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THE FUTURE OF EU FINANCING

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FOREWORD

JIM CLOOS

TEPSA Secretary-General

In this latest edition of TEPSA's EUCO Debriefs, we address the sensitive issue of the future financing of European Union (EU) policies. We asked eight experts to respond to the following question:

The EU is confronted with major challenges – geopolitical, policy-based, societal. The financing needs over the next years will be gigantic; estimates of the investment gap vary between experts, but they go into the hundreds of billions annually. The EU needs a holistic look at all aspects of financing, the EU budget and own resources, NextGenerationEU-type (NGEU) financing, national financing and the issue of State aids, and ways to mobilise private investment. How do you assess the situation, and what should the EU do about it?

The April Conclusions of the European Council (EUCO) on "A new European Competitiveness Deal" attach significant importance to this issue in paragraph 17 and in the separate sub-chapter devoted to the Capital Markets Union (CMU). The Letta report on *Much More Than a Market* starts with a chapter on 'A Single Market to Finance Strategic Goals'; it calls for a "savings and investments Union" to unlock the potential of the Single Market.

The financing challenges for the EU are staggering. New developments like the Green Deal, the Digital Transition, a new Security and Defence policy, the assistance to Ukraine and the enlargement to the East and the Western Balkans require investments in the hundreds of billions. At the same time, traditional policies like the Common Agricultural Policy (CAP), Cohesion and development will continue to consume a major part of the EU budget. The traditionally quite diverse views in the Member States about the EU budget will make agreement difficult; the reduced margins of budgetary manoeuvring for EU Member States with a high public debt will not help either.

There is no magic nor simple solution. The EU budget amounts to a mere 1% of EU gross national income; even with a significant increase, it would still only be a small part of the investments needed. The EU must therefore explore other routes to find new funding. One is to build on the NGEU approach chosen in 2020 and to create, on the model of the Recovery and Resilience Facility (RRF), other specific investment funds. Another is to finally complete the CMU and thus mobilise the considerable savings that exist in Europe. The experts cover these issues from various angles. There is one other important theme that is briefly alluded to in Fabian Zuleeg's contribution. It concerns national State aids. The question here is to ensure the necessary flexibility to allow for public investments while maintaining a level playing field within the EU; as we saw during the COVID-19 crisis, the Member States are far from being equal in terms of their capacity to provide State aids.

Stéphane Saurel pleads for working in different directions because the EU needs innovative thinking and an integrated approach. Public funding alone will not do the trick, nor will an exclusive focus on the EU level. Concerning the EU budget he injects a reality check; the sad fact is that Member States look primarily at their net balances. They must also understand that the seriousness of today's situation requires a fresh start, as happened in the late eighties with the first Delors package, which led to a whole new way of planning the EU budget and a substantial increase over time. The question is whether the Union has the will and capacity to "engineer a new 'Delors' moment."

Eulalia Rubio Barceló defends the same idea. She considers that it is better to fix the common budget than to create ad hoc borrowing capacities; NGEU was a success, but it only worked because there was an absolute emergency. In her view, for the net payers there is not a significant difference between creating this kind of new EU debt and increasing the EU budget. A new budgetary deal should include an increase of the size of the EU budget, structural changes to facilitate and better organise the use of EU debt financing within the budgetary scheme of the EU, and a reform of the own resources to equip the EU with significant revenue-raising capacity. She adds that a reform of the Cohesion and agricultural policies is necessary.

Johanna Breuer concentrates her contribution on this latter issue. She advocates a "3 C's" approach, with a reform of the CAP and the Cohesion Policy, but also a much better communication efforts; you need buy-in from the EU citizens and a much better understanding of the difficult choices one must make when setting up public budgets. Interestingly, she looks at the two policies also from a social angle: a reform of direct and coupled payments under Pillar 1 of the CAP would not only free up funds for innovation and research in agriculture, but also for financial support to young farmers. Cohesion Policy reduces inequalities between regions, but the funds tend to support households with higher income rather than those with lower income.

Fabian Zuleeg recalls that not all transformations will need financing through public investment, hence the need for a much more private sector-oriented outlook notably regarding the CMU. But he has no doubt that EU borrowing will be the only way out, whether you call this "Eurobonds" or something else. Policy-makers should start talking about this seriously now and reflect on the interaction with capital markets and European and national administrations, rather than wait for another huge crisis before rushing things through. The resistance will be fierce, but there is simply no alternative.

Adriaan Schout raises the issue of the correct implementation of the EU budget and the RRF. He is critical of the way this happens. The unsatisfactory way the EU goes about managing its budget partakes in a more general weakness in the EU's current political-administrative system. Ensuring the effectiveness and the legality of EU spending is imperative because this determines the legitimacy of the budget in the eyes of the public - particularly in the net-contributing countries. The Commission should entrust its auditing tasks to an independent agency. Member States need to charge their supreme auditing institutions with auditing the effectiveness of EU spending.

Aneta Spendzharova makes the same point and looks more specifically at the implementation of the RRF. Institutions and Member States must monitor this closely and watch out for misuse of EU public finances. EU bodies, such as the European Court of Auditors (ECA), the European Anti-Fraud Office (OLAF), and the European Public Prosecutor's Office (EPPO) need continued high-level political support and resources to successfully conduct their important mandates, against the backdrop of heightened corruption risks. This is an important angle because if one wants to use the NGEU approach as a precedent, one must be able to show that the RRF has worked and is not being misused by criminal organisations.

Michele Chang has for a long time been saying that the EU can only manage the major economic, political, and geopolitical challenges it faces if financial integration proceeds beyond the modest efforts so far made for a CMU. The latter is key for unlocking private financing and leveraging limited public spending. Progress is too slow. As she notes, "a genuine CMU worthy of the name would have three components: common insolvency laws, common supervision, and some form of safe asset." She refers to the Letta report, which makes suggestions on supervision, insolvency regimes, and creating a single benchmark for European financial markets.

Erik Jones agrees with her. The EU is far from alone in struggling with these difficult issues. Building financial trust at the national level took hundreds of years in Britain, more than a century in the United States, and many decades in Canada. By contrast, the EU has made huge progress in mapping and completing its Banking Union and CMU over an incredibly brief period in history, though, as Jones highlights, "muddling through without adequate financial institutions … [risks] repeating the kind of turmoil we saw during the European Union's sovereign debt crisis – with all of the political division and financial hardship that such a crisis implies." That is why the proposals Letta makes in his report for completing Europe's CMU and Banking Union are essential for European stability and prosperity.

The debate about financing will loom large in the coming years and will be one of the top priorities during the new 2024-2029 cycle. The think tank world has a particular responsibility to help policy-makers make the right choices. The contributions you will find below are a good illustration of what it can deliver. They provide ideas and operational suggestions for future improvement. It is no exaggeration to say that the answers found to the financing conundrum facing the EU will define its future development.

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ABBREVIATIONS

BAR	Brexit Adjustment Reserve
CMU	Capital Markets Union
CAP	Common Agricultural Policy
ECA	European Court of Auditors
EP	European Parliament
EPPO	European Public Prosecutor’s Office
ETS	Emissions Trading System
EU	European Union
EUCO	European Council
ESMA	European Securities Market Authority
MFF	Multiannual Financial Framework
NGEU	NextGenerationEU
OLAF	European Anti-Fraud Office
RRF	Recovery and Resilience Facility

Addressing the financing needs of the European Union through three C's: reforming Cohesion and CAP funds and communicate European funding efforts to stakeholders and citizens

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The EU's struggle for more financial resources has been a constant feature of European integration, as has the struggle for budgetary reform. A key problem is the transfer nature of the budget, which pits contributors against recipients, with all Member States clinging to the predictability of the budget and hindering substantive reform processes. In the absence of a flexible budget for public goods at the EU level, we therefore struggle to act in budgetary solidarity across issues and over time and tend to pit national interests against each other.

There are ways around the rigid structure of the EU budget: NGEU-type financing is one possibility, as the temporary nature of a budgetary instrument makes it easier to agree and predict the financial consequences for each Member State. However, a holistic approach to EU financing should first be based on reforming the two big "C's" in the budget: the Cohesion funds and the CAP, which are in urgent need of reform because they are not working as we want them to. Reforming these funds must become a priority and will allow us to redirect financial resources. The focus of this policy brief is that:

- CAP and Cohesion funds require substantial reform,
- Communicating these reform processes to stakeholders, interest groups and citizens is key.

The Cohesion funds are often framed in terms of creating opportunities in the single market and promoting regional equality. And indeed, Cohesion Policy has and continues to reduce inequalities between regions, but Cohesion funds also tend to support households with higher income rather than those with lower income. The status quo, therefore, cannot achieve the goals of social justice and cohesion, both of which are highlighted in Enrico Letta's recent publication on the single market. This is a paradox: we do not want to "leave anyone behind", a phrase that is frequently mentioned in current financing debates, but the Cohesion funds are not set up to deliver such individually targeted spending goals. The recent 9th Cohesion Forum forms part of the efforts for budgetary reform, and specifically engages with the distinction of funding as place-based versus people-based. Signs of progress are the more direct engagement of sub-regional and local communities to identify their own priorities.

Reforming the CAP is much more difficult, and money spent on the agricultural sector continues to be wasted. The agricultural sector is both a contributor and a victim of climate change and will have to adapt to extreme weather conditions and the consequences of pollution in the coming years. However, the funding structure of the CAP is currently ill-equipped to deal with these social and economic challenges. Recent changes to agricultural legislation have significantly weakened environmental requirements for farmers, but food security and production sustainability are closely linked to the wellbeing of citizens. A substantial reform of direct and coupled payments under Pillar 1 will, for example, free up funds for innovation and research in agriculture or for financial support for young farmers to enter the agricultural market.

However, the ability to reform both policy areas, to introduce new own or other types of resources at EU level, must be linked to a third "C": communicating the reform processes to stakeholders and European citizens. At present, citizens do not understand the link between the need for EU-wide public funding and national economic growth, cohesion, and prosperity. We therefore need a level of basic knowledge among citizens about public finances that makes it easier to understand the rationale behind policy decisions. Communication can easily be linked to policy implementation, with something as tangible and concrete as the creation of new housing (a problem area highlighted by Enrico Letta). Approaching housing projects from the EU level is much more concrete for most citizens than funding innovation, research, or biodiversity.

Approaching European public funding with a strategy to raise interest and understanding of European public finance can be a new way of informing citizens about the opportunities that exist. A missed opportunity is the lack of communication on the tax on non-recyclable plastics; taxing a waste product makes sense from the point of view of consumers. Introducing similar new own resources could encourage public support and create steady sources of income for financing EU policies. A positive example is the communication during the COVID-19 pandemic. Here, European citizens understood the need for a coordinated EU approach and the necessary public funding during the lockdown and economic downturn. In the likely future event of extreme climate emergencies, we will need similar communication efforts to promote European fiscal solidarity.

Show me the money: financing Europe's strategic, green and digital ambitions through Capital Markets Union

MICHELE CHANG

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The Conclusions of the special meeting of the EUCO on 17 and 18 April reflected the numerous challenges facing the EU. There was no shortage of initiatives, including the provision of military support to Ukraine, additional support to refugees ("calls on all donors to maintain or increase their level of assistance" (p. 3)), and formulation of a "new European competitiveness deal" (p. 5) that would "boost the Union's competitive transition towards digital sovereignty... and towards climate neutrality" (p. 5). What was lacking was a plan on how to pay for this.

Indeed, the Conclusions noted that "all relevant tools [...] should be leveraged" (p. 6) and that "deepening the CMU is key to unlocking private capital" (p. 8), but they lack the urgency required. The CMU, an idea originally designed to entice the United Kingdom to remain part of the EU, has languished as a project that is "big on rhetoric, small on policy" Since 2015, a number of legislative initiatives have made some progress on CMU, but the European Commission nevertheless concedes that "EU capital markets remain fragmented" While CMU proposals like the strengthening of market data transparency and amending the Alternative Investment Managers Directive are relevant, they are also insufficient, particularly given the capital needs of the EU.

What is the next step? The Conclusions give the impression of urgency, but the calls to action were quite modest. A genuine CMU worthy of the name would have three components: common insolvency laws, common supervision, and a safe asset. CMU first raised insolvency laws in 2016, and the use of the word "harmonising" (p. 8) in the conclusions is promising. Less promising is reluctance to move towards common supervision due to Member States with well-functioning capital markets like Ireland, Sweden, and Luxembourg refusing to delegate supervision to the European Securities Market Authority (ESMA). No mention was made of an EU safe asset akin to US Treasury (long-term) bonds and (short-term) bills that have contributed to the depth and liquidity of US capital markets and lowered US borrowing costs. EU institutions have issued debt, such as the bonds issued to fund the NGEU budget that could provide a model for future EU debt issuances, but insufficient political will exists to issue additional bonds backed by the EU budget (as the NGEU bonds are), let alone debt issued under joint and several liability of Member States.

The recent Letta report suggested rebranding the CMU in favour of creating a "savings and investments Union" in order to emphasise the real objective of capital market integration, which is the ability finance important goals like those mentioned in the EUCO conclusions. Letta proposes a bottom-up strategy to delegate supervision to ESMA over time (p. 34), harmonising insolvency regimes (p. 35), albeit with few details, and creating a single benchmark for European financial markets (p. 36), starting with making bonds issued by the European Commission, the European Investment Bank, and the European Stability Mechanism homogenous, rather than creating a European safe asset.

The relative modesty of these proposals reflects their political difficulty. Nevertheless, the urgency of the need for European capital calls bolder measures. How will the EU pay for the digital transition, climate change, rising defence costs, and manufacturing subsidies? The EU budget will not expand to a suitable size to achieve these objectives. Moreover, the effectiveness of any public money requires considerable private funding as well. While Macron's proposal for a CMU with common supervision, bankruptcy laws and a safe asset within 12 months may not be politically feasible, the ambition is correct. This is Europe's best and most politically realistic chance to achieve the of goals it has set for itself.

Optimising the European Financial Area for stability as well as prosperity

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Former Italian Prime Minister Enrico Letta makes the strong case that Europeans can only mobilise the resources necessary to support a green and digital transition if they succeed in using their own huge pool of savings efficiently and while attracting additional resources from abroad. That case only becomes stronger when the overlapping imperatives of providing for European security and stabilising the EU's strategic partners (and candidate countries) in Eastern Europe and the Western Balkans are taken into account. In his speech at the Sorbonne, French President Emmanuel Macron clearly agrees. Such huge challenges cannot be met piecemeal, on a Member State-by-Member State basis, particularly without damaging Europe's internal market. Hence, both Letta and Macron lend their support to efforts to strengthen the European Banking Union and to complete Europe's CMU as an essential first step in achieving a more secure and prosperous European Union in the face of these huge challenges.

Two facts that neither Letta nor Macron stress are: first, Europeans are not alone in facing this requirement, as governments everywhere struggle to find ways to match savings and investment efficiently; second, the alternative of muddling through without adequate financial institutions is not a marginal weakening of collective efforts but an ever-increasing risk of repeating the kind of turmoil we saw during the European Union's sovereign debt crisis – with all of the political division and financial hardship that such a crisis implies.

The institutional reform recommendations that make up what we call 'banking union' and 'capital markets union' in the European Union are hardly *sui generis* European imaginings. On the contrary, they are the fruits of a long and painful experience with repeated financial crises over the past three centuries. As a result, as Geoffrey Underhill and I show in a recent paper published in The World Economy, the financial histories of the United Kingdom, the United States, and Canada are replete with illustrations of what can happen when one or more of these institutional arrangements for reassuring cross-border investors or stabilizing financial institutions are not in place. The danger is particularly acute during periods of large-scale public infrastructural investment. America's first major financial crisis, which bankrupted many state governments, followed huge investments to connect inland waterways for transport.

The political effort required to stabilise financial markets is not uniquely European either. Trust is not natural in financial relationships, everyone is afraid of moral hazard, and so club-like arrangements tend to predominate over efforts to treat financial stability as a public good. The problem that the British, the Americans, and the Canadians learned through terrible experience is that no financial 'club' is an island that can be fully insulated from instability in other parts of the financial system. On the contrary, the more club-like, exclusive arrangements are often the weakest and most vulnerable links in the chain of financial contagion. Just remember what happened to the savings and loans in the United States in the 1980s and the building societies in Britain at the start of the financial crisis.

The political effort to build financial trust at the national level took hundreds of years in Britain, more than a century in the United States, and many decades in Canada. In all three countries, the institutional effort to 'optimise' the financial system so that it is both stable and efficient remains a work in progress. In many cases, the 'progress' made by one generation is stripped away by reformers from the next – often with disastrous consequences.

By contrast, the EU has made huge progress in mapping and completing its Banking Union and CMU over an incredibly short period in history (even if that period feels like an eternity to many Europeans). When Letta and Macron call upon Europeans to complete those projects, it is not because they are 'nice to have'; it is because they are essential to Europe's stability as well as its prosperity. This necessity is all the more apparent given the huge financial requirements for the green and digital transition, the need to ensure European competitiveness, and the imperative to provide for European security and enlargement.

The Union needs a Delors-like 'budget package deal'

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No more 'ad hoc' borrowing capacities: let's fix the common budget

NGEU was undoubtedly a success. Since its adoption, there have been many calls to replicate it. Implicit in these calls is the assumption that setting up new ad hoc EU borrowing instruments for specific purposes is politically easier than increasing the EU budget. There are reasons to doubt that. From the point of view of the 'frugals', absent a major reform in the EU's Own Resource system, raising new EU debt is not so different from increasing the size of the EU budget: both mean an increase of their net contributions. This can work in a state of emergency, but in normal times, and given the current Union's fragmented political landscape, it is hard to imagine all key EU and national actors rallying behind a single spending priority.

Instead of more ad hoc borrowing instruments, we need a structural reform of the EU budget. At the minimum, a reformed EU budget should integrate a simpler procedure to set up temporary off-budget instruments in case of emergencies. This could be done by establishing a permanently higher Own Resource ceiling (say, at 3% of EU GNI), allowing the Council to set up new borrowing or guarantee-based instruments in case of emergencies without having to follow the long and tortuous process of amending the Own Resources Decision. We could even envisage the possibility to allow the Union to debt-finance the EU budget. According to some experts (see here or here) this would be legally feasible under the current Treaties. It would provide many advantages to the establishment of temporary off-budget instruments: it would give the European Parliament full oversight over the use of all EU funds and allow the Union to borrow on a quasi-permanent basis, lowering the costs of servicing EU debt.

Admittedly, convincing Member States to move in this direction may prove challenging. However, it is worth noting that the Commission would not have full discretion to borrow. To comply with the Treaty's budget balance principle, a maximum ceiling for borrowing would have to be set out in the Own Resources Decision and borrowed amounts would have to be counter-balanced by a corresponding increase of the Own Resources to give the Union the means to cover the costs of debt service at any time. As noted by Grund and Steinbach, to make it politically acceptable, it could also be possible to earmark the borrowing proceeds to certain EU expenditure by changing the EU Financial Regulation.

Need to be serious on Own Resources

Whether inside or outside the EU budget, we cannot endlessly create new EU debt without equipping the Union with sufficient revenue-raising capacity. The package of new Own Resources proposed by the Commission in December 2021 and updated in June 2023 is a pragmatic move and should be adopted, but will not provide significant amounts to boost the EU's spending capacity in the coming years. In this respect, an idea floated by the Commission is to propose another Own Resource based on a common European corporate tax base. However, there have been many attempts in the past to harmonise EU corporate tax bases and they have not led anywhere. A more promising solution is proposed by Saint Amans: to set up an Own Resource based on Pillar 2 of the OECD global agreement on multinational taxation. In particular, as the EU has already adopted Pillar 2 but many other jurisdictions (such as the US and China) have not, all Member States will be entitled to collect extra-revenues from US or Chinese multinationals not being taxed at 15%. It makes sense to mutualise these extra-revenues and use them to finance EU-level public goods. The same logic of protecting Member States' revenues by setting up common tax borders could be replicated in other areas, such as personal income or wealth taxation.

A comprehensive reform package

Calls to increase the level of EU-level spending will not succeed if not accompanied by changes in the revenue side and some commitment to increase the effectiveness and impact of EU spending. The Delors I budget package back in 1988 led to doubling the EU budget because it linked the increase of EU spending to changes in the revenue side (the creation of the GNI contribution) and other institutional and procedural changes (the creation of MFFs and the introduction of discipline rules for CAP spending). Today we need a similar Delors-like broad pact. This should include a commitment to increase the size of the EU budget, structural changes to facilitate and better organise the use of EU debt financing, new EU Own Resources to equip the EU with significant revenue-raising capacity and reforms in some EU spending areas, particularly the biggest ones (Cohesion and CAP).

1988-2028: will a second major European financial reform take place?

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A public budget shall reflect a political project. The budget of the European Union is a fine-tuned balance between ambitions and necessary compromises, an equilibrium influenced by enlargements and emerging challenges. It is above all the result of gradual sedimentation marked by significant inertia: priorities add up more than they are being replaced over time; the benefits gained by Member States, in terms of expenditure or revenue, are difficult to call into question. Each negotiation of a Multiannual Financial Framework (MFF) tends to take the existing one as a starting point.

The temptation to draw up what the Member States could most usefully do together in an environment marked by ever more rapid and profound changes exists in academic circles, but that is not the way it works in real life for policymakers. Objective criteria, such as added value, subsidiarity, additionality, or proportionality, do not belong to the vocabulary of the political negotiations. Net balances are their cornerstone, much more so than any general European interest.

The first European financial reform dates back to 1988. The so-called Delors I package, followed a few years later by the Delors II package, put an end to a period of crisis, characterised by conflicts between the Council and the European Parliament, as well as tensions around the question of budgetary imbalances and the inadequacy of resources to cover growing expenditure needs. The enlargement to Spain and Portugal and the conclusion of the Single European Act provided a new political stimulus. The financial reform consisted in setting up political priorities, the so-called financial perspectives, introducing a new, more equitable own resource based on the Member States' relative prosperity, and creating Cohesion Policy with pluriannual programming as one of its core principles. It required political will, an out-of-the-box way of thinking and an ability to engineer the negotiations.

40 years later, with a new MFF starting on 1 January 2028, the question is whether a second major European financial reform may take place. At least, the ingredients are in place: a situation of poly-crises, a need to invest massively to not put our security, stability, and competitiveness at risk, and a high degree of awareness that business as usual is no longer a way forward.

The current EU budget has been pushed to its limits by Russia's war of aggression against Ukraine, as well as by global competitiveness challenges, climate change, and irregular immigration. A new global order is in the making, a technological revolution is ongoing, and climate change ought to be addressed urgently.

Massive investments are needed. There is a need to modernise the carbon-based industrial base and move to more energy efficient means of transport and buildings, to seize opportunities coming from artificial intelligence and the new digital economy, as well as to step up public investments in security and defence.

In this context, the Commission has announced its intention to put forward a policy-based post-2027 MFF, moving the focus from programmes to policies. It has also called for the MFF to be simpler, more agile, and more flexible, to adapt to new needs and unforeseen challenges, allowing the emergence of a stabilisation role for the EU budget. The performance-based approach of the RRF adopted in the midst of the COVID-19 crisis in 2020 is likely to infuse the design of some of the main EU policies. Current reflections also investigate ways to optimise resources by developing new funding sources, improving co-financing arrangements, using blending options and budgetary guarantees effectively.

But the magnitude of the challenge is such that even an ambitious MFF, in its volume and structure, would not be enough. In the Conclusions of the 17-18 April Special EUCO, Leaders recalled that “investments in key strategic sectors and infrastructures require a combination of both public and private financing working together” and that “the EU budget and the European Investment Bank Group continue to play an important role”. There is indeed a need to pool resources to tackle the challenges and to make the best use of any single available euro.

The call from Enrico Letta for a “Savings and Investments Union”, developed from the incomplete CMU, goes in that direction. This is key, to not only keep European private savings within the EU but to also attract additional resources from abroad, and channel them efficiently.

The path to greater competitiveness and prosperity lies in a holistic approach that brings together all players, to leverage the strengths of both the public and private sectors, at the EU as well as national level. The time has come to connect the dots in the most efficient manner possible. That will require political will, not only in Brussels but also in capitals, and, equally important, the ability to put in place an efficient negotiation strategy. The big question is whether the Union has the will and capacity to engineer a new ‘Delors’ moment.

Modernising the EU budget seriously?

ADRIAAN SCHOUT

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The new college will have to outline its budget plans as soon as possible to match its political programme and to get the work started. Costly ambitions now high on the EU agenda encompass industrial policy, defence and support for Ukraine, the Green Deal, migration, and infrastructure (energy, digitalisation, and transport). In addition, there is considerable pressure to decide on the continuation of NGEU, which has almost doubled the EU budget. Given the difficulties in reforming the existing budget and the new priorities, it is safe to assume that there will be calls for 'fresh' money.

Yet, before deciding on the overall size of the EU budget, it is important to consider the related issues regarding the effectiveness and the legality of EU spending. Both determine the legitimacy of the budget in the eyes of the public - particularly in the net-contributing countries. As regards effectiveness, any decision on modernising the priorities within the budget should in part depend on the assessments of the EU added value of spending. The legality of spending relates to whether the money has been spent according to the rules: absence of corruption, spending according to EU rules of public procurement and state aid, and due accountability.

The focus of monitoring has been on legality, not on effectiveness. As experience with Cohesion Policy shows, target overload is one of the complications in monitoring spending. The plethora of targets includes social, regional, gender and environmental considerations. Hence, the focus has been on procedures and receipts (the legality of spending). As a consequence, the plans for the renovation of a theatre and for building airports, for instance, may have ticked all the right boxes but the end result may still lack a viable economic basis.

As regards effectiveness and Cohesion funds, the main objective has been convergence, with disappointing results. The new spending method of the NGEU budget shifted the attention away from monitoring input indicators towards outputs. It is no longer the receipts that are monitored, but milestones (qualitative achievements) and targets (quantitative achievements) to measure progress. Yet, the new method may be even worse given that it is still not the impact (effectiveness) that is assessed. Reforms take years to be implemented (if at all) and the problem of target overload has remained. As someone involved in the monitoring of NGEU explained, many projects are below par, but the money can always be allocated by approving the intended reforms. As a corollary, input accountability has been diluted but we still lack a system of monitoring added value (let alone EU added value). The worst of both worlds.

There are more problems with monitoring the EU budget that are indicative of the state of good governance in the EU more generally. Importantly, we lack a reliable and transparent accounting system. For example, the accounting system for Cohesion funds is organised within the Commission Directorates-General and is not in the hands of independent auditing agencies. Moreover, national supreme audit institutions examine national spending but not the impact of EU programmes. On the whole, the monitoring of the EU budget is weak in terms of transparency, independence, and attention for effectiveness.

The important question is why so little progress has been made in auditing effectiveness and legality of EU spending. Discussing new policies and budgets seems to be more appealing than addressing the technicalities of monitoring. And EU funds are regarded as entitlements and as subsidies added to the national budget. Some even go so far as to drop notions of effective and accountable spending as the EU budget should be seen as transfers between rich and poor countries. Finally, not disbursing the money may result in additional national budget deficits if the EU funds are not allocated. Auditing may hinder politics in this particular case.

Some steps can be taken to improve the legitimacy of the EU budget. First, the Commission should entrust its auditing tasks to an independent agency. Secondly, Member States need to charge their supreme auditing institutions with auditing the effectiveness of EU spending. However, chances are slim that the EU Commission and the Member States will agree to these measures. Better spending may still be a distant objective.

NextGenerationEU and the EU's public finances: Who is keeping watch?

ANETA SPENDZHAROVA

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The investment gap to meet the EU's green transition goals of net-zero greenhouse gas emissions by 2050 is real and pressing. NGEU and, particularly, the RRF, which can mobilise up to EUR 648 billion,[1] provide unprecedented EU public financing to push ahead with the COVID-19 pandemic recovery in a way that furthers Europe's green transition. At the same time, the EU institutions and – equally – the Member States need to monitor closely how the RRF-funded projects are implemented (or not) and watch out for misuse of EU public finances.

The Commission's mid-term evaluation of the RRF reveals that it took a while for the Member States' administrations to identify suitable projects to fund through the RRF. Furthermore, the implementation of multiple projects is lagging behind, and there have been reports of improper usage of the RRF.

Hungary is often talked about, especially when it comes to Viktor Orbán's strategic use of EU grants to maintain his grip on power and advance crony capitalism in the country. At the same time, beyond Hungary, there are significant risks of siphoning off EU funding for private gains in Member States such as Bulgaria, Slovakia, Greece, Italy, and Spain. As recently as April 2024, the police forces arrested more than 20 suspects in Italy, Austria, Romania, and Slovakia, on request of EPPO, as part of a major investigation into massive fraud and embezzlement of EUR 600 million worth of RRF funding earmarked for Italy.

The RRF is beneficial for Member States in urgent need of public financing for green transition projects, but it is also lucrative for more nefarious actors. As Politico aptly summarised, even Europe's drug kingpins have pivoted to stealing EU cash from the RRF. This mobilisation has unfolded amidst political pushback against anti-corruption agencies. For example, in Slovakia, Robert Fico's government has started dismantling the Special Prosecutor's Office responsible for corruption cases, including cases against officials from the country's ruling political party.

Effective cooperation between the EU institutions, such as the Commission, the European

[1] As the Commission explained in its latest update, with the amended RRF Regulation, additional grants under the Emissions Trading System (ETS) and Brexit Adjustment Reserve (BAR) have been made available to the Member States. Furthermore, the Member States requested less loan support than the originally foreseen amount. These two changes (more grants through the ETS and BAR and less loans requested by the Member States) result in a total RRF amount of EUR 648 billion by the end of 2023.

Central Bank, the European Investment Bank and the European Investment Fund as well as the Member States, is essential to make NGEU work. When it comes to the vigilant oversight of EU public finances, the European Parliament, the ECA, OLAF, and EPPO are vital watchdogs of the public interest.

Particularly the ECA has drawn our attention to the idiosyncratic EU financial landscape, which resembles "a patchwork construction requiring further simplification and accountability." This patchwork pattern of EU public finances leaves important blind spots. The head of the EPPO, Laura Codruța Kövesi, originally from Romania, has warned against the dangerous mobilisation of "mafias, who have turned their eyes on EU subsidies and VAT fraud" and are putting the newly set-up EU public finances in danger. So far, 23 Member States participate in the EPPO, but the organisation is rather stretched in terms of properly trained staff and budgetary resources. In the future, this might impede its efforts to prevent organised crime from looting the EU's coffers.

This comes to show that vital as they are for the green transition, EU public finances such as the RRF are also vulnerable to misuse by politically connected crony capitalists or, even worse, organised crime. The ECA and the EPPO play a crucial role in safeguarding the citizens' interests and watching out for the lawful spending of EU public finances. The EU needs to ensure continued high-level political support and sufficient resources, such as staff and budget, so that they can successfully carry out their important mandates to make sure that NGEU funding has worked as intended.

Financing the Zeitenwende

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The EU is finding itself in a new era full of challenges, following on from the watershed moment of Russia's invasion of Ukraine. Responding to this poly-permacrisis will require enormous public and private investments.

There are major transformations - the technological revolution, the green transition, Europe's demographic change, and the security and defence architecture - requiring investments in infrastructure, skills and innovation, while, at the same time, boosting Europe's competitiveness. Proactive industrial policy already weighs on national public finances in many countries, for example in the form of subsidies, as well as distorting the EU's level playing field. All these transformations need to be just and fair, keeping populations on board.

The immediate priority is to invest in defence and security in its widest sense. This implies investments in hard security (providing material to Ukraine, replacing material already provided, modernising and increasing capacity of Europe's military, in equipment and human resources) but also in dual-use sectors and in the provision of economic security, which is a public good that will have to be paid for. The challenge and cost of reconstruction of Ukraine will further add to financial pressures.

For all transformations put together, the need for investment is enormous, whatever the exact amount, but national fiscal capacities are already strained. Not all transformations will need to be financed predominantly through public investment. Given the fiscal pressures, rather the opposite is true: much of this investment will have to come from the private sector, more so than in the past, particularly regarding competitiveness, technology, and sustainability. This will require a much more private sector-oriented outlook and overcoming political barriers, for example with regard to the CMU.

But even when drawing in significant private sector investment, it will leave an enormous unmet public financing gap, not least when it comes to providing the funding needed to facilitate and leverage private investment. In addition, there will be a need to finance instruments that can de-risk private investments, which will require significant public funding as an underpinning, and the EIB will continue to be called upon. There are also many areas that will have to be financed directly through public money, for instance in defence and security.

Much of the fiscal pressure will be at Member State rather than EU level. But capacity at national level is also limited and, paradoxically, these pressures will limit the possibilities for a reform of EU financing, be it in the overall size of the MFF or in the instruments available at EU level. Taxation at EU level will remain a taboo, despite its potential effectiveness, especially in connection to tax advantages for companies that invest in public goods such as sustainability. While the MFF will see some reallocation, the scale of the resulting funding for these transformative investment priorities will be nowhere near what is needed.

EU borrowing will be the only way out. While there is strong political resistance in some key countries, notably Germany, when the fiscal crunch fully hits, this will be overcome as the alternative would be inaction, which will be politically impossible. Thus, the EU will have some form of (quasi-)permanent borrowing in the near future. This probably will not come for a few years yet, and will almost certainly not be called Eurobonds, but the underlying drivers are inescapably pushing the EU in this direction.

In what areas are public investments and EU-level borrowing needed? There is the legacy of the RRF, with the original loans due to be repaid from 2028 onwards; it is more than likely that some form of permanent, ongoing support will be necessary. The greater need for defence and security spending, coupled with demands from the US for Europeans to take greater responsibility for their own security, potentially accelerated by Trump, will also increase the momentum for EU-level borrowing; and so will Ukraine's reconstruction when it begins in earnest.

Eurobonds are the only way out then, so they will come even though they are contentious. But now would be a good time to start discussing what they will look like, and the governance needed, starting the interaction with capital markets and European and national administrations and institutions, rather than ending up with something that needs to be rushed through when the need becomes inescapable, and which risks not only being ineffective but also politically divisive. Alas, many leaders are still avoiding these inescapable conclusions, not facing up to the realities the *Zeitenwende* implies, including for EU financing, trying hard to command the tide to turn.