Memo to the commissioner responsible for the European Union budget

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You take over responsibility for the European Union budget at a time of climate emergency, a war near the EU's border, heightened security risks, increased global protectionism, slow productivity growth and a weak European economic outlook. Demands for new EU spending are mounting.

While opinion polls suggest significant alignment among EU citizens on what the EU's priorities should be but member countries remain divided over the size of the EU budget and how to finance it. Old questions about the value added of traditional EU policies continue to resurface. Following the mid-term reviews of the 2021-2027 Multiannual Financial Framework (MFF) and the 2021-2026 Recovery and Resilience Facility, the proposal for the next MFF starting in 2028 should be prepared soon.

Propose substantial budget reform by mid 2025

Focus on funding for European public goods

Push to unblock decision-making

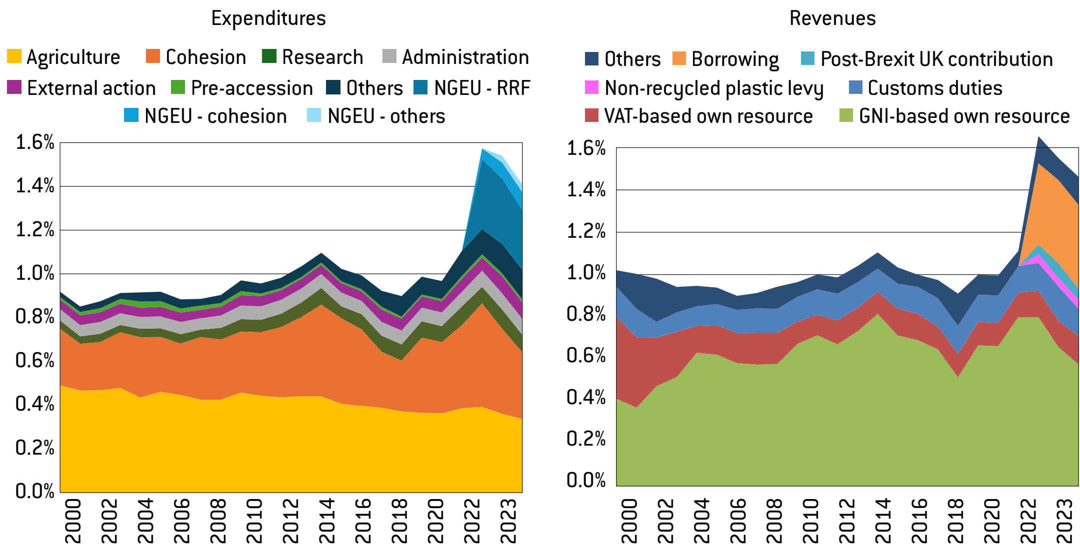
State of affairs

EU budget spending

Since the mid-1980s, EU budget spending has amounted to about 1 percent of EU GDP. The EU's main pandemic response was an unprecedented debt-financed instrument, NextGenerationEU (NGEU). Its announcement had a stabilising effect by convincing market participants about EU-wide solidarity in supporting vulnerable countries, even if disbursement of NGEU money was slow.

On average, NGEU provides spending power of an additional 0.4 percent of GDP from 2021 to 2026 (Figure 1, Panel A), beyond preferential loans. Its largest component, the Recovery and Resilience Facility (RRF) supports six main objectives – most notably the climate and digital transitions – with an indicator-based funding model (as opposed to the traditional cost-based funding model and the performance-based funding model, even if the Commission claims that the instrument is performance-based; Darvas *et al*, 2023). The other components of NGEU top up existing cohesion, agricultural, research and investment funds.

Figure 1: Implementation of the EU's annual budgets, % GNI, 2000-2023



Source: Bruegel based on European Commission data and adopted EU annual budgets. Note: Agriculture includes fisheries. 'NGEU - cohesion' is the top-up to the European Regional Development Fund (ERDF) and European Social Fund (ESF). 'NGEU-others' is composed of top-ups to Horizon Europe, InvestEU, the European Agricultural Fund for Rural Development (EAFRD), the Just Transition Fund (JTF) and the Union Civil Protection Mechanism (RescEU).

The EU has for a long time been adjusting the MFF at the margin and has tried to incorporate recent priorities via budgetary mainstreaming

For political, institutional and legal reasons, the EU has for a long time been adjusting the MFF at the margin, without radical changes to its size, composition and contribution to stabilisation (except for NGEU). Instead, European leaders have tried to incorporate recent priorities via budgetary mainstreaming, including cross-cutting policy goals (climate, biodiversity, gender), in all phases of the budget cycle.

EU budget revenues

EU countries unanimously agree on so-called 'own resources' (EU budget revenues, Figure 1, Panel B) to finance the MFF. In the 2021-2027 MFF, the expenditure ceiling is 1.1 percent of gross national income, while the own-resources ceiling is 1.4 percent of GNI (apart from NGEU debt service). Except for the GNI-based revenue, which acts as a balancing item, the other largest revenues, including customs duties, a value-added tax own resource and a non-recycled plastic packaging waste levy, are determined by the underlying revenue base and specific formulas. The plastic waste levy, while not increasing overall budget revenues (since the balancing GNI-based contributions are reduced correspondingly), incentivises country-level recycling policies, an important side effect.

To repay NGEU debt, the own resources decision secured an additional annual revenue stream of 0.6 percent of GNI up to 2058. This can only be called on to pay the interest and debt amortisation of NGEU debt. This commitment was about ten times the expected debt service costs when NGEU was approved in 2021, and is still several times more now, after interest rates increased.

Your predecessor proposed several possible other EU budget revenues, based on the EU's carbon border adjustment mechanism (CBAM), the emissions trading system (ETS), national accounts data on corporate profits and the re-allocation of taxing rights under Pillar One of global tax reform agreement, brokered with 138 countries by the Organisation for Economic Co-operation and Development.

Dwindling market enthusiasm for EU debt

Since the start of monetary tightening, interest rates on EU bonds

have increased relative to national debt. Technical reasons for this increase were addressed by the issuance since January 2023 of single branded EU bonds rather than separately labelled bonds. But there is a deeper reason: investors do not see the EU as a permanent player in the bond market, since EU leaders emphasise the temporary nature of EU bond issuance and the priority of debt repayment. This contributes to the negative market perception, which in turn feeds the scepticism of reluctant member states about further EU debt issuances.

Negative market perception about EU debt is fuelled by the emphasis on the temporary nature of EU bond issuance

Challenges

You will face two major challenges, which will be aggravated by the forthcoming EU enlargement.

Increasing tension between strategic goals and the budget's size and allocation

You must decide whether to accept the inevitability of a small (close to 1 percent of GDP) budget, or to make an ambitious attempt to reconcile new priorities with the budget's size. In the past, budget adaptation has been implemented in an *ad-hoc* fashion, rather than built into the system. Your challenge will be to decide whether to seek root-and-branch MFF reform, or to adjust it at the margins and pursue the new political priorities outside the MFF.

Your next challenge will be to reconcile budget composition and EU priorities. EU budget discussions focus increasingly on European public goods (EPGs). These can be defined as goods not supplied at an adequate level without public intervention, and which should be provided at the EU level to internalise externalities and reap the benefits of scale, while ensuring that local preferences are taken into account.

Some elements of the two largest EU budget spending items are not in line with the evolving goals of the EU.

Article 39 of the Treaty on the Functioning of the European Union (TFEU) defines five objectives for the Common Agricultural Policy (CAP): agricultural productivity, income support, market stabilisation, food supply and reasonable food prices. Horizontal

mainstreaming introduced additional climate and biodiversity goals. While market stabilisation and food supply could classify as public goods, direct transfers to farmers – the CAP's largest component – pursue re-distributional purposes and do not amount to an EPG that should be funded by the EU. Yet direct transfers are paid solely by the EU budget without national co-financing, even if there is no such requirement in the Treaty, while the CAP's rural development component is co-financed. Consequently, the CAP is oversized. Moreover, the European Court of Auditors found the CAP's 'greening' policies to be likely ineffective at reducing the climate impact of agriculture in Europe.

Likewise, cohesion policy has a Treaty-based justification (Article 174 TFEU), but does not always meet the definition of an EPG, to the extent that most cohesion projects do not involve externalities and scale benefits. Moreover, its effectiveness can be improved, and it is essential to tackle corruption to avoid improper use of funds in some member states. It needs to be seen whether the new toolbox addressing rule- of-law deficiencies can reduce the scope for misuse of EU fund.

Several European public goods have been underrepresented in the EU budget

Other EPGs have been underrepresented in the EU budget. Research funding is a good example of a successful EPG. It's share in the MFF has only marginally increased from 6.9 percent on average in the 2010s to 7.8 percent in 2022. Potential EPGs include European strategic investments, single market measures, the European space programme, migration and border management, and security and defence, which take low shares of EU spending. External action – accounting for about 8 percent of the MMF – is another crucial category reflecting the EU's responsibility to support less-developed nations.

Finally, the MFF is not designed for cyclical stabilisation, partly because of its small size and reflecting moral hazard concerns (which, however, could be addressed). While NGEU had a positive announcement effect, its deployment was slow. A major challenge for you is to devise a much faster mechanism for such a large shock.

The difficulty in agreeing on genuine own resources

Traditionally, in the EU, spending has driven revenue: the size of expenditures was fixed at close to 1 percent of GDP and revenues

were decided accordingly, based on unanimity of EU countries. This procedure reflects provisions in the EU Treaties, which maintain the taxing right as an exclusive national prerogative. Since GNI-based national contributions predominantly fund the EU budget, a 'culture of net balances' has limited the scope for budget expansion: politicians often focus on how much their country gets from and pays into the EU budget. As a result, net payers have blocked attempts to increase the size of the budget, fearing that their taxpayers would finance even more expenditures elsewhere in the EU. This viewpoint is wrongheaded, since it disregards the economic impact of the EU budget. Your challenge will be to fight against it.

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Arguably, new own resource to replace GNI-based contributions represents an opportunity cost to member states' budgets, to the extent that those revenues would go to the EU budget instead of national budgets. Thus, your challenge will be to explore new own resources that are acceptable to EU countries, minimise net balance considerations and bring about behavioural change or other additional benefits. For example, taxing emissions is good for the environment, while EU-level corporate taxation – especially if based on harmonised tax bases – could benefit the single market by reducing undue tax competition, and could also be the basis for a centralised industrial policy (via reduced tax rates for preferred industries).

Enlargement

The budgetary challenges for the EU will become even more difficult in an enlarged EU of 35 or more members. First, as the new entrants will all be net beneficiaries, at unchanged policies, significant resources will have to be directed to those countries. Second, under the current unanimity requirement for the approval of the MMF, there is the risk of decision-making paralysis. Your challenge will be to find remedies to these concerns.

Recommendations

You should make a comprehensive reform proposal by June 2025, otherwise it will be difficult to add substantial new elements later. The proposal should incorporate the following changes:

Propose an increase in MFF expenditure

A budget worth 1 percent of GNI is insufficient

To deliver the EU's ambitious priorities and to include the EPG component of NGEU in the MFF, a budget worth 1 percent of GNI is insufficient. A dramatic increase is politically unrealistic, but nevertheless you should make an ambitious proposal to the European Council: increase the current 1.1 percent of GDP MFF by 20 percent of the estimated investment needs of the twin transition, ie 0.7 percent of GDP, and by a new flexibility reserve of 0.2 percent of GDP. This would increase the size of the MFF to 2 percent of GNI.

Embrace a European public goods approach

Such a larger budget should embrace a European public goods approach. It should focus on areas where the EU can bring real added value. EPGs can be classified into 'genuine' EPGs delivered and financed at EU level, and projects pursuing EU priorities financed at the EU level, but for which delivery takes place at national level.

In the first category, projects tackling EU challenges at EU level should in principle be politically less contentious than other forms of EU spending, because they weaken the 'net balance' narrative and do not carry the risk of moving to a 'transfers union'. Hence, the production of genuine EPGs should reduce the tensions between so-called 'creditor' and 'debtor' countries.

Examples of EPGs include common digital infrastructure, cross-border green energy projects, common purchasing of critical raw materials, border management, handling of migration inflows, procurement of vaccines, economic security and defence. These correspond broadly to the European priorities identified in the informal European Council in Versailles in March 2022.

Revamp programmes to deliver EPGs

A pragmatic idea to enable the delivery of EPGs would be to rely

on current EU programmes, revamping and refocusing them on cross-country projects. Some parts of NGEU, the Connecting Europe Facility, InvestEU, Horizon Europe and REPowerEU could support common initiatives at EU level. European initiatives are also the core of the Innovation Fund. Moreover, if reformed to allow financing via EU resources and devoted to EU-wide interventions, the Important Projects of Common European Interest (IPCEI) would offer a useful tool for a reformed EU industrial policy. EU countries could put forward transnational projects benefitting from common financing if they comply with EU fiscal rules (Bakker *et al*, 2024).

Reform cohesion policy and the CAP

Limiting the scope of cohesion policy and the CAP to the pursuit of EPGs, and increasing their effectiveness, are fundamental

Limiting the scope of cohesion policy and the CAP to the pursuit of EPGs, and increasing their effectiveness, are fundamental for an EU budget that aims to provide the greatest value added. A rethinking could build on the experience with the RRF. Two innovative aspects of the RRF are its focus on reforms and investments in exchange for financial support, and its indicators-based approach, which, however, should be upgraded to a performance-based instrument.

Significant elements of the CAP do not pursue EPGs, but reflect national public goods or other policy preferences. You should therefore seek to introduce 50 percent national co-financing of direct payments in the next MFF. In addition to freeing-up one-sixth of the MFF funds for the provision of EPGs, this would reduce the cost of enlargement via the EU budget by one-fifth. Fundamental CAP reform should also involve the gradual replacement of decoupled direct payments with coupled direct payments linked to environmental protection. In the past, coupled direct payments were linked to the production of specific products – and it was wise to eliminate such payment conditions to avoid the overproduction of certain products and to allow farmers to respond to market demand. In the future, payment conditions should be based on environmental protection and progress in reducing harmful emissions.

There could be more flexibility by reducing the number of different headings in the MFF, which would mean a smaller number of categories to which funds are bound.

Ensure rapid mobilisation of emergency funds

You should be prepared to adopt further temporary instruments outside the MFF (beyond the 2 percent limit) on a suitable legal basis (not necessarily limited to Article 122 TFEU), under exceptional circumstances. It will be essential to put in place a procedure that secures fast mobilisation and implementation of emergency funds. Borrowing seems to be an ideal source of financing for an emergency instrument, similarly to NGEU, within the legal limits (Grund and Steinbach, 2023). More generally, there is an economic rationale to finance investments that produce future returns by issuing debt. Introducing debt revenues as own resources would be an unprecedented, but legally feasible way. The EU's regular presence on bond markets would improve market perception of EU debt.

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Promote a new instrument for defence spending

In responding to the mounting external security threats, defence is a quintessentially European public good, though most of its delivery occurs at national level. Since there is an urgency to increase EU countries' defence capabilities, while EU fiscal rules constrain the fiscal space, we recommend the prompt roll-out of an exceptional and temporary debt-financed EU instrument to boost such capabilities. The cross-country distribution of defence investment should follow an efficiency logic, though its results would benefit the whole EU.

Develop genuine own resources

You should break the net-balance perspective by funding the EU budget with 'genuine' own resources, which should be those taxes and levies for which the EU holds the exclusive or shared competence under the current Treaty framework. This includes customs duties and ETS and CBAM revenues. All of these revenues – not just 75 percent as currently applied to customs duties – should be channelled to the EU (excepting a small collection cost). Second, you should also explore to what extent the tax revenues to be collected as a result of implementing the OECD Pillar 2 agreement establishing a 15 percent global minimum tax (Directive (EU) 2022/2523) could accrue to the EU. Under these rules, jurisdictions where a multinational company sells its goods or services may have a right to

collect top-up taxes in case the minimum is not collected elsewhere. Since there is good reason for this right to tax to be attached to the EU single market, you should claim these revenues as genuine resources (Saint-Amans, 2024). Among various new revenue options, you should put most of your political capital into those that offer the largest EU budget revenues.

You should also continue the work of the previous Commission on fostering various kinds of own resources that could exert positive externalities, including environment protection, limiting undue tax competition and providing a base for an EU-wide industrial policy.

Move to qualified majority voting

The decision-making procedures related to the EU budget must be overhauled

The decision-making procedures related to the EU budget must be overhauled. This is important also to cope with the consequences of enlargement. You should use the legal leeway under the Treaties to move the adoption of the MFF from unanimity to majority voting, to avoid the risk of decision-making paralysis. Specifically, the passerelle clause under Article 312(2) TFEU could be used, under which the European Council may unanimously authorise the Council to adopt the MFF Regulation by qualified majority voting (QMV). This would mean that spending ceilings under the MFF would also be adopted by QMV and MFF adoption would be aligned more with the annual budget procedure.

In the delivery of EPGs, vertical coordination will have to be ensured between the EU budget and the implementation of the new EU fiscal framework, agreed in April 2024. Hence, you need to work closely with the commissioner responsible for economic and financial affairs. Also, the Commission's organisation must be revamped to allow efficient delivery of EPGs.

It would also be appropriate to move from seven-year to five-year planning periods to align with the European political cycle. As priorities may shift substantially, it would appear opportune to strengthen the mid-term review which, so far, has been a rather minimalist exercise.

References

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