Rt Hon Nicky Morgan MP
Financial Secretary
HM Treasury
1 Horse Guards Road
London SW1A 2HQ

9 July 2014

Dear Nicky,

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

1. Thank you for your EM, dated 25 June 2014, on the 2015 Draft Budget, EM 10340/14 & 10341/14, dated 16 June 2014, on Draft Amending Budget 3 (DAB3) to the 2014 Budget, and your letter, dated 25 June 2014, on the same. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered these documents at its meeting on 8 July 2014. In doing so we took account of the evidence heard on 24 June 2014 from Nadia Calviño, Director General, DG Budget (BUDG), and Silvano Presa, Director, DG Budget (BUDG), European Commission, and your own evidence before the Sub-Committee on 1 July 2014, for which we are grateful. We are also grateful to you for ensuring that the Committee had sight of the EM on the 2015 Draft Budget in advance of the evidence session.

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 disbursement 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.

The Lord Boswell  
Chairman of the European Union Committee