Financial Management in the European Union

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SUMMARY

1 In 2007, expenditure by the European Union budget totalled €114.0 billion and revenue was €117.6 billion. In that year, the United Kingdom made a gross contribution of €13.4 billion to the European Union. Its net contribution was €6.1 billion, the largest after Germany following an abatement of €5.2 billion.

2 This report follows our practice in recent years of updating the United Kingdom Parliament on the efforts being made by the European Commission (the Commission), working with Member States, to strengthen the financial management of the European Union. It draws upon the audit findings of the European Court of Auditors (the Court); information from the European Anti-Fraud Office (OLAF); the results of our own audit findings in the United Kingdom on the use of European Community money; and a review of the various initiatives underway to strengthen financial management.

3 This report covers:

- the 2007 Budget and the Court of Auditors' audit opinion on the 2007 financial statements (Part 1);
- performance on the main expenditure areas and reported incidence of fraud and irregularity (Part 2); and
- the initiatives to improve financial management and accountability (Part 3).

Findings

4 In November 2008, the Court published its report on the Commission's implementation of the 2007 budget. For the first time the Court provided a positive Statement of Assurance, without qualification, on the *reliability* of the accounts. In reaching this conclusion the Court sought assurance that all revenue, expenditure, assets and liabilities had been recorded and that the annual accounts faithfully reflected the Community's financial position at the year-end.

5 On the second element of its Statement of Assurance, however, and for the fourteenth successive year, the Court did not provide a positive Statement of Assurance on the *legality* and *regularity* of most categories of European Union expenditure. It found that the 'Administrative and other expenditure' and 'Economic and financial affairs' expenditure were legal and regular. But for the main areas of expenditure, Cohesion (formerly known as *Structural Measures*) and *Agriculture*, it reported a material level of error. The Court treats as material an error in excess of two per cent of total expenditure in that policy area.

Agriculture expenditure

6 The estimated overall level of error reported by the Court on agricultural expenditure of between two and five per cent was not significantly different from the previous year. The estimated error rate for the European Agricultural Guarantee Fund (EAGF), which accounted for some 80 per cent of *Agriculture* spending in 2007, was slightly below materiality. The increasing use of the Single Payment Scheme, across Member States, and the increasing application of the Integrated Administration and Control System, which links payment to registered parcels of land, were important factors reducing the error rate. But the Court found a significant level of error in expenditure on rural development under the European Agricultural Fund for Rural Development, which led the Court to conclude that expenditure on Agriculture as a whole was affected by a material level of error.

7 In its report on 2007 the Court raised a number of concerns about the application of the Single Payment Scheme within the United Kingdom. As with previous years many of these issues appear to have arisen because the United Kingdom's interpretations of European regulations differed from those of the Court during the implementation of the new scheme.

8 The National Audit Office has reported separately on the delays and errors in payment that accompanied the introduction of the Single Payment Scheme in England, and the action being taken to address these delays. The Department for Environment, Food and Rural Affairs included provisions totalling some £320 million in its accounts for 2007-08 (a reduction from £348 million for 2006-07) as an estimate for potential financial corrections arising from disallowed payments under the Single Payment Scheme for 2005 and 2006 and other, smaller, schemes administered by the Rural Payments Agency and Devolved Administrations. Since publication of the Department's 2007-08 accounts part of this provision has crystallised. The Commission, in July 2008, issued a financial correction of £54.9 million for irregularities in administering the 2004 Arable Area Payments Scheme.

9 The Regulations for funding the Single Payment Scheme stipulates that reimbursement to Member States by the Commission shall be reduced on a sliding scale for payments made to claimants after the annual payment deadline. The Rural Payments Agency made late payments after the 2005 Scheme deadline resulting in a reduction in reimbursement of some £63 million.[1] This £63 million was therefore paid from Exchequer funds and resulted in a loss of that amount for the United Kingdom taxpayer. This figure is in addition to the provision outlined in paragraph 7.

Cohesion Expenditure (formerly known as Structural Measures)

10 Expenditure on Cohesion, which includes the European Regional Development Fund and European Social Fund, continues to be the biggest source of error in the European Union budget. The Court concluded that expenditure on Cohesion projects was subject to material error, and reported that at least 11 per cent should not have been reimbursed by the Commission in 2007. Errors were mainly due to inclusion of ineligible costs, over-declaration of money spent, or failure to respect procurement rules.

11 The Court tested a sample of 16 national supervisory and control systems to assess how effectively they functioned. It reported that three were 'not effective', 11 only 'partially effective' and the remaining two were classified as 'effective'. One of the partially effective supervisory systems was in Northern Ireland. The European Commission considers these findings to be an improvement on the sample reviewed in 2006, when the Court assessed the majority of systems as 'ineffective'.

1 Department for Environment, Food and Rural Affairs Resource Account for the 2006-07 financial year. HC 585, 12 November 2007.

12 The Court noted that at the end of 2007 there were some €138.6 billion of Cohesion Policy commitments outstanding (unused commitments carried forward to meet future spending) from the 2000-2006 financial period which is referred to as a Financial Framework. During that period Cohesion policy expenditure was made through five distinct funds - four 'structural' funds and one 'cohesion' fund. Some €84 billion of the outstanding commitment related to the structural funds (over 2.3 years' expenditure at the 2007 spending rate). Although the 2007-2013 Framework is in progress, payments to beneficiaries of structural funds from the 2000-2006 Framework will continue until 2009 and for the Cohesion Fund until 2010. Setting up new programmes while others are running down requires officials to work to different sets of rules drawn up for different time periods.

13 In the United Kingdom the Department for Communities and Local Government, which is responsible for expenditure on the European Regional Development Fund, included a provision of £72.9 million in its accounts for 2007-08 to cover potential ineligible grant payments which may be subject to financial corrections by the Commission.

14 Cohesion projects in Member States are co-financed by the European Union Budget. The other co-financer varies and could be the Member State itself or other public, private or third sector organisations. In the current economic climate the availability of private sector financing is reducing. This will create challenges for the continued delivery of Cohesion projects in the United Kingdom.

Financial Corrections

15 The Commission has stated that it will take tougher action to suspend payments and make financial corrections, across all programmes, where Member States fall below standards. Financial corrections across all expenditure areas and all Member States led to the recovery of €843 million in 2008 compared with €287 million for 2007. The Commission forecasts that a further €1.5 billion of corrections will be finalised by March 2009. The Commission does not publish a comprehensive breakdown of corrections by Member State.

Irregularity and fraud

16 It is important to distinguish between irregularity and fraud. Irregularities are transactions which have not complied with all of the regulations that govern European Union income and expenditure, and may be intentional or unintentional. Fraud is an irregularity that is committed intentionally and constitutes a criminal act that only the courts can determine as such.

17 Data from the European Anti-Fraud Office (OLAF) showed that, on a like-for-like basis, the number of irregularities reported by Member States to the Commission, including possible fraud, decreased from 12,565 in 2006 to 11,033 in 2007 (some 12 per cent) but the total value of reported irregularities increased by some 20 per cent to €1,392 million. The drop in the number of cases reported was due in part to a higher reporting threshold. The increase in total value was due to the reporting of a small number of very large irregularities. The United Kingdom reported 1,666 irregularities (including possible fraud), an increase over 2006 of 18 per cent by number and 125 per cent by value. The increase was due to more extensive control checks carried out in the Cohesion expenditure area.

18 OLAF continued to observe that its estimates of irregularity and fraud depended upon the quality of information reported by Member States and should be treated with caution (particularly comparisons across Member States). It reported that the distinction between suspected fraud and other irregularities was not consistent, as Member States did not always have the same definition of criminal risk, and a significant proportion of reports did not distinguish between irregularity and suspected fraud.

Efforts to improve financial management

19 In January 2005, the European Commission made it a strategic objective to strive for a positive Statement of Assurance from the Court. It published an Action Plan in January 2006. It reported in February 2009 that the implementation of the Plan was complete.

20 The Commission's Action Plan identified a need to simplify the regulatory framework governing expenditure. The United Kingdom Committee of Public Accounts came to a similar conclusion in 2005, when it identified the complexity of existing programmes as a significant factor inhibiting the achievement of a positive Statement of Assurance. The Commission has simplified some areas. In Agriculture, for example, the Single Payment Scheme, based on the area of land farmed, has replaced 11 production-based subsidy schemes. The Commission made efforts to simplify Cohesion programmes throughout 2008 and has indicated it will propose further measures in 2009 on the basis of recommendations from a joint Commission and Member State working group.

21 The fundamental review of the European Union budget, currently under way, offers an opportunity to consider how financial management can be further strengthened. In response to the consultation process, the Court proposed key principles that it considered should guide the Commission in designing the eligibility, governance and management arrangements for Community spending: clarity of objectives, simplification, transparency and accountability, and realism. On the last of these the Court believed that some expenditure programmes had been set up in a way that made it difficult to ensure that the conditions for spending were met. In its summary of the points raised during the consultation, published in November 2008, the Commission highlighted a desire amongst consultees for: increased transparency of the European Union budget; simplification of the budget; strengthening the responsibilities of Member States, which manage around 80 per cent of the budget; and more budget flexibility to allow a quick response to changing needs.

22 In December 2008, the Commission published a paper addressed to the European Parliament, the Council of the European Union and the Court on what should constitute a tolerable risk of error in spending European Union funds. The Commission suggested that the risk of error would inevitably vary by expenditure area, and that it might be appropriate for the threshold which defines the material level of error for the legality and regularity of underlying transactions to vary also. It argued that reducing error in some expenditure areas could carry a disproportionate cost. It concluded that the European Parliament and the Council of the European Union, as budgetary authority, could set a threshold for the auditors to consider in different policy areas taking into account political imperatives, benefits of a policy, inherent risk, potential for further simplification and the additional cost associated with reducing error rates. The Commission has invited the other European Institutions to respond to the paper.

23 Some Member States are taking steps to increase the transparency with which they have used European monies. In July 2008, the Treasury published the first annual consolidated statement of European Union expenditure in the United Kingdom. The statement brings together expenditure from across government departments and other public bodies, and the Devolved Administrations. The Netherlands and Denmark have also produced their own form of statements and Sweden plans to publish its first statement in April 2009.

Conclusion on financial management

24 Initiatives implemented in recent years by the European Commission and Member States to improve the financial management of European monies have started to produce beneficial effects. According to the Court's report for 2007 the error rate for agriculture expenditure, for example, was only just above the level at which the Court considered it material.

25 But the Court's finding that at least 11 per cent of cohesion expenditure should not have been reimbursed indicates that substantial progress is still needed to improve performance in this area. Work has started on this, with some simplification of the rules for the 2007-2013 Financial Framework, but the progress needed is likely to take some years yet and requires continued simplification of these still complex programmes. The current European Budget Review and the work on the 2014-2020 Financial Framework due to start soon offer an opportunity to simplify the rules governing this expenditure whilst defining closely the intended outcomes.

Recommendations

i **The European Court of Auditors, and the United Kingdom Committee of Public Accounts, have highlighted the inherent complexity of some European programmes as a contributory factor leading to error.** The Treasury, working with the other United Kingdom departments, should take the opportunity afforded by the current European Budget Review and forthcoming discussions over the shape of the 2014-2020 programmes to press for simplification during deliberation over future policy objectives.

ii **The current financial climate could increase the risk that Cohesion projects funded jointly by European and private money are held up by, or cancelled, due to lack of private funding.** The United Kingdom paying authorities, in conjunction with Treasury, should monitor the implementation rate of the 2007-2013 Cohesion programmes, establish the extent to which planned projects are likely to be dependent on private funding and have in place a plan to mitigate any risks if such funding is not forthcoming.

iii **While the National Audit Office has previously reported on a range of issues related to the implementation of the Single Payment Scheme in England, the Court raised a number of concerns about the application of the detailed regulations. As with previous years, many of these issues appear to have arisen from differing interpretations of European regulations by the United Kingdom authorities, the Commission and the Court.** The United Kingdom authorities have worked with the Commission to seek agreement on the interpretation of regulations. But they should extend this work to include, where possible, the Court to achieve greater clarity and agreement on the interpretation of the 2007-2013 Financial Framework regulations.

iv **The Commission does not publish an easily accessible summary of the corrections it imposes each year broken down by Member State.** This information would be useful to national Parliaments in judging the quality of administration of European Union funds in Member States. The Treasury should encourage the Commission to bring together and publish information on the financial corrections it makes across all policy areas, and to break this information down by Member State.

v **OLAF continues to report that the reliability of published information on fraud and irregularity is reliant on the quality of information submitted by Member States and should be treated with caution.** The Treasury should press OLAF and other Member States to develop a consistent arrangement for reporting and recording irregularity and fraud across the European Union. The Treasury should encourage OLAF to state alongside its published figures where it has concerns about the quality and timeliness of the information submitted.

vi **There is a risk that, in launching the Cohesion programmes under the 2007-2013 Financial Framework, the prompt and efficient closure of the 2000-2006 programmes in the United Kingdom is not given sufficient priority.** The United Kingdom departments responsible for managing the residual 2000-2006 programmes should have appropriate project management arrangements to close the programmes as quickly as possible, including effective arrangements for clearing outstanding irregularities. The aim should be to minimise the risk of error, and allow administrative resources to be focused on bringing programmes in the 2007-2013 Framework into operation.

vii **Some Member States, including the United Kingdom, have taken forward initiatives to improve the quality of information they produce for their national parliaments on their use of European Union monies.** The Treasury should take every opportunity to encourage greater transparency in the use of European Union funds across Member States, for example, by encouraging debate at the Council of the European Union on the experiences of Member States with the different approaches developed so far.