

## 1. Introduction<sup>1</sup>

The present budget of the European Union has long ceased to represent European policy priorities; it is the result of decisions taken decades ago and subsequent incremental adjustments decided under the pressure of external events or for political expediency. Its increasing detachment from emerging needs and policy priorities undermines support for the Union among public opinion.

Most resources are transferred to the EU budget from national budgets – thus apparently falsifying the Treaty prescription on own resources – and the member states negotiate the repartition among themselves of spending on agriculture and structural funds, and resulting net balances. National interests are framed in terms of how much national treasuries will pay and what farmers and regions will receive back home.

The main multi-annual spending programmes are decided separately by the European Council, based on discussions in different Council formations. Often, when they come before the Council for consideration, decisions are already prejudged by agreements between the main countries. The role of Parliament has been a subsidiary one, since their powers under the Treaty are scanty; budgetary matters have not been an issue for European elections, since the duration of the multi-annual financial framework (MFF) is unrelated to the term of office of Parliament and the decisions are taken behind closed doors by the European Council.

This state of affairs must radically change following the ongoing review: with the MFF that will start in 2014, the EU budget should really become an instrument to support and foster current policy goals.

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<sup>1</sup> This paper builds upon ideas first presented in the response to the European Commission's public consultation on the 2008-09 budget review, available at the following address: [http://ec.europa.eu/budget/reform/library/contributions/us/20080415\\_US\\_33.pdf](http://ec.europa.eu/budget/reform/library/contributions/us/20080415_US_33.pdf).

Alfonso Iozzo is Chairman of Cassa Depositi e Prestiti; Stefano Micossi is Director General of Assonime, Professor at the College of Europe and a member of CEPS Board of Directors, Maria Teresa Salvemini is professor of economic policy at Università di Roma, La Sapienza. For contacts with the authors write to [stefano\\_micossi@assonime.it](mailto:stefano_micossi@assonime.it)

## A new budget for the European Union?

**Alfonso Iozzo, Stefano Micossi  
& Maria Teresa Salvemini**

In May 2006 Parliament, Council and Commission agreed that the Commission would “undertake a full, wide ranging review covering all aspects of EU spending, including the Common Agricultural Policy (CAP), and of resources, including the UK rebate, and report in 2008-09”.<sup>2</sup> The mandate is therefore broad and no issue is excluded: the Commission should set ambitious targets for itself and not shirk from addressing controversial issues, since its proposals will play an important role in shaping the outcome of the budget review.

This Policy Brief considers possible changes in the budget structure that would provide a separate and transparent account of its main activities. It also addresses the issue of net balances, the possible role of a European tax and European bonds, and some changes in decision-making procedures.

The main proposal is that the European budget could be reorganised in a tripartite form, with separate Chapters for its redistributive tasks, the production of European public goods and the use of financial resources raised in capital markets for large projects of European interest. Net balances should only arise in connection with redistributive transfers between the member states and be closely aligned to an index of countries' relative prosperity, as will be discussed. These changes, and some related adaptations of decision-making

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<sup>2</sup> Commission document SEC (2007) 1188 final, Communication from the Commission “Reforming the budget, changing Europe – A public consultation paper in view of the 2008-09 budget review”, p. 2.

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procedures, should make it possible for the European budget to become the subject of partisan political debates in the public arena for the European elections.

## 2. A new structure for the EU budget: current operations

The EU budget today comprises two activities of a very different nature: on the one hand, the redistribution of resources between the member states, on the other, the production of European ‘public goods’ through common institutions and policies. While broadly responding to shared goals, redistribution is conceptually and analytically quite different from the implementation of common policies to foster, say, free movement, internal security or food safety, which are European ‘public goods’ and belong to the ‘allocative’ function of a public budget, in the classical definition of Musgrave.<sup>3</sup>

Redistribution is motivated by considerations of justice and equality rather than the optimal allocation of resources for the satisfaction of collective demands. At the EU level the main redistributive programmes are the Regional, Structural and Social Funds, including structural funds under CAP and Fisheries policies, and other minor items. The official goal of these programmes is to reduce income disparities within the Union and foster economic convergence of the poorest regions. As noted by Tabellini,<sup>4</sup> a less open rationale for the transfers has been to provide side-payments compensating losers from integration, or more generally spreading the benefits of integration among countries bargaining over what policies to coordinate, and how.

Another feature of redistributive expenditures justifying their separate consideration is that they are administered by the member states and their regions, albeit under Commission guidelines and controls, rather than directly by the European Commission.

Therefore, the transparency of the EU budget and the understanding of the effects of its current operations by the public would be greatly enhanced if spending for these two types of activity were presented under separate budgetary Chapters, as shown in Table 1. Direct payments to farmers under the CAP have been included in Chapter One, in view of their eminently redistributive nature, while CAP payments for market support, as long as they continue, should be reported under Chapter Two (public goods).

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<sup>3</sup> Richard & Peggy Musgrave, *Public Finance in Theory and Practice, Fifth Edition*, McGraw-Hill International Edition, 1989, cf. Chapter 4.

<sup>4</sup> Guido Tabellini, *The assignment of tasks in an evolving European Union*, CEPS Policy Brief No. 10, February 2002.

Efficiency as well as transparency considerations require that the activities under these two Chapters be financed by separate revenue sources, designed so as to closely mirror the nature of, and the benefit from, the corresponding spending flows. It seems eminently sensible that transfers between the member states – which are an essential ingredient in their negotiating equilibria within the European Council – be borne by national budgets in proportion to gross national income (GNI) shares in aggregate Union income. On the other hand, the production of European public goods should be financed by ‘true’ own resources, accruing directly to the European coffers and levied on citizens-consumers and commercial enterprises, who reap the main benefits of these activities.

The EC Treaty requires that “the revenue and expenditure shown in the budget shall be in balance” (Article 268.3). The logical and functional relation that we propose between revenues and expenditures within each of the two broad activities of the EU – redistribution and production of public goods – entails that each Chapter should show a separate zero balance.

The concept of net balances for individual member states would have a meaning only for redistributive activities recorded in Chapter One, which by definition entails financial transfers between the member states. On the other hand, benefits from the consumption of public goods cannot be meaningfully imputed to individual member states, given their nature as indivisible goods, whose benefits accrue to citizens and commercial operators regardless of individual consumption and residence. To the extent that resources for financing public goods are directly raised from individual agents, there is no way of imputing their production costs to the member states. Therefore, in Chapter Two it would be meaningless and infeasible to calculate net balances by member state.

At present the budget of the Union draws its resources from custom and agricultural levies (traditional resources), a VAT resource levied on a ‘notional’ harmonised VAT base,<sup>5</sup> and a ‘fourth’ resource based on gross national income (GNI). The latter plays a residual role: its amount is determined ex-post so as to fill the gap between actual spending and the revenues flowing from the traditional and VAT resources. This residual is allocated among the member states in proportion to their share in the Union’s GNI, and is paid by each member state out of its national budget. In 2006 this GNI resource represented about 65% of total revenues.

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<sup>5</sup> The base is calculated on the basis of national VAT receipts and capped at 50% of each member’s GNI so as to correct for the allegedly regressive nature of VAT. In practice, when capping applies, this resource is turned de facto into a GNI-based resource. Since 2002 the VAT call rate for the Union was 0.5%.

Table 1. A new structure for the EU budget

**CHAPTER ONE: TRANSFERS BETWEEN THE MEMBER STATES**

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| <p><b><u>Expenditures</u></b><br/> Structural Funds:</p> <ul style="list-style-type: none"> <li>• European regional development fund</li> <li>• European social fund</li> <li>• Structural Funds for agriculture</li> <li>• Financial instrument for fisheries guidance</li> </ul> <p>Cohesion fund<br/> Direct Payments to farmers<br/> Other expenditures: e.g. special transfers for emergency assistance<br/> <b>TOTAL CHAPTER ONE</b></p> | <p><b><u>Revenues</u></b><br/> GNI resource<br/> Transfers under generalised correction mechanism<br/> Balancing item*</p> <p><b>TOTAL CHAPTER ONE</b></p> |
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**CHAPTER TWO: EUROPEAN PUBLIC GOODS**

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| <p><b><u>Expenditures</u></b><br/> Economic policies for growth and integration</p> <ul style="list-style-type: none"> <li>• R&amp;D Framework programme (including Joint Research Centre and other permanent outfits)</li> <li>• Enforcement &amp; surveillance of Internal Market</li> <li>• Lisbon priorities (including minimum wage)</li> <li>• Market-related expenditures for CAP</li> </ul> <p>Internal security and immigration</p> <ul style="list-style-type: none"> <li>• Border control, including Frontex</li> <li>• Visa, legal and illegal migration, Europol, EU prosecutor, etc.</li> </ul> <p>External action</p> <ul style="list-style-type: none"> <li>• Trade</li> <li>• Common foreign service and Joint actions</li> <li>• Development assistance</li> </ul> <p>Common defence</p> <ul style="list-style-type: none"> <li>• Common procurement Agency</li> </ul> <p>Administration</p> <ul style="list-style-type: none"> <li>• EU Institutions (Parliament, Council, Commission, Court of justice, Court of auditors, ESC, CoR, Ombudsman, etc.)</li> <li>• Internal Market agencies (EMEA, Food Safety, etc ...)</li> <li>• Admin. of structural funds and special projects, and interest payments on EC bonds</li> </ul> <p><b>TOTAL CHAPTER TWO</b></p> | <p><b><u>Revenues</u></b><br/> Vat – EU surcharge<br/> Duties and levies (possibly: Energy tax)<br/> Balancing item*</p> <p><b>TOTAL CHAPTER TWO</b></p> |
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**P.M.: OVERALL REVENUE CEILING ON COMBINED TOTAL OF CHAPTERS I AND II: 1. 27 % OF AGGREGATE GNI.**

**CHAPTER THREE: CAPITAL OPERATIONS**

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| <p><b><u>Expenditures</u></b><br/> Special common projects: e.g. Galileo<br/> (-) loan reimbursement<br/> <b>TOTAL CHAPTER THREE</b></p> | <p><b><u>Revenues</u></b><br/> Proceeding from EU loans<br/> (-) redemptions of EU bonds<br/> <b>TOTAL CHAPTER THREE</b></p> |
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\* The balancing item is determined ex-post, as under current arrangements, to balance revenues and expenditures and thus respect the Treaty requirement of budgetary balance.

It comes as no surprise that the present system of EU resources roughly corresponds to this scheme already: yet another confirmation that observed institutional and financial settings tend to reflect negotiating equilibria between the member states.<sup>6</sup> Indeed, payments recorded under Chapter One roughly amount to 60% of total spending through the EU budget, somewhat lower, but not too far from the observed share of the GNI resource; similarly, the share of spending devoted to European public goods is roughly in line with that of traditional revenues and the VAT – with about 5% of spending for public goods covered by budgetary transfers from the member states.

The system that has been described hardly seems in line with the Treaty prescription that “the budget shall be financed wholly from own resources” (Article 269.1), since most resources come from the national budget of the member states and are allocated to the EU each year under national budgetary procedures. In practice, however, as has been seen, the actual burden-sharing corresponds to the prevalent redistributive purpose of the EU budget, where payments between the member states were agreed over the years as a compensation for the acceptance of common policies that would bring different benefits and impose different burdens on individual countries.

However, that composition of spending no longer reflects European priorities, as is made clear by the increasing unwillingness of creditor member states to accept the existing structure of net payments to the EU budget. There also seems to be a broad consensus that, while the overall ceiling on resources for the EU budget – 1.24% of aggregate GNI – needn’t increase, a greater share of spending should be devoted to European public goods.<sup>7</sup> Most stakeholders and analysts consider that this change could be brought about by trimming CAP spending – i.e. by phasing out market-related payments and gradually renationalising direct payments to farmers – and correspondingly increasing the resources devoted to integration, growth-enhancing initiatives, and internal and external security.

Were this to happen, the composition of financing should also evolve, so as to avoid a growing inconsistency between the expenditure and the revenue side of the EU budget. Accordingly, the weight of the GNI resource should decrease and that of revenues levied directly on European citizens should increase; it is in this connection that the question of a European tax comes to the fore. We will return to this issue.

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<sup>6</sup> Andrew Moravcsik, *The choice for Europe: Social purpose and State power from Messina to Maastricht*, Ithaca, NY: Cornell University Press.

<sup>7</sup> André Sapir et al., *An Agenda for a Growing Europe: Making the EU System Deliver*, Oxford University Press, 2003.

### 3. A new structure for the EU budget: capital operations

Besides the two Chapters that have been described, the EU budget should have a third Chapter for capital operations, to include common projects that today are mainly financed by current revenues but that instead – due to their nature of capital investment – should be financed by issuing Community bonds in capital markets.

This is not a proposal to introduce debt financing for current operations of the EU, or to support public investment to directly stimulate growth. Capital markets should be tapped only to finance large projects of European interest identified by the European Council and Parliament, on the basis of a proposal by the Commission, with reference to strictly pre-defined criteria of common interest. Once the criteria for project selection are well identified, there seems to be no reason to preclude this possibility in order to fund projects of a European scale and distinct European added-value, that would significantly enhance European technology and capital stock and have measurable positive returns, albeit perhaps spread over long time horizons.

The public good nature would be defined by the fact that individual countries would have insufficient incentive to undertake the investment in isolation, but the investment is nonetheless considered useful collectively, also in view of its capacity to engender complementary national programmes. Criteria for eligibility should be set in advance in a Council Regulation and strictly applied; projects of sole national interest should not be considered on the list, as was the case with the Trans-European Networks.

The list of such projects should be fairly short, and their scale fairly large; selection on the basis of European value-added entails that participation of companies’ research outfits would be solely on the basis of their actual capacity to bring competences and valuable resources to the success of the project, not on the basis of sharing the initiative between member states.

The resources thus raised should be made available to the projects on favourable terms – and to this end the Community budget could shoulder interest payments wholly or in part – but recipients should be required to pay them back over a suitable time horizon.

Bonds should be issued directly by the European Commission. A new financial facility could be created for this purpose whose management could be delegated to the EIB, as already is the case with the EIF and the Guaranty Fund, under control of the Ecofin Council (the Economic and Financial Committee), Parliament and the Court of Auditors.

Examples of qualifying projects could include investments for the creation of cross-border material and immaterial infrastructures, such as networked research projects with large financing requirements; truly cross-border transport and communication networks; large projects for space (Galileo) and defence (common standards and technology platforms); technologies (and prototypes) for clean energy; energy transport facilities to eliminate existing bottlenecks and foster an integrated market.

Potential beneficiaries could include universities and research centres, space and defence agencies, private and public enterprises, public administrations. As a rule, projects should be managed by a separate entity, already existing (such as the defence procurement Agency) or to be created ad hoc.

#### 4. Net balances

Conflict over net balances has become a major impediment to the creation of an EU budget more attuned to today's policy priorities. Net contributors vote against any increase in resources since they fear they will carry a disproportionate burden; the beneficiaries of spending programmes fight hard against any decrease in available funds. Thus, the room for redirecting resources towards new priorities is slim.

Hard-fought negotiations over net balances have also led to a proliferation of clauses granting special treatment to some member states, both on the revenue and spending side. The British rebate – equal to two-thirds of its ex-ante deficit – over the years has led to the concession of discounts to other countries.<sup>8</sup> The overall result, however, does not appear equitable: countries with similar levels of prosperity are confronted with quite different net payments and receipts. As a result, not only has the budget become ever more opaque, but its legitimacy has been increasingly questioned.

Serious change in the budget is not likely unless the net balance issue is resolved first; any solution can only be based on a generalised correction mechanism that would not only bring net balances automatically in line with some agreed criterion, but where all creditor member states would be treated equally.

A proposal in this direction was put forth by the Commission in 2004<sup>9</sup> but did not make it through

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<sup>8</sup> Austria, Germany, the Netherlands and Sweden have obtained a discount in the financing of the rebate as well as reduced rates for VAT contributions; and two of them also enjoy reduced GNI contributions.

<sup>9</sup> See Commission proposals for a Council Decision on the system of the EC's own resources and for Council Regulation on the implementing measures for the correction of budgetary imbalances..., COM(2004) 501 of 3.8.2004.

Council.<sup>10</sup> It was based on the idea of granting a partial refund to creditor member states on their net balances exceeding a certain threshold (as a percentage of GNI); the cost of the correction would be shared by all member states, acting de facto as a ceiling on overall redistribution. The presence of a threshold meant that net balances, as a ratio to GNI, would continue to differ among creditor countries. This system appears cumbersome and opaque as to its final effects, and falls short of offering a logical rationale for sharing the burden of redistribution.

A better system has been recently proposed by De La Fuente et al.<sup>11</sup> whereby net balance would be kept in line with an index of relative prosperity – basically measured by real incomes per capita on a PPP basis – through a system of horizontal transfers between the member states. This scheme would fundamentally change member states' incentives at the negotiating table, since:

- (a) any increase in spending in favour of the citizens and regions of a member state would also raise its budgetary transfers to the Union, thus eliminating the incentive to free ride on the common budget;
- (b) discussion over horizontal spending programmes would no longer be distorted by distributional considerations.

The application of this mechanism would be facilitated by the tripartite budget that has been outlined above, which explicitly separates redistributive programmes from other expenses and assigns the GNI resource to their financing. Thus, the use made of national budgetary allocations for the EU budget would become fully transparent: it would be clear how much is

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<sup>10</sup> On this the European Council of 16-17 December 2005 concluded as follows: "The UK budgetary correction mechanism (the UK abatement) shall remain, along with the reduced contribution to the financing of the abatement benefiting Germany, Austria, Sweden and the Netherlands, as agreed at the 1999 Berlin European Council. The UK abatement remains in full on all expenditure except in relation to the new Member States as set out below. Starting in 2013 at the latest, the UK shall fully participate in the financing of enlargement costs for countries which have acceded after 30 April 2004 except for CAP market expenditure 1. To this end the UK budgetary mechanism shall be adjusted by progressively reducing the total allocated expenditure in line with the modalities in Annex III. During the period 2007-2013 the additional contribution from the UK shall not be higher than 10.5 billion euro, in comparison with the application of the current Own Resources Decision. In case of future enlargement the additional contribution referred to above will be adjusted accordingly (except for Romania and Bulgaria)."

<sup>11</sup> Angel de la Fuente, Rafael Doménech & Vasja Rant, "Addressing the net balances problem as a prerequisite of EU budget reform", paper prepared for the BEPA Conference on EU Public Finances, Brussels, 3-4 April 2008.

refunded to each country for redistribution in favour of its own regions and citizens, and how much is paid to other member states to foster convergence, or in the name of solidarity. These transfers would respond to acceptable criteria of equity and fairness, since they would be closely aligned with relative income levels.

On the other hand, since resources for the financing of European public goods would directly accrue to EU coffers without passing through national budgets, as will be explained below, attendant decisions would be freed of distributional considerations and could be taken solely on the grounds of common interest and European added-value.

## 5. Own resources

The system of own resources does not seem to fully comply with the Treaty prescription that “the budget shall be financed wholly from own resources”, since most revenues are disbursed ex-post by the member states from their own national budgets, under the GNI resource. Moreover, the present system encourages the member states to treat the common budget as part of national spending priorities, and then to negotiate the allocation of spending in the EU budget as a counterpart to ‘their’ payments into the common budget.

Therefore, it should be changed. This requires a suitable new Regulation decided by the Council under Article 269 of TEC (or, rather, article 312 of the revised Treaty, likely to be in force when the decision will be taken).

As has been argued, the new system should explicitly envisage two different sources of current revenues: transfers from national budgets to finance redistribution between the member states would be covered by the GNI resource; and ‘own’ resources to finance the production of European public goods would accrue directly to the EU. In this context, discussion about a European tax may perhaps appear less threatening even to the most ardent custodians of national sovereignty.

First, as has been described, there would be no new burdens for European taxpayers, but only a different structure of revenue collection, since the overall cap on EU resources would not change. Second, the composition of total revenues as between transfers from national budgets and direct tax collection from taxpayers for the EU budget would depend on the composition of spending. More direct tax collection could only come about as a result of explicit decisions by Council and Parliament to reduce redistributive transfers and increase common policies, say for border control or common defence. Increased tax collection from citizens would directly correspond to an increased provision of public goods at the EU level, compensated by reduced taxation at national level.

As to the forms of direct tax collection by the Union, any tax levied at the EU level should respond to simple principles of efficiency and transparency. Therefore, EU taxes:

- (a) should have a broad base and be levied at a small rate, to minimise allocative distortions (neutrality);
- (b) should be simply and uniformly assessed (simplicity);
- (c) should be automatically transferred to the EU without going through national budgets (independence);
- (d) should make EU citizens aware of what they pay to the EU budget (transparency);
- (e) would not need to worry about redistributive goals, which would be addressed by appropriate spending programmes and would be financed separately (subsidiarity).

These criteria seem to rule out all forms of direct taxation, since the criteria of simplicity and independence could not be met. In particular, a corporate income tax would not meet any of the above criteria, given the small tax base and the different criteria for corporate taxation in the member states.

The natural candidate to supply most resources for the production of European public goods is the VAT, which can meet all of the above criteria and already has a common infrastructure for tax administration and collection. VAT revenues from a ‘European surcharge’ could be channelled directly to the EU coffers. Overall VAT rates would not change, but invoices and cashier receipts throughout the value chain would show separate charges for the national and the EU VAT, so as to make citizens aware of the destination of their money.

Recourse to other taxes linked to specific goals should not be excluded, provided they respect the criteria described above. One candidate that comes to mind is some form of energy tax, that could strengthen incentives for energy saving, and whose revenues could be used for funding research on clean energy and other actions to promote energy efficiency Europe-wide.

## 6. Decision making

All the changes that have been discussed would lose much relevance if budgetary decisions remained uninfluenced by citizens’ will and political orientations within public opinion. To this end, some changes in decision-making are also required to bring fundamental choices before the electorate on the occasion of European election and to unify decisions on the European budget.

The Treaty of Lisbon has changed decision-making on budgetary matters by:

- (a) Bringing the multi-annual financial framework (MFF) into the Treaty (art. 312) and involving Parliament in the decision (Council must obtain the consent of Parliament); decisions will be taken by unanimity, but the European Council may authorise Council to decide by qualified majority voting;
- (b) Applying co-decision between Council and Parliament to yearly budgets;
- (c) Eliminating the category of compulsory expenditures, that notably subtracted agriculture spending from Parliament's remit.

The expanded powers of Parliament offer the opportunity to 'politicise' discussions on budgetary allocations and bring political differences before the electorate on the occasion of European elections. The required adjustments in decision-making procedures can be implemented without Treaty changes.

Firstly, all decisions on multi-annual programmes should be brought into the single framework of the MFF, and the practice of separate negotiations on agriculture and research programmes should be discontinued. Thus, it would be possible to move to a unitary consideration of all expenditures in the EU budget and to evaluate the trade-offs involved in assigning resources to different budget lines.

Secondly, the duration of the MFF should be aligned with the term of office of Parliament, running for five years. Parliament could then seek a mandate from the electorate on the desirable evolution of the budget at each European election. Popular legitimacy would strengthen the Parliament's hand in its negotiations with Council. For this approach to be feasible, the decisions on the MFF would have to be adopted by Council and Parliament around mid-term in the legislature.

Parliament and Council should consider applying all the above changes already to the decisions on the MFF starting in 2014. Parliament can foster such an evolution by refusing to collaborate on a budgetary process based on old rules.

## 7. Summing up

The ongoing review of the EU budget offers an important opportunity to break with the past and move to a budget that really can reflect current policy needs and priorities. In this regard, the European Commission bears huge responsibilities, since its proposals will shape the debate in Council and Parliament.

This paper does not address new policy priorities for the European budget, a separate subject that would have required much lengthier treatment.<sup>12</sup> Rather, our focus has been on the structure of the European budget and the relationship that should be established between the expenditure and the revenue side.

Our main proposal is to partition all operations in the current EU budget into two separate Chapters, devoted respectively to redistributive transfers (Chapter One) and the production of European public goods (Chapter Two). Each Chapter would have its own dedicated sources of revenue: transfers from the member states to finance redistribution, and taxes levied at European level to finance European public goods. Each Chapter would have to be in balance at all times.

Within this new budgetary framework, the issue of net balances can be strictly confined to sharing the burden of redistribution within Chapter One. A system of horizontal transfers between the member states should ensure that net balances remain strictly in line with relative income levels on a PPP basis at all times, based on the method recently proposed by Angel de la Fuentes, Rafael Doménech and Vasja Rant. This change would remove from budgetary negotiations all incentives for the member states to fight for larger funds since – given the constraint on net balances – any euro of extra transfers obtained by one country for its regions or citizens would be paid back under the GNI resource.

We have also argued that the Union should be allowed to tap capital markets by issuing bonds to finance large projects of European interest that have positive returns, even if over long time-frame, and therefore can be paid back. Union bonds would in no case finance current operations. Project selection would meet strict criteria of European value-added set in advance by Council and Parliament.

Finally, decision-making procedures should be changed so as to ensure that all expenditures be decided simultaneously, so that all relevant trade-off involved in the decision to spend in the different programmes is taken fully into account. The duration of the MFF should be aligned with the term of office of Parliament, and budgetary priorities should become a matter for European elections.

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<sup>12</sup> See Daniel Gros, *How to achieve a better budget for the European Union*, CEPS Working Document No. 289, April 2008.

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