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Thinking ahead for Europe

The Multiannual Financial Framework post-2020:

Balancing political ambition and realism

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The EU budget is suffering not simply from a technical crisis, but rather from a deep crisis of trust on the part of EU citizens. Public support for the mainstream political class in general and the EU institutions in particular is rapidly waning. Restoring this trust is the single-most important task in countering rising populism and the forces intent on dismantling the European Union. This paper argues that the EU budget offers one of the most visible tools available to express the principles of the European Union in concrete action; its improvement is therefore essential for building trust. It aims to offer food for thought to promote reflection on the future of the budget, in view of the challenges facing the EU.

1. Setting the scene

The current situation reveals a growing disconnect between expectations of the EU budget, its structure and its financial capacity. The budget is facing an unprecedented challenge, financially and politically. The general consensus is that it needs to be reformed in terms of expenditure and resources, but member states are loathe to pay more into the EU, to lose funding allocated to them or to allow the creation of genuine resources for the EU budget. They respond in the affirmative to change, as long as this entails little change for them.

To undertake meaningful reforms of the EU budget, there is a need to clarify what the EU budget's primary functions should be in a modern Europe, and for member states to accept that there will be a change in the way in which the budget functions and the finances are allocated and collected, including the rebates and budgetary compensation. The political mind-set towards the EU budget has to change. The instrument is a key element of the image of the European Union, and the image of the EU budget is very poor at the moment. Business as usual is not a viable way forward.

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2. Reviewing some basic functions of the EU budget

It is clear that the EU budget should support EU objectives. On specific budgetary items, the Treaty is rather vague. However, the consolidated Treaty of the European Union (TEU) clearly states that the EU should promote economic, social and territorial cohesion and environmental protection. The consolidated Treaty on the *Functioning* of the European Union (TFEU) mentions the need for social, regional and cohesion funds, as it does for research and development. For external action, the TFEU also identifies the need for budgetary capacity. For agricultural policy, the TFEU requires this to be a fully common policy with a set of common objectives, but it does not specify that there should be a common budget for it.

We can thus clearly state that the EU budget is required to have funding to cover territorial cohesion, research and external action. In other areas, however, it is less clear *how and who* finances them. The treaties are not overly prescriptive on *what* the EU should finance and what size the budget should be.

3. What basic principles should guide the EU budget?

The following principles are recalled for their particular importance and policy implications:

- *Subsidiarity*. The level of governance (and thus also the financing) should be taken at the level of governance that is most effective.
- *Additionality*. Expenditures should create additional benefits (i.e. not substitute for expenditures expected to be paid from national budgets).
- *Solidarity*. The EU budget should support regions in financial difficulties.
- *Effectiveness and efficiency*. These principles are similar, but they have different meanings. A high-speed train might be fast, and thus effective, in transporting passengers to their destination, but if there are too few passengers it will be highly inefficient as an investment.
- *European value added***.** The EU budget should finance interventions that have a European rather than local value added.

4. What are the new challenges affecting the budget?

The objectives of the EU and the EU budget have changed and increased over the years, but the structure of the budget has not kept pace with changing circumstances. When the financial and migration crises hit, the EU and its budget were not up to the challenge, damaging the credibility of the Union and the credibility of its financial arm, the EU budget.

The budget was ill-prepared to manage the shocks, but particularly damaging was the extremely weak funding for our common borders, a quintessentially EU-level task with a very low budget. Scrambling to secure the necessary resources required considerable time, damaging citizens' perceptions of the EU in the process. It is fair to say that the EU budget's mechanisms and the meagre allocation to the Justice and Home Affairs heading reflected a lack of interest on the part of member states in EU-level non-pre-allocated funding. To reserve the income for agriculture and cohesion policy headings meant that needed expenditures for Justice and Home Affairs were sacrificed in the hope that if nothing happens, the EU might muddle through. The migration crisis and tensions in Ukraine triggered loud wake-up calls that the EU budget needs to focus on Europe's greatest concerns.

Below are some additional risks the EU budget currently faces:

- *Increased global instability,* which puts the EU at risk of further migratory pressures and security threats.
- *Increased climate change-related extreme natural events.* The rate and violence of extreme climatic events have increased markedly in recent decades and are expected to worsen. The EU budget may face increased demands to intervene within the EU and in external action whenever such events occur.
- *Brexit* is creating economic uncertainties and will also affect the size of the EU budget and its distribution.

5. Main issues to be addressed for post-2020

The points above set out the principles and challenges ahead, leading us to these questions:

- Do we have a budget that can cope with the new objectives and challenges ahead?
- What are the reform processes in motion?
- What should the EU budget aim to address?
- What should be the focus of reform for the period 2020?
- What is the role of the financial instruments and the European Fund for Strategic Investments (EFSI)? Can they meet the financial challenges ahead?
- How should the budget be financed? Does Brexit cause a major disruption to the budget?

5.1 Do we have a budget capable of coping with the new objectives and challenges ahead?

The answer is probably no. Fundamental problems affect its capacity to function in line with changing and growing needs. These problems are to a large extent an historical outcome, but they nevertheless need to be urgently corrected, as discussed below:

- *The EU budget structure is outdated*, based on decisions and priorities that were central in the 1970s and 1980s. Over the years, the budget has undergone many reforms, but they have been boxed into a pre-existing structure and set of priorities that were created in response to completely different circumstances. The world has since changed but the budget has been very constrained in its ability to intervene. Headings under research and development, cross-border infrastructure, internal policies and external action have failed to provide the necessary funds to address the modern challenges the EU faces, such as the very difficult threats in matters of security and migration.
- *The EU budget is too rigid.* It was unable to react in a timely fashion to the financial and migration crises, giving citizens the impression not only that the EU does not protect them, but that it even exposes them to shocks. From the point of view of citizens, the EU budget itself has appeared inappropriate and unable to react.
- *The size of the EU and its objectives have increased markedly in the last two decades, while its share of EU GNI has fallen.*

- *The budget has been mainly based on politically pre-allocated funds.* It is not designed to handle rapidly changing circumstances and needs. While the EU budget has to support the objectives of the Treaty, numerous challenges are better treated at EU level that have not been covered adequately in the financial rules and allocations.
- *The budget's effectiveness is undercut by an excessive net-balance approach*, making it very difficult to direct funding to new priorities and emerging EU-wide objectives.
- *The EU budget has not been sufficiently efficient or effective*, thereby damaging its image. Despite a large number of reforms, the reputation of the EU budget is still in need of improvement.
- *Based on the subsidiarity and EU value-added criteria, some of the objectives and supported measures are questionable.*
- *The large number of reforms, new rules and financial mechanisms have increased the complexity for beneficiaries*, and in some cases have de facto reduced access to funds for some groups. The right balance between the efficiency and cost of controls needs to be struck.

5.2 *What are the reform processes in motion?*

Despite the critical assessment above, the EU budget has already undergone a number of reforms. The MFFs of 2007-14 and 2014-20 have seen big advances in reforming budget operations within the headings and shifting the focus on European value added, or more prosaically, in financing EU-level objectives. Budget lines have been streamlined and certain requirements for EU objectives have been earmarked, such as for climate change and innovation. The following processes are also now in motion:

- *The mid-term review*. The European Commission released its mid-term review in September.[1] It is undoubtedly a promising step to improve the functioning of the budget and address unexpected eventualities, but it is not yet a 'revision' of the measures in the EU budget, and with good reason. A major budgetary reform in the middle of a programming period is unwise. What the review addresses is the capacity of the budget to respond to changes in priorities and needs while reinforcing effectiveness and efficiency. In the next multiannual financial framework the instruments can be improved further.
  - The document presents a thorough analysis of the 2014-2020 progress in implementation.
  - It proposes detailed reforms to allow the budget to function until 2020, including additional tools to address unforeseen events and ensure budgetary stability.
  - It proposes new tools to increase simplification, effectiveness and efficiency.
- ***The High Level Group on Own Resources*** will release proposals for a reform of the Own Resources by the end of 2017.

In addition, the European Commission will prepare the ***proposals for the next MFF***, a key instrument to change the EU budget into a financial instrument able to cope with the modern challenges of the EU. These reforms may change the mind-set that dominates the budget,

[1] Mid-term review/revision of the multiannual financial framework 2014-2020: An EU budget focused on results, COM(2016) 603 final, 14 September 2016.

namely the rigid pre-allocation of 80% of the budget and the net balance focus of member states.

5.3 What should the EU budget aim to address?

This is an important question, and there is no clear answer, but we should reflect on the need to put in place a budget that:

- *Addresses the concerns of citizens, in symbiosis with national budgets*

Symbiosis means *de facto* to apply better – not more and not less - the *subsidiarity and additionality principles*. The EU budget should not be used to finance what can be done locally, but rather to intervene in circumstances where national budgets are unable to cover EU objectives. It could complement national budgets.

- *Enhances the value of EU membership and demonstrates the benefits of pooled resources*

The EU has not managed to convince governments of the benefits of a common budget and the savings it can bring. Savings from common action are high in the case of research, for example. But the same should be true of common borders management, police and intelligence cooperation. Savings are important in all cross-border collaboration.

In drafting the future EU budget, the following additional questions should be considered:

- What is the best method of governance to achieve different objectives and policies?
- How should the current policies be adjusted to better reflect new needs?
- Should the EU budget have more expenditure in areas of central management, i.e. not pre-allocated funding?
- Should the size of the EU budget remain the same, grow or shrink, despite the increased need in the areas of border controls, migration and security?
- If so, should the EU budget fully finance the Common Agricultural Policy? Could this policy be financed based on a *co-financing system using the principle of solidarity*, i.e. to support those countries where the fiscal capacity is lower to pay the direct payments?
- What kind of expenditure levels and what implementation modes/governance are needed in the area of external action, particularly if the EU wants to address the roots of migration?
- How will the EU reach its climate and energy objectives?
- How can the budget react to potential additional crises, such as the migration crisis? Is the proposal to create a European Union Crisis Reserve adequate in itself or will it need to be enhanced?
- How can the budget ensure that it fulfils the required interventions?

5.4 What should be the focus of the reform for the post-2020 period?

The budget is still seen by many as a budget to secure additional funding for national or regional objectives, rather than a budget to deliver the EU's needs and objectives.

With a constrained budget, it is imperative that it focuses on areas where common action is most needed, i.e. those actions with a high *European value added (EVA),* with some exceptions in the area of Cohesion Policy. However, as pointed out by a number of academics,[2] it is difficult to agree on the meaning of EVA. Without clear criteria, most expenditures can be given a 'European value added' stamp. The qualifying criteria need to be identified. Some potential criteria were listed in a briefing for the Dutch Presidency Conference in January 2016,[3], which could be identified with the public goods nature of the expenditures, their wider value at EU level, as well as considering the solidarity aspects and the link to EU objectives.

5.5 What role for the financial instruments in the future?

The EU increasingly relies on financial instruments to cover the additional needs of the EU budget. The latest introduction of the EFSI (European Fund for Strategic Investments) has considerably expanded the non-grant financial operations of the EU. Some have seen this as a way to expand the reach of the EU budget with limited funding, but there is also the view that financial instruments can replace grants and reduce the EU budget.

Financial instruments are important to ensure that the EU budget only offers grants when projects are of high public value and that the services generated will not be financed by the private sector. The financial instruments complement, but do not substitute for grants, or at least the substitution is limited.

In fact, as confirmed in the independent report to the High-Level Group on Own Resources,[4] the EFSI and other financial instruments tend to work better in attracting finance in economically advanced EU member states. Until now the main beneficiaries have not been the countries receiving high cohesion fund support and this is partially due to the nature of these instruments and the simple fact that the risk levels in problem areas keep investors away.

In addition, detailed concerns were also raised by the Court of Auditors.[5] This report shows that too many expectations have been placed on financial instruments while the actual implementation showed those to be often oversized, leading to lower-than-expected leverage. The present MFF and the mid-term review propose improvements to remove some barriers for the efficient implementation of financial instruments. While financial instruments are an important complement to grants, those cannot substitute for grants in many cases, especially not in underdeveloped areas. These instruments can play an important a role, but they do not fit all needs.

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[2] See D. Tarschys (2005),"The Enigma of European Value Added, Setting Priorities for the European Union", SIEPS Report 2005:4, Swedish Institute for European Policy Studies, Stockholm; J. Núñez Ferrer and D. Tarschys (2012), *Investing where it matters – An EU budget for long term growth*, CEPS Task Force Report, CEPS, Brussels, and F. Heinemann (2015), "Strategies for a European EU Budget", ZEW Mannheim and University of Heidelberg Working Paper, November.

[3] J. Núñez Ferrer (2016), Briefing on the Multiannual Financial Framework, presented at Dutch Presidency Conference, Amsterdam, 28 January.

[4] J. Núñez Ferrer, J. Le Cacheux, J. Benedetto and M. Saunier (2016), "Study on the potential and limitations of reforming the financing of the EU budget", Report for the High-Level Group on Own Resources.

[5] European Court of Auditors, "Implementing the EU budget through financial instruments - lessons to be learnt from the 2007-2013 programme period", Special Report No 19/2016.

In any case, the financial instruments should be made more compatible with the EU grants, to make it easier to combine them. This would increase the return on investment of EU projects, ensuring that elements that can be financed by the financial sector are done so. Proposals to this end have been tabled, but will those be enough?

There is a need to streamline the grant and financial instruments to make them more accessible and able to be easily combined. The Budget review proposal offers important reforms to improve these instruments in these areas.

5.6 How should the budget be financed?

This paper does not focus in particular on own resources, but there is one issue to reflect upon. Governments have the ability to use fiscal tools to induce changes in behaviour that is consistent with their objectives. But these important tools are not available to the EU, despite the fact that it seeks to achieve a number of objectives that could be advanced appropriate fiscal resources, such as a carbon tax. Creating tax-based revenue sources for the EU does not automatically entail the transfer of taxation powers to the EU; those powers can remain a member state competence and approved at the level of the Council. In fact, 'EU taxes' already exist, even if the revenues are not collected for the EU budget, as is the case with the emissions trading system (ETS). Is it not appropriate to put in place a limited set of tax-based instruments that would be well suited to help the EU achieve its agreed objectives?

5.7 Is Brexit causing a major disruption?

Brexit has raised a concern in EU budget circles that the UK's withdrawal from the EU may significantly diminish the level of budgetary contributions received, but this is more an accounting problem than one of substance. Brexit will reduce contributions to the EU budget, but also the expenditures to the UK. The net effect will be painful but not dramatic.[6] The UK's decision to leave the EU also presents an opportunity to reflect on the core objectives of the EU budget in a modern European Union. Brexit may reduce considerably the obsession with net balances that has characterised EU budget negotiations, and shift the discussion onto the gross rather than the net contribution of member states.

6. Summary and conclusions

The challenges to the EU and the EU budget are unprecedented. As the financial arm of the EU, the EU budget's inability to respond to the concerns of EU citizens in a decisive manner has damaged the perception of the EU in the eyes of its citizens.

There is a need to act decisively. This paper identifies some important changes needed to the way we think about the EU budget and the way it is allocated:

[6] Jorge Núñez Ferrer and David Rinaldi, "The Impact of Brexit on the EU Budget: A non-catastrophic event", CEPS Policy Brief No. 347, 7 September 2016, CEPS, Brussels.

- The EU budget should focus more on EU-wide objectives and reflect a consensus on the best way to govern different policies.
- We need to change the prevailing attitudes expressed towards the EU budget, shifting away from a net balance approach, including rebates and correction mechanisms on the revenue side.
- The EU budget should complement national budgets, offering real additionality and taking action in areas excluded from national budgets. The EU budget can act as an effective vehicle promoting efficiency and savings – a fact that is not yet sufficiently appreciated.
- The way in which EU policies are funded, particularly the CAP, may need to be reconsidered even if the budget is not significantly reformed, e.g. using a co-financing system in line with the cohesion objective, such as the fiscal capacity of member states.
- There should be an in-depth review of the various measures financed by the EU budget. Are they in line with the present needs of the EU? Do they provide real EU value added?
- Financial instruments and the European Fund for Strategic Investments (EFSI) are important additions to the budget to distinguish between projects that need grants and those that need some guarantees or partial support to become bankable. Financial instruments cannot replace grants in many areas, particularly when the actions primarily produce public goods.
- Finally, Brexit will undeniably pose a disruption in many policy areas, but its effects on the EU budget are manageable and can be turned into an opportunity.

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