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RETHINKING THE EUROPEAN UNION'S POST-BREXIT BUDGET PRIORITIES

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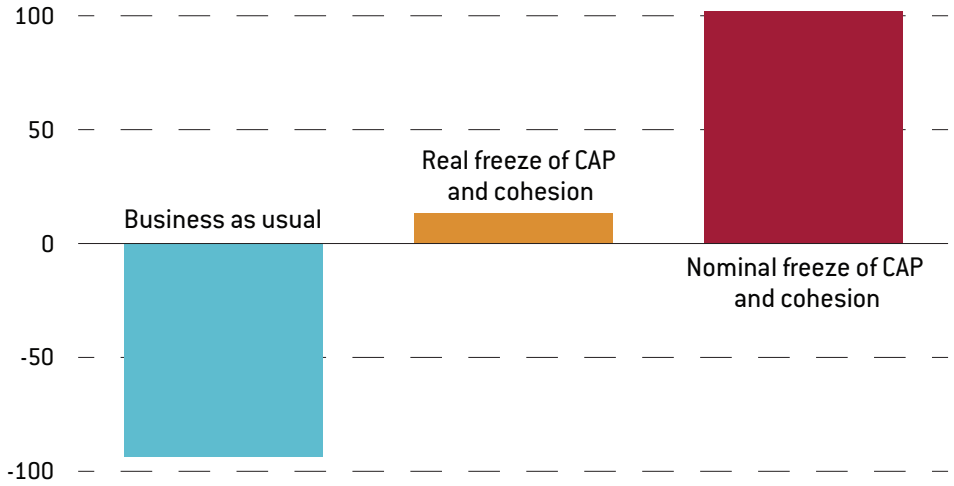
THE HOLE IN THE POST-BREXIT MULTIANNUAL FINANCIAL FRAMEWORK (€BNS)



Source: Bruegel. Note: no UK contribution; spending beyond CAP and cohesion and all revenues increase with GNI. See Table 2 for explanations.

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THE ISSUE

The European Union's budget is fundamentally different from the budgets of federal countries and amounts to only about one percent of the EU's gross national income. The literature shows that the Common Agricultural Policy (CAP), which takes 38 percent of EU spending, provides good income support, especially for richer farmers, but is less effective for greening and biodiversity and is unevenly distributed. Cohesion policy, 34 percent of 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 €100 billion for the 2021-27 period. In addition, EU budgeting is based on a complex and outdated methodology.

POLICY CHALLENGE

There will be a €94 billion Brexit-related hole in the EU budget for 2021-27 if business continues as before and the United Kingdom does not contribute. EU countries might be reluctant to increase contributions to fill this hole while also covering spending on new priorities. We show that freezing agriculture and cohesion spending in real terms would fill the Brexit-related hole, but new priorities would then need to be funded by an increase in the percent of GNI contribution. Freezing in nominal terms – thus cutting in real terms – would generate enough to cover most of the new priorities. This would be topped-up by a UK contribution if a EU - UK deal is reached. A fundamental overhaul of the EU budget, including its methodology, is crucial.

1 INTRODUCTION

The informal European Council meeting of 23 February 2018 kick-started the negotiations on the post-2020 European Union budget. The EU's political leaders emphasised the importance of spending more on tackling illegal migration, on defence and security, and on the Erasmus+ education programme, while stressing the continued importance of cohesion policy, the Common Agricultural Policy, research and innovation and pan-European infrastructure[1].

The new Multiannual Financial Framework (MFF) must be agreed unanimously, increasing the likelihood that inertia will hold back radical change. However, a 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 neighbourhood, heightened immigration pressures, the wavering United States commitment to NATO and questions over the effectiveness of a large share of EU spending. The EU budget is a reflection of the EU's priorities. What the MFF discussions will deliver is therefore of great importance.

It is also important to understand the peculiar nature of the EU's budget. The EU is a group of developed states with significant and large government sectors. Unlike in federal states, crucial government functions such as social security, healthcare and defence are provided by national states in the EU (foreign aid and research support are provided by both the EU and member states). Therefore, further functions could be delegated to the EU only if members are ready to reduce or give up their activities in these areas.

The key question then becomes which functions can be delivered more effectively jointly and how should the EU budget and its corresponding activities best complement what countries already do at national level. This requires carefully thinking about European public goods and how best to provide them.

Moreover, federations often provide stabilisation policy primarily at federal level, which is 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 stabilisation efforts by providing insurance.

2 THE CURRENT EU BUDGET

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

The largest spending category is the Common Agricultural Policy (CAP), followed by the Structural and Cohesion Funds. These account for 72 percent of EU commitment appropriations[2], or €775 billion in 2014-20. 'Competitiveness for growth and jobs' is the third biggest component, with €143 billion. This includes several well-known elements such as the Horizon 2020 research programme and Erasmus+. Administration with €70 billion covers the operational costs of EU institutions. With €66 billion, 'Global Europe' includes the EU foreign policy instruments – notably aid, neighbourhood policies and other external actions. 'Security and citizenship' covers domestic issues such as health, consumption, justice and asylum – totalling €18 billion. Finally, 'Sustainable growth: natural resources' is allocated €11 billion, mostly for maritime affairs and fisheries. We focus on the two largest spending categories: CAP and cohesion.

2.1 THE COMMON AGRICULTURAL POLICY

Total net public spending (CAP and national spending) on agriculture in the EU is larger than in the US as a share of GDP, but is in the middle range of OECD countries. CAP spending aims to achieve five objectives: greater agricultural productivity, a fair standard of living for the agricultural community, market stabilisation, food security and reasonable prices for consumers. Moreover, the EU regulation on financing the CAP (Regulation

1. See http://www.consilium.europa.eu/en/meetings/european-council/2018/02/23/.

2. Expenditure committed in any given year (which might be spent in subsequent years). EU budget commitments exceed payments by about €10 billion a year, leading to an ever-rising volume of outstanding commitments, known as *reste à liquider* (RAL). RAL is expected to exceed €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 and therefore we report those.

1306/2013) specifies viable food production, sustainable management of natural resources, climate action and balanced territorial development as further objectives. Through the CAP's 'greening' and 'cross-compliance' conditions on subsidies, it attempts to incentivise environment and animal welfare best practices.

CAP commitment appropriations for 2014-20 amount to €408 billion. Of this amount, Pillar I (direct payments to farmers and market support) has a ceiling of €313 billion, of which 94 percent (€294 billion) could be used as income support for farmers. Intervention in case of shocks to agricultural markets is expected to amount to €18 billion. These supports are fully EU financed. The remaining commitments of €96 billion go to rural development (Pillar II), with the amount roughly doubled by co-financing ranging between 25 to 75 percent depending on the region and measure.

The distribution of CAP payments to EU countries is based on mixed principles. More longstanding EU members were able to base entitlements on historical support values, while support for more recent EU members is based on the so-called regional model, whereby the payment per hectare is the same for all farmers, but with much lower average amounts than in the older member states. As a result, different countries receive rather variable levels of CAP payments.

Richer countries where wages are higher receive more CAP funding per agricultural worker, when common sense would suggest that the greatest income subsidy should be given to those who earn the least. European Commission (2018) highlights that 80 percent of direct payments go to 20 percent 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 done 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. Studies often point to the need to collect more data and to make CAP evaluations more systematic. ECA (2017) found the CAP's 'greening' policies to be likely ineffective at reducing European agriculture's climate impact. ECORYS *et al* (2016) raised serious concerns about national implementation of the CAP and the policy's overall impact. Hoelgaard (2018) argues for phasing out of direct payments, the introduction of national co-financing of direct payments to farmers and a focus on real public goods.

Overall, CAP spending mainly goes to richer farmers, with uneven distribution between EU countries. The direct payments as presently designed are ineffective or possibly counterproductive in achieving the goal of greening European agriculture. It is rather questionable whether earnings support for farmers has European value added. This calls for a fundamental reform and also reductions in the overall size of the CAP, possibly replaced by national (co-) funding of farmer earnings support.

2.2 REGIONAL POLICY

A key EU objective is to strengthen cohesion by tackling regional development disparities, especially by targeting the least-favoured regions.

Regional policy has commitment appropriations of €367 billion for 2014-20, allocated between the European Regional Development Fund (ERDF, 55 percent), the European Social Fund (ESF, 23 percent), the Cohesion Fund (20 percent) and, sometimes included, the Youth Employment initiative (1 percent). These funds co-finance economic development projects drawn up region by region. Projects must demonstrate how they contribute to progress towards 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, the ERDF and ESF have separate budget subdivisions for different regions based on their GDP per capita (GDP/cap) €185 billion is set aside for 'less developed regions' (with GDP/cap of less than 75 percent of the EU average). 'Transition regions' (with GDP/cap between 75 percent and 90 percent of the EU average)

receive €36 billion. 'More developed regions' (with GDP/cap above 90 percent of the EU average) receive €56 billion.

Macroeconomic model simulations conclude that such funds have a positive impact, but the results of empirical studies are more mixed. Marzinotto (2012) concluded that by and large, the available literature showed that the most growth-enhancing investments were infrastructure and education. More direct empirical tests sometimes find a positive, albeit 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 might deliver only a short-term effect. However, there is no consensus in the literature and other studies do not find a higher rate of convergence in funded regions compared with non EU-funded regions. More recent works have found similarly mixed results[3].

3 THE FUTURE EU BUDGET

It is unfortunate that discussion about the EU budget is frequently centred 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 as much as the numbers show because of ineffective programme 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. If these funds improve the economic outlook of cohesion countries (even in the short term), the implication is a larger European market benefitting all countries. Companies based in net payer countries can benefit from projects financed by cohesion funds. Cohesion funds might boost the imports of 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.

3.1 RETHINKING EU SPENDING

The first priority in the EU spending debate should be to increase the efficiency and effectiveness of current programmes. Our literature review suggests that improved targeting can mean EU programmes continue to achieve their goals as now, but with lower spending. In particular, as European Commission (2018) 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 organising earnings support at the European level has little rationale, such support could be moved to member states. Similarly, better targeting, stronger action against corruption and focusing Cohesion and Structural Funds on those regions truly in need of catching up, or that are truly poor, should deliver the best growth dividends. European Commission (2018) outlines possible new spending priorities (Table 1).

Table 1: European Commission new spending priorities scenarios, 2021-27 MFF (€bns)

	2014-2020 MFF	Scenario 1	Scenario 2	Scenario 3
EU border protection	4	8	22.5	150
European Defence Union	0.6	3.5	10.5	20.5
Mobility of young people	14.7		30	90
Digital transformation	35		35	70
Research and innovation	80	80	120	160
External actions	66 (MFF) + 31 (EDF)		100	100
Total	231			
Total ex. UK contributions	201		318	591

Source: Bruegel based on European Commission (2018). Note: EDF = European Development Fund, a major provider of foreign aid, is outside the EU budget. European Commission (2018) proposed to bring this fund into the EU budget.

3. For example, Pinho *et al* (2015), Fratesi and Perucca (2014), Pellegrini *et al* (2013), Crescenzi and Giua (2017), Becker *et al* (2017). In a European Commission report, Pienkowski and Berkowitz (2015) also 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.

Their middle scenario would necessitate about €117 billion in additional resources from 2021-27, while the most ambitious scenario would necessitate an additional €390 billion[4]. A key question is the savings that a relative reduction in CAP and cohesion spending would provide. We discuss this in section 3.2.

A second important question of priorities is whether there is a need for a specific euro-area fiscal stabilisation instrument, such as some form of insurance system to assist countries suffering from country-specific shocks (Claeys and Wolff, 2018), and if so, whether it should be within the EU budget or outside it as a new instrument. 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 stabilisation instrument, having it within the EU budget would bring several advantages (Wolff, 2017). An EU budget line would avoid creating a new *ad-hoc* (probably inter-governmental) 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, and because there is a perception that existing EU resources are poorly used. Politically, an important precondition for mobilising new resources therefore seems to be better use of existing EU resources. Creating the euro-area line within the EU budget institutionalises 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 programmes).

3.2 EU BUDGET REVENUES

Setting spending priorities, along with setting the total volume of the EU budget, necessitates parallel thinking about the revenue side. One issue is whether the EU budget revenues should increase beyond the current level in percent of GNI. A second question is whether new resources should be created (for example, in line with the proposals of Monti *et al* (2016)). We do not look into the revenue side in detail. Many countries have already voiced their opposition to increasing their contributions relative to GNI. We therefore consider it as important that the EU starts a serious debate on direct tax resources. A tax on CO2 emissions, for example, would be a welcome source of revenue (and a sensible way of advancing the EU's climate goals) and would be feasible without treaty change. Redirecting revenues from the EU emissions trading system to the EU budget would also be feasible.

4 THE NEXT MFF AFTER BREXIT

The EU budget could develop in a number of ways post-Brexit. The United Kingdom might contribute to the next MFF and some of the commitments of the current MFF are planned to be spent in the UK after 2020. However, since the UK contribution to the EU budget and EU spending in the UK is uncertain until the EU27-UK treaty is signed and ratified, we first present scenarios that exclude the UK from the next MFF. Subsequently, we assess possible UK contributions.

4.1 MFF 2021-27, NO UK CONTRIBUTION

As the UK has been a net contributor to the EU budget, Brexit might leave a large hole. In order to quantify the this hole, we first calculate that the GNI of the EU27 will increase by 28 percent in total from 2014-20 to 2021-27. Of that, roughly half is real growth and the other half is inflation[5].

Assuming the UK's net contribution to the next MFF is zero and all spending in and revenue from the EU27 increases with GNI, there will be a €94 billion hole in the next MFF, or about €13 billion per year from 2021-27 (Table 2, scenario 1). Without any reduction in certain expenditures relative to GNI, a significant increase in national contributions would be needed to fund this gap. Moreover, the new spending priorities listed in Table 1 would require at least an additional

4. Beyond border control, the Commission report does not include scenarios for immigration-related issues, such as integration of immigrants.

5. We base our calculations on the November 2017 European Commission and the October 2017 IMF forecasts; see details in the online annex.

€100 billion. That would mean that the revenues would have to increase to 1.2 percent or more.

Since the effectiveness of CAP and cohesion spending is dubious, we consider further scenarios (Table 2):

- Scenario 2: CAP and cohesion spending is increased with inflation only, ie by 13 percent, while other spending and all revenue items grow with the 28 percent increase of GNI; this would result in a surplus of about €13 billion (or about €2 billion per year) available for spending on other priorities;
- Scenario 3: CAP and cohesion spending is fixed at the 2014-20 MFF levels in nominal terms (implying a 13 percent decline in real terms), while everything else is increased by 28 percent; this would result in an overall surplus in the MFF for new spending priorities of about €102 billion, or about €14 billion a year.

While these scenarios are illustrative, they show that the Brexit hole in the budget could be filled by, for example, freezing the real value of CAP and cohesion spending, which would still involve a nominal increase of 13 percent. This option was not raised by European Commission (2018), which suggested that nominal cuts would be necessary. In fact, our scenario 3 shows that without any nominal cut, nominal freezing of CAP and cohesion spending would make available €102 billion for other spending priorities, which is not that far from the additional resources needed for the middle scenario in Table 1. But this would come at the expense of a 13 percent decline in the real value of CAP and cohesion spending, while scenario 2 would require an increase in the revenues to 1.1 percent to fund the new priorities.

4.2 ASSESSING POSSIBLE UK CONTRIBUTIONS TO THE 2021-27 MFF

The UK might substantially contribute to the next MFF if:

- An exit deal is signed and the principles laid down in the December 2017 agreement on the financial settlement between the EU27 and the UK are implemented[6], and
- The EU and UK sign a comprehensive economic partnership agreement for the post-2020 period involving a UK contribution to the EU budget, similarly to, for example, Norway's contribution.

The December 2017 agreement resulted in the acknowledgement of the broadest possible liabilities for the UK: for 2019-20, the UK will contribute as if it were a member of the EU, while post-2020 the UK will pay its share of all liabilities and commitments accumulated by the EU up to 31 December 2020, including its share of the pensions of EU employees. Moreover, the UK will not benefit from a share of EU assets.

The December 2017 document clearly explains the principles of financial settlement with one important exception: whether the rebate-adjusted or non-adjusted historical contributions will be used to calculate the UK's share of the post-2020 contributions.

Table 2: Scenarios for the 2021-2027 MFF for 27 countries without a UK contribution (€bns)

Payments				Revenues	
	Scenario 1:	Scenario 2:	Scenario 3:		
CAP	463	408	362	Total own resources	1,097
Cohesion	431	379	336	Other revenues	55
Other spending	352	352	352		
Total	1,246	1,139	1,050	Total	1,152
Balance	-94	13	102		
Total % GNI	1.1%	1.0%	0.9%	Total % GNI	1.0%

Source: Bruegel; see the online annex. Note: Scenario 1 = CAP/cohesion increase with GNI; Scenario 2 = CAP/cohesion increase with inflation; Scenario 3 = CAP/cohesion nominal fix at previous MFF level. Other spending and all revenues increase with GNI. Numbers on the left side refer to payments, not commitments.

6. 'Joint report from the negotiators of the European Union and the United Kingdom Government on progress during phase 1 of negotiations under Article 50 TEU on the United Kingdom's orderly withdrawal from the European Union', 8 December 2017, see: https://ec.europa.eu/commission/sites/beta-political/files/joint_report.pdf.

Table 3: Estimate of the UK's net contribution to the EU budget after 2020 according to the draft EU/UK financial settlement (€bns)

UK's net contribution	2021-27	Post-2027
If non-rebate adjusted share	28	8
If rebate adjusted share	17	6

Source: Bruegel; see details in the on-line annex. Note: post-2027 UK contributions primarily relate to EU staff pension payments.

We therefore calculate two scenarios (Table 3), which show that the UK might contribute between €17-28 billion in 2021-27. The December 2017 agreement has not at time of writing been ratified and is therefore uncertain.

Moreover, the exit fee might not be the UK's only contribution to post-2020 EU budgets. If the UK and the EU sign a comprehensive economic partnership agreement for the post-2020 period and the UK participates in some EU programmes, the UK might also make annual contributions to the EU budget, like Norway and Switzerland. Norway's net contribution to the EU has been historically about half of the UK's relative to GNI[7]. Switzerland's net contribution has been much smaller, while Iceland was in fact a net beneficiary of EU spending in 2015 (Table 4). In case of a Canada-style FTA between the EU and UK, no budgetary contributions will be implied, but countries with which the EU have FTAs do not benefit from EU programmes like Horizon 2020 and Erasmus+.

In the right-hand column of Table 4, we calculate illustrative UK contributions to the 2021-27 MFF. A Swiss-type contribution would suggest only €3 billion for the full seven-year period, while a Norway-type contribution would suggest €31 billion, or about €4.5 billion per year.

Therefore, if there is both an exit deal and a new comprehensive partnership agreement between the EU and the UK, the Brexit-hole in the next MFF will be smaller than that implied by a no-deal scenario.

5 CONCLUSIONS

The EU budget is and will remain far from what public finance theory or experience of fiscal federations suggests in terms of spending priorities. The key direction of spending reform should be to focus on true European public goods that can be more efficiently provided jointly than by member states separately. To this end, more independent evaluations of various EU programmes, 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 hole in the MFF arising from Brexit to be filled. For example, increasing CAP and cohesion spending by inflation only – 13 percent in total from 2014-20 to 2021-27 – would be sufficient to cover the Brexit hole, but new priorities would then need to be funded by an increase in the percent-of-GNI contribution.

Table 4: Possible UK contributions to the 2021-27 EU budget arising from preferential market access and participation in EU programmes

	Historical contributions by country (% GNI)	Total UK net contribution in 2021-27 if UK GNI share as per the first data column (€bns)
Iceland	-0.05%	-11
Canada	--	0
Switzerland	0.02%	3
Liechtenstein	0.03%	7
Norway	0.16%	31
United Kingdom	0.33%	65

Source: Bruegel; see details in the online annex. Note: the first data column shows the average of 2010-16 for the UK, average of 2014-15 for the non-EU countries. The main reason for the discrepancy between the €65 billion number included in this table, which would results from the UK's continued contribution based on its 2010-16 historical share, and the €94 billion hole in the EU budget indicated in Table 2, scenario 1, is the depreciation of the British pound against the euro after the Brexit referendum in June 2016. Thereby UK GNI expressed in euro declined substantially, so the same share of UK GNI amounts to a lower value in euros. Another reason for the discrepancy is that UK economic growth from 2014-20 to 2021-27 is expected to be somewhat lower than EU27 growth. Furthermore, UK's historical contribution is based on the 'operating budgetary balance' concept.

7. About half of Norway's gross contribution is paid directly into the EU budget, while the other half goes to European Economic Area (EEA) and Norway grants to promote European cohesion efforts.

Freezing the CAP and cohesion budgets in nominal terms would generate enough to cover most of the new priorities, but would led to a cut in real terms, a politically difficult outcome.

Reforms should be differentiated. We do not see a justification for European subsidies to top up farmer earnings, but there are justifications 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 in the US. Cohesion policy has a European justification, but needs better design, targeting and control. Furthermore, some of the other existing spending areas, such as research and youth mobility, also require increased resources in our view.

The EU will therefore also need to consider increasing revenues or possibly the creation of a dedicated EU tax, such as a carbon tax.

The case for a euro-area stabilisation tool for symmetric shocks is less clear-cut. However, if risk-sharing tools are to be strengthened, we see a clear case for doing it within the EU budget and not as an *ad-hoc* instrument.

Finally, the EU should scrap its outdated and overly complex budgeting methodology, which leads to an ever-rising stock of outstanding spending commitments (*reste à liquider*), and instead adopt the best practices used by governments and multinational organisations based on accrual multi-annual budgeting, supplemented with a cash budget.

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