. Saving lives at sea is not optional. And those countries who fulfil their legal and moral duties or are more exposed than others, must be able to rely on the solidarity of our whole European Union.

We will ensure a closer link between asylum and return. We have to make a clear distinction between those who have the right to stay and those who do not. We will take action to fight smugglers, strengthen external borders, deepen external partnerships and create legal pathways.

And we will make sure that people who have the right to stay are integrated and made to feel welcome. They have a future to build – and skills, energy and talent. I think of Suadd, the teenage Syrian refugee who arrived in Europe dreaming of being a doctor.

Within three years she was awarded a prestigious scholarship from the Royal College of Surgeons in Ireland. I think of the Libyan and Somalian refugee doctors who offered their medical skills the moment the pandemic struck in France.

If we think about what they have overcome and what they have achieved, then we simply must be able to manage the question of migration together. The images of the Moria camp are a painful reminder of the need for Europe to come together. Everybody has to step up here and take responsibility – and the Commission will do just that.

The Commission is now working on a plan for a joint pilot with the Greek authorities for a new camp on Lesbos. We can assist with asylum and return processes and significantly improve the conditions for the refugees.

But I want to be clear: if we step up, then I expect all member states to step up too. Migration is a European challenge and all of Europe must do its part. We must rebuild the trust amongst us and move forward together.

And this trust is at the very heart of our Union and the way we do things together. It is anchored in our founding values, our democracies and in our Community of Law – as Walter Hallstein used to call it. This is not an abstract term. The rule of law helps protect people from the rule of the powerful. It is the guarantor of our most basic of everyday rights and freedoms. It allows us to give our opinion and be informed by a free press.

Before the end of the month, the Commission will adopt the first annual rule of law report covering all member states. It is a preventive tool for early detection of challenges and for finding solutions. I want this to be a starting point for Commission, Parliament and member states to ensure there is no backsliding.

The Commission attaches the highest importance to the rule of law. This is why we will ensure that money from our budget and NextGenerationEU is protected against any kind of fraud, corruption and conflict of interest. This is non-negotiable.

But the last months have also reminded us how fragile it can be. We have a duty to always be vigilant to care and nurture for the rule of law. Breaches of the rule of law cannot be tolerated. I will continue to defend it and the integrity of our European institutions. Be it about the primacy of European law, the freedom of the press, the independence of the judiciary or the sale of golden passports. European values are not for sale.

These values are more important than ever. I say that because when I think about the state of our Union, I am reminded of the words of John Hume – one of the great Europeans who sadly passed away this year. If so many people live in peace today on the island of Ireland, it is in large part because of his unwavering belief in humanity and conflict resolution.

He used to say that conflict was about difference and that peace was about respect for difference. And as he so rightly reminded this House in 1998: *“The European visionaries decided that difference is not a threat, difference is natural. Difference is the essence of humanity.”*

These words are just as important today as they ever have been. Because when we look around, we ask ourselves, where is the essence of humanity when three children in Wisconsin watch their father shot by police while they sit in the car? We ask where is the essence of humanity when anti-Semitic carnival costumes openly parade on our streets?

Where is the essence of humanity when every single day Roma people are excluded from society and others are held back simply because of the colour of their skin or their religious belief?

I am proud to live in Europe, in this open society of values and diversity. But even here in this Union – these stories are a daily reality for so many people. And this reminds us that progress on fighting racism and hate is fragile – it is hard won but very easily lost.

So now is the moment to make change. To build a truly anti-racist Union – that goes from condemnation to action. And the Commission is putting forward an action plan to start making that happen.

As part of this, we will propose to extend the list of EU crimes to all forms of hate crime and hate speech – whether because of race, religion, gender or sexuality. Hate is hate – and no one should have to put up with it.

We will strengthen our racial equality laws where there are gaps. We will use our budget to address discrimination in areas such as employment, housing or healthcare. We will get tougher on enforcement when implementation lags behind. Because in this Union, fighting racism will never be optional.

We will improve education and knowledge on the historical, cultural causes of racism. We will tackle unconscious bias that exists in people, institutions and even in algorithms. And we will appoint the Commission's first-ever anti-racism coordinator to keep this at the top of our agenda and to work directly with people, civil society and institutions.

I will not rest when it comes to building a Union of equality. A Union where you can be who you are and love who you want – without fear of retribution or discrimination. Because being yourself is not your ideology. It's your identity. And no one can ever take it away.

So I want to be crystal clear – LGBTQI-free zones are humanity free zones. And they have no place in our Union. And to make sure that we support the whole community, the Commission will soon put forward a strategy to strengthen LGBTQI rights.

As part of this, I will also push for mutual recognition of family relations in the EU. If you are parent in one country, you are parent in every country.

## Conclusion

This is the world we want to live in. Where we are united in diversity and adversity. Where we work together to overcome our differences – and pull each other through when times are hard. Where we build today the healthier, stronger and more respectful world we want our children to live in tomorrow.

But while we try to teach our children about life, our children are busy teaching us what life is about. The last year has shown us just how true this really is. We could speak of the millions of young people asking for change for a better planet. Or of the hundreds of thousands of beautiful rainbows of solidarity posted in the windows of Europe by our children.

But there is one image that stuck in my mind from the last six difficult months. An image that captures the world through the eyes of our children. It is the image of Carola and Vittoria. The two young girls playing tennis between the rooftops of Liguria, Italy.

It is not just the courage and talent of the girls that sticks out. It is the lesson behind it. About not allowing obstacles stand in your way, about not letting conventions hold you back, about seizing the moment. This is what Carola, Vittoria and all the young people of Europe teach us about life every day. It is what

Europe's next generation is all about. This is NextGenerationEU. This year, Europe took a leaf out of their book and took a leap forward together. When we had to find a way forward for our future, we did not allow old conventions hold us back. When we felt fragility around us, we seized the moment to breathe new vitality into our Union.

When we had a choice to go it alone like we have done in the past, we used the combined strength of the 27 to give all 27 a chance for the future. We showed that we are in this together and we will get out of this together.

The future will be what we make it. And Europe will be what we want it to be. So let's stop talking it down. And let's get to work for it. Let's make it strong. And let's build the world we want to live in. Long live Europe! ■

## **Ursula von der Leyen is President of the European Commission**

*This article is based on the [State of the Union Address](#) delivered at the European Parliament Plenary, Brussels, 16 September 2020*



# The impact of GDPR on data flows and national security

The CJEU has ruled that the EU-US Privacy Shield is invalid. Joshua Meltzer considers the impact and suggests ways forward

**T**he Court of Justice of the European Union recently delivered its verdict in the Schrems II case, ruling that the EU-US Privacy Shield is invalid. This column addresses the implications for adequacy and standard contractual clauses as well as the broader issue of how to balance national security and privacy goals. It concludes with observations about the potential impact of the decisions for the US and beyond and suggests some ways forward.

The recent Court of Justice of the European Union (CJEU) decision in Schrems II finding that the EU-US Privacy Shield is invalid and its additional findings with respect to standard contractual clauses, closes off key mechanisms for transferring personal data from the EU to the US, with important impacts on trade and the development of technologies such as cloud computing and artificial intelligence (AI).

This is the second time the CJEU has found that the General Data Protection Regulation (GDPR) mechanisms for transferring personal data from the EU to the US is invalid<sup>1</sup>. The earlier CJEU decision in Schrems I found that the European Commission adequacy decisions with respect to the EU-US Safe Harbour was invalid<sup>2</sup>. An adequacy decision is a finding by the European Commission that a third countries privacy laws are essentially equivalent to the rights and obligations under the GDPR<sup>3</sup>.

The importance of data flows for transatlantic economic relations necessitates that the US and EU engage in a third attempt to develop a mechanism that can enable data flows and pass muster with the CJEU.

However, whether this remains a fruitful path forward is uncertain in light of what we now know about the approach of the CJEU to adequacy under GDPR. In particular, the focus on how government agencies access data for national security purposes is becoming the key barrier to data flows between the EU and the US.

More broadly, the CJEU decision makes clear that all the key GDPR mechanisms for transferring personal data from the EU to third countries are unstable, namely adequacy decisions, standard contractual clauses (SCCs) and binding corporate rules (BCRs)<sup>4</sup>.

In this respect, the CJEU decision will have ramifications beyond its immediate impact on data flows between the EU and the US. The following addresses the explicit CJEU findings on adequacy and SCC as well as the broader issue of how to balance national security and privacy. The paper concludes with observations about the potential impact of the decisions for the US and beyond and suggests some ways forward.

*...what is needed is an international agreement on how to balance national security and access to data, with other key goals such as privacy*

In this column I focus on two key issues at play in this most recent Schrems case: (1) the disconnect between application of EU law to national security agencies in third countries compared with domestic security agencies; and (2) and the severe limits the decision places on existing GDPR mechanisms for transferring personal data from the EU to third countries. I also offer observations on what this will mean for data flows, and in particular the implications for small and medium sized enterprises (SMEs).

### **Privacy and security in a world of global data flows**

A core issue in both Schrems cases was how national security agencies operate to preserve security and also ensure sufficient levels of privacy, and whether this is consistent with GDPR.

The attempt by GDPR to extend EU privacy rights and obligations to countries and entities receiving EU personal data reflects a broad dynamic, which is that as the global free flow of data increases the scope for national security agencies to access the personal data of everyone, national privacy standards need to be globalised as well to be effective.

Yet, governments often provide different levels of privacy protection and redress depending on whether a person is a citizen and where they are located. Under the Fourth Amendment to the Constitution, the US provides different levels of legal redress to people in the US compared to those outside the US, including access to US courts. GDPR in effect seeks to extend the full suite of rights and obligations available in the EU under GDPR, to any country receiving EU personal data.

Underlying the CJEU decision in Schrems I and Schrems II that invalidated the EU-US Safe Harbour agreement and in this most recent case, has invalidated the EU-US Privacy Shield, is a disconnect between the GDPR's international impacts, and its domestic application to member state national security agencies.

In both Schrems cases, the issue was US government access to personal data for national security purposes and the rights of EU citizens in the US to judicial review and redress. In both cases the CJEU found that the US fell short in that the US was not according EU personal data the protection and rights of redress available in the EU.

When it comes to access to data for national security purposes, under EU law, including GDPR, any limitation on EU rights to privacy must be 'necessary and proportionate'<sup>5</sup>. At the same time, national security is the sole responsibility of member states<sup>6</sup>.

In effect, each EU state is given the discretion to balance national security needs with data privacy rights. Yet, the EU is not according a similar discretion to third countries.

In fact, GDPR uses the threat of withdrawing access to EU personal data as a tool to seek reform of other country's security agencies to reflect the CJEU notion of proportionality, while exempting member state governments from similar expectations or threats. This effectively sets up the CJEU as the arbiter of whether other countries' approaches to accessing data for national security purposes are proportional<sup>7</sup>.

This disconnect between GDPR's international and domestic application when it comes to national security also risks EU demands becoming increasingly detached from the reality and practices of national security agencies.

On the one hand, the outcome in the US between security and privacy reflects US constitutional constraints, national security needs and privacy concerns.

In the EU, it does not appear that any such balancing took place, leaving the EU approach to privacy untouched in important ways by the equities and needs of member state national security agencies.

The result is a set of demands on third country national security agencies that the EU does not, and could not, make of its own national security agencies. This dissonance between what the EU is expecting of other governments and what it is able to ask of its member states is compounded by various findings that EU data may in fact be safer and accorded better due process when in the US than in the EU<sup>8</sup>.

### **The inadequacy of adequacy decisions**

The issue with how the US government accesses data for national security is what led the CJEU in both Schrems cases to invalidate the European Commission's adequacy finding with respect to the US. This Schrems decision also makes clear that not only adequacy decisions but also SCC and BCRs are much more limited than originally thought.

Another consequence of the Schrems decision is to underscore the fragility of these GDPR data transfer mechanisms. As the Irish High Court and CJEU overturns a second adequacy finding by the Commission, the CJEU has made clear that SCCs (and BCRs) may require data flows to be terminated at any point should the processor in the third country be unable to comply with GDPR, either due to requests from a third government for access to data or due to changes in legislation.

These outcomes will inevitably increase risk for businesses that rely on cross-border transfers of personal data. This will affect not only the large tech companies but also those in manufacturing and services that are increasingly data driven.

To understand the implications of this decision for these GDPR transfer mechanisms, it is helpful to reflect on the institutional incentives and priorities driving the different findings by the European Commission on the one hand, and EU domestic courts and the CJEU on the other.

The European Commission in making an adequacy decision weighs a range of goals that are in tension with each other. While focused on assessing whether US laws and practice are adequate under GDPR, the Commission also takes into account the impact of stopping flows of personal data on international trade, investment and diplomatic relations.

In contrast, the process for challenging an adequacy finding rests upon findings by a National Data Commissioner, findings by domestic courts, and finally the CJEU. None of these bodies is expected to consider the range of issues at play for the Commission.

Instead, the question is more narrowly whether the third country provides a level of privacy protection consistency with the Charter of Fundamental Rights of the European Union. It is these competing institutional incentives and focus that helps explain the different conclusions as to whether the US confers adequacy.

These internal institutional tensions raise several issues for the EU. First is the validity of other adequacy findings. For instance, what does the Commission really know as to how national security agencies in Israel, Japan or Argentina collect, use or share EU personal data.

Second is the stability of any adequacy findings. The narrow focus of the CJEU on consistency with the EU Charter and demand for essential equivalence leads very little room for different approaches to privacy in other countries, reducing scope for adequacy findings and to using any transfer mechanism under GDPR.

When it comes to determining whether the actions of other governments in collecting data for national security purposes are consistent with GDPR and the EU Charter, the vague standard of proportionality has led the Commission and CJEU to different conclusions regarding the adequacy of US limits and safeguards<sup>9</sup>.

Taken together, this suggests that all adequacy decisions by the Commission must be treated as potentially suspect and open to being declared invalid by the CJEU.

Another impact of this Schrems case is to limit the availability of SCC (and BCRs)<sup>10</sup>. The issue with SCC (and BCRs) is that it is a contractual obligation that does not bind other governments. Therefore, where practices by national security agencies for accessing personal data are inconsistent with GDPR, SCCs do not obviously remedy this problem.

The CJEU nevertheless held that SCCs remain valid where the controller adduces additional safeguards that rectify these gaps<sup>11</sup>. It is not clear what these safeguards are or how they could work in practice.

Another wrinkle here is the finding by CJEU of the accountability for processors in the EU to ensure that the legislation in the third country allows the data processor to comply with the SCC, before transferring personal data<sup>12</sup>.

It is not clear whether this merely requires comparing third party laws with GDPR or also the practice of national security agencies, which is harder to assess but arguably what should matter the most.

The result is that after Schrems II, all GDPR mechanisms for transferring personal data to third countries are much more limited in scope, durability and stability.

### **Some implications of Schrems II for cross-border data flows, trade, privacy and security**

The first thing this Schrems case makes clear is the extent of the tension created by GDPR between balancing access to and use of data, and the privacy rights and obligations in GDPR (Mattoo and Joshua Meltzer 2018).

The EU view is that they can have strong privacy and a strong digital economy, including cross-border data flows, and this is likely correct at a certain level of abstraction.

However, the details of GDPR now make clear how GDPR sets up real tensions and trade-offs in terms of getting what the EU wants under GDPR in terms of privacy, and access to and use of data consistent with a robust engagement in the digital economy and digital trade (Jia *et al.* 2019).

In practical terms, Schrems II calls into question the availability of adequacy findings, SCCs (and BCRs) as reliable and stable mechanisms for cross-border data transfers. If the US is still not adequate, then it must be the case that other countries, including China will never be adequate and not only that, but it is hard to see how any Chinese company collecting EU personal data can transfer it back to China consistently with GDPR. Large companies may have to localise data storage and process in the EU.

Yet for small companies, the impacts are most pronounced. For many, setting up in the EU is not an option. There are SCCs, but depending on the government, additional safeguards may be needed for SCCs to be viable.

Again, it is unclear what such safeguards may be or whether SMEs could implement them even if they exist. The CJEU decision also establishes an obligation on processors in third country to notify controllers in the EU of changes in legislation that prevent compliance with a SCC.

This is an additional monitoring burden on SMEs in third countries and failure here can expose these companies to liability for harm caused to EU data subjects. The difficulties with SCCs also create additional costs and disincentives for EU companies to develop digital supply chains with SMEs in third countries.

As discussed, another issue at play is the balance between how security agencies use data for security, and also protect personal privacy in a globalised world. It is likely that GDPR is too unilateral and too EU-specific, and that national security is too important, for GDPR to lead to the types of changes the EU needs for an adequacy finding to work.

The EU bet with GDPR has been that the economic importance to US companies of allowing cross-border data flows of EU personal data will be enough to force the US to reform how its national security agencies collect and use data.

This has been a somewhat reasonable bet so far in that the US has shown a willingness to negotiate and engage in some reform. But even here, US reforms in order to obtain an adequacy decision have been limited and as we now know, not enough.

It is also the case that the trend is not in the EU's favour. For while the economic importance of data grows, so do the security issues related to data flows. In fact, the trend is arguably towards security becoming a more important organising principle for how digital economies develop and where data flows.

Given this, the risk is that GDPR fails to lead to enough US reform that can justify another adequacy finding, forcing the EU into self-imposed data isolation.

In such an outcome, large US and other companies will still service the EU market but the EU will become increasingly closed, reducing access to large global data pools and the opportunities for insights and the machine learning that underpin AI developments that the EU seeks to develop (European Commission 2020).

Given these risks and developments, what is needed is an international agreement on how to balance national security and access to data, with other key goals such as privacy. Such an outcome could be deemed an international agreement under GDPR article 45(2)(c) that would support an adequacy finding and by extension, short up access to SCC and BCRs. ■

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*Author's note: the author was an expert witness for Facebook in the latest proceedings before the Irish High Court.*

### Endnotes

1. *Schrems and Facebook Ireland v Data Protection Commissioner* (hereinafter "Schrems II") (2020) CJEU Case C-311/18
2. *Schrems v Data Protection Commissioner* (hereinafter "Schrems I") (2015) CJEU Case C-362/14
3. EU General Data Protection Regulation, 27 April 2016, L119/1 (hereinafter 'GDPR'), art. 45(3)
4. SCCs are included in contracts that bind entities in a third country to processing personal data consistent with GDPR; BCRs are commitment international conglomerates make to treat personal data consistent with GDPR when transferring data overseas within other units, to treating personal data consistent with GDPR,
5. Charter of Fundamental Rights of the European Union, article 52(1); GDPR art. 23
6. Treaty of the European Union, article 4(2) provides that "national security remains the sole responsibility of each EU member state."
7. *Schrems II*, paragraph 178

8. European Agency for Fundamental Rights 2015. "Surveillance by Intelligence Services: fundamental rights, safeguards and remedies in the EU"; Sidley Austin 2016. "Essentially Equivalent -A comparison of the legal orders for privacy and data protection in the European Union and the United States", January 2016; Opinion of [Geoffrey Robertson QC](#), 14th January 2016.

9. Schrems II, paragraph 176

10. Commission Decision of 16 December 2016 amending Decisions [2001/497] and [2010/87] on standard contractual clauses for the transfer of personal data to third countries and to processors established in such countries, under Directive [95/46] (OJ 2016 L 344

11. Schrems II, para 133

12. Schrems II, para 144

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Jia, J, G Jin and L Wagman (2019), "[The short-run effects of GDPR on technology venture investment](#)", VoxEU.org, 7 January.

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This article was originally published on [VoxEU.org](#)

# New challenges to transfers of personal data



Scott Marcus considers the recent CJEU judgement and the impact on data transfers between the European Union and the United States

**O**n 16 July 2020, the Court of Justice of the European Union (CJEU) issued its judgment in a case that is widely referred to as Schrems II (CJEU 2020a and 2020b), and the decision is a bombshell! The judgment not only immediately invalidates Privacy Shield, but may also have the effect, once the dust has settled, of effectively blocking transfers of personal data to the USA using the popular mechanism of Standard Contractual Clauses (SCCs).

The US and the EU are the world's largest trading partners, and the transfer of personal data constitutes an important component and enabler for that trade. Those transfers are important, not only to US digital firms, but also to EU consumers who use their services, and to many EU and US businesses.

The judgment eliminates or cripples two of the main mechanisms employed today to enable that data transfer. In the extreme case, this judgment could theoretically block those data transfers.

The judgment not only immediately invalidates Privacy Shield, but may also have the effect, once the dust has settled, of effectively blocking transfers of personal data to the USA using the popular mechanism of Standard Contractual Clauses (SCCs)<sup>1</sup>.

This is the second time that transfers of personal data to the US were put at risk by a CJEU decision that sought to ensure respect for the privacy rights of EU persons. This time, as in 2016, we expect that workarounds will be found, and that the impact will be significant but will not prove to be extreme in the end.

### **Background of the case**

The case is a continuation of the Schrems I case (see Marcus and Petropoulos, 2015), where an Austrian privacy advocate and Facebook user, Maximilian Schrems, lodged a complaint with the Data Protection Commission of

Ireland claiming that the transfer of his personal data by Facebook Ireland to Facebook Inc. in the United States could not properly safeguard his privacy interests. Schrems alleged that Facebook could not and did not prevent US government surveillance greatly in excess of that permitted under European law.

In Schrems I, the CJEU ruled in favour of Mr Schrems, and invalidated a Safe Harbour agreement between European Union and the United States that dated back to 26 July 2000. This verdict put at risk data transfer arrangements that had then been in place for fifteen years, and that had benefitted not only the large US digital platforms, but also

*... the disruption to business would likely be limited – most Europeans who want to use services from Facebook, Google, Amazon, Apple or the many smaller firms that likewise benefit from transatlantic transfer of personal data are likely to simply check the box*

European consumers who used US-based digital services, as well as a wide range of businesses large and small on both sides of the Atlantic. The CJEU allowed time, however, for authorities on both sides of the Atlantic to try to find workarounds.

Some firms took steps to keep as much of their data as possible in Europe; some data, however, needed to be transferred to the USA.

The European Commission responded at the time by encouraging firms to resort instead to Standard Contractual Clauses (SCCs), which represent an alternative means of meeting EU privacy requirements when transferring personal data to third countries.

In Marcus and Petropoulos (2015), we predicted that this approach would run into trouble sooner or later. *“The model clauses would appear to be at best a weak and temporary circumvention of the ECJ’s decision in the Schrems case, since US-based firms cannot and presumably will not avoid making the data available to US intelligence services, and will be prevented by US law from informing surveilled entities and individuals that they have done so. The decision in the Schrems case, after all, had nothing to do with commercial privacy practices – it was all about government surveillance for purposes of national security. This cannot be governed by private contract. Given that Safe Harbour has already been invalidated, it seems unlikely that the [CJEU] in a subsequent case would permit the model clauses to stand.”*

The European Union succeeded in negotiating Privacy Shield arrangements with the Obama administration that attempted to deal with the problem. As we explained in Marcus (2017), the institutional framework of Privacy Shield was weak, and fully dependent on the good will of the US administration (which looks very different under Trump than it did under President Obama).

Key portions of Privacy Shield are letters from one US department (for instance, the Office of the Director of National Intelligence (ODNI)) to another (the Department of Commerce). Those letters merely described existing US practice – they made no commitments going forward. It should have already been clear that US courts would not interpret those letters as binding commitments to a foreign government on the future conduct of the United States.

These obvious defects in Privacy Shield and in the use of SCCs turned out to be central to the CJEU's 16 July 2020 judgment.

### **What are Standard Contractual Clauses (SCCs)?**

For cases where no Adequacy Decision is in place, the GDPR provides for several alternative mechanisms, each of which enables transfers of personal data without requiring explicit informed consent from each user. SCCs represent one of these mechanisms<sup>2,3</sup>.

The SCCs are defined in an annex to Commission Decision 2010/87/EU, as amended by Commission Implementing Decision (EU) 2016/2297. They represent clauses that seek to ensure that the data transferred to a firm in a third country that cannot be certified as protecting personal data to a degree comparable to that of the EU are nonetheless adequately protected.

It is important to note once again that the SCCs are a general mechanism that governs the relationship between the EU-based data exporting firm and the third country-based data importing firm. The third country government is not a party to the agreement, and is not constrained by it.

When the CJEU first issued the Schrems I Decision, the Commission encouraged firms to rely on SCCs since the Safe Harbour from 2000 had been invalidated. This created a bizarre, Alice in Wonderland situation, since the SCCs

do nothing to constrain the actions of the third country government. Simply put, Commission's initial response to Schrems I did nothing at all to address the excessive government surveillance that had been the grounds for the Schrems I decision.

The SCC Decision 2016/2297 speaks very briefly about the obligations of the exporting firm to consider legal institutions and practices in the data importing third country<sup>4</sup>, but this has not been enforced and in practice for the most part probably has not been done.

As far as the obligations of the supervisory authorities responsible for privacy enforcement at member state level, the referral from the DPC (the privacy supervisory authority of Ireland) to the Irish High Court and from there to the CJEU makes clear that neither DPC nor High Court were certain that Irish authorities or courts had the authority to block transfers in a case where a Commission Adequacy Decision said that they were permissible.

### **What the CJEU decided**

The direct result of the CJEU decision was that the Adequacy Decision for the Privacy Shield agreement, which the Commission enacted in 2016 and which was ratified by Parliament, has been invalidated, apparently with immediate effect. As of now, no Adequacy Decision is in effect for data transfers to the United States.

The validity of Standard Contractual Clauses as a mechanism was sustained. A number of press articles mistakenly assume that this means that little will change.

We note once again that the SCCs represent a general mechanism for two undertakings to agree to exchange data in a way that respects personal data. The Commission Decision that put SCCs in place established a general mechanism, independent of the country to which data is to be transferred.

As a practical matter, the CJEU imposed or clarified important obligations on the firms that transfer data from the EU to third countries.

- Data exporting companies (or more specifically in GDPR jargon, their data controllers or processors) are now required to *“ensure that data subjects whose personal data are transferred to a third country pursuant to [SCCs] are afforded a level of protection essentially equivalent to that guaranteed within the European Union by that regulation ... To that end, the assessment of the level of protection afforded in the context of such a transfer must, in particular, take into consideration [not only the effect of the SCCs themselves, but also] as regards any access by the public authorities of that third country to the personal data transferred, the relevant aspects of the legal system of that third country, in particular those set out, in a non-exhaustive manner, in Article 45(2) of [the GDPR].”*
- Member state data privacy supervisory authorities now have both authority and responsibility to assess third country surveillance. If the SCCs cannot be complied with in a third country, taking all circumstances into account and in the absence of a valid European Commission Adequacy Decision, the competent supervisory authority is required to suspend or prohibit a transfer of data to a third country pursuant to SCCs. If complaints are brought to the supervisory authority, they are required to diligently react to them.

For the current case, the Adequacy Decision of 2016 has now been invalidated, so the Irish supervisory authority is now free to act and is presumably obliged and empowered to go further in addressing the complaint that Schrems raised.

The new CJEU decision also effectively establishes the formal rules for overturning Commission Adequacy Decisions, and they are exactly in line with what has haltingly happened in this case. The national supervisory

authority is obliged to consider complaints that might be brought to it, even in cases where an Adequacy Decision is in place, and they are obliged to consider whether the Adequacy Decision is justified.

Should the national supervisory authority find an Adequacy Decision to be unjustified, it cannot simply override the Adequacy Decision, but must instead bring its concerns to the CJEU for resolution.

### **Grounds for invalidating the Adequacy Decision for Privacy Shield**

The General Data Protection Regulation (GDPR), which had not existed at the time that the case was first lodged, speaks of the need for transfers of personal to third countries to consider *“the rule of law, respect for human rights and fundamental freedoms, relevant legislation, both general and sectoral, including concerning public security, defence, national security and criminal law and the access of public authorities to personal data”, and to ensure that EU persons have “effective and enforceable data subject rights and effective administrative and judicial redress for the data subjects whose personal data are being transferred.”*<sup>5</sup>

The CJEU expands on this somewhat by stating that, for intrusion on the protection of personal data to be viewed as being proportionality, the corresponding law *“must lay down clear and precise rules governing the scope and application of the measure in question and imposing minimum safeguards, so that the persons whose data has been transferred have sufficient guarantees to protect effectively their personal data against the risk of abuse.*

*It must, in particular, indicate in what circumstances and under which conditions a measure providing for the processing of such data may be adopted, thereby ensuring that the interference is limited to what is strictly necessary.”*

The CJEU concludes that the relevant surveillance programmes in the United States fall well short of this standard. The High Court of Ireland had already noted that the Fourth Amendment to the Constitution of the United States

(the most important cause of action available to challenge unlawful surveillance) does not apply to EU citizens; for an EU person to establish standing can be exceedingly difficult; and the NSA's activities under Executive Order 12333 are not subject to judicial oversight and are not justiciable.

The CJEU further notes that the relevant statute for foreign intelligence<sup>6</sup> provides no meaningful limitations on surveillance, and that the court that provides oversight<sup>7</sup> authorises whole programmes, not individual surveillance. CJEU appears to have been particularly concerned that the various elements of US law and presidential executive orders permit indiscriminate bulk collection of data.

Equally important, the CJEU judgment notes that the GDPR *"requires everyone whose rights and freedoms guaranteed by the law of the Union are violated to have the right to an effective remedy before a tribunal."*

The judgment notes that not all US surveillance measures are subject to judicial review, and there are multiple indications throughout the judgment that European persons face challenges in achieving redress<sup>8</sup>.

The main mechanism that the Commission relied on in its Adequacy Decision is that of the Privacy Shield Ombudsperson. The CJEU was not impressed. The Ombudsperson may be able to mediate, but it does not provide a tribunal for redress. The Ombudsperson is *"an integral part of the US State Department"*, and thus cannot be assumed to be independent from the executive. Moreover, there is nothing in Privacy Shield *"to indicate that that ombudsperson has the power to adopt decisions that are binding on those intelligence services."*

In fact, the US government neglected to appoint an Ombudsperson for the first two years of the Trump administration. Until 20 June 2019, the position was unoccupied<sup>9</sup>. The CJEU did not mention this, but the European Parliament has repeatedly expressed concern.

It is also important to note what has not changed as a result of the CJEU judgment. It is the Adequacy Decision enabling unrestricted transfers of personal data to the USA that has been invalidated. Privacy Shield per se presumably remains in force for now, including the commitments that US firms made to the US Department of Commerce, which are enforceable by the US Federal Trade Commission. These commercial arrangements have been unproblematic, but they are largely irrelevant to both the Schrems I and Schrems II decisions.

Since Privacy Shield never included an actual agreement with the US Government to limit its surveillance activities in any meaningful way (Marcus, 2017)), there is nothing to invalidate as regards surveillance by the US Government.

Again, what has changed is that Privacy Shield is no longer sufficient to justify an Adequacy Decision.

### **Near term implications**

The CJEU ruling is clear enough, but the timing and effects might take some time to play out.

Data exporting companies are now obliged to promptly examine the laws and practices under which data that they send to firms in data importing countries oblige the importing firms to make the data available to public authorities. Specifically, Facebook Ireland is obliged to consider whether Facebook, Inc. in the USA is obliged to turn data over to the US NSA and FBI, and whether US protections for EU persons who are injured by the transfer are adequate (or can be made adequate) when that happens.

Given that the CJEU has already stated at length its reasons for considering current US practice to be inadequate, it would be perverse (but not inconceivable) for data exporting firms like Facebook Ireland to conclude otherwise unless some positive change is introduced. Firms like Facebook are not in a position to force the US Government to

change its data surveillance practices; however, US authorities might well choose to do so in order to protect the free flow of data across the Atlantic, which clearly benefits both US internet firms and EU consumers.

In 2016, the Obama administration agreed to Privacy Shield. Privacy Shield did not fully address the issues raised in Schrems I, but with PPD 28 the US government at least recognised (to its credit) that Europeans have legitimate privacy interests in the United States. Privacy Shield also provided an Ombudsperson mechanism to create at least the possibility of friendly resolution.

Even though US firms benefit greatly from the free flow of data, a Trump administration is unlikely to demonstrate this kind of flexibility. Nothing good will happen before November – an America first, EU-bashing political response seems much more likely.

If Trump is voted out of office in November, it should be possible to have a calm discussion with a Biden administration, but any positive resolution by US and EU authorities will probably not be quick or easy. There are too many distinct deficiencies in US law and practice.

The Irish DPC, the supervisory authority, likewise now has an obligation to act. It seems likely that they will offer Facebook a little time to respond. If absolutely nothing were done, it seems clear that they have both authority and responsibility to block further data transfers from the EU to the USA. That would be an extreme and unfortunate course of action, but it is highly unlikely in practice.

The CJEU ruling does not establish a timetable for companies or supervisory authorities to reach decisions, but it is quite possible that companies will feel the need to change their business practices in order to mitigate the risk of being forced to abruptly halt transatlantic data flows.

Some of the firms impacted by the ruling might simply find ways to stop exporting data from the EU to the United States altogether. The personal data of EU persons would remain within the EU, either in data centres operated by the firms in question, or else perhaps in cloud services that contractually commit that the data will never leave the EU.

This probably implies cost and time for the firms involved – process re-engineering, software engineering, and expansion of data centre capacity are likely to be in the cards. How practical this will be depends greatly on the business model of each firm, on the manner in which it manages its data, on the extent it depends on combining EU data sources with US data sources, and perhaps critically on the size of the firm and the scale economies available to it.

Article 49 of the GDPR already clearly specifies what legal options are available to companies when neither an Adequacy Decision nor the SCCs provide a basis for the transfer. The two options that are most relevant here are that the user can provide informed consent, or the data can be sent if it constitutes an integral component of the provision of a service that the user has explicitly requested<sup>10</sup>.

Would conforming to these Article 49 provisions be the end of the world? Probably not!

When one accepts a software licence today, one is generally obliged to check a box whereby one approves the licence. Firms that export data to the US might well conclude that their safest option is to require their users to check a box acknowledging that their data may under some fairly broad circumstances be handed over to US intelligence services, and that their options for judicial redress in the USA in that case are negligible.

Irritating for all perhaps, but not a fundamental change. What exact phrasing would be suitable, and would not ruffle feathers with the US intelligence community, remains to be seen, but this seems to be the most likely course.

Even so, the risk of a legal challenge claiming that the checked box does not represent a truly informed consent might remain.

If this approach holds up, the disruption to business would likely be limited – most Europeans who want to use services from Facebook, Google, Amazon, Apple or the many smaller firms that likewise benefit from transatlantic transfer of personal data are likely to simply check the box<sup>11</sup>. ■

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### *Endnotes*

1. Most press articles appear to have fundamentally misunderstood the ruling, focusing on the ruling permitting continued use of SCCs. The use of SCCs as a general mechanism continues to be permitted, but there are new obligations to consider whether transfer to public agencies in the countries that receive the data are respectful of the privacy rights of EU persons. For the USA, the CJEU's view on this is clear.

2. Art. 46 GDPR: "The appropriate safeguards ... may be provided for, without requiring any specific authorisation from a supervisory authority, by: (a) a legally binding and enforceable instrument between public authorities or bodies; (b) binding corporate rules in accordance with Article 47; (c) standard data protection clauses adopted by the Commission ..."

3. Binding corporate rules are another, suitable for interrelated entities within a group of enterprises. For purposes of

*this discussion, binding corporate rules are roughly equivalent to SCCs, and will not be discussed further. Art. 4(20) GDPR defines binding corporate rules as “personal data protection policies which are adhered to by a controller or processor established on the territory of a member state for transfers or a set of transfers of personal data to a controller or processor in one or more third countries within a group of undertakings, or group of enterprises engaged in a joint economic activity”.*

*4. Footnote 1 of the Decision states that “Mandatory requirements of the national legislation applicable to the data importer which do not go beyond what is necessary in a democratic society on the basis [that] they constitute a necessary measure to safeguard national security, defence, public security, the prevention, investigation, detection and prosecution of criminal offences or of breaches of ethics for the regulated professions, an important economic or financial interest of the State or the protection of the data subject or the rights and freedoms of others, are not in contradiction with the standard contractual clauses. Some examples of such mandatory requirements which do not go beyond what is necessary in a democratic society are, inter alia, internationally recognised sanctions, tax-reporting requirements or anti-money-laundering reporting requirements.”*

*5. Art. 44-46 GDPR: “Any transfer of personal data which are undergoing processing or are intended for processing after transfer to a third country ... shall take place only if, subject to the other provisions of this Regulation, the conditions laid down in this Chapter are complied with by the controller and processor, including for onward transfers of personal data from the third country ... to another third country ... A transfer of personal data to a third country or an international organisation may take place where the Commission has decided that the third country ... in question ensures an adequate level of protection. Such a transfer shall not require any specific authorisation. When assessing the adequacy of the level of protection, the Commission shall, in particular, take account of the following elements: the rule of law, respect for human rights and fundamental freedoms, relevant legislation, both general and sectoral, including concerning public security, defence, national security and criminal law and the access of public authorities to personal data, [emphasis added] as well as the implementation of such legislation, data protection rules, professional rules and security measures, ... case-law, as well as effective and enforceable data subject rights and effective administrative and judicial redress*

*for the data subjects whose personal data are being transferred [emphasis added] ... The Commission, after assessing the adequacy of the level of protection, may decide, by means of implementing act, that a third country ... ensures an adequate level of protection ... In the absence of [such] a decision ..., a controller or processor may transfer personal data to a third country or an international organisation only if the controller or processor has provided appropriate safeguards, and on condition that enforceable data subject rights and effective legal remedies for data subjects are available."*

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7. The United States Foreign Intelligence Surveillance Court (FISC).

8. This author has served, and continues to serve, as an expert witness in multiple US court proceedings involving then-illegal government surveillance. I can say from personal experience that even for a US citizen, it is nearly impossible to achieve redress.

9. EurActiv (2020), US to appoint permanent Privacy Shield Ombudsperson, as EU pressure tells, <https://www.euractiv.com/section/data-protection/news/us-to-appoint-permanent-privacy-shield-ombudsperson-following-eu-pressure/>

10. Art. 49 GDPR: "In the absence of an adequacy decision pursuant to Article 45(3), or of appropriate safeguards pursuant to Article 46, including binding corporate rules, a transfer or a set of transfers of personal data to a third country or an international organisation shall take place only on one of the following conditions: (a) the data subject has explicitly consented to the proposed transfer, after having been informed of the possible risks of such transfers for the data subject due to the absence of an adequacy decision and appropriate safeguards; (b) the transfer is necessary for the performance of a contract between the data subject and the controller or the implementation of pre-contractual measures taken at the data subject's request; ..."

11. It is however possible that some services for which a licence is not required for casual use today might now be obliged to require the user to check a box.

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*This article was originally published on [Bruegel](#)*



# Europe needs a fully-fledged CMU

The coronavirus crisis makes progress on CMU even more important. Luis de Guindos, Fabio Panetta and Isabel Schnabel outline priority areas for reform to foster European capital markets

**T**he capital markets union (CMU) is one of the cornerstones of the euro area's financial architecture. But progress in developing it has been slow. Since the agreement on establishing CMU in 2015, many sub-projects have been launched, and some completed, but European capital markets are still far from being fully integrated.

Despite the fact that the coronavirus (COVID-19) crisis has made CMU more important than ever, progress has unfortunately slowed, notwithstanding the substantial headway made on the fiscal side with the agreement on the European recovery package (Next Generation EU).

Financing the post-crisis recovery is one of the most pressing challenges Europe is facing today. Capital markets will be crucial. The new bond issuance by the European Commission, in the context of Next Generation EU, relies on well-functioning capital markets<sup>1</sup>.

But public funding cannot do the heavy lifting alone; it will have to be complemented by substantial private financing. With the banking sector under pressure due to the pandemic, private bond and equity markets can play an important role in complementing bank financing.

In order to recover from the pandemic and strengthen the euro area's growth potential, a new push is needed towards the long-term ambition of creating a genuine single European capital market that is deeply integrated and highly developed.

This will not only mobilise the resources needed to reboot the euro area economy after the global contraction. It will also help meet the additional challenges posed by external developments, such as Brexit and global trade tensions<sup>2</sup>.

In addition, it will provide opportunities for accelerating the transition to a low-carbon economy – thereby supporting the European Union’s ambition to be a leader in green finance – and for funding the transition towards the digital economy. A single capital market will also strengthen our common currency’s role on the global stage.

And last but not least, a deeper and more integrated financial system is also needed from a monetary policy perspective, as integrated capital markets improve the transmission of our single monetary policy to all parts of the euro area. In turn, this will help limit the risk of growing asymmetries among member countries as our economies recover from the COVID-19 shock at different speeds.

*The COVID-19 pandemic has re-emphasised the importance of the CMU project and the need to make rapid progress*

Our aim with this blog post is to re-emphasise the importance of strengthening efforts to advance the CMU project, in the light of the European Commission's forthcoming new Action Plan<sup>3</sup>. First, we explain why CMU is important, especially due to the COVID-19 crisis.

Second, we describe the current state of play regarding capital market development and integration in the EU, and identify the areas where progress is needed most.

And third, we set out a roadmap of policy measures that would remove core barriers to further integration.

Following this roadmap would benefit the euro area, the EU and its citizens. It would stabilise funding sources for households, companies and governments, foster cross-country risk-sharing and consumption smoothing, and stimulate growth and the post-COVID-19 recovery.

The measures we propose are broad in nature and require strong commitments, in line with the ECB's long-standing view that the CMU project has to be ambitious<sup>4</sup>. Accomplishing these reforms could trigger a virtuous cycle of better economic outcomes and further reforms, strengthening the European project. We recognise that developing and integrating European capital markets will primarily be a market-led process, so the measures we propose are designed to enable market forces.

### **Why is CMU even more important due to the COVID-19 crisis?**

Even before the pandemic, the ECB was a strong supporter of the CMU project. CMU aims to deepen and further integrate capital markets in order to establish a genuine single capital market within the EU, which would allow investors, savers, firms and market infrastructures to access a full range of services and products, regardless of

where they are located<sup>5</sup>. Let us explain why CMU matters, and why it is particularly important due to the COVID-19 crisis.

First, European firms would benefit from more diverse funding sources, which would allow them to adapt more effectively to changing funding conditions. Easier access to market-based financing instruments would lessen firms' reliance on bank financing when the banking sector has been weakened by a shock, such as the COVID-19 crisis. This would also support the smooth transmission of monetary policy.

Second, progress towards CMU would increase private risk-sharing across countries and actors, generating positive effects from a macroeconomic stabilisation perspective and making economies more resilient to local shocks. This is particularly important now, with the risk of diverging economic development within the euro area due to the shock from the pandemic.

Within Europe, increasing cross-border ownership of stocks and debt securities and cross-border business financing would be an important way of sharing risks and thereby stabilising households' consumption and firms' investment over time<sup>6</sup>. Equity markets tend to have particularly strong risk-sharing properties. Several studies also emphasise that equity funding is more resilient to shocks than debt funding, and can be considered more stable from a risk-sharing perspective<sup>7</sup>.

Third, boosting capital markets through policies aimed at increasing equity financing would support growth and innovation. Research suggests that firms with higher growth potential generally resort more to (public or private) equity financing than debt financing and that capital markets are better at financing innovation and new sources of growth<sup>8</sup>.

This makes capital market funding particularly attractive with a view to boosting Europe's potential growth after the pandemic. A fully fledged CMU would improve funding conditions for innovative firms, which would mean brighter prospects for jobs and growth in a more sustainable economy, thereby helping to successfully implement the structural changes that will be unavoidable after the crisis.

Fourth, advancing CMU would speed up the transition to a low-carbon economy. Recent analysis suggests that an economy's carbon footprint shrinks faster when it receives a higher proportion of its funding from equity investors than from banks or through corporate bonds<sup>9</sup>. Given equity investors' propensity to fund intangible projects, equity markets might be more successful in funding green innovation and supporting the reallocation to green sectors.

Fifth, integrated euro area capital markets would strengthen the international role of the euro, as deep and liquid financial markets are fundamental to a currency's ability to attain international status<sup>10</sup>. By reducing transaction costs, deeper markets would make using the euro more attractive for international financing and settlement. More liquid markets also mitigate rollover risk and are thus perceived as safer by investors.

A stronger international role for the euro would benefit our monetary policy, including through greater policy autonomy and improved monetary policy transmission, with positive spillbacks and lower external financing costs<sup>11</sup>. It would complement other measures supporting the international role of the euro, such as the expansion of euro liquidity facilities during the COVID-19 crisis<sup>12</sup>.

Finally, progress on CMU would dovetail with another key EU objective: completing the banking union. Banks and capital markets complement each other in financing the real economy, so the two projects are mutually reinforcing<sup>13</sup>.

On the one hand, more integrated capital markets support cross-border banking activities, as banks exploit economies of scale and offer similar capital market products across the EU.

More cross-border holdings would also allow banks to have more diversified collateral pools for their securitised products and covered bonds. This could ultimately make banks more resilient, as they would benefit from a wider investor base for capital market-based funding instruments and a broader market to which they could sell non-performing assets.

On the other hand, a more resilient and integrated banking system supports the smooth functioning and further integration of capital markets. Just as with CMU, the benefits of banking union become even more visible due to the pandemic.

### **Where do European capital markets stand today and what has happened during the pandemic?**

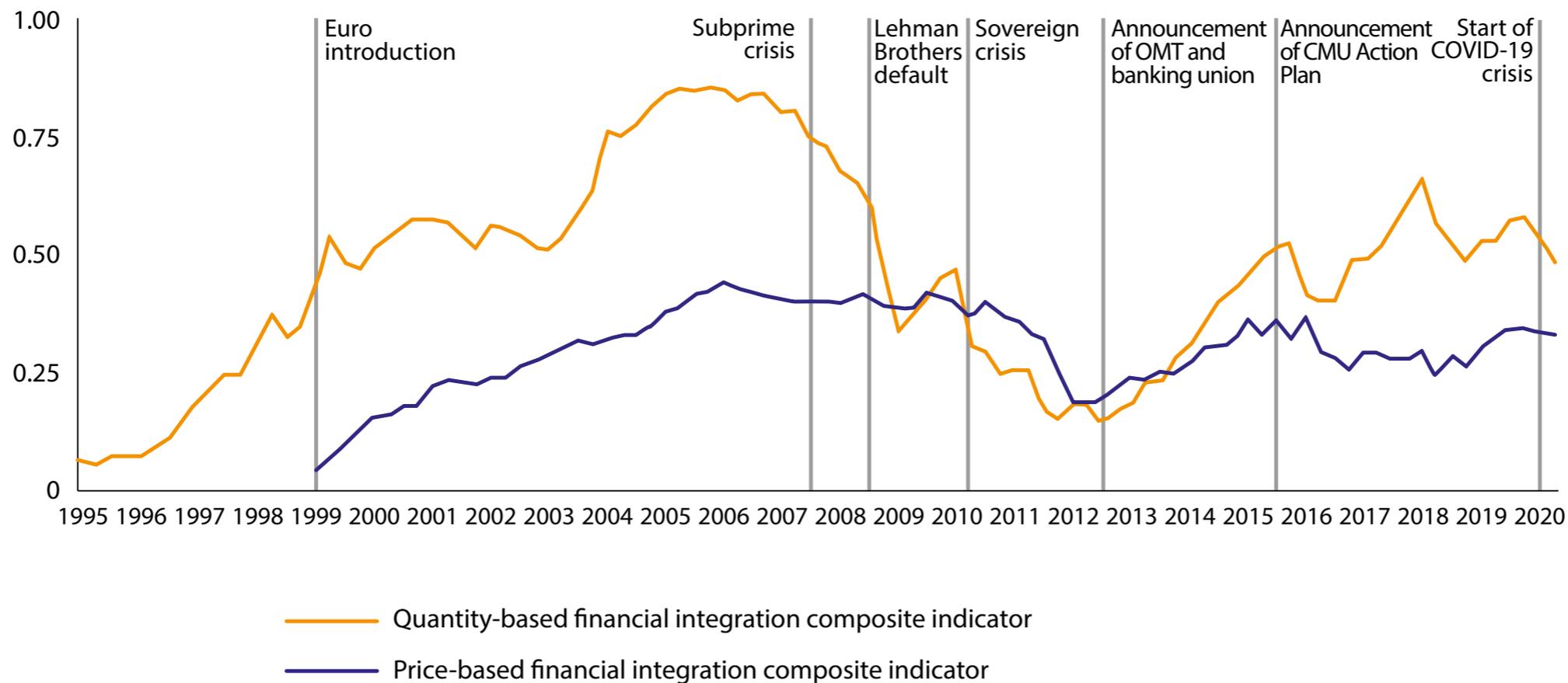
The first CMU Action Plan of 2015 has generated some positive developments in European capital markets. Among other things, it led to some progress on harmonising and improving insolvency frameworks<sup>14</sup>. and on establishing a new EU framework for covered bonds and simple, transparent and standardised securitisations. But a significant 'CMU effect' has yet to be seen in the data – partly because these measures have only been implemented recently and their full impact will take some time to emerge<sup>15</sup>.

European capital markets – and especially equity markets – remain underdeveloped and insufficiently integrated at the European level. While there was a strong positive trend in capital market integration following the great financial and euro area crisis, as shown by the price- and quantity-based indicators in Chart 1, the integration of equity markets has stagnated since 2015 and has even declined since the fourth quarter of 2017.

# Chart 1. Price and quantity-based indicators of financial integration

Quarterly data:  
Q1 1995 - Q2 2020

www.worldcommercereview.com



Notes: The indicators are bound between zero (full fragmentation) and one (full integration). The result of the quantity-based composite indicator for Q2 2020 is based on money market and equity market benchmark data from Q2 2020; for the bond market, Q1 2020 benchmark data are used. For a detailed description of the indicators and their input data, see the [Statistical annex](#) to the ECB report "Financial Integration and Structure in the Euro Area" (see source below) and Hoffmann et al. (2019).  
Source: ECB (2020), [Financial Integration and Structure in the Euro Area](#), March 2020.

Cross-border holdings of debt have increased, but this is mainly true for shorter maturities, which are less stable than longer-term debt<sup>16</sup>. Another notable trend is that investment funds are playing an increasingly important role in cross-border integration<sup>17</sup>. However, overall risk-sharing is still low compared with the levels typically observed across regions or states within a single country or federation<sup>18</sup>.

While it is too early to fully assess the impact of the COVID-19 outbreak on EU capital markets, some initial indicators show that the pandemic has triggered a refragmentation within euro area financial markets, mainly through bond and equity markets. At the height of the pandemic, this meant that our private purchase programmes could not reach the non-financial corporations (NFCs) of all euro area countries in the same way<sup>19</sup>.

Capital market development is also lagging behind<sup>20</sup>. While the US economy is financed through capital markets to a significant degree, the euro area economy continues to be mainly financed by banks and through unlisted shares.

Nevertheless, the role of capital markets in providing a stable source of funding to the European economy is expanding, thereby moving the euro area's financial structure towards a more balanced composition<sup>21</sup>.

NFCs have gradually diversified their funding structures and are increasingly financing themselves in the market by issuing debt securities. At the same time, however, corporate bond markets are very uneven across euro area countries.

Even though the share of all equity instruments in total financing in the euro area is comparable to other countries, financing through equity traded on public markets (listed shares) remains relatively uncommon, and well below the levels seen in other major economies<sup>22</sup>.

Conversely, loans and unlisted shares account for particularly large proportions of financing in the euro area economy. Similarly, the EU is lacking in early-stage private equity investment (see Chart 2). Data on venture capital investment relative to GDP show that even in Finland and Estonia, which are the most advanced EU countries in this area, the ratio is less than one-fifth of that in the United States.

Early-stage financing is not the only ingredient missing for innovative firms to flourish: the EU is also lagging behind the United States as regards an ecosystem that promotes the next stages of growth when firms mature and need to scale up their businesses<sup>23</sup>.

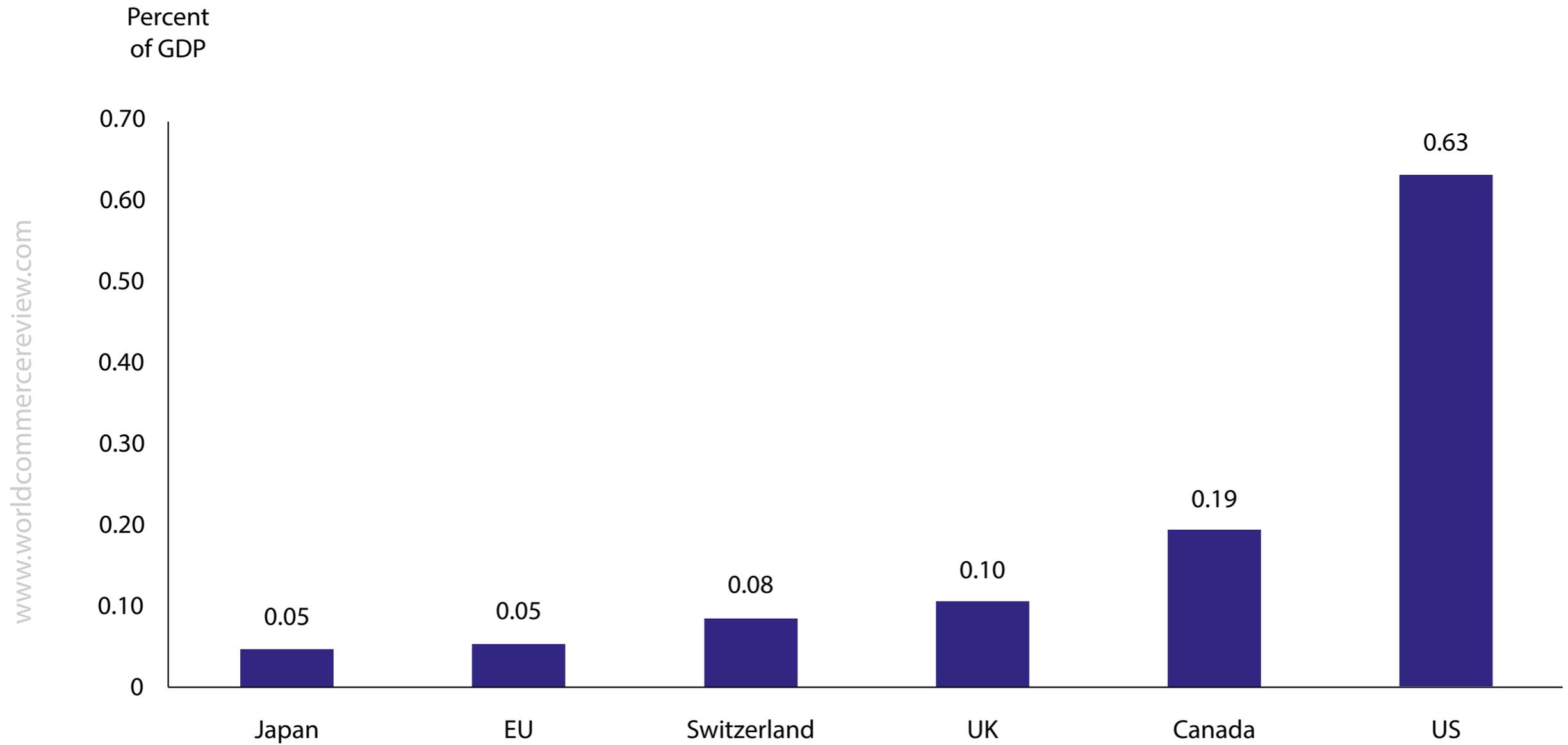
European equity markets are underdeveloped for a number of reasons, all of which influence both the supply of, and demand for, equity finance<sup>24</sup>. One important element is investor behaviour: equity ownership by investors, in particular retail investors, is low despite the growth of the investment funds sector, and skewed in the population compared with the United States.

At present, only 9% of the adult population of the euro area own publicly traded shares, compared with 52% in the United States. The picture across the euro area is mixed, both in terms of retail investors' preferences across asset classes and in the overall level of household investments (see Chart 3).

Unsurprisingly, the equity share of private pension investment is particularly low in countries with large pay-as-you-go systems<sup>25</sup>. By contrast, countries with large funded pension systems and, therefore, large aggregate private retirement savings, typically have the most developed capital markets<sup>26</sup>.

The flip side of Chart 3 and the limited investments in capital market products is that European savers hold large amounts of bank deposits. Appropriate equity shares in funded pension systems would help to ensure satisfactory

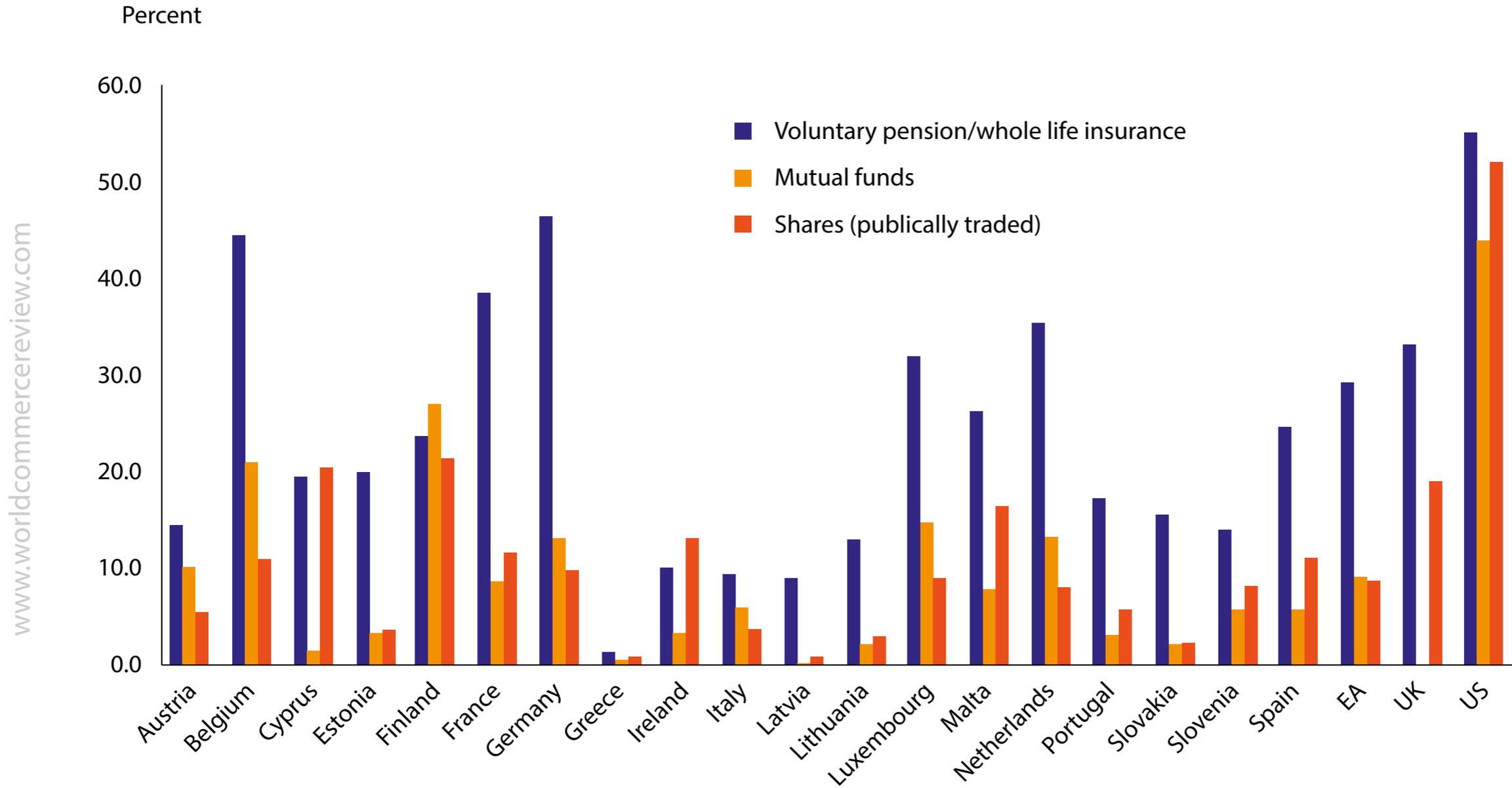
**Chart 2. Venture capital investments in 2019**



*Notes: For Japan only 2018 data are available. Data for the EU show the average for all EU countries for which data are available. Data are not available for Croatia, Cyprus, Malta and Slovenia.*

*Sources: OECD and IMF World Economic Outlook.*

**Chart 3. Share of households holding different asset classes by country**



Notes: Chart shows shares of asset types relative to the value of real assets by household (in percentages) from the ECB's Household Finance and Consumption Survey. All data are from 2014 with the exception of Estonia, Ireland, Malta, Netherlands, Portugal and Finland (2013) and Spain (2011). Data on mutual funds for the United Kingdom were not available. Sources: ECB's Household Finance and Consumption Survey, Forbes, ICI and Gallup.

returns for citizens over the long periods of time relevant for retirement savings. Adequate diversification rules across European countries in the new pan-European Personal Pension Product would help improve private financial risk-sharing.

Another element is the interconnection between the structure of the EU economy and that of EU financial markets. Depending on the sectors in which they operate, firms may be better served by bank or market-based finance<sup>27</sup>.

On the one hand, firms relying more on bank finance can be protected from the vagaries of investor sentiment<sup>28</sup>. On the other hand, a lack of market-based financing, particularly equity financing, can impede innovative firms in Europe from flourishing and becoming global champions, since banks – by contrast with venture capital or private equity firms – tend to finance less risky projects.

The size of firms also matters for financial structure. The large share of loans and unlisted shares in euro area NFCs' external financing sources (see Chart 4) partly reflects the larger share of small and medium-sized enterprises (SMEs) in the euro area.

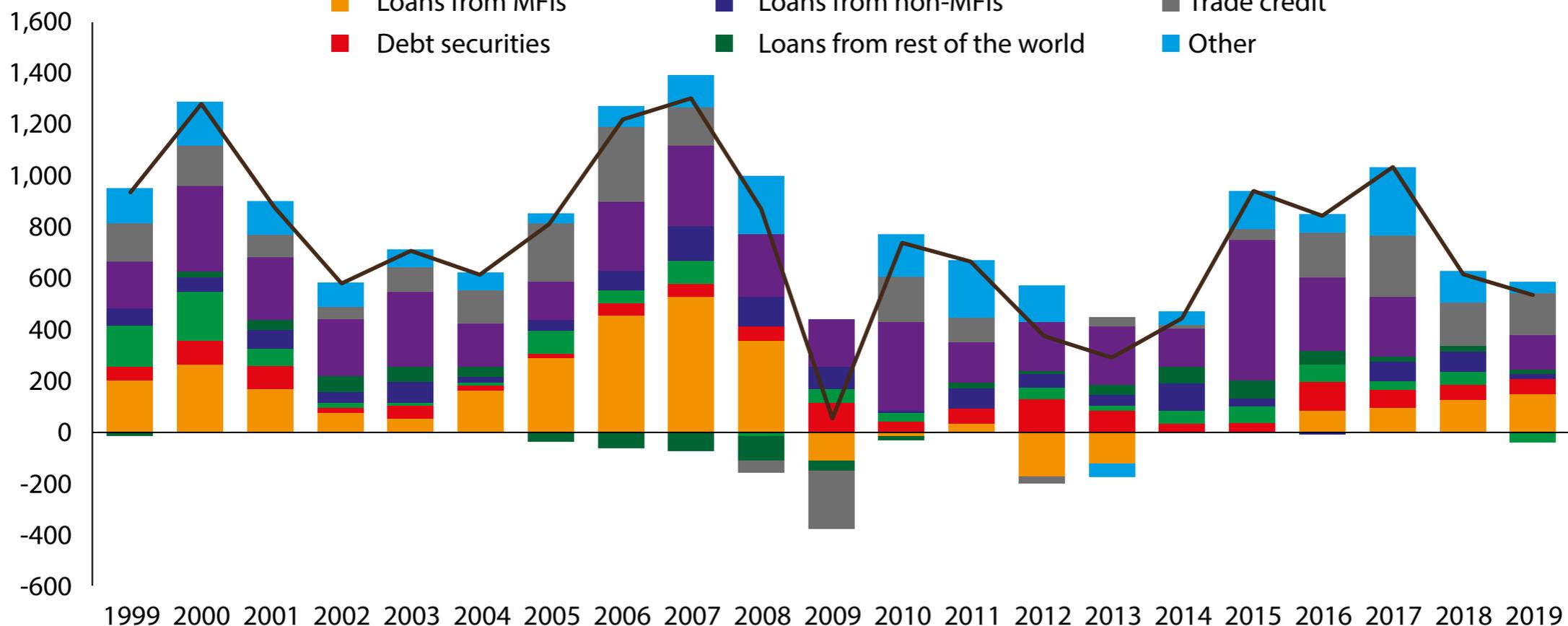
Research analysing the willingness of European SMEs to pay for external financing shows that they are willing to pay a non-negligible premium for debt funding, in particular in the form of bank loans, over external equity funding<sup>29</sup>.

As this cannot be explained completely by factors such as the debt-equity bias in taxation, the same research suggests that the bank-based system may have created a bias towards those types of firms that are better served by debt finance rather than equity finance, which may hamper innovation.

### Chart 4. External financing of euro area NFCs by instrument

Annual flows;  
€ billions;  
1999-2019

- Total external financing
- Listed shares
- Unlisted shares and other equity
- Loans from MFIs
- Loans from non-MFIs
- Trade credit
- Debt securities
- Loans from rest of the world
- Other



Notes: "MFIs" stands for "monetary financial institutions". Non-MFIs include other financial institutions as well as insurance corporations and pension funds. "Other" is the difference between the total and the instruments included in the chart, and includes inter-company loans and the rebalancing between non-financial and financial accounts data. 2019 data refer to data for the end of the third quarter of 2019.

Sources: ECB (euro area accounts) and ECB calculations.

While additional research would be needed to pinpoint other factors explaining the reluctance of EU firms – especially smaller ones – to become publicly listed, oft-cited drivers include the burden of the increased transparency and reporting requirements that result from public listing, a preference for relationship-based funding, or concerns about loss of control and dilution of existing shareholders.

Legislative proposals recently published by the European Commission in response to the COVID-19 crisis intend to reduce some of the red tape associated with listing<sup>30</sup>.

### **A roadmap for CMU**

The European Commission's new CMU Action Plan should be ambitious and aim to bring out the full potential of well-developed equity markets and integrated EU capital markets in order to stimulate both the demand for, and supply of, capital market instruments and services. Priority should be given to the following mutually reinforcing areas<sup>31</sup>:

1. Regulation and legal frameworks
2. Supervision and oversight
3. Fiscal policy and public debt markets
4. Financial market development
5. Securitisation

### **Regulation and legal frameworks**

EU capital markets must be able to rely on common rules and regulatory policies that support a level playing field for all market participants. The single rulebook must be strengthened and applied consistently throughout the EU.

Despite the objective to create a single European market for financial services, non-EU service providers still have to navigate a patchwork of regimes adopted at member state level in order to access national markets. A single, unified approach is needed, particularly in view of the level playing field challenges that might appear after Brexit.

Standardisation and harmonisation are instrumental in developing new markets. A case in point is the green bond market where the EU is already the global leader<sup>32</sup>. A reliable, verifiable and transparent EU green bond standard based on the EU Taxonomy would significantly enhance the credibility of this asset class. To serve its purpose and prevent greenwashing, the EU green bond standard must strike a balance between being selective in financing investment projects and avoiding disproportionately strict rules for issuers.

Collecting, processing and disclosing data will become ever more relevant for market players. For example, it is still challenging for investors to perform due diligence in relation to the management of European equity portfolios since relevant company information is widely scattered across multiple databases and has generally not been harmonised across borders.

An adequately designed European Single Access Point, developed under the lead of the European Securities and Markets Authority, would provide investors with centralised access to all relevant financial, trading and regulatory information on European companies and their securities.

In the longer term, further harmonisation of general legal frameworks would be desirable. Investors must be able to trust the predictability of the legal framework.

In particular, market participants would find it easier to invest in firms located in different member states if core elements of insolvency regimes, such as the definition of insolvency triggers, avoidance actions and the ranking

of claims, were harmonised at best-practice levels<sup>33</sup>. If full harmonisation of these regimes seems unfeasible, the development of dedicated EU-level regimes or procedures should be considered.

### **Supervision and oversight**

Given that risks do not stop at the EU's internal borders, there is a strong case for implementing EU-wide supervision of capital markets. This could also ensure consistent implementation of the single rulebook to provide a level playing field for investors and market players.

In particular, capital markets can only function smoothly if they can rely on efficient and robust market infrastructures. Additional efforts to better integrate and supervise key market infrastructures are essential to ensure a level playing field for issuers and investors.

This could include genuine EU-level supervision of systemically important EU central counterparties and greater supervisory convergence for central securities depositories by promoting the centralisation of supervisory powers (or at least enhanced cooperation at EU level), as well as launching efforts to ensure that reliable infrastructures are in place to deal with more sophisticated cyber threats<sup>34</sup>.

### **Fiscal policy and public debt markets**

To promote the development of capital markets, national tax frameworks should avoid distorting incentives for firms and investors regarding capital structure. In particular, the existing bias in favour of debt over equity should be addressed in a decisive manner to facilitate the issuance of listed equity by firms<sup>35</sup>.

Further simplification and cross-border convergence of withholding tax procedures would reduce the administrative burden for cross-border investors. This could pave the way for the development of a common,

adequately designed, sovereign safe asset, which could have important benefits for financial stability, integration and development in the euro area<sup>36</sup>.

The issuance of a low-risk security at European level would enhance the financial system and would be an important component in developing a proper euro area term structure<sup>37</sup>.

The EU joint debt issuance for the establishment of the European recovery fund could represent a first step in this direction, as the current proposal includes a plan to issue EU-level bonds with different maturity dates between 2028 and 2058. A safe asset of this nature could lead to the emergence of a genuine single securities market in the EU.

In contrast to other currency areas, financial integration and risk-sharing among market participants in the euro area is impeded by the current lack of a pan-European, neutral and harmonised channel for the issuance and initial distribution of debt securities that would address the fragmentation of debt markets along national lines.

### **Financial market development**

Efforts to improve financial literacy would support the CMU agenda and, more importantly, allow households to reap the benefits of capital markets. Citizens would then be better equipped to critically assess investment advice and broaden their long-term investment options<sup>38</sup>.

We would welcome initiatives from the European Council and Commission to make financial literacy a priority in lifelong learning and to develop an EU competence framework. The same goes for proposals that seek to ensure the provision of adequate and fair advice and thus improve retail investors' trust in advisers and capital markets<sup>39</sup>.

It would be useful to identify best practices for financial education initiatives, and member states themselves could devise further initiatives with a broad impact in the long term, such as incorporating financial education into secondary school curricula.

A further major determinant of financial market development is the structure of pension schemes. While we recognise the profound social choices involved in designing national pension systems, we also note that increasing private retirement savings rates in response to demographic changes could have a strong positive impact on European capital markets<sup>40</sup>.

Adequate options for portfolio compositions, including various choices about the equity share and (European cross-country) diversification (as embedded in the new pan-European Personal Pension Product, for example), would offer households opportunities to improve their retirement incomes.

The European long-term investment fund was designed to address the lack of equity funding for innovative and young firms. However, this instrument has so far not worked as expected and should be amended in a targeted fashion, for example by increasing the investor pool and simplifying applicable tax rules. Firms could then attract more cross-border and retail investors.

In addition, in the light of the unavoidable increases in debt in order to finance the post-COVID-19 recovery and potential defaults, European markets for trading impaired assets should be better developed and integrated.

### **Securitisation**

Securitisation allows banks to transfer parts of the risks associated with their lending to other investors and can therefore broaden companies' investment bases and funding conditions.

While the new European framework for simple, transparent and standardised securitisation (finalised in 2017) has dealt with the weaknesses and excesses that contributed to the financial crisis of 2008, it has not proven fully effective in reviving the much-reformed EU markets.

A review should be conducted to explore how existing rules could be improved. This could include options for facilitating the securitisation of impaired assets.

### **Conclusion**

Advancing CMU is not just about capital markets and financial institutions. It will be of benefit to all of us, entrepreneurs, employees, savers and citizens alike. The COVID-19 pandemic has re-emphasised the importance of the CMU project and the need to make rapid progress. We should be realistic that the benefit to be gained from some measures will take longer to emerge than others.

For instance, while further harmonising insolvency frameworks or integrating financial literacy into school curricula could have a very significant impact, it will be many years before we see the related effects.

But other measures, such as the creation of a European Single Access Point for company information or the removal of the tax advantage of debt, could be implemented over a relatively short time period and would have near-term implications.

Nevertheless, these reforms should be pursued jointly and immediately in order to achieve the desirable level of ambition, as many of them create synergies. Progressing with reforms in all these areas is particularly crucial in view of the COVID-19 pandemic. It could speed up the European recovery and increase the growth potential, which would also strengthen public finances.

Most importantly, it could facilitate the structural changes that have become unavoidable as a result of the pandemic and support the transition to a low-carbon and digitalised economy. The COVID-19 crisis is thus a wake-up call to strengthen CMU and make the EU economy more robust and resilient. ■

## Luis de Guindos is Vice-President of the ECB, and Fabio Panetta and Isabel Schnabel are Members of the Executive Board of the ECB

### Endnotes

1. See Panetta, F (2020), *"Sharing and strengthening the euro's privilege"*, The ECB Blog, 12 June.
2. See, for example, Bergbauer, S et al. (2020), *"Implications of Brexit for the EU financial landscape"*, Financial Integration and Structure in the Euro Area, March, ECB.
3. Several recent reports include suggestions on CMU from market participants and policymakers. See European Commission (2020), *"Final report of the High Level Forum on the Capital Markets Union - A new vision for Europe's capital markets"*; The Next CMU High-Level Expert Group (2019), *"Savings and Sustainable Investment Union"*; Panagiotis, A and Wright, W (2019), *"Report: Unlocking the growth potential in European capital markets"*, New Financial; Lannoo, K and Thomadakis, A (2019), *"Rebranding Capital Markets Union: A market finance action plan"*, CEPS-ECMI Task Force; Bhatia, VA et al. (2019), *"A Capital Market Union for Europe"*, Staff Discussion Notes, IMF; and AFME (2018), *"Capital Markets Union: Measuring progress and planning for success"*.
4. See ECB (2017), *"ECB contribution to the European Commission's consultation on Capital Markets Union mid-term review 2017"*, May.
5. For the ECB, *"the market for a given set of financial instruments and/or services is fully integrated if all potential market participants with the same relevant characteristics: (1) face a single set of rules when they decide to transact in those*

financial instruments and/or services; (2) have equal access to the above-mentioned set of financial instruments and/or services; and (3) are treated equally when they are active in the market". See Baele, L et al. (2004), ["Measuring financial integration in the euro area"](#), Occasional Paper Series, No 14, ECB, April.

6. See Beck, R, Dedola, L, Giovannini, A and Popov, A (2016), ["Financial integration and risk sharing in a monetary union"](#), Financial Integration in Europe, April, ECB.

7. Equity contracts imply gains for stock owners in good times but losses in bad times, whereas debt contracts are characterised by fixed payments over the life of the contract. Studies showing the positive effects include: Artis, MJ and Hoffmann, M (2012), ["The Home Bias, Capital Income Flows and Improved Long-Term Consumption Risk Sharing between Industrialized Countries"](#), International Finance, Vol. 13, No 3, pp. 481-505; Forbes, KJ and Warnock, FE (2014), ["Debt- and Equity-Led Capital Flow Episodes"](#), in Fuentes, M, Raddatz, CE and Reinhart, CM (eds.), Capital Mobility and Monetary Policy: An Overview, Chapter 9, Central Banking Series, Central Bank of Chile, pp. 291-322; and Milesi-Ferretti, GM and Tille, C (2011), ["The Great Retrenchment: International Capital Flows During the Global Financial Crisis"](#), Economic Policy, Vol. 26, No 66, pp. 285-342.

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9. See De Haas, R and Popov, A (2019), ["Finance and carbon emissions"](#), Working Paper Series, No 2318, ECB, September; and Popov, A (2020), ["Does financial structure affect the carbon footprint of the economy?"](#), Financial Integration and Structure in the Euro Area, March, ECB.

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12. See Panetta, F and Schnabel, I (2020) *"The provision of euro liquidity through the ECB's swap and repo operations"*, *The ECB Blog*, 19 August.

13. See Constâncio, V (2017), *"Synergies between banking union and capital markets union"*, keynote speech at the joint conference of the European Commission and European Central Bank on European Financial Integration, Brussels, 19 May.

14. Through *Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt*.

15. See de Guindos, L (2019), *"Building the EU's capital markets: what remains to be done"*, speech at the Association for Financial Markets in Europe Conference, Supervision and Integration Opportunities for European Banking and Capital Markets, Frankfurt am Main, 23 May.

16. See ECB (2020), *Financial Integration and Structure in the Euro Area*, March.

17. See, for example, Giuzio, M and Nicoletti, G (2018), *"Integrating euro area corporate bond markets: benefits and potential financial stability challenges"*, *Financial integration in Europe*, May. Funds that are domiciled in financial centres facilitate the diversification of asset holdings across euro area countries, see Vivar, LM, Lambert, C, Wedow, M and Giuzio, M (2020), *"Is the home bias biased? New evidence from the investment fund sector"*, *Financial Integration and Structure in the Euro Area*, March, ECB.

18. See Giovannini, A, Horn, C-W, Mongelli, FP and Popov, A (2020), *"On the measurement of risk-sharing in the euro area"*, *Financial Integration and Structure in the Euro Area*, March, ECB.

19. A case in point is our commercial paper purchase programme, explained in a recent blog post by de Guindos, L and

Schnabel, I (2020), [“The ECB’s commercial paper purchases: A targeted response to the economic disturbances caused by COVID-19”](#), The ECB Blog, 3 April.

20. One way of defining financial development (or financial modernisation for an already highly developed financial system like that of the euro area) that is also applicable to capital markets is the process of financial innovation, as well as institutional and organisational improvements in the financial system that reduce asymmetric information, increase the completeness of markets and contracting possibilities, reduce transaction costs and ensure a high level of competition. See the preface to ECB (2020), *op. cit.*; and ECB (2008), [“Financial development: concepts and measures”](#), Financial integration in Europe, April.

21. The data in this paragraph are taken from ECB (2020), *ibid.*

22. Stock market capitalisation was 56% in the EU27, 163% in the United States, 149% in Japan and 110% in the United Kingdom. The data are taken from the [2019 ECMI Statistical Package](#).

23. See Lannoo, K and Thomadakis, A, *op. cit.*

24. These include cultural barriers to equity investment, unavailability of uniform firm information, biases in taxation, low levels of financial literacy, the design of pension systems and products, low public investment in fundamental research and more market-oriented research and development, and the lack of technology clusters.

25. The equity share is less than 20% in the median EU country, compared with 30% in Switzerland, 44% in the United States and 51% in Australia. See, for example, Giovannini, A, Hartmann, P, Imbs, J and Popov, A (2018), [“Financial integration, capital market development and risk sharing in the euro area”](#), keynote speech at the 8th International Conference of the Financial Engineering and Banking Society, 4 June.

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27. See, for example, Rajan, RG and Zingales, L (2003), “Banks and markets: the changing character of European finance”, in Gaspar, V., Hartmann, P and Sleijpen, O (eds.), *The Transformation of the European Financial System, Proceedings of the Second ECB Central Banking Conference, Frankfurt am Main*, pp. 123-167; Rajan, RG and Zingales, L (2001),

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29. See, for example, ECB (2020), *op. cit.*; and Brutscher, PB and Hols, C (2018), *“The corporate equity puzzle”, EIB Working Papers, 2018/03.*

30. European Commission (2020), *“Coronavirus response: Making capital markets work for Europe’s recovery”, 24 July.*

31. Some of these proposals were included in the High Level Forum’s report on CMU and in other reports mentioned above (see footnote 3 for more details).

32. In 2019 more than half of global issuance was concentrated in the EU and almost half of global green bond issuance was denominated in euro. For more details, see ECB (2020), *“The international role of the euro”, June.*

33. Research finds that improving insolvency frameworks in euro area countries towards best practice enhances private financial risk-sharing through capital markets. See, for example, Giovannini, A, Hartmann, P, Imbs, J and Popov, A (2018), *op. cit.*

34. The ECB has played a key role in fostering public-private cooperation, for example by launching a new cyber-threat intelligence sharing platform for market infrastructures under the Euro Cyber Resilience Board. See Panetta, F (2020), *“Protecting the European financial sector: the Cyber Information and Intelligence Sharing Initiative”, introductory remarks at the fourth meeting of the Euro Cyber Resilience Board for pan-European Financial Infrastructures, February.*

35. As part of the 2015 Action Plan on Building a Capital Markets Union, the European Commission proposed relaunching work on the common consolidated corporate tax base, including a *legislative proposal*, which has still not been agreed on by the European Council. Research shows that allowing firms to deduct a notional interest rate on equity against their profits (on top of the existing deductibility of interest expenses) is likely to be beneficial for financial stability as, in the case of Belgium and Italy, it effectively reduced firms’ leverage. See, for example, Hebous, S and Ruf, M (2017), *“Evaluating the*

*effect of ACE systems on multinational debt financing and investments*”, *Journal of Public Economics*, Vol. 156, pp. 131-149; and Schepens, G (2016), *“Taxes and bank capital structure”*, *Journal of Financial Economics*, Vol. 120, Issue 3, pp. 585-600.

36. For a discussion of the features of a safe asset of this nature, see Alogoskoufis, S, Giuzio, M, Kostka, T, Levels, A, Molestina Vivar, L and Wedow, M (2020), *“How could a common safe asset contribute to financial stability and financial integration in the banking union?”*, *Financial Integration and Structure in the Euro Area*, ECB, March.

37. See also Panetta, F (2020), *“Sharing and strengthening the euro’s privilege”*, *The ECB Blog*, 12 June.

38. Research finds that levels of financial education vary widely across the euro area, and that financial literacy enhances capital market participation and fosters private financial risk-sharing via capital markets. See, for example, Giovannini, A, Hartmann, P, Imbs, J and Popov, A (2018), *op. cit.*

39. See the High Level Forum’s report on CMU (European Commission (2020), *op. cit.*) for specific proposals regarding inducements for financial advisers and how to enhance the quality of financial advice.

40. For example, an estimation of the impact for the euro area if all member countries increased the share of equity investments in their pension savings to a “regular” level for diversified long-term portfolios (about 39%) shows that the additional equity demand would amount to about 3.7% of total equity market capitalisation. See, for example, Giovannini, A, Hartmann, P, Imbs, J and Popov, A (2018), *op. cit.*

This article is based on *The ECB Blog*, 02 September 2020

The background of the slide features a composite image. The top half shows a view of the Earth from space, with blue oceans and green landmasses. The bottom half shows a human brain, with the top half of the brain appearing to be composed of or merged with the Earth's surface. The entire image is set against a dark green background.

# Financing the EU: new context, new responses

Clemens Fuest and Jean Pisani-Ferry consider the EU budget, which has to be reassessed in light of the Next Generation EU programme

**R**oughly two thirds of the European Union's budget is financed out of member states' national tax revenues. These resources, based on gross national incomes, are transparent, fair and in line with the principle of subsidiarity but they lead to political debates that emphasise the cost of EU spending rather than the benefits, and add to the perception of the EU budget in terms of net balances, rather than value added.

The financing of the EU budget must be reassessed in the light of the July 2020 decision to launch the Next Generation EU programme. Budget resources could include a plastics charge, a carbon border adjustment mechanism, a digital tax, revenues from emissions trading and a financial transactions tax.

We evaluate these options against four criteria: whether the origin of the revenue can be assigned to a particular member state; whether the revenue can be raised in isolation or requires pan-European tax coordination; whether the new resource can help reduce tax distortions in the EU; and whether the resource is related to EU policies.

Revenues from emissions allowances fit these criteria best. Carbon emissions do not primarily cause damage only where they occur. Taking the EU cap on emissions as a given, additional emissions in a particular member state should be regarded as a negative externality on other member states. Emission reduction objectives are set at EU level.

Whoever auctions off an allowance, wherever the corresponding emission occurs in the EU, and wherever the resulting good or service is consumed, the impact on common policy outcomes is the same. In this regard, proceeds from the sale of emissions trading system allowances are not that different from customs duties.

Compared to the ETS, the other candidates for EU own resources are less convincing. Carbon border adjustments are intended to limit international competitive distortions rather than to generate revenue.

Digital taxes and minimum corporate taxes are best left to the process underway in the Organisation for Economic Co-operation and Development. On a financial transactions tax there is no agreement within the EU.

Total ETS revenues up to 2050 would approach €800 billion in a realistic scenario and possibly even €1.5 trillion assuming the scope of the ETS and the share of auctioned permits are increased. ETS revenues therefore would be largely sufficient to repay the Next Generation EU debt.

However, they would generate distributional effects, and so part of the revenues should finance grandfathered rights that would accrue to the member states. The EU can tackle the distributional issues involved in the reform of own resources.

*The decision to introduce new resources is ultimately political and the discussion about it is likely to involve strong distributional aspects*

## Introduction

The debate on the financing of the European Union budget is never-ending. Because it is overly loaded with quasi-constitutional, and at any rate highly political considerations about the nature of the EU, it has consistently served as a battlefield between those who regard the EU as a confederation of sovereign states and those who believe in its federal destiny.

We have no intention of reopening the existential debate. But we posit that two new facts call for a pragmatic re-examination of the financing of the EU budget:

- The decision by the European Council to launch the Next Generation EU (NGEU) recovery programme in response to the COVID-19 crisis.

In its conclusions, the European Council of July 2020 requested from the Commission proposals for new own resources that could be used for early repayment of NGEU borrowing;

- The emergence of potential new resources that have an intrinsically pan-European character.

We start by reviewing the financing of the EU. We then turn to arguments for or against reforming the existing system, before putting forward criteria for assessing potential new resources.

We then take up the potential revenue implications of climate policy, dealing first with the emissions trading system and second with the taxation of carbon at the border.

We discuss digital taxation and other potential candidates for own resources, especially the financial transaction tax. As this analysis leads us to conclude that there is a strong case for turning ETS revenues into an EU own resource, we return to the issue to discuss implementation issues.

### **The financing of the EU budget**

The EU budget has a number of characteristics that make it unique. There is a fixed ceiling on revenues and spending, and there is no debt financing – with the exception of the recent €750 billion EU Economic Recovery Fund (Next Generation EU), which was announced as a one-time measure.

The revenue comes from so-called 'own resources'. This is a misnomer that combines genuine own resources (the 'traditional own resources', mostly tariffs) and statistical aggregates (the VAT resource and the gross national income resource). Custom duties are true own resources because they are levied at the port of entry of foreign merchandises, but result from demand emanating from wherever in the EU the corresponding goods are consumed or utilised.

After deducting a fee for administration costs (currently 20 percent of the revenue), the remainder goes to the EU. The VAT resource and the GNI resource, however, are levied by each and every member state and are widely considered by them as national contributions to the EU budget, not as resources 'owned' by the EU.

In recent years the EU budget has been financed essentially by the GNI resource. However, this resource was only introduced in the early 1990s (Figure 1). Earlier budgets were mostly financed by the VAT resource and the custom duties, the share of which in total revenues was about one-half in 1980.

**Figure 1. Structure of own resources of the European Community/EU, 1958-2018**

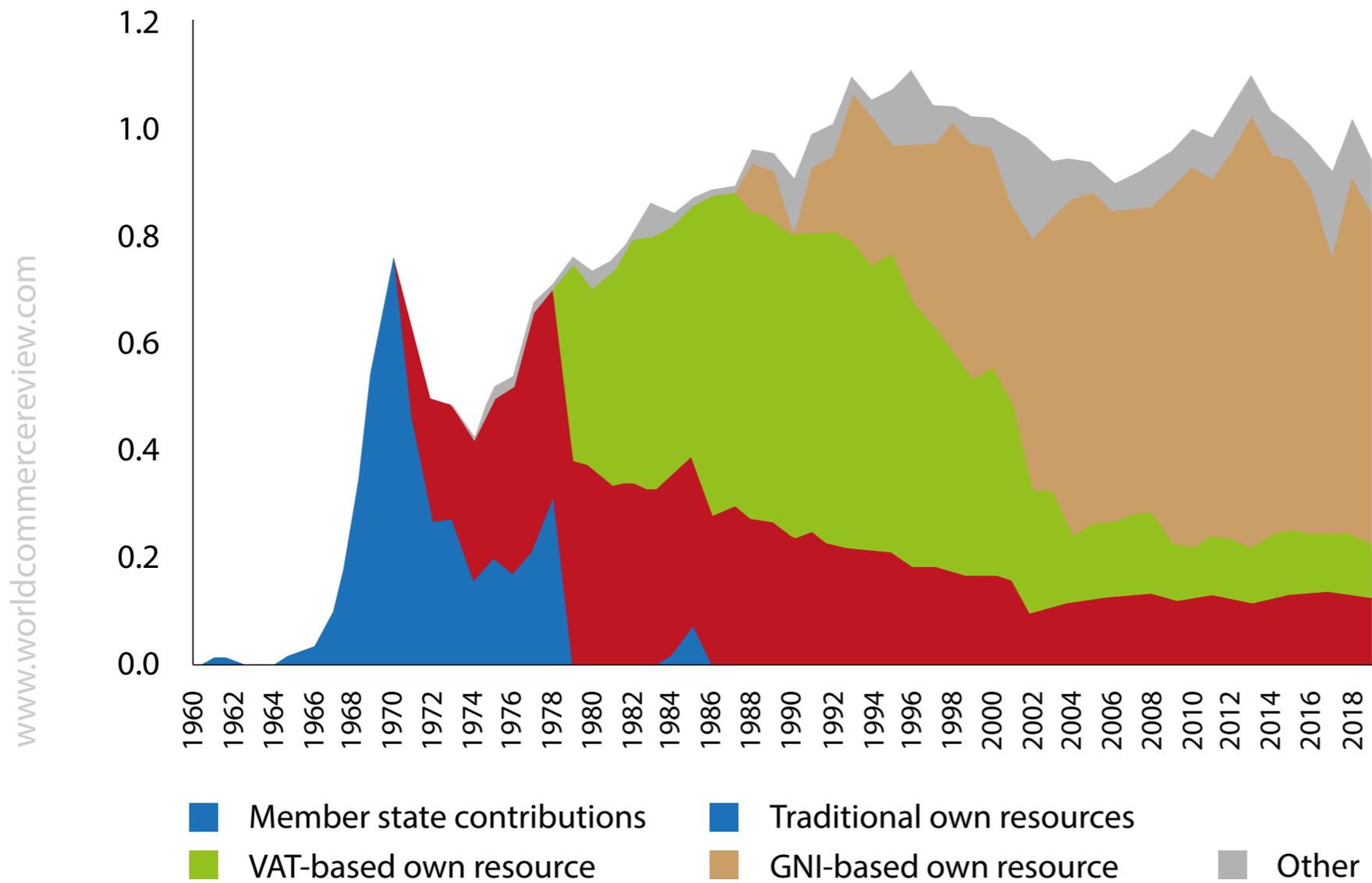


Figure 1. Structure of own resources of the European Community/EU, 1958-2018

In fact, the structure of EU budget resources has been remarkably unstable over time, evolving from an exclusive reliance on national contributions (before 1970) to a combination of genuine own resources and a VAT top-up (from the mid-1970s to the 1980s) and to a renewed predominance of national contributions (from the 1990s onwards) (Cipriani, 2014).

Today, the GNI resource provides roughly two thirds of the overall financing of the EU budget. Given this revenue structure, it is fair to say that the EU budget is primarily financed through contributions made by the member states out of national tax revenue.

This instability results from a legal factor and an economic factor. The legal factor is that although Art. 311 of the Treaty on the Functioning of the European Union (TFEU) states that *“Without prejudice to other revenue, the budget shall be financed wholly from own resources”*, it does not define what is meant by that, nor does it provide any detail on possible resources.

It basically leaves to the Council the responsibility of deciding by unanimity what these resources should be: the Council *“may establish new categories of own resources or abolish an existing category.”* The economic reason is that the genuine own resources the EU relied on after the 1970 decision to *“replace financial contributions from member states by the communities’ own resources”* were unstable: revenues from tariffs dwindled as a consequence of trade liberalisation, and other specific revenues were too limited in the first place to provide stable revenue streams<sup>1</sup>.

### **Why change the system of own resources?**

In the debate about reform of the own resources system, it is important to distinguish two questions. The first is whether the EU should have its own – possibly limited – power to levy resources through taxation, rather than relying on the fiscal sovereignty of its member states.

This debate is about fundamental changes to the institutional setup of the EU, which would move it closer to a federal structure.

The other question is whether the system of own resources should be changed given the current institutional setup, with a fixed ceiling on expenditure, no deficit financing and national fiscal sovereignty as the bases for the financing of the EU.

We focus on the second question, that is on reforming the own resources system, taking as given the current EU institutional setup.

Discussions about reform of the EU own resources system often start from the (undisputable) observation that the existing system of financing is dominated by the GNI resource. Whether this dominance is good or bad is disputed.

The GNI resource has a number of advantages: it is transparent, it leads to a distribution of the financing burden between member states that is proportional to their respective capacities, and it allows member states to finance their contributions through the taxes that are best suited to local conditions and local preferences, which is in line with the principle of subsidiarity.

There are two main critiques of the dominance of the GNI resource. First, it is perceived as having a distorting effect on political decisions in the member states about the EU budget.

The High Level Group on Own Resources (HLGOR), which was created in 2014 to propose reforms to the own resources system, described this issue as follows:

*“Member states that are net contributors to the EU budget first look at their contribution on the revenue side — and try to minimise this amount as much as possible. The costs are immediately visible whereas the consequent benefits are often indirect and more dispersed.”<sup>2</sup>*

A related observation is that the dominance of GNI contributions encourages thinking about the EU budget in terms of net balances. Perceiving benefits from the EU budget as being reflected by net balances would be appropriate if the budget consisted purely of transfers between member states, essentially leading to a zero-sum game.

But EU spending on public goods that benefit all member states and their citizens, and that creates added value that benefits the EU economy as a whole, cannot be looked at through such a lens. Therefore, to the extent that European public goods are financed through the EU budget, net balances are a misleading measure of national benefits from this budget<sup>3</sup>.

The second critique is that, in the same way customs duties were naturally allocated to the common budget in a customs union, the financing of the EU through GNI contributions ignores potential resources that, because of their genuinely European character, should be regarded as an efficient source of funding of the EU budget.

This applies, first, to tax bases that have by nature a pan-European character and cannot be mobilised by individual member states, and second to mobile tax bases that can only be taxed if member states coordinate their policies.

Potential candidates for such new own resources are for example levies on the carbon content of imports, which should not accrue to the country where the port of entry is located and whose ultimate destination inside the

single market is hard to trace; or taxes on profits of multinational companies if they evade taxation through profit shifting unless states coordinate their policies.

Naturally, the existence of such resources is not by itself a justification for spending more at EU level, and the corresponding revenue could simply be redistributed to the member states proportional to their GNI. It would however be more efficient to allocate these resources directly to the financing of the EU budget.

### **Criteria for introducing new resources**

Irrespective of the pros and cons of GNI-based resources, it is fruitful to discuss options for introducing new own resources. Most likely, these resources would complement but certainly not entirely replace GNI-based contributions.

Taking the volume of spending in the EU budget as given, introducing new own resources would imply a reshuffling of the burden of the financing of the EU across member states. GNI-based contributions would presumably keep the function of balancing the budget at the margin, but their weight would be mechanically reduced.

In the case of a new own resource based on existing national tax instruments, the impact would essentially be distributive, to the extent that the incidence across member states of the new resource differs from the distribution of GNI. There would be no first-order efficiency gain to speak of.

But if the tax base was genuinely EU-wide, or if it is sufficiently mobile to avoid taxation by individual member states, the introduction of the new own resource would lead to lower taxation on other factors.

It would therefore result in a change in the structure of taxation and a reduction of existing tax rates, potentially yielding efficiency gains.

The decision to introduce new resources is ultimately political and the discussion about it is likely to involve strong distributional aspects. However, it is important that this decision be based on objective criteria. We suggest the following:

- Whether the origin of the revenue can be assigned to a particular member state;
- Whether the corresponding revenue can be raised in isolation or requires pan-European tax coordination;
- Whether the introduction of the new resource can help reduce tax distortions in the EU;
- Whether the resource is related to EU policies.

More than one of these criteria should be satisfied. For example, revenues that can be assigned to a member state and can be raised without coordination do not add anything to the public finance equation and therefore are not suited in any particular way to serve as an own resource, even if they correspond to the EU's political priorities.

The focus should be on where a strong case can be made for using tax instruments as a basis for own resources. This applies in particular to revenues that are European by nature because they can only be levied via a common decision, or cannot be ascribed to any particular member state in a meaningful way.

The introduction of such resources would both broaden the tax base, potentially reducing distortions, and increase the proportion of the EU budget that is financed from 'truly' European revenue sources.

Customs duties, for instance, were particularly suited as an EU own resource because it would not be appropriate to allocate the revenue to the country where the port of entry for the imported goods is located.

In addition, customs duties are related to trade policy, which is a competence of the EU. At its meeting on 17-21 July 2020, the European Council decided that the EU should work towards the introduction of new own resources.

The council conclusions explicitly mention a charge on non-recycled plastic, a carbon border adjustment mechanism, a digital tax, a reformed emissions trading system (ETS), and finally a financial transaction tax.

The timing of these potential new own resources is important. The plastics charge is agreed to start already in 2021, the border adjustment mechanism and the digital levy are to be introduced in 2023. There is no specified timetable for the ETS.

The financial transaction tax is mentioned as a potential project for the next MFF, which implies that it will play no role in the current reform of the own resources system. The revenues are to be used, among other things, to service the debt incurred for the EU Recovery Fund<sup>4</sup>.

In the following, we focus primarily on the suitability of two types of potential new resources: carbon-related levies (through the auctioning of emission allowances within the framework of the ETS, and through a potential carbon border adjustment mechanism), and taxes on the profits or the revenues from the cross-border provision of digital services.

We also discuss a number of other potential bases for own resources, albeit with less detail: the financial transaction tax, the tax on non-recycled plastic and the corporate income tax.

Some of the candidates for new own resources, such as a corporate income tax or financial transaction tax, have a presumably permanent character, while others have a temporary character, either because their tax base is set to shrink (not least because that is the very purpose of the taxation), as is the case for carbon levies, or because they are temporary fixes (as for the digital services tax, if international discussions on new cooperative arrangements for corporate income taxation lead to a comprehensive redefinition of taxing rights).

Clearly, the EU budget should be financed by permanent resources, but as a consequence of recent decisions, temporary revenue is needed to service and pay down the debt incurred in the context of the NGEU Fund. Given this, a revenue source which is available for a limited amount of time may be appropriate.

Of course, the EU will need own resources for other purposes, but using temporary resources for a transition period would buy time to develop other options.

### **Revenues from the emissions trading system**

The EU has ambitious climate policy objectives. All but one of the member states have endorsed the goal of reaching EU-wide climate neutrality in 2050, but this political commitment has not yet been translated into an operational strategy<sup>5</sup>. Current climate policy is based on a framework that includes EU-wide targets and policy objectives for the period from 2021 to 2030.

This framework, which also represents the EU contribution to the Paris Agreement, notably entails a 40 percent greenhouse gas emissions reduction target by 2030 (compared to 1990), as well as renewable energy and energy

efficiency targets. President von der Leyen has committed to revise this framework, raising the emissions reduction target to 50-55 percent by 2030.

The main EU policy tool to translate these objectives into practice is the ETS, which covers emissions from the power sector, industry and intra-EU flights (ie. about 45 percent of total EU emissions). Non-ETS sectors (ie. transport, buildings and agriculture) are dealt by the Effort Sharing Regulation (ESR, Regulation (EU) 2018/842), which requires member states to pay fines if they fail to reach them.

In the medium term it would be desirable to expand further the scope of the ETS and to bring in more sectors. The same carbon price would then apply to all participating sectors, which would ensure consistency and efficiency. Ultimately, all sectors could be brought in.

It would also be desirable to give up national objectives, because they are incompatible with the EU-wide, cost-efficient reduction of emissions. The proper basis for sharing efforts between member states should be the marginal cost of emission reductions.

If a member state can exceed its national objective at cost that is lower than the cost for another member state to reach its goal, the common interest dictates that the first country should make the effort, even if it is not in accordance with preassigned objectives.

Consistent with this approach, ETS revenues should accrue to the EU, rather than to the member state where the emissions take place.

Allocation of revenues from the ETS to a particular member state is perfectly feasible: the location of emissions is precisely defined. But there is no reason why proceeds from the sale of emissions permits should accrue to the country where emissions are taking place. The emitting industry does not impose any particular damage on that country in terms of its carbon dioxide emissions.

Rather, taking the EU cap on emissions as a given, an additional emission in a particular member state should be regarded as a negative externality on the other member states (because it forces them to reduce their own emissions, or accept that their common objective will be missed)<sup>6</sup>.

The basic reason why ETS revenues should be allocated to the EU is that the corresponding policy is fundamentally a common policy. Emission reduction objectives are set at EU level in view of common Nationally Determined Contributions put forward within the framework of the United Nations Framework Convention on Climate Change conferences.

Whoever auctions off an allowance, wherever the corresponding emission takes place in the EU, and wherever the resulting good or service is consumed, the impact on common policy outcomes is the same. In this respect, proceeds from the sale of ETS allowances are not that different from customs duties.

Moreover, the bulk of emission allowances destined for auction are allocated to member states on the basis of historical emissions (and a remainder is allocated on distributional grounds to the least wealthy member states). Revisions are infrequent.

Emission allowances therefore have the character of a rent that is granted to member states. The higher the ETS carbon price, the more member states benefit from it. In this set-up, a decision by the EU to increase the pace of

decarbonisation and to reduce the overall volume of emissions may paradoxically result in a higher rent, especially for carbon-intensive countries.

These are strong reasons why, on pure economic grounds, proceeds from the auctioning of emission permits should be allocated to the EU and not to any particular member state. Obviously, a shift from national resources to an EU resource would raise significant transitional and distributional difficulties.

Like any 'Pigouvian' resource, ETS revenues will fall as the EU moves towards reaching its CO<sub>2</sub> neutrality objective. But for a time of transition, which is likely to last until 2050 at least, the ETS will continue to generate revenue (Box 1).

Moreover, proceeds from the auctioning of permits are likely to exceed the 2019 level of €15 billion in the years to come. This is because although global emissions volumes are set to decline, three factors will gradually contribute to increasing revenues:

- The increase in the carbon price;
- The substitution of free allowances by auctioned allowances;
- The broadening of the ETS scope to sectors currently not covered.

Simulations indicate that total ETS revenues in the 30 years to 2050 would amount to about €300 billion in an exceedingly conservative scenario (Box 1, scenario 1: no price rise, no reduction in the share of free allowances, no widening of the scope of the ETS).

But the amount could approach €800 billion in a more realistic scenario (Box 1, scenario 3: price rise in line with revised carbon neutrality objective, reduction in the share of free allowances), or even €1.5 trillion, or €50 billion per year on average in a maximalist scenario (Box 1, scenario 5), in which most free allowances would be eliminated and most sectors would be covered. We are therefore speaking of a potentially significant resource.

### **Taxing carbon at the border**

One of the challenges for carbon pricing policy in the EU is that it may generate leakage effects and undermine the competitiveness of producers of carbon-intensive goods. If the carbon price increases in the EU but not in other countries, European companies will lose domestic and foreign market shares and production could simply be relocated to other countries. This would be counterproductive in terms of both climate protection and economic development in Europe.

A carbon border adjustment (CBA) mechanism has been proposed as a way of preventing this leakage effect. In principle, a CBA could be applied symmetrically to imports and exports. Its logic is similar to that of border adjustment in the case of indirect taxes such as value added tax and excise taxes.

Goods imported to the EU would pay a charge which reflects their 'carbon content' – that is the CO<sub>2</sub> emissions generated by their production (the charge being calculated so that the overall price on these CO<sub>2</sub> emissions is the same as the EU carbon price).

Symmetrically, goods exported to other countries would get a rebate reflecting the difference between the carbon price paid for their production in Europe and the carbon price in the destination market. A symmetric CBA would level the playing field between producers facing different carbon prices in the countries where their production is located<sup>7</sup>.

### **Box 1. Potential future revenues from ETS auctions**

The ETS is the world's largest carbon market. Being a cap-and-trade system, it sets a maximum level of emissions, a cap, and distributes emissions permits to firms that produce emissions. Each year's emission allowances are either given out for free (approximately 40 percent) or auctioned. The free allowances are meant to reduce the risk of carbon leakage (transfer of production to countries with laxer emission constraints) and to support new entrants. Currently, the cap is reduced yearly by approximately 48 million tonnes in accordance with the EU decarbonisation objective.

In addition, since 2019, the Market Stability Reserve (MSR) has operated, with the objective of reducing the surplus of allowances that are on the market as a consequence of past recessions, during which demand for emissions was below the cap. In 2020, the MSR reduced the total amount of allowances by a little below 400 million tonnes. The current recession is bound to increase further the surplus of allowances in circulation given the significant drop in industrial production, potentially justifying additional allowance- withdrawal measures. In order to get a sense of the magnitude of the potential revenues from the ETS until 2050, we ran a couple back-of-the-envelope computations. In line with preliminary data on the decline in industrial activity due to the pandemic, we estimate that 50 percent of the allowances distributed or auctioned in 2020 will not be used, further increasing the total number of allowances in circulation. This implies that the MSR will reduce the number of new allowances by nearly 600 million in 2021.

In all scenarios, we assume that the EU will reach its 2050 carbon neutrality objective.

This means that the pace at which the ETS cap is reduced must increase compared to what is currently planned. Scenarios 1 through 4 assume the current scope of the ETS is maintained, with a linear reduction of allowances to achieve the 2050 objective of zero net carbon emissions.

In scenarios 1 through 3, the share of ETS allowances auctioned remains unchanged at approximately 60

percent. Essentially, this means that the EU does not pair the ETS efforts with a border adjustment mechanism meant to reduce the risk of carbon leakage.

Scenario 1 considers the very conservative assumption that the price of carbon will remain more or less constant (at around €25/tCO<sub>2</sub>) despite the decrease in supply. It can therefore be viewed as a lower bound for the generated revenue over the next decades. Scenario 2 takes the intermediary price trajectory put forth in the Commission's 2016 EU Reference Scenario (€25/tCO<sub>2</sub> in 2030, €50 in 2040 and €85 in 2050). Note that the predicted price for 2030 has already been attained.

In order to be in line with our assumption that the EU will achieve carbon neutrality in 2050, we consider a third price trajectory, which is put forth in the 'decarbonisation' scenario from the background material to the 2050 Long-Term Climate Strategy. In this scenario, the price reaches €50/tCO<sub>2</sub> in 2030, €100/tCO<sub>2</sub> in 2040 and €200/tCO<sub>2</sub> in 2050.

While scenario 3 maintains the assumption that only 57 percent of allowances are auctioned, scenario 4 assumes that the share of auctioned allowances reaches 80 percent. This decrease in the provision of free allowances to sectors heavily exposed to international competition could result from intensified international cooperation in the reduction of global emissions, or from the creation of a border adjustment mechanism aimed at reducing the risk of carbon leakage.

Finally, in scenario 5, the overall scope of the ETS is broadened in order to include 50 percent of agricultural and transportation sectors. Again, we consider a linear decrease in the amount of emissions. For the sake of simplicity, we assume for scenarios 4 and 5 that the corresponding changes in the functioning and the scope of the ETS take place already in 2021.

Estimates for the revenue generated in 2021-2050 range from €329 billion to €1.5 trillion, depending on the scope and the projected price of carbon.

**Table 1. ETS revenue scenarios**

	Share of auctioned allowances	Scope of ETS	CO <sub>2</sub> price trajectory	Generated revenue (€ billions, 2021-2050)
Scenario 1		Current scope	Constant price (€25/tCO <sub>2</sub> )	329
Scenario 2	57%		2016 EU Reference Scenario	442
Scenario 3				789
Scenario 4		Expansion of the ETS to cover 50% of the agricultural and the transport sectors	'Decarbonisation' price scenario	1120
Scenario 5	80%			1500

Source: Bruegel.

Despite the Market Stability Reserve, ETS revenues would potentially remain volatile. The EU could possibly introduce a floor price to stabilise the carbon price, thereby providing a cleaner signal to economic agents and contributing to a steadier income stream.

If a CBA was indeed symmetric, it would by itself generate little revenue – in fact its revenue could even be negative if the carbon content of exported products was higher than that of imports<sup>8</sup>.

A CBA applied to both imports and exports would also imply that the EU would not be able to effectively steer the carbon content of domestic economic activity. This is because carbon pricing with full and symmetric border adjustment implies that the carbon price effectively applies to domestic consumption but not domestic production.

Production in the EU could remain highly carbon-intensive as long as the produced goods are exported. Whether this would be perceived as compatible with climate protection objectives is doubtful.

In fact, the EU intends to introduce a CBA which is restricted to imposing a levy on carbon-intensive imports (European Commission, 2020). This has consequences for leakage and competitiveness issues.

The competitive disadvantages of EU production relative to production outside the EU would be neutralised for sales in EU markets, but not in markets outside the EU. Nevertheless, a properly designed CBA restricted to imports could make a significant contribution to reducing carbon leakage (Box 2).

### **Digital taxation**

The European Council conclusions of July 2020 mentioned the possibility of an own resource based on a digital levy. In recent years the implications of digitisation for taxation have attracted great attention in the international tax policy debate. The view is widespread that current principles for allocating taxing rights are not suitable for companies with digital business models, and that as a consequence these companies do not pay taxes where they should and as they should.

## Box 2. The design of a carbon border adjustment mechanism

Setting up CBA raises a number of questions about the design of the import levy. Policymakers need to decide which goods are covered, which emissions will be taken into account, how the CBA levy is calculated, whether carbon pricing in the countries of origin should be recognised and, last but not least, how it can be designed to comply with WTO rules (Horn and Sapir, 2019; Droege and Fischer, 2020).

A pragmatic approach would be to restrict the CBA to the sectors with the greatest leakage risk. In a pilot phase it could start, for instance, with only steel, chemicals and cement. Taking into account carbon prices and the carbon content of production in origin countries would be appropriate, given the objective of preventing leakage, but raises technical difficulties, unless these countries themselves rely on an ETS or an explicit carbon tax.

It would also be necessary to avoid conflicts with WTO principles. There are many ways to achieve this, which differ in terms of their administrative complexity and the incentives they create for foreign producers and governments to reduce CO<sub>2</sub> emissions<sup>9</sup>. At a more general level, WTO compatibility requires that a CBA does not discriminate against foreign producers relative to domestic producers. This suggests that free emissions allowances for domestic companies in sectors with a high risk of carbon leakage would have to be phased out if a CBA is introduced.

Some commentators hope that a CBA would raise significant revenue, and that taxes would be paid by foreign producers rather than European consumers. This is in part an illusion. Revenues will depend on a number of factors (the coverage of the CBA, the extent to which carbon pricing in the origin countries is taken into account, the way in which the carbon content of products is calculated, how carbon intensity of foreign production develops over time and of course how the EU carbon price develops). The range of possible outcomes in terms of revenue is broad. Krenek *et al* (2019), who used a simulation model and considered CBA

scenarios with broad coverage, found that, for 2023, revenue raised could be between €36 billion and €83 billion<sup>10</sup>. These are very large numbers. For instance, in 2018, customs duties on all products imported to the EU amounted to €25 billion. Whether the trading partners would accept new import duties of this magnitude is questionable. A realistic CBA system would probably collect significantly less revenue<sup>11</sup>.

Finally, the fact that revenues from a CBA would be paid by importers does not mean that the burden of taxation would fall on foreign producers exclusively. Domestic consumers would face higher prices on imported final goods and, indirectly, on domestic final goods with a high content of carbon-rich imports. These higher prices would be the channel through which information on the carbon content of imported goods would reach the European consumer, and because of which consumers would tilt their consumption baskets in favour of less carbon-intensive domestic goods.

Overall, we do not primarily regard a carbon border adjustment mechanism as a direct source of revenue, but rather as a device intended to limit competitive distortions in a world in which countries do not move at the same speed towards decarbonisation. The primary objective in fighting global emissions is that the largest possible number of countries should strive to decarbonise their economies, in which case the CBA would raise no revenue whatsoever.

A CBA would however have major indirect revenue effects, through its impact on the ETS. From 2013 to 2020, only 46 percent of ETS allowances were sold or auctioned; the rest were allocated for free<sup>12</sup>. For 2021 to 2030, the goal is to increase the share of auctioned allowances to 57 percent, still far from complete coverage.

Free allocations are essentially destined for carbon-intensive sectors facing international competition. In the presence of a CBA, they could be further reduced or possibly even abolished. As a result more revenue would be raised from the ETS.

There is also growing evidence suggesting that existing international tax rules allow multinational companies to avoid taxes (Beer *et al*, 2020; Tørsløv *et al*, 2020; Fuest *et al*, 2020). This gives them a competitive advantage over national firms and brings into question the fairness of the overall tax system.

This applies in particular to corporate income taxation. Companies pay corporate income tax in the countries where they are legally resident or have a physical presence. Digital business models allow firms to operate in foreign countries without a physical presence and without legal residence.

Current rules about the international distribution of taxing rights do not foresee that firms pay corporate income taxes in countries where they sell their products. Income taxes are paid primarily in the countries in which corporations reside and where they develop and produce their products and services.

According to these rules, it is appropriate that United States digital companies that develop and produce their services in the US do not pay corporate income taxes in Europe. In the same way, European automotive companies that export cars to the US should pay corporate income taxes primarily in Europe, not in the US.

The matter is being discussed at global and EU levels. The tax challenges of the digital economy are being addressed within the framework of the Organisation for Economic Co-operation and Development's base erosion and profit shifting (BEPS) action programme.

The aim is to agree on new principles for the allocation of taxing rights: a country in which digital companies operate without significant physical presence (a market jurisdiction) would be granted taxing rights on the basis of a formula determining that a share of the profits of multinational firms are to be taxed in the market countries where the company sells its products.

Digital companies would not be subject to specific taxation, but the new international architecture would be designed in such a way that part of the corresponding tax base would be reallocated to the jurisdictions where users of digital services are located (OECD Pillar I proposal).

At EU level, the matter is being addressed within the framework of long-standing discussions on the Common Consolidated Corporate Tax Base (CCCTB). The European Commission tabled in 2011, and relaunched in 2016, a proposal for a Common Consolidated Corporate Tax Base that would redefine the tax base for multinational companies operating in the EU.

In 2018, the Commission proposed a reform of international corporate tax rules, which would introduce the concept of 'digital presence', so that companies with digital business models would be liable to corporate income taxation even in countries where they operate without a physical presence.

But since such a reform requires international coordination and would only be feasible in the medium term, the European Commission also proposed as an interim solution the introduction of a tax on the revenue from the provision of certain digital services (European Commission, 2018b).

This digital services tax would define a set of services provided through the internet and would require companies above a certain size to pay a 3 percent tax on revenues from delivering these services.

In the Commission proposal there would be no deductibility of costs, so that this is a tax on turnover, not on corporate income. A possible alternative also considered would be a tax on net income (after deducting a series of costs incurred in the market jurisdiction). Some EU countries have already introduced, or have announced that they intend to introduce, digital services taxes.

Given the complexity of the issue and remaining differences of views, discussions at OECD level will certainly require additional time before an agreement can be reached. In the meantime, the EU could still move ahead with its digital services tax.

To provide a significant and lasting contribution to EU own resources, such a tax would however have to overcome a number of challenges:

- The aim of discussions held at the OECD is to reach agreement on a structural response that would redefine the allocation of taxing rights to national jurisdictions.

Many EU member states are adamant that a structural solution of this sort should be put in place and the EU itself has been consistently supportive. But such a solution would allocate revenues to individual member states and deprive the EU of a new own resource;

- The Commission proposal for a Common Consolidated Corporate Tax Base that would redefine the tax base for multinational companies operating in the EU does not envision allocating taxing rights to the EU, but rather to redefine them for member states;
- For these reasons, a digital services tax could only serve as a temporary fix for an interim period. Moreover, its unilateral introduction would be contentious, especially with the US, as it would be seen (and actually is seen) as targeting US digital giants. The US government has already announced that it would respond with tariffs on EU exports to the US;

- Finally, revenues would be limited. The Commission estimated in 2018 that a 3 percent tax on the gross turnover of companies with total revenues above €750 million and EU revenues above €50 million would yield €5 billion annually<sup>13</sup>.

The actual resource flow could be significantly lower, if the tax is levied on net turnover or if other amendments are introduced to accommodate US concerns. In its factsheet of May 2020, the Commission actually lowered its estimate to €1.3 billion annually<sup>14</sup>.

Given this, while we see the potential role of the digital services tax initiative in the context of the complex international discussions on a new allocation of taxing rights, and while in view of the single market, we certainly regard a European digital services tax as preferable to a collection of national digital services taxes, we doubt it could provide a structural response to the tax optimisation problem. We think that for the reform of the EU own resources system, the focus should be on other instruments.

### **Other resources**

Several other revenue sources have been mentioned as potential candidates for new own resources. In addition to the ETS, a carbon border adjustment mechanism and a digital levy, the July European Council conclusions mentioned the possibility of a financial transactions tax and confirmed a charge on non-recycled plastic<sup>15</sup>.

Irrespective of the ongoing discussion on the potential merits and drawbacks of a financial transactions tax from the point of views of efficiency and fairness, the following should be borne in mind when assessing the suitability of the FTT as an EU own resources:

- The European Council explicitly mentions the FTT as a potential resource not for the next MFF but for the subsequent one;
- Proposals for an FTT are supported only by a minority of member states, at least at this stage. An enhanced cooperation procedure was initiated in 2013 by 11 member states. The latest proposal, on the initiative of Germany, is supported by 10 member states in total.

A variable-geometry approach would not be suitable for financing the EU budget, unless countries that do not introduce the FTT make other contributions to the EU budget as compensation. In addition to being complex, this solution would require the negotiation of an ad-hoc agreement;

- According to the Scientific Council of the German Ministry of Finance, expected revenue would be around €3.5 billion annually (Wissenschaftlicher Beirat beim BMF, 2020). This would be a comparatively small contribution to the financing of the recovery plan.

Estimates of the revenue from an FTT are furthermore highly uncertain, since market structure and the volume of transactions can evolve significantly in response to taxation;

- One could argue that the FTT would be particularly suited as a basis for own resources because financial transactions related to activities in the EU as a whole are concentrated in leading financial hubs including Luxemburg, Paris and Frankfurt. However, one should bear in mind in this context that regional specialization is a general feature of the European internal market. This fact alone is not sufficient as an argument that revenues should not be ascribed to the country where they are collected.

However, if EU member states were to introduce an FTT at European level for use as an EU own resource, it would certainly be preferable to a multitude of national and uncoordinated FTTs, primarily because national FTTs may distort financial transactions within the EU.

The tax on non-recycled plastic, meanwhile, will be payable as of the start of 2021. In the light of the criteria discussed earlier, this tax is not particularly suitable as an own resource. To start with, the revenue can easily be (and actually is) ascribed to the member state where it is collected. Moreover, the main purpose of the tax is to reduce plastic litter, which is primarily a local environmental issue.

The European Commission fact sheet of May also mentions a levy *“on operations of companies that draw huge benefits from the EU single market”* and mentions revenue of €10 billion annually. Although this would be significant, we regard this levy as a rather uncertain temporary substitute for the common consolidated taxation of corporate profits, and doubt it could be a stable resource for the EU finances.

Finally, the introduction of a Common Consolidated Corporate Tax Base is primarily a project to reduce compliance costs for businesses operating across borders. Currently they have to deal with 27 different national tax systems, which is a burden in particular for small and medium-sized firms.

In principle these benefits are independent of the use of this tax as a base for an own resource. In some ways, ascribing the revenue to the member states would be easier under a CCCTB than it is now, because the CCCTB would use formula apportionment rather than separate accounting, which is arguably more vulnerable to tax planning.

In any case, using corporate taxes as a basis for own resources would require agreement on a common tax base. Past attempts to achieve this have not been successful; progress will take time.

Moreover, in the area of corporate taxation, an additional and more fundamental consideration is that the flexibility to react to current developments, such as changes in international tax competition or economic crises and booms, is important. The question is whether this flexibility is compatible with the principle of unanimity in EU-level decision-making in taxation.

Given this, corporate taxes could be a future candidate for own resources, but only after reforming the institutional framework and creating more room for decision making by majority.

### **An ETS-based own resource: implementation issues**

The conclusion from the previous analysis is that revenue from the ETS is not the only, but by far the most promising candidate for new EU own resource and for financing the recovery plan. The potential introduction of an ETS-based own resource however raises two related issues:

- How the potential revenue stream would compare to the debt repayment stream resulting from the legacy of the Next Generation EU recovery plan;
- How the transition from a member-state resource to an EU own resource should be managed.

On the basis of the July 2020 European Council conclusions, the EU is expected to borrow up to €390 billion (in 2018 prices) from 2021 to 2026 and to pay down the corresponding debt by 2058 at the latest.

Given that, at the time of writing, the euro yield curve for AAA-rated bond is entirely in negative territory, interest costs can be ignored in a first approximation at least.

The simulation presented earlier indicates that expected revenues from ETS auctions from 2021 to 2050 period would represent an amount commensurate, and possibly in significant excess of the future debt repayments. In particular, the criteria for introducing new resources, which we regard as realistic, would lead to a cumulated €789 billion revenue stream over the next 30 years.

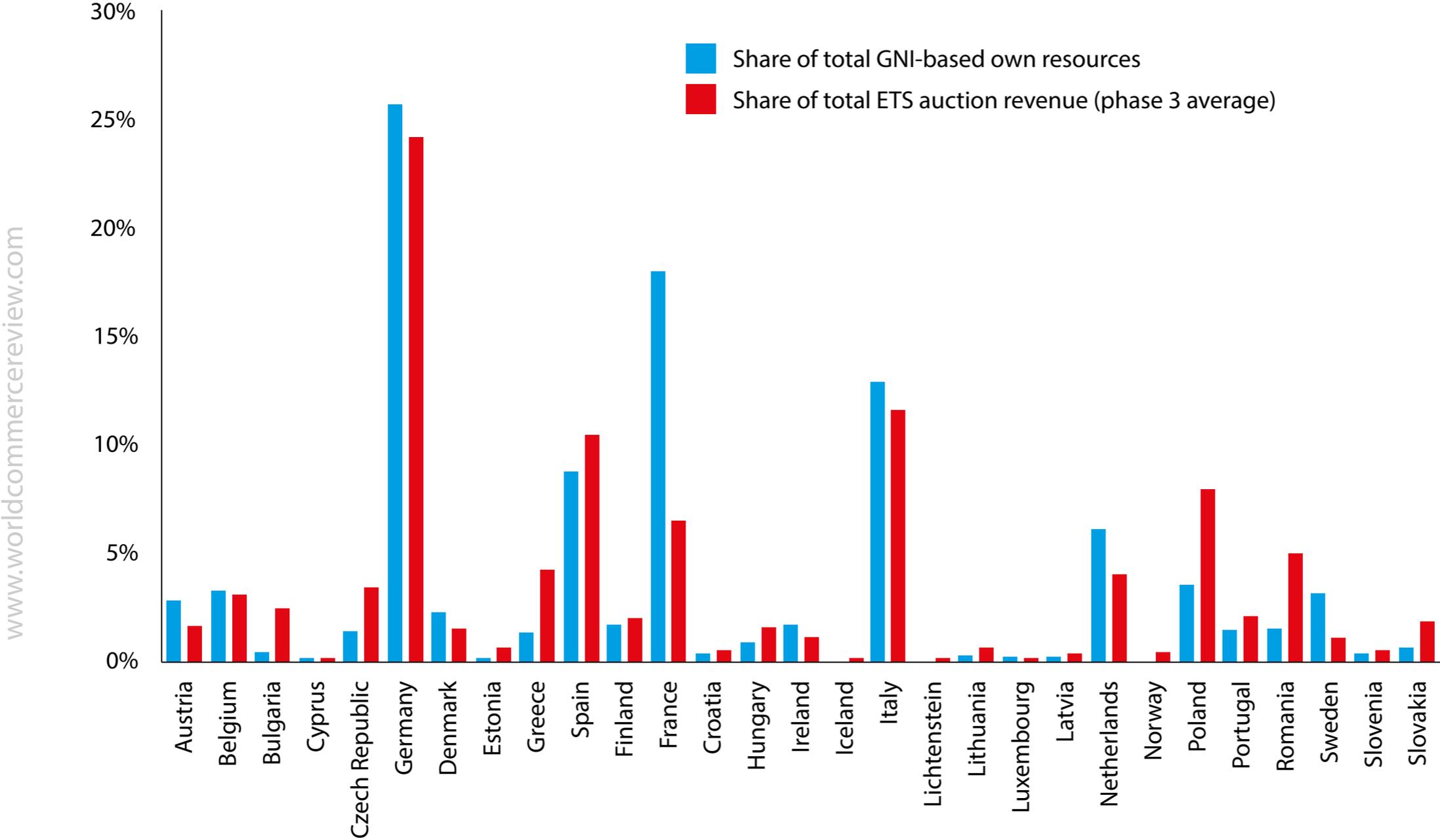
In 2018 the European Commission proposed to use 20 percent of current ETS revenues as an EU own resource. Under the current practice of allocating more than 40 percent of the ETS allowances for free, the revenue raised would be small – the European Commission (2018a) estimated that between €1.2 billion and €3 billion annually would be raised for the EU budget, which is very little.

Even if the share of free allocations was reduced significantly, the effect on the overall composition of own resources would be small. But these are conservative estimates.

Moreover, as we have explained, there are no convincing reasons why ETS allowance ownership and, as a consequence, auction revenues should be allocated to member states as they currently are. This suggests that the greatest part of the revenues could be used to fund the EU budget.

Transforming auction revenues into an EU resource and reducing GNI contributions accordingly would however entail significant reallocation from carbon-intensive to less carbon-intensive member states (Figure 2).

**Figure 2. Comparative distribution of GNI contributions and ETS revenues**



Source: Bruegel based on European Commission.

There are sound justifications for such a reallocation: if the distribution of emission allowances across member states is kept constant, the rise in the ETS carbon price would result in major gains for some member states: for example, under the realistic scenario, ETS auction revenues for 2030 would amount to 0.51 percent of GNI for Bulgaria and 0.35 percent in Slovakia.

Anyhow, redistributing existing rights would be opposed by some member states, so at minimum, a transition period would be necessary. Offsetting excessive short-term redistributive effects could furthermore require side payments, possibly through rebates or other compensation measures. But we see no reason why the EU should depart from the principle that revenue from ETS auctions has the character of a genuine own resource.

A way to avoid an abrupt shift in revenue from member states to the EU would be to transfer to the EU the whole proceeds from the auctioning of emission allowances, and to redirect annually to member states notional auctioned emissions revenues, computed as their share of 2019 auctioned emissions multiplied by the annual EU linear reduction factor and corrected for the impact of the MSR.

These notional auctions would be valued at a price capped at the level of the 2019 ETS carbon price. This would preserve countries' initial revenues while making room for a gradual increase in the revenue accruing to the EU.

Such a formula would amount to a recognition that countries are entitled to a grandfathering right and should not be deprived of it. In addition, side payments from and to member states could be introduced to correct for any undesirable distributional effects from the swapping of the GNI-based resource for ETS revenue.

In practical terms therefore, proceeds from ETS auctions would become a new EU resource. Compensatory mechanisms would be introduced to ensure a gradual transition and address distributional concerns.

As EU budget expenditures would remain unchanged while GNI contributions would be swapped for ETS revenues, our proposal would be budgetarily neutral. Currently, member states must devote at least 50 percent of ETS revenues to energy and climate-related objectives<sup>16</sup>.

This commitment could easily be translated into pluriannual targets for specific climate-related spending, which would be financed by member states out of the diminution of the GNI contributions.

Simulations suggest that in a realistic scenario, ETS revenues could be sufficient to repay the Next Generation EU debt, finance the gradual phasing-out of national ETS auction revenues, and contribute to the financing of the EU budgetary expenditures, or to the financing of offsetting transfers to certain member states (Box 3 and Figure 3).

In a scenario in which 80 percent of allowances would be auctioned off and half of the transport and agriculture sectors would be covered by the ETS, the net revenue to the EU would be more significant and would, at least temporarily, result in a change in the structure of the financing of the EU budget (Figure 4).

We do not consider a case in which the EU would miss its decarbonisation objectives and would continue auctioning off allowances beyond 2050, but in this case, obviously, corresponding resources would have a more lasting character.

## **Conclusions**

At its July 2020 meeting, the European Council took the unprecedented decision to launch a new and ambitious recovery programme. This decision, taken in response to what the heads of state and government rightly regarded as a major threat to the future of the EU, has the character of a game-changer.

### Box 3. A proposal for phasing out national ETS revenues

Over the next decades and especially with the prospect of rapidly increasing prices, the ETS has the potential to generate large revenues. The reallocation of these revenues from member states to the EU's own resources would have to take place progressively. We argue that this 'phasing-out' could be engineered simply by capping the amount that member states receive for each auctioned allowance at the current carbon price of €25. All additional revenue, resulting from increases in the number of auctioned allowances compared to 2018, or from the increase of prices above €25, would constitute an EU own resource.

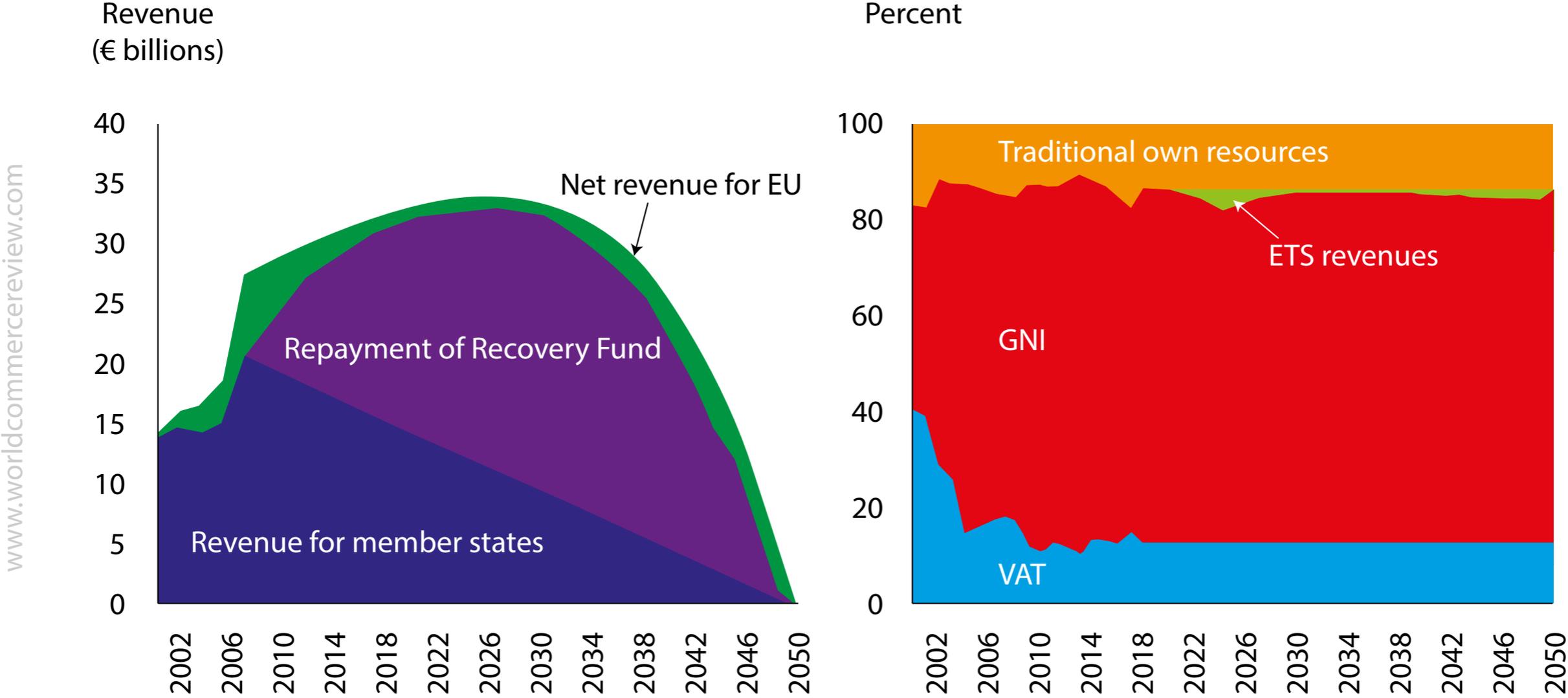
Given the overall trend of decreasing allowances (in order to achieve the 2050 carbon neutrality objectives), this would amount to a reduction in the revenues received by member states from the ETS. The reduction in national revenues would be compensated for by cutting the amount of GNI-based own contributions to the EU budget. Possibly, direct offsetting transfers would be added to limit the distributional effects arising from the member states' unequal revenues from ETS auctions.

Note that the initial increase in revenues for member states results from the expected intervention of the MSR in order to reduce the amount of allowances in circulation. As a result, the number of auctioned allowances will likely increase in the next few years, despite a tightening of the overall cap.

In addition, the excess revenue would enable the complete repayment of the €390 billion that the EU is expected to borrow between 2021 and 2026. The total €789 billion generated by the ETS under scenario 3 could be used as follows:

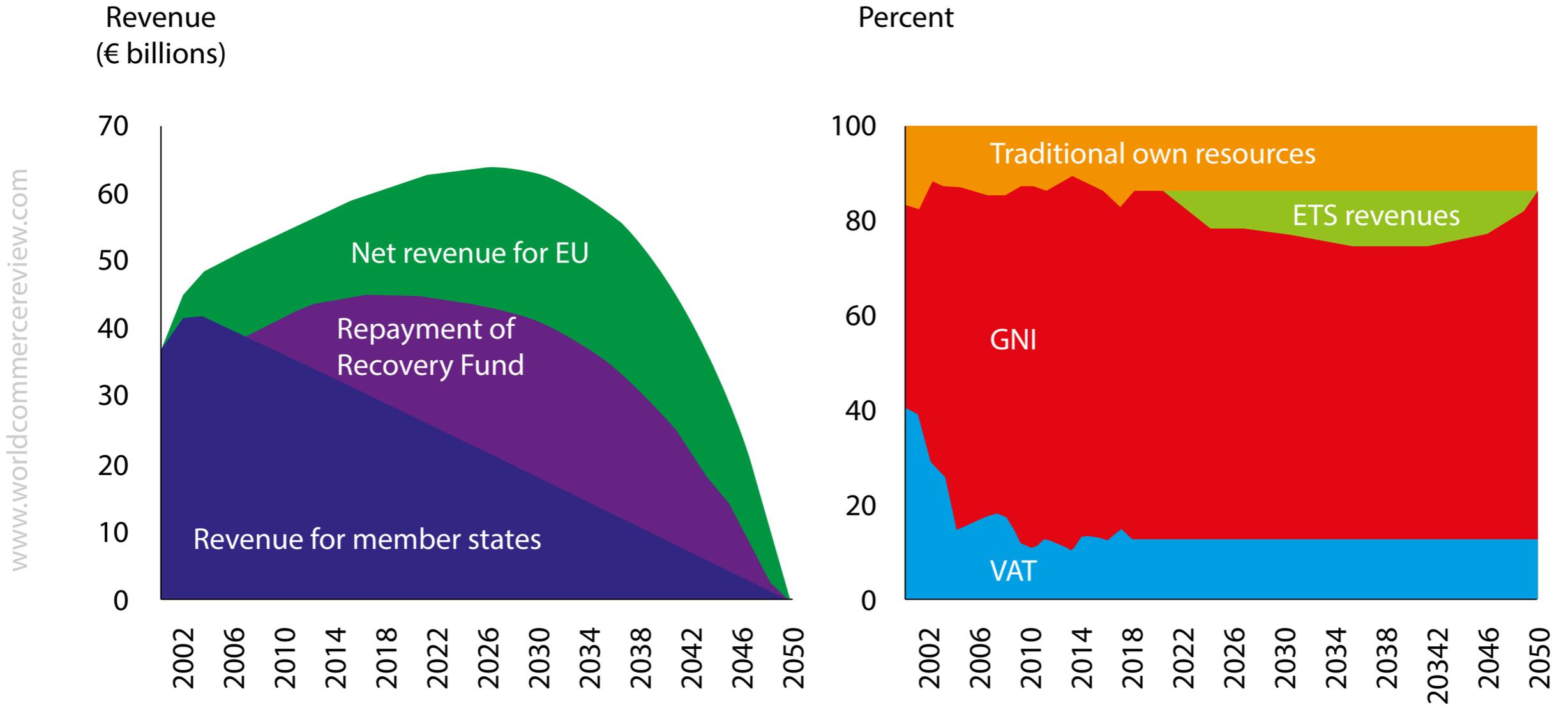
- €329 billion would accrue to member states as grandfather rights;
- €390 billion would be allocated to the repayment of the Next Generation EU debt;
- A remaining €70 billion would finance EU budgetary expenditures, enabling a corresponding reduction in member states' GNI-based contributions, or could be used to offset transfers to certain member states.

**Figure 3. Possible allocation of ETS revenues and structure of EU resources (net of debt repayment) under scenario 3**



Source: Bruegel.

**Figure 4. Possible allocation of ETS revenues and structure of EU resources (net of debt repayment) under scenario 5**



Source: Bruegel.

Pre-existing discussions about the financing of the EU budget must be reassessed in the light of this bold move. This applies in particular to the old discussion on EU own resources.

Our conclusion, after having examined the potential candidates for new EU own resources, is that only a swapping of GNI contributions for ETS revenues would match the spirit and magnitude of the decision taken in July.

Other options may have merits and can be considered, but only the revenue from the ETS has both the economic characteristics of a genuine EU own resource and the potential to deliver quantitatively meaningful sums. Allocating it to the financing of the budget would be a strong signal of the EU commitment to climate neutrality.

Moreover, maintaining the status quo while accelerating the pace of decarbonisation would give rise to unjustifiable rents. The time to decide is now.

The distributional issues raised by our solution are significant, but solvable. We have offered one solution, but other options are possible. Under realistic assumptions, ETS revenues in the EU are set to increase significantly before they ultimately decline and dwindle.

The corresponding revenue stream will most likely be sufficient to pay back the Next Generation EU debt, finance grandfather rights, and leave sufficient amounts for offsetting transfers to member states unfavourably affected by the swap. The EU has solved harder problems. It can tackle this one. ■

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## Endnotes

1. See the [Council decision of 21 April 1970](#) on the replacement of financial contributions from member states by the Communities' own resources.
2. HLGOR (2016), p.23. A different view is taken, for instance, by the German Advisory Board to the Federal Ministry of Finance (2016). This report emphasises the advantages of GNI contributions in terms of transparency and subsidiarity and argues that a significant part of current EU spending is indeed redistributive without creating much added value, so that net balances do have a certain relevance.
3. See our report to ministers Le Maire and Scholz on EU public goods (Fuest and Pisani-Ferry, 2019).
4. "The Union will over the coming years work towards reforming the own resources system and introduce new own resources. As a first step, a new own resource based on non-recycled plastic waste will be introduced and apply as of 1 January 2021. As a basis for additional own resources, the Commission will put forward in the first semester of 2021 proposals on a carbon border adjustment mechanism and on a digital levy, with a view to their introduction at the latest by 1 January 2023. In the same spirit, the Commission will put forward a proposal on a revised ETS scheme, possibly extending it to aviation and maritime. Finally, the Union will, in the course of the next MFF, work towards the introduction of other own resources, which may include a Financial Transaction Tax. The proceeds of the new own resources introduced after 2021 will be used for early repayment of NGEU borrowing." [Conclusions of the Special meeting of the European Council](#) (17, 18, 19, 20 and 21 July 2020).
5. [European Council Conclusions](#), December 2019.
6. Since 2013 the cap on emissions has been set at EU level rather than at the level of each member state.
7. See, for instance, Krenek et al (2019), p. 10.
8. There is an impact of CBA on ETS revenues that needs to be taken into account.
9. For a detailed discussion see Droege and Fischer (2020), p. 32-33.
10. See Krenek et al (2019), p. 19. These numbers refer to a scenario group which plausibly assumes that carbon intensity continues to decline over time.

11. The numbers in Krenek et al (2019) are based on the assumption of broad coverage and a carbon price of €69. It is more likely that, at least in the short to medium term, coverage will be more limited, and the EU carbon price may take more time before it reaches €69.

12. Source: European Environmental Agency, <https://www.eea.europa.eu/data-and-maps/dashboards/emissions-trading-viewer-1>

13. See [https://ec.europa.eu/commission/presscorner/detail/en/MEMO\\_18\\_2141](https://ec.europa.eu/commission/presscorner/detail/en/MEMO_18_2141)

14. See [https://ec.europa.eu/info/sites/info/files/factsheet\\_3\\_en.pdf](https://ec.europa.eu/info/sites/info/files/factsheet_3_en.pdf)

15. Strictly speaking it is a charge member states would pay from their national budgets.

16. See EU Directive 2003/87/EC.

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*This article is based on a [Bruegel Policy Contribution Issue n° 16 | September 2020](#), which is a version of a paper prepared by the authors for the Informal Meeting of EU Ministers for Economic and Financial Affairs (ECOFIN) in Berlin, 11-12 September 2020. The authors thank Lionel Jeanrenaud for excellent research assistance, and Benoît Leguet, Simone Tagliapietra and Georg Zachmann for insightful comments on an earlier draft.*

# The challenge of climate finance

Alexander Lehman and Mark Plant discuss low-carbon transition challenges and consider the EU agenda for coordinating with emerging markets

**A**ddressing the challenge of financing the low-carbon transition will require substantial investment in the European Union and in emerging and developing economies.

Sustainable finance frameworks have proliferated in advanced and emerging markets but fragmentation of financial flows due to different classification systems and standards for green financial instruments is a real risk. Ensuring consistency should be a core agenda for the new International Platform on Sustainable Finance (IPSF).

Estimates suggest that about 70% of the infrastructure investment needed for the low-carbon transition will have to be deployed in the emerging markets and developing economies (EMDEs). Countries' updated nationally determined commitments, which are due ahead of the COP-26 UN climate summit in 2021, will underline the scale of this challenge.

They are bound to highlight considerable financing shortfalls as resources from national budgets and development funds will be scarce in the aftermath of the current recession.

The substantial investment needs compare with as yet scarce flows of private climate finance. Such flows are at present dominated by development institutions, and by private funds blended with such concessional financing, though the target of an annual \$100 billion transfer from the advanced to the developing countries for green investment is not yet met.

A new [paper](#) finds that private sources account for just over half of total climate finance mobilized globally, as national development banks and multilateral development banks dominate this area.

Of the total climate finance for projects in non-OECD countries only between one fifth and one third was derived from cross-border flows, and only 15% of the total global volume of climate finance flowed from OECD to non-OECD countries.

The implementation of the EU's 2018 sustainable finance agenda laid the basis for the financial sector to fund a greater share of the low-carbon transition and to reflect climate risks in prudential regulation. EU rule-making has already produced a number of results: a taxonomy of economic activities aligned with climate policy which will be in effect from 2021; a proposal for a green bond standard; and a regulation on investment funds that can be labelled as supporting the low-carbon transition.

*If the new IPSF is to become a real forum for common rule-making, the EU will need to contend with concerns in other jurisdictions that the EU framework has reinforced the fragmentation of global climate finance*

The revision of the non-financial reporting directive, which would align the EU with the recommendations of the G20 Task Force on Climate Related Disclosures (TCFD), remains under discussion.

What has perhaps been overlooked is that EU regulation will have profound implications for international flows of climate finance, on which developing countries in particular will depend to finance their investments in climate mitigation and adaptation.

EU investors could be an important source of private climate finance, as they already account for over 40% of the total portfolio debt outstanding in emerging and developing economies. But regulation now needs to be reviewed to facilitate cross-border flows of climate finance.

### **A potential forum for coordination**

The new International Platform on Sustainable Finance, launched by the EU in 2019, could be one venue for coordination of climate finance regulation. In this forum, the EU partners with thirteen other economies, including key emerging markets such as China, India and Indonesia.

Potentially, and given that key jurisdictions are already represented, this group could play a central role in converging on common standards, for instance on disclosure or on the green labels used for financial instruments.

To date, the agenda for this group remains somewhat vague and has been limited to sharing and comparing national initiatives. Members of the group are likely to voice strong and disparate national interests, which will have to be reconciled:

- Among the five non-EU high-income countries in the group there will be interest in developing a local green

financial market place (eg. Singapore) and green banking standards (Switzerland); or in adopting strong environmental, social and governance (ESG) standards by portfolio investors (as promoted by Norway's large sovereign wealth fund).

- Two emerging markets participating in the Platform, China and Indonesia, are **assessed** as already having mature sustainable finance frameworks, including sustainability reporting requirements, green loan definitions, and a local green bond framework, similar to the provisions adopted in the EU.
- Several participants have developed independent green bond standards. China, based on its own taxonomy, accounts for more than two thirds of the green bonds issued by emerging markets in recent years. Indonesia and Chile have issued substantial amounts of sovereign green bonds in international markets in recent years.
- The group also includes smaller lower middle-income countries, including Kenya, Morocco and Senegal, where issuance of green financial products is developing within very limited local capital markets.

Despite its size — this group accounts for roughly half of global greenhouse gas emissions and about 45% of global GDP – the EU platform could become more representative. In early 2020, 25 countries were working on sustainable finance roadmaps, which may produce similar classification systems and standards for green capital market products.

These countries include key emerging markets such as Brazil, Nigeria, Mexico or Vietnam, who should be encouraged to join the EU platform. Crucially, the United Kingdom will now diverge from the EU in a separate regulatory regime, and should also be brought into the Platform.

## **The EU's role**

From the EU's perspective, an overriding ambition within the IPSF should be that a high standard for sustainable finance is protected internationally. This should address the risk that 'greenwashing' by individual issuers, fund managers or jurisdictions – the misleading disclosure to prospective investors or conduct by the borrower that deviates from initial commitments – could undermine the entire sustainable finance asset class.

Asset managers, in both retail and professional markets, should be offered transparent green finance products of a consistent high standard. This could replicate the success of other EU capital market standards, such as for retail investment funds.

At the same time, the EU should ensure that financial products that fund EMDE projects based on local taxonomies remain eligible for green funds structured by EU asset managers or for loan refinancing, making it consistent with open international markets for climate finance.

For instance, an EU registered fund marketed as low-carbon or 'Paris-aligned' under the new EU benchmark regulation should be able to include green bonds from a wide range of developing country issuers.

This should require that such issuers comply with EU standards for borrower disclosure and verification by accredited firms of the non-financial aspects in bond documentation, such as the use of proceeds.

## **Principles for coordinating cross-border flows**

Coordination between central banks on supervision and stress testing are well under way within the Network for Greening the Financial System.

In the EMDEs, and in particular in lower middle-income countries, national banking systems will remain the dominant source of climate finance, as the rapid expansion of capital markets or attracting international investors focused on ESG criteria are not realistic.

Agreement on green banking principles, which remain much more diffuse than in the capital markets space, are therefore essential. The IPSF could spearhead this initiative, thereby addressing the current lack of international coordination.

The IPSF could focus on three areas in particular:

- EU investors and cross-border banks will be bound by taxonomies that define green activities eligible for designated green financial instruments, and possibly for incentives.

A [comparison](#) of such classification systems shows that the EU system is by far the most complex, setting metrics and thresholds for 70 climate mitigation activities and 68 adaptation activities. The Chinese system, by contrast, is much more general and does not include specific screening criteria.

Developing countries will include local investment priorities (especially in climate adaptation) and local environmental issues, such as pollution abatement. There should be common design principles for taxonomies, though which activities benefit from incentives may well differ across jurisdictions.

- Disclosure by financial firms and their large corporate clients is a foundation for offering financial instruments with added green qualities.

Implementation of the recommendations of the G20 Task Force on Climate Related Disclosure (TCFD) is weak among mid-sized companies and in emerging markets, as requirements for the measurement of environmental impact are rare in the real sector.

The EU directive on non-financial reporting, which is currently under revision, should define practical environmental reporting templates. The EU could support capacity building in large emerging markets implementing similar standards, and open the proposed EU repository for ESG data to private sector issuers of green bonds.

- Standards for the origination and labelling of green financial products. Given this greater transparency, green financial products can emerge that are readily recognised by investors.

The future green bond standard, and the now adopted low-carbon benchmarks for investment funds are the key necessary pieces of EU legislation. Even though the market for green bonds and ESG funds has grown rapidly on the basis of private sector standards, regulation will need to address incentives for 'greenwashing' by debt issuers and investment firms.

Emerging market issuers and fund managers should have the option of meeting the future EU green bond standard, including by working with locally accredited verifying agents, which are recognised by the EU as subject to equivalent supervision.

If the new IPSF is to become a real forum for common rule-making, the EU will need to contend with concerns in other jurisdictions that the EU framework has reinforced the fragmentation of global climate finance.

Many of the partner countries represented in the platform and other key emerging markets now have credible sustainable finance frameworks of their own.

As the climate challenge is global, realigning financial flows also requires a coordinated response. The new EU forum should be as inclusive as possible. ■

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*This article was first published on [Bruegel](#)*



# Deeper recession, wider divergences

Maarten Verwey and Björn Döhring consider the Commission's Summer 2020 interim forecast, and argue that a rapid response at the EU level is needed to minimise hysteresis

**F**orecasters agree that the economic fallout from COVID-19 has caused the sharpest drop in economic activity in Europe and globally since WWII. Just how deep the drop of activity was in the second quarter, which sectors were most strongly affected by containment measures, and how swift the rebound will be as they are gradually lifted is still very uncertain.

This column describes how the European Commission's Summer 2020 interim European Economic Forecast now estimates a deeper drop of output in the second quarter of the current year than was anticipated earlier. The recovery is also now expected to be less swift than was projected in Spring, with differences across member states set to be more pronounced.

Minimising hysteresis and avoiding persistent economic divergences within the EU and euro area requires the rapid agreement and deployment of common support measures at the EU level. The risk otherwise is of significant distortions to the internal market and of even deeper divergences between countries that could ultimately threaten the smooth functioning of the monetary union.

The economic impact of the COVID-19 pandemic spread around the globe extremely swiftly. In 2007-2008, it took more than a year from the appearance of cracks in the US subprime mortgage market to the collapse of Lehman Brothers in September 2008, and the trough of the ensuing recession was reached in both the US and the euro area in the second quarter of 2009 ([NBER](#), [CEPR](#)).

In 2019-2020, it took 3½ months from the first reports on a novel virus in Wuhan to the imposition of lockdowns around the world in late March, and the trough of output in Europe is likely to have been reached in the course of the second quarter.

## **The recovery will be more drawn out than anticipated**

In an environment that is so fast-moving, standard monthly or quarterly macroeconomic indicators are of limited use. Moreover, they are often released with substantial lags – for example, the preliminary flash estimates for second-quarter GDP will become available at the end of July.

Faced with the fast pace of events as well as vast uncertainty about the dynamics of the pandemic and the economic impact of containment measures, forecasters have turned to alternative data to gauge developments in quasi-real time<sup>1</sup>.

*Avoiding persistent drags from a debt overhang and unemployment hysteresis and minimising the still very large downside risks will require continued policy support*

- *Medical indicators* depict a peak of new COVID-19 infections in the EU in the first half of April and a stabilisation at low levels since the second half of May. At the same time, the global number of new infections continues to be on the rise, with no clear indication of an inflection point (Figure 1a).
- *Indicators related to containment measures* illustrate the swift imposition of severe restrictions and their gradual lifting as well as the behavioural responses to the pandemic and related containment measures, for example in mobility patterns (Figure 1b).
- *Economic activity indicators* provide an early estimate of the depth of the economic fallout, for example measures of energy use (Figure 1c) and pollution as well as financial and survey data.

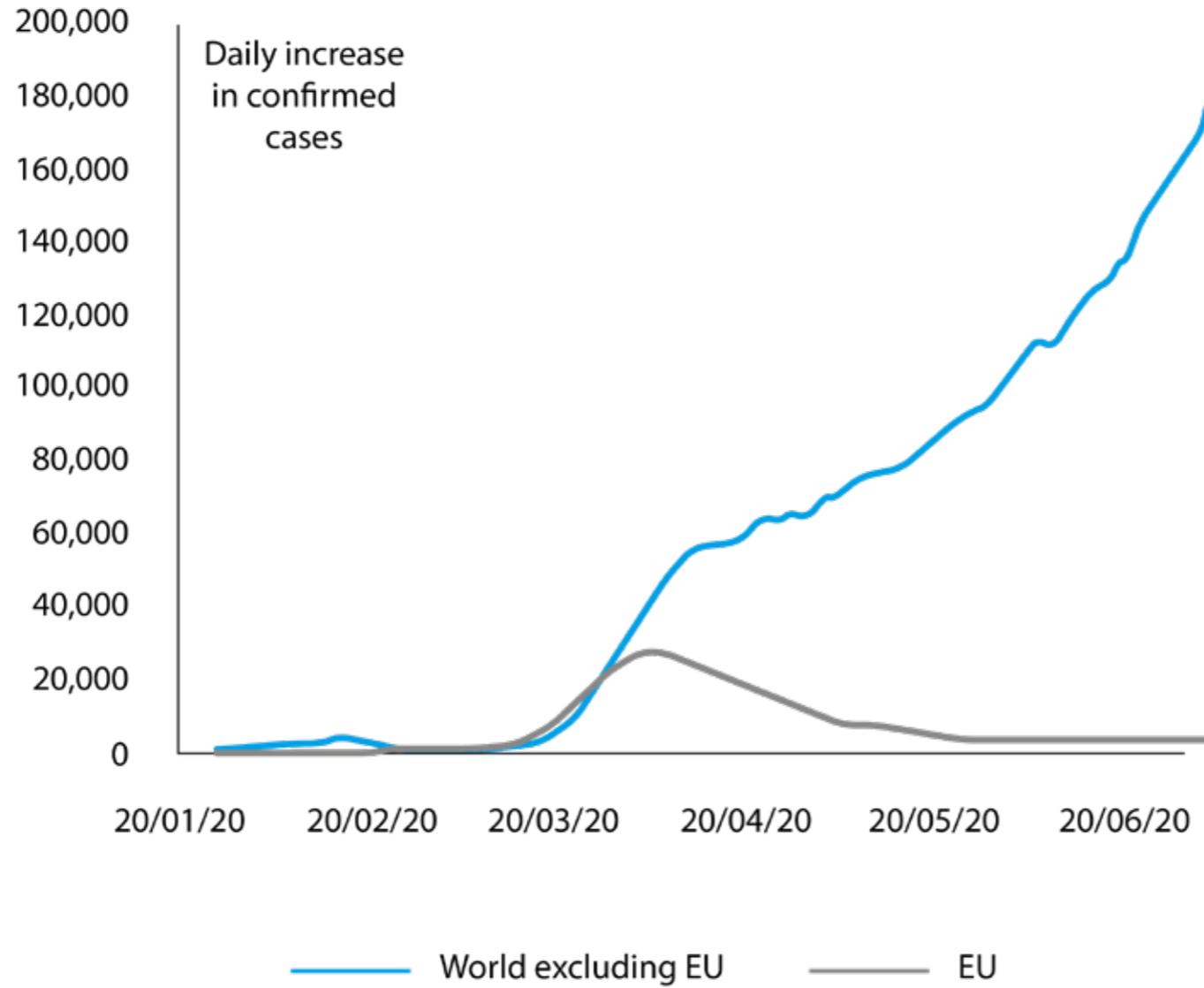
Taken together, these data suggest that economic activity in the euro area was hit harder in the second quarter than initially expected. Consequently, the Commission's [summer interim forecast](#) has revised GDP lower for this year, mostly on account of a later and more gradual lifting of containment measures than anticipated earlier. Other international institutions and private-sector forecasters have also revised their projections for 2020 lower in their latest forecasts (Figure 2).

High-frequency data now also point to a rebound of activity in the past few weeks. The Commission's business surveys for June not only confirm an increase of output expectations but also a bottoming-out of actual activity. The assessment of recent production improved strongly in industry in June and robustly in the retail sector, but only just points to a turnaround in services.

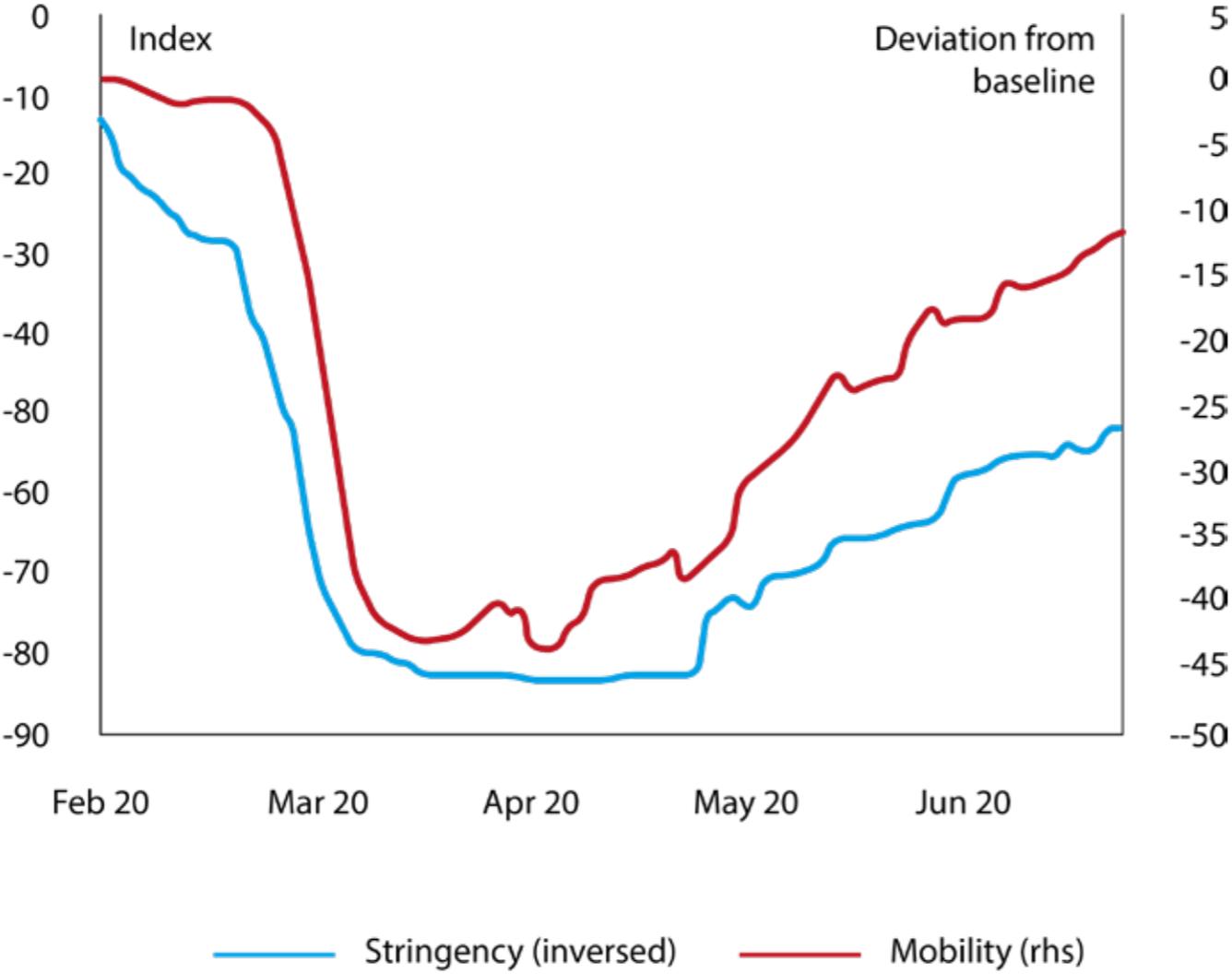
Despite some differences in the quantification of the negative impact this year and the subsequent rebound, there is broad agreement about the general outlook, and in particular that the recovery will remain incomplete by 2021.

**Figure 1. Pandemic and containment measures, real-time data**

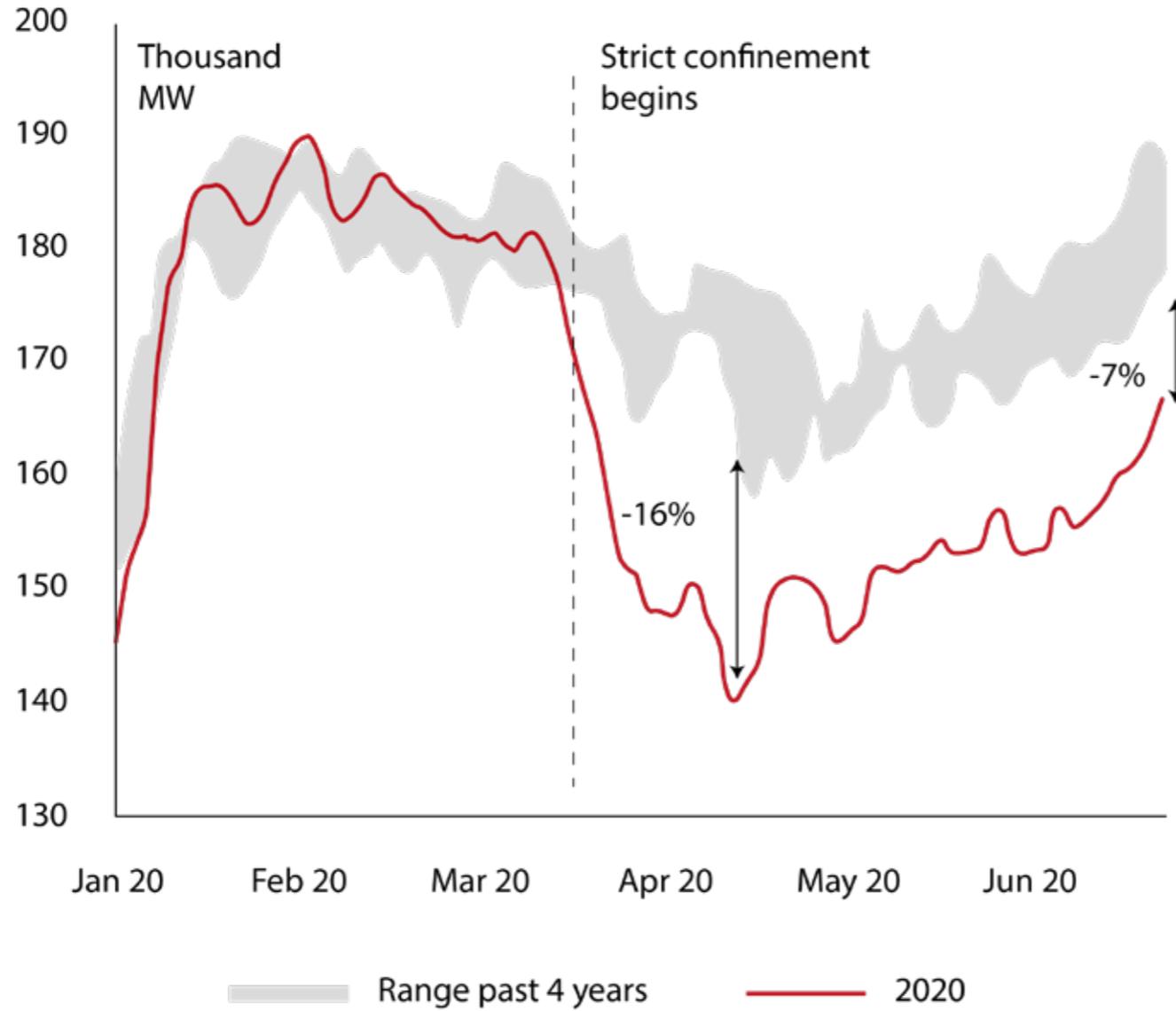
a) Daily new infections



b) Stringency of containment, mobility, euro area



### c) Electricity use



Note: Temperature adjusted 7-day rolling average.

Sources: 1a) ECDC; 1b) Oxford University, Google; 1c) ENTSO-E, NOAA

The Commission's Summer interim forecast is based on a number of assumptions regarding the pandemic and the lasting effects of the recession. In particular, the forecast baseline assumes no major second wave of infections.

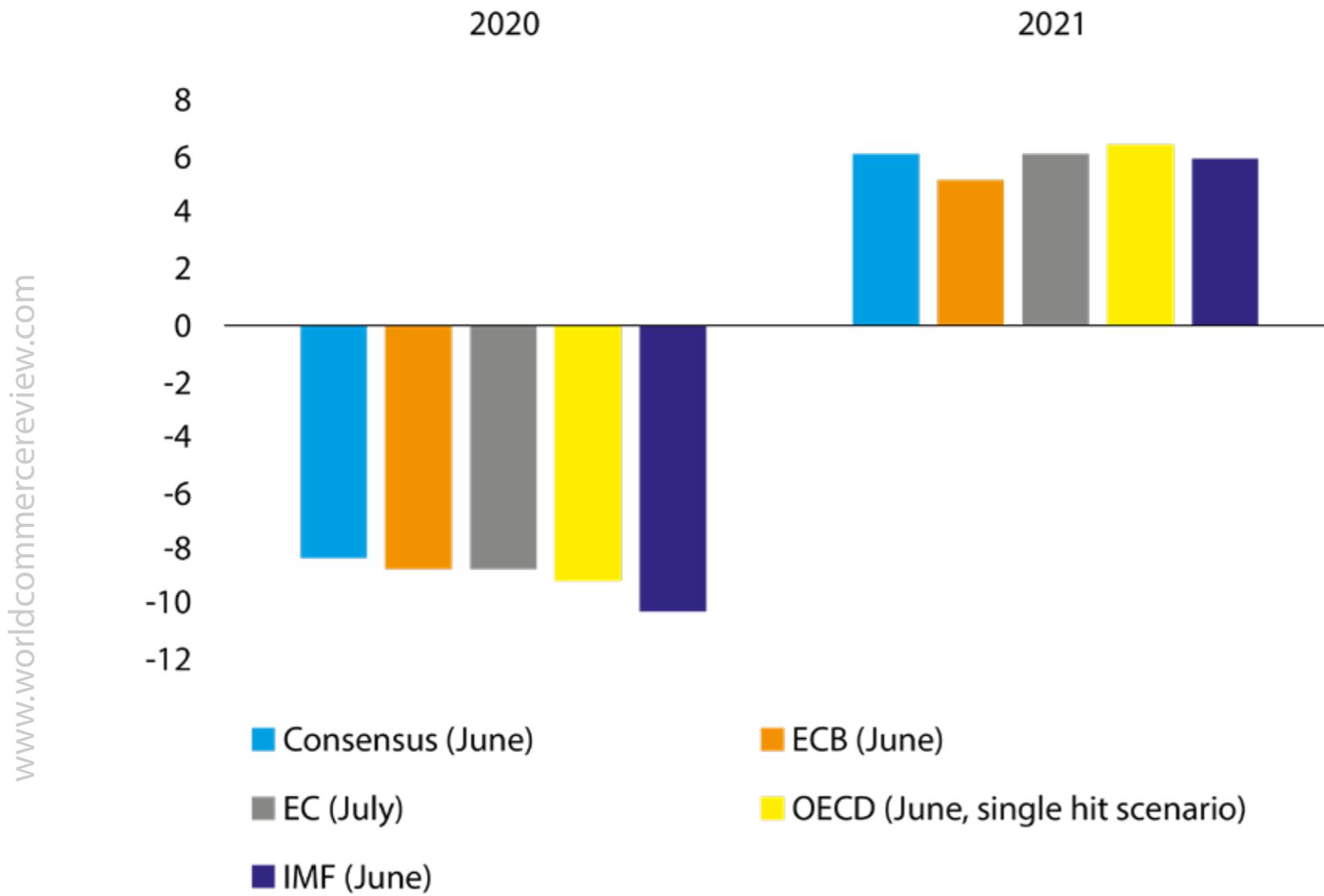
By contrast, the ongoing global spread of the virus, in particular in the US and in a number of emerging market economies, is expected to dampen the rebound of global activity and world trade. It is further assumed that containment measures in Europe will continue to be gradually eased, but that social distancing and consumers' prudence will continue to hold back the recovery in activities that involve personal contact, such as tourism and recreational activities.

The measures that have been put in place to protect jobs and shield firms from bankruptcy are assumed to be effective, without however being able to avoid unemployment increases and insolvencies altogether.

On this basis, euro area (EU) GDP is now projected to drop by 8¾% (8¼%) this year and to increase by 6% (5¾%) in 2021. The quarterly profile implies that output in the fourth quarter of 2021 will still be 2% below the level in the fourth quarter of 2019 in the euro area, and 1¾% in the EU. In the Spring forecast (European Commission 2020a), this gap was projected at ½% for both areas.

Remaining restrictions and voluntary social distancing are likely to affect sectors to which personal interaction is central more permanently than others. Estimations carried out by DG ECFIN's geographical desks confirm that the sectors hit the most in the second quarter are tourism and recreational services, and to a lesser extent manufacturing, construction and wholesale and retail trade. Accommodation and food services, as well as recreational services, are the sectors in which activity is expected to remain the most subdued also in the second half of this year.

**Figure 2. Recent GDP growth forecasts for the euro area**



Sources: DG ECFIN, ECB, IMF, OECD, Consensus

The increase of the unemployment rate, to 6.7% in May, has so far been remarkably mild in the EU as a whole, on the back of strong policy support for keeping workers in employment relationships during the episode of output losses.

However, some laid-off workers have not been able to actively look for jobs during the lockdowns or withdrew from the labour market to care for relatives and were therefore not counted as unemployed. The drop of hours worked by 2.6% already in the first quarter points to significantly larger shifts in the underutilisation of labour in recent months than unemployment data suggest.

Looking ahead, bankruptcies are likely to rise in the most persistently affected sectors, and some further rise of unemployment will be hard to avoid. This combination will lead to some lasting crisis impact (hysteresis), even in the relatively mild forecast baseline.

### **Cross-country differences will be large**

The negative impact of the crisis is set to differ widely across EU member states. The pandemic has hit countries simultaneously and the nature of the shock appears to have been very similar.

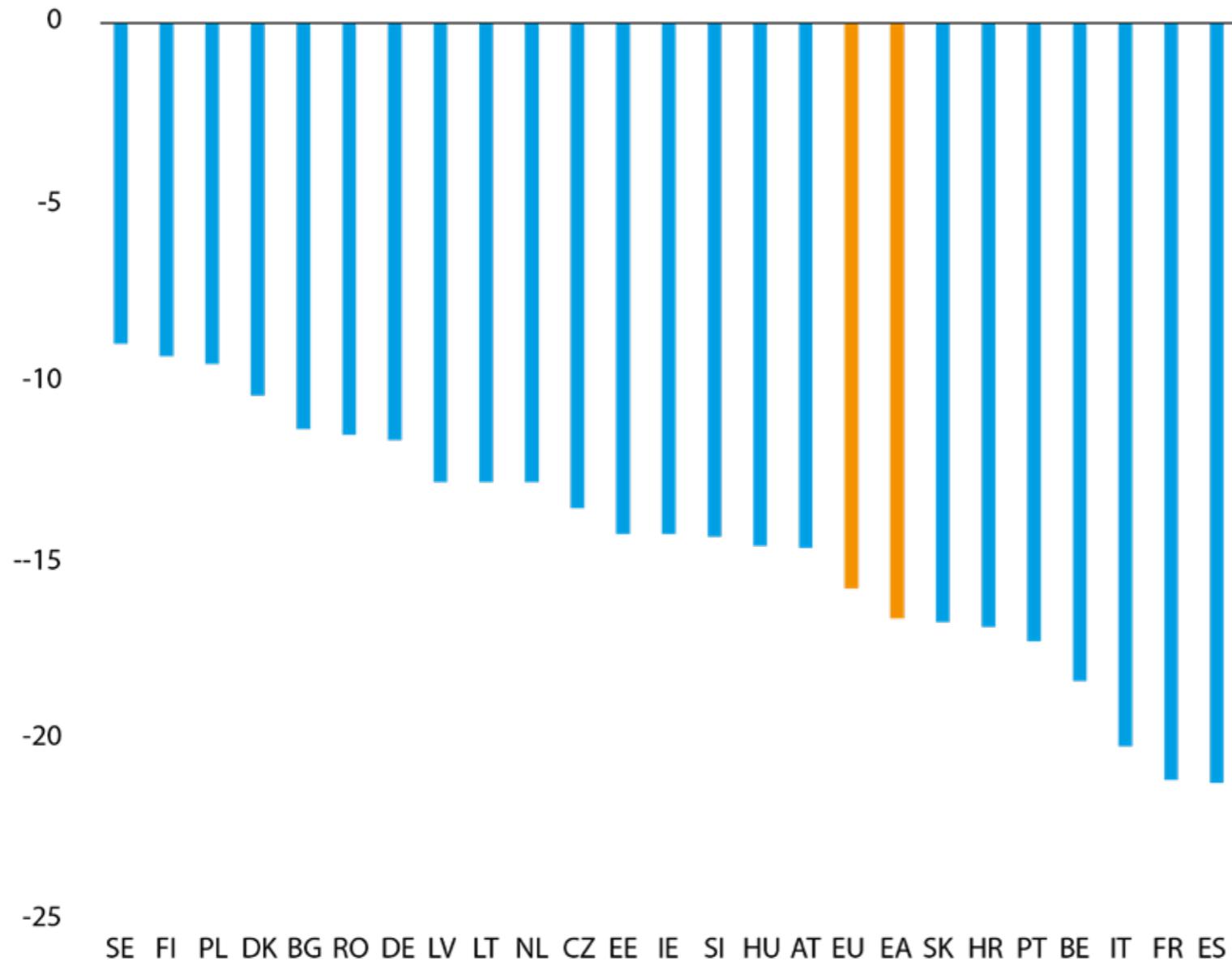
Nonetheless, the projected loss of output over the first two quarters of 2020 compared to the last quarter of 2019 ranges from less than 10% in Finland, Sweden and Poland to more than 20% in Italy, France and Spain (Figure 3a). These differences in the initial impact reflect the severity of the COVID-19 outbreak, the stringency of containment measures as well as different economic structures.

In particular, an important share of personal services such as accommodation and food services and a large dependence on tourism increased the negative impact on member states (Figures 3b and 3c)<sup>2</sup>.

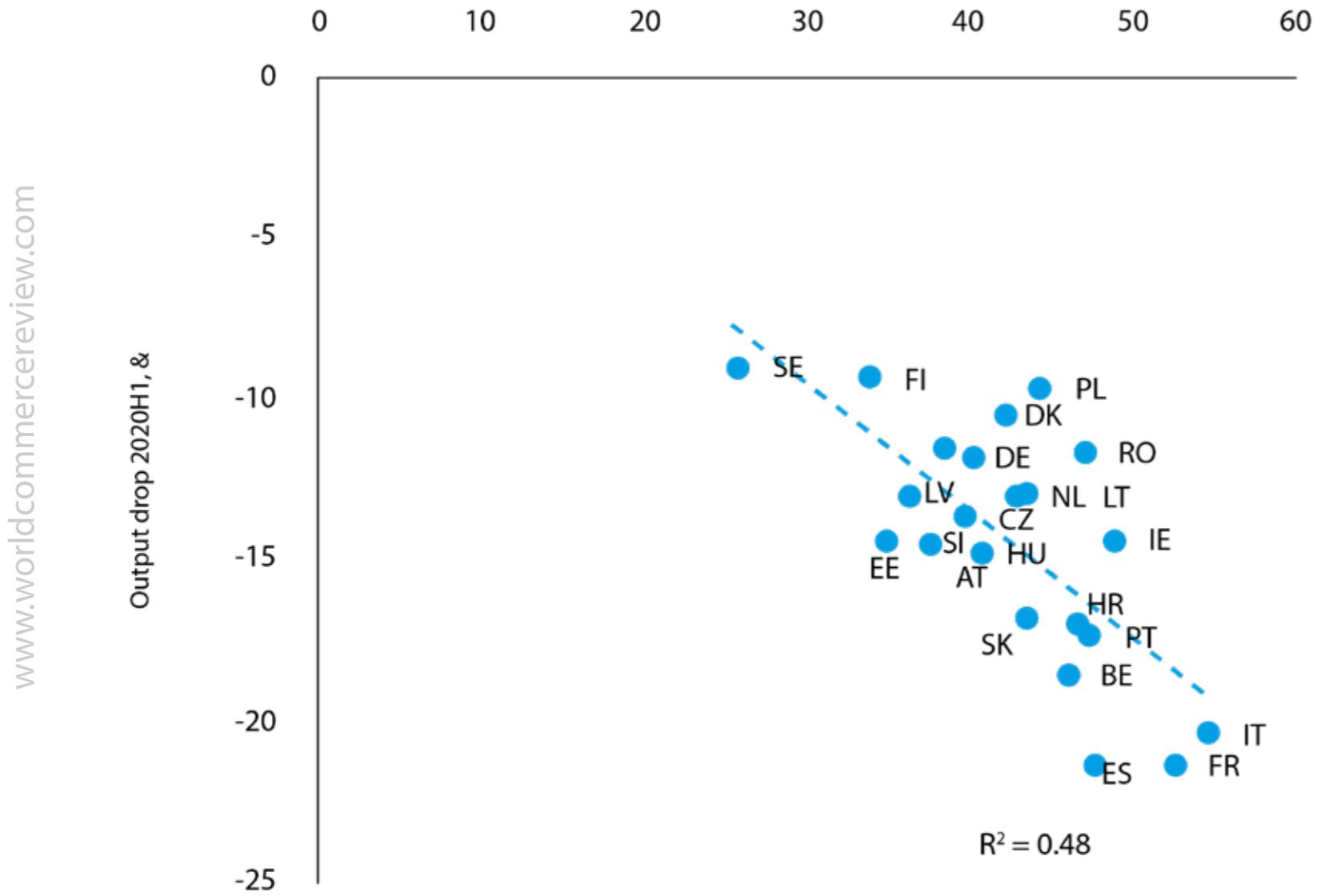
**Figure 3. Cumulated loss of output by 2020Q2, drivers**

a) Cumulated GDP loss

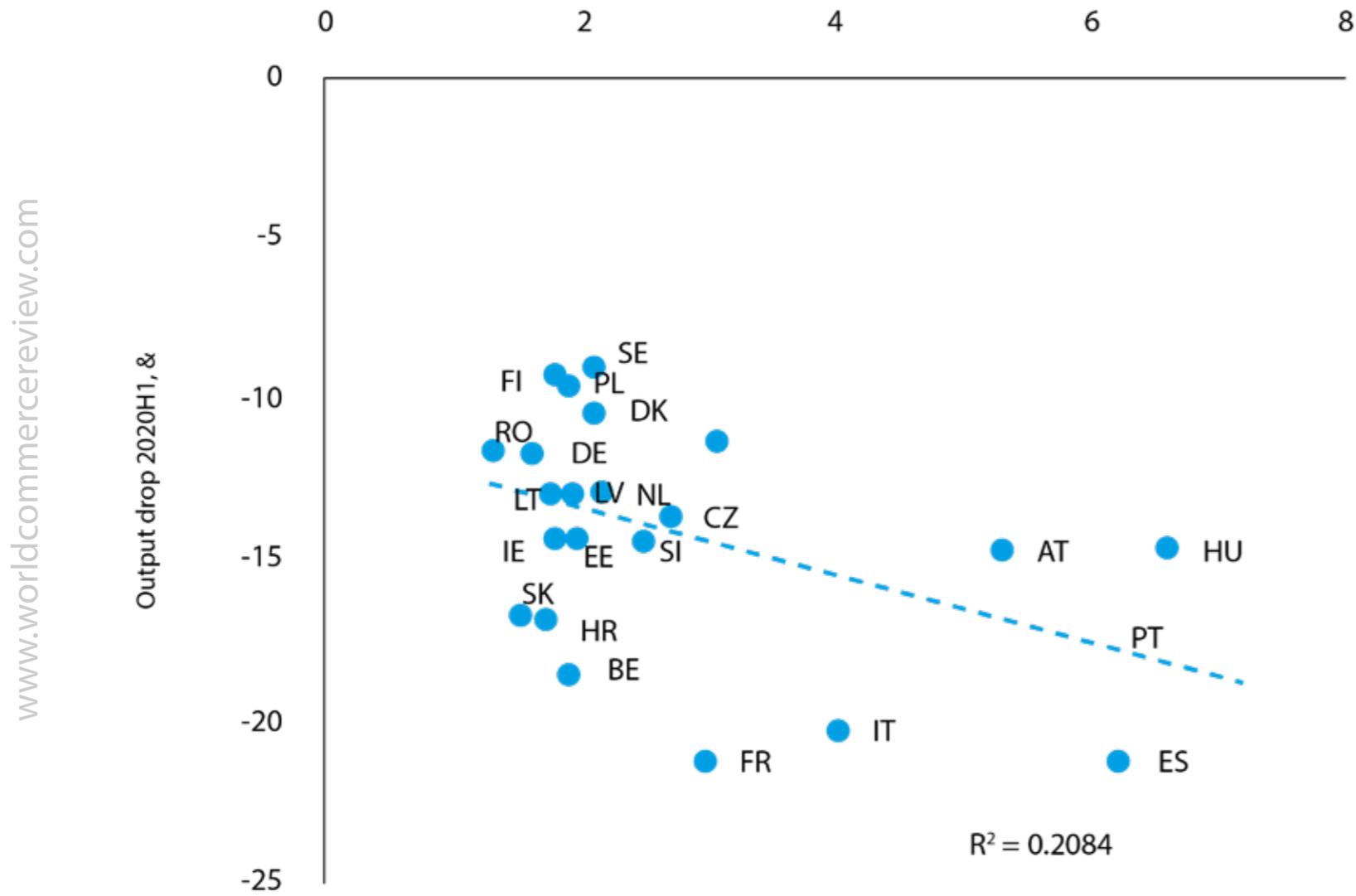
www.worldcommercereview.com



## b) GVA share of accommodation and food services

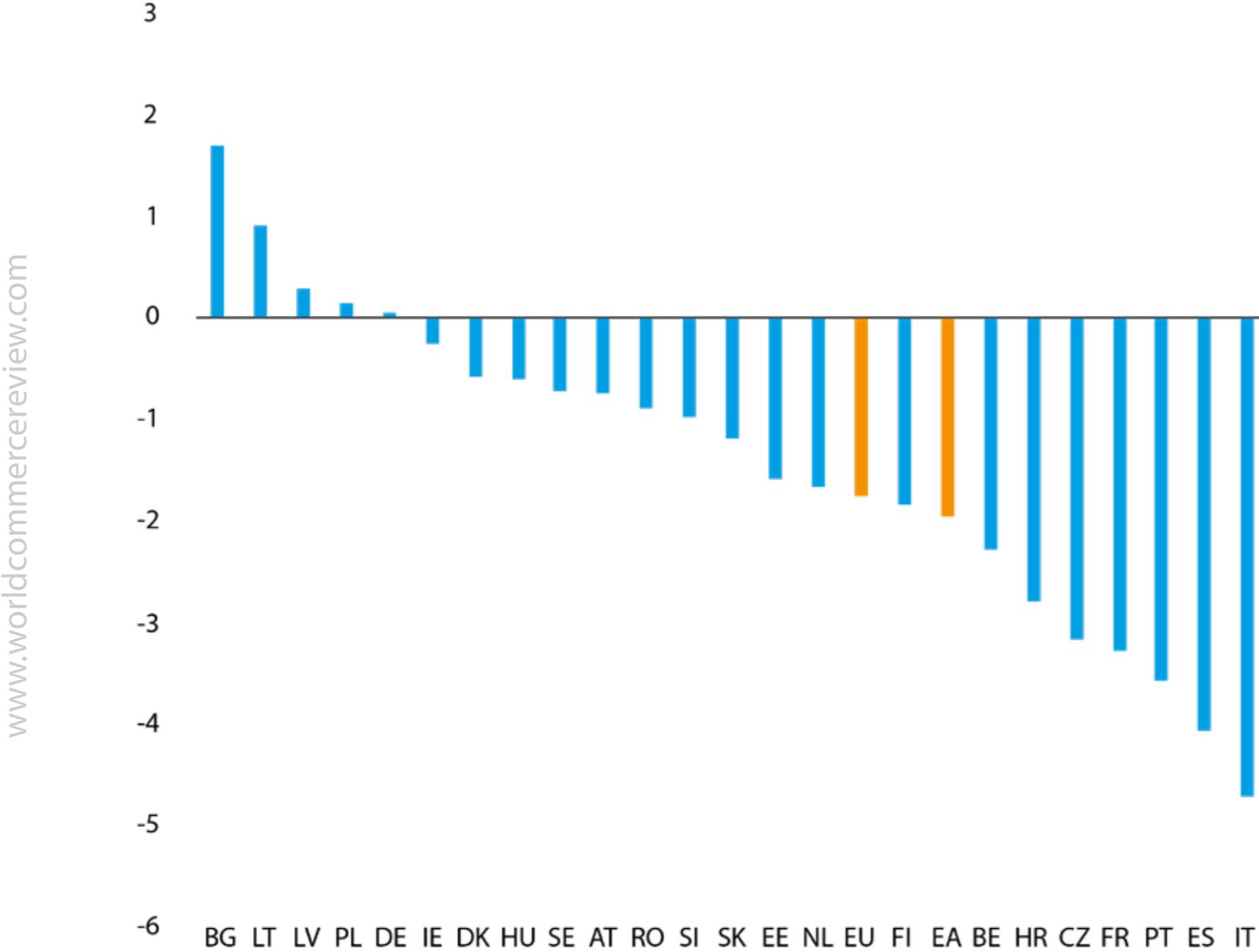


### c) Stringency of containment (index average 32020H1)



Sources: 3a) DG ECFIN; 3b) DG ECFIN, Oxford University; 3c) DG ECFIN, Eurostat.

Figure 4. Cumulated change of GDP, 2019Q4 to 2021Q4



Source: DG ECFIN

These divergences are likely to persist also in the recovery. The countries hardest hit so far are expected to continue lagging behind at the end of the forecast horizon (Figure 4).

Labour market developments could amplify the divergence even further. Here, differences across member states are also pronounced, reflecting not only output losses related to the severity of the pandemic and sectoral exposure to COVID, but also institutional features such as the share of short-term contracts and the design and strength of policy responses such as partial unemployment schemes.

Differences in average firm size between member states may also play a role, with small firms being financially more constrained than larger firms. Doerr and Gambacorta (2020) construct a regional employment risk index on the basis of firm size and sectoral specialisation that shows particularly high values for Greece, Spain, Italy, Cyprus, Portugal, Slovenia and parts of France. This puts an emphasis on the need for targeted measures that reflect the geographical differences in Europe's economic fabric.

### **Need for a large recovery package responsive to sectoral and geographical differences**

The Summer interim forecast underscores the need to accompany the recovery with a major fiscal support as outlined in the Commission's 'Next Generation EU' proposal (European Commission 2020b). The downward revisions to the outlook for GDP point to a larger investment gap, indebtedness and financing needs of the public and private sectors than estimated in May, highlighting the urgency even more.

During the past decade, external demand made a major contribution to the recovery from the Great Recession that started in 2009 and the recovery from the sovereign debt crisis since 2013. By contrast, exports are unlikely to come to the rescue this time around, as the COVID-19 pandemic is not only a truly global crisis, but it also continues to affect many of the EU's largest trading partners particularly heavily.

This is confirmed by the continued fast spread of the pandemic outside Europe's borders and ensuing downward revisions to the global growth outlook. More onus is therefore on endogenous domestic demand as a key driver of the recovery.

Large funds have been made available by member states and the EU to protect workers' incomes and prevent bankruptcies during the crisis, but this alone will not be enough to ensure a swift and complete recovery (Revoltella *et al.* 2020).

Avoiding persistent drags from a debt overhang and unemployment hysteresis and minimising the still very large downside risks will require continued policy support.

Careful targeting of this support is essential. In line with the downward revisions to GDP, the shortfall of investment in the EU in 2020 and 2021 compared to the path expected last autumn is even larger than estimated in the spring forecast (European Commission 2020a).

The outlook for economic activity in the countries and sectors most affected by the crisis has been revised down further. Often faced with limited fiscal space, they are also projected to recover more slowly than others. Left unaddressed, these divergences between member states could become persistent and lead to fragmentation within the Single Market and the monetary union.

Moreover, the recovery offers the opportunity to boost investment with an orientation towards the green and digital transitions.

With the recovery plan 'Next Generation EU', the Commission proposes to act on these differentiated financing needs through a combination of several instruments amounting in total to €750 billion over four years (European Commission 2020b, Verwey *et al.* 2020).

Political agreement on this package is needed in the coming weeks in order to implement this fiscal stimulus in a timely manner. ■

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#### *Endnotes*

- 1. Haldane (2020) and references therein; several recent VOX columns including: Leiva-León et al (2020); Chen et al (2020); and Deb et al (2020).*
- 2. In a simple regression, the average stringency of containment measures in the first half of 2020 and the gross-value-added share of accommodation and food services explain more than half of the cross-country variation of output in the first half of 2020.*

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This article was originally published on [VoxEU.org](#)

# Is the market prepared?

The SCA deadline is nearing. Marius Galdikas says the need to adapt will be a watershed moment for businesses

**D**igital payment providers and vendors in the European Union are facing the fast-approaching deadline to implement Strong Customer Authentication (SCA). The EU legislation was slated to come into force on September 14, 2019. But instead, the new requirements were deemed too complex and pushed back to a rolling deadline. Still, for multiple businesses, the changes will come into force on December 31, 2020, and extend a bit into 2021 for [exceptional circumstances](#). The need to adapt will be a watershed moment for businesses.

### **What are SCA requirements?**

SCA requirements are a part of the EU-wide Payment Service Directive 2 (PSD2), which aim for a unified, smoother euro area payment system. The crux of SCA is the legal requirement and technical application of extra steps in the payment process.

Usually, authentication of this type combines a form of secret knowledge, such as a PIN or password, with a physical object - a chip, card, registered SIM card and phone, or another authentication device. Those requirements must be unrolled to all online transactions and contactless payments made within the EU, and the clock is ticking on rolling out solutions that unite vendors and payment providers in ways both compliant with the law and technically sound.

The changes affect a long list of activities and crucial points for both payment providers and various vendors. Without proper understanding and implementation of the new types of authentication, immediate problems arise. Vendors should act now on SCA, to prevent confusing shoppers, declined payments or abandoned shopping carts. Furthermore, implementing the changes on time will improve the credibility of vendors, as well as the entire payment provider industry.

At the moment, the current behavior of market players suggests that the SCA rules are either confusing, or the business is uncertain about their implications.

However, a wait-and-see stance is not an option, as when the deadline arrives, companies will have no choice but to sort out its compliance to resume business as usual. Although posing certain challenges, the new regulation may, in fact, be key to nurturing further market development - once the initial hurdles are overcome.

### **Growing market calls to strengthen security measures**

The EU has tracked the challenges of the PSP business over the years, suggesting key areas of improvement, especially in combating fraud and scams.

*it is crucial for vendors to seek out sound PSP partners that would help ensure their business is equipped with the right technical solutions and capable to accommodate the necessary forms of authentication*

For now, a lot of responsibility falls on national legislation, but also on the PSP companies. Detecting fraud is a matter of tracking potentially unauthorised transactions. Scams, on the other hand, are defined as misleading schemes which end up redirecting funds.

The EU has set some [requirements and goals](#) to solve the payment process in a way that prevents unwanted transactions and can keep detailed records to increase the possibility for cross-border consumer protection.

The EU map of e-commerce and payment systems is highly varied, with both leaders and laggards. But this map also has room for growth due to increasing complexities of cross-border transactions. The current common euro area payment system built a network between banks, but the connections between vendors and payment providers are not any less complex, and also face challenges hindering growth.

Notably, Eurostat also [discovered](#) a growing e-commerce connectivity between EU countries. In 2019, 35% of purchases were made across borders and sourced from an EU country. This compares to 29% of the total purchases back in 2014. Until April 2020, most e-commerce covered physical goods and travel, with most vendors using their proprietary apps or other points of sale.

The looming deadline of the SCA challenges both payment processors and vendors that are struggling with the pressure of the COVID-19 pandemic. The new regulations arrive at a time when the online payment business has already worked hard on security and stricter KYC requirements. Now, the challenge is both legal and technical, as it calls to test and apply even more efficient, secure tools for user authentication.

### **Boom of e-commerce heightens fraud risk**

With the growth of e-commerce and cross-border transactions, there has been a noticeable increase in online-

related revenue. But this growth correlates with increased pressure from fraud attempts. As more users moved online for any activities from basic shopping to purchasing content, this extended the trend of busy online trade.

By April 2020, e-commerce had grown globally by **209% year-on-year**. This trend coincided with a 13% increase of online fraud in April, compared to the same time period for 2019.

That said, not all vendors saw only net positives from increased online spending during lockdown. For some vendors, the past few months were a struggle with day-to-day expenses, and some are still seeking to raise revenues.

Thus, the new SCA regulations may come off as a bigger challenge for some businesses due to unfortunate timing. As their transactions will now need to follow a more complex format, some analysts have described the enforcement of SCA as *"kicking retailers while they're down."*

While the EU is aiming to be hospitable to digital modes of payment, its financial rules remain strict to ensure safety and compliance. The current mode of transactions is less secure, differentiated from the usual PIN and chip of bank cards. The SCA aims to change that by bringing businesses to apply a form of multi-factor authentication, thus preventing account theft and unauthorized transactions.

### **Racing to meet the deadline**

Not all businesses and PSPs are on the path to becoming 'SCA-ready' as some are still **battling** pandemic-related strain on their resources, making it difficult to migrate to the new framework.

In addition, a number of businesses, mostly SMBs, are still unaware of the SCA's true impact on their activities.

Although SCA compliance should be at the top of everyone's mind, it was overshadowed by the current global events. However, if market players want to meet the deadline, the new implementation should become a top-list priority for vendors, and they should also start looking for partners already implementing robust forms of verification in accordance with the newly proposed rules.

Also, what should not be overlooked is that SCA encompasses not just 2FA, but much more, including dynamic linking and proper messaging to the customer about operations being authorised.

An everyday challenge to e-commerce vendors will be facilitating a bulk-payment approach, where each payment order has a unique ID and requires distinct PIN codes for verification. However, generating many PINs – and fast – becomes tricky, especially for banks still running on legacy systems, which are not up to speed to SCA requirements.

That said, vendors could fill in the gaps with a reliable PSP, which has already taken care of all the intricacies concerning the new law.

In our case, we became an early adopter of SCA regulations: reacting to the growing transaction volume, we released an [App](#), which covers multi-factor authentication and one-tap approvals for payments. It will also be the basis for numerous innovations we have planned to implement in the near future.

### **The time to act is now**

The EU has been lenient so far, and there is still time for businesses to face the SCA requirements. Even with the challenges ahead, both PSP and retailers can benefit from a clear, unified set of rules.

**Estimates** place card fraud at €1.3 billion per year. It is unknown how this number will float in the coming months, and with the growth of online payments.

However, if implemented, SCA will prevent more cases of fraud while completing the growing interrelated network of vendors and payment providers within the EU.

At this point, resources and knowledge are already available, along with clear EU guidelines. To meet the nearing deadline, it is crucial for vendors to seek out sound PSP partners that would help ensure their business is equipped with the right technical solutions and capable to accommodate the necessary forms of authentication.

Overall, the SCA implementation will put up more barriers against fraud, raising the importance that PSPs and vendors prioritize the December 2020 deadline. Even though there is a set of challenges to be considered, meeting SCA requirements can be still achieved without affecting the day-to-day business - it all comes down to what steps the company is willing to take next. ■

**Marius Galdikas is CEO at ConnectPay**