TO THE COMMISSIONER RESPONSIBLE FOR THE EUROPEAN UNION BUDGET

By Zsolt Darvas

* You take over responsibility for the EU budget at a difficult time. Budget discussions have deepened divisions between member states over agriculture, cohesion, better spending, innovation and new priorities. Views on the desired size of the budget also diverge, while Brexit (if it happens) will leave a hole in the budget. Rule-of-law issues in some countries complicate matters.

  You will need to address a number of issues including the shares of spending on different objectives, the revenue side of the budget and accounting practices. You should also promote the idea of a cyclical stabilisation instrument for the euro area, such as a common unemployment benefit scheme. And when a calmer period arrives after the EU budget is approved, you should initiate a fundamental rethink for the post-2027 period.

* REVIEWING PRIORITIES
* NEW SOURCES OF REVENUE
* AVOIDING DUPLICATION

* DIVISIONS OVER PRIORITIES

You take up your role at a time when intense discussions are ongoing about the 2021-27 Multiannual Financial Framework (MFF), proposed by the previous Commission. The debate has deepened the divisions between EU countries in terms of their differing emphasis on agriculture, cohesion, better spending, innovation and new priorities. Views on the desired size of the budget diverge similarly, while Brexit (if it happens) will leave a hole in the next MFF. This already complicated situation is coupled with concerns about the rule of law in some member states, which is particularly relevant for the EU budget, since rule-of-law deficiencies might undermine the sound use of EU funds. It is likely that the unanimity requirement for MFF approval will result in an outcome similar in structure to the current MFF, and will limit changes, even if they are desirable.

Because a lot should be changed. The EU budget has a number of shortcomings. You have an important role in pushing the discussion in the right direction first within the new Commission, and then by convincing the representatives of member states and the European Parliament. Given the advanced stage of the negotiations and the time constraints – there must be agreement on the new MFF before the end of 2020 – you might not be able to put a fundamentally new proposal on the table, but you will be certainly able to steer the discussion. And importantly, after the next MFF is approved, in a calmer environment, you will be able to initiate the analytical work necessary to support a more fundamental reform of the EU budget for the post-2027 period.

1 STATE OF AFFAIRS

1.1 A peculiar and complicated budget

* COMPLEMENTING NATIONAL SPENDING

The EU is a group of developed states with significant and large government sectors. EU spending is just about 1/50th of what member states spend. The key questions are which functions can be delivered more effectively jointly, and how should the EU budget best complement what countries already do at national level. This requires careful thinking about European public goods and how to provide them (Darvas and Wolff, 2018a).

Federations often provide economic stabilisation during cyclical downturns primarily at federal level, which is intrinsically linked to the allocative function of public finance, or redistribution between individuals. But in Europe, the welfare state is large and basically national. There is no EU or euro-area wide cyclical stabilisation instrument, only crisis-management facilities to help countries that lose market access[1]. Proposals for alternative fiscal-stabilisation instruments are off the table because of strong resistance from some member states. The December 2018 Euro Summit conclusions called for a budgetary instrument for convergence and competitiveness for the euro area, to be part of the EU budget, without mentioning a possible counter-cyclical instrument[2] and indeed counter-cyclicality was not mentioned in the June 2019 Eurogroup conclusions[3]. Without such a centralised fiscal-stabilisation instrument, fiscal-policy coordination remains the only tool to influence the EU or the euro-area fiscal stance. While the Barroso Commission was able to coordinate a synchronised fiscal stimulus in 2009, the success of the coordination of national policies crucially depends on whether there is a common shock and therefore a common interest.

* FISCAL STABLISATION

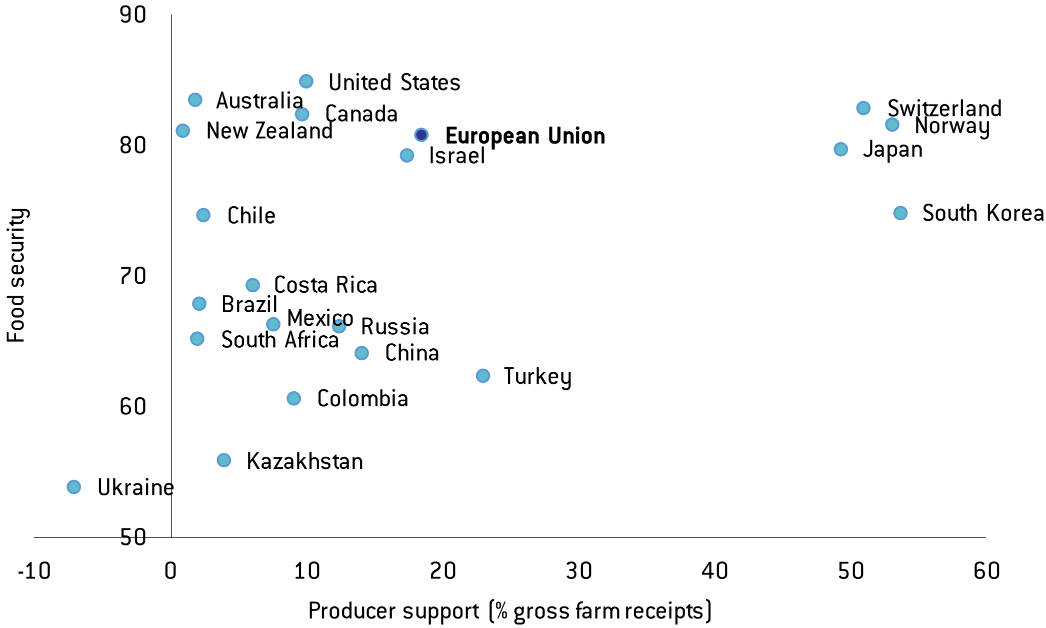
While the current MFF proposal includes some simplifications, such as the reorganisation of several spending programmes and a reduction in the number of such programmes, the structure of the proposed budget remains overly complex and outdated. The continued distinction between 'commitments' and 'payments' leads to an ever-rising stock of spending commitments (*reste à liquider – RAL*). No other country, federation or international organisation – including the United Nations, International Monetary Fund, Organisation for Economic Cooperation and Development, and also organisations that make long-term investments, such as the World Bank and the European Investment Bank – uses such a complex budgeting framework.

* BUDGET STRUCTURE

1.2 A budget with an outdated rationale and contestable effectiveness

The rationale behind the largest EU budget spending item, the Common Agricultural Policy (CAP), is weak. Nor is it clear CAP spending has achieved its goals, despite some triumphant

Figure 1: Agricultural support vs food security, 2017



Source: Bruegel based on OECD for producer support, Economist Intelligence Unit (EIU) for food security. Note: The OECD's producer support estimate is the annual monetary value of gross transfers to agricultural produces from consumers and taxpayers, arising from government policies that support agriculture. The EIU's food security indicator measures affordability, availability, and quality and safety of food in 113 countries. It is available for 20 European Union countries (14 of the first 15 EU members with the exception of Luxembourg, and six newer members), from which we calculated the GDP-weighted average.

* AGRICULTURAL SUBSIDIES

communications from the previous Commission. The European Court of Auditors (2017) found the CAP's 'greening' policies to be likely ineffective at reducing the climate impact of agriculture in Europe. Alliance Environnement (2017) suggested inefficiencies in managing environmental impacts, while Pe'er *et al* (2014) concluded that the new environmental prescriptions are so diluted they are unlikely to benefit biodiversity. ECORYS *et al* (2016) raised serious concerns about the national implementation of the CAP and the policy's overall impact.

Figure 1 shows that countries with higher agricultural subsidies do not achieve better food security. The EU has less food security than the United States, Canada and Australia, and is broadly similar to New Zealand, while these countries provide far lower agricultural subsidies. Campbell-Baier and Darvas (2019) found that food prices tend to be higher in countries with higher agricultural subsidies, contradicting the perception that agricultural subsidies can help keep food prices low. And there is some evidence for subsidies restraining productivity.

While further research is needed to better understand the drivers and implications of cross-country differences in food security, food prices and agricultural productivity, these findings raise concerns about the general effectiveness of agricultural subsidies. Considering the specific analyses of CAP's environmental impacts, it thus seems that the only goal the CAP unambiguously achieves is income support. Income support is essentially a social policy, but there are doubts about its fairness, and whether it is desirable in the first place. Richer EU countries, where agricultural wages are higher, receive much more CAP funding per agricultural worker than poorer countries (Darvas and Wolff, 2018b), when common sense would suggest that the greatest income subsidy should be given to those who earn the least. European Commission (2018) highlighted that 80 percent of direct payments go to 20 percent of farmers, questioning the fair distribution of CAP allocations. The proposal of the previous Commission to direct CAP funding away from large farmers towards small and medium farmers was welcome but insufficient to eliminate the distortions caused by the subsidies.

* COHESION POLICY

The second largest EU budget spending item, cohesion (or regional) policy, has various EU-wide social, political and economic rationales, but needs major reform. The academic literature on the effectiveness of the EU's cohesion policy is inconclusive: some studies find positive long-term impacts, others find positive but only short-term impacts, while others find no or even negative impacts[4]. Such a diversity of results suggests that the policy does not always fulfil its potential. Similar conclusions were reached in the seminal work of Bachtler *et al* (2013, 2017), who also argued that progress in addressing the problems has been slow and inconsistent, and some regions experienced a deterioration of implementation quality during the 2007-13 period.

* CORRUPTION RISK

Interview conclusions reported by Darvas *et al* (2019) suggested

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that in some countries, local stakeholders have different attitudes towards cohesion and national funds, which sometimes leads to less-careful management of EU funds. Corruption is a risk in some countries, as are rule-of-law deficiencies, which might hinder the detection and punishment of fraud.

1.3 New spending priorities

* SPENDING WITH PAN-EUROPEAN IMPLICATIONS

Several priorities for EU spending have gained more importance and new priorities have emerged. Environmental pollution has clear cross-border implications and more environment-related EU funding is welcome. In a globalised and digitalised world where Europe lacks sufficient productivity growth, research, innovation and digital transformation – areas with a pan-European rationale – have become more prominent. Likewise, the benefits of student mobility help not only the individuals involved, but also host universities and, more indirectly, the EU by fostering more knowledge about it and support for it. The immigration crisis of 2015-16 highlighted deficiencies in the EU's asylum system and the vulnerability of EU borders, which again have major pan-European implications. For example, the way Greek and Italian borders are protected has an impact on the arrival of illegal migrants in Denmark or the Netherlands. The increased security threats justify some common funding of defence-related projects, even though defence remains an entirely national prerogative. Some projects would perhaps be unrealistic at national level, such as the EU's satellite programme. While the EU combined (both the EU budget and EU member-state budgets) is a larger donor of foreign aid than any non-EU country, the achievement of the United Nations Millennium Development Goals requires more support. It would also be in the best interests of the EU to engage more with Africa, given Africa's importance as a source region for immigration to the EU.

These spending priorities require more EU resources, while Brexit (if it happens) will leave a hole in the next MFF. The proposal by the previous Commission essentially entails a nominal freezing of CAP and cohesion spending from the 2014-20 MFF to the 2021-27 MFF, along the lines of the recommendation in Darvas and Wolff (2018a), which leaves a reasonable amount of money to be spent on new priorities if national contributions as a share of GDP remain the same. The proposed relative decline in total cohesion spending is broadly in line with the diminishing share of EU27 citizens (not including the UK) living in less-developed regions, while the proposed cut in CAP direct payments should have been larger.

2 CHALLENGES

* MFF NEGOTIATIONS

Your biggest challenge will be the finalisation of the MFF negotiations. This will prove to be difficult for numerous reasons. Beneficiaries of existing programmes, such as the CAP and cohesion, will insist on keeping their privileges, while member-state representatives who are less convinced of the usefulness of such EU spending will be reluctant to agree to more contributions. Meanwhile, new priorities require more resources, while Brexit will leave a financing hole. The discussion about linking EU funds to participation in the European Public Prosecutor's Office or a procedure analysing the sound observance of EU rule-of-law principles, make the debates even more contentious. The unanimity requirement for the approval of the MFF might limit desirable changes. It will be a major challenge for you to avoid such an outcome.

* IMPLEMENTATION

While the EU's decision-making history shows a record of last-minute compromises, you cannot exclude the possibility that the MFF will not be approved by the end of 2020. That would result in a major difficulty, given that the 2020 annual budget ceilings will be carried over to 2021, without the implementing legislation necessary for new programmes. In this case you will have to ensure the smooth continuation of ongoing programmes, while further intensifying the already intensive discussions about the new MFF.

Once the MFF is approved, your job will be much easier, but not without further challenges. An immediate task will be to negotiate and approve the implementating legislation. If the MFF is approved only in late 2020, then the new MFF period will start without the implementating legislation being ready, similar to the situation at the start of the 2014-20 MFF. In that case you will face a major challenge in mitigating the adverse impacts of the lack of implementating legislation.

* COMBATING FRAUD

The adoption of annual budgets, which does not require unanimity and essentially translates the agreed MFF into concrete annual plans, is a much smoother process.

The implementation and control of adopted budgets will provide additional challenges, especially in countries where the risk of corruption and inappropriate management is high. While the existing European anti-fraud office, OLAF, will continue its administrative investigations into irregularities and fraud affecting the EU's financial interests in all EU countries, the European Public Prosecutor's Office, an independent EU office, will from 2020 be responsible for investigating and prosecuting crimes against the EU budget, such as fraud, corruption or serious cross-border VAT fraud, in its participating member states[5]. More intensive regular checks in those countries that have not joined the European Public Prosecutor's Office could be recommended. If approved, it will be a challenge for you to evaluate the appropriate level of the intensity of checks.

* RULE OF LAW

In addition, a new rule-of-law procedure is under discussion[6], which would enable the Commission to suspend payments in case of general deficiencies in the rule of law. The proposed procedure has a number of sensible elements (Claeys and Darvas, 2018). If this procedure is approved and becomes operational, you will have to cooperate with other commissioners and face the major challenge of objectively measuring rule-of-law deficiencies. And should the Commission conclude that there is a general deficiency in a particular member state, you will have to propose a sanction, knowing that the Council has a tendency to reject financial sanctions against member states.

3 RECOMMENDATIONS

Given the advanced stage of negotiations about the next MFF, the diversity of member states' views and the time constraints, you might not be able to influence the next MFF decisively. Still, you should try to steer in line with the following recommendations. And when a calmer period arrives after the MFF is approved, you should initiate a fundamental rethink of the EU budget for the post-2027 period.

3.1 Agricultural policy

* ENVIRONMENTAL GOALS

Direct payments should be phased out, or, at least, national co-financing should be introduced (in line with Hoelgaard, 2018). It would be similarly important to develop a uniform formula for agricultural support, to correct the current uneven distribution of CAP payments across EU member states.

Since there is an EU-wide rationale for correcting market failures and promoting public goods, such as environment and biodiversity, and for insuring against large risks such as earthquakes and animal disease epidemics, as in the US, you should retain and even reinforce the CAP's environment goals, but make the CAP more impactful, along the lines recommended by the European Court of Auditors and several other organisations and academic researchers.

* MORE-DEVELOPED REGIONS

The current rural development goals of the CAP would be best integrated into cohesion policy, thereby strengthening the synergies between different EU funds and avoiding possible overlaps between CAP and cohesion policy.

3.2 Cohesion policy

You should reconsider whether cohesion funding needs to be provided to more-developed regions. The minor share of EU funding in the combined GDP of more-developed regions[7] shows that very few local beneficiaries can access EU funding and the funding cannot make a sizeable difference in terms of the achievement of EU goals. Countries dominated by more-developed regions could easily replace EU cohesion funding with national funding. You should either work to eliminate the allocation of cohesion funding

* PERFORMANCE FRAMEWORK

to more-developed regions, or condition it on interregional cooperation with regions from less-developed countries, as found to be beneficial by Darvas *et al* (2019).

The effectiveness of cohesion policy should be improved by making it results-oriented (that is, tackling the actual problems for which an intervention was designed), and not indicator-oriented (such as measuring the length of roads built). The current Performance Framework has not been able to achieve such a change (Darvas *et al*, 2019). The Commission's proposal to shorten and simplify the rulebook and to eliminate some procedures is welcome, but more is needed to focus cohesion policy on results. *Ex-ante* evaluation of the real needs and objectives should not be only a formal commitment to comply with an obligation, but the most important step in designing cohesion programmes. It is important to define the basic method to be used for the reports providing justifications, and there should be comparison of methodologies when they are different.

* CORRUPTION RISK

Another way to improve the effectiveness of cohesion policy would be to focus on longer-term strategic programmes and projects, which involve more planning and greater implementation efforts. But setting up long-term strategies does not require such a high degree of flexibility in terms of reallocation as the previous Commission proposed.

To improve the control of cohesion spending, and more generally all kinds of EU spending, you should rectify the various shortcomings of the EU's fraud-fighting framework, as recommended by the European Court of Auditors (2019). In addition, you should push forward the proposal for more intensive checks for countries not participating in the European Public Prosecutor's Office and implement it vigorously once adopted. Likewise, once the rule-of-law procedure is approved, you should work out an operational procedure and implement it forcefully. There is also great potential when the focus is on results in wider use of the simplified cost option[8] and financing not related to costs, but to results[9]. Such a shift in focus could also alleviate problems associated with possible corruption and improper use of the funds, since beneficiaries will have to demonstrate that they have achieved results, instead of just declaring costs, which (in case of corruption or mismanagement) could be much higher than reasonable costs under sound management. For high corruption-risk countries, national public procurement practices should be analysed very strictly, as should whether purchase prices for EU-funded projects correspond to market prices.

* EUROPEAN PUBLIC GOODS

To improve the ownership of projects, some increase in national co-financing rates would be welcome, which should be feasible given the improved economic situation and the low interest rate environment, which greatly helps fiscal sustainability in the member states[10].

3.3 Other spending priorities

Beyond improving agricultural and cohesion policies, the top priority in the EU spending debate should be to assess which spending areas constitute European public goods and how best to provide these goods, in light of the significant budgets of member countries and competences stipulated in the EU treaty. EU spending should focus on issues with clear pan-European implications, which can be delivered more effectively jointly.

Areas including environment protection, research, youth mobility, border protection, defence, security and migration have clear pan-European implications, as do some mega-projects such as the Galileo satellite system. You should increase the funding available for these areas at the expense of lower agricultural income subsidies.

The EU has a responsibility for helping its less-fortunate neighbours and other parts of the world, and has an interest in doing so if it wants to reduce the migration pressure in the long run. Yet the communication of the previous Commission showed that certain elements of this spending category are planned to be multiplied by a factor of either 1.2 or 1.3 compared to the current MFF (at current prices, excluding the UK from the current MFF), while EU27 GNI is expected to increase by a factor of 1.28 (again, at current prices). So an increase in spending with a factor of 1.2 implies a decline as a share of GNI. You should push to significantly increase the funding for the EU's external actions as a share of GNI.

3.4 EU budget revenues

Most of the proposals by the previous Commission to change the revenue side of the EU budget are quite reasonable and you should support them.

* COMMON CORPORATE TAX BASE

The provision of EU public goods would justify the introduction of 'genuine' own resources, in order to align some objectives of the EU with the bloc's revenue sources. The three concrete proposals of the previous Commission point to the right direction. A plastic-waste levy and a share of the revenues of the EU emissions trading system would contribute to the EU's climate and environment goals, while a share of corporate taxes based on the Common Consolidated Corporate Tax Base (CCCTB) would require an agreement on CCCTB in the first place, which would help tax avoidance. Though the CCCTB discussion seems to be stuck, you should actively advocate for it, while also exploring the potential for further environmental taxes.

Since the EU is a customs union with a common external trade policy, it is reasonable to direct customs revenues to the EU budget, minus the collection costs. The actual collection costs are much lower than the 20 percent share currently retained by member states, but also much smaller than the 10 percent value proposed by the previous Commission. You should reduce the retained value to reflect actual costs, but if it is difficult to estimate, then to a symbolic value of, say, 1 percent.

* NATIONAL CONTRIBUTIONS

However, even in the most ambitious scenario about genuine own resources, national contributions will remain the major source of financing of the EU budget. Given the proposed increase in the provision of truly European public goods that benefit every European country, moving national contributions even closer to the distribution of GNI is sensible, to which *ad-hoc* corrections (like the rebates) are not necessary. You should pursue elimination of all rebates and other revenue correction mechanisms, starting from the first day of the next MFF.

3.5 EU budget structure

The EU should scrap its outdated and overly complex budgeting methodology, and instead adopt the best practices used by governments and multinational organisations based on accrual multi-annual budgeting, supplemented with a cash budget.

3.6 Euro-area budget

The term sheet[11] approved by the June 2019 Eurogroup for the budgetary instrument for convergence and competitiveness for the euro area is quite general and suggests that it will duplicate the goals of the existing EU budget, in particular cohesion policy (accounting for 34 percent of the 2014-20 MFF) and 'competitiveness for growth and jobs' (accounting for an additional 13 percent of the 2014-20 MFF). You might have little leverage to influence the discussion about this new instrument, as it is driven by the Eurogroup, but you should encourage the Eurogroup to develop an instrument that offers added value compared to existing instruments. A counter-cyclical stabilisation instrument, such as a common unemployment benefit scheme, would be such a tool. It could also involve a higher level of harmonisation of labour markets to the benefit of a better-functioning monetary union.

NOTES

1 Facilities include the European Stability Mechanism, Balance of Payments Facility and Outright Monetary Transactions.
2 See https://www.consilium.europa.eu/en/meetings/euro-summit/2018/12/14/.
3 Available at https://www.consilium.europa.eu/en/meetings/eurogroup/2019/06/13/.
4 See Hagen and Hohl (2009), Marzinotto (2012), Pienkowski and Berkowitz (2015), Crescenzi and Giua (2017), and Darvas *et al* (2019).
5 At the time of writing, 22 EU countries have joined the European Public Prosecutor's Office, with the exceptions of Denmark, Hungary, Ireland, Poland, Sweden and the United Kingdom.
6 See http://europa.eu/rapid/press-release_IP-18-3570_en.htm.
7 In the 2014-20 MFF, more-developed regions receive cohesion funding amounting to a mere 0.07 percent of the combined GDP of these regions, which would fall to an even lower value in the 2021-27 MFF.
8 Simplified cost options (SCOs) designate the "*the use of flat rate financing, standard scales of unit costs and lump sums*" when declaring costs as part of projects, with the European Commission paying out such costs instead of only reimbursing 'real costs'. It is expected that by 2020, SCOs will cover approximately 33 percent of the European Social Fund, 2 percent of the European Agricultural Fund for Rural Development and 4 percent of the European Regional Development Fund/Cohesion Fund budgets. More-developed regions make greater use of SCOs than less-developed regions (Brignani and Santin, 2018).
9 Article 125(1) of the financial regulation applicable to the general budget of the Union allows EU contributions in the form of financing not linked to costs in two alternative cases: either (i) the fulfilment of conditions set out in sector-specific rules or Commission decisions; or (ii) the achievement of results measured by reference to previously set milestones or through performance indicators.
10 See the memo to the commissioner responsible for economic affairs in this volume.
11 See https://www.consilium.europa.eu/en/press/press-releases/2019/06/14/term-sheet-on-the-budgetary-instrument-for-convergence-and-competitiveness/.

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Suggested citation:
Darvas, Z. (2019) 'Memo to the commissioner responsible for the European Union budget', in M. Demertzis and G.B. Wolff (eds) *Braver, greener, fairer: Memos to the EU leadership 2019-2024*, Bruegel, available at https://bruegel.org/2019/07/memos-2019/