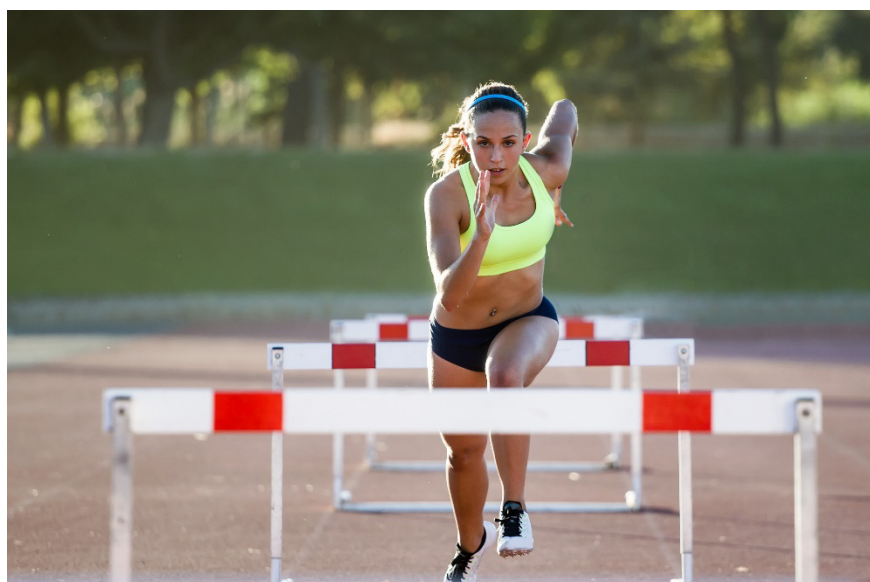


STUDY

Requested by the BUDG committee



Options for a stronger and more agile EU budget



Policy Department for Budgetary Affairs
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Directorate-General for Internal Policies
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Options for a stronger and more agile EU budget

Abstract

The EU budget has to reconcile certainty in generating funding for what are, predominantly, multi-annual investment programmes, with a capacity to generate funding on a sufficient scale when circumstances and priorities change. Off-budget mechanisms have largely been preferred for dealing with the latter. This study presents recommendations, drawing on several scenarios, for how the EU budget could be recast to enable it to be more agile and responsive in dealing with new and future challenges requiring EU-level expenditure or lending.

This document was requested by the European Parliament's Committee on Budgets.

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LIST OF ABBREVIATIONS

BAR	Brexit Aid Reserve
BoP	Balance of payments
B&L	Borrowing and Lending
CAP	Common Agricultural Policy
CP	Cohesion Policy
CPF	Common Provisioning Fund
EAG	External Action Guarantee
EAR	External Assigned Revenue
EAV	European Added Value
ECA	European Court of Auditors
ECB	European Central Bank
EFSD	European Fund for Sustainable Development
EFSD+	European Fund for Sustainable Development Plus
EFSI	European Fund for Strategic Investments
EFSM	European Financial Stability Mechanism
EFTA	European Free Trade Association
EIB	European Investment Bank
EP	European Parliament
EPG	European Public Good
ESM	European Stability Mechanism
ETS	EU Emissions Trading System
EU	European Union
FR	Financial Regulation
FRONTEX	European Border and Coast Guard Agency
FRT	Facility for Refugees in Turkey
MEP	Member of the European Parliament
MFA	Macro- Financial Assistance
MFF	Multi-annual Financial Framework
MS	Member State
NDICI	Neighbourhood, Development, and International Cooperation Instrument

NGEU	Next Generation EU
OECD	Organisation for Economic Co-operation and Development
OR	Own Resources
PG	Public Goods
RRF	Recovery and Resilience Facility
SEAR	Solidarity and Emergency Aid Reserve
TFEU	Treaty on the Functioning of the European Union
STEP	Strategic Technologies for Europe Platform
SURE	European Instrument for Temporary Support to mitigate Unemployment Risks in an Emergency
UAR	Ukraine Aid Reserve

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EXECUTIVE SUMMARY

For the EU budget (or, perhaps more accurately, the EU-level fiscal system) to be ‘strong’ and ‘agile’, it has to reconcile competing objectives and constraints. It requires certain and reliable funding to meet Treaty commitments and decisions taken by the Budgetary Authority, including the many multi-annual investment programmes. It also has to enable the EU to generate funding on a sufficient scale and in a timely manner when crises hit or when circumstances and priorities change.

The objective of this study, succinctly explained in the terms of reference, is to explore how the EU budget and other financing mechanisms at the EU level could be made more flexible and responsive, enabling the Union to address crises with minimal recourse to extra-budgetary constructions, but also through reforms able to enhance parliamentary oversight.

The work undertaken for this study consisted of desk research, brainstorming by members of the project team and interviews with experts. The willingness of the interviewees to engage with the project has been both welcome and highly gratifying, and has provided a wealth of insights into what is undeniably a difficult subject.

Context and background

Within the ‘galaxy’ of EU budgetary and financial mechanisms, the core is the multi-annual financial framework (MFF) which establishes annual ceilings for the main expenditure programmes and the EU budget which contains some mechanisms outside the MFF ceilings, such as the Solidarity and Emergency Aid Reserve (SEAR). These are funded mainly by Own Resources, agreed in the Own Resources Decision which has to be ratified by all Member States according to their national constitutional procedures.

Certain other EU policies have been funded by assigned revenues, mainly from external sources, including transfers from members of the European Free Trade Association. Previously, these external assigned revenues (EAR) were a small proportion of EU outlays, but with the agreement of the Next Generation EU package in 2020, the magnitude of EAR expanded massively because the borrowing by the EU to fund it was deemed to be this category of revenue.

Among the consequences of this shift – temporary, it should be recalled – was to undermine key principles of the EU budget, such as unity (having a single budget) and universality (not earmarking revenue for specific purposes). It also required an increase, also temporary, in the own resources ceiling, the maximum amount Member States commit to allocating to the EU.

This ceiling is conventionally a fraction of a percentage point higher than the annual expenditure ceilings agreed in the MFF and the difference between the two ceilings, known as the headroom, plays a crucial role in allowing the EU to borrow from financial markets. It acts as an implicit guarantee that the Member States, collectively, will be obliged to cover the EU’s outgoings (including any defaults or calls on guarantees).

Bringing in the economics of public finance

In the economics of public finance, there are well-developed conceptual models for analysing the attributes of public goods and services, as well as fiscal and budgetary relations between different tiers of government. Much of this analysis has been developed to explain arrangements and public policy choices in the USA and certain other federal systems, but its resonance for the EU’s finances is often hard to discern.

Nevertheless, in exploring options for reforming the EU budget and its finances more generally, insights from these theories can be useful. In particular, what constitutes an EU public good and clarity about what is meant by the term 'European added value' are tricky questions. The first part of the study therefore goes into some depth on how the EU might take more account of such principles in rethinking its budgetary framework.

Indeed, in contrast to Member States which are expected by the EU to put in place effective fiscal frameworks to underpin their public finances, it can be argued that there is no equivalent framework at EU level. The study therefore proposes a framework comprising five dimensions: expenditure, revenue, risks associated with the balance sheet, governance and legitimation.

Scenarios

The purpose of the scenarios is to explore possible trajectories for a reform of EU finances, thereby helping to tease out how they could become more 'flexible and responsive', while reducing the resort to 'extra-budgetary constructions'. Three main scenarios were selected for the study, together with a further three more specific ones.

Many crucial dimensions have to be reconciled and concerns allayed, and having scenarios which are distinctive enough to draw attention to merits and drawbacks is useful for this purpose. However a scenario is neither a blueprint for a new model nor a description of how to move from 'a' to 'b'. Rather, it is a device to draw attention to the challenges of moving in a specified direction.

Two of the main scenarios explore opposed, and mutually exclusive, options for the EU's finances. The first is to restore the primacy of the MFF and the annual budget by better integration of off-budget mechanisms. For the second, the reverse is assumed, as it depicts a more formal separation of the borrowing and lending components of EU finances from the EU budget.

The first appears to be most conducive to fulfilling the objectives set out in the terms of reference for this study. Simply put, doing more through the OLP and thus the Budgetary Authority is most consistent with the spirit of the Treaty and institutional expectations, not least from the standpoint of legitimation. A challenge will, however, be to retain sufficient flexibility in adopting new mechanisms, while concerns would arise about the need for a higher own resources ceiling.

The second scenario would both simplify the EU budget and raise new complications in the EU's broader finances. It would make it easier to preserve the integrity of the income and expenditure side of the budget in fulfilling its established functions, insulating the EU budget from the costs emanating from borrowing. Instead, dealing with several off-budget mechanisms would become a matter for Member States, with a risk of detracting from transparency.

Scenario 3 is about tweaking the status quo to deal with known problems and anomalies, but without radical change, very much in the tradition of 'muddling-through'. Several of the proposals put forward for the Commission for the mid-term review of the MFF can be seen through the lens of tweaking, but the notion can also be extended to encompass the furthering of a number of other recent trends.

Precisely because it would be a tweaking of established features of the EU budget, scenario 3 can be considered the least difficult of the three to implement. It also has the potential to deal with some of the shortcomings of the current framework, but to the extent that it favours lowest common denominator changes, would preclude more radical reforms many would argue the EU budget needs.

The three specific scenarios look, respectively, at retrenchment of the budget consistent with one of the scenarios in the 2017 White Paper on the Future of Europe, having a macroeconomic stabilisation mechanism at EU level and options for external action.

Of these, it should be stressed that retrenchment is highly implausible, but is included to show what the 2017 White Paper option would imply. By contrast, having a macroeconomic stabilisation capacity has long been seen as necessary for an economic and monetary union and would be consistent with theoretical analysis which suggests assigning such a function to the highest level of governance.

Likely demands associated with supporting Ukraine, as well as other geo-political developments, can be expected to require better funded mechanisms for external action. The analysis examines the cases for having such mechanisms inside the EU budget or, instead, preferring off-budget mechanisms, with the latter made up predominantly of loans.

To provide a degree of comparability, the presentation of the scenarios included explanations and commentary and, for each, a table was completed comprising seven elements and distinguishing (where appropriate) between economic, political and institutional considerations:

- a brief description of the scenario;
- the motivation for considering it;
- means of realising it;
- expected outcomes;
- obstacles to making it happen;
- timetable; and
- feasibility.

Conclusions and recommendations

The current system of EU finances, of which the budget remains the largest part, is still capable of meeting most expectations of it, but is under increasing strain, with the corollary that the time is ripe for more far-reaching changes than have been attainable since 1988. The prospect of a further enlargement sooner than previously foreseen adds urgency to this conclusion.

This study has drawn attention to principles of public economics and how they might be adapted to the EU's finances. A related matter is how to accommodate the continuing gap between expectations about what the EU aspires to use fiscal mechanisms to achieve and the constraints on not only the MFF, but other financing mechanisms. A wide-ranging reflection on an EU fiscal framework comprising the five elements described above would be worthwhile.

Several recommendations are put forward for how the different components of the EU fiscal framework might be recast. These are summarised below.

- Regarding expenditure, two main issues should be confronted. The first is to look again at what public goods the EU budget finances, taking account of what economic theories suggest should be done at the EU level, while also recognising political imperatives and the distinctive character of the EU level of governance. Doing so is bound to be contentious because it would call into question the rationale for some existing budget lines.
- Second, more attention needs to be paid to European added value, notwithstanding the difficulty of agreeing a common definition of the term. A radical change could be to distinguish between three functions of the EU budget: EU public goods; making existing spending more 'agile' for macroeconomic stabilisation purposes; and external action.
- A target should be set for a higher share of revenue from 'genuine' own resources (as opposed to national contributions), with a binding date.

- As far as possible new own resources should be linked with EU policies and strategic objectives, notably related to the twin transitions. Fairness among Member States can be facilitated by having a basket of resources, but adopting this approach could add to administrative burdens.
- Within reason, the proliferation of lending mechanisms should be rationalised, perhaps under the management of a European Debt Agency. Extending the mandate of the European Stability Mechanism (ESM) and bringing it into the EU legal order should be explored.
- The Budgetary Authority should propose a deadline for new budgetary/fiscal capacities, starting with mechanisms orientated towards reinsurance.
- Legal bases other than Article 122 TFEU should be used where possible.
- Consider a ten-year rolling MFF with more frequent break points.
- Try to reconcile the best of the various forms of tracking, monitoring and evaluation adopted in Cohesion Policy and the RRF, to facilitate improved performance budgeting.
- The ordinary legislative procedure should routinely be applied when new mechanisms for EU funding are proposed, even in times of crisis or urgency, keeping exceptions to a minimum.
- Consider having articles in the Financial Regulation which specify the conditions under which new funding mechanisms can be introduced without co-decision by the European Parliament, setting stringent rules to limit the use of such mechanisms.

The study team is aware that there will be objections to some of these recommendations, but also observes that, thirty-five years on from the major reform of 1988 and despite the many incremental changes that have been made, the case for a more radical reform of the EU's finances is increasingly compelling. As stated by Ursula von der Leyen in her 2023 State of the Union address: 'We need to discuss the future of our budget – in terms of what it finances, how it finances it, and how it is financed'. An inter-governmental conference focused on the budget could be the solution.

INTRODUCTION

The EU's budget is facing multiple challenges, casting doubt on its ability to mobilise support in a timely and effective manner for new policy imperatives, because its rules, principles and procedures lack the flexibility to enable the EU to tackle emerging problems. Instead, faced with the combination of demands for funding to contend with successive crises and the desire to reorientate EU spending to new priorities, there has been an increased resort to off-budget mechanisms. Previously, a reasonable interpretation would have been that the EU's **budget**, negotiated annually within ceilings agreed as part of the multi-annual financial framework (MFF) could be equated with the EU's **finances**, but this is no longer accurate.

The proliferation of off-budget mechanisms has undoubtedly led to greater complexity in the 'galaxy' of EU finances; it raises difficult questions about the relationship between the traditional budget and the new mechanisms. Major concerns include legitimisation, notably the role of the European Parliament, and potential risks to expenditure plans and future priorities. However, these are symptoms of an underlying dysfunctionality in the EU's budgetary architecture.

Interpretation of the terms of reference

At the heart of this study are the words 'strong' and 'agile'. For a budget (or, perhaps more accurately, an EU-level fiscal system) to reflect these two adjectives, it would need to be able to reconcile certainty in generating funding for what are, predominantly, multi-annual investment programmes, with a capacity to generate funding on a sufficient scale when circumstances and priorities change. Doing both is likely to require provisions for amending the MFF, including (but not only) during mid-term reviews, alongside imaginative use of the range of financing mechanisms, notably borrowing and lending, as well as guarantees.

The dilemma to be confronted is that the protracted negotiations leading to the MFF have become a 'grand bargain', unable to be unpicked without significant political upheaval. Yet once the bargain is struck, budgetary responses are severely constrained, leaving the EU struggling to find ways to accommodate demands to react. The EU budget is also supposed to adhere to a range of principles which further limit how it is implemented, although some of these principles (notably universality and unity) are increasingly not respected as a result of how certain new funding mechanisms have been structured.

The objective of this study, succinctly explained in the terms of reference, is to explore how the EU budget and other financing mechanisms could be made more flexible and responsive, enabling the Union to address crises with minimal recourse to extra-budgetary constructions, but also through reforms able to enhance parliamentary oversight.

In line with the terms of reference, the study is structured around a number of scenarios that define and explore different options for resolving the issues arising at different levels of governance. In preparing the scenarios, key concerns include how EU policies are funded, the reconciliation of predictability of expenditure and flexibility, especially in responding to the unexpected, and a variety of procedural issues.

Overview of research approach and methodology

The work undertaken for this study consisted of desk research, brainstorming by members of the project team and interviews with experts. The willingness of the interviewees to engage with the project has been both welcome and highly gratifying, and has provided a wealth of insights into what

is undeniably a difficult subject. The project team is very grateful to all of them for taking part and drawing attention to relevant documents and emerging issues around the future of the EU's finances.¹

To steer the discussion with experts, an 'interview guide' was developed (explained further in section 2 of this analysis), covering the various topics of interest for the study. This approach was adopted in preference to a more structured questionnaire because it ensured that the interview was focused on issues the interlocutor was best placed to answer or explain, while avoiding posing unnecessary questions. The guide was sent in advance to the interviewee. Interviews were conducted using Teams which allowed an automatic transcript to be taken (subject to obtaining the permission of the interviewees, none of whom refused). Doing so simplified the task of keeping a full account of what was said and identifying 'highlights' from the discussion. In several cases, interviewees took time to discuss prospective solutions with the team members conducting the sessions.

Concepts and terminology

A distinction between an EU budget comprising income and expenditure, on the one hand, and off-budget mechanisms dominated by loans, on the other, might seem straightforward. However, the reality is more complex and warrants some elaboration. The Budgetary Authority (the Council and the European Parliament) is responsible for agreeing the annual budget. The annual budget includes everything inside the MFF, financed by EU own resources and certain other revenues, as well as certain other programmes financed from EU revenue, but outside the policy headings of the MFF.

As terms, the budget and the MFF are often, albeit inaccurately, conflated. The MFF is a planning framework for periods of at least 5 years, setting annual ceilings for expenditure in each broad heading of the budget. Within the MFF, substantial amounts are pre-allocated to individual Member States as a result of the various formulae to determine where spending is allocated – principally for agricultural direct payments and Cohesion Policy – limiting the scope for the Budgetary Authority to exercise discretion on annual spending. In the context of the mid-term review of the MFF a further, emerging concern is that certain budget lines – notably the impact of inflation in increasing office costs and staff salaries, and rising interest payments – are non-discretionary in the sense of being set outside the control of the Budgetary Authority, eroding the scope for discretionary spending.

Mechanisms outside the MFF comprise three types of expenditure (well summarised by ECA, 2023a: paragraphs 17-18). The first is the flexibility instruments that the MFF Regulation sets, and which address needs such as emergency assistance in the face of a natural disaster. The second is external assigned revenue for specific programmes, mainly consisting of contributions by third countries, the Innovation Fund financed by the Emissions Trading System (ETS), and the non-repayable support part of NextGeneration EU. The third is guarantees from the budget that are paid-in to reserves (a Common Provisioning Fund) for InvestEU and the EFSD+. The latter two are part of the budget, but not constrained by MFF ceilings. They are further assured by the margin – known as 'headroom' – between the MFF ceiling for commitments and the higher Own Resources ceiling.

A fourth set of mechanisms consists of various forms of EU lending: Macro-Financial Assistance (MFA), EURATOM, assistance to Member States (the BoP Facility, EFSM and SURE), and the RRF loans. All of these are backed by the headroom in case of default. Of these four cases, only the first concerning flexibility instruments that the MFF regulation covers, is constrained by the ceiling of the MFF. For the other three, the headroom provides a secure financial base for unexpected eventualities and for borrowing and lending operations. Budgetary operations outside the MFF offer a greater degree of flexibility because they can be created (or activated) relatively more quickly, typically by using Art. 122

¹ None of the interviewees is named in the report, other than in the list in the annex, and in the small number of instances where there is a direct quotation from an interview, it is anonymised.

TFEU as the legal base, though at the cost of less intense scrutiny by the Budgetary Authority. As ECA (2023a) warns, the potential liabilities ‘must be carefully monitored to ensure that the headroom is maintained at a level that does not interfere with the capacity to call upon the necessary amounts needed for the EU budget’.

Further mechanisms arise from inter-governmental agreements outside the Treaty, notably the European Stability Mechanism and the Single Resolution Fund, the latter related to Banking Union. Both can be thought of as euro area entities. In addition, the European Investment Bank, covering all twenty-seven Member States and engaging in activities outside the EU, is separately capitalised; its shareholders are EU Member States. The EIB, although legally based in the EU Treaties, has its own legal personality and has financial autonomy. Qualitatively, therefore, the EIB is very different from other lending mechanisms.

Outline of this report

This study presents findings from the four tasks proposed in the tender submitted to the EP services. The next section draws on the economics of public finances and fiscal federalism to assess how well the EU’s finances conform to relevant conceptual models, and points the way towards an EU level fiscal framework (task 1). Section 2 summarises the background to the scenarios, starting by summarising (without attribution to individuals) some of the key messages gleaned from interviewees, then providing an overview of the EU’s finances at present, and sketching the six scenarios and how they are framed (task 2). The third section then concentrates on elaborating the six scenarios (task 3) and is followed by conclusions and recommendations (task 4).

1. TOWARDS A FISCAL FRAMEWORK FOR THE EU'S PUBLIC FINANCES

To misquote slightly Jacques Delors' well known aphorism, the EU's finances are an unidentified fiscal object. Theories and concepts from the public finance literature – mostly developed by scholars looking at the fiscal constitution of the United States and certain other federal countries – struggle to explain a system in which the highest level of governance has a comparatively narrow and fiscally limited remit. Yet the budget is also one of the most contested elements of the EU institutional structure.

Over the past few years, the proliferation of off-budget spending instruments in response to various crises, shocks and/or perceived new needs has significantly increased the overall size and complexity of the EU's public finances. For many of these off-budget items, the European Parliament has only a limited role in decision-making and oversight, in contrast to its responsibilities for the appropriations of the annual budget under the MFF.

The EU has set itself ambitious goals in the fields of climate, environmental protection, digitalisation, sovereignty, and external action and defence. While the EU annual budget and the MFF remain the most important part in terms of size, temporary new programmes (Next Generation EU, SURE, etc.) have been created, most of which earmark transfers, in the form of grants or loans, to national governments in order to promote specific expenditures. The 'galaxy' of EU public finances is thus becoming ever more diversified, raising new concerns about internal coherence, economic efficiency, financial sustainability, and democratic control.

This section starts by reviewing relevant public finance theories and what light they can shed on potential reforms of the EU's finances. It then discusses the 'galaxy' of EU finances before examining the components of a putative EU level fiscal framework and how to construct one.

1.1. Searching for a theory of the EU's finances

Can established theories help in the design of a more coherent, more flexible and resilient, and more democratically accountable European public finance setting? Economic theories of the institutional design of public finance frameworks in multilevel government settings (fiscal federalism, pioneered by Oates, 1972) are built upon two main strands of analyses: the functions of government, proposed by Musgrave (1959) and public goods – see boxes 1 and 2.

Equipped with these basic concepts, the classical theory of fiscal federalism purports to allocate competences in multilevel government settings, be they genuine federations, more or less decentralised unitary states, or even supranational organisations such as the EU. The first step consists in noting that most public goods have a spatial dimension; they display non-rivalry and/or non-excludability over a limited area.

The provision of such 'local' public goods should be decentralised according to the 'principle of fiscal equivalence' (Olson, 1969): for efficiency reasons, each local public good should be provided by a local government whose constituency coincides with the area in which its benefits are enjoyed

Box 1: Government functions

Musgrave (1959) proposed a classification of government policies under three main headings: allocation (the provision of public goods and its financing by levying resources on private agents), distribution (income redistribution by means of the tax-benefit system), and stabilisation (dampening fluctuations in macroeconomic activity and/or unemployment).

Box 2: Public goods in theory

Public goods were defined in the seminal paper by Samuelson (1954) as goods that display two main characteristics: non-rivalry (consumption by one more agent does not reduce the well-being of those who were previously consuming the good) and non-excludability (excluding those who do not contribute to financing the provision of the good is not technically feasible). Such 'pure' public goods (or services) are in practice not very common; defence and security are probably those that come closest to this theoretical definition. But many goods display at least some degree of either characteristic (Buchanan, 1968). Due to non-excludability, financing the provision of public goods is plagued by problems of collective action and free-riding behaviour (Olson, 1965), a source of suboptimal provision that forms the rationale for public provision and tax financing. Because of non-rivalry, it is efficient to allow the broadest possible access to the benefits of these goods.

(decentralisation principle, Oates, 1972). Subsequent developments extend the principle to revenue on the logic that better accountability is achieved if revenue is raised at the same level as money is spent.

Whenever this 'principle of fiscal equivalence' is not fulfilled, there will be 'spill-over effects', i.e. some non-residents of the constituency will benefit from at least some of the goods provided by the local jurisdiction, while not contributing to its financing; provision will therefore be suboptimal. In the classical theory of fiscal federalism, such situations may be corrected by a system of cash transfers, either horizontally (among local governments) or from the central government (matching grants, proportional to the cost of the local public good provision).

Regarding the other two functions of government (redistribution and macroeconomic stabilisation), this line of reasoning leads to the conclusion that, in an economically integrated area with a high

degree of mobility of goods and economic agents (households and firms), they should be allocated to the central government. Cross-border spill-over effects and tax competition are potentially large and would, otherwise, generate a suboptimal provision by decentralised governments, because they take no account of benefits enjoyed outside their jurisdiction.

In the functionalist tradition of analyses dealing with the allocation of competences between the European and national levels of government in the EU, these concepts and conclusions have inspired many studies pointing to the need for a transfer of competences from the national to the EU level, in turn requiring a larger European budget. Thus, the MacDougall Report (1977) argued that, in a context of progress toward economic and monetary union, a European budget would have to be increased, in stages (with an initial step at 2% of GNI, then 5-7%), in order to finance the provision of European public goods and fulfil its task of macroeconomic stabilisation. The report envisaged the creation of a European defence budget as one of the first steps in this fiscal integration process. All this seems quite detached from what has in fact happened, though it may be noted that the new own resources ceiling adopted after the creation of Next Generation EU is 2% of GNI and that the present MFF includes a (modest) European Defence Fund.

1.2. Heterogeneous preferences, incentives for decentralised governments and soft budget constraints

Such analyses disregard a number of dimensions of assigning competences to the various levels of government in a multilevel setting (Oates, 2005). Two such neglected aspects may be regarded as particularly important omissions, especially in the EU context. The first is the issue of heterogeneous preferences with respect to public goods: in the case of uniform centralised provision, some citizens

and/or jurisdictions will have to accept a quantity and/or quality of public goods different from what they would have chosen had they been the sole decision-makers.

Apart from the unavoidable difficulties of achieving unanimity and the associated risk of a sub-optimal provision of public goods, this mode of decision-making is also likely to generate demands for compensating side-payments. Indeed, it is precisely what has been observed in the European context, with the proliferation of rebates and the demands for *'juste retour'* or the conditioning of agreement on getting a predefined national share in the common project. Even where there is a common goal, as is the case for greenhouse gas reduction targets, decentralisation may be warranted to allow for heterogeneous preferences in how to achieve the common goal.

Box 3: Soft budget constraints and fiscal discipline

The notion of 'soft budget constraint' is derived from the assumption that governments' spending decisions are submitted to fiscal discipline, under the dual scrutiny of their own taxpayers and their creditors on financial markets. Whenever a policy is transferred to a higher level of government or financing is provided by this higher level, fiscal discipline is somehow diluted, and the constraint it exerts on the lower-level government becomes softer. In order to balance this effect, rules are usually imposed on lower-level governments' budgets; alternatively, various conditions may be imposed on the use of centrally provided funding.

The second category of neglected factors has been emphasised by the vast literature on 'public choice' and on incentives bearing on decentralised governments in multilevel settings (Oates, 2005). They may be subsumed under the heading of the 'soft budget constraint' - see box 3. Whenever public good provision is centralised, or grants are provided to decentralised governments to pursue some agreed common goal or provide some public good, the fiscal sustainability constraint bearing on the sub-central levels of governments may become softer. To counteract this bias toward fiscal irresponsibility, various devices may be enacted: various brands of balanced-budget rules, limits on debts and/or deficits, as in the Stability and Growth Pact, no-bail-out clauses, etc.

1.3. The past and present of existing federations

The process of historical formation of existing federations can be a source of inspiration or imitation when it comes to designing decentralised fiscal institutions. Indeed, the initial design of the EU budget in the early 1970s, with own resources relying almost exclusively on customs duties and external levies, closely mimicked the precedents of the US or German unifications in their initial stages. Similarly, the MacDougall Report (1977) and many subsequent prospective analyses of the EU have, more or less implicitly, been based on such teleological premises.

When carefully analysed and compared, it appears that the historical experiences and present fiscal arrangements of existing federations are in effect very diverse. This is true not only of the assignment of competences and the sharing of financial burdens amongst government levels, but also with respect to fiscal rules and no-bail-out clauses on decentralised budgets. Yet, perhaps surprisingly, they seem to achieve about the same degree of mitigation of idiosyncratic macroeconomic shocks (Burriel et al., 2020), though they don't seem to enforce the same degree of fiscal discipline on decentralised governments, suggesting that there are many different ways of designing fiscal institutions in decentralised settings, some generating softer budget constraints than others.

Box 4: A Hamiltonian moment?

When the proposal was made, in 2020, to issue common debt to fund the Next Generation EU programme, many commentators referred to an EU ‘Hamiltonian moment’. Indeed Sargent (2012) shows how the second US constitution, in 1788 under the influence of Hamilton, managed to solve many of the dysfunctional aspects of the former Acts of Confederation by pooling the pre-existing public debts of the 13 founding federal states into a common federal debt, creating a federal Treasury and empowering the federal government with the ‘unlimited power to tax’. He fails, however, to mention that the agreement was signed for a limited period of time (until 1835), and that strong disagreement about its prorogation was one of the factors leading to the American Civil War.

The case of the United States is particularly interesting in that strict no-bail-out clauses and balanced-budget constitutional rules impose fiscal discipline (relatively successfully, with few exceptions) on state and local governments, but not on the federal government, as illustrated by the most recent shenanigans around the federal debt ceiling. Moreover, the various institutional designs in existing federations seem to fail in coordinating central and decentralised governments in their stabilisation function, as shown during the 2009 Great Recession in the US, with the federal level enacting strong countercyclical fiscal measures, while state and local governments were cutting expenditures in a pro-cyclical manner in order to obey their balanced-budget rules. Box 4 recalls how the US developed its system late in the 18th century.

1.4. European public goods and European added value

In practice, public goods are very seldom, if ever, ‘pure’, in the sense of fully meeting both criteria in their definition (non-rivalry and non-excludability). Rather, as emphasised by Buchanan (1968), there is a continuum of goods along these two dimensions, some closer to the definition of a private good, others closer to public goods.

Hence, the spill-over effects (or external effects when dealing with interpersonal interdependencies) are almost never completely absent, and their intensity, or even perceived importance, varies from one good to another, and often according to circumstances, as exemplified by recent European advances in the fields of public health or defence, for instance. Analysing the results of recent waves of Eurobarometers, Allemand et al. (2023), for example, show that the demand for European provision of public goods is currently high among EU citizens in many areas (such as asylum and migrations, external policy and defence, health, energy, etc.).

In a similar and closely related manner, the notion of ‘European added value’ of EU spending, though often invoked to justify transferring a competence to the EU level, is by no means unequivocal. In some cases, it refers to a situation very close to the previously discussed notion of European public goods, i.e. the cases in which centralised provision leads to a larger quantity and/or a better quality of the public goods by minimising spillovers. In others, it points to the cost-effectiveness of centralising policies at the EU level: provision by national governments would prove more costly (Heinemann et al., 2023).

1.5. The evolving galaxy of EU public finances

In 1988, when the EU budget was substantially reformed after several years of conflict between the institutions of the Union (Laffan, 1997), a key innovation was the move to what subsequently became known as the Multi-annual Financial Framework. By setting limits for annual expenditure over a span of seven years (initially, five years for the 1988-92 period), the MFF sought – it largely succeeded – to defuse the disputes seen earlier in the decade between the Commission, the Council and the Parliament over annual allocations of EU spending. Although the adoption of the MFF model was not

easy, it is noteworthy, as was pointed out by one of the experts consulted for this study, that it was done without Treaty change. Indeed, it took until two decades later for the MFF to become primary law in the Lisbon Treaty. However, as now, the MFF was formalised in an Inter Institutional Agreement, and there is a case to be made that prior to the Lisbon Treaty, the EP had a more equal role in the decision than it has now.

Separately from the EU budget, there was substantial borrowing and lending at the EU level, principally through the European Investment Bank. As Laffan (1997: 217) observed, ‘the inexorable but quiet growth of this facet of EU finances stands in stark contrast to the fierce battles about the size distribution and objectives of the community budget’. This is not so surprising: the EIB mandate is to support investment and there is an expectation that the projects it funds will generate financial returns capable of servicing and repaying the loans. It does not provoke distributive disputes in the same way as the budget for which the notions of net contributors, net recipients and *juste retour* so often feature in the debates. Moreover, the EIB is meticulous in appraising proposals to ensure their financial viability.

Today, however, the range of instruments outside the MFF (some, as explained in the introduction, still within the procedures of the EU budget) has proliferated in a manner that would have seemed implausible a quarter of a century ago. The EU budgetary ‘galaxy’ comprises a variety of mechanisms through which the EU borrows for specific purposes, alongside flows of revenue earmarked for specific purposes, rather than going into the general revenue of the Union. In 2017, the European Parliament constructed a chart to illustrate this profusion of mechanisms, some of which had arisen as a result of crises of the previous decade, while others reflected policy innovations. Examples of the former include the European Financial Stability Mechanism (EFSM), designed to ease the sovereign debt crisis) and the Fund for Refugees in Turkey (FRT), while the creation in 2014 of the European Fund for Strategic Investment (EFSI, now InvestEU), was aimed at boosting investment levels).

Further major additions to the galaxy were introduced as a result of the pandemic. The first was SURE, a mechanism providing loans to assist Member States in meeting the costs of the temporary increase in unemployment consequent upon lockdowns. More significantly, the agreement in 2020 of Next Generation EU, saw direct borrowing, on a temporary basis because of the nature and depth of the crisis, by the EU to fund a combination of grants and loans to Member States. These flows are to enable them both to boost investment and to accelerate their recovery from the steep economic downturn of 2020. In contrast to previous borrowing instruments, they create a liability for future EU budgets to service and repay the loans. An updated galaxy chart incorporating these new funds was constructed by Begg et al. (2022: figure 4) in a study for the EP.

In effect, this evolution has led to a separation between the EU budget – with explicit and well-known rules applicable to its expenditure, revenue and procedures – and a much more diffuse set of borrowing and lending arrangements (European Court of Auditors, 2023a). Yet there are many linkages between the former and the latter; together they engender risks and the prospect of political conflict. Some EU borrowing and lending is based on guarantees provided by the EU budget, and there can be complementary guarantees from all, or a selection of, Member States.

1.5.1. Practical problems

As any student learning about the EU budget is taught, it is governed by nine principles: unity, budgetary accuracy, annuality, equilibrium, unit of account, universality, specification, sound financial management and transparency. Among these, several are called into question by recent developments. Thus, unity in the sense of having all expenditure in a single overall envelope is compromised by having separate arrangements for the budget and NGEU. Universality means all revenue going into a single ‘pot’, without being earmarked for particular purposes (except for some

minor exceptions), but the revenue raised for NGEU (and other forms of external assigned revenue) breaches this principle. Sound financial management could potentially be harder to ensure if there were to be (unpredictable) calls on the guarantees offered for various loan funds.

Even annuality is complicated by the fact of substantial multi-annual programmes, both within the MFF and through NGEU, while assuring equilibrium (revenue=expenditure) could become more difficult depending on how borrowing and lending operations (the balance sheet, in accounting terms) affect the income and revenue of the EU's finances.

EU borrowing to fund NGEU adds a qualitatively different practical problem of how interest charges will affect the EU budget. In 2020, the low prevailing rates meant that the borrowing could be financed at very low cost and, indeed, it makes economic sense to invest when this is the case. However, the rapid rise in inflation since the summer of 2021 has led central banks in advanced economies, including the ECB, to push up interest rates, eating into the headroom available under the temporarily increased own resources ceiling. The European Parliament has recently adopted a resolution expressing its concern at the risk of crowding out spending on programmes subject to MFF ceilings.

Inflation causes a further problem because of the practice in the MFF of applying a 2% annual inflation correction to maintain the real value of ceilings which are expressed in absolute amounts. The ECB's monetary policy strategy until 2021 was to aim for inflation to be close to but below 2%², so that the correction was appropriate; indeed, for most of the last two MFF periods, actual inflation was below this rate. However, the likely result of inflation during the current MFF will be sizeable decreases in the real value of expenditure. Moreover, the effects will cumulate year by year resulting in a bigger cut in towards the end of the MFF, unless inflation reverts to 2%.

1.5.2. Legitimation challenges

The principal concern about legitimation is the lesser role of the European Parliament in overseeing 'off-budget' instruments and mechanisms, compared with its responsibilities in relation to the MFF and the annual budget. Whether for decision-making or discharge procedures, there are well-specified procedures through which the EP exercises its role alongside the Council as the second arm of the Budgetary Authority. The Authority has to approve the spending ceilings in the MFF and the annual budgets. This is far from the case for borrowing and lending, notably NGEU. As a report from the European Court of Auditors (ECA, 2023a) explains, there are also varying governance arrangements for different B&L mechanisms, accentuating the legitimation challenges. The report draws attention to a core dilemma, namely that for each individual mechanism it is easy to explain (and defend) how it was set up at the time – usually in response to a pressing crisis – yet it becomes increasingly hard to defend the overall package of B&L mechanisms.

The duration of the MFF is a second dimension of legitimation worthy of attention, even though there is no evident impetus for change. Kengyel (2018; 2017) has examined in detail the arguments for three options: five years, to coincide with the terms of, respectively, the Commission and the EP; seven years, as it has been since 1992; and a five + five arrangement in which substantial revisions could be envisaged at the break point. He favours the last of these, noting that the EU budget is predominantly an investment budget with many multi-annual programmes, and mentioning the long lead times involved in agreeing both the MFF ceiling and regulations to implement programmes. Kengyel also mentions a rather scornful comment from the ECA that the duration of the MFF can stretch to 13 years once allowance is made for the provision to spend up to three years beyond its end (N+3) and the lengthy prior negotiation period.

² A new strategy adopted in 2021 maintains the 2% benchmark, but allows for a temporary level above it to be tolerated, a change decried by some commentators concerned about weakening the commitment to price stability

However, the 2014-19 Commission and Parliament were in office during an MFF agreed by their predecessors and were involved only in the early stages of developing its successor. This manifestly detracts from the scope for putting spending programmes before electorates in party manifestoes – the norm in democracies – let alone tax proposals for which the Parliament is only consulted. Moreover, the arguments for insulating expenditure decisions from European elections is open to question. After all, many EU Member States with the most effective fiscal frameworks (recently examined by Begg, Kuusi and Kylliäinen, 2023) have multi-year expenditure programmes negotiated at the start of a new parliament. These are typically settled in a matter of weeks following elections, not the increasingly lengthy periods taken for the MFF.

A third strand to legitimation concerns the revenue side of the EU budget. The Own Resources Decision, because it has to be ratified by national parliaments, is barely influenced by the EP. Efforts to have new revenue instruments assigned to the EU's finances therefore have to be pursued indirectly by the EP. Member State control of revenue can be defended on many grounds, but having a parliament which can vote on expenditure but not on how to fund that expenditure is anomalous and affects incentives. Simply put, a body which need not worry about how to raise revenue will have a bias towards higher spending.

Giving the EP more powers in revenue raising would not be a simple exercise and would be strongly resisted by Member States. Moreover, MEPs who advocate it should be reminded to be 'careful what they wish for', because adopting new EU level taxes or other own resources is unlikely to be a recipe for pleasing citizens. Nevertheless, in any fundamental reform of EU finances, it deserves to be considered. If funding EU public goods is seen to be necessary, there is a strong democratic logic in parties having programmes for EP elections that contain both revenue and expenditure pledges.

1.6. Towards an EU level fiscal framework

Fiscal frameworks at Member State level have been under scrutiny, following the proposals by the Commission (2022) to review the EU's fiscal governance. While the EU's finances are qualitatively very different in character from those of a typical Member State, the case for developing an EU level fiscal framework to take account of the increasingly complex 'galaxy' is compelling. Plainly, the main challenges are about how to accommodate what is likely to be continuing and extensive resort to borrowing and lending to fund EU policies. Indeed, one of the headline proposals of the Commission (2023a) proposal for the mid-term review of the MFF is to establish a Facility for Ukraine, using the headroom of the EU budget.

Five main constituent parts of a putative fiscal framework can be envisaged. The first is justifying why expenditure should take place at the EU level, while the second is how resources to pay for it should be raised. Neither are new questions and there is an abundance of past work on the rationales and the options, although it is undeniable that key concepts such as European added value or EU public goods are hard to make operational. Similarly, own resources as understood in the EU do not correspond very well to the theoretical concept of 'own taxes' in standard economic terms because so large a proportion of OR are, in fact, inter-governmental transfers.

A third question, one which has come to the fore as a result of the growth of borrowing and lending, is how to manage, on the one hand, the associated risks and, on the other, the relationship between the EU's income and expenditure account (the budget) and its balance sheet (the borrowing and lending). This is both a technical question and one of political economy. Fourth, a framework has to have appropriate governance mechanisms, while a related fifth consideration is legitimation. For the latter, the differing roles and engagement of the EP, depending on the funding mechanism, are a key concern, though not the only one.

1.6.1. Expenditure on EU policies

The history of the EU core budget (subject to the MFF ceilings) is well known (Laffan, 1997; Benedetto, 2019), as are the reasons for its current composition and why it is difficult to change. It is also easy to understand why, particularly in response to crises, mechanisms relying on assigned revenue rather than own resources have been used, culminating in NGEU which, on an annual basis, comes close to doubling the funding for EU policies. However, an important point raised by some of those interviewed for this study is that the term ‘EU policies’ has two components: policies to promote EU level public goods and policies which, in practice, fund Member State level (often, also, sub-national) public goods.

In considering expenditure on EU policies, the principles of fiscal federalism provide disappointingly little help. Some thought has been given in the past (Sapir, 2004) to what policies should be funded at EU level or not. Subsequent work (Gelauff et al., 2006) tried to apply a subsidiarity test to different categories of public spending, but it is hard to discern even a limited, if any, link between these approaches and what the EU budget funds. This is unsurprising given the *juste retour* mentality (and the formalisation of national pre-allocation of spending) pervading budget negotiations for so long, but as Buti et al. (2023) observe, breaking free of this mentality calls for fresh thinking on what EU public goods are or should be in future. They suggest three categories:

- ‘Pure’ (in a theoretical sense) EU public goods funded and delivered supranationally;
- Public goods which fulfil EU aims, but with funding provided to Member States to deliver them – NGEU being a prime example;
- National (or sub-national) public goods funded by the EU.

Although a precise list of European public goods corresponding to the theoretical definitions given above seems difficult to agree upon, there are some for which a consensus has emerged. Because climate clearly is a global common, possessing both properties (non-rivalry and, most conspicuously, non-excludability), the fight against climate change undoubtedly has to be coordinated at the world level; but the EU level of decision-making on common objectives is obviously the right one. Closely related, energy policy, with its goals of reducing greenhouse gas emissions and of making the EU more autonomous and more resilient, is also considered a common concern.

Other dimensions of the global environment, such as biodiversity or the fight against plastic pollution, share with climate the properties of being European public goods. Pooled purchasing of vaccines can also be seen through this lens. More recently, war assistance to Ukraine has elicited the mobilisation of EU funds, while the prospect of helping in rebuilding the country after the war foreshadows the need for potentially much larger amounts of financial assistance. Macroeconomic stability may also be considered a public good. In the EU27 context, the existence of large macroeconomic spill-over effects is undeniable, though macroeconomic interdependence is larger amongst members of the Eurozone and the incidence of multiplier effects can be hard to assess - see box 5.

Box 5: Multiplier effects and macroeconomic spill-overs

Fiscal multipliers measure the induced effect of a fiscal stimulus on economic activity (GDP). Recent empirical research shows that fiscal multipliers are larger in times of recession, that tax cut multipliers are lower than spending multipliers, and that multipliers on public investments are larger than those on current public expenditures. In an economically integrated area, fiscal multipliers on decentralised public expenditures or taxes will be lower on local GDP due to the existence of spill-over effects: part of the benefits of the fiscal stimulus is enjoyed outside the jurisdiction, generating free-rider behaviours.

A choice between grants and loan-based mechanism will often arise and there will be many public goods for which using common debt to finance investments is optimal. Examples include the fight against climate change, for which firm commitments have already been made, and those, such as contributing to the Ukraine war effort and financing its rebuilding, or achieving more sovereignty in critical supplies (batteries, chips, etc.) on which there is considerable agreement (Allemand et al, 2023), not to mention unexpected future common shocks.

According to pure public finance theory (Barro, 1979), whether the supply of European public goods should be financed by issuing common debt or by increasing OR depends on the nature and the time span of the related expenditure. Thus, a temporary expenditure or an investment expenditure should be financed by issuing debt, essentially because all types of tax instruments generate distortions in private incentives that prove costlier than debt when the need for financing is only temporary. In addition, investment typically has a larger multiplier effect and will, in principle, generate future benefits that will yield higher taxable bases (Bozou and Creel, 2023). In other cases, an increase in taxation is warranted. A further factor is whether the investment itself generates a financial return on a scale able to service and amortise the debt.

1.6.2. EU revenue

EU revenue has a varied history, starting with national contributions in the early days, moving to genuine own resources (customs duties) in the 1970s, reverting to a predominance of national contributions as the size of the budget grew from the 1980s, incorporating a variety of 'external assigned revenues' (EAR) as deals were done with (especially) third countries to contribute to EU programmes, then being reinforced – if formally only on a temporary basis – by direct borrowing from the markets to fund NGEU. The funding of NGEU is also a form of EAR, but of an order of magnitude greater than previously.

EAR are provided for in the Financial Regulation (Article 21.2), but pose a dilemma (Begg et al., 2022), in as far as they are predicated on being a small proportion of EU revenue. However, when EAR become so much higher, the principle of 'universality' – revenues not being earmarked for specific form of spending – ceases to be respected.

To meet future demands emanating from EU borrowing one way or another, either more money will have to be extracted from EU taxpayers, or other expenditure within the budget will have to be cut. Debates on potential instruments to use as new EU own resources have gone round in circles since the implementation of the first MFF in 1988.³ Yet in all that time the only innovation has been the modest plastics levy – itself in practice a national contribution, as opposed to a resource unequivocally 'owned' by the EU level. Nevertheless, the exigencies of repaying NGEU loans and providing for probable future loan funds mean that the impasse over new OR will have to be resolved. Although the choice of which new resources to adopt will be highly contested, the underlying question is, rather, how much to raise in this way and what it would entail for governance. In particular, the question of whether the European Parliament should eventually acquire some powers to set own resources has to be posed.

There could be, and no doubt will be, endless debate on the merits of the many different candidates to serve as new ORs. Already, a proportion of the revenue from the Emission Trading Scheme (ETS) is used for two EU policies, the Innovation and Modernisation Funds, despite the scheme's initial design being to allocate the revenue raised to Member States, arguably to reflect likely differences in its incidence among them. Nevertheless, it is one of three prospective new ORs put forward by the Commission (2021) in a first 'basket' of new ORs. But as the mid-term review Communication of 20th June 2023

³ For example, Begg et al, 2008, Monti et al. (2016), WIIW (2021)

acknowledges (Commission, 2023a), it will not be enough. Moreover, as an accompanying communication, issued on the same day, concedes ‘the legislative discussions on the proposal made in December 2021 have made limited progress’ (Commission, 2023b). More fundamentally, it is the relationship between the GNI resource, future EU expenditure (including for debt service and repayment) and new ORs that should be centre-stage.

The GNI resource is very useful for the EU budget because of how it adjusts automatically to ensure that revenue matches expenditure. Many a finance minister of a national government would welcome such certainty of revenue for their own treasuries. Equally, especially in a time of intensified pressures on Member State budgets, the same finance ministers bemoan the monthly payments to ‘Brussels’. Lowering the GNI-based national contributions, while retaining its balancing role, is likely to find favour.

The question then becomes how to make up the difference: cutting EU spending will appeal to some, but will horrify others; logically, therefore the foot-dragging over new own resources has to be overcome. While this is already accepted in the Own Resources Decision because of the special circumstances of NGEU, the case for a decisive move towards genuine OR (as opposed to national contributions), going beyond the amounts needed for this purpose is compelling. It would not be a panacea, because EU taxpayers will still face a payments burden and the distribution of that burden will vary depending on the resources chosen. Moreover, as some interviewees have indicated, the administrative costs of multiple new resources yielding only comparatively little revenue (such as the plastics levy) can make them difficult to justify, more so if they are tied to a GNI key.

1.6.3. Risks from borrowing and lending

Given the scale and diversity of EU borrowing and lending expands, attention needs to be paid to how it is managed and the potential risks for the fiscal sustainability of the EU level. At national level, the theoretical conditions for fiscal sustainability are very simple: so long as the nominal interest on public bonds (r) is lower than the nominal growth of the economy (g), the debt to GDP ratio will decline. In the opposite case, the debt to GDP ratio will be subject to a ‘snowball’ effect, and sustainability would require a primary budget surplus.

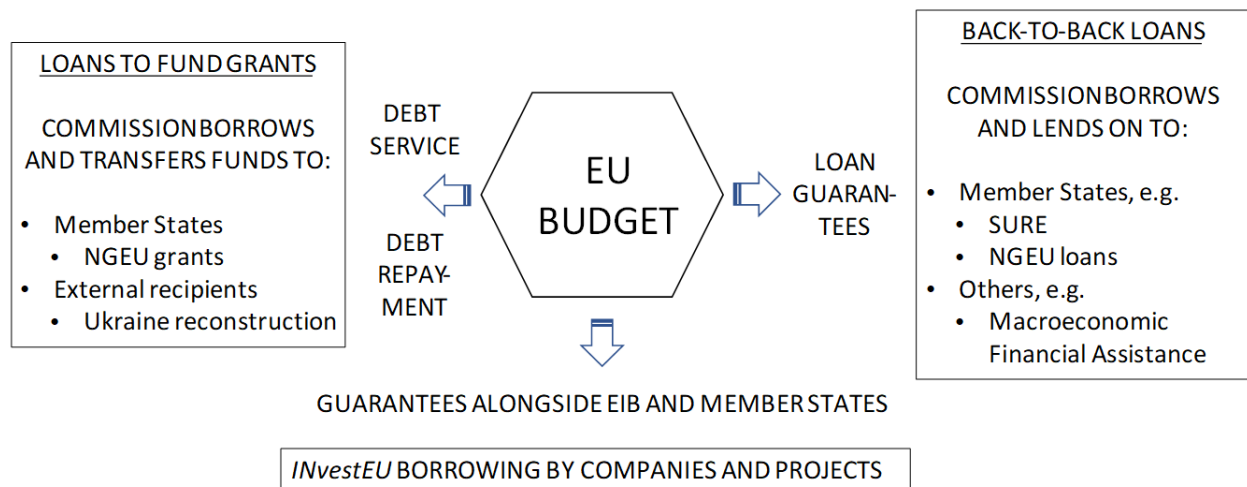
In an EU fiscal framework, an equivalent calculation may be warranted, even though the particular form of EU debt mechanisms, notably their relationship with the ‘headroom’ in the EU’s own resources ceiling, differs from the national setting. It is nevertheless worth looking at the current position. Over the past decade, $r - g$ has consistently been negative in the EU, and still is, in spite of the interest rate increase over the past two years and the recent slowdown of economic growth, because of inflation. But future evolutions of the critical gap are notoriously difficult to predict, and debts can endure for relatively long periods.

The three main borrowing agents in the EU are the Commission, the European Stability Mechanism and the European Investment Bank (EIB). Thus far, the Commission has enjoyed AAA rating from two of the main rating agencies and AA from the third. As a Commission news brief explains⁴, because of ‘its high credit rating, the Commission – on behalf of the EU – obtains favourable conditions for its issuances. The benefits are then being passed on to the EU Member States and third countries and lead to savings for the EU budget, depending on the nature and objectives of the funding programmes’. At present the ESM has the same ratings profile as the Commission while the EIB is AAA from all three main agencies.

⁴ https://commission.europa.eu/news/european-commission-mandates-scope-rate-its-creditworthiness-2022-06-23_en#:~:text=The%20European%20Commission%20is%20currently%20rated%20AA%20%2FOutlook,granted%20a%20AAA%2FOutlook%20stable%20unsolicited%20rating%20by%20DBRS.

What distinguishes the Commission is that in some respects it does not have a sovereign state behind it or an explicit 'power to tax', but relies instead on the headroom in the EU budget. It is arguably also helped by the balancing characteristic of the GNI resource, obliging Member States to provide revenue to match EU expenditure (now including debt service payments). Debts also have to be repaid after 2027 and the EU level also issues debt guarantees. Figure 1 provides a simple overview.

Figure 1: The financial exposure of the EU budget to borrowing and lending activities



Source: project team

What the figure shows is that there are three distinct types of B&L with differing associated forms of financial exposure. The model that started with the EFSI programme launched by the Juncker Commission and now adopted for InvestEU has a provision in the budget for guarantees, supplemented by guarantees from the EIB and, where they elect to offer them for particular projects, by Member States. If these guarantees were to be called, the amounts already provided for would be expected to absorb the losses, and the experience to date suggests that the small number of defaults will remain well within the provisions. The guarantees for back-to-back loans would only be called if either a Member State or another recipient defaulted, a small risk at present, although substantial loans to Ukraine could be more problematic. It is, therefore, the grant component of NGEU which has the greater risks, not so much of default, but of managing the debt service and repayments.

The EU has a Common Provisioning Fund which aims to cover certain liabilities – see box 6 for a description of its main features.

As a quasi-sovereign borrower, even though it is rated as an international institution, the EU has managed to convince markets of its credit-worthiness. However, if debt were to increase or become a more permanent feature of the EU's finances (which to some extent it already is, given the long repayment trajectory for NGEU) discussion of the viability and sustainability of the debt profile might arise.

Evidence from interviewees suggests current debt management is effective and the sub-title of a new ECA (2023b) report is broadly positive: 'an encouraging start, but further alignment with best practice needed'. The ECA applauds the speed with which the debt management function was set up and the quality of initial decisions, but also makes recommendations aimed at improving practice. For the time being, there seems to be no urgent reason for a separate agency, although it is something that could be worth revisiting. The outcome of the mid-term review of the MFF, specifically of the proposal for a new special instrument (EURI) to cover the rising cost of debt may have a bearing.

Box 6: Particulars of the Common Provisioning Fund

The CPF, provided for in Art. 212 of the Financial Regulation, is a single fund providing financial backstops for several budgetary guarantees and financial mechanisms. Its main advantages are, first, to enable efficiency gains, by using the same staff, portfolio management and governance systems, thereby lowering the costs of asset management and implementation. Second, by covering several liabilities with different risk profiles and timeframes, a unified portfolio is also smaller than having several portfolios separately.

The resources for the CPF come from 'legacy instruments' (which already existed under previous MFFs, and 4 new 'contributing instruments'. The CPF became operational in January 2021 and at the end of 2022 its market value stood at EUR 14.39 billion, making it the largest asset portfolio directly managed by the Commission. Its assets are expected to increase by EUR 25 billion by the end of the current MFF. The main initial components were the assets of the EFSI Guarantee Fund and assets associated with what is now the Neighbourhood, Development and International Cooperation Instrument (NDICI) and the European Fund for Sustainable Development (EFSD). Large inflows from InvestEU and the External Action Guarantee under the NDICI (EUR 2 to 3 billion per year) are expected in subsequent years.

Different compartments exist inside the CPF which allow the contribution of the different instruments to be tracked, although cross-subsidisation is supposed not to occur. The share of compartments is determined on a pro rata basis, reflecting the contributions to and withdrawals from the assets of the CPF by each contributing instrument. There is also an additional 'omnibus compartment' which holds Member States provisions. It will be split into several Member States compartments (per country).

Source: project team

Recent macroeconomic developments, most prominently the acceleration of inflation and the significant rise in interest rates, make the current situation potentially less sustainable (Claeys et al., 2023). The total amount of EU outstanding debt has already reached EUR 400 billion, exceeding the current sovereign debt of many Member States, and close to that of the Netherlands. Higher interest rates mean the cost of servicing this debt is already substantially more than had been anticipated at the time NGEU was launched. Although several Member States have, in recent months, signalled resistance to a second round of NGEU or making it permanent, EU borrowing under various headings is likely to continue when NGEU comes to an end. Moreover, with NGEU repayments scheduled to last until 2058, debt management will remain a crucial part of the EU's finances.

In order to make the market for EU bonds more efficient and liquid, hence minimise the cost of debt, a number of practical changes have already been made by the Commission and the ECB; but the greatest impact on the existing spread between EU bond yields and those of national bonds issued by Germany or France (in spite of the fact that the EU debt enjoys AAA ratings) would come from securing future debt service and making debt clearly sustainable (Claeys et al., 2023). This can be achieved without legislative change (or only minimal changes), but it would imply either significantly curtailing existing expenditure programmes, or increased national contributions to the EU budget under the GNI resource. Both solutions would have considerable drawbacks; and both would exacerbate disputes about net contributions. A foretaste of all this will be what is decided about the EURI instrument proposed by the Commission (2023a) for the mid-term review of the MFF.

1.6.4. Recasting governance

The diverse approaches to governance of different facets of EU finances warrant attention. The ECA (2023a) analysis proposes several sensible recommendations aimed at rationalising the existing arrangements and enhancing governance. They are to have:

- an ex-ante assessment of any proposed new mechanism;

- an overall assessment, on a regular timetable, of the ‘financial landscape’;
- integration of funds certain funds into the EU accounts (citing the Modernisation Fund); and
- integration into the ‘EU legal framework’ of funds at present outside it, such as the ESM.

The ECA’s primary focus, unsurprisingly, is on procedural and accountability matters, but from economic and political perspectives, other important facets of the current mix require attention. An important one is how the demands on the budget resulting from the expanded borrowing will be serviced and repaid, and what happens if loan guarantees – even if rarely – were to be called. In particular, there is a need for clarity on how and when the own resources of the EU will be called upon for these purposes, although, for NGEU loans, it is only after the end of the current MFF in 2027 (and before 2058) that repayments will start, with the expectation that they will be funded by new own resources.⁵

The legal base used for new mechanisms is a further governance concern. Loan mechanisms in the EU, to cite the ECA (2023a) report ‘are grounded in different basic acts’. These range from treaties concluded by a specific group of Member States (such as the ESM, signed by euro area Member States) to Council regulations (such as SURE), based on Art 122, TFEU. A specific question is whether the regular resort to Article 122 TFEU as the legal base should be rethought. The Article enables the Commission to propose, ‘in a spirit of solidarity’ to provide financial assistance to a Member State facing an adverse ‘economic situation’. Although the article refers specifically to energy products and mentions ‘severe difficulties caused by natural disasters or exceptional occurrences beyond its control’, it does not preclude other difficulties as a basis for assistance. Crucially, it is the Council which decides on the proposal from the Commission, while the European Parliament only has to be informed of the decision taken. A clear implication is that the article can be used flexibly and relatively quickly, albeit at the risk of becoming **too** easy to use resulting in what one contributor to the validation workshop disparaged as ‘sliding into a quasi- permanent Article 122 regime’.

Another tricky question is how to accommodate funding mechanisms for a subset of Member States within an EU fiscal framework. The most awkward division is between Eurozone members and the rest. For the former, the case for an additional fiscal capacity, particularly for macroeconomic stabilisation, has long been on the agenda. There is also the possibility that calls will be made in future on the Balance of Payments Facility.

In order to clarify the purpose and design of such a fiscal instrument, it is useful to distinguish between two types of macroeconomic shocks: asymmetric ones affecting one or a subset of member countries, and common or symmetric shocks hitting all Member States. For the former, national fiscal (and other) policies are appropriate responses, though they might usefully be complemented by some form of mutualisation fund when national governments are financially constrained. For the latter, instead, a common and/or coordinated fiscal response is needed, which would call for the creation of a permanent fiscal stabilisation instrument at the Eurozone level. Because it would have to be countercyclical, it would have to rely either on common debt, much as NGEU, or on some form of rainy-day fund, unemployment insurance fund (SURE offers a template) or similar. A macroeconomic stabilisation capacity is explored below in one of the specific scenarios in section 3.

Regarding the duration of subsequent MFFs, several interviewees, while acknowledging the misgivings from a democratic standpoint, have expressed scepticism on whether there is much appetite for changing it from seven years. It is though, worth pointing out that if the current MFF were to be followed by a further seven-year one, it would end in 2034 – a year that will coincide with a change of Commission and an EP election.

⁵ Detailed in the 2021 Own Resources Decision (Council of Ministers, 2021)

1.6.5. Legitimation

Unsurprisingly, the research and interviews conducted for this study reveal diverse views on the legitimation of the EU's finances. The loss of influence of the EP resulting from the increased B&L is undeniable, but solutions are hard to find. Within the galaxy of EU finances, the EIB is Treaty-based (Art. 309, TFEU) and it has its own legal personality and InvestEU is part of the budget, while the ESM is an inter-governmental Treaty of the Eurozone members, not an EU entity. These three debt mechanisms, do not elicit direct legitimation concerns in relation to the EP. By contrast, many other mechanisms were created in response to crises and, bluntly, the EP was largely side-lined in their creation and monitoring, and there is some ambiguity about whether, as the entity empowered to discharge, it would have this role, for example for NGEU.

This legitimation concern is most acute for NGEU, not just because of its sheer scale compared with other B&L mechanisms, but also because of how it interacts with future EU budgets and the Own Resources Decision. A separate angle on legitimation is respect for the principles underlying the EU budget.

1.7. Moving towards an EU fiscal framework

Recent developments in EU policies and their consequences for public finances, both at the EU and at the national levels, plead in favour of elaborating some form of EU fiscal framework, which may include a variety of features, according to the kind of objectives it is meant to achieve. Fiscal rules as applied in Member States and through the Stability and Growth Pact are not needed, but the notion of fiscal standards proposed by Blanchard et al. (2021) may offer some insights. At the very least, for financial sustainability and EU-level monitoring of common policies, it would be advisable to build a coherent set of general-government assets-and-liabilities accounts: this would help to avoid double-counting national debt financed by back-to-back lending by the EU, but also making the amounts of EU-backed debt explicit. Such an accounting framework may also prove useful for ensuring consistency with the new EU fiscal rules for Member States expected to be adopted soon and enforced after January 2024.

Given the emphasis on European public goods identified and discussed above, the EU fiscal framework should also feature a precise accounting of those expenditures, both EU and national, that contribute to their provision. This would be consistent with the conditionality written in some recently adopted EU policies (NGEU, state-aid rules, etc.). Equipped with this accounting framework, it may become possible to reach agreement on some variant of a 'public finance golden rule': not the classic one, that removes public investment expenditures from the calculus of the authorised public deficit, but one that would leave those national public expenditures that finance the decentralised provision of European goods out of the national public deficits submitted to the EU fiscal rules.

Once the choice of providing European public goods has been made, there are several possible ways of organizing their provision and financing them. Centralising provision at the EU level would imply that the cost is entirely borne by the EU budget as for the EU external services and external border protection (FRONTEX). But for other European public goods, decentralised provision is probably the best option, given the limited operational capacities of the EU and the heterogeneity of national preferences on the ways of hitting common targets. Such a decentralised solution is indeed the choice made in the fields of climate change, energy, etc. In order to foster adequate decentralised provision, fiscal incentives then have to be offered to national governments, as is the case in NGEU for instance. But decentralised provision implies that the EU authorities (Commission, Council and Parliament) are able to monitor implementation; it may also lead to differentiation among Member States, and possibly to competitive strategies (in relation to state aids).

Fiscal incentives granted to national governments may be either grants or loans. In traditional fiscal federalism theory, grants are seen as more efficient, and should be matching grants (i.e. covering a fixed fraction of the targeted expenditure). But, as emphasised above, such pure transfers may also soften the recipient government's budget constraint, so that loans, which only subsidise the interest cost of the debt, may be preferred.

With such a proliferation of new EU level action plans and programmes, as well as new off-budget financial instruments, tensions and contradictions on the EU public finances have accumulated to a point where something has to be done. The next sections of this study present various scenarios for how to move towards a more optimal approach.

2. BACKGROUND WORK FOR SCENARIOS

As proposed in the tender and approved at the kick-off meeting, three main scenarios and three more specific scenarios were defined and are elaborated in section 3 of this report. They capture distinctive ways of dealing with the many concerns set out in the previous section, as well as illustrating how transformation of specific dimensions could be achieved. Since this study began, a Commission (2023a) communication on the mid-term review of the 2021-27 MFF has been published and it has been taken into account in developing the scenarios. However, this study is not intended to be a critique of those proposals. Instead, they add to the backdrop against which the longer-term future of the budget is assessed.

2.1. Insights from interviews

As anticipated, the interviews have proved to be very helpful, not just in clarifying key features of the EU's finances and pinpointing shortcomings in current arrangements, but also in identifying options for the future and potential pitfalls of certain solutions. Many of the issues discussed are taken up elsewhere in this study, but some of the findings and implication around specific topics are presented here.

While there is not an easily delineated consensus on the definition of European Public Goods (EPGs), interviewees agreed the budget should focus more on them. One interpretation is that such goods correspond to challenges even the biggest Member States cannot solve on their own. In addition to climate change, energy and security were often mentioned. However, many respondents also stressed the need to pay more attention to European added value in at least two senses: efficiency in delivery of EPGs; and situating spending at the most suitable level of government, in other words a budgetary subsidiarity principle,

How to provide for the servicing and repayment of NGEU loans was discussed by most interviewees. Although mechanisms are mapped out in the Own Resources Decision, there was scepticism about timely agreement on new own resources on the scale required. If this route is blocked (or significantly delayed) the implication (as noted in section 1) is that either GNI contributions will have to rise or other EU spending programmes will face a squeeze (or both), either of which would be resisted.

A fourth option could be to roll over the debt with fresh borrowing, much as national Treasuries do routinely. In the Own Resources Decision (Council of Ministers, 2021), possible latitude to do so is afforded by Art 5.1.b which states that borrowing should be managed 'so that no new net borrowing takes place after 2026'. Art 5.2 sets out how the borrowing should be repaid with a deadline for completing repayment of 2058 and stipulates a maximum for any given year. Taking the two articles together, there does not seem to be a prohibition on rolling over debt in the short-term, so long as the maximum payment and the 2058 deadline are respected. Whether this would be in the spirit of the ORD provisions is a different matter.

Inflation at a rate in excess of the 2% annual adjustment built into the MFF is widely understood to mean an erosion of the real value of EU expenditure programmes, but the interviews revealed little sympathy for correcting this for three main reasons. The most telling is that at a time when all budgets are under stress, making a case for shielding the EU budget, by implication asking Member States to contribute more, is politically difficult, although it could be argued that inflation in Member States will boost their nominal revenue, especially if tax thresholds are not raised. A second point to emerge is that the absorption rate for EU spending tends to fall short of 100%, resulting in some margin. Third, for many years the inflation was between 0 and 1% and there was no suggestion of trimming the nominal value in these times. Overall, a sense conveyed was that 'a deal is a deal' and it would be unwise to reopen it because of what may well be a temporary surge in inflation, and could open Pandora's box.

With NGEU focused on projects also potentially eligible for Cohesion Policy support or loans from the EIB, one concern mentioned is that the pipeline of projects is over-stretched, with the attendant risk of less worthy projects being funded. Moreover, at the national level, the same individuals are often involved in implementing Cohesion Policy and the RRF, yet face different procedural requirements. While at first glance this might seem problematic and counter-productive, it allows for more flexibility and provides varied ways to have some objectives delivered. Yet, evidence from a number of interviewees suggests that hopes of a reduction in administrative costs have not been realised.

In future, output-linked payments might be the better choice, as they make budget negotiations more sensible and lead to better results and longer term impacts. However, a note of caution should be sounded because the results focus of the RRF does not conform sufficiently to the norms of performance-based budgeting espoused by, notably the OECD.

Reducing the MFF to five years was adjudged by interviewees to be difficult, even if there is a democratic and legitimisation logic to aligning it with the Commission and EP mandates. Practical problems would arise because of the multi-year nature of many expenditure programmes. Independently of the duration of the MFF, more flexibility should be aimed for. One possibility mentioned could be a rolling programme in which more flexibility is permitted under 7 year or 5+5 year durations. There was a cautious welcome for the 2023 midterm review of the MFF because it has real substance to it, even though it is inevitable that some interlocutors will find fault. An issue of the MFF which receives too little attention is the length of the negotiations. Needing two years for an agreement is neither justifiable, nor sustainable.

On the whole, interviewees were reluctant to speculate on, let alone support, the case for new financial mechanisms limited to the eurozone exclusively, such as an instrument for macroeconomic stabilisation. Moreover, it was pointed out that agreement within the eurozone could not be taken for granted. Equally, integrating the ESM into the EU framework, though legally challenging, could be a useful evolution of EU finances. The ESM has substantial firepower for stabilisation purposes, but is constrained by being outside the EU legal order and by its mandate (which is in the process of being reformed, although ratification is proving to be slow). Several interviewees were asked about the idea of a European Monetary Fund, an option on the table in the 2010s, but there was little sense of what it might be in the current galaxy or what a pathway towards it would be.

Rationalisation of the many off-budget mechanisms will not be easy, but fresh thinking may be warranted about 'who does what' and to what extent. A proportion of NGEU loans (as opposed to the grant component) could, in principle, be substituted by EIB loans, although it should be recognised that NGEU loans go to Member States, whereas the EIB has traditionally lent predominantly to private sector entities. To the extent that NGEU loans are then transmitted to companies, one step in the process could be simplified. Similarly, Commission programmes for lending to Ukraine, may be less cost effective than finance channelled through other entities.

Regarding whether the role of the EP has been diminished in times of crisis, one viewpoint is that it has not changed in relation to the MFF and the annual budget. Mainly because of the imperative of urgency, it may be difficult to build the Parliament systematically into procedures for future responses crisis procedure. Nevertheless, many interviewees recognised the legitimisation problems associated with a lesser role for the Parliament in the funding of major EU policies by off-budget mechanisms.

Despite rising interest rates, the EU is clearly not facing any difficulty in attracting bond purchasers from financial markets and, as several interviewees observed, the auctions to date have been substantially over-subscribed. Plainly, though, the rise in interest rate has implications for the costs of debt service, prompting a number of interviewees to want decisions on new own resources to be accelerated. Even so, the additional 0.6% of GNI headroom provided for in the Own Resources Decision is a very

substantial buffer, leading some interviewees to suggest the problem is exaggerated, albeit with the corollary that if more of the headroom is used, national contributions will rise.

2.2. Succinct overview of the current system

Following on from the discussion in section 1 of this study, a brief description of the main features of the EU's finances today offers a starting point for the development of scenarios. In the galaxy of EU finances four key distinctions can be made, overlapping in some respects. An obvious first one is between the budget, and off-budget mechanisms, with the equally obvious observation that the latter have grown relative to the former. The Inter-Institutional Agreement (IIA), Council of Ministers, 2020 and the MFF Regulation constitute the legal base for the former, but for the latter the legal base varies, although Article 122 TFEU is often the preferred choice.

Second, there is a distinction between EU policies based on own resources (including, in this context, national contributions formally defined as OR in the Own Resources Decision) and funding relying on borrowing by the EU level. The latter vary in purpose and, as the discussion in section 1 emphasises, have become increasingly diverse. Some are temporary and crisis related, while others are permanent. In the wider galaxy, there are also loan mechanisms, notably the ESM (itself based on an intergovernmental treaty and hence outside the EU legal order), which are limited to the Eurozone or other selected Member States.

A related, third difference is in how EU lending and borrowing is administered, especially regarding where responsibilities lie for interest payments, amortisation of the debt and guarantees in case of default. In essence, the main divide is between borrowing for which the EU budget is central and mechanisms making use of the headroom between planned expenditure and the own resources ceiling. There are provisions in the EU budget for *InvestEU* and the *Neighbourhood, Development and International Cooperation Instrument (NDICI)*, both covered by the Common Provisioning Fund described above in section 1.6.3.

A fourth cleavage is between EU policies providing grants and those that offer loans, typically on favourable terms to Member States and other beneficiaries. In the past, the budget would have been equated with grants and financial instruments⁶ with loans, but this separation manifestly breaks down with the substantial grants provided by NGEU. Indeed, the grant component of NGEU requires the EU budget not only to pay the interest, but also over time to repay the loans incurred.

For lending and borrowing, at one extreme there are the long-established arrangements for the EIB with an established governance structure. Various financial instruments internal to the budget also have a role in Cohesion Policy, albeit one which only became substantial during and since the 2007-13 MFF. They nevertheless account for a relatively small proportion of CP interventions (4% in 2007-13 and expected to rise to 6% in the 2014-20 MFF, according to Wishlade and Michie, writing in 2017; and projected to remain at 6% for the current MFF). As these authors make clear, 'financial instruments' is a catch-all term that covers loans, guarantees and public equity stakes in economic activities, manifestly different forms of intervention, although a common thread is the expectation that the beneficiary repays loans and generates a return able to meet the costs of the support. Financial instruments of this sort have the advantage of being able to be recycled, in the sense that if (for example) an amount is repaid it can be loaned again without adding to aggregate lending

A very helpful paper by Grund and Steinbach (2023) explores the legal basis for the use of borrowing in the EU budget. They note the lack of consensus among academic lawyers and their intriguing conclusion is that 'The Treaties neither deny nor explicitly empower the EU to finance its budget with

⁶ To limit confusion, the term 'mechanisms' is used for lending and borrowing other than in Cohesion Policy for which the term financial instruments is kept as a specific nomenclature.

debts'. They also cite a judgement from the German Constitutional Court which they interpret to mean that there is no explicit 'prohibition against raising debts'.

In addition, they examine whether borrowing could become an own resource for the EU, emulating the way it was used – as external assigned revenue – to fund NGEU. While noting that political intent (keeping NGEU temporary) and, perhaps, keeping EAR below the level of own resources to meet the concerns of the German Constitutional Court might militate against a large resort to borrowing, they argue legally it would be enough to amend the Own Resources Decision. Because the ORD requires ratification by all national parliaments, it is still an onerous threshold, but they are clear that the Treaty *per se* is not an obstacle.

Questions would also arise about the sharing of liabilities. EU debts are not jointly and several guaranteed – meaning a call could be made on any individually for all of the amount – but apportioned according to a GNI-related key. This limit to the liability of a Member State is crucial in mitigating objections from them, especially (as in Germany) where the constitutional court has issued ruling which have to be taken into account.

2.3. Brief overview of scenarios retained for the study

The purpose of the scenarios is to explore possible trajectories for a reform of EU finances, thereby helping to tease out (as stated in the terms of reference for this study) how they could become more 'flexible and responsive', while reducing the resort to 'extra-budgetary constructions'. Assuring better 'parliamentary accountability' is a core consideration, but there are many others. Many crucial dimensions have to be reconciled and concerns allayed, and having scenarios which are distinctive enough to draw attention to merits and drawbacks is useful for this purpose. It is, though, important to stress that a scenario is neither a blueprint for a new model nor a description of how to move from 'a' to 'b'. Rather, it is a device to draw attention to the challenges, requirements and likely policy implications of moving in a specified direction.

2.3.1. Sketches of the six scenarios

Two of the main scenarios aim to explore opposed, and mutually exclusive, options for the EU's finances. The first is to restore the primacy of the MFF and the annual budget by better integration of off-budget mechanisms. It would, *inter alia*, mean a reassertion of the various principles governing the MFF and the annual budget (universality, unity etc.). Procedurally, the scenario would be expected to result in a common approach, irrespective of whether EU expenditure was funded by own resources or borrowing. This would overcome the disjunction between how spending subject to MFF ceilings and, especially, NGEU spending are administered through the EU budgetary machinery, with different methods for monitoring and evaluation. Further procedural issues would arise in relation to loan guarantees and the servicing of debt.

For the second, the reverse is assumed, as it depicts a more formal separation of the borrowing and lending components of EU finances from the EU budget. Here, the emphasis will be on what having borrowing and lending separated from the budget would entail and on how to recast the various inter-linkages between the two. Key procedural questions include the scope for rationalisation of the disparate borrowing and lending mechanisms, and it examines the scope for better engagement of the EP in fostering accountability and in ensuring legitimisation.

As originally proposed in the tender, scenario 3 was to be about tweaking the status quo to deal with known problems and anomalies, but without radical change, very much in the tradition of 'muddling-through'. Now that proposals have been table for the mid-term review, they provide a new 'live' basis for scenario 3, including a possible solution in the form of the EURI instrument to the question of how

to protect spending programmes. However, it has to be stressed that this scenario is not a critique of these proposals.

The three remaining scenarios are more limited in scope because they relate to specific facets of the EU’s finances. Scenario 4 is retrenchment of the budget to focus on policies associated with sustaining and enhancing the single market. Although admittedly pretty implausible and unlikely to command much support, it is consistent with one of the options from the 2017 White Paper on the Future of Europe. It could, moreover, stimulate thinking on EU public goods.

As far back as the 1969 Barre and 1970 Werner reports on how to achieve economic and monetary union, there has been debate on the need for a supranational fund for macroeconomic stabilisation. The experience of the pandemic has shown that an EU level response (SURE) in this regard was helpful for many Member States. But the relationship with the budget would be complicated and the procedures for legitimation for the Budgetary Authority – especially the role of the EP – would need careful thought.

Scenario 6 concerns the external dimension of the EU’s finances, a domain which has seen fluctuation in the past in linkages with the budget. In a world beset by geo-political uncertainty – most immediately in connection with Ukraine – and with crises frequently demanding EU level funding responses, the scenario explores two sub-scenarios for future EU action.

2.3.2. Presentation of scenarios

To facilitate comparability of the scenarios, a template for presenting and assessing them was developed in table format. A blank version is shown as table 1. In principle, the template could be used for other scenarios.

Table 1: Template for scenarios

	[Insert title of scenario]
Brief outline	
Motivation	
Means of realising it	
i) Politically	
ii) Legally	
iii) Institutionally	
Specific outcomes	
i) For the EU budget (MFF)	
ii) For financial mechanisms	
iii) For economic governance/EAV/ economically	

Possible obstacles and objections	i) Politically
	ii) Legally
	iii) Institutionally
Timescale for implementation	
Feasibility assessment	

Source: project team

The logic behind the template is that there are several common considerations to take into account. These are to a large extent self-explanatory, but some elaboration is warranted. The first two sections provide a simple description of what the scenario comprises and the motivation for pursuing it. There may well be differences among proponents of the scenario and stakeholders it will affect about the motivations and rationale, but they do not necessarily alter the broad direction indicated.

The subsequent three sections concern, respectively, what is needed to make the scenario happen, the intended outcomes and the obstacles to realising it. Each of these is then split into three sub-sections. For the means and obstacles, these consist of political, legal and institutional factors central to the plausible execution (or blocking) of the scenario. The aim here is to establish whether there is, for example, a reasonable prospect of political support and a legal basis (means), or whether (obstacles) that pose substantial (or even intractable) problems. For outcomes, the three categories concern, first, the EU budget (MFF and annual), financial instruments and mechanisms, and a broader assessment of the effects on economic governance, European added value, and what can be thought of as the consistency of the scenario with the broader economic principles outlined above in section 1.

To complete the template, a sense of the timescale needed to implement the scenario is presented along with a summary assessment of its feasibility. Both these latter assessments are affected by the interplay between the means, outcomes and obstacles and may well give rise to contrasting judgements from different perspectives.

3. SCENARIOS ELABORATED

Having laid the ground-work for the scenarios, this section presents them. In each case, there is a table using the template described in the preceding section, supplemented by discussion of some of the more contentious ramifications of the respective options.

3.1. Scenario 1: primacy of the EU budget

Bringing the bulk of off-budget financial mechanisms inside the Budget, and thus fully subject to oversight by the Budgetary Authority, can be viewed as a means of returning to a conception of the EU budget/finances most consistent with the Treaty. This would mean (at least) the integration of mechanisms currently off-budget but guaranteed under the headroom of the Own Resources (ORs) ceiling, namely:

- Recovery and Resilience Facility (RRF) loans financed by NGEU borrowing;
- Financial assistance instruments to EU countries (i.e. BoP, EFSM and SURE, in the form of back-to-back loans) and non-EU countries (Macro-Financial Assistance and EURATOM back-to-back loans).

Other instruments aimed at implementing EU policies (the European Peace Facility and the Modernisation Fund) but currently outside the budget, should be relatively easy to integrate – as happened with the EDF in the last MFF cycle. Grants to Member States under the RRF should have been disbursed to Member States by 2026 and are not, as a result, central to this scenario.

From an operational perspective, this would lead to the increase of the MFF annual ceiling, putting more emphasis on the discussions on prospective new own resources. This would also lead to a debate about specific headings and a necessary modification of the current legislative framework, as any change of the MFF does. To this extent, as mentioned in paragraph (11) of Council Regulation (EU, Euratom) 2020/2093, i.e. the MFF Regulation, ‘specific provision should be made for the possibility to enter commitment and corresponding payment appropriations into the budget over and above the ceilings set out in the MFF where it is necessary to use special instruments’. Similarly to the Common Provisioning Fund, the additional resources would be used contingently.

In a longer-term perspective, integrating instruments not covered by the Own Resources ceiling could be envisaged, although the need to revisit their legal bases would represent a significant obstacle. In particular, the cleavage between the euro area and non-participating Member States affects the scope for integration of the ESM and the Single Resolution Fund.

Grants from EFTA states to EU Member States to reduce social and economic disparities, most of which come from Norway and Switzerland, are likely to have to stay outside the budget procedure - as well as other external assigned revenues - because they rely on the states in question. As these resources are spent through their respective expenditure programmes, being subject to the discharge procedure, their role within the new EU budget is certainly relevant but the impact played by national sovereignty should not be underestimated. At the same time, it is worth stressing that, although these grants do not stem from the appropriations in the annual procedure, they are nevertheless currently part of the annual available credits for the Authorising officer. This means their (at least) partial inclusion in the revised framework cannot be excluded ex ante.

Rebalancing EU finances within the MFF framework will probably require a permanently higher own resources ceiling and could necessitate increased guarantees from Member States, both of which would be expected to lead to resistance from (especially) current and possible future net contributors. A compromise deal to mollify them could be done by focusing more on the sorts of European Public Goods they find most congenial, and by creating new ORs that would blur the notion of net balances

and somewhat change the distribution of financial burdens among Member States. It is also, as pointed out by some of those interviewed for this project, worth noting that some of today's net recipients could become net contributors by the next MFF, especially if Ukraine and others were to accede to the Union during the next MFF. Table 2 summarises the scenario.

Table 2: Integrating borrowing into the EU budget

	Scenario 1 – Integrating borrowing & lending and additional off-budget instruments
Brief outline	Integration of EU-borrowing and lending (B&L) instruments as well as specific off-budget instruments (i.e. European Peace Facility, Innovation Fund, Modernisation Fund ...) into the MFF. This will simplify the EU budget galaxy, (re)unify the budget and complement the already existing budgetary guarantees (EFSD+ and InvestEU). In order to ensure a stronger and more effective macroeconomic stabilisation function, including budgetary guarantees within the budget line could make sense. Conversely, the inclusion of more contingent liabilities could put more strain on current provisioning arrangements and make responses to future external shocks/crisis harder.
Motivation	The main motivations behind this scenario are: <ol style="list-style-type: none"> 1. The EU budget galaxy has become increasingly complicated, especially as a result of recent crises. 2. The share of the MFF as a proportion of (widely defined) EU finances, has fallen, undermining the unity principle. 3. Debt service and reimbursement would be better secured, reinforcing the market rating of EU debt. 4. There is lack of legitimation for off-budget mechanisms, because the EP is limited in its function of budgetary oversight. 5. Mechanisms have different legal bases, decision-making and other procedures, even though the same actors approve them at Member State-level.
Means of realising it	
i) Politically	Would need unanimity and consensus of all the Member States.
ii) Legally	<p>Art. 310.1 TFEU, requiring budgetary balance, may be incompatible with this scenario, although Grund and Steinbach (2023) argue that borrowing is allowable under the TFEU. While their analysis suggests no obstacle to EU borrowing and lending, treaty modification (with ratification by all the Member States) might be advisable to forestall challenges.</p> <p>The Own Resources Ceiling would have to be raised permanently to provide additional 'headroom'. The current 2% of GNI limit is a temporary one, specifically for the duration of NGEU, providing for 0.6% GNI in addition to the 1.4% in the Own Resources Decision. This higher figure is, in effect, a form of budgetary guarantee.</p> <p>The EU financial regulation (Art. 211 concerning provisioning) may have to be changed to adapt to the new scenario.</p>
iii) Institutionally	<p>The EP should be in favour of this measure, as MEPs would have enhanced oversight over the EU budget.</p> <p>National Parliaments would have to ratify an amended Own Resources Decision.</p>

Specific outcomes	<p>i) For the EU budget (MFF)</p> <p>A bigger amount for provisioning, along with amounts set aside to provision the budgetary guarantees and the loans to non-EU countries, could be needed within the budget, depending on whether the choice is to continue to rely on the headroom instead. Contingent liabilities stemming from financial assistance to EU Member States are currently not provisioned. Therefore, if a Member State defaults on a repayment, the EU should draw the necessary amounts from the other Member States, using the headroom between the MFF ceiling and the ORs ceiling. Currently, the Common Provisioning Fund defines a specific management structure for guarantees. There is, however, no substantial difference between guarantees that are provisioned and guarantees that hinge on the headroom. If all borrowing instruments are included within the budget, the Council and the EP would expand their budgetary oversight over EU funds.</p> <p>Change of the MFF structure to adjust to this new addition:</p> <ul style="list-style-type: none"> - Adding a new Heading covering debt servicing.
ii) For financial mechanisms	<p>Financial mechanisms would be subject (ideally) to a single legal base.</p> <p>The number of budgetary guarantees for some instruments could change: if considered a worthwhile approach, the Common Provisioning Fund would need to be broadened in scope (as more financial instruments needing guarantees could be created). This would require amendments to Art. 212 of the Financial Regulation, which covers the CPF, to bring together several similar instruments (guarantee funds), existing across different policies and programmes, under a single umbrella.</p>
iii) For the economic governance/EAV/ economically	<p>It may become a 'Hamiltonian moment' for the EU's Finances, taking it closer to a model more consistent with fiscal federalist theories.</p> <p>Having introduced a temporary common lending and borrowing capacity, the following step would consist of establishing a permanent EU central fiscal capacity. This could be complemented by a permanent unemployment reinsurance scheme.</p> <p>The debt issued at EU level, in addition to contributing to macroeconomic stabilisation, would facilitate the development of euro denominated safe assets, seen as a long-term objective of economic and monetary union.</p> <p>The issuance of new EU debt, supported by financial investors, is likely to add to pressures to reform the own resources system, and could strengthen the overall system from an accountability point of view.</p>
Possible obstacles and objections	<p>i) Politically</p> <p>Member States currently benefiting from 'corrections' and those concerned about erosion of their sovereignty might be against taking this step. More generally, there is little appetite from the Member States to change the MFF.</p> <p>ii) Legally</p> <p>The Treaty may have to be changed (and thus renegotiated with a consensus), although Grund and Steinbach identify a range of Treaty articles that might be used. As always, though, Treaty change would be difficult and unlikely to happen soon.</p> <p>iii) Institutionally</p> <p>The Council and the Commission might not want to give more power to the EP (which would, in its Budgetary Authority role, have to approve the expanded budget and thus also all the borrowing instruments), as this would change the power dynamics.</p>

Timescale for implementation	At the earliest, the next, or possibly next but one, MFF. Finding a consensus and modifying the Treaties (if needed) could easily take a decade or more. However, there could be scope for interim solutions or use of existing Treaty articles other than 122 TFEU. The likely forthcoming enlargement could see a need to modify the Treaty and other legislative changes.
Feasibility assessment	Politically very difficult. This could be a step too far for many Member States, especially net contributors. Even net recipients may be hostile, as they would lose decision-making power. However, a sharper focus on EPGs, blurring the notion of 'net contributor', could be a motivating factor for sceptics. Council opposition renders change more difficult.

Source: project team

A wholesale integration of off-budget mechanisms is a radical idea and doing so would undoubtedly be contentious. It is, nevertheless, useful to consider some practicalities. A first, is that the EU budget has been shown to struggle in recent years in responding to crises. One option to cope with the unexpected would be making funds akin to NGEU permanent. However, instead of channelling the resources to the Member States directly, as is currently being done with the RRF milestone-based approach, an 'NGEU 2.0', orientating the funding towards the financing of European public goods, rather than projects easily identifiable as being for the benefit of individual Member States could help to mitigate objections. Illustrative examples (far from exhaustive) are:

- Cross-border digital connectivity;
- Cross-border energy projects;
- Common purchases of raw/critical materials;
- Border management;
- Procurement of vaccines.

As a large strand of the literature confirms, it is extremely challenging to provide a precise definition of European Public Goods, even if, like the proverbial elephant, 'you know one when you see one'. Moreover, analysing them only under economic lenses could be a mistake, since the ultimate decision on which European public spending areas to prioritise is highly political.

The shape of the EU's finances is a second major challenges. One possibility could be to Include all the large borrowing instruments into a specific heading (Heading 8 – Borrowing instruments, for example, which would be the only heading of the MFF that could disregard the 'in balance' part of Art. 310 TFEU). This method would keep the MFF's structure as close to the current version as possible and could be a compromise for those Member States, who do not want to open the MFF to borrowing. The current 7 headings of the MFF would continue as at present.

A coherent plan for own resources would also be needed, not least because of the need to have a permanently higher own resources ceiling, needed to provide headroom. Although many Member States can be expected to emphasise the simplicity of national contributions based on a GNI key, it tends to encourage a juste retour mentality (even though one message from the validation workshop for this study was that the said mentality may be in retreat). EU revenue under this scenario will need to accommodate both 'traditional' spending and outlays associated with debt servicing and amortisation. This will reinforce the case for new own resources on a sufficient scale to be able to cope with the demands arising from borrowing, but would benefit from a different approach. Thus:

- There are many revenue sources which have been suggested as new ORs, and the pros and cons of these have been extensively analysed, so that it is important not to be drawn into another round of debates on the merits of particular resources.
- Instead, the crucial decision is to agree to have new ORs, perhaps by setting a binding timetable for progressively increasing the share of new ORs in total EU revenue, and possibly a target for this share. An attempt to define a binding process is already included in Annex II of the IIA, i.e. the specific section dedicated to the “cooperation on a roadmap towards the introduction of new own resources”. According to Part B of the roadmap, the Commission should make a proposal of additional Own Resources, including a financial transaction tax and a financial contribution linked to the corporate sector or a new common corporate tax base, by June 2024, on which the Council will deliberate by July 2025. As noted in the latest update Commission (2023b), progress on existing proposals has been slow. These are subject to approval by Member States, according to their constitutional provisions.

Certain other features would also need attention, such as the approach to the management of EU assets and liabilities and the apportionment of risk. The EU as a quasi-sovereign borrower is not new, in that the EIB has a well-established governance structure, but borrowing distinct from the ‘development bank’ function of the EIB will need specific governance. How to build on the Common Provisioning Fund and the Commission experience of debt management since the launch of NGEU will be a key challenge.

3.2. Separation of the budget from borrowing and lending

The case for trying to rationalise the profusion of borrowing and lending mechanisms in the EU’s finances is strong, but it is important also to examine the economic purposes they serve. A possible motivation for having a separation between B&L and the MFF ceilings could be to create an EU variant on the concept of a golden rule in which the rationale for borrowing would become progressively more closely associated with public investments in line with EU policy objectives and European public goods, distinguishing them from responses to crises.

Legally, there would be limits to formalising borrowing and lending as a separate dimension of EU finances. Several legal bases already underpin existing B&L, suggesting that the Treaty would not be an obstacle to Scenario 2. ‘Financial instruments’ (including certain off-budget instruments) are covered in Art. 208.2 of the Financial Regulation which states that *‘Member States may contribute to the Union’s financial instruments, budgetary guarantees, or financial assistance. If authorised by the basic act, third parties may also contribute’*, confirming the validity of this scenario. In addition to what is suggested in the table, one could also envisage an amended interinstitutional agreement (IIA) to put the MFF and the different borrowing instruments under the same umbrella, while keeping them operationally separate.

Some of the main issues of the borrowing and lending instruments would persist: NGEU would still have to be reimbursed. The whole principle of NGEU was to borrow money that would be reimbursed by new own resources (within the budget); with this proposed separation, either the MSs would have to reimburse NGEU receipts themselves (which seems contrary to the principle of NGEU) or EU resources would have to be raised through an alternative means, distinct from the own resources used to fund the EU budget. Some kind of sinking fund could be created, with these separate resources. Table 3 sets out the main features of the scenario.

Table 3: Separation of borrowing and lending within EU finances

	Formalisation of borrowing and lending as a separate dimension of EU finances
Brief outline	As the ECA and others have argued, the proliferation of off-budget instruments has led to an over-complicated system with an inadequate governance that needs to be rationalised. The proposal underpinning this scenario is to place borrowing and lending mechanisms in a separate stream of EU finances.
Motivation	There are currently multiple interlinkages between the EU budget and the borrowing instruments. Some instruments have guarantees that are implemented inside the Budget (Common Provisioning Fund). For NGEU, the reimbursements are to take place through future calls on the Budget. Separating the borrowing and lending would attenuate concerns about debt-related outlays crowding out spending from the EU budget.
Means of realising it	
i) Politically	To realise this clear separation, a consensus from Member States would be needed. Since the budget would be easier to ring-fence, the EP might have an interest in this scenario
ii) Legally	Inside the TFEU, the budgetary procedures are covered in Arts. 310-325. The off-budget instruments are not covered by them. There is, therefore, no obvious Treaty constraint separating on- and off-budget mechanisms.
iii) Institutionally	The Commission and the Council play a significant role in off-budget B&L, therefore they should be in favour of it. This should suffice for the means of realising it, as there is no obvious complicated legal procedure to pursue. To the extent that it requires modification of the MFF, the EP would also have support this revised framework.
Specific outcomes	
i) For the EU budget (MFF)	By formally separating B&L, the EU Budget would be slightly reduced in size. Some elements to be taken out would be: <ul style="list-style-type: none"> • The servicing and repayment of NGEU borrowing; • InvestEU (perhaps...); • The public sector loan facility; • The Common Provisioning Fund (CPF). Separating B&L would, ceteris paribus, also enable the own resources ceiling to be reduced, thereby meaning fewer national resources allocated to the MFF. The Member States would, however, still have to contribute to the off-budget elements, but politically sensitive direct funding by MS of the EU budget would decrease.
ii) For financial mechanisms	Having a weaker link to the Budget could allow more B&L mechanisms to be created by the Member States as inter-governmental mechanisms. NGEU could be dealt with by: Rolling over a proportion of the loans in times of fiscal stringency (subject to the provisions in Art 5.2 of the Own Resources Decision) rather than repaying linearly; Shifting the burden of repayment to beneficiaries (could be either Member States or projects generating financial returns); or User charges where loans generate services of value to users
iii) For economic governance/EAV/economically	A focus on European public goods and an NGEU 2.0 building on the borrowing capacity of the EU. The EP would have a smaller budgetary role (off-budget more likely to mean outside its control).

<p>Possible obstacles and objections</p> <p>i) Politically</p> <p>ii) Legally</p> <p>iii) Institutionally</p>	<p>Member States in favour of furthering EU integration could be against this, if they interpret it as going backwards.</p> <p>By effectively having two different budgetary procedures, the EU budget would be less transparent, as it would seem more complicated. The formalisation of off-budget mechanisms would leave open the question of consolidation of these mechanisms.</p> <p>Another issue would be guaranteeing the B&L outside any legal framework. The Member States would have to find another way to be able to give these guarantees to investors.</p> <p>While there would appear to be no impediment coming from the TFEU, this new construction would need revision of the FR and the MFF Regulation. By formally separating the B&L, principles behind the EU budget would not be sufficiently respected, notably unity, universality and balance for the B&L.</p> <p>In the EU construction, the EP is supposed to play an overseeing role in the EU budget. By effectively separating B&L, the EP would lose influence. It is, therefore, likely that the EP will be against this measure</p>
<p>Timescale for implementation</p>	<p>Waiting for the next MFF (2028-34) would be the easiest way to proceed. This would also give time to create an off-budget guarantee for CPF-linked projects and NGEU reimbursement.</p>
<p>Feasibility assessment</p>	<p>Legally, separating borrowing and lending should not pose insuperable problems. The Member States, the Council and the Commission could, in principle, take it forward, despite likely objections from the EP.</p> <p>The NGEU reimbursement could also raise questions, making it more difficult.</p> <p>Concerns might arise about how financial markets would view EU borrowing without the Own Resources ceiling headroom as a guarantor.</p>

Source: project team

There could be a role for a further reform of the ESM to provide a backstop, provided a way could be found to broaden it from Eurozone members to EU27. However, the difficulty in completing ratification of the reform of the ESM to enable it to become a backstop for banking union (currently awaiting Italian approval) is not auspicious. Another potential approach would be to have an off-budget Common Provisioning Fund (CPF) and guarantees for the different instruments. They would have to be redefined, as they would no longer be backed by the OR headroom. To retain the trust of investors, a different form of guarantee from Member States would be needed, recognising that the Own Resources Decision, which is ratified by 27 Member States, provided for a certain ‘automaticity’ highly appreciated by investors and rating agencies and would not be easy to emulate. An option could be a common framework for the off-budget mechanisms, including some form of guarantee fund. Member States would have to resort more to national public spending funded domestically, instead of through EU mechanisms. This could affect net fiscal transfers across borders.

Modifications in the direction of scenario 2 could start during the second part of the current MFF, but probably later. The resources allocated to the budget lines linked to off-budget instruments could be transferred to other projects. It is also worth mentioning that separating B&L could be difficult to communicate to citizens, or even to financial markets, unless there is a clear and secure guarantee mechanism.

3.3. Status quo tweaked

The history of the EU budget in recent decades has been of small, incremental changes and a reluctance to countenance more radical development. Politically, tweaking tends to be the least disruptive approach to amending the EU's finances, partly because it implies keeping changes to a minimum, but partly also because the accommodations reached to arrive at previous deals do not need to be unpicked. Typically, there is an asymmetry between those who gain from a new arrangement, who quietly accept it, and those who might lose from it who will object loudly. In political economy terms, decisions are ducked, rather than confronted. The result is a status quo bias for the MFF and the budget and it is one explanation for why off-budget instruments have often been the preferred solution to new demands.

Nevertheless, there is scope for constructive tweaking, building incrementally on some recent innovations in the budget and lessons from how NGEU has been implemented. Similarly, proposals made for the mid-term review of the MFF could be consolidated and possibly extended insofar as they resolve problems. Procedural changes, for example to give more emphasis to performance budgeting, can make a difference to both the outputs and results of EU spending, while integration of funds, as was done for NDICI and now proposed for STEP, can simplify implementation. There is potentially also some scope for increasing flexibility by new forms of collaboration with Member States, as with 'cross-border projects of common interest'⁷.

The obvious downside of tweaking is to militate against transformations in the EU's finances likely to usher in desirable longer-term reforms. From a public economics perspective, the gap between what theory suggests ought to happen and the reality is likely to widen. In particular, reassessment of which public goods should be funded at EU level is inhibited. From a political and institutional perspective, lowest common denominator outcomes will leave a legacy of dissatisfaction or even resentment which may, moreover, build over time. As a limited scenario, it would not diverge much from current arrangements and would do little to render the budget more agile. Table 4 presents the main features of the scenario.

Table 4: Limited changes: status quo tweaked

	Status quo tweaked
Brief outline	Moderate changes to the EU budget aimed at dealing with known problems, with a particular focus on how on- and off-budget components of EU finances can be better organised, though without radical change.
Motivation	<p>In a seven-year MFF, flexibility can be difficult to achieve, but amendments can become vital to its proper functioning. This is especially true when unforeseen events, such as the invasion of Ukraine, raise expectations of a budgetary response from the EU.</p> <p>The interactions between NGEU and the EU budget have, perhaps inevitably, given rise to unanticipated problems. Partial mitigation of these problems can be achieved without extensive changes in the budget.</p> <p>One specific concern is how to deal with the decline in the real value of MFF ceilings. The problem arises from the 2% inflation assumed, against a backdrop of actual inflation well above that rate.</p>

⁷ https://energy.ec.europa.eu/system/files/2019-10/memo_pcis_final_0.pdf

<p>Means of realising it</p> <p>i) Politically</p> <p>ii) Legally</p> <p>iii) Institutionally</p>	<p>Even a limited ‘tweaking’ approach will have to reconcile competing preferences at Member State level.</p> <p>Amendment of the IIA and, possibly, a revised Own Resources Decision, but would probably not need much more.</p> <p>Commission proposals; European Council likely to be key decision taker; limited role for the EP in advancing specific priorities.</p>
<p>Specific outcomes</p> <p>i) For the EU budget (MFF)</p> <p>ii) For financial mechanisms</p> <p>iii) For economic governance/EAV/ economically</p>	<p>Proposals on dealing with the rising interest burden as a call on future annual budgets, maybe building on the proposed EURI instrument.</p> <p>Probably only marginal adjustments, if any, of main expenditure programmes.</p> <p>Unlikely to result in substantive changes.</p> <p>Articulation of possible developments beyond current MFF;</p> <p>Could lead to refinement of ideas on EU added value, aiming at obtaining a uniform, operationalizable and measurable concept instead of being subject to multiple (and sometimes incompatible) interpretations. This would better explain the underlying reasons for the benefits of undertaking policy action at European level in a particular field and would help to guide decision makers towards a more effective and targeted intervention approach.</p> <p>The major drawback of a tweaking approach is that it postpones the harder choices, including rethinking of how principles from public economics should inform the EU budget and the role of EU finances, more generally.</p>
<p>Possible obstacles and objections</p> <p>i) Politically</p> <p>ii) Legally</p> <p>iii) Institutionally</p>	<p>Unless seriously incompatible demands surface, the politics will be mainly about staking out positions for the future, but not enough to derail the process.</p> <p>None obvious, other than limited amendments to existing legislative acts underpinning the EU’s finances.</p> <p>EP likely to want to maintain or extend its budgetary competences.</p>
<p>Timescale for implementation</p>	<p>Rapid, not least because this is essentially a scenario for the shorter-term and hence within an MFF or the next. Familiar procedures would be used.</p>
<p>Feasibility assessment</p>	<p>All sides will want to reach an agreement, even though there will be tough bargaining.</p>

Source: project team

The mid-term review of the MFF can be seen as an illustration of this scenario, and its outcome will be instructive – see the overview in section 4.2 below. The Communication published by the European Commission in June 2023 stresses how the stability and predictability of the Budget could be impaired if certain adjustments are not made. The Flexibility Instrument provides only limited additional flexibility above the MFF ceilings of approximately EUR 1 billion per year, and is insufficient to cope

with further external shocks which must be considered likely in the volatile geopolitical and economic context expected in the years ahead.

At the same time, a more profound recalibration of the budget will meet resistance from many sides. In the redefinition of the Interinstitutional Agreement or the Own Resources Decision, resistance could emerge among Member States, insofar as positions on the OR ceiling or the nature of additional expenditure and revenue sources can be expected to differ markedly. Nonetheless, reflections on new own resources (without a precise definition of the supporting own resources, it would be difficult to maintain the EU's ability to finance its priorities and policies in the long-term) and amendments for a stronger flexibility of the budgetary instrument should be encouraged, even if in a limited fashion. There may also be scope for shifting contingent liabilities away from provisioning to the headroom.

Given the implementation of such a system would require political unanimity from Member States, the risk of compromises based on the lowest common denominator is substantial, and the likelihood is of only minor revisions in the spending programmes within the current structure. In short, the scenario has the merit of being the most readily attainable, but at the same time the least capable of overcoming known or emerging weaknesses in the budgetary galaxy, postponing rather than making the (many) hard choices. Yet as explained above, it could be more ambitious than minimal tweaking.

3.4. Retrenchment

Scenario 4 implies a retrenchment towards a limited number of areas of competence of the EU, by solely sharing the single market between Member States. This would mean a smaller budget for the EU and a focus on the 'core principles', with provision of fewer EU public goods. It would also result in some regaining of power by Member States over spending in areas delegated at present to the EU (renationalisation of development aid is one of the areas cited in the White Paper on the 'Future of Europe'). Table 5 summarises the scenario.

Table 5: Retrenchment of the EU budget

	Retrenchment
Brief outline	Based on Scenario 2 in the 2017 White Paper on the 'Future of Europe' <i>Nothing but the single market</i> , a perspective for the EU that elicited only negligible support at the time. The White Paper states explicitly that the budget would be 'refocused to finance essential functions needed for the single market'.
Motivation	<p>Simplifying the EU and its budget by focusing only on the 'most important' elements associated with a well-functioning single market, with an implicit focus on free movement of goods and capital. All the effort would be put on a narrower field of competence, allowing for more control for the Member States in areas where they had less of a say before.</p> <p>Mix of spending funded by own resources and borrowing only for investment associated with a more effective single market.</p> <p>Lowering EU budget reduces calls on national contributions.</p> <p>The EU's budget and functioning could also become clearer (including for citizens).</p> <p>Likely to appeal most to net contributors Member States and, perhaps, those less receptive to closer union or subject to Eurosceptical political pressures domestically.</p>

<p>Means of realising it</p> <p>i) Politically</p> <p>ii) Legally</p> <p>iii) Institutionally</p>	<p>Would need to overcome resistance from CAP and Cohesion Policy interests.</p> <p>It would need:</p> <ol style="list-style-type: none"> 1. Unanimity in the Council 2. An absolute majority in the EP <p>The Council, with the consent of the Parliament (absolute majority) can adopt a new MFF.</p> <p>The changes in the MFF are compatible with Art. 312 TFEU.</p> <p>Institutions and stakeholders would have to agree on a major overhaul of the MFF and the institutional setup. Significant international ramifications.</p>
<p>Specific outcomes</p> <p>i) For the EU budget</p> <p>ii) For economic governance/ EAV/economic and social effects</p>	<p>Delete the headings of the MFF that don't concern the single market. This would be likely to mean mainly keeping:</p> <ol style="list-style-type: none"> 1. Heading 7 (Administrative costs) 2. Heading 1 (Market, Innovation and Digital) 3. Perhaps, some parts of Cohesion Policy associated with Green Deal and digital objectives <p>Reduction of the budget (no CAP, not much Cohesion policy, etc), possibly by two-thirds. This would mean going from EUR 1,074.3 billion in 2018 prices, to less than 360 billion for the next period.</p> <p>Creation of numerous different funds outside the scope of the EU budget, to compensate for the loss of competencies resulting in a lower budget. However, including new financial tools would impede the simplification process and broaden the EU's budgetary galaxy.</p> <p>Non-economic European public goods largely disappear.</p> <p>With diminished cohesion policy allocations providing fewer incentives, the European Semester could be less relevant for Member States.</p>
<p>Possible obstacles and objections</p> <p>i) Politically</p> <p>ii) Legally</p> <p>iii) Institutionally</p>	<p>Achieving unanimity in the Council and an absolute majority in the EP very difficult.</p> <p>The main beneficiaries of CAP support will oppose loss of support for farmers.</p> <p>Member States benefiting most from Cohesion Fund in the 2021-2027 MFF will also be hostile: they would have a significant loss of receipts and would have to finance public investment projects from national sources.</p> <p>Many Member States could interpret the changes as going backwards in European construction.</p> <p>Commitments in Treaty to CAP and Cohesion expenditure.</p> <p>For the EU institutions, a reduced influence (in terms of influence on EU citizens) and loss of jobs. Threatens the geopolitical importance of the EU institutions.</p>

Timescale for implementation	Starting with the 2028-2034 MFF. During the negotiations, actors would agree to reduce the headings of the MFF and the sums attributed to it.
Feasibility assessment	Very difficult to implement politically. Would constitute a big step backwards in European construction. Overall, too many objections to be considered feasible.

Source: Project team

In addition to the changes within the MFF, some modifications to the Financial Regulation (FR) might have to be undertaken. Other possible outcomes are the possible creation of inter-governmental off-budget funds to replace the budget funding, and the possibility for MS to choose between increased national public spending or curbing the provision of public goods hitherto at EU level.

While starting with the 2028-34 MFF is the most obvious pathway, the retrenchment could also be implemented gradually, to be smoother. The 2028-2034 MFF would feature the current headings, but with reduced amounts of resources to prepare the countries for the retrenchment. The retrenched MFF would start from 2035. While net contributors to the budget may be more amenable to resorting to a retrenchment, social Europe would be at risk of being undermined. Overall it is hard to see circumstances in which this scenario would obtain support.

3.5. Macroeconomic stabilisation

Advocated since the MacDougall Report (1977) and the Delors Committee Report (1989), Scenario 5 focuses on implementing a macroeconomic stabilisation mechanism. This could be done either at EU or Eurozone level. The rationale for it is that market integration creates macroeconomic spill-over effects and interdependencies, and these are even stronger in an economic and monetary union. The European added value of such a fiscal instrument is supported by many economic studies, including recent estimates of the macroeconomic effects of NGEU and SURE conducted by the ECB, by the EU Commission and independent researchers (e.g. Bozou and Creel, 2023). While both these initiatives were temporary and linked to the pandemic, the case for a permanent SURE was made by Corti and Alcidí (2021) and there have been many calls for a successor to NGEU. While the latter plainly is much more than a stabilisation mechanism, a stabilisation capacity was also examined in one of the reflection papers accompanying the 2017 White Paper on the Future of Europe (European Commission, 2017b).

Macroeconomic stabilisation in an economically integrated union may include a variety of objectives. In many previous proposals for creating a fiscal capacity, the main objective was stabilisation of Eurozone Member States in the face of asymmetric shocks, or common shocks having differentiated effects on individual Member States. Such a fiscal capacity, limited to the Eurozone, could (for example) take the form of an Unemployment Reinsurance Fund. However, the political and institutional interest in such a mechanism only for the Eurozone has faded since the late 2010s partly because its potential benefits are deemed to be low, given the economic weight of the Eurozone in the EU, especially after Brexit. The ESM already performs the task of emergency financial assistance to individual Eurozone countries facing financial difficulties in the face of asymmetric shocks.

Another route for setting up a permanent stabilisation mechanism would be to build upon the achievements of the RRF component of NGEU. Although the RRF goes well beyond stabilisation and was not directly linked to the macroeconomic effects of the pandemic, its principles could nevertheless be adapted to encompass a response to EU-wide macroeconomic shocks, such as those resulting from the Covid pandemic and the energy price shock caused by the war in Ukraine. Moreover, linking macroeconomic aims, an element of cross-border transfers and a focus on EU strategic aims could be a political selling-point.

The current context could, therefore, be an opportunity to integrate such a mechanism, although the interviews for this study revealed widely differing views on whether a successor programme to NGEU is plausible. The measure (summarised in table 6) would be best constructed in such a way as to be compliant with Art. 220.1 of the Financial Regulation, which stipulates the terms for loans or credit lines made available to Member States or third countries. Alternatively, amending the ESM and integrating it into the EU legal order could become the basis for a stabilisation mechanism with a broader remit than crisis management.

Table 6: A fiscal capacity for macroeconomic stabilisation

	Macroeconomic stabilisation
Brief outline	<p>A fiscal capacity for countercyclical action and/or for stabilising the EU economy in reaction to large, negative, common macroeconomic shocks, either limited to the Eurozone or for the whole EU.</p> <p>While not introduced purely as a stabilisation mechanism, the RRF (by seeking to boost investment expenditure) could be a model. Alternatively, some form of Unemployment Insurance as an employment support mechanism could be envisaged: SURE, while loan based, might therefore be a model.</p>
Motivation	The need for a flexible, countercyclical fiscal instrument (or instruments) to coordinate and add to national fiscal responses to shocks, with a possibility to differentiate across Member States.
Means of realising it	
i) Politically	Needs to overcome the resistance of Member States likely to oppose the necessary increase in the size of the EU budget.
ii) Legally	<p>If a permanent borrowing mechanism were put in place inside the budget, the TFEU might have to be changed (Art. 310 “in balance”).</p> <p>The legal base for SURE was Art. 122 TFEU. It could also be used for a new capacity, in the first instance as a temporary arrangement. However, if it were to become a permanent mechanism, Art. 175.3 TFEU, as a special instrument outside the MFF ceilings, is the more likely legal base.</p>
iii) Institutionally	Unanimity in the Council and majority in the EP.
Specific outcomes	
i) For the EU budget (MFF)	<p>If it is included in the EU budget, either raising both the expenditure and OR ceilings.</p> <p>If separate from the budget (as NGEU and SURE) were, debt service implies an increase in OR ceiling.</p>
ii) For financial mechanisms	Either setting aside a (substantial) financial reserve (‘rainy-day fund), or making EU borrowing a permanent feature.
iii) For economic governance/EAV/economically	More focus on European Added Value (EAV) and EPGs. There might be calls to link support to national reforms or progress in addressing country-specific recommendations
Possible obstacles and objections	
i) Politically	Reluctance of many Member states fearing a ‘transfer Union’, but also concerns about adding indirectly to already high levels of national debt.
ii) Legally	<p>Some national constitutional courts (in particular the German one) may challenge conformity with national constitutions and/or EU treaties.</p> <p>While Art. 220 (1) of the FR allows the Commission to borrow funds if needed, point (2) states: “<i>The borrowing and lending shall not involve the Union in the transformation of maturities, or expose it to any interest risk or to any other commercial risk.</i>”, which would have to be taken into account.</p>

iii) Institutionally	Similarly, while Art. 122 TFEU allows the EU to act in exceptional circumstances, as might Art 175.2, Art. 125 could be used against it.
	Finding unanimity in the Council could be difficult, especially those Member States which are already substantial net contributors.
Timescale for implementation	Starting with a new MFF period would be the easiest (2028-2034 MFF)
Feasibility assessment	Given recent experience in creating temporary responses, creating a permanent fiscal capacity appears feasible. Although, from a technical/legislative standpoint, agreement at EU27 level might be attainable, politically, it would probably be easier if it were limited to the Eurozone because of the common interest of participating countries.

Source: project team

In addition to the specific outcomes mentioned in the table, other elements have to be considered. To incentivise Member States worried about fostering a transfer-union, an emphasis could be on spending more on European Public Goods as the means of making achieving stabilisation effects, making the changes beneficial for all. Institutionally, such a mechanism could mean the creation of new financial instruments outside the EU budget. New instruments or funds could be i) a European Climate Fund (already under development), or ii) an employment Fund. Both could also be included within the budget.

If such a stabilisation mechanism were “Eurozone only”, objections would possibly arise from excluded countries, but also by Eurozone countries themselves. Finding consensus on the TFEU (if modified) would be difficult.

To allow for a smoother transition, the above-mentioned timeline could also be modified: the 2028-2034 MFF could be used as a transition phase, the fiscal capacity only being fully introduced from 2035. To mollify Member States fearing the adoption of a macroeconomic stability mechanism would become a ‘transfer union’, the basis for a compromise could be reinforcing conditionality and increasing the share of loans in funding packages under the mechanism.

3.6. External action

To fulfil its global roles and commitments, the EU has previously made use both of expenditure headings within the MFF and a variety of off-budget mechanisms. Actions at the supranational level are the largest contribution to development aid by the EU, but work alongside efforts by national agencies. However, as a recent briefing by Gavas and Perez (2022: 3) argues, although the aggregate investment in support of developing countries has grown, ‘the lack of coordinated action and absence of a unifying framework have led to fragmentation, duplication, incoherence, competition for visibility and undercutting of commercial investors in ways that can produce economic distortion’. There can be little doubt that external demands on EU finances will remain substantial in the coming years.

Apart from the strong likelihood that substantial EU-level support for Ukraine (whether through continuing macroeconomic financial assistance or once reconstruction begins in earnest), geo-political crises (unpredictable by definition) are bound to see calls for the EU to intervene financially elsewhere. Several off-budget lending mechanisms have been used over the years for external action, some of which, such as macro-financial assistance, are permanent features of the EU fiscal landscape, while others (the Fund for Refugees in Turkey and Trust Funds are examples) have been temporary.

Different mechanisms can be envisaged for EU external action, depending on the nature of the demand to be met. For these reasons, the scenario presented here has two variants, partly echoing scenarios 1 and 2 presented earlier in this section. Tables 7 and 8 summarise them.

The first relates to mechanisms already in the EU budget, of which the Neighbourhood, Development, and International Cooperation Instrument (NDICI), with an MFF ceiling set at EUR 79.5bn for 2021-27, is the most substantial. The Regulation (2021/947) governing NDICI, was formally adopted in June 2021. The External Action Guarantee (EAG) of the NDICI is subject to the OLP and can provide EUR 3 billion for loans and grants. Additional support is offered through the European Fund for Sustainable Development Plus (EFSD+), enhanced compared with its previous incarnation (EFSD) for the current MFF. It comprises a mix of blended finance (that is, complementing Member State initiatives or those from development banks, including the EIB) and guarantees.

Outside the MFF ceilings, but still 'on-budget'; there is a proportion of the Solidarity and Emergency Aid Reserve (35% of it, equating to EUR 420 million per year at 2018 prices) reserved for interventions such as Humanitarian Aid to third countries. With the many natural disasters of recent years, SEAR is already largely exhausted barely halfway through the current MFF and a substantial boost to it is proposed in the mid-term review of the MFF.

Something between the RRF and InvestEU models could be the basis for establishing and managing a fund that could be used externally and is therefore presented as a second option. It could bring together MFA, the probable agreement on a new Ukraine Facility, proposed in the mid-term review, and other existing or ad hoc funds, such as the European Peace Facility.

Table 7: Expansion of the Budget and the MFF for external actions

	Options for external action
Brief outline	Flexibility to secure funds that respond to unanticipated demands in 3 rd countries: humanitarian emergencies, Ukraine Macro-Financial Assistance, and Pre-Accession Assistance. Within the budget and MFF, create a new sub-heading under Heading 6: Neighbourhood and the World, and enlarge the humanitarian aid component within the Solidarity and Emergency Aid Reserve (SEAR). Continue to allow the SEAR, like the Flexibility Instrument, to exceed the ceiling of the MFF.
Motivation	Allow the EU to respond credibly and speedily to unanticipated needs and emergencies in partner countries and other third countries.
Means of realising it	
i) Politically	Consensus for better preparedness to face emergencies to which the core budget can respond, requiring unanimity in the Council for the MFF, and a qualified majority for the budget and new implementing regulations.
ii) Legally	The MFF regulation, is passed under Article 312 TFEU. The budget is passed under Article 314 TFEU. The next MFF regulation could enlarge the SEAR (possibly sooner, as is proposed in the mid-term review).
iii) Institutionally	As at present, the Commission proposes and manages the funds.
Specific outcomes	
i) For the EU budget	The size of the EU budget would grow as funds are placed in reserve or disbursed.
ii) For financial mechanisms	No effect
iii) For the economic governance/EAV/economically	No direct effect

Possible obstacles and objections	
i) Politically	Net contributor Member States may oppose an increase in the budget, or the increased reliance on/risk for Own Resources.
ii) Legally	Any adjustment to the MFF or Own Resources requires unanimity across Member States, (Articles 311-312 TFEU).
iii) Institutionally	Institutional obstacles are not foreseen if political and legal obstacles are managed.
Timescale for implementation	If there is a sense of urgency, then agreement and implementation could be rapid, as has occurred previously and seems likely for the proposed Facility for Ukraine.
Feasibility assessment	Highly feasible legally and institutionally. Less feasible politically given unanimous voting and a visible increase in budget size. However, political difficulties could be overcome with adequate consensus. MFF/budget enlargement is not reinventing the wheel.

Source: project team

Table 8: An EU External Action Fund

	An EU External Action Fund
Brief outline	<p>Rapid approval of new funds for unanticipated external eventualities, supported by Own Resources but outside the budget and the MFF. This would build on limited funds outside the budget, placing them in a coherent framework.</p> <p>A regulation could establish the legal base for an external action fund modelled on either the Recovery and Resilience Facility (for example by using funds borrowed by the EU to provide grants, back-to-back loans on favourable terms or both) or InvestEU (where guarantees from the EU budget are offered to investors).</p>
Motivation	<p>Allow the EU to respond to emergencies in partner countries and other third countries, or support development. There has been a multiplicity of external funds, either related to the EU budget or separate from it. These are the product of uneven responses in the last decade to crises and policy priorities. It is not always possible for the EU to respond to external crisis in a sufficiently timely manner.</p> <p>Demands may include reconstruction in Ukraine, climate change emergencies, migration or refugee crises, security of food supplies, or even global responses to future pandemics.</p>
Means of realising it	
i) Politically	Consensus for better preparedness to face significant external emergencies. Unanimity between Member States is needed for a more ambitious reform. More modest changes achieved by qualified majority.
ii) Legally	<p>Regulation passed under Articles 209 and 212 TFEU to create a similar fund to the RRF, EFSD+ or InvestEU that can respond to emergencies in third countries. It would be repaid from Own Resources and from borrowers.</p> <p>The Ordinary Legislative Procedure would apply. Own Resources may require an upwards adjustment to create the necessary margin.</p>
iii) Institutionally	The Commission would propose and manage the funds in cooperation with partners, Member States, and international organisations.

Specific outcomes	
i) For the EU budget	There would be a demand on Own Resources
ii) For financial mechanisms	More coherence in finances outside the budget, while exposing Own Resources to risk
iii) For the economic governance/EAV/economically	Extension of credit may increase EU fiscal sustainability or place it at risk
Possible obstacles and objections	
i) Politically	Member States may oppose an increase in the budget, or increased reliance/risk for Own Resources.
ii) Legally	Legal challenges based on Articles 209 and 212 TFEU, as they have not been utilised previously to this end. Adjustment to Own Resources requires unanimity across Member States (Article 311 TFEU) and ratification by national parliaments
iii) Institutionally	Institutional obstacles are not foreseen if political and legal obstacles are managed.
Timescale for implementation	This could be rapid as occurred in the context of the Covid emergency in 2020.
Feasibility assessment	Feasible with political consensus. It faces hurdles concerned with political agreement and the legal basis for its implementation, but there are past precedents such as the EU's financial decisions of 2020.

Source: project team

Many previous initiatives have involved loan mechanisms to support external action, and there has also been resort to hybrid funding which combines loans and grants. Examples include the various Trust Funds and the Facility for Refugees in Turkey, as well as the EFSD and the EFSD+. A challenge will be where to locate the EAG, as it might more logically fit into an integrated loan mechanism.

For both variants on external action, Ukraine is likely soon to be a test case and the proposals in the mid-term review suggest a likely way forward. However, by its nature much of external action is development aid and requires good coordination with Member States. An important challenge for this scenario is, therefore, to ensure that this is achieved.

4. CONCLUSIONS AND RECOMMENDATIONS

A first, over-arching conclusion is that the current system of EU finances is still capable of meeting most expectations of it, but it is under increasing strain, with the corollary that the time is ripe for more far-reaching changes than have been attainable since 1988.

To adapt a metaphor much used during the sovereign debt crisis of the first half of the 2010s, kicking the can down the road cannot go on indefinitely. Too many facets of the EU's finances are unsatisfactory and the risk of incoherence is growing. In particular, much more attention needs to be paid to how to make the budget more flexible, notably by enhancing the means by which discretion can be exercised in adjusting spending to changing circumstances. From this perspective, interest payments associated with NGEU arguably add another layer to non-discretionary spending, squeezing the room for spending decided by the Budgetary Authority.

Political imperatives and differences among the EU institutions inevitably complicate matters, though there is, arguably, an increased urgency to confronting the shortcomings of the budget sooner rather than later. Reform should have the aim of arriving at a new framework for the next MFF and the EU Budget, as well as rethinking the role of borrowing and lending, while also being agile enough to cope with hard-to-predict future internal and external eventualities.

Box 7: Anticipating the effects of further enlargement on the EU budget

Previous enlargements have led to changes in the EU budget. In some respects, accession of Ukraine, all or most of the Western Balkan countries and Moldova – potentially in one ‘big bang’ – would have implications for the EU budget similar to those faced in the 2007-13 MFF.

- All the likely acceding countries will have a level of GNI per head well below the EU average;
- They will have significant infrastructure development needs;
- The share of agriculture in GDP is high, with the most pronounced effect likely to come from a large candidate like Ukraine where it was 10.9% in 2021 (i.e. pre-invasion) and is also the country's largest source of foreign earnings. The share in Ukraine is around eight times the EU average and more than twice as high as the EU Member State with the largest share (Romania at a little over 4%).
- Ukrainian agriculture is competitive without significant subsidies and tensions have already been seen as a result of Ukrainian exports of cereals to the EU. The logic of direct payments (still one of the largest MFF budget lines) may need to be re-examined
- Reconstruction in Ukraine will call for imaginative financing packages, posing questions about the mix of grants and loans, as well as the use of guarantees to stimulate private investment;
- An open question in light of recent concerns about how the EU responds collectively to Russian aggression is whether (and if so how) defence should feature more prominently;
- The much lower GNI per capita than current EU Member States of the candidates will lead to a rerun of the statistical effect of two decades ago. This saw recalibration of GNI per head of EU regions and Member States relative to the EU average, affecting eligibility for, notably, Cohesion Policy support. Formulae for allocating resources will, therefore, have to be reviewed;
- Much the same applies to own resources, given the present dominance of the GNI resource, and a shift from being a net recipient to being a net contributor will occur for some Member States, potentially triggering new demands for ‘corrections’.
- Candidates may have differing and distinctive perspectives on the options for new own resources, not least in relation to their incidence on them compared to Member States;
- A last issue is how much to try to settle in advance of accession and the extent to which the interests of candidates should be taken into account.

Source: project team

While the extent and timing of further enlargement(s) are a matter of speculation, the implicit promises to Ukraine of a rapid accession and the probability that it would be alongside accession for both Western Balkan countries and Moldova can be expected to have ramifications for the EU budget and its finances more generally. Already in her 2023 *State of the Union* speech⁸, Commission President von der Leyen has identified changes in the EU budget as one of the key policy areas to be reviewed pre-enlargement:

'We need to discuss the future of our budget – in terms of what it finances, how it finances it, and how it is financed'.

Her words signal that all aspects of the budget may have to be looked at afresh and suggest that the forthcoming enlargement could well provide the impetus for a radical transformation of the EU's finances. An extensive analysis is beyond the terms of reference of the present study, but box 7 signals some likely repercussions for the EU budget.

4.1. Conclusions on scenarios

Of the three main scenarios elaborated in the previous section, the first appears to be most conducive to fulfilling the objectives set out in the terms of reference for this study. Simply put, the more that can be done using the OLP and thus the Budgetary Authority the better, especially from the standpoint of legitimation, even if some flexibility in adopting new mechanisms is foregone. An expanded or reconfigured Common Provisioning Fund may be required with effects on the risks incurred by the EU budget. The scenario would, though, not be easy to realise because it implies a permanent increase in the own resources ceiling to provide headroom for borrowing. Such a development would be likely to induce opposition from Member States reluctant to see a higher budget.

The second scenario would make it easier to preserve the integrity of the income and expenditure side of the budget in fulfilling its established functions, without requiring the EU budget to meet the costs emanating from borrowing. Instead, the burden would have to be organised in a more explicitly inter-governmental way. Having parallel systems of EU finances would be less transparent and would render more dubious the channels of legitimation.

A contentious matter would be how support for Ukraine (or any other third country) is mobilised under the two main scenarios. Under scenario 1 MFA+ and other forms of support would be incorporated into the budget as part of external spending, partly relying on the headroom, but requiring some expenditure. In scenario 2, an external lender/guarantor, such as the ESM, could support the financing by single Member States and would not be included in an EU budget line.

There will be the customary temptation to fall back on the third scenario, on the grounds that it is what usually happens, but as stated above, the time for a change is now. Even so, 'tweaking' is an elastic concept. Despite the concern that 'status quo tweaked' circumvents rather than addresses longer term challenges facing the EU budget, 'tweaking' can cover a range of prospective developments. Many commentators would regard the mid-term review of the 2014-20 MFF as having been minimal and it is an open question whether the changes introduced in the last two MFFs were commensurate with the extent of change in the EU since 1988. The greater ambition of the current mid-term review proposals from the Commission could, however, point the way to a more extensive form of tweaking, albeit with the unavoidable caveat that agreement on the proposals (at the time of writing) cannot be taken for granted.

⁸ https://ec.europa.eu/commission/presscorner/detail/en/speech_23_4426

Among the specific scenarios, there is no plausible trajectory towards retrenchment, leading to the simple conclusion that it can be dismissed as a way forward, having only been included to illustrate the ramifications of an extreme possibility. By contrast, macroeconomic stabilisation in an increasingly deeper Union is a function of public finances for which the case for an EU level capability is persuasive, even if there are many obstacles to overcome. It would be consistent with economic theory and can, perhaps, be best advanced by small steps, rather than a radical shift of competence from Member States. Similarly, it is hard to avoid the conclusion that the EU's finances will have to strengthen permanent mechanisms for external action, rather than persist in resorting to ad hoc responses to crises.

4.2. The mid-term review of the MFF

Although the Commission proposals of June 20th 2023 for the mid-term review of the MFF (Commission, 2023a) go further than in previous cycles, they would not lead to significant change, with the exception of the proposed new Facility for Ukraine. While the present study does not aim to appraise the proposals in the review, they suggest some of the topics likely to influence the debate on the longer-term developments of EU finances. As explained in the Commission communication, its main proposals are:

- To set up a Facility for Ukraine worth EUR 50 billion over the period 2024-27. Together with resources from existing programmes, the support for Ukraine is expected to reach EUR 70 billion over the remainder of the current MFF.
- Allocation of EUR 15 billion to cover the additional costs of coping with refugees, both from Ukraine and elsewhere
- The creation of a Strategic Technologies for Europe Platform (STEP) which can be seen, at least partly, as a response to the US Inflation Reduction Act. It can also be interpreted as giving substance to debates on the mooted EU Sovereignty Fund and mainstreaming strategic investments. STEP will, to a considerable extent, draw on a range of existing programmes (the document lists a range of funds and programmes 'on- and off-budget to provide support to clean-tech, biotech and digitalisation'. There is also an expectation that the investments to be supported from EU funding will attract further investment able to multiply the effects. However, in aggregate the MFF revision in relation to STEP will be comparatively modest, with projected increases in the ceiling of Heading 1 by EUR 3.5 billion, Heading 3 by EUR 5 billion and Heading 5 by EUR 1.5 billion: a total of EUR 10 billion spread over four years, on the assumption that it is applied from 2024-2027.
- Propositions for dealing with the effect of higher interest rates in relation to NGEU through a new 'special instrument' to meet costs in excess of those initially programmed. The proposed new EURI instrument⁹, put forward in the Commission communication, would protect other spending by providing for the difference between the amounts projected in 2020 for debt service when NGEU was launched and the higher amounts now anticipated because of the surge in interest rates. Because this difference cannot be known in advance, there is no maximum amount for the instrument. It will be mobilised 'in the framework of the annual budgetary procedure' and, importantly, be over and above relevant MFF ceilings. However, as noted above, the proposal will face resistance from many Member States.

In addition, the Commission calls for additional spending on administration, largely to offset the shortfall in real terms arising from the 2% deflator applied to the MFF. It also proposes an increase of

⁹ Not to be confused with the European Union Recovery Instrument (Council Regulation (EU) 2020/2094 of 14 December 2020 establishing a European Union Recovery Instrument to support the recovery in the aftermath of the COVID-19 crisis), now more commonly referred to as NGEU.

EUR 3 billion (an increase of 75%) in the Flexibility Instrument, based on the projection that the original allocation of EUR 4 billion will have been used up by the end of 2024.

Initial reactions expressed during the General Affairs Council discussion of 10th July 2023 on the mid-term review reinforce the message that substantive change in the MFF will be hard to achieve. The Ukraine Facility was broadly supported, but some details were questioned. Poland, for example, argued for frontline countries to be eligible for support, while Germany stressed the need to engage the private sector. There was also sympathy for the proposals on an increased allocation for migration, although the details elicited diverse comments.

By contrast, support for STEP is uneven and there was predictable opposition from several Member States to the Commission requests for additional funding to accommodate the administrative cost increase or compensating the EU budget for higher interest payments (EURI). STEP could, nevertheless, be a model for developing EU-level industrial policy and adding to the coherence of policies in support of the twin transitions or boosting strategic autonomy.

Similarly, the proposed Ukraine Facility (see sidebar) could become the model for a more broadly orientated external action mechanism in the EU finances, able to go beyond the limited capabilities of the SEAR and integrating other instruments (MFA and NDICI) focused on neighbouring countries.

Box 8: A new Ukraine Facility?

The facility proposed by the Commission, with a budget of up to EUR 50 billion for 2024-27, is meant to combine meeting short term needs and support for the reconstruction and modernisation of the economy.

It is to be organised around three pillars covering: grants and loans; guarantees for investors; and technical assistance. It will replace existing support mechanisms, notably MFA+ and NDICI.

There will be conditionality in the form of an obligation to produce a 'Ukraine Plan' with delivery targets to be met to justify disbursements.

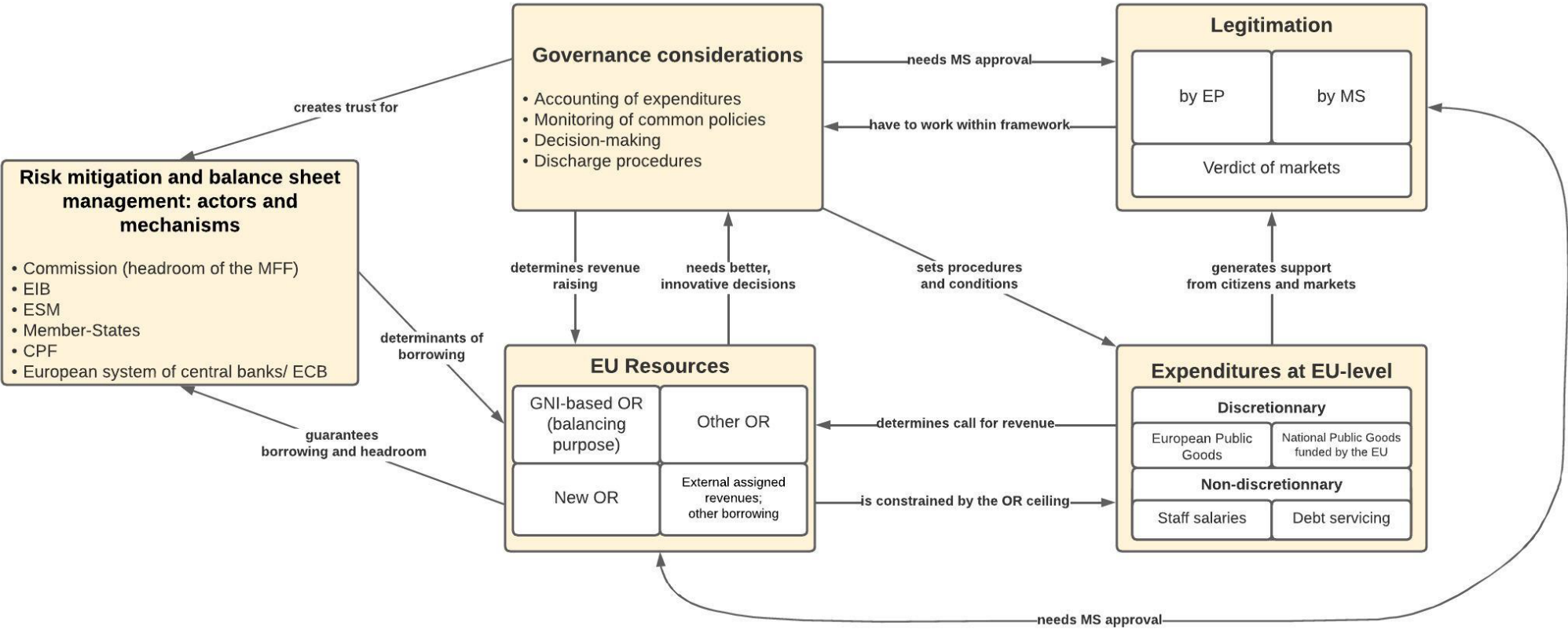
4.3. Thematic conclusions and recommendations

Conclusions and recommendation are presented for several of the themes examined in preceding sections. A useful starting point would be to recognise that the EU level would benefit from defining its own fiscal framework. Figure 2 proposes the components of an EU fiscal framework, building on the discussion in section 1 above, and of how they interact with one another, highlighting the importance not just of finding solutions to specific problems, but also of having regard to the effective functioning of the system of EU finances as a whole. One aim in proposing a framework is to move away from the ad hoc approach to (especially) new funds in response to crises, criticised by ECA (2023a) and others.

4.3.1. Expenditure

For well-known reasons, a sizeable proportion of EU expenditure bears only a tenuous relationship to what economic theory suggests should be in a supranational budget. The three-way distinction proposed by Buti et al. (2023) between EU public goods delivered by the EU level of government, EU public goods funded supranationally but delivered at Member State level, and national public goods funded by the EU budget can be a useful typology for rethinking spending priorities, while further lessening the pull of the *juste retour* mentality. A challenge will be to reconcile national envelopes, themselves substantially determined by the formulae governing allocations from the largest budget programmes, with the array of politically determined EU priorities the budget aims to fund.

Figure 2: The components of an EU fiscal framework



Source: project team

- >> R1: This is a nettle that should be grasped, with a careful review of what the EU funds and how to rebalance its budget, recognising that certain redistributive transfers are a legitimate function of a top level in a fiscal federation. A solution, bound to be contentious, could be to move, over time, to some form of fiscal equalisation among Member States in order to help the least affluent to provide those European public goods that are nationally financed. NGEU is, to some extent, an example insofar as it entails net fiscal transfers.
- >> R2: Stress the added value of spending at the EU level, in the sense of making clear what the advantages of spending at the EU level are (compared with the national level) and clarifying when it is more cost effective to spend at EU level, should be central to planning of EU spending. A radical change (as suggested during the validation workshop) could be to distinguish between three functions of the EU budget: EU public goods; making existing spending more 'agile' for macroeconomic stabilisation purposes; and external action.

4.3.2. Revenue

With external assigned revenue having risen by an order of magnitude because of EU borrowing to fund NGEU, the Treaty provision that the EU budget 'shall be financed wholly from own resources' (Art. 311, TFEU) manifestly will not hold if borrowing to finance EU policies becomes the norm. As set out in the Own Resources Decision, this is a temporary expedient, formally due to end in 2026. However, if successor programmes modelled on NGEU (for whatever purpose, crisis-related or not) are adopted, the current position would be increasingly untenable.

The composition of own resources, especially the dominance of the GNI resource, is also ripe for new thinking. The GNI resource has the valuable property of adjusting to balance changes in EU expenditure, such that revenue matches expenditure and will be needed indefinitely. Nevertheless, as a result of recent developments the time has come to end the decades-long procrastination over new own resources. This is not so much about revisiting the rather sterile debates about **which** resources should be selected, so much as arriving at a political agreement on **how** to change OR, notably because of the new demands on the EU budget to service and repay loans.

- >> R3: Set a target, to be agreed by the institutions, for a substantially higher share of 'genuine' OR (with the stipulation that they substitute for much of the GNI resource) in total revenue and specify binding dates for achieving it, while retaining a smaller GNI resource to assure balance. If appropriate, **a limited form of inter-governmental conference**, in conjunction with the EU institutions, could provide a way forward.
- >> R4: As far as possible, favour prospective new own resources linked with EU policies and strategic objectives (as for NGEU), notably related to the twin transitions, complementing those already proposed such as the ETS or the CBAM. Although the uneven national incidence of any particular new OR will inevitably lead to friction about fairness, having a basket of revenue streams can help to mitigate this concern, and there could be scope for differentiated call rates on the GNI resource to offset unfair burdens. However, lower GNI call rates (or fixed amount reductions) are already a feature of 'corrections' and regarded as anomalous, and there would be concern that a more complex system would add to the administrative burden, however fair.

4.3.3. Risks

The EU has been able to implement a large increase in borrowing by the Commission, particularly for NGEU, rapidly and effectively, earning a positive assessment from the ECA for its management of the debt and associated risks. As seen by financial markets, the EU is a highly rated borrower, but markets

appear not to distinguish between different mechanisms (loans and guarantees), with implications for maintaining this credit rating in future.

>> R5: Explore the case in the medium-term for consolidating different EU borrowing and lending programmes and, perhaps, delegating the Treasury function currently undertaken by the Commission to a separate debt management agency, once there is clarity on whether EU borrowing is to remain substantial. One possibility could be to integrate the European Stability Mechanism into the EU legal order and assign it this task, building on the permanent crisis mechanism currently put in place by the ESM for the euro area, allowing for (at least a partial) EP budgetary oversight. A simpler solution would be resorting to a regulation to establish a new European Debt Agency for the specific task of managing EU borrowing and lending.¹⁰

The lack of central EU fiscal capacity is at odds with the tenets of fiscal federalism. It could take many forms, but two priorities should be to provide, on a permanent basis, mechanisms for macroeconomic stabilisation and for long-term investment in EU public goods. A complicating factor is how to reconcile the differing requirements of Member States participating, or not, in the euro. Although in the longer term, further euro accessions would mitigate the problem, likely new accessions would add to the number of Member States not participating in the euro.

>> R6: The Budgetary Authority should propose a deadline for new fiscal capacities, starting with mechanisms orientated towards reinsurance.

Given that the Parliament's role in borrowing and lending is limited, a case can be made for boosting not only the information flow, but as suggested by Begg et al. (2022) for presenting it in a manner that makes it more transparent to legislators. More broadly, with the balance-sheet of the EU now of increased economic and political salience, it is important that all sides be aware of how risks are likely to evolve and their likely impact on the expenditure and revenue accounts that have largely been the focus of attention up to now.

4.3.4. Governance of the MFF and other components of the EU's finances

Decision-making on the EU's finances is both complex and time-consuming, unsurprisingly with so complex a galaxy of mechanisms. It is, however, also institutionally unbalanced insofar as the Council and the Commission have the lead roles in off-budget mechanisms, whereas Parliament as one arm of the Budgetary Authority, is confined to approving the MFF, settling the annual budget under the OLP and discharge procedures. Plainly, the use of Art. 122 for responses to crises explicitly excludes the Parliament, but as Grund and Steinbach (2023) show, other legal bases could be used for novel mechanisms.

>>R7: Explore options for rooting innovative, off-budget budgetary responses in legal bases other than Art. 122, with the aim of engaging the Parliament more extensively in the decision-making processes.

There is little appetite for changing the duration of the MFF, yet having a seven-year span when the mandates of the Commission and the EP are five years can be seen as anomalous. Shortening the MFF to five years faces the difficulty that multi-year investment programmes dominate EU expenditure. Moreover, they have lead times for preparation and extensions that can mean an effective period of considerably more than seven years. Yet a longer (for example five-plus-five) span carries risk of making the budget less flexible.

¹⁰ A proposal by Amato and Saraceno (2022) could provide a starting point.

>> R8: Consider a ten-year rolling MFF with more frequent break points.

The use of milestones and targets as in the RRF – which means a focus on outputs and results – has advantages over the input-based approach traditionally adopted for Cohesion Policy. However, at national level it is often the same administrators having to cope with two different monitoring systems.

>> R9: Reconcile the best of the two approaches in the pursuit of an approach to decision making, monitoring and evaluation that emphasises performance-orientated budgeting.

The application of the 2% deflator will reduce the real value of EU spending programmes, but there is resistance to increasing EU revenue to compensate, although the EURI instrument proposed in the mid-term review could be a way forward. A return to price stability will solve this problem and there is still some slack within ceilings from commitments not being taken up. However, a linked question could be why the principle applied is to set a cash limit, rather than an expenditure rule linked to nominal GNI.

The uncertainty about developments in Ukraine calls for flexible mechanisms. If loans have the option of being translated into grants, subject to conditionality, strong incentives for effective use of the funding from the EU would be in place. In advancing the Facility for Ukraine proposed in the mid-term review, these considerations should be to the fore. A possible model is the Brexit Aid Reserve (BAR) of EUR 5 billion, whose operationalisation through the MFF Regulation is similar to that of the Solidarity and Emergency Aid Reserve. The BAR is deployed through amending budgets to compensate Member States whose GNIs have been disproportionately affected by Brexit. If so, a Ukraine Aid Reserve, building on the fund proposed in the mid-term review, could be established under similar rules and permitted to exceed the MFF's ceiling.

A fund linked directly to the EU budget would be less suitable for longer-term, post-conflict reconstruction in Ukraine. The models of the RRF or InvestEU may, instead, be more appropriate, for these distinctive needs. Nevertheless, the essential conclusion is that solutions can be found.

4.3.5. Legitimation

The limited role of the EP in procedures governing policies funded by off-budget mechanisms is well understood and is a source of disquiet for the Parliament, although other institutions are not necessarily unduly concerned. However, from a legitimation standpoint the current position can scarcely be regarded as satisfactory. NGEU is an especially striking case, because of how the borrowing for it enters the budget as external assigned revenue and is administered. Yet it is outside the MFF ceilings and is not subject to the annual budget procedures, thereby undermining the prerogatives of the Budgetary Authority.

>>R10: It should not be difficult to ensure that the ordinary legislative procedure is applied for any new mechanisms, even in times of crisis or urgency, when EU funding is proposed. Exceptions should be kept to a minimum. As canvassed by the ECA, for future decisions on lending, if legislation has to be passed hurriedly (for example under Article 122), retrospective impact assessments should be required.

>>R11: Consider having articles in the Financial Regulation which specify the conditions under which new funding mechanisms can be introduced without co-decision by the European Parliament, setting stringent rules to limit the use of such mechanisms.

4.4. Concluding remarks

Developments in the EU budget over the last thirty-five years since the major reform of 1988 have, on the whole, been piecemeal and have struggled to keep pace with the many changes in the objectives, structures and membership of the Union. 'Time for a change' is both a persuasive political narrative and, from a more technical standpoint, a valid description of how the EU's finances ought to evolve. Rather than facing a 'Groundhog Day' future in which the same debates are re-hashed and lowest common denominator outcomes are reluctantly agreed, the argument that 'the time for a change is now' is becoming increasingly compelling. Part of 'time for a change' may also be to look beyond the regular negotiations (MFF, annual budget etc.) to have a more upstream review of the EU's finances, possibly in the form of a limited inter-governmental conference, as put forward above in relation to recommendation 3, but with broader terms of reference than own resources.

This study has drawn attention to principles of public economics and how they might be adapted to the EU's finances. It has also tried, in the scenarios, to explore differing ways in which the budget might evolve. These are not roadmaps, spelling out steps that *should* be taken, so much as narratives about what moving in a particular direction entails. They do, nevertheless, demonstrate the far-reaching nature of changes that might be envisaged if some of the shortcomings in the EU's fiscal framework are to be addressed.

In addition to the anticipation of enlargement, the mid-term revision of the MFF can be a basis for changing the direction of the debate, even if it ultimately results only in limited immediate changes. The review puts on the table a number of proposals that could pave the way for subsequent more radical developments, especially in external action and in the consolidation of measures related to technology, competitiveness and industrial transformation (STEP). The latter, for example, could evolve into an ambitious 'sovereignty fund' with goals comparable to the US's Inflation Reduction Act.

But bigger questions remain around how to accommodate the continuing gap between expectations about what the EU aspires to use fiscal mechanisms to achieve and the constraints on not only the MFF, but other financing mechanisms. 'Agility' in a budget has many layers to it, ranging from the ease with which new demands (crises being the most glaring example) can be met within existing structures, to the capacity to introduce novel mechanisms sufficiently rapidly without compromising legitimacy. NGEU showed that, when pushed, the EU could act quickly by developing an exceptional approach, yet support for a successor programme appears to be lukewarm. Agility is also about exploring whether existing funding mechanisms work sufficiently coherently together and could be repurposed to enhance their collective impact.

Lending has manifestly become a significant and growing component of the EU fiscal framework and the associated borrowing has to be managed with care. In particular, the interactions between the EU's fiscal balance sheet and its income and expenditure accounts is an area of concern because of the prospect that non-discretionary debt service and amortisation expenditures will crowd-out spending decided or desired by the Budgetary Authority. The conjunction of higher debt and rising interest rates is already a problem for national governments, but hardly a new one, whereas it is a new phenomenon for the EU budget.

New own resources could be seen as the solution, but are no panacea. Adopting new resources on a scale sufficient to meet the costs of debt (as envisaged in the Own Resources Decision) would, in principle 'protect' the remainder of the EU budget, albeit only by implying a higher aggregate collection of taxes from EU citizens and businesses. A radical option could be to adopt borrowing as an own resource, shifting it away from being a form of external assigned revenue. The analysis by Grund

and Steinbach (2023) is encouraging, but new thinking would be needed on the long-term interaction between borrowing and conventional own resources.

The own resources ceiling plays a pivotal role because it simultaneously sets a limit to the obligations of Member States and provides financial markets with a credible guarantee on the safety of lending to the EU. However, in a period of above average inflation, it is subject to the anomaly (Claeys et al., 2023) that as nominal GNI increases, both the OR ceiling and the nominal tax revenue (*ceteris paribus*) of Member States rises, whereas the inflator for MFF ceilings is set at 2%. While it is undeniable that the reverse is true in periods of low inflation, such as the decade prior to the pandemic, it is another procedural feature of the EU's finances that could benefit from fresh thinking.

In all this, transparency and legitimation cannot be neglected. For citizens, understanding the means by which the EU manages its finances is a daunting task and the relative invisibility of EU finances in election debates accentuates the problem. Reliance on Article 122 and allowing only for a limited engagement of the European Parliament may have been justifiable at the time certain new mechanisms were being conceived, but such an ad hoc approach cannot be defended as a norm. However politically tricky, therefore, legitimation needs to be reaffirmed.

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ANNEX 1 LIST OF INTERVIEWEES

Members of the European Parliament

1. Johan Van Overtveldt (Chair of European Parliament's Committee on Budgets), 10/05/2023
2. Margarida Marques (Vice-Chair of European Parliament's Committee on Budgets), 22/05/2023
3. Jan Olbrycht (Member of European Parliament's Committee on Budgetary Control), 30/05/2023

Main Interview programme

4. Alain Lamassoure (Former Minister Delegate for the budget in France and Chairman of the European Parliament's Committee on Budgets between 2009 and 2014), 11/05/2023
5. Jorge Núñez Ferrer (Director for Cohesion Policy and EU budget, CPMR), 23/05/2023
6. Eric von Breska (Director of Revenue and Multiannual Framework, DG Budget, European Commission), 24/05/2023
7. Marketta Henriksson (Head of Secretariat for EU Affairs, Finnish Ministry of Finance) 31/05/2023
8. Corrado Checcherini (State General Accounting Department, Italian Ministry of Finance), 01/06/2023
9. Thomas Westphal (Director-General, Council of the European Union) and Nicolaj-Ting Mortensen, 01/06/2023
10. Agnès Bénassy-Quéré (Sous Gouverneur, Banque de France, formerly French Treasury), 06/06/2023
11. Alfredo De Feo (Scientific Director at European College of Parma Foundation), 08/06/2023
12. Marco Buti (Tommaso Padoa-Schioppa Chair in European Economic and Monetary Integration at EUI, former Head of Cabinet of Commissioner for Economy Paolo Gentiloni), 13/06/2023
13. Mario Nava (Director-General, DG Reform, European Commission) 21/06/2023
14. Judith Hermes (Director for European Policy, German Ministry of Finance), 21/06/2023
15. Niall Bohan (Director of Asset, Debt and Financial Risk Management, DG Budget, European Commission), 23/06/2023
16. Mads Nørgaard Jørgensen (Head of EU Unit, Danish Ministry of Finance), 04/07/2023
17. Kai Wynands (Head of Multiannual Financial Framework & Annual Management Cycle Unit, Secretariat-General, European Commission), 05/07/2023
18. Rolf Strauch (Chief Economist and Management Board Member, European Stability Mechanism), 06/07/2023
19. Alberto Gasperoni (Principal Manager of Audit Chamber V Financing and administration of the EU, European Court of Auditors) and José Parente (Head of Task of Special Report 05/2023 on *The EU's financial landscape. A patchwork construction requiring further simplification and accountability*, European Court of Auditors), 10/07/2023
20. Peter Berkowitz (Director of Policy, DG Regio, European Commission), 19/07/2023
21. Jean-Christophe Laloux (Director General, Head of Lending and Advisory Operations within the European Union and European Free Trade Association (EFTA), European Investment Bank) and Caroline Gaye (Head of Unit Mandate Operations Management, European Investment Bank), 21/07/2023
22. Zsolt Darvas (Senior Fellow at Bruegel), 04/08/2023

ANNEX 2 INTERVIEW GUIDE

Purpose of the study and contribution of interviews

In recent years, the public finances of the EU have changed radically as a result of the creation of a range of borrowing mechanisms to fund or support EU policies. This evolution has, however, occurred in a rather haphazard manner, but lacks an overall logic. As described in the sub-title of a recent European Court of Auditors (ECA) report: it has become ‘a patchwork construction requiring further simplification and accountability’. Meanwhile, despite many changes of detail, the Multi-annual Financial Framework (MFF) is not that different in overall structure from what was introduced 35 years ago when the EU budget last underwent major reform.

To inform proposals for reform of the MFF and the EU finances more broadly, the aim of the interview is to draw on your experience and expertise of EU budgetary matters. This interview guide sets out the themes potentially to be explored in the interview, as well as specific questions. We realise that some topics may be outside your areas of responsibility or your direct knowledge and will steer the interview accordingly.

Multi-annual financial framework

Until quite recently, the MFF constituted the great majority of EU finances and was governed by a set of principles (unity, balance, etc.). Latterly, however, both the share of the MFF and compliance with the principles have been eroded, including through an increase in external assigned revenue and a larger use of loan guarantees, as well as a wider resort to borrowing and lending. Many financial assistance instruments adopted by Council regulation and determined by key guidelines, with only limited formal involvement of the Parliament.

- Can these trends be reversed in such a way as to restore the primacy of the MFF?
 - Any suggestions on how to integrate lending mechanisms into the MFF and how could it be made to work in practice?
- How might the evident asymmetry between the powers of the European Parliament in approving MFF ceilings and its much more limited role in new mechanisms, such as the RRF, be resolved?
- Would a reversion to five-year cycles for the MFF be worthwhile?
 - If so, mid-term to mid-term, or aligned with the Commission and EP terms?
- Is there anything new to be said on the well-known challenges of own resources?
- Should the EP have a formal decision-making role on own resources?

Proliferation of debt mechanisms

The ‘galaxy’ of EU means of financing EU policies has extended well beyond the MFF. Some of the mechanisms are temporary (SURE), while others are permanent (EIB). In some cases, the EU budget provides a guarantee to lenders (Invest EU). There are also loan-based mechanisms formally outside the EU legal order, such as the European Stability Mechanism, which nevertheless have explicit EU purposes. The plethora of lending mechanisms gives rise to a range of questions and policy challenges.

- Are there easy answers to how loans are to be repaid and can the coherence of guarantees in the event of default be improved?
- Should the various lending mechanisms be brought together and, if so, how might this plausibly be engineered to overcome the patchwork referred to by the ECA?
- The Commission has had to take on a debt management role: does this cause problems?

Beyond NGEU

The agreement on NGEU marked a significant change in EU finances by allowing the Commission to borrow to finance grants and loans to Member States, albeit as a one-off measure. Expectations have, however, now been raised that a permanent mechanism of this sort will be established.

- Would such a development be desirable?
 - If so, for what purposes and subject to what conditions?
 - Should the temporary increase in the own resources ceiling be made permanent?
- NGEU results in net fiscal transfers, especially towards Member States in the South and in Central and Eastern Europe: can net contributors be persuaded to accept this move towards a ‘transfer union’?
- Grants for similar policy goals under the MFF and NGEU (RRF) are subject to different monitoring and evaluation approaches: is this a problem?

The macroeconomic stabilisation role of public finances

There have been many proposals for an EU central fiscal capacity to provide European public goods beyond these currently in the MFF. In particular, closer economic and monetary union implies a need for a supranational fiscal stabilisation capacity. SURE, implemented in response to the pandemic, was a temporary measure, but agreement on possible permanent measures has been elusive.

- Is an additional fiscal capacity (or capacities) needed?
 - If so, for what purposes: pure stabilisation; temporary responses to crises or specific objectives (like NGEU and SURE) or a permanent fund for designated EU public goods and services?
 - Is it realistic to apply the principle of subsidiarity to the choice of EU public goods?
 - What is your opinion regarding the demand for Euro denominated safe assets, considering their potential EU impact from an economic and geo-political perspective?
- Given that participation in the euro is likely to be well short of 27 members for the foreseeable future, should any new fiscal capacity(ies) be for all Member States?
 - What would the impact on EU coherence and solidarity of measures limited to the Eurozone?

Governance challenges

The expansion of the EU budget galaxy in recent years has raised legitimacy concerns with respect to the role of the EP as a Budgetary Authority, and seen the erosion of the application of many of the principles governing EU budgeting.

- How could the role of EP in budgetary oversight be safeguarded in responses to crises?
 - Should urgency of action be allowed systematically to diminish the EP’s involvement?
- Is there a need to revise the various treaty-based principles bearing on EU budgets?
- Cumulative inflation since the start of the current MFF will substantially erode the real value (‘purchasing power’) of MFF expenditure programmes and NGEU allocations. Should the presumed 2% rate of inflation underlying the MFF be recalibrated and, if so, how?
 - Will the forthcoming review of the MFF be an opportunity to deal with this anomaly?
- ‘Ownership’ and accountability are frequently mentioned as essential elements in fiscal frameworks: might there be a greater role for the European Fiscal Board in scrutinising EU finances?
 - How else could ownership be encouraged and strengthened?
- Although the unforeseeable cannot, by definition, be foreseen, would it make sense to have a contingency fund able to deal with the unexpected and, if so how big should it be?
- The MFF 2021-2027 already includes an instrument for Pre-Accession Assistance worth EUR 14.6 billion. With Ukraine, Moldova and Georgia having submitted applications and started accession negotiations, should this fund be boosted?
 - Should pre-accession assistance be grants or loans, similar to the EUR 18 billion of support for Ukraine for 2023 through a new Macro-Financial Assistance + instrument?

To conclude, is there anything we have overlooked that you would draw to our attention?

The EU budget has to reconcile certainty in generating funding for what are, predominantly, multi-annual investment programmes, with a capacity to generate funding on a sufficient scale when circumstances and priorities change. Off-budget mechanisms have largely been preferred for dealing with the latter. This study presents recommendations, drawing on several scenarios, for how the EU budget could be recast to enable it to be more agile and responsive in dealing with new and future challenges requiring EU-level expenditure or lending.
