HM Government

Review of the Balance of Competences between the United Kingdom and the European Union

EU Budget

Summer 2014

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Executive Summary

This report examines the balance of competences between the European Union and the United Kingdom in the area of the EU Budget, and is led by HM Treasury. It is a reflection and analysis of the evidence submitted by experts, non-governmental organisations, businesspeople, Members of Parliament and other interested parties, either in writing or orally, as well as a literature review of relevant material. Where appropriate, the report sets out the current position agreed within the Coalition Government for handling this policy area in the EU. It does not predetermine or prejudge proposals that either Coalition party may make in the future for changes to the EU or about the appropriate balance of competences.

The EU Budget report considers evidence received as part of the call for evidence period, which ran from 21 October 2013 to 17 January 2014. During this period, the Government sought views from a wide range of stakeholders, including other Member States, European Institutions, the Devolved Administrations, the academic community, think tanks and the general public. A list of evidence submitted can be found in Annex A.

Discussion in the evidence focussed less on the existing competence on the budget, that there is an EU Budget, funded by Member States and managed centrally through the European Commission. Instead, rather than challenging that legal structure, evidence focussed on the way that competence is implemented – how the budget system is set up, how budget money is spent and how it is managed.

This report considers, therefore, how the budget impacts upon the UK national interest, which also requires a consideration of evidence on what the UK's national interest is in the EU Budget. All of these issues are explored in greater detail in Chapter Three of this report.

Responses from stakeholders, across the academic community, think tanks, representative groups and Devolved Administrations, suggested that while the balance of competences in the area of the EU Budget is largely appropriate, the application of competences could be improved by reform of budget structures, through improving the financial management of the EU Budget in Member States and EU Institutions alike and particularly through reform of budget expenditure, focussing on areas of genuine added value.

Evidence gathered as part of this report focussed around three discussion areas: agreeing the budget, spending the budget and running the budget.

In summary of the evidence received, the *Agreeing the Budget* section of Chapter Three considered the process by which the EU Budget is organised by institutions; how institutions agree on the size of the budget, how institutions vote on the budget and how the long-term budget is structured. Views were heard in this area on:

- The overall size of the EU Budget, which was seen by some to be small as a percentage of Gross National Income (GNI), when compared to federal budgets in, for example, the United States. However, the unique structure and focus of the EU Budget was recognised, with expenditure not directly comparable with that of Member States;
- The need for a long-term budget period, with respondents largely supporting the need for long-term planning to support recipients, though difficulties were seen in agreeing budget periods by unanimity;
- The length of the Multiannual Financial Framework (MFF) period, with discussion of the relationship between the MFF period and European Parliament electoral cycles and the need for flexibility as well as long-term certainty. Some respondents supported a longer MFF period, to provide greater long-term certainty for spending plans, while others supported a move to the Treaty minimum of five years, to align with the terms of Members of the European Parliament (MEPs). Some also noted the inflexibility of long-term periods, supporting mid-term reviews of spend to provide planning flexibility;
- The roles of institutions in agreeing the budgets, with discussion in particular of the role of the European Parliament on the revenue side of the EU Budget system. Some respondents felt that the European Parliament's limited role in decision-making on revenue enabled the Parliament to, broadly, support increases in the overall size of the budget.

The *Spending the Budget* section of Chapter Three considered the relative value for money of areas of the budget, looking at how the budget is organised by budget headings and how the budget is delivered to recipients. This section also considered the UK's abatement, which is directly linked to the distribution of expenditure in the budget. Views were heard in this area on:

- The value of expenditure in the budget, where in particular Heading 1A, covering expenditure on research and innovation, was seen as a priority for a greater share of the budget, although views were also heard in support of structural and cohesion funds, particularly in poorer Member States. The value for money of the Common Agricultural Policy (CAP) was questioned by a large proportion of respondents, with particular concerns about the value of Pillar One of the CAP;
- The most effective methods of spend in the budget, where respondents largely accepted that this question depended on the aims of particular programmes, for example, automated payments were most applicable for delivering direct payments to farmers through the CAP, while grants were more sensible for providing funding for academic research, though increased use of innovative financial instruments was suggested by some respondents;
- The link between the UK abatement and value for money, where respondents discussed the UK abatement, with some recognising the link formed by the 2005 'disapplication' between reform of the expenditure side of the EU Budget and the size of the UK's abatement.

The *Running the Budget* section of Chapter Three considered the financial management structures which control budget expenditure, including the roles of the European Court of Auditors (ECA) and Member States in ensuring budget money is well spent. This section also considered the commitments and payments system, the 'off-budget' items of spend and the Own Resources system. Views were heard in this area on:

- The financial management system for the EU Budget, where respondents broadly argued for a continued effort to improve financial management of the EU Budget. Respondents also broadly supported the work of the ECA, recognising its difficult role and noting the importance of close cooperation between Member States, who manage the majority of expenditure through the budget, and the ECA;
- The commitments and payments system, with several respondents supporting the existing system and its perceived focus on long-term stability and ensuring good value in spend. Others, however, raised significant concerns about the increasing failure of the system, particularly focussing on the growing liability of 'RAL', or unspent commitments, in the EU Budget;
- Off-budget items, where several respondents raised concerns about the scale of instruments outside the MFF. Others, however, noted the importance of some of these instruments in providing emergency relief both inside and outside the EU;
- Own Resources and corrections, where respondents discussed the future of the revenue side of the budget, with broad support for the Gross National Income (GNI) resource as a primary source of revenue. Other revenue streams were discussed, though respondents largely noted that proposed resources like a Financial Transaction Tax (FTT) would disproportionately impact on the UK. The correction mechanisms on the revenue side of the budget, applicable to several Member States, including the UK and Germany, were also discussed in more general terms, with respondents largely critical of their continued existence, though recognising the negotiating realities which were at cause. Proposals for a generalised correction were discussed, though there was no consensus on how this would be formed.

This report finally considered, in Chapter Four, the future challenges for the EU Budget and the questions raised by evidence which will need further consideration as the budget continues to develop In particular, the report considered the implications of further development of the Euro Area and the potential impact on the EU Budget. The final chapter also looked at questions around further reform of the budget for the future – looking ahead to future discussions on the budget – and the future of the financial management system, where several respondents in Chapter Three of the report made proposals for moderate reform of the existing system.

Introduction

This report is one of 32 reports being produced as part of the Balance of Competences Review. The Foreign Secretary launched the Review in Parliament on 12 July 2012, taking forward the Coalition commitment to examine the balance of competences between the UK and the European Union. It will provide an analysis of what the UK's membership of the EU means for the UK national interest. It aims to deepen public and parliamentary understanding of the nature of our EU membership and provide a constructive and serious contribution to the national and wider European debate about modernising, reforming and improving the EU in the face of collective challenges. It has not been tasked with producing specific recommendations or looking at alternative models for Britain's overall relationship with the EU.

The review is broken down into a series of reports on specific areas of EU competence, spread over four semesters between 2012 and 2014. More information can be found on the review, including a timetable of reports to be published over the next two years, at www.gov.uk/review-of-the-balance-of-competences.

The EU Budget report comes at a significant moment in the history of the EU Budget, at the outset of the first long-term budget package, or Multiannual Financial Framework (MFF), to represent a reduction on the package before. After several years of discussion, it is therefore an appropriate moment to reflect on the development of the budget system and present the views on all sides of those discussions which will inform future negotiations.

As set out in the EU Budget Call for Evidence document published in October 2013, the EU Budget report is intended to cover the running, priorities and structure of the budget of the European Union, including the financial management system of the budget. This report does not consider evidence on detailed proposals for reform of sections of the budget, for example reform of CAP, or Structural and Cohesion Funds. Views on these areas are covered in other reports – in the Agriculture and Cohesion reports of this semester, respectively.[1]

The analysis in this report is based on evidence gathered during the call for evidence period, running from October 2013 to January 2014. During this period, the Government sought views from a wide range of stakeholders, including other Member States, European Institutions, the Devolved Administrations, the academic community, think tanks and the general public. A list of evidence submitted can be found in Annex A. A literature review of relevant material, as well as opinions received in the course of regular business from a range of organisations, people and countries, has also been drawn on.

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1 HMG, *The Balance of Competences Between the UK and the EU: Agriculture Report,* published in parallel; HMG, *The Balance of Competences Between the UK and the EU: Cohesion Policy Report,* published in parallel.

For the purposes of this review, we are using a broad definition of competence. Put simply, competence in this context is about everything deriving from EU law that affects what happens in the UK. That means examining all the areas where the Treaties give the EU competence to act, including the provisions in the Treaties giving the EU institutions the power to legislate, to adopt non-legislative acts, or to take any other sort of action. Ultimately, respondents focussed less on the balance of competence in the strictest sense and more on the application of competence in the area of the EU Budget. One area discussed by a small number of respondents, which does have a more direct impact on the balance of competences in its classic sense is the question of introducing new revenue-raising powers for the EU institutions, which would represent a shift in an area of competence that is currently exclusively held by Member States.

Definition of EU competence

The EU's competences are set out in the EU Treaties, which provide the basis for any actions the EU institutions take. The EU can only act within the limits of the competences conferred on it by the Treaties, and where the Treaties do not confer competences on the EU they remain with the Member States.

There are different types of competence: exclusive, shared and supporting. Only the EU can act in areas where it has exclusive competence, such as the customs union and common commercial policy. In areas of shared competence, such as the Single Market, environment and energy, either the EU or the Member States may act, but the Member States may be prevented from acting once the EU has done so. In areas of supporting competence, such as culture, tourism and education, both the EU and the Member States may act, but action by the EU does not prevent the Member States from taking action of their own.

The EU must act in accordance with fundamental rights as set out in the Charter of Fundamental Rights, such as freedom of expression and non-discrimination, and with the principles of subsidiarity and proportionality. Under the principle of subsidiarity, where the EU does not have exclusive competence, it can only act if it is better placed than the Member States to do so because of the scale or effects of the proposed action. Under the principle of proportionality, the content and form of EU action must not exceed what is necessary to achieve the objectives of the EU Treaties.

For the budget in particular, this means examining the areas where the legislation around the EU Budget, and the negotiations and decisions which flow from that legislation, have an impact on the UK national interest. This report, particularly Chapter Three, *Impact on the National Interest*, will consider the debate which exists around what constitutes the national interest in the context of the EU Budget, before setting out views from gathered evidence on whether the existing EU Budget system operates in a manner that is favourable to the national interest.

The report will first present, building on the detail published as part of the original Call for Evidence, the development of competence in the area of the EU Budget – considering the history of the EU Budget as a system and the development of the legal framework which underpins it. The report will then consider the current state of competence as it affects the UK today. Chapter Three, as noted above, presents views on the impact the budget has on the UK national interest. The final chapter, Future Options and Challenges, will consider the further questions coming from this evidence and the debates around the budget as it develops further.

In reading this report, it is important to note the key principles of the Balance of Competences Review. This is intended to gather and summarise evidence from a variety of sources, to act as a reference in the future.

Chapter 1: Development of EU Competence

1.1 The EU Budget has been, and remains, an evolving system. From the first European Communities' budgets to the multi-annual structure employed today, this evolution reflects the changing structure, priorities and challenges in the European Union over its history. The competences of the European Union with respect to the EU Budget are set out in Treaties. This section provides the historic background on the evolution of the EU Budget system and the development of its treaty framework. In doing so, the chapter covers the broader relationship between the UK, the EU and the EU Budget.

The Development of the Treaty Framework of the European Union (TFEU)

1.2 The Treaty of Rome, ultimately superseded by the Treaty on European Union (TEU) and the TFEU, was agreed on 25 March 1957 and entered into force on 1 January 1958. It established the European Economic Community (EEC) and had a number of economic objectives, including establishing a European common market. Since 1957 a series of Treaties have extended the objectives of what is now the European Union beyond the economic sphere. The amending Treaties, with the dates on which they came into force, are: the Treaty of Brussels (1 July 1967) which provided for the merger of the institutions of the three Communities; the Single European Act (1 July 1987), which provided for the completion of the Single Market by 1992; the TEU – the Maastricht Treaty (1 November 1993), which covered matters such as justice and home affairs, foreign and security policy, and economic and monetary union; the Treaty of Amsterdam (1 May 1999), the Treaty of Nice (1 February 2003) and the Treaty of Lisbon (1 December 2009), which made a number of changes to the institutional structure of the EU.

1.3 Following these changes, there are now two main Treaties which together set out the competences of the European Union: the TEU and the TFEU.

The Original EU Budget System Pre-UK Entry (1951-1973)

1.4 The European Coal and Steel Community (ECSC), under the Treaty of Paris (1951), was established to maintain peace in Europe following World War Two and to drive the economic growth of its members: Belgium; France; Italy; Luxembourg; the Netherlands; and West Germany, primarily within the energy sector. In pursuing these objectives it began the development of a European system of budgets for the separate policies of the new Communities. This system expanded with the Treaty of Rome (1957) and the creation of the EEC and the European Atomic Energy Community (EURATOM), sharing institutions with the ECSC.

1.5 Separate budgets existed for the Communities, covering administrative costs, operations, and research and investment in each area. By 1965, these budgets were unified into the first European budget system – the 'General Budget of the European Communities', with the ECSC and Euratom budgets incorporated into the EEC budget. Until 1970, this budget was funded solely through national contributions by Member States.

Own Resources

The Own Resources system refers to revenue collected from Member States to fund the EU Budget. This system has developed into a complex structure of four parts seen today:

Traditional Own Resources (TOR), which are mainly import duties on goods brought into any given Member State from outside the European Customs Union. Member States retain 25 per cent of import duties collected in order to cover collection costs, and pass 75 per cent on to the European Commission;*

- Value Added Tax (VAT)-based resource, calculated by applying a set call rate to a hypothetical harmonised VAT base;
- Gross National Income (GNI)-based resource, which reflects the residual EU Budget expenditure to be financed once TOR VAT-based contributions and 'Other' revenue (see below) are taken into account. The Commission estimates residual financing needs of the budget as the percentage of EU GNI, which is then applied uniformly to individual Member States' GNI. The GNI-based resource currently accounts for the largest share of own resources (68 per cent of total EU revenue in 2011); and
- 'Other' revenue, which includes income from EU staff, unspent money from previous years and any other income, for example, from fines levied by the European Commission.

* *The 25 per cent retained to cover collection costs is applicable under the current Own Resources Decision (that is, the 2007 Own Resources Decision) relating to the 2007–13 financial framework. Under the MFF deal achieved at the February 2013 European Council, this has been revised downwards to 20 per cent, but will need to be agreed by Member States under a new Own Resources Decision.*

1.6 The first system of Own Resources, the revenue side of the EU Budget – see text box below, was introduced in the Own Resources Decision of 1970, which included what are still the primary 'traditional' Own Resources of the budget: customs duties and agricultural levies, along with a VAT-based contribution originally capped at one per cent of a VAT base and applied gradually as progress was made in harmonising the VAT bases.

1.7 As a unified resource system was developed, the first common, unified expenditure policies were also being introduced. These included the European Agricultural Guidance and Guarantee Fund (EAGGF), greater expansion of research policy, a new European Social Fund (ESF) and European Regional Development Fund (ERDF). The ERDF was set up in 1975, championed particularly by the UK and Italy to ensure that EU membership could show tangible economic benefits at home. It has become the main way that the EU has implemented its regional policy.

Budgets Before Financial Perspectives (1973-88)

1.8 The first enlargement of the Communities in 1973 saw the accession of the United Kingdom along with Denmark and Ireland, with the new Member States gradually implementing the resources system which had been negotiated by the original six Member States.

Early Correction Mechanisms

The Fontainebleau European Council of June 1984 agreed the basis of what is now the UK's permanent 'abatement'. This set a reduction to the UK's contribution of 66 per cent of the difference between the UK's share in the EU VAT base and its share of total allocated expenditure. The UK had argued that a permanent correction was needed as a result of a particularly unusual budgetary balance – at the time of the European Council in 1984, the UK was by far the second largest net contributor to the budget, while also being the third poorest Member State of the ten (see data Chart 1.1 below).

This 1984 correction, the UK's abatement, was financed by other Member States through their usual financing shares. Germany, however, was able to argue that this created a separate imbalance and was allowed a correction of its own at Fontainebleau – a 33 per cent reduction on its share of financing the UK's abatement.

Today, as the 2014-2020 MFF period begins, several more Member States will receive corrections to their contributions (see text box).

1.9 The introduction of the UK correction, or abatement, was seen as a necessary rectification of a budgetary imbalance, as demonstrated in Chart 1.1.[1] At the time of the 1984 European Council in Fontainebleau, the UK was the third-poorest Member State, in terms of GNI per capita, while also making the second-largest net contribution to the budget. As a result, the June 1984 European Council agreed the following text (the Fontainebleau Principle), which remains the guiding principle behind budgetary corrections today. The Conclusions said that:

> Expenditure policy is ultimately the essential means of resolving the question of budgetary imbalances. However, it has been decided that any Member State sustaining a budgetary burden which is excessive in relation to its relative prosperity may benefit from a correction at the appropriate time.[2]

1.10 This high UK net contribution was primarily borne out of relatively low UK receipts from the budget, particularly in the area of agricultural spending, which dominated the EU Budget at this time. This was largely the result of an agricultural sector which was relatively small as a proportion of the overall UK economy, when compared to that of other Member States.

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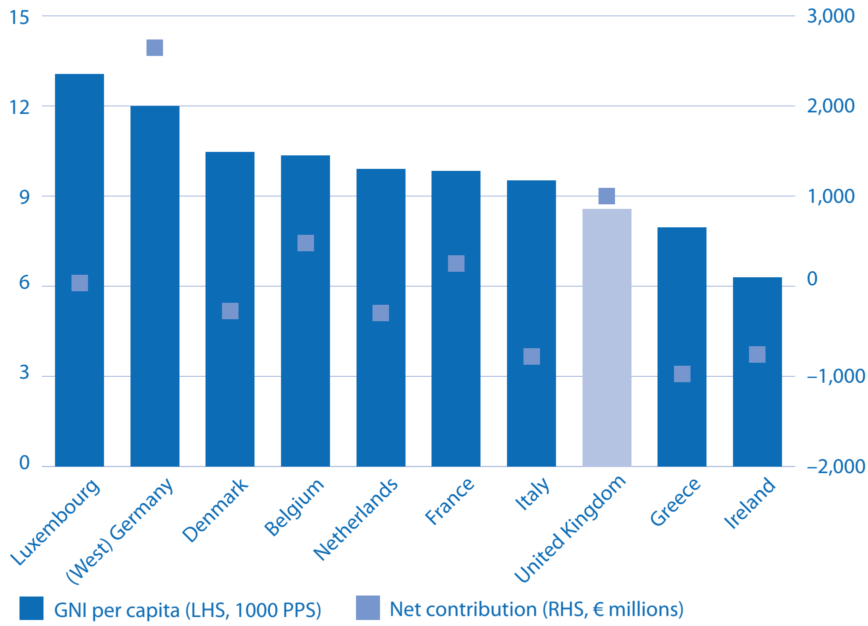
1 A term describing the disproportionate balance between a Member State's contribution to the EU Budget and the receipts that it receives. In some cases, a Member State may claim that its net balance is unfairly disproportionate to its economic size (as has been the case for the UK). In these cases, the Member State may request the introduction of a 'correction' to moderate their contribution to the budget.

2 Council of the European Union, *European Council Meeting at Fontainebleau*, Conclusions of the Presidency (1984).

Chart 1.1: Member States' Gross National Income Per Capita and Net Contributions to the EU Budget, 1983.



Source: Information derived from European Commission, *EU Budget 2008, Financial Report* (2009), pp 91-105. GNI at current market prices per head of population.

1.11 As further Member States joined the Community (Greece in 1981 and Spain and Portugal in 1986), the policies undertaken in the budget also grew, with growth in the ESF and ERDF, new policies in fisheries and research and rapid growth in agricultural spend under the EAGGF. New efforts to match increased expenditure with new resources saw the expansion of the VAT resource. The Fontainebleau European Council in 1984 agreed new expanded powers of budgetary discipline, controlling the growth of the EAGGF, with the Council aiming to reduce the rapid increase in the size of the budget as a whole.

1.12 The Brussels Merger Treaty (1967) made several significant changes to the structure of the budget, establishing much of the procedure which we recognise in the budget today. By 1977, the European Court of Auditors (ECA) had been established, by a UK-driven initiative intended to secure effective auditing of EU finances, and the European Parliament had been given powers of 'discharge' of the budget, the ability to reject the budget agreed by the Council and the ability to propose its own amendments to the Council's agreed budget.

1.13 This new structure, with increased powers for the European Parliament, saw several challenging negotiations of annual budgets – with several budgets through the 1980s not agreed in time for the New Year and therefore falling into contingency procedures. The EU Budget's natural evolution following progressive expansions has resulted in a gradual shift of focus. The budget began as a bargain between the founding Members and has developed into the current series of complex bargains based on the individual priorities of the growing number of Member States. This focus on Member States seeking to secure the best possible individual deal by getting at least as much from the EU Budget as they put in, rather than on the needs of the EU Budget as a whole, is known as *juste retour* and has contributed to the challenges faced in agreeing annual budgets.

1.14 In addition to this shift towards *juste retour*, the annual budget also took on an element of progressive redistribution with structural funds becoming emblematic of this evolution. The existence of this challenging system was a major factor in the introduction of the first financial perspective, which would later come to be known as the Multiannual Financial Framework (MFF).

Reform and Enlargement (1988-2013)

1.15 The crisis over annual budget agreements in the 1980s prompted a radical shift in the process and planning of the budget. European Councils in February 1988 and June 1988 adopted a series of new measures. Additional resources were required over 1988-92, more closely matched to Member States' relative prosperity. Annual budgets also saw prioritisation of expenditure towards the new cohesion policies, aimed at developing the poorer enlargement Member States' economies so that they converged toward the growth rates of the long standing Member States, and new efforts to slow the growth of agricultural expenditure.

1.16 The first Financial Perspective introduced multiannual planning to the budget, aiming to control growth year-by-year by setting ceilings on expenditure (total budget and category of spend) in advance by unanimity in Council, beneath which annual budgets needed to be set by Qualified Majority Voting (QMV).[3] In practice, the first Financial Perspective was adjusted on several occasions to reflect changing expenditure priorities, but the system brought improved certainty and stability to the budget.

1.17 The reform of the Own Resources system in 1988 brought the system closer to that in place today.[4] The VAT-based resource was changed to a capped system where a Member State's VAT base could no longer exceed 55 per cent of its Gross National Product (GNP), reduced to 50 per cent over 1995-99. The traditional Own Resources were reformed to a system whereby Member States retained ten per cent of duties collected to cover the costs of collection and paid 90 per cent to the EU Budget (over 1970-87, Member States contributed 100 per cent of their TOR revenue to the Commission, of which ten per cent was returned through the budget as expenditure in EU accounts). From 2001, the retention rate was increased to 25 per cent over the 2000-06 financial framework, with 75 per cent paid to the EU Budget. 1988 also saw the introduction of a fourth category of revenue – a contribution based on Member State GNP, which would be used as the 'balancing' resource (that is, making up the remainder of revenue required, adjusting for the income seen from other resources). This GNP resource has, over time, become the largest element of revenue to the budget.

1.18 The Edinburgh European Council of December 1992 agreed the first elements of the second Financial Perspective, for 1993-99. This Financial Perspective introduced the new Headings of the budget, splitting expenditure by policy priority, rather than by the mode of expenditure. The accession of Austria, Sweden and Finland in 1995 saw further correction mechanisms applied to the budget, benefitting the new Member States. A major adjustment of the 1993-99 Inter-institutional Agreement took account of the growth of the Community to 15 Member States, raising the level of expenditure across the budget and incorporating a new, temporary 'Compensations' heading for the new Member States which ensured that they would not receive less from the budget while they were phasing into the system than they did as pre-accession countries.[5] Otherwise, the second Financial Perspective remained largely stable throughout the rest of the period.

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3 Interinstitutional Agreement on Budgetary Discipline and Improvement of the Budgetary Procedure (1988).

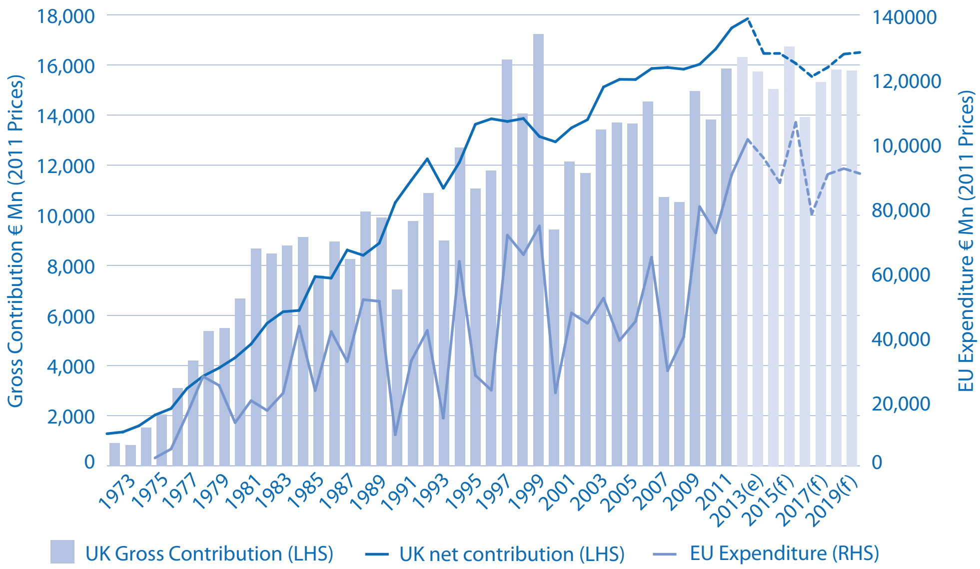
4 Decision 88/376/EEC on the System of the Communities' Own Resources, 1988.

5 Interinstitutional Agreement on Budgetary Discipline and Improvement of the Budgetary Procedure, 1993.

1.19 The third and fourth Financial Perspectives, covering 2000-06 and 2007-13 were marked by the rapid expansion of the European Union, with a total of 12 new Member States acceding to the Union in 2004 and 2007. This had several major impacts on the budget system, most notably a substantial increase in the size of the budget which by this time accounted for approximately €100bn a year in payment appropriations.

1.20 A greater focus towards the Structural and Cohesion Funds (SCFs), which particularly benefited the new Member States, saw increased expenditure in that area to target economic cohesion between the richer and poorer regions of the expanded EU, while expenditure on development, on climate action and on research and development also increased substantially. Enlargement from the 1980s onwards resulted in the inclusion of less affluent countries. This began with the Mediterranean expansion to Greece in 1981 followed by Spain and Portugal in 1986. Expansion to include Central Eastern European countries spanned the 1990s culminating in the 2004 enlargement to include the A8 countries. This increase in expenditure on SCFs, and in new Member States in particular which were eligible for pre-accession funding to assist with necessary political and economic reforms before joining the EU, saw the development of a large stock of commitments which have not yet been translated into payments, known as 'RAL', which put significant uncertainty on the payments side of the budget and therefore on contributions from Member States.

Chart 1.2: EU Budget Expenditure and UK Contributions (1973-2011).



Source: European Commission, *Commission Financial Report for 1973-2008 Gross Contributions Data and 1973-2006 EU Expenditure Data* (2008); European Commission, *Commission Financial Report for 2009-11 Gross Contributions Data and 2007-2011 EU Expenditure* (2011); European Commission, *Commission Financial Report for 2012 Gross Contributions Data and 2012 EU Expenditure Data* (2012).

1.21 The system of Own Resources remained largely unchanged from 2000 to 2013, with a greater proportion of contributions coming through the GNI-based resource, which effectively replaced the GNP-based resource with the introduction of the Own Resources Decision (ORD) agreed on 29 September 2000. This stated:

> It is appropriate to use the most recent statistical concepts for the purposes of own resources and accordingly to define gross national product (GNP) as being equal for these purposes to gross national income (GNI).[6]

1.22 This ORD came into force on 1 January 2002 and the formal change to the GNI-based resource happened as part of the current ORD, effective from 1 January 2007.

1.23 In 2005, as part of the negotiations for the 2007-13 Financial Framework, the then UK Government agreed to adjust the UK's abatement, so that non-agricultural expenditure in the new Member States would not count towards the calculation of the UK abatement. This 'disapplication' was seen to be part of the support for new Member States and was phased in gradually over 2009-11. It resulted in a substantial decrease in the size of the abatement and increased sensitivity of the value of the abatement to rebalancing of spending towards new Member States.[7]

1.24 The European Council agreements on the 2014-20 MFF in February 2013 set out a new phase in the history of the EU Budget.[8] For the first time, Heads of Government agreed a real-terms reduction in multi-year expenditure ceilings. The UK's abatement was also left unchanged. The new MFF Regulation, setting this historic agreement into EU law, was adopted in December 2013.

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6 Council Decision 2000/597/EC on the system of the European Communities own resources, 2000.

7 In May 2013, the European Commission estimated the cost of the abatement 'disapplication' over the 2007-2012 at more than €9bn.

8 Regulation 11791/7/13 REV 7 laying down the Multiannual Financial Framework for the years 2014-2020, 2013.

Chapter 2: Current State of Competence

2.1 The EU Budget procedures, documented in the previous chapter, have evolved to form the system which we have in place today. This chapter sets out the latest developments in the EU Budget and how the current legal framework operates.

The Current EU Budget System

2.2 The structure and priorities of the EU which exists today are considerably different to those seen when the organisation was created by the Treaty of Paris (1951). The Member States of today's EU, emerging from a global financial crisis, are greater in number and more economically diverse than at the organisation's inception. There is also a broad spectrum of priorities across the Member States reflecting different economic, social and political circumstances. The EU's policies, and how they are financed by the budget, have to be agreed between these diverse Member States.

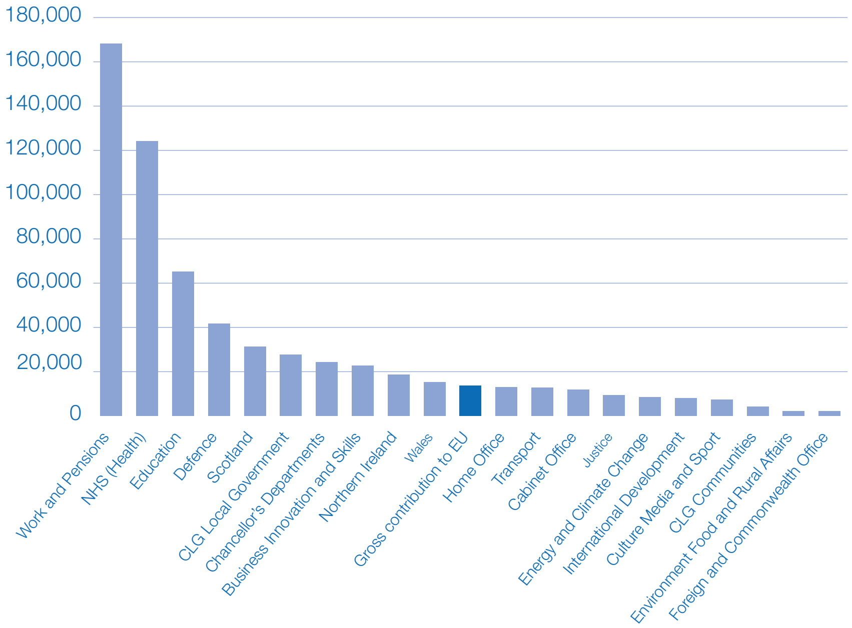
2.3 Indeed, many areas of reform would require unanimity in Council, and with the agreement of other institutions including the European Parliament, to deliver. While unanimity has assisted the pursuit of UK national interests, such as blocking increases to the EU Budget, it has also served as a block to other important UK priorities as evidenced by France's obstruction of the UK-driven reforms to CAP spending. Conversely, the use of QMV on less significant issues has allowed for some progress in other areas that is often in the UK's interests.

2.4 This political reality means that the budget today is a product of compromise and cannot always reflect the UK's preferences, or those of any other Member State, in every policy area. It also explains why the budget's evolution over the years has been gradual rather than radical. The EU Budget is primarily agreed through action by three key institutions – the budgetary authorities of the Council and European Parliament and the European Commission, who are responsible for proposing new budgets and for implementing EU Budget expenditure.

2.5 The European Commission makes proposals for the regulations and decisions set out in this chapter, including the MFF which sits above the annual budgets that decide actual spend in each year. The Council and European Parliament then agree final budgets, initially the European Council in the case of the MFF, with MEPs and Ministers voting by the rules set out below.

2.6 The European Council agreed the 2014-2020 MFF in February 2013. This marked a new phase in the history of the EU Budget. For the first time, Heads of Government agreed a real-terms reduction in multi-year expenditure ceilings. The financing side of the budget, the Own Resources system, was largely unchanged and the UK's abatement was left unchanged by the agreement. The impact of the new ceilings was set out in the Office of Budgetary Responsibility's (OBR) March 2013 'Economic and Fiscal Outlook', which estimated that UK contributions to the EU were reduced by £3.5bn over the forecast period to 2017-18.[1] A comparison of the UK's gross contribution to the budget against the annual budgets for UK Government departments is set out in Chart 2.1 below.

Chart 2.1: Total Managed Expenditure by Departmental Group and Gross Contribution to the EU Budget 2012-13.



Source: PESA (March 2014). HM Treasury, *Public Spending Statistics* (April 2014).
Available at: www.gov.uk/government/publications/public-spending-statistics-release-april-2014, accessed on 10 May 2014.

2.7 Further reform of the budget in the February 2013 European Council agreement saw modestly greater shares of total expenditure towards research and innovation, while a substantial new area of spend, the Connecting Europe Facility, provided greater funding for infrastructure in transport, energy and the media. For more on the content of the budget headings, see the text box below. The UK's abatement remains, without further alteration.

2.8 For the first time, the new long-term framework was agreed under the terms of the Treaty of Lisbon, requiring formal consent of the European Parliament which was granted in November 2013. The MFF Regulation was then formally adopted by Council in December 2013.[2]

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1 Office of Budgetary Responsibility (OBR), *Economic and Fiscal Outlook* (2013).

2 Council of the European Union, Council Regulation 11791/7/13 REV 7 Laying Down the Multiannual Financial Framework for the Years 2014-2020, 2013.

2014-2020 Budget Headings

For 2014-20, the budget framework is split into six broad areas of expenditure (the headings of the budget), as set out below.

1. Sustainable Growth

   1a. Competitiveness for growth and employment (including Connecting Europe); Research and innovation; education and training; trans-European networks; social policy; economic integration; and accompanying policies.

   1b. Cohesion for growth and employment; including Structural and Cohesion Funds. Convergence of the least developed EU countries and regions; EU strategy for development outside least prosperous regions; inter-regional cooperation.

2. Preservation and Management of Natural Resources

   2. Includes CAP (encompassing market-related expenditure and direct payments to farmers); common fisheries policy; rural development; and environmental measures.

3. Citizenship, Freedom, Security and Justice

   3a. Freedom, security and justice; justice and home affairs; border protection; immigration; and asylum policy.

   3b. Citizenship; public health; consumer protection; culture; youth; information; and dialogue with citizens.

4. EU as a Global Player

   4. Covers all external action ('foreign policy') by the EU. It does not include the European Development Fund.

5. Administration

   5. Covers administrative expenditure of all the European institutions, pensions and EU-run schools for staff members' children ('European schools').

6. Compensations

   6. Temporary heading which includes compensatory payments relating to the latest expansion of the EU.

The Current Treaty Framework of the European Union

2.9 There are now two main Treaties which together set out the competences of the European Union: TEU and TFEU.

2.10 Article 5(2) of the TEU specifies that the Union has the competence to act 'only within the limits of the competences conferred upon it by the Member States in the Treaties to attain the objectives set out therein', known as the principle of conferral. The two main Treaties, the TEU and the TFEU, set out the legal basis for Union action in relation to various policy areas such as the Single Market, economic and monetary policy and energy policy.

2.11 In some policy areas, such as the customs union, the EU has exclusive competence to act, which means that only the EU may legislate and adopt legally binding acts in those areas unless the Member States are expressly empowered by the EU to act (Article

2(1) TFEU).[3] In other areas, such as the Single Market and consumer protection, the EU and the Member States share competence in which case the Member States may exercise their competence to the extent that the EU has not exercised, or has decided to cease to exercise, its competence (Article 2(2) TFEU).[4] The EU also has coordinating and supporting competence in certain areas, such as the protection and improvement of human health, to carry out actions to support, coordinate or supplement the actions of the Member States without superseding their competence in those areas (Articles 2(5), 5 and 6 TFEU).

EU Legislative Process

2.12 EU legal acts such as regulations and directives are generally adopted by what, after the Lisbon Treaty, is known as the 'ordinary legislative procedure' (formerly known as the 'co-decision procedure'). In most cases, only the European Commission can propose a new legal act. But it cannot become law unless it is jointly adopted by the Council, which is composed of ministers from each Member State, and the European Parliament. Under this procedure, the Council acts on the basis of QMV, where only a specified majority of votes is required and the share of votes of each Member State reflects its population size.

2.13 The Treaties also set out a small number of cases where EU legal acts are adopted under different procedures, referred to as 'special legislative procedures'. For example, acts in some areas, such as foreign and defence policy, can only be adopted if the Council acts unanimously, so the act will not be adopted if a Minister from any one Member State vetoes it.

The Treaty

2.14 Articles 310 to 325 of the TFEU set out the legal basis for the EU Budget, covering the funding of the budget, the MFF and the annual budget.

2.15 The funding of the EU Budget, the Own Resources system, is covered in Article 311 TFEU. This states that the Council shall unanimously, after consulting the European Parliament, adopt a decision laying down provisions relating to the system of own resources. This must then be approved by all Member States in accordance with their respective constitutional requirements. In the UK's case, approval requires an Act of Parliament.

2.16 Long-term EU Budget ceilings are established in the MFF which is covered in Article 312 TFEU. This provides that the Council, acting unanimously after obtaining the consent of the European Parliament, shall adopt a regulation laying down the MFF. The documents that comprise the MFF are scrutinised by the UK Parliament but do not need to be approved through an Act of Parliament.

2.17 The EU annual budget is covered in Articles 313 to 319 TFEU. These articles set out the broad process for each year's annual budgetary procedure, including the role of the European Commission, the Council, the European Parliament and the ECA.

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[3] See article 3 TFEU for the list of areas in which the Union has exclusive competence to act.

[4] See Article 4 TFEU for the areas in which the Union shares competence with the Member States.

2.18 Each annual budget is agreed by a qualified majority of the members of the Council and by a majority of the members of the European Parliament. The documents that comprise each annual budget are scrutinised by the UK Parliament but do not need to be approved through an Act of Parliament.

2.19 The TFEU sets out rules relating to the MFF and annual budget. Article 312 states that each MFF should last at least five years and should set ceilings in commitment appropriations (planned spend each year) and payment appropriations (actual spend each year). Article 312 and Article 315 set out what happens in the case where no MFF or annual budget is agreed. There is little detail in the TFEU on what the EU Budget should be spent on: Article 312 states only that categories of expenditure shall correspond to the EU's major sectors of activity which are then set out in other documents.

2.20 Further procedures on the budget are set out in a series of legal instruments, described in greater detail below.

The Multiannual Financial Framework (MFF) Regulation

2.21 The MFF Regulation sets out the annual ceilings on commitments and payments (i.e, the maximum amounts that can be spent).[5] It also sets out the high level rules of the operation of the budget for that period.

2.22 Agreement by Council to the MFF Regulation signals the codification of the MFF in EU law, thereby allowing spending under the MFF subject to agreement to the various sectorial regulations (see below). The MFF Regulation also sets out the budget for, and limits of, 'off-budget' items described in the text box below.[6] The Council agrees the MFF Regulation unanimously after obtaining the consent of the European Parliament. The adoption of the 2014-20 MFF by the European Parliament is the first time a free standing MFF Regulation has been adopted. Prior to the Lisbon Treaty, the MFF was provided for in an Inter Institutional Agreement (IIA). For instance, the 2007-13 IIA, setting out multiannual ceilings was adopted under a pre-Lisbon procedure by consensus in Council and with the agreement of the European Parliament. See Chapter One for more information on the system prior to the Treaty of Lisbon.[7]

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5 OBR, *Economic and Fiscal Outlook*.

6 OBR, *Economic and Fiscal Outlook*, citing MFF Regulation; Regulation 1927/2006 establishing the European Globalisation Adjustment Fund, 2006.

7 Interinstitutional Agreement 2007-2013 between the European Parliament, the Council and the Commission on Budgetary Discipline and Sound Financial Management, 1996.

'Off-budget' Items

The EU Budget system includes a series of items 'outside the MFF'. These 'off-budget' items are set out in the MFF Regulation and are financed through the EU Budget. They provide flexibility and additional funds if needed within a budget year.

Flexibility Instrument

This allows the financing, for a given financial year, of clearly identified expenditure that could not be financed within the limits of the ceilings available for one or more other headings.

Emergency Aid Reserve

Allows for a rapid response to specific aid requirements of third countries following events which could not be foreseen when the budget was established, first and foremost for humanitarian operations, but also for civil crisis management and protection.

European Solidarity Fund

Allows financial assistance in the event of major disasters occurring on the territory of a Member State or of a candidate country

European Globalisation Adjustment Fund

Provides specific, one-off support to facilitate the re-integration into employment of workers in areas, sectors, territories or labour market regions suffering the shock of serious economic disruption.

The **European Development Fund (EDF)** is sometimes considered to be an off-budget item, but is not financed through the EU Budget system. It is instead funded by Member States through a separate contribution. More detail on the EDF is provided in the Development Cooperation and Humanitarian Aid report, in the first semester of the Balance of Competences Review.

2.23 Annual budget Regulations are adopted in each year of the MFF period, with the budget size agreed in each year set at a level within the ceilings of the MFF as outlined in the MFF Regulation. Like the MFF Regulation, Annual budget negotiations begin with a proposal from the European Commission followed by agreement of the Council and European Parliament. The Council, as set out above, agrees the annual budget by QMV.

2.24 Within annual budget years (i.e. when spending is taking place), however, the European Commission will in most years present a 'draft amending budget' (DAB). DABs seek to adjust the annual budget agreement to take into account changing needs, or requirements for additional expenditure or use of 'off-budget' flexibilities. Many of these DABs therefore include a request for (sometimes substantial) additional budget expenditure within the MFF ceilings. As amending budgets represent an amendment to the original annual budget, they are agreed in the same way – by QMV in Council and requiring the agreement of the European Parliament. The UK has been heavily critical of the number and scale of DABs proposed by the European Commission in recent years.

The MFF Inter-Institutional Agreement (IIA)

2.25 The MFF IIA sits underneath the MFF Regulation, in effect providing more detail on the procedures of the budget, for example on how the 'off-budget' mechanisms will work and on how annual budgets will work.[8] The IIA cannot set the levels of spending within the MFF as this can only be done through the MFF Regulation.

2.26 The Council agrees this instrument by QMV and through the ordinary legislative procedure with the European Parliament. The most recent version was agreed concurrently with the 2014-20 MFF Regulation.

The Own Resources Decision (ORD)

2.27 The ORD sets out how the budget will be financed by Member States. This instrument sets out the rules by which contributions to the EU Budget are made. The current system means Member States broadly make contributions according to their relative economic size.

2.28 The ORD also contains correction mechanisms, including the UK abatement and those for several other Member States, as described in the text box below. These are aimed at adjusting for the relative low receipts of some countries and compensating for 'excessive' budgetary burdens in relation to their relative prosperity, drawing on the Fontainebleau Principle, set out in Chapter One.

Correction Mechanisms for Other Member States

In addition to the UK, several other Member States who are net contributors have made the case that their contributions represent an 'excessive' budgetary burden in relation to their wealth. For the 2014-20 period it has been agreed, subject to the approval of the ORD by all Member States, that five other Member States will have correction mechanisms of their own. These are split into three types:

Correction on the contribution to the UK abatement

The UK abatement is financed by the other 27 Member States, but Austria, Germany, the Netherlands and Sweden pay only 25% of their normal share. As this is an inherent part of the UK abatement mechanism, it is a non-time limited agreement and therefore continues to apply through the current ORD.

Reduced VAT contribution

The rate of call of the VAT-based own resources for Germany, the Netherlands and Sweden will be fixed at 0.15% for 2014-20; all other Member States have a rate of call of 0.3%.

'Lump sum' correction

For 2014-2020, Denmark, the Netherlands and Sweden will benefit from gross reductions in their annual GNI contribution of €130 m, €695 m and €185 m respectively. Austria will benefit from gross reductions in its annual GNI contribution of €30 m in 2014, €20 m in 2015 and €10 m in 2016 (all figures in 2011 prices).

[8] Interinstitutional Agreement 2014-2020 between the European Parliament, the Council and the Commission on budgetary discipline and sound financial management, 2013.

2.29 The ORD fleshes out the Treaty obligation to finance the EU Budget and the form of its adoption following national approval requirements and procedures meaning that its status is very close to that of the Treaties themselves. The successive ORDs have been designated as Union Treaties under the European Communities Act 1972.

2.30 The Council agrees the ORD by unanimous voting. The European Parliament is consulted following which the ORD must then be approved by Member States in accordance with their respective constitutional requirements. In the UK's case, approval requires an Act of Parliament.

The Own Resources Regulations

2.31 At present, the implementing measures for the EU's own resources are provided for by a single Regulation adopted by the Council after consulting the European Parliament. This Regulation is adopted by QMV. This is in the process of being split into two Regulations, the 'Implementing Regulation' and the 'Making Available Regulation' which are estimated to come into effect in January 2016 and apply retroactively.

Table 2.1: UK Transactions with the European Union

	£ billion						
	Outturn	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Expenditure transfers to EU institutions							
GNI based contribution	12.3	13.8	13.1	12.9	13.0	12.4	13.1
UK abatement	–3.2	–4.1	–4.2	–4.0	–4.4	–4.7	–4.5
Receipts from the EU to cover the costs of collecting Traditional Own Resources[2]	–0.7	–0.8	–0.7	–0.7	–0.7	–0.7	–0.7
less other attributed costs[3]	–0.1	–0.1	0.0	0.0	0.0	0.0	0.0
Total contribution to TME and PSNB[1]	8.3	8.9	8.1	8.1	7.9	7.1	7.9
Traditional Own Resources[2]	2.9	3.1	3.0	3.2	3.5	3.4	3.5
VAT payments to the EU[4]	2.4	2.2	2.6	2.6	2.7	2.8	2.9
Public sector receipts from the EU[5]	–4.0	–5.2	–4.6	–4.6	–4.6	–4.8	–5.0
Net payments to EU institutions	9.6	8.9	9.1	9.4	9.5	8.5	9.3
plus other attributed costs[3]	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Net contribution to the EU budget	9.7	9.0	9.1	9.4	9.5	8.5	9.3
Gross contribution to the EU budget[6]	13.7	14.2	13.7	14.0	14.1	13.3	14.4

[1] These contributions are included in current AME – see table 4.17 in the March 2014 *Economic and fiscal outlook*.

[2] Traditional Own Resources (TOR) consists of customs duties and sugar levies. These dutis are excluded from public sector current receipts because they are collected on behalf of the EU. Customs duties include duties on agricultural products. Under the current EU financial framework, the UK, like all Member States, retains 25% of the amount of TOR it collects to cover the costs of collection and this reduces TME in the National Accounts. This will change to 20% in the next financial framework, then the new Own Resources Decision comes into force.

[3] These figures relate to the cost of additional receipts for DECC and DEFRA (from the EERP, CAP health check, school fruit, food aid programmes) under the Department Pays Principle.

[4] Contributions calculated by applying a call-up rate, currently 0.3%, to a notional 1% harmonised VAT base. Not included in public sector current receipts because treated as an EU tax in the National Accounts.

[5] These receipts are not netted off public sector expenditure in the national accounts, because they are deemed to finance spending by the EU.

[6] Calculated as the net contribution to the EU budget, excluding pubic sector receipts from the EU.

Source: Office for Budgetary Responsibility (OBR), *Transactions with the European Union* (2014).

The Sectorial Regulations and Financial Management

2.32 Each area of spending has a regulation to provide the legal basis for their operation. These are the legal documents which underpin all EU programmes under the MFF and set the levels for those programmes. The majority are co-decided with the European Parliament and agreed by QMV in Council.

2.33 Detail on this spending is explored in individual Balance of Competences reports on each area. Reports on the largest areas (Structural and Cohesion Funds and Agriculture) will be published concurrently with this report.

2.34 The European Commission is obliged to take appropriate measures to ensure that, when actions financed under these regulations are implemented, the financial interests of the EU are protected. This protection takes the form of the application of preventive measures against fraud, corruption and any other illegal activities, effective checks and, if irregularities are detected, the recovery of amounts wrongly paid and, where appropriate, effective, proportionate and dissuasive administrative and financial penalties.

2.35 Member States are under a legal obligation (Article 325 TFEU and the Convention on the Protection of Financial Interests) to counter illegal activities at the expense of the EU and make fraud against the EU Budget punishable criminal conduct.

2.36 Article 325 of the TFEU provides that Member States shall counter fraud and any other illegal activities affecting the financial interests of the EU, by taking measures that act as a deterrent and effectively protect the EU Budget. The European Commission proposed a new Directive to protect the financial interests of the EU, which is currently being negotiated.

2.37 The OLAF may carry out investigations, including on-the-spot checks and inspections, in accordance with the provisions and procedures laid down in Regulation 883/2013/EC (which came into force on 1 October 2013, replacing Regulation 1073/1999/EC and Regulation (EURATOM) 1074/1999 of the European Parliament and of the Council concerning investigations conducted by the OLAF. This regulation permits on-the-spot checks and inspections to be carried out by the Commission / OLAF in order to protect the European Communities' financial interests against fraud and other irregularities.

Financial Management, Budget Discharge and Fraud

The European Commission implements the EU Budget in accordance with the principles of sound financial management. The European Court of Auditors (ECA), the independent external auditor of the EU, publishes an Annual Report on the implementation of the EU Budget, with one component being the Statement of Assurance (DAS) – an opinion on the Commission's accounts (checking if the books were well kept) and EU expenditure (checking if transactions were made in accordance with the rules). The ECA audits the budget based on sample transactions throughout the year, at EU, national, regional and individual beneficiary level, and provides an estimate of the 'error rate' in the budget. This reflects the ECA's estimation of the degree of non-compliance with the rules governing EU spending, such as breaches of public procurement rules, ineligible or incorrect calculation of costs claimed to the EU co-financed projects or over-declaration of land by farmers. In other words errors may or may not be suspected as fraudulent.

Error

In its latest report concerning the 2012 accounts, the ECA concluded that some payments were affected by material error, with an estimated error rate of 4.8 per cent for the EU Budget as a whole. The ECA regards 2 per cent as an acceptable level of error, and may refuse to give an unqualified DAS unless error rates are below that level. On this basis, the ECA has signed-off the EU Budget accounts but has been unable to give an unqualified DAS for nineteen consecutive years.

Budget Discharge

The budget 'discharge' is the final annual approval of the Commission's implementation of the budget. It is the responsibility of the European Parliament to decide whether it will grant this, based in part on a recommendation from the Council and on the ECA's report. The European Parliament can refuse to grant the Commission 'discharge' for its management of EU funds in a given year, with serious political consequences for the Commission's future. For example, the non-granting of the discharge for 1996 initiated the process which led to the fall of the Santer Commission. Several Member States, including the UK, have criticised the current state of financial management. The UK Government has not voted in favour of discharge of the EU Budget for the last three years.

Financial Management, Budget Discharge and Fraud *continued*

Fraud

Any suspicion of fraudulent activity involving EU funds is reported to OLAF. OLAF is an administrative investigative service of the EU, with the mission of combating fraud, corruption and other illegal activities affecting the EU, including serious misconduct within the EU institutions. It aims to ensure that EU taxpayers money is spent appropriately, that the EU is not being deprived of due revenue and that EU staff behave according to rules and regulations. OLAF also assists the Commission and national authorities in combating fraud and contributes to strengthening of anti-fraud measures. It works closely with national authorities investigation services, police, legal and administrative authorities to counter fraud. In the annual Fight against Fraud report for 2012, the Commission estimates that the financial impact of irregularities reported as fraudulent for 2012 was €399m.

The UK Government has expressed disappointment that the ECA has been unable to give an unqualified Statement of Assurance to the EU Budget for 19 consecutive years. The ECA's findings undermine the credibility of the EU Budget and clearly show that the UK's strong stance on financial management is justified. When countries across Europe are taking difficult decisions to tackle their deficits, taxpayers need to have confidence that every effort is being made to improve the management of EU funds.

Chapter 3: Impact on the National Interest

Overview

3.1 This chapter considers the evidence received in the call for evidence period. It will first look at the national interest regarding the EU Budget, recognising the spectrum of views on the issue, including the UK Government's view of what is in the national interest and views from stakeholders. Second, this chapter will analyse the evidence received in response to the call for evidence document published in October 2013. This will look at questions of whether the budget system, priorities, size and mechanisms operate counter to, or in support of, the UK's national interest.

3.2 In the first section, the chapter will discuss views heard from stakeholders on the national interest in relation to the EU Budget. It is that understanding of the national interest, and the differing views on what the national interest means in the context of budget negotiations, which underpins the discussion of the application of competence on the EU Budget.

3.3 In the second section, the chapter splits into three sub-chapters, recognising the three thematic areas of the budget system. The focus in this chapter is on the application of competence on the EU Budget, rather than the balance of competence itself, which was not discussed substantially in the evidence received (although discussion of new own resources for the EU Budget does touch on an area of exclusive national competence).

- Agreeing the budget: covering views on the fundamental rationale for the EU Budget, the overall scale of the budget, the roles of institutions in budget negotiations (and how these roles can impact on the lack of reform in the budget) and the relationship between MFF and annual budgets.
- Spending the budget: considering the value for money of the budget, views on the comparative value of major areas of expenditure (and the correction mechanisms linked directly to expenditure areas) and the particular delivery methods of expenditure.
- Running the budget: which includes the financial management structures of the budget, the role of the ECA, the budget's major structures (primarily the commitments and payments system) and the revenue system for the budget (Own Resources).

3.4 Each of these sections has been set out with a summarising question, which aims to provide a framework for consideration of the evidence submitted, alongside the UK Government's views on the national interest in that area.

The National Interest

3.5 In assessing whether the application of competence in the EU Budget, as it currently stands, is aligned to the UK national interest, it should first be noted that a range of views exist on what the UK national interest is in relation to the budget. Evidence received considered a variety of interests as the primary UK national interest: from restraining the size of the budget and limiting the expense to taxpayers; to retaining the UK's abatement; and, in some cases, to targeting increased UK receipts from the budget. Some of these interests, naturally, present contradictions which make an assessment of whether the budget is in the UK's national interest dependent on individual consideration of priorities. Some of those views are presented in this section, along with the view of the UK Government.

3.6 The UK Government has taken a clear view on the need for restraint and reform in the EU Budget, through recent negotiations on the MFF, annual budgets and the Own Resources Decision. The UK's overriding priority through these negotiations, particularly on the MFF, has been to seek restraint in the size of the budget, with the consequent moderation in the UK's contribution to the EU Budget thereby contributing to deficit reduction in the UK.

3.7 The UK Government set out in June 2010 the view that 'the most urgent task facing this country is to [...] reduce the deficit'.[1] This was part of the Government's plan to return the public finances to a sustainable path, which has restored fiscal credibility, allowing activist monetary policy and the automatic stabilisers to support the economy.

3.8 The relationship of the EU Budget to deficit reduction plans is clear and direct – the UK's contribution to the EU is made through the UK national budget. Most changes to the overall size of the EU Budget, to the revenue system or even to the distribution of EU expenditure between headings of the budget or Member States, will have an impact on the UK's contribution. As a result, the UK has consistently been guided by an overall priority to restrain the size of the budget, thereby restraining the UK's contribution to the EU.

3.9 In the view of the UK Government, therefore, restraining the size of the EU Budget is seen as being firmly in the UK national interest. Protecting the UK's abatement, with its own impact on the UK contribution to the EU, is also a clear priority, as the Prime Minister noted following the European Council political agreement on the MFF in February 2013:

> As a result [of the disapplication of sections of expenditure from the UK's rebate calculation in 2005], almost whatever budget deal was done; our net contributions were always likely to go up As a result of this deal, however, they will be going up by less. The only two sensible things we could do to protect the British taxpayer in these negotiations were to get the overall budget down and to protect what is left of our rebate.[2]

3.10 The UK Government has also taken clear positions on the distribution of expenditure between headings and Member States. The UK has consistently argued for increased expenditure on research and innovation and international development – and a substantial reduction in the size of the budget allocated to the Common Agricultural Policy, focussed on direct payments, and administration. The UK has argued that Structural and Cohesion Funds should be directed primarily towards poorer regions in poorer Member States, rather than being redistributed around rich Member States. However, within the UK, the Devolved Administrations have differing views on the approach to structural funds. This domestic difference of opinion on the national interest is not unique to the UK and has also been seen in Germany, specifically with regard to structural funds. These priorities, in the

1 HM Treasury, *Budget 2010* (2010) p1.

2 HC Deb 11 February 2013, vol 558, col 570.

view of the UK Government, recognise the positive impact that a well-targeted, restrained EU Budget can have on the UK national interest, through growth and stability across Europe.

3.11 However, views on the aims of the budget, and therefore how EU Budget funds should be distributed between budget headings, relies on agreement on the fundamental purpose of the budget itself. Responses from the academic community, and discussion at the academic round-table event during the call for evidence period particularly considered the uncertainty around the purpose of the budget.

3.12 Much of the evidence received as part of this report has recognised the political and economic importance to the UK of restraining the size of the EU Budget. However, just as there is debate about how the EU Budget impacts on the national interest, there is equally debate about the national interest itself, with respondents raising several other potential focuses for the EU Budget, relating to the UK interest.

3.13 In considering 'the rationale for having an EU Budget', the Centre for European Reform argued that the fundamental rationale was 'to help poorer parts of the EU develop economically. This is good for those places, but also good for the UK, given economic and trade links'.[3] This suggests that the EU Budget could aid the UK national interest through promoting collective growth across Europe.

3.14 Others referenced the impact receipts from the UK budget could have on the UK domestic economy. The Russell Group particularly stressed this point, focussing on research and innovation, an area of the budget where UK institutions are particularly well-placed to receive substantial funding from the EU Budget:

> EU funding streams are key to the continued growth of research excellence in the UK, to innovation and to the creation of economic value [...] Overall, investment in EU funding streams for research and development generates an excellent return for the UK economy.[4]

3.15 Finally, several respondents made the link between the EU Budget and the UK national interest through the effect of sharing the strain on public finances. World Wildlife Fund UK (WWF-UK) argued that the budget adds value in:

> All areas where each Euro spent at the European level is more effective than a Euro spent at the national level, resulting in reduced overall public spending for achieving the same results (or same overall public spending for better results).[5]

An assessment of the 'added value' of the EU Budget could therefore, in the views of some respondents, be key to assessing the EU Budget and the UK national interest.

3.16 The Welsh Government acknowledged the need for overall budget restraint – in the UK's national interest, though wanted to avoid an outcome that led to large cuts to income for its rural areas. It also wanted to ensure that Structural Funds would be able to support local disadvantaged communities.[6] The consideration of evidence relating to the value of the EU Budget will follow in the *Spending the Budget* section of this chapter.

3.17 George Lyon MEP specified the need to go beyond the classification of the UK as an overall net contributor and to take into consideration wider benefits which impact other Government priorities, such as job creation and exports that flow from being in the EU

[3] Centre for European Reform, *submission of evidence*.

[4] Russell Group, *submission of evidence*.

[5] WWF-UK, *submission of evidence*.

[6] Welsh Government (Jane Hutt AC/AM), *submission of evidence*.

Single Market.[7] Business for New Europe also argued that the UK gains more out of the Single Market than it contributes.[8] When considering the EU Budget and its impact on the UK national interest, it may also be helpful therefore to consider the wider benefits of EU membership discussed in other reports of the Balance of Competences Review, such as the Research and Development report, to which the UK's contribution to the budget grants access.

Agreeing the Budget

To what extent does the long-term structure of the budget, and the decision-making processes that agree it, have an impact on the national interest?

3.18 In this section, we consider evidence taken on the overarching processes which agree the EU Budget, including the MFF, annual budget and Own Resources Decision. We consider the negotiation and agreement processes for setting budgets in the long and short term; the voting rights of the institutions in those negotiations; and the length of long-term budget plans. We also consider the total size of the EU Budget, particularly over the medium to long term (for example, 2014-20).

Size of the Budget

3.19 The overall rationale for the budget was seen by many to have a close relationship with the overall size of the budget, an approach seen in recent negotiations. Several respondents, particularly from the academic community, noted that the EU Budget, when compared to federal budgets was comparatively small. The comparison between the EU Budget and federal budgets was originally made as part of the 1977 *MacDougall Report*, which considered the future of the EU Budget at that time:

> As regards the general level of economic activity, the instruments remain very largely in national hands, but since public expenditure at the Community level might rise from the present level of 0.7% to 2 – 2½% of gross product, it might be possible for Community finance to play some part in stabilisation and growth policy [...] There is a strong contrast between this situation and that of a large public sector federation, like the federations already in existence [...] In existing federations like the United States and the Federal Republic of Germany, federal public expenditure is around 20 to 25% of GNP.[9]

3.20 This comparison between the EU Budget and federal budgets (particularly those of Germany and the United States), was seen in several responses suggesting that there was a case for a large EU Budget, depending on the tasks set for the budget to perform.[10]

3.21 Whether this is the 'right' comparison, however, is a matter of substantial debate. On one side, some respondents suggested that a budget of approximately one per cent of EU GNI may not be of significant enough size to have a measurable economic impact across the EU.[11]

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7 George Lyon MEP, *submission of evidence*.

8 Business for New Europe, *submission of evidence*.

9 Commission of the European Communities, *Report of the Study Group on the Role of Public Finance in European Integration* (1977) p 20.

10 Dr Giacomo Benedetto, *submission of evidence*.

11 *Note of Academics' EU Budget Seminar, London 10 January 2014.*

3.22 Others, however, recognised that the current aims of the EU Budget, and the policies that it funds, are not generally consistent with those of national budgets:

> The EU Budget totals less than 1% of EU gross national income, as it does not need to mirror national budgets, for instance for funding direct health care for citizens, or for the running of schools. National budgets do those things.[12]

3.23 Indeed, the *MacDougall Report* itself accepted this point to an extent, recognising at that time the potential evolution of 'a small public sector federation in which the supply of social and welfare services (health, education, social security and welfare) would essentially remain at the national level'.[13] Nevertheless, at that time, as the Community continued to develop, a larger budget was foreseen than that we see today.

3.24 Others saw the size of the budget as being 'about right', with the primary discussion centring on how the budget was spent. One argument heard in several stakeholder meetings, including with Alex Boyd of the European Parliament was that one per cent of GNI, targeted well at effective policies, could be effective – recognising that one per cent of GNI represents approximately one trillion euros over 2014-20.[14]

3.25 Finally, there were some who saw the budget as being substantially larger than necessary, reflecting the perceived potential for significant cuts in several areas of the budget (the relative value of which will be considered in the *Spending the Budget* section of this chapter). The Fresh Start Group particularly saw the potential for substantial reductions in the size of the budget through cuts to the administrative budgets of EU institutions, to EU aid (seeing this as an area for Member States' action), Education and Culture and Institutional Communications.[15]

3.26 It is also clear that, if the UK national interest is served by moderating the UK's contribution to the EU Budget, then a budget of a substantially greater level than that seen currently, naturally resulting in substantially increased contributions, would not fit with that primary objective for the UK in budget negotiations. Business for New Europe recognised this point in the context of the recent MFF negotiations:

> The recently agreed cut of 3.4% in real terms to the 2014-20 budget is a move in the right direction, encouraging a better use of resources, and showing what Britain can achieve if it is active at the negotiating table.[16]

3.27 As set out in the Prime Minister's statement in paragraph 3.9, the UK Government has been clear that in its view, the interests of UK taxpayers are best served by securing restraint in the size of the EU Budget. It was this view which underpinned the UK negotiating position for the 2014-20 MFF, a deal which saw the first cut in history in the long-term budget framework, cutting €35bn from the previous period.

3.28 It is the Government's view that this MFF deal represents a real step towards reform in the EU and is a better-framed budget in terms of growth, jobs and competitiveness. Reform of EU spending is a long-term project, but the agreed MFF delivers important progress and is a good deal both for Europe as a whole and for UK taxpayers.

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[12] Brussels and Europe Liberal Democrats, *submission of evidence*.

[13] Commission of the European Communities, *Report of the Study Group on the Role of Public Finance in European Integration,* p 20.

[14] Alex Boyd, *Note of Discussion on the EU Budget Call for Evidence, 17 January 2014*, p 1.

[15] Fresh Start Project, *Budget and Institutions* (2012) pp 110-115.

[16] Business for New Europe, *submission of evidence*.

Length of the MFF

3.29 A significant area of discussion seen in responses and round-table sessions was on the reflection of the rationale for the budget in some of the key budget structures. The formation and length of the MFF was one such area where national budgets and the EU Budget were widely compared. While the Treaty of Lisbon set a minimum length for the MFF at five years, the common practice since the introduction of MFF periods in 1988 has been to agree MFF ceilings over seven-year periods. For example, 2007-13, 2014-20.

3.30 Discussion in this area split into two core questions: first, should the budget have a long-term period as well as annual negotiations and second, how long should that period be?

3.31 On the need for a longer period (or MFF), there was broad agreement that the introduction of extended planning rounds provided greater certainty in an area which had seen several difficult annual budget negotiations before their introduction in 1988.

3.32 Evidence discussed, for example, the need for and challenges of agreeing a long-term budget by unanimity. Some saw this as a challenge to reform, with Member States able to block reform of particular areas of expenditure, such as the CAP, to protect individual interests. On the other hand, it was noted by others that requiring unanimity also gave the UK the ability to protect its priorities. This ability to veto a long-term budget which conflicted with UK priorities has enabled the UK to achieve significant successes in recent years, including in the most recent MFF negotiations. The UK Government therefore broadly accepts that requiring unanimity on major issues and having qualified majority voting on others, including the annual budget, is defensible.

3.33 Respondents broadly focussed on the following advantages in this area:

- Agreement by unanimity – 'first, no MFF can be passed unless everyone agrees. This allows the UK but also every other Member State to try to enforce red lines';[17]
- Long-term policy planning – 'in the first two MFFs this new structure for longer-term planning enabled a significant rebalancing of spending between policy areas, notably increasing the absolute and relative importance of structural/cohesion policy';[18]
- Difficulty of negotiations – 'in a system in which so many actors have to be included in the agreements, at least the process need only be gone through every few years'.[19] 'The principle of having a multiyear EU Budget (of seven years) is sensible, as it would be too burdensome to decide on an annual basis';[20]
- Budget certainty – 'a long-term commitment to science, research and innovation is needed to provide stability for the future and ensure the UK can maximise its potential [...] identifying funding opportunities, building international consortia and preparing bids takes time so researchers need to be sure that there will be funding available for projects in the medium- to long-term';[21]
- De-politicisation – 'long-term budgetary periods are much more preferable to yearly budgets because [...] they depoliticise the annual budgetary process'.[22]

[17] Dr Giacomo Benedetto, *submission of evidence*.

[18] Professor Robert Ackrill, *submission of evidence*.

[19] Professor Iain Begg, *submission of evidence*.

[20] WWF-UK, *submission of evidence*.

[21] Russell Group, *submission of evidence*. See also Welsh Government (Jane Hutt AC/AM), *submission of evidence*.

[22] Professor Robert Leonardi, *submission of evidence.*

3.34 However, alternative views were also recognised in the evidence:

- Difficulty of aligning with domestic budgets – The Northern Ireland Executive noted, as a recipient from the EU Budget, the challenge 'where we are asked to provide longer term commitments [...] beyond the current 3 year Budget cycle we in Northern Ireland operate';[23]
- Agreement by unanimity – 'the current system of unanimously-agreed long-term budget periods can mean that sensible decisions, like investment in research and innovation and HE [higher education], are easily blocked by Member States with specific interests'.[24] 'Negotiations over the long-term EU Budget are also inherently biased towards the status quo, since they are subject to unanimity, with every single Member State able to veto an agreement,'[25] Furthermore, agreement by unanimity can also be difficult to deliver in good time with one respondent suggesting that 'In order to prevent the blocking of progress in implementing decisions, majority voting should be applied to all budgetary decisions';[26]
- Inflexibility to respond to new pressures – [The MFF] further blunts the effectiveness of the EU Budget as a stabilisation mechanism, with the ceilings for the period 2007-13, for instance, determined before the global financial crisis struck';[27]

3.35 Dr Dermot Hodson of Birkbeck, University of London goes on, however, to note that the MFF for 2014-20 'introduces a greater degree of flexibility over such decisions, *inter alia*, by allowing expenditure on youth unemployment and research to be brought forward'.[28] Meanwhile, others suggested that 'a robust mid-term review process [...] should help to ensure that spending can be reviewed earlier and adjusted to reflect the priorities of the day'.[29] Hodson finally summarises the broader balance of debate on the question, noting that 'as things stand the economic limitations of long budget periods are outweighed by the political benefits of long-term consensus over budget decisions'.[30]

3.36 It is the Government's view that the balance between greater certainty from a long-term planning period (which UK-based budget recipients largely supported) and the opportunity to bring greater leverage to bear in negotiations (through use of the 'veto') are strong points in favour of the MFF as a negotiating structure which is in the interest of Member States like the UK.

3.37 On the question of how long an MFF period should be, respondents noted the limit set by the Lisbon Treaty, which requires an MFF period of at least five years.[31] Within this limit, respondents' views varied on two points:

- Greater flexibility, longer planning: As in the discussion around the need for the MFF, above, there was some discussion about the trade-off between having increased long-term certainty of funding, for example, 'this brings greater stability to spending, and enables better planning', 'this certainty and transparency [of the 7 year structural fund period] has had a strong and positive impact on strategic planning', and the

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[23] Northern Ireland Executive (Simon Hamilton MLA), *submission of evidence*.

[24] Universities UK and UK Higher Education International Unit, *submission of evidence*.

[25] Open Europe, *Seizing the Moment: Aligning the EU Budget with Europe's Economic Needs* (2012).

[26] Professor Robert Leonardi, *submission of evidence.*

[27] Dr Dermot Hodson, *submission of evidence*.

[28] Idem.

[29] Institute for European Environmental Policy, *submission of evidence*.

[30] Dr Dermot Hodson, *submission of evidence.*

[31] Article 312 TFEU.

increased flexibility of a shorter MFF, for example, 'a degree of flexibility is needed to take account of emergencies, changing circumstances, and to allow priorities to be reconsidered in mid-term.[32] [33] So a multiannual framework needs to be longer than two years but probably shorter than seven'.[34]

- Alignment with European Parliament calendar: Several respondents noted the possible link between the MFF period and the European Parliament electoral calendar, with five year periods. The National Farmers' Union (NFU) noted that 'There is an argument that a new European Parliament can find its activities and ambitions significantly constrained by a budget deal that has previously been agreed'.[35]

3.38 On the latter question, views were mixed, with some arguing in favour of a direct alignment with European Parliament periods:

> Budget and Parliamentary cycles should be aligned at 5 years to give better accountability. MEP candidates would then be able to stand on platform spelling out what size of budget they wanted and what their priorities would be.[36]

Professor Iain Begg of the London School of Economics and Political Science noted however that this 'depends on the view taken on the EU as a level of government' and indeed on the view on how long the MFF should be on planning grounds, with those arguing in favour of a period greater than five years naturally therefore seeing alignment with the European Parliament as a lesser priority.[37]

3.39 It is worth also noting that, while evidence suggests that a longer framework provides greater certainty for the planning of major projects through the EU Budget, it may not be an absolute necessity. National budgets, particularly in the UK, have generally been set for periods far shorter than seven years while including funding for major projects, a point also noted in the consideration of the commitments and payments system in the EU Budget in the *Running the Budget* section of this chapter.

Roles of Institutions in Agreeing the Budget

3.40 The role of institutions in agreeing budget periods was also seen as a key question for many respondents, with a particular interest in the role of the European Parliament on the revenue side of the budget. Evidence has been considered, above, on the impact of requiring unanimity in Council to agree an MFF period, but by contrast (as Chapter Two of this report sets out), the annual budget and the regulations underpinning the MFF require agreement by QMV in Council. At the same time, the European Parliament's consent is required to agree an MFF period, but only an opinion is required for the Own Resources Decision. Views were seen from respondents on all of these questions.

3.41 Respondents broadly noted that the process for agreeing budgets, the MFF in particular, was not the same as in other areas of policy, with some benefits for the UK:

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[32] Centre for European Reform, *submission of evidence*.

[33] Welsh Government (Jane Hutt AC/AM), *submission of evidence*.

[34] Brussels and Europe Liberal Democrats, *submission of evidence*, although it is worth noting that this submission also suggested that exceptional periods of longer than seven years could be justifiable for particular projects with long-term plans, including, for example, the Connecting Europe Facility and the International Thermonuclear Experimental Reactor (ITER).

[35] National Farmers' Union, *submission of evidence*.

[36] George Lyon MEP, *submission of evidence*. Please also see: Leonardi, Dimitrakopoulos, Boyd, *submissions of evidence.*

[37] Professor Iain Begg, *submission of evidence*.

> Procedures concerning the EU Budget are in general more restrictive than those concerning Union legislation. Special legislative procedures apply for decisions on own resources – EU Budget revenue – and for decisions on the multiannual financial framework fixing annual ceilings to expenditure.[38]

3.42 On the roles of institutions in agreeing an MFF, Open Europe noted in 2012 a changing role for the European Parliament:

> The Lisbon Treaty enhanced the role of the European Parliament in negotiations over the EU long-term budget, giving MEPs an effective veto (or at least codified the practice in law) [...]Therefore, through the Commission's agenda-setting powers and the Parliament's veto powers, the EU institutions are also an obstacle to reforming the budget.[39]

3.43 This increased involvement was seen to have had a significant impact on the timing of negotiations by some respondents. Fiona Wishlade of the University of Strathclyde's European Policies Research Centre noted:

> The input of the European Parliament added several months to the process of agreeing the MFF. While some aspects of the agreement were important (in relation to the annual budget, for example), it contributed to the overall atmosphere of brinkmanship, which was arguably counterproductive.[40]

3.44 Despite this, the NFU suggested that the UK could wield its influence more effectively in negotiations, bearing in mind that 'the UK has 73 MEPs (the third biggest number) and is one of the top 4 most powerful in the council'.[41]

3.45 Professor Robert Ackrill of Nottingham Trent University argued that a distinction between the roles of the European Parliament and national Parliaments was important to maintain, focussing particularly on the timing of budget periods and European Parliament elections:

> It is wrong to compare the EP with national parliaments in terms of the powers of budgetary determination. As the process of elections, manifestos and policy commitments is so different with the EP, linking MFF and EP cycles would, arguably, require a much greater role for the EP in MFF determination.[42]

3.46 Others suggested an increased level of cooperation and coordination between national Parliaments and the European Parliament on all issues. WWF-UK made this point in particular:

> National and European Parliaments: this relationship on the EU Budget is currently extremely weak. It would make a lot of sense to strengthen it, notably to develop a better shared view of key spending priorities at the EU level. For example the environment is considered a priority for Cohesion policy at the European level but neglected by some MSs [sic]: better discussions between national and European Parliaments would help smooth these discrepancies.[43]

3.47 On the role of the European Parliament on the revenue side of the budget system, Hodson and others raised the question of whether the European Parliament's limited role on Own Resources actually resulted in upward political pressure on the size of the budget:

38 Brussels and Europe Liberal Democrats, *submission of evidence*.

39 Open Europe, *Seizing the Moment*, p 9.

40 Fiona Wishlade, *submission of evidence*.

41 National Farmers' Union, *submission of evidence*.

42 Professor Robert Ackrill, *submission of evidence*.

43 WWF-UK, *submission of evidence*.

> In the EU case [...] the European Parliament can (and generally does) seek higher EU expenditure without bearing responsibility for revenues, which come, in part from Member States.[44]

3.48 Others, however, challenged this point:

> I accept there is a question about how representative the current parliament is of the 'normal' electorate given the poor turn-out at EU elections and the performance of smaller protest parties in what is often a mid-term referendum on incumbent governments.[45]

3.49 Alternatively, Dr Dionyssis Dimitrakopoulos of Birkbeck, University of London argued that the synchronisation of the electoral and budget cycles could increase democratic accountability and therefore public interest in European Parliament elections, by bringing closer the link between elections and decision making financial outcomes which directly impact on citizens.[46]

3.50 Alex Boyd, of the European Parliament, was sceptical about the impact a greater role for the Parliament would have on the discussion of budget size. The view shared in a discussion during the call for evidence period was that 'it was indeed more likely that MEPs' 'asks' on the budget would only increase. MEPs were seen to be more distanced from voters – and not always seen as local representatives [...] and would not feel the same pressure as national MPs'.[47]

Summary

3.51 Respondents considered:

- The overall size of the EU Budget, which was seen by some to be small as a percentage of GNI, when compared to federal budgets. However, the unique structure and focus of the EU Budget was recognised, with expenditure not directly comparable with that of Member States;
- The need for a long-term budget period, with respondents largely supporting the need for long-term planning to support recipients, though difficulties were seen in agreeing budget periods by unanimity;
- The length of the MFF period**,** with discussion of the relationship between the MFF period and European Parliament electoral cycles and the need for flexibility as well as long-term certainty;
- The roles of institutions in agreeing the budgets, with discussion in particular of the role of the European Parliament on the revenue side of the EU Budget system;

Spending the Budget

Does the EU Budget of 2014 represent a 'modern' and high-quality budget, focussed on areas of added value, in the interests of the UK?

3.52 In this section, we consider the 'added value' of the EU Budget, including: the distribution of expenditure between major areas of the budget; the distribution of spend between Member States; the most effective methods of delivering expenditure and the relationship between the UK's abatement; and the added value of the EU Budget.

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44 Dr Dermot Hodson, *submission of evidence*.

45 Professor Cillian Ryan, *submission of evidence*.

46 Professor Dionyssis Dimitrakopoulos, *submission of evidence*.

47 Alex Boyd, *Note of Discussion on the EU Budget*, p 2.

EU 'Added Value'

3.53 The Commission's EU Budget Review of 2010 identified five core principles against which spending options should be assessed; of which 'EU added value' was one.[48] [49] Through these principles citizens should be able to have a better view of what the budget is for and how choices have been made.[50] EU added value is a significant principle because it provides a framework for assessing whether citizens get a better deal through spending at an EU rather than national level.

3.54 The Commission pointed to the possible economies of scale that pooling resources could result in and summarised that, as a result, the EU Budget should be used to finance EU public goods; actions that Member States could not finance themselves, or where the collective could ensure better results[51] from the EU.[52] Examples of EU public goods include Research and Development and Climate policy which are considered more effective when delivered at an EU level than by Member States acting alone, although it is worth noting that at a national level, Member States can and do spend on public goods, including defence. Business for New Europe also argued that the UK gains more out of the Single Market than it contributes to the EU Budget.[53]

3.55 In its response to the Commission's Review of the EU Budget in 2009, the Government set out a framework for deciding whether spending proposals were appropriate and offered 'EU added value' compared to spending at the domestic level.[54] The framework considered three main areas:

- The right level – spending at the EU level should take place where there are clear additional benefits from collective efforts, compared to Member States acting individually;
- The right action – spending at the EU level should take place where it is appropriate, proportionate and flexible to do so, with consideration to a full range of financing (including both grant and loan finance);
- The right value – spending at the EU level should take place on the available evidence base, facilitating achievement of objectives in the most cost-effective way, backed by sound financial management and with a greater focus on delivery of outcomes in programme design and evaluation.

3.56 Submissions to this report and other relevant sources of literature presented several perspectives about how to define 'EU added value' of spend.

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48 Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, the Committee of the Regions and the National Parliaments, *The EU Budget Review* COM(2010) 700 final, October 2010.

49 The other four were: delivering key policy priorities; a results-driven budget; mutual benefits through solidarity; a reformed financing of the budget.

50 European Commission, *EU Budget Review*, p 4.

51 Commission Communication, *EU Budget Review*, p 5.

52 George Lyon MEP, *submission of evidence*. IEEP, *submission of evidence*, p 4 also makes the point that net contributor Member States also need to take account of the *indirect* benefits of EU membership as well as those seen directly from the EU Budget.

53 Business for New Europe, *submission of evidence*.

54 HMG, *Balance of Competences Review: EU Budget, Call for Evidence* (2014), p 11.

3.57 In their 34th Report of Session 2010-12 the House of Lords European Union Committee described European added value as:

> Spending [that] should take place at EU level only when it is more effective than spending at national level.[55]

3.58 WWF-UK also saw added value where each euro spent at the European level is more effective than a euro spent at the national level, having an overall impact of reducing public spending in that area while achieving the same results.[56]

3.59 The Northern Ireland Executive was clear that spending from the EU Budget should occur where 'there are clear additional benefits from collective effort compared with action solely from individual Member States'.[57]

3.60 The NFU suggested that the budget should be focussed on areas where 'it can add value at the EU level and support the single market'.[58]

3.61 According to the Russell Group, in order to get added value from EU spending, the budget should focus on areas which boost growth and jobs in both the long and short term.[59]

3.62 The House of Lords European Committee distinguished 'value added' from '*juste retour*'. The latter focuses on the level of funding returning to a Member State from the EU Budget, even if such funding fails to offer demonstrable added value.[60] The Committee recognised how difficult it is to arrive at a single definition, but does acknowledge that criteria such as 'effectiveness, efficiency and synergy' are helpful considerations.[61]

3.63 The Institute for European Environmental Policy (IEEP) acknowledged the complexities and challenges of defining 'EU added value' when the concept is open to different interpretations by different actors.[62] Nevertheless it does suggest that developing a common approach would help to improve the transparency of decision making and help EU expenditure better meet key EU policy objectives.[63] IEEP suggests that more of a focus on public goods forms part of that common approach.[64]

3.64 Whilst views differed on the specificity of how to define added value, a substantial number of submissions expected added value to be taken into account when deciding on which areas of spend to allocate EU funds. It is worth noting, however, that several respondents, particularly from the academic community, recognised that finding a single, clear definition of added value was extremely difficult given the link between this and the varying views among institutions and Member States of the purpose of the EU Budget.[65]

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55 House of Lords European Union Committee, *The Multiannual Financial Framework 2014-2020* (HL 2010-12, 297).

56 WWF, *submission of evidence*.

57 Northern Ireland Executive, *submission of evidence,* p 2.

58 NFU, *submission of evidence*.

59 Russell Group, *submission of evidence*.

60 House of Lords European Union Committee, *The Multiannual Financial Framework*, p 18.

61 Idem.

62 IEEP, *submission of evidence*.

63 Idem.

64 Idem.

65 *Note of Academics' EU Budget seminar, London 10 January 2014.*

EU Budget Areas of Spend

3.65 The seven year framework for the EU Budget from 2014 – 2020 was agreed at the end of 2013. It consists of five 'headings' or broad areas of spend and is summarised in the text box in Chapter Two. The distribution of budget expenditure between broad spending areas was a significant area of discussion for respondents, with views from a substantial number on the right 'shape' of the budget to provide best value for money for taxpayers.

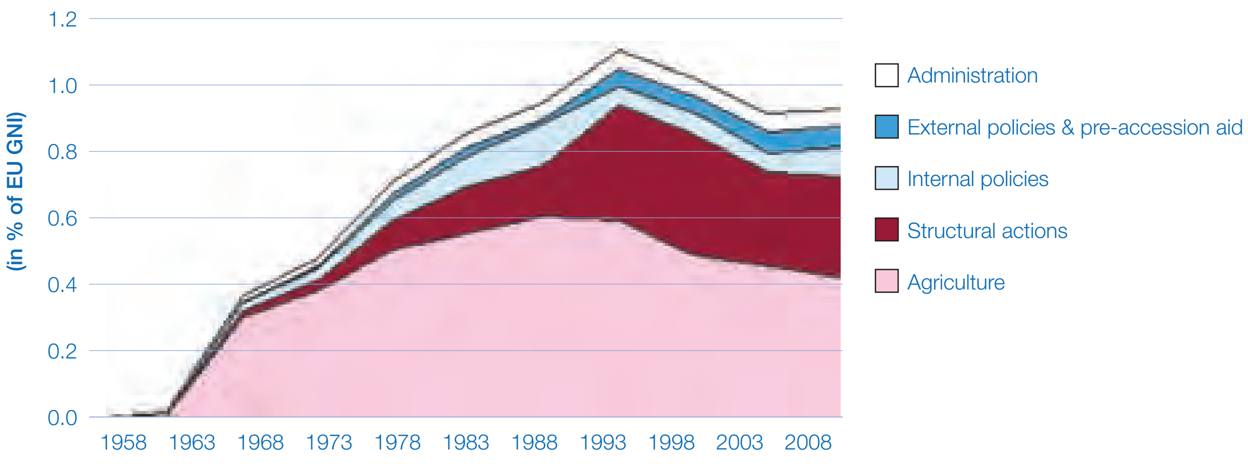
3.66 This report considers the 'relative' value of areas of expenditure through the EU Budget, rather than assessing the detail of policy in individual thematic areas and programmes. Detail on individual areas of spend can be found in other relevant reports as part of the Balance of Competences Review. In particular, the importance of expenditure on research and development is explored in the Research & Development report of Semester Two, while detail on the policy of the Common Agricultural Policy (CAP) and on the Structural and Cohesion Funds is considered in the *Agriculture* and *Cohesion* reports of this Semester respectively.

3.67 Some submissions critiqued the overall design of the EU Budget at a high level, describing its overall priorities as misaligned with modern day needs, reflecting a legacy from the 1970s, and as having a distribution between major areas of expenditure 'very similar to [...] 1957'.[66] [67] This recognised an inherent inertia in the EU Budget, borne out of the need for the agreement of all Member States – and of institutions including the European Parliament to any substantial reform. An illustration of the evolving shape of the budget is set out in the chart below.

3.68 There was further criticism about the current distribution of spending across headings:

> 73% of the EU's budget is spent on CAP and regional policies, while another 6% is spent on administration. This does not leave much funding for other ventures.[68]

Chart 3.1: Development of EU Budget Expenditure, 1958-2008



Source: European Commission, *History of the Budget* (n.d.), available at: ec.europa.eu/budget/reform2008/history/history1957_en.htm, accessed on 6 June 2014.

[66] Fresh Start Project, *Budget and Institutions*, p 108.

[67] *Note of EU Budget seminar, Brussels 3 December 2013.*

[68] Business for New Europe, *submission of evidence.*

3.69 Other evidence pointed to the general need for the budget to take into account the economic circumstances across Member States. According to the IEEP:

The budget has not kept pace with the changing needs of an expanding Europe and there is a corresponding requirement to re-align goals with current and future challenges.[69]

3.70 IEEP suggested that there are different challenges currently facing the EU, compared to those at the time when the budget was first created. Examples of new challenges include globalisation, climate change and an ageing society. As such a 'set of workable criteria' might help 'to guide the identification of future spending priorities in a more transparent way'.[70] Alex Boyd also agreed that 'The focus of the budget should be more towards future needs, rather than historic patterns'.[71]

3.71 Other submissions that responded on the question of added value pointed to specific areas of expenditure to increase, decrease or reform as a result of judgements on what was perceived as being high or low value-added spend.

Evidence Presented on Higher Added-Value Spend

3.72 A number of submissions called for increased spending on innovation, research and development (R&D), including responses from universities, academics and other institutions that openly declared an interest in this area of spend.

3.73 Universities UK and the UK Higher Education International Unit (UUK & IU) recognised the significance of this 'additional funding source for UK universities, particularly in the context of national budgetary constraints', and in its view, there are grounds to increase the proportion of the budget spent on research.[72] Open Europe called for spending on research and innovation to be 'radically increased' because it saw this as the 'the one area where the EU Budget really can add value'.[73] Business for New Europe also agreed that R&D spending should be given higher priority within the overall budget.[74]

3.74 The IEEP described research and innovation as a spending area of 'longer term strategic relevance', benefitting local communities in the UK.[75] [76] Alex Boyd described it as an area where the major focus of spend should be.[77]

3.75 Professor Cillian Ryan of the University of Birmingham drew attention to positive externalities associated with research funding in the university sector.[78] UUK and IU pointed to the benefits of collaborative research brought about by joint funding[79], as did Dr Giacomo Benedetto who noted that:

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69 IEEP, *submission of evidence*, p 4.

70 Idem.

71 Alex Boyd, *Note of Discussion on the EU Budget Call for Evidence, 17 January 2014*, p 2.

72 Universities UK, *submission of evidence*.

73 Open Europe, *Seizing the Moment*, p 3.

74 Business for New Europe, *submission of evidence*. The Russell Group also argued for an increase in the amount of money and proportion of EU Budget allocated to research and innovation; Russell Group, *submission of evidence*, p 3.

75 IEEP, *submission of evidence*.

76 *Note of EU Budget Seminar, Brussels 3 December 2013.*

77 Alex Boyd, *Note of Discussion on the EU Budget Call for Evidence, 17 January 2014*, p 2-3. In the previous MFF (2007-2013), a significant proportion of research and innovation spending was funded under 'Heading 1A' of the budget.

78 Professor Cillian Ryan, *submission of evidence*.

79 Universities UK, *submission of evidence*.

Investment in innovation, research and development [...] are considered to be added value because they provide greater collective benefits without being re-distributional spending and at greater efficiency then providing those benefits through exclusively national policies.[80]

3.76 A submission from the Russell Group drew attention to the suitability of research funding to cross border funding streams, which in turn allowed for the pooling of expertise and benefits from economies of scale.[81]

Evidence Presented on Lower Added-Value Spend

3.77 While not unanimous, several respondents called for less spending on direct payments as part of the CAP, viewing it as low-value spend.[82] Further detail on the value of aspects of the CAP, building on the high-level comments received in response to this report, is explored in Chapter Two of the *Agriculture* report of this Semester of the Balance of Competences Review.

3.78 Professor Cillian Ryan described agriculture related direct payments as a form of internal transfer analogous to unemployment benefit or a state pension[83] because there was no longer a link between payments and production.

3.79 Open Europe pointed to the opportunity cost of CAP payments that could benefit other headings and that resources were being channelled away from where they could have the biggest effect on jobs and growth. They also noted that:

The main problem with the budget is that far too much money is allocated to wasteful and failing policy areas such as the Common Agricultural Policy and an EU-wide regional development policy.[84]

3.80 The House of Lords European Committee called for greater reform of the CAP, particularly Pillar One, and for reductions in the CAP budget as well as the gradual phasing out of direct payments to farmers so that funds can be redistributed towards other programmes offering growth potential. In this way the MFF will focus funding on areas that will support growth and encourage innovation.[85]

3.81 Business for New Europe suggested that the CAP's share of the budget would decrease from 40% to around 27% by the end of the current budget period.[86] Nevertheless there were still calls for reform:

Large farms in older Member States still receive much more than those in poorer newer Member States, and this needs to change. CAP should not give an increasing amount to farmers if they have more land as this benefits those who need the money least. Too little of the money goes towards improving the environment and boosting sustainability (14%).[87]

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80 Dr Giacomo Benedetto, *submission of evidence.*

81 Russell Group, *submission of evidence*. Open Europe also noted the potential economics of scale in their submission; Open Europe, *submission of evidence*, p 27.

82 *Note of EU Spending Seminar, Brussels 7 November 2013.*

83 Professor Cillian Ryan, *submission of evidence*.

84 Open Europe, *Seizing the Moment*, p 4.

85 House of Lords European Union Committee, *The Multiannual Financial Framework*.

86 Business for New Europe, *submission of evidence,* p 2.

87 Business for New Europe, *submission of evidence*.

3.82 Notably the NFU recognised the need to reform the way the EU Budget is spent:

> The NFU has never shied away from budget cuts at the European level for agriculture, but reductions must be applied equally and fairly. In future, the NFU believes that the policies that comprise the CAP should be pared right back to the primary objective of increasing agricultural productivity by promoting technical progress and rational development of agricultural production. Initiatives relating to the social development of the agricultural sector could be left for national competences.[88]

3.83 The lower agriculture subsidies paid by those Member States that joined the EU from 2004 onwards compared to those paid by the older Member States contribute to concerns surrounding the long-term sustainability of CAP spending and support calls for significant reform. The Balance of Competences report on Agriculture discusses the CAP and the EU approach to agriculture in more detail.

3.84 Views were more mixed on cohesion, the second biggest area of EU Budget expenditure. The three main structural funds[89] that comprise cohesion policy are:

- The ERDF, which finances the promotion of innovation and knowledge transfer, stimulating enterprise and supporting successful businesses, ensuring sustainable development, production and consumption, and building sustainable communities. It is allocated on a regional basis.
- The ESF, which finances projects in the labour market that focus on improving skills, social integration and access to employment opportunities. It is also allocated on a regional basis.
- Cohesion Fund which finances developments in transport networks, environmental projects, and energy and transport projects that offer environmental benefits.[90] It is allocated at national level and is limited to Member States with a national income below 90% of the EU average.

3.85 The House of Lords European Union Committee noted the benefit ESF brought throughout the Union, but that other funds (such as the ERDF) should be targeted at poorer Member States, with a view to withdrawing it from better-off Member States in the long term.[91] Limiting funding to less developed and newer Member States was seen as a way of gaining greater added value from the Cohesion Fund.[92]

3.86 Open Europe noted the benefits of limiting structural funds to EU Member States with income levels at or below 90% of the EU average.[93] It further suggested that there is an unsatisfactory correlation between the funding and results of structural funds and that the involvement of all Member States, irrespective of their wealth is economically irrational. It also questioned whether structural funds bring any added value to Britain.[94]

88 National Farmers' Union, *submission of evidence*.

89 House of Lords European Union Committee, *The Multiannual Financial Framework*, p 23.

90 Established in 1994 to assist less-developed member states with a Gross National Income (GNI) of less than 90% of the EU average.

91 House of Lords European Union Committee, *The Multiannual Financial Framework*, p 25.

92 *Note of EU Spending Workshop, London 7 November 2013*, p 2.

93 Open Europe, *Seizing the Moment*, p 15. A similar view was also expressed by Fresh Start; Fresh Start, *submission of evidence*, p 7.

94 Open Europe, *Seizing the Moment*, p 14-15.

3.87 Business for New Europe was critical of the carousel nature of funds moving from national governments of richer Member States, being routed through the EU, only to come back again to poorer regions of the same Member States.[95] It also suggested that funding should be performance-linked, noting that there is no financial incentive in place to reward efficiency or penalties if the money is not used to boost efficiency.[96]

3.88 Submissions also questioned whether there would be administrative cost savings if more cohesion funding was delivered at the Member State level.[97]

3.89 The Balance of Competences report on cohesion which discusses the value for money, funding programmes and financial tools in place to support cohesion policy in more detail.

Administration

3.90 The majority of submissions that provided responses covering administration called for savings, or a reduction in budget expenditure on administration.

3.91 Open Europe suggested that the European Commission should go further in reducing its headcount to maximise savings on back office and administrative functions, referencing the 33% reduction in back office costs in UK Government departments, agreed as part of the 2010 Spending Review.

> To reflect the savings that are taking place in the UK and government departments across Europe, we propose a 20% cut to the Commission's administration and back office spending, loosely premised on the average cut of 19% to Whitehall departmental spending, and the 16.9% average cuts to Spanish departmental budgets.[98]

3.92 Proposals to help achieve those savings included reducing allowances and benefits for EU staff, increasing the retirement age to 65 and commissioning an independent review, along the lines of the UK's 2011 *Hutton Review*, to examine the long term sustainability of EU pensions.[99] Fresh Start suggested the Commission should participate in a cuts and efficiency programme that addresses, amongst other things, overall pay bill and pension arrangements for EU staff.[100]

3.93 It is worth noting that the new Staff Regulations and the Interinstitutional Agreement (IIA) for 2014-20 introduced a series of reforms which will impact on EU administrative expenditure, including an increase in the retirement age for new staff to 66 and a commitment to reduce the number of staff by 5% between 2013 and 2017.[101]

3.94 The Scottish Government also called for the Commission to exercise administrative efficiency and reflect the departmental reforms Member States have made.[102]

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95 Business for New Europe, *submission of evidence*.

96 Business for New Europe, *submission of evidence*.

97 *Note of EU Spending Workshop, London 7 November 2013*, p 1.

98 Open Europe, *Seizing the Moment*, p 19.

99 Idem.

100 Fresh Start Project, *Manifesto for Change*, p 17.

101 Please see: Interinstitutional Agreement 2013/C 373/01 of 2 December 2013 between the European Parliament, the Council and the Commission on budgetary discipline, on cooperation in budgetary matters and on sound financial management, 2013; and Staff Regulations, Reg. 62/11 as most recently amended by Regulation (EU, Euratom) No 1023/2013 of the European Parliament and of the Council of 22 October 2013, OJ 2013 No L 287, p 15–62.

102 Scottish Government, *submission of evidence*.

3.95 The Scotch Whisky Association (SWA) provided a different view, calling for the reallocation of administration resources to the Commission's Directorate-General for Trade. SWA suggested that more resources are required to negotiate Free Trade Agreements that will eventually positively impact the UK's access to markets.[103]

3.96 The Commission has recognised a need to search for increased efficiency and performance in its administration. Its 2010 EU Budget review pointed to investigating savings that could be made from developing shared IT systems across institutions and looking at the way it delivers and designs spending programmes.[104]

Financial Instruments

3.97 Innovative financial instruments (IFIs) are designed to leverage the EU Budget and increase its impact. There are a range of IFIs already in use within the current headings of expenditure. Examples include risk-sharing instruments within research, development and innovation investment and equity instruments used within energy, climate change and infrastructure spending.[105]

3.98 The Government is broadly supportive of the increased use of private finance and such instruments, provided that they do not lead to an increase in the overall size of the budget, that risks are sufficiently managed and that there is adequate administration of schemes at the Member State level.[106]

3.99 Most submissions that provided a response to the 'call for evidence' question on financial instruments agreed that the appropriate mode of spending depended on the type of activity or project being funded, as well as the type of sector and beneficiary being supported.[107] [108] The Northern Ireland Executive in particular summarised this view:

> Repayable loans appear to be the Commissions preferred option going forward in the post 2014 period as it gives a rolling return not achieved through a one off grants system. In developing Operational Programmes however one size does not always fit all and while we plan to use repayable loans in our developing [Operational Programmes], particularly ERDF, it is likely we will maintain some aspects of funding using the traditional grant method.[109]

3.100 Delegates at the EU-spending workshop thought that there could be more provision of loans rather than grants, suggesting that 'this would require much better business cases to be developed and more conditionality to funding'.[110] The question of whether the European Investment Bank would be better placed to provide loans, rather than using money from the EU Budget, was also raised.

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[103] Scotch Whisky Association, *submission of evidence*.

[104] Commission Communication, *EU Budget Review*, p 19.

[105] House of Lords European Union Committee, *The Multiannual Financial Framework*, p 61.

[106] Ibid, p 62.

[107] This was a point made by several respondents. For example: Brussels and Europe Liberal Democrats, *submission of evidence*, p 6; and Fiona Wishlade, *submission of evidence*, p 4.

[108] WWF-UK, *submission of evidence*.

[109] Northern Ireland Executive (Simon Hamilton MLA), *submission of evidence.*

[110] *Note of EU Spending Workshop, London 7 November 2013,* p 4.

3.101 IEEP argued that financial instruments could make EU funds go further and add value:

EU financial instruments can be seen to add value by multiplying the effect of EU funds when they are pooled with other funds or include a leveraging effect that enables private finance to be attracted. In our view these instruments do have a clear role in supporting the development of a more sustainable European economy.[111]

3.102 The Welsh Government expressed keen support for the use of alternative modes of expenditure and pointed to the £150m Joint European Resources for Micro to Medium Enterprises (JEREMIE) fund as an example of a scheme that is helping support businesses to grow.[112]

3.103 However IEEP also asserted that public goods, especially concerning the environment, would continue to require grant financing and that 'supportive political framework conditions' are required to ensure that financial instruments exhaust their full potential.[113]

The UK Abatement

3.104 Several respondents, particularly at the Brussels round table event and in submissions from the academic community, considered the link between the UK abatement and the balance of expenditure described above. This link can be made in several ways. Some respondents noted a link resulting from the UK's public priorities in recent budget negotiations – notably the 2014-20 MFF – where some saw the UK's prioritisation of protecting the UK abatement as a barrier to achieving reform in the budget; for example, on reform of the CAP. Another link made, however, argued that the 2005 reform of the UK abatement set up a link between the abatement and the distribution of expenditure between areas of spend and between Member States. Some argued, therefore, that the UK abatement in its current form was to an extent a reflection of the value of the budget, unlike other correction mechanisms). The own resources system in general, including the revenue side of the budget and other corrections (and generalised corrections) is covered in the *Running the Budget* section of this chapter.

3.105 The impact of the abatement, and the UK's position in defence of the abatement, on negotiations was a concern for some respondents. Evidence submitted by Fiona Wishlade of the University of Strathclyde made the case that the UK defence of the abatement comes at the cost of achieving other successes:

UK defence of the rebate is one of several elements that impede a wholesale reform of the EU Budget.[114]

3.106 Similar evidence, from the NFU, argued that indeed the abatement could be seen as a disincentive to the UK accessing budget funds by dominating UK Government priorities during negotiations:

The abatement issue and the UK's correction can be a deterrent to accessing European funds. Such fiscal plans can dictate the policy negotiation process for the UK.[115]

[111] IEEP, *submission of evidence*.

[112] Welsh Government (Jane Hutt AC/AM), *submission of evidence*.

[113] IEEP, *submission of evidence*.

[114] Fiona Wishlade, *submission of evidence*.

[115] National Farmers' Union, *submission of evidence*.

3.107 Others were more broadly critical of the existence of the UK's abatement, and the formula which underpins it. Phedon Nicolaides of the College of Europe argued:

> The present rebate is based on a rather ad-hoc formula that applies only to the UK. The "burden" for the funding of the rebate that falls on the remaining Member States is also rather arbitrarily adjusted. The whole system is predicated on ad-hoc deals that lack transparency, fairness and economic logic.[116]

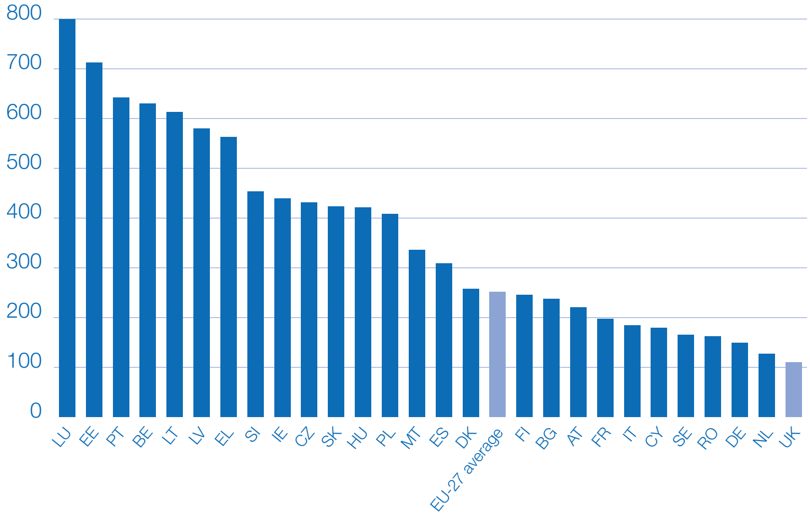
3.108 Other respondents saw no need for change in this area.[117] However, Business for New Europe noted the economic logic that it was the abatement which maintained the UK's net position in the budget.[118]

3.109 Open Europe, during the MFF negotiations, noted the direct link often made between the UK abatement and reform of expenditure, particularly of the CAP. Some respondents noted that the abatement could in effect 'buy' reform of the budget and become a negotiating tool in itself. In this case, Open Europe argued:

> In order to even consider giving up the rebate, the UK would need to be given firm guarantees that reforms would indeed happen. What happened in 2005 when Tony Blair gave up part of the rebate, in return for promises of CAP reform that never really materialised, cannot happen again. In other words, reform first, then rebate later.[119]

3.110 The link between reform and rebate is, arguably, already closer than some respondents suggested, with views from others heard in round table events recognising one indirect impact of the 2005 disapplication of some areas of spend from the abatement. With substantial reform of the CAP, or focus of Structural Funds towards poorer regions in poorer Member States, the UK's abatement already reduces without need for negotiation. It is also worth noting that this disapplication has come at a cost to the UK – of €2.9bn in 2012.[120]

Chart 3.2: EU receipts, 2012, Euros per Capita



Source: 2012 Financial Report (receipts) and AMECO (population). Note: figure for Luxembourg (€2,879 per capita) is an outlier in the series, since Luxembourg has a small population and houses several EU institutions, including the European Court of Justice and the European Court of Auditors. In order to allow easy comparison between other Member States, the left hand axis is limited to €800.

116 Dr Phedon Nicolaides, *submission of evidence.*

117 Centre for European Reform, *submission of evidence*. See also *Running the Budget* section on revenue system.

118 Business for New Europe, *submission of evidence.*

119 Open Europe, *Seizing the Moment*, p 34.

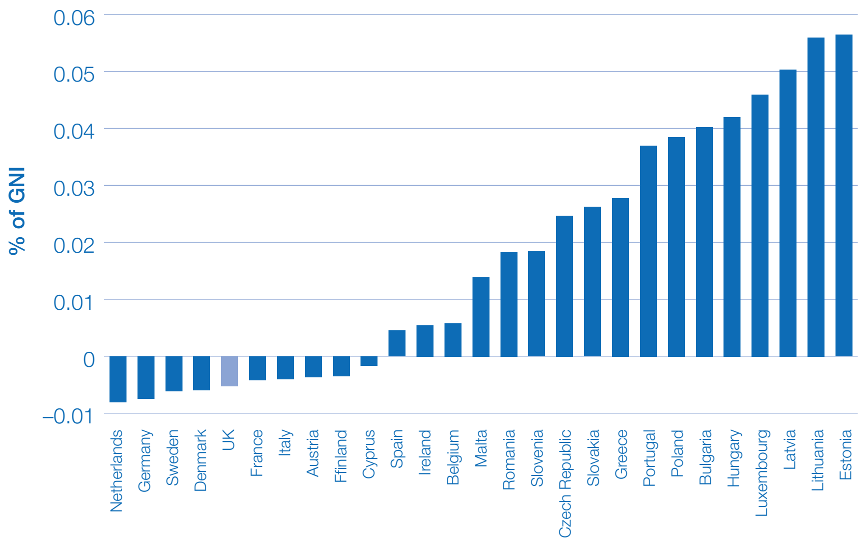
120 Commission figures from May 2013 ACOR (current prices).

3.111 That the abatement remains as substantial as it is in part a result of continuing distortions in the direction of spend. CAP still accounted for 43% of EU expenditure in 2012, of which France received €5bn more than the UK did in 2011 (around 2.5 times the size of the UK abatement in that year). Professor Cillian Ryan noted this continued focus on agricultural spend in his evidence:

> The original case for the UK rebate was largely driven by the imbalance between the UK contribution to the EU Budget and its low share of CAP receipts by comparison with other high-income EU countries. Given that arguably the EU no longer has a competency function in supporting redistributions to the agricultural sector, if there was significant reform of this spending, it would largely obviate the need for the UK rebate.[121]

3.112 The UK Government position on this issue remains clear – recognising the impact that the abatement has on the UK's contribution to the EU. Expenditure distortions mean that the UK continues to have the lowest per capita receipts from the EU Budget. In 2012 the UK was the second largest net contributor despite being among the poorest net contributors. The abatement is not, therefore, a matter of *juste retour* (which concerns the amount returning to Member States), but instead of ensuring the UK pays a fair share towards the EU Budget.

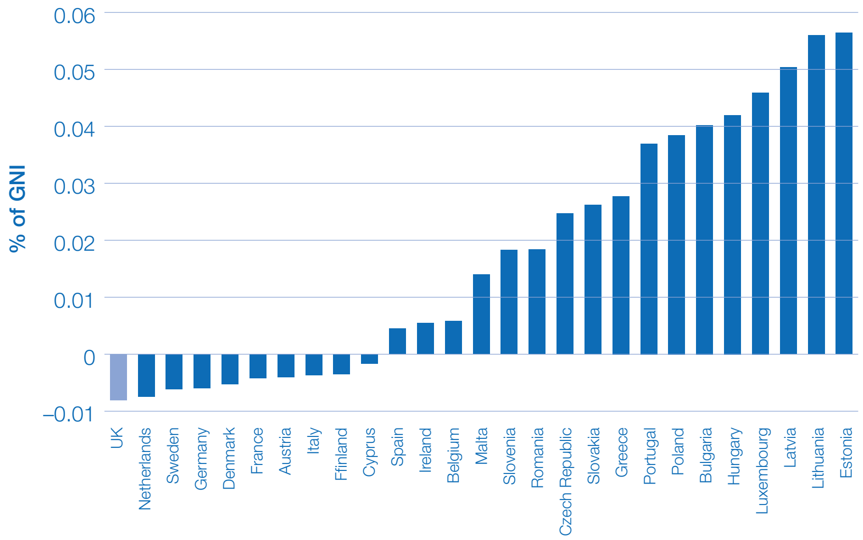
Chart 3.3a: Member States' Net Contributions to the EU Budget with the UK Abatement Applied



Source: HM Treasury calculations based on European Commission, *Commission Financial Report for 2012*. 'Net balance' is defined as 'total receipts less total own resource contributions'.

[121] Professor Cillian Ryan, *submission of evidence*, p 1.

Chart 3.3b: Member States' Net Contributions to the EU Budget Without the UK Abatement



Source: HM Treasury calculations based on European Commission, *Commission Financial Report for 2012*. 'Net balance' is defined as 'total receipts less total own resource contributions excluding the UK abatement'.

3.113 Ultimately, on the UK abatement in particular, there was no consensus of views across respondents. Some respondents argued that 'corrections, on any reasonable view of multi-level governance, are a nonsense'.[122] However, there were significant views to the contrary, with others arguing that 'the UK's abatement was entirely justified – no convincing case had been made for its removal or reform'.[123]

3.114 Certainly, considering the fact that without the UK abatement, the UK would have a net contribution twice that of France and one and a half times that of Germany, it has been the strongly-held view of successive UK Governments that a budgetary distortion remains and the continued defence of the UK abatement remains firmly in the UK national interest.

Summary

3.115 In this section, respondents considered:

- The value of expenditure in the budget, where in particular Heading 1A, covering expenditure on research and innovation, was seen as a priority for a greater share of the budget due to the perceived positive impact on growth.
- The most effective methods of spend in the budget, where respondents largely accepted that this question depended on the aims of particular programmes, though increased use of innovative financial instruments was suggested by some.
- The link between the UK abatement and value for money, where some respondents recognised the link formed by the 2005 'disapplication' between reform of the expenditure side of the EU Budget and the size of the UK's abatement.

[122] Iain Begg, *submission of evidence*.

[123] Alex Boyd, *Note of Discussion on the EU Budget Call for Evidence, 17 January 2014*, p 3.

Running the Budget

To what extent does the EU Budget protect UK taxpayers' money through effective financial management and organisation of the budget system?

3.116 In this section, we consider the processes by which the EU institutions manage expenditure through the EU Budget, including: the financial management process itself and the discharge process; the system for planning spend through the budget (the commitments and payments system); and the revenue system, by which Member States contribute to the budget.

Financial Management, Error and Fraud

3.117 The role of institutions in managing EU Budget money and in agreeing budget contributions was a touchstone for many respondents. On financial management, there were views both critical and supportive of EU and national institutions, with a broad view that the overall system could always be improved. Several respondents considered the role of the ECA and their refusal to give the budget an unqualified statement of assurance for a number of years, though equally, others were supportive of both budget and ECA.

3.118 The commitments and payments system was another area of discussion, with some evidence noting its importance in delivering long-term plans, and others noting the risks and lack of transparency it can bring. Finally, the revenue side of the budget considered proposals for new taxes to fund the EU Budget and the future of correction mechanisms for Member State contributions, with several respondents referencing the possibility of a generalised correction.

3.119 On financial management, views split clearly between those who saw the budget as a well spent and well managed system and those who saw the inability to receive an unqualified statement of assurance from the ECA as a symptom of mismanagement.

3.120 In particular, respondents noted the 'error rate' in the EU Budget – a measurement of the implementation of the budget in accordance with the relevant legislation (and, to be clear, not the level of fraud in the budget, as the Call for Evidence for this report sets out).[124] UK Members of Parliament and delegates to the Council of Europe argued:

> Management of this huge sum by the EU has been notoriously bad. For approaching two decades the EU's own Court of Auditors has consistently refused to sign off the vast majority of the accounts [...] A key problem is one of propriety and property. To those dealing with "EU money" it has not come from any taxpayer, but been magicked [sic] out of thin air. There is no sense of ownership, nor guilt at any waste or loss.[125]

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[124] As does Hodson, *submission of evidence*.

[125] Brian Binley MP, Davit Harutyunyan MP, David TC Davies MP, *The Other Strasbourg Britain's Division of Competences Review: A View from the Council of Europe*.

3.121 Indeed, statistics from the latest ECA report show an increase in the rate of error in the EU Budget over recent years and particularly concerning figures in the major spending areas of agriculture and regional policy.

Table 3.1: Error Rates in the EU Budget (2010-12)

Overall Error Rate			Agriculture: market and direct support			Regional policy, energy and transport		
Year of Report	Budget year	Error rate	Year of Report	Budget year	Error rate	Year of Report	Budget year	Error rate
2011	2010	3.7%	2011	2010	2.3%*	2011	2010	7.7%
2012	2011	6.0%	2012	2011	2.9%	2012	2011	6.0%
2013	2012	4.8%*	2013	2012	3.8%	2013	2012	6.8%

*According to the ECA, 0.3 percentage points of this increase is a result of the change in methodology.

*At the time called 'Agriculture and Natural Resources'.

Source: *European Court of Auditors, Annual Audit Reports,* 2011-13.

3.122 Several respondents argued, however, that:

> The current discharge process is working perfectly well [...] [institutions including OLAF, ECA, European Parliament and Commission] have served to reduce the incidence of corruption and mismanagement to levels that are usually much lower than what is customary in individual Member States.[126]

3.123 Alex Boyd suggested that the ECA was 'seen to be doing a good job and needed greater encouragement [...] the ECA set high standards and their reports should be acted upon'.[127] This also recognised the reality that many of the issues underpinning the rate of error in the EU Budget originate in Member States.

3.124 Several respondents suggested that the majority of these errors were at a national level through 'shared management', with some noting that '80% of EU spending is enacted through the Member States', including the UK.[128] Indeed, some respondents noted that while the error rate is a factor in failing to receive an unqualified statement of assurance from the ECA:

> The majority of errors occur at a member state level and this may be because of confusion with reporting processes on the part of beneficiaries or an incorrect amount being used in error.[129]

3.125 Indeed, George Lyon MEP, Vice President of the European Parliament's Budget Committee, further noted in his evidence that the UK Government, Northern Ireland Executive and Scottish Government had all been responsible for such errors in recent years. A point also noted by the NFU:

> There is something of a paradox that exists in the EU auditing process. Member States are left to develop, implement and deliver EU funded programmes. It is only when they are operational that the EU will determine whether or not rules have been broken and disallowances incurred. Indeed, Defra's delivery of CAP incurred significant disallowance for the UK.[130]

[126] Professor Robert Leonardi, *submission of evidence*.

[127] Alex Boyd, *Note of Discussion on the EU Budget Call for Evidence, 17 January 2014*, p 2.

[128] Professor Robert Ackrill, *submission of evidence*.

[129] George Lyon MEP, *submission of evidence*.

[130] National Farmers' Union, *submission of evidence*.

3.126 Equally, while the system in the UK may not be directly comparable with that of the EU Budget, George Lyon compared the 2012 error rate in the EU Budget (4.8%) with a rate of 4.4% in the 2012 US federal budget.[131] The system in the UK does not allow for direct comparison of 'error' in the budget.

3.127 In the UK, the audit of central government departments' financial statements is undertaken by the National Audit Office (NAO). When auditing the financial statements, the NAO provides an audit opinion as to whether the accounts provide a true and fair view. This effectively means whether, in the opinion of the auditors, the relevant accounting standards have been followed correctly. They also provide an opinion on regularity. When providing assurance over regularity, the NAO are examining whether voted Parliamentary control totals have been exceeded and whether the expenditure and income recorded in these financial statements have been applied to the purposes intended by Parliament and other authorities which govern them.

3.128 Where departments breach their budgets, or where there is evidence of material levels of fraud and error, the NAO will qualify departments' accounts in the same manner as the ECA by refusing to give a clean audit opinion because of levels of errors in the use of the EU Budget.

3.129 The Scottish Government, in their submission of evidence, argued that while 'it is critical that there is a robust, but proportionate, approach to the sound financial management of the budget's resources when distributed through the various spending programmes', there were several areas that needed further consideration, including comment on the challenging level of 'materiality' in the error rate, the relationship between auditors and differences in interpretation all posed particular challenges for budget recipients. One suggestion was to consider 'the role of the EC's auditors around providing advice [...] to examine the appropriateness of advice-giving in the context of independent audit, in order to deal with avoidable irregularities'.[132] Similarly, the NFU suggested that 'it would seem more appropriate that the EU and it institutions works with Member States as EU programmes are developed to ensure that disallowance is minimised and that schemes are effective and legally compliant from the outset'.[133]

3.130 Another suggestion for reform of the financial management system came from the Brussels and Europe Liberal Democrats, who proposed a greater role for 'the budgetary control committees of national parliaments', who could 'receive and examine Member States own audit and control practices concerning the EU Budget managed by them', working closely with the European Parliament and Council.[134]

3.131 The role of the European Parliament in financial management was also raised and discussed in depth at the Brussels event in December 2013. At that event, a greater role for the European Parliament Budget Committee was suggested, with the Committee taking on a role similar to that of the Public Accounts Committee of the UK Parliament – with the Commission, other institutions and Member States challenged on their part in EU Budget error.[135] Alex Boyd, of the European Conservatives and Reform Group of the European Parliament, suggested that institutions including the European Parliament could do more in this area, though this would require 'increased, better-targeted, information from the Commission [...] to ensure Member States and MEPs could fully scrutinise the system – in the way the Public Accounts Committee in the UK scrutinises the UK's national

[131] George Lyon MEP, *submission of evidence*.

[132] All from Scottish Government, *submission of evidence*.

[133] National Farmers' Union, *submission of evidence*.

[134] Brussels and Europe Liberal Democrats, *submission of evidence*.

[135] *Note of EU Budget Seminar, Brussels 3 December 2013.*

budget'.[136] To achieve this, Boyd suggests one solution could be an inter-institutional agreement on transparency of budget information.

3.132 In the discussion held in Sofia, attendees argued that 'comparatively only very small levels of fraud were uncovered in EU programmes' and this was therefore not a significant issue.[137] George Lyon referenced Commission estimates that only 0.2% of the budget is subject to fraud – noting as the Call for Evidence did for this report (and as set out in the text box on Financial Management in Chapter Two of this report) that fraud and error are substantially different concepts in the EU Budget.[138]

3.133 In any event, there remains a view, seen widely in submitted evidence and noted by Dermot Hodson that the consistent negative assessments by the ECA have 'undermined trust in how the EU manages public money' noting a 2012 Euro-barometer poll which showed that 'almost three quarters of EU citizens consider there to be corruption within the EU institutions'.[139] Certainly, there is more that can be done in this area, to improve the oversight of budget money, the rate of error in the budget and the public perception of the EU Budget.

3.134 On the error rate and the recent findings of the ECA, the UK Government has expressed extreme disappointment that the ECA has been unable to give an unqualified Statement of Assurance to the EU Budget for 19 consecutive years. The ECA's findings undermine the credibility of the EU Budget and clearly show that the UK's strong stance on financial management is justified. When countries across Europe are taking difficult decisions to tackle their deficits, the UK Government believes that taxpayers need to have confidence that every effort is being made to improve the management of EU funds, by the Commission and all Member States.

The Commitments and Payments System

3.135 Evidence also discussed the commitments and payments system in the EU Budget, and its part in management of the budget. This system, unlike many national budgets, sees a mismatch between the budget 'promised' and the budget available to spend, which raised questions around transparency and planning in several submissions of evidence, particularly from the research sector, where delays in adoption of the additional budget in 2012 was seen to have risked the future of some projects.

3.136 Some respondents saw advantages in the existing system:

- Increases control over the budget: 'Paradoxically, it delivers greater control over the budget by the governments than if spending were released straight away [...] Commitments [...] are only fully delivered in 'payments' if the recipient complies with all the conditions, attracts the right amount of co-financing and spends any advance correctly';[140]
- Opportunity for long-term planning: Respondents at the Brussels event suggested that the commitments and payments system allowed for long-term planning, with the ability to plan a project in the knowledge that a flexible system of 'payments' flowing from promised funding would be available when needed. The 'snowball of liabilities' as a result – the growing stock of RAL (see box below) was seen as a natural consequence of a system of this type.[141]

[136] Alex Boyd, *Note of Discussion on the EU Budget Call for Evidence, 17 January 2014*, p 2.

[137] *Note of EU Budget Seminar, Sofia, Bulgaria, 19 December 2013*.

[138] George Lyon MEP, *submission of evidence*.

[139] Referenced by Dr Dermot Hodson, *submission of evidence.*

[140] Dr Giacomo Benedetto, *submission of evidence.*

[141] *Note of EU Budget Seminar, Brussels 3 December 2013.*

Commitments, Payments and 'RAL'

The EU Budget is different to the budgeting system the UK has in place. The EU system operates with commitments (which are planned or budgeted spend) and payments (which are actual realised spend, determining Member States' contributions). The UK system operates on accruals, or payments only.

In some spending areas, this differentiation is of little consequence. With direct CAP payments, a commitment turns in to a payment in the same year with no time lag. In other areas the differentiation is important. With Structural Funds (which might include large infrastructure projects) there is a lag between commitments being realised into payments and some commitments are never spent. This could be because projects take time to implement or because matched funding from a Member State is not available. This creates unspent commitments, known as "RAL" – from the French 'Reste à liquider'.

There are some rules to try to limit the build-up of unspent commitments, including rules on the expiration of unused commitments. Nevertheless, the stock of RAL has been growing, particularly over 2007-13, and now stands at over €200bn. This creates uncertainty in planning. In the negotiation for 2014-20 the UK put primacy on payments rather than commitments, given the uncertainty of commitments.

3.137 Several respondents also raised concerns with this system, noting the impact that it could have on planning, the disconnect between what was promised and what was actually available and concern with the growing liability of unspent commitments:

- No improvement on national systems – Several respondents noted that most Member States funded long-term projects, including infrastructure and research projects, without needing a system of commitments and payments. However, the accruals-based systems of some Member States, notably the UK, did not build up the same liabilities of unspent commitments as seen in the EU Budget.[142]

- Gap between commitments and payments – 'The organisation of the EU Budget into commitments and payments can be problematic if the gap between the two different appropriations is too large, which can create a payment credit shortfall'.[143] This can have a significant impact on planning of spend – and potentially on contributions (see inset box, above). It can also have an impact on the public perception of the budget, leading to confusion about which figure (commitments or payments) represents the 'real' budget.

- Build up of 'RAL' – The growth of the RAL (unspent commitments) was seen by some respondents as an issue linked to the gap between commitments and payments, but also to 'the need for a medium-term in which *juste retour* is a key factor'.[144] In this case, the disconnect could be seen as a product of some sides of the negotiation seeking increasing receipts (or an ability to claim increased receipts through increasing commitments), while others sought to reduce the size of contributions through

[142] Alex Boyd, *Note of Discussion on the EU Budget Call for Evidence, 17 January 2014*, p 2.

[143] Russell Group, *submission of evidence*.

[144] Professor Iain Begg, *submission of evidence*. Also Russell Group, *submission of evidence.*

reducing the payments side. This was seen by some respondents as an area where action was needed, with 'currently around €230bn of these commitments [...] rolling forward into the new MFF from the previous one'.[145]

- Disconnect in planning within institutions- Linked to the above, the Russell Group also noted that 'the Commission is able to enter into new commitments, such as signing new research grant agreements which require pre-financing, but they run out of payment appropriations to cover these commitments'.[146] The impact of this commitments-side focus in the Commission can result in uncertainty for recipients. Research Councils UK noted that 'a lack of payment credit could for example result in late payment of pre-financing, for which the Commission would have to pay interest to beneficiaries'.[147] A payments-led system would, in theory, provide greater certainty for contributors of the amount needed for the budget and therefore the impact on Member States' fiscal positions and would ensure that institutions 'commit' only the amount which is actually likely to be available in any given year.

'Off-Budget' Items

3.138 In considering the transparency of the budget, some respondents also covered views on the system of 'off-budget' items – or items 'outside the MFF', with broad recognition from most that some flexibility is needed in the system, but recognising that this does not necessarily require off-budget instruments, which could be seen by some to lack transparency. Some referred to the European Development Fund, which was seen as an 'off-budget item', though its contribution does not come through the same system as the EU Budget.[148]

3.139 Some respondents put forward the case that off-budget items were necessary to ensure the budget ran smoothly and was able to respond to unforeseen circumstances:

> The held "off-budget" provides a safety valve for the budget and allows for the EU to respond to emergency situations. Given the length of the seven-year budgetary period, a potential corrective mechanism is useful in being able to provide emergency aid to stricken areas as has been the case during the last few years.[149]

> Some expenditure in the EU Budget is occasional and very unpredictable. Catastrophes within the Union or outside need responses but one cannot foresee the extent of these beforehand. Instruments have been agreed that aim at providing rapid response to exceptional or unforeseen events, and provide some flexibility beyond the agreed expenditure ceilings within certain limits.[150]

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[145] George Lyon MEP, *submission of evidence.*

[146] Russell Group, *submission of evidence*.

[147] Research Councils UK, *submission of evidence*.

[148] The European Development Fund was covered in greater detail in: HMG, *The Balance of Competences Between the UK and the EU: Development Cooperation and Humanitarian Aid* (2013).

[149] Professor Robert Leonardi, *submission of evidence*.

[150] Brussels and Europe Liberal Democrats, *submission of evidence*.

3.140 Iain Begg noted that off-budget items could be seen by some as 'occasionally necessary to break a logjam' by finding additional expenditure outside the publicly agreed ceilings.[151]

3.141 Some respondents suggested drawing a line at the point where those instruments which provided emergency relief (the European Solidarity Fund and the European Aid Reserve) would be held off-budget, but that all other expenditure would be held on-budget 'to ensure proper transparency'.[152]

3.142 Recognising the advantages and disadvantages above, the NFU suggested that maintaining flexibility in the budget was important, but that this might be achieved by 'allowing flexibility between funding headings', without off-budget items acting 'as some type of savings account for the European funds'.[153] This view was echoed by the Brussels and Europe Liberal Democrats, who argued that 'if the MFF were already more flexible, these latter instruments [off-budget instruments] would not be so necessary'.[154]

Own Resources

3.143 Evidence also considered the Own Resources, or revenue, system of the budget. Views in this area were varied, with some respondents discussing options for alternative revenue streams for the EU Budget, such as a greater focus on the use of the GNI resource. Others discussed the correction mechanisms which are a part of the current budget system (see Chapter One) and some considered alternatives, including a generalised correction mechanism.

3.144 This report has already discussed the roles of institutions in agreeing the revenue side of the budget in the *Agreeing the Budget* section of this chapter. The UK abatement has also already been considered as part of the 'Spending the Budget' section of this chapter.

3.145 There was less evidence provided on the need for reform of the Own Resources system. Respondents provided, however, a critique of the existing system, considered some of the alternative mechanisms and noted the potential impact on the UK of some of those alternatives. Some argued that the existing system was acceptable without reform:

> It is adequate in its present form which expresses a good level of solidarity between rich and poor countries in the EU.[155]

> The current system based on GNI is reasonable in terms of fairness and efficiency.[156]

> This is a sensible system. No change is needed.[157]

> GNI percentage transfers [which make up the bulk of the revenue into the EU Budget system] are the fairest and most accountable source of revenue based on ability to pay.[158]

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[151] Professor Iain Begg, *submission of evidence,* p 3. Also argued in Robert Ackrill, *submission of evidence*, p 7.

[152] Alex Boyd, *Note of Discussion on the EU Budget Call for Evidence, 17 January 2014*, p 2.

[153] National Farmers' Union, *submission of evidence*.

[154] Brussels and Europe Liberal Democrats, *submission of evidence*.

[155] Robert Leonardi, *submission of evidence*.

[156] Professor Fiona Wishlade, *submission of evidence*.

[157] Centre for European Reform, *submission of evidence*.

[158] Dr Giacomo Benedetto, *submission of evidence*.

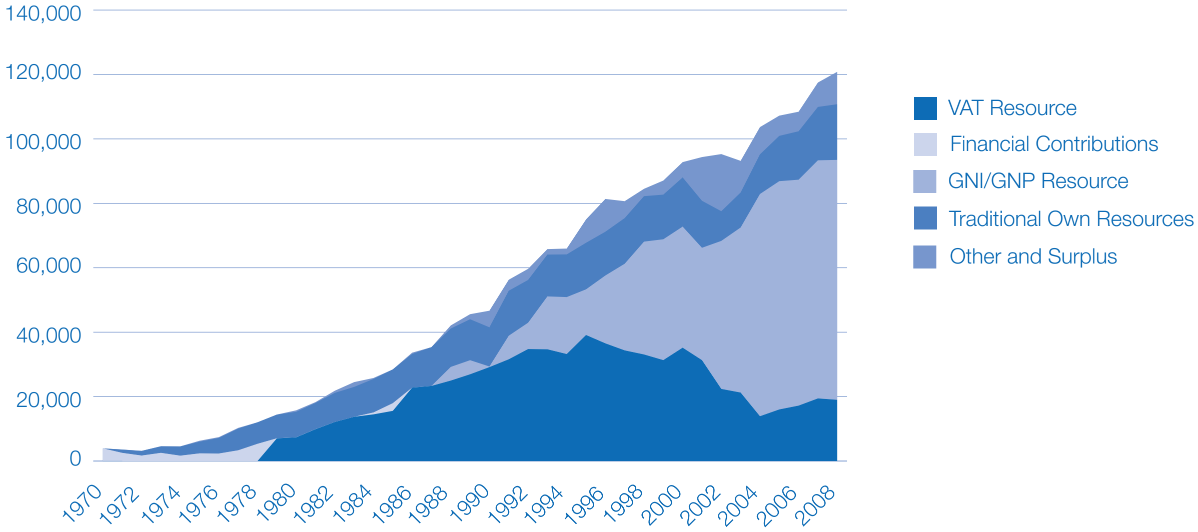
3.146 Others have suggested, however, that the contributions system is fundamentally flawed through lack of transparency and Member States' interests in *juste retour* (that is, the focus on a Member State's net contribution);

'The current own resources system is complex, does not respect fully the precept of "own resources", and is undermined by correction systems. It is too dependent on contributions of Member States according to their GNI. The link between the funded actions of the Union and its sources of revenue should be understandable for the general public. It is not. Ideally long-term corrections should not be needed and all major sources of revenue should be linked to the activities of the Union'.[159]

3.147 As George Lyon MEP noted, 'a High Level Group on Own Resources is to be formed which will consider the most prudent approach to funding the European budget'.[160] However, some respondents discussed alternative funding streams, including progress on a Financial Transaction Tax (FTT) to fund the EU Budget (greater detail on the general EU Financial Transaction Tax can be found in the Taxation Report of Semester One of this Review);

Many Member States had called [during MFF negotiations] for new own resources, including a Financial Transaction Tax [which proceeded by enhanced cooperation between a group of Member States].[161]

Chart 3.4: Development of EU Budget Revenue, 1958-2008



Source: *European Commission, EU Budget, 2008 Financial Report, Annex 3 'Revenue 1970-2008'* (2009).

3.148 Several respondents questioned the impact that an FTT to fund the EU Budget could have on the UK. The Scottish Government in particular noted that 'there are likely to be significant costs associated with moving to an alternative system, particularly one involving direct taxation of citizens'.[162] Indeed, at the Brussels round-table event, this was considered by several attendees as likely to be firmly against the UK's national interest by disproportionately affecting UK taxpayers.[163]

[159] Brussels and Europe Liberal Democrats, *submission of evidence*.

[160] George Lyon MEP, *submission of evidence*.

[161] Alex Boyd, *Note of Discussion on the EU Budget Call for Evidence, 17 January 2014*, p 3.

[162] Scottish Government, *submission of evidence*.

[163] *Note of EU Budget Seminar, Brussels 3 December 2013.*

3.149 Several others also suggested that whatever the method of bringing in revenue to the budget, Member States would continue to see this as 'their' contribution, with the principle of *juste retour*, theoretically, distorting the impact of new own resources on Member States' positions:

One argument for this [introduction of new own resources] was that their introduction would help move the EU Budget debate beyond its current standing as a separate policy, with a focus on national budget balances, towards a new emphasis on what the EU should be doing. I think that this view is naïve: just as with traditional own resources currently, the money will still come 'through' Member States, even if it is not directly 'from' them.[164]

Although methods such as a Financial Transactions Tax or a change to the VAT levy have been proposed as a means to get away from the idea of net contributions, such alternatives would not solve the problem. Member States with a high number of financial transactions or VAT payments would still calculate that revenue as part of a net national contribution.[165]

3.150 Some respondents also criticised the proliferation of correction mechanisms on the revenue side of the budget, including, but not limited to, the UK abatement. Again, this was often seen, particularly by academics, as a representation of some Member States' focus on achieving a 'fair' net contribution:

The corrections on contributions are difficult to justify; 'corrections' should, arguably, be part of the expenditure side of the balance sheet, not an adjustment of contributions.[166]

This focus on budget balances and the *juste retour* has, as I have argued repeatedly, distorted all discussion over the EU Budget. This problem finds its ultimate expression in budgetary corrections, which are a political sop to Member States who are obsessed with budget balances, rather than what EU Budget is spent on. They have no economic rationale at all.[167]

3.151 However others noted that the need for corrections stemmed from the difficulties of negotiation:

Corrections, on any reasonable view of multi-level governance, are a non-sense, but they reflect an inability to agree on what is a sensible package of expenditure. It should be seen as a political problem to be resolved by a fundamental rethinking of what the EU Budget is for, rather than increasing resort to a range of corrections.[168]

3.152 Others recognised that several Member States, including the UK, Germany and Sweden, also receive corrections on their contribution. Indeed, the size of the 'other corrections' for Member States other than the UK is now notably greater than the size of the UK abatement. Finally, the generalised correction was discussed by some respondents as a means to ensure fairness across all Member States' contributions – with several suggested systems.[169] Nicolaides argued that 'an explicit system that is based on this kind of logic (ability to pay and receive) should be more transparent and fairer [than other

164 Professor Robert Ackrill, *submission of evidence*.

165 Dr Giacomo Benedetto, *submission of evidence*.

166 Fiona Wishlade, *submission of evidence*.

167 Professor Robert Ackrill, *submission of evidence*.

168 Professor Iain Begg, *submission of evidence.*

169 On which Dr Benedetto, *submission of evidence*, p 13-14 and Nicolaides, *submission of evidence*, p 1 go into the greatest detail.

corrections, like the UK abatement]. Naturally, the threshold for a generalised rebate remains to be established'.[170]

3.153 The theory of a generalised correction has, however, been discussed for several decades. In the absence of such a correction, Alex Boyd returned to defend the case for the UK abatement as being 'entirely justified', though 'if one could be devised to provide fairness and equality in contributions, a generalised correction could be a way forward, possibly in the form of a % cap [in] GNI for net contributors'.[171]

3.154 Broadly, therefore, evidence from respondents argued that corrections across all Member States were a symptom of fundamental issues in the budget system – including difficulty in agreeing on the expenditure side of the budget and a focus among some Member States on achieving a 'fair' net contribution. Some respondents suggested the need for a generalised correction, with no consensus on what a generalised correction should look like – though several options were proposed.

Summary

3.155 In this section, respondents considered:

- The Financial Management system of the EU Budget, where respondents broadly argued for a continued effort to improve financial management in the EU Budget. Respondents also supported the ECA, noting the importance of close cooperation between Member States and the ECA.
- The Commitments and Payments system, with several respondents supporting the existing system and its perceived focus on long-term stability and ensuring good value in spend. Others, however, raised significant concerns about the increasing failure of the system, particularly focussing on the growing liability of 'RAL', or unspent commitments in the EU Budget.
- Off-budget items, where several respondents raised concerns about the scale of instruments 'outside the MFF'. Others, however, noted the importance of some of these instruments in providing emergency relief both inside and outside the EU.
- Own Resources and corrections, where respondents discussed the future of the revenue side of the budget, with broad support for the GNI resource as a primary source of revenue. Other revenue streams were discussed, though respondents largely noted that proposed resources like a Financial Transaction Tax would disproportionately impact on the UK. The correction mechanisms on the revenue side of the budget (which are applicable to several countries, including the UK and Germany) were also discussed in more general terms, with respondents largely critical of their continued existence, though recognising the negotiating realities which were at cause. Proposals for a generalised correction were discussed, though there was no consensus on how this would be formed.

[170] Professor Phedon Nicolaides, *submission of evidence.*

[171] Alex Boyd, *Note of Discussion on the EU Budget Call for Evidence, 17 January 2014*, p 3.

Chapter 4: Future Options and Challenges

4.1 In this chapter, we consider the potential implications of the discussion of the national interest and the impact the EU Budget has on the national interest, set out in the previous chapters. We consider some of the challenges that the budget will face in the future – including evidence received from respondents on developments in the Euro Area – and some of the questions emerging from this report.

4.2 Evidence received on all areas of the report has provided an important commentary on the impact that the EU Budget has on the UK. Evidence has considered the need for long-term planning in the budget, the need for institutions to work closely to achieve agreements, the value of the expenditure that comes from the budget and the consequent need for the UK abatement. It has also considered some of the questions around the management of the budget – both in tackling error and fraud in budget spending and in controlling areas like the commitments and payments system and ensuring the budget is funded in a fair and transparent way.

4.3 It is important to remember in considering this chapter that, as this report has set out, many areas for major structural reform would require unanimity in Council – and the agreement of other institutions including the European Parliament – to deliver. While the UK therefore has a 'veto' in such cases, all other Member States have the same responsibilities and powers. Therefore, while this report may include evidence which suggests amendments to the budget system which might be in the UK's national interest, others may consider that those reforms would not be in their national interest – or in the interest of the Union as a whole. Nevertheless, below we set out some of the challenges which will be faced by the Union in this area in the coming years. We then set out the further questions which emerge from this report, for consideration by those approaching the next reform of the EU Budget.

Future Challenges

4.4 Euro Area developments:

- Several respondents commented on the future of the EU Budget with respect to ongoing developments towards closer integration in the Euro Area. The possibility of using the EU Budget as a facility as part of this development was raised by some – discussed below – although the development of an alternative budget, or substantial reform of the existing system, was not covered by the legal scope of this report. The impact on the UK of further Euro Area integration and any related 'solidarity' mechanisms will be covered by the Semester Four 'Economic and Monetary Policy' report;

- In summary of the evidence received as part of the call for evidence on this report, some respondents suggested a need for a Euro Area budget as the Euro Area continues to develop. This was particularly seen in evidence from the Brussels and Europe Liberal Democrats, who suggested, simply, that the Euro Area 'should in due course have its own budget'.[1] This was seen by some as a possibility, separate to the EU Budget, as a 'parallel budget for the Eurozone [...] made available by enhanced cooperation'.[2] These views reflected recent informal proposals by European Union institutions for Euro Area solidarity mechanisms;

- Alternatively, several respondents, particularly from the academic community, questioned the necessity of a Euro Area budget.[3] Fiona Wishlade linked the difficulty seen in finding agreement in other areas of EU Budget negotiations with this point, arguing that 'it is difficult to envisage that the structure of the budget would change significantly in future given the drivers underpinning agreement on the budget – net balances and *juste retour*, coupled with national vetoes'.[4] Indeed, this recognises some of the potential risks to the UK national interest, were non-Euro Area Member States to become implicated in Euro Area expenditure.

4.5 Return to growth – an opportunity to reform the budget?

- The MFF agreement for 2014-2020, with its delivery of increases in spending on research and innovation, was seen by some respondents as a step in the right direction towards growth spending;[5]

- However, a large proportion of respondents commenting on the added value of EU Budget expenditure argued that there was further to go in re-shaping the budget towards higher value, growth-focussed expenditure;

- 'Added value' relates to expenditure that provides a collective benefit which could not have been achieved as efficiently through Member States acting in isolation. Climate policy as well as research and development are often cited as examples of areas that add value at an EU level and are discussed in greater detail in the *Research and Development* report that forms part of the Balance of Competences Review;

- One future question might therefore be around the evolving shape of the budget beneath the now-agreed MFF ceilings and ensuring that, the budget agreed for 2014-2020 is delivered in the most effective ways possible, to the highest value areas of expenditure. The mid-term review of the budget, during the MFF period, may be a key moment for this discussion.

4.6 Financial management – opportunities to improve the delivery of the budget:

- As debate continues on the relationship between the UK and the EU, the budget (and the UK contribution in particular) is a clear touchstone for the UK public. Ensuring that the budget is well-spent and that the financial management processes which protect taxpayers' money in the EU are robust and appropriate was a key point made by several respondents in this report;

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1 Brussels and Europe Liberal Democrats, *submission of evidence*.

2 Dr Giacomo Benedetto, *submission of evidence*.

3 Professor Cillian Ryan, *submission of evidence*.

4 Fiona Wishlade, *submission of evidence*.

5 Research Councils UK, *submission of evidence*.

- Respondents focussed on two key challenges for the future; that a) all sides work towards a more transparent, well-spent budget system and b) institutions and Member States work to ensure that the discussion around financial management of the budget is truly transparent, aiming to clear some misconceptions about the level of fraud and error in the budget.

4.7 Agreeing budgets and expenditure priorities:

- Further enlargement of the EU will lead to the necessary consideration and incorporation of an even greater number of views on what should amount to priority areas for EU Budget expenditure. The increased level of complexity that a greater number of Member States will bring to the existing *juste retour* approach will be a challenge for agreeing future budgets, internal versus external expenditure, and public goods;
- Additional factors, such as globalisation, an aging population and climate change will also contribute to the challenge of agreeing annual budgets that appropriately reflect the needs across all Member States as they grow in importance and urgency. Accommodating such factors and their increasing urgency will continue to be a challenge for future policy makers;
- As highlighted by some respondents, the focus of the budget should be more towards future needs, rather than historic patterns.[6] One question facing future decision makers may be how the EU accommodates and anticipates future needs when establishing EU Budgets as historic patterns of expenditure and prioritisation become less relevant to the needs of the evolving EU.

Summary of Discussion

4.8 On ‘agreeing the budget’, Chapter Three of this paper discussed:

- The overall size of the EU Budget, which was seen by some to be small as a percentage of GNI, when compared to budgets in Federal budgets in, for example, the United States. However, the unique structure and focus of the EU Budget was recognised, with expenditure not directly comparable with that of Member States;
- The need for a long-term budget period, with respondents largely supporting the need for long-term planning to support recipients, though difficulties were seen in agreeing budget periods by unanimity;
- The length of the MFF period, with discussion of the relationship between the MFF period and European Parliament electoral cycles and the need for flexibility as well as long-term certainty;
- The roles of institutions in agreeing the budgets, with discussion in particular of the role of the European Parliament on the revenue side of the EU Budget system.

6 Alex Boyd, *Note of Discussion on the EU Budget Call for Evidence, 17 January 2014*, p 2.

4.9 On 'spending the budget', Chapter Three of this paper discussed:

- The value of expenditure in the budget, where in particular Heading 1A, covering expenditure on research and innovation, was seen as a priority for a greater share of the budget due to the perceived positive impact on growth;
- The most effective methods of spend in the budget, where respondents largely accepted that this question depended on the aims of particular programmes, though increased use of innovative financial instruments was suggested by some;
- The link between the UK abatement and value for money, where respondents discussed the UK abatement, with some recognising the link formed by the 2005 'disapplication' between reform of the expenditure side of the EU Budget and the size of the UK's abatement.

4.10 On 'running the budget', Chapter Three of this paper discussed:

- The Financial Management system of the EU Budget, where respondents broadly argued for a continued effort to improve financial management in the EU Budget. Respondents also supported the ECA, noting the importance of close cooperation between Member States and the ECA;
- The Commitments and Payments system, with several respondents supporting the existing system and its perceived focus on long-term stability and ensuring good value in spend. Others, however, raised significant concerns about the increasing failure of the system, particularly focussing on the growing liability of 'RAL', or unspent commitments in the EU Budget;
- Off-budget items, where several respondents raised concerns about the scale of instruments 'outside the MFF'. Others, however, noted the importance of some of these instruments in providing emergency relief both inside and outside the EU;
- Own Resources and corrections, where respondents discussed the future of the revenue side of the budget, with broad support for the GNI resource as a primary source of revenue. Other revenue streams were discussed, though respondents largely noted that proposed resources like a Financial Transaction Tax would disproportionately impact on the UK. The correction mechanisms on the revenue side of the budget (applicable to several Member States, including the UK and Germany) were also discussed in more general terms, with respondents largely critical of their continued existence, though recognising the negotiating realities which were at cause. Proposals for a generalised correction were discussed, though there was no consensus on how this would be formed.

4.11 While responses from stakeholders to this report suggested that the existing balance of competences with relation to the EU Budget is reasonable (very few responses raised issues – such as the introduction of new taxes to fund the EU Budget – which would impact on Member States' competences), respondents' focus on the application of competence on the EU Budget raised several questions about the structures and priorities of the budget.

4.12 In particular, respondents' focus on the question of whether the EU Budget provides good value for taxpayers' money raised, in the first instance, discussion of how to define 'added value' and second, which areas of the EU Budget best fit that definition. A significant number of respondents, from a variety of different backgrounds, suggested that despite the open debate about what constitutes good value in the EU Budget context, research and development expenditure, particularly that seen through Heading 1A of the budget, delivers the clearest 'added value' for EU Budget funds.

4.13 On structural issues, there was substantial discussion (but little consensus) among respondents on the length of the long-term MFF budget period. There was substantial discussion of the financial management of the budget, however, and while several respondents gave strong support for the work of EU institutions including the European Court of Auditors on this point, there was broad consensus among respondents that more can be done – within institutions and Member States – to improve financial management of EU Budget money and to reduce the rate of error.

4.14 Finally, there was some discussion among respondents of the Own Resources system, with a small number of respondents discussing the previously-proposed introduction of new Own Resources to fund the budget. Respondents showed broad support for the GNI resource and others, including the Scottish Government, noted concerns about the introduction of a Financial Transaction Tax which would (until its rejection by European Council in 2013 and progress by enhanced cooperation among a limited group of Member States) have disproportionately impacted on the UK.

4.15 Several respondents criticised the continued existence of correction mechanisms in the budget system – though some respondents called for a generalised correction to replace the current selection of different mechanisms. While, in this context, several respondents were critical of the UK abatement, several others recognised the link between the abatement and 'added value' of the budget, setting it apart from other corrections. Finally, other respondents noted that without the abatement, the UK's net contribution to the budget would be twice that of France and substantially greater than that of Germany and therefore argued that the UK abatement remains fully justified.

Annex A: List of Evidence Received

Ackrill, Professor Robert, Nottingham Trent University

Begg, Professor Iain, London School of Economics and Political Science

Benedetto, Dr Giacomo, Royal Holloway, University of London

Binley, Brian MP, parliamentary delegate to the Council of Europe

Boyd, Alex, European Conservatives and Reformists Group, European Parliament

Brussels and Europe Liberal Democrats

Business for New Europe

Centre for European Reform

Davies, David TC MP, parliamentary delegate to the Council of Europe

Dimitrakopoulos, Dr Dionyssis, Birkbeck, University of London

Fresh Start Project

Gore, Tony

Harutyunyan, Davit MP, parliamentary delegate to the Council of Europe

Hodson, Dr Dermot, Birkbeck, University of London

Institute for European Environmental Policy

Leonardi, Professor Robert, LUISS Guido Carli University, Rome

Lyon, George MEP

National Farmers' Union

Nicolaides, Professor Phedon, College of Europe

Northern Ireland Executive

Open Europe

Research Councils UK

Russell Group

Ryan, Professor Cillian, University of Birmingham

Scotch Whisky Association

Scottish Government

Swedish Institute for European Policy Studies

Universities UK and UK HE International Unit

Welsh Government

Wishlade, Fiona, University of Strathclyde

WWF - UK

Any references to MEPs reflect their status at the time of the Call for Evidence period.

Annex B: Engagement Events

A number of engagement events took place during the duration of the Call for Evidence period. Events listed generated submissions to the Call for Evidence and attendees are given below. Each event was recorded with a written summary of the discussion, agreed by attendees, which are entered as evidence published alongside this report.

Seminar on EU spending - hosted jointly by HM Treasury (HMT), the Department of Business Innovation and Skills (BIS) and the Department for Environment, Food and Rural Affairs (Defra), November 2013, London

- (Chair) Professor John Bachtler, European Policies Research Centre, Strathclyde University.
- Business for Britain
- Convention of Scottish Local Authorities
- Department for Communities and Local Government
- European Commission
- Institute for European Environmental Policy
- National Farmers Union
- National Council of Voluntary Organisations
- Open Europe
- Research Councils UK
- Royal Society for the Protection of Birds

Seminar on the EU Budget – hosted jointly by HM Treasury and the United Kingdom Permanent Representation to the European Union (UKRep), December 2013, Brussels

- (Chair) George Lyon, MEP, Vice Chair European Committee on Budgets
- Richard Ashworth, MEP, European Committee on Budgets
- Business Europe
- Brussels School of International Studies
- European Commission (Directorate- Generale for Budget)

- European Parliament
- Institute for European Environmental Policy
- National Farmers Union
- Office of the Scottish Executive, Brussels

Round-table discussion on the EU Budget, Cohesion and Agriculture reports, Sofia, Bulgaria, December 2013

- (Facilitator) Cat Evans, Europe Directorate, Foreign and Commonwealth Office
- Dessislava Nikolova, Institute for Market Economics (IME)
- Olga Chugunska, Bulgarian Chamber of Commerce and Industry (BCCI)
- Michael Davidson, UK Embassy in Bulgaria

Academics round-table discussion on the EU Budget, January 2014, London

- (Chair) Harold Freeman, Deputy Director EU Institutions and Policy, HM Treasury
- Professor Dermot Hudson, Birkbeck, University of London
- Professor Dionyssis G. Dimitrakopoulos, Birkbeck, University of London
- Dr Julie Smith, University of Cambridge
- Professor Iain Begg, European Institute, London School of Economics
- Professor Robert Ackrill, Nottingham Trent University
- Fiona Wishlade, Co-Director, European Policies Research Centre, Strathclyde University

Horizontal Interest Groups workshop on the EU Budget, January 2014, London

- Marcus Corry,European Policy Forum
- Charles Crawford, Alumni of the Foreign and Commonwealth Office
- Peter Cullum, Road Haulage Association
- Marie-Madeleine Kanellopoulou, European Commission Office, London
- Graham Mather, European Policy Forum
- Sir Peter Marshall, Alumni of the Foreign and Commonwealth Office
- Francis Morgan, British Airport Authority
- Dr. Charles Trotman, Country Land and Business Association
- Professor Dame Helen Wallace, British Academy

Annex C: Other Sources

The following list is not exhaustive but sets out some of the main sources drawn upon in preparing the analysis:

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Blankart, Charles B; and Koester, Gerrit B, 'Refocusing the EU Budget – An Institutional view', *Centre for Research in Economics, Management and the Arts*, Working Paper No. 2009-16 (2009).

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Somai, Miklos, 'EU Transfers and the Next Financial Framework', *Eastern Journal of European Studies Volume 2 Issue 2* (2011).

Spence, James, 'A High Price to Pay? Britain and the European Budget', *International Affairs*, 88: 6 (2012).

Thompson, Gavin; and Harari, Daniel. *The Economic Impact of EU Membership on the UK* (2013).

Zuleeg, Fabian. 'The EU Multi-annual Financial Framework (MFF): Agreement but at a Price', *European Policy Centre* (2013).