

# FINDING COMMON GROUND

## A PRAGMATIC BUDGETARY INSTRUMENT FOR THE EURO AREA

### Executive summary<sup>1</sup>

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We outline a pragmatic proposal for a budgetary instrument for the euro area in line with the decision of the December 2018 Euro Summit. It is based on a very simple principle: any new instrument should make the euro area function better as a currency union. This is the only way to justify a euro area instrument in the first place. This principle has two implications.

First, duplication of existing tools needs to be avoided at all cost. In the current situation, we see a looming risk of layering a new instrument onto existing programmes such as EU structural funds, to which the new instrument would add no real value.

Second, the two objectives set out in the Euro Summit decision – competitiveness and convergence – ought to be operationalized strictly in terms of their contribution to a better functioning of the euro area as a currency union.

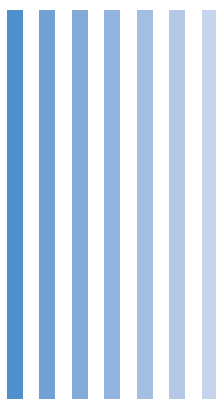
This in turn implies:

- pursuing competitiveness specifically requires improving productivity growth in the Eurozone. Whereas a currency area can theoretically live with low growth, productivity remains the best practical way to reduce imbalances and create policy space.
- pursuing convergence specifically requires improving business cycle convergence in the Eurozone. Whereas convergence of living standards may be politically desirable, business cycle divergence has proven a risk to the stability of the euro area as a whole.

To achieve these goals, we propose a budgetary instrument with the following features:

- Two expenditure components:
  - It should support an appropriate mix of structural reforms and public investment so as to result in similarly resilient economic structures throughout the Eurozone, fostering both productivity and business cycle convergence
  - It should finance dynamic national co-financing rates throughout the EU budget where that can contribute to business cycle convergence

<sup>1</sup> The policy paper solely reflects the personal views and opinions of the authors but not necessarily those of the institutions with which they are affiliated..



- One revenue component
  - assigned revenue based on a simulated common corporate tax base in the euro area. By reducing contributions in bad times and increasing them in good times, this would help improve business cycle convergence
- The instrument would have a balanced budget at all times. Its envelope would be fixed at the start of the MFF period, and the distribution of spending across the two components would be decided politically every year. The revenue side would follow a simple rule decided at the start of the period. Coherence with common rules should be ensured.
- Decision-making would lie with the Euro Summit and Eurogroup. A new euro area committee of the European Parliament would have a say.

# TABLE OF CONTENTS

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<b>Introduction</b>	<b>1</b>
<b>1. The Euro Summit decision</b>	<b>1</b>
<b>2. Competitiveness and convergence for the euro area</b>	<b>2</b>
2.1 Competitiveness as productivity	2
2.2 Convergence as business cycle convergence	3
<b>3. Why the EU budget does not deliver on these objectives</b>	<b>4</b>
<b>4. A concrete proposal</b>	<b>5</b>
4.1 Expenditure – Reforms & Investment and Dynamic Co-Financing Rates	5
4.2 Revenue	7
4.3 Size, Participation and Governance	9
<b>Conclusion</b>	<b>10</b>
On the same topic	11

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# INTRODUCTION

In December 2018, the Euro Summit tasked the Eurogroup to spell out the details of a “budgetary instrument for convergence and competitiveness for the euro area” by June 2019. A common stabilisation function was ruled out. Yet, even if scepticism abounds, this offers the prospect of opening a new chapter for EMU by creating an instrument for common fiscal policy for the first time. However, neither the summit nor the Eurogroup has given any concrete guidance on the shape of this instrument. We attempt to fill this void with a concrete, pragmatic proposal that clearly identifies the main objectives of the new instrument, what it should spend money on, and how it should be funded.

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OUR GUIDING PRINCIPLE IS SIMPLE: THE NEW INSTRUMENT SHOULD ABOVE ALL CONTRIBUTE TO MAKING THE EUROZONE QUA CURRENCY UNION FUNCTION BETTER.

Our guiding principle is simple: The new instrument should above all contribute to making the Eurozone qua currency union function better. This is the only way to justify an instrument that caters for euro area member states as opposed to the EU as a whole. This principle has two overarching implications: First, it means that the new instrument should not duplicate tasks better carried out within the current EU budget for the Union as a whole. Second, it means that the objectives of competitiveness and convergence should be operationalised in terms of creating a more resilient and better functioning euro rather than be geared to more general goals such as raising growth, income or employment levels.

Taken together, this implies that the instrument should mark a clear departure from the current functioning of the EU budget in a way more conducive to the good functioning of the Eurozone.

## 1. THE EURO SUMMIT DECISION

After difficult negotiations, the Eurozone leaders agreed on a compromise that set out a number of parameters for the euro area budgetary instrument:

*In the context of the Multiannual Financial Framework (MFF), we mandate the Eurogroup to work on the design, modalities of implementation and timing of a budgetary instrument for convergence and competitiveness for the euro area, and ERM II Member States on a voluntary basis. It will be part of the EU budget, coherent with other EU policies, and subject to criteria and strategic guidance from the euro area Member States. We will determine its size in the context of the MFF. The features of the budgetary instrument will be agreed in June 2019. The instrument will be adopted in accordance with the legislative procedure, as foreseen by the Treaties, on the basis of the relevant Commission proposal to be amended if necessary.*

This decision creates a number of limitations and constraints for the budgetary instrument:

1. The objectives are “competitiveness and convergence” as opposed to “competitiveness, convergence and stabilisation” as suggested by France and Germany in their Meseberg declaration last summer. Despite many calls in favour, this means that mere stabilisation, e.g. help to countries hit by a shock, is out of the question and has been relegated to the technical level.<sup>2</sup>

<sup>2</sup> For a broader discussion on options for a fiscal policy instrument for the euro area, see Guttenberg, L. and Hemker, J. (2018), [A fiscal instrument for the euro area: no escape from politics](#), Jacques Delors Institute Berlin Policy Paper.

2. The budgetary instrument should be part of the EU budget and its size will be decided at the same time as the EU's finances under the MFF in general. What exactly this implies is unclear. We therefore take this as a political statement: The decision on the size of the budgetary instrument has to be taken together with the other important decisions on EU finances and should be seen as part of an overall financial envelope. It also means that the European Parliament as co-decision-making institution on the EU budget must have a say.

3. Member States (read: the Eurogroup and the Euro Summit) should have the power to determine "criteria and strategic guidance". This means that decision-making on the budgetary instrument cannot be technocratic but is ultimately political in nature.

At the same time, the summit gave no guidance on the expenditure items or on possible revenue sources. It did not explain how decision-making should work and how the two objectives should be operationalised in practice. This is where our proposal comes in.

## 2. COMPETITIVENESS AND CONVERGENCE FOR THE EURO AREA

The Euro Summit chose competitiveness and convergence as the new instrument's two main objectives. Yet of course, both terms mean different things to different people. What is specific about the new instrument is its focus on making the euro work better. Therefore, we should operationalise convergence and competitiveness strictly in terms of what helps make the eurozone function better as a currency union.

### 2.1. Competitiveness as productivity

When applied to a currency union, the term competitiveness appeals to an analogy: the euro area is imagined to be competing in the world economy in the same way that businesses compete in global markets. In this vein, some equate competitiveness with measures of price competitiveness such as unit labour costs.

However, the analogy between a business and the euro area quickly encounters limits. A business has well-defined annual profit or loss and will be forced out of business if losses mount. In contrast, countries and currency unions obviously do not post annual profits and do not "go out of business" when their economic performance deteriorates. The goal of pursuing "competitiveness" at the euro area level cannot therefore be (improved) "profits" but "raising economic performance", or living standards more broadly speaking.

The outcome may then be, as Paul Krugman once wrote, that competitiveness becomes "just a funny way of saying productivity".<sup>3</sup> In our view, pursuing competitiveness in the context of the euro area should indeed be operationalised by promoting productivity growth.

3. Krugman, P. (1994), *Competitiveness: A Dangerous Obsession*, Foreign Affairs March/April 1994 issue.



WE SHOULD OPERATIONALISE CONVERGENCE AND COMPETITIVENESS STRICTLY IN TERMS OF WHAT HELPS MAKE THE EUROZONE FUNCTION BETTER AS A CURRENCY UNION.

Ultimately, boosting productivity is the only way to lift the economy's growth potential. There is a theoretical argument that a monetary union can also function at low levels of potential growth as long as recessions can be absorbed evenly across members. This is not only cynical reasoning. It also does not work in the real world: productivity remains probably the only silver bullet to strengthen the euro area in all dimensions. It can help to reduce imbalances and boost fiscal space by bringing in more tax revenues and bringing down relative debt levels. In addition, it strengthens monetary policy space by driving up long-term real interest rates via giving the single monetary policy more scope to fight deflationary area-wide recessions.

## 2.2. Convergence as business cycle convergence

The concept of promoting convergence is often falsely reduced to the goal of achieving comparable living standards – an idea already deeply ingrained in the current EU budget.<sup>4</sup>

However, a currency union can cope with divergences between richer and poorer regions, as the example of the U.S. shows. What is vital to the stability of a currency union, however, is for business cycles to be relatively aligned between members, with most going through boom and bust periods at about the same time.<sup>5</sup> This is because, in a currency union, the central bank's monetary policy should be appropriate not only for the area as a whole but for most if not all of its members.

The euro area crisis was not caused by countries having different income levels or by their GDP not converging to similar levels fast enough. The eurozone was hobbled by the build-up of imbalances that had significant roots in the fact that monetary policy was systematically too tight for some countries while too loose for others.

This is why the budgetary instrument should aim at business cycle convergence, an objective that the EU budget cannot and does not deliver on (see below), rather than duplicating the EU budget's objective of fostering income level convergence.

In summary, a focus on a better functioning of the euro area points to the following operationalisations of the goals set forth in the Euro Summit decision:

1. The pursuit of “competitiveness” requires a focus on productivity growth for the eurozone as a whole, with a focus on those countries that are lagging behind.
2. The pursuit of “convergence” requires a focus on further synchronising business cycles to avoid the build-up of dangerous imbalances.



THE BUDGETARY  
INSTRUMENT SHOULD  
AIM AT BUSINESS  
CYCLE CONVERGENCE

<sup>4</sup> In fact, this is what the cohesion fund is explicitly set up to address.

<sup>5</sup> IMF (2018), *Economic Convergence in the Euro Area: Coming Together or Drifting Apart?* IMF Working Paper 18/10.

### 3. WHY THE EU BUDGET DOES NOT DELIVER ON THESE OBJECTIVES

The EU is already equipped with considerable spending power. For the period 2014–2020 the block's multiannual budget (MFF) adds up to nearly 1.1 trillion euros, 371 billion of which are spent on "economic, social and territorial cohesion" – namely the structural funds.<sup>6</sup>

So why not just use the EU budget as we already know it to make the Eurozone work better?

Because the EU budget and in particular the structural funds were set up with a completely different objective. The funds were established to counteract side-effects of the EU Single Market, not to address the needs of monetary union. They were designed to help poorer countries and regions catch up. That way, they foster convergence of income levels – but that is precisely not the type of convergence the Eurozone needs, as we have argued above. Indeed, in the run-up to the crisis, structural funds exacerbated business cycle divergence as they flowed to countries already growing well above potential such as Greece or Portugal; the annual net transfer of both countries from the structural funds alone amounted to well above 1.5% of GDP for the period 2000–2009.<sup>7</sup>

This is a direct consequence of a second feature of the EU budget: It is rather rigid by design because it is supposed to provide reliable funding for projects over a longer time horizon. That is why in the MFF negotiations, not only are the overall ceilings for EU expenditures fixed, but de facto roughly 80% of the whole budget is already distributed among the member states and – in the case of the structural funds – the 281 regions of the EU for the upcoming seven years. This then translates into multiannual-programmes to be submitted from the regions to Brussels and then into thousands of local projects. Thus, the EU budget in its current form not only pursues the wrong form of convergence to make the Eurozone work better – it offers no prospect of the strategic guidance and political decision-making the Summit clearly envisioned for the budgetary instrument.



THE EU BUDGET AND IN PARTICULAR THE STRUCTURAL FUNDS WERE SET UP WITH A COMPLETELY DIFFERENT OBJECTIVE

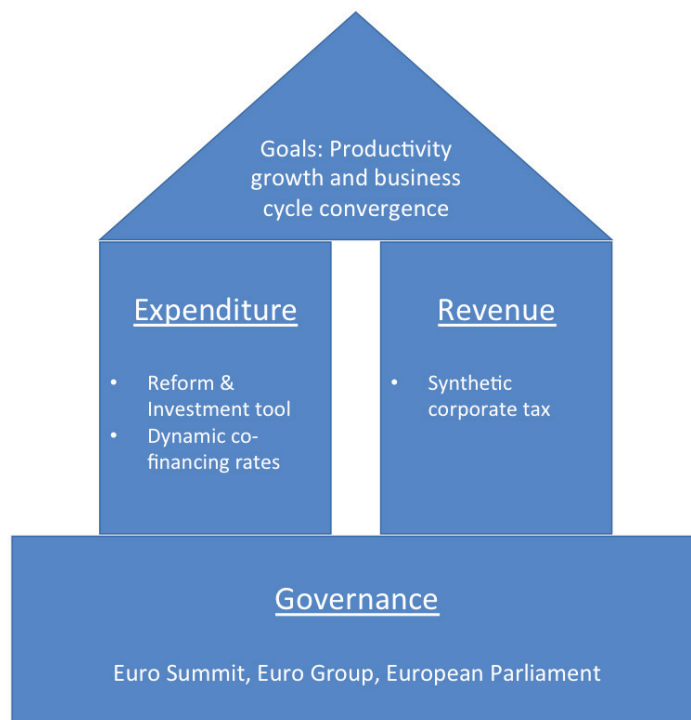
<sup>6</sup>. On top of that comes an envelope of another 100 billion buried in the Agricultural budget devoted to rural development.

<sup>7</sup>. Enderlein, H. Funke, O. & Lindner J. (2015), *The EU budget: which fiscal capacity at the European level?*, in: Richardson, J. & Mazey, S. (ed.), *European Union: Power and Policymaking*, Routledge, New York.

## 4. A CONCRETE PROPOSAL

Based on the above, the budgetary instrument should promote productivity and business cycle convergence with the overarching goal of making the eurozone work better in a way that the current EU budget cannot. To do so, the instrument should have two main expenditure aims: First, support reforms and public investment that create positive effects for the eurozone as a whole. Second, improve business cycle convergence by adjusting co-financing rates for eurozone member states throughout the EU budget, depending on their relative business cycle position. The revenue side should support the two overarching objectives by relying on synthetic corporate taxes (see below), a cyclically-sensitive revenue source. Finally, the instrument should foster compliance with the fiscal and economic governance rules and should be based on political decisions from the Eurogroup and Euro Summit.

CHART 1 ■ Schematic make-up of budgetary instrument



In detail, this means the following:

### 4.1. Expenditure – Reforms & Investment and Dynamic Co-Financing Rates

The instrument for competitiveness and convergence should have two overarching spending compartments (or budget lines). The first should facilitate structural reforms and public investment. The second should dynamically fund national co-financing requirements in cyclical downturns. Both compartments should strengthen productivity growth and boost resilience to downturns, thereby increasing business cycle convergence.



### Reform & Investment Tool



REFORMING PRODUCT AND LABOUR MARKETS, MODERNIZING INSTITUTIONS AND TARGETED PUBLIC INVESTMENT ARE KEY TO ENABLING PRODUCTIVITY GROWTH AND MAKING SURE THAT BUSINESS CYCLES BECOME MORE ALIGNED IN THE EUROZONE.

Reforming product and labour markets, modernizing institutions and targeted public investment are key to enabling productivity growth and making sure that business cycles become more aligned in the eurozone. This is where the budgetary instrument should make a substantial contribution: It should feature a Reform & Investment Tool.

Its functioning would be simple: Not unlike the basic idea behind the original reform contracts or the recent Commission proposal on a reform delivery tool, Member states could apply for support for public investment or for mitigating the short-term costs of structural reforms. However, they would need to clearly demonstrate how the investment or the reform would not only be in the interest of their own economy but yield substantial benefits for the Eurozone as a whole. This could be the case either if the measure has tangible spill-over effects for other Eurozone members or if it makes a substantial contribution to making the country's economy more resilient to downturns, hence ensuring a better convergence of business cycles.

The measures presented should be aligned with the country-specific recommendations (CSRs) under the European Semester. This ensures that the budgetary instrument fits in with the wider economic governance framework.

The Euro Summit would need to sign off each year on the list of measures to be financed through the budgetary instrument (see below on governance). It would need to feature a good balance of investment and reform measures. As a rule, support for a country's investment measures should never be larger than that for structural reforms as long as the CSRs for that country point to substantial structural reform needs. In turn, support for reform measures should be commensurate with the degree of ambition and importance of the reform for the Eurozone as a whole. It would be up to the Commission to determine the amount of support for each reform measure.

Moreover, member states could propose packages of reform and investment that exploit complementarities between targeted spending and the proposed structural reforms. Passing complementary reform packages including a demand-side component can be vital to their success. Where appropriate, the euro area instrument could be targeted at complementary public spending that increases the salience of a given structural reform. This could, for example, include active labour market policies (ALMPs), skills-training and education to support a specific labour market reform, simultaneously increasing R&D in a sector when introducing a product market reform or investing in staff training or ICT upgrades when reforming public institutions. There is an added bonus to going down this path. Measuring the costs of reforms is both controversial and difficult. Financing these complementary policies which come with a clearer bill thus can be of help.

### Business cycle convergence: Dynamic co-financing rates



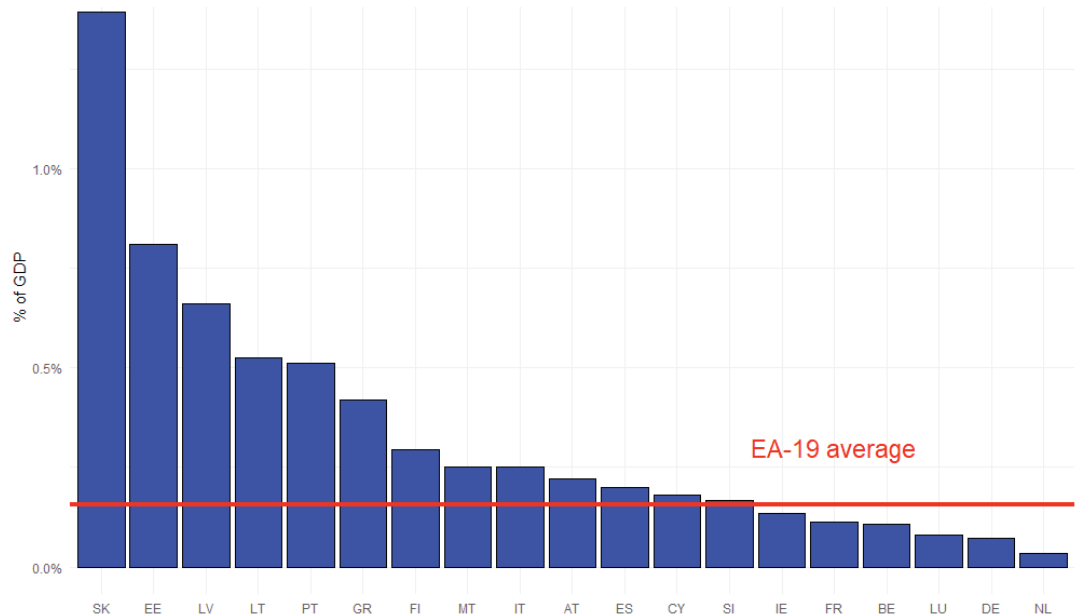
BESIDES THE INVESTMENT/REFORM TOOL, THE INSTRUMENT SHOULD ALSO HAVE AN EXPENDITURE LINE THAT MORE DIRECTLY SUPPORTS BUSINESS CYCLE CONVERGENCE.

Besides the investment/reform tool, the instrument should also have an expenditure line that more directly supports business cycle convergence. This should be done via a temporary substitution of national co-financing by Eurozone members throughout the EU budget.

In the period 2014–2020 Eurozone member states spent roughly 123 billion euros to co-finance money they receive from structural funds. Temporarily paying for these co-financing obligations from the euro area budgetary instrument in the event of a downturn would be a contribution towards converging business cycles.

Especially for smaller member states such as Greece, Portugal, the Baltics or Slovakia, national co-financing can account for 0.4–1.8% of annual GDP. On average, national co-financing accounts for 0.16% of GDP in the euro area. Chart 2 displays the data.

**CHART 2 ■ National co-financing of EU Structural and Investment Funds in % of GDP**



Source: Own calculations, ESIF funds 2014–2020, AMECO

To put these figures into perspective, note that the discretionary fiscal stimulus in the unprecedented economic downturn of 2009–2010 added up to only 1.1% of member states’ GDP in 2009 and 0.8% in 2010. Substituting these amounts in the case of a downturn could therefore modestly but materially improve the fiscal position in the short term, helping to synchronize economic cycles.

In the case of severe downturns in the euro area, even a complete suspension of national co-financing (currently 18bn euros) could be envisioned on a temporary basis.

## 4.2. Revenue

In terms of the macroeconomic impact, the revenue side of a new budgetary instrument is as important as the expenditure side.

As described in part 3, current EU budget funding is relatively static over time as it mostly relies on member state contributions based on gross national income (GNI). But in order to maximize positive effects for the currency union, the revenue side of a euro area budgetary instrument should promote business cycle convergence to the largest extent possible.

One straightforward solution would be to fund the instrument with a eurozone-wide tax that is cyclically sensitive, i.e. that inherently raises more money from countries in upswings and less in downturns. However, such a funding source would face two challenges: First, both legally and politically we are far from certain that this is within reach in the near future. Second, in the



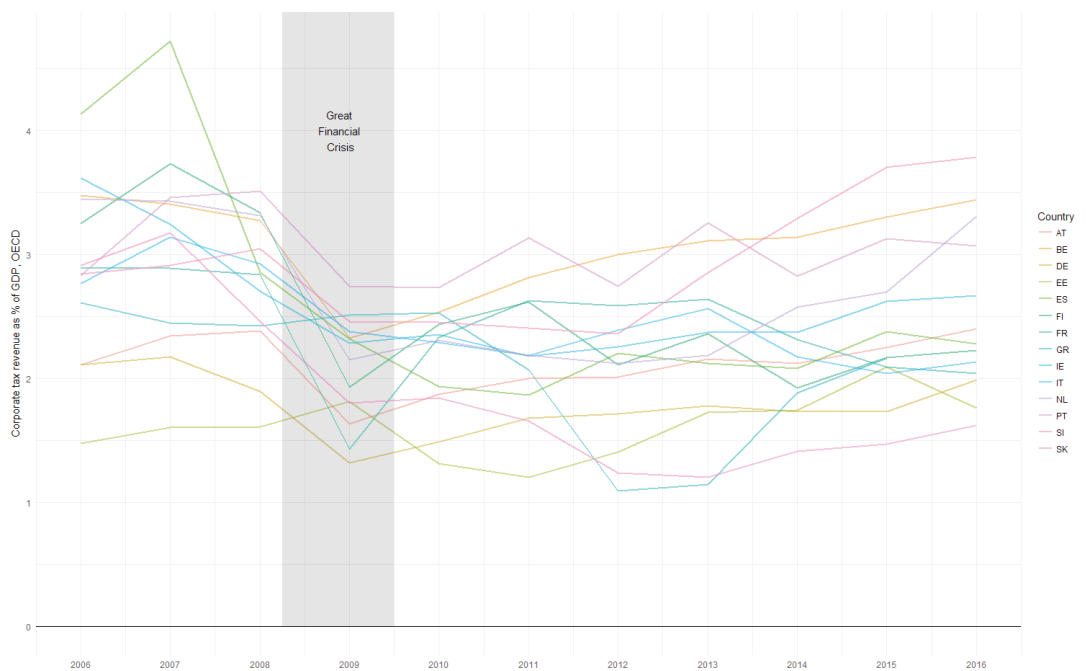
THE REVENUE SIDE OF A EURO AREA BUDGETARY INSTRUMENT SHOULD PROMOTE BUSINESS CYCLE CONVERGENCE TO THE LARGEST EXTENT POSSIBLE.

case of downturns affecting the whole eurozone, such a tax as a primary funding source could require the instrument either to go into deficit or to cut expenditure.

Both challenges make us favour an alternative solution: A synthetic funding source mimicking the cyclical features of corporate taxation but at the same time guaranteeing political and legal feasibility and a balanced budget.

This would work as follows: Akin to the synthetic VAT contributions in the EU budget, member states would agree on an estimated common corporate tax base for the sole purpose of calculating their share of financing the budgetary instrument. Contributions would be scaled to always reach the predetermined aggregate, with the cyclical changes in the (estimated) corporate tax base only affecting the composition of contributions in each period. Of course, if a common corporate tax were actually agreed upon in future, it could replace the synthetic funding source suggested here.

As a result, the instrument's overall envelope would remain constant over time and it would always achieve a balanced budget. At the same time, varying contributions would tend to synchronise business cycles between euro area members, rendering the currency union more stable.<sup>8</sup>



Source: OECD data

All these principles could be enshrined in an intergovernmental agreement among participating member states, as member states do already for example for the European Development Fund.

<sup>8</sup>. An additional possibility would entail building up a strategic reserve when the eurozone as a whole is in an upswing. In a eurozone-wide downturn, the strategic reserve could then be used to cover part of member states' contributions to further align business cycles.

### 4.3. Size, Participation and Governance

Besides the revenue and expenditure components, three crucial questions relate to the size of the instrument, participants, and governance.



THERE IS NO SPACE IN THE MFF TO ACCOUNT FOR THE BUDGETARY INSTRUMENT.

First, how big should the instrument be? Obviously, the economic impact of any fiscal policy crucially hinges on the volume of revenue and expenditure. Our proposal is no different. But we would argue that it works for an annual size of 10bn euros as it would for 100bn. Still, one thing seems clear for us: The budgetary instrument only makes sense if Eurozone member states are willing to put money on the table above and beyond what they are currently willing to contribute. The simple reason: There is no space in the MFF to account for the budgetary instrument. Even at a very modest size of 0.2% of GDP per year (ca. 25bn euros), the instrument would consume almost the entirety of the 27bn euros of structural funds going to Eurozone countries on average per year. Similarly, it is neither feasible nor desirable to shift significant funds from eastern Europe to the euro area, to take away the money from EU budget recipients in western Europe or to stop giving catch-up aid to laggard regions in the Eurozone (and there are plenty). It runs counter to the fundamental rationale of the EU budget and the sums simply do not add up.

Second, who should participate in the instrument? According to the summit, the instrument addresses “the euro area, and ERM II Member States on a voluntary basis”. This is consistent with the two objectives we have identified. ERM II countries (currently only Denmark) already largely forego the possibility of an independent monetary policy and hence for all practical purposes function like a eurozone member. It should, however, be excluded that ERM II countries can enter and exit at will as otherwise this would give them an incentive only to participate when it favours them. In practice, countries should decide at the beginning of each MFF whether or not they want to join for the full period, and countries joining ERM II during the period should decide at the moment of their entry.

Third, how should the instrument be linked to Eurozone rules? As for the MFF at large, countries should not be able to benefit from the budgetary instrument if they persistently defy common rules. This should not mean that they should immediately be barred from any access once they hit the thresholds under the SGP or the MIP – after all such developments are often the result of adverse economic developments. But they should indeed be denied access when they refuse to comply with whatever measures Commission and Council ask them for once they have breached the rules. In this way, the budgetary instrument could contribute to stronger compliance with the common rules.



THE SUMMIT HAS MADE CLEAR THAT THE INSTRUMENT SHOULD BE “SUBJECT TO CRITERIA AND STRATEGIC GUIDANCE FROM THE EURO AREA MEMBER STATES”

Finally, who should decide? The summit has made clear that the instrument should be “subject to criteria and strategic guidance from the euro area Member States”. This suggests a firm intergovernmental grip on how this instrument works and a political rather than a purely technical decision-making process on how the money is spent. We assume that both the Eurogroup and the Euro Summit would want to be regularly involved in the most important decisions. In our proposal, two kinds of decisions have to be taken on a regular basis: First, how to divide the expenditure between the co-financing tool and reform/investment support. Second, what investment objectives and reforms should be supported in each member state.

At a first step, a Euro Summit in parallel to the February informal European Council could decide on the share between co-financing and reform/investment support in parallel with the euro area recommendation for the coming year. Second, a Euro Summit right after the June European

Council, which adopts the CSRs, could adopt the list of investment projects and reforms that could be financed by the instrument in the upcoming year. This would be in time to be taken into account for national budget planning. At the same time, this would be too early for member states to be certain about their contributions, so no stakeholder could apply a net contributions logic.

The European Parliament should be involved in the deliberation process and should have a say both with regard to the February decision on the respective shares and the June decision on the concrete expenditure items. To this end, it should institute a separate committee for eurozone matters. National governments should be accountable for their voting behaviour to national parliaments, which should also have a right of information. The Commission should administer the instrument and should implement the decisions taken; the Court of Auditors should ensure sound financial management and should ex-post scrutinise all expenditures.

## CONCLUSION

The attempt here has been to propose a euro area budgetary instrument that takes into account the constraints formulated by the Euro Summit and still makes sense from an economic point of view. For us, this means first and foremost that the instrument work towards two objectives that can truly make the Eurozone work better: improved productivity and greater business cycle convergence.

The discussion on a fiscal tool for the Eurozone is now politically tied to the MFF negotiations. That is why we think it is so important to get the design of the budgetary instrument right at this stage and not to build a second instrument that simply does what the EU budget has always done. There will likely be no second chance for designing such an instrument before the next MFF negotiations in 2025 – but there is always the chance to change the design of an instrument at the margin once it is up and running. This is why Eurozone member states should do their utmost to put this instrument on the right track from the start.



EUROZONE MEMBER STATES SHOULD DO THEIR UTMOST TO PUT THIS INSTRUMENT ON THE RIGHT TRACK FROM THE START.

## ON THE SAME TOPIC

- Guttenberg, L. and Hemker, J., [A fiscal instrument for the euro area: No escape from politics](#), Policy Paper, Jacques Delors Institute Berlin, March 2018
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