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The EU budget in an era of austerity: setting the example or compensating for national spending cuts?

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"All across Europe, governments, businesses and families are choosing carefully where to spend their money. It is a time to think carefully about where to cut back and where to invest for the future." [1]

"Britain and the EU's other largest payers made clear in December that the EU budget should be frozen, and we will stick to that. The EU has to take the same tough measures as national governments are taking across Europe to tackle public deficits. That means a restrained EU budget focused on the things that will get our economy growing." [2]

"National governments are facing hard financial constraints, so Europe must use its resources more wisely, but with no less ambition. The 'Europe 2020' strategy requires a budget that maintains Europe's investment in a common future and makes the common agricultural policy more efficient. Europe needs smarter energy policies that reconcile production, supply and distribution with environmental concerns." [3]

"The European Parliament has issued a challenge to the Member States who want to freeze the EU's next long-term budget covering the period 2014-2020. These countries should spell out which priorities they would drop as a consequence of the freeze, say MEPs. If all the objectives and policies agreed for the EU are to be completed, a minimum increase of 5% is needed compared to the 2013 budget." [4]

Introduction

When presenting the proposal for the next Multiannual Financial Framework (MFF), José Manuel Barroso stressed that the message coming from many European capitals had been understood: in the current climate of austerity of national public finances, there is no scope for (significantly) increasing the resources available to the EU and the only option is to make choices among chapters of expenditure, ensuring the money available is spent in the best way possible. But at the same time he defined the 'Budget for Europe 2020' [5] as 'ambitious' and 'innovative', able to take up the policy challenges that the European Union will be facing in coming years, not least by ensuring investment in areas important for future growth (which have been slashed at national level) are protected and facilitated at EU level.

Unsurprisingly, the proposals raised strong objections, not least focusing on what increase for EU spending (whether within the MFF or outside) is implied by the proposals. But the fundamental question goes deeper: to what extent will the new multiannual budget (2014-2020) be able to close the ever-growing gap between EU's political ambitions and its financial means (and instruments). Moreover, the current difficult economic context poses the more general issue of what role should – and can – be played by the EU budget in the recovery of European economies: should the Union set an example by cutting expenditures or should it give itself the financial means to fulfil its high political and economic ambitions? Whether and how this 'trade-off' has been addressed by the European Commission's proposal is the main focus of this paper.

To answer this question, the first step requires some demystification on two different levels: first-of-all, a discussion on the future EU budget cannot avoid being framed in the current 'State of the Union' and the likely development of MFF negotiations to determine whether there might indeed be a mismatch between what the EU budget should be, i.e. what it should deliver and how, and what role the Member States and therefore the next negotiations will assign to it. Second, it is necessary to analyse the potential for synergy and additionality, and the different nature and function of the European budget when compared to national ones need to be outlined.

Using this analysis makes it possible to determine what role the long-term EU budget should have and to what extent the European Commission proposals address the European challenges that need to be tackled.

1. European Commission, *A Budget for Europe 2020*, Communication from the European Commission, COM(2011) 500 final, 29.6.2011.
2. www.bbc.co.uk/news/world-europe-13970135
3. www.guardian.co.uk/commentisfree/2011/jul/02/poland-eu-presidency
4. www.europarl.europa.eu/en/headlines/content/20110429FCS18370/1/html/2014-2020-budget-freeze-not-possible-unless-agreed-policies-are-slashed
5. European Commission, *A Budget for Europe 2020*, op. cit.

1. The context of next MFF negotiations : the risk of budget stalemate

The starting point for an analysis of the role of the future EU budget must be a realistic assessment of the potential progress of the negotiations on the 2014-2020 MFF. Several elements suggest that there is a high risk of budget stalemate in the European Union. From the painful negotiations of the previous MFF 2007-2013 to the difficulties of the approval of the 2011 annual budget, Member States' reluctance and fatigue are palpable.[6] While there have been many reform proposals from experts and stakeholders concerning the next Multiannual Financial Framework, the general feeling is that governments have no willingness to go beyond small incremental changes in the structure of the EU budget and in the overall amounts allocated.

It is within this context that in October 2010 the European Commission published the 'EU Budget Review', fulfilling its mandate to "undertake a full, wide-ranging review covering all aspects of EU spending, including the Common Agricultural Policy, and of resources, including the United Kingdom rebate, and to report in 2008/2009." [7] The Budget Review did, however, not really put into question the traditional policy priorities of European spending, such as the Common Agricultural Policy or Cohesion Policy. Rather, the review tried to identify (new) rationales for EU spending, focusing on the added value of existing spending instruments. Indeed, while some proposals for change and improvement are put forward in the document, the European Commission has been cautious, not suggesting any major overhaul of the budget.

In this respect, the Commission has accepted the *status quo* logic which has dominated in the past months and years. While the structure of the budget has witnessed some modifications over the years, national positions have remained virtually identical since the beginning. Inertia has characterised previous MFFs, while at the same time the policy challenges (and competences) of the European Union have been evolving. As a result, the EU budget is suffering from a significant mismatch between its means and the objectives the EU is tasked to pursue, both in terms of absolute and relative amounts of resources allocated to each chapter of expenditure.

The inertia in the development of the EU budget has been exacerbated by the current economic crisis, which has highlighted and reinforced the very poor state national finances are in. At the same time, the European Commission has been given an increased role as public finance 'watchdog' with the introduction of the European Semester, the proposals for a renewed Stability and Growth Pact and the Euro+ Pact. Member States have accepted a stricter commitment to public finance consolidation, and most are now struggling to square this with the need for future investment to generate growth. In this context, 'Union bashing' has become a common discourse in European capitals. The result for the budget negotiations is that a number of heads of government have stipulated that the future multi-annual EU budget must also respect the climate of austerity.

More generally, within the European Union there is currently a high level of mistrust, between Member States themselves and between Member States and the European institutions. This is especially the case in relation to economic governance, and the Greek/Euro crisis: net payers such as Germany have suffered from a significant fatigue, at citizen and policy-maker level, concerning their image as European 'paymasters'. This difficult situation has been accompanied by, or has even exacerbated, the rise of nationalism, parochialism and euro-sceptic attitudes in many Member States. When thinking about the future common EU budget, this mainly translates into the logic of *Juste Retour*, which was already very strong during past MFF negotiations. When sitting at the negotiation table this time, it is likely that governments will think even more about the possible national return of each euro spent at the EU level.

Against this background, one can easily expect that the time from now to the end of 2012, when Member States are supposed to find an agreement on the next MFF, will be characterised by very difficult negotiations, aimed at cutting wherever possible and reducing the room for any change or reform. Taking the *status quo* scenario as a starting point reduces the ability to make significant progress towards a policy-driven budget: rather than asking what needs to be

6. F. Zuleeg, *In danger of breakdown: is the EU approaching budget stalemate?*, EPC Issue Paper No.63, January 2011.
7. European Commission, The EU Budget Review, COM(2010)700final, October 2010.

done at the EU level, it reduces the question to how to make the most out of a given pot of EU money.

2. National and EU budgets: different means for different functions

"The EU budget is small (1.01% of EU gross national income) because it does not need to mirror national budgets. [..] It is an investment budget – 94.3% is spent in the Member States" [8]

A second important demystification concerns the respective roles of the EU and of national budgets. Discussing the possibility of the EU budget as 'compensating' for national spending cuts reflects a narrow interpretation of the actual function of the European budget.

The EU budget is very different from national ones: as noted by the European Commission in the quotation above, the European budget 'does not need to mirror national budgets'; this goes both for the type of expenditures and for the relative amount of resources allocated.

With regard to the types of expenditures, there are two elements worth noticing. Firstly, the EU budget fulfils a redistributive function between Member States (or more accurately mostly between Europe's regions) which is not and cannot be fulfilled by national budgets. As practical application of the principle of solidarity underpinning European integration, Cohesion Policy redistributes resources to the poorest regions of Europe. While this redistributive function might not be as significant as it should be, given the small size of the budget, never-the-less it has been an effective tool for re-allocating between regions and countries of the EU, not least for the New Member States where these funds are a very significant part of public investment budgets.

Secondly, the EU budget aims to create synergies with national budgets, and therefore concentrate on those goods which cannot be produced in an effective manner at national level. EU funding is meant to address market failures at the European level, and to deliver European public goods. This is where the notion of added value of EU spending has its *raison d'être*. Simply put, in these areas there is an added value of spending at the EU level if a euro spent at the EU level is more effective (or creates more return) than if it were spent at national level.

The challenge here is to define what constitutes a European public good. Economically, we define a public good as a non-excludable and non-rival good; in a national context, the government would produce such a good, as the market has no interest in producing a good from which nobody can be excluded and where use by one person does not impede the use by someone else. But 'pure' public goods are hard to find at the national or European level. In this respect, the EU public good argument is more often related to European market failures. At European level, there are market failures produced, for instance, by cross-border consideration (e.g. pollution, research and innovation), or by economies of scale that cannot be exploited at national level.[9]

In contrast to national budgets, the EU budget does not need to spend on all traditional policy areas of a national government, given the functions and competences the EU is tasked to fulfil. In any case, its size will never allow a true compensation of Member States' budget cuts. In a context where increasing the overall amount of the budget is not an option, the only viable solution becomes to select European public goods where returns are maximised, or where a specific problem cannot be addressed at national level but is effectively solved by EU spending. As a consequence, a clear discussion is needed about where cuts might be necessary and where, instead, increasing expenditure can enhance added value of EU spending. Unfortunately, as also reflected in the Commission proposal on the next MFF, such open debate about policy priorities does not really take place, and the budget remains 'locked-in', determined by vested interests or general inertia.

3. The Multiannual Financial Framework 2014-2020: neither setting the example, nor compensating for national spending cuts

Whether we take a more 'optimistic' or a rather realistic perspective on the next Multiannual

8. European Commission (Staff Working Document), The added value of the EU budget, SEC(2011) 867 final, 29.6.2011
9. http://ec.europa.eu/dgs/policy_advisers/docs/eu_public_goods_zuleeg.pdf

Financial Framework negotiations, it is argued here that the future EU budget will and should neither set an example, nor compensate for national spending cuts. The proposals put forward last week by the European Commission further reinforce this conclusion, given their cautious nature (e.g. in terms of overall increase) coupled with elements of innovation and of a stronger focus on those public goods which cannot be provided by Member States.

The proposal of the European Commission: a budget for Europe 2020

Since the publication of the EU Budget Review in October 2010, two issues have gained importance in the debate: better spending and the use of new financial instruments.[10] They correspond to two major issues the EU budget has been forced to face in the context of the current crisis: namely the need to increase added value of spending (better spending) and the need to leverage private capital to respond to pan-European investment needs (use of new financial instruments). Analysing the proposal of the Commission with these two variables in mind can be illuminating in terms of the proposed role attributed to the budget.

The call for 'better spending' has been translated in the MFF proposal by a greater focus on those projects that have demonstrated the added value of European action in the past, and those actions that respond to the objectives of Europe 2020. The Budget for Europe 2020 has thus been presented as respecting the principles outlined in the Budget Review:

- focus on delivering key policy priorities;
- focus on EU added value;
- focus on impacts and results;
- delivering mutual benefits across the European Union.

The Budget Review, the consultation procedure which had preceded it, and the discussion which has followed, might have had the merit to push the European Commission to re-consider EU rationales for action and be explicit about them. They are finally listed in the MFF proposal:

- Funding of common policies that Member States have agreed should be handled at the EU level.

- Express solidarity between all Member States and regions, to support the development of the weakest regions, which also allows the EU to function as a single economic space.

- Finance interventions to complete the internal market – that not even the most prosperous Member States could finance on their own.

- Ensure synergies and economies of scale by facilitating cooperation and joint solutions to issues that cannot be supplied by the Member States acting alone.

- Respond to persistent and emerging challenges that call for a common, pan-European approach.[11]

By clearly outlining the dimensions along which EU spending should be oriented, the Commission has stressed the pan-European nature of the EU budget, whose objective is to create synergies rather than to compensate. Such synergies can be created by closing gaps in European integration (e.g. the Single Market) or by responding to those market failures that go beyond national frontiers.

However, this 'clarifying' approach of the Commission has unfortunately not been translated into a major overhaul of the traditional spending chapters. While there is some reshuffling of funding from one chapter to the other (e.g. future food aid for the most deprived people will now be funded by Heading 1, 'Smart and inclusive growth') to better focus on Europe 2020 policy priorities, the usual approach – consisting of looking separately at each spending policy rather than setting priorities across policy areas – has remained. As already set out in previous papers,[12] reforming the budget can only be effective if a more general discussion is underway with regard to the definition of policy areas for action, not restricted to policy fields decided *ex ante*.

Against this background, the proposals of the Commission have nevertheless put forward some innovations with regard to the implementation

10. E. Molino, F. Zuleeg, *Key political messages regarding the upcoming EU Multiannual Financial Framework post 2013*, Paper written as part of a Framework contract with the Committee of the Regions, January 2011.
11. European Commission, *A Budget for Europe 2020*, op. cit., p. 8.
12. E. Molino, F. Zuleeg, *The EU added value test to justify EU spending: what impact for regions and local authorities*, Paper written as part of a Framework contract with the Committee of the Regions, April 2011.

of policies, aimed at enhancing the efficiency of spending. In particular, the 'partnerships contract' foreseen for Cohesion Policy could become an effective means to " set the commitment of partners at national and regional level to utilise the allocated funds to implement the Europe 2020 strategy, a performance framework against which progress on commitments can be assessed." [13] In addition, the Commission has committed to further simplification, in particular through the proposal of reducing the number of programmes, putting different instruments under a single framework, mainstream priorities across policy areas, and taking advantage of externalisation (i.e. use of executive agencies) in order to implement the programmes.

When it comes to the use of new financial instruments, the Commission has decided to go further than the Europe 2020 Project Bonds,[14] a rather small facility aimed at credit enhancement of PPP projects to meet some of Europe's infrastructure investment needs. There is a widespread agreement that the European Union has very significant needs in terms of pan-European infrastructure, whose financing will not be able to come from public investment alone. For this reason, the EU budget aims to fulfil the role of an 'investment budget', which would create leverage to facilitate private investment in pan-European economic infrastructure. The proposed 'Connecting Europe Facility' aims to respond to this new function of the EU budget; not compensating for national cuts but focusing on those market failures of a cross-border nature, which need to be addressed in order to have a well-functioning Single Market.

The Commission proposes to allocate €40 billion to accelerate the development of infrastructure connecting the EU; an additional €10 billion will come from the Cohesion Fund, devoted to infrastructure. The money is supposed to be split among energy (€9.1 billion), transport (€31.6 billion) and ICT (€9.1 billion). It aims to fund pre-identified transport, energy and ICT priority infrastructures of EU-wide interest. The facility will be centrally managed by the Commission with the support of an executive agency and financial intermediaries, and the technical implementation of the projects will be done on the ground by the project promoters.

The Connecting Europe Facility has the potential to both show the added value of European spending and to re-orient at least some part of the EU budget towards long-term, strategic investment, which will further highlight the distinction between EU and national budgets. Previous experiences with new financial instruments, in particular in cooperation with the European Investment Bank, have produced good results and have therefore created additional momentum for the Commission to find further solutions.

It, however, remains to be seen what the reaction of Member States and other stakeholders will be with regard to this new facility. In particular, the potential implications on the funding of Cohesion Policy have already provoked some reactions in the European Parliament.

'Better spending' and the use of new financial instruments have shaped the discussion around the EU budget in the past months, and have contributed to a reflection on what European resources can deliver the best results. The proposals set out by the European Commission, with the corollary of a cautious overall threshold (1% of EU GNI in payments), have the potential to deliver on both aspects. However, on the basis of the scenario we have described, two questions remain: will Member States accept a move away from the *Juste Retour* logic, by accepting this renewed focus on pan-European objectives/public goods? And, within the context of the financial crisis, is this budget the means to help European economies out of these troubled times?

4. How can the EU budget cope with the risks of budget stalemate and the need for austerity?

The proposal of the European Commission needs to challenge the tendency of Member States to see the budget in pure accounting terms. A sensible effort has been made by the European Commission to focus on the added value of EU spending, and to clarify what the role of the EU budget in relation to national budgets could be. However, the stalemate scenario could once again reinforce the mismatch between EU ambitions and its means.

The European Union needs to deliver on Europe 2020 and its objectives of smart, inclusive and sustainable growth. Moreover, in the context

13. European Commission, A Budget for Europe 2020, op. cit., p. 12.
14. http://ec.europa.eu/economy_finance/consultation/index_en.htm

of acute crisis in countries such as Greece and Portugal, growth is a prerequisite for a sustainable reduction of debt. Conversely, the absence of growth would most likely necessitate support for weaker Member States unable to service their debt. Such growth must be achieved in the long term, because the ever-increasing divergences among Member States' economies need to be reduced: without growth in the poorest regions and in the periphery, the euro-zone is in severe trouble – and the European Union with it. So what contribution can the long-term budget make and what are the other, alternative, means available to the EU?

Exploiting the full potential of EU instruments

With regard to the first question, and taking into account the recent MFF proposals, it appears that there is still a margin to enhance the added value of EU spending. It seems contradictory that the Commission accepts the traditional EU policies as the key policy priorities – especially in relation to the Common Agricultural Policy – without really putting them under discussion, justifying their existence through the willingness of Member States to have EU spending in these fields. The result of such *ex post* justification is that another chance has (partially?) been lost to reconsider all elements of EU spending, which could have shown that the best option would not only be to spend better on some items, but also to spend on something else if the rationale is weak on existing spending.

To be fair, the Commission proposals have done at least part of the exercise, orienting spending more towards the provision of EU public goods and enhancement of added value. However, such efforts risk being jeopardised by the attitude of Member States, which at first might claim to focus on the highest added value of each euro spent at EU level, but might easily forget these principles when calculating the direct return on the money put into the common pot.

Two other strategic directions towards which the proposals for the next MFF seem to point are worth highlighting.

Firstly, the need to explore different forms of cooperation between the private and public sector, which has been acknowledged by proposing a 'Connecting Europe Facility'. As mentioned, the public is unable to provide the capital investment needed for pan-European infrastructure. The use of this new mechanism is worth promoting through the European Union budget, and would reinforce its feature as an 'investment budget'. Yet, for now, the amount devoted to 'Connecting Europe' is quite limited, the practical 'implementability' of the Facility is not clear and such types of investment might be needed in sectors not covered by the facility.

Secondly, the question of the autonomy of the EU budget needs to be tackled. The European Commission has done so in its proposal, by putting forward a new system of own resources based on a financial transaction tax and a new VAT resource.[15] For the budget to fully achieve its objectives and go past the *Juste Retour* logic, its autonomy must be strengthened. It is very unlikely that Member States will agree to the introduction of a purely 'European tax' (e.g. the proposed financial transaction tax), and it is possible that such a decision would have the contradictory effect of further alienating the citizens. However, there might be scope to explore intermediate solutions to increase the independence of EU resources, such as the option of reversing the revenue of the European Financial Stabilisation Mechanisms (EFSM) so that it goes directly into the common EU pot.

Beyond the EU budget: which paths will reinforce long-term growth?

If the European budget is just one of the means to foster growth in the European region, the EU should use all other possible instruments to reinforce the recovery from the crisis.

In this respect, there are two main 'tools' available to the European Union, the first of which is a non-spending instrument: the Single Market. The European Common Market remains one of the main achievements of the Union, and it can be defined as a major 'European public good'. However, its potential is still far from being fully realised, as many barriers still exist that hamper the four freedoms. In addition, more can be done to ready the Single Market for the future knowledge economy. It is in this context that the Single Market Act[16] was presented in

15. European Commission, *A Budget for Europe 2020*, op. cit.
16. http://ec.europa.eu/internal_market/smact/index_en.htm

April as another way to boost growth and jobs in the EU, and a way out of the crisis. In such a difficult economic context, a completed Single Market has become a condition *sine qua non* to increase confidence and offer a more stable investment framework to economic actors. A functioning market will help the European Union to get back on the track of economic growth and social progress, without having to resort to new spending policies.

A second instrument is related to the potential of the EU to stimulate and support productive investment. A 'new deal' based on investment is needed, consisting of a range of different components.[17] Firstly, economically weaker countries need to be supported in creating the conditions to enable productive investment, such as a simplification of administrative procedures and labour-market reform. Secondly, productive investment, such in human capital (e.g. education), should receive a separate treatment in the assessment of public debt to strike a balance between the imperative of fiscal consolidation and the need to invest in order to enhance their future competitiveness. Thirdly, the establishment of a dedicated investment fund – a new Stability and Growth Fund (SGF) aiming specifically to deliver the goals of Europe's growth strategy, Europe 2020, in countries unable to make the necessary investments themselves. Funds from the SGF would not be a bail-out but loan-based investment. Finally, an increased use of new loan/private-public partnership instruments, including project bonds, to increase leverage. This would require some funding from the SGF, the European Investment Bank or the European Bank for Reconstruction and Development.

Further economic integration, a reinvigorated Single Market, reduced divergence and growth in the periphery using surplus savings from the centre would increase Europe's economic dynamism. While this would require some funding from the European budget, the Connecting Europe Facility and wider Cohesion Funding could be the starting point for the establishment of such an investment programme.

Discussing the potential of next MFF: much ado about nothing?

The present paper argues that the current difficult economic and political context will only allow for cosmetic changes to the structure and main features of the next Multiannual Financial Framework. With its proposal, the European Commission has tried to strike a balance between respect for austerity and the investments needed, making an effort to focus on the added value of EU money rather than 'compensating' for national cuts.

However, the main chapter of expenditures has not been modified, and it is still not clear how the 'innovations' - e.g. the Connecting Europe Facility - will work. By balancing out the different expectations and requests, coming from Member States, institutions and other vested interests, the proposal on the next MFF does not seem courageous enough to serve the cause it should, namely ensuring the long-term growth promised by Europe 2020.

The European Union has certainly a role to play in boosting long-term growth and creating the conditions for it. However, the budget might not be the best tool to exploit, especially because it is very difficult to break the logic of *Juste Retour*, at least for now. Against this backdrop, releasing the full potential of the Single Market, by removing existing barriers and readying it for the future knowledge economy, and focusing on a new deal based on increased investment and support for structural reforms, are two concrete options which could put the EU back on the track of long-term economic and social growth, without requiring a complete reorientation of the next MFF.

17. These paragraphs are based on F. Zuleeg, J. Emmanouilidis, *A New Deal to help save the euro*, EPC Commentary, 10.5.2011.