

# The EU's Multiannual Financial Framework and some implications for CESEE countries

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*The European Union's budget – which is fundamentally different from the budgets of federal countries and amounts to only about 1% of the EU's gross national income – continues to be heavy on agricultural and cohesion spending. The literature shows that the EU's common agricultural policy (accounting for 38% of EU spending from the current budget) provides good income support, especially for richer farmers, but is less effective for greening and biodiversity and is unevenly distributed. The EU's cohesion policy (accounting for 34% of current EU spending) contributes to convergence, but it is unclear how strong and long-lasting the effects are. Spending on new priorities such as border control could require additional funds of at least EUR 100 billion in the 2021–2027 period, but there will be a EUR 94 billion Brexit-related hole in the EU budget for 2021–2027 if the EU loses the United Kingdom's share of contributions and the EU's work program as a share of gross national income remains unchanged. The European Commission's May 2, 2018, proposal for the 2021–2027 budget makes several welcome steps in reforming the EU budget, e.g. by reorganizing spending commitments toward priorities which have gained more importance recently, while reducing the share of spending on agriculture and cohesion policies. But many details remain quite fuzzy and need to be spelled out further before a critical appraisal can be made. Moreover, the new draft budget for agriculture foresees larger cuts for rural development support – important for environment and biodiversity goals – than for direct subsidies to farmers. Also, we would argue that the European Commission needs to make a significantly stronger attempt at measuring the actual “European value added” of the various proposed initiatives. Therefore, while we regard the European Commission's proposal a good basis for subsequent negotiations, we propose a number of significant changes.*

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A fundamental rethink of the EU budget is called for in the context of the changing global environment with increased security risks, turmoil in the EU's neighborhood, heightened immigration pressures, the wavering U.S. commitment to NATO, stronger global economic competition, and questions over the effectiveness of a large share of EU spending. After all, the EU budget ultimately reflects the priorities of the European Union.

At the same time, the EU's budget is of a peculiar nature because the EU unites a group of developed states with significant and large government sectors in a single market. Unlike federal states, the EU countries have retained the provision of crucial government functions such as social security, healthcare and defense, while foreign aid and research support are provided by both the EU and member countries. Any further functions are thus delegated to the EU only to the extent members are ready to give up sovereignty.

In such a setting, the key questions are: Which functions can be delivered more effectively jointly? And how should the EU budget and corresponding action best complement what countries already do at the national level? This requires careful thinking about European public goods and how best to provide them.

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Moreover, in a federation, stabilization policy is typically conducted at the federal level, thus being intrinsically linked to the allocative function of public finance or redistribution between individuals. But in Europe, the welfare state is large and basically national. The EU budget could at best support national stabilization efforts by providing insurance.

Finally, Brexit will leave a large hole in the EU budget: According to calculations made by Darvas and Wolff (2018), the EU budget revenues for 2021–2027 would be EUR 94 billion smaller than expenditures if the EU loses the United Kingdom's share of contributions but leaves its work program as a share of gross national income unchanged. While the U.K. might contribute to post-2020 EU budgets if an exit deal is signed and if the U.K. will continue to participate in certain EU programs and/or get a certain degree of preferential access to EU markets, in all likelihood such contributions will compensate only a small part of the Brexit gap. EU countries might be reluctant to increase contributions to fill this gap while having to fund new spending priorities. As outlined by Darvas and Wolff (2018), freezing agriculture and cohesion spending in nominal terms – thus cutting in real terms – would not just fill the Brexit-related budget hole, but would generate enough to cover most of the new priorities.

Against this backdrop, section 1 analyzes the current 2014–2020 Multiannual Financial Framework (MFF) of the European Union, with a focus on the two largest spending categories, the common agricultural policy (CAP) and cohesion policy (CP), which have major relevance for Central, Eastern and Southeastern European (CESEE) countries. In section 2 we scrutinize the May 2, 2018, proposal of the European Commission for the next 2021–2027 MFF. Section 3 concludes.

## 1 The current EU budget

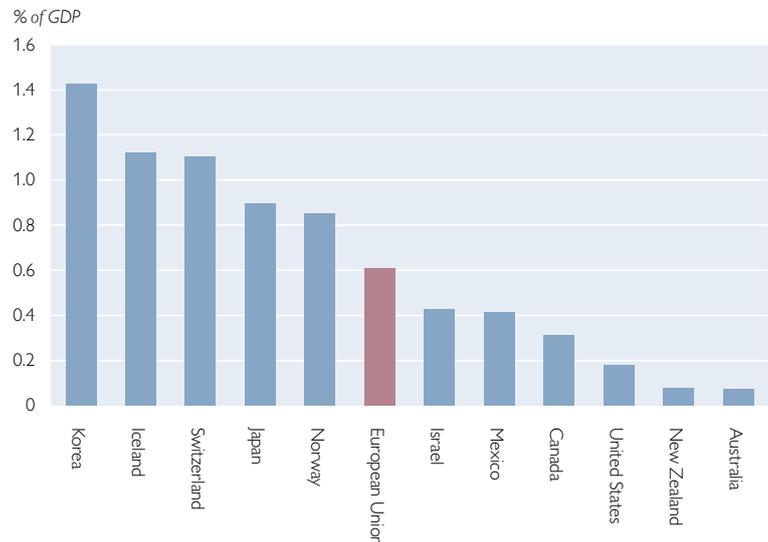
The EU budget is financed by member countries' contributions, which are primarily related to gross national income and value added taxes. The EU also receives 80% of customs duties on imports from outside the EU and sugar levies, while member countries keep 20% to cover collection costs. Some additional revenues arise from fines imposed by the EU. The overall budget is about 1% of the EU's gross national income and must be balanced.

The largest spending category is the common agricultural policy (CAP) with EUR 408 billion in terms of commitment appropriations<sup>2</sup> for 2014–2020, or 38% of the total EU budget. Structural and Cohesion Funds with EUR 367 billion account for another 34% of EU spending commitments. The third-biggest component (EUR 143 billion) relates to “Competitiveness for growth and jobs” programs, which include several well-known elements such as the Horizon 2020 research program and Erasmus+. EUR 70 billion have been set aside to cover the costs of operating the EU institutions and EUR 66 billion have been earmarked for the EU's “Global Europe” policy, which includes foreign policy instruments – notably aid, neighborhood policies and other external actions. Finally, the EU is committed to spend EUR 18 billion on “Security and citizenship” issues (covering domestic

<sup>2</sup> Expenditure committed in any given year (which might be spent in subsequent years). EU budget commitments exceed payments by about EUR 10 billion a year, leading to an ever-rising volume of outstanding commitments, known as *reste à liquider* (RAL). RAL is expected to exceed EUR 250 billion by 2020. EU budgets set ceilings for both total commitments and payments, but only commitment ceilings are set for individual items of the budget, which is why we report those.

Chart 1

**Net support to agricultural producers in selected OECD economies (2016)**



Source: OECD Agricultural Policies database.

Note: Producer Support Estimate (PSE): the annual monetary value of gross transfers from consumers and taxpayers to agricultural producers, measured at the farm gate level, arising from policy measures that support agriculture, regardless of their nature, objectives or impacts on farm production or income. It includes market price support, budgetary payments and budget revenue foregone, i.e. gross transfers from consumers and taxpayers to agricultural producers arising from policy measures based on current output, input use, area planted/animal numbers/receipts/incomes (current, noncurrent) and noncommodity criteria.

issues such as health, consumption, justice and asylum) and EUR 11 billion on “Sustainable growth: natural resources” (covering mostly maritime affairs and fisheries). We focus on the two largest spending categories, which are especially important for the CESEE countries.

**1.1 The common agricultural policy**

Total net public spending (CAP and national spending) on agriculture in the EU is larger than in the U.S. as a share of GDP, but is in the middle range of OECD countries (chart 1), suggesting that the total volume of agricultural support in the EU is not excessive. Yet the EU’s approach differs from that of our countries when it comes to the composition of such spending as will be shown below, where we also offer a number of critical observations about the CAP.

Principally, CAP spending aims to achieve five objectives: greater agricultural productivity, a fair standard of living for the agricultural community, market stabilization, food security and reasonable prices for consumers. As further objectives, the EU regulation on financing the CAP (Regulation (EU) No 1306/2013) specifies viable food production, sustainable management of natural resources, climate action and balanced territorial development. Through “greening” and “cross-compliance” conditions on subsidies, the CAP attempts to incentivize environment and animal welfare best practices.

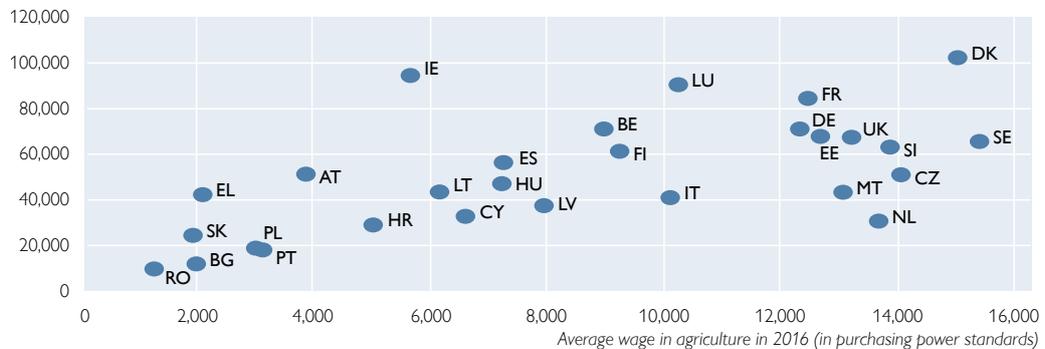
Of the total commitment of EUR 408 billion for 2014–2020, Pillar 1 spending (direct payments to farmers and market support) is capped at EUR 313 billion. Thereof, 94% (EUR 294 billion) may be used as income support for farmers, whereas EUR 18 billion have been earmarked for market interventions in case of agricultural shocks. Such support payments are fully EU financed. The remaining commitments of EUR 96 billion relate to rural development (Pillar 2), to be topped up by national cofinancing, ranging from 25% to 75% depending on the region and measure. Pillar 2 programs essentially serve to protect the environment, mitigate climate change and support the modernization of farms, risk management and research.

However, there is no uniform allocation key for the distribution of CAP payments to EU countries. For older EU members, payment entitlements are calculated on the basis of payments received by individual farmers during a reference period (“historical model”), resulting in different aid levels per hectare. In contrast, support for more recent EU members is based on the so-called regional model, where all payments received in a region are divided by the number of eligible

Chart 2

### Relation between CAP funding and wages in agriculture

Preallocated CAP funding per job in agriculture (2014–2020)



Source: Bruegel calculation using Eurostat data.

Note: Since the purchasing power of EUR 1 differs across member countries, we express income in purchasing power standards.

hectares, resulting in a flat rate – and much lower average amounts than under the historical model. As a result, different countries receive different levels of CAP funding.

In fact, richer countries where wages are higher receive more CAP funding per agricultural worker (chart 2), when common sense would suggest that the largest income subsidies should go to the countries with the lowest agricultural incomes.<sup>3</sup>

According to the European Commission (2018a), 80% of direct payments go to 20% of farmers, which raises further questions about the fair distribution of CAP allocations.

To our knowledge, no independent evaluation encompassing all aspects of the CAP has been carried out in recent years. Alliance Environnement (2017) suggested inefficiencies in managing environmental impacts, while Pe'er et al. (2014) concluded that the new environmental prescriptions are so diluted they are unlikely to benefit biodiversity. The studies often point to the need to collect more data and to make CAP evaluations more systematic. The European Court of Auditors (2017) found the CAP's "greening" policies to be likely ineffective in reducing the climate impact on agriculture in Europe. ECORYS et al. (2016) raised serious concerns about the national implementation of the CAP and the policy's overall impact. Hoelgaard (2018) argued for direct payments to be phased out or – if such support is considered important for political reasons – for the introduction of national cofinancing of direct payments, to compensate for lower European support. National cofinancing could also increase the ownership of such spending. Hoelgaard also proposed to focus on real public goods, such as environment, biodiversity, ecosystems, mitigation and adaptation to climate change, and moreover called for insuring against large risks such as earthquakes and animal disease epidemics, as is done in the United States. And he made a case for providing support for less favored areas with natural handicaps, such as areas which face the risk of depopulation but are important for environmental protection.

<sup>3</sup> The CAP does not subsidize wages of agricultural workers, but subsidizes incomes of farmers (who could then use the money to pay higher wages). Still, since one of the main goals of the CAP is to provide a fair standard of living for the agricultural community, and agricultural workers account for the bulk of this community and most of the CAP is used for income support, chart 1 is helpful in illustrating a possible misallocation of CAP spending.

## 1.2 Cohesion policy

Another key EU objective is to strengthen economic, social and territorial cohesion by tackling disparities between the levels of development of the various regions and by reducing the backwardness of the least favored regions.

To support regional policy, the EU made commitment appropriations in the amount of EUR 367 billion for 2014–2020. The bulk of this sum (55%) has been allocated to the European Regional Development Fund (ERDF), with the European Social Fund (ESF, 23%) and the Cohesion Fund (20%) accounting for most of the remainder. Sometimes the Youth Employment Initiative (1%) is also included here. These funds have been designed to cofinance regional economic development projects. Projects must demonstrate how they contribute to progress toward a broad range of objectives, from research and development activities and small and medium-sized enterprises to public administration and social inclusion.

In order to stimulate convergence, there are separate ERDF and ESF budgets for different regions in different GDP per capita ranges. For 2014–2020, EUR 185 billion have been set aside for “less developed regions” (with GDP per capita of less than 75% of the EU average). “Transition regions” (with GDP per capita between 75% and 90% of the EU average) will receive EUR 36 billion, and “more developed regions” (with GDP per capita above 90% of the EU average) EUR 56 billion.

While there is no consensus in the literature, the predominant empirical evidence suggests that, while depending on the prevailing circumstances, the impact of cohesion policy is often rather ineffective. A comprehensive literature survey by Marzinotto (2012) concluded that the impact assessments of regional fund spending depend on the methodology used. While macroeconomic model simulations conclude that such funds have a positive impact, the results of empirical studies are more mixed. Marzinotto concludes that by and large, the available literature finds investments in infrastructure and education to be the most growth-enhancing investments, but studies reaching such conclusions typically abstract from the actual allocation of EU funds across themes of intervention and sectors. More direct empirical tests sometimes find a positive, even if often small, impact of EU funds on growth convergence. In particular, investment in human capital and R&D generates positive long-term effects on growth convergence, while other spending, such as infrastructure spending, might deliver only a short-term effect. Yet there is no consensus in the literature, and other studies do not find that the rate of convergence has been higher in funded regions than in non-EU-funded regions.

More recent papers arrive at similarly mixed results. For example, Pinho et al. (2015) and Fratesi and Perucca (2014) report rather negative results, Pellegrini et al. (2013) and Crescenzi and Giua (2017) find a positive growth impact of EU regional policy, while Becker et al. (2017) conclude that regional policy has a positive, but short-lived effect on growth: The loss of eligibility in fact comes with a negative effect that offsets previous positive effects. In a European Commission report Pienkowski and Berkowitz (2015) conduct a comprehensive literature survey and conclude that most studies find a positive but small impact, especially in less developed regions. Some studies find no significant impact or even a negative impact.

Overall, various surveys as well as our overview of more recent works suggest that EU funds have a growth potential, but may not always deliver in practice because they are either poorly managed or used for the wrong types of investment.

## 2 The future EU budget

It is unfortunate that the debate about the EU budget frequently focuses on the balance between payments into the EU budget and EU spending in a particular country. Such an approach is rather reductive. Countries receiving more from the EU budget than they pay in (central, eastern and some southern European countries) might not benefit to the extent the numbers suggest because of ineffective program design, but might receive funding as part of the political deal when they entered the Single Market. Net contributors (most western and northern European countries) should not look at their contribution to the EU budget as a loss to domestic taxpayers, because the indirect benefits might offset the direct financial contribution. While some estimates aimed at quantifying these indirect benefits exist, we see some issues with the calculations, so let us just mention some key channels without quoting actual estimates. If these funds improve the economic outlook of cohesion countries (even in the short term, since the literature review concluded that long-term benefits are questionable), the implication is a larger European market benefiting all countries. Companies based in net payer countries can benefit from projects financed by cohesion funds. Cohesion funds might boost imports by the countries where those funds are spent. Finally, cohesion funding also contributes to completing the Single Market, which is a key growth driver for the EU as a whole.

### 2.1 Fundamentally rethinking EU spending

The first priority in the EU spending debate should be to assess which spending areas constitute European public goods and how best to provide these goods, also in light of the significant budgets of member countries and competences stipulated in the EU treaty. EU spending should focus on functions with clear pan-European implications and can be delivered more effectively jointly. Areas like border protection, defense, security, migration have clear pan-European implications. For example, the way Greek and Italian borders are protected has an impact on the arrival of illegal migrants in Denmark or the Netherlands. As regards border protection, the key task is precise program design so that European border protection services act as a true support for the national border guards that have the prime responsibility of ensuring border protection. Details matter when border protection services are to be increased significantly at the EU level – not least as such programs touch on delicate issues of sovereignty. There are also major synergies in pan-European projects in research, for example. Some project would perhaps be infeasible at the national level, like the EU's satellite program.

The second key issue is to increase the efficiency and effectiveness of current programs. Our literature review suggests that it is rather questionable whether the CAP and cohesion policy achieve their goals. Since a radical change to long-established EU policies is rarely an option, improved targeting should be a priority. In particular, as the European Commission (2018a) has suggested, cutting spending on industrial farming while maintaining support for small-scale farmers could limit the political costs while improving the greening of farming policy. Since organizing income support for one particular economic sector at the European level has little rationale, such support could be moved to member countries, at least gradually, by introducing and gradually increasing national cofinancing. Similarly, better targeting, stronger action against corruption and focusing the Cohesion

Fund and structural funds on those regions truly in need of catching up, or that are truly poor, should deliver the best growth dividends. Since a number of spending priorities gained importance in recent years, such as border control, migration, security, defense, research, digital transformation and youth mobility, the reorganization of CAP and CP spending would provide the financial means, even if the United Kingdom will not contribute to the next MFF and national contributions as a share of gross national income of the EU-27 are not increased.

The third important issue is whether there is a need for a specific euro area fiscal stabilization instrument, such as some form of insurance system to assist countries suffering from country-specific shocks (Claeys and Wolff, 2018), and if so, whether such an instrument should be within the EU budget or outside it. This question is all the more important because after Brexit the euro area's weight within the EU will increase.

Provided a political decision is reached on the establishment of a euro area fiscal stabilization instrument, having it within the EU budget would bring several advantages (Wolff, 2017). A euro area budget line within the EU budget would avoid creating a new ad hoc (probably intergovernmental) institution and would avoid an additional political and financial wedge between euro and non-euro area countries. But there is a more important political economy argument. Creating new budgetary resources for the euro area faces fierce resistance because insurance is more useful for fiscally weaker countries than for stronger countries, and because there is a perception that existing EU resources are poorly used. Politically, better use of existing EU resources therefore seems to be an important precondition for mobilizing new resources. Creating a euro area budget line within the EU budget institutionalizes this need to reform the budget.

However, there would also be significant obstacles. The EU budget is based on a rather complicated set of treaty rules, allowing for limited flexibility and essentially no borrowing capacity (beyond financial assistance programs).

## **2.2 The May 2018 MFF proposal**

The May 2, 2018, proposal by the European Commission (2018b) for the broad outline of the 2021–2027 Multiannual Financial Framework (MFF) provides the basis for subsequent negotiations between EU member countries and various European institutions. We evaluate this proposal in light of the principles and empirical evidence we discussed so far and we recommend repeating this exercise once the next MFF has been approved (which is expected to happen before end-2020, when the current MFF expires).

Overall, in our view the European Commission's proposal provides a good basis for subsequent negotiations and includes a number of bold suggestions, like a stronger focus on European public goods, a new rule of law procedure and a reform of budget revenues. But it has a number of deficiencies related to the structure and transparency of the budget, lack of cofinancing of direct farmer transfers and timid external action, while the proposed tools for euro area stabilization and euro adoption are conceptually weak, as we also argued in Claeys and Darvas (2018). We focus on the broad design of the proposal and again on the two largest EU spending categories, cohesion policy and the CAP, which have great relevance for the CESEE countries (CESEE countries are the biggest beneficiaries of the EU's cohesion policy, and the EU's CAP is also considered important by

CESEE policymakers). We do not offer a detailed discussion of the euro area stabilization tool (see Claeys, 2018), the euro adoption tool and the structural reform support tool (Claeys and Darvas, 2018).

A positive element of the proposal is that increased spending was proposed in a number of spending categories which really constitute European public goods: huge increases in border control and defense spending; significant increases in research/innovation/digital spending; some increases in migration spending. These spending categories have a truly pan-European rationale, as we argued earlier.

Of course, one always needs to discuss the various modalities, but the direction and the boldness of some of the proposals are clearly welcome.

Rather surprisingly, the European Commission (2018b) did not quantify the impact of the proposed cuts in spending in the two main spending areas (CAP and cohesion) which supposedly suffer from cuts; it only quantified the current price changes in those spending items which are proposed to be increased. Having quantified the proposed changes both in nominal and real terms for agricultural and cohesion spending, Darvas and Moës (2018) conclude that cohesion spending commitments are planned to be increased by 6% – but with inflation eroding the real value, the proposed changes would actually lead to a reduction of 7% in real terms (if inflation will be 2% per year, as the MFF calculations assume). The CAP would be subject to a 4% cut – which corresponds to a reduction of 15% in real terms based on the assumption of a 2% inflation rate.

Thus, by leaving broadly unchanged the combined spending for these two policies in nominal terms, the proposed changes would indeed provide financial resources for other spending priorities, as proposed by Darvas and Wolff (2017). The relatively larger cuts in CAP spending compared with cohesion spending are also in line with our earlier argument, highlighting that we see little value added in European income subsidies to one particular economic sector (agriculture), while there is a European rationale for cohesion policy – but there is a need for better implementation.

We also welcome the proposal for the increased national cofinancing of cohesion and CAP Pillar 2 spending. Larger national contributions might improve ownership and result in more careful management of the funds. However, a drawback of the proposal is that there are no plans to implement national cofinancing of direct payments to farmers. Moreover, the proposal envisages rural development (Pillar 2) to be cut more heavily than direct transfers (Pillar 1). We suggest to increase the share of Pillar 2 relative to Pillar 1 in subsequent negotiations. Moreover, we suggest that CAP spending should be linked to biodiversity and environmental goals. Beyond changes in commitment allocations, the European Commission promised to present a deep reform of the CAP, the details of which were yet to be published at the time of writing.

Another aspect is the proposed rule of law procedure. In fact, Demertzis (2018) and Demertzis and Goncalves Raposo (2018) have proposed a systematic evaluation of governance and institutional quality developments in the EU, including the rule of law. Rule of law is a fundamental value of the EU and it has a clear connection to the EU budget: rule of law deficiencies could hinder the proper implementation of the EU budget. A rule of law procedure is therefore worthwhile considering and the details of the proposal should be studied carefully.

### 3 Summary

The EU budget is, and will remain, far from what public finance theory or experience of fiscal federations suggest in terms of spending priorities. The key direction of spending reform should be to focus on true European public goods that are more efficiently provided jointly than by the member countries separately. To this end, more independent evaluations of various EU programs, as well as the overall allocation of EU resources, should be conducted.

Our review of CAP and cohesion funding suggests that there is scope for efficiency gains, which would allow some of the Brexit-related hole in the MFF to be filled. We do not see a case for European subsidies to top up farmer incomes, but there is a case for correcting market failures and promoting public goods, such as environment and biodiversity, and for insuring against large risks such as earthquakes and animal disease epidemics, as is done in the United States. There is also a European rationale for cohesion policy, but at the same time the framework needs better design, targeting and control. Furthermore, some of the other existing spending areas, such as research and youth mobility, migration and defense, also require increased resources in our view.

The European Commission's May 2, 2018, MFF proposal made several welcome steps in these directions, e.g. by reorganizing spending commitments toward priorities which have gained more importance recently, while reducing the share of spending on agriculture and cohesion policies. But many details remain quite fuzzy and need to be spelled out further before a critical appraisal can be made. And not all cuts undertaken in the CAP go in the right direction, as rural development resources that are critical for environment, biodiversity and climate change mitigation are subject to larger cuts than the harder-to-justify subsidies to farmers. More generally, we would argue that the European Commission needs to make a significantly stronger attempt at measuring the actual "European value added" of the various proposed initiatives. Therefore, while we regard its MFF proposal a good basis for subsequent negotiations, we have made the case for some significant changes.

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