Conference report

Prospects for the EU Financial Perspective in an Age of Austerity

Friday 4 – Sunday 6 February 2011 | WP1089

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"The challenge is not to spend more but to spend better""

Key points

- Fundamental change in the next European Union (EU) multi-annual Financial Perspective (budget) is unlikely. The next Financial Perspective is likely to be more of the same and slightly larger in absolute terms.
- The EU budget is unlikely to be fully fit for 21st century challenges as the preoccupation with net balances and *juste retour* arguments are likely to continue. The relative size of agriculture in the next budget is likely to decline slightly while expenditure in small areas, such as Research and Development and External Action, are likely to increase. The 'budget' should be more flexible to enable the EU to act more effectively and deliver across budget chapters.
- Many regard setting a reduced budget now in light of the current austerity is unlikely to be appropriate, given the next Financial Perspective may extend for several years beyond the impact of austerity.
- There is however a case for possibly shortening the duration of the next Financial Perspective, and factoring in longer term relatively low growth.

Introduction

1. The degree to which the next European Union (EU) budget should be affected by the current austerity in several Member States formed a central theme in this Wilton Park conference. The background is perhaps best encapsulated in a December 2010 letter from five heads of government to Commission President Barroso: "European public spending cannot be exempt from the considerable efforts made by the Member States to bring their public spending under control... payment appropriations should increase, at most by no more than inflation over the next financial perspectives ... improved European spending efficiency, accurate tracking of commitment appropriations, seeking out where we can gain economic leverage and simplifying the financial framework (can help)".

2. In terms of both size and functions, the EU budget is hardly comparable with Member State budgets. EU spending constitutes about 2% of overall public expenditure in the EU. In contrast, federal budgets in the US and Canada were respectively 62% and 39% of total government expenditure in 2008. In absolute terms, the 2007-13 Multi-Annual Financial Framework (MFF) provides for €976 billion in commitments, or 1.11% of EU Gross National Income (GNI), and payments total €926 billion (1.05% of EU GNI). In 2011, €141.9 billion in commitments and €126.5 billion in payments (1.01% of EU GNI) are forecast. In terms of percentage of GDP, national government revenue was almost 50% in France, 46% in Italy, 42% in Germany, 41% in the UK and just under 40% in Poland in 2008 (itshould be noted national budgets of course have different purposes and focuses).

3. The EU budget is highly controversial, not least because it is seen to be complex, opaque, inter-governmental, remote and hence ostensibly less legitimate. The EU budget largely funds areas which many consider do not address key 21st Century challenges. For example, agriculture only constitutes 1.8% of EU Gross Domestic Product (GDP) yet

receives 41% of the EU's 2009 budget. The Common Agricultural Policy (CAP) does not benefit small farmers but multinationals and high net worth individuals. Critics of the EU budget point to the high salaries paid to EU staff (for example, senior officials in the European External Action Service (EEAS) are paid almost twice what UK ambassadors receive). EU funds are often unused, and the Court of Auditors finds many irregularities. Research budgets have produced limited results, and large projects such as GALILEO and the International Thermonuclear Experimental Reactor (ITER) have experienced substantial cost overruns. The EU should draw a line under failure, as for example the UK did with its Nimrod project. The EU Commission's budgeting process lacks centralised discipline with each Directorate General making its own plans. Lastly, the EU should use its funds to leverage more co-financing from the private sector and other sources.

4. Many acknowledge the EU budget's shortcomings but argue that looking at the EU budget solely in terms of accounting principles does not provide the full picture. There are substantive off balance sheet benefits such as the EU's contribution to 60 years of peace in Europe, and its role in fostering greater pan-European prosperity through the institutions, policies and rules that underpin a Single European Market of half a billion consumers. Net contributors to the EU budget, far from losing money by supporting poorer countries and regions, gain through the resulting creation of demand for exports and related jobs. If waste in EU institutions is the concern, one should not forget considerable waste at all levels of government in Member States.

5. The Commission published its Budget Review in October 2010, and consultations are underway before the European Council and SURE Committee respond in Spring 2011. By 1 July 2011, the Commission will present its proposals for the next MFF and Own Resources (OR), and Member States will have to agree the next financial framework in 2012.

Structure

6. The Treaties underpinning the EU and its evolution impact considerably on the structure of the EU budget. This explains the large shares of agriculture and cohesion, and the absence, for example, of any allocation for military spending. EU expenditure is dominated by agriculture (42% of which direct agricultural aids and market related expenditure constitute 30% and rural development, environment and fisheries constitute 11%), and cohesion (30%). Other areas of expenditure are: competitiveness (10%), administration (6%) and the EU as a global partner (6%). Agriculture has fallen from about 60% of the budget in 1988 to 42% in 2009, whilst cohesion expenditure will increase from about 24% in 1988 to 36% in 2013. The highest growth rates are for Research & Development (R&D), Trans-European Network (TENs), and the EU's external role.

7. The MFF's budgetary discipline and predictability is achieved through overall and sectoral ceilings and the requirement that expenditure has to be based on EU legal foundations. The budget reflects trade-offs between a growing number of Member States, the European Parliament and a wide range of interested sectors. It allows innovations where possible: programmed budgetary expenditure has been complemented by ad hoc instruments (emergency aid, solidarity fund, globalisation adjustment fund) with EU OR (revenues) serving as collateral to support crisis stabilisation mechanisms.

8. The EU budget has to balance predictability and flexibility. Financial frameworks have bought 'budgetary peace' and ensured strict financial discipline and medium-term predictability. However, the past decade in particular reveals how exposed the EU is to sudden developments, and the limited role it can play. Expenditure mechanisms therefore need to be more flexible to react to unforeseen circumstances and changing priorities. The amount made available for climate change (€150 million between 2010 and 2012) illustrates how the EU's budget does not play a role commensurate with its ambition. It is not only a question of inflexibility and limited funding, but also the slow response of EU Governments. For example, there have been recurrent shortfalls with regard to Palestine which have had to be addressed *ad hoc* rather than through a more structured approach.

However, flexibility has been possible in some areas though these were difficult to negotiate. . For example, in 2007-9, €8.4 billion was available for GALILEO, food aid and the European Economic Recovery Plan (EERP). The EU's response to the earthquake in Haiti and floods in Pakistan has been efficient and generous.

9. There has also been an excessive focus on 'net balances' or *juste retour* logic which pre-allocates expenditure. The *juste retour* approach of how much any Member State receives in return for its contributions should become less prominent. The question though is not always what a Member State receives, but what it contributes. If net contributions were to be reduced, there is a risk of Member States receiving little back. If the considerable macro-economic and cohesion benefits of the EU budget were given greater prominence in debates, the *juste retour* approach may have less weight. However, given the pressing need to reduce national deficits, especially in an era of austerity, this appears unlikely.

10. Many Member States continue to advocate change in the composition of budgetary expenditure to enhance relevance and added value. Economic and social cohesion should remain one of the budget's key aims, but so should growth enhancing investment in R&D, pan-European networks and infrastructure. To achieve this, CAP expenditure would be reduced in real terms; cohesion spending allocated to poorer regions in richer countries would be reduced, and private sector investment should increasingly be leveraged. While the case for a strategic reassessment of the budget's priorities remains, any change in the composition of the budget needs to be complemented by ever more efficient management.

Size of the Budget in an Era of Austerity

11. The EU budget is equivalent to only 1.2% of the EU's GNI which is small compared to the size of national budgets. The EU budget has, in fact, been relatively well controlled while many national budgets are experiencing large deficits because by law the EU budget by law must be balanced (accordingly the EU budget actually runs a surplus of around € 5 billion a year which, as unspent funds, is returned to member states). The EU budget, which increased 3.2% per annum in the past decade, has expanded less than Member State budgets. For example, the UK's own budget increased 7.8% per annum and EU 27 national budgets increased on average 4.9% per annum over the same period. Given EU Gross GNI increased 3.4% per annum, the EU budget grew less than average EU GNI, even in spite of the major enlargement to Central Europe.

12. The difficult budgetary position of many Member States will affect the EU budget for at least the medium term. The question is if all national budgets shrink, should the EU budget be reduced as well? Some maintain the long term sustainability of public finances must not be undermined, and cuts across almost all expenditure lines are needed. The UK Treasury (finance ministry), for example, in the course of its domestic spending review has sent letters to departments outlining up to 40% cuts in expenditure over the next four years. Without political direction, budgeting becomes a shopping list exercise. Savings are needed, and ceilings can deliver it.

13. Many though maintain there is no obvious reason why the necessary reduction in current national spending should have an automatic impact on the EU budget. The size of the EU budget should be retained because the considerable bulk of current expenditures and unfunded entitlements fall solely within national competences. In spite of the prevailing austerity, and some calls to reduce the EU budget's size, many believe its size will remain about the same.(this is not public information.)

Reforming Expenditure

14. When considering increasing or decreasing the size of the EU budget, it is important to consider the scope for reform in respective expenditure items. Any fundamental review of EU policies should ask: why is there a need for an EU public policy in this area? What areas need a public policy and to what degree should they be common? To what extent should it be financed by a common budget?

15. Some maintain the debate should focus less on spending levels, and more on looking at EU and national budgets in tandem. The EU budget could be financed more intelligently through:

a. greater flexibility across budget chapters

b. refocusing all existing spending policies to maximise contributions towards meeting Europe 2020's goals of smart growth for an economy based on knowledge and innovation; sustainable growth which is more resource efficient and greener, and inclusive growth fostering high employment and social and regional cohesion;

c. concentrating funding on investments for the future, notably in the areas of skills, research and innovation, energy and sustainable transport;

d. linking the EU budget to strengthening the EU's economic governance;

e. continuing efforts towards making EU programme delivery systems more user-friendly, simple, performance-related and efficient whilst maintaining high standards of accountability;

f. looking at EU spending programmes comprehensively, not least by considering their costs in terms of administrative expenditure at EU and Member State levels, and also by looking at how the benefits of spending in one Member State can produce benefits in others.

g. making wider and more systematic use of innovative financial instruments including EU project bonds, notably for financing large-scale cross border investments in energy, transport and telecommunications

h. seeking increased efficiency and performance in EU institutions own administrative resources and identifying ways to meet new challenges from within existing resources.

16. In the medium term, EU spending in Eurozone members is likely to be more conditional on national compliance with the Stability and Growth Pact, and mechanisms such as the European Financial Stability Facility (EFSF) and European Stability Mechanism (ESM), which will have greater ability to constrain national borrowing. The current size of the EFSF implies an average level of guarantees of more than 4 % of GDP of participating Member States. The more a country contributes to the EFSF or ESM, the more it will assume the risk of others, and have greater influence on other Member State fiscal policies.

17. The dominance of grants in EU expenditure is costly and limits the ability to leverage funds from other sources. Financial instruments linking EU funds with loans and private sources are rare. New financial instruments, largely entrusted to the European Investment Bank (EIB), for example the Risk Sharing Finance Facility, can produce substantial leverage effects. The budget should, therefore, be used more to leverage investment through: new financial instruments blending grants and loans from the EIB, European Bank for Reconstruction and Development (EBRD) and Member State development banks and public-private partnerships (PPPs). The EU could guarantee bonds issued by the EIB or private companies, and create another guarantee fund under the EU budget. Performance based budgeting can link financial support to specific, measurable, achievable, relevant and timed objectives. There should be incentives for programme managers to underspend and add value (i.e. merge projects).

" Relevant quotes if applicable"

Common Agricultural Policy

18. Three break out groups were mandated to identify actions which could be taken forward in the two largest areas of expenditure (agriculture and cohesion policies) and in one area where there is generally believed to be a need for additional expenditure (investing in green R&D).

19. The CAP has three principle objectives: viable food production; sustainable

management of natural resources and climate action (environmental public goods, green growth through innovation, climate change mitigation and actions for adaptation), and maintaining the territorial balance and diversity of rural areas (to support rural employment and maintaining the social fabric of rural areas).

20. Some argue agricultural policy should be renationalised but many believe it is dangerous to do so as it would infringe the Single Market, end the common support framework and endanger the EU's common commercial policy. Leaving aside detrimental internal effects, externally renationalisation would make it even more difficult to conclude international trade agreements.

21. Although many agree the CAP needs fundamental reform, agriculture is gradually being liberalised. Further reductions are not as simple as commonly presented. Often areas considered as a potentially ripe for reform are difficult to change from the political point of view. However, the group identified four possible reforms:

a. remove direct payments from the CAP but maintain a common policy. Direct payments could be gradually phased out over the next three Financial Perspectives;

b. in lieu of payments, give some security to farmers. As direct payments *inter alia* act as a buffer against price changes, a safety net (to keep intervention measures in place, even if not active) could be retained for use during, for example, crises;

c. develop a toolkit for risk management;

d. develop the Rural Development Policy (second pillar of the CAP).

Competitiveness could be increased through innovations, income diversification, keeping rural areas viable and further forestation.

Cohesion policy

22. There are two streams of structural cohesion funds: cohesion funds earmarked to assist the integration of Spain, Greece, Ireland and Portugal to improve their competitiveness and to meet the challenges of Economic and Monetary Union (EMU), and secondly funding for regions in all Member States whose GDP is less than 75% of average EU GDP.

23. Cohesion policy enhances the solidarity and competitiveness of the EU. In the past decade, cohesion policy has *inter alia* created one million jobs and connected 20 million to the supply of clean water. It has generated higher GDP and has helped mitigate the impact of the financial crisis. However, many new, and even old, Member States have experienced problems using cohesion funds. For example, the Netherlands wants cuts in the size of the EU budget, in part because it has the worst structural funding absorption rate.

24. Cohesion policy needs to be better co-ordinated and implemented, and aligned with other EU policies. Six specific actions to improve cohesion policy include: a. simplification of objectives and user funds to make policy and delivery more effective; b. allowing funding to flow to poorer regions in poorer, rather than richer, Member States; c. linking a certain percentage of structural funds to meeting EU 2020 objectives of creating roughly 15 million new jobs by 2020 and increasing public and private R&D investment by about one per cent of GDP; d. keep the current co-financing system with ratios varying according to project and country so differentiated rates apply; e. linking projects to national structural economic reform programmes, and f. using alternative ways of funding, such as innovative finance and leveraging more private finance, to reduce reliance on grants.

Investing in Green Research and Development

25. Large projects need to be part of the European dimension but do they necessarily need to be part of the EU budget? Clean energy technologies are unlikely to develop without some government support, whether in the form of grants, tax breaks etc. Typically, capital

intensive investments, such as generating green technologies, face substantial economic, technological and regulatory uncertainties.

26. A balanced portfolio of R&D projects funded from the EU budget needs to be designed to facilitate acceleration of decarbonisation to reach mid-term 2020 climate objectives, and to develop a diversified technology mix to meet 2050 objectives.

27. Cooperation and coordination among Member States and EU support policies will have to be improved. For example, initiation of European Energy Research Alliances (aimed at realising pan-European R&D pooling national and EU resources) is a step in the right direction. Grants should be an instrument of last resort. Competition for funds should be encouraged whenever possible. Public funding should be output driven whenever suitable with engagement of private innovators. Projects with high costs might require the provision of at least part of the funds upfront. Institutions set up to allocate funds need to be lean and flexible enough to avoid institutional inertia and lock-in.

28. The group identified six priorities for advancing green goals within the context of the EU budget:

a. create a better balance between loans and grant, using more public-private partnerships and better use of the EU budget as a guarantee to private enterprise, with rollover funds for start up ideas;

b. integrate SET with other EU resources and policies (state aid rule revision), i.e. less onerous procedures and competition between funding pots/prizes;

c. make public financial support less technology specific and leaving decisions to the market, i.e. not pick winners;

d. regulate first, fund second (e.g. EERP in Estonia);

e. implement climate change mainstreaming/proofing (not a tick box exercise) into policy making with rewards and sanctions, and f. internationalise ITER, and have stand alone enterprises outside the EU budget.

Own Resources

29. When considering reform of the EU budget, the structure of expenditure, revenue (OR) and corrections have to be considered together. Treating one issue independently of the others will not advance reform. The shape of expenditure and revenue are closely connected, with some arguing that expenditure should be decided first and then apportioning revenues.

30. The treaty provides that (without prejudice to other revenue) the EU budget is to be balanced and financed wholly from own resources (OR). In other words, the EU budget is not allowed to undertake deficit spending. The EU's budget is therefore predictable and stable from a financial point of view; has sufficient resources; and its direct link to national budgets provides strong incentives for budgetary discipline.

31. In 2010, the bulk (76%) of revenues came from GNI-based resources of Member States while 12% came from traditional OR (e.g. customs tariffs), 11% from Value Added Tax (VAT)-based resources and 1% from other sources. The GNI-based resource was introduced to match Member State payments to their ability to pay. So richer countries pay more but there are some budgetary corrections on the revenue side resulting in France being the largest contributor paying 20% of the EU budget, followed by Germany (18%), Italy (15%), Spain (11%), and the UK (8%). l32. In the 2007-13 Financial Multiannual Framework, there are three different types of budgetary corrections: a. the UK correction as agreed at Fontainebleau in 1984 remains with the basic principle unchanged, namely to reimburse the UK 66% of the difference between what it pays and what it receives ; b. Austria, Netherlands, Germany and Sweden limit their contribution to the financing of the UK correction and have a reduced VAT resource rate. The Netherlands and Sweden also have a gross reduction in their GNI resource contribution; c. some countries such as Spain,

Italy and Poland receive compensations from the expenditure side such as the Farm and Food Policy Project (FFPP) agreement which is full of transitional arrangements, administrative and opportunity costs, and allocation according to EU regulations which make it difficult to use. However, many do not agree that expenditure should be seen as compensation for revenue distortions.

33. The EU budget is regarded as overly complex and opaque as it relies too much on national budgets and is largely disconnected from EU policies. Revenue gathering often imposes penalties on small countries, and is inefficient given corrections are needed. The current system obliges smaller and less affluent countries to pay more as a percentage of GDP (net of the UK rebate and TOR) than larger and more affluent countries. For example, Latvia, Lithuania, Romania and Slovenia pay just above 1 % of their respective GDPs while the Netherlands pays 0.27% of GDP, the UK (0.49%), Sweden (0.50%), Germany (0.72%), Italy (0.92%), and France (0.99%) of GDP.

34. Many Member States therefore consider the system unfair either due to their net contribution, correction mechanisms, and the pressure to pre-determine in which Member States receive certain categories of expenditure. The process of funding the EU therefore increases tensions between Member States. Some therefore believe OR is in urgent need of deep reform. However, some argue discussions on reforming OR during the negotiations will not feasible as the matter should have been addressed three years ago.

35. The absence of concrete proposals for new OR since 1988 indicates how difficult reform is. New proposals from the Commission will require careful preparation and strong support at all levels. Criteria should not just be technical, but also reflect a high degree of political pragmatism. The EU should ideally find an autonomous resource that would not need to be collected by Member State administrations. The issue of autonomy should not be misunderstood as meaning a change of sovereignty regarding taxation. The power to raise taxes independently at the European level is not on the agenda under the Lisbon Treaty. The Commission is currently considering is a financing mechanism closer to that outlined at the outset of the European Community, such as duties collected from a common custom tariff.

36. Some suggest it may be simpler if Member States just made contributions as a straight percentage of their GNI, but others suggest eliminating the GNI resource or change the method of calculation. Any ‘ideal’ EU funding system should satisfy commonly agreed principles such as economic efficiency, equity, stability, visibility, simplicity, administrative cost effectiveness, regional neutrality, financial autonomy and sufficiency. None of the present EU resources fulfils all of these principles to the same extent.

37. A series of criteria for assessing the appropriateness of new OR are contained in the Commission’s 2010 Budget Review:

a. Delivering key policy priorities to implement the Lisbon Treaty, the *acquis* and help deliver the EU 2020 strategy;

b. EU added value through application of the subsidiarity principle and complementarity between EU and national and regional budgets;

c. a budget driven by results with performance budgeting, conditionality, simplified implementation;

d. mutual benefits through solidarity, but wide distribution of benefits, enabling geographically concentrated interventions

e. reformed financing of the budget requiring OR to be linked again to common policies, thus improving transparency and fairness.

38. New ORs contributing directly to EU objectives could create a bridge between the revenue and expenditure sides of the budget. A resource that is cross-border in nature should not be hard to identify. Resources for which bases are highly mobile across boundaries would be particularly relevant. New possible OR alternatives include:

a. resource based on VAT has been long been favoured by the Parliament and Commission. Members could administer collection as now, thus limiting cost, but make it unsuitable as a fully autonomous resource. This resource would be visible to citizens as the share of tax accruing to the EU budget would be clearly indicated on each bill. However, this may make the EU more unpopular amongst citizens (see 39 below). Furthermore, VAT is a regressive tax;

b. EU corporate income tax could create substantial efficiency gains and reduce compliance costs for companies operating across borders. Resources based on corporate income and energy would share the same advantages as the EU VAT in terms of buoyancy and collection but disadvantages in terms of visibility. However, it is uncertain whether it could be established in a reasonable timeframe. Coherence with reform of the energy taxation directive would need to be ensured;

c. the proceeds from auctioning of greenhouse gas emission allowances could be transferred to the EU budget with a percentage revenue earmarked to Member States for climate and energy. Such a resource would relate closely to the *acquis* and could place climate change at the centre of budgetary negotiations. Commitments have already been made as to the use of parts of the revenue arising from auctioning. Geographic balance though may be a source of concern for some Member States. A levy on carbon dioxide emissions of €330 per thousand litres could raise €110 billion;

d. a tax on the aviation sector could also relate closely to the *acquis*. However, the aviation industry may be particularly sensitive to charges, and setting a tax on aviation is difficult at the national level. A standard duty on flights of €1 per km could produce total estimated income of €12.8 billion;

e. a tax on the financial sector may be the only popular new resource. However, legislators should proceed carefully given the complex technical issues and high risks emanating from the high mobility of financial institutions (notably headquarter relocations), market disruptions and the likelihood that new taxes may reduce the capital that banks have available for lending. Financial sector taxation at the rate of 0.1% could produce €20 billion a year.

39. In times of austerity, many consider it would be counter-productive to propose the creation of new taxes which could slow economic recovery. Introducing a new OR could raise anti-EU resentment especially given the issue of subsidiarity. Citizens are fed up with taxes and any new tax to pay for the EU, even if suddenly only more visible, is likely to be opposed vigorously. Furthermore, some of the largest Member States remain opposed to the creation of an 'EU tax'.

Conclusion

40. Recent financial perspectives have lasted seven years, but the era of financial austerity suggests there is scope to think of a shorter period, perhaps 2 or 3 years. Setting the next MFF for several years after the period of austerity will have ended is unlikely to be appropriate. The EU needs a vision for the medium term that goes beyond the current crises. Others argue austerity may last longer, not only as the effects of the financial crisis continue but also given likely long-term low growth in the EU caused by an ageing population, relative under-investment and increasing competition from growth economies. There is also a strong argument for a new financial perspective to coincide with the five year terms for the European Parliament and Commission to ensure accountability.

41. The EU cannot continue to endure a situation in which its budget is not seen to benefit all. The young in particular need a new narrative outlining the case for the EU and its budget. Outreach activity, notably with national parliaments and improved communication with stakeholders and citizens, is indispensable.

42. The next Financial Perspective is likely to offer more of the same but be slightly larger

in absolute terms . It is difficult to get the UK rebate right, given its political symbolism. The end result will be the same dish on a slightly larger plate but with a few spices added to allow a little additional funding for inflation and smaller growth areas such as R&D. The next budget will therefore be evolutionary, not revolutionary.

Nick Hopkinson*
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* Nick Hopkinson is a former Director at Wilton Park and is founding director of the Wilton Park USA Foundation – see www.wiltonparkusa.org

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