THE LETTA REPORT: A SET OF PROPOSALS FOR REVITALISING THE EUROPEAN ECONOMY

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(*) This paper has benefited from conversations held with the Economic Counsellors of the Permanent Representation of Spain to the European Union, as well as colleagues from other national central banks and the ECB in the House of the Euro.

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Abstract

Europe is facing a number of major challenges in the near future, including managing the climate transition, the effects of technological transformations and geopolitical changes. European and national authorities are aware that the tools currently in place are insufficient to address these challenges and that a determined reform drive is therefore needed.

At the start of a new European institutional cycle, the set of proposals in the Letta report, aimed at completing the Single Market and adapting it to the new circumstances, constitute a major contribution to the European economic policy debate. The most important initiatives include the revitalisation of the capital markets union, the creation of a pan-European State aid scheme based on national contributions, the promulgation of a European code of commercial law as an alternative to the harmonisation of the 27 existing national systems, the incorporation into the Single Market of sectors that have so far been largely outside it (such as energy and telecommunications) or, in the legislative field, the prioritisation of the use of regulations, which are directly applicable in the Member States, over directives, which require transposition into the legal systems of each country.

The report's diagnosis is largely shared by the various national authorities, who also welcomed the main thrust of the proposals. However, it is not difficult to see that the implementation of the latter requires a consensus that, in practice, may be difficult to achieve.

Keywords: Single Market, European integration, capital markets union, industrial policy, competitiveness, climate change, geopolitics, innovation.

JEL classification: E61, E62, F13, F15, F36, F45, G28.

Resumen

Europa se enfrenta a un conjunto de retos de gran importancia en el futuro próximo, entre los que destaca la gestión de la transición climática, de los efectos de las transformaciones tecnológicas y de los cambios geopolíticos. Las autoridades europeas y nacionales son conscientes de que las herramientas actualmente disponibles no alcanzan para abordar eficientemente estos desafíos y de que es necesario, por tanto, un decidido impulso reformista.

Al inicio de un nuevo ciclo institucional europeo, el conjunto de propuestas del informe Letta, orientadas hacia la culminación del mercado único y su adaptación a las nuevas circunstancias, constituyen una aportación de primer orden al debate de política económica europea. Las iniciativas más importantes incluyen la dinamización de la unión de los mercados de capitales, la creación de un esquema de ayudas de Estado paneuropeas basado en contribuciones nacionales, la promulgación de un código de derecho mercantil europeo como alternativa a la armonización de los 27 ordenamientos nacionales existentes, la incorporación al mercado único de sectores que hasta ahora han estado en gran medida al margen de este (como la energía y las telecomunicaciones) o, en el ámbito legislativo, la priorización de la aprobación de reglamentos, directamente aplicables en los Estados miembros, frente a las directivas, que requieren de transposición a los ordenamientos jurídicos de cada país.

El diagnóstico del informe es, en gran medida, compartido por las distintas autoridades nacionales, que también han acogido favorablemente los grandes enunciados de las propuestas. No obstante, no es difícil entrever que la puesta en funcionamiento de estas últimas requiere consensos que, en la práctica, puede ser difícil alcanzar.

Palabras clave: mercado único, integración europea, unión de los mercados de capitales, política industrial, competitividad, cambio climático, geopolítica, innovación.

Códigos JEL: E61, E62, F13, F15, F36, F45, G28.

Contents

1 Introduction

2023 marked the 30th anniversary of the single European market. On 30 June of that year, the European Council called for an independent High-Level Report to identify barriers to the smooth functioning of the Single Market and proposals to overcome them. Three months later, the Commission and the Spanish and Belgian Presidencies of the Council asked Enrico Letta, former Italian Prime Minister, to lead the drafting of the report. The report, entitled "Much more than a market", was presented to the European Council on 18 April 2024.

The initial motivations for establishing the Single Market were twofold. In part, it served as a political tool to help forge a European identity, but above all it was an economic instrument, since the removal of borders was expected to create a competitive environment that would raise welfare.

The Single Market is built upon "four fundamental freedoms": the free movement of goods, services, people and capital. Three decades on, the Letta report finds that the Single Market has only partially been realised. Furthermore, it concludes that the Single Market should be adapted from its original design to address the challenges of today's world. First, Europe's weight in the world economy is diminishing. This owes not only to the rapid growth of many emerging economies, but also to the European Union's (EU) growth gap with other advanced economies, such as the United States. Second, Europe must face competitors whose commitment to the existing multilateral rules is increasingly in doubt. In view of all this, the report calls for action to counter these trends.

The Letta report puts forward a wide array of proposals, covering areas such as financing the EU strategic goals, fostering the growth of industries considered key for the future, accelerating the climate transition and redefining international trade relations in today's complex geopolitical landscape. Some of the ideas proposed have been suggested in the past but have not been put into practice. Implementing all the initiatives at the same time would likely be unfeasible given the enormous political capital and funding this would demand.

The Letta report makes an important contribution to setting the EU's strategic economic priorities for the new policy cycle, following the recent constitution of the European Parliament. However, it will not be the only such contribution. A further key report, on the future of European competitiveness and entrusted to another former Italian Prime Minister, Mario Draghi, is due to be presented in September. There is even a third report in the pipeline, on defence policies and commissioned to former Finnish President Sauli Niinistö.

The Letta report's recommendations are grouped into six sections, which cover (i) enhancing human capital, research and innovation in Europe, (ii) financing the strategic goals, (iii) scaling up European companies and providing industry-specific recommendations, (iv) ensuring that the policies implemented leave no segment of the European economy behind, (v) governance and the regulatory environment, and (vi) the external dimension and

EU enlargement. This paper sets out the main points of the proposals, following the same order as the report.

2 Research, innovation and education

In recent decades, productivity growth has been persistently slower in Europe than in other advanced economies, particularly the United States. This could be attributed to multiple factors, including lower levels of investment, population ageing, smaller business size and various human capital shortcomings, which are, in turn, associated with a slower pace of innovation generation and diffusion.

To address the human capital challenges, the report proposes, perhaps somewhat rhetorically, complementing the four fundamental freedoms with a fifth one, which should be integrated into the Single Market framework and, thus, play a role in European integration. This fifth freedom encompasses research, innovation, knowledge, education and data utilisation.

Broadly speaking, the initiatives outlined in this section of the report assign a central role to the public sector. In particular, public authorities would be tasked with determining and promoting priority areas of research (cited examples include artificial intelligence (AI), quantum computing, materials science and pharmaceuticals).

The report's more specific proposals include the creation of a "European Knowledge Commons", a kind of knowledge repository that would offer open access to a wide array of content, such as educational resources, data sets and publicly funded research. This requires the deployment of the necessary digital infrastructure, particularly in relation to cyber security. Advocating open access to knowledge could potentially conflict with efforts to boost incentives for innovation, such as protecting intellectual property, but this issue is not addressed in the report.

In addition, the report proposes three types of action to enhance human capital. First, it calls for pan-European programmes to boost the digital skills of the population as a whole. Second, it proposes designing incentives to retain innovation talent in Europe, together with developing intra-EU mobility programmes for researchers. Lastly, in the field of education, the report proposes the creation of degrees offered jointly by universities across different European countries.

The report's emphasis on innovation is consistent with the idea that the EU should reduce its external dependence to reinforce its strategic autonomy. In practice, however, it is not clear how far Europe can manage without suppliers from other advanced economies for the most cutting-edge technologies, such as AI.

3 Financing Europe's strategic goals

Europe faces a number of major challenges that demand far-reaching action. The report highlights three of these: the green and digital transitions, EU enlargement and bolstering European defence capabilities. The difficulty in addressing these strategic priorities is their high cost.

The report outlines how public and private resources could be channelled to help finance these goals. In particular, it proposes a three-phase sequential action plan, focusing first on mobilising private capital, then on reforming State aid, and finally on EU-wide public investment. The reasoning behind this sequence is that each phase will, politically speaking, facilitate the next. The next three sections of this paper explore the proposals for mobilising private resources, the initiatives for utilising public resources (whether in the form of industrial policy implemented through State aid or as direct public investment), and a series of proposals to maximise the impact of investment spending.

3.1 Private financing

The report calls for renewed efforts to complete the capital markets union (CMU), which remains incomplete despite the initiatives undertaken in the last decade.[1]

Discussions on the CMU typically begin by noting two stylised facts, which also serve as the starting point for the Letta report. First, the share of financing provided by capital markets to the overall economy is considerably smaller in Europe than in other jurisdictions. Second, in Europe, the volume of private savings (and savings in the economy overall) far exceeds that of investment. In other words, the EU has, in aggregate terms, a capacity positive net lending position vis-à-vis the rest of the world, which is reflected in net financial outflows. Taken together, these two stylised facts suggest that European capital markets should be developed and integrated, since this would help channel a greater share of surplus savings towards financing investment projects within Europe rather than elsewhere (and would also attract capital from the rest of the world). Ultimately, increased investment would lead to a more dynamic European economy.

Furthermore, the scarcity of capital market finance does not affect all European agents equally. In particular, although there is, in aggregate terms, a surplus of savings available to finance investment, there is, at the same time, a marked deficit in the resources available to fund certain segments of non-financial corporations. This is particularly true of young firms in their growth phase (i.e. scale-ups), whose investments have the potential for high returns but are subject to marked uncertainty. These firms face obstacles in obtaining financing both from banks (since they lack a credit history and assets to put up as collateral) and capital markets (due to the latter's limited development).

1 González Mínguez and L'Hotellerie-Fallois (2024) describes the progress made towards the CMU in recent decades, as well as the most recent proposals.

Against this background, the report contributes to the ongoing debate on the measures required to complete the CMU (or as the report terms it, the Savings and Investment Union). The specific proposals, which the report suggests should be implemented as simultaneously as possible for maximum transformative impact, are as follows.

— Fostering asset securitisation as a means of freeing up additional lending capacity for financial institutions and redistributing risk towards agents more willing to bear it.

— Creating pan-European long-term savings products with tax incentives. The report argues that the smaller size and lesser role of European institutional investors (and pension funds in particular) compared with other advanced economies means lower demand for financial instruments issued by firms. The initiative seeks a reallocation of private savings across financial products, reducing the share held in bank deposits in favour of fixed income and equity instruments traded on capital markets.

— Introducing a harmonised European framework for categorising investors: institutional, qualified individual and retail, in an effort to promote cross-border investment. In addition, the report proposes integrating financial literacy into school curricula to encourage retail investor participation in capital markets.

— Introducing tax incentives for financing under the European Long-Term Investment Fund (ELTIF) framework to help firms without access to public markets raise financing.

— Providing public sector guarantees for bank credit to fund the climate transition.

— Creating two pan-European stock exchanges, to be supervised by the European Securities and Markets Authority (ESMA). The first would be tailored to SMEs, with simplified listing requirements. The second, more specialised exchange would focus on financing high-risk, high-return start-ups, where the subset of authorised institutional investors would be subject to a less stringent prudential regime.

— Integrating the trading and settlement platforms currently existing in European capital markets. The report argues that the fragmentation of these capital markets infrastructures limits economies of scale, and therefore tends to lead to higher financing costs for private agents.

— Integrating supervision of the various capital market participants. In addition to trading and settlement platforms, these markets consist of a diversity of groups of participants, including financial instrument issuers, asset managers, collective investment vehicles, rating agencies and market data providers. As per the report, the fact that most of these agents are regulated and supervised by national authorities leads to capital market fragmentation, preventing the emergence of agents/participants that could deliver services at more competitive prices. The report proposes shifting from national-level supervision to a scheme where ESMA assumes supervisory responsibilities for major entities based on criteria such as their size, cross-border activities and systemic importance. The system would be similar to banking sector supervision, where the Single Supervisory Mechanism oversees significant banks and national competent authorities supervise less significant ones. According to the report, this approach would be preferable to full centralisation, which would mean foregoing, at least in the short term, the benefits that come with national authorities' familiarity with their local markets.

— ESMA governance reform. In parallel to integrating supervision within ESMA, the report also urges a reform of ESMA's decision-making processes. Under the current system, the Chair and the competent national authorities have voting rights in ESMA's governing bodies. The report proposes replicating the European Central Bank's (ECB) governing bodies, with a Management Board composed of six members (including the Chair) and a Board of Supervisors (equivalent to the ECB's Governing Council) composed of the representatives of the national competent authorities plus the six members of the Management Board. The aim is to ensure that ESMA's decisions are guided by more independent criteria and not influenced by purely national interests.

— Harmonising national practices in areas such as insolvency proceedings or withholding taxes on capital income.

— Establishing a common European safe asset, with high trading volumes and low risk, which would help to contain price fluctuations during periods of turbulence, thus creating a safe-haven asset. Such a European asset would provide a common anchor to set the prices of the other financial assets on the continent. The Letta report suggests that a European safe asset could be created by centralising issuances from the various EU institutions: the European Commission, the European Investment Bank and the European Stability Mechanism/European Financial Stability Facility. In any event, this measure would be relatively limited in its capacity to create a large stock of European debt, compared with that of Member States. Specifically, the debt issued by the above institutions currently amounts to around €1.3 trillion, considerably less than the €2.5 trillion issued by Germany. The potential for this stock of European debt to grow significantly in the future will hinge on whether Member States can reach an agreement on a common instrument to succeed NextGenerationEU, which is by no means certain given the challenges in building political consensus on this issue in Europe.

Turning to payment systems, the report calls for the introduction of the digital euro. This would help strengthen the Single Market by two means. It would, for the first time, provide an interoperable digital means of payment covering the entire euro area and all transaction types (in person and virtual, and online and offline). It would also reinforce Europe's strategic autonomy by reducing the current reliance on entities from other jurisdictions.

The report presents a roadmap with ambitious deadlines for implementing the proposals, with several to be realised by 2025 (including the review of the securitisations regulatory framework, the pan-European stock market designed specifically for SMEs and the EU-wide long-term savings products), and all of them by 2027.

The Letta report is not the only recent paper calling for further development of the CMU. Others include statements by the ECB Governing Council, the Eurogroup (both in March 2024) and the European Council (in April), along with the report commissioned by the French government to Christian Noyer (also in April). The positions taken by the various national authorities in the current discussions suggest that reaching political agreements on most of the issues raised will not be straightforward. A case in point are the proposals to give ESMA centralised supervisory powers.

3.2 The role of public funding

The EU's investment needs are enormous, which is why public funding should be available to complement private investment. That said, perhaps the rationale for using public resources is above all strategic, tied to the perception that an active industrial policy approach is needed. This means using public resources to shape the sectoral structure of the economy as desired, especially in the current geopolitical context, and given that other jurisdictions are also employing public funding tools for similar purposes. In addition, the provision of certain investment goods (such as those associated with the green and digital transitions) is warranted by the resulting efficiency gains.

That said, although the report argues in favour a central fiscal capacity in the long run, this does not appear politically viable in the short term. Specifically, it would face resistance from certain Member States that view the Recovery and Resilience Facility as an instrument created in the specific context of pandemic, and argue that it should not have a successor going forward. Instead, the report proposes a temporary mechanism based on State aid for pan-European projects.

The Treaty on the Functioning of the European Union prohibits the provision of State aid (i.e. transfers of State resources to firms in the same country) due to its adverse effects on competition, although exceptions are made where aid is geared towards meeting objectives of common interest or correcting market failures. Moreover, the Commission has recently adopted a flexible approach here, granting exemptions to the rule in response to the pandemic, the energy crisis and, more recently, the risk of Europe's industrial base being eroded by domestic subsidies granted by the US and Chinese authorities. A case in point is the Inflation Reduction Act in the United States, where the aid mechanisms are based on tax credits for investment.

This string of events may well justify exemptions from the State aid rules. At the same time, sustaining such measures over time could adversely affect competitive market conditions by creating an uneven playing field within the Single Market, depending on the jurisdiction where each firm is based (since the fiscal space available varies across the different Member States).

Therefore, once it is recognised that public resources should be mobilised to support certain productive sectors, it is important to ensure this does not lead to fragmentation of the Single Market. The report's proposal involves combining stricter enforcement of State aid rules by each Member State with increased EU-level funding support. To this end, a mechanism would be introduced whereby the Member States contribute to a common fund for financing pan-European initiatives.

In addition, the report calls for a unified governance system for both pan-European and national State aid to ensure the efficient use of public resources. For EU-wide support, the report points to the current Important Projects of Common European Interest scheme as a model. This scheme requires that projects involve firms from more than one Member State and generate positive spillover effects for the remaining EU countries through value chains.

For many Member States, transferring part of their resources to fund pan-European State aid as an industrial policy tool is politically more acceptable than fully transferring European industrial policy to the Commission. However, there may still be opposition from Member States that have traditionally been more reluctant to grant State aid, either nationally or at European level, as well as from larger countries that might prefer to prioritise their domestic industry.

3.3 Improving investment efficiency

A sub-section of the Letta report describes actions in three areas designed to enhance the efficiency of both public and private investment spending: the circular economy, public procurement and administrative capacity.

3.3.1 The circular economy

This section includes strategies to extend the lifespan of products and use recycled materials in their production. This is particularly important for Europe, given its significant reliance on raw materials from other parts of the world. Additionally, the lower use of resources, which is associated with the circular economy, helps combat climate change. For these reasons, the report argues that circular economy considerations should be incorporated into investments made in Europe.

The proposed measures include requiring a certain percentage of recycled content in the production of some goods (similar to existing requirements for batteries and plastics). Such regulations have the potential to become a major catalyst for innovation.

Securing market financing for investments aimed at driving industrial-scale production of recycled materials might be difficult. The report therefore suggests complementing private funding with resources from certain European financial programmes, such as the EU's Innovation Fund or the European Investment Bank. Lastly, it suggests that public tendering processes incorporate circularity requirements to stimulate demand for such goods.

3.3.2 Public procurement

Public procurement has a key role to play in supply chains and stimulating productivity growth in Europe. However, the European Court of Auditors has highlighted several problems in public procurement. The procedures are too complex, which discourages SMEs from participating and leads to overly long procedures, with lengthy periods between the call for tenders and the contract award. Moreover, the lowest price award criterion tends to prevail, undermining quality and innovation, and hindering the development of local production chains that can compete with goods produced in third countries with less stringent labour and environmental standards.

To address these problems, the report recommends developing a regulation to limit Member States' discretion in setting public procurement conditions, thereby facilitating SMEs' access to tenders, in particular to those from other countries. In addition, the regulation should also establish requirements for contract awards so as to reduce the emphasis on cost in favour of other criteria, such as supply chain security, durability and innovation.

3.3.3 Strengthening administrative capacity

The report proposes setting up a new European facility to assist Member States in reforming their public administrations. This is seen as a necessary measure to maximise the impact of investment. This facility would provide support in areas including digitalising public administrations, modernising their management, updating civil servants' skills and improving cooperation among public administrations, particularly across different countries.

4 The importance of scale in the Single Market

This section of the Letta report begins by describing a readily verifiable stylised fact: on average, firms are significantly smaller in Europe than in the main competitor countries, especially the United States and China. According to the report, this has negative implications for innovation, productivity, job creation and, ultimately, European economic security.

The corollary to this is that increasing firm size could significantly help curb the EU's gradual decline in global relevance, which has been driven by unfavourable demographic developments in Europe and the rise of emerging economies. The report thus advocates policies aimed at increasing the average size of European firms, while ensuring that these measures are compatible with maintaining a competitive environment. As discussed in the previous section, one of the main obstacles to European firms' growth is a lack of available financing during the scale-up phase.

However, the report highlights certain productive sectors where economic policy decisions have prevented firms from operating outside the domestic market, which evidently limits their size. Specifically, when it was designed, certain sectors deemed of strategic national interest were deliberately left out of the single European market. These sectors were finance, electronic communications and energy, all of which are key enablers of activity for the economy as a whole.

The report argues that it is no longer appropriate for firms in these sectors to remain confined by national borders. Non-EU competitors in these strategic sectors are larger in scale, which enables them to achieve economies of scale that would also be available to EU firms in a fully integrated European market.

The Letta report also argues for a scaling up of firms in other sectors. First, the transport sector, which, for obvious reasons, can directly contribute to the integration of the Single Market. Second, the events of the current decade, beginning with the pandemic and later the war in Ukraine, suggest that health and defence are also strategic sectors, indicating that their services should be provided at the European level.

The recommendation to promote a scale-up in business size is not without controversy. From a competitive standpoint, it could be argued that having only a small number of firms in the market could reduce incentives to innovate.

Box 1 outlines the report's diagnosis of the current situation in each of these sectors in Europe, along with the corresponding economic policy recommendations.

5 Distributing the benefits of the Single Market broadly

This section of the report begins with the recognition of the fact that the benefits of the Single Market are not being distributed evenly across all Europeans, but rather accrue disproportionately to those better equipped to capitalise on the opportunities. These are more highly skilled individuals (who enjoy better employment opportunities in other Member States that are not their own) and large enterprises (which can more readily expand their operations across Member States more readily than SMEs).

These issues were recognised at the outset of the Single Market, driving the introduction of various tools intended to share the benefits more uniformly and, in particular, provide assistance to the most vulnerable regions. The cohesion policy is the foremost of these tools. The report argues that as the Single Market grows deeper, the policies designed to counter the unevenness of its impact on different groups must be reinforced. Failure to do so risks citizens becoming disillusioned with the European project. In particular, the text argues for the continuation of the cohesion policy, although it does not enter into the current debate on whether it should involve a greater degree of conditionality in the future.

The report identifies several areas of action that are somewhat disparate in nature, as detailed below.

5.1 Territorial inequalities and the “freedom to stay”

The report calls for policies to be put in place to create opportunities in declining regions, so that the people who live there are not forced to leave owing to a lack of job opportunities and access to education and other services in general. As the report spells out, the free movement of people in the Single Market must coexist with the freedom to stay. This discussion echoes the debate in Spain about cross-regional differences in demographic trends.[2]

The specific policies proposed in the report are as follows.

- Include territorial inequalities among the issues under multilateral surveillance integrated into the European Semester (part of the EU’s framework of economic governance intended to coordinate Member States’ economic and social policies). The rationale behind the proposal is the fact that competence for policies aimed at mitigating territorial imbalances lies fundamentally at national – not European – level.

- Strengthen supranational cooperation (especially between neighbouring regions belonging to different countries). To this end, the report first calls for cross-border projects to be given greater priority among those financed with European resources (compared with the current situation, where the share of

2 Banco de España (2021).

supranational projects financed under the cohesion policy and the Recovery and Resilience Facility is very low). Second, the report suggests stepping up interoperability projects for public digital services. It also calls for the European Commission to support the creation of permanent institutional arrangements between border regions. In addition, the report lends its backing to the proposal put forward by the European Commission in late 2023 for the creation of a single procedure that removes the administrative and legal barriers in cross-border regions. Lastly, it suggests lifting all the existing hurdles to cross-border work.

— Invest in digital infrastructures and skills as an effective way of empowering people to exercise their "freedom to stay".

— Provide services of general interest (digital communications, financial services, energy, sanitation, education) at affordable prices across the entire Union. This requires EU legislation to be prepared and then transposed to national legal frameworks.

— Implement policies to alleviate the shortage of affordable housing. Housing policy is a competence of the Member States.[3] However, as a European effort to address this problem, the report calls for a review of any EU legislation that may, in various ways, have an impact on Member States' housing markets.

5.2 The Single Market and social cohesion

— The report contains a number of proposals, mainly relating to employment, to combat the perception that the benefits of the Single Market are not shared equally by all European citizens.[4]

— Ensure an ambitious transposition into national legislation of a number of European texts aimed at strengthening protection for workers (such as the Directive on adequate minimum wages and the Council recommendation on strengthening social dialogue in the EU).

— Extend the system by which professional qualifications earned in a Member State can be automatically recognised in other Member States, allowing better mapping of labour demand and supply across the Union.

— Create a single administrative procedure across the Union to comply with the rules on posted workers (i.e. those sent by their employer to work in another Member State). This goal is motivated by the complexity of these procedures in some countries.

3 Banco de España (2024b) explores Spanish housing affordability problems and outlines the necessary aspects of any public policy that intends to tackle the problem.

4 However, it does not address the profound change that the labour market may undergo in the future as a result of technological and demographic shifts under way. See Banco de España (2024a).

— Remove barriers to the recruitment of skilled workers from third countries.

— Introduce measures to ensure that the free movement of workers is not used by some employers to relocate their operations to EU countries with more lenient labour regulations. To that end, the report advocates bolstering the powers of the European Labour Authority, the body entrusted with ensuring equal labour conditions across the Union in terms of, for example, occupational safety.

— The report calls for several measures that are all intended to encourage the development of social economy actors (covering a wide range of activities and organisational models). These measures include developing mechanisms to facilitate their access to finance and their participation in public procurement.

5.3 Support for business and, in particular, bolstering SMEs

European firms must contend with highly disparate regulations across different Member States, concerning, among other issues, administrative requirements, legal arrangements (e.g. in the event of insolvency), customer protection and even product labelling. This regulatory disparity is highly burdensome for firms that wish to expand their activity abroad, given the difficulties in accessing information on the legal regulations of each country and then complying with them, making such expansion very costly in terms of human and financial resources.

Ultimately, these form a roadblock that fragments the Single Market and constitutes a major obstacle for European firms expanding their activity beyond their country of origin. In addition, the report argues that, as a large portion of these costs are fixed, irrespective of the size of the company's cross-border operations, SMEs are particularly negatively affected. This discussion echoes the debate in Spain, where it has often been argued that certain aspects of regional regulation could encourage fragmentation of the national market.

The aim, then, is to harmonise, streamline and reduce the complexity of national regulatory procedures. One of the report's key recommendations offers an alternative to the costly harmonisation process: enact a European Code of Business Law enacting new business rules in addition to the 27 existing national laws; an idea it terms a "28th regime". This is a highly ambitious proposal that, if undertaken, would mean that European businesses could choose to be governed by either national or European legislation. By selecting the latter, a firm could ease its regulatory burden, avoiding the need to comply with the different legal regimes of multiple Member States.

Creating this new legislation is a complex process that cannot be completed quickly. As a result, the report argues that the provisions of the new European Code of Business Law should replace national regulations governing those areas for which the EU is exclusively responsible. The report also recommends taking action in the two areas it deems most critical: cross-border service provision and tax harmonisation.

With regard to the integration of services markets, among other actions, the report proposes that the European Commission make greater use of its powers to overcome the lack of political will to remove the remaining barriers (which generally stem from the uneven transposition of the Services Directive), making greater use of procedural infractions if necessary.

As regards tax fragmentation, the report argues that the lack of harmonisation of tax systems constitutes a major obstacle to the effective functioning of the Single Market. The proposals made to combat this fragmentation include the following.

— The VAT rules in force ensure a reasonable degree of consistency across national systems (in terms of tax rates, tax bases, exemptions, etc.), while granting countries some room for manoeuvre. The issue that needs to be addressed is the significant complexity of the administrative procedures in place to comply with tax obligations for cross-border transactions.

— Excise taxes on energy pose an obstacle to the Single Market, owing to the proliferation of national exemptions following the energy crisis caused by the war in Ukraine.

— From a more general perspective, the report proposes using Article 116 of the Treaty on the Functioning of the European Union to accelerate tax harmonisation (in principle, tax harmonisation requires unanimous approval from all Member States; however, applying Article 116 would only need a qualified majority). This article, which addresses situations in which disparities between the legal or regulatory provisions in different Member States distort the conditions of competition to such an extent that they impede the proper functioning of the Single Market, could be applied in two specific situations:

  - To unify the criteria for determining the corporate tax base (possibly with differentiated frameworks for large corporate groups and SMEs) in order to limit tax competition.

  - To simplify the withholding taxation on dividend and interest income received by foreign investors, with a view to encouraging cross-border investment.

5.4 Strengthening consumer protection

— Removal of the obstacles that, despite the approval of the Geo-blocking Regulation in 2018, still hinder consumers in one Member State making online purchases from retailers in another.

Lastly, to give this set of initiatives decisive momentum and visibility, the report proposes the appointment of a Vice-President under the next European Commission, whose responsibilities would include cohesion policies, the provision of services of general interest and support to SMEs.

6 Reviewing European legislation

European firms often complain that burdensome regulations and excessive red tape undermine their competitiveness, acting as a major brake on the smooth functioning of the Single Market and the dynamism of the European economy. The report diagnoses the following two problems.

— Overlapping regulations, which hamper firms' activity, insofar as they create legal uncertainty and give rise to inefficiently high spending on regulatory compliance, thus undermining the competitiveness of European companies. These costs are particularly burdensome for SMEs and indirectly favour non-EU competitors.

— The practice of "gold plating" (i.e. Member States adding additional requirements to EU directives beyond what is stipulated) results in greater fragmentation of the Single Market, creating uneven playing fields across Member States.

Following a firm commitment by the President of the European Commission, Ursula von der Leyen, during the last legislative term, to simplify regulatory burdens, the report makes a series of related proposals split into five sections. The first four mirror the chronological phases of rule design, adoption, implementation and enforcement. The fifth addresses initiatives to simplify existing regulations.

6.1 Design

— The report suggests, first, speeding up and simplifying the consultation processes that precede the drafting of proposals with the aim of eliminating redundancy and, second, fostering the participation of interest groups that tend to be less active (consumer associations, environmental groups, SMEs, etc.).

— The report calls for the streamlining of, and greater transparency in, impact assessments, with more involvement from the European Commission's Joint Research Centre. To this end, it is proposed that each impact assessment should analyse a list of possible economic policy alternatives, setting out their advantages and disadvantages, rather than evaluating a single course of action.

6.2 Adoption

— Under the ordinary legislative procedure, the European Commission drafts legislative proposals, which are then discussed separately by the two co-legislators, i.e. the Council of the EU (consisting of government ministers from each Member State) and the European Parliament. To use a simplified description of the procedure, each of these two institutions can propose amendments to the Commission's draft proposal. Finally, negotiations take place between the two co-legislators to see if they can agree on a complete set of amendments. The Letta report argues that the outcome of the procedure is sometimes suboptimal, owing to the absence of a sufficiently rigorous analysis of the implications of the amendments. This ultimately results in the rules adopted reflecting complicated balances of power rather than a sound decision-making process grounded in the available evidence. The report proposes that the assessment of these amendments be done through a simplified update of the original impact assessment of the Commission's proposal. This approach would ensure that legislative negotiations are guided by a clear understanding of the impact of the proposed changes (whether economic, social, environmental, etc.).

— To safeguard the Single Market, the report calls for the introduction of what it refers to as the "principle of non-regression". Under such a principle, the legislative process must be guided by Article 1 of the Treaty on European Union, under which Member States commit to "creating an ever closer union among the peoples of Europe". In order to uphold this principle, the report calls on the Commission to exercise its power to withdraw a legislative proposal if it considers that the amendments introduced by the co-legislators threaten the Single Market.

— To tackle gold plating, the report calls for a reaffirmation of the "Delors principle", which advocates for maximum harmonisation of essential provisions. In practice, this translates into one very important recommendation: prioritising regulations over directives for adopting Single Market-related rules because regulations are directly applicable in all Member States, whereas directives require transposition into national law. This transposition potentially allows for the inclusion of requirements beyond those laid down in the directives themselves.

6.3 Implementation

— There is currently a mechanism (SOLVIT) that European citizens and businesses can use when they perceive their rights to have been breached by authorities in a Member State other than their own. In particular, they can submit a claim to SOLVIT when they consider that they have been affected by obstacles to the Single Market. The report proposes elevating SOLVIT's legal status to increase its operational capacity and standardise the criteria applied by different national SOLVIT offices.

6.4 Enforcement

— Use AI to detect breaches of Single Market rules.

— Improve infringement procedures, in particular to speed up their processing and result in sufficiently dissuasive penalties, which is not the case at present. The report proposes creating a specific agency to this end.

— In the next Commission, appoint a dedicated Vice-President for the Single Market, specifically tasked with serving as the role of Chief Enforcement Officer.

6.5 Simplification of existing regulations

— Recast of legal rules that cover the same ground.

— Adopt a horizontal legislative instrument to reduce firms' reporting obligations.

— Accelerate the digitalisation of administrative procedures, with two key initiatives: increase the pace at which different European public authorities are signing up to the single digital gateway known as the Once-Only Technical System (which allows information on different administrative procedures in any EU country to be submitted just once) and establish the EU Digital Identity Wallet so that citizens and firms can reliably identify themselves vis-à-vis any European public or private body.

7 The external dimension

The section in the report that addresses issues beyond the Single Market's borders is split into two parts, with suggestions relating to trade and financial links (between Europe and the rest of the world) and the EU enlargement process.

The first part begins by explaining why global concerns (particularly regarding trade and financial flows with the rest of the world) are increasingly central to discussions on how the Single Market is structured. On the one hand, the current fraught geopolitical scenario is prompting reflection on the desirability of reducing the interdependence between the European economy and the rest of the world owing to economic security considerations. On the other hand, climate change is a global problem that requires a response at that same global level. This has already led to the recent adoption of some legislation in Europe, including, but not limited to, the European Critical Raw Materials Act, the European Chips Act and the Net-Zero Industry Act.

In addition, early 2024 saw the Commission issue a statement launching a set of initiatives aimed at strengthening economic security. These initiatives relate to the screening of foreign direct investment in Europe, assessing the risks associated with European outbound investment, controlling exports of dual-use goods[5] and encouraging R&D spending on dual-use technologies.

The report makes several more proposals:

— Create a new council – to be called the Economic Security Council – in addition to those already in place within the Council of the European Union. Individual Member States would then appoint an Economic Security Minister. The aim is to provide a coordinated response to the challenges in this area, since acting in unison would protect individual Member States against possible hostile measures taken by third countries.

— Enhance methodologies for identifying and mitigating risks associated with certain critical technologies, such as semiconductors, AI, quantum computing and biotechnology. In particular, the report calls for the private sector to be fully engaged in this effort.

This section of the report pays particular attention to the recent erosion of the EU's historical ability to set international trade standards. In particular, several countries have taken a critical stance towards the EU's inclusion of strict environmental and social standards in bilateral trade treaties, which they tend to view as protectionism. The report calls for a more pragmatic approach to be taken in this area.

5 I.e. products that have both military and civilian applications.

The report also suggests giving the European Parliament a greater role in international treaty negotiations. The aim is to prevent national parliaments from imposing additional conditions on those agreed at European level, which in the past has hindered the adoption of the corresponding agreements.

The report also argues for greater use of economic diplomacy, promoting strategic partnerships with third countries. This would help mitigate the impact of recent instances where certain countries have used their wealth in the natural resources that Europe needs to wield bargaining power.

Lastly, the report calls for the development of a Transatlantic Single Market, encompassing the United States and the EU. The document recognises, however, the difficulty of moving forward with such a proposal in the current context.

Second, regarding enlargement, the report calls for prospective Member States to gradually gain access to the Single Market before full accession. Furthermore, this should start with those elements that can deliver the greatest and most immediate benefits to candidate countries, thus boosting the population's acceptance of EU accession and reducing the associated social cost. This is also the rationale behind the proposal to create a solidarity mechanism for enlargement to offer financial support to those most affected by the costs of EU membership.

Enlargement also needs to be accompanied with a number of conditions that candidate countries must meet in advance. Together with strict compliance with the obligations arising from the rule of law, the report argues that a country in receipt of EU funds must first build up the necessary administrative and institutional capacity to absorb those funds.

8 Conclusions

The Letta report comprehensively describes why improving the Single Market should be a top priority in the next European legislative cycle. The text usefully sets out the areas in which the Single Market, now 30 years old, displays shortcomings that undermine well-being in Europe. It also effectively describes how deepening the Single Market can help address the major challenges of today's world, such as the climate transition, technological transformations and geopolitical shifts.

It offers a comprehensive roadmap of proposals for achieving the priority objective of strengthening the Single Market. Accordingly, the report is set to play a major role in setting the EU's strategic economic policy agenda in the coming years. That said, the report cannot be considered the definitive answer to the challenges faced by Europe, but rather a starting point for the discussion.

First, the report provides many suggestions based on plausible descriptions of causes and effects. However, these proposals should ideally be verified by means of rigorous economic analyses prior to any implementation.

Second, despite its exhaustiveness, there are issues that are not addressed in the report. A case in point is the banking union. Two of its pillars, the Single Supervisory Mechanism and the Single Resolution Mechanism, are operational, but the third – the European deposit insurance scheme – is as yet incomplete. Completing the banking union is a necessary condition for the creation of an effective single market for banking services with pan-European banks. Moreover, in the absence of the single deposit insurance scheme, the response to severe crisis scenarios is likely to remain somewhat national in tone rather than European, making it impossible to fully prevent instances of financial fragmentation. This would lead to uneven financing (and, thus, competitive) conditions across countries, thereby undermining the Single Market.

A second issue that is not given extensive consideration is how to fund the various initiatives. Many require additional resources at European level for their implementation. However, the report largely skirts the debate surrounding joint debt, with the exceptions of the relatively vague mentions of the role of a central fiscal capacity for the long-term financing of industrial policy and a potential increase in green bond issuance, along with the more explicit mention of the possibility of issuing Eurobonds to finance defence spending, conditional on the previous establishment of plans for repayment upon their maturity

It is in this latter context that the report makes its only allusion to the EU budget, noting that one option may be to establish "viable strategies for augmenting the EU's own financial resources". However, it is very likely that the debate on the EU budget will heighten in view of the drafting of the next Multiannual Financial Framework, which will see the enlargement to the east account for considerable resources. This will likely confront European governments with politically complex dilemmas, perhaps including the need to make far-reaching changes to some flagship European policies, such as the common agricultural policy or the cohesion policy, or to raise additional resources for the European budget, whether by increasing national contributions or introducing the EU's own sources of funding.

If the report's recommendations are to be successfully implemented, political will is essential. It is relatively easy to agree on the diagnosis and overarching objectives, which explains why national authorities have embraced the broad strokes of the report's recommendations. However, it will undoubtedly be much more difficult to reach agreement on specific steps, since Member States' preferences do not perfectly align.

The main difficulty lies in creating mechanisms that help make the short-term costs of some specific initiatives more bearable for each country in return for greater benefits over a longer time horizon. There is no magic formula to achieve this, as these advantages are normally realised over time periods longer than the length of the policy cycle.

Nevertheless, it might be useful if the reforms are negotiated as broad sets of actions, such that every concession a country makes in one area can be set against a benefit gained elsewhere. The fact that the report's recommendations are coming at the beginning of a new European Commission mandate should help, to a certain extent, to make them easier to apply, given the Commission's right to initiate the legislative process. Therefore, concrete proposals should be submitted quickly (while allowing enough time to carry out the prior impact analyses).

Lastly, authorities reaching out to and persuading European citizens of the benefits of the reforms could further facilitate the implementation of the initiatives contained in the report.

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Box 1
SECTORAL RECOMMENDATIONS

Telecommunications

Diagnosis:

- Pro-competition regulations have been useful in each domestic market to foster technological progress and reduce the cost of consumer services.

- However, large domestic players argue that the high degree of competition created in each country by the regulatory framework in place has squeezed their margins, which reduces the resources available for new infrastructure investment and, in the future, will tend to result in lower-quality services. This line of argument (which is not usually shared by industry regulators and the non-dominant players) has led them to call for a change in competition rules which, in particular, allow national mergers of firms. The report is in line with this view.

- In any event, as a result of the regulations there is not one single European market but 27 independent domestic markets. If the European Union (EU) were deemed to be the relevant market, there would be, most likely, an inefficiently high number of players.

- Lastly, developments in global digital markets have prompted an unbalanced relationship between telecommunication firms and online platforms with the balance of power tipping in favour of the latter.

Objectives and instruments:

- Establish a single European market which allows operators to achieve economies of scale and benefit from the resulting lower costs. It is argued that, even after the subsequent cross-border mergers, the larger market would allow for both higher competition and the generation of incentives for the investment needed.

- Transform the current regulatory model as a prerequisite for creating that single European market. In the absence of regulatory harmonisation, potential national mergers would not foster the creation of a single European market and ultimately there would be a risk of lower levels of competition. In particular, the report calls for replacing the current model – based on very loose cooperation between national regulators – with a new two-layered model. First, the Commission would be given regulatory powers on transnational services and networks. Second, national regulators would be responsible for local services and networks and consumer protection. The Artificial Intelligence Act and Digital Services Act, which confer extensive regulatory powers on the Commission, or even the distribution of competences in the Eurosystem between the European Central Bank and national central banks, are quoted as models in this regard.

- Harmonise radio spectrum allocation rules across countries. According to the report, this is a necessary condition for mobile operators to be able to offer pan-European services. In addition, there are calls for spectrum auctions not to be designed on the basis of revenue maximisation since that could be detrimental to further investment needed.

- Pay more attention to cybersecurity and digital sovereignty. This embodies the perception that there is a need to increase strategic autonomy which, in particular, must take the form of supply chain management based on trusted suppliers.

- Correct the imbalance in power between telecom operators and big tech companies (which has already been started by the digital market and service laws).

Energy

Diagnosis:

- Energy was one of the sectors kept outside the perimeter of the Single Market at its inception. However, since the launch in 2015 of the Energy Union Strategy, important – albeit incomplete – steps have been taken to integrate national energy markets.

- Energy costs in Europe have remained, after the recent crisis, higher than in other jurisdictions.[1] Moreover, divergences between electricity prices in individual Member States have increased. These two developments result in a loss of competitiveness, which is particularly severe in energy-intensive industries and more pronounced in countries where price levels remain high.

Objectives and instruments:

- Integrate national energy markets (particularly, in the case of electricity). Integration is even more desirable against the backdrop of the economy decarbonisation process given that, as a result of a hypothetical full integration of national electricity markets, the share of renewable energies in total electricity generation would be higher and, moreover, the network roll-out costs would be smaller, because lower aggregate European investment in wind turbines and solar panels would be necessary. Naturally,

1 Banco de España (2023) analyses the consequences for Europe of the recent energy crisis, focusing on Spain, and examines the challenges outstanding.

integration requires the construction of interconnections. The latter limit storage needs and provide more certainty about the volume of energy produced and its price and, consequently, reduce investment risk, fostering private capital inflows. That said, a prerequisite for the roll-out of interconnections is generating mutual trust between Member States to dispel an individual country's fears of ensuring security of supply under stressed conditions.

— Synchronise energy planning across energy sources and countries.

— Introduce additional instruments to finance cross-border infrastructures. Specifically, in a context of limited public resources (due to the lack of fiscal space in many countries) and scant private resources (since the projects are on a large scale with high risks), it is proposed that EU-wide green bonds be issued.

— Increase security of supply. In particular, three aspects are mentioned:

- An energy system including many small installations is subject to a high risk of sabotage or unauthorised data access. This warrants the implementation of strict cybersecurity measures in the development processes of new infrastructures or generation assets.

- Rigorous application of the rules for monitoring foreign direct investment in the European energy sector.

- For the energy transition, diversification across several countries of the supply of critical materials that Europe does not produce (and refocusing on more trusted suppliers).

— Communicate effectively to third countries the foundations of the Carbon Border Adjustment Mechanism in order to prevent disputes and friction with them.

Defence

Diagnosis:

— European countries have not invested enough in military equipment and defence over the last three decades, which has led to limited production capacity and high reliance on imports.[2]

— However, at the same time, military equipment is usually purchased nationally from a local industry, if one exists.

Objectives and instruments:

— Pool the production of military equipment in Europe so that there are pan-European manufacturers which satisfy the demand of the individual Member States, to achieve the related economies of scale.

— Put in place arrangements to ensure that there is cross-Member State cooperation on defence to dispel the possible concern of non-arms producing countries that arms may not be available in times of need.

— Make the whole defence supply chain European. There are two reasons for doing so: first, to encourage strategic autonomy and second, perhaps less controversially, to contribute to the re-industrialisation of Europe.

— Develop the means required to finance greater future defence efforts. The report considers several alternatives: the possibility of issuing defence Eurobonds (the future repayment of which could require setting up channels to increase the EU's own financial resources), creating a specialised credit line by the European Stability Mechanism for defence, adapting the European Investment Bank's policies (beyond current dual-use project finance) or granting public guarantees to lending to finance investment by companies in the sector.

Space

Diagnosis:

— Space activities have traditionally had a national and public focus (given their strategic nature) and public funding is earmarked for the respective national industries.

— Space activities are one of the areas where, as a result of recent geopolitical developments, the pursuit of greater strategic autonomy has been more intense.

— As a result, the production of dual-use goods is increasing in this area (but, unlike other jurisdictions, military uses are less developed than civilian ones in Europe).

Objectives and instruments:

— Step up coordination among the various European institutional actors operating in this area.

— Reduce the scope of application of the so-called "geo-return method", whereby the resources that a

2 López Vicente, Rodríguez Vives and Rojas (2024) discuss various proposals on the joint and coordinated provision and financing of this European public good.

Member State allocates to European Space Agency programmes are channelled, in the form of contracts, to companies located in the same country.

— Use the proposals on the capital markets union and Europe-wide public procurement arrangements included in the report to develop the aerospace industry.

Health

Diagnosis:

— The EU is overly (and increasingly) reliant on external suppliers of active drug components and vaccinations.

— There is no single market in the pharmaceutical sector on many fronts: some authorisations are still granted at national level, the population of individual countries has uneven access to different treatments because the relevant policies are not uniform, etc.

Objectives and instruments:

— Boost European capacity for drug research and production.

— Invest in disease prevention technology: artificial intelligence, robotics and telemedicine can improve patient screening, which is profitable in the long term (since undetected illnesses increase subsequent treatment costs).

— Encourage European-wide (instead of national) clinical trials to reduce their cost.

Transport

Diagnosis:

— Certain strategic developments in the transport sector mesh well with the agenda to transition to a green economy.

— But to date progress towards the so-called Trans-European Transport Network (TEN-T), an integrated European intermodal transport network, has been limited.

Objectives and instruments:

— Rail transport: remove technical and regulatory barriers to the integration of national rail services, facilitate access for non-national operators to passenger and freight transport and establish a pan-European high-speed rail network connecting major cities.

— Road transport: complete the liberalisation of freight and passenger transport by road (currently not fully open to competition from suppliers from other countries) and develop electric vehicle recharging networks.

— Air transport: increase coordination between national air space managers, in order to deploy more advanced and interoperable technologies.

— Maritime transport: carefully design its integration into the Emissions Trading System to prevent the ensuing higher costs from reducing EU sea freight and shifting it to road transport or to sea transport between non-European ports.

— Urban mobility: promote active mobility (walking, cycling), strengthen public transport, standardise the rules for the movement of cars in low emissions zones across the EU.

— Financing: increase the resources of the Connecting Europe Facility (CEF), which is the vehicle currently in place to finance the TEN-T, and complement the CEF with other sources of funding (national budgets, private investors).

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