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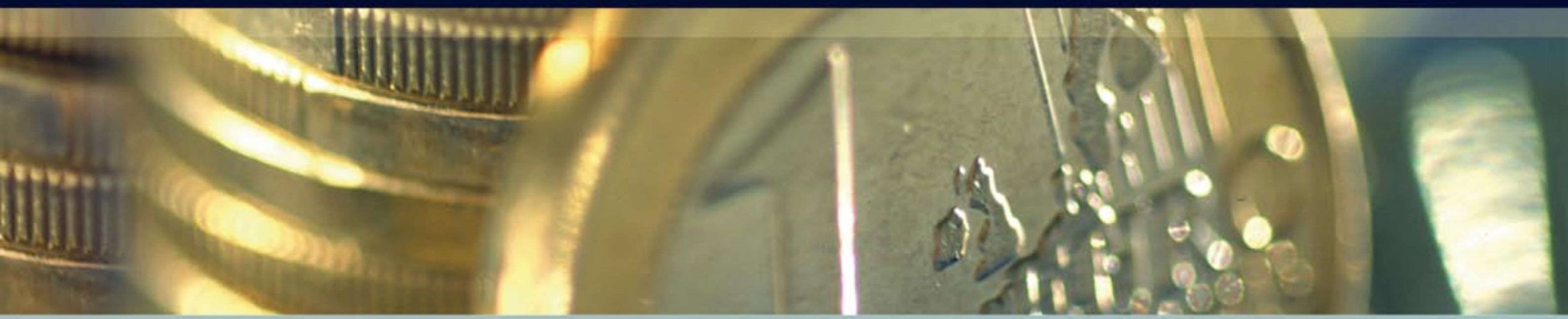

"Constrained Flexibility" as a tool to facilitate reform of the EU budget

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"Constrained Flexibility" as a Tool to Facilitate Reform of the EU Budget

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Abstract

The Sapir report in 2004 famously dubbed the EU Budget a historical relic. In spite of calls from many quarters for a comprehensive budget reform, the Council negotiation was hampered by many institutional and political constraints and managed to deliver only limited change. However, the final agreement on the Multiannual Financial Framework 2007/13 did introduce a potentially important novelty, namely a review clause in 2008/9. Such an occasion should be seized to introduce appropriate incentives and tools for revamping the EU budget with the aim of making it consistent with the Lisbon-oriented objectives of the EU. This paper argues for the respect of the Multiannual Financial Framework over the period covered rather than in every single year and per every single heading. This should be accomplished via an inter-temporal guarantee of the respect of the Multiannual Financial Framework and coupled with cost-benefit analysis of the additional spending carried out at the EU level. Such "constrained flexibility", which can be introduced either under the current or the new Lisbon Treaty, should be supported by appropriate governance arrangements to ensure the respect of subsidiarity, allow an efficient running of the budget and enforce budgetary discipline.

JEL Classification: E61, E62, H5, H6, H77

Keywords: European Union, EU budget, Lisbon strategy.

[(*)] Forthcoming in *Public Finance and Management*.
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1 Introduction

The Sapir report famously dubbed the EU Budget a "historical relic" (Sapir et al., 2004: 197). Five years later, we argue that the EU Budget remains outdated with respect to the needs of today's Europe.

This is so in spite of the increasing awareness of its shortcomings and Commission's proposals which were relatively innovative on both the revenue and the expenditure side of the EU budget[1]. However, intense budgetary negotiations over those proposals, concluded by the Council agreement of December 2005, finally delivered only little change.

The low ratio between input (the Commission's proposals) and output (the result of Council negotiations) was the result of a set of interrelated factors. Three of them were in our eyes particularly prominent:

- The then prevailing scepticism in the public opinion on the benefits of European integration which had culminated with the negative outcome of the French and Dutch national referenda for the adoption of the EU constitutional Treaty in May/June 2005;

- The dominant approach which, by emphasizing the so-called *juste retour*[2] or "net balances", make the negotiations over the EU budget a zero sum game;

- The unanimity rules for the adoption of the Multiannual Financial Framework, (hereafter, MFF)[3] which favours only marginal movements away from the previously hard fought budget equilibrium.

As a result, the weight of the past both in terms of expenditure, revenues and budgetary procedure has tended to prevail leading over time to an increasingly suboptimal distribution of tasks between the EU and the national level[4].

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[1] See European Commission (2004a).
[2] For an analysis of the *juste retour* debate see, e.g., Le Cacheux (2005) and Altomonte and Nava (2006).
[3] The defunct draft constitution did contain a provision to remove the unanimity rule for the MFF starting from 2013 in favour of the introduction of the Qualified Majority Voting (QMV) rule. That provision was however repealed in the new Treaty signed in Lisbon on 13 December 2007.
[4] See Buti and Nava (2003). Note, however, that for the first time in history, the EU Budget of 2008 is finally committed to spend more (although by very little) in sustainable growth (Competitiveness and cohesion expenditure) than in Preservation and Management of Natural Resources (Agriculture and Rural Development).

However, in the midst of so little change, the December 2005 Council agreement did introduce one potentially important change: a review clause[5] for 2008/09 which represents a novelty in the political economy of the budget.

We believe that this Budget Review should not be regarded as a routine budgetary *rendez-vous* where most of the discussion focuses on Member States' contributions to and intake from the EU budget. Rather, it should become as a strategic appointment where content, procedure and rules of the EU budget are agreed upon, though their implementation is deferred to a future date. In other words, the "Maastricht method" for the creation of EMU should be used.

While this may make reform politically more palatable, the urgency of re-orienting the EU budget towards growth and employment cannot be disregarded. As a step in that direction, this paper proposes to introduce a clause of "constrained flexibility" by which the ceiling of the MFF is respected over the whole period – in the current MFF, 2007/13 - rather than in every single year. Such a move is meant to increase the flexibility of the EU budget, without undermining its stability or altering its overall size.

The structure of the paper is the following. Section 2 assesses the state of the debate on of the EU budget after the December 2005 negotiations, including the 2008/09 Budgetary Review. Section 3 looks at rationale, objectives and effects of the introduction of constrained flexibility and illustrates how the proposal could work in practice. Section 4 concludes.

2 The state of play on the EU budget

2.1 The Financial Framework 2007/13

The European Council needed two semesters to agree on the final budget deal ‘on the basis’ of the initial Commission proposal of MFF. The first attempt, under Luxembourg Presidency in June 2005, failed, and then a second successful attempt took place under the UK Presidency in the second half of 2005.

[5] It is revealing of the underlining discussions the fact that in French (and in all Latin languages) the term "review " has been translated with the term "revision" (*révision budgetarie*) which is far stronger than review.

In December 2005, the European Council agreed on a total level of commitment appropriations over the 2007-2013 period of € 862.4 billion (2004 prices), then increased to 864.3 billion in the Inter-institutional Agreement with the European Parliament and the Commission corresponding to 1.048% of the EU's Gross National Income (GNI). Compared to the initial Commission proposal the cut is equal to € 160.7 billion (15.7%) for the period 2007/13 (see Table 1).

Table 1 ***Expenditure ceilings for the period 2007-13(*)***

	Previous period (Jun.99)	COM Initial proposal (Feb.04)	Council Final deal (Dec.05)	Interinstitutional Agreement (Jun.06)
€ billion	770.6	1.025	862.4	864.3
% of EU GNI	*1.11%*	*1.26%*	*1.045%*	*1.048%*

(*) Commitments, 2004 prices

Source: European Parliament and Council (2003), European Commission (2004), European Council 2005 European Parliament, Council and Commission (2006) and own calculation.

The absolute amount of the cut imposed by the European Council and Parliament, 160.7 billions over the seven years, which amounts to about 23 billions per year leads to an overall budget for the period 2007-2013 which is 5.6% smaller in percentage of GNI (about 0,062 percentage points) than the EU budget of the period 2000-2006, in spite of the fact that the Union now counts 12 Member States and 110 millions people more, whose average income is much lower that the one of the 'old' EU.

What is even more revealing is to observe where these cuts are concentrated. The table below shows that largest reductions, both in absolute and in relative amounts, are concentrated in the growth and competitiveness expenditure, but also in expenditure for security and external action. Substantial cuts, in absolute amounts, also appear in the cohesion expenditure, while funds for the Common Agricultural Policy (CAP) are kept substantially unchanged.

The combination of these cuts provokes as a result an increase, with respect to the initial Commission proposal, of the relative weight of the CAP in the total EU budget (from 29.4% to 33.9%) and a major decrease of other expenditures (growth and competitiveness from 13.0% to 8.6%, and external expenditure from 9.3% to 5.7%) as shown in Table 2 below.

Arguably, the final allocation of spending under the main titles does not appear consistent with the Lisbon strategy which aims at enhancing innovation, knowledge and competitiveness[6]. Consequently, limited room for manoeuvre was left to enhance the role of the EU budget in fostering the Lisbon goals, as pursued in the mid-term review of the Lisbon strategy (European Commission, 2005)[7]. As a result, the challenge of transforming the EU budget into an effective tool of economic policy remains to be seized[8]. The EU Budget Review constitutes the opportunity for setting in motion a new dynamics.

***Table 2 MFF: proposal and outcome** (*)*

	Percentage of each expenditure in the IIA 2000-2006	Percentage of each expenditure in the Commission Proposal for 2007-2013	Δ Proposal Commission-Inter-institutional Agreement 2007-2013 Percentage reductions	Percentage of each expenditure in the agreed MFF
Growth and Competitiveness	7.6%	13.0%	-44.2%	8.6%
Economic and Social Cohesion	34.1%	33.6%	-10.7%	35.6%
Agriculture and Natural resources (**)	44.7%	39.5%	-8.2%	43%
Citizenship and Security		1.8%	-41.8%	1.2%
External Actions	4.7%	9.3%	-48.3%	5.7%
Total			-15.7%	

(*) Only the most significant headings of EU Budget are reported and therefore totals do not account for 100%

(**) The difference between the Commission Proposal and the final MFF for the CAP expenditure only is equal to -2.6%, the rest of the 8.2% cut is concentrated in rural development expenditure.

Source: European Parliament and Council (2003), European Commission (2004), European Council 2005 European Parliament, Council and Commission (2006) and own calculation.

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[6] See e.g. Pisani-Ferry (2005).

[7] This challenge is made even more difficult by the fact that on the revenue side of the budget , the European Council introduced a number of ad hoc measures whose overall logic and consistency is unclear, at least to us. VAT resource has been further reduced and even differentiated across countries (Germany 0,15%, Austria 0,225%, Sweden and the Netherlands 0,10%, all others 0,30%), an *ad-hoc* and *una tantum* discount has been granted to the GNI's Dutch and Swedish contribution, the UK rebate has been modified in a way that it is certainly less than what it would have been without modification, but still higher than what it was in the 2000-2006 period.

[8] In Buti Nava (2003), using a simple model which balances considerations of efficiency and preference, we argued that the current budgetary distribution of expenditure is suboptimal in economic terms since some expenditure financed at the EU level would better be decentralised (e.g. agricultural expenditure) and some national expenditure would better be centralised (e.g. research).

2.2 The Budget Review of 2008/09

In spite of little change, the budgetary agreement of December 2005 introduced a major novelty: a Budget Review at mid-term. There is no doubt that this review constitutes a potentially relevant development from a governance standpoint and an element of hope for future reforms. In preparation to the Review, the European Commission has launched a wide-ranging consultation on the EU finances, calling for a "no taboo" debate (European Commission, 2007b).

Begg (2007) provides a lucid analysis of what the 2008/09 Budget Review could and should do and argues for it to become a roadmap for change. We subscribe to the need for the Review to sketch a roadmap for action and we argue that the Budget Review should be used, at least, in two ways: i) to agree on the main changes to improve the relevance and coherence of the EU Budget; ii) to introduce an innovation of the type described in section 3, rather than focusing on fine tuning of budgetary figures which are inevitably controversial.

As for the first point, the European Council has the chance to take in this field an approach similar to what, in other areas, has produced rather innovative result: that is to decide today (in 2008/09) what will happen at a given date in the future (between 2014-20), subject to the fulfilment of certain conditions. Indeed, time-distance between decision and implementation did facilitate many of the most innovative EU policies (EMU, Schengen agreements, Single Market). The political economy reasoning for that is twofold: i) long-distance thinking makes it easier for politicians to shake off, at least partly, short term constraints; ii) politicians who decide will not be the same who will implement the decision and this makes it easier to decide for the common good rather than for their own good. No previous budgetary negotiations had the luxury of a time-distance of five years before implementation.

As for the second point, experience shows that any partial change to already agreed figures may constitute more an obstacle than an opportunity for future agreements. A clear example of that was given by the Council agreement of 2002 on agricultural commitments for the period 2007/13 instigated by a deal between France and Germany. Because of the practical impossibility to revise it, that agreement was taken as an exogenous constraint in the 2005 negotiations and, by freezing a large chunk of the budget, *de facto* constituted one of the greatest obstacles to reform in the sense of a more Lisbon-friendly budgetary settlement.

Furthermore, budgetary figures immediately pull the debate away towards issues such as *juste retour* where rationale arguments have little place and political arm-twisting dominates.

While an agreement in the Budget Review on future general orientations for the EU budget would be an important pre-condition for reform, it is unlikely to be sufficient to trigger a major reform for the 2014-20 MFF if it is not associated with some concrete, "experimental" innovation showing that higher flexibility of the EU budget can already prove its usefulness in the interim period. The proposal in the next section aims at fulfilling this goal.

3 "Constrained flexibility" to facilitate budget reform

3.1 Unlocking the EU budget

Is the status quo and political inertia going to prevail indefinitely? Can the EU Budget be unlocked to allow it to play a stronger role in the Lisbon strategy for growth and jobs? The literature points to at least three aspects which need to be considered in any proposal of reforming the EU budget:

1) Achieving coherence in EU public finances. The theory of fiscal federalism postulates that there should be coherence in the allocation of public spending across level of government and vis-à-vis the final goal to be attained[9]. As to the EU budget, it is evident that there is an inconsistency between the current spending allocation and the so-called Lisbon strategy for growth and jobs which constitute the backbone of the EU economic policy. The call for "coherence" between the EU goals and means was probably the most compelling recommendation of the Sapir report (Sapir et al., 2004) and we believe it is widely shared by academics and commentators.

2) Devising a comprehensive solution. Any EU budget reform should provide a comprehensive solution. Because of political entrenchment between expenditure, revenue and decision making mechanism it is not possible to address only one aspect. Tackling separately these three aspects makes impossible to move away from the *juste retour* approach.[10]

[9] See e.g. Musgrave and Musgrave (1959) and Oates (1972).
[10] For a call to devise a comprehensive solution, see, i.a. Gros and Micossi (2005).

The most contentious points (e.g. the UK rebate) have a bearing on revenue, expenditure and on the decision making procedures.

3) Fostering the political incentives for reform. In spite of the needs highlighted above, there is very little political appetite for reform. In particular, the political conditions for any grand reform based on *tabula rasa* do not exist, as every single budgetary negotiation since 1988 has demonstrated. Short term costs arising from displeasing cohesive constituencies defending strong corporatist interests outweigh medium terms gains for the economy and society as a whole. If these political economy obstacles are not tackled, any reform project is doomed to fail[11].

The three above-mentioned points, when taken all together, seem to create an apparently inextricable knot and leave little margin to the possible reforms. Basically, it seems as if "we know what to do, but we also know that there is no way we can achieve it"[12].

Given these constraints, the only politically feasible way forward is an incremental one: using the existing – admittedly small – room for manoeuvre to increase the flexibility of the EU budget so as to make it more consistent with the Lisbon objectives and the Lisbon cycle. Not only the economic literature, but also budgetary and political negotiations reveal quite clearly the awareness that some additional flexibility is needed. A provision already exists in the 2006 Inter-institutional Agreement to guarantee a minimum flexibility to the MFF[13]. As an example of such flexibility, in November 2007, the Council agreed to move some 2.2 billions away from the CAP to finance the European GPS GALILEO project which was running short of funds[14].

[11] See, e.g. Alesina et al. (2001).

[12] This is very close to the famous statement by Jean-Claude Juncker, Prime Minister of Luxembourg and President of the Eurogroup, who, in relation to structural reforms, said "We all know what we have to do; however, we don't know how to be re-elected once we have done it". Buti et al. (2008) explains under what conditions such statement is empirically correct.

[13] Since the introduction of the MFF (previously known as Multi-annual Financial Perspective) in 1988 the tendency has been towards reducing flexibility since both duration and number of headings and subheadings have increased. At the same, the means by which flexibility has been sought have also evolved over time: from reserves in the first MFF till in the current MFF, a provision for a revision of (each heading of) the MFF up to 0.03% of the GNI. That revision can be taken jointly by the EP and the Council under qualified majority.

[14] GALILEO is a project to develop a European navigation system by satellite. At the time of the Commission proposal, the French Minister of Agriculture, Michel Barnier, whose country is the main beneficiary of the CAP, welcomed the proposal to fund GALILEO using CAP funds', by stating on 28 September 2007 during a press conference at the EU Council: *"c'est simplement de la bonne gestion de l'argent communautaire sur un projet stratégique"*.

Three conditions need to be fulfilled to successfully introduce “constrained flexibility” into the EU Budget: i) an inter-temporal guarantee of respect of the MFF; ii) a cost-benefit analysis of the additional annual spending carried out at the EU level so to ensure the respect of subsidiarity; iii) an effective governance, entailing an appropriate allocation of responsibilities between EU institutions to allow for an efficient running of the budget and enforce budgetary discipline. These three issues are dealt with hereafter.

3.2 "Constrained flexibility": four options

Under the current budgetary procedures, the agreement on the MFF (following Council unanimity rule) determines the maximal amounts per year and per main heading of expenditure for each of the 7 years of the MFF. Then an annual negotiation (following co-decision procedure) determines the annual spending ceilings for each type of expenditure. As shown in chart 1, experience since 1988 (the first year the MFF were introduced) shows that the actual spending of EU is well below the authorised expenditure decided under the MFF[15].

Our proposal, which we dub "constrained flexibility", aims at reallocating EU expenditure towards Lisbon-related programmes without calling into question the overall amount set by the MFF. This proposal can be declined in four different options with increasing level of ambition (and hence decreasing level of political acceptability, at least in current circumstances). Table 3 outlines the main features of these options.

The first option amounts to frontloading certain expenditure categories by allowing some headings of the MFF (see Table 2 above) to be exceeded for some years to the detriment of other headings, so to respect in each year the total ceiling appropriation as defined by the MFF. However, this is rebalanced in the following years so to respect also the overall 7-year amount of each heading as defined by the MFF. While this minimalist option would inject some flexibility in the EU budget, it suffers from a very serious drawback since it offers only a limited possibility to foster Lisbon-type expenditure. Indeed, if expenditure needs to be rebalanced within each heading over the 7-year cycle that would mean cutting back later on expenditure for "Growth and competitiveness" below the level agreed upon in the MFF[16].

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[15] In the current situation, the unspent commitments are given back to Member States, instead of funding community projects, according to the share of gross contributions of each Member State to the EU budget.
[16] In the concrete example of GALILEO, above that the additional funding of GALILEO in 2007 (obtained by reducing Agricultural expenditure in 2007) would need to be reversed by 2013

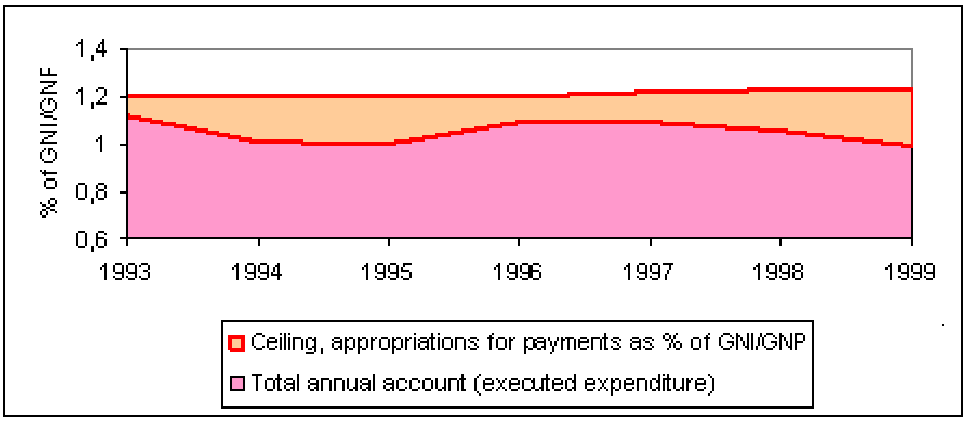
This clearly reduces the appeal of the higher flexibility granted by this option. Given this limitation, this option is disregarded in the rest of the paper.

The second option is to allow some headings to be exceeded in any single year to the detriment of other headings, while respecting in each year the total ceiling appropriation as defined by the MFF. However no compensation for each heading is foreseen in the following years[17]. This stronger focus on certain expenditure headings can be achieved while respecting the total annual appropriations of the MFF, due to the recurrent underspending.

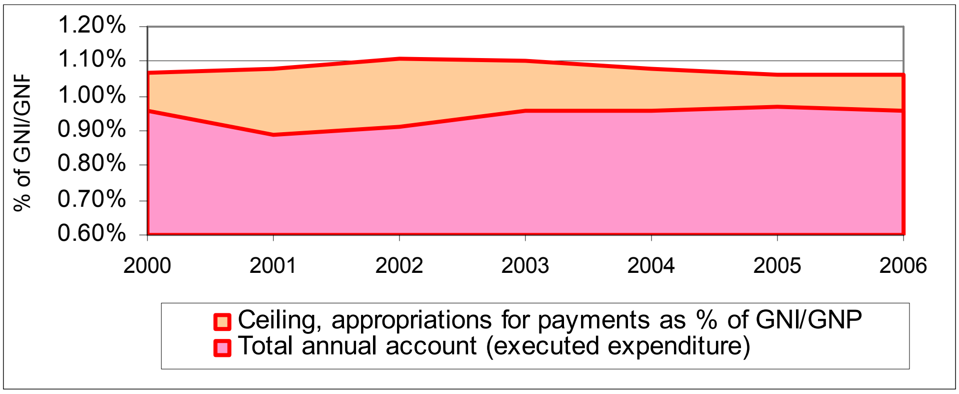
[17] In a sense, the difference between the first and the second options corresponds to that between price level and inflations targeting. Under the latter, bygones are bygones.

Chart 1 Appropriations and executions

	Delors II						
	1993	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**
Ceiling, appropriations for payments as % of GNI/GNP	1.2	1.2	1.2	1.2	1.22	1.23	1.23
Total annual account (executed expenditure)	1.12	1.01	1	1.09	1.09	1.05	0.99
Difference (as % of GNI)	0.08	0.19	0.2	0.11	0.13	0.18	0.24



	Agenda 2000						
	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
Ceiling, appropriations for payments as % of GNI/GNP	1.07	1.08	1.11	1.10	1.08	1.06	1.06
Total annual account (executed expenditure)	0.96	0.89	0.91	0.96	0.96	0.97	0.96
Difference (as % of GNI)	0.11	0.19	0.20	0.14	0.12	0.09	0.10



Source: European Commission (2007a).

Under the third option, some headings would be exceeded in any year and even the total spending amount of some years could be higher that the ceiling appropriation defined by the MFF for those years, but this is rebalanced by reduced expenditure in outer years and in other headings. Therefore, the overall ceiling appropriation of the MFF is respected, though not necessarily the MFF appropriations for each heading. This would make it possible to exceed the amount of any MFF category in a given year (even beyond the 0.03% of EU GNI, mentioned in footnote 13) provided the overall amount of spending does not exceed that of the MFF for the 7-year cycle.

Under the previous three options, the annual budget balance prescribed by art. 268 of the Treaty is respected[18]. This means that, whatever the amount of spending carried out each year, sufficient resources "will be called" (even in the case of the third option where annual spending can go beyond the appropriation ceiling of the MFF). The fourth option (which will be analysed in section 3.3) removes this constraint. It amounts to option three supplemented by the provision that in the years where expenditure exceeds the overall ceiling appropriation, the difference would be financed by borrowing (via, e.g., the so-called Eurobonds[19]). We believe that the first three options of constrained flexibility are feasible both under the current as well as the new Lisbon Treaty, which contemplates MFF in the new article 270a[20]. As to the fourth option, given the constraint respect of the ceiling appropriations over the MFF time horizon, this implies that the budgetary-equilibrium rule of Art 268 of the Treaty is respected over the 7-year cycle rather than annually[21].

[18] Art. 268 of the new EU treaty provides for the following "the revenue and the expenditure shown in the budget must be in balance", which in conjunction with Art. 272, calls for the annual respect of the rule of equilibrium in any given year between expenditure and revenues.
[19] For a similar proposal see Iozzo et al. (2008).
[20] The present MFF are regulated by an Interinstitutional agreement and they are simply outside the Treaty. The existing Treaty does not contemplated MAFF, so constrained flexibility could be introduced in the annual budgetary procedure without prejudice to the existing Treaty. The next MFF (2014-2020) will have to be framed within art 270a of the Lisbon Treaty. Paragraph 1 of art 270a reads *"the annual budget shall comply with the multiannual financial framework"* and paragraph 3 adds *"The financial framework shall determine the amounts of the annual ceilings on commitment appropriations by category of expenditure and of the annual ceiling on payment appropriations"*. However, the same paragraph 3 adds *"The financial framework shall lay down any other provisions required for the annual budgetary procedure to run smoothly"*. This "provision" is exactly what would allow introducing into the MFF the concept of "constrained flexibility". Therefore, a way to introduce it after 2014, would be to agree – e.g. in the follow up of the EU Budget Review - that "constrained flexibility" is enshrined in the new MFF to be adopted on the basis art. 270a as a way to improve the annual future budgetary procedures.
[21] To a certain extent, under this option, the EU budget would be aligned to the spirit of the Stability and Growth Pact which prescribes a broadly balanced budget in cyclically-adjusted terms, meaning that the annual headline budget could be in deficit or surplus.

Table 3 ***Constrained flexibility: different options***

	Respect each MFF heading annually.	*Respect each MFF heading over 7-year cycle; Respect total MFF every year*	*Possibly exceed any given MFF heading annually and over the 7-year cycle. Respect total MFF every year*	*Possibly exceed any given MFF heading annually and over the 7-year cycle Respect total MFF over the 7-year cycle (and not annually)*
Respect Art. 268: Annually	Current budgetary Procedure	Option 1	Option 2	Option 3
Respect Art. 268: Over the 7-year cycle				Option 4

Essentially, constrained flexibility aims at introducing into the annual budget procedure the flexibility that the mechanism of the MFF does not grant, without relinquishing financial discipline and stability which are probably the best rationale for the MFF[22].

Chart 2 provides an illustration of how constrained flexibility would work.

At time *0*, the overall amount of the MFF (b_{max} in the chart) and its yearly distribution and ceiling for each expenditure category was set. Let us assume that, at time t_1, the allocation for a certain category is considered no longer adequate to attain the policy priorities of the EU. Given the difficulty to re-negotiate the MFF, we envisaged larger expenditure for the policy priorities from t_1 till t^*, while respecting the overall spending allocation over the time period *0-T* covered by the MFF. As shown in the chart, in order to ensure respect of the agreed total financial envelope, total expenditure would have to go down in the period t^*-T: the larger expenditure on the policy priority (C+B-D), where D is the underspending in the period 0-t_1, would be matched by the planned underspending (F+E)[23] on other policies. In order to depart as little as possible from the yearly MFF ceiling, the amount of front-loading will be established within the limits of regular under-spending that, as shown in chart 1 above, occurs each year to an amount roughly comprised between 10 and 20% of total spending. In other words, the increase in some Lisbon-type expenditure will quite probably be matched, within the same year, by some reduction of other expenditure. That would imply that the second and the third option described above become very similar.

[22] For a recent description of the the annual and multiannual budgetary negotiations process, and oth their interrelation, see Lindner (2006).

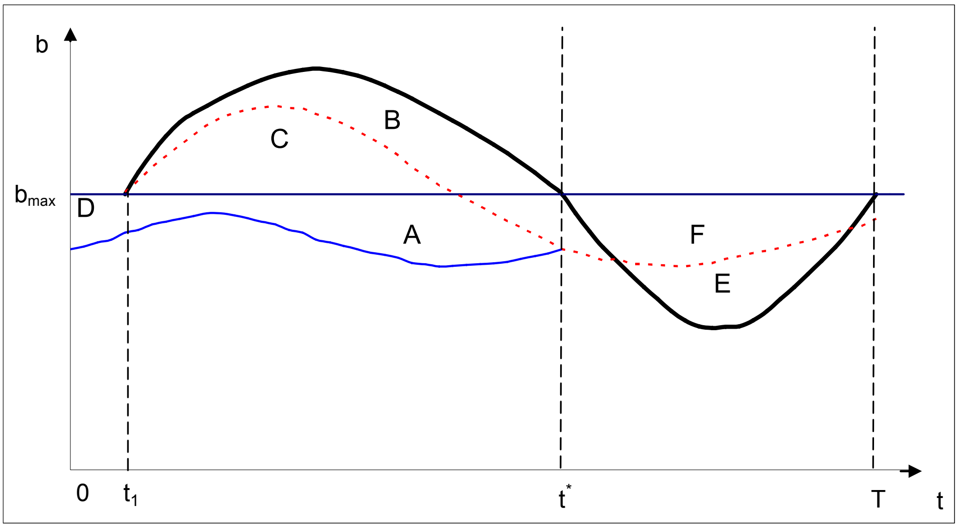
[23] Matching of the overspending with underspending has to be made in discounted terms since 1 € at time t_1 is worth more than 1€ at time *T*.

However, as underspending of expenditure is only an estimate, it may happen that in some years the total spending exceeds the MFF's ceiling: in such a case, in order to respect art. 268 which imposes a yearly budget balance, there would be a call for higher revenue from Member States[24]. Even in this case, however, the excess is bound to be very small.

At t^*, a re-assessment takes place and the path of expenditure in the remaining years will be determined taking into account of whether in the period t_1-t^* the under-spending in other categories is higher or lower than that in 'Lisbon-type' programmes. In our illustrative example, there is indeed a net overspending (equal to C that corresponds to the total amount of ex ante overspending reduced by A, where A=B) which will have to be followed by underspending in the remaining period till *T*. In our chart, the decline in spending in the second part of the period would be reduced from (F+E) to F, where E=A.

If, in spite of the higher Lisbon spending, the final net effect were negative, savings of the previous years could simply be 'stored' and reused in the following years. 'Storage' of the savings, under the current annual equilibrium rule, can only happen at the national level (reduced call of funds in given years for increased call of funds in the following years, still in respect of the overall own resources ceiling). Option four – briefly described in the next section - explores the implications of allowing storage at the EU level.

Chart 2 "Constrained flexibility": an illustration



[24] Still respecting the overall ceiling of own resources (1.24% of EU GNI) which is in current days so much higher the effective EU budget that it not anymore biting.

To give to the EU budget the ability to move resources from one to the other category constitutes a distinct advantage of this proposal. Today's EU budget suffers from a paradox. During the budgetary negotiations, namely the 7-year MFF, but to some extent also the annual budgetary negotiations, the political focus is on "saving" and "reducing" the ceiling appropriations (i.e. the amounts that are assigned to each heading in the MFF). However, during the annual budgetary execution phase the political focus is on the "full execution" of the agreed amounts and there is no premium for saving. Actually, during the execution phase, savings tend to be seen more as a stigma of bad financial management (or imprecise financial expenditure forecasting) of that particular budgetary heading than as a signal of a search for lower costs of service provisions. On the contrary, constrained flexibility, by allowing the possibility to transfer underspending to other headings and over-time would provide incentives for an efficient and cost-conscious budgetary execution worthwhile. These incentives would help to strengthen the legitimate focus of cost-consciousness not only at the moment of the negotiations of the 7-year MFF, but also during everyday's budgetary execution.

3.3 Constrained flexibility and budgetary equilibrium

The fourth option outlined above constitutes the most ambitious variant of the constrained flexibility proposal as it would allow the EU budget to respect over the seven year cycle instead than annually not only the total of the MFF, but also the budgetary equilibrium rule. The latter provision would require a change of in article 268 of the Treaty. Therefore, this does not pertain to the realm of political feasibility at present. However, it is worth exploring also that possibility as that could be considered in the future perhaps once 'milder' forms of constrained flexibility will have shown their value.

Consider first the case of net overspending following net underspending with respect to the MFF maximal amounts[25]. In this case, savings of the previous years can simply be 'stored' and reused in the following years. Under a very strict interpretation of the annual budgetary equilibrium rule, inter-temporal storage can only be made at the national level (reduced call of funds in given years for increased call of funds in the following years).

[25] With "net overspending" we intend the net effect of the "Lisbon overspending" and the typical underspending of the Eu budget. Chart 1 shows that most often the greatest underspending happens early in the 7-year cycle exactly when there may be more need for more Lisbon-type expenditure. This means that this case is more likely to happen that the other case considered below.

By allowing the EU budget to store the saving in a reserve, inter-temporal storage could happen also at the EU level with two main advantages. We just argued that the possibility to move resources across budgetary headings would constitute a powerful incentive to strengthen the cost-conscious execution of the budget: *a fortiori* that is true when funds can be moved across headings and across years. If, as in our Chart 2 after t_1, net overspending precedes net underspending, to the extent that this is not covered by additional national contributions, financing possibility at the EU requires the EU to borrow on the financial markets. In other words, the EU would issue 'Eurobonds' or 'Lisbon bonds' for the additional part of expenditure.

3.4 The governance of constrained flexibility

As indicated above, moving away from the spending distribution decided in the MFF require proving the value added of Community programmes. The burden of proof would be on the European Commission.

In all policy areas, the Commission has adopted a so-called "better regulation" policy to decide on whether a legislative intervention is needed or not. The better regulation policy is made by two pillars: a) the impact assessment that should demonstrate beyond doubt that legislative intervention is the preferred option to take, and b) stakeholders' consultation to make sure that the Commission is aware of stakeholders' wills and expectation, and vice-versa, before taking any action. The purpose of both tools is to make evidence-based policy and to create a cooperative, and essentially "no-surprise", climate with all stakeholders. Expenditure allowed under the constrained flexibility scheme should also respect these two principles: a thorough impact assessment is needed as a proof of the need of additional expenditure in a given year for a given type of expenditure and spelling out the ways the additional expenditure is then compensated by lower expenditure in outer years. In principle, the better regulation principles should be met not only by the Commission, but also by the Council and the European Parliament when amending significantly Commission's proposals. Introducing transparency and strong analytical backing in the governance of constrained flexibility is the condition for the stakeholders' endorsement of the new approach.

How could constrained flexibility work in practice?

In the current setting, before May of the year t-1, the Commission makes a proposal for the EU Budget of the year t, where the amount of expenditure of each main category of the Budget is the same as or less than the expenditure agreed in the MFF. Under a standard co-decision procedure with two readings, subject to QMV in the Council and simple majority in the European Parliament, the Commission's proposal is eventually adopted. Constrained flexibility aims at endowing the budgetary procedure with a similar flexibility also for the annual expenditure greater than what agreed in the MFF under the three constraints (not exceeding the total MFF over the 7-year period, respect of the budgetary equilibrium-rule and proof of added value) discussed above.

Under constrained flexibility, during the annual procedure the Commission should propose the annual amount of expenditure, under the annual ceiling of financial expenditure (exactly as today) and in addition to that, the Commission should propose expenditure going beyond the annual MFF's ceiling, showing its added value and spelling out how the multiannual total expenditure will be then respected. The burden of the proof of the need of tilting the annual expenditure away from what decided in the MFF, but maintaining the overall 7-year expenditure total, is with the Commission when it proposes the additional expenditure.

Council and Parliament will adopt annually the full Commission proposal (expenditure under the annual MFF's ceiling plus the additional expenditure) along the very same procedure as today, i.e. co-decision with two readings, under QMV in the Council and simple majority in the Parliament. In case the fourth option is retained, Council and Parliament should also be able to decide, acting on a proposal by the Commission, how much of the increased expenditure should be financed by issuing bonds.

4 Conclusions

The Budget Review of 2008/09 provides in our view a unique window of opportunity to engage in well-targeted reforms, which, to the extent that create the conditions for further steps down the road, may unlock the reform of the EU budget.

The conundrum in which Europe is now can be described as follows: there is a necessity to bring the EU budget closer to the declared economic and political EU objectives; however, the combination of the unanimity rule and the political economy constraints discussed above makes it very difficult to move away from any reached status quo. The result is that the EU budget looks at least two decades behind economic and social reality of today's Europe.

The need for EU Budget reform is greater than before, because 2005 agreement on the 2007/13 MFF did not seize the opportunity of transforming the EU budget into an effective instrument for fostering the Lisbon strategy. However, the political difficulty is also greater than before, because the status quo is the easiest solution, and because no Member State is taking the leadership in pushing for a serious and comprehensive reform. The stratification of several ad-hoc agreements in the last 20 years has produced a situation where political entrenchment is such that partial reforms (i.e. only to the revenue or the expenditure side) has little chance to be approved by any Council negotiation. Hence, what is needed is a reform sufficiently small that it can be accepted, but comprehensive enough (i.e. touching expenditure, revenue and decision making procedure) that it can be seen as balanced.

To increase the chances of having a significant reform adopted down the road, the 2008/09 Budget Review should "lock in" the main changes in the EU budget to be introduced in the MFF for 2014-20. The strategy of putting a significant time-distance between the moment of the decision and the moment of the implementation has proven very effective in other EU areas and has facilitated reform.

To provide the right incentives for reform, this paper proposes to introduce the experimental innovation of constrained flexibility which could start operating already under the current MFF. This proposal amounts to transforming the respect of the MFF ceiling from an annual to a multiannual rule so that the EU budget would gain in flexibility, although being still constrained over the whole MFF's period.

This is not an absolute novelty as exemplified by the minimum flexibility enshrined in the 2006 Interinstitutional Agreement and the November 2007 Council agreement to move some 2.2 billions away from the CAP in favour of the European GPS GALILEO project. Constrained flexibility would make such flexibility linked to the overall total of the MFF, and frame such decisions within the regular annual procedure for the adoption of the EU budget, thus allowing planning them at the beginning of each year rather than at the end. Such flexibility appears particularly useful to reallocate and boost expenses related to competitiveness: the need to adapt the public budgets – and hence also the EU budget - to the rapid shift in comparative advantages brought about by globalisation makes such room for manoeuvre potentially precious.[26]

To give to the EU budget the ability to move resources from one to the other category constitutes a distinct advantage of this proposal and an important incentive for reform since it would strengthen the focus of cost-consciousness, not only at the moment of the negotiations of the 7-year MFF, but also during everyday's budgetary execution.

Clearly, the opportunity to start refocusing the EU budget onto the current EU political priorities does not come for free. Constrained flexibility amounts to moving a small part of the multiannual expenditure away from the unanimity of the MFF to the QMV of the annual budgetary procedure[27]. This would also risk shifting some of the political bickering that normally takes place at the moment of the negotiations of the MFF down to the level of annual negotiations. Should this happen, the annual 'budgetary peace' within the EU budgetary authority (Council and European Parliament) which has been attained with the introduction of the MFF could be called into question. While one should not go back to the dark days before the MFF, there is an increasing consensus that in the trade-off between stability and flexibility, the current system clearly errs on the side of the former. The danger of protracted institutional wrangling should not be belittled, but this risk is tempered by the fact that annual negotiations are made under QMV rather than under unanimity[28].

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[26] On the need to rapidly shift resources from declining to rising activities in a globalised world, see European Commission (2008).

[27] That sum roughly represents 10% of the budget, which amounts to some 80 to 90 billions euros over 7 years that are likely to attract different interests.

[28] Most observers of the GALILEO negotiations were struck by the gap between the level of consensus around the idea to use Agricultural savings to finance GALILEO and the procedural and political difficulty to make that a reality. There should be an easier way to make real what the vast majority judges a right decision.

In any event, the introduction of constrained flexibility could encompass a review clause to allow the necessary adaptation after an experimental period.

Introducing QMV for a small, but relevant, part of the MFF via the annual negotiations, is of course only a second best to the introduction of QMV *tout court* for the MFF negotiations, but it is probably the maximum that can be achieved in the current political context.

In sum, the proposal of constrained flexibility would, though only at the margin, help reconcile budgetary allocation and new EU policy goals. If successful, this could open the door to more ambitious reforms. We hope that once Members States see that the additional flexibility improve the effectiveness of the EU budget without endangering its overall stability, become readier to embark in a more ambitious reform of the EU finances.

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