EU BUDGET PRIORITIES, EXPENDITURES AND RESOURCES

Rethinking EU Finances in Light of the Crisis: Balancing Growth and Austerity Needs

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As we approach the start of the next Multiannual Financial Framework (MFF) negotiations, any independent observer following the European Union (EU) budget issue over the last years cannot stop from having a strong sense of *déjà vu*. As in 2004, the European Commission's proposal has been preceded by an "open letter" from a group of "net contributors" setting a limit on the size of the budget. As in 2004, while researchers and experts engage in an intellectually appealing discussion on how to re-align EU spending in accordance to "added value" considerations or on the general benefits of moving towards a real own-resource based financing system, an army of bureaucrats in the Ministries of Finance are already defining their positions in the coming negotiations by calculating the impact of different scenarios of reform on net budgetary balances.

And yet, the political and economic context in which the next MFF negotiations will take place is radically different from the context in which the latest MFF negotiations developed. In 2005, when the European Council reached a compromise on the 2007-13 financial perspectives, the European economy was growing at a rate of around 2%. As is the case today, national public finances were in bad shape, but middle-term economic forecasts were optimistic. Indeed, the main issue of concern was how to render the EU economy more dynamic, as this 2% rate of growth was considered highly dissatisfactory and a proof of "quasi sclerosis" in a world growing at annual rates of around 5% and with the United States' economy strongly rebounding at rates of 4%. Concerning the political context, the EU had just come through the most challenging enlargement of its history, with the entry of 10 new countries having an average income level equivalent to less than 50% of the EU-15 average. Against this backdrop, there was a general consensus among both EU officials and independent observers on the need to "re-direct EU funding to the goals of creating a dynamic knowledge-based economy and on helping new Member States to catch up with the rest as rapidly as possible".[1]

1. André Sapir *et al.*, "An Agenda for a Growing Europe- Making the EU Economic System Deliver", ("The Sapir Report"), July 2003, p. 128, available at: http://www.euractiv.com/ndbtext/innovation/sapirreport.pdf

Today, the economic and political climate is quite different. EU leaders are still worried about the EU's potential for long long-term growth, but also, and more urgently, about the EU's capacity to fully recover from the crisis. Indeed, the EU economy as a whole is growing at 1.8%, but the outlook remains highly uncertain due to the (still unresolved) eurozone debt crisis and the fragility of the financial system. Besides, the aggregate picture hides important differences between Member States. In particular, a new divide is emerging between core eurozone countries, some of them growing at rates of above 2% (i.e. Germany), and so-called "peripheral euro countries" (Greece, Ireland, Spain and Portugal), with very low or negative growth rates. Finally, public finances are in very bad shape. Despite the consolidation effort undertaken in 2010, the aggregate deficit in Europe is forecasted at 4.1% of Gross Domestic Product (GDP) for 2011 (and 6.1% of GDP in the eurozone). The situation is particularly worrisome in peripheral euro countries, with deficits of around 7-10% of GDP. Indeed, these countries find themselves in a negative spiral of low or negative growth rates, tightened budgetary policies and high deficits. It is not clear how they are going to break this vicious circle and regain growth.

Thus, the question is how to re-think the EU multiannual budget in this new austerity / low growth context. Some believe that, at the moment when many Member States are making efforts to curb their level of public spending, the EU budget should be equally submitted to a "cure" of austerity. Others, on the contrary, think we need, more than ever, an ambitious growth-enhanced EU budget in order to "compensate" for spending cuts at the national level. Which of these two sides is right? There are reasons to reject the first approach. Calls for the EU to "set a good example" by applying austerity are more fuelled by ideological convictions than economic rationales. The EU budget is by law on balance, and therefore not pressed by financial markets to reduce any deficit. Having said so, it is true that, as things stand, revenues for the EU budget accrue from national budgets; thus, it is not totally absurd to make a conceptual link between austerity at the national level and the EU budget. On the other hand, the second approach also poses some problems. Claiming to re-launch the EU economy with a 1-percent-of-EU-GDP budget is quite unrealistic. However, this objection needs to be qualified as well: while EU-level spending is irrelevant as a percentage of the EU's GDP, it can have a significant effect on particular policy domains and territories. Thus, for instance, in 2008, funding from European Regional Development Fund and the Cohesion Fund accounted for 28% of total investments on transports, communications and energy, and for 50% of total expenditure on the environment in the so-called "cohesion countries".[2]

So what is the right vision for the next MFF? Probably the most intelligent solution is to adopt a mid-point position; that is, to think on ways to convert the next MFF into an effective tool to re-launch the EU economy while at the same time looking for ways to increase the efficiency of EU spending. What are the practical implications of this in terms of size and composition of

2. European Commission, Report, "Fifth Report on Economic, Social and Territorial Cohesion", Directorate-General for Regional Policy, November 2010, p. 153, available at: http://ec.europa.eu/regional_policy/sources/docoffic/official/reports/cohesion5/pdf/5cr_en.pdf

the MFF is difficult to say, but we can formulate some general reflections on how to adapt EU finances to the double challenge of low growth and budgetary austerity.

The EU budget and growth: Do not neglect short-term needs

A first important issue concerns our ideas on how the next MFF can stimulate growth. Calls for a more "growth-oriented" EU budget are not new; indeed, this has been the main 'motto' of reform over the last decade or so. Up until now, however, when pleading for a "growth oriented EU budget" we usually referred to increasing EU funding on long-term investments – a vision popularised by the influential 2003 Sapir Report, which called for a major increase of EU spending on research and innovation, higher education and trans-national infrastructures.

Investing on the long-term is indeed necessary, particularly now that the crisis has forced many countries to cut back on public investment. There are many ideas under discussion on how to ensure the financing of long-term, strategic investments, including the Commission's proposal of "project bonds". And we should welcome these initiatives. Having said so, it would be erroneous to focus the next MFF exclusively on the long-term. In current circumstances, we should not under-estimate the short-term economic impact of EU spending. In particular, two things should be kept in mind when negotiating the new MFF.

First, as Europe's post-crisis recovery remains tentative, any changes in the MFF should be mindful of its effect on demand in the short run. Hence, for instance, it is more important than ever to ensure a well-designed phase-out programme for countries and regions losing eligibility to Cohesion Policy funding in the post-2013 period, so as to prevent that the loss of funding hamper their recovery. Concerning the Common Agricultural Policy (CAP), despite all justified criticisms on the effectiveness and appropriateness of current CAP Pillar 1 spending, we should not neglect the fact that this is the only EU direct income support programme. Thus, any reform on CAP direct payments for the post-2013 period should pay adequate attention to its short-term redistributive impact.

Second, EU leaders should do their utmost to prevent eurozone peripheral economies from plummeting into a long recession. This leads us to the broader question of how these economies can regain growth in the short to medium term, and what the EU budget can do in this respect. The dominant thinking in EU and international *fora* is that these countries need to reform their labour and product markets to become competitive again. This might be true, but one should be mindful of the political difficulties inherent to passing such reforms (which entail long-term benefits, but negative short-term effects in terms of job losses or greater job insecurity). Adding to the negative impact of budgetary austerity plans, if left on their own, it is hard to believe that these countries will be able to pass these reforms and regain growth in the near future.

Against this backdrop, it seems necessary to use part of EU spending in the coming MFF to stimulate growth and facilitate reforms in these countries. A solution in this respect could be

the creation of an *ad hoc* reserve fund in the next MFF for countries receiving assistance from the European Stability Mechanism (ESM) or at risk of being bailed out by the ESM. Contrary to the current ESFS or the future ESM (whose aim is to provide financial assistance to governments to help them honour their debt payments), this ad hoc fund would be geared to stimulate growth. It would be used to finance or co-finance programmes having strong counter-cyclical properties (i.e. training programmes and mobility grants for workers and financial aid for Small and Medium-Sized Enterprises). The "moral hazard" would be diminished by conditioning the disbursement to reform implementation, hence using EU spending as an incentive tool to pass politically-costly reforms.

Another option is to create a permanent EU-wide stabilisation fund geared to provide temporary assistance to any EU country suffering from exceptionally negative economic circumstances. While today the idea of setting up an EU stabilisation mechanism seems politically unrealistic or too radical, one should note that it was seriously discussed in the early 1990s, at the moment of creating the Economic and Monetary Union (EMU). Indeed, it was such a mainstream idea that in 1993 an independent group of economists entrusted by the Commission to examine the role of public finances on the EMU concluded the following:

> *The group shares the view of much of the literature on EMU that there is a strong case for a Community role in assisting Member States to absorb severe specific shocks. This is in order to compensate for the loss of the exchange rate as an adjustment instrument and for the loss of an independent monetary policy, and should help to prevent longer-lasting economic deterioration which could increase the pressure for greater redistribution. It should also make it easier for Member States to respect fiscal discipline.*[3]

The same report notes that such an EU stabilisation fund would not require a lot of spending (i.e. around 0.2% of EU GDP). If well designed, it would work as a sort of insurance: it would be activated automatically on the basis of a reliable indicator monitoring changes in real activity – that is, countries would be eligible only if and when the indicator would report a major fall in real economic activity relative to the EU average – and its use would be halted as soon as no further changes occur, irrespective of the level at which the national economy would become stable again.

The EU's budget and austerity: Exploring the efficiency gained from a better coordination of national and EU-level spending

The other big challenge for the next decades is austerity. As said before, as long as the EU's budget is financed by national budgets, austerity at the national level will require an effort to

3. Henrich Matthes *et al.*, "Stable Money – Sound Finances. Community public finances in the perspective of EMU", *European Economy*, n° 53, 1993, p.6, available at: http://ec.europa.eu/economy_finance/publications/publication7524_en.pdf

implement EU spending programmes in a more efficient way. Already, we see some positive moves in this respect, such as current debates within EU cohesion communities on the need to reinforce the Commission's control on the use of EU funding or to introduce a more performance-based approach in the allocation of funding and in evaluation. However, this is a partial approach to the challenge of austerity, which does not take into account the potential efficiency gains that can derive from reorganising spending tasks and from a better coordination of public spending at the national and EU-level.

In effect – as pointed out by a recent report from three prominent Members of the European Parliament (Jutta Haug, Alain Lamassoure and Guy Verhofstad) – in various policy areas there are duplicities between EU and national-level spending. In these areas, better coordination and some pooling of resources at the EU-level could translate into efficiency gains.[4] Thus, for instance, it would be nonsense if the creation of the new EU external action service is not accompanied by a restructuring of national diplomatic services, so that the new EU external action service does not entail extra-cost for taxpayers, but on the contrary, net savings. In the domain of research, we have a European Research Council, but also multiple National Research Councils that finance research activities according to national priorities, unaware of the actions financed by their neighbours. Better coordination in this area would avoid duplicities and fruitless competition, ensuring a more efficient use of public resources on research in Europe. Finally, there are many potential savings from coordinating national spending on defence, as shown by Fabio Liberti.[5] European governments' concern to develop and protect its own national defence industry has led to absurd situations, such as the development of 16 armoured fighting vehicles or 11 different frigates in the 27 Member States. And the effectiveness of national-level spending in defence is questionable. One fact is particularly appalling: the EU has 27 national defence army forces that combined make a total of 2 million soldiers, but only 2% of these soldiers are capable of carrying out "high intensity action" (that is to say fighting).

To sum up, while the EU budget should not be isolated from austerity concerns, due to its limited size, we cannot expect major savings from applying austerity at the EU-level. A more efficient response to the austerity challenge is to look at ways to make savings by better coordinating EU and national-level spending. In some areas, it might be intelligent to pool services or financial resources to benefit from economies of scale. In others, more "ex ante" coordination of national budgetary processes might be the right answer. Such ex ante coordination could be conducted within the context of the so-called "European Semester", providing the latter pays adequate attention to the quality of public finances and not only to deficits and debts levels.

4. Jutta Hauh, Alain Lamassoure and Guy Verhofsdat, "Europe for Growth : For a Radical change in Financing the EU", CEPS/Notre Europe, 6 April 2011, available at: http://www.notre-europe.eu/uploads/tx_publication/Europe_for_Growth__For_a_Radical_Change_in_Financing_the_EU.pdf
5. Liberti, Fabio, *Defence Spending in Europe: Can we do better without spending more?* Notre Europe, forthcoming.

Final remark: How to finance the EU budget?

We have already noted that, as things stand, revenues for the EU budget accrue from national budgets. Thus, to a certain point, it is understandable that austerity at the national level translates into calls for freezing the EU budget. However, this state of affairs is not inevitable. There is a very simple way to avoid calling on national budgets, and that is by creating new "EU own resources" to finance the EU budget.

The idea of creating a new "tax" in a period of crisis is seen by some as a non-sense. Yet, what is really non-sense to have the Greek or the Irish government contributing to the common budget with a direct payment from their respective national budgets while at the same time receiving a "bail out" from the rest of eurozone governments to cover their debt obligations": as pointed out by the previously mentioned report[6], fully funding the EU with independent sources of revenue is possible; it is only a matter of political will. The report proposes two reform scenarios. In the short- medium-term, they propose to fund the EU budget with a genuine EU VAT tax (at a rate of one percent) and a EU carbon tax on carbon dioxide (CO_2) emissions not covered by the Emissions Trading Scheme (ETS). The EU carbon tax would consist of an imports tax and of a tax on the production of fossil fuels (carbon, oil and gas), at a rate of 20€ per ton of CO_2 emissions. For the long-term, they propose a partial offsetting of the carbon tax by an EU financial transaction tax (a tax of 0.05% on exchange-traded equity and bonds), thus anticipating the possible "success" of the EU carbon tax in mitigating emissions.

6. Hauh *et al., op. cit.,* 6 April 2011.