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In danger of breakdown: is the EU approaching budget stalemate?

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Executive Summary

The Budget Review aimed to align the EU budget to today's challenges, and to introduce significant reforms. But the policy environment, including the impact of the crisis, and the political economy of budget negotiations have changed significantly. In addition, the Lisbon Treaty has enshrined a status quo bias by stipulating that, if no agreement is found, the last year of the previous budget framework is continued, giving many actors an incentive to block progress if the situation deviates too far from previous outcomes.

There is a real possibility that no agreement will be found, which would have severe consequences for the EU to deliver on its commitments. Even if stalemate can be avoided, the next budget negotiations are unlikely to result in significant reform. Some limited changes and innovations might be possible, especially if there is a general consensus. It is also likely that there will be a continuation of the gradual changes seen in recent years. But overall, the level of reform is likely to be disappointing.

The EU would continue to be deprived of an important policy instrument to deal with emerging policy priorities. Citizens would continue to feel alienated by an EU that spends most of its money on historic priorities rather than current policy challenges. A stalemate or limited progress sends a powerful signal that the EU's Member States and institutions are unable to collectively deliver the EU's ambitious policy agenda. Can the EU really afford to continue into the next decade with a budget that is not fit for purpose?

Introduction

The debate on the EU budget has been going on for a number of years, focusing on a range of thorny issues: How big should it be? What should the money be spent on? How should it be financed? Who gets how much? What functions (redistribution, efficiency, political) should it fulfil? How should its governance work?

The negotiations for the next Multi-Annual Financial Framework (MFF), due to run from 2014 to 2020[1] have now started, in part shaped by the publication of the Budget Review in autumn 2010. It was launched in May 2006 and tasked the Commission 'to undertake a full, wide ranging review covering all aspects of EU spending, including the CAP, and of resources, including the UK rebate, to report in 2008/9' (European Parliament, Council & Commission, 2006).

Despite a planned publication date of 2009, it was delayed. The key reasons included the ratification and coming into force of the Lisbon Treaty (European Union, 2007), with some voicing fears that the discussion of budgetary issues at the EU level could have a negative impact on ratification in countries such as Ireland, where a referendum was required. In addition, the EU institutions were in a state of flux (with the Commission's mandate due to expire and the European Parliament elections in June 2009), and the external environment had changed significantly with the financial and economic crisis impacting strongly on Europe's economies. An unauthorised draft of the document became available at the end of 2009 (CEC 2009), with the final version not published until 19 October 2010 (CEC 2010f).

This paper charts the arguments raised in the Budget Review debate but shows that the environment in which the MFF negotiations will take place has already been substantially altered, especially with the impact of the economic crisis, resulting in the findings of the Budget Review having limited impact. The governance changes introduced by the Lisbon Treaty will further reduce the impetus for reform by reinforcing the status quo bias. And there is a significant danger that future negotiations will reach a stalemate, with potentially severe impacts on the ability of the EU to deliver on agreed policy priorities. Those who had high hopes that the Budget Review would result in an EU budget more closely corresponding to the EU's current challenges are thus likely to be disappointed and reform is likely to be limited, with few innovations and, at best, continuing gradual change.

I. A big deal?

Does the EU budget actually matter? EU expenditure is certainly not the only European instrument to implement common policies – for example, legislation plays a much more significant role in the European integration process – and it is small, at around 1% of EU GDP. Nevertheless, it is one of the key policy instruments available at EU level with particular significance for economic policies and for the EU's visibility across Europe.

When discussing the EU budget, it is important to make the distinction between the annual budget and the multi-annual budgetary framework. The main focus of this paper is on the next Multi-Annual Financial Framework (MFF).[2]

At EU level, there is always a difference between the budget commitments set in the MFF and the actual amount of money paid out. The EU always spends less than what is allocated to the budget, with unspent money usually being used to reduce the Member State contributions rather than being reallocated to other spending areas. The budget always has to balance, as the EU cannot borrow money, i.e. there is no EU-level public debt.

Traditionally, the MFF negotiation process is dominated by the Member States, with only limited influence from the European institutions or other stakeholders. The negotiations between the Member States require unanimity, favouring a package deal where every Member State can report some success back to its domestic political constituency.

The current budget

Budget commitments were €141.5bn in 2010, equivalent to 1.2% of EU Gross National Income (GNI), below the ceiling for the EU budget of 1.24% of GNI. The biggest amount is allocated to cohesion and competitiveness, with the bulk of this money spent through the European Structural Funds. In 2010, this amounts to €64.3bn, more than 45% of the total. Support under the Common Agricultural Policy (CAP) amounts to €43.8bn or 31% of the total, with environment, fisheries and rural development spending at €15.7bn or 11% of the total. The EU as a global player, and administrative expenditure are each at under 6% of the total (CEC 2010d). Over recent financial frameworks, the importance of agriculture spending has reduced while funding for cohesion and competitiveness has increased. The most significant geographical shift in recent years has been the accommodation of the accession of Central and Eastern European countries, which are generally significant recipients of cohesion and agricultural funds.

The current structure of EU expenditure does not correspond well to the challenges the EU faces today. It is still mainly driven by historical spending priorities. Despite long-standing and repeated proposals for reform (see for example Sapir 2003), the budget continues to be dominated by agriculture and cohesion funding. Some new spending areas have been introduced, for example, research funding, which has been made possible as the proportion spent on agriculture has reduced over time. The main spending blocks have also been reformed – for example, agricultural spending is now also focused on improving environmental outcomes and fostering rural development, while cohesion funding aims to deliver the policy priorities of the Lisbon Agenda, Europe's growth strategy from 2000 to 2010[3], in the current MFF. There still remains, however, a large degree of inertia.

Financing the budget

Revenue comes from three sources: traditional own resources (mostly customs duties), a component of VAT and, most significantly, from a GNI contribution of Member States. In 2010, VAT and traditional own resources make up around €14bn each of a total budget of almost €122bn, with the remainder of over €93bn coming from the GNI contribution, equivalent to more than three quarters of the total. This reflects a long-term trend, where the importance of the GNI resource has become predominant. Germany

traditionally pays the most, €23.7bn in 2010, followed by France at €20.3bn and Italy at €16.2bn. The UK only pays €13.2bn due to the UK rebate, which is worth almost €4bn in 2010. Germany, the Netherlands, Austria and Sweden also benefit from correction mechanisms but at a much lower scale than the UK.

Net balances

Calculating how much each country pays into the EU budget versus the amount they receive is fraught with difficulties. However, the Commission has provided an estimate of operating budgetary balances (OBB) for 2009 (CEC 2010c) as shown in the table[4] below.

	OBB in mio	Population in mio		OBB p.c.	
Belgium	- 1,453	10,7	€	- 136	Net player
Bulgaria	642	7,6	€	84	Net recipient
Czech Republic	1,777	10,4	€	- 171	Net recipient
Denmark	- 821	5,5	€	-149	Net player
Germany	-8,107	82,2	€	- 99	Net player
Estonia	582	1,3	€	448	Net recipient
Ireland	47	4,4	€	11	Net recipient
Greece	3,252	11,2	€	290	Net recipient
Spain	1,794	45,3	€	40	Net recipient
France	- 4,739	64	€	- 74	Net player
Italy	- 4,079	59,6	€	- 68	Net player
Cyprus	7	0,8	€	9	Net recipient
Latvia	514	2,3	€	223	Net recipient
Lithuania	1,511	3,4	€	444	Net recipient
Luxembourg	- 83	0,5	€	- 166	Net player
Hungary	2,772	10	€	277	Net recipient
Malta	12	0,4	€	30	Net recipient
Netherlands	- 20,26	16,4	€	- 124	Net player
Austria	- 432	8,3	€	- 52	Net player
Poland	6,489	38,1	€	170	Net recipient
Portugal	2,243	10,6	€	212	Net recipient
Romania	1,756	21,5	€	82	Net recipient
Slovenia	- 262	2	€	- 131	Net player
Slovakia	580	5,4	€	107	Net recipient
Finland	- 430	5,3	€	- 81	Net player
Sweden	- 704	9,2	€	- 77	Net player
UK	- 1,363	61,2	€	- 22	Net player

In 2009, Germany was the largest net contributor with a balance of €8.1bn, followed by France at €4.7bn and Italy at €4.1bn. The UK only paid €1.4bn due to the rebate, less than the Netherlands at €2.0bn and Belgium at €1.5bn. The biggest net recipients were Poland at €6.5bn Greece at €3.3bn, Hungary at €2.8bn and Portugal at €2.2bn. On a per capita basis Luxembourg, Denmark and Belgium were the largest net contributors at €166, €149 and €136, respectively[5], followed by Slovenia at €131, the Netherlands at €124 and Germany at €99. The biggest net recipients on a per capita basis were Estonia at €448, Lithuania at €444, Greece at €290, Latvia at €223 and Portugal at €212.

While it is clear that the EU budget is small in comparison to national budgets, it nevertheless contains significant amounts, with a degree of redistribution across Europe. In this context it is not surprising that the EU budget has always triggered a high degree of debate.

II. In need of reform

The EU budget review

The Commission launched the Budget Review with a wide-ranging consultation in 2007. The consultation paper focused on the principles that should underpin the EU budget rather than focusing on amounts and concrete allocation of funding (CEC 2007). This produced a wide variety of responses, including submissions from Member States, regions, civil society, academics and think tanks.[6] During 2008, there was also a range of workshops and conferences, as well as the publication of a multitude of studies focusing on aspects of the Budget Review, many of these organised and commissioned by the Commission itself. As a result, during 2008, the Commission amassed a wide range of research, data and opinions as an input to the Budget Review.

The Budget Review Communication (CEC 2010f) has picked up many of the issues raised in the Budget Review process. It aims "to present a holistic vision of budget reform, covering both the expenditure and the revenue side of the budget" (p 2), setting out key principles for the EU budget: delivering key policy priorities, EU added value and mutual benefits through solidarity, being results-driven and with a reformed financing system. It links the budget strongly to the EU "smart, sustainable and inclusive" growth strategy, Europe 2020 (CEC 2010e), while also aiming to deliver on citizenship, Europe's neighbourhood and Europe's global role.

A large section of the Communication is dedicated to budget reform to achieve better results, for example through increased flexibility. It also notes that the budget will need to take account of the changes in economic governance and future enlargements, but clearly there are uncertainties in these areas. Finally, the Communication proposes "a new phase in the evolution of EU financing" with "three closely linked dimensions – the simplification of Member States' contributions, the introduction of one or several new own resources and the progressive phasing-out of all correction mechanisms" (p 26). As explored below, these reforms of the EU's financing system are inevitably highly controversial.

A long-standing debate

The debate on the shape and function of the EU budget has been ongoing for a number of years, with a corresponding demand that the EU budget needs to be reformed to better meet the EU's challenges and add value to EU activity (see for example Begg, 2004). In the past, the arguments have often been polarised between different actors – as detailed later in this paper. On one side a number of academics and think tanks working on European policy, as well as institutions such as the European Parliament, have argued that the EU budget needs to be developed further to meet the EU's challenges. This includes, for example, the development of a meaningful own resource (an EU tax), an increased EU budget and/or a shift away from agricultural funding to other priorities, and a reform of governance that removes some powers from the Member States. On the other side stand analysts and, crucially, national Finance Ministries, especially in the net payer countries, which believe that control of the EU budget should rest with the Member States, doubting the added value and legitimacy of a more 'Europeanised' budget.

Juste Retour

The thinking of the Member States generally follows the 'Juste Retour' argument. The idea behind 'Juste Retour' is that Member States not only take into account the amount of money they have to pay into the EU budget but also what they receive in terms of EU spending, i.e. they evaluate their net position. In many EU Member States, national politicians feel that they must justify their EU budget negotiation position and the outcome of the negotiations in terms of 'Juste Retour'. Seeing the EU in this way can easily lead to the accusation that EU funding is often 'circular funding', i.e. net payers receive back their own funds, recycled through the EU budget.

Critics of the Juste Retour approach have pointed out that it is becoming increasingly difficult to determine in a sensible way where the money is spent, given the interdependence of European economies, with economic operators working across borders and multiplier effects across borders. They note that the 'Juste Retour' approach encourages seeing "the EU budget as a zero-sum game to the extent that net cash flow gains achieved by one country are exactly offset by net cash losses by another. By contrast, a public goods approach will often be a positive-sum game, even if the burden of paying for it is uneven" (Begg, Enderlein, Le Cacheux. & Mrak 2008). A focus on Juste Retour can also create a large degree of rigidity, meaning money must be spent where it is assigned, not where it is most effective.

The focus on Juste Retour by the Member States conflicts with the Commission's attempts to reform the budget. The unauthorised draft of the Budget review (CEC 2009) notes that the Juste Retour issue "poisons every debate on the EU budget" (p 28). The Budget review Communication notes, "Budget negotiations have recently been heavily influenced by Member States' focus on the notion of net positions with the consequence of favoring instruments with geographically pre-allocated financial envelopes, rather than those with the greatest EU added value" (CEC 2010f, p 25). Many proposals for budgetary reform propose mechanisms to attempt to overcome the focus on Juste Retour, by, for example, splitting the redistributive spending from spending aimed at creating European public goods and funding each area differently (see for example, de la Fuente, Doménech & Rant 2008 or Iozzo, Micossi & Salvemini 2008).

A tax for the EU?

A further key area of debate has been the question of how the EU finances itself. The current system relies increasingly on the contributions made by Member States in proportion to their Gross National Income (GNI). However, many analysts have argued that the EU should have a revenue stream for which it is fiscally responsible. The most commonly argued candidate for such an 'EU tax' is a proportion of value-added tax (VAT), but other past proposals have included a carbon/energy tax, a tax on financial transactions, corporate incomes and a tax on electronic communications (see for example CEC, 2009). The Budget Review Communication lists the taxation of the financial sector, revenues from auctioning under the greenhouse gas Emissions Trading System, a charge related to air transport, VAT, energy taxation and corporate income taxation as possible candidates for a new EU own resource (CEC 2010f, p 27).

Proponents believe that an EU-level tax would make the EU system more visible and accountable and could break the political deadlock of 'Juste Retour' by divorcing revenue from expenditure. For example, Iozzo, Micossi & Salvemini (2008) propose that taxes should be levied at the European level to finance EU public goods, focusing on a VAT 'European surcharge' as the most appropriate financing mechanism. There are, in fact, numerous scenarios on the table that could potentially improve the functioning of the financing of the EU budget from an economic perspective (see for example Begg, Enderlein, Le Cacheux & Mrak 2008).

However, a number of analysts have questioned the added value of an EU tax, and there is significant opposition to any changes to the EU's resources from some Member States (see, for example, Government of the Federal Republic of Germany, 2008 or Government of the Netherlands, 2008). It is also unlikely that such a tax would remove the focus of Member States on Juste Retour, as information on the amount raised by such a tax in each country would be taken into consideration by the Member States. Some commentators have also questioned whether it would meet the objective of bringing the EU closer to its citizens, as an EU tax might create a political backlash when money is directly transferred to Brussels, especially in times of reduced spending and increased taxation.

Linked to the revenue issue is the question of correction mechanisms and rebates, most notably the UK rebate. The idea behind correction mechanisms is that for some countries the balance between EU expenditure that is spent in their country, and the contribution they make to the EU budget is not at the right level. Most notably, and most significantly in terms of size, is the UK rebate, which was introduced in 1984. The main argument at the time was that the UK received little of EU spending, which was mostly focused on the CAP, and therefore should pay less into the EU budget.

Other net payers such as Germany, the Netherlands, Austria and Sweden also benefit from more minor correction mechanisms. While many commentators have argued that the idea of rebates is outdated and should be phased out, including the Commission (see for example BBC 2010a & CEC 2009), the UK government would come under severe domestic pressure if they were willing to give up the rebate. Getting rid of the UK rebate would require a unanimous vote and the UK uses this as an effective bargaining chip (see Begg 2005). The Budget Review Communication (CEC 2010f) proposes the progressive phasing-out of all correction mechanisms but it remains to be seen how politically feasible this is. At this stage, such progress seems unlikely.

Spending well?

There has been an equally polarised debate on the expenditure side. Many have questioned the underlying rationale of spending, arguing that there needs to be a clearer focus on why there is a need for European spending. It has been argued that the EU should focus on the provision of European public goods, which is also one of the recurring themes in the submissions to the Budget Review. The EU Budget Review Communication (CEC 2010f) proposes, "the EU budget should be used to finance EU public goods, actions that Member States and regions cannot finance themselves, or where it can secure better results" (p 5).

Using the provision of European public goods as the basis for the budget potentially provides a clear economic rationale. However, the term 'public good' is used rather loosely, covering a variety of different concepts and consequently policy areas. Zuleeg (2009) argues that the rationale for EU action needs to be examined in greater detail to determine where there are genuine EU public goods, where EU spending can correct other market failures, and where there are different underlying rationales for intervention, be they political, environmental or social/distributional.

Another potential role for the European budget is redistribution – to transfer funding from the richer Member States (or regions) to those with greater need – providing for many the underlying rationale for cohesion funding. However, the size of the EU budget and the necessary administration can potentially make it inefficient as a redistribution mechanism. It is also not necessarily possible to make a clear distinction between the public good and redistribution functions. For example, the Budget Review Communication (CEC 2010f) notes the mutual benefits of solidarity, through increased stability and increased market size. In this context, the underlying rationale for the spending could be seen as compensation, with cohesion funding as the mechanism to buy political agreement for market liberalisation from those countries that would benefit least from the process.

Many have argued that the EU should focus its spending on the main policy challenges it deals with, an approach also reflected in the Budget Review. Delivering key policy priorities is one of the functions of the EU budget according to the Budget Review (CEC 2010f). Proponents of this approach point out the need to deal with new challenges in policy fields such as energy/climate change, external relations and competitiveness, where the EU has a specific policy interest. ECORYS, CPB & ifo (2008) argue that there are three policy areas where the future EU budget needs to be intensified – climate change and energy, knowledge and innovation, and common security and foreign affairs. However, unless the budget is expanded, which is unlikely at this stage, any funding for new policy priorities has to come out of another spending area in the current budget, making it hard to overcome entrenched interests.

Making decisions

While there is some inertia, the EU budget clearly has changed over time, with the most significant shift being in the gradual reduction of agriculture spending, accommodation of the Eastern enlargements, and the increase in funding for policies connected to cohesion and competitiveness. However, the changes resulting from recent negotiations have been far from transformational. The overall size, structure and priorities have been broadly retained.

The main reason why change has been slow lies in the governance of the budget. The EU budget is negotiated between the Member States, with unanimity still the rule, blocking significant reform. While the Commission proposes an overall framework, what emerges is very much down to horse-trading between Member States, with Juste Retour playing a dominant role in the negotiations. This is very unlikely to change in the near future. As explained below, the Lisbon Treaty has given the European Parliament (EP) a greater role but the process is still dominated by the Member States. MFF negotiations have few connections to the policy priorities of the European institutions, with the political cycles of the institutions differing from budget negotiation cycles.

A debate on reforming the EU budget must, therefore, "include the overall process by which the EU budget is determined, adopted and implemented, given the increasing difficulty in getting agreement in recent years" (Zuleeg & Hagemann 2008). The EU Budget Review Communication (CEC 2010f) does tentatively propose a new time period for the MFF (5+5 years) – but this remains the only significant proposed change to governance. Even though the Sapir Report (Sapir 2003) proposed the removal of unanimity back in 2003, unanimity still dominates the process.

Overall, it is clear that the EU budget is very different from a national budget, including the terms of its governance, said to be potentially reflecting ambivalence about what the EU is for (Begg 2009). While some, including the EP, have advocated that the EU should have its own revenue sources and be politically accountable for its spending, the reality is still very different, with few signs that the Member States are willing to contemplate a significant change in the status quo. "Member States want to retain a large degree of control over outcomes. They also often argue that negotiations must take place behind closed doors so they can 'horse-trade' more freely" (Zuleeg & Hagemann 2008).

These are not the only 'red lines' for the Member States (see also Zuleeg & Hagemann 2008). Clearly, the net payers demand a strict limit on the overall size. The UK is strongly attached to the rebate. The new Member States want to maintain emphasis on cohesion and agriculture, etc. While a number of countries have also pushed for reform – for example, the UK wanting to see a significant reform of the CAP – the overall picture is one of entrenched positions with little common ground, and an unwillingness to compromise or finance the collective decisions that have been made.

The contrast, between what analysts have proposed and the actual budget and its governance, remains as wide as ever. This leads to a situation where many well-argued reform proposals are on the table, but have few chances of implementation. For example, Begg (2009) uses the fiscal federalism literature to argue convincingly that there are lessons to be learned that should be applied to the EU budget. However, he concludes that anyone who looks at economic or political theories as a guide to EU budget reform is likely to be disappointed, given the political realities in the EU. The more controversial proposals contained in the Budget Review (CEC 2010f), e.g. regarding the financing of budget, are thus unlikely to be implemented.

III. A new policy environment

Not only are the more controversial proposals unlikely to be implemented, but also many of the framework conditions have changed, even in the short period since the main Budget Review process took place. While many of the issues that were raised before and during the consultation period remain pertinent, it also needs to be recognised that a new analysis of what might be the core drivers behind the next MFF negotiations is necessary.

Changing priorities

One of the key issues that the Budget Review aims to address is to assess the EU budget in light of the EU's current policy priorities. This is in line with a wide range of commentators who have pointed out the discrepancy between the EU budget and the EU's priorities (see for example Begg 2009 or Gros 2008). The unauthorised draft of the budget review (CEC 2009) identifies growth and jobs, sustainable resource management in a low carbon society, and an ambitious external projection of European interests as key areas of EU action. This follows on from the consultation, where global competitiveness and climate change within the context of globalisation were identified as key themes (CEC 2008b). As noted above, the Budget Review Communication (CEC 2010f) highlights Europe 2020, citizenship and the external dimension as key spending priorities.

But despite the relatively short time that has elapsed, the goalposts have changed. One of the key areas that need to be addressed is the implementation of the Lisbon Treaty, which has budgetary implications. In particular, the external relations institutional framework has changed fundamentally. The post of High Representative of the Union for Foreign Affairs and Security Policy (HR) has extended competences, and the Treaty also introduced the European External Action Service (EEAS), a kind of European diplomatic corps. There are financial implications here, which need to be taken into account in the budget negotiations. For example, the Budget Review Communication (CEC 2010f) notes, "The Council, the Parliament and other institutions have requested some additional posts linked to the Lisbon Treaty. The launch of the EEAS will initially require additional posts to support the recruitment of Member State diplomats although over time the whole process should seek to be neutral from a budgetary point of view" (p 19).

Some of the more prominent topics are also slipping down the policy agenda and are thus less likely to have a major impact on the budget. Both in the consultation and the wider debate, the budget has been highlighted as a key instrument to drive the EU's transformation to a green, low-carbon economy. The EU had set climate change targets in 2007, and made them legally binding in 2009. They include 'a reduction in EU greenhouse gas emissions of at least 20% below 1990 levels' (CEC 2010g). While the EU is still committed to these climate change targets, the failure of the international negotiations in Copenhagen in December 2009 and little progress in the subsequent meeting in Cancun, as well as the worsening economic situation, have altered the mood. A more ambitious 30% reduction target is off the table for now, even though the Commission has argued that it could be achieved with a similar level of funding that was originally foreseen for the 20% target (CEC 2010a).

While the main implementation tool at EU level was to be the Emissions Trading System (ETS), implying that the impact of the climate change targets on the expenditure side of the EU budget is likely to be limited, the Budget Review Communication proposes "re-prioritisation inside policies like research, cohesion, agriculture and rural development – with a clear political earmarking" (p 10) to deliver the 'green' objectives. It remains to be seen whether these objectives will be seen in the coming debate as being as important as dealing with the economic crisis.

Impact of the crisis

The dominant issue that changed the agenda at the European level has been the economic crisis. The Commission proposed the European Economic Recovery Plan (EERP) in November 2008 (CEC 2008a),

which was endorsed by the European Council in December 2008. It contained a fiscal spending boost of €200bn, including €30bn of European money. The EU budget component of the spending did not, however, have a smooth ride. In addition to reprioritising and front-loading existing EU budget lines, the Commission also proposed to spend €5bn on broadband and energy projects, which was to come from the funds in the EU budget that were not spent, i.e. the gap between the money allocated to the EU budget and the amount paid out, which normally goes back to the Member States. Using unspent money flexibly or more flexible allocation of funds at EU level have always been controversial, as Member States want to retain the final say on what happens with these resources. In the case of the EERP funding, this meant that the process of getting these funds released took a long time and was politically damaging on domestic and international fronts. For many commentators these difficulties have reinforced the need for more flexibility, and, for the next budget negotiations, the need for flexibility is once again on the agenda. Many have argued that the Commission needs to be able to have access to more flexible funds, including the Budget Review Communication, which notes, "it is clear that the current budget has proved too inflexible to meet the pressure of events" (CEC 2010f, p 23).

The EERP also highlighted the importance of non-expenditure tools to implement EU objectives, in particular, loan funding from the European Investment Bank (EIB). The vast majority of the EU-level contribution to the EERP came from the EIB, with the EERP stipulating that the EIB would increase its lending by some €15bn in 2009 and a similar amount in 2010. This was seen as especially important in the context of the credit crunch, as loan funding to companies was seen as being under pressure. With the continuing difficulties in the financial sector, the role of the EIB in supporting future policy priorities is likely to also increase, featuring prominently in the Budget Review Communication (CEC 2010f) in terms of boosting investments for the future and relieving capital constraints.

The creation of Eurobonds might also be a tool to achieve EU growth objectives by generating additional investment. Here it is important to make a distinction between two related but separate proposals on the table. In the first case, there could be a common facility at the European level to finance government debt, benefiting from the high credibility of countries such as Germany to lower interest rates for all eurozone members. For example, the Belgian Prime Minister Leterme proposed a European Debt Agency in March 2010, which would issue debt backed by all eurozone governments and thus benefit from lower interest rates (euobserver.com 2010).

In the context of the EU budget, however, Eurobonds could also be used to finance trans-European infrastructure projects – for example, building up a smart European energy grid. These projects would also benefit from the lower interest rates, but the driving idea here is that they would be used to finance investment in European-wide public goods. The Budget Review Communication (CEC 2010f) proposes this kind of instrument under the heading of EU project bonds. However, the idea of Eurobonds has been discussed over a number of years but they continue to be opposed strongly by countries such as Germany, making it unlikely that there will be significant progress in this area.

In other areas the impact of the economic crisis is adding pressure to increase expenditure, most notably in the area of 'Social Europe', and in particular, to deal with rising unemployment in most EU Member States. But there are few policy instruments available at EU level, with the only significant funding available through the European Social Fund, part of the European Structural Funds. A debate on the European level is currently questioning whether this fund should remain part of regional policy or whether a fund targeted at Member State level is needed to tackle high unemployment (euractiv.com 2010a). However, the Budget Review Communication (CEC 2010f) does not propose such a radical change, instead only stipulating that it should be focused more on the Europe 2020 objectives.

Europe 2020

The formulation of the new European growth strategy, Europe 2020 (CEC 2010e), the successor to the Lisbon Strategy (European Council 2000) potentially provides a strategic framework for EU spending decisions. It is focused on just five headline targets of innovation, education, labour market participation,

poverty and climate change. The EU budget is mentioned as a key implementation tool for the strategy: "The EU multi-annual financial framework will also need to reflect the long-term growth priorities. ... The discussion should not only be about levels of funding, but also about how different funding instruments such as structural funds, agricultural and rural development funds, the research framework programme, and the competitiveness and innovation framework programme (CIP) need to be devised to achieve the Europe 2020 goals" (p 20, CEC 2010e). A serious reorientation of the EU budget to implement the goals of Europe 2020 would suggest, at the very least, a shift in spending.

Orienting spending on Europe 2020 will also have implications within budget lines. In the last budget, the European Structural Funds were refocused strongly on achieving the aims of the Lisbon Strategy, especially in the old Member States. A similar process would have different implications for the next budgetary period, given the focus on a smaller number of priority targets and the new emphasis on education, poverty and climate change policies.

Alternative revenues

As discussed above, the possibility of a genuine EU tax seems remote. However, there are specific questions that have arisen regarding new revenues that accrue at the EU level, and in particular, the revenues arising from the introduction of auctioning in the ETS. The Commission proposes that these revenues accrue to the Member States, while recommending that at least half of the revenues be used for climate change policy actions (CEC 2010b). Some have proposed, however, that these kind of resources should in the longer term become the basis for a reform of the EU's own resources (CEC 2009). The Budget Review Communication (CEC 2010f) notes these revenues as one possible source for a new EU own resource.

This is an issue that might well arise in other policy areas, too. For example, revenues can accrue through fines in competition cases, and through activities of the European Central Bank. These kinds of revenues are difficult to handle in the European context as their main function is not revenue raising, but the revenue is incidental to the achievement of other policy goals. This means that the revenues can fluctuate significantly. In general, the ECB revenues are distributed to the National Central Banks of the eurozone (ECB 2010).

Changing needs

Even in those areas where the EU budget is significant – agriculture and cohesion funding – the economic environment has been changing, potentially influencing the next budget negotiations. From a budgetary perspective, there are no significant enlargements to be expected in the next few years, with the likely accession of Croatia and potentially other Western Balkan countries and Iceland to have a relatively minor impact on the budget.

However, the economic crisis has also had a serious impact on most European countries' GDP with the impact varying as some countries and regions were much more affected than others. This will potentially change both the contributions of countries and their receipts, particularly in regard to funding under the cohesion funding budgetary items. Countries such as Greece, Spain, Ireland and Portugal might have an increased need for cohesion funding, and the situation might also have been aggravated in countries such as Hungary, Latvia and Romania. Countries such as the Netherlands, Germany and Poland might have improved in relative terms. Overall, these changes could alter the relative position of both net recipients and net contributors, with increasing divergence between the countries performing well and those in crisis.

The economic environment for agriculture is also changing. In the run-up to the economic crisis, agricultural prices were rising steeply alongside global energy and commodity prices. Food (as well as commodity and energy) prices are increasing again in 2010/2011 – starting with wheat price increases in Europe due to the fires that destroyed a large part of the crop in Russia and the subsequent export ban. In part increasing food prices were caused by rising demand from developing countries and speculation, but also by increasing scarcity of resources including agricultural land. In addition, the role of agriculture is potentially changing, for example in the provision of biofuels, safeguarding the rural environment, and

providing raw materials for bio-based industry, e.g. pharmaceuticals. This could potentially alter how and to what degree agriculture needs to be supported.

A different political economy

The economic environment is not the only major area of change that has occurred since the main elements of the budget review were concluded. In the political field, the second Barroso Commission is now in place and the new European Parliament is in operation. In addition, there is now a permanent President of the European Council, Van Rompuy. Given the predominance of the Member States in budget negotiations, his role as someone who builds consensus between the Member State governments is potentially crucial if he can establish himself as a neutral broker for all players involved.

There have also been significant political changes in the Member States. The most significant changes have probably taken place in two of the largest Member States, Germany and the UK. These are particularly important for budget negotiations, as Germany is traditionally the paymaster of the EU (i.e. the biggest net payer by some distance), and the UK has the UK rebate, an equalisation mechanism that ensures that the UK receives a significant amount of money back from the budget.

In Germany, the former CDU-SPD coalition has been replaced by a CDU-FDP coalition. It is unclear in what way this will influence the budget debate. However, in the debate on assistance for Greece there seemed to be little appetite for further funds being used at the European level and many in Germany argue that the high payments necessary to save the eurozone should be taken into account when negotiating the next budget. There is also a longer term trend where Germany questions its role as the EU's paymaster, making it likely that Germany will push for a reduced EU budget.

In the UK, the election produced an unfamiliar outcome – a Conservative-Liberal Democrat coalition rather than the usual single-party government. While the Conservatives will clearly be unwilling to consider a significant reduction in the rebate that would result in higher UK contributions to the EU budget (Reuters 2010), their coalition partners would be more likely to consider reducing the rebate in return for EU budget reform. However, in the debate over the EU Annual Budget for 2011, David Cameron, the Conservative UK Prime Minister, made it clear that there will be a hard UK line in the EU budget negotiations, suggesting that the influence of the Liberal-Democrats on this topic is relatively limited.

The UK position is also a good example of another trend that is likely to impact on the EU budget debate – the introduction of austerity programmes. In response to the deteriorating public finance situation in the EU, most EU countries have introduced austerity budgets, cutting spending and increasing taxation. This will have a significant impact for the net payers' negotiation position. The UK has already spearheaded a debate on the impact of austerity on the EU budget for 2011 (see for example Reuters 2010, or BBC News 2010b), which was backed by a range of countries, including the most significant net payers. It will be increasingly difficult to argue politically that the EU budget should be shielded from these cuts. There might also be pressure to introduce austerity measures for EU public servants, given that such measures are being introduced in many Member States. The Budget Review (CEC 2010f) notes that, "Overall, a strict discipline will have to be pursued by all EU institutions to ensure that administrative expenditure is contained in the future" (p 19). Given the pressures at national level, this seems to be an objective with relatively limited ambition.

The governance challenge

The economic crisis has also been one of the triggers for the eurozone crisis, given its impact on public finances. While many of the eurozone imbalances preceded the crisis, it exposed the fact that the cost of borrowing for some countries was artificially low and their public finances were unsustainable. As a result, governments in the economically stronger Member States, together with the IMF, had to step in to bail out Greece, and then provided an umbrella fund to deal with further crisis regarding eurozone members' sovereign debt. In November 2010, Ireland became the first country to access support under this umbrella after further crisis in its banking system.

As a result, governance of the eurozone is now being discussed at the European level with many proposals on the table on how to enforce public finance sustainability. One area that has been given serious consideration is the use of the EU budget as a disciplining mechanism, for example withholding EU funds from countries that breach public finance rules. "Breaches of budgetary rules should be punished faster – by withholding funds from the EU budget or by fines, placed in an interest-bearing account, pending remedial action" (The Economist 2010, p 72). A joint Franco-German paper noted, "The EU budget could work as complementary leverage to ensure compliance with the key macro economic conditions of the SGP [Stability & Growth Pact]" (euractiv.com, 2010b). Over the coming years, the proposals on improved governance from the Van Rompuy Task Force are likely to impact on the EU budget. For example, it recommended "making a range of EU expenditures conditional upon compliance with the SGP (Stability and Growth Pact]" (Taskforce on Economic Governance 2010, p 1).

IV. Institutional change

The creation of Van Rompuy's post is part of the wider change in the institutional structure with the Lisbon Treaty coming into force at the end of 2009. Changes introduced will significantly influence future budgets. Where the annual budget is concerned, the role of the European Parliament has been enhanced. It is now being closely involved in the process, including scrutiny of both obligatory and non-obligatory expenditure.[7] To some extent, this increased power also applies to the MFF, where the EP has to give consent to the proposed regulations by a simple majority. This is a significant increase in powers for the EP (see for example Mayhew 2009). The EP has shown in the past that it will use its powers and influence to get involved in the decision-making process, which was clearly demonstrated in the conflict over the 2011 annual budget, where the EP pushed for a greater recognition of its role in the MFF negotiations.

There are also provisions that could potentially reduce the power of the veto – Member States could now decide that future budgets will be negotiated by majority voting. However, there are many obstacles to such a change. For example, Benedetto (2009) points out that "it is difficult to imagine how a member with an unpopular individual rebate could allow majority voting to take effect."

Status Quo bias

But despite the intentions of the 'Reform Treaty', the Lisbon Treaty also contains provisions that could make transformational change of the EU budget less likely. It specifies that, "Where no Council regulation determining a new financial framework has been adopted by the end of the previous financial framework, the ceilings and other provisions corresponding to the last year of that framework shall be extended until such time as that act is adopted" (Para 4, Art 312, European Union 2010).

A number of commentators have pointed out that this is likely to further strengthen the existing status quo bias (see for example Gros 2008 or Hagemann & Zuleeg 2008), i.e. that any substantial deviation from the previous MFF creates an incentive for those Member States that have most to lose to block the whole process, reverting back to the allocation of the last year of the previous MFF. Indeed, there is now a very real possibility that Member States, who also have to negotiate with the European Parliament, will not find an acceptable compromise for the next MFF, with the negotiations ending in a stalemate.

This makes it unlikely that the EU can manage to achieve a substantive budget reform: "the reference point for many Member State negotiators will be the final expenditure in 2013" (ibid, p 4). While this status quo bias undoubtedly existed before the Lisbon Treaty, it is now enshrined in law.

The 2011 budget

The impact of the Lisbon Treaty on budget negotiations was already highlighted in the negotiations for the 2011 Annual Budget. The European institutions' initial demand for an increase of the budget of 5.9%, in part reflecting new commitments under the Lisbon Treaty, were rejected by the European Council, which demanded the increase be limited to 2.9%. Some EU Member States wanted to go even further – to effectively freeze the budget – but this did not command a majority among Member States.

The European Parliament subsequently accepted the limitation to 2.9%, but only if the Council would undertake to give the EP assurances that its role in future MFF negotiations would be substantial (referring to the new powers in the Lisbon Treaty), and that a new own resource for the EU would be on the table. These demands led to a stalemate in the negotiations when they were rejected by a number of Member States, including the UK and the Netherlands (see for example euractiv.com 2010d or European Parliament 2010).

Although in the end a compromise was found, the process already demonstrates that in the framework of the new rules of the Lisbon Treaty, some Member States (and possibly EU institutions) are willing to default to the previous year's budget if their demands in the negotiations are not met. For the next

negotiations of the MFF, it points to a real possibility that no agreement will be reached and that negotiations will end in a stalemate, leading to the roll-over of the 2013 budget to subsequent years, a process that was already in place with regard to the annual budget.

While the detailed impact of such a stalemate is not yet apparent, there are clearly a number of policy areas that would be affected. Reform of large spending blocks would become extremely difficult and there would be little money for new and emerging policy priorities, including no budget provision for the EEAS, for example. The MFF's governance would not be reformed and it would be difficult to use it as an instrument to encourage compliance with the Stability and Growth Pact. Multi-annual programming in areas such as cohesion policy would become virtually impossible. More analysis is needed to chart the full impact of such a stalemate, especially since it now looms large as a possibility. But it seems clear that such a stalemate would be a major inhibitor for the EU to deliver on its policy priorities.

V. Plus çà change?

The EU had embarked on a substantial review of how the EU budget works, attempting to make the budget more appropriate for the challenges the EU faces. But the review process has been overtaken by more recent events. The environment in which the EU finds itself, and the political economy of budget negotiations, have changed significantly.

Clearly, the EU needs an effective and flexible budget to deal with crisis situations and to address the EU's long-term challenges, including those relating to the financial and economic crisis. Not least is the need to find funds to support the EU's growth strategy, Europe 2020, in an environment of unprecedented tight public finances. In addition, the main recipients of EU funds are arguing that support needs to be maintained, specifically in areas such as agriculture and cohesion funding (see for example euractiv.com 2010c).

But the EU budget is under significant pressure. Austerity programmes in the Member States, and changes in domestic political set-ups in countries such as Germany and the UK, make it unlikely that there will be an increase in the EU budget or significant reform of correction mechanisms and the EU revenues. The net payers are likely to argue for the EU budget to be reduced, while the UK will resist significant changes to the rebate.

Even before the recent developments explored in this paper, there was a status quo bias, due to the unanimity provisions, the incentive for Member States to focus on Juste Retour, and the domestic political realities underpinning the budget negotiation process. The Lisbon Treaty now enshrines the bias toward the status quo, with the new provision that the last year of the previous MFF is continued if no agreement is found. While there is a greater role for the EP, Member States still dominate the EU budget process and there are currently few incentives for them collectively to make far-reaching changes.

This might easily lead to a stalemate in the forthcoming budget negotiations, as is already threatening to happen for the 2011 Annual Budget. This would seriously hamper the EU's ability to deliver on its collective priorities – there would not be sufficient resources for new policy priorities and flexibility, and the ability of the EU to respond to crises would continue to be limited.

Even if a stalemate can be avoided, at best, there is limited opportunity for reform. Some changes and innovations might be possible in limited areas, especially if there is a general consensus. Issues that might fall under such a definition are mechanisms to encourage better spending of the funds, some more (but limited) flexibility and the increased use of alternatives to traditional spending, for example in the form of EIB loans. If negotiations do not break down, it is also likely that there will be a continuation of the gradual changes seen in recent years, including for example a reorientation between different policy areas, away from CAP towards more competitiveness/growth. But overall, the level of reform is likely to be limited.

This points to the very real possibility that the EU budget negotiations will not deliver the hoped for step change at the European level and might end in a stalemate which hinders the EU's ability to act. In a situation of unprecedented socio-economic challenges, the EU would be deprived of an important policy instrument for dealing with emerging policy priorities. Citizens would continue to feel alienated by an EU that spends most of its money on historic priorities rather than current policy challenges.

The Budget Review notes, "Agreeing the way forward will be a major challenge for the European Union, but also a major prize. It would represent a powerful signal that the European Union is equal to the task of harnessing the tools at its disposal to make a real difference for its citizens." However, the converse also applies – if the EU budget negotiations end in stalemate, it sends a powerful signal that the EU's Member States and institutions are unable to collectively deliver the EU's ambitious policy agenda. But even if the EU manages to avoid such a stalemate, the outcome is unlikely to deliver the reform of the budget needed, with a strong inherent status quo bias. Can the EU really afford to continue into the next decade with a budget that is not fit for purpose?

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Endnotes

1. NB that the Budget Review also raises the possibility to change the cycle to 10 years (5+5) with a significant review at the mid point to align the MFF more closely with political cycles (EP, Commission).
2. When the paper refers to the EU budget, the reference should be read to mean the MFF rather than the annual budget unless stated otherwise.
3. Now replaced by Europe 2020.
4. Table based on author's own calculations using European Commission data (in millions) (CEC 2010c) and Eurostat population data. Figures include the impact of correction mechanisms such as the UK rebate.
5. Luxembourg net payments are, however, outweighed by the receipts from EU administrative spending which are not included in the operating budgetary balance. To a lesser extent, the same applies to Belgium.
6. The submissions are available at http://ec.europa.eu/budget/reform/issues/read_en.htm
7. Previously, the EP could only amend so-called non-obligatory expenditure, while obligatory expenditure (spending specified in the Treaties) was the reserve of the Council. This meant large parts of spending, including agriculture, were not under the influence of the EP.