

THE LONG-TERM EU BUDGET: SIZE OR FLEXIBILITY?

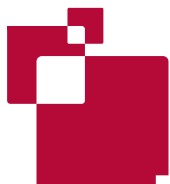
BENEDICTA MARZINOTTO

Highlights

- The EU is in the process of negotiating its 2014-20 financial framework. Failure to reach an agreement would imply a delay in the preparation of the strategic plans each member state puts together to explain how it will use Structural and Cohesion Funds. Even if solutions are found – for example annual renewals of the budget based on the previous year's figures – there will be political and institutional costs. EU leaders have too often and too forcefully advocated the use of the EU budget for growth to be able to drop the idea without consequences.
- The overwhelming attention paid to the size of the budget is misplaced. EU leaders should instead aim to make the EU budget more flexible, safeguard it from future political power struggles, and reinforce assessment of the impact of EU-funded growth policies.
- To improve flexibility a commitment device should be created that places the EU budget above continuous political disagreement. We suggest the creation of a European Growth Fund, on the basis of which the European Commission should be allowed to borrow on capital markets to anticipate pre-allocated EU expenditure, such as Structural and Cohesion Funds. Markets would thus be a factor in EU budget policymaking, with a potentially disciplining effect. Attaching conditionality to this type of disbursement appears legitimate, as capital delivered in this way is a form of assistance.

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THE LONG-TERM EU BUDGET: SIZE OR FLEXIBILITY?

BENEDICTA MARZINOTTO, NOVEMBER 2012

THE NEGOTIATIONS ON THE 2013 EUROPEAN UNION BUDGET came to a stalemate after member states failed to reach an agreement on the disbursement of unpaid bills for 2012. Negotiations on the EU budget for 2014-20 also risk collapse. In both cases the problem is a disagreement between the net contributors and the net recipients about the absolute size of the budget. While tensions over the size of the budget have a long history, this time is different because EU leaders have too often and too forcefully advocated the use of the EU budget for growth to be able to drop the idea without incurring political and institutional costs for the EU as a whole.

The Multiannual Financial Framework (MFF, 2014-20) negotiations should be finalised by December 2012 to allow time for the legislative phase from January to May 2013. Failure to reach an agreement on the 2014-20 budget implies, among the various costs, a delay in the preparation of the strategic plans each member state puts together to explain how it intends to use Structural and Cohesion Funds.

This Policy Contribution reviews the discussion about the size of the EU budget. We suggest that the discussion is plagued by ideological differences and by the failure of EU leaders to discuss what type of growth they want, when they use Structural and Cohesion Funds for investment. The battle over size is one with no future and is unlikely to solve fundamental ambiguities about the role of the EU budget. EU leaders should instead prioritise a more flexible EU budget, that is safeguarded from future political power struggles, with reinforced impact assessment of EU-funded growth policies and conditionality. To at least partly address these priorities, we suggest the creation of a flexible European Growth Fund that would allow the European Commission to borrow on capital markets to advance the disbursement of EU money typically used to finance investment (ie Structural and Cohesion Funds).

THE SIZE OF THE EU BUDGET FOR 2014-2020

The 2014-20 MFF negotiations revolve chiefly around the size of the EU budget. Three broad camps can be identified. The Friends of Better Spending coalition includes Austria, Finland, France, Germany, Italy, the Netherlands and Sweden, and argues for the explicit use of the budget for growth and competitiveness and a size that should not exceed 1 percent of EU GNI. The Friends of Cohesion coalition groups together Bulgaria, Cyprus, the Czech Republic, Estonia, Greece, Hungary, Latvia, Lithuania, Malta, Poland, Portugal, Romania, Slovenia and Spain and is generally supportive of the European Commission's MFF proposal. In a more isolated position, the United Kingdom is arguing for significant downsizing of the budget and is threatening to exercise its veto power.

The European Commission proposed a budget for 2014-20 worth roughly €1033 billion in commitment appropriations (1.08 percent of EU gross national income). Including off-budget items, the proposal reaches a figure of €1093 billion (1.14 percent of EU GNI)¹. The Commission's proposal is rather conservative and implies, in real terms, a small cut in the size of the budget down to 1.08 percent from the 1.12 percent of EU GNI of the current 2007-2013 MFF. Capping the budget at 1 percent of EU GNI implies a cut of €75 billion from the formal Commission proposal, but a much larger cut of €135 billion when accounting for all off-budget items. On 29 October 2012, the Cypriot EU Presidency tabled a draft proposal that drops close to €60 billion from the Commission proposal (after discounting for the reclassification of some budget items)². Another proposal, from European Council President Herman Van Rompuy, goes for a deeper cut in the order of about €81 billion from the comprehensive Commission draft budget³.

1. European Commission (2012a).

2. Council of the European Union (2012).

3. European Council (2012).

Differences in the proposals do not justify risking the suspension of EU spending in 2014 when the MFF is due to start. But the size of the EU budget is charged with political symbolism. Over-focusing on its size diverts attention from more important issues and some missed opportunities. First, EU leaders have been advocating the use of EU funds to spur growth and employment during the crisis; at the same time they have failed to agree on what kind of economic growth they wanted. Second, the fight about expenditure ceilings is predicated on the assumption that EU funds are ineffective or unable to generate added value, which has yet to be shown convincingly. Third, and linked to the previous issue, the EU has failed to deliver a rigorous impact assessment of EU cohesion policy, an exercise that should precede any discussion about budget size. Fourth, the obsession with size signals a fundamental disbelief in the effectiveness of the conditionality that will be attached to the disbursement of cohesion spending.

There is another reason why failure to reach a deal on the long-term EU budget, and the recent breakdown of the negotiations for the 2013 budget, are self-inflicted political and institutional costs for the EU as a whole. The deadlock undermines the so-called 'Compact for Growth and Jobs', which was designed to show the EU's commitment to supporting economic growth in the face of criticism about the excessive focus on austerity. Agreed at the European Council of 28-29 June 2012, the Growth Compact⁴ was a political commitment to quickly spend about €120 billion from unused Structural and Cohesion Funds, and from European Investment Bank (EIB) loans, especially in crisis countries⁵. Agreement by EU leaders to encourage faster absorption, swiftly followed by refusal to pay into the EU budget to allow the actual disbursement of EU funds marks the death of the Growth Compact and possibly of future pan-European initiatives for growth.

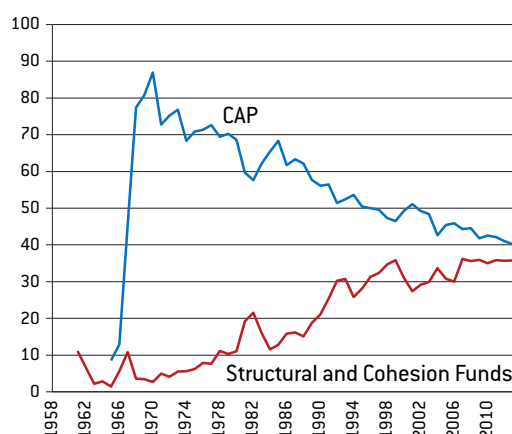
While during the crisis the EU was concerned that some member states seemed unable to absorb available EU funds, attention has now shifted to the supply side. The use of EU funds for growth, especially growth in the countries that do not have national resources to finance investment, cannot succeed unless a mechanism is put in place that allows for their rapid disbursement. In addition,

the disbursement of funds should be conditional on the presence of an appropriate institutional framework (eg respect of EU single market directives). Finally, once the funds have been disbursed, assessment of their impact should be rigorous and the withdrawal of funds could become possible if they have been used inappropriately (eg it is clear that they are not used for investment but rather for consumption).

WHAT TYPE OF GROWTH?

Tensions over the size (and the composition) of the long-term EU budget are a constituent part of any MFF negotiation. Some negotiators assume implicitly that the Common Agricultural Policy (CAP), which is to a great extent just a form of income support to the benefit of producers, represents a dead weight the EU has to carry from one period to the other because of strong political lobbying by some member states and considerable institutional inertia. This is too simplistic. First, the CAP has not been stable. The share of the EU budget devoted to supporting farmers has progressively decreased while spending on competitiveness and cohesion has grown (see Figure 1). Second, not all agree on the desirable objective of Structural and Cohesion Funds, which are supposed to be, whether rightly or wrongly, the most productive expenditures of the EU budget⁶. And yet, while the EU has long advocated the use of the EU budget for growth, it has failed to agree on what type of growth.

Figure 1: CAP versus Structural and Cohesion Funds as % of total EU budget expenditures



Source: Bruegel based on European Commission (2009, 2012b).

4. See http://www.consilium.europa.eu/uedocs/cms_sdata/docs/pressdata/en/ec/131388.pdf.

5. European Council (2012c).

6. The evidence on the growth effects of EU cohesion policy is mixed, see Marzinotto (2012); Santos (2008).

When EU leaders claim that EU funds are an instrument for growth, they may be talking about at least five different objectives; these may all be achieved at once, but some of them may also be inconsistent with one another:

- Stimulate demand during recession; this is more or less what is intended when EU leaders invoke the application of unused Structural and Cohesion funds during the crisis;
- Improve a country's growth potential through capital expenditure, but also by spending on technology and skills; this is not necessarily at odds with the idea that investment is mostly needed in periods of crisis: prolonged periods of recession impact on the growth potential of a country by forcing a significant reduction of productive investment;
- Create the conditions for growth in countries that would otherwise not grow;
- Achieve growth in the most efficient manner, which would imply investing in areas from which the return on investment is highest;
- Generate European added value by investing in projects with cross-border benefits, the costs of which must be borne by parties proportionally.

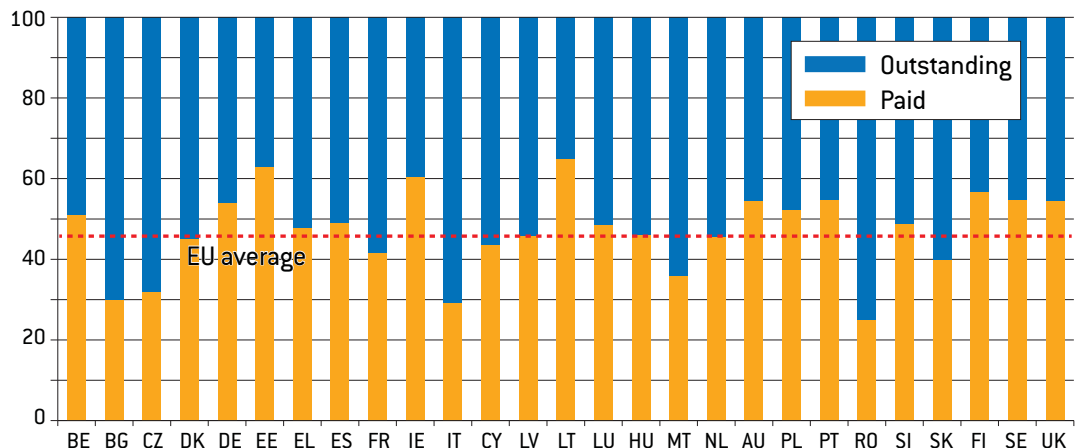
Failure to discuss what type of growth the EU needs and to recognise that some of the objectives may be inconsistent⁷ (eg generating either efficient growth or European value added may be counter to the solidarity objective of generating growth where it is most needed) probably contributes to the ambiguity of the different national positions on the role of the EU budget⁸.

BEYOND ABSORPTION

During the crisis the attention of EU leaders was focused on the slow absorption of Structural and Cohesion Funds (ie the slow pace at which they were using pre-allocated EU funds). The reasons for slow absorption typically vary, ranging from the difficulty of pulling together national funding to match EU grants, to poor management capacities and lack of viable projects. At the end of 2011, few EU countries had a record of well above-average absorption of EU funds (Estonia, Ireland, Lithuania and to a lesser extent Germany) (Figure 2). However, there are numerous EU instruments that have been conceived for the purpose of fostering absorption in the individual member states (see Box 1).

Whilst absorption may become a problem after EU funds have been pre-allocated, we are now in a situation in which the real problem is one of supply of funds, because net contributors are resistant to contribute to the EU budget. This is evident at the beginning of each MFF but tensions can also emerge over the annual EU budget, as the failed negotiations for the 2013 budget suggest. Whilst an agreement on the 2014-20 MFF must be found in the shortest possible time, the delivery of the EU budget could benefit from some reframing to prevent annual deals being blocked: the use of these funds for fostering economic growth, an objective on which all parties seem to agree, requires in fact a much greater degree of flexibility than there is at present.

Figure 2: Percentage of used EU funds as of end 2011



Source: Bruegel based on data from DG REGIO

7. An early discussion of potential inconsistencies is in Boldrin and Canova (2001).

8. An interesting proposal to combine the need to generate European value added and accommodate national preferences is provided by Santos and Neheider (2009).

Supply side constraints

The idea of employing unused Structural and Cohesion Funds to finance investment projects gained traction during the crisis. However, it is not feasible to mobilise them all in a short period, as any money given to EU beneficiaries consists of outflows from net contributors and hence an out-

right government liability. They need to be disbursed gradually until the end of each MFF, which in spending terms closes two years after the official end of the MFF. Based on the numbers for the 2007-13 MFF, gradual disbursement implies that a maximum annual amount of about €50 billion may be transferred in cash to the beneficiaries of EU funds. Anything above this figure would not be

BOX 1: AVAILABLE TOOLS TO BOOST EU FUNDS' ABSORPTION

The slow and inefficient absorption of Structural and Cohesion Funds is not new. Over the years and in particular under the Financial Perspective 2007-13, the EU has devised various instruments to facilitate absorption in the member states. Some provide mainly economic support; others technical and to some extent political support, especially in countries under financial assistance.

a. Economic support

- **Commission pre-financing:** the EU provides a pre-financing sum before each project's completion that amounts to 5 to 7.5 percent for 'old' member states and 7 to 10.5 percent for 'new' member states, depending on the type of project.
- **Co-financing rate:** the EU contribution to total project costs vary depending on the objective for which the funds have been allocated, whether for convergence or competitiveness, and on the category of recipient countries, whether 'old core' or peripheral countries. As a result, the size of the contribution from the EU can vary from a minimum of 50 percent to a maximum of 85 percent. In the crisis, the maximum co-financing rate has been increased to 95 percent to facilitate absorption and tackle the main problem of the unavailability of national resources to match EU Funds.
- **JEREMIE (Joint European Resources for Micro to Medium Enterprises):** allows the use of pre-allocated EU funds as venture capital, loans or guarantee funds to support the activities of small and medium enterprises (SMEs). It is a form of pre-financing, as the money is channelled to member states before the completion of the project, whilst allowing managing authorities to gather the resources in holding funds that can be managed by the European Investment Fund (EIF).
- **JESSICA (Joint European Support for Sustainable Investment in City Areas):** assists member states in devising alternative financing instruments to invest in underdeveloped urban areas.

b. Technical and political support

- **Technical assistance:** some EU funds are explicitly earmarked for technical assistance for an amount equal to 0.25 percent of each fund's annual provision. When the initiative is taken at the member state level, technical assistance may represent between 4 and 6 percent of the total costs of each Operational Programme, depending on the type of project.
- **JASMINE (Joint Action to Support Micro-finance Institutions in Europe):** mainly provides technical assistance to micro-credit providers (eg assessment or credit rating).
- **JASPERS (Joint Assistance to Support Projects in European Regions):** provides technical assistance to new member states in collaboration with the European Investment Bank (EIB) and the European Bank for Reconstruction and Development (EBRD); technical assistance is given free of charge following a member state's request, and is mainly directed to the preparation of large infrastructure projects.
- **Taskforce:** a Taskforce for Greece was created in the summer of 2011 with the purpose of offering support on the ground to managing authorities in the selection of the most worthy projects within existing Operational Programmes.
- **Conditionality:** a formal commitment to accelerate the absorption of Structural and Cohesion Funds is included in the macroeconomic adjustment programme of two of the euro-area countries currently under financial assistance (ie Greece and Portugal).

doable and face the opposition of the countries that are net contributors to the EU budget, namely Germany, the UK, France, Italy, the Netherlands, Sweden, Austria, Denmark and Finland⁹.

The supply-side problem has been recognised. This explains the effort to devise alternative financial engineering instruments that may be used to leverage a yearly sum greater than the €50 billion potentially available. The EIB has been identified as the ideal candidate to help expand capital supply. Three proposals have been put forward and approved by EU leaders. First, the capital base of the EIB has been increased by €10 billion to allow more capital to be raised on markets, and hence an expanded supply of loans to finance large infrastructure projects. Second, it has been suggested that EIB loans could be used to match Structural and Cohesion Funds, thus providing co-financing, which EU member states are unable to provide at times of severe budgetary constraints¹⁰. Third, the EU has launched a project bonds initiative¹¹. Project bonds are issued by private entities for investing in large (revenue-generating) infrastructure projects. The role of the EU and the EIB is only to provide credit enhancement to private issuers, under the condition that the proposed projects satisfy criteria set *ex ante* by the European Commission.

However, there has been no proposal to use the EU budget itself for the purpose of enhancing the supply of capital or, size aside, to make delivery of already agreed commitments more automatic. One obvious constraint that explains this timid approach is that the EU Treaty prohibits deficit spending, namely borrowing by the EU to finance ordinary budgetary expenses. However, a closer look at the commitments of the EU budget would suggest some degree of exposure anyway.

The EU as a borrower

The EU budget covers directly the risks associated with any financial assistance provided either to non-euro area countries through Medium-Term Financial Assistance (MTFA) or to euro-area countries through the now expired European Financial Stabilisation Mechanism (EFSM). Moreover, it covers indirectly risks associated with other forms of support.

The EFSM with a lending capacity of €60 billion was created in May 2010 to respond to the crisis, whilst the MTFA with a maximum lending capacity of €50 billion already existed. Under both programmes, the European Commission borrows money on capital markets under implicit EU budget guarantee, but only up to a total amount that should not be above the EU budget's own resources margin (ie the difference between own resources and payment appropriations)¹². The rationale for imposing this threshold is to protect the EU budget from the possibility that financial resources granted to vulnerable EU countries are not recouped.

The EU budget has also commitments, the risks of which it covers indirectly. These commitments consist of financial assistance to third countries provided under three instruments for a total amount that may not exceed €30 billion: Macro-Financial Assistance (MFA), Euratom loans and EIB loans to third countries. The current total exposure is €18 billion, of which EIB loans represent the largest and almost exclusive component¹³. In this case, the risk is not directly covered by the EU budget but by the 'Guarantee Fund for External Actions', the value of which should never be lower than 9 percent of the total outstanding debt. The Fund consists of direct payments from the EU budget and the provisioning amount is calculated and transferred a year after the loans have been granted.

A FLEXIBLE EUROPEAN GROWTH FUND

To overcome constraints on the supply of funds, create a commitment device and isolate the EU budget policymaking, we propose the creation of a European Growth Fund (EGF) within the long-term EU budget that would allow large amounts of outstanding Structural and Cohesion Funds to be transferred without delays to support economic recovery in the most vulnerable countries. The European Commission is already contracting borrowing on capital markets or with financial institutions under implicit EU budget guarantees to provide assistance to highly indebted countries. Our suggestion is that a similar model is applied to provide resources to finance growth-enhancing initiatives for an amount that should not exceed the size of the unused Structural and Cohesion

9. The problems of unpaid bills for 2012, which led to a collapse in the negotiations on the 2013 budget, show that the process may become very political almost independently of the size of due payments.

10. See also Marzinotto (2011).

11. See http://ec.europa.eu/economy_finance/financial_operations/investment/europe_2020/index_en.htm.

12. Regulation No 407/2010 of May 2010 establishing a European financial stabilisation mechanism explicitly states that "the outstanding amount of loans or credit lines to be granted to Member States... shall be limited to the margin available under the own resources ceiling for payment appropriations".

13. EIB loans to third countries represent 98 percent of the current exposure.

Funds. One obvious constraint is that the EU may not opt for deficit spending to finance ordinary budgetary expenditures, and cohesion spending is one such ordinary expense. And yet, crisis times may justify labelling growth spending as an extraordinary expenditure just like the financial assistance to high-spread countries.

How to apply? What financing structure? What safety nets?

Member states should be able to apply for the EGF in the same way that they do for financial assistance. Assistance will be granted by the Council's qualified majority. Each member state (or managing authority) may apply for funding to invest in projects with medium- to long-term impact up to a sum that cannot exceed the size of the country's unallocated Structural and Cohesion Funds. Contextually, the member state (or managing authority) can apply for technical support to the preparation of the project, whether it is a large infrastructure project of over €50 million or a smaller project, for example improved access to finance for SMEs¹⁴.

The European Commission would decide, on a case-by-case basis, to reduce the national co-financing rate by at least 10 percent¹⁵. The actual saving in national resources would amount to just 5 percent as the remainder is used to make interest payments on the fresh capital received to fund a project. The EU loan to each member state would be short-to medium-term debt with a maturity varying from one to nine years until two years after the formal end of the MFF. The capital would be paid back in instalments as the cash becomes available each year following approval of the annual EU budget until the end of the MFF plus two years.

To reduce the exposure to risk, a guarantee fund could be created based on the example of the 'Guarantee Fund for External Actions'. Net contributors would thus transfer only the amount that is necessary for building up the new Guarantee Fund. The provisioning amount for the Guarantee Fund would be calculated and transferred with the next year's EU budget. The size of the Guarantee Fund should not impose any excessive (yearly) burden on net contributors (see Figure 3).

The greatest advantage from such a plan is that it eliminates the political constraints that are at the basis of the current discussion about the 2013 EU budget. There would be less of an incentive for using annual EU budget negotiations for political objectives, as the markets are a convincing creditor.

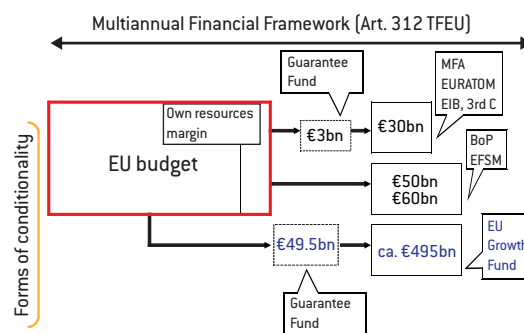
Comparison with similar instruments

The EGF would have a governance structure similar to a financial assistance package. The destination of use, however, would be comparable to project bonds. However, it would differ from both in important respects. For example, while financial assistance may become a permanent transfer from strong to weak member states if the latter are unable to repay, the EGF would be the advance payment of an already-agreed solidarity transfer from rich to poor regions, provided the money is really used for investment to contribute to the catching up of poor regions and to impede the formation of poverty traps. Moreover, while project bonds are issued by private entities and the EU provides just credit enhancement, the EGF would consist of bonds issued by the European Commission under implicit EU budget guarantee.

Seen in comparative perspective, the EGF would have a number of advantages:

- Member states would apply for the fund not only when there is a national growth problem, but even a problem limited to just one region, to which the central government is unable to

Figure 3: The governance of the European Growth Fund



Source: Bruegel. Note: it is assumed that total spending on competitiveness and cohesion stays at €495 billion as in the European Commission's proposal

14. EIB loans to third countries represent 98 percent of the current exposure.

15. Technical assistance may be provided under the already existing instruments. See Box 1.

- respond in the short-term.
- The EGF would be an instrument for investment in emergency times, while project bonds are an instrument for good times. Under uncertainty, risk aversion should rise and it may be difficult to pool together a critical mass of private bond issuers.
 - Project bonds have been conceived to finance only few large transnational infrastructure projects, raising doubts about the EU's capacity to realise proper portfolio diversification. The EGF could be used to finance any type and size of project.
 - Credit enhancement to private issuers is granted provided the proposed project satisfies a number of criteria set *ex ante* by the European Commission. Setting criteria *a priori* is problematic in itself because a project's feasibility and cost-efficiency are likely to clash with the objective of financing investment where this is most needed. The EGF would be a tool to allow disbursement of EU funds, the initial allocation of which was done bearing in mind the wealth of regions relative to the EU average.
 - The cash provisioned in the Guarantee Fund would be liquidated to the assisted member states at the end of the MFF. This alleviates the problem of excessive concentration of payments into the EU budget in the last years of the MFF.

CONCLUDING REMARKS

The EU budget could be an important source of economic growth. The rapid use of funds in periods of crisis is an essential condition for success. Various tools are already available that can support the absorption of unused EU funds, ranging from the possibility to bargain a higher EU co-financing rate to pre-financing through JEREMIE and various forms of technical assistance (Box 1). But there is also a problem on the supply side, with net contributors to the EU budget refusing to commit to EU expenditures. Failure to reach an agreement will translate into a delayed absorption of funds in the 2014-20 MFF. But it will also nullify all efforts to present the EU as an agent for growth, marking the death of the Growth Compact.

The priority is to make the EU budget more flexible, protect it from political blackmail, while reinforcing monitoring of EU-funded projects and their impact. The EU with the support of member states should collect the necessary impact assessment data and should consider withdrawing funds when EU money is not used in an appropriate fashion. This is a more worthy battle for net contributors than the battle about size.

To improve flexibility each member state should be able to apply for an early disbursement of EU funds. Our European Growth Fund would be a revamped Growth Compact providing for a mechanism to avoid delays in disbursement, whilst locking net contributors into a relationship with markets. The positive side is that all EU countries can benefit from it, euro-area and non-euro area countries, and that, in conditions of uncertainty, it would be a more realistic method than project bonds for the financing of long-term projects. It would be not a perfect, but a functional method to at least meet most of the 'possible growth objectives' we have listed. EU money is used to finance investment projects that improve a country's growth potential, yet this may have substantial demand effects if there is a large investment upfront. At the same time, this is only a different method to deliver the money and does not alter the allocation method of EU cohesion spending, which is based on the idea that countries with a lower-than-average GDP per capita need to receive proportionally more than others; in this respect it remains a solidarity instrument (ie a development policy). By contrast, as EU member states continue to consider the EU budget 'national money', whether this is paid in or paid out, and until the EU does not have own resources, projects that generate European value added and whose benefits are likely to be diffuse shall better be financed through EIB loans¹⁶.

The revamped Growth Compact would also improve the perception that some EU member states may have of the institutional and macroeconomic conditionality attached to the disbursement of EU funds. The 'assistance model' behind the EGF in fact implies that beneficiaries accept conditionality *ex ante*, which would make the European Commission's intervention legitimate.

16. On the need to exploit synergies between Structural and Cohesion Funds and EIB loans, see Marzinotto (2011).

17. European Council (2012b).

The EGF could co-exist with the idea recently floated by European Council President Van Rompuy of a risk-sharing mechanism for the euro area¹⁷. Our European Growth Fund is a budget for the effective allocation and redistribution of resources in Europe; it is a way of increasing the flexibility of permanent transfers from rich to poor regions, provided they are really used for productive investments. The risk-sharing mechanism would be stabilising when the euro area is hit by asymmetric shocks resulting in only temporary transfers from unaffected to crisis-hit

countries. Not only could the EGF and the risk-sharing mechanism co-exist, but they might even be complementary in the case of euro-area countries. Crises are typically associated with a drop not just in actual growth but also in the growth potential of a country through the investment channel. When a crisis hits, the euro-area budget may prevent too dramatic a drop in actual growth, whilst immediate EU-financed investment would prevent a country from falling onto to a different, lower-growth path.

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