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# EU Finances in Search of a New Approach

It has been said before, too many times: the EU budget is overdue for reform. Despite many changes in detail, the shape and procedures of the budget in 2023 would be easily recognisable to those who negotiated and implemented its major reform in 1988. So too would be many of the points of contention about it, such as the large proportion of spending allocated to Cohesion Policy and direct payments to farmers, the lack of flexibility, the impasse over new own resources and the persistence of rebates accorded to some member states on their gross contributions to EU revenue.

What would not be recognisable to a time traveller from the late 1980s is the proliferation of off-budget mechanisms through which important EU policies are funded. They include the various means by which financial assistance to third countries is distributed, ad hoc responses to crises (such as the sovereign debt crisis, starting with Greece, then dealing with refugees in 2015) and, most recently, the large programmes associated with the NextGenerationEU (NGEU) package, launched in 2020 in response to the COVID-19 pandemic. Borrowing and lending was not, of itself, a new phenomenon, with the European Investment Bank (EIB), in particular, being long established as a source of funding for investment projects. As Laffan (1997, 217) pointed out, there was a sharp contrast between "the fierce battles about the size distribution and objectives of the community budget and the largely uncontested second arm of the EU's finances".

However, the resort to off-budget mechanisms has a number of consequences that call for a recasting of the governance of EU finances. The prospect of a further substantial enlargement of the EU adds urgency to the issue and was explicitly mentioned by Ursula von der Leyen in her 2023 State of the Union address. Reflecting on what would need to be done prior to the accession of Ukraine and other likely candidates, she singled out the budget:

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* Some elements of this piece build on Grund and Steinbach (2023).

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"We need to discuss the future of our budget – in terms of what it finances, how it finances it, and how it is financed" (von der Leyen, 2023).

The latter half of her statement is succinct, but it is worth elaborating on its meaning. "What it finances" invites a reappraisal not only of the different headings of spending that have dominated EU budgets for decades, but also asking whether a more wide-ranging review of the expenditure side is needed. There are several facets of "how it finances it" to consider. Among them are: the choice between grants and loans, the extent of conditionality, and whether (or when) co-financing by member states or other interests is justified. "How it is financed" could be somewhat narrowly understood to be the mix of EU revenue, currently dominated by net contributions, and the scope for boosting the share of "genuine" own resources. Having crossed the Rubicon of funding EU policies by direct borrowing from financial markets for NGEU, albeit temporarily, a separate aspect is whether borrowing should become a routine source of funds.

These three dimensions of the EU budget help to frame this article and are expanded in the sections that follow. However, there is another dimension to take into account. It stems from the broadening of EU finances, with the implication that they now need to be analysed as a whole, rather than being equated largely with the EU budget. Doing so requires attention to be paid not only to the different components of the galaxy of EU finances (Begg et al., 2022), but also to the complexities of the interactions between the different components. A key proposition of this article is that there is a need to develop an EU-level fiscal framework, distinct from those of member states.

## What it finances: EU expenditure

The EU's expenditures derive from a combination of Treaty obligations, political choices made decades ago as well as more recently, pressures to support sectors and territories affected by economic integration, and some areas for which a case can be made that the EU is the most appropriate level of governance to undertake the spending. It is often described as a budget for investment, an assertion that can be defended for spending on Cohesion Policy and research, but is more questionable for direct payments (most of which go to farmers and still account for over a quarter of EU expenditure) and for a proportion of external action.

If, however, EU budget specialists were asked today to start with a blank sheet of paper and write down what the EU should spend on, it is a safe bet that it would be very different from the current list. But rather than focus on specific spending lines, the upstream question that needs to be answered is why the EU spends and what spending should be assigned to it in a multi-level system of public expenditure. Fuest and Pisani-Ferry (2019) list eight broad areas for European public goods (EPGs) and argue persuasively for putting the provision of public goods at the heart of European integration. They assert that "enhanced provision of European public goods requires additional funding, but it should not increase the overall tax burden for EU citizens"; their reasoning is that "the overall tax burden should decline if public goods are more efficiently provided at European than at national level" (Fuest and Pisani-Ferry, 2019, 2).

A useful approach to EPG is provided by Buti et al. (2023) who distinguish between: provision by the EU level in the pursuit of EU policy goals; transfers to member states, nevertheless aimed at EU objectives; and inter-governmental transfers to member states to fund national public goods. Buti et al. argue that the first category is the easiest to justify and, as a corollary, least prone to the disputes about net contributions and *juste retour* that have been so toxic over the decades. It potentially encompasses a variety of public spending, including responses to climate change, much of EU external action (although there can be overlap with national policies) and administrative activities required to sustain the Union.

The second category is exemplified by how the funding from NGEU is distributed, with the obligation to devote much of the funding to climate actions and digitalisation – the twin transitions at the heart of current EU policy narratives. However, there are sizeable net fiscal transfers from the Recovery and Resilience Facility (RRF), which, though temporary, enable net recipients to boost public investment without aggravating fiscal policy stresses, thereby fulfilling a macroeconomic stabilisation function. EU funding of national public goods is both allocative – investments intended to promote economic growth – and distributive, albeit between member states, rather than in the sense conventionally used in public economics (dating from the seminal work of Musgrave, 1959) of between richer and poorer households or citizens. The investment supported by, above all, cohesion policy encompasses infrastructure and other goals such as enhancing skills, social inclusion or territorial balance.

Discussion of what constitutes EU added value (EVA) is closely related to EPGs, but finding agreement on it is difficult. In some respects, EVA is an intuitively obvious concept, yet also a devilishly slippery one. A comprehensive special issue of the European Court of Auditors Journal (2020) illustrates its complexity and offers a plethora of interpretations. Often, discussion of EVA slides into justification of EU integration overall, with many contributors to the special issue emphasising the broad regulatory role of the EU. However, in considering the EU finances, it can help to narrow the debate to simpler aspects of EVA. While economic efficiency – whether through economies of scale and scope, or elimination of damaging externalities, such as adverse spillovers – is a powerful rationale, it cannot be the sole justification for EU-level spending. A related rationale is to ensure that a suitable quantity of public goods is produced, a goal that may be compromised at other levels of government if they are unable to appropriate the benefits of its spending and, consequently under-invest. In addition, as Rubio (2020) stresses, there are political considerations which sometimes over-ride economic principles.

### How it finances it: Mechanisms for, and governance of, spending

EU funding can be split along a number of dimensions. Grants from Brussels were traditionally the mainstay of EU budget funding, but loans (known as financial instruments) have been used to a limited extent in cohesion policy. More recently, as noted above, loans have acquired greater prominence, especially in pandemic-related actions.

Borrowing by the EU to enable EU policies to be funded operates in different ways. The EIB has its own legal personality and funding arrangements and funds projects largely on a commercial basis, entailing investment appraisal intended to verify the validity of the project. Other EU borrowing is to fund loans for a specific purpose, ranging from Macro-Financial Assistance (Ukraine is a significant beneficiary today) to the temporary SURE instrument (agreed in 2020 and taken up by most member states) which sought to underpin national initiatives to maintain employment during the pandemic. These are back-to-back loans, which means the EU borrows (exploiting its favourable credit rating) then lends on to recipients who benefit from better loan terms than if they sought to borrow directly from financial markets. Recipients are responsible for repaying and servicing the loans, with the EU guaranteeing the loans.

NGEU was a new departure. Its loan component also operates through back-to-back loans, but the grant component means that future EU budgets become liable for debt service and repayment, the latter probably only starting

from 2028 and extending for up to three decades. This has ramifications. First, the debt-related outlays will be a first call on the EU budget, outside the control of the Budgetary Authority (the Council and the European Parliament) in the sense that it cannot choose to alter the amount.

This, in turn, prompts questions about how these new payments are accommodated: essentially a choice between cutting other expenditure or raising additional revenue, although a possibility would be more extensive co-financing, either at the national level or other stakeholders. In this context, there has long been pressure from net contributors to keep the headline total of the EU budget low as a means of capping what they have to contribute. Unsurprisingly, net recipients, the Commission and the European Parliament take the opposite view. The principal alternative is to raise additional revenue, either through higher national contributions or through new own resources; neither is easy.

Conditionality has been a vexed question. On one side, pressures have grown over the years to ensure programmes are well-conceived – *ex ante* conditionality – with the goal of making it more likely that money will be well spent; this is not especially contested. Macroeconomic conditionality – requiring member states to adhere to sound fiscal policy – has been much more controversial, partly because it can be seen as punishing regions for the failings of national governments, but partly also because it can undermine economic development. Rule of law conditionality, as applied to funds from the Recovery and Resilience Facility (the main mechanism of NGEU), elicits the most rancour, because it imposes a political test on disbursement of funds, not just an economic one.

Related to conditions is evolution in the approach to monitoring and evaluation. The direction of change is towards performance-based budgeting (PBB), defined by the OECD (2023) "as the systematic use of performance information to inform budget decisions, either as a direct input to budget allocation decisions or as contextual information to inform budget planning". It entails a focus on what the policy produces by way of direct outputs and broader results, a contrast with the more conventional input approach under which recipients had only to show funds were being used in accordance with sound financing rules. The RRF, with its use of milestones and targets as the basis for disbursements, adopts a PBB approach, although work by Darvas et al. (2023) suggests it falls short of its stated ambitions. An open question in this regard is how useful common indicators can be in assessing programme success.

## How it is financed: EU revenue

Proposals for new own resources to cover the NGEU repayments are set out in a roadmap in Annex 2 of the 2020 Interinstitutional Agreement,[1] and in the 2021 Own Resources Decision[2] which also included the introduction of a plastics levy as a new resource. The European Commission (2021) put forward a range of proposals, but conceded 18 months later (European Commission, 2023) that "the legislative discussions on the proposal made in December 2021 have made limited progress".

There are many obstacles to the introduction of "genuine" own resources, as distinct from national contributions (even though these are formally designated as own resources, meaning the member states are committed to honouring them), so much so that no new resources were approved between 1988 and 2021. Fundamentally, the problem is that member states are loath to accord a "power to tax" – a key feature of most polities – to the EU. The need for unanimity is also a deterrent to selecting new resources.

While there has been no shortage of studies and ideas on possible new resources (High Level Group on Own Resources, 2016; Schratzenstaller et al., 2022), a persistent difficulty is their uneven incidence on particular member states. Candidates proposed over the years include carbon taxes to be collected by the EU, a share of corporate income tax, financial transactions taxes, obscure sources such as the monetary income of central banks, and even a small charge on every SMS text message sent. It does not take much imagination to see why member states using low corporate taxes as an instrument of industrial policy to attract inward investment would oppose an EU corporate tax, or why those with comparatively high proportions of fossil fuels in their energy mix would object to EU carbon taxes.

From the perspective of most member states, the largest share of own resource – the GNI contribution – has notable attractions. The formula behind it may be impenetrable to citizens, but for national finance ministries, it is a distinct line in their budgets and elicits only limited contestation once the septennial deal on the multiannual financial framework (MFF) and the own resources decision is concluded. For the EU level, the GNI resource has one key attribute which is to rise or fall as expenditure occurs, thereby balancing the budget while also assur-

1 Official Journal of the European Union, L 433 of 16 December 2020, 28-46.
2 Official Journal of the European Union, L 424 of 15 December 2020, Council Decision (EU, Euratom) 2020/2053.

ing the EU level of certain revenue. Many possible own resources would lack such certainty. Over the years, the GNI resource has also been one of the means by which member states that claim to face unfair net contributions have had them abated.

These "corrections" can seem perverse, especially when they routinely result in the gross contributions of richer member states as a proportion of GNI being lower than their poorer partners, but they have proved vital to overall agreement since first being conceded to the UK in 1984. They are nevertheless a decidedly peculiar way of managing the revenue side of the budget and there was a hope in 2020 that Brexit would allow a phasing-out of corrections. That it did not happen highlighted the deeply political nature of the EU budget. Although the plastics levy, introduced in 2021, is an innovation, it is tied to gross national income and is, consequently, de facto also a national contribution, leading some member states to argue that it adds to administrative costs for negligible benefits. Moreover, even this limited innovation is subject to a form of correction favouring member states with GNI per capita below the EU average.

## An EU fiscal framework

The combination of conventional EU budget programmes and off budget mechanisms has come about more as a result of exceptional circumstances than explicit design. As the European Court of Auditors (2023, paragraph 93) explains, although "there were reasons for creating new types of instruments, the piecemeal approach taken to set up the EU's financial landscape has resulted in a patchwork construction of instruments with different sources of finance and governance arrangements".

Interactions between income and expenditure on one hand, and public debt on the other, are central to public finances in most polities and, it is worth recalling, are the subject of intrusive oversight at the EU level. It is, therefore, something of an irony that the implications of having EU debt have been insufficiently analysed. Begg et al. (2023) propose five dimensions for a putative EU fiscal framework: the first two are the traditional income and expenditure; then there is management of risks; and governance of decision-making and legitimation complete the framework.

The various linkages between the five dimensions are crucial for an EU fiscal framework (see Figure 2 of Begg et al., 2023). Increased debt service costs (or risks of default), for example, affect choices on income or expenditure. Risks generated by choices made by the Council and Commission, with the Parliament only consulted, can leave the Budgetary Authority to deal with the consequences. Much depends on how guarantees and provisioning are structured.

In the EU setting, the own resources ceiling plays a vital role because it does two things. First, the headroom between the MFF ceilings for expenditure and the own resources ceiling provides an assurance that member states will increase their contributions if called, for example, to cover defaults on loans. As a result, financial markets can regard lending to the EU as safe. Second, as occurred with NGEU, raising the own resources ceiling can boost the EU's capacity to borrow. Guarantees are also offered by a Common Provisioning Fund, established under Article 212 of the Financial Regulation, inside the EU budget, as a first line of support for certain loans.

## Conclusions

The status quo bias afflicting the budget should be no surprise because it is the result of difficult compromises between competing sectoral interests, as well as those of member states with widely differing priorities and expectations of what the EU should fund. Equally, it is hard to deny that there are unrealistic expectations of what EU budgetary interventions should do, especially in alleviating crises, given the constraints on budgetary autonomy at the EU level, i.e. a capability-expectations gap. Insights from public economics may be useful, even if due allowance is made for the *sui generis* nature of the EU and its budgetary distinctiveness. For example, some of the propositions found in fiscal federalism, such as the principle of equivalence, might be adduced. This principle suggests that expenditure should be undertaken and financed in the territory where its benefits accrue, both to reflect preferences and to align incentives. It might reasonably be applied in support of funding demonstrably European public goods by genuine own resources.

The pathologies of the EU budget, and its finances more generally, are well known and point the way to a reform agenda. Considering recent demands for budgetary responses, enhancing the agility and flexibility of the EU level is a high priority, though the rigidity of the MFF model is an obstacle. An approach best characterised as incremental to altering the budget entrenches the status quo, and key governance mechanisms, not least the need for unanimity, make more radical change difficult. Yet the prospect of enlargement, as signalled in the quotation above from von der Leyen (2023), provides opportunities to rethink what purposes the budget serves. Answers should be rooted in a fresh look at the EPGs that the budget is best equipped to provide and improved understanding of how value is added by spending at the EU level.

The EU needs, in parallel, to decide how best to use borrowing and lending as an integral part of its budgetary strategy. Grund and Steinbach (2023) show convincingly that there is scope to do so without Treaty change. The piecemeal approach undoubtedly helped find solutions to, for example, the migrant crisis (the Facility for Refugees in Turkey) or the rapid implementation of SURE, but the EU should not rely repeatedly on cobbling together a package. A more comprehensive and considered framework would also enhance the "agility" of the EU budget by adding to options for actions.

Although the EU has repeatedly shown it can act quickly when pushed, the frequent use of Article 122 as the legal base for emergency action not only stretches the intent of the article, but also gives a disproportionate role to the Council in decision-making. The corollary is that the European Parliament is side-lined, undermining legitimation. A better approach would be to work towards an EU fiscal framework in which the interactions between the income and expenditure accounts and the balance sheet of EU finances are more coherent in how interventions are devised. Doing so would ease the sorts of complications that have arisen, such as the difficulties associated with servicing and repaying debt incurred to fund NGEU grants.

Regarding how to proceed, a first opportunity is the mid-term review of the MFF, currently in progress. It is unlikely to shift the dial massively, but could begin to alter the terms of debate on future EU finances. Proposals on the next MFF, likely to be put forward in the course of 2025, are a second opportunity, and also one with scope for greater innovation, because they will have to emerge early in the mandates of the next Commission and European Parliament.

What is it to be, yet another rerun of "groundhog day" or acceptance that the "time for a change" is now?

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