



This paper was commissioned by the School of Transnational Governance, European University Institute and the College of Europe. The purpose of the paper is to initiate discussion among the participants of the high level policy dialogue.

Event title:

The New EU Multi-Annual Financial Framework

Date:

30 November 2017, Bruges

Title of paper:

Reforms towards a relevant EU budget

Authors:

Jorge Nunez Ferrer, Senior Research Fellow, CEPS

Roberto Musmeci, Research Assistant, CEPS

Marta Pilati, Research Intern, CEPS

REFORMS FOR A RELEVANT EU BUDGET

Paper for the High Level Policy Dialogue on the New Multi-Annual Financial Framework, 30 November 2017, Bruges

Abstract

The European Union budget negotiations have been dominated by the concept of net balances or 'juste retour', related to an unspecified measure of 'fairness' based on the notion that member states have the right to have a certain amount of EU funding spent in their own country. The net balance approach is constructed on the reductionist logic that the EU budget is merely a transfer from treasuries to the EU and that it is redistributed in a system linked indirectly to a GNI allocation. This is supposedly 'fair', but is far from it. This interpretation of fairness originates from the relative low value added, objective free budget allocation decided in the 1980s. Today, the EU budget is subjected to ex-ante conditionalities, linked to thematic areas of intervention based on EU objectives and increasingly assigned to centrally managed items (thus not pre-allocated). It is also used to leverage additional funding in a manner that benefits member states not according to their GNI. The changes that the EU budget has undergone in the last two decades and the size of the leveraged funds for investment, make a net balance approach to the budget and associated corrections illogical, borderline dishonest. The nature of the EU budget has morphed, and so has the distribution of the benefits. The challenges the EU is facing today are serious and deserve to be addressed by a budget that is relevant, flexible, and able to provide a common response from European players. The exit of the UK from the European Union should be taken as an opportunity to rethink the logic of the budget and review its objectives. Just some simple changes in the way the agricultural policy is financed would go a long way to help improving the EU budget. Unfortunately, instincts of member states run deep, entrenching themselves in protecting their 'public Euro flow position' regardless of the actual impact. This not only detrimental to the interests of the EU, but even to the interests of member states themselves. This paper exposes the short-comings, but also the opportunities.

Authors: Jorge Nunez Ferrer¹, Roberto Musmeci² and Marta Pilati³ (CEPS)

¹ Senior Research Fellow, CEPS

² Research Assistant, CEPS

³ Research Intern, CEPS

Table of Contents

Contents

Table of Contents.....	3
1. The Inadequacy of the current EU budget structure	4
2. The irrelevance of net balances	4
2.1. The beneficiaries of the EU budget are no longer clear	6
3. Overview of emerging challenges.....	7
3.1. Regional and macro-regional divergence and cohesion.....	8
3.2. Brexit.....	10
3.3. Impact of Brexit on regional funding eligibility.....	11
4. Easy and realistic reforms	11
4.1. Reforming the financing of the Common Agricultural Policy	12
4.2. Removing headings from corrections	13
4.1. Simplifying grants and financial Instruments.....	14
5. The case for EU Own Resources.....	16
6. Summary and conclusions	18
References	19

1. The Inadequacy of the current EU budget structure

The initial aim of the EU budget, about 30 years ago, was not to finance common EU specific priorities but rather to compensate Member States (MS), regions and sectors which were expected to be negatively affected by increased integration and trade. In this framework, the net balance logic was developed in order to ensure a balance between what MS contributed to the EU budget and what they would get in return, i.e. a 'juste retour' (Benedetto et al., 2017). It is in this context that the Common Agricultural Policy (CAP) and Cohesion Policy were developed. Negotiations around allocations to the CAP, regional policy and the size of rebates dominated decision-making for decades.

Over time, however, EU operations have shifted towards a broader number of policy objectives that have a more European, rather than local, focus. Additionally, the rise in the use of non-pre-allocated, centrally managed funds and financial instruments limits the capacity of the net balance logic to properly estimate the true beneficiaries of EU resources. The obsession of member states to ensure that the CAP and regional policy offer a 'fair' return to the contribution to the EU, has led to the underfunding of important policy areas (such as border security). This has led to a situation in which the main structure of the EU budget is outdated and does not reflect the needs, priorities and operations of the present EU. The European Commission has worked within these imposed limitations by reinforcing the European value added and efficiency of operations within the headings and pre-allocated funds. This has generated some improvements, but ultimately also a suboptimal allocation of resources to EU objectives. This opinion is shared by the High Level Group on Own Resources led by Mario Monti as well as by the background report produced for the group (Núñez Ferrer et al, 2016) and Benedetto et al. (2017). To better address current needs, contributions to the EU budget should be dissociated from expenditures, and the net balance approach to negotiations should be abandoned. Indeed, net balances ignore and jeopardise the investment function and potential of the EU budget and, in addition, they misrepresent the true size of EU operations.

This paper will discuss the irrelevance of the net balances, the need to focus on the instabilities created by growing regional imbalances, the implications of Brexit and how some simple reforms can go a long way to ensure a better allocation of EU budget resources.

2. The irrelevance of net balances

Member States still focus on the net balance implications of the EU budget, despite of several shortcomings. The aim of this chapter is to show that the net balance approach to the EU budget is close to absurd, today more than ever. It is at the source of a rigidity in the budget which can have detrimental consequences. The net balance obsession is also accompanied by the 1% ceiling imposed by wealthier net contributors. The combination of net balances and a strict ceiling makes the budget unfit to focus efficiently on EU objectives. To overcome the EU budget's rigidity, the European Commission, with the assistance of the EIB (European Investment Bank) and EIF (European Investment Fund), has increasingly adopted financial instruments (FIs) and created out-of-the-budget mechanisms to expand the budget's reach.

Financial instruments offer the benefit of using a rather small amount of funding from the EU budget to mobilise additional financing from private and public co-investors, a result that is known as leverage effect. Although the first instruments for small and medium enterprises (SMEs) date back to the 1990s, since the 2000-2007 Multiannual Financial Framework (MFF) they have been gaining relevance in a number of areas. Due to the need to counteract the effects of the financial crisis, the EU also launched EFSI (the European Fund for Strategic Investment), which uses the EU budget as a provider of

guarantees and equity. With € 21 billion of investment from the EU budget and the EIB group, EFSI is expected to leverage € 315 billion by 2018 from public and private partners. An expansion of EFSI to 2020 has already been approved to add another € 185 billion in leverage to reach € 500 billion in total. FIs and EFSI are not the only instruments that have a leverage effect, blending instruments for external action have also been introduced since 2007 and are quickly expanding. The leveraged financing mobilised by EU resources ignored during negotiations.

The approved EU budget for the years 2014-2017 amounts to € 600 billion. However, this figure does not represent additional € 493 billion that are 1) leveraged by budget related instruments such as EFSI, ESI (European Structural Investment) Funds and Blending instruments; 2) contributed by Member States to instruments outside the budget such as the ESM (European Stability Mechanism) and EDF (European Development Fund). Once these resources are added to the official budget, the size of EU operations grows to more than € 1 trillion. This is equal to approximately 1.86% of the EU's GNI - almost the double of the official budget (1% of EU GNI) (Benedetto et al., 2017).

Table 1 and Figure 1 present an overview of all the extra resources leveraged by EU investments, as of 2017.

Table 1 Total funds mobilized by EU operations as of 2017, EUR million

Total Additional Mobilized Investment (2014-2017)		493,017.54
Budget related instruments		
EFSI	225,300.00	
Blending Facilities ⁴	57,300.00	
Horizon 2020	5,584.19	
ESIF	52,199.82	
LGTT ⁵	10,857.14	
COSME ⁶	6,900.00	
InnovFin ⁷	13,714.29	
EGF ⁸	76.90	
Non- budget related instruments		
EDF (2014-2016)	18,449.07	
EIF capital	387.00	
ESM contributions	80,550.00	
EIB capital	21,699.13	
EU Budget (2014-2017)		600,873.81
Total funds mobilized by EU operations (2014-2017)		1,093,891.35

⁴ Includes: Latin America Investment Facility (LAIF), Asia Investment Facility (AIF), Investment Facility for Central Asia (IFCA), Africa Investment Facility (AfIF), EU-Africa Infrastructure Trust Fund (ITF), Caribbean Investment Facility (CIF), Investment Facility for the Pacific (IFP), Neighbourhood Investment Facility (NIF), Western Balkans Investment Framework (WBIF).

⁵ Loan Guarantee Instrument for Trans-European Transport Network Projects (LGTT).

⁶ COSME is the EU programme for the Competitiveness of Enterprises and Small and Medium-sized Enterprises (SMEs) running from 2014 to 2020.

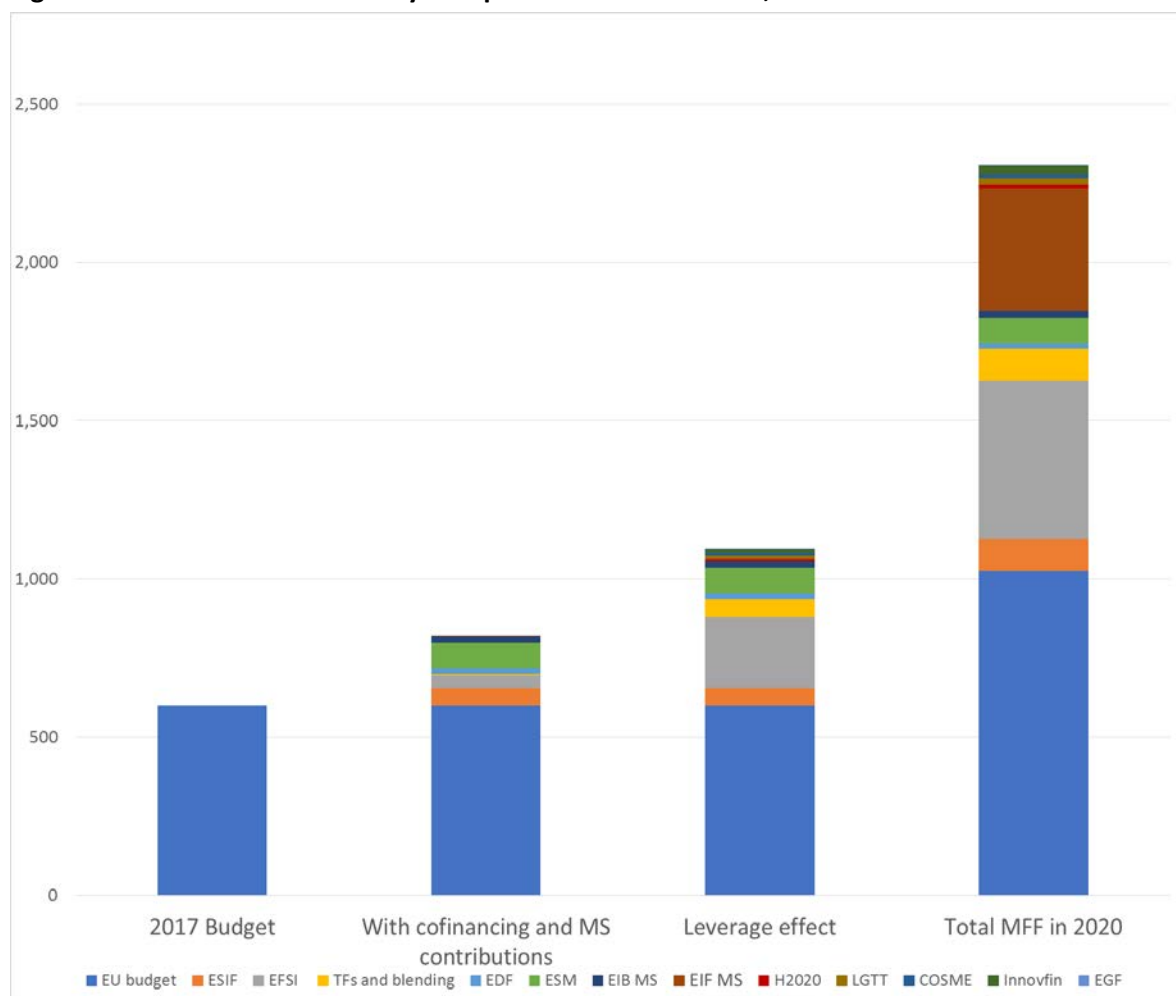
⁷ Until 2020, "InnovFin – EU Finance for Innovators" will offer a range of tailored financial products for research and innovation (R&I) by small, medium and large companies and the promoters of research facilities.

⁸ European Globalisation Adjustment Fund. This special instrument, included within the MFF, has an annual budget of €150 million and can finance up to 60% of the cost of projects. For the period 2014-2017, the EGF has financed projects for a total amount of €115 million and has mobilized €76.9 million of co-finance from MS.

Source: Benedetto et al. (2017)

Figure 1 presents graphically the information of Table 1 and also shows the potential size of those operations over the whole 2014-2020 period. The aim is to illustrate the important size of the amounts moved by the budget although are not an integral part of it.

Figure 1. Total funds mobilized by EU operations 2014 to 2017, EUR Billion



Note: in “Total MFF in 2020” the expansion of EFSI is added and the overall expenditures of MS in co-financing ESI Funds are doubled.

Source: Authors, based on Table 1

Importantly, these estimations do not consider additional pledged contributions made by MS to the ESM. These amount of € 704 billion (€683,5 billion above the € 80.5 billion have already been paid in). Once this is taken into account, the size of potential EU operations by 2020 reaches over €2,5 trillion, more than doubling the EU budget size over the MFF period.

2.1. The beneficiaries of the EU budget are no longer clear

As laid out in Núñez Ferrer et al. (2016), the financial benefits of the EU budget, which include grants and funds leveraged by financial instruments, are not equivalent to the simple movement of money from a national treasury to another one, passing through Brussels. The paper, which served as a

background report for the High Level Group on Own Resources, clearly displays how the centrally managed part of the budget, as well as financial instruments and ESFI, brings more benefits to the more advanced member states. Indeed, research shows that R&D investment has an important economic impact on the country benefiting from the investment (see the Guellec and Van Pottelsberghe (2004) report for the OECD). In the EU, the main recipients of common funds for R&D are the more advanced and wealthier member states. Compared to the past, today MS's benefitting from ESI funds have to follow stricter requirements for their investment strategies⁹. The aim is to ensure a more consistent disposal of EU resources which aligns national investment strategies with EU 2020 objectives and the 11 thematic objectives of ESIF¹⁰. The greater change from the past is that the use of EU funding by national authorities is not only based on decisions by local beneficiaries, but by and large have to serve broader purposes that impact the EU as a whole. To some extent, ESI Funds have become a means for wealthier member states to assist poorer countries and regions to reach EU standards. For example, the costs of applying the environmental acquis, achieve carbon emission reductions, and reach road, product and other safety standards are supported by the EU budget. Expenses which are not linked to an EU target are rare. Many EU standards are high and would not have been pursued by MS with a lower GDP per capita. The member states that have imposed these targets are the wealthier ones, which also happen to be the net contributors to the EU budget, thus helping poorer countries meet the objectives.

3. Overview of emerging challenges

This section looks into some of the challenges that the EU will have to face in the coming years, where the EU will play an essential role. While Brexit is often presented as a major disruption for the Union, it is not the only nor the more serious one.

A variety of worrying socio-economic trends should grasp the attention of policymakers. First, rising poverty and inequality goes hand in hand with increasing divergence between peripheral and urban areas. Indeed, peripheral areas not only suffer on average of a higher poverty rate, but also may have less access to services such as healthcare and education. In turn, cities attract more skilled labour force and are the locus of technological progress and innovation. Nonetheless, inequality may rise even within a city, where low income-low skilled workers are increasingly marginalised (Núñez Ferrer et al. 2017). Second, ageing population and migration create demographic challenges which are related to rising poverty (as the State has less resources to fund pensions) while needing to invest in social integration of migrants, i.e. an immediate need with long term returns. Third, the EU needs to take into account the increasing climate change impacts that may damage economic activities (e.g. due to floods and droughts) and the environment. Last but not least, global instability and asymmetric shocks may expand.

⁹ Regulation (EU) No 1303/2013

¹⁰ 1) Strengthening research, technological development and innovation; 2) Enhancing access to, and use and quality of ICT; 3) Enhancing the competitiveness of small and medium-sized enterprises, the agricultural sector (for the EAFRD) and the fisheries and aquaculture sector (for the European Maritime and Fisheries Fund); 4) Supporting the shift towards a low-carbon economy in all sectors; 5) Promoting climate change adaptation, risk prevention and management; 6) Protecting the environment and promoting resource efficiency; 7) Promoting sustainable transport and removing bottlenecks in key network infrastructures; 8) Promoting employment and supporting labour mobility; 9) Promoting social inclusion and combating poverty; 10) Investing in education, skills & lifelong learning; and 11) Enhancing institutional capacity building & efficient public administrations.

This paper presents a recent analysis indicating some worrying trends that have been emerging under the radar. While the EU has put renewed emphasis on aggregate EU growth and competitiveness, it has lost sight of growing economic divergence within the EU. Developments show something more complex than just regional divergence within countries. Indeed, it also shows a rapid agglomeration of economic activities in north and central areas of the EU, leaving entire member states behind. Trends show the emergence of some thriving, innovative macro-regions in the centre and large macro-regional stagnant peripheral ones.

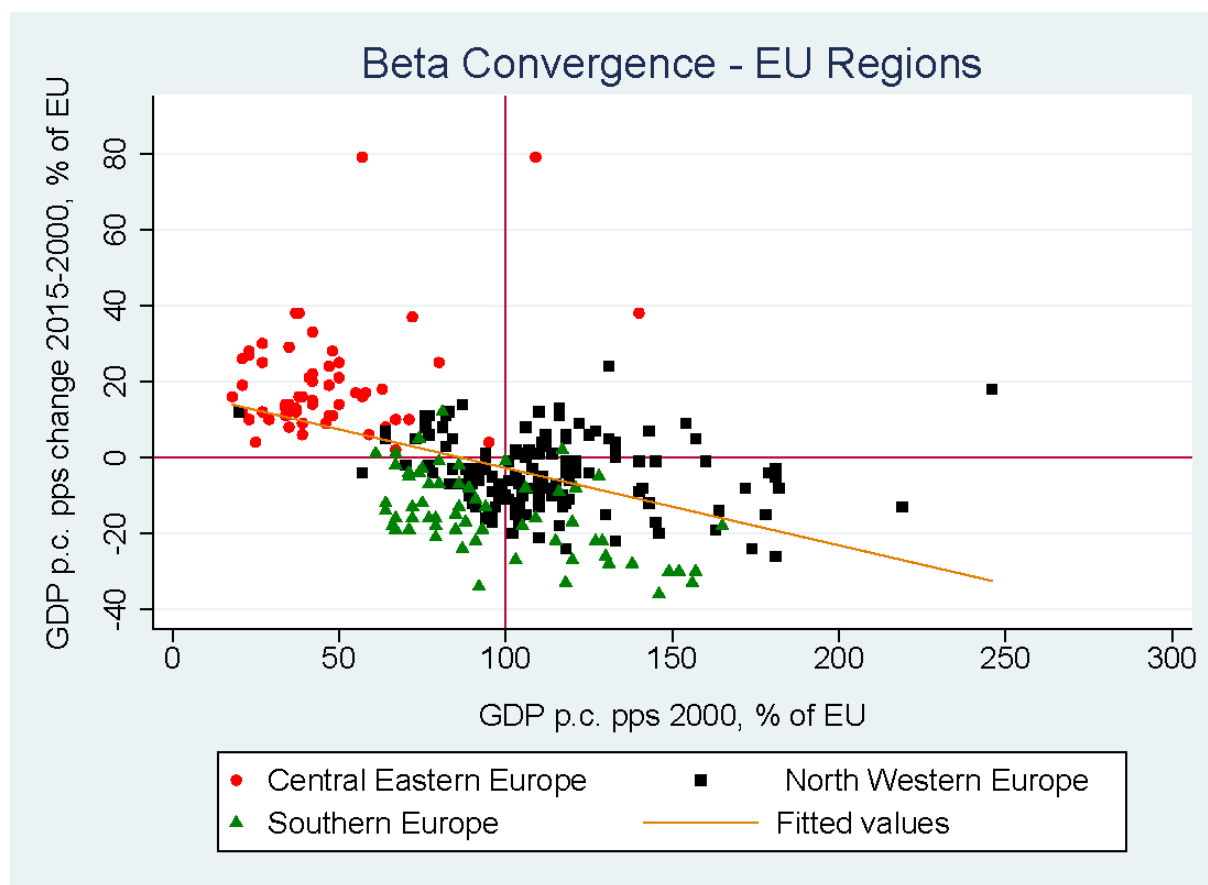
3.1. Regional and macro-regional divergence and cohesion

Convergence among European regions is the fundamental principle on which cohesion policy stands: funding investment on below-average regions to speed up their catching up with richer ones. However, territorial cohesion has lost consideration during the past decade, as the aftermath of the global financial crisis shifted attention towards aggregate measures of wealth at EU level, which mask internal dynamics.

The five scenarios published in the white paper of the Commission on the future of Europe (European Commission, 2017a) focus primarily on the aggregate growth rate of the EU and the need to address challenges created by the crisis at EU level. The whole white paper does not mention cohesion, regional policy or convergence. This is probably the first time that a reflection document on the future of the EU does not mention this regional policy as a pillar, as far as the authors can assess. It is the culmination of the message of the 2003 Sapir report, calling for a greater emphasis on competitiveness. But nearly 15 years down the line and after the financial crisis, is regional policy really '*passé*'? Unfortunately, disparities between regions, within regions and between countries have deepened with the crisis and are expanding, with considerable potential political repercussions. Luckily, the reflection paper on the future of the EU budget (European Commission, 2017b) rescues regional policy from oblivion and presents the observed trends. However, do we need the same policy as in the past? What do the trends tell us?

An ongoing analysis of convergence among EU regions, measured in terms of GDP per capita (PPS) as percentage of the EU average, shows interesting developments (Alcidi et al, 2018). Figure 2 plots EU regions (NUTS 2) showing their position relative to the EU average in year 2000 and the change to their position in 2015. Overall, EU regions have been converging towards the average, i.e. differences among them have been reduced. Indeed, Central Eastern regions, which were the poorest compared to the EU average in 2000, are those that experienced large positive change. However, while the overall trend is encouraging, some other dynamics emerge. There are many regions, represented in the bottom left quadrant of figure 2, which were poorer than the EU average in year 2000 and over 15 years they have further lost wealth relative to other regions. Interestingly, many of these regions belong to Southern Europe, highlighting a geographical dimension of this phenomenon. Conversely, many North Western European regions belong to the top right quadrant. These are regions that were richer than the EU average in year 2000 and that have further gained in their relative position. These developments show that, while at the aggregate level European regions are converging towards the average, there are "champion" regions which are richer and grow faster than the rest of the Union. At the same time, there are declining regions which are become increasingly worse off compared to the EU average.

Figure 2 EU regional Convergence

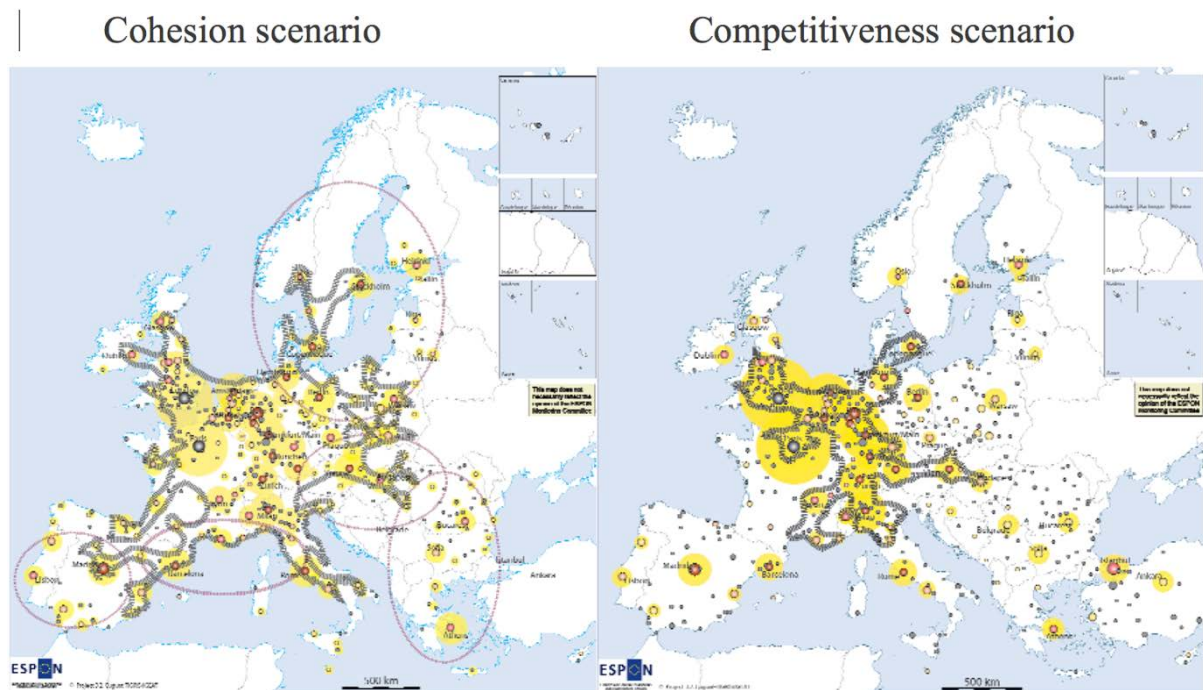


Source: (Alcidi et al, 2018)

Note: Central Eastern Europe: Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia. North Western Europe: Austria, Denmark, Germany, Finland, France, Luxembourg, Netherlands, Sweden, United Kingdom. Southern Europe: Cyprus, Greece, Italy, Malta, Portugal, Spain. Inner London West excluded (GDP p.c. pps 2000, % EU = 500). Irish regions excluded (latest data available is 2014). Belgian regions excluded (oldest data available is 2003).

Already in 2007, a study by ESPON presented a future scenario for 2030 where economic activity would increasingly concentrate into a few central regions in case the EU focused its efforts only on competitiveness at aggregate EU level, leaving the periphery lagging behind. Agglomeration trends may increase competitiveness by fostering innovative clusters and highly interconnected regions, but at the expense of large parts of the EU. The study compared this to a more active policy addressing cohesion and constraining this high concentration of activities in a limited area of the EU. While some of the assumptions of the study may today be questionable, for example it does not take into account the strong development of some new member states in central Europe, the trends are in line with our observations (Figure 3).

Figure 3. Policy choice: Cohesion or Competitiveness policy for 2030 by ESPON



Source: ESPON (2007), p.53

However, allowing peripheral regions to decline in such a manner is politically risky for the EU, and it begs the question if this is what the EU is really about. Social, economic and political instability may become a reality rather than a challenge in the medium term.

Although social policy is not a competence of the EU, reforms around these issues should be debated in the context of a more relevant use of EU resources for cohesion. The policy may also be reformed to take into account a more cross border nature of economic macro-regions, or introduce some competition between regions for the funds, or change the eligibility criteria, as GDP per capita is an unfit indicator for income disparities.

3.2. Brexit

Brexit will likely result in a reduction in the EU budget. The debate is now surrealistically revolving on the EU's complex challenge to cover the approximately € 10 billion net shortfall per year contribution to the EU budget. Who will cover this, how can the EU operate without this money? The answer is short: we can live with it.

€ 10 billion is less than 10% of the GDP annual growth rate of the EU and 0,0008% of the post Brexit EU GDP or approximately 0,5% of UK annual GDP (based on 2016 figures). During the latest programming period, the EU's financial operations have increased well beyond € 10 billion. Annual lending by the EIB in the EU is eight times larger than € 10 billion and the value of overall investment generated by EIB projects is a multitude of times higher.

If there were a willingness, the Common Agricultural Policy could easily be reformed to fund its objectives in a more direct and cost efficient manner, with little impact on results. As will be further explained later in this paper, the CAP is a regressive policy which allocates fund according to a formula

based on historical payments associated with production levels of 30 years ago¹¹. A small reform effort would reduce by more than € 10 billion CAP's expenditures without much of an impact on the sector.

Even without implementing additional reforms, the Brexit shortfall would automatically be reduced to half of its value (with or without hard Brexit). The UK would either need to pay access to the single market and/or participation in any programme it wants to be part of, or in the case of a hard Brexit without any agreement, WTO tariff rates imposed to the UK would bring new income to the EU budget. Conservative estimations set this figure at approximately € 5 billion, i.e. half of the expected Brexit shortfall.

3.3. Impact of Brexit on regional funding eligibility

After Brexit, the EU average GDP will be lower than today's figure, because the UK GDP is above average. Consequently, some may argue that some regions will become ineligible for structural funds because they will become richer relatively to the EU average GDP.

Nonetheless, while the overall EU GDP level would decrease, the European Commission does not expect a large change in regions' GDP per capita. Not many regions would lose their status as beneficiaries of cohesion funds by 2019-20.

However, the average EU-27 income per capita in PPS would fall by only 1.3%, which translates into a change in regional GDP per capita in PPS by a similar amount, thus hardly changing the eligibility of regions to cohesion funds. Considering that some regions have become eligible for cohesion funds since 2007, one may argue that 'convergence funding' eligibility will mainly be affected by economic conditions and growth rates and not so much by Brexit. This is because very few regions are near the threshold of eligibility (75% of the EU average GDP per capita), and some of them may cross it because of their own economic growth, rather than for a small change in the average EU GDP.

It can thus be argued that Brexit's monetary impact on the EU budget will not be as large as expected and can quite easily be compensated by small reforms. Additionally, the change in EU GDP due to the departure of the UK from the Union will not cause radical disruptions to the current regional eligibility to structural funds.

This section has shortly presented some challenges that the EU should expect to face in the coming years. On one hand, the emergence of territorial disparities should be analysed more carefully and be taken into stronger consideration. On the other, the negative effects of Brexit may be exaggerated and not cause the major disruptions that some may expect.

4. Easy and realistic reforms

These sections will present a few clear cut, easy to understand reform proposals which are even simple to implement. The first proposal is to finance the CAP differently, which would liberate the budget from an unnecessary burden. The second is to remove headings with clear European Value Added out of any correction mechanism, and the third aims at improving the functioning of the budget with some real simplification efforts. The last is certainly less straightforward or easy to put in practice.

¹¹ The allocation of CAP payments stems from the original budgetary allocations based on average yields per hectare and similar considerations from the 1991 reform to comply with the WTO GATT agreement. This explains significant differential in support between member states.

4.1. Reforming the financing of the Common Agricultural Policy

This section reports and summarises the proposed reforms for the Common Agricultural Policy (CAP) as they are presented in (Núñez Ferrer et al., 2016). The model was first developed by Núñez Ferrer (2008) and explores the consequences of changing CAP's financing approach into one based on fiscal solidarity, following the example of cohesion funds.

As already mentioned, the expenditures of the CAP direct payments are based on a formula developed in 1991 which aimed to compensate some farmers for price falls due to the introduction of the General Agreement on Tariffs and Trade (GATT) in 1991. Today's payments to farmers are thus based on historic data that is no longer relevant for addressing current needs. As argued by many (Baldwin, 2005; Heinemann, 2017; Núñez Ferrer and Kaditi, 2007; Núñez Ferrer, 2007), the CAP today is a regressive policy that paradoxically supports large landowners under the pretence of supporting the farm's income. Direct payments are exacerbating rather than reducing farm income disparities within the sector, if not even overall. The political colouring of the payments from blue to green with cross-compliance or environmental obligations does not change the fact that there is no link between the costs of the practices and the direct payments, a link that is fortunately more prominent for rural development funds. Consequently, farmers are generally either under- or overcompensated to reach the objectives of the direct payments.

Taking into account that a meaningful reform of the CAP seems always close to impossible, while the need to have a better functioning EU budget is rather urgent, the background report for the High level group on own resources by Núñez Ferrer et al. (2016) suggests basing CAP disbursements on the same principle used for cohesion funds, i.e. looking at the position of the country's GDP per capita compared to the EU average. The proposal links the amount of CAP funding received to the relative wealth of the MS in line with the notion of solidarity, which would thus co-finance CAP disbursements. MS whose GDP per capita is above the EU average would not receive any funding from the CAP, thus financing themselves the full amount of support to farmers. Countries whose GDP per capita is between 90% and 100% of the EU average would pay 80% of the CAP payments, while countries between 75% and 90% of the average would have a 50% co-financing rate. Payments to MS that are below 75% of the EU average, i.e. the same threshold for cohesion eligibility, would be completely funded by the EU budget.

Surprisingly, this method would decrease the cost of CAP for the EU from € 40 billion to only € 11 billion (see table 2 for the change for each MS). Rich countries would no longer benefit from EU transfer to their farmers; this would be the case of France that today receives approximately 15% of all CAP resources. As it is no longer a net beneficiary from the CAP, France would only transfer the difference to Brussels. Even if the policy itself does not change at all, this reform would have the healthy side effect of revealing the imbalances in payments and the lack of logic of the policy, maybe leading to a more constructive policy debate.

Table 2. Estimated change in contribution to the CAP after a “cohesion based” approach would be implemented (Figures from 2014, EUR thousands)

	National contribution to the CAP with current model	Contribution to the CAP after the proposed reform	Change in contribution
AT	958.8	252.8	-706.0
BE	1,173.8	309.4	-864.4
BG	119.4	31.5	-88.0
CY	48.3	12.7	-35.6
CZ	421.2	111.0	-310.1
DE	8,664.3	2,284.1	-6,380.2
DK	772.1	203.6	-568.6
EE	55.5	14.6	-40.9
EL	520.0	137.1	-382.9
ES	3,067.4	808.6	-2,258.8
FI	594.6	156.8	-437.9
FR	6,352.5	1,674.7	-4,677.9
HR	121.8	32.1	-89.7
HU	293.5	77.4	-216.2
IE	465.6	122.8	-342.9
IT	4,704.4	1,240.2	-3,464.2
LT	102.6	27.1	-75.6
LU	85.9	22.7	-63.3
LV	69.6	18.3	-51.2
MT	22.2	5.9	-16.4
NL	1,931.2	509.1	-1,422.1
PL	1,154.6	304.4	-850.2
PT	498.8	131.5	-367.3
RO	427.0	112.6	-314.4
SE	1,297.7	342.1	-955.6
SI	106.9	28.2	-78.7
SK	215.3	56.8	-158.5
UK	6,338.3	1,670.9	-4,667.4
Total EU	40,583.7	10,698.8	-29,885.0

Source: Núñez Ferrer et al. (2016)

4.2. Removing headings from corrections

Brexit would bring the opportunity for getting rid of all rebates from the EU budget. This could introduce some healthier debates on the budget rather than on the size of corrections. However, the 1984 the Fontainebleau Agreement stating that “any Member State sustaining [a] budgetary burden which is excessive in relation to its relative prosperity may benefit from a correction at the appropriate time”¹² will remain in place. Calls for corrections may continue to exist. It should be not possible, however, that member states receive a correction on policies with high European Value added from which they are main beneficiaries. It was close to absurd that the UK rebate included in the calculation administrative expenditures, or even research funding. If there are corrections, those need to be based on a link between the contentious headings and the correction.

¹² European Council, Conclusions of the Session of the European Council at Fontainebleau, 25- 26 June 1984

It would be rational to base calculations of any rebate on policy areas that do not have a high EU added value. The issue around the definition of EU added value has been addressed by many¹³, but rebates could just be considered on those items which are not clearly linked to high level priorities of the EU. The rebates would be computed on disputed policies, or parts there-off. Questions on the nature of EU investments, the efficient allocation of resources and their alignment with the principles of subsidiarity, additionality and proportionality should be taken into account when discussing the added value of EU investment. Corrections would be subject to review if the policies are reformed.

The following plausible and relatively easy reform consists in excluding some EU budget headings from the net balance or correction calculations. The headings that should not be taken into consideration for the calculation of net balances are:

Heading 1a – Competitiveness for growth and jobs because it pursues policies with high EU added value.

Heading 3 – Security and citizenship because it pursues policies with high EU added value.

Heading 4 – External action should not be included by definition.

Heading 5 – Administration because it funds activities conferred by MS to the EU.

The two headings which could be part of correction calculations are:

Heading 1b – Economic, social and territorial cohesion

While this heading conforms to the principle of solidarity in the EU and has been reformed to focus on EU objectives, there are areas of disputed EU value added. Some corrections could be envisaged to be eliminated in exchange for future reforms.

Heading 2 – Sustainable growth and natural resources

The CAP, and particularly the direct payments, is highly distortive and suboptimal, failing to efficiently target objectives as the funding pre-allocation is not related to the costs of achieving the policy objectives. In the absence of an appropriate deep reform of the policy, which may lead to funding reallocation to efficiently target objectives, member states that consider themselves disadvantaged by the policy should be able to seek a correction. Of course, the financing system based on solidarity presented in section 3.4 would make such corrections questionable.

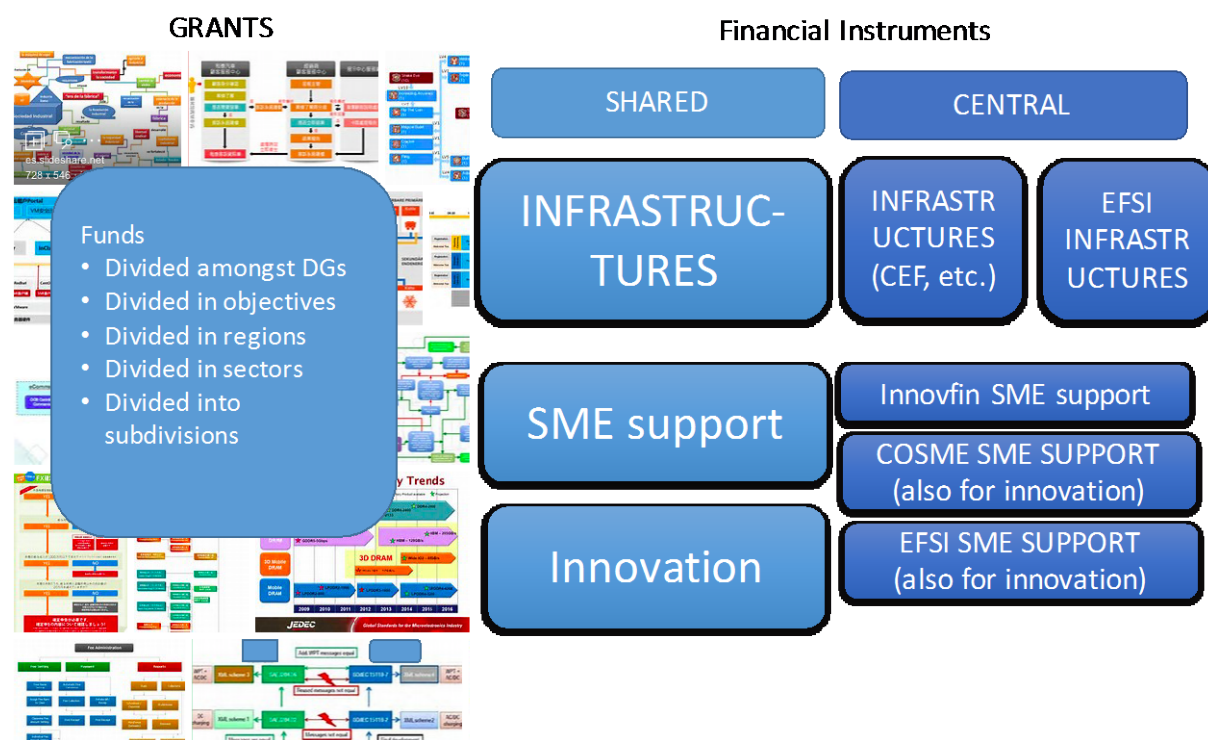
4.1. Simplifying grants and financial Instruments

The size of the EU budget is small, and possibly may even shrink as a consequence of Brexit. Nonetheless, financial instruments can be used to efficiently leverage additional funding from other co-investors. The use of financial instruments has indeed increased in the past two decades and the number of available financing mechanisms has proliferated. Financial instruments are different from grants because they operate when there is potential availability of private investment if the risk is partially covered, while grants are more appropriate for public goods without clear returns for the private sector.

¹³ See for example Tarschys (2005 and 2011), Núñez Ferrer and Tarschys (2012), and Heinemann (2015).

The increasing number of both grants and financial instruments available for a rapidly growing number of policy areas has had the direct consequence of increasing complexity. These funding sources operate under the authority of different Directorate Generals and institutions (EIB, EIF, and national authorities and financial intermediaries). They often require different eligibility criteria and performance measurement frameworks (Núñez Ferrer et al. 2017). The rapid creation of funding categories and the complexity has even led to duplication of instruments for accomplishing the same objective (see Figure 3).

Figure 4 Existing grants and financial instruments maze



Source: Presentation to the European Parliament by Núñez Ferrer, 16 March 2017

There is space for reforming the existing financing mechanism (both grants and financial instruments) by creating a clearer organization which couples a policy objective with only one form of grant and financial instrument. As an example, the existing situation where support for SMEs can be disbursed by three different centrally managed financial instruments should be avoided. Additionally, application procedures, requirements, performance monitoring and auditing systems¹⁴ should be harmonised so to reduce complexity and smoothen operations. It should also improve the possible combination of both forms of support.

Coordination among instruments is key. As mentioned, complexity can be a source of discouragement for applicants and reduce the efficient allocation of resources. For example, stronger collaboration between ESI funds, Horizon 2020 and EFSI should be envisaged.

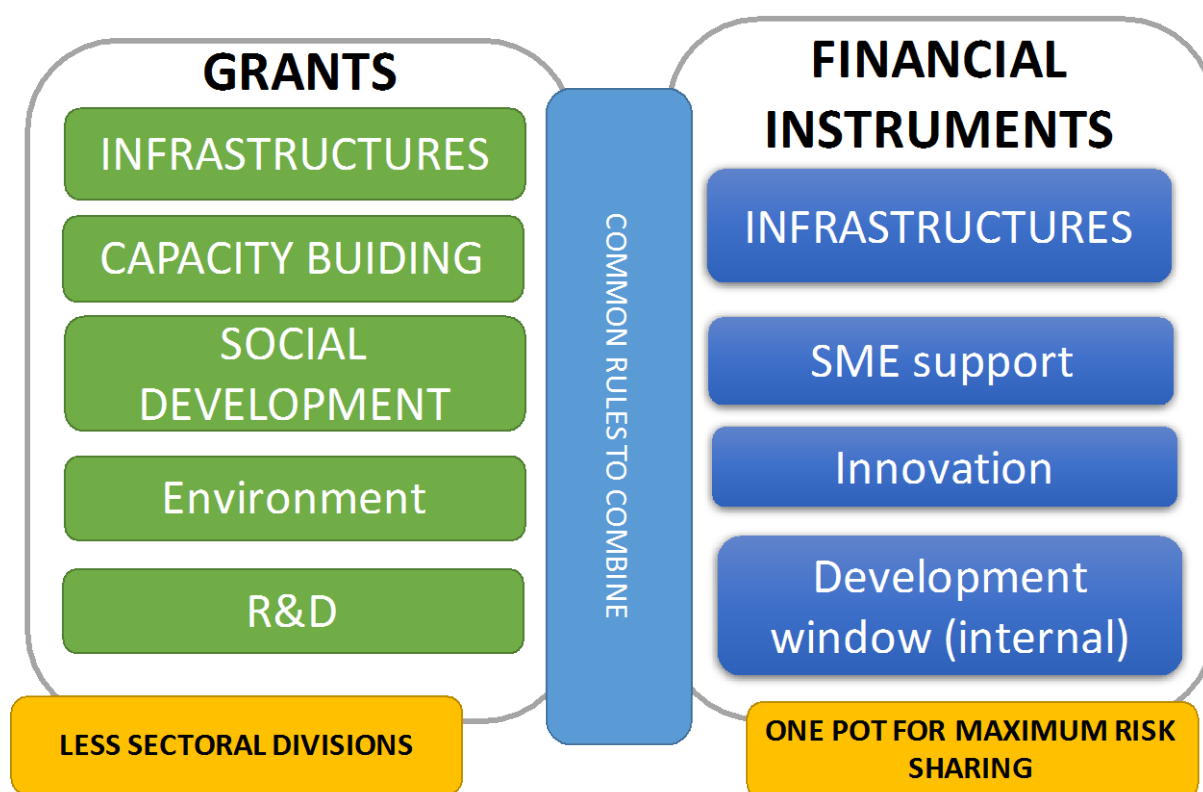
Some chaos persists concerning financial instruments, which today can be either created regionally by managing authorities, or centrally by centrally managed funds, or even outside the budget by EFSI. A way to reduce the complexity around financial instruments for investment, while at the same time reducing risk, is to pool all instruments under one mechanism, for example EFSI (Núñez Ferrer et al.

¹⁴ For simplification options for the auditing system the report by the High Level Group on simplification (

2017). This would require a reform of the way financial instruments are set up and governed. By expanding the scope of EFSI's operations, economies of scale for investment could be achieved, thus benefitting from lower risk thanks to diversification.

The ideal budget structure, even if probably unrealistic to implement, would have large key headings supported by large financial instruments (as is EFSI) (Figure 5). Both grants and financial instruments could intervene with simple but efficient rules in areas where they are most needed, with little and flexible pre-allocation.

Figure 5. A Simplified clean EU budget



Source: Presentation to the European Parliament by Núñez Ferrer, 16 March 2017

5. The case for EU Own Resources

At the beginning of this paper the case for abandoning the net balance logic dominating EU budget negotiations was laid out. The need for dissociating EU resources from expenditure is evident as was also stated in the report by the High Level Group on Own Resources (HLGOR) led by Mario Monti (HLGOR, 2017).

EU own resources would alleviate the member states' burden of financing the EU budget from the public purse, while allowing the EU to also use fiscal incentives to target EU objectives. This could help smoothing the process of abandoning the net balance approach. The report by HLGOR identifies a variety of potential sources for EU revenues. These are:

- 1) A levy on CO₂ (carbon pricing) which would be applied to everything that generates greenhouse gas. The consequent effect on prices not only creates revenues for the budget, but creates an incentive to consume 'greener' products.
- 2) The inclusion of the European Emissions Trading System proceeds (ETS). Revenues arising from the auction of emission allowances could be transferred to the EU budget.
- 3) A motor fuel levy. This tax is already present in all MS, thus it could be envisaged that all or part of the revenues collected nationally are transferred to the EU.
- 4) Electricity tax on consumption, which would be easier and more transparent to collect.
- 5) Corporate income tax which would also lead to a harmonization of national taxes on corporate profits.
- 6) Financial transaction tax or an alternative tax on financial activities.
- 7) A new VAT-based tax to replace the existing one.

A recent paper by Benedetto and Núñez Ferrer (2017) explores the potential package deal that could introduce new own resources. The landscape at the moment is not very conducive to any own resource. However, there may be some steps that can be taken:

- a) It is unlikely that a corporate income tax would easily be agreed as a resource, but there is a potential common interest for all member states to harmonise the base to create more transparency and have a common agreement on what is taxed. While taxation rates remain a national competence, a common base can allow not only a common contribution to the EU budget, but also a better overview across member states of what is taxed and the effective taxation rate, which may be different from the official tax rate.
- b) Carbon tax as a resource will be difficult to get it through and may face considerable resistance by some member states.
- c) The recovery of the ETS proceeds may be at least in part possible.
- d) A real VAT would be a very transparent and effective resource, but resisted (for the wrong reasons) by member states. It is more likely that the present VAT resource is simply abolished altogether.
- e) The Financial Transaction Tax is unlikely to get through, although it is our opinion that it is one of the best candidates, a very small tax would help reduce speculative transactions, be barely noticeable for most operations, but also provide resources for the EU. Unfortunately, there is little interest and probably little understanding of it at political level.
- f) An aviation tax reappears often in discussions on resources and could be an opportunity, even if it is not included in the report by the High Level Group on Own Resources.

All this considered, there is a good chance of creating a harmonised base for the corporate income tax (and little or no chance of having an EU corporate income tax in the foreseeable future) and some opportunities for a tax related to carbon emissions.

6. Summary and conclusions

This paper looks at some of the main aspects affecting the negotiations on the future MFF and dares to present simple but feasible reforms. It first demonstrates the absurdity of the net balance consideration, given the impact of centrally planned instruments, the expansion of financial instruments, the creation of EFSI and the multiplication of instruments financed outside the budget. The obsession with fixing the size of the EU budget to 1% of GDP makes increasingly little sense.

The paper also shows that the Brexit shortfall is not a major budgetary risk and easily resolved.

The expenditures of the EU budget, in particular centrally planned instruments, but also those under the cohesion policy, have increased their European value added considerably. Many criticisms of the EU budget are out of date, with the exception of the Common Agricultural Policy which uses as a basis for allocating the direct payments a distorted formula which has little relevance with the challenges of the sector.

In the absence of any real will to reform the CAP, the paper proposes to finance the policy differently by following the well-known principle of solidarity that Cohesion policy uses, i.e. transfers based on the MS capacity to finance in terms of GDP per capita of the member states. The result would be a close to 75% fall in the transfers to finance the CAP through Brussels and most likely a much clearer and healthier view of the CAP distribution, which could lead to healthier debates on the policy.

Every simplification of the budget has led to complication, adding exceptions, guidelines and further controls, to a point that the budget has in some areas reached a complexity that would bring joy to Kafka. In a world requiring integrated and more efficient solutions it is important that the complex web of rules and criteria are simplified, avoiding duplication of instruments covering the same policy areas.

To conclude, while there is little appetite for new own resources, there is an opportunity to push for a harmonised base for corporate income taxes, but without leading to an actual EU tax. There may be a limited chance for a small tax on carbon emissions.

References

- Alcidi C., Núñez Ferrer, J., Di Salvo M., Musmeci R., Pilati M. (2018). "Income Convergence in the EU: A tale of two speeds". CEPS, Brussels, January.
- Baldwin, R. (2005), "The Real Budget Battle: Une crise peut en cacher une autre", CEPS Policy Brief No. 76, CEPS, Brussels, June.
- Benedetto G. and Núñez Ferrer J. (2017). "Securing a Package Deal for Reform of Own Resources and the EU Budget", Paper presented at the 2017 UACES Research Conference, Krakow, at panel 607 EUFINACCO (CRN): Panel II: Financial Accountability (Policy Perspectives).
- Benedetto G., Rinaldi D., Núñez Ferrer J., Musmeci R., and Pilati M. (2017). "Post-2020 EU Budget: Breaking Free of the Net Balance Approach". FairTax Project - EU Tax as an EU Own Resource Conference, CEPS. Forthcoming.
- ESPON (2007), "Scenarios on the territorial future of Europe". ESPON Project 3.2, Luxembourg. Available at: http://central2013.eu/fileadmin/user_upload/Downloads/Tools_Resources/General/Espon_Scenarios_1.pdf
- European Commission (2017a), "White paper on the future of Europe - *Reflections and scenarios for the EU27 by 2025*", COM(2017)2025, 1 March 2017.
- European Commission (2017b), "Reflection paper on the future of EU finances", COM(2017) 358, 28 June 2017
- Heinemann (2015), "Strategies for a European EU Budget, Working paper for the Brussels Symposium", 14 January 2016, FiFo, pp. 91-108.
- HLGOR (2016), "[Future Financing of the EU: Final report and recommendations of the High Level Group on Own Resources](#)", High Level Group on Own Resources, Chaired by Mario Monti, December. Available at: http://ec.europa.eu/budget/mff/hlgor/library/reports-communication/hlgor-report_20170104.pdf
- Núñez Ferrer, J., J. Le Cacheux, G. Benedetto, M. Saunier, F. Candau, D. Emonnot, F. Lachet-Touya, J. Mortensen, A. Potteau and I. Taranic (2016), "Study on the potential and limitations of reforming the financing of the EU budget", on behalf of the High Level Group on Own Resources, 3 June (http://ec.europa.eu/budget/mff/hlgor/library/highlights/hlgor-studies-external-studyonfinancingofeu-budget-june-2016_en.pdf).
- Núñez Ferrer, J., Rinaldi D., Hassel H., Nesbit M., Illes A., Paquel K. (2017). "Key challenges and opportunities for Cities and Regions and MFF post 2020". Report for the Committee of the Regions. Available here: http://cor.europa.eu/en/documentation/studies/Documents/MFF_post%202020.pdf
- Núñez Ferrer, J. (2007), The EU Budget, the UK rebate and the CAP: Phasing them both out?, CEPS Task Force Report, CEPS, Brussels, pp. 108.
- Núñez Ferrer, J. and D. Tarschys (2012), Investing where it matters – An EU budget for long term growth, CEPS Task Force Report, CEPS, Brussels.
- Núñez Ferrer, J. and E. Kaditi (2007), "The EU added value of agricultural expenditure – From market to multifunctionality – Gathering criticism and success stories of the CAP", Study for the

Núñez Ferrer, J. (2008), "Can reforming own resources foster policy quality?", SIEPS, Working Document No. 3, SIEPS, Stockholm. Policy Department on Budgetary Affairs, European Parliament, Brussels, 5 December.

Núñez Ferrer, J. (2017), "Can reforming own resources foster policy quality?", SIEPS, Working Document No. 3, SIEPS, Stockholm. Policy Department on Budgetary Affairs, European Parliament, Brussels, 5 December.

Sapir, A., P. Aghion, G. Bertola, M. Hellwig, J. Pisani-Ferry, D. Rosati, J. Viñals and H. Wallace (2003), *An agenda for a growing Europe: Making the EU economic system deliver*, Report of an independent High-Level Study Group established on the initiative of the President of the European Commission, Brussels, July.

Tarchys (2011), "The EU Budget: What Should Go In? What Should Go Out?". Sieps 2011:3

Tarschis, D. (2005), *The Enigma of European Value Added, Setting Priorities for the European Union*, SEIPS Report 2005:4, SIEPS, Stockholm.