Position Paper on EU budget 2021-2027

Aiming at a common market, not redistribution

10 July 2020

Foreword

This Position Paper (hereinafter “the Paper”) is a response to the ongoing negotiations on the 2021-2027 EU multiannual financial perspective (hereinafter “EU budget”) which started after the European Commission presented its EU budget proposal on 2 May 2018. Recently in the context of the COVID-19 health care and economic crisis, the European Commission updated its proposal with suggestions regarding measures for the EU’s economic recovery.

By taking the European Commission’s initial proposal as a basis for the analysis and comparing it to the updated version, this Paper assesses to what extent the newly proposed EU budget reflects the principles of maximizing added-value of the EU taxpayers’ money, contributing to the goals of the EU and its member states in a rapidly changing global environment as well as increasing transparency and democratic accountability.

The Paper discusses the size of the proposed EU budget, its revenue and expenditure, evaluates the proposals which form the basis of the ongoing negotiations in the EU27 and suggests directions for a future reform of the EU budget. It is aimed at both policy makers and citizens of the EU27 who are interested in having a budget that would contribute to the well-being and security of citizens in practice rather than on paper.

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Key points

In 2018 the European Commission presented its proposed EU budget as “new,” “modern” and “focused.” However, in terms of its expenditure and revenue the budget proposal continues to diverge significantly from what would appropriately address current challenges facing the EU27 and contribute to its economic dynamism, well-being and security. An updated version from late May 2020 proposed only minor changes to the earlier budget draft, despite extraordinary circumstances related to the COVID-19 and the increased need to use scarce taxpayers’ money in the most effective way. Moreover, by proposing an additional borrowing of 750 billion euro without an appropriate reform of the traditional spending areas, the recent proposal is yet another illustration of how entrenched the deficiencies in the current EU budget are. The idea of massive borrowing at the expense of future financial obligations of EU taxpayers and without a budget reform also shows the EU’s inability to rise to the current challenges.

After the UK’s exit the proposal to increase the contributions of the EU27 in order to maintain the same budget size as in 2014-2020 is ill-founded, especially taking into account that its significant share would continue to be redistributed to farmers, causing inefficiencies and raising questions of fairness. The financial effects of Brexit and the needs related to the joint response to the COVID-19 crisis should be handled by reducing funding for agriculture – a legacy of the post-war situation that is far detached from the contemporary challenges facing the EU. The size of the EU budget should be an outcome of the total sum of decisions to fund those projects and policy areas which comply with the principles of subsidiarity and European added value and which contribute to the common goals of the EU27 set out in the EU Treaty. The structure of the post-Brexit and post-COVID-19 EU budget should be different in terms of quality and underlying reasoning. Failure to reform the budget could further strengthen redistributive conflicts inside the EU and increase the risk of disintegration of the Single market.

A number of changes to the EU budget structure proposed by the European Commission are in the right direction, proposing to increase funding for those areas where it may add value. However, the sums allocated for the common agricultural policy and cohesion policy are still far too large, making altogether around two thirds of the proposed EU budget, while the sums proposed for those areas which could bring value-added and contribute to the goals of the EU27 are modest. This ill-spending should be redirected to the areas which contribute to the consolidation of the common market, and more generally create positive spill-overs from EU funding to its member states, maximizing benefits from interdependencies and minimizing risks from it. The examples of such targeted spending include cross-border infrastructure, external border protection, facilitation of structural reforms, education and science, and health care programmes.

The revenue side of the EU budget should be made more transparent and connected to the contributions of its member states based on agreed proportion of their GNI, while other sources
should be phased out either as a result of external trade policy decisions (removal of import duties) or by the agreement of member states (in the case of VAT based revenues). The proposals to introduce new sources of revenue, such as a tax on the access to the common market, contradict the principles of a more transparent and manageable budget.

The proposed new tax revenue measures which could eventually lead to EU wide taxes are not justified and would increase the overall tax burden. Some of the proposed new taxes would be counter-productive to the EU efforts to re-shore production and increase investments in the EU common market. Besides, since taxation competences are core state powers, they should remain a matter of the EU member states on the grounds of democratic legitimacy. Corrections of payments (rebates) should be phased out, given that their presence significantly reduces the transparency of the EU budget.

A misguided debate on the size of the EU budget

The size of the EU budget has become one the main subjects of the discussion that started immediately after the European Commission presented its proposal for a new multiannual financial framework for 2021-2027, which forms the basis for negotiations [1]. The European Commission proposed a budget of 1.279 trillion euro equivalent to around 1.11% of gross national income (GNI) of the EU27, maintaining that it is close to the size of the 2014-2020 budget (1.13% of EU27, i.e. excluding the UK).

The debate which followed divided EU member states into “frugal” countries, or “the 1 percenters” (the Netherlands, Austria, Sweden and Denmark), that would like to cap the overall size of the EU budget at 1% of its GNI, and most of the rest that would like it to be of a size proposed by the European Commission, mostly because their governments would like to keep funding for agriculture and cohesion on a level similar to the previous MFF.

The European Parliament stepped into the debate early by proposing to raise the size of the next EU budget to 1.3% of GNI, with a couple of countries voicing their support for this. As negotiations gathered pace, the Finnish rotating presidency and, in early 2020, the new president of the European Council focused on finding an acceptable compromise of around 1.07% of GNI. Most of media reporting on the negotiations of the EU budget also focused first of all on the overall size of the budget [2].

Similarly, when in late May 2020 the European Commission presented its renewed proposals for the EU budget 2021-2027, much of the focus was on aggregate figures, especially the 750 billion euro proposed additionally to the slightly revised 1.100 trillion euro of the EU budget, altogether amounting to 1.85 trillion euro [3].
However, the exclusive focus on the size of the EU budget is misguided. It exposes a “path-dependency” in terms of each member state and interest group that is used to benefiting from the EU funding and trying to defend their historical amounts of money. The most common method of assessing the European Commission’s proposal is to compare it with the current level of funding, especially by comparing current and future balance of national payments to and receipts from the EU budget. As a rule, those EU member states which pay more into the EU budget than receive from it (“net payers”) are supporting a smaller future budget. Meanwhile those that receive more from it compared to their payments (“net beneficiaries”) support a larger EU budget. Besides, beneficiaries of the support for agriculture and cohesion funding focus on maintaining their past levels of funding.

This dominant way of thinking about the EU budget, that is often characterized by the French term of “juste retour”, explains why it has been so difficult to really reform the EU budget in order to align it with the current challenges and EU priorities. When each EU member state aims to maximise receipts and minimize payments to the EU budget, while protecting their traditional categories of funding from the EU budget, the notions of solidarity and common EU interest become diluted and are put aside.

The appropriate method of coming to the desirable size of the EU budget is to start from the needs of the common market and an assessment of potential projects and programmes which meet the criteria of European value added and contribute to the EU priorities with positive spill-overs. The most evident example is the consolidation of the functioning of the common market through investment into cross-border infrastructure (energy and transport) projects facilitating commerce and movement between the member states. The size of the EU budget would be an outcome of the debate on the nature, number and amounts required for each such EU project.

It is ironic that, as previous negotiations on the current (2014-2020) Multiannual Financial Framework (MFF) show, it is programmes that meet the criteria for European value added, such as trans-European networks, that are cut during the final stage of negotiations when each member state is given some side-payments to facilitate reaching a compromise. Also, as the failed attempt at reaching a compromise among member states at the February 2020 European Council meeting illustrates, programmes which could be chosen to be sacrificed also include new ones such as defence and security. It is another illustration of how proposed funding for new common challenges might fail to get member states’ support just because in the first place they all are interested in defending their current funding (in terms of programmes and amounts of money).

Arguably, it is politically very difficult to start debate on EU budget reform from “a white sheet of paper.” However, the current dominant method of each member state defending EU funding programmes, most of which simply redistribute resources without contributing to the EU priorities, is far detached from the rhetoric of the EU institutions that accompanies these negotiations. The
newly proposed EU budget and national positions of member states with regard to it are a reflection of yesterday’s priorities, horse-trading and dominance of narrow interests rather than today’s challenges, common goods and value added for EU citizens. As long as the “path dependency” logic dominates debates on the EU budget, the aim of the reform should be to downsize it as much as possible and to minimize distortions and inefficiencies. Unfortunately, the recent proposal of the European Commission goes in the opposite direction by suggesting a significant increase in the EU budget through borrowing as a way to ease the agreement on the next EU budget.

The EU budget expenditures – a new wine in old bottles

In terms of the structure of expenditures, the 2021-2027 EU budget proposed by the European Commission in 2018 had some welcome reform initiatives, but they were minor and fell far short of what was required for a serious budgetary reform. Although the European Commission claimed that for the first time the largest share of the budget was proposed to be allocated to programmes such as Erasmus, Horizon Europe, Digital Europe, Single Market Programme, Border Management and Security, Neighbourhood, Development and International Cooperation Instrument, they would make up slightly above one third of the total EU budget [4]. Although the proposed amounts of money for some of them are significantly higher compared to the current levels, their increase in absolute terms is also modest because of the current low absolute amounts.

On the other hand, the proposed reductions for common agricultural policies, fisheries and cohesion are very small, e.g. only 5% in the case of Common Agricultural Policy, and the absolute amounts of funding are significantly larger compared to other programmes. Thus, for example, the European Commission emphasizes that the sums proposed for migration and external border protection are increased 2.6 times – the steepest increase of all areas, but their total amount is below 35 billion euro (in current prices). The funds for Single market, innovation and research programmes are set below 120 billion euro. However, Common Agricultural Policy (direct payments to farmers and rural development funding) is allocated three times more, a total of 365 billion euro [5]. The European Commission attempts to present all relatively new programmes which could meet the criteria for European value added to be funded from the EU budget as if they now dominated the new EU budget. However, a large number of the new programmes and their catchy titles cannot disguise the remaining huge disproportions in terms of actual money allocated to them compared to funds earmarked for Common Agricultural Policy and Cohesion Policy.

Funding for the Common Agricultural Policy is the most serious concern and shortcoming of the EU budget. The EU financial support for farmers has been significantly reformed since the 1980s, when it accounted for around 80% of total EU budgetary expenditure and relied on market distorting instruments such as production based subsidies and price support measures (e.g. interventionist procurement). During the course of the reform support for farmers has been shifted
to less market distorting instruments such as direct payments and the proportion of the EU budget spent on agriculture decreased. Direct payments redistribute money from taxpayers to farmers instead of relying on price support measures, which used to artificially keep food prices higher.

However, Common Agricultural Policy still remains a major item of the EU budget representing an example of redistributive policy aimed at supporting the income of one particular profession – farmers. Similarly, albeit on a smaller scale, the EU supports the fishing industry through its Common Fisheries Policy, which also redistributes resources and distorts incentives. **The EU budget should not be used for redistributive purposes because (i) it is too heterogeneous and (ii) redistribution through the EU budget raises questions of social fairness.**

These dilemmas are well illustrated by the debate surrounding the differentiation of direct income payments paid to farmers from EU-15 and those paid to farmers in Central and Eastern European countries. The differentiation, which has been contentious since accession of Central and Eastern European countries into the EU, is rightly criticized by farmers from the latter countries as being discriminatory and unfair. However, if it were harmonized upwards, i.e. by aligning the direct payments with those that farmers in France, Belgium and other EU-15 countries receive, it would raise the issue of fairness of such policy with respect to other societal groups in Central and Eastern European countries. Farmers would become one of the wealthiest professions only because of the EU’s “path dependency.” Moreover, large farmers have traditionally been the main beneficiaries of the Common Agricultural Policy, further distorting the redistributive nature of the EU funding.

Redistribution on the national level would conform better with the principle of subsidiarity and make such policies more transparent to the taxpayers whose contributions are channelled to supporting farmers. Thus, it could be considered as a less distortive method to exit from the current redistribution on the EU level. However, redistribution through national budgets has other drawbacks such as privileged support of particular business sectors at the expense of taxpayers, inefficient use of scarce resources and distortion of competition. It should also be noted that the EU continues to apply import duties, sometimes still extremely high, on imports of agricultural and food products from other WTO members. These customs duties function as a hidden tax on consumers, especially on low-income households that spend a larger proportion of their budget on food, usually not being aware of this additional cost aimed at protecting EU farmers from external competition. Besides, **farming and fisheries should be subject to state aid rules similarly to other types of business which compete on the market without EU or state support measures** that are financed by taxpayers and consumers and result in diverting resources from other productive uses.

**The elimination of redistributive programmes such as funding for agriculture is an essential precondition for the EU budget to meet the basic principles of effectiveness, fairness and subsidiarity.** To a large extent the same applies to the cohesion policy which is a more recent relic from the 1980s-1990s, when it was introduced as a side-payment to Southern European countries
for the support to the consolidation of the Single market and adoption of the single currency. Currently structural funds, which form part of cohesion policy, can be used for different purposes and in different areas ranging from transport infrastructure to research and other types of public investment. In some areas, where they facilitate the cross-border economic activities among EU member states through upgrading infrastructure or facilitate structural reforms like higher education reform, they provide European added value.

However, the availability of significant amounts of cohesion money by itself generates a demand for their “absorption,” and this results in dubious projects. They distort business incentives when absorption of EU funds becomes more important than meeting market demand. They create incentives for corruption and rent-seeking, in particular in those countries where they make up a significant proportion of public investments. This has been the case in many Central and Eastern European countries, especially since 2009, when public investments from national budgets have been reduced due to economic and financial crisis, and EU funding became a major source contributing up to 60-70% of public investment. In addition to incentivizing ill-judged business decisions, corruption and rent-seeking, the availability of significant cohesion funding creates a culture of dependency and subsidy mentality, which leads to overestimation of the importance of those funds and attempts by EU member states to maintain them with too little attention given to their actual effectiveness.

The recent May 2020 proposal of the European Commission preserves the dominance of funding for agriculture and cohesion, even suggesting an increase in the funding for agriculture by 15 billion euro, linked to the European Green Deal. Although it places much stronger emphasis on investment into economic recovery and long-term modernization, it still foresees significant amounts of money to be redistributed through the EU budget potentially leading to above mentioned distortions. It should also be noted that the recent turn of the EU to allocate funds aimed at economic convergence in the form of loans and credit guarantees is questionable on the grounds of distorted incentives and an increased burden on taxpayers. Artificial reduction of risk premium is likely to encourage excessive risk taking by business, while provision of EU funds to certain uses can artificially redirect private resources from those investments which might be more sustainable being based on market signals. Green and digital transitions are more sustainable and conducive to the EU’s economic and social objectives when they are driven by market-based innovations rather than centrally funded and guided decisions.

It is essential to remember that the main economic benefit and the driver of cohesion and convergence is membership in the EU common market. However, the common market is “far from being completely in place” as it was acknowledged in 2010 by the high level group chaired by Mario Monti [6]. Moreover, in response to the COVID-19 pandemics, EU member states introduced significant barriers to the cross-border flows of goods and people within the EU. Therefore, if the EU institutions and its member states are serious about economic growth, convergence and
cohesion, they should focus on removing obstacles to the functioning of the common market, rather than on fighting for the “juste retour” during the negotiations on the next MFF. They should reform the EU budget so that it is concentrated on those areas and projects which facilitate cross-border trade, investment, provision of services and travel. As the migration and COVID-19 crises have shown, safeguarding the common market, especially free movement of people, implies more effective management of EU external borders. These types of measures, which require additional resources, qualify for a coordinated EU level action funded from the EU budget.

Programmes aimed at facilitating academic exchange and joint research projects that promote the circulation of best teaching practices, research and scientific excellence and are not funded by the business sector might also belong in the category of programmes that contribute to the European added value. However, they could be better targeted by linking them with indicators of performance of national education and research systems and appropriate co-financing of national budgets. On the other hand, those areas where private investments are made and risk taking by innovating in the fields of biotechnology, lasers, artificial intelligence and other technologies is rewarded in the market, the EU budget should not be used as it can result in distorted incentives, capital allocation and returns.

Also, EU global policies, including support for reforms in neighbouring countries, should be funded from the EU budget, provided that they do not distort incentives and competition in those countries and assist in creating better conditions for trade, investments and regulatory environment. However, it is through the improved access to its large common market and dissemination of best practices rather than financial aid that the EU can best contribute to the development of other countries in the world. Funding for defence should not duplicate NATO and focus on removing administrative barriers to the provision of military equipment and improving logistics and infrastructure that links EU member states, which can be used for dual purposes (civilian as well as military operations).

Finally, the use of EU budget funding is justified when it is used for the purpose of complying with those EU safety norms that are based on scientific evidence and have cross-border effects. Nuclear safety and decommissioning nuclear power plants fall into this category as they are linked to the EU membership and EU wide regulations that aim at protecting citizens. Such regulations should always be evidence-based.

The other proposals of the European Commission related to the expenditure side of the next EU budget – for example, reduction in the number of programmes from 58 to 37 proposed in 2018 – are of minor significance compared to a structure of expenditures which continue to favour traditional policy areas. Despite the claims of a more transparent and simplified budget structure, it remains difficult to understand for most EU citizens who are not experts in these matters. The labels put on spending categories of the current MFF such as “smart and inclusive growth” or
“Sustainable growth: natural resources” hide a variety of different types of spending instruments, some of which have quite contradictory effects and diverge significantly from those labels. In the May 2020 proposal for the next EU budget the European Commission has been using new catchy titles such as „an ambitious and innovative budget,” „Next Generation EU” and „Recovery and Resilience Facility” alongside more neutral titles such as “Cohesion and values” or “Natural resources and environment.” However, they include variety of instruments, often deviating from the declared principles “a stronger focus on European added value,” “a more streamlined and transparent budget,” “less red tape for beneficiaries,” “a budget that performs” [7].

To conclude, each EU budget programme should be assessed on the basis of the following principles:

– EU funding for EU-wide goals,
– effectiveness in terms of common goals, rather than narrow interests,
– subsidiarity, meaning that policies and programmes of redistributive nature should be decided on the national (or regional) level and funded from national budgets.

These principles should be put into practice to become operational principles and EU institutions and member states should prove how each EU budget programme conforms to them. Ex-ante assessment of conformity with the said principles would reduce the need for additional monitoring and make it possible to conform better with the aims of a streamlined and transparent budget and less red tape for beneficiaries, which is particularly important in the times of crisis.

EU Budget Revenue – one step forward, three steps back

As it was noted before, for the 2021-2027 period, the European Commission proposed 1.279 billion Euros in commitments equivalent to 1.114% of the EU-27 GNI. The EU budget revenue structure is currently based on three main sources: a GNI based revenue (making around 70% of total budget revenue), own “traditional resources” (customs revenues and already eliminated sugar levies) and the VAT-based revenue stream. This type of revenue structure reduces transparency of the budget.

It is further complicated by the presence of payment corrections (rebates) which are seen as an outcome of the demands of the UK in the 1980s, although other net-payers also take advantage of these corrections.
Upon the withdrawal of the UK, the European Commission has seized to propose the elimination of all corrections on the revenue side of the EU budget. This is a welcome proposal which would indeed contribute to a more transparent and simplified budget structure. Unfortunately, as the negotiations on the new EU budget progressed, it became clear that other beneficiaries of payment corrections – Germany, the Netherlands, Austria, Denmark and Sweden – strongly resist the elimination of rebates. Moreover, in the May 2020 proposal the European Commission softened its tone on the elimination of rebates, most likely, in order to get support from the “frugal four” for the additional borrowing of money allocated to funding the economic recovery and allocating a significant share of those borrowed funds as grants to those member states which experienced the largest effects of COVID-19.

The European Commission also missed an opportunity to make a major step in the direction of a more transparent and streamlined revenue structure and to eliminate ill-judged sources other than the core GNI-based payments. The money collected as customs duties, sugar levies and VAT-based revenue account for almost as much as the funds foreseen for the Common Agricultural Policy. A gradual exit from these revenue sources as well as a reduction of the funding for agriculture would represent a real reform that would conform with the principles routinely declared by the EU institutions. GNI-based payments would be simple and easy to understand for citizens. They would also be fair and proportionate to the level of economic development of each member state.

Moreover, the European Commission made a step in the opposite direction by proposing new types of resources: 20% of revenues from the European emissions trading system, re-launching a common consolidated corporate tax base and introducing national contributions calculated on the amount of non-recycled plastic packaging waste. These new sources, according to the European Commission, would contribute on average around 22 billion Euros annually and account to about 12% of total revenue. The proposed new sources of revenue from the European emissions trading system, a common consolidated corporate tax base and national contributions from non-recycled plastic packaging waste would further complicate the revenue structure and make it less transparent.

Besides, the revival of the idea of introducing a consolidated corporate tax base defies the position of a number of EU member states. Those states signalled opposition to this idea on the grounds that it was necessary to maintain tax policy instruments for faster economic growth and/or according to the principle that taxation matters should remain within the competences of member states. This proposal is also questionable in the light of the assurances given to Ireland at the time of the second referendum on the Lisbon Treaty that the EU would not seek to advance tax harmonization.

In its May 2020 proposal the European Commission goes even further by suggesting additional EU wide taxes such as a digital tax and tax on companies which benefit from the Single market. The
latter does not only add to the complexity of the current revenue system, but it also contradicts the call for re-shoring of production back to the EU from other regions of the world. Finally, the idea of an increase in the EU budget by borrowing and postponing the payment over the next 30 years after the end of the 2021-2027 financial framework, would inflict an additional burden on the EU taxpayers.

To conclude, the declared principles of transparency and administrative simplicity would be best achieved if the EU budget revenue system were reformed by moving towards a GNI-based budget. It would be easy to understand for the citizens of EU member states, proportionate to the level of economic development and cheap to administer. Finally, it would be in line with the principles of democratic representation because as long as there is no EU wide polity there should be no EU-wide taxes.