The EU Economic and Financial Affairs Sub-Committee have written to the Financial Secretary to the Treasury, setting out its views on the 2015 Draft Budget and the Draft Amending Budget No3 to the 2014 Budget, in a chain of correspondence.

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I am writing with regard to COM (2014) 329 FINAL, Draft Amending Budget No 3 (DAB 3) to the General Budget 2014 – COM (2014) 329 FINAL.

We understand that your EM on this proposal is shortly to be received. However, given the importance of the document we have taken the decision to write to you at the earliest opportunity.

The Commission defends this proposal on the grounds that budgetary pressures make recourse to further funds unavoidable. In light of the significant figures involved, we would be grateful for your detailed response to the Commission’s assertions, as follows.

What is the principal cause of such a large amendment being proposed? Is it the backlog of unpaid payments from the previous MFF period, the front-loading of the current MFF, unforeseen circumstances, or a combination of all three?

Given that the Contingency Margin is defined as “a last-resort instrument to react to unforeseen circumstances”, is the Commission’s proposal to resort to it as “the only available instrument to react to the budgetary impact of unforeseen circumstances” justified? Is it justified in seeking to mobilise the Contingency Margin for 2014 in full? Can you confirm reports that the UK and seven other Member States have written to assert that “a proposal for the mobilisation of the contingency margin in 2014 would not only be legally questionable but also unnecessary, premature and not a ‘last resort’ option”? What is the basis for this assessment, and in particular your argument that recourse to the contingency margin is legally questionable?

The Commission repeatedly cites a major shortage of payment appropriations as a justification for the proposal. It notes that shortages of payment appropriations are visible across all headings, and that there is a sizeable backlog of unpaid payment claims for 2007-13 programmes, amounting to €23.4 billion in Heading 1b (Economic, Social and Territorial Cohesion). Is the Commission correct to identify this as a problem? Why has it occurred on such a scale? What can be done to provide a long-term solution that would avoid recourse to such significant budgetary revisions as this? If funds have already been committed, for instance to ERDF recipients in Member States including the UK, where do the Government believe such funds should be drawn from, if not from the Contingency Margin?

The Commission notes six sets of unforeseen circumstances which it argues justifies calling on the Contingency Margin, including frontloading of various programmes; a top-up for the Fund for European Aid to the Most Deprived (FEAD); a large number of outstanding cohesion policy payment claims; rural development; European Fisheries Fund; and the financial package of support for Ukraine. While we accept that the ramifications of recent events in Ukraine could not have been anticipated, do you share our scepticism that all the other circumstances cited by the Commission were entirely unforeseen? If our scepticism is justified, why were such problems not taken into account in previous budgetary negotiations?

The Commission states that it has taken into account the “extremely limited” possible sources for redeployment. However it appears only to have identified €65 million from the reserve for Sustainable Fisheries Partnerships Account that can be reallocated. Do you share our view that it is unlikely that all possibilities for redeployment have been exhausted? If so, which other areas would you identify as potential targets for redeployment?

Do you share our concern about the Commission’s warning that it may also have to propose the mobilisation of the Contingency Margin for 2015 at a later stage? Is the Commission’s warning that offsetting the Contingency Margin in 2016 “would be imprudent” a tacit admission that it will also need to be mobilised in 2016? In light of this, is it realistic, as the Commission asserts, to expect the offsetting to be distributed over the years 2018-2020, because such additional payment needs “are to a significant extent compensated by lower payment needs in later years of the 2014-2020 MFF”? What will happen if this does not prove to be the case?
In our letter to the former Financial Secretary to the Treasury, Rt Hon Greg Clark MP, on 24 July 2013, we asked if he could give any guarantee that the 2014 Draft Budget would not be subject to significant further amendment. We expressed concern about the effect on budgetary discipline of the decision to provide flexibility between years. We also warned that the relationship between payment and commitment appropriations had broken down. At his appearance before the Committee the previous day, we warned that in the deal secured on the MFF, there may be the potential for problems in the future in terms of front-end loading, which would increase the pressure on the budget. In our 15 October 2013 letter to his successor, Rt Hon Sajid Javid MP, we drew attention to the potential for, and consequences of, front-loading of annual budgets under the MFF, and suggested that the headline deal achieved in 2013 was therefore not as good as at first sight and had not addressed fundamental problems.

Noting that the Commission specifically cites front-loading as one of the “unforeseen circumstances” that have necessitated this budgetary amendment, do you agree that this proposal has borne out our predictions? What do such apparently intractable problems indicate about the efficacy of the EU budgetary process? Do they demonstrate that the mechanics of the process are no longer fit for purpose and need to be significantly overhauled? If so, how can the process be reformed to ensure that the budgetary process does not repeatedly and irretrievably break down?

We would be grateful for a response to these questions, as well as a full account of the timetable for negotiations on the proposal, by 24 June 2014. We also look forward to discussing these issues both with yourself and the Commission in the context of our forthcoming scrutiny of the Draft Annual Budget for 2015. In the meantime we will hold this document under scrutiny.

I am copying this letter to William Cash MP, Chair of the Commons Committee; Sarah Davies, Clerk to the Commons Committee; Arnold Ridout, Legal Adviser to the Commons Committee; Les Saunders, Cabinet Office, Thomas Kenny and Gary McMillan, International Tax Strategy & Co-ordination, HM Treasury.

LETTER FROM THE UK GOVERNMENT TO THE CHAIRMAN, 25 JUNE 2014

Letter from Rt Hon Nicky Morgan MP, Financial Secretary, HM Treasury to the Chairman

Draft Amending Budget No. 3 to the General Budget 2014 (DAB3/2014)

Thank you for your letter asking detailed questions on the Draft Amending Budget No.3 to the General Budget 2014 (DAB3/2014). As you acknowledge in your letter, you wrote in advance of receiving the Government’s Explanatory Memorandum on DAB3/2014 – and this EM, which has subsequently been sent, sets out the Government’s overall position.

The current timetable of negotiations has not changed since the submission of the EM. It remains unclear when the Presidency will return the proposal to Budget Committee for further discussion. The negotiation on DAB 3/2014 may be taken forward in parallel with the wider discussions on the draft annual budget for 2015, which will follow the usual timetable over the second half of 2014.

In your letter, you begin by asking the cause of the size of the Commission’s proposed amendment. The Commission’s argument is based on all the points you suggest in your letter. The Commission cite the unpaid payments from the previous MFF period and frontloading of the current MFF as reasons for why they need more money now. They also make the claim that both of these were “unforeseen” at the time of the agreement to the MFF ceilings. In addition, they present some other elements of the request as purely “unforeseen”, such as the funding for Ukraine.

You ask whether we accept the Commission’s rationale for requesting mobilisation of the Contingency Margin (“CM”), and also about the joint statement issued on the CM with other Member States. The Government does not agree with the Commission that the CM is “the only available instrument to react to the budgetary impact of unforeseen circumstances”. As set out in the Government’s EM on DAB3/2014, the Government’s view is that the Commission should always look first to reallocate funds from within existing agreed budgets to meet emerging in-year pressures, rather than coming to Member States with requests for additional money.
The UK signed a joint statement along with seven other Member States – Germany, Sweden, Denmark, Netherlands, Finland, Austria and France – and it is included in an annex to this letter for your information. This was prepared in advance of the publication of DAB3/2014, and as such addressed expectations (namely the mobilisation of the CM to meet commitments dating from before this MFF) rather than the actual content of DAB3/2014. Having said this, the sentence which you highlight in your letter is fully in line with the Government’s current position on DAB3/2014, as expressed in the EM, and is based on the same assessment – i.e. that the Commission should always look first to reallocate funds from within existing agreed budgets.

In terms of the specific point you make around the argument that the mobilisation is “legally questionable”, the Government does not have a definitive legal position on this issue. One potential argument could say that, given the CM may only be mobilized “as a last-resort instrument to react to unforeseen circumstances”, payments for pre-2014 commitments by definition cannot be considered as “unforeseen circumstances” and thereby are not a legitimate premise for mobilisation of the CM.

The inclusion of this argument in the joint statement reflects that this was one of several issues being considered by the signatory Member States in questioning whether the Commission should be mobilising the CM at this stage. The Government’s primary position on DAB3/2014 is not a legal one but the principled position set out in the EM and reiterated above.

You ask several questions about the backlog of unpaid payment claims under heading 1b, and what the Government feels should be done about this. First, the Government recognises that this is an issue that has to be addressed, insofar as it represents a pressure on the EU budget in this and in future years. The Commission states that it has arisen as a result of Member States submitting claims in 2013 around €10bn (£8bn) above those from 2012.

In terms of a long-term solution, the Government does not accept that significant budgetary revisions are required. These claims represent one pressure which has to be managed by the Commission alongside many other pressures. This should be done in a manner which sees real budgetary restraint, in this and in future years, and the solution need not be higher budgets. The Government has not given the Commission specific instructions as to where in the budget these funds should be drawn from, but in general feels that the Commission should look to areas which are under-implementing and which represent poor value for money if re-allocation is required.

You list several of the programmes which the Commission suggests represent examples of “unforeseen circumstances”, and voice scepticism over whether these, with the exception of payments relating to Ukraine, should be regarded as genuinely unforeseen. I agree that it is unclear why many of these pressures should not have been anticipated by the Commission.

You also ask why these problems were not taken into account in past budget negotiations. The Commission should have made better provision for them in compiling the detail of the 2014 budget, insofar as they were aware of these pressures. I do not think that the emergence of these pressures indicates that the Government should have taken a different approach to the budget negotiations, which were informed by our commitment to payment restraint.

You express scepticism that the Commission have exhausted all possibilities for redeployment as alternatives to bringing forward DAB3/2014. The Government shares this view, in particular given that, as you point out, the Commission have found only €65m in potential reallocations. In terms of where such funds should be found, as stated above, the Government has not given the Commission specific instructions, but in general feels that the Commission should look to areas which are under-implementing and which represent poor value for money.

The Government has put its views on DAB3/2014 clearly and repeatedly to the Commission and other Member States, initially via the joint statement and subsequently in the official-level Council Budget Committee and other meetings. In doing so, we have been supported by the other Member States which signed up to the joint statement.
You then express a longer-term concern that the Commission are planning to mobilise the CM repeatedly in future years, raising questions about whether these funds could be offset at the end of the MFF period. You refer to previous letters and comments made by the Committee raising concerns that the scope for “front-loading” annual budgets via the use of the CM rendered the MFF “not as good as at first sight”. Finally, you ask whether these issues demonstrate that the mechanics of the EU budget process are no longer “fit for purpose” and are therefore in need of significant reform.

I agree, in a general sense, that the Commission are likely to continue to come forward with significant requests for funds in future years – their recently published draft budget for 2015, an EM on which you will be receiving alongside this letter, is evidence of this trend. It is clear that significant front-loading into the first few years of the MFF (i.e. via multiple annual budgets at the payment ceilings and mobilisations of the CM) would impose pressure on later years of the deal.

The Government does not accept, however, that these recent developments have in any way demonstrated that the MFF is “not as good as at first sight”. The MFF agreed last year delivered the first ever real terms cut to the EU budget. The MFF deal included provision for the CM to operate as a mechanism to move expenditure between years but within the overall MFF ceiling. The fact that the Commission have chosen to request the mobilisation of the CM in the first year does not in itself indicate that the MFF and the mechanics of the EU budget specified within it are unfit for purpose.

The Government is very clear in its support for budgetary restraint in the EU, and is mindful of the importance of a continued strong position to ensure the successful delivery of the historic MFF deal. This is why the Government has taken a clear stance in the annual budget 2015 negotiations that there should be a significant margin between the budget and the annual ceiling, and more generally takes the view that, when in year pressures emerge such as the current DAB3/2014 request, the Commission should always look first to reallocate funds from within existing agreed budgets rather than coming to Member States with requests for additional money.

It is also worth recalling that Commission proposals can be blocked on a qualified majority vote basis, and that initial Commission proposals, such as draft annual budgets, are invariably reduced through negotiations with Members States ahead of final budgets being agreed.

The initial responses given to the Commission by the Government and by other Member States on the draft annual budget 2015, in addition to DAB3/2014, demonstrate that such large requests from the Commission are not something that will be accepted as usual practice. I intervened at Ecofin last Friday to set out the Government’s objections to the Commission’s annual budget proposal, and was supported by a number of other Member States including Germany, the Netherlands and Sweden.
The Draft 2015 Budget

2. The Commission states that it is proposing a 2.1% increase in commitments (to €145.6 billion) and a 1.4% increase in payments (to €142.1 billion) for 2015. We agree with you that, in doing so, the Commission is not comparing like with like, since its comparison assumes that DAB3 will be agreed as proposed. In comparison with the 2014 Budget as agreed, the Commission is, as you state, proposing a 4.9% increase in payment appropriations.

3. We also agree with you that in any sound budgetary process there should be a margin between the agreed budget and the annual ceiling. As you state, unforeseen pressures can and will emerge, and we note your view that past precedent suggests that the margin needs to be several billions of euros. As we explore below, the absence of such a margin is one indicator of the immense strain that the budgetary process is now under.

4. Having said that, your observation that the proposed level of payments expenditure “is too high” over-simplifies the problem. You state that you do not intend to plan the Commission’s budget in detail for them. While we agree with you that the Commission has a responsibility to explain why such an increase is proposed, in making your assertions it is more convincing the Government and the like-minded Member States (you cite Germany, the Netherlands and Sweden) to make concrete proposals as to how the 2015 Draft Budget can be trimmed. In your EM and in your evidence before us, you suggested that savings could be made under Heading 1a (Competitiveness for Growth and Jobs), Heading 1b (Economic, Social and Territorial Cohesion), Heading 2 (Sustainable Growth: Natural Resources), Heading 3 (Security and Citizenship) and Heading 5 (Administration). In your evidence before us, you identified the school fruit scheme under Heading 2, the Marco Polo II programme and cuts to the administration budget, but were unable to give precise details as to the amounts involved. In the absence of such information we remain doubtful as to the scale of the reduction in payments that such cuts would amount to. We would therefore be grateful for clarification as to the specific ways and amounts in which payment appropriations in the 2015 Draft Budget can be cut. Is your statement that savings can be made under Heading 1a compatible with your assertion that greater focus on this heading is a positive step? Overall, how much of the 4.9% increase can realistically be trimmed?

5. Nadia Calviño observed that the new MFF focuses “as much as possible [on] the headings that contribute more to growth and jobs: innovation, infrastructure and all the things to do with setting the basis for the future of Europe.” We agree with you that the increase in funding in Heading 1a (Competitiveness for Growth and Jobs) is a step in the right direction. It is regrettable that the constraints of the agreed Multiannual Financial Framework for 2014-2020 mean that it is only a small step. As we set out in our 2011 and 2012 reports on the MFF, reform of the Common Agricultural Policy (CAP) is imperative, and far greater efforts must be made to reduce the CAP’s budget and to begin phasing out direct payment to farmers. A further reduction in the CAP’s budget would allow the MFF to focus funding on areas that will support growth and encourage innovation. Notwithstanding the fall in CAP spending in the new MFF overall, we regret that Heading 2 (Sustainable Growth: Natural Resources) remains as much as 40% of the overall Budget. The size of the CAP budget means that the capacity for the EU to promote growth, jobs and competitiveness, which many would argue is more important, will continue to be hamstrung.

6. Taking into account the constraints of the MFF deal, in which specific ways do you believe that the EU Budget should be targeted in this and future years to ensure that economic recovery and growth is sustained in the years ahead? Is enough being done to focus spending on Heading 1a (Competitiveness for Growth and Jobs), or are we at the limit of what is realistically achievable under the current MFF deal?

Draft Amending Budget 3 (DAB3) to the 2014 Budget
7. In addition to the 2015 Draft Budget, the Commission has made a request for additional payments of €4.7 billion, albeit it argues that this will be offset to some extent by increased revenue and by transferring the remnants of last year’s budget. As such, the Commission argues that, in terms of its absolute size, it is a relatively small draft amending budget. For our part, we fear that the size of DAB3 calls into question the overall effectiveness of the budget-making process and that there is a significant cash flow problem. Do you share this analysis?

8. We note that the Commission justifies the request on three grounds: first (and most significantly), the backlog of bills for programmes and projects that have been pre-financed by Member States, including a backlog of cohesion policy payments amounting to €23 billion; second, the frontloading of programmes; and third, unexpected events such as the EU’s actions in Ukraine. Like you, we are sympathetic to the Commission’s actions in the latter case, although we note your observation that the Commission has already found the resources for disbursal of €250 million for Ukraine. However the key questions of the acceleration of payments and the frontloading of programmes deserve to be analysed in more detail.

**Backlog of payments**

9. On the backlog of payments, the Commission states that the problem has arisen because of the speed of expenditure, and in particular because the rhythm with which bills have come in has been unexpected. Silvano Presa told us that “the forecast for Member States turned out to be much more accurate than before”, in part because Member States sought to spend money quickly because of the automatic decommitment of funds after two or three years. Nadia Calviño added that the UK Government had announced that €1.3 billion of bills would be coming from the UK to be paid. Does the Commission’s explanation tally with your own understanding of why such a massive backlog has built up? What is the explanation for such a large payment request being made by the UK? You state that it is unclear why the Commission did not anticipate many of these pressures and that the Commission should have made better provision for them in compiling the detail of the 2014 Budget, insofar as it was aware of them. To your knowledge, did anyone within the EU institutions or Member States anticipate these problems or urge the Commission to adjust the Budget at the time? Is the fact that the scale of this problem appeared not to have been anticipated an indictment not only of the Commission, but also of the Council and the European Parliament, as well as the budget-making process as a whole?

10. We welcome your statement that the growing backlog of payments is an issue that needs to be addressed. However, when we asked you to identify a long-term solution to the problem, you stated only that “the solution need not be higher budgets. The Government has not given the Commission specific instructions as to where in the budget these funds should be drawn from, but in general feels that the Commission should look to areas which are under-implementing and which represent poor value for money if re-allocation is required.” As set out below, we share your view that the Commission should look first to redeployment, and that further sources for redeployment other than the €65 million thus far pinpointed by the Commission need to be identified. However, the sheer scale of the problem cannot be tackled by redeployment alone. Is your own statement that the Commission should look first to redeployment to meet some of the commitments a tacit admission of this fact?

11. In light of this, is it not incumbent upon the UK and like-minded Member States to assist the Commission in identifying a long-term solution to the issue, not least given that €1.3 billion of bills pertaining to the UK remain outstanding? In seeking to identify solutions, will you need to move from generalities to specifics? Do you agree that the EU budgetary process is groaning under the weight of such seemingly intractable problems? In light of this, what assurances can you give us about the efforts that the UK and like-minded Member States are making to tackle this growing problem? Can the issue really be addressed without resort to significant budgetary revisions?
Frontloading

12. On the frontloading of programmes, the Commission told us that there was a political decision to advance the payment of programmes that would boost growth and employment, and that this decision was supported by the UK. You confirmed that this was the case, and that the Government continue to support the frontloading of such programmes as Erasmus, the youth employment initiative, COSME and Horizon 2020 in the MFF as a reflection of the Government’s priorities in supporting growth and competitiveness. You state that “it is clear that significant front-loading into the first few years of the MFF … would impose pressure on later years of the deal”, and that the Prime Minister was well aware of the implications of the decision to frontload. Yet at the same time you point out that “when the Council negotiated the seven-year multi-annual financial framework it did not specify the detail of how it would work.” This was surely a mistake on the Council's part, adding weight to our view that the UK and other Member States took insufficient account of the pressures that frontloading would create on the budgetary framework at the time the decision was made. Silvano Presa told us that if estimates do not prove as accurate as they should be between now and 2020, “the difficulties will lie with other programmes and adjustments will need to be made. The risk has, in a way, been transferred to other programmes within the general framework.” Are you confident that it will be possible to offset such spending in future years? Will it be possible to return to a more orthodox understanding of the purpose of a contingency margin in the future? What will be the outcome for the overall MFF if the pressure on the later years of the budgetary framework becomes untenable? Is there a danger that the overall MFF deal will unravel?

The Contingency Margin

13. The Commission has asserted that it is proposing resort to the Contingency Margin only as a last resort, and that it will continue to seek opportunities for redeployment within the existing budget proposals. While we welcome the Commission’s commitment to “continue this effort for the remainder of the year”, we are disappointed that the message from the directors-general is that “it does not look as if there is going to be a big margin for other reallocations in the remainder of the year”. We urge the Commission to redouble its endeavours to locate further sources of redeployment, and welcome your efforts to encourage the Commission to do so. However, we reiterate that redeployment on its own will not deal with the magnitude of the problem. Thus the question of the Contingency Margin inevitably comes into play.

14. Nadia Calviño told us that “all the parties were aware of the challenges of these budgets, but the European Commission said at the time … that the budget can be implemented if we are able to use the margin of flexibility that has been embedded in it. If we are able to use the contingency margin and advance the payments, and if we are able to use the special instruments et cetera, then we can implement the tasks that are entrusted to the European budget. They knew the consequences. That is why the European Council also signed up to the need for flexibility when implementing the yearly budget within the ceilings of the multiannual financial framework.” Is this an accurate description of the MFF negotiations? If so, should the Council not have foreseen the inevitability of the Commission’s recourse to the Contingency Margin? Is this another example of a failure of the budgetary process?

15. The Joint Statement by eight Member States, including the UK, stated that “a proposal for the mobilisation of the Contingency Margin in 2014 would … be legally questionable”. However the Commission maintains that the proposal is legal, stating that “the existence of ‘unforeseen circumstances’ that may justify the mobilisation of the Contingency Margin to cover additional payment needs has … to be assessed against the state of play in February 2013 when the MFF payment ceilings were first established.” Your own letter of 25 June 2014 appears to cast doubt on the strength of the joint statement’s argument when you state that “the Government does not have a definitive legal position on this issue”, that “this was one of several issues being considered by the signatory Member States in questioning whether the Commission should be mobilising the CM at this stage”, and that “the Government’s primary position on DAB3/2014 is not a legal one but [a]
principled position”. In your evidence to us, you went further, stating that “‘legally questionable’ does not mean ‘illegal’; it means that there is a form of words in relation to ‘unforeseen’ and ‘as a last resort’, and we are not convinced that what is proposed meets that definition. That does not necessarily mean that it is ‘illegal’”.

16. In our view, to counter the Commission’s assertion that recourse to the Contingency Margin is a last resort because the Global Margin for Payments is not available, you would have to demonstrate the availability of a viable alternative to the Contingency Margin for the sum requested. Without this there is no basis on which the Court of Justice could impugn the Commission’s justification that using the Contingency Margin is a last resort. The argument employed in the Joint Statement, and repeated in your letter, that “payments for pre-2014 commitments … cannot by definition be considered as unforeseen circumstances” is not credible in our view. There is nothing in the term “unforeseen circumstances” in paragraph 1 of Article 13 of the MFF Regulation that could be construed to preclude such circumstances arising in the year before the additional appropriations need to be paid, so long as they were unforeseen. It is quite possible for pre-2014 commitments to lead to further expenditure than foreseen in 2014, such as the under-estimation of the backlog of payments under the Cohesion policy.

17. In light of this, do you stand by the Joint Statement’s assertion that resort to the Contingency Margin would be legally questionable? How would you respond to the suggestion made at the evidence session that a more effective approach would be to make sure that the inevitable increase in the budget is recognised as the result of a cash-flow problem, so that a clear statement is written into the minutes that reinforces the supremacy of the MFF and its seven-year numbers and makes clear that you expect compensating reductions in later years for the money that is brought forward to deal with the backlog of payments and frontloading of the MFF?

**Future years**

18. When we asked the Commission whether the scale of the problem meant that the Contingency Margin would be called upon in 2015 and 2016, Nadia Calviño told us that “we anticipate that by 2016 the payment appropriations situation should be eased … because we will have finished the payments of the past and the new programmes will be small in terms of pre-commitment by the European budget.” Nevertheless, she conceded that “it is almost impossible to say what is going to happen in 2016. If Member States are suddenly much more efficient, and launch the programmes much faster, we may have a problem in 2016. But … it would not be a responsible budgeting approach now to say that we are now going to activate the contingency margin in 2015 and 2016.”

19. In light of this uncertainty, we share your concern that the Commission is likely to continue to come forward with significant requests for funds in future years. While we urge you to continue your efforts to ensure that the Commission only turns to the Contingency Margin as a last resort once all opportunities for redeployment have been exhausted, the scale of the problem again illustrates the need to identify a long-term solution to the problem.

**The budgetary process**

20. All these issues feed into our broader concerns that the budgetary process itself is unsatisfactory. While we note your observation that the gap between payments and commitments has fallen from 7% to 5% and the Prime Minister has described that gap as perfectly safe, we repeat our view that a disjuncture between the two has occurred. Is the Commission correct in stating that the underbudgeting of payments has arisen because of “the economic crisis and the obligations of budgetary restraint”? Is it therefore a temporary problem or has the disconnect in the relationship between payments and commitments become a permanent structural feature of the budgetary process? You state that part of the problem lies in adjusting to “a new budget era” of fiscal constraint.
Can you elaborate on this? What in your view is the cause of this disjuncture, and how can it be corrected?

21. Both you and Nadia Calviño deny that the budgetary process is no longer fit for purpose. We disagree. In our view the strains in the budgetary process that the 2015 Draft Budget and DAB3 have brought to light show that the budgetary process needs radical modernisation. It is a highly complex mechanism with insufficient flexibility to take account of the real world and how a budgeting process works in practice. Aside from the wider reforms to the MFF that we advocated in our past reports, we believe that the time has come to give serious thought to a review of the budgetary process itself. Ideally, this would complement the current review of Own Resources, as how the forward plans and budgets are set and managed and how they are funded are all part of the same system. To continue in the present vein risks bringing the entire exercise into disrepute. It is therefore incumbent on all sides urgently to identify a solution to these problems. You state that “there are question marks around the budgetary system, particularly on the balance between payments and commitments”, that “it is certainly fair to raise the issue of whether the budget should be calculated in a different way” than this “very unusual system”, and that “there may be broader scope to look at how the whole picture of the way the budget works”. However you also state that this is not your primary focus at the present time. While we appreciate the urgency of reaching a satisfactory deal on negotiations on the 2015 Budget and DAB3, this is a nettle that needs to be grasped. What reassurances can you give us that the Government are taking these issues seriously and are seeking to work alongside the Commission, the European Parliament and other Member States to address them? For our part, we stand ready to provide any assistance to your efforts that we can.

22. We note your statement that a formal position in Council is expected in early September. We would be grateful if you could ensure that we are able to undertake effective scrutiny of the proposals before Council adoption of its initial position. What further discussions do you anticipate taking place before the end of July? Is there any likelihood that Council will reach an initial position by then? In light of this, we would be grateful for a response to this letter by 22 July 2014, or sooner if significant progress is expected in Council in the meantime.

23. At your appearance before the Committee on 1 July, the Committee invited you to respond in writing to a number of points directly relevant to the issues raised in this letter, as follows:

- Further details of the programmes that you identified as candidates for cuts, and the amounts involved (Q20);
- Your response to the Committee’s questioning of the Joint Statement’s claim that resort to the Contingency Margin is “legally questionable” (Q22);
- Further information on the position of other Member States on the 2015 Draft Budget and DAB3 (Q25);
- A response to the Committee’s question as to how the budgetary process can be improved (Q27);
- Providing information, ideally in tabular or graphic form, setting out the relationship between payments and commitments over the past ten years and explaining the reason why it has changed (Q29).

24. We would be grateful if your response to this letter could also respond to these points. Pending receipt of your reply we will continue to hold the documents under scrutiny.

25. I am copying this letter to Sir William Cash MP, Chair of the Commons Committee; Sarah Davies, Clerk to the Commons Committee; Arnold Ridout, Legal Adviser to the Commons Committee; Les Saunders, Cabinet Office, Thomas Kenny and Gary McMillan, International Tax Strategy & Co-ordination, HM Treasury.
LETTER FROM THE UK GOVERNMENT TO THE CHAIRMAN, 23 JULY 2014

Letter from David Gauke MP, Financial Secretary, HM Treasury to the Chairman


Thank you for the letter on these matters sent to my predecessor as Financial Secretary. First, I wanted to offer an update on progress in the budget negotiations since my predecessor appeared in front of the Committee on 1 July.

On 15 July, Coreper reached an agreed Council position on the 2015 budget, calling for a budget of €140.0bn (£112.2bn). This represents a €2.1bn (£1.7bn) cut to the Commission’s draft budget, and provides for a margin of €1.9bn (£1.5bn) between the budget and the 2015 annual ceiling set out in the MFF.

In Coreper, there was no formal vote as it was clear that a qualified majority was in place to support the Council position. Our Permanent Representative indicated that had there been a vote, the UK would have abstained on both Parliamentary scrutiny and substantive grounds, and regretted that greater cuts were not found. We do, however, welcome the fact that this position does support the overall delivery of the PM’s deal on the Multiannual Financial Framework.

As we suggested to you in the recent evidence session, we will have to vote formally via Council written procedure in early September. We will be abstaining in this vote. If the annual budget were to clear scrutiny by the time of the vote, we would still abstain on substantive grounds.

In terms of DAB3/2014, there has been no further progress since we last updated the Committee. We continue to expect that DAB3/2014 will be discussed alongside the negotiations on the 2015 annual budget in the autumn.

In your letter, you ask for our views on how the Commission’s draft budget could be cut. The press release from the Council, which sets out the revised breakdown by heading, is available at the following address:


As noted above, we felt that further cuts could have been found beyond these €2.1bn (£1.7bn). In particular, we would have been keen to see further cuts in administration, Heading 5 of the budget, where the Council proposal still represents a 2.1 per cent increase on the 2014 agreed budget.

You asked about how the budget could be targeted in 2015 and future years to ensure that growth and economic recovery is sustained across the EU. The MFF deal done by the Prime Minister secured a commitment to increase spending on high-value research and development, universities, and other pro-growth investment via Heading 1a of the budget. Pleasingly, we have seen the reorientation of expenditure to these areas, provided for by the MFF deal, play out in the 2015 annual budget negotiations. The agreed Council position ensures a 24.5 per cent increase in Heading 1a compared with the 2014 budget.

At the hearing with my predecessor, you asked for further details of how we plan to find sufficient cuts to the existing 2014 budget so as to avoid the need for additional expenditure on DAB3/2014.

I should re-iterate our overall approach to negotiations on the budget. We start from the fundamental principle of the importance of budgetary discipline, and this determines our stance in negotiations. As my predecessor made clear in her previous letter on DAB3/2014 and at the hearing, we do not provide a line-by-line breakdown of cuts or savings to the Commission. This is because we see the role of Member States as setting the overall parameters of spending, and the role of the Commission as managing the detail of the budget so as to ensure that the EU lives within its means.

You ask whether the Government stands by the assertion in the Joint Statement that the use of the contingency margin is “legally questionable”. On this, I do not have anything more to add to the reasoning set out in our previous letter to the Committee. As we set out in this letter, the Government does not have a definitive legal position on this issue – this explains the use of the term “legally questionable”. The Government’s primary position on DAB3/2014 is not a legal one but the principled position set out in the original Explanatory Memorandum and reiterated in the letter sent and the hearing held since that EM was sent.

You ask several questions asking why scale of the problems caused by the pressures included in DAB3/2014 were not anticipated, and whether these represent an indictment of the budgetary process. As my predecessor made clear in the last letter on this subject, it is unclear why many of these pressures should not have been anticipated by the Commission. The Government does not agree, however, that this is an indictment of the budgetary process. In-year pressures of some sort will always emerge. The challenge is to ensure that there is
sufficient flexibility built into budgets and in-year margins below the annual ceilings to allow resources to be reallocated to meet genuinely unforeseen pressures.

You ask some more general questions about risks of the MFF becoming untenable as a result of the mobilisation of the contingency margin. As we said in our last letter to the Committee on this subject, it is clear that significant front-loading into the first few years of the MFF would impose pressure on later years of the deal. This is one of the reasons behind the Government’s view that the Commission should always look first to reallocate funds from within existing agreed budgets to meet emerging in-year pressures. Having said this, the MFF deal did include provision for the contingency margin to operate as a mechanism to move expenditure between years but within the overall MFF ceiling. The fact that the Commission have chosen to request the mobilisation of the contingency margin in the first year does not in itself indicate that the MFF is in some way untenable.

You ask several questions about the relationship between payments and commitments, and how it may have changed in recent years. As my predecessor made clear at the evidence session, the Government does not accept that the relationship has broken down. Indeed the gap between payment and commitment ceilings has fallen from 7 per cent during the last MFF to 5 per cent over the current MFF. The Prime Minister has described this gap as “perfectly safe”. The Government finds this downward trend encouraging as it contributes to mitigating the steady build-up of unpaid commitments.

You requested a table comparing payment and commitment appropriations over recent years. This is set out in an annex. As it makes clear, the gap between payments and commitments is significantly tighter in 2014 than any of the previous four years. The gap between payments and commitments in the Council position represents a further tightening at just 3.6 per cent. This is evidence of the value of the 2014-20 MFF deal in bearing down upon the build-up of commitments, and should help to address the current backlog.

Finally, you ask for a response to the Committee’s questions as to how the budgetary process can be improved. As my predecessor said in giving evidence to the Committee, it is certainly fair to raise the issue of whether the budget should be calculated in a different way. She made it clear, however, that rather than focusing on potential reform of the system, the Government’s energies for now are fully focused on the amount of money that the UK is going to be expected to find in 2014 and 2015 – and more generally on the successful implementation of the 2014-20 MFF deal, where the Prime Minister delivered the first ever real-terms cut to the EU budget. This is where my focus too will be as Financial Secretary.

**Annex: Historical trend for payments and commitments appropriations**

<table>
<thead>
<tr>
<th>Year</th>
<th>Commitment appropriations</th>
<th>Payment appropriations</th>
<th>Percentage difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>2014</td>
<td>€142.2bn</td>
<td>€135.5bn</td>
<td>4.7%</td>
</tr>
<tr>
<td>2013</td>
<td>€150.9bn</td>
<td>€132.8bn</td>
<td>11.9%</td>
</tr>
<tr>
<td>2012</td>
<td>€147.2bn</td>
<td>€129.1bn</td>
<td>12.3%</td>
</tr>
<tr>
<td>2011</td>
<td>€142.0bn</td>
<td>€126.5bn</td>
<td>10.9%</td>
</tr>
<tr>
<td>2010</td>
<td>€141.4bn</td>
<td>€122.9bn</td>
<td>13%</td>
</tr>
<tr>
<td>2009</td>
<td>€116.1bn</td>
<td>€113.4bn</td>
<td>2.3%</td>
</tr>
<tr>
<td>2008</td>
<td>€129.1bn</td>
<td>€120.3bn</td>
<td>6.8%</td>
</tr>
</tbody>
</table>

LETTER FROM THE CHAIRMAN TO THE UK GOVERNMENT, 29 JULY 2014

**Letter from the Chairman to David Gauke MP, Financial Secretary, HM Treasury**

The Draft EU Budget 2015 and Draft Amending Budget 3 (DAB3) for 2014

Thank you for your letter, dated 23 July 2014, on the 2015 Draft Budget and on Draft Amending Budget 3 (DAB3) to the 2014 Budget. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 29 July 2014.
We are pleased to welcome you to your new post as Financial Secretary. However we regret to state that we are disappointed by the standard of this response to our detailed letter of 9 July 2014. The letter provides scant information beyond the position set out by your predecessor at her appearance before the Committee on 1 July 2014.

We are particularly disappointed by the lack of detail on the further cuts that the Government would have wished to have seen. You cite only further cuts in administration, and provide no further details. You state that “we do not provide a line-by-line breakdown of cuts or savings to the Commission. This is because we see the role of Member States as setting the overall parameters of spending, and the role of the Commission as managing the detail of the budget so as to ensure that the EU lives within its means.” We find this attitude to be both complacent and counterproductive. The Government’s failure to pinpoint specific areas for cuts makes it all the harder for an effective case for reductions to be made. As we said in our 9 July 2014 letter, it is more convincing if the Government and like-minded Member States make concrete proposals as to how the Draft Budget can be trimmed. Your failure to do so tends to give weight to the Commission’s argument that there is little room for further cuts or for reallocation within the existing budgetary framework. The fact that COREPER has agreed a position not to the UK’s satisfaction suggests that you have been equally unable to convince other Member States of your case.

Likewise, we regret your failure to engage with our concerns about the efficacy of the budgetary process. You state that the fact that the Commission has chosen to request the mobilisation of the contingency margin does not in itself indicate that the MFF is in some way untenable. Yet you give us little cause for optimism that this will not ultimately prove to be the case. You do not agree that the fact that the scale of the problems lying behind DAB3 were not identified is an indictment of the budgetary process. Yet you give us little comfort that the underlying issues are being addressed in any systematic manner. You state that it is fair to raise the issue of whether the budget should be calculated in a different way, but that the Government will nevertheless not be focussing on such issues. Once again, we find this to be a complacent attitude. If the UK and like-minded Member States do not lead the way in seeking sensible reforms to the budgetary process then it will not be surprising if the flaws in the system persist for years to come, to the detriment of all.

We note the table attached to the letter setting out the gap between commitments and payments since 2008. You state that the gap is significantly tighter in 2014. Can you clarify if the 2014 figure takes into account the DAB3 proposal? Given that payments exceed commitments in each of the years, and continue to do so for 2015 even if at a reduced level, we question your assertion that “this is evidence of the value of the 2014-2020 MFF deal in bearing down upon the build-up of commitments, and should help to address the current backlog.” Can you explain the rationale behind this claim? Is it true to say that the high gap in 2010-2013 was a temporary phenomenon arising from the financial crisis and EU-wide recession? Should we expect a small gap to persist in the future? Or should we expect a budget where commitments are lower than payments in the future? Is this not the only way in which the build-up of commitments can be reduced? You repeat that in the 2014-2020 MFF deal “the Prime Minister delivered the first ever real-terms cut to the EU budget.” Do you take as the basis for this claim the agreed level of payments or commitments?

Given that a general approach on the 2015 Draft Budget has now been reached, we now clear that document from scrutiny. However we will continue to hold DAB3 to the 2014 Budget under scrutiny pending the progress of negotiations. We would be grateful for an update on both when negotiations resume in the autumn, and by 30 September 2014 at the latest.