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What European budget for post-crisis Europe?[1]

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As chance would have it, EU Member States are called to negotiate a new EU multiannual budget for the 2014-2020 period while the economic and financial crisis continues to hit their economies and their public finances. So far, the negotiations of the new multi-annual budget are strikingly similar to past budgetary negotiations. And yet, the political and economic context is radically different from the context in which the latest multi-annual financial framework (MFF) negotiations developed.

In 2005, when Member States reached a compromise on the 2007-2013 EU budget, the European economy was growing at a rate of approximately 2%. Like today, national public finances were in bad shape, but middle-term economic forecasts were optimistic. Indeed, the main issue of concern was how to render the EU economy more dynamic, as this 2 percent rate of growth was considered highly dissatisfactory and a proof of "quasi sclerosis" in a world growing at annual rates of around 5 percent and with the United States' economy strongly rebounding at rates of 4 percent. From the point of view of solidarity, the challenges were also clear: the Union had just accomplished the most ambitious enlargement in its history, with the entry of ten countries with income levels well below that of the EU-15. With the so-called "cohesion countries" (Spain, Ireland, Portugal and Greece) experiencing remarkable growth, there was no doubt that EU solidarity efforts must focus mainly on the new Members. Finally, there were occasional crises affecting the European integration project– remember the French rejection of the draft Constitutional Treaty – but these were notably politico-institutional crisis, with practically no effect on the European budget.

Today, the economic and political climate is quite different. We are still worried about the EU's potential for long long-term growth, but also, and more urgently, about the EU's capacity to avoid recession. Indeed, medium-term growth forecasts are extremely uncertain and there is no guarantee that the crisis will be entirely behind us by 2014. The crisis has also revealed the existence of other EU solidarity needs than the traditional long-term challenge of helping the least developed countries catch up. This raises a question on whether the EU budget should in the long term cover these other solidarity needs (more related with financial and economic stabilisation), or should it rather maintain its focus on fostering the catch up process of poorer economies. Finally, the crisis has led to the introduction of major institutional and legal reforms in the system EU economic governance. These reforms will have a direct and significant impact on national public finances and national budgetary procedures and, indirectly, they might have implications for European public finances.

This article aims to provide some thoughts on the short-term and long-term implications of the crisis for the EU budget. The first part examines the immediate effects of the crisis on the negotiations over the 2014-2020 financial framework. The second part discusses the long-term implications of the current reforms of EMU governance for European public finances.

[1] This tribune is the updated English version of the article « Quel budget européen pour l'Europe de l'après crise? », published in the journal *Regards Croisés sur l'Économie*, Num. 11, June 2012.

1. The short-term implications: how the crisis affects negotiations for the 2014-2020 financial framework

As said above, the on-going negotiation over the 2014-2020 budget reproduces to a large extent the logic and power struggles of previous budgetary negotiations. Yet, the crisis has slightly changed countries' positions in EU budgetary negotiations and has raised new types of demands. It has also put into evidence some structural weaknesses of the European budgetary system which were already known but have not been seriously addressed until now.

1.1. "Better spending" in a period of budgetary austerity

The most obvious impact of the crisis comes from budgetary constraints at the national level. With more than 85% of the European budget financed by transferences from national budgets, the climate of budgetary austerity has translated into growing calls for a more smaller and efficient EU budget

In truth, there is nothing new to member states' demands for a small EU budget: the negotiation of the 2007-2013 budget was preceded by a letter by six EU 'net contributors' countries asking for an EU budget no bigger than 1% of GDP, and this time there has been a letter by five 'net contributor' countries asking for a freezing of EU spending at 2013 levels (which is roughly equivalent to ask for a 1% GDP budget)[2]. What is different from the past is that the classic net contributors' demand for 'less spending' is intertwined with a demand for "better spending" coming from a larger number of countries.

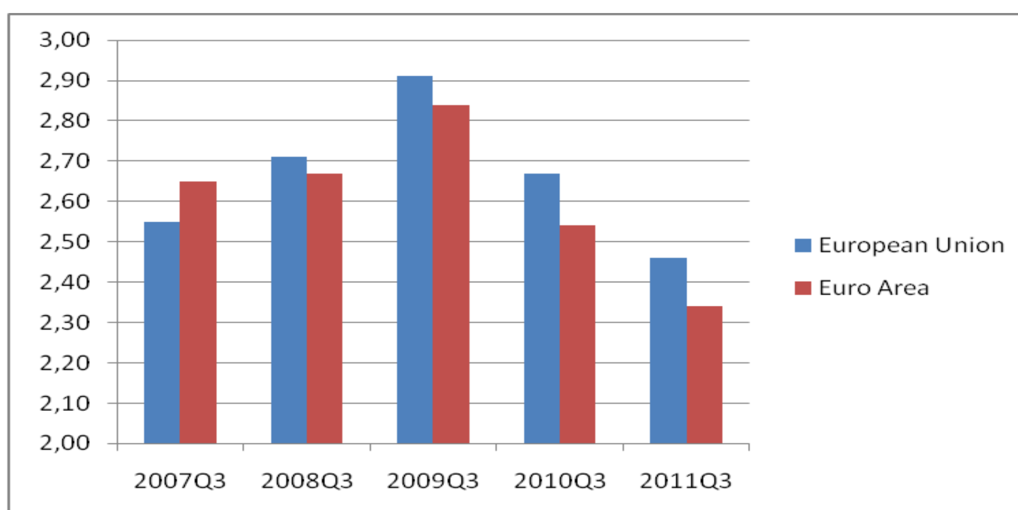
The calls for 'better spending' have been particularly visible in debates concerning the EU cohesion policy. The crisis has bluntly shown the problems of competitiveness and governance affecting the "cohesion countries' of the 1990s (Spain, Ireland, Portugal and Greece), as well as the weaknesses of the growth models followed by these countries during the past two decades. All this has raised doubts about the effectiveness of EU cohesion funding in influencing the environment of competitiveness, as well as to concerns about fraud and misuse in some Member States. Aware of these concerns, the Commission has proposed a series of reforms aimed at increasing the effectiveness and accountability of EU cohesion funding in 2014-2020. Some of these measures are: the establishment of more and stricter 'ex ante' conditions for the use of aid; the introduction of a "performance reserve" to reward the best performers; the concentration of EU funds on a small number of thematic priorities, the improvement of the systems of monitoring and evaluation and the fact of conditioning the disbursement of EU cohesion funds to the pursuance of sound macro-economic policies (the so-called "macro-economic conditionality). At the time of writing this paper, the introduction of these measures is being object of a vivid debate both among the member states and in the European Parliament.

1.2. Financing the recovery

The wave of fiscal consolidation efforts has also curtailed EU countries' capacity to support growth, and more precisely, to finance long-term growth-enhancing investments. As shown in graphic 1, the level of public investment experienced a peak in 2009 (when most EU countries undertook stimuli policies) but since then it has decreased to a level lower than the pre-crisis level, both in the 27 Member States as a whole and in the euro area (see graphic 1).

[2] The signatories of the February 2003 letter were Austria, Germany, France, the Netherlands, Sweden and the UK; the signatories of the December 2010 letter were Germany, France, Finland, the Netherlands and the UK.

Graphic 1. Public investment* (in %GDP), Q3-2007 - Q3-2011



Source: Eurostat, quarterly non-financial accounts for general government
*public spending in "gross fixed capital formation"

Against this backdrop, a strong consensus has emerged on the need to step up efforts at the EU level to finance the economic recovery.Two initiatives have been taken in this respect in the 2012 June European Council; the decision to increase by €10 billion the capital of the European Investment Bank (EIB) and the launch a pilot phase of the "EU project bonds initiative", which will be entirely financed by the current 2007-2013 financial framework via redeployment within the envelopes of existing programmes in 2012 and 2013.

The launch of the "EU project bonds" , which are also expected to play a relevant role in the coming 2014-2020 financial framework, reinforces a trend which started in the latest programming period towards an increasing use of "innovative financial instruments". These instruments can take different forms (loan guarantee mechanisms, risk-sharing facilities) and are jointly managed by the Commission and the EIB. They allow the use of the EU budget as a leverage tool to attract private investment in areas of EU interest.

Innovative financial instruments present several advantages with respect to the traditional grants. To start with, as they attract further private capital, they permit the EU to achieve bigger results with the same amount of public spending (according to the Commission, through the use of these instruments a multiplier effect of around 15-20 in terms of EU spending compared to the investment amount can be achieved). They can also help correct some of the weaknesses of the financial market (notably, the strong risk aversion as a result of the current economic and legal uncertainty)[3]. Finally, contrary to popular belief, these instruments pose no more financial risk than grants, given that the Commission's risk guarantee is limited to its budgetary contribution. However, the results of these innovative instruments are uncertain (there are doubts in particular about the ability of the EU project bonds to attract private capital). Moreover, the technical complexity of these instruments

[3] Glachant *et al.* (2010).

elicits concerns over the ability of the European Court of Auditors to exercise budgetary control and the European Parliament to effectively monitor the functioning of these instruments[4].

1.3. The reform of the EU financing system: detailed proposals at debate

The crisis has also helped to advance the argument for a reform of the EU financing system. The need to review the system, in particular by reducing the EU budget's dependency over national budgets, was already widely accepted among experts and independent observers. However, this was hardly recognised as a need by the member states themselves. With the crisis and the subsequent degradation of national public finances, some member states have started to embrace the idea of creating new EU sources of revenue to partially off-set the national contributions to the EU budget.

Another difference with respect to past budgetary negotiations is that, for the first time, the Commission has decided to accompany the proposal for the 2014-2020 financial framework with detailed proposals to reform the EU financing system. Apart from the removal of all rebates and compensations, the Commission proposes introducing two new EU resources: a true VAT own resource (which would substitute the current statistical VAT) and a tax on financial transactions. If introduced, these two new resources would reduce the weight of national contributions in the financing of the budget from the current 85.3% to 40.3%[5].

Judging by the reactions of EU countries to these proposals, one could think that it is still too early for a radical reform of the EU's financial system. However, it is worth noting that the Commission's proposal foresees the possibility of establishing these new resources "from 1 January 2018 at the latest". This gives countries the possibility to come to a decision on this sensitive issue by delaying its implementation.

2. The long-term implications of the crisis: a "fiscal union" without a common budget?

In the long term, what impact will the crisis have on the European public finances? While this is clearly difficult to predict, one can imagine at least three potential implications. First, the current economic and financial crisis has put into evidence some weaknesses of the original EMU architecture. Among other things, it has shown the difficulties of EMU countries to stabilize their economies when being under market pressure. All this raises a question on whether we will need some kind of specific action to address EMU imbalances in the future, and whether the latter will have to operate within the EU budget. Second, the crisis has led to the creation of a new intergovernmental EMU solidarity mechanism, the European Stability Mechanism (ESM). There is a question on whether it should be integrated into the Community budget in the long run. Finally, the reinforcement of fiscal discipline for member states (through the approval of the Treaty on Stability, Coordination and Governance and strengthening of the Stability and Growth Pact) might have some non negligible budgetary implications at the European level.

2.1. Addressing EMU imbalances

The role of today' EU budget with respect to solidarity is basically confined to helping poorer countries in their catch up process. This is the goal of the EU cohesion policy, which remains by large the most important EU financial solidarity mechanism. However, the crisis has put into evidence the

[4] Study commissioned by the European Parliament's Committee on Budgets, "The implications of EIB and EBRD co-financing for the EU budget", May 2011.
[5] Proposal for a Council decision on the system of own resources of the European Union, COM(2011) 510 FINAL, 29 June 2011.

existence of other EU solidarity needs affecting in particular EMU countries. One of the things the crisis has revealed is that EMU countries are particularly ill-equipped to stabilize their economies when suffering a recession, as they cannot devaluate their currencies. This problem was already detected in the years prior to the creation of EMU. At that time, many independent experts consider essential to equip the EMU with an insurance-type mechanism to provide temporary and conditioned financial assistance to countries in recessionary periods. The proposal of creating such a mechanism was evoked in the Delors Report[6], and it was seriously discussed and analysed during the early 1990s, both by independent economists and by the services of the European Commission[7].

It is not clear that there is a need to 'revive' the 1990s proposal to create an EMU-wide macro-economic stabilization fund. One might argue that the creation of the European Stability Mechanism (ESM) makes it unnecessary, as the ESM will in practice help those EMU countries under financial pressures. At the same time, it could be argued that an EMU macro-economic stabilization scheme would act prior to the ESM, helping countries in downturns before the latter turn into liquidity problems, thus reducing the risks of entering into an ESM rescue plan.

Another question is whether a mechanism of this type would have to be integrated into the EU budget. In principle, the most logical would be to let the mechanism operate outside the EU budget, not only because it would only cover the Euro area member states but also because, as any insurance fund, it could not operate under the balanced-budget rule that is imposed to the annual EU budget.

2.2. Two permanent mechanisms of macro-economic stability

One of the institutional novelties related to the crisis is the creation of a permanent mechanism for macro-economic stability for euro area countries. This new European mechanism (the European Stability Mechanism - ESM) will start to function in July 2012, replacing the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM).

Like the current EFSF (and unlike the EFSM), the ESM will be an intergovernmental organism operating outside the European budget. This has three major implications. First, decisions concerning the concession of aid must be taken unanimously, except in special circumstances[8]. Second, the aid granted by the ESM will be guaranteed by individual (not joint) guarantees by Members of the Eurozone: each country will be responsible for the amount of the guarantee provided but not for the total risk assumed by the ESM. Finally, the ESM will not be under the surveillance of Community institutions. To be more precise, the accounts of the ESM will not be audited by the European Court

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[6] "In order to reduce adjustment burdens temporarily, it might be necessary in certain circumstances to provide financing flows through official channels. Such financial support would be additional to what might come from spontaneous capital flows or external borrowing and should be granted on terms and conditions that would prompt the recipient to intensify its adjustment efforts" (Delors Report, p. 19).

[7] The role of EU public finances in cushioning asymmetric shocks was seriously explored in two influential reports on EMU published by the European Commission in the early 1990s, the famous "One Market, One Money" Report (1992) and the "Stable Money, Sound Finances" Report (1993). In this latest report, an independent group of economists entrusted by the Commission to examine the role of public finances on the EMU concluded the following: "The group shares the view of much of the literature on EMU that there is a strong case for a Community role in assisting Member States to absorb severe specific shocks. This is in order to compensate for the loss of the exchange rate as an adjustment instrument and for the loss of an independent monetary policy, and should help to prevent longer-lasting economic deterioration which could increase the pressure for greater redistribution. It should also make it easier for Member States to respect fiscal discipline" - European Commission (1993), "Stable Money, Sound Finances – Community Public Finances in the Perspective of EMU", *European Economy,* n° 53, 1993, p.6.

[8] Article 4.4 of the Treaty establishing the European Stability Mechanism provides for an emergency voting procedure (a qualified majority vote requiring 85% of votes) in cases where the Commission and the European Central Bank both consider that not taking an urgent decision on the distribution of financial assistance would threaten the economic and financial sustainability of the euro area.

of Auditors – as is the case for each Community expenditure – but by an 'ad hoc' committee made up of five members (one of them coming from the European Court of Auditors and two other members coming from national auditing institutions). The annual report drafted by this committee will be sent to national parliaments, auditing institutions from Eurozone Member States and the European Court of Auditors – but not to the European Parliament.

These three elements (the voting rules, the underlying guarantee structure and the budgetary control system) distinguish the ESM from the "Balance-of-Payments Assistance Facility" (BoP mechanism) which provides aid to countries outside the euro area experiencing financial difficulty. Integrated in the European budget, the BoP mechanism is activated by a Council decision taken by a qualified majority. Like the EFSF and the ESM, it works by borrowing funds on the financial markets in order to loan them to struggling countries at reasonable rates. However, unlike the ESFS and the ESM, it is the Commission and not an intergovernmental organisation who borrows the money. The money borrowed by the BoP mechanism is guaranteed by the European budget, and therefore guaranteed by a joint guarantee from the 27 Member States (as the EU Treaty stipulates that EU countries are jointly responsible to keep the Community budget on balance). However, the BoP's maximum lending capacity is fairly limited: before the crisis it was set at 12 billion euros and was later increased to 50 billion euros. Finally, like any Community expenditure, the use of the BoP mechanism is audited by the Court of European Auditors and the European Parliament.

Table 1 – Two permanent, macro-economic support instruments in Europe: the European Stability Mechanism (ESM) and the Balance-of-Payment Assistance Facility (BoP)

	European Stability Mechanism	**Balance-of-Payment Assistance Facility**
Beneficiary countries	Euro area countries	Countries outside the euro area
Maximum lending capacity	500 billion euros	50 billion euros
Voting rules for granting aid	Unanimity among the 17 euro area countries, except in emergency situations (in this case, a qualified majority of 85% of votes)	Council decision taken by a qualified majority
Underlying guarantee structure	Loans guaranteed by individual (not joint) guarantees from EMU countries	Loans guaranteed by the EU budget and, as a last resort, by a joint guarantee by the 27 Member States
Budgetary control	Ad hoc committee made up of five members (with just one member from the European Court of Auditors)	European Court of Auditors

As they have very different operating rules and intervention capacities, it is worth questioning whether or not maintaining two separate instruments is justifiable and pertinent in the long term. There are strong arguments in favour of keeping both mechanisms. It could be argued that countries outside the euro area are better equipped to face liquidity crises because they can always resort to devaluating their currency and can count on their own central bank, so they need less financial assistance than countries within the euro area (which justifies the maximum amount being limited to 50 billion euros for the BoP mechanism). One could also argue that it is precisely because countries within the euro area have potentially high financial assistance needs that an intergovernmental mechanism is necessary (it is not possible to borrow 500 billion euros based on a guarantee from an annual European budget of approximately 130 billion euros). Finally, because it is national budgets that serve as a guarantee for the ESM, it is only normal that budgetary control be carried about by national, non-Community institutions.

While these arguments are all valid, it should nevertheless be pointed out that the ESM has two significant weaknesses: the fact of being submitted to unanimity and the fact of relying on individual guarantees by countries. Rather than integrating it with the European budget and merge it with the BoP mechanism, it would be preferable in the future to change the voting rules and the underlying guarantee structure of the ESM. It is worth noting that, if this step is taken, the creation of "eurobonds" will not be far off. The only difference would lie in the fact that the ESM would continue to be a mechanism to provide occasional financial aid for struggling countries, and not a system for pooling the risk of borrowing under normal conditions in all Members of the euro area.

2.3. Stricter budgetary discipline at the national level

In addition to the creation of a new European solidarity mechanism, the crisis has pushed Member States to strengthen the rules and procedures to ensure budgetary discipline at the national level. To this end, the Stability and Growth Pact was first reformed (notably through the introduction of semi-automatic sanctions) and, more recently, there has been the approval of the Treaty on Stability, Coordination and Governance (TSCG) which, if everything goes as planned, should enter into force before the end of the year.

Because these reforms will most likely have a strong impact on budgetary policies at the national level, they could also indirectly have budgetary implications at the European level. Two issues merit further reflexion on this topic.

First, many experts fear that stricter budgetary discipline would weaken nations' ability to carry out anti-cyclical fiscal policies. This argument is not universally shared[9], but if these fears proved founded in the coming years, it would mean serious reflexion must be taken about the possibility of creating a macro-economic stabilisation instrument on the scale of the EMU or the EU (a possibility that was very seriously discussed and analysed at the beginning of the 1990s, during the creation of the EMU, both by independent economists and the European Commission's services).

Second, the application of the "balanced budget rule" at the national level risks severely limiting Member States' ability to make growth-fostering investments in the future. Despite its name, the TSCG "golden rule" would not save investment expenditures from the calculation of authorised deficit levels: even in an economy with strong growth and a debt-to-GDP ratio less than 60% of GDP, Member States would be required to maintain a nearly-balanced budget (a structural deficit of 1% of GDP). Under these conditions, the EU should have to play an even more important role in financing the so-called "investments of the future" (for example, investments needed to ensure the transition to a low-carbon economy), because Member States would not have budgetary margin of manoeuvre to do it.

Conclusion:
Towards increasingly complex and fragmented European public finances

The crisis as well as the reforms recently introduced in the EU economic governance might have important implications for European public finances. Among other potential implications, there is a clear trend towards greater differentiation between EMU and non-EMU countries, which has already have budgetary ramifications with the creation of specific EMU-wide financial assistance mechanisms (EFSF, ESM).

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[9] For an overview of the different opinions on the impact the TSCG would have on the ability of different Member States to carry out counter-cyclical fiscal policies, see Verhelst (2012), Whelan (2012) and Funk Kirkegaard (2012).

One might wonder whether in the long term, these reforms would lead to the creation of a truly 'federal' EMU budget, endowed with its own resources and capable of exercising macro-economic stabilisation functions. After all, the existence of a common budget seems a logical component of a future EMU 'fiscal union', and financing the EMU solidarity actions through a common budget would avoid the current tensions between EMU donor and recipient countries. However, we should not underestimate the strong political resistance to a move of this type. In particular, it seems unlikely that national governments and parliaments accept such a transfer of budgetary competences to the EU level. What seems more realistic is to imagine a reinforcement of the current trend towards creating EMU-wide intergovernmental financial mechanisms operating outside the EU budget, funded like the ESM through national contributions and controlled by national parliaments.

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