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The EU's finances: can the economically desirable and the politically feasible be reconciled?

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# The EU's finances: can the economically desirable and the politically feasible be reconciled?

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Of all the regular negotiations at EU level, those on the EU budget and, more generally, the EU's public finances are among the most contested and acrimonious. This is something of a paradox, because not only is the EU budget a small fraction of the aggregate public spending by all levels of government – barely two percentage points – but the margins over which bargaining takes place are comparatively tiny and would pass under the radar if they arose inside a country. Indeed, there have been examples of shifts of tens of millions of euros being sufficient to conclude a deal in a Multi-annual Financial Framework (MFF) amounting to around one thousand billion (at current prices) over a seven-year period.

National positions are strongly held and are hard to reconcile with one another, making it hard to muster support for transformation of the EU budget. Disputes centre on the size of the budget, the net contributions or receipts of different Member States, the composition of spending and the manner in which the budget is funded. Nevertheless, a compromise is eventually reached, generally pleasing no-one and with only limited changes to previous MFFs.

This paper briefly reviews relevant economic theories and how they relate to efforts to explain the added value of the EU budget. It then considers what Brexit changes and appraises the prospects for breaking with the strong propensity to maintain the status quo. Predictions and conclusions complete the paper.

## 1. Could this time be different?

As has been stressed in recent contributions to the debate on the Future of Europe, such as the Sorbonne speech by Emmanuel Macron<sup>2</sup>, Europe faces an array of challenges for which current arrangements do not provide an adequate basis for a response. Refugees, climate change, security, social inclusion and the digital economy are just some of the watchwords to ponder. The negotiation of a new MFF for the period after 2020 ought, therefore, to be an opportunity for fresh thinking about what the EU spends and why. The anticipated departure of the UK from the union is a further influence, and discontent with the narrative and consequences of austerity can also be expected to affect the next settlement.

Yet, since the last major reform of the budget in 1988, its broad shape has remained very stable. Over these three decades, the EU has expanded from twelve to twenty-eight – considerably more diverse – members, has established the euro and has been through a series of economic crises since 2008, yet the budget has changed very little in scale. The composition of expenditure has evolved somewhat, but the bulk of it continues to be on direct payments to the agricultural and fisheries sectors and on policies to support regional economic development. In spite of repeated attempts to

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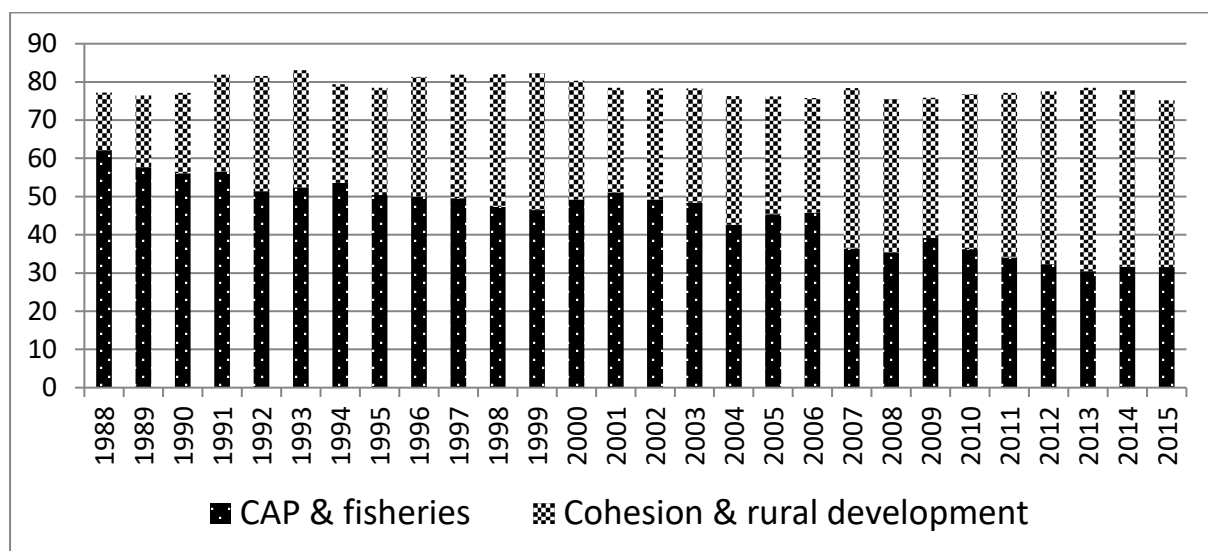
<sup>2</sup> <http://www.elysee.fr/declarations/article/initiative-pour-l-europe-discours-d-emmanuel-macron-pour-une-europe-souveraine-unie-democratique/>

find alternatives and to confer greater autonomy on the EU level’s finances, it raises its revenue from the same revenue streams as in 1988, and the proportion funded by so-called ‘national contributions’ has increased.

Following the publication of the Commission White Paper on the Future of Europe (Commission, 2017a) and the complementary Reflection Paper on EU finances (Commission, 2017b), together with the report of the High-Level Group on Own Resources chaired by Mario Monti (HLGOR, 2016), debate on the next MFF has started earlier than usual in the multi-annual cycle. Cynics will argue that the outcome will, nevertheless, not differ much from previous MFFs; but could – to borrow a phrase – this time be different? Various efforts have been made over the years to reflect on what sort of budget should be in place and what constitute credible EU level public goods. Thus, the Sapir report (2004) sought to orientate the budget towards growth promoting investment, while many contributors (see Blankart and Koester, 2009, for a discussion) have queried the dominance of what they regard as (re)-distributive payments from the Common Agricultural Policy (CAP) and Cohesion Policy.

It would be easy to dismiss the present EU budget as a hotchpotch that reflects path dependency, lowest common denominator decision-making and the numerous veto points that restrict the feasible outcomes. At barely 1% of EU gross national income (GNI)<sup>3</sup>, it is tiny compared with typical central government budgets or sub-national budgets – whether in federal or unitary states. Equally, it is much larger than that of a typical international organisation and reflects the assignment of specific policy functions to the EU level of government. Some three quarters of spending has consistently been spent on just two main policy areas over the last thirty years (figure 1). The principal change has been a steady rise in the share of Cohesion Policy, while the CAP’s share has fallen, but taken together they have been remarkably consistent.

**Figure 1 Proportion of EU budget spent on two main policy areas, 1988-2015 (% of total spending)**



Source: EU Financial Report 2008 and EU Financial Report 2015

<sup>3</sup> For most purposes GNI, rather than GDP is the benchmark used to measure the EU budget. Although the difference is minimal in aggregate, it matters for some Member States for which GDP does not provide a sufficiently accurate picture of prosperity because of substantial flows of remittances or property income.

Repeated attempts to introduce radical reform have rarely gained much traction when confronted with the realpolitik of the EU and one of the conspicuous features of the budget is just how stable spending has been. There is a strong bias towards the status quo and although there are always attempts to bring in economic rationales for EU spending, it is the 'politically feasible' which tends to prevail. Brexit could, in principle, facilitate a fresh approach, but may be less of a 'game-changer' than many hope.

## 2. A little theory

Several strands of theory, whether rooted in public economics, political science or European integration studies, have some bearing on the EU budget. Fiscal federalism, in particular, might be thought of as providing a basis for analysing which functions of public finance should be located at the EU level. A standard starting point is the distinction between stabilisation, allocation and distribution (Musgrave, 1959).

Stabilisation involves the use of public finances to steer aggregate demand in the economy, broadly in line with Keynesian reasoning. In a multi-level fiscal system, the boost to demand can be for the economy as a whole through the 'federal' level (irrespective of whether the country is federal or unitary) running a deficit, or by varying the flows of public funds to a region so as to mitigate the consequences of an asymmetric shock. There is a rich academic literature on these effects, although there is far from a consensus on their magnitudes and effectiveness.

Allocation concerns which level of government is responsible for funding and producing public goods. It has to reconcile local preferences, the territorial scope of the public goods funded, and the availability of resources. A standard interpretation is that goods or services of benefit only to local residents should be funded by those same local residents, but if there are significant spillovers to other jurisdictions, then the argument for top-down funding becomes more persuasive.

Distribution (or re-distribution) is commonly understood to be at the level of citizens, implying taking from the rich to give to the poor. If distributive policies are decentralised, poorer citizens will have incentives to move to richer areas in the expectation of larger welfare benefits, while richer citizens will prefer lower tax areas. In the logic of fiscal federalism, the solution is for distributive policies to be centralised so as to curb economically wasteful competition between jurisdictions.

Public choice models suggest a range of possible strategies and consequent outcomes when constituent parts of a union compete for public expenditure. However, the focus in such models tends to be on securing resources for specific purposes from budgets controlled by central government, whereas the primary goal in the EU is to maximise either gross or, more often, net receipts (or its inverse: minimising net contributions). Member States compete for the common pool of EU resources for public goods (Osterloh et al. 2009) and, to this extent, it is standard pork-barrel politics. But what distinguishes the EU's fiscal arrangements from the highest tier of government in both federal and unitary states, is that the EU level is also in competition for Member State funds. Consequently, parallel games are being played: one involves the Member States contesting EU money with each other; in the other the EU is pitted against sub-national government and the other priorities of national governments, including through regulations imposing co-financing.

Top-down transfers are the norm in most fiscal constitutions, with some also having horizontal equalisation schemes (for example, the *Finanzausgleich* in Austria and Germany through which some Länder are contributors and others recipients), though even these are generally mediated by the central government. The optimal design of transfer systems is much studied, but characterised by conflicting standpoints. Shah (2007) posits a dichotomy in inter-governmental fiscal transfers between ‘dividing the spoils’ and a ‘framework for accountable and equitable governance’. In OECD countries, the share of sub-national expenditure financed by transfers from central government is typically just under a half, with the lowest rates found in the Nordic countries in which income tax is collected locally. These proportions give the central government a strong say over what sub-national levels do. Clearly, though, the EU is different, rendering comparisons with other multi-level systems largely meaningless. To provide an initial answer to the question in the title of this paper: economic theory is of limited help in analysing the EU’s finances.

### 3. From theory to European added value

Considerable effort has, nevertheless, been devoted to the rationale for spending by the EU level, with the focus often on whether there is added value from such spending. In the range of governance modes that characterise the EU, it is the regulatory (Majone, 1994) one that has traditionally been the mainstay of European integration, its primary consequence being the construction of much of the *acquis communautaire*. Latterly, an enhanced role for the EU level has emerged in coordination of social and economic policies, whether through the various sectoral strategies (notably employment and social inclusion), the European semester or the more overarching frameworks of the Lisbon Strategy and the Europe 2020 strategy. However, using public finances as a mode of governance is limited at the EU level by the small size of the budget, such that the rhetorical question ‘what is the EU [budget] for?’ in public finance terms is not easy to answer.

While some principles loosely drawing on insights from fiscal federalism can help, they are at best tenuous, largely because of the piecemeal manner in which EU spending evolved. The reflection paper on the EU’s finances presented by the European Commission (2017b) suggests two dimensions which ought to be prominent in defining added value: fulfilling treaty obligations; and generating ‘European’ public goods, not least to support the single market and EMU as core features of EU integration. The paper recalls the principle of subsidiarity and argues that EU spending should add to, rather than substitute for, national spending.

All the MFF discussions, not least those that apportion spending among the Member States, concern commitments (that is, plans for future spending). These can differ from actual spending for a number of reasons: large projects under Cohesion Policy may be slow to start; contracts may be cancelled, or underlying conditions (notably in relation to the CAP) may change. In Cohesion Policy, the N+3 rule, which calls for committed expenditure to be incurred within three years, is especially sensitive, and (as in agreeing the previous MFF) the expansion of the amounts still to be spent (*reste à liquider* or RAL) can be expected to be a divisive issue, both among groups of Member States and between the EU institutions.

Several ways of allocating EU expenditure are in evidence and these can be categorised in overlapping ways. A first distinction is between pure common goods, EU-funded national public goods and distributive transfers. Administrative expenditure and EU external action are common

goods to the extent that they are not explicitly for the benefit of individual Member States, although even here the battles that go on around the locations of EU agencies testify to exertion of national interests. Most EU funding is, however, for national public goods such as support for infrastructure, skills or environmental purposes. Only some transfers to farmers would qualify strictly as distributive, given the EU does not directly contribute to social protection outlays.

A second way of distinguishing spending is according to how eligibility for it is assessed. For some allocations, it is the design of the policy that is pivotal, with the treaty establishing the necessity of EU expenditure. Thus, Title III TFEU establishes that there should be a Common Agricultural Policy (CAP) and that among its objectives is to increase the 'individual earnings of persons engaged in agriculture' (art 39.1b, TFEU). It is noteworthy that such support for farming is common to all developed economies. This aim implies public spending, but does not signal how much. In practice, the amount for each claimant is derived from complex formulae embracing the size of farm, historical entitlements to support, and commitments to environmental and other goals. Moreover, past experience has been that CAP negotiations resulting in outcomes with spending commitments occur separately from the main budget negotiations, but then become binding.

The treaty also stipulates that there should be a funded multi-annual framework programme for research (art. 182, TFEU). It does not state what principle should apply, but in successive programmes, 'excellence' has been the primary criterion for funding. Because excellence is not, necessarily, evenly distributed across Member States and tends to be found disproportionately in richer regions, the corollary is that receipts from the research budget will favour richer Member States. Calls from some CEE countries for a more even distribution manifestly conflict with the insistence on excellence.

A third allocation principle, applied above all to cohesion policy, is assessment of needs. Thresholds for GNI per capita are used to determine eligibility for the Cohesion Fund (the Member State must be below 90% of the EU-28 average) and the 'convergence' objective of the European Structural and Investment Funds (75% of the average), the latter accounting for around two-thirds of the cohesion budget (taking account of Cohesion Fund receipts). Although there is some evidence that lobbying by well-organised regions can boost what they receive (Bodenstein and Kemmerling, 2012) or that those which have strong institutional capacity are more likely to be favoured by the Commission (Dollmuth, 2011), the dominant influence on the spatial distribution of EU spending in this policy area is relative prosperity.

### **3.1 Added value in practice**

Clearly, added value is a slippery concept, and is prone both to diverging interpretations and political ambiguity, accentuated by the propensity of political leaders to find value in what benefits them. Thus, spending on agriculture can be portrayed as being about food security, not redistribution towards farmers, while many a local economic development project is claimed to be a vital contribution to EU international competitiveness. Latterly, for the CAP, food quality and management of the countryside have also been cited as 'public good' reasons for public support and have, moreover, been presented as shifting the balance between distributive and allocative payments. It is an open question whether these are simply cunning ploys to provide a veneer of rationalisation for indefensible payments or have genuine merit.

Cohesion is still more complicated. A standard Commission view, articulated for example in the 6<sup>th</sup> and 7<sup>th</sup> Cohesion Reports (Commission, 2014 and 2017), is that cohesion spending is public investment and that, as such, it is qualitatively different from the social transfers that flow from richer to poorer regions and households for equalisation purposes within Member States. Yet the cohesion budget is routinely described as being distributive. Can these positions be reconciled? It is undoubtedly true that what Cohesion Policy actually funds is not social protection and, as a consequence, that it does not directly redistribute from rich to poor citizens. Indeed, there is no certainty that the poor will benefit at all from the sizeable receipts that poorer regions or Member States obtain. Typical cohesion projects are for infrastructure, human capital enhancement, business development, promoting social inclusion or reform of institutional capacity. It is only if the receipts ‘trickle-down’ that they will be truly redistributive in the conventional sense.

While there are clearcut examples of public goods with evident transnational reach or which would be difficult to justify at the national level – well-documented in the Reflection Paper – there are many elements of current EU spending for which it is far harder to demonstrate (Commission, 2017b) unambiguous added value for the EU overall. Moreover, political constraints render some areas where economies of scale or scope might arise – standard reasons for spending by a higher tier of government – hard to agree. Pooling defence spending or foreign policy, for example, would make economic sense, but has hitherto been inhibited by national sensitivities, although recent initiatives suggest there might eventually be a greater willingness to countenance some common defence policies.

Some EU spending is associated with closing gaps in fiscal capacity. The Cohesion Fund’s original purpose was to assist lower income Member States to maintain public investment while consolidating their public finances to be eligible for stage three of EMU. There is also a trade-off between achieving equalisation and attaining the aggregate objectives of the union. Equally, a desire to harmonise policy content, may lead to measures mainly meeting EU preferences rather than those of the national or, indeed, regional level. In this regard, a warning from Musgrave (1997: 71) deserves to be heeded: ‘the efficient provision of public goods is important, but a model of federalism which bypasses issues of distribution is incomplete and may well be misleading’.

### **3.2 Justifying EU spending: principles and their limitations**

Despite trying hard to justify different components of current EU spending on a subsidiarity test, a study by Ecorys et al. (2008) found that much could not be defended and much was missing. Even so, some simple tests to justify spending at the EU level can help to frame the debates on the future of the EU’s finances after 2020.

- The easiest is cost effectiveness: If spending at the EU level allows public goods to be produced at lower unit cost than at national or sub-national level, the case is strong. Pooling research funding, provided grants are subject to sufficiently robust excellence criteria, is a frequently cited example. There will be subsequent complications about how the resulting public goods are distributed and hence a need to consider the incentives facing authorities in drawing from the ‘common pool’ of public goods. For example, effective lobbying may result in imbalances in who gains from the common pool, and there have been instances of territorial boundaries being redefined so as to ensure eligibility for more generous levels of regional support.

- Second, spending at the EU level could make it easier to achieve the optimal level of public goods. In some cases, such as transport infrastructure, the returns on the investment by one country may accrue to users elsewhere who do not contribute to the project costs, prompting objections from tax-payers in the jurisdiction funding the public good. The result is likely to be under-provision because of this inability to internalise the benefits. EU level spending is a solution to this conundrum. Conversely, there can be unnecessary duplication of certain public goods by several Member States resulting in the aggregate benefit becoming less than the sum of the parts.
- Fiscal capacity constitutes a third reason, especially if norms of solidarity apply. When governments lack resources, they have to curb desirable spending, something likely to be more acute in the aftermath of the crisis years as legacy debts have to be reduced. This rationale has been present in the EU budget (the Cohesion Fund) but is also pivotal in justifying inter-governmental transfers in any system, albeit with difficult choices needed about how to organise them so as to maintain incentives for appropriate spending (Shah, 2007).
- Political necessity can, in practice, be a compelling reason for EU spending. At a time of concern about low investment, insufficient action to deal with the challenges posed by refugees and economic migrants, or the inability of Member States to alleviate the social consequences of years of economic stagnation, calls for the EU to act are bound to surface. Unsurprisingly and appropriately, several of these new priorities are highlighted in the Reflection Paper. The rationale is greater when the burden of dealing with common objectives is unevenly shared among Member States. There is a persuasive case, for example, for greater EU spending on dealing with the upsurge of migrants in light of the uneven territorial incidence of the costs of control and integration of refugees. Similarly, assuring the security of citizens is likely to be welcomed. However, expectations often have to be tempered because of the limited means at the EU's disposal and the need to avoid undue overlap with what is done – and expected to be done – at national level.

Such tests can help to make the concept of added value operational, but will always stumble when confronted with political realities, not least because when it comes to MFF negotiations, the Member States fall into a number of camps, not all of which are necessarily mutually exclusive, equally influential or, indeed, consistent over time. These preferences often shape what individual Member States regard as added value. France, for example, traditionally defended the CAP, thereby aligning itself with lower-income Member States with much less productive agricultural sectors, but more recently has become less supportive. As a significant net contributor, it became one of the countries pushing, prior to the current MFF, for a smaller budget as part of the so-called Noordwijk group, but one of the themes of Emmanuel Macron's Sorbonne speech was the EU should increase its budget, and another was to open the door to curbs on the CAP.

Some of those best disposed toward Cohesion Policy are sceptical about the value of substantial EU research programmes, more likely to accrue to richer regions and countries. The UK, for example, received 17.3% of the money under the 2007-13 7<sup>th</sup> Framework Programme for research, nearly double what Italy received, while Sweden's 4.3% was just under three times as much as went to all eleven countries of central and eastern Europe (1.5% in aggregate). Any option for new own resources will provoke national assessments of the fairness of its likely incidence among Member States, and so on.



#### 4. How much does Brexit change?

The UK has been one of only two Member States to have been a net contributor in every year since it joined the then EEC in 1973; there are no prizes for deducing the other is Germany. Few readers will need to be reminded of the long running battles fought by Margaret Thatcher, captured in the phrase 'I want my money back', after she came to power in 1979, culminating in the agreement (at the 1984 Fontainebleau European Council) to grant the UK a rebate. Since then, somewhat paradoxically, the UK has generally been in favour of wide-ranging reform of the budget yet, because the rebate cannot be undone without its consent, seemed prepared to accept unsatisfactory compromises so long as the rebate remained in place. That said, the amount the UK has paid over the years rankles in its domestic politics and was one of the factors behind the Brexit vote.

An intriguing question is, therefore, how the departure of the UK will affect the politics and economics of the EU budget, with many hoping it will provide an opportunity for more extensive reform. A first effect of Brexit would be the loss of the UK net contribution, averaging around €10 billion per annum in recent years. There are three possible solutions: the twenty-seven remaining Member States will have to pay more; EU spending will have to be cut; or the UK will, emulating Norway and Switzerland, have to be persuaded to continue paying into the EU's coffers.

With agreement having been reached at the December 2017 European Council on a 'divorce bill', the likelihood is now that (at least in round numbers, recognising that the timing of UK payments is still to be determined), the UK net contribution will continue at roughly its current rate for at least two years into the next MFF. The shortfall in revenue would remain for the future, but politically the money from the UK could be very helpful in postponing some of the harder decisions on future spending until a possible mid-term-review of the next MFF.

Some argue there is a fourth solution of endowing the EU with greater revenue raising powers, but analytically this would be much the same as asking the Member States to pay more, because any revenue raised would be from the tax bases of the Member States, even if it were presented as a new tax wholly hypothecated to the EU level. Thus, while Nunez-Ferrer and Rinaldi (2016) are correct to argue that the EU would not face a revenue shortfall in the narrow sense of being unable to generate resources, the loss of the UK contribution would have to be offset somehow.

A second effect of Brexit will be to remove a powerful supporter of certain preferences for the EU's finances. The UK has been a strong advocate of, *inter alia*: keeping the budget small and rejecting new own resources; of boosting the use of financial instruments (Brussels-speak for loans) alongside direct payments and grants; of concentrating Cohesion Policy spending on the lower income Member States; of increased spending on making the EU more competitive and doing so by spending less on the CAP; and giving greater priority to global Europe. Plainly, several other Member States share these preferences, albeit to differing degrees, and would seek to reaffirm them in the absence of the UK, but the balance among all Member States is bound to shift after Brexit.

One clear expectation, bearing in mind the hitherto cast-iron nature of the UK rebate, is that Brexit will facilitate an end to the system of corrections through which a minority of Member States have their gross contributions to the EU cut, obliging the rest to pay more. It is undoubtedly a bizarre arrangement and is far from transparent to tax-payers, yet it is important to recall why it has arisen. The *ex-ante* amounts Member States have to pay into the EU are largely proportional to their

prosperity, and imbalances stem mainly from the mix of expenditure undertaken by the EU. Hence, unless the composition of spending changes substantially, the remaining net contributors (already under pressure to fill the gap left by the UK) will have no motive to withdraw their demands for corrections.

Brexit may also open the door to a larger budget (as a proportion of GDP), as hinted at recently by Commission President Jean-Claude Juncker in his 2017 State of the Union address<sup>4</sup>, and stated explicitly in his Sorbonne speech by Emmanuel Macron: ‘nous avons besoin d'un budget plus fort au cœur de l'Europe, au cœur de la zone euro’. But stiff resistance must also be expected and it is noteworthy that the ‘non-paper’ from the Germany finance ministry on ‘paving the way towards a stability union’ is robust in rejecting an additional fiscal capacity at EU or Eurozone level as ‘economically unnecessary for a stable monetary union’. Similarly, Magdalena Andersson (the Swedish Finance Minister) was unequivocal in her view that asking her country to pay more ‘than we do today would be, to say the least, difficult to explain to the Swedish public’. As reported by Bloomberg<sup>5</sup>, ‘the EU cannot continue spending the same amount of money when one of the largest countries, one of the largest contributors, leaves,’ according to Danish Finance Minister Kristian Jensen, speaking in December 2016. Elsewhere<sup>6</sup>, Jensen said: ‘the important thing is what Denmark has to pay. And I don't think we should pay one krone more than we do now’.

There will be a temptation to believe the departure of the UK will remove an obstacle to rethinking the EU budget. While there will indeed be some shift in the balance of Member States towards those favouring a larger budget, other net contributors will still resist, making it hard to imagine a significant increase in the size of the budget or a marked shift towards more (re-)distributive spending. However, the UK would probably have been sympathetic to higher spending on some of the proposed new priorities, notably security. Consequently, Brexit may be less of an opportunity for reform than some fondly imagine.

## 5. Can the status quo bias be overcome?

One of the enduring paradoxes around the EU's finances is that widespread support for reform of the budget typically results in limited change in the main features of the budget. Someone asked to start with a blank sheet of paper would be pretty unlikely to produce a framework resembling what is in place today, but no-one has yet worked out how to arrive at a decisive break with the past. As a result, the same broad headings of expenditure can be traced back to the major reform of 1988. Within spending envelopes, however, there is more flexibility and evidence of shifts in emphasis over the years, albeit rather less than claimed by more sanguine commentators, witness the continuing scale of spending on agricultural and cohesion policies. What Kaiser and Prange-Gstöhl (2017) refer to as ‘incremental’ change rather than ‘path-breaking reforms’ is therefore the more likely outcome: the EU budget changes course at the pace of an ocean liner, not a speed-boat.

The reason is that there is a tangled web of compromises and side-deals behind the budget settlement, constituting a delicate balance of interests which, though making little sense objectively,

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<sup>4</sup> In, it should be noted, a departure from the original version of the official text of his speech

<sup>5</sup> <https://www.bloomberg.com/news/articles/2016-12-18/brexit-entails-budget-cuts-for-what-s-left-of-eu-denmark-says>

<sup>6</sup> <https://www.thelocal.dk/20170328/danish-minister-we-will-not-pay-more-to-eu-after-brexit>

allows deals to be achieved, sometimes in a puzzling way. Thus, France has reluctantly tolerated the British rebate in much the same way as the UK has the large CAP, because they can be seen as two sides of the same coin. Even if Brexit forces all sides to think more imaginatively about new options, it will be difficult to weave a new web. Some mould-breaking reforms are nevertheless conceivable.

Even so, several features of the budget are likely to be especially obstinate. In spite of recent calls for a larger budget, a meaningful increase is implausible because higher contributions by net contributors will be strongly resisted, while poorer or cash-strapped net recipients will not want to pay more. A rather fanciful line of argumentation is that if only the EU had true own resources, it could afford to spend more, but the most basic premise of the search for such new resources – reaffirmed in the report of the HLGOR (2016) – is that they would replace, not add to, current national contributions. In any case, once a budget ceiling is set, the means by which revenue is raised is arguably a second-order matter.

Another feature of the EU budget is the limited equalisation it provides, with some CEE countries receiving quite substantial net inflows. Net contributions and the expectation of *juste retour* are among the most contentious elements of the MFF negotiations and typically involve meticulous scrutiny by Member States, with resort to corrections where need be to enable Member States to arrive at net positions that are politically tolerable. While rarely framed as a debate on equalisation, the disputes are, in practice, about what is an acceptable degree of transfer, both for net payers and net recipients. Its significance is that it so often dominates debate about what spending programmes to have, with the net balance mattering more than what is meant to be achieved by the policy.

For all these reasons, and despite the many new priorities put forward for EU spending, it will be difficult to make radical changes in the composition of EU spending. Without an increase in the size of the budget, the fundamental political economy dilemma is that creating space to spend more on new priorities means existing beneficiaries will have to forgo some of what they receive at present. Co-financing of agricultural subsidies could prove to be a litmus test, because the prolonged resistance to radical transformation of the CAP has inhibited other changes. But no one should be surprised if the always very effective agricultural lobby successfully opposes such a change.

## 5.1 New own resources and corrections

Although the choice of own resources is not prominent in the negotiations among Member States, the EU institutions have regularly, though with conspicuously little success, pushed for ‘genuine’ own resources in place of the ‘national contributions’ that have provided the bulk of the EU’s revenue. The usual pattern is for ideas to be floated early in the MFF cycle for a potential new resource (or resources, in the plural), then for the Member States to argue that while it might be worth exploring in the fullness of time, it is much more important to concentrate on what really matters, namely the expenditure deal. As a result, there is a strong status quo bias. According to Blankart and Koester (2009), an explanation reflecting public choice theory is that Member States have opted to limit bargaining on the revenue side so as to concentrate on the expenditure side.

The arguments around new own resources have gone round in circles for many years, (Begg, 2009; HLGOR, 2016). The dilemma can be simply stated: nearly everyone agrees on the attractions of a new approach, but there is no consensus on what the new approach should be; as a result, the status quo largely remains. It is worth reiterating two conclusions from the previous work: first,

there is no shortage of viable candidates; but, second, none can be considered ideal because, on the sorts of criteria used to appraise them, each will exhibit some shortcomings. A carbon tax, for instance, would penalise Member States more reliant on dirty coal, while the yield from a profits tax could be unduly volatile because of the macroeconomic cycle.

In revisiting the matter, the HLGOR (2016) identifies a list of possible resources. Some are old favourites such as a share of the proceeds of VAT or corporate income tax; others, such as using a financial transactions tax and, perhaps, allowing Member States to choose whether to hypothecate the yield from the tax to contributions to the EU budget, are more novel. Doubts are, however, bound to arise about whether the volatility of the yield from an FTT is an obstacle, especially if countries with large financial centres do not take part, resulting in diversion of activity (at which the financial sector tends to be very adept) to jurisdictions not covered by the tax.

The HLGOR concludes that both the traditional own resources and the GNI resource should remain, though with the latter contributing a smaller share. There is a compelling justification for retaining the GNI resource because of the way it is designed, alongside the obligation for the EU budget to balance, requiring a resource flexible enough to adjust if expenditure either over- or under-shoots. The GNI resource achieves this because the amount called from Member States acts as a ‘balancing flow’, ensuring EU revenue matches expenditure. For this purpose, the GNI resource could be much smaller than at present, although it would still need to be big enough to offset fluctuations in the yields of any other resources.

Objections to new resources are, however, not just about their merits as sources of revenue in the EU context, but also about whether Member States are prepared to confer a ‘power to tax’ on the EU level. It is intriguing to speculate on whether the European Parliament, in particular, would find it congenial to be responsible for determining tax streams and rates in the way national parliaments do. Imagine, for example, a candidate to be an MEP or a cross-border party grouping campaigning to introduce a European corporate income tax or to replace customs duties by a carbon tax. For many Member States, the incentives to concede are by no means obvious, and many national parliaments would be expected to resist such an encroachment on their sovereignty.

For these reasons, it is important to frame the debate on new own resources not just as one on whether a sufficiently credible new resource can be identified and calibrated to fund at least a proportion of the EU budget, but also as one about what might be called the overall fiscal constitution of the Union. Despite the criticisms of national contributions, the existing system works well enough and is reasonably fair in sharing the burden of paying for the EU. The corollary is that genuine new own resources will be a hard sell in which political factors outweigh the economics.

## **5.2 Financial instruments**

One means by which the EU is able to enhance the impact of its budget is by leveraging-in additional resources through loan financing of projects. The European Investment Bank (EIB) has been one of the principal sources of such loans, but other channels have also been important, for example private sector participation in some EU research programmes. Loans make sense where the project in question generates a financial return which can then be used to service the loan. EU level involvement is desirable if it helps to overcome adverse selection by financial markets through which only safe or lucrative projects are backed by private lenders. By offering guarantees, the EU can

enable more marginal, though still worthwhile, projects to be financed at acceptable cost. Moreover, the funds can be recycled once the period of the loan ends, rather than requiring further contributions from tax-payers. However, financial instruments are, typically, not allocated geographically, prompting concerns that they favour richer areas.

Intriguingly, the UK was always keen on reinforcing the role of loan finance, arguing a decade ago (HM Treasury, 2008: 18) that in ‘some instances, loans or blended grant/loan instruments may achieve more efficient outcomes than grants’. With the creation of the European Fund for Strategic Investment (EFSI), one of the major initiatives of the Juncker Commission, there was a step-change in the scope of innovative financing. The HLGOR (2016) notes the steady increase in use of such instruments and comments in particular on the EFSI, noting that in aggregate it is of a similar scale to Cohesion Policy spending.

The HLGOR (2016: 33) poses an interesting question: ‘who is likely to benefit in the future with the expansion of centrally managed headings and financial instruments. Is it those who receive more transfers, or those who mobilise the most funding from support triggered by the EU budget?’ The significance of the question lies in the finding that financial instruments mainly benefit richer countries leading the HLGOR to criticise ‘the erroneous position of some Member States that consider that they do not benefit from contributing to the EU budget, based solely on the public fund flows’. These observations suggest a dilemma about financial instruments. On the one hand, they can amplify the impact of the EU budget and, as the HLGOR stresses, counter perceptions that the net balances in EU finances are a zero-sum game. On the other, an expansion of financial instruments, especially EFSI, may conflict with equity goals by favouring richer Member States.

Three caveats are worth mentioning. First, the various levels of the public sector collectively need to borrow to fund financial instruments and it is likely they can do so more efficiently by acting together, but for those with the best credit ratings, there may be no real advantage. Second, while it is tempting to believe financial instruments are an unalloyed addition to the EU’s fiscal capacity, there will inevitably be crowding-out of other uses of the funds: the prospect of a ‘free lunch’ should still be treated with scepticism. A third concern is that a steady pipeline of projects amenable to financial instruments is required if they are to achieve their potential. Thus, while there are undeniable attractions in expanding the use of financial instruments, they should not be regarded as a panacea and likely political objections should not be under-estimated.

### 5.3 Conditionality and incentives

Having been a major source of contestation in the negotiation of the last MFF, conditionality is already emerging as a difficult challenge for the next, even though over-zealous resort to conditionality could backfire, both economically and politically. Particular care will be needed in aligning incentives and in ensuring conditions are appropriately targeted, recognising how the scope for imposing conditionality is affected by the nature of EU spending. Several of the large programmes funded by the budget are multi-annual, a first consequence of which is that they lock-in the allocations of resources, limiting flexibility in spending. A second is that the profile of actual spending, as opposed to commitments, is unbalanced over time.

Three distinct types of conditionality are relevant to the EU budget. The evidence suggests the most successful is the *ex-ante* obligations under Cohesion Policy. These require the articulation of

strategies and the adoption of appropriate administrative arrangements before approval of the operational programme by the Commission. There have also been efforts to boost institutional capacity including through technical assistance offered as an integral part of budgets. A more strategic approach to economic development has been shown to improve results and to respond better to the needs of supported territories (Bachtler et al., 2016).

Much more contentious are conditions imposed on governments obliging them to pursue sound economic governance – an expression coined to circumvent objections to the term ‘macroeconomic conditionality’. In essence, this calls for EU spending in a Member State to be withheld or postponed if it does not comply with rules on fiscal discipline or macroeconomic balance. While such mechanisms have suffered from persistent implementation problems (for an overview, see Begg, 2017), the conditionality could act in a blunt manner by punishing regions or sectors for failings they are unable to influence. Though not yet used, including in the curious episode in the summer of 2016 when Portugal and Spain incurred fines of zero euros for doing too little to reduce their public deficits, there is clearly support for attaching more binding conditions to EU spending.

A third sort of conditionality is more directly associated with the quality of programmes. Devices such as performance reserves, disbursed only if certain milestones are achieved, can provide programme authorities with incentives for effective management. It is this third category which is likely to attract interest in the forthcoming negotiations, because a challenge for the EU budget will be to show it is receptive to administrative innovation. Some of the ideas floated in the Reflection Papers point towards an increased interest in carrots, rather than sticks.

## 6. Governance and other considerations

The tension between the economic and political in deciding the EU budget is not just about the mix of spending and, to a lesser extent, how the EU’s revenue is raised, but also about the procedures and the roles of different bodies. In addition, a very different public finance role fulfilled by the EU is in monitoring national budgets. The Stability and Growth Pact and the various new governance arrangements agreed in response to the financial, economic and sovereign debt crises that struck between 2008 and 2011 have substantially reinforced the powers assigned to the EU’s institutions. As discussed above in relation to conditionality, linking the EU budget to these broader governance goals has emerged as a contentious issue.

How the MFF is decided and what is possible are largely dictated by the Treaty, but some aspects of its governance may be worth a fresh look, if only in relation to possible treaty changes affecting what can be envisaged for the budget. In particular, the obligation to balance the annual budget and the expectation that any surplus is returned to Member States diminishes the potential stabilisation role of the budget. Similarly, although there have been calls for the EU to react to the social consequences of the years of crisis, EU spending for this purpose would be at odds with the long-standing assignment of welfare policies as a member state competence.

There has usually been a narrative around each MFF. For example, 2000-06 was known as ‘Agenda 2000’, linking to the substantial enlargement of the EU in 2004; for the latest round (2014-20), it was the Europe 2020 strategy, the ambitious set of goals to achieve ‘smart, sustainable and inclusive growth’. No obvious *leitmotif* suggests itself at present, other than variations on ‘re-launch’ or

‘aftermath of crisis’, neither of which is sufficiently alluring. A better tone might stem from emphasising ‘investing in [a reformed] Europe’ perhaps going back to the future by adding the ‘growth and jobs’ theme central to the Lisbon strategy. Cynics might claim it matters little what the label is if the budget does not evolve much or is perceived as too distant from citizens/tax-payers.

## **6.1 Actors and stakeholders**

The European Parliament formally has co-decision powers over the MFF (but not the means by which EU revenue is raised), but has had relatively little influence on the broad deals reached previously. In past rounds it has mainly acted only after the European Council has reached agreement and had little to show for the mid-term review of the 2014-20 MFF, something the EP had succeeded in including in the agreement. Although the EP (and, to some extent, the Commission) wanted a more extensive review (Becker, 2016), it was largely blocked by Member States concerned not to re-open the overall scope of the MFF. The mid-term review, finally agreed in June 2017 after being delayed by the UK election, did not change the budget much for the remaining years of the 2014-20 period. The political significance of a limited role for the Parliament is that it tends to give more weight to the inter-governmental bargaining characteristic of the Council configurations than to the supranational level.

The sub-national level in many Member States can be influential. In federal countries, powerful state or regional governments often have primary responsibility for the policies that are supported financially by the EU budget, such as economic development, but regional and local authorities in other national settings often have similar responsibilities delegated by central governments. As a result, the formulation of national policy positions has to accommodate these regional interests. An extreme example often cited is that of Bavarian agricultural interests which, partly because of the delicate politics of the CDU/CSU coalition of centre-right parties, has led Germany to indulge the CAP, even though the net cost of the policy to Germany is high.

Sub-national interests in centralised states also have different incentives from their national governments where they can obtain a bigger flow from the common pool of EU spending. For sub-national governments that rely substantially on inter-governmental grants from central government, securing support from the EU budget (principally from the cohesion envelope) provides resources over and above what it would be entitled to on a purely national settlement, even more so if they trigger national co-financing. Indeed the additionality principles applied to cohesion spending are meant to ensure this. It is hardly surprising, therefore, that the sub-national governments are often at odds with their central counterparts.

## **6.2 A supplementary fiscal capacity**

A specific question is whether the EU (or perhaps only the Eurozone) may need a supplementary fiscal capacity to complement what is provided for in the MFF. The Eurozone is unlike other currency areas in lacking its own fiscal stabilisation capacity. Although the large size of the public sector in EU Member States means that automatic stabilisers can have powerful effects at the national level in smoothing aggregate demand or mitigating regional shocks, unlike many other jurisdictions where such a role is limited, they do not function so effectively across national borders. In addition, mechanisms for coordinating and constraining national fiscal policy limit this effect. Despite attempts by the Commission, especially, to stress the euro area fiscal stance – reinforced by the recent establishment of the European Fiscal Board – there is no explicit means of arriving at a

collective EU (or Eurozone) fiscal policy. The notion of an additional fiscal capacity, with a mandate to foster macroeconomic stabilisation, has therefore come to the fore.

However, it elicits conflicting reactions. Some of the more ambitious ideas put forward in the 2012 Four Presidents' report were quietly dropped by time of the Five Presidents' report in 2015, and the Reflection Paper published in 2017 is still more tentative. Granted, it discusses options such as a rainy day fund or a European unemployment insurance fund, but such measures would be well shy of something on the scale of 5-7% of GDP set out forty years ago in the MacDougall report (Commission, 1977), let alone what is the norm in most OECD countries.

Some new ideas, albeit with only limited scope for achieving much in stabilisation, were put forward in the December 2017 'Saint Nicholas' package from the Commission<sup>7</sup>. It includes proposals for funds to promote structural reforms, to support convergence towards euro membership and to assist in coping with an asymmetric shock. However, the figures signalled are in hundreds of millions of euros for the first two and there appears to be an expectation that loans rather than grants will be the main means by which the third is realised. The political timidity behind these orders of magnitude means they will not be game-changers.

The reasons for caution are understandable. Potential creditor countries fear they will invariably be contributors to any such fund and worry about moral hazard if debtor nations sense an easy means of keeping public spending above sustainable levels. Critics also include those who doubt the value of fiscal activism, despite recent analyses suggesting a greater need for fiscal policy when interest rates are at the zero lower-bound.

If any additional fiscal capacity gains favour, a number of governance considerations will have to be examined. They include how the new instrument would be administered and revenue raised, for whom and under what legal framework. Despite the stated wish to use the EU budgetary framework, new instruments may be outside the existing EU framework as a separate inter-governmental arrangement, but could be designed to be integrated after a certain period. The modalities of scrutiny and accountability would have to be established and the relationships with existing EU mechanisms and institutions clarified.

### **6.3 Duration of the MFF**

The duration of the MFF is another facet of governance likely to be reviewed. It is worth recalling that the reason for introducing a multi-annual framework was to forestall the regular disputes between the Council and the European Parliament in the 1980s over the annual budget. Having a longer-term framework means the big decisions are thrashed out in a single, albeit protracted, negotiation, but tricky questions arise about legitimation. Seven year MFFs in a context of five year mandates for the Commission and the Parliament de-politicise the budget in the sense that spending programmes cannot directly be associated with election campaigns, promises by parties or the ambitions of Commissioners.

Instead, precisely because the MFF spans at least two institutional mandates, plans are either inherited or formulated for future incumbents, and in the case of the 2014-2019 mandate, the

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<sup>7</sup> These are described in the Communication on 'New budgetary instruments for a stable euro area within the Union framework', Brussels, 06.12.17, COM(2017) 822



institutional terms will have ended before the next MFF is settled. Buti and Nava (2009) note the advantages of one cohort of politicians taking decisions they will not have to implement, because it makes it more likely they will decide for the common good. Yet the fact remains that long-term public finance considerations achieve little traction in the EU budget; on the contrary, it has acute trouble breaking free from the narrow focus on net balances that has dominated successive MFFs. It is not for nothing that the status will have endured with comparatively few innovations through five MFF cycles by 2020.

In 2014, with the Commission, the Parliament and the MFF all being renewed there was more of an opportunity to align the MFF with the quinquennial institutional cycle (though it should be recalled they were at different points in the calendar year), but the Member States prevailed in blocking it. If seven year MFFs continue, it will take until 2034 for the end of the MFF again to coincide with the renewal of the institutions – in this instance, with the new Parliament and Commission in place just prior to the start of the MFF. If five year MFFs are introduced, there would then be a question about whether the span should be mid-point to mid-point or should be identical to the institutional mandates. The latter would allow a new Parliament and Commission to put forward spending (and, potentially, revenue-raising) plans – in so doing, seeking to garner support directly from citizens and Member States – to be implemented after coming to power, and might be regarded as democratically ‘normal’. However, the evident political consequence would be to diminish the role of Member States.

## 7. Predictions and other conclusions

A number of predictions can be hazarded about how the MFF negotiations will unfold. First, political factors will, again, over-shadow economic reasoning in shaping the outcome and it may even expedite decision-making if a fruitless debate on economic principles is avoided. Second, Brexit will not have as profound an effect as might be anticipated, not least because it is as likely to sharpen some of the divisions among Member States as to mitigate them. The corollary is that although lip-service will be paid to ‘European added-value’ or ‘the common interest’, it will be difficult to prevent the rather less lofty principle of *juste retour* remaining pivotal in reaching agreement. As always, there will be calls (already visible in the Reflection Paper) for simplification, efficiency and flexibility, but there is more than a whiff of ‘motherhood and apple pie’ about such calls.

A third set of predictions on the likely contours of an agreement follows from the first two:

- The balance of political pressures will deter any significant shift in the current size of the EU budget, implying that the margin for negotiation will be small fractions of a percentage point of EU27 GNI, around a headline figure of 1%;
- Net operating balances for some of the CEE countries will remain substantial, but perhaps diminish slightly;
- Direct payments and economic development funding for lower income regions and member States will continue to be the largest components of EU spending;
- Corrections will not disappear, although simplification of the means of calculating them could be envisaged, based on a common formula, rather than the current array of ad hoc measures;

- More effort will go into designing ‘financial instruments’ capable of gearing-up the impact of the budget, especially for investment purposes, with the perceived success of the EFSI influencing opinion, but the spatial distribution of loans could prove to be problematic;
- The European Council will still be the dominant actor in achieving a settlement, while the role of the European Parliament will remain marginal.

However, a fourth category of predictions concerns where the main focus of disputes will be and thus what might become the headline developments of the new MFF:

- Co-funding of direct payments (mainly to farmers), though certain to face strong opposition, may become a key proposal so as to free resources for new policy purposes;
- While some new priorities will be favoured in the budgets, the negotiations will centre on restricting the scale of the appropriations for them, with sizeable amounts resisted;
- A limited opening will be created for new own resources, possibly through a process of opting-in for those Member States choosing to hypothecate the yield from a particular tax (such as an FTT) to substitute for a proportion of their national contributions. However, a more extensive recasting of the revenue side of the budget will encounter strong resistance and GNI contributions are likely still to be the largest share of revenue;
- Conditionality, already a source of considerable conflict in the negotiation of the 2014-20 MFF, will be harder still to agree, but there is likely to be greater interest in providing positive incentives for ‘well-judged’ spending of EU funds – in other words, more carrots and fewer sticks;
- Alignment of the MFF to the five-year political cycles of the Commission and the Parliament will be considered, but faces the evident complication that there is already a disjunction in timing because the MFF will only start in 2021, eighteen months into the mandate of the next Parliament. A more consequential mid-term review of a seven year MFF may, therefore, be the basis for a compromise, but the onus will be on the Parliament to make more of it.

Although these predictions imply ‘status quo’, characterised by piecemeal and incremental changes, more than ‘radical reform’, the wider debate on the future of Europe also has to be taken into account. Depending on which of the five scenarios in the Commission White Paper (including combinations thereof, or what Jean Claude-Juncker described as scenario 6 in his 2017 *State of the Union* address) becomes the basis for the evolution of the EU post-Brexit, an altogether different future for EU finances (including, but not limited to, the EU budget) could be imagined.

Three main themes will arise. The first is whether any complementary fiscal capacity will be sought, for instance to deal with one of the specific policy challenges, such as border security or Eurozone development, outside the framework of the MFF, or to facilitate a step-change in European integration. There are precedents, such as the (admittedly, very small compared with the MFF) European Globalisation Adjustment Fund or the European Development Fund, although some Member States have queried why they should be outside the MFF. Plainly, the vision set out by Juncker of all members participating sooner rather than later in Schengen and the euro is simpler in this regard. The creation of the European Stability Mechanism and the plans announced in the Saint Nicholas package for its evolution into a European Monetary Fund would entail a significant rethinking of EU fiscal arrangements.

Second, in the absence of Treaty change or, indeed, of enough time to ratify a revised Treaty, developments in the period after 2020 are likely to be confined to what can be achieved within current constraints. This need not lack ambition. For example, the creation of the EFSI as a means of boosting investment shows how a substantial innovation can arise. But the wider evolution of EU public finances is likely to occur only beyond the next MFF. Nevertheless, it will be important for debate on the next MFF to take account of other aspects of public finances, rather than to plan the MFF in isolation.

Third, if the proposals of Emmanuel Macron prevail by encouraging those who want to go ahead and not to be deterred by the unwilling, it could be awkward for the institutions representative of the EU as a whole. Should differentiated integration become, as many now expect, the 'new normal' (not only around the Eurozone), the modalities of funding policies adopted by only a subset of Member States will be crucial. The most immediate case is a form of fiscal stabilisation capacity for Eurozone members, but much the same points would arise if some want to move to, for example, full banking union (entailing common deposit insurance or a shared fiscal backstop for bank resolution – also proposed in the Saint Nicholas package) or a form of 'migration union'. Key questions would include how revenue is raised, the institutional channels through which the spending is administered and scrutinised and how participation is decided. Can the European Parliament and the Commission, as (soon to be, following Brexit) EU27 institutions, legitimately oversee a policy covering nineteen or fewer Member States? Are non-participants entitled to object to Commission resources being used on policies they do not adopt, and so on?

To return to the title of the paper, the politically feasible must be expected to dominate the economically desirable in settling the next MFF. Giving more weight to the economically desirable will require prior answers to the intractable question of where the EU is going. The latter debate is launched, but will probably still not be resolved in time for the next MFF. Perhaps, though, there will be greater clarity in time for the subsequent one....

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