Aktuelle politische
Debattenbeiträge

IW-Policy Paper 10/2018

On the Future of the European Union

Normative derivation and restructuring potential in the new Multiannual Financial Framework

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Köln, 30 May 2018

Contents

JEL-Classifikation:
H61 – Budget, budget systems
O52 – Europe
H41 – Public goods

Summary

The debate concerning the future of the EU has been in full swing ever since Emmanuel Macron's (2017) Sorbonne speech. New threats to internal and external security in Europe require a stronger EU. In addition, Brexit is ripping a hole in the EU finances. This pressure for reform must be used to establish new priorities in the EU budget when discussions are held about the next Multiannual Financial Framework (MFF) 2021–2027. The European Commission has put forward different options for consideration as part of the discussion process, and this study is based on them. It takes the form of a normative review of EU tasks, which has two evaluation criteria:

- Firstly, there will be a discussion concerning which political areas should be the responsibility of the EU, and which of the member states. Cross-border spillover effects, economies of scale, preference differences and the subsidiarity principle, all have an important role to play when assessing EU added value on the basis of existing criteria and studies.

- Secondly, various policy fields will be examined to establish whether, and to what extent, they meet Musgrave's three criteria of public finance policy: allocation/growth, distribution/structural change cushioning, macro-economic stabilisation.

As a result, the following recommendations are derived:

- In the area of **security** – especially in defence policy, external border security, and the fight against terrorism – the EU should have a clear responsibility, because security is a European public good from an allocative view. Here the EU budget clearly needs more resources.

- Although it is true that in the areas of **research, education, infrastructure and digitalisation,** targeted state funds can fundamentally promote the potential for growth, this is primarily the task of the member states. Yet if sufficient cross-border spillovers can be identified, an EU responsibility is justified. The funds for these future-oriented tasks should be increased in the EU budget if they are of cross-border relevance.

- With regard to agricultural and cohesion policy the assessment is mostly critical. In relation to **agriculture subsidies,** an EU responsibility can hardly be derived and they cannot be sufficiently justified against the Musgrave criteria either. Neither is there any valid justification for the EU to be responsible for **cohesion policy in prosperous member states.**

As a result, the highly expensive agricultural and cohesion policy should be de-prioritised. Big levers can be made available by means of a reallocation of EU funds. In fact, with savings of around 2 per cent in current agricultural and cohesion spending, the Erasmus+ programme could be doubled or, alternatively, expenditure for cross-border infrastructure could be increased by half or the additional defence expenditure proposed by the European Commission could be funded. To be able to fund all the tasks that are identified here as priorities, a reduction of agriculture and cohesion expenditure of around 10 per cent in the new MFF would suffice, assuming a nominal growth of a good 28 per cent within seven years.

1 Introduction

The future of the European Union (EU) is currently subject to great debate. This is happening against the backdrop of the new challenges and tasks facing the EU. These include Brexit, the refugee crisis, repeated terrorist attacks, an erosion of democratic structures in some of the EU member states, the less Europe-friendly policies of the Trump administration in the USA, as well as the more aggressive behaviour of Russia, China and Turkey, which are increasingly making an impact on political processes across the EU (such as in the Balkans). In the face of these challenges, the EU has to show its ability to act and establish new priorities. It is necessary to make convincing arguments for strengthening the EU through targeted reforms. In addition, politicians must have the courage to tackle existing problems and inefficiencies in the EU.

First, we will provide a short overview of several options proposed by the European Commission for the reorientation of the EU budget from 2021 (Chapter 2). In the main Chapter (Chapter 3) we will undertake a normative review of EU tasks with the aim of identifying priorities. In Chapter 4 we will explain how focussing on priority EU tasks that create real added value, can be easily implemented in the EU budget by making savings in the agricultural and cohesion policy without raising the budget ceiling.

2 The new MFF from 2021 to 2027

The future direction of the EU and the prioritisation of EU tasks are closely linked to the debate about the new MFF. The European Commission has already presented some options and proposals for the upcoming discussion (Oettinger, 2018; European Commission, 2018a). The future MFF is coming under pressure from two sides (Oettinger, 2018). On the revenue side, there is a problem caused by the United Kingdom's (UK) exit from the EU and the loss of the UK's net contribution. There are different figures to estimate the financial exact effect. We rely on Darvas/Wolff (2018), according to which the gap left by Brexit is estimated at 73 billion euros during the seven-year term of the MFF. Additional spending is necessary, not least because as a result of the Bratislava Roadmap, the EU is faced with new tasks in order to strengthen external and internal security (European Council, 2016). In view of these pressures, the European Commission intends to increase the EU budget to 1,11 per cent of gross national income (GNI) in the next MFF compared to about 1 per cent of GNI currently.

In addition, the European Commission proposes discussions on new taxes to fund the EU budget. This links to suggestions put forward by the high-level group on own resources (HLGOR, 2016). The EU Commission mentions, for example, income from a plastic tax on disposable plastic products, from a 20 per cent share of the revenues from the EU emissions trading scheme, a tax on the common consolidated corporate tax base, the seigniorage of the European Central Bank, as well as income from a simplified value added tax.

However, there are different reasons for opposing this:

- There is considerable political opposition gathering against an increase of the EU budget. It is true that the new German government indicates that it is prepared in principle to increase its EU contributions. France has also agreed to something similar. However, other countries such as the Netherlands, Austria, Sweden, Denmark and Finland have stated that they are not prepared to do so; some are even demanding that the EU budget should be reduced, given that the EU will now be smaller due to Brexit (Handelsblatt.de, 2018).

- There must be a push for reform. A useful pressure to implement some ground breaking reforms results from Brexit and the establishment of the Bratislava Roadmap. In view of the dubious European added value of the Common Agriculture Policy and the cohesion policy directed at all member states, there is considerable scope for clearer priorities and more efficiency in the European budget (Chapter 4.2).

- Before discussing an increase in the EU budget, all existing expenditures first need to be scrutinised and possibilities for restructuring and shifting spending between categories in the EU budget need to be examined. Hence, in Chapter 3 the authors undertake a task review in order to establish priorities for future EU tasks and expenditures.

Table 2-1 provides an overview of the amounts to be funded in the EU budget, whether it be for the loss of contributions as a result of Brexit, or for additional priority expenditure. It is based on a communication that the European Commission published on 14 February 2018 (European Commission, 2018a). In the paper, the Commission presents for selected expenditure categories the current situation and shows different options for their possible increase. The information in Table 2-1 is more or less self-explanatory. A more detailed explanation can be found in the aforementioned communication and in the task review in Chapter 3. However, a brief explanation is necessary with regard to the following aspects:

- Under the heading European Defence Union, various smaller elements are included: 3.5 billion euros for research on defence, 7 billion euros for the co-financing of defence industrial development, as well as additional expenditure of 6.5 billion euros to financially support operations with defence implications (European Commission, 2018a).

- In the expenditure category Economic and Monetary Union (EMU) – more fiscal integration, the European Commission has suggested around 25 billion euros as a ballpark figure for budget lines in the EU, which are intended to promote structural reforms in euro area countries and for the convergence of non-Euro States. An estimated sum for a further possible stabilisation function is not provided in the communication, but neither is it identified as a priority in the normative task review of Chapter 3.

- The authors of this paper have proposed two further options for increasing the spending on cross-border infrastructure in addition to those suggested by the European Commission. Starting from a volume of the Connecting Europe facility of around 30 billion euros (European Commission, 2018b) a 50 per cent and a 100 per cent increase are put up for discussion (as with the category research and development).

In some expenditure categories, two options are put forward. In this way, a medium-scale and a large-scale option can be identified. In the medium-scale version, the smaller option is chosen in each case (indicated with (1)). Then the sum of these categories is generated and added to the sum of the expenditure types without option. Accordingly, in the medium-scale version there is an additional funding need of 240.7 billion euros overall. When the large-scale option is chosen in each case, using the same procedure, the funding needs amount to an additional 480.7 billion euros.

Table 2-1: Funding requirements for the Brexit funding gap and additional expenditure for priority tasks

	MFF 2014–2020	Menu options of the European Commission	
	Figures in billions of euros		
		Target need	Increase need
Funding gap caused by Brexit		73	73
European Defence	0.6	17	16.4
External border control (1): medium-scale solution	4	25	21
External border control (2): large-scale solution	4	150	146
Erasmus+ (1): medium-scale solution	14.7	30	15.3
Erasmus+ (2): large-scale solution	14.7	90	75.3
Investment in digitisation – Doubling of expenditure	35	70	35
Research and Development (1): +50%	80	120	40
Research and Development (2): +100%	80	160	80
Infrastructure (1) – Connecting Europe Facility: +50%	30	45	15
Infrastructure (2) – Connecting Europe Facility: +100%	30	60	30
EMU: Budget line for reform assistance and convergence	0	25	25

Numbers pertain to the seven-year time period of the MFR.

Sources: Darvas/Wolff, 2018; European Commission, 2018a; German Economic Institute

3 Normative evaluation of EU tasks and new priorities

A normative task review and prioritisation can be undertaken with regard to two objectives: the allocation of tasks between the EU and the member states, and the public finance policy function of expenditure for the goal dimensions allocation, distribution and stabilisation (according to Musgrave, 1966).

3.1 Goal dimension 1: Task assignment between EU and member states

The normative question of the distribution of responsibilities between the EU and its member states should focus on the question of which level is best suited to provide public goods for the inhabitants of these entities. A number of authors have already expressed their opinion about the task allocation between the EU and the member states on the basis of the following normative economic requirements (e.g. Alesina et al., 2005; Heinemann, 2005; SVR, 2016; Weiss et al., 2017; König, 2018).

The following factors are relevant when considering the normative reasons for task allocation:

- **Cross-border external effects or spillovers** can justify a central policy at EU level, because in this way they can be (better) internalised (e.g. in climate protection). The creation of public goods and the restriction of free-riding behaviour can also be justified in this way. In contrast to private goods, public goods are characterised by non-rivalry in consumption (Sohmen, 1976, 286). Furthermore, no one can be excluded from using them.

- In the same way, **economies of scale** can also justify centralisation at EU level, if economies of scale, cost savings and increases in efficiency can be achieved to a significant degree.

- However, **strong preference heterogeneities** (e.g. for public goods) can work against a harmonisation at EU level, or a central delivery of public goods.

- Moreover, the **principle of subsidiarity** needs to be taken into account. It states that “in areas which do not fall within its exclusive competence, the Union should act only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the member states, either at central level or at regional and local level, but can rather, by reason of the scale or effects of the proposed action, be better achieved at Union level”. At the same time, European added value is also addressed.

3.2 Goal dimension 2: Functions of public finance policy according to Musgrave

Alongside the task allocation between member states and the EU, a second goal dimension will be introduced here. When asking about the fundamental economic meaningfulness of expenditure categories, three different aims of budget policy are usually distinguished: allocation, distribution and stabilisation. These terms are used in public finance, based on the work of Musgrave (1966), and which in part can be supplemented by related goal dimensions, are used as a basis for evaluation:

- Firstly, public finance policy is applied to improve the **allocation of production factors.** The funding of public goods also belongs inherently to this category, because public goods cannot be delivered by the private sector, since there is not sufficient willingness to pay on behalf of the users, because although everyone profits from them, no one can be excluded from using them. In addition, from an allocative perspective, we also examine the extent to which public expenditure serves to promote an increase in productivity and economic growth.
- Secondly, with regard to the **distribution aim** of the budget policy, the issue is about correcting the distribution of income that has been produced by the market process, for reasons of social policy, on the grounds of fairness or other political considerations. In addition, we include in this category the ability of public spending to smooth the adjustment process caused by structural change.
- Thirdly, the **stabilising function:** Public finances policy also has the task to be anti-cyclical, that is to reduce the economic and social effects of slumps in economic activity, and ideally of smoothing out economic fluctuations both downwards and upwards.

3.3 Combination of both goal dimensions

3.3.1 Overview

In this chapter, the two goal dimensions are brought together so that a broadly based review of tasks can be undertaken. The normative distribution of tasks according to the first goal dimension is informed by the relevant studies already mentioned above (including Alesina et al., 2005; Heinemann, 2005; SVR, 2016; Weiss et al., 2017; König, 2018). The main focus of the evaluation is on the second additionally introduced goal dimension, the Musgrave functions for the justification of public finance policy. Table 3-1 provides an overview of the results of this normative evaluation of the expenditure categories, which will be discussed below.

The colours in the columns of the Musgrave categorisation indicate how closely the individual policy areas align with these goals. The key to the coloured gradation is as follows: dark green signifies fully achieved, light green signifies partially achieved and yellow signifies a mixed and partly critical evaluation.

Table 3-1: Overview of normative evaluation of EU tasks

	Task Assignment	Musgrave-Functions of Public Finance Policy		
		Allocation / Economic Growth	Distribution / Support of adjustment to structural change	Macroeconomic stabilisation
Defence and Security Policy (e.g. PESCO)	EU			
Control of EU external borders	EU			
Justice and Home Affairs (general)	MS			
Justice and Home Affairs (cross border, e.g. preventing terrorism)	EU			
Research and Development (general)	Mainly MS			
Research and Development (cross border, e.g. Horizon 2020)	EU			
Education (general)	MS			
Education (cross border, e.g. Erasmus+)	EU			
Infrastructure (general)	MS			
Infrastructure (Connecting Europe Facility)	EU			
Investment in digitisation (e.g. national broadband network)	Mainly MS			
Digitization (cross border investments, EU regulatory framework/harmonisation)	EU			
Cohesion Policy (for underdeveloped EU regions)	EU			
Cohesion / Regional Policy in highly developed EU countries	Mainly MS			
Agricultural Subsidies	MS			

EMU: Central macroeconomic stabilisation function	Mainly MS			
Single Market (four freedoms and Competition Policy)	EU			
Trade Policy	EU			
Environmental and Climate Policy	Mainly EU			
Social Policy (Labour Market Policy) (general)	MS			
Social Policy (Labour Market Policy) (free movement of persons, Benchmarking)	EU			
Tax Policy (general)	MS			
Tax Policy (cross border, combating aggressive tax planning internationally)	Mainly EU			

MS: member state.

Colouring of Musgrave-function of public finance policy: dark green: function fully achieved; light green: partially achieved; yellow: mixed and partially critical evaluation; for further explanation see Chapter 3.3.2.
Reading aid 1: Regarding defence and security policy an EU-wide public good is provided so that the colouring is dark green in the field “Allocation / Economic Growth”.
Reading aid 2: Agricultural subsidies in the current form hardly contribute to an EU-wide public good and also not meaningfully to economic growth so that the colouring is yellow in the field „Allocation / Economic Growth“.
Source: German Economic Institute (own compilation)

3.3.2 The task categories in detail

With regard to the **defence and security policies as well as the control of EU external borders,** the EU should become more active, as the following arguments demonstrate. External (and internal) security are typical public goods. That is also to be valued positively according to Musgrave's categorisation (colour coding: dark green throughout in the first Musgrave function, no relevance in the other Musgrave functions). Moreover, economies of scale and efficiency gains can be achieved via closer cooperation in defence, security and migration policies. With regard to the defence policy for example, around 80 per cent of military equipment is procured purely on a national basis, which leads to duplicate acquisitions and insufficient utilisation of the cost advantages of central purchasing. (European Commission, 2016a).

The cost of insufficient cooperation between the member states with regard to security and defence is estimated at 25 to 100 billion euros per year (European Commission, 2016a). Surveys of the Eurobarometer also show that there are clear and rather homogenous preferences amongst EU citizens for a joint defence and security policy for EU member states (European Commission, 2017a). On average, 75 per cent of those asked were in favour of this. In Austria, the country with the lowest approval rate, there was still a majority in favour of a joint security and defence policy (56 per cent). However, on the political level, traditionally considerable differences in handling defence policy prevail, for example if France and Germany are compared. It remains to be seen in how far the current political deliberations of many member states to work together more closely in this area in the EU will change this. Moreover, there are significant preference differences in migration policy, as the controversial distribution of refugees to member states shows.

Moreover, there would be further advantages to strengthening the EU's defence, security and migration policies. Within the framework of a controlled migration policy, the protection of EU external borders is not only a public good. This measure also serves to preserve the Schengen Area, that is the absence of controls at internal borders of the Union, which have been partially reintroduced since the refugee crisis. In addition, the debate surrounding net contributions could be mitigated. In contrast to agricultural and cohesion policy, expenditure for Europe-wide public goods would no longer be easily attributable to individual nations.

Indeed, first steps have already been taken to strengthen the EU's defence, security and migration policy. With regard to defence and security, in November 2016 the Commission put forward a proposal for a European Defence Action Plan, (European Commission, 2016b), which was intended to strengthen research, industry, and capability development in this field (Wientzek, 2017). In December 2016, the European Council explicitly welcomed and supported this action plan. Moreover, in December 2016, the European Council also approved an Implementation Plan on Security and Defence (European Council, 2018). This includes a coordinated annual review on defence, the creation of a military planning and conduct capability to improve crisis management structures, which was established on 8 June 2017, a strengthening the EU's rapid response toolbox, including EU-financing of the EU battlegroups, which were established in 2005.

This also includes the Permanent Structured Cooperation (PESCO). The aim of this is for the participating countries to work more closely together and jointly invest in development, procurement and the use of military weapons (Rathke/Rohde, 2017). The Council agreed to establish the PESCO on 11 December 2017. All EU countries take part except for Denmark, Malta and the UK. The participating countries have recently agreed on a list of 17 projects, the first of which were formally approved by the Council on March 6, 2018.

Regarding **migration policy,** significant recent measures include the establishment of "hotspots" for arriving refugees, the rescue of refugees travelling by boat, as well as attempts to harmonise asylum systems, redistribute refugees within the EU, and return individuals who are refused refugee status (European Commission, 2017b). Furthermore, there are also attempts to restrict irregular migration through agreements with Turkey and other Mediterranean countries, and to combat trafficking and causes of flight. Much of this is proving to be difficult and protracted. An important function in the framework of migration policy is the improvement of the control of EU-external borders. To support this the European Border and Coastguard Guard (Frontex) was founded in 2016. Within the framework of a rapid reserve pool, Frontex has 1,500 border guards at its disposal, although it is still lacking equipment (European Commission, 2017c). As suggested by the European Commission's (2018a) options for increasing priority expenditures (Table 2-1), it is clear that effective external border protection is considerably more expensive. This means, in turn, that for this priority spending area, much higher EU expenditure is necessary.

In the following task categories, a distinction is made between general tasks and those that have cross-border relevance. This differentiation makes it possible to clearly determine the exact areas in which it makes sense to transfer tasks to the EU and where instead the subsidiarity principle should be followed.

The general **Justice and Home Affairs Policy** also contributes in an important way to the public security (dark green in the first Musgrave function, no relevance in the other Musgrave functions). Yet here, as a rule, there are no cross-border spillovers. Instead, it is more a question of regionally limited public goods. In addition, regionally heterogeneous preferences are also apparent in the different justice systems. These arguments contest the general harmonisation or centralisation of justice and home affairs responsibilities at EU level. However, combatting terrorism or other types of cross-border crime is difficult for individual member states alone. Cooperation is required here. In particular, the EU-wide exchange of information about such crimes and cooperation between the relevant national authorities make sense and are often crucial. Thus, for these cross-border aspects, a strengthening of EU functions is both justifiable and necessary.

The distinction between general and cross-border aspects is also relevant for expenditure related to **research, education, infrastructure, and digitalisation**. These public spending categories partly deliver public goods, for example in basic research or the provision of schooling (including compulsory schooling). Moreover, from an allocative perspective, research, education, infrastructure and digitalisation also promote economic growth (dark green in the first Musgrave function), which can be shown theoretically and empirically proven (IW/IW Consult, 2016). In addition, higher economic growth brings with it – as a result of higher tax revenues – a boost in national distribution capacity (light green in the second Musgrave function). Furthermore, targeted national education expenditure can serve to better cushion structural change (dark green in the second Musgrave function).

As a rule, possible spillovers with regard to these aspects are restricted locally, regionally and nationally. Therefore, there is no general justification for the EU to be active in these areas. For this to be the case, relevant cross-border aspects need to be present. In relation to the promotion of research these could, for example, be EU-wide projects which draw on the best researchers across member states. With regard to education, while national systems differ from one country to another (Weiss et al., 2017), the Erasmus+ programme offers young people financial support to study or work in other EU countries, which at the same time helps to improve the understanding across the EU.

With investments in the infrastructure and digital networks, the same subsidiary caveat applies, unless it involves cross-border investments, as for example is explicit in the Connecting Europe Facility. Moreover, with regard to digitalisation, the EU has an important role to play in creating a legal framework for the digital single market, since national regulatory divergences often represent unnecessary trade barriers. These future-oriented task areas have clearly been underfunded in the EU budget up to now. Thus, a targeted increase in sub-areas with sufficient cross-border relevance makes sense and should be prioritised.

The **cohesion policy** of the EU – often also referred to as regional or structural policy – has, with reference to Musgrave's functions, primarily a distribution aim. If financial resources were only redistributed from the richer EU regions in favour of the poorer EU regions, this would clearly be a task of the EU, in its role as the coordinator of this reallocation. If, moreover, the funds were effectively deployed in the poorer countries, the aim of allocation/growth would also be fulfilled. However, these requirements are only partially fulfilled – which is taken into account in table 3-1.

In fact, over time, cohesion policy has increasingly lost its focus (light green marking in the Musgrave function distribution). It is true that EU treaties commit the EU to a policy of economic, social and territorial cohesion. Thus, they have the particular goal of reducing income divergences among the EU's regions and of enabling particularly disadvantaged regions to catch up. In principle, the cohesion policy is a suitable instrument to make that happen. However, over time the cohesion expenditure has increasingly been used for other purposes (Busch, 2018). In addition, there is not only disagreement as to whether the cohesion policy of the EU promotes income convergence between the EU regions, but also to what its effect is on economic indicators such as growth and employment (yellow marking for the first Musgrave function allocation/growth). In this regard, empirical studies come to different conclusions (Bachtler et al., 2017, 11; for a short overview see Busch (2018) and Darvas/Wolff (2018)). Thus, the empirical evidence regarding the economic effects of the EU cohesion policy is unclear, although efficient administrative structures benefit from its effective use.

Against the backdrop of these critical findings, a distinction has to be made: A cohesion policy that supports the EU's poor regions is part of the EU's responsibility and should be more strongly focussed and operated more effectively, with a view to the allocation/growth target. However, a regional and structural policy in the more prosperous EU countries, should, according to the principle of subsidiarity, be primarily the responsibility of said member states themselves, who also have responsibility for their effectiveness with regard to allocation/growth and distribution. If the EU budget's cohesion expenditure were to be concentrated on the economically weakest member states, estimated potential savings of around 150 billion euros over the seven years of the MFF would be achievable.

Instead of being the responsibility of the EU, **agricultural subsidies** (as a key element of the European Common Agricultural Policy) should be located at national level and clearly reduced. Even if preferences for agricultural support do not vary greatly within the member states, there is no sufficient justification for it to be within the remit of the EU, because hardly any economies of scale or cross-border spillovers exist. When public goods such as environmental protection or landscape conservation are delivered, generally speaking they are of a local nature (Heinemann, 2005; Weiss et al., 2017). This is also largely the case for the argument for security of supply. Only in relation to regulatory aspects, EU responsibilities are justified , e.g. with a view to agricultural trade policy or state aid control

In relation to the Musgrave functions, the judgement regarding the existing agricultural subsidies is also predominantly negative (colour coded yellow in the first and second Musgrave function). With regard to the first function (allocation/growth), security of supply is an issue of relevance. However, it appears questionable whether subsidies are really indispensable for large farms that can reap significant economies of scale. Also the delivery of mainly local public goods (such as landscape conservation, environmental protection, animal health or biodiversity) as a justification for subsidies needs to be critically scrutinised. While subsidies are, in principle, a possible means to foster environmental health, it is hard to understand why agriculture should be financially supported for achieving these goals, while in other industries sustainability goals are pursued by means of costly regulations and taxes. To justify agricultural subsidies with sustainability goals is not much more than an easily recognisable political immunisation strategy (Cramon-Taubadel/Heinemann, 2017).

With regard to the second Musgrave function (distribution und cushioning of structural change), this refers to the EU treaty goal (Art. 39 TFEU) of ensuring a "fair standard of living" for farmers. Even if this formulation opens up some room for interpretation, there is little to be said for the existing way of providing subsidies (Cramon-Taubadel/Heinemann, 2017). If welfare state standards are applied, the goal should be to provide temporary help to needy farming enterprises. However, EU agricultural subsidies overwhelmingly benefit large enterprises: in 2015, 18 per cent of enterprises received around 80 per cent of all direct payments (Cramon-Taubadel/Heinemann, 2017). In addition, no means testing exist which takes account of other income sources of those receiving subsidies – a fact that is also criticised by the European Court of Auditors (Cramon-Taubadel/Heinemann, 2017). Moreover, also the use of agriculture subsidies to cushion structural change can hardly be used as a blanket justification either. Only in a few EU countries (especially in the east of the EU) is the proportion of the workforce employed in agriculture still high enough for a reduction in agricultural employment to generate relevant macroeconomic adjustment burdens. And even if this is the case, the cushioning of such change is primarily a national task (overall colour coding yellow regarding the second Musgrave function).

At present, in relation to the governance of the **EMU**, there is controversy over whether a fiscal macroeconomic stabilisation instrument should be introduced at a central EMU level. This is being discussed primarily within the framework of the theory of the Optimal Currency Area (OCA theory). Its proponents claim that a central stabilising mechanism is needed to better cushion asymmetric shocks. However, in the view of the authors of this policy paper, this is predominantly a national task, whether via flexible markets, or via the use of national automatic fiscal stabilisers. Particularly, the effectiveness of the national wage adjustment mechanism is better than often perceived, especially in the southern European countries (Matthes et al., 2016; Matthes/Iara, 2017). Moreover, it is hard to justify that some Euro countries demand a stabilisation instrument, while, at the same time, they are not prepared to balance their fiscal budget when times are good, and thereby make provision for the next crisis. This is not the right condition to introduce some kind of central stabilisation insurance.

The proponents (e.g. for a common unemployment insurance) also employ some arguments from Public Choice Theory (e.g. Weiss et al., 2017) and particularly cross-border spillovers of fiscal policy. Since expansive effects of national fiscal policy are also effective outside the country concerned, there are fewer incentives for such a country to employ its own fiscal policy anti-cyclically. This argument can be qualified given that as a rule the extent of such fiscal spillovers is only limited (see Matthes et al., 2016 for a short overview of the literature). At most, they might play a politically relevant role for small open economies. However, the spillover argument runs contrary to a considerable heterogeneity of preferences with regard to fiscal policy, whether in general terms (Busch, 2015) or also concretely, with regard to the willingness to have a central stabilising function, which is vehemently rejected particularly by northern European countries.

Also with regard to the Musgrave function, doubts can be expressed about a central stabilising mechanism at EMU level, even if there is scope for evaluation here. The main objective of such an instrument is macroeconomic stabilisation (third Musgrave function), where, however, as previously discussed, the need for a central arrangement can be questioned (light green colour coding). With regard to the second Musgrave function (distribution, yellow colour coding): The authors see the danger that a stabilisation instrument could lead to unwanted transfer payments (permanent redistribution) between the member states, even if this was initially not intended. Also with the first Musgrave function (allocation/growth), scepticism prevails (yellow colour coding): It is true that a central stabilisation instrument could lessen an economic crisis and possible hysteresis effects. Moreover, macroeconomic stability can also contribute to improving the conditions for an efficient allocation of resources. However, business cycle variations are not unusual in a modern market economy. In the opinion of the authors of this IW policy paper, the danger of moral hazard is more important. If countries are able to fall back on a stabilisation mechanism, they might forego necessary structural reforms, and pursue a policy that does less to support growth and allocation.

To some extent, it makes sense to support structural reforms of euro area countries and a convergence of non-Euro countries with limited EU funds, as advised by the European Commission and also the coalition treaty of the Federal Republic (see the last expenditure category in Table 2-1). However, in the early 1990s, the cohesion fund was established to support member states with economic and structural weaknesses in preparing for EMU. After EMU entry of these countries, the cohesion fund was not eliminated again. Thus, when new instruments to support structural reforms are created, the funding could come to a sizeable degree from the cohesion fund.

Tasks and expenditures related to the **Single Market and trade policy** are clearly the responsibility of the EU. A centralisation of Single Market rules is important in order to avoid competition distortions between the member states, and a partial harmonisation of product-related standards is a prerequisite for the free movement of goods. EU responsibility is also advisable in **trade policy**, particularly since considerable economies of scale can be achieved, because when the EU concludes free trade agreements with non-member countries, it clearly has greater negotiating power than individual countries. With regard to the Musgrave functions, EU responsibilities for the Single Market and trade policy does not only create public goods in the wider sense (colour coding dark green in the first Musgrave function). In addition, by breaking down internal and external trade barriers, free trade promotes factor allocation, and with it prosperity and growth (IW/IW Consult, 2016). However, trade opening also results in higher international competitive pressures, and thus leads to adjustment costs (yellow colour coding in the second Musgrave function). However, the induced structural change is a precondition for the gains from trade and therefore indispensable.

In the field of **environmental and climate policy**, the EU has an important function (particularly in relation to global greenhouse gases) because spillovers and free-rider effects play a role here, making environmental and climate protection an international public good. It is true that with regard to local and national pollutants, the external effects are regionally limited. However, given that their reduction is costly, pollution abatement can lead to considerable distortions in international and European competition. There is also a case to be made here for the EU to establish common standards of protection using scientifically objectifiable data.

With regard to the Musgrave functions, only the sphere allocation/growth is relevant. In terms of allocation, environmental and climate policy can, principally, internalise of external effects. Moreover, by adopting a pioneering role, the EU can (at least temporarily) create new export opportunities. However, precisely in the case of global pollutants, before all concerning climate change, high standards of abatement can lead to competitive disadvantages if other trade partners are significantly less ambitious. As a result, production could be relocated to countries with lower standards (carbon leakage) which would be detrimental to the global climate change target (overall: light green colour coding in the first Musgrave function).

Social policy should primarily be the responsibility of the member states. In this policy area, there are hardly any cross-border spillovers, and also no significant economies of scale (Heinemann, 2005). Furthermore, there are heterogeneous preferences in the sphere of social policy that are also attributable to the different levels of prosperity and performance of European economies. This is illustrated by expenditure figures for social protection, which are only available after a time delay, but which only change slightly in the short term. The social protection ratio in Romania and the Baltic States was the lowest in 2014, at around 15 per cent of GDP, with the highest being in France, with around 34 per cent of GDP.

There are further reasons for the member states to be in charge of social policy. For example, a far-reaching harmonisation of social standards by the EU could overstrain the poorer member states and adversely affect their competitiveness. This would amount to a hidden protectionism. Therefore, it is not surprising that the central and eastern European countries in particular have strongly criticised the proposed tightening of the Posting of Workers Directive.

An EU responsibility makes sense if areas of social policy (and labour market policy) are concerned that are important for the free movement of workers and the self-employed in the EU. A limited coordination of national social security systems (e.g. in relation to the transferability of pension rights) serves to promote the mobility of workers in the EU. In addition, by means of a process of benchmarking in social policy (and in labour market policy), e.g. within the framework of the European Semester, the EU can support member states to adopt best practices. However, in all these areas the EU should only support and complement the member states in the social policy sphere. Also the European Pillar of Social Rights initiative (European Commission, 2018c) has to take into account this fundamental priority of responsibility of the member states.

With regard to the Musgrave functions, the main function of social policy is the distribution and the cushioning of structural change (dark green colour coding). However, that is only valid at national level and not for the limited tasks that are perceived at EU level. Also with regard to the Musgrave function allocation/growth, a distinction must be made between the two levels. Redistributive and protective social policy (and labour market policy) can promote the formation of human capital and social peace, but depending on how it is organised, it can also lessen work incentives, contribute to rigid markets, and reduce growth and employment due to the increase in labour costs (yellow colour coding). In contrast, the social policy tasks assigned to the EU can promote allocation and growth if they contribute to a better factor allocation, or, via a benchmarking process, favour structural reforms for more growth, competitiveness and flexible markets (dark green colour coding of the first Musgrave function, the other functions are not relevant).

A similar differentiation is appropriate in relation to **tax policy.** Here, too, there is a predominantly national responsibility, mainly because there are hardly any economies of scale and there are clear preference differences, which become apparent when looking at the diverse structures of the tax systems of the member states (Heinemann, 2005). If taxes with virtually immobile tax bases are considered, there are no appreciable cross-border spillovers. If, however, taxes are based on mobile bases (including capital, company profits and in particular, licences and patents) then EU responsibility can also be justified. Because national tax policies do exist that invite companies to undertake aggressive tax planning. This can then result in taxes not being paid to the member states where the respective value added is created. The EU ought to establish a framework to prevent such free-rider strategies in the broader sense (Weiss et al., 2017).

There is also EU-level responsibility when taxes from member states are used as implicit or explicit state aid.

With regard to the Musgrave functions, national tax policy inevitably leads to allocative distortions, which need to be minimised (yellow colour coding in the first Musgrave function allocation/growth). This is true mainly for income and excise taxes (and less so for broad based value added taxes and for environmental taxes that aim to internalise external effects). At EU level, factor allocation can be improved if taxation and value added creation are more closely related. Moreover, a common consolidated corporate tax base at EU level would also reduce costs of tax administration for companies (overall: dark green colour coding in the first Musgrave function). However, a far reaching tax harmonisation could run the risk of reducing international tax competition which provides incentives to improve the cost-benefit relation of public finance policy. In the second Musgrave function (distribution and cushioning of structural change), national tax policy (and above all a progressive income tax) is a key instrument of redistribution. However, excise taxes can also be degressive and burden low incomes disproportionately (overall: light green in the second Musgrave function). Moreover, national taxes can play an important role in anti-cyclical business cycle policy and thus in macroeconomic stabilisation (dark green in the third Musgrave function). EU efforts against aggressive corporate tax planning strategies would contribute to more tax fairness between the member states, even if it is not easy to define fairness in this context (light green in the second Musgrave function).

3.3.3 Interim conclusion

The most important results of the task review can be considered the following:

- In the area of **security** – especially in defence policy, external border security, and the fight against terrorism – the EU should have a clear responsibility, because security is a European public good from an allocative view. Here the EU budget clearly needs more resources.
- In the spheres of **research, education, infrastructure and digitalisation,** it is true that targeted state expenditure can basically promote the growth. However, this is primarily the task of member states. However, EU-level responsibility can be justified if there are sufficient cross-border spillovers. Up to now, these future-oriented tasks have been funded with too few resources and should be given additional funds in cases of cross-border relevance.
- The bulk of the EU budget is allocated to agricultural and cohesion policy. In the case of **agricultural subsidies,** EU responsibilities are not sufficiently demonstrable, and neither are they sufficiently justifiable according to Musgrave’s criteria. In addition, there is no valid reason for the EU having responsibility for the **cohesion policy in prosperous member states.** As a result**,** these areas should be deprioritised in the new MFF.

4 Potential for restructuring in the EU budget

4.1 The political trilemma

Due to conflicting goals and interests, negotiations about the new MFF will be like the metaphorical attempt to square a circle:

- Brexit and the well-justified spending priorities in the categories of security and future-oriented growth are increasing funding requirements (Table 2-1).
- A number of member states are strongly opposed to an increase in the EU budget, and some are even demanding a reduction because of Brexit (NZZ, 2018).
- Restructuring the EU budget in favour of the new spending priorities and at the expense of agricultural and cohesion policy is meeting with political resistance from those who profit from this expenditure. That is illustrated not least by the coalition agreement of the new German government. Equally, the European Parliament has already spoken in favour of continuing the cohesion policy even in the prosperous member states, and postponing a reform of the Common Agricultural Policy until 2024, when the pressure for reform due to Brexit will have abated.

The European Commission has to find a way out of this trilemma. In the Communication of 14 February 2018, it outlined numerous options and made more specific proposals with the Communication on 2 May 2018 (European Commission, 2018a; 2018d; Chapter 2). It calls for limited restructuring in the MFF in favor of priority tasks such as defense, security, research and education (Erasmus+) and at the expense of agricultural and cohesion policy. However, the proposed cuts of 5 to 7 per cent are too small. Thus, the indicated trilemma cannot be solved. With such a minor reshuffling of expenditures the necessary funding cannot be raised for the Brexit financial gap and the additional expenditure for priority tasks with EU added value. Instead, contributions from member states would have to be increased and new sources of revenue opened up for the EU. Although the proposals of the European Commission are going in the right direction, they are ultimately too timid, because they under-exploit the potential for restructuring the MFF.

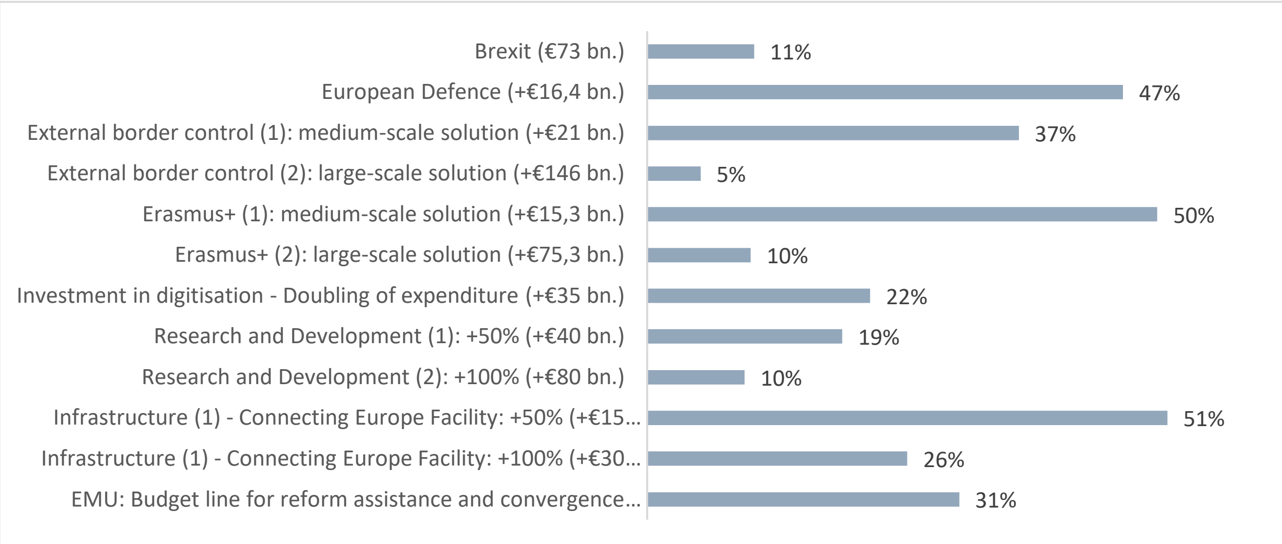
4.2 Restructuring potential by reducing agricultural and cohesion policy spending

The following discussion will show the enormous financial potential for the priority EU tasks that exist, simply by restructuring the existing EU budget framework, without increasing it or drawing on any new funding sources. According to statements from the European Commission (2018a), the current MFF expenditure for the CAP amounts to around 400 billion euros, and for the cohesion policy around 370 billion euros (including the UK). Altogether, that is around 770 billion euros.

Below, these items will be juxtaposed against the possible additional expenditure for the priority task areas, as proposed by the authors based on the European Commission (2018a; Table 2-1). Restructuring would also cover the funding gap caused by Brexit to the sum of around 73 billion euros. First comparisons will be made, based on the status-quo data; and then a dynamic timeframe simulation will be drawn up, which also takes account of nominal growth, and with it the higher spending scope in the MFF from 2021.

In the first step, we consider which aspects of the said items can be financed by a reduction in agricultural and cohesion expenditure of just 1 per cent which amounts to savings of around 7.7 billion euros (Figure 4-1). With this alone, around 11 per cent of the Brexit funding gap could be closed, or alternatively, even almost half of the additional expenditure proposed by the European Commission for joint defence, that is 16.4 billion euros. Put it another way: With a 2 per cent reduction in agriculture and cohesion expenditure the Erasmus+ programme could be doubled, the spending on cross-border infrastructure could be increased by a half or, alternatively, the additional defence spending, proposed by the European Commission, could be fully funded.

Figure 4-1: Spending potential by reducing the EU expenditure of agricultural and cohesion policy



Reading aid: By reducing agricultural and cohesion policy expenditure by 1 per cent, x per cent of the listed amounts could be funded.
Sources: European Commission, 2018a; German Economic Institute

In a second approach it can be calculated how high reductions in the agriculture and cohesion budget need to be in order to fund all the additional priority expenditure at the same time. Here two versions are analysed, a medium-scale one and a large-scale one (see Table 2-1 and the respective explanations):

- Figure 4-2 illustrates the medium-scale version, whereby the funding need for all additional priority expenditure and the Brexit gap amounts to around 240 billion euros. This amount could be made available if spending on the agriculture and cohesion policy was reduced by 31 per cent. This lies within the framework that the European Commission presented in its options paper (European Commission, 2018a). An IW analysis of the cohesion policy has also shown, that savings of around at least a third could be achieved if the EU were to concentrate its support on poor regions, and the more prosperous member states were responsible for their own regional development, according to the subsidiarity principle (Busch, 2018).

- Figure 4-3 shows that in the large-scale version there would be a funding need for additional priority expenditure and the Brexit gap of around 480 billion euros. To achieve this, agriculture and cohesion expenditure would need to be reduced by 62 per cent.

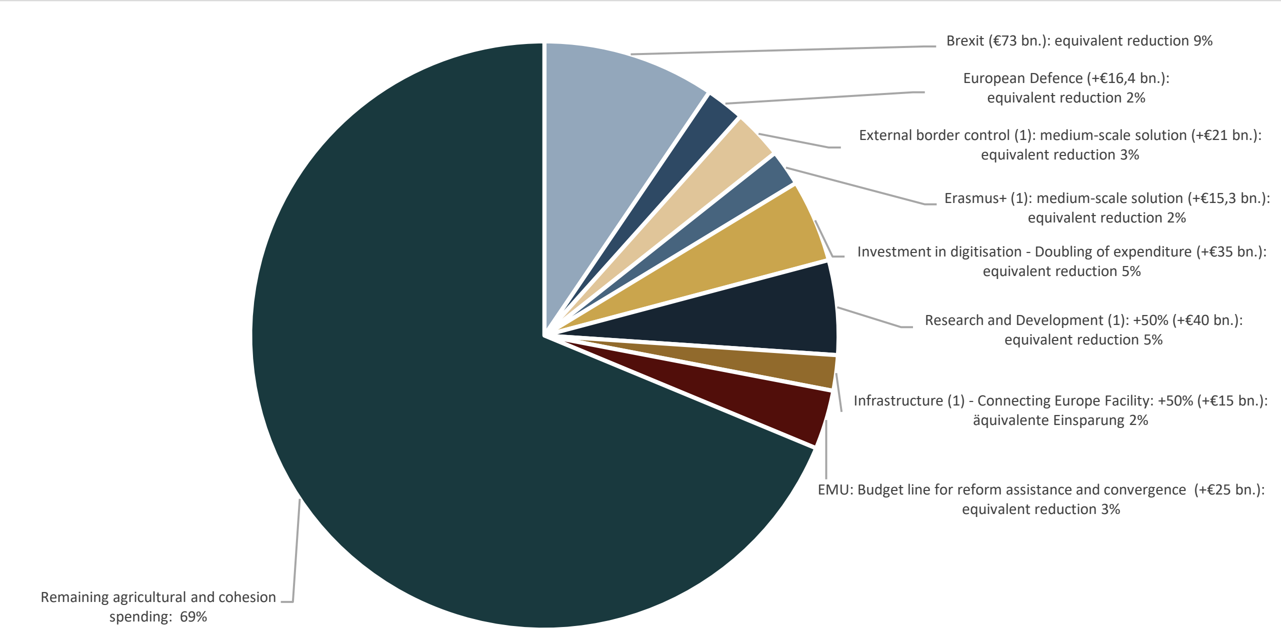
In a dynamic timeframe these savings needs are clearly lower. As the EU budget is tied to gross national income, the financial leeway increases with (nominal) economic growth. Based on an extension of forecasts of the European Commission and the IMF (from October 2017), it can be estimated that within seven years, between 2020 and 2027, the nominal gross national income could increase by a good 28 per cent (Darvas/Wolff, 2018). This result only changes only slightly if one takes the updated forecast of the IMF from April 2018 as a basis.

Thus, for the **medium-scale version** we have the following overall rounded estimate: It was previously shown that in the static scenario agriculture and cohesion expenditure would have to be reduced by 31 per cent in order to fund, by means of reallocation, around 240 billion euros of additional priority expenditure in the medium-scale version. If one assumes an increase in expenditure (based on the projected growth of GNI) of a good 28 per cent over seven years, the reduction need of 240 billion euros becomes a reduction need of approximately 310 billion euros. At the same time, an increase in agriculture and cohesion expenditure of a good 28 per cent would correspond to an amount of around 220 billion euros, so that this would be a total of almost 990 billion euros (770 + 220 billion euros) in seven years. If instead agricultural and cohesions spending was frozen at the current level of 770 billion euros (which would mean a reduction in real terms), the foregone increase of 220 billion euros due to nominal growth would be available for reallocation. This would mean that in seven years only a reduction in agricultural and cohesion expenditure (of 770 billion euros) by 90 billion euros to around 680 billion euros would be necessary to achieve the necessary savings of 310 billion required to fund the priority tasks. An amount of 90 billion euros would correspond to a reduction in agriculture and cohesion expenditure of around 9 per cent in comparison to the (potential) 990 billion euros, or to a reduction of about 12 per cent in relation to the current level of 770 billion euros. From a political perspective, this lower reduction need would to be much easier to communicate.

For the **large-scale version,** the need for reduction in agriculture and cohesion expenditure is decreased by using the growth-induced additional cushion of 220 billion euros from around 62 per cent to around 40 per cent in relation to the (potential) 990 billion euros, or to about 52 per cent in comparison to the current level of 770 billion euros. With such a halving of agricultural and cohesion spending in the new MFF, it would be possible to have, for example, a huge increase in external border security spending to 150 billion, as well as a doubling of the expenditure for research and development and for the Connecting Europe facility.

Figure 4-2: Need for percentage reductions in agricultural and cohesion policy expenditure to finance priority expenditures and Brexit

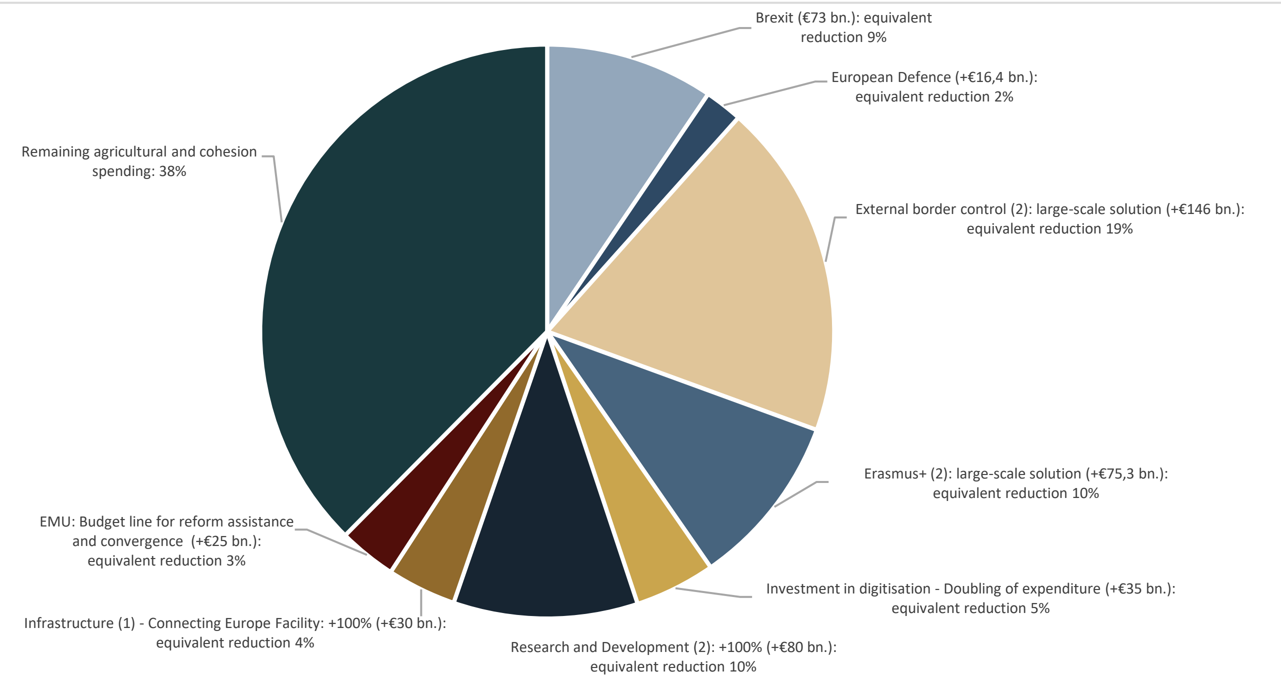
Medium-scale version of budget restructuring



Source: European Commission, 2018a; German Economic Institute

Figure 4-3: Need for percentage savings in agricultural and cohesion policy expenditure to finance priority expenditures and Brexit

Large-scale version of budget restructuring



Source: European Commission, 2018a; German Economic Institute

5 Summary and conclusion

The debate about the future of the EU and the next MFF is taking place against the backdrop of new threats to internal and external security in Europe, as well as the Brexit funding gap in the EU budget. There must be a push for reforms when discussing the MFF 2021-2027, to establish new priorities in the EU budget. The European Commission has put forward various options for consideration in this regard, which this study takes as its starting point. It identifies different spending categories that can either be prioritised or deprioritised. It does so via a two-dimensional normative task review. First, there is a discussion as to which policy categories should be the responsibility of the EU, and which should be that of the member states. Secondly, a number of political areas are examined to see whether, and to what extent, they meet the three Musgrave functions of public finance policy: allocation/growth, distribution/structural change cushioning, macro-economic stabilisation.

The priority areas of the EU are identified as external and internal security (particularly defence policy, external border security and the fight against terrorism), and the future-oriented and growth-promoting areas of research, education, infrastructure and digitalisation, but the latter only when there are sufficient cross-border spillovers. The funding resources for these priority areas in the EU budget should clearly be increased. The assessment concerning the agriculture and cohesion policy is overwhelmingly critical. In relation to agricultural subsidies, the EU does not have any clear demonstrable responsibilities and neither can this policy be sufficiently justified in relation to the Musgrave functions. Nor is there a sufficient justification for a broad EU responsibility for cohesion policy in prosperous countries. Therefore, agricultural and cohesion policy, which are highly remunerated in the EU budget, should be deprioritised.

By means of reallocation in favour of priority tasks, big levers can be made available. With a reduction of around 2 per cent from agricultural subsidies and cohesion expenditure, either the Erasmus+ programme could be doubled, or expenditure for cross-border infrastructure could by increased by half, or the additional defence expenditure, proposed by the European Commission (2018a), could be funded. To fund all the expenditure items identified as priorities in a medium-scale version, a reduction of only around 12 per cent in agricultural and cohesion (nominal) expenditure would be required, assuming a nominal growth of a good 28 per cent within seven years.

Brexit and the changed geopolitical situation must be used to finally place the MFF on an economically more meaningful footing. The European Commission has proposed to slightly cut expenditures for agricultural subsidies and cohesion policy. However, it should be more courageous in its reform proposals.

The positioning of the German federal government can be criticised in two respects. Firstly, it is weakening the pressure for reform by promising higher EU contributions at such an early stage. Secondly, confronted by the multiplicity of lobby interests representing agricultural and cohesion policy, it is also obviously lacking the courage to seek a relevant reform of these policies. Here, too, there is need for more economic reasoning and ambition for reforms.

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