

Becker, Peter

**Research Report**

## The right moment to reform the EU budget

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# The Right Moment to Reform the EU Budget

*Peter Becker*

The High Level Group on Own Resources (HLGOR) chaired by Mario Monti presented its final report on 17 January 2017. It contains recommendations for reform of the European Union's own resources system. In October 2016, as part of its mid-term review of the EU's Multiannual Financial Framework (MFF 2014-2020), the European Commission marked starting points for reforms on the expenditure side of the EU budget. Now, the EU is turning its attention to the revenue side. The European Commission must draw up its proposals for the next MFF, applicable after 2020, by the end of 2017. The debate on a comprehensive reorganisation of European budget policy will then begin to gather speed.

The European budget system has slowly developed into a long process of path dependency since 1988. Many parts of the system, with its entrenched mechanisms and structures, have now become obsolete and are in need of reform. The immense difficulties the EU faced in appropriately and effectively responding to the recent crises and challenges have exposed the weaknesses of European budgetary policy. The EU should, therefore, now take the opportunity to reform and not, as so often happens, continue with the status quo by seeking compromise based on the lowest common denominator. The need for change is further reinforced by two aspects:

1. The advent of Brexit, the exit of one of the biggest contributors in recent years, increases pressure to reform both the revenue and the expenditure side. At present, it appears inconceivable that the remaining

net contributors will close the income gap whilst retaining current spending priorities and financial volumes. Conversely, it is equally unrealistic to simply reduce the EU budget by the volume of British payments and reduce percentage spending priorities accordingly, with the associated consequences for individual Member States. Rather, the EU must discuss appropriately reallocating the additional financial burdens arising from the departure of the UK from the EU.

At the same time, the British rebate and all rebates on the rebate associated with this special arrangement will no longer apply after Brexit. This increases the pressure to abandon any exceptions, corrections and special regulations when reforming the EU budget system – on the revenue side as well as on the expenditure side.

2. The EU-27 are committed to the common goal of protecting and consolidating

the cohesion and unity of the European Union. However, MFF negotiations always involve serious distributional conflicts in which conflicting interests and disputes between Member States come to light – something that, at least, will not promote EU cohesion. The current migration crisis and the continuing consequences of the deep economic and social crisis in the euro area have also torn open new lines of conflict that continue to exacerbate existing disagreements between net contributors and net recipients. Italy's continued refusal to approve the compromise on reform proposals debated in the context of the MFF mid-term review showed how closely these differences – also on factual issues – are linked to MFF negotiations. Italy justified its blockade by pointing to the refusal of many central and eastern European Member States to implement the agreed distribution of refugees.

### **Remit and Findings of the Monti Group**

The final report of the HLGOR now triggers the process of discussing the starting points, objectives and need for a reform of European budgetary policy on the revenue side. In negotiating the current Multiannual Financial Framework 2014-2020, the European Parliament (EP) in particular had pushed for a reform of the EU own resources system and the introduction of an EU tax. However, in the face of resistance from the majority of Member States, Parliament was only able to establish the High Level Group on Own Resources. The review of the current system of own resources is intended to be based on the principles of simplicity, transparency, justice and democratic legitimacy. The group, consisting of three representatives each from the European Commission, the EP and the Council of Ministers, was completely independent and arbitrarily extended the scope of its original mandate. In its report, the Monti Group recommends a comprehensive structural reform of the EU budget

with renewed focus on spending as well as on revenues.

At the heart of the final report is the attempt to solve the basic problem of current EU budget policy and to stop thinking in terms of net balance categories. Therefore, to overcome this net balance logic, a more comprehensive assessment of the costs and benefits of EU membership might be required. According to the Monti-group, the EU budget is an 'investment budget' and not a 'zero-sum game' in which gains for one Member State automatically mean losses for another. A contribution to the EU budget should not be considered a cost but an investment in common public goods.

The working approach of the group reflected this search to find a way out of the political impasse of European net balance logic:

1. The Monti Group sought to gain an impression of the willingness to implement reforms and the available scope of those reforms through a number of discussions with members of the EP and national parliaments as well as with researchers and budgetary policy experts. All participating institutions should commit themselves, at least in principle, to a truly comprehensive reorganisation of European budget policy.

2. By extending its analysis and recommendations on the expenditure side of the EU budget, the HLGOR attempted to put together a larger negotiating package. This package should contain benefits for every actor and institution. The more the report advocates reforms on the revenue side, the more convincing its arguments for changes on the expenditure side should be.

As a consequence, the HLGOR placed the concept of 'European added value' at the centre of its report. In future, European added value should be the main criterion for assessing the appropriateness and legitimacy of the EU budget. The report's message was that only by looking at both sides of the balance sheet will we be able to recognise and precisely identify this European added value. The group defined European added value as the increase of

values arising through the actions of the European Union in addition to the actions of the Member States. However, given the limited resources of the EU budget, it seems inevitable that the policy fields would be given differing priorities depending on where such added value is best achieved. On the expenditure side, the EU budget should, therefore, focus on areas where the *greatest* European added value is to be expected or where promoting central public goods can only be achieved through joint European action. This would be the case, for example, in areas of internal and external security or in spending on research and development that generate new jobs and additional growth.

As a precondition for its reform proposals, the Monti Group committed itself to sticking to existing EU primary law, meaning that all the group's recommendations were to be implemented within the framework of the current Treaty of Lisbon, requiring no changes to it. Hence, the group does not call into question either unanimity when approving decisions on own resources, as stipulated in Article 311 of the Treaty, or the EU's prohibition on borrowing. It also does not demand the EU has its own competence to tax European citizens or call for an increase in the total volume of the budget. Rather, the HLGOR advocates retaining the proven guidelines of the current own resources system, such as the principle of budgetary balance, and also retaining current traditional own resources (i.e. customs revenues and sugar levies) or own resources based on gross national income (GNI). However, all currently granted exceptions to this system in the form of rebates or corrective mechanisms should, in the group's opinion, be abolished; Brexit will offer the perfect opportunity to achieve this.

The Monti Group sees a particular difficulty in the fact that own resources are not uniformly recognised in the Member States' national budgets. Sometimes they are declared as government spending, as payments to international organisations and,

in some countries, only the net balance of cash flows is included in the national budget. However, financing the EU should not be considered a national burden. Rather, these are financial resources owed to the EU to accomplish common objectives. The first step, therefore, is to clearly and uniformly specify own resources in national budgets in order to ensure the transparency and comparability of EU funding.

In a second step, the group then advocates establishing new own resources for the EU. However, these should not simply serve to generate new revenue for the EU, but also have a political incentive effect, namely, by helping to more effectively achieve the EU's political objectives and thus enhance European added value. The group argued that, of course, each new source would have both advantages and disadvantages; as a result, there can be no ideal option for new own resources. Hence, a comprehensive and sustainable reform of the own resources system ought to be based on a combination of various new revenue streams.

In its report, the HLGOR details a wide range of possible new own resources from production, consumption and environmental policies. Possible revenues might include a combination of a reformed value-added tax, a European corporation tax (based on a common consolidated corporate tax) and the European financial transaction tax (FTT) or alternatively a banking levy. Various new revenue sources might come from environment policy, including a form of energy taxation, for example, a CO<sub>2</sub> levy, a tax on electricity, a fuel tax or a tax on EU emission trading. A reform of the revenue mix should increase the financial contribution from today's traditional own resources by around one-fifth to more than half of revenue. Against that, transfers from national budgets in the form of GNI own resources, which are based on the national wealth of each Member State, could be reduced significantly.

Finally, in its report, the group also advocates the possibility of incorporating a

*géométrie variable* into European budgetary policy and calls for a separate Euro zone budget which should serve to stabilise the common currency and the Euro zone.

## Two Further Elements of Reform

The next reform debate must also find solutions for two important issues that were not part of the HLGOR's final report:

### Lack of Flexibility in the EU Budget

The recent crises have revealed a lack of flexibility in European budgetary policy and the EU budget and thus the inability of Brussels to respond to political challenges with adequate resources and with new spending priorities. MFF headings and their financial resources are largely set irrespective of developments in the political environment. Currently, around 80 percent of the EU budget is already fixed for seven years at the beginning of the MFF period and this means that it is very difficult for the EU to respond to unforeseen challenges.

If, however, the intention is to enable the EU to respond appropriately to new developments in future, there are basically two options:

1. The EU will need to have extensive reserves at its disposal which it can fall back on in times of crisis and when a fast response is required. This seems to be the approach favoured by the European Commission. However, this solution could mean that EU Member States must either transfer funds which may be used only in an emergency and remain unused until a crisis occurs, or the Member States must give firm commitments to make the promised funds available to the EU immediately in emergency situations.

2. The EU will need to have far more comprehensive options for reallocating funds within its budget than has been the case to date. This could mean that the commitment of funds, for instance, for eligible regions or for farms would only be binding until a crisis occurs that requires political

priorities and also budgetary priorities to be redefined.

Obviously, both options have advantages and disadvantages. While the provision of reserves is likely to cause national finance ministries to doubt whether a crisis really is significant enough to unlock reserves, conversely, the reserves would provide a constant incentive for the Union's institutions not to leave this money unused. In the case of larger or more protracted crises, Member States would also have to be concerned about having to pay more funds on top of those reserves already made available.

In contrast, the redeployment option would initially mean that payments by Member States to the EU budget would not increase and only in case of extreme crises might additional payments be required. Conversely, approved funds from the EU budget would then be up for grabs again, affecting the planning security of European funding. A reallocation would be always associated with losses that would affect some Member States or specific policies or sectors of the economy. In times of crisis, this could lead to delays and EU-internal conflicts over redistribution and allocation when rapid and decisive action is required.

In principle, there should be an option to adapt and modify MFF priorities and their funding as the result of a policy decision. The more comprehensive, wide-reaching and yet specific the pre-allocation of spending priorities in the EU budget are, the easier it should be to revise them. At the same time, the crisis reserve should be increased so that in acute situations Brussels can react quickly to implement policy decisions without the need to seek consensus. The EU must also find a way to increase its financial and hence political room for manoeuvre. Narrowing the range of possible reactions by pre-allocating the majority of its resources would mean that the EU is imposing excessive and unnecessary political restrictions on itself.

### Spending Is Not Efficient Enough

Given the limitations on current and also future budgetary resources available to the EU, European budgetary policy will have to seek to use its scarce financial resources more efficiently:

1. Spending should be significantly more targeted at the common objectives of the EU, i.e. toward European political added value. This is not only recommended by the Monti Group, but almost all observers have been calling for this for many years.

2. The efficiency and control of fund management should be improved. Given the amounts paid out from European structural and agricultural funds, deadweight and fraud cannot be avoided. However, deadweight losses would certainly recede if only the poorest and most underdeveloped regions in the EU were eligible for EU funds. And evidence of fraudulent use will hopefully soon be pursued by a European Public Prosecutor resulting in those European funds being reimbursed.

3. European and national funding should be more closely linked. European money should always be used to complement national funding and not replace it. Following this principle, the instruments of graduated national co-financing could become the rule for all European funding policies, including agricultural policy. An MFF reform of this kind would also make corresponding modifications of state aid law necessary.

4. Currently, funds from the EU budget are primarily spent as grants. Greater use of innovative financial instruments, i.e. loans or credit, could allow for multiple use of limited European resources. One innovative example is the Juncker fund for strategic investments.

### Persuading Reform Sceptics

The political effectiveness of the final report and its influence on agenda-setting and forming opinions among the main actors of the MFF negotiation process will depend, firstly and in particular on the

Member States' willingness to change the current system and, secondly, on the persuasiveness of the reform recommendations forwarded by the HLGOR.

The willingness to compromise and to fundamentally reform the European budgetary system is very limited among Member States for many reasons, particularly because of domestic politics. The initial views and assessments contained in the HLGOR's final report are already showing up the traditional lines of conflict among Member States. The net *contributors*, such as the Netherlands, Sweden, Denmark and Germany simply acknowledged only some of the HLGOR proposals and saw their views confirmed that comprehensive reform was mainly required on the expenditure side and reform of the European system of own resources was unnecessary. By contrast, the Central and Eastern European net *recipients* stressed the need to continue with current spending policies and make appropriate financial resources available, particularly for European structural funds. In the European Parliament (EP), members of the budget committee supported the core recommendations of the report and called for an end to net balance logic by opening up new and genuine sources of own resources. Moreover, MEPs questioned the need to restrict the MFF to one percent of EU GNI, given the various challenges and new tasks, the EU needs additional resources in order to achieve its goals. The foreseeable losses from one of the largest net contributors after Brexit should be offset by additional funds from new own resources.

There seems to be a broad consensus and agreement with the recommendations of the Monti Group only on the question of abolishing own resources coupled with value added tax in Member States. Measuring this source is exceedingly complicated and opaque and also, as a result of multiple adjustments, the revenues are disproportionately small compared to the costs of collecting and calculating them.

The reluctance of Member States to implement reform might be reversed if the

Monti Group's proposals were able to overcome reservations and scepticism through their consistency and persuasiveness. However, this does not seem to be the case. Although all stakeholders agree with the HLGOR's argument to refocus the EU budget on creating European added value whilst respecting the principle of subsidiarity, this understanding is superficial. Unanswered questions remain as to what European added value might be, where it could be found and how it would be measured. Even the HLGOR's proposal to fundamentally reform the own resources system with a new mix of revenue sources was received with scant approval from the Member States. Only Italy and Luxembourg support this core recommendation of the Monti Group.

Despite the general aim of protecting the uniformity of the EU budget, the majority of Member States were sceptical of considerations to allow new forms of differentiation and to create a separate budget for the Euro zone. However, the receptiveness of governments whose taxpayers would have to pay for a special budget of this kind will be decisive in discussions about this proposal.

It seems that the MFF negotiations will follow the same almost traditional lines of conflicts between net contributors and net recipients and between the Council and the European Parliament. There is still little willingness for comprehensive change among Member States, especially as the individual EU partners do not agree on a common analysis of the weaknesses of the own resources system, and therefore implicitly on naming the starting points for reform.

The recommendations of the Monti Group are already under threat of being crushed by these traditional conflicts relating to distribution and legitimacy. As so many reports in the past, the HLGOR report might be acknowledged but then quickly disappear into a drawer.

The 'drawer solution' would, however, not do justice to the quality and accuracy of the HLGOR's proposals for reform of the EU budget and for rebalancing Member State and joint budgetary responsibilities. The

Monti Group report contains some valuable starting points for redesigning the MFF which should be seriously considered and taken into account by Member States, the European Commission and European Parliament.

The HLGOR's approach of initiating a fundamental reform of the EU budget by making changes on both the revenue and on the expenditure side is supposed to encourage all those involved to become more willing to start implementing reform. Net contributors and particularly the largest among them, Germany, should reconsider their one-sided criticism of the lack of efficiency and effectiveness in the Common Agricultural Policy and in European Structural Funds. Sometimes this criticism even goes so far as to call for these policies to be scrapped completely. Completely re-nationalising these spending policies anchored in European primary law would be impossible without changing the Lisbon Treaty anyway. However, the mention and anchoring of these policies in the Lisbon Treaty says nothing about the financial resources or about the objectives and conditions that could be linked to these European funds.

By the same token, net recipients should accept criticism of the lack of efficiency of their programmes funded by European Structural Fund and focus their arguments more on the joint objectives of the EU. The EP for its part should not only call for truly genuine European own resources, i.e. an EU tax, with the sole intention of increasing budget volumes without feeling responsible and bearing the political costs of this direct burden on European taxpayers. In addition, European parliamentarians must seriously commit to improving the efficiency and targeting of European funding policies. They should also resist the temptation to respond to the foreseeable financial consequences of Brexit with a seemingly simple solution and to only call for compensation in the form of additional payment obligations from current net contributors, without also naming spending programmes where savings could be achieved.

The Monti Group's recommendation to link new EU own resources with policy steering effects could be a useful and acceptable compromise for all stakeholders. The group's proposal to only spend funds from the EU budget on measures with the highest European added value deserves a closer assessment and the general support of all stakeholders.

The precise definition of European added value, however, has been highly controversial for many years and the Monti Group provides no general definition either. Certainly, focussing on a *relative* European added value, as proposed by the HLGOR, might offer a way out. Even within the two largest areas of expenditure (the Common Agricultural Policy and cohesion policy), European resources should continue to promote priority projects that will bring the EU closer to its political objectives and thereby promise considerable European added value. Instruments of concentration and conditionality already serve to pave the way for refocussing European Structural Funds on common goals and European added value. The Common Agricultural Policy also experienced a similar realignment of funding priorities when it added a 'greening' component to common climate and energy policy goals.

However, further measures are still possible as part of a gradual reinterpreting of the content of the largest areas of expenditure in the EU budget. The hitherto dominant re-distribution function of EU spending policies could be reduced gradually and the allocation function be given more prominence.

### **Timetable and Next Steps**

The European Commission has until the end of 2017 to submit its proposal for a new MFF for the period after 2020. In doing so, it will review and undoubtedly take into account the recommendations of the Monti Group. The period of reflection has already begun, both within the Commission and the European Parliament and among the

Member States of the EU-27. It will first be necessary to consensually agree on an assessment of the shortcomings of the current system. Without agreement on a joint analysis of flaws and weaknesses, it will be impossible to agree on starting points for change.

Negotiations will then have to be concluded by the end of 2019 or no later than the beginning of 2020. A certain overlap with this MFF negotiation process and negotiating the terms of Brexit will be unavoidable. In addition, there may be links between the two negotiation processes, for example, cushioning possible burdens on individual EU-27 members as a result of the withdrawal of the UK from the Single Market and the Customs Union with EU funds.

Germany, the largest Member State, will need to focus on maintaining cohesion among the EU-27 countries in both negotiating arenas. The largest net contributor will need to prepare itself to take on additional financial burdens for this goal to be achieved. During negotiations, Germany should be careful that its willingness in principle to take on additional financial burdens in the short term is not linked to a decision on the long-term structural reform of the EU budget. A reform of this kind must include a refocussing of European spending priorities as well as an overhaul of the own resources system. Whatever changes are proposed, forms of differentiation must not undermine the principle of budget uniformity.

In principle, the objective should be for the EU to extend the scope for decision and policy-making in its budgetary policy and to become less dependent on the goodwill of its Member States.

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**SWP**  
Stiftung Wissenschaft und Politik  
German Institute for International and Security Affairs

Ludwigkirchplatz 3-4  
10719 Berlin  
Telephone +49 30 880 07-0  
Fax +49 30 880 07-100  
[www.swp-berlin.org](http://www.swp-berlin.org)  
[swp@swp-berlin.org](mailto:swp@swp-berlin.org)

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