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#MFF

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THE MFF PROPOSAL: WHAT'S NEW, WHAT'S OLD, WHAT'S NEXT?

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On 2 May 2018, the European Commission released its proposal for the next Multiannual Financial Framework (MFF), covering the years 2021-27. In its own words, the Commission tabled 'a new, modern long-term budget, tightly geared to the political priorities of the Union at 27'. This article analyses how much change and how much continuity the current proposal truly contains and discusses the next steps and possible negotiation dynamics. We find that:

- The proposal is larger than today's MFF when comparing nominal and real volumes, but smaller in relation to EU27 Gross National Income (GNI).
- The planned shift of spending from traditional to new policies is bolder than in previous MFF proposals.
- During the negotiations, the traditional coalitions of net recipients and net contributors might splinter in view of new cleavages concerning rebates and eligibility criteria for Cohesion funds.

1. What is on the table?

The Commission published a set of documents that describe its plans for EU spending and revenue after 2020. The part that received the most attention is a proposal for a new MFF regulation. The MFF aka the EU's long-term budget, allocates funds to different policy areas ('headings') and sets out maximum spending levels ('ceilings') for the EU. Since annual budgets are constrained by these ceilings, the priorities set in the MFF decisively influence EU policy during a seven-year period. Therefore, the Commission proposal is keenly watched and commented on by EU member states and interest groups. However, the MFF regulation itself simply establishes the overall size and maximum spending levels per budget heading and some general provisions concerning the functioning of the EU budget (such as flexibility or reform procedures). Other aspects concerning the specific design and structure of EU spending programmes will be fixed in sector-specific legal acts and these will be proposed by the Commission in late May and June and negotiated separately. The Commission also proposed a new Own Resources Decision (ORD), which governs how the EU finances itself. We discuss it in section 5. While there is an obvious link between the spending and the revenue side of the EU budget, the ORD follows a different approval procedure.

2. A complex political context

MFF negotiations are one of the most difficult political battles in the EU. They involve the European Parliament and the Council, but are de facto largely intergovernmental, with the final deal being adopted by the European Council by unanimity[1]. In theory, addressing common issues at the EU level is beneficial for all the 27. But in practice, negotiations between Member States follow the logic of a zero-sum game, pitting net recipients, which want to maintain or increase the amounts of EU spending they get, against net contributors, which favour limiting the budget's overall size.

Even if the economic context is better now than in 2011-13, when the current (2014-20) MFF was debated, the upcoming negotiations promise to be particularly difficult. First, there is the Brexit gap, a financial shortfall of an estimated €84-98 billion over seven years caused by the UK's departure. Views on how to adjust to this hole (cutting spending or increasing revenues) alter traditional dynamics among net contributors and net recipients. On top of that, the EU is confronted by new spending needs in areas such as migration and border control, external security and digital transformation, which require between €91 and €390 billion of additional resources between 2021-2027 according to the Commission[2].

Furthermore, a tough calendar lies ahead. The Commission has published its proposal just one year before the European elections and it is lobbying for an agreement to be taken before the last plenary of the current European Parliament (April 2019). As the past three MFF negotiations took more than 20 months to be finalized, this schedule looks very tight. And, for the moment, the European Council's work programme (the 'leaders' agenda') prepared by President Tusk envisages negotiations lasting until the end of 2019[3].

3. Assessing the proposal: Size and rebalacing

How does the Commission proposal compare to the current MFF? Several factors complicate the evaluation. First, the Commission describes some of its proposals in nominal terms (current prices) while others are adjusted for inflation (constant prices). Second, Brexit reduces the EU's GNI by a sixth and therefore inflates the relative size of the MFF. Third, to properly compare the post-Brexit budget with the current one, we need to look at current EU spending in the remaining 27 Member States and not at EU28 spending. Finally, the proposed 2021-27 framework includes the European Development Fund (EDF), which is worth around €5 billion per year and is excluded from the current MFF. Thus, it increases the proposed budget by 0.03% of GNI. Ultimately, any assessment depends on which perspective one chooses:

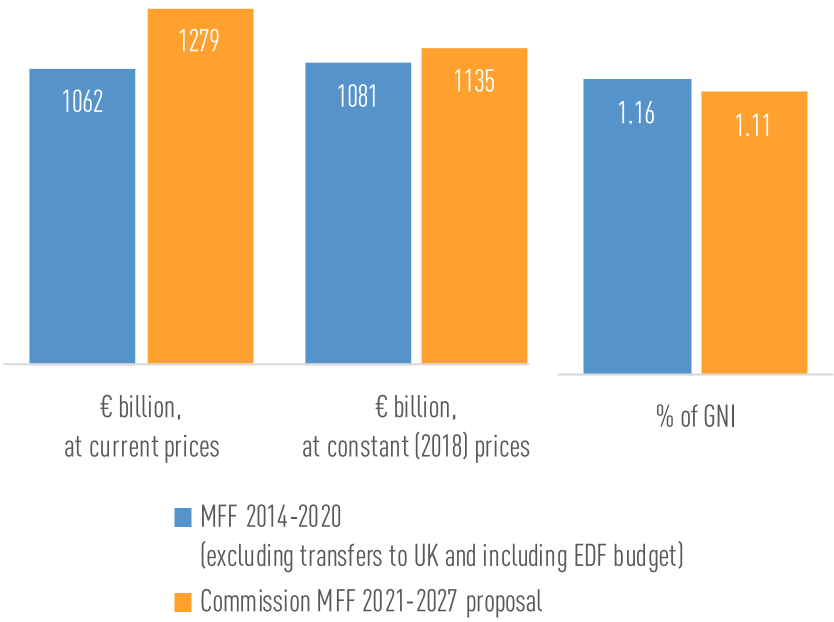
1. **It is much bigger in current prices.** The Commission proposes increasing spending on the EU27 by €217 billion (or 20.4%) to €1279 billion.
2. **It is slightly bigger in constant prices.** In real terms (using the 2% fixed deflator set out in the MFF regulation), the proposed MFF is worth €1135 billion in 2018 prices, or an increase of €54.3 billion (5%) compared to EU27 spending in the period 2014-20 (including the EDF).
3. **It is smaller in relative terms.** At the moment, spending on the EU27 under the current MFF stands at about 1.13% of EU27 GNI. An additional 0.03% is spent on the EDF, bringing total spending to 1.16%. The Commission proposes an MFF worth 1.11% including the EDF, implying a reduction by 0.05 percentage points.

1. The European Parliament needs to give its consent to the Council's position, meaning that it may approve or reject the Council's deal but cannot insert amendments.

2. Bruegel's calculus, based on European Commission's Communication 'A new, modern Multiannual Financial Framework for a European Union that delivers efficiently on its priorities post-2020 – The European Commission's contribution to the Informal Leaders' meeting on 23 February 2018', COM(2018) 98 final.

3. http://www.consilium.europa.eu/media/21594/leaders-agenda.pdf

FIGURE 1 ▪ The Commission's proposal for 2021-2027 compared to the current MFF



Source: Authors' calculations based on European Commission data.

A comparison with the last two MFF negotiations shows that the current proposal is in line with a long-running trend: the Commission proposes a re-balancing of spending priorities, reducing the relative weight of the Common Agricultural Policy (CAP) and Cohesion funds in the budget. However, the re-balancing planned this time is bolder than usual; there are significant changes in all areas (see table 1). The new priorities are clearly visible: In real terms, spending on internal and external security more than doubles and funds dedicated to improving competitiveness increase by a third. Within this category, spending on research, innovation and digital amounts to €114.8 billion, an increase of 64% in nominal terms according to the Commission.

TABLE 1 ▪ Re-balancing proposed by the Commission (last year of the proposed MFF compared to the last year of the preceding MFF, in real terms)

SPENDING CATEGORY	(A) CHANGE 2006 V 2013	(B) CHANGE 2013 V 2020	(C) CHANGE 2020 V 2027*
Competitiveness (research, innovation, infrastructure)	+ 194%	+15%	+34%
Cohesion spending	+31%	-5%	-7%
Common Agricultural Policy	+3%	-12%	-15%
of which direct payments / pillar 1	-3%	-12%	-11%
Security and interior	+162%	+9%	+258%
Foreign policy	+40%	+15%	+80%
Administration	+31%	+6%	+10%

** with reform support programme included in cohesion spending*

Sources for columns A and B: European Commission, EU public finances, 5th edition (tables 6.1 and 7.1). Source for column C: Authors' calculations based on European Commission data.

Note: Columns do not refer to official budget headings but rather assign individual programmes to spending categories.

It is remarkable that the Commission has proposed to decisively cut expenditure on the CAP. In nominal terms, the cut may appear small at only 5%, considering that the MFF has to cope with that significant Brexit gap. However, it entails serious reductions in real terms, as the cumulative impact of inflation erodes the value of the payments. By 2027, CAP spending would be 15% lower than in 2020. Whether or not this is politically feasible is outside the scope of this paper, but one should note that the current MFF already entails a cut in CAP spending in real terms[4]. It is also notable that direct subsidies to farmers (Pillar 1) are much less affected in the proposal than funds for rural development (Pillar 2). This has a distributional impact. Countries with a large share of Pillar 1 funding, like France and Poland, would be less affected than member states that extensively rely on Pillar 2, such as Portugal and Estonia. At the same time, planned changes to the calculation method for direct payments mean that eastern European farmers might receive more money per hectare in the future.

Concerning Cohesion policy, the changes are especially complex to assess. Overall, Cohesion spending will see an increase of 6% in nominal terms. In real terms, however, it faces a 7% cut. If one does not follow the Commission in classifying the new reform support programme (which offers financial and technical assistance to member states reforming their economies) as Cohesion spending and only takes into account the three traditional funds (the European Regional Development Fund, the European Social Fund and the Cohesion Fund), spending in constant prices decreases by 9%. If one takes spending in 2026 instead of 2027 as a point of comparison, the reduction even exceeds 12%. Independently of these considerations, the balance between funds shifts considerably. The Cohesion fund will clearly be substantially cut while the European Social Fund is increased. As in the CAP, the distribution of monies between member states can also be expected to change if, as the Commission implies, payments will be no longer based on GDP per capita alone but also on indicators like unemployment rate and migration. This could mean less money for eastern member states and more for Mediterranean countries.

4. Conceptual innovations in spending programmes

Apart from changes in MFF size and structure, the Commission's communication announces some interesting innovations in post-2020 EU spending programmes and instruments.

For example, the proposal includes ideas for instruments that support the functioning of the European Monetary Union. These comprise a Stabilisation Function and a Reform Support Programme. The former is intended to help countries affected by large asymmetric shocks and is open to all EU countries (not only euro area members). In terms of size, it is by no means a fully-fledged Eurozone budget in the spirit of French president Macron. It can provide up to €30 billion in back-to-back loans and grants covering the costs of the interest, financed via member state contributions equivalent to the income they derive from the European Central Bank's seigniorage. The instrument would kick in before the ESM (European Stability Mechanism) and would be activated by a simple majority of the Council. The Reform Support Programme has a budget of €25 billion, the bulk of it (€22 billion) serves to finance a 'Reform Delivery Tool' which offers member states financial incentives to implement key reforms identified as part of the European Semester. The programme also includes a Convergence Facility worth €2.2 billion, providing dedicated financial and technical support to member states wishing to join the euro.

There is also a radical reshaping of EU financial instruments and guarantees. The European Fund for Strategic Investment (EFSI) created by the Juncker Plan and all existing centrally-managed financial instruments are replaced by a single, multi-policy guarantee instrument at EU level ('Invest EU

4. In the negotiations of the current MFF 2014 2020, the CAP budget was broadly maintained in nominal terms at the level of 2013 spending. In consequence, CAP spending is expected to fall in real terms over the duration of the current MFF.

Fund"). An important novelty is that this new EU guarantee will be provided to different implementing partners (such as national promotional banks, or the ERDB) and not only to the European Investment Bank group as is the case for EFSI.

Finally, the Commission proposes to introduce a mechanism linking the respect of the 'rule of law' to the disbursement of EU funds. Rather than sanctioning breaches of fundamental EU values according to Art. 7 TFEU, the Commission targets generalised deficiencies in the rule of law that threaten the EU's financial interests. For example, a country might be unable to manage EU funds or to combat fraud and corruption because it lacks an independent judiciary system. Under this proposal, the mechanism would be activated by the Commission, which decides whether the conditions are fulfilled and what kind of sanctions should be imposed. The proposal is adopted unless the Council rejects it by qualified majority ('reversed qualified majority'). The final beneficiaries of EU funds are not expected to be affected by sanctions because member states are obliged to continue implementing the affected programmes.

N.B.: all these changes are not part of the draft MFF regulation. They will be detailed in sector-specific legislative acts, whose approval is submitted to qualified majority in the Council. However, as in the past MFF negotiations, some of these elements may be included in the European Council's MFF conclusions, thus de facto pre-empting major policy changes in EU sectoral regulations.

5. Own resources and the question of rebates

Financing an overall larger budget and more priorities, the ORD requires special attention. In spite of possible financial shortfalls, the Commission regards Brexit as a political opportunity that should be grasped to push for comprehensive reforms of the EU's revenue system. This is due to the end of the UK rebate, a reduction of an estimated 66% that country's overall contribution. Its removal will automatically imply the end of the 'rebates on the rebate', originally granted to Germany, Netherlands, Austria and Sweden, net contributors, who thereby pay only 25% of their normal share of the UK's rebate. Their removal will translate into a sudden increase of these four countries' contributions. The Commission's intention is to eliminate these rebates and other corrections granted to these four countries plus Denmark (such as reduced call rates on the VAT Own Resource and lump-sum reductions to GNI-based contributions), but to phase them out over a period of five years so as to give them time to adjust. However, some of the countries in question have already expressed their opposition to Commission's plan to end rebates.

Simultaneously, the Commission proposes a 'basket' of new Own Resources that does not do justice to measures elaborated previously, e.g. in the so-called Monti report (2017). Besides revenues from the Emissions Trading system and simplified VAT-based contributions, the Commission proposes a 3% rate applied to the (not yet implemented) Common Consolidated Corporate Tax Base (CCCTB) and a levy of €0.80 per kilo on non-recycled plastic packaging waste. The former is calculated to yield €12 billion per year – once the CCCTB is adopted. Given that negotiations have been going on more or less unsuccessfully for years, this source of financing is anything but certain. The latter will make up to €7 billion (at €0.80/kg). According to the Commission, it is a 'not a tax-based own resource'. In fact, it would be like an extra levy and will certainly reignite the debate on the behaviour-changing effect of flat-rate taxes and the social impact on poorer consumers. Resistance is already growing, e.g. in Germany.

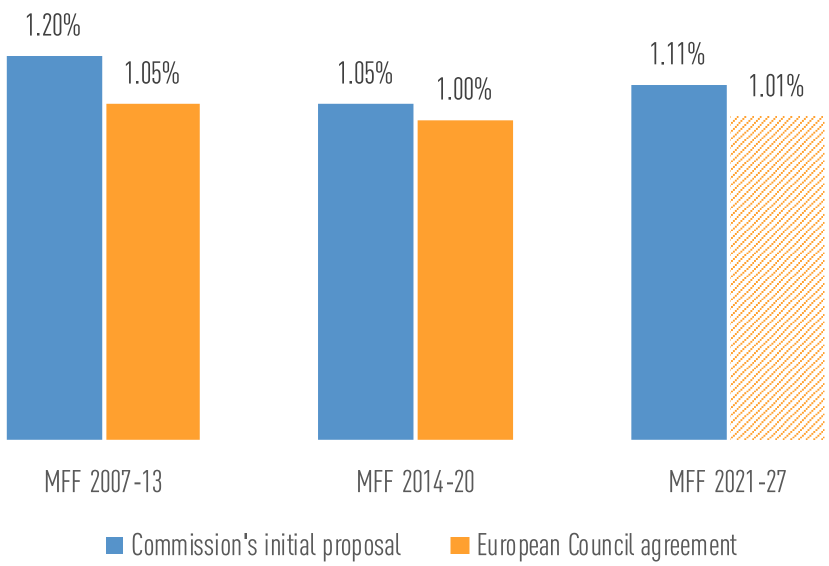
The ORD is subject to an approval procedure different to that of the MFF regulation. It requires unanimity in the Council but must also be ratified by all Member States' national parliaments, while the European Parliament has no say. Furthermore, unlike the MFF regulation, the ORD does not expire after seven years and continues to be valid until a new Decision enters into force. Therefore, the EU's revenue system has a stronger status quo bias than EU spending.

6. What to expect from negotiations

The presentation of the Commission's MFF proposal marks the start of a long negotiating period involving both European Council and Parliament. As noted above, external factors may change the dynamics between net contributors and net recipients, and complicate negotiations.

On past experience, a classic 'negotiating effect' is a significant cut in the overall size of the MFF from the Commission's proposal to the final deal. Figure 2 illustrates the difference between the Commission proposal and the MFF adopted by the European Council in previous negotiations. If we assume a similar dynamic this time, the result would be a meagre 1.01% of EU27 GNI (or 0.98% without the European Development Fund).

FIGURE 2 ▪ Proposed MFF volumes compared to volumes after the negotiation



Source: Authors' calculations, based on European Commission data.

Another typical negotiation effect is the difference in cuts between pre-allocated and non-pre-allocated spending. Since net recipients tend to protect pre-allocated spending (which accounts for most), and net contributors ask for reductions in the budget's overall size, the areas more exposed to cuts are those where the distribution is not pre-ordained but rather determined by the Commission according to need and merit in a specific situation (see table 2).

TABLE 2 ▪ Difference in spending by heading between Commission proposal and European Council decision

	2007-2013	2014-2020
Mostly pre-allocated spending		
Cohesion spending	-8%	-4%
Common Agricultural Policy	-7%	-4%
Mostly not pre-allocated spending		
Competitiveness	-39%	-24%
Security and internal policies	-27%	-17%
Foreign policy	-19%	-16%
Administration	-14%	-2%

Source: Authors' representation based on European Commission,. EU public finance, 5th edition. Tables 6.2 and 7.2.

Given that member state rhetoric is as focused on net returns as ever, we can expect the same dynamic to work this time, too. On top of that, the fronts between net contributors and net recipients may become entrenched due to the proposed cuts in cohesion policy and CAP. Nevertheless, new dynamics among member states need to be considered, namely an erosion of the 'classic' net recipients and net contributors fronts:

- there may be changes within the net recipients' coalition. New issues such as the rule of law conditionality or the fact of complementing the GDP with other eligibility criteria for the distribution of cohesion spending (particularly unemployment levels and migration) can create new splits among them.
- there may be changes within the net contributors' coalition. Net contributors like the Netherlands or Austria are unwilling to increase their contribution. =Others like France and Germany have announced their willingness to pay higher contributions. The debate on the removal of the 'rebates of the rebate' may create new divisions among net contributors.

What's more, the UK's departure may change the dynamics of negotiations in the Council. During the last MFF negotiations, the UK government played a crucial role, forcing a significant last-minute reduction in the overall ceiling for payments. It is true that Austria, Sweden, Denmark and the Netherlands have so far taken a strong stance against any increase, but without a big country such as the UK in their group they may be unable to keep their demand alive until the bitter end.

Finally, what can we expect from the European Parliament? Having only the right to accept or reject the Council's agreement en bloc, the Parliament usually plays a secondary role in MFF negotiations. In the last negotiation, which took place in a context of national fiscal consolidation, MEPs did not even challenge the overall figures agreed by the Council and merely asked for targeted improvements (e.g. reinforcement of flexibility provisions, an overall commitment to use maximum flexibility, the introduction of a revision clause and the creation of a high level experts group on own resources among others). This time, the economic context is more favourable, but the political calendar is an issue. If the current Parliament wants to have a voice in the design of the next MFF, it has to vote on it before the European elections in May 2019, giving it little time to negotiate with the European Council.

Conclusion

The post-Brexit MFF proposed by the Commission can be seen as a post-crisis budget. Despite the financing gap left by Brexit, spending is planned to increase in both nominal and real terms. Comparatively high projected growth and inflation rates overall ensure that the proposal is – at 1.11% of EU27 GNI – still proportionally smaller than the current framework. At the same time, general government spending in the member states keeps increasing, from 44.6% of EU GDP in 2007 to 45.8% in 2017. In other words, the volume of the 2018 MFF proposal is around €120 billion bigger than that put forward seven years ago, while spending in the member states has increased by €800 billion over the same period.

The rebalancing proposed by the Commission is relatively ambitious but by no means radical. The economic environment facilitates a rebalancing without much pain despite Brexit: Priority areas like innovation, migration and defence receive significantly more funding even though cuts to the CAP are moderate and Cohesion spending slightly increases.

During the negotiating phase, it is likely that the conflict between net recipients and net contributors will matter greatly, but new cleavages are visible even today. Fights over the retention of rebates or the criteria for cohesion funding might break up traditional coalitions.

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