A two-tier federal budget for the European Union

Andrew Duff and Luis Garicano
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Executive summary

The European Union is taking on new tasks. But unless legal and political constraints on its budget are lifted, the Union will be left with inadequate financial resources. Further enlargement, not least to Ukraine, will be improbable. The authors propose a radical restructuring of the EU budget after 2027 into a two-tier structure: a federal tier funded by true own resources to pay for European public goods, managed by an EU Treasury in the Commission; and a confederal tier financed by national contributions for domestic policies supported by the EU but implemented nationally. The national veto would be removed from EU budgetary decisions. Beyond the question of the EU budget, wider treaty change is needed for the government of the Union to become more capable and democratic. We recommend that the European Council charges an independent group of reflection with the task of preparing options for a new Convention.
Introduction

This Discussion Paper makes the case for a further revision of the founding treaties of the European Union. We make this argument despite a prevailing fear of treaty change, especially within the European Council. Inescapable events in the opening decades of the 21st Century oblige the EU to assume more tasks, taking over where Europe’s nation-states fail. The financial crash, the COVID–19 pandemic, climate change, the return of war to Europe, immigration pressures, and the unreliability of the transatlantic partnership all contribute to this trend. The need for more discernible and centralised government at the level of the Union has never been more evident.

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The Treaty of Lisbon (2007) is inadequate as a basis for the more federal government which Europe now requires. As the federalising logic of European integration prevails, the conferral of more competences on the Union and the transfer of more powers to its institutions must be reflected in formal constitutional change. There should be a shift in the balance of fiscal power, with relatively more spending at the EU level and less nationally.

We are aware of the recent proposals of the European Parliament to amend the EU treaties, and of the duty that now falls to the European Council, under Article 48(3) TEU, to decide whether to accept those proposals as a basis for calling a new Convention (the first for twenty years).

We look forward to the publication by the European Commission of a number of ‘pre-enlargement’ policy reviews in 2024, including on institutional matters, as initiated by President von der Leyen in her most recent State of the Union speech. This exercise is to be complemented by an official report from Mario Draghi on how to boost the competitiveness of the European economy. The Belgian presidency of the Council of the EU has also invited Enrico Letta to report on the future of the internal market. Von der Leyen told MEPs: “We will need to think about how our institutions would work — how the Parliament and the Commission would look. We need to discuss the future of our budget — in terms of what it finances, how it finances it, and how it is financed”.

The problem

The current state of the EU budget, substantively unreformed since 1988, attracts widespread criticism. It is too small for the job the EU has to do; it is over complicated, deeply obscure and inherently difficult to reform. The main rules are clear enough: all items of expenditure are included in the general budget and there is a mandatory balance between revenue and expenditure [Article 310 TFEU]; the annual budget is decided jointly by the Council and Parliament [Article 314 TFEU]; but the Council decides by itself and by unanimity over revenue matters (‘own resources’) [Article 311 TFEU]; and expenditure is subject to a multiannual financial framework (MFF), also decided by the Council acting unanimously but with the consent of the European Parliament [Article 312 TFEU].

Such a strict reading of the treaty provisions provides little clue as to the real character of the EU’s finances. For one thing, many large items of EU expenditure, such as the European Development Fund or the Peace Facility, are not included in the EU’s official budget. And in their obsessive homage to Margaret Thatcher’s insistence on juste retour — “getting our money back” — the states, amid much bickering, have littered the EU’s budgetary system with rebates, abatements, supplements and derogations. Neither the full costs of the Union’s borrowing and lending operations nor some external assigned revenues — such as fees collected from the EU’s associate states — are properly reflected in its annual budget. The Court of Auditors has not been backward in pointing out these anomalies.

The official annual EU budget for 2024 amounts to €190 billion, or 1% of EU GNI. This is co-financed by the EU’s direct revenue sources plus indirect contributions from national treasuries based on gross national income (GNI) — the latter comprising some 75% of the total revenue. A small portion of state VAT receipts supplements the GNI contributions. The EU’s direct revenue comes from customs duties, levies and penalties.

For a moment, during the worst of the pandemic crisis, the EU appeared on the verge of creating a solid construction out of the highly imperfect set of budgetary and crisis-response tools that had piled on top of each other over the previous decades. Several elements
were in place: a recovery plan, geared towards future investment for all 27 member states, backed by the EU budget, disbursed as grants and not just loans.

But at that stage, one crucial element went missing: a mechanism to pay back the debt. The European Parliament had insisted during the approval process of the new COVID-19 funds, known as NextGenerationEU, that no new MFF would be agreed without a legally binding interinstitutional agreement, including a calendar for the implementation of new own resources. Initially, in December 2020, such a legally binding roadmap was agreed between the Commission, Council and Parliament. The agreement called for a basket of own resources formed of a plastic-based contribution (2021); a package comprising a Digital Tax, a Carbon Border Adjustment Mechanism (CBAM) and the Emission Trading Scheme (ETS) (2023); a financial transactions tax (2024); and the new OECD tax on residual profits of large multinationals (2027).

Of this package, however, only the levy on non-recyclable plastic waste has been introduced, which now amounts to some 4% of total revenue. The Commission has made proposals for a basket of additional new revenue comprising 30% sliced off the takings from the existing EU ETS, 75% of the CBAM revenues collected by member states, and a temporary 'statistical' own resource based on 0.5% of the notional EU company profit. The European Parliament has approved a version of this proposal. But the lack of necessary unanimity in the Council is obstructing further progress. An earlier proposal to introduce an EU financial transaction tax had already been blocked by the Council.

It is hard to overestimate how essential new own resources are. Instead of strengthening the Union, taking on a new debt instrument and new expenditure commitments without new revenue will handicap its future. But unanimous agreement on such a reformed, comprehensive, and larger EU budget seems far out of reach. That is why suppressing the national veto is indispensable in budgetary matters.

Faulty decision making

The methodology for EU decision making in the financial and budgetary fields defies logic. The rule of rigid unanimity in Articles 311 and 312 TFEU puts national parliaments and not the European Parliament in the driving seat. However, few if any national parliaments have the general interest of the European Union at the centre of their preoccupations. Rather, the governments and parliaments of the net recipients from the EU budget want to maximise their receipts, while the governments and parliaments of the net contributors to the EU budget seek to minimise their contributions.

Although there should be decisions at the next Convention about shifting from unanimity to qualified majority voting (QMV) in the Council, this will not be popular among national parliaments jealous about any diminution of their powers. The European Parliament and the Commission are hoping that the general passerelle or bridging clause can be deployed to shift decision making in the Council from unanimity to QMV or to convert a special law of the Council into the ordinary legislative procedure [Article 48(7) TEU]. But as that passerelle itself can only be triggered by unanimity in the European Council — under the threat of a unilateral veto by any one national parliament — the device is effectively dysfunctional.

In its latest reform package, the European Parliament rightly proposes a treaty amendment to activate the passerelle by QMV. But even so, applying QMV to Articles 311 and 312 TFEU would need the suppression of another clause, Article 353 TFEU, that was introduced by the British in the negotiations over the Lisbon treaty, and which expressly precludes the deployment of the passerelle in the financial area. While progressive Members of the European Parliament want to abolish this prohibition, there is no overall majority in the House to do so. This leaves the Parliament in the extraordinary position of being an oddball democratic assembly that has declined to assert classic parliamentary rights over the raising of government revenue.

The eurozone needs a treasury

Just as current EU rules no longer give a faithful impression of the budget, the rules around the Economic and Monetary Union (EMU), dating as far back as the Treaty of Maastricht in 1992, are antiquated. What began as a more or less technical exercise in convergence around a single monetary policy, has become an elaborate continual operation to monitor national economic policies and, where necessary, to adjust national policy choices. The banking turmoil after 2007 and the sovereign debt crisis of 2012 have led the EU institutions into a perennial process of centralising regulation.
The 20 member states that have adopted the euro as their single currency are now subject to a degree of risk sharing under EU supervision that is neither prescribed by the treaty nor adequate to ensure eurozone stability. Although the Commission attempts to coordinate the policies of the eurozone states according to economic guidelines agreed by the Council [Article 136(1) TFEU], it is not competent to promote a common fiscal policy of the Union. The Commission is not an EU Treasury — and in any case it has no store of treasure.

**The European Central Bank is the only institution able and willing to fill the gaps created by the treaties.**

The European Central Bank is the only institution able and willing to fill the gaps created by the treaties. It has gradually increased its surveillance and supervision of Europe’s financial system, as well as the financial support it provides to EU governments and banks under the guise of monetary policy. But such actions are lacking in democratic legitimacy, have been challenged in the courts, and provide a poor substitute for a central, democratic treasury.7

Proposals to deepen the integration of capital markets, long in gestation, are stalled. So is the plan to complete the Banking Union with a European Deposit Insurance Scheme: in June 2022, the Eurogroup officially abandoned the effort to build such a scheme. Hence, of the three pillars of Banking Union only one, the Single Supervisor, is complete. The planned Single Resolution Mechanism and Single Resolution Fund do exist, but they are unused in practice — like a Rolls-Royce permanently parked in the garage. With the single exception of the resolution of Banco Popular in Spain, every other banking failure has been dealt with in the traditional way by national regulators, showering the failing bank with taxpayers’ money. And even the Single Supervisor is not working as intended, as national regulators insist on multinational banks keeping enough liquidity and capital in each country, thereby negating the largest gain from cross-border mergers and creating permanent so-called ‘home-host’ conflicts. In sum, neither the Capital Market Union nor the Banking Union is advancing under the rigid rule of unanimity. Political tension between the poorer and richer states of the eurozone is palpable. EMU totters on, awaiting the next crisis, in hock to a common monetary policy unaided by a common fiscal policy.

**Increasing fiscal capacity**

Reacting to internal financial crises and external shocks of recent years, the EU has increased the power of the Commission to borrow money for specific purposes on behalf of the member states, raising the ceiling of own resources to permit it to do so. In 2020, the post-pandemic NextGenEU programme launched the Recovery and Resilience Facility (RRF) of €724 billion. Social bonds to the tune of €100 billion to mitigate unemployment risks in emergency (SURE) have also been issued, guaranteed by the eurozone states. But these flotations are not federal eurobonds issued jointly and severally by the Union, and they are temporary only. That these EU bonds are subject to national and not supranational financing explains their underperformance in the global financial markets.8 Any serious constitutional reform of the Union requires the installation of a permanent fiscal capacity supplied by sovereign eurobonds, along with requisite reforms of the institutions.

Although the pooling of national debt is prohibited by the ‘no bail out’ treaty clause [Article 125 TFEU], there is provision for the transfer of funds between eurozone member states in an emergency [Article 122 TFEU] — an ‘emergency’ facility that has been used fifteen times in the last few years. In the only change made to the Treaty of Lisbon since it entered into force in 2009, a European Stability Mechanism (ESM) has been added to the instruments at the disposal of the eurozone “to safeguard the stability of the euro area as a whole” [Article 136(3) TFEU]. The ESM was set up in 2013 as an intergovernmental body, operating by unanimity, effectively subject to a German veto. A reform to allow the ESM to lend money to the EU’s Single Resolution Fund for failing banks is blocked by Italy, which prefers to keep relying on the (unconditional) largesse of the ECB.

How are RRF bondholders — to the tune of €807 billion at current prices — to be paid for thirty years if not from the EU budget?

An important new element of the EU level borrowing made permissible after the financial crash and COVID-19 pandemic is that the disbursement of funds takes the forms of grants as well as loans.9 As we have seen, the sums involved are not insubstantial. How are RRF bondholders — to the tune of €807 billion at current prices — to be paid for thirty years if not from the EU budget? The 2021-27 MFF is now being revised upwards,
in the teeth of Hungary’s opposition, to include another €50 billion for Ukraine, plus increased spending on asylum, immigration and refugees of €9.6 billion, as well as an extra €1.5 billion on strategic defence technologies. The total MFF plus NextGenEU amounts to €2.02 trillion.

Fiscal federalism

What principles should guide the federalisation of the Union’s finances? First, each level of the multilevel government should enjoy an autonomous fiscal capacity sufficient to meet its own obligations, thereby adhering to the EU’s general principle of sincere cooperation among the institutions and between the institutions and the states [Article 13(2) TEU].

Second, the division of responsibilities between the different levels of government must respect the principle of subsidiarity whereby actions, by reason of their scale or effects, must be taken at their most efficacious level [Article 5(3) TEU]. Rigorous application of the principles of subsidiarity and proportionality through the EU’s existing institutions, including national parliaments, should militate against over-centralisation [Protocols 1 & 2]. In any case, competences not conferred on the Union remain with the member states [Article 4(1) TEU].

Third, so long as the states conform to commonly agreed rules of fiscal discipline, the EU should desist from excessive interference in the tax and spend policies of the member states. Conversely, member states which are not in compliance with agreed deficit rules should not be allowed to receive funding from the revised EU budget. Discipline would be reinforced if new investment measures at the EU level, such as a European Climate Investment Facility, were tied to compliance with both fiscal and political goals. An independent European Fiscal Agency should be established to inform objective decisions about the disbursement of grants and loans and to assist the Commission in its oversight role under Article 126 TFEU.

As a rule of thumb, federal taxes should aim to be broadly based and levied at a low rate. Their purpose needs to be clearly articulated and democratically legitimated. A federal budget requires the conferral on the Commission of the power to collect taxes. As we have already noted, modification of the system of own resources, including the involvement of the European Parliament in codecision, is necessary [Article 311 TFEU]. That reform should be accompanied by a widening of scope in the single market provisions with respect to the harmonisation of national tax law, accompanied by a shift from unanimity to QMV [Article 114 TFEU].

The main task of the EU Treasury would be to raise funds for investment in European public goods.

A capacity to act as a fully legitimate federal treasury should lessen the temptation of the Commission and Council to interfere in fiscal matters at the national level as long as budgetary discipline is maintained. The main task of the EU Treasury would be to raise funds for investment in European public goods. Bonds issued by an EU Treasury Secretary and guaranteed by the federal budget would surely enjoy AAA rating. As Mario Draghi argues, “federal borrowing and spending would lead to greater efficiency and more fiscal space, as aggregate borrowing costs would be lower”.

A two-tier budget

To clarify lines of accountability, we propose that in the next MFF from 2027, the EU budget should be restructured formally into two parts. A top federal tranche should be devoted to the delivery of European public goods and paid for by genuine own resources raised through an EU Treasury located in the Commission. The lower, confederal part of the budget should continue to be supplied by national GNI contributions to support those domestic policies implemented nationally by central, regional or local governments. This includes the costly Common Agricultural Policy and other EU structural funds where the principle of additionality is problematic to apply in practice.

The new EU level budget needs to be both large and flexible enough to cope with any current and future task that falls logically to the supranational authority. The operations of the EU Treasury would include equalisation between member states and regions in
times of asymmetric financial crisis through existing mechanisms of the Cohesion Fund or the ESM (brought within the purview of EU law and run by the Treasury).

Size matters. Even with the NextGenEU initiative, the EU budget is still small in federal terms, being just 2% of total public expenditure across the 27 member states, or 1% of EU GNI. As the renegotiation of the MFF after 2027 is already in sight, there must be wider and urgent understanding of the quantitative leap now required of the EU budget. Paying for NextGenEU and Ukraine’s recovery are inevitable calls on the budget. So should be the inclusion in the MFF of the Single Resolution Fund and the ESM.14 Under the reforms proposed here, the brunt of future increases in the size of the budget would come from genuine own resources and not the GNI contributions. As the Union Treasury spends more, its national finance ministries will be able to spend less.

In 1977 the seminal MacDougall Report for the Commission recommended that provision should be made for the gradual growth of the ‘pre-federal’ budget to a maximum 7% of European Community GDP. Today, a similar evidence-based enquiry would seem to be a necessary préalable to budgetary reform.15 A new MacDougall should advise not only on the overall size of the future budget but also on the division between the upper and lower levels of the budget.

European public goods

The definition of European public goods requires careful calibration.16 They should be inclusive, useful for all member states and every EU citizen. Their European relevance should add value, attaining economies of scale possible only at the pan-European level. They should be consensual and consistent with EU political objectives. They would be stable, long-term policies as befits the purpose of a permanent fiscal capacity belonging to the Union. They can be expected to have international relevance, reflecting the EU’s assertion of sovereign autonomy.

Examples of European public goods and services are not difficult to find. In any case, the federal tranche of the budget should support the administrative costs of the EU institutions (about 6% of the current budget). EU level public investment in making the green transition and in digitalisation are obvious candidates. Much needed cross-border infrastructure in energy supply should be an early priority. Sustained support for science research and technology development, for example through an expanded Horizon programme, would find their place. So would whatever investment is needed to bolster the Union’s security and defence against Russian threats, international organised crime and terrorism. EU border management requires more resources as immigration pressures grow. The common procurement of vaccines became suddenly salient in the pandemic.

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Constitutional change

The reform of the budget we advocate here has two overwhelming political advantages. It will save national treasuries money. And it will directly connect the EU citizen taxpayer with the EU government in Brussels. That stronger affinity should transform European election campaigns, reinforcing the accountability of MEPs to their electorate, and strengthening the European Parliament’s scrutiny of the Commission. The installation of a Treasury Secretary, perhaps as Vice-President of the Commission, would certainly catalyse further internal reform of the college.

Demarcating between the more federal and more national parts of the budget would not end the essential intergovernmental negotiation that precedes the birth of every new Multiannual Financial Framework. But the emergence of the Commission in a leadership role coupled with the elevation of the codecision powers of the European Parliament should ease the path to agreement. It will also bring uniformity and consistency to the legislative processes whose current differences complicate the marriage of the three elements: own resources [Article 311 TFEU], MFF [Article 312 TFEU] and financial regulation [Article 322 TFEU].

We recall that the first step towards the federalisation of the EU budget requires the democratisation of the process. Here’s a suggestion for the amendment of the third paragraph in Article 311 TFEU:

“The European Parliament and the Council, acting in accordance with a special legislative procedure,
shall adopt a decision laying down the provisions relating to the system of own resources of the Union. In this context they may establish new categories of own resources or abolish an existing category. That decision shall not enter into force until it is approved by four fifths of the States in accordance with their respective constitutional requirements.

The European Parliament and the Council, acting by means of regulations in accordance with the ordinary legislative procedure, shall lay down implementing measures for the Union’s own resources system.”

And the second paragraph of Article 312 TFEU could read:

“2. The European Parliament and the Council shall adopt a regulation laying down the multiannual financial framework. The Council shall act by qualified majority in accordance with Article 238(3)(b). The Parliament shall act by a majority of its component members.”

In Article 312(1) TFEU an adjustment is needed to stipulate that each MFF shall last five years and no longer (unlike the current practice of seven years). This will allow the MFF to be revised within each term of the Commission and Parliament — both expedient and democratic.

If these changes seem too radical for the Convention, the very least that must be done is the suppression of Article 353 TFEU to allow the passerelle to apply to the budgetary system as and when political will for integration is revived.

While making the basic shift from unanimity to QMV in the budgetary field is relatively straightforward, turning the Maastricht EMU into a fully-fledged fiscal union — involving revision of Articles 123 and 125 TFEU — requires deeper reflection. Codifying in terms of primary law what has already become established practice would be a useful start, but a comprehensive reassessment of the EU toolkit is necessary before it assumes responsibility for supranational investment, macroeconomic stabilisation and common fiscal policy. The Commission’s potential role as EU Treasury in international financial affairs also merits review.

Conclusion

At present, as we know, the government in Hungary seems determined to lead opposition to any treaty reform in the federal direction. Other states can hide behind Viktor Orban’s threatened veto. Moreover, certain rich and eurosceptic states — notably, Austria, Denmark, the Netherlands and Sweden — seem particularly unwilling to relax the national grip over EU finances. Those who retain a federal vision of the future of Europe need to become much more persuasive. After all, although the decision to open a Convention can be taken by a simple majority, a revised treaty can only be concluded by unanimity [Article 48(4) TEU]. The treaty exercise must be very well prepared, therefore, and be focussed on modernising the constitutional framework of the Union so that future federal steps can be taken smoothly once the political will to deepen integration has strengthened.

The EU institutions under new leadership at the end of 2024 should be able to inject fresh momentum into the deepening of the internal market and its concomitant budget reform. Greater recourse to the enhanced cooperation provisions of the treaty, for instance to complete the Capital Market Union, would allow the more integrationist member states to lead by example [Article 20 TEU]. Ideally, however, all member states should be persuaded to move forward together. If ultimately that proves not to be possible, the government of the Union will have to be restructured to manage an inner federal core group of states and an outer, confederal tier. That would add another layer of complexity to the already challenging demands of treaty change.

It may be prudent, therefore, for the European Council to couple its decision in principle to open a Convention with the establishment of an independent expert group to prepare options for treaty amendment. There are useful precedents in EU history where a groupe des sages has examined complex problems and found ways and means to unblock institutional stagnation. A Group of Reflection appointed by the European Council, made up of independent experts who do not represent the vested interests of the institutions, should be asked to take a holistic view of the constitutional evolution of the Union, and make suggestions for improvement to its governance by way of modification of the treaties. Such a Group could report back to the heads of government, in the European Council’s new formation, early in 2025.

It may be prudent for the European Council to couple its decision in principle to open a Convention with the establishment of an independent expert group to prepare options for treaty amendment.
The recent fraught mid-term revision of the MFF — still to be endorsed by the European Parliament under Article 312(2) — should remind us of the essential fragility of the Union’s budgetary foundations. Instead of tinkering on the margins to conjure up something sub-optimal that is the only thing that can be agreed, would it not be better to ask what we really want to do as a European Union, and how it should then be paid for? Such a back-to-basics approach may result in the startling conclusion that the EU is now sufficiently mature as a polity to require the federalisation of its budget and the acquisition of a proper common fiscal policy. Many onlookers see the need for radical reform of the Union: only those embroiled in the institutional circus of Brussels seem incapable of such detachment. The financial markets, for their part, would surely be reassured were the EU to affirm its commitment to fiscal integration by tackling EU treaty change. And in this election year of 2024, many voters in every member state will be looking for a clear sense of leadership at the European level which might elude them nationally.

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Voters should be told, in no uncertain terms, by mainstream European voices that, if no constitutional change is soon agreed, the future of the European Union will be hobbled by a lack of financial resources, a weak currency, a limited capacity to act effectively, latent disunity and a stuttering democracy.
For a fuller discussion, see Andrew Duff, *Constitutional Change in the European Union: Towards a Federal Europe*, Palgrave Macmillan, 2022 (Open Access).


State of the Union, 13 September 2023.


Article 353 also proscribes QMV for the ‘flexibility clause’ (Article 352) concerning EU inferred powers and for a softening of the unanimity requirements in Article 7 TEU concerning a breach of the rule of law.


See Giovanni Bonfanti & Luis Garicano, *Do financial markets consider European common debt a safe asset?*, Bruegel Blog post, 8 December 2022.

The European Investment Bank has borrowed money to issue loans to member states for many years.

European Council Conclusions, 1 February 2024. As part of the deal, €10.6 billion is cut from other spending commitments, including €2.1 bn from Horizon Europe.

Luis Garicano, *Combining environmental and fiscal sustainability: A new climate facility, an expenditure rule, and an independent fiscal agency*, VoxEU, CEPR, 14 January 2022.

Mario Draghi on the path to fiscal union in the euro zone, Europe’s economic challenges, The Economist, 6 September 2023.

Under the principle of additionality, EU funds should not be used merely as a substitute for national spending but only as a value-added supplement to it.


Report of the Study Group on the Role of Public Finance in European Integration.


In other words, super QMV, defined as 72% of the states representing 65% of the population.

The Tindemans Report (1975) being perhaps the most notable.
The European Policy Centre is an independent, not-for-profit think tank dedicated to fostering European integration through analysis and debate, supporting and challenging European decision-makers at all levels to make informed decisions based on sound evidence and analysis, and providing a platform for engaging partners, stakeholders and citizens in EU policymaking and in the debate about the future of Europe.

The European Politics and Institutions programme covers the EU’s institutional architecture, governance and policymaking to ensure that it can move forward and respond to the challenges of the 21st century democratically and effectively. It also monitors and analyses political developments at the EU level and in the member states, discussing the key questions of how to involve European citizens in the discussions over the Union’s future and how to win their support for European integration. The programme has a special focus on enlargement policy towards the Western Balkans, questions of EU institutional reform and illiberal trends in European democracies.