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The objective of this paper is to promote a reflection on the future of the European Union's budget, based on the challenges presently faced by the EU. The positions presented are solely those of the author and in no way reflect the position of the Dutch Presidency.

The 2003 Sapir report claimed that "*as it stands today, the EU budget is a historical relic. Expenditures, revenues and procedures are all inconsistent with the present and future state of EU integration*."[2] The report considered the budget out of line with the key objectives of the Lisbon strategy, which at the time was the main concern of the EU. Three enlargements and several unprecedented crises later, this statement still appears to hold true. Nevertheless, many reforms of the budget have been undertaken, but these seem still unsatisfactory or at least several steps behind the needs that arise.

Maybe the key to the EU budget ability to rise to the occasion is rooted in the way the decision-making process works. The budget structure has remained over decades surprisingly similar despite the increasing number of objectives.

When summarising the pattern of negotiations of the European Union's Multiannual Financial Framework (MFF), we can discern the following: The European Commission prepares a package of reforms for the next MFF, which attempts to integrate as much as possible new EU objectives into existing headings. It has generally avoided, where possible, to change too much the pre-allocated funding to member states. It has, however, also attempted to add funding and/or shift funding to non pre-allocated centrally managed headings, such as the heading for research and development, the Connecting Europe Facility or other internal policies of the EU, and some to external action. Net contributors subsequently demand a strict payment ceiling, while beneficiaries of the various pre-allocated budget headings defend the transfers they benefit from.

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[2] Sapir Report (2003), p.172

Proper negotiations then start focusing on the distribution of the pie, i.e. a net balance negotiation, based on the public money transiting to and from the EU budget. At the last stages, the European Parliament intervenes to increase the agreed budget level, demands more flexibility or asks for additional review clauses in the mid-term period. A budget is agreed for seven years, much to the relief of all negotiators. This outcome is heralded as a success, because the EU still manages to agree on a budget despite the need for unanimity. The actual effectiveness of the budget has often been secondary in the negotiations.

The problem of this model of negotiations, is that it is dominated by the Council's and the European Commission's desire to minimise the changes to the budget to fit the priorities of the moment into an existing budget structure with an existing pre-allocation. Direct support budget lines in the Common Agricultural Policy are renamed, from compensation payments, to direct payments, to green payments. The Cohesion Policy introduces new permitted measures, more controls, more strategic guidance, adaptations to the maximum levels of support to avoid disturbing the distribution of funds. The European Parliament also has a controversial position, because it has no role in the revenue side of the budget, but only in the expenditure side, and thus will focus on demanding increases in the EU budget size. Nevertheless, the Parliament's power is still limited in this respect. In the last negotiations its influence has however been very important in other respects, namely in introducing a much needed (and now fully used) flexibility in the budget and imposing a deeper mid-term review, including on Own Resources.

The consequences can be summarised as the following:

- The main two priorities (and pre-allocated headings) of the budget have remained the biggest headings for decades: Agriculture and Cohesion, which represented 78% of the EU budget in 2014.
- While headings on research and development, cross border infrastructure, internal policies and external action have increased in size, they have difficulties to grow due to the resistance to reduce the main two headings and to the imposition of a tight budget ceiling.
- The main two headings are adapted to integrate the EU objectives through permitted measures, cross compliance, earmarking, strategic requirements, etc.
- The EU budget is rather rigid, with seven year frameworks limiting the possible changes in priorities and funding redistribution.
- Historical path dependency and rigidities have over time led to a budget that while reformed seems increasingly unfit to support the multiple objectives of the EU, as well as unable to respond to a world of rapid change in the areas of trade, finance and security.

On a more positive note, rigidities in the budget have led to important innovations. New financial instruments to expand the reach of the budget have been created, more flexibility has been introduced, and the quality of policies has increased.

Nevertheless, the budget has largely failed to accommodate the growing and rapidly evolving needs of the EU. The EU budget cannot be an effective financial arm of the EU if it needs to preserve the priorities and distribution of funding amongst member states, while keeping the same level of expenditures as % of GNI. The EU budget negotiations are very

inward looking - a sort of internal power balancing structure - rather than a mechanism to ensure that the EU has the means and the policies required to address its key priorities. The EU's strong reliance on a regulatory approach, without a financial arm capable to respond to multiple and changing challenges, gives citizens the impression that the EU is a "regulatory monster" which, however, fails to respond and protect them when needed. The benefits of the EU, such as free trade in the single market, are diluted by the existence of a freer global trade. Many see the EU as exposing citizens to shocks rather than protecting them, thereby fostering nationalism.

The budget has no financial clout in key areas where the EU is weak. This is not a surprise, but it brings up the question of whether the EU and its financial arm are fit for the challenges of today. This does not mean that the EU budget necessarily needs to intervene in every crisis; however, if it does not, what is the alternative instrument, and most importantly, what should the EU budget be for?

Have we reached the "inflection point", the moment where the financial and political costs of the status quo are larger than the financial and political cost of reform? This is the point which made the 1988 reforms possible according to Lindner (2006).

Here are some reflections on the four topics that will be addressed in the conference:

I. What budget does the European Union need?

The budget is still approached by many as a brinkmanship instrument, based on rights for financial transfers and rather questionable concepts of fairness and contributory net balances in the distribution of the EU budget, rather than the financial backing of the EU core needs and objectives. The introduction has described to what extent the EU budget is now unfit to address the needs of the EU.

With a constrained budget it is imperative that it focuses where common action is imperative, i.e. those actions with a high European Value Added (EVA). Other expenditures should be in line with the solidarity principles of the EU.

Thus the EU budget should be focusing on actions generating an EVA and assisting cohesion. This is simpler said than done. Tarschys (2005 and 2011) and Núñez Ferrer and Tarschys (2012) and Heinemann (2015) address the difficulty of conceptualising what EVA means in practice. Without clear criteria most expenditures can be given a "European Value Added". Maybe the present combined pressures in the areas of energy, climate, security, competitiveness and economic growth are already giving a hint that a limited budget needs a flexible approach to how value added changes with circumstances, especially under a strict budget limit.

An agreement on those parts of the budget that address an EVA would need to be based on a number of criteria:

- Is the value generated higher than separate national actions?
- Who are the beneficiaries of those actions and is the distribution of funding and risk between the public and private sector appropriate[3]?
- Related to the above, what is the public good nature of the investment?
- What is the cross-border element of the investment?
- Are the costs in line with the proportionality principle?

In the case of support for cohesion, the funding is provided to support the financial burden of poorer countries to develop their economies and to achieve EU standards and objectives. In this case, for more local Value Added it is important to ask the following questions:

- Are the investments undertaken having a real impact on the economy or are they contributing to achieving EU standards and objectives?
- Is the project in line with the additionality principle?
- Is the project in line with the proportionality principle?
- Is the financing in line with a "financial" subsidiarity/solidarity principle, i.e. the local financial means do not allow to perform the investment?

These are just some of the questions that need to be taken into account when performing a review of the EU budget.

There is also a further reflection that needs to be mentioned for the future, namely where the EU budget stands with respect to the emerging calls for a 'Eurozone Budget' (Le Cacheux and Laurent, 2015). Does the EU budget have any role in the Eurozone or not? It has used its limited European Financial Stabilisation Mechanism (EFSM) instrument to help Greece, but has no role in the European Stability Mechanism (ESM). There is a need to clarify the role of instruments and review the role of the different institutions and the decision-making process. The EU is changing, but the structures required and the place of the EU budget within these structures is still not fully clarified. It is difficult to define the future reforms if the budget objectives are not clear within the European construct.

II. How best to organize the Own Resources of the European Union?

The Own Resources of the European Union have, over time, developed into a very complicated set of resources and rebates. There is a wide consensus that the EU Own Resources mechanism is unsatisfactory, but there is no agreement on what a good system should be. The assessment of the High Level Group on Own Resources led by Mario Monti presents a very detailed and precise review of the present mechanism and past proposals for reforms. The High Level Group will present proposals in 2016, based on a reflection of the group and the result of an inter-institutional conference that will include national parliaments in June 2016. This is a difficult task, since previous reform attempts have failed so far.

[3] The word appropriate is used, because it is in practice very difficult to find the "correct" distribution. Financial instruments are the one of the approaches today in search for balanced risk approaches.

On what principles should a new Own Resources system be based? We already have a system that ensures a high level of sufficiency and stability, but it has led to drawbacks. It fosters a net balance approach and thus promotes a rigid pre-allocation of funding, making EU funding distribution as a core negotiation issue, rather than being based on a policy rationale[4].

Principles that could be used to assess possible EU Own Resources:

EU Budget assessment criteria	
Global criterion	**Specific criterion**
Budgetary	Sufficiency
	Stability
	Budgetary discipline
Integration	Financial autonomy
	Transparency
	Link to EU policies
Efficiency	Economic efficiency
	Operating cost efficiency
Equity	Fairness
	Horizontal equity
	Vertical equity

Another aspect to take into account is a 'real' universality of the budget resources, i.e. not linked to expenditures (and thus also to net balances).

A difficult question to address is the kind of Own Resources to introduce. Every resource has its positive and negative features and there seems to be a strong resistance to allow the EU to have such resources. Taxes can have very different implications depending on the items taxed and their characteristics (Begg et al., 2008).

The following questions arise:

- Should the taxes reflect equity between member states or citizens?
- On which metric should they be based?
- Who will set the rates?
- Should or can all new resources be considered fully owned by the EU?
- Can, if so needed, new resources be counted as part of the share of the GNI resource contribution?

The following table presents the different options for genuine Own Resources made by the European Commission reports leading to or accompanying proposals.

[4] For a highly critical analysis see Haug, Lamassoure and Verhofstadt (2011)

1998	2004	2011
CO_2 energy tax	EU energy tax	Taxes on the financial sector (financial transaction tax and financial activity tax)
Modified EU VAT	EU VAT	Auctioning revenues under the ETS
Excises on tobacco, alcohol and mineral oil	EU corporate income tax	Charges related to air transport
EU corporate income tax		EU VAT
Tax on transport and telecommunication services		EU energy tax
Income tax; interest income tax		EU corporate income tax
Tax on ECB gains from seniorage		

An interesting fact to reflect upon is that apart from the Common Customs Tariff, the Emissions Trading System is a clear EU tax, but revenues of which are not attributed to the EU budget. Making those a revenue is discussed in the annex to the European Commissions proposals in 2011, but not in the proposal itself.

Other issues to reflect upon are the possibility of taxes under reinforced cooperation (the case of Financial Transaction Tax, but maybe others as well), and what consequences would this bring, notably towards possible limitations to the harmonisation of the internal market for example?

Should there be a system of lump sum corrections or a generalised correction mechanism? The systems of corrections used until today or those proposed by the Commission have a number of drawbacks. They are first of all rather *ad hoc* and based on an increasingly flawed rationale, as explained in topic point IV below. If any system is introduced, it should be related to specific disagreements on specific expenditures (in line with the comment by the Court of Auditors[5] on the Commission's Own Resources reform proposals of 2011). This would allow clearer negotiations on reforms in the future.

III. **Is there a need for more flexibility in the European budget?**

The MFF is negotiated for a period of seven years and while budget stability and predictability has its benefits, it may be a barrier to respond to uncertain times. The EU has been confronted in recent years with multiple events and growing instability, and the EU budget has encountered considerable difficulties in responding to those challenges. Thankfully, much could be achieved with the new flexibility instruments that were agreed at the end of the negotiations for the MFF 2014-2020, which the European Parliament insisted on.

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[5] Court of Auditors, Opinion No 2/2012 of 20 March 2012, point 43

The increased flexibility proved invaluable in 2015, as the European Commission managed to finance the European Fund for Strategic Investments (EFSI), compensate farmers affected by the Russian ban and help those affected by the milk price crisis, support Greece, fund actions to support Ukraine, frontload funding for the Youth Employment Initiative (YEI), and raise funding for the refugee crisis. This has been an unprecedented mobilisation under the flexibility instrument. As needs exceeded the EU budget's capacity some external action activities are being financed by trust funds outside the budget, i.e. the regional Trust Fund for Syria, and the Trust Fund for the Central African Republic.

For 2016, limited margins of approximately four billion Euro may be used for unexpected expenses, but this is less than what was needed in 2015. Furthermore, frontloading exercises, such as the one for the YEI, allow for future funding to be deployed earlier. If the funds are successfully used, but the situation does not improve, there might be a shortage of funds in the second half of this MFF. YEI is mainly a training programme and cannot generate employment demand for those participating if the economy does not improve.

A number of questions arise:

- What kind of flexibility is needed in the budget? Between headings, or also options to increase the ceiling? For the moment, the latter is ignored, while trust funds are *de facto* created to spend above the ceilings.
- Is flexibility acceptable if it first and foremost affects non pre-allocated headings which have high European value added? The headings used to finance the flexibility needs are mainly the Horizon 2020 and Connecting Europe Facility.
- Should budget lines which have low EU Value Added be cut (or obligations transferred to national budgets) to create a much larger contingency margin or even a substantial emergency fund to be called upon quickly when needs arise?

IV. Can we avoid a negotiating process dominated by '*juste-retour*' interests?

The debate on the resources and size of the EU budget is generally presented as a debate between 'egoistic' Member State treasuries and those defending 'EU common goods', but this is highly simplistic. There is a need to revisit the arguments, because they are out of date. Member States are also not fully "egoistic", as net contributors are not seeking the full reimbursement of the funds. It is worth noting that in 2014 the United Kingdom and Denmark, which are rather critical of the EU budget, met the 0,7% of GNP development aid targets (closely followed by the Netherlands) and well above the OECD 0,29% average (and higher than their 'net contributions' to the EU budget). It is thus questionable that "getting the money back" is the objective of critical Member States. There seems instead to be a clear animosity about the present objectives and use of the EU budget.

Studies frequently underline the notion and consequences of the "net balances", which focus on the monetary aspects of the financing of the EU budget and fully leave out of consideration the indirect benefits that all countries reap as a result of the economic and financial integration, such as notably the "four freedoms": free movement of goods, services, labour and capital. However, these studies often do not address the question whether the EU budget expenditures actually promote and benefit the EU, and whether the

expenditures are financing the necessary actions to iron out the problems arising from this integration. Are these expenditures a precondition for the four freedoms to operate? Are the EU budget expenditures related to essential tasks of the EU? Member States may disagree because the EU budget does not seem to be fit for its purpose. The EU budget's lack of prioritisation of the Justice and Home Affairs budget, for example, has *de facto* led to considerable negative consequences in the refugee crisis.

The net balance disputes and the rebates may well be a reflection on how Member States value the importance of the EU budget expenditures, but a net balance approach is not a solution and actually exacerbates the weaknesses on the expenditure side.

Reforms are needed and the net balance approach needs to be changed radically. The present operational budgetary balances are not reflecting the nature of the budget today, nor do they lead to any improvement in the budget.

The factors calling for a profound change in the way the budget is discussed and negotiated are the following:

1. **With the increase in the pursuit of projects of common interest in structural headings, the European Value Added of many expenditure items has increased.** Net contributors have repeatedly asked for higher EU Value Added, and these changes are moving are in line with their demands. Improvements in the European Value Added of policies should weaken the net balance rationale. High European Value Added projects are not only to be found in the Horizon 2020 and Connecting Europe Facility headings. Also the EU regional and rural funding headings are increasingly being used to achieve common EU objectives, such as the reduction in greenhouse gas emissions, or to achieve levels of environmental protection often *de facto* based on the preferences of richer Member States.
2. **The increase in the use of Financial Instruments (FIs)**: This relatively new and growing element further distances the EU budget source of finance from the location, size and impact of operations and expenditures. In addition, with the appearance of the EFSI, all FIs combined can potentially *mobilise investment funding* to a size matching and exceeding the Cohesion Policy. The benefits of those non pre-allocated instrument can be considerable. A net contributor may potentially benefit to a level exceeding its "net cost" of the EU budget to an extent that can no longer be ignored.
3. **The benefits of Financial Instruments and funding for research and innovation considerably affects the distribution of the financial impact of the EU budget**: The investment generated by those instruments is sizeable and cannot be ignored in calculations on the 'net returns'. Analysis of figures and evaluations show that finance mobilized by those instruments tends to be stronger in wealthier regions. Net balances are therefore becoming increasingly obsolete as a measure of the EU budget benefits to the Member States.

The combination of these three points should make Member States reconsider the way ‘net balances’ are used and corrections calculated. A possible reflection could be the following:

- Could the Member States agree which expenditure items are High Value Added and remove them from any correction? Those could then be financed by ‘real’ Own Resources.
- Can controversial headings be then financed by the GNI key and ‘corrections’ be negotiated that are in line with a measure of the ‘disadvantage’ or ‘excess contribution’ some Member States are subjected to?
- Can those corrections be subject to reviews based on reform progress in the controversial headings?

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