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of the Regions

COTER

Commission for
Territorial Cohesion Policy
and EU Budget

New financial rules applicable to the general budget of the European Union – Impact on Local and Regional Authorities

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This report does not represent the official views of the Committee of the Regions.

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BFOR	Budget Focused On Results
CF	Cohesion Fund
CoR	European Committee of the Regions
COSME	Competitiveness and SME
CPR	Common Provision Regulation
DG	Directorate General
EAFRD	European Agricultural Fund for Rural Development
EC	European Commission
ECA	European Court of Auditors
EEC	European Economic Community
EIB	European Investment Bank
EIF	European Investment Fund
EFSI	European Fund for Strategic Investments
ESIF	European Structural and Investment Funds
ERDF	European Regional Development Fund
EARDF	European Agricultural and Rural Development Fund
ESF	European Social Fund
ESI	European Structural and Investment
ESIF	European Structural and Investment Funds
ETC	European Territorial Cohesion
EU	European Union
FIs	Financial Instruments
GBER	General Block Exception Regulation
IFAC	International Federation of Accountants
IGJ	Investment for Growth and Jobs
INTOISAI	International Organization of Supreme Audit Institutions
ISA	International Standards on Audit
JAP	Joint Action Plan
LRA	Local and Regional Authority
MA	Managing Authority
MFF	Multiannual Financial Framework
MTR	Mid-term review (or revision)
OMB	(US) Office of Management and Budget
OP	Operational Programme
SEFA	Schedule of Expenditure of Federal Awards
SME	Small- and medium-sized enterprises
SCO	Simplified Cost Option
IFAC	International Federation of Accountants
YEI	Youth Employment Initiative

Executive summary

In December 2016, the European Commission launched the mid-term review/revision (MTR) of the EU budget, which resulted in a large number of proposed amendments to the Regulation on the financial rules applicable to the general budget of the Union and other related EU regulations. These aimed to improve the implementation of the EU budget during the current Multiannual Financial Framework (MFF) period (2014-2020), in response to the numerous extraordinary challenges that had emerged since the latest budget was adopted. Contrary to expectations, however, the proposals did not present fundamental changes to the current budget structure.

The proposals have placed considerable pressure on lawmakers given the sheer number of reforms called for, many of which attempt to improve delivery through a process of simplification. It is difficult to understand the implications of the proposals for local and regional authorities (LRAs), because many authorities have not yet been able to adopt and/or adapt all of the existing rules.

This report first explores the causes that have undermined the ability of the EU budget to address modern challenges. It then attempts to identify the main impact of the proposals on LRAs, through an in-depth review and analysis of the latest documentation, supplemented by personal interviews with key local, national and regional authorities. A main finding is that past reforms have made the implementation of programmes and the achievement of goals excessively complex for managing authorities (MAs) and beneficiaries.

Fundamental difficulties in implementing the EU budget

The EU budget has undergone many important reforms since the turn of the century. The reforms that started in the MFF 2000-2006, which focused mainly on improving the management of funds and redirecting the funding to growth-oriented investments in line with the Lisbon Agenda, were undermined by the financial and refugee crises. Over the past 10 years, the EU budget has lagged behind events, as multiple internal and external instruments have been appended to the budget in response to new needs, particularly in the area of Financial Instruments (FIs) and trust funds.

This response to crises has unfolded at the same time that the EU budget has been subjected to a process of 'gold-plating', designed to avoid the risk that mistakes would be committed. In the course of this process, the budget has not only become more complex in the number of activities it performs, but it has also become more difficult to implement. Attempts to simplify the EU budget have paradoxically led to more complexity.

Simplification and coherence

The new proposals aim to simplify and facilitate the use of different EU funds in an integrated and coherent manner, i.e. to allow the funds to be more easily combined. However well-intentioned this aim may be, it may nevertheless prove unrealistic, given that such attempts in the past have often led to the issuance of more exceptions, rules and guidelines. This study explores this conundrum and other fundamental questions: Does the review/revision offer a better approach? Can the reforms lead to a better use of funds? Do the changes respond to the demands of the High-Level Group of Independent Experts on Monitoring Simplification for Beneficiaries of the European Structural and Investment Funds, established by the Commission in July 2015, to advise it on the next steps it should take?

This report reviews the reform proposals that are relevant for LRAs and reaches the following conclusions:

- **The mid-term review/revision, in all its complexity, fails to ensure that the proposals for simplification will in fact lead to simplification**, given the looming threat of newly delegated acts and the creation of many new guidelines for each simplification. It is unclear whether the simplifications aim to allow stakeholders to more effectively and efficiently implement programmes and projects or are largely designed for the convenience of the European Commission in managing the EU budget.

- **In the area of auditing**, there is some movement towards expanding the use of the ‘single audit’, which refers to a system of internal control and auditing based on the idea that each level of control builds on the preceding level, but the benefits for national auditors are questionable. **Some of the present weaknesses are retained, such as leaving the door open to exceptions and delegated acts. Amendments proposed by the European Parliament link the recognition of national audits performed under recognised standards to the level of co-financing of the projects, thereby practically eliminating any effect of simplification**. If the auditing procedures in a member state are recognised, why would an audit of a project with a 50% co-financing rate be audited with different standards than one with a 70% rate?

- The proposals achieve simplification in the area of **lump-sum payments**, but they can potentially introduce **'complications' via delegated acts and guidelines**. **The European Parliament's proposed amendment adds negotiated criteria for each single agreement on a case-by-case basis, which create new bureaucratic complications and exceptions and eliminate any possible benefit of the reform.**

- The use of **performance-based payments is an interesting and worthwhile** reform proposal, reducing some of the bureaucracy and auditing difficulties. The managing authorities (MAs), however, are concerned about the **potentially perverse incentives created by such payments**. Public policy objectives often address difficult areas, such as meeting the needs of the long-term unemployed or other groups of marginalised people, and performance-based payments **may predispose the authorities to avoid tackling challenging cases where the risk of failure is high or to eschew using innovative programmes**.

- **Achieving synergies among European instruments** are key and important objectives. The reforms, however, will most likely not manage to significantly increase the synergies between the various funds. Most of the reforms focus on increasing synergies with the European Fund for Strategic Investments (EFSI), while much work still needs to be done towards harmonising the methodologies and terminology employed across all the EU funds. In the area of combining grants with FIs, the use of a single group of rules is now proposed, which is a major improvement. However, **the exemption of centrally managed FIs from state aid rules and also from ex-ante assessments for SME support needs to be reassessed carefully from the point of view of consistency**. Some concerns have been raised by a national audit office concerning the audit responsibility of those instruments. The study also argues that FIs are better deployed through a centrally managed fund.

- **Joint Action Plans** are being promoted to support specific areas, such as youth unemployment programmes, using a combination of funds. These plans can deploy different simplification options in combination, such as performance-based and lump-sum payments, linked to specific targets**.**

In sum, the overall assessment reached by this study is mixed. The mid-term review introduced more flexibility into the EU budget, which is both necessary and desirable. In terms of actual simplification for LRAs, it is unlikely that LRAs will experience any revolutionary change in their operations, and the amendments proposed by the European Parliament will further limit its impact, with the final result being a far cry from implementing the High-Level Group's recommendations for the 2014-2020 programming period. Any true simplification will need an authentic single auditing system as well as a concerted plan to deepen trust in LRAs to avoid the accumulation of excessive rules and monitoring.

1 Introduction

In September 2016, the European Commission launched the mid-term review/revision (MTR) proposals, which presented a number of amendments for the implementation of the EU budget, but these were not aimed at changing the structure of the budget itself. The sheer number of proposed changes in specific sections of the Regulation on the financial rules applicable to the general budget of the Union,[1] the Regulations for the European Strategic Investment (ESI) Funds, as well as for the Multiannual Financial Framework (MFF) and the European Funds for Strategic Investments (EFSI) put lawmakers under considerable pressure. But this should not come as a surprise, however, as the MTR had been launched before many governments and local authorities had been able to implement the existing budget provisions.

The Committee of the Regions (COR) issued an Opinion in June 2017 on the mid-term revision of the MFF.[2] In this Opinion, the COR points out the importance of local and regional authorities (LRAs) in implementing EU policy and allocating the EU budget funds. It also stresses the need for a full-scale, mid-term revision of the MFF. In particular, it calls for an upward revision of the MFF ceilings rather than solely using flexibility instruments or creating new funding instruments external to the MFF (Trust Funds) to circumvent the fact that the budget is essentially underfunded.

The COR Opinion lists the challenges that the EU budget needs to address, from unemployment to security issues, reiterating the importance of supporting the objective of territorial cohesion and presenting a vision on the functional development of urban and rural areas.

The mid-term review/revision is still under deliberation, but the MTR does not take the opinion of the COR sufficiently into account. It focuses primarily on simplification and flexibility instruments while maintaining the original ceilings, without reviewing the policy approach to territorial cohesion.

Due to the need to ensure continuity in the operations of the budget, the Council adopted some aspects of the MFF mid-term revision on 20 June 2017.[3] The Council Decision amends the 2014-2020 MFF flexibility provisions by adjusting the ceilings accordingly for the years 2018-2020.[4] The Council did not adopt the

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[1] See http://ec.europa.eu/budget/mff/lib/COM-2016-603/COM-2016-605_en.pdf

[2] See the CoR Opinion at http://cor.europa.eu/en/activities/opinions/pages/opinion-factsheet.aspx?OpinionNumber=CDR 5838/2016

[3] See Official Journal, Council Regulation (EU, Euratom) 2017/1123.

[4] Regulation (EU, Euratom) No 1311/2013 laying down the Multiannual Financial Framework (MFF) for the years 2014-2020.

creation of Trust Funds or a change in the ceilings of the budget, thus ignoring the COR's warning that the budget ceilings may prevent the EU from being able to handle the challenges of the coming years, such as the refugee crisis. The COR's (justified) concern over the potential rise of a serious payment backlog was ignored. This backlog would be the result of the overly optimistic assumptions made by the European Commission, which had been the case in the previous MFF.

The remaining reforms on simplification and auditing to be agreed in the mid-term revision are of key importance for LRAs as well as for final beneficiaries. The EU budget has been accumulating rules and regulations on the use of funds over the last two decades in response to previous instances of mismanagement. The instrument also needed more controls due to the accession of countries with low administrative capacities. This situation was compounded by the financial crisis and the pressure of member states to monitor the quality of projects and produce evidence of actual results.

The rapid accumulation of new rules led national and local authorities and beneficiaries to protest the increasingly heavy administrative burdens, which are partially to blame for the delays in programming as well as for the number of errors that have crept into their implementation.

In addition to the increase in regulatory pressures, there is an urgent need for better integration of funds and financial instruments, combining for example Horizon 2020 funding with European Regional Development Funds (ERDF) and European Social Funds (ESF), as well as with the European Fund for Strategic Investments (EFSI). The problem is that even within the European Structural Investment Funds (ESIF) the rules vary by sectoral fund. This means that the ERDF, ESF, EARDF (European Agricultural and Rural Development Funds), etc. are not subject to the same procedures and auditing rules. The rules also vary in the centrally managed funds, such as COSME (the EU programme for the Competitiveness of Enterprises and Small and Medium-sized Enterprises) and Horizon 2020, which the EU wants to combine with ESIF. In fact, the rules for SME support of the ESF are different from those of COSME for the very same operations.

Thus, harmonisation and simplification are sorely needed. But any reforms must be balanced against the need to show real value added from the EU projects. In 2015, the Commission launched the Budget Focused on Results (BFOR) initiative with the aim of sharpening the focus on performance and results.

These legislative proposals are well-intentioned, but will they bring real change? There is a saying in the EU that "every simplification results in more complications”. Will this outcome be averted this time round? This report sees some progress, but also considerable risks, because the door for “complicating the simplification” is still open.

It will require considerable effort to repair the damage inflicted on governments’ trust in the processes involved in implementing the EU budget. And given the present situation, there is a risk that any efforts at simplification may lead to highly restrictive rules on when and how the simplification should apply in delegated legislation and guidelines, for these have been seen as the very culprits creating the complexity in the first place.

This report begins by providing a short background in chapter 2 on how the EU budget arrived at its present situation and the reasons for the increased administrative burdens, including the foundations of the perceived excessive financial controls. Ultimately, it finds that the real problem is *a lack of trust between the EU institutions, governments and LRAs*. Fuelled by a persistently negative media reports on the EU budget, this mistrust drove the European Commission to attempt to minimise risks by imposing layer upon layer of reporting and auditing requirements. This chapter also briefly discusses the implications of the Council’s decision on flexibility, as the only part of the mid-term review in which an actual decision has been taken.

The report then reviews in chapter 3 the proposals for simplification in the areas of auditing and financial control. Chapter 4 addresses the potential effects of increasing the synergies between different funds and financial instruments. Selected case studies are also presented, along with various concerns expressed by local authorities about the potential impact of the reform proposals. Chapter 5 presents conclusions.

2 Context

The principle of sound financial management of the EU budget was enshrined in the EEC Treaty of 1957. In 1975, the European Court of Auditors (ECA) was established to reinforce this principle. In 1977, with the expansion in the financial operations of the EEC, the first financial Regulation was introduced, which established the basic principles of management of the budget.

Due to the increasing size of the EU budget, successive enlargements and the increasing weight of the Cohesion Policy, management reforms were undertaken in the 1990s in view of the prospect of further enlargement. Amendments to the 1992 Maastricht Treaty and the 1997 Amsterdam Treaty reinforced this trend with the additional provision (Art. 317, TFEU) that: "Member States shall cooperate with the Commission to ensure that the appropriations are used in accordance with the principles of sound financial management".

In 1997, new standards were introduced for co-financed projects by the Structural Funds (COM 2064/97).[5] The European Commission undertook a series of reorganisations in an attempt to introduce proper management procedures. Cipriani (2007, p.108) explains how the European Commission was moving away from a structure of a "classical international organisation of generalists into a modern administration of policy managers (…) It must be recognised that the task was not easy as the Commission was trying to implement in a few years' time more reforms than it had made in the previous 40 years." As the author points out, however, these reforms were not early enough or sufficiently far-reaching.

The accumulated management problems finally led the European Parliament to refuse to discharge the 1996 budget. This decision coincided with the publication of a negative report[6] by a Committee of Independent Experts charged with investigating fraud, mismanagement and nepotism, including a review of the procedures for awarding financial contracts. The report highlighted a number of dysfunctional processes at the level of financial management as well as other forms of professional misconduct, which finally led to the resignation of the entire College of Commissioners under Jacques Santer.

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[5] Commission Regulation (EC) No 2064/97 of 15 October 1997 establishing detailed arrangements for the implementation of Council Regulation (EEC) No 4253/88 as regards the financial control by Member States of operations co-financed by the Structural Funds

[6] Committee of Independent Experts (1999), "Second report on Reform of the Commission Analysis of current practice and proposals for tackling mismanagement, irregularities and fraud", Vols I and II, 10 September.

The report by the Committee of Independent Experts highlighted the lack of management and monitoring, with the Commission primarily focusing on planning and negotiating. The resignation of the entire College was followed by a reform process in financial management and more importantly by the adoption in 2002 of a comprehensively reformed financial Regulation (Regulation (EC) No 2012/2002).

Despite these efforts, a fundamental problem persists in the financial Regulation to this day: the European Commission is held responsible for the sound management of all EU funds, whereas 80% of the EU budget is implemented by the member states under ‘shared management’, i.e. under the control of the member state authorities. The latter are not accountable to the EU. This creates the wrong incentives at national (or local) level, because national bodies tend to take the view that they are only under a control and reporting obligation, but are not accountable to the EU, which in fact, is true. This includes the budgetary Control Committee of the European Parliament. As Cipriani (2010) points out, this fact tends to exempt the implementing bodies from the obligation of rendering any account and demotivates governments from taking any action (Bachtler and Mendez, 2011).

The consequence of this situation has been an increase in legislative and control measures, leading to a multiplicity of ex-ante requirements aimed at preventing mismanagement at national level, rather than viable solutions in ‘shared management’. These are reflected in the financial Regulations, regulations governing the EU budget programming requirements and multiple delegated acts and guidelines. This paper cannot dwell on the consequences and intricacies of such an approach, but it has led to an increasing complexity for local authorities when planning actions involving Structural Funds, to delays in the preparation of national operational programmes and to difficulties in getting projects up and running and the funds properly allocated to regions.

But these developments are not sufficient to fully explain the growing complexity and number of proposed changes to the financial Regulation. The EU has confronted a multiplicity of challenges over the last two decades, which have sorely tested the resilience and functioning of the EU budget. The scope, nature, management and control of its expenditures have been called into question. Some of the pressures led to a reform of the financial Regulation in 2012 (966/2012), which was accompanied by the rules of application delegated Regulation (1268/2012). The latter reform increased the flexibility of the budget and has proved essential for the challenges in the years after 2014.

Below are listed the main drivers that led to the various reforms:

i. The scandal over control of the EU budget that erupted under the Santer Commission induced the EU to improve the financial controls to re-establish its credibility.

ii. The advent of the Lisbon Agenda and the subsequent Europe 2020 objectives drove the EU to re-focus funding towards priorities and areas of value added, including innovation in particular. These developments also increased the use of financial instruments to expand the reach of the EU budget.

iii. The accession of new member states from Central and Eastern Europe created a group of important EU budget beneficiaries that lacked the administrative capacity to manage the funds. This drove the European Commission to increase controls, to take a more interventionist stance on national management procedures and to introduce further controls.

iv. The increased focus on results led to demands to incorporate more strategic planning processes into programme development, requiring the different funds (ERDF, EARDF, ESF, etc.) to be coordinated in an integrated manner with the national strategies.

v. The challenges presented by climate change have pushed the budget into linking support further towards EU environmental objectives and requiring local authorities to focus more on climate policies.

vi. The financial crisis brought considerable pressure on the EU to expand its reach, leading to the adoption of the European Fund for Strategic Investments (EFSI), an external fund guaranteed by the EU budget, while also further increasing the pressure for the budget to show results and value added.

vii. The impact of the financial crisis on member states and the inability of many of them to meet deficit and debt criteria laid down in the Stability and Growth Pact have put pressure on the European Commission to propose linking EU funding to macroeconomic conditionality.

viii. The challenges led to the introduction of new flexibility rules into the financial Regulation in 2012, allowing the budget to be more responsive to changing needs.

ix. The security crises created by the migration flows have required the EU to create new external instruments (Trust Funds), which again lie outside the MFF, but are partially funded by the EU budget.

The financial Regulation[7] of 2012 (accompanied by the common provision Regulations for ESIF,[8] Horizon 2020[9] and external action[10]) was expected to protect the financial interests of the European Union in a difficult operational landscape. Considerable reforms were introduced to bring some coherence to the budget, particularly to better integrate the financial instruments into the operations of the budget and still allow for flexibility in reallocating funds between headings and budgetary years. But these changes have been insufficient. In addition, the drive for better budgetary control combined with a multiplication of instruments have led to an ever-growing complexity.

According to a presentation made by Rossbacher (2017) since the 2000-2006 Multiannual Financial Framework, the volume of Cohesion Policy regulations and associated decisions and guidance documents has increased from 1,250 pages to 4,050 pages. And over 50% of the additional documentation was issued for the 2014-2020 Multiannual Financial Framework (not taking into account the potential increase with the mid-term review/revision).

The increasing complexity of the funding instruments and the delays in implementation led the European Commission to set up in 2015 a High-Level Group of Independent Experts on Monitoring Simplification for Beneficiaries of the European Structural and Investment Funds, which presented its report in November 2016.

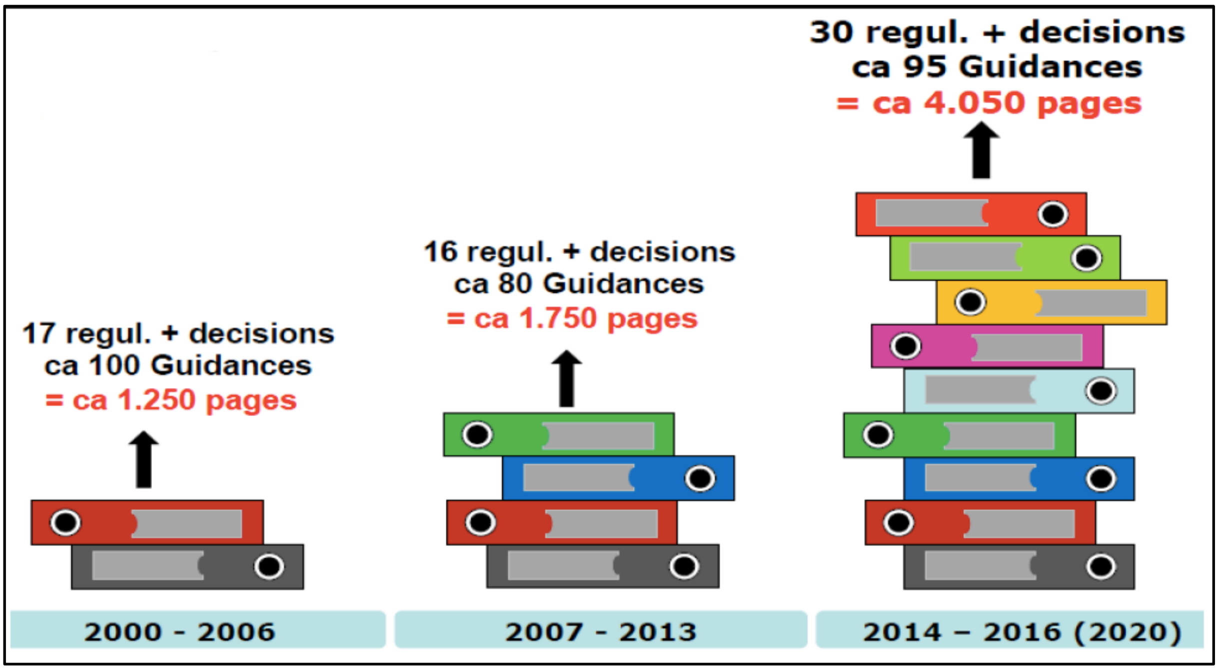
[7] Regulation (EU, Euratom) No 966/2012 on the financial rules applicable to the general budget of the Union.

[8] Regulation (EU) No. 1303/2013 laying down common provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund.

[9] Regulation (EU) No 1290/2013 laying down the rules for participation and dissemination in Horizon 2020 - the Framework Programme for Research and Innovation (2014-2020).

[10] Regulation (EU) No. 236/2014 laying down common rules and procedures for the implementation of the Union's instruments for financing external action.

Figure 1. Growth in Cohesion Policy documents and number of pages



Source: Rossbacher (2017).

The European Commission (2016a) also launched a public consultation with stakeholders in April/May 2016, which revealed a number of problematic issues. The demands and suggestions for simplification and more flexibility made by the 111 respondents have guided the European Commission in its preparation of the latest mid-term review/revision proposals for the financial Regulation (COM(2016) 603 final).

The stakeholders' concerns were summarised in the explanatory memorandum of the mid-term review/revision proposals and published in a summary report by the European Commission in June 2016. The following three main concerns were highlighted:

- **Increase in complexity.** The proliferation of rules in general and at the sectoral level have led to an increasing complexity for the national and local authorities, creating delays in the implementation of EU regional development programmes. The rules governing different types of funds have also unnecessarily increased in number.

- **Excessive controls.** A multiplicity of auditing controls and audits is required by the EU at national and project level, which may also impose different requirements on the beneficiaries and managing authorities, thereby creating further cost and complexity.

- **Complexity for combining funds.** Unnecessarily strict limitations on combining different forms of assistance, such as grants and financial instruments. The reformed financial Regulation in 2012 eliminated the main barriers, but it did not remove the bureaucratic burden of having different eligibility requirements for different grants and financial instruments.

The mid-term review together with the newly proposed changes to the financial Regulation seek to respond to the call for ***more effectiveness and efficiency*** issued by the Budget Focused on Results (BFOR) initiative.[11] Simplified procedures have been introduced aimed at increasing the speed and quality of delivery without damaging budgetary control.

The proposed Regulation aims to address the criticisms expressed by stakeholders and introduces several reforms which are presented in the next section. Changes have been also introduced in the sectoral financial rules.

There is little that has been published on financial rules with relevance to local and regional authorities (LRAs) in the last few years.[12] The main relevant publications are the report by the High-Level Group on Simplification and the Opinion of the Court of Auditors (1/2017), which together form the basis of this report.

The best source of material on the present issues with the financial Regulation comes from the High-Level Group on Simplification and the submissions it receives from various authorities.

This information is important in order to understand the problems affecting the financial regulations and to accurately evaluate whether the reforms respond to these concerns.

2.1 Concerns over auditing procedures

Auditing is a serious concern for the beneficiaries, the local authorities, managing authorities, auditors and the European Commission itself. The High-Level Group on Simplification generally produces short reports with recommendations by area, but for auditing, it released a 20-page analysis and list of recommendations (Letáčková, 2016).

[11] More information can be found at the web portal: http://ec.europa.eu/budget/budget4results/index_en.cfm

[12] Author's note: The Terms of Reference for this report called for an examination of only the last two years, which is a very limited time frame for this topic

It is important to analyse problems in the area of auditing because they often arise from wider problems, such as vague terminology and legal definitions that cause uncertainty about their meaning and how auditors will evaluate a project.

The report on auditing is quite precise and reflects the concerns sent by the stakeholders, such as the submissions by the Dutch local authorities and Polish authorities (see Interprovincial Overleg, 2015 and Polish Regions, 2016).

Auditing procedures have been reinforced over the years, but the rules and control structure have fostered a counterproductive auditing culture. This has resulted in in three negative impacts described by Bachtler and Mendez (2011) and quoted in the Letáčková (2016, p. 4) report on auditing:

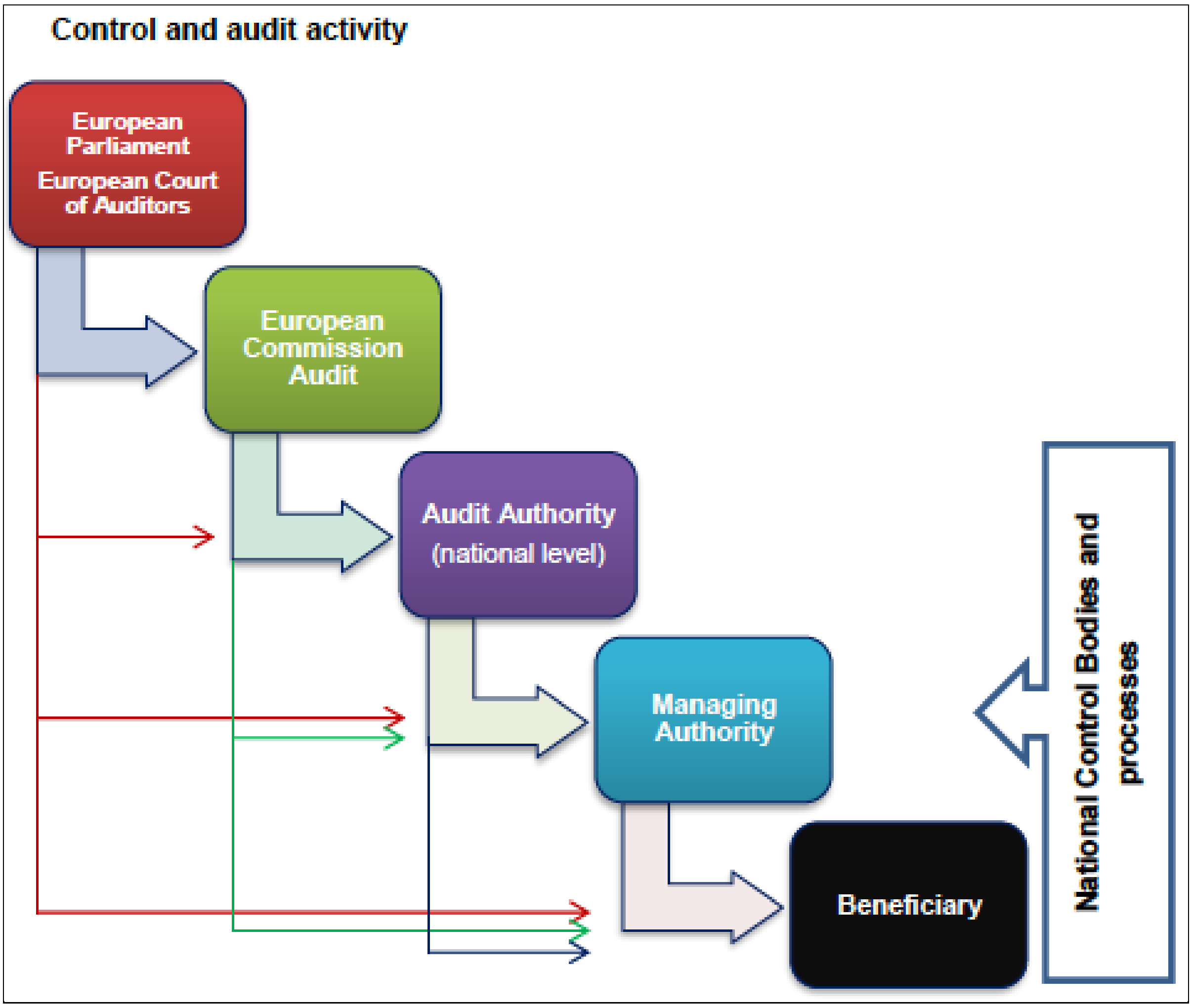
1. It diverts the attention of officials from substantive work.
2. It encourages the selection of the least risky (and therefore the least innovative) projects.
3. It spreads distrust throughout the system.

These are serious allegations, given that the objectives of Cohesion policy are to support regions based on the principle of solidarity and to promote innovation. Letáčková (2016) attributes this dilemma to the progressive accumulation of procedures to safeguard the financial interests of the European Union through increasing levels of regulation to compensate for the distance between the actual expenditure and the multiple layers of auditing. Auditing offices are also accountable to different government bodies. The Commission, for example, is accountable to the European Parliament, but national auditing offices are accountable to the national Parliaments (which in turn are not held accountable by the European Parliament). This situation generates different interests and a lax attitude at the national level towards auditing of local agencies and may generate pressures from Brussels to micro-regulate.

In addition, beneficiaries can face various auditors, depending on the system set up by the member states. Different funding sources may necessitate several different audits. Letáčková (2016) cites cases where the same project may be audited with different requirements by four different auditing entities: EU financial authorities, EU auditing authorities, national control authorities and the managing authorities. The auditing cascade is illustrated in Figure 2 below.

One element missing from the figure are the intermediary bodies, which cause additional complexity by creating another level between the beneficiary and the managing authority. The figure also cannot represent parallel audits.

Figure 2. The auditing cascade



Source: Letáčková, 2016, p. 5.

The system has become so focused on the auditing layers that the function of the auditing process, i.e. to efficiently and cost effectively ensure that the beneficiary correctly implements the project, becomes secondary. This shortcoming creates uncertainty in the mind of the beneficiary concerning the auditing requirements and generates excessive costs of compliance.

A paper by Germany's Federal ESF Management Authority (ESF, 2016) on the European Social Fund states:

> The time and cost needed for the implementation of the funding on the part of the administration and the project operators is no longer proportionate. In the funding period 2014 - 2020, there is such a high degree of complexity that the flexible, rapid and legally secure use of ESF funds is made considerably more difficult, especially in periods of economic crises and special problem situations.

Letáčková (2016) has a good summary of the situation faced. It complains that the current auditing model for ESI Funds oversteps the customary requirements for auditors. Under normal circumstances, the role of the auditing authorities is to provide recommendations to the managing authorities (MAs), leaving the decisions on implementation to those bodies, including such issues as the imposition of financial corrections. The EU auditing rules require MAs to assume some competences of controllers and managers – a role they should not fulfil and one that results in the issuing of increasing amounts of rules intended to avoid errors. In fact, the EU auditing process has been driven by the aim of reducing the error rate, which de facto has been brought down two-thirds to around 3% today. This achievement in itself is not undesirable, but it has been accompanied by negative side-effects. The drop in the error rate has been driven by gold-plating,[13] which in some cases, has actually increased the error rate and discouraged a results-oriented approach.

The Letáčková (2016) document even directly reproaches the EU institutions, particularly the Parliament, for focusing on the wrong indicators, evaluating the success of auditing based on the number of programmes suspended or the number of corrections effected. The impact of the projects themselves is given a lower priority. These are crude measures that will not help regions in difficulty, especially those that lack administrative capacity to improve.

It is interesting to observe that the perceived excessive audit burden is *de facto* the result of attempts to introduce simplified, more agile auditing processes. The reforms have led to greater accuracy in the auditing, but also to an overall increase in the audit burden, as Karakatsanis and Weber (2016) demonstrate. According to their analysis, the introduction of the so-called single audit principle for internal auditing has led to higher demands being placed on the managing authorities. This indicates that calling for a single audit system alone is not sufficient to reduce the audit burden.

2.2 Solutions proposed by the High-Level Group on Simplification

The High-Level Group on Simplification proposed measures to achieve a better auditing system based on expanding and improving the single audit procedure. This proposal appears to reflect the implied conclusions of the evidence submitted to the group by the Dutch and Polish stakeholders (Interprovincial

[13] The term gold-plating refers to the introduction of additional rules and regulatory obligations. It is often used to criticise the application of excessive rules, which ultimately interfere with achieving the intended policy goals.

Overleg, 2015 and Polish Regions, 2016). The Dutch submission explains that the auditing of beneficiaries in the Netherlands follows procedures and standards that are commonly accepted, and thus do not require separate audits and control at higher levels. The national audits build on the information submitted, adding layers into a single comprehensive audit.

The proposal of the High-Level Group recommends a single auditing process through multiple reforms, strengthening the nine principles of audits, as presented in Figure 3.

Figure 3. Nine principles of the audit system post-2020

Source: Letáčková (2016), p. 16.

For each principle, recommendations have been put forward, based on mutual recognition and alignment of audits and supported by educational programmes and mutual cooperation. These recommendations then lead to a better, more results-oriented, cost-effective and proportional auditing system.

These principles form the basis of the recommendations put forward in the declaration issued at the sixth meeting of the High-Level Group (HLG, 2016a). The group emphasises the need for proportionality and the desirability to create a system based on mutual recognition of audits. It called upon the European Commission to come up with a roadmap to begin implementation of this new system in the 2014-2020 period.

The recommendations are divided into four groups, which are outlined in the following table.

Table 1. Implementing the main principles of auditing – recommendations

Strengthening the preventive role of the audit	○ **Improving the educational role**, e.g. with the identification of best practices. ○ **Strengthening the methodological role of the audit**, with European and national auditors collaborating in identifying the repetitive and redundant processes and introducing mutual recognition in order to develop a functioning single audit. ○ Strengthening the **advisory role of the audit**. Auditors should offer recommendations and help authorities.
Ensuring the quality of audit findings and improving the procedures	○ There should be an improvement in the **quality checks**, including the elimination of assumptions and guidelines that create legal uncertainty and complexity. Changes in the assumptions and guidelines should not lead to retroactivity, which causes disruptions. ○ Standards of the audit should be those in place at the signing of contracts, not at the date of the audit. ○ A **regular exchange of experience** among auditing authorities and also with member states is recommended.
Proportionality	○ The **single audit principle** should be introduced to create more certainty, reduce repeated and obsolete procedures and create certainty and reduce costs for the beneficiaries. ○ More **proportionality with financial corrections**, differentiating between errors and fraud and proportional to the size of the projec.t ○ Reduce the excessive use of suspensions and interruptions, using those actions only when absolutely essential.
Actions concerning the interpretation and application of rules	○ The Commission guidelines should not act as legislative obligations and be imposed on the managing authorities. ○ Extra-legislative requirements applied and imposed on some member states and not others should be abolished to ensure equal treatment of beneficiaries across member states. ○ Changes in the rules should be phased in over a transition period.

2.2.1 Access to EU funding for SMEs

One of the priorities of the EU is to promote the development of SMEs. Funding SMEs is a complex process that is carried out through the provision of grants, loan guarantees, mezzanine loans or equity. Many forms of support are generally provided through intermediary banks, which makes the monitoring of their deployment complex.

SMEs are supported by various funds, but the amount of support is rather limited, according to the HLG (2016b, p.14). The HLG highlights the following issues:

- The **management system of the European Structural and Investment Funds (ESIF) is complex and fragmented,** driving the costs up for SMEs that want to benefit from the funds and dissuading many from even requesting them in the first place.

- There is insufficient **collaboration among administrations,** which leads to an **insufficient integration of resources** and of **projects**. The HLG deplores the fact that past simplification did not lead to effective simplification. The ESI funds are still fragmented by different rules. Its members propose the actions outlined in Table 2.

Table 2. Improving access to funding for SMEs

‘Think small first’ and ‘Only once’	o The HLG calls for introducing the concepts of **‘Think small first’** and **‘Only once’**, e.g. no multiple auditing and no multiple application to different funds for the same project.
Reduce the costs associated with the different application processes	o In order **to reduce the costs associated with the different application processes**, thereby enhancing ESI funds access, it recommends making the Small Business Act mandatory at national and regional level under ESI funds, with specific reference to the design and implementation of the project cycle for SMEs and the ‘Only once’ principle. o The HLG further encourages member states to implement specific simplification measures at the national and regional level as well as to pro-actively incorporate the relevant stakeholders in those processes.

Reinforcing coordination within the Commission	o This should be undertaken along the lines of the Better Regulation Initiative, in order to limit gold plating. o There is a need to **harmonise State aid** rules to ensure that definite and time-consistent rules are established ex-ante (i.e. before implementation). o **Retroactive application of new rules** and guidance, particularly in the case of audits, **should be prohibited.** Beneficiaries should not have to bear the burden of regulatory changes or new legal interpretation. o The Commission should promote a **'one-stop shop' approach**, where projects using different funds only need to follow one procedure. Common rules and simplified costs should be introduced across DGs.
Common action by the Commission and the member states	o The group recommends common action of the Commission and member states in order to enhance **capacity-building and training for public authorities**, and encourage the simplification of the reporting system, notably through **better e-governance and IT services**. Overall, further simplification can be achieved by publicising good practices in terms of efficient application procedures to reduce the costs associated with differentiated procedures.

2.3 Coordination with financial instruments

The HLG (2016c) also assessed the use of financial instruments and the level of complementarity with EU funds. While the group considered the financial instruments important and useful, it found several problems in their design. The rules were not adapted to the nature of the instruments. Financial instruments cannot be designed like grants. These concerns are also reflected in the study for the European Parliament on EFSI as another financial instrument (Rinaldi and Núñez Ferrer, Rinaldi al., 2017) which shows tensions between the nature of instruments and the pressure for detailed rules and control. Financial instruments are by their nature demand and risk-scale determined tools.

Setting up financial instruments is a long and difficult process, requiring the preparation of ex-ante assessments of the justification for creating them in the first place. Some of these requirements should be reviewed. A problem has emerged in that financial instruments in shared management, direct management and ultimately EFSI essentially perform the same or very similar functions for beneficiaries but have different requirements and procedures. For example, financial instruments for SMEs created by the European Social Fund (ESF), COSME and EFSI and even in some cases by Horizon 2020 target the same beneficiaries, but they do not apply the same rules.

The difficulties encountered by LRAs as a consequence of these different requirements and rules are reflected in the findings of the workshop on FIs in Cohesion Policy organised by the COR and the Slovak Presidency in September 2016 (COR, 2016). In response to a questionnaire administered at the workshop, experts from the member states and LRAs gave their views of the Financial Instruments. The respondents expressed concern over the process of setting up the instruments, highlighting the complexities and lack of coherence of the process, such as the mismatch between procurement processes and the selection of intermediaries.

The respondents found the state aid rules complex and even illogical, and expressed astonishment that they do not apply to centrally managed instruments. They also found the combination of grants and financial instruments excessively difficult due to differing rules, which are in some aspects not clearly defined.

Table 3 highlights some recommendations for the financial instruments, most of which originating in the HLG's report (Letáčková, 2016).

Table 3. Improving the coordination with financial instruments

Proportionality and level of administrative burden	○ The burden for managing authorities to set up financial instruments should not be higher than the one for grants. ○ **The privileges that the EIB benefits from** in terms of implementation and compliance with state aid rules should be extended to national banks and member states using financial instruments. ○ **Better training and the exchange of good practices** are needed, with support being country- and case-specific due to the heterogeneity of operations with financial instruments. (It is important to note that while the EU has set up a FI-compass to support member states, the funding dedicated to it is lower than the support in 2007-2013.) ○ The requirements for final recipients should be aligned as closely as possible to market practice.
Ensure complementarity	○ Avoid deploying different financial instruments for the same actions and beneficiaries. ○ Harmonise rules amongst ESI Funds and between ESI Funds and other sources of EU support.

Ensure alignment with market needs	○ Do not undermine private financiers by blocking their pay-outs, if issues emerge with State aid rules during implementation.
Use a more functional mechanism to select bodies running the financial instruments	○ Facilitate the implementation of financial instruments by using appropriate selection mechanisms (set out in the CPR and CDR 480/2014) and not using public procurement.

2.3.1 Reducing gold plating

Gold plating is highlighted repeatedly by the High-Level Group (HLG, 2016b) as a recurrent problem for beneficiaries. An excessive use of guidelines that are then imposed as quasi-regulations should be avoided. The Group's recommendations in this area are summarised in Table 4.

Table 4. Improving the coordination with financial instruments

Limiting the number of guidelines	○ **Avoid adding other layers of legislation and guidelines** that are strictly implemented and which negate simplifications. ○ Do not impose guidelines on all member states that emerge from a request or specific issue relative to one or a few member states. ○ Guidelines should be replaced by a wider process of **dissemination of good practices** and/or be restrained to individual country issues. ○ New clarifications on the implications of regulations and guidelines should **not be retroactively applied** for all operations and beneficiaries.
Address the multiplicity of approaches to public procurement and state aid	○ This can be done by ensuring that requirements for projects by ESI Funds are not more stringent than those imposed by other sources of funding, and imposing legal consistency across state aid rules.
Monitoring and evaluation requirements	○ These should be more focused on core information, namely basing the evaluation on a **results-driven approach** rather than on burdensome procedures. In addition, reporting mechanisms between ERDF and ESF should be aligned.

Common actions by the Commission and member states	○ These should aim at enhancing **capacity-building and training for public authorities**, and encouraging the simplification of the reporting system, notably through **better e-governance and IT services**. Overall, further simplification can be achieved by publicising good practices in terms of efficient application procedures in order to reduce the costs associated with differentiated procedures.

2.4 Flexibility

The introduction of 'flexibility', in all its guises, into the EU budget has allowed the EU to address unforeseen challenges. However, LRAs have expressed concern that flexibility may reduce the overall budget available for structural funds. The mid-term review proposals on flexibility are the only ones on which a Council decision has been taken and this section gives a first assessment of the potential implications.

The mid-term proposals included the following reforms:

- Amending the MFF Regulation to further increase the capacity of the Flexibility Instrument and the Emergency Aid Reserve, and to remove restrictions limiting the effectiveness of instruments allowing for the reuse of margins remaining from previous financial years.

- Creating trust funds, which for the moment are limited to external actions as tools for intervention for internal challenges. These can be useful for taking rapid reaction to crises in regions, but they are also an imperfect tool for the EU budget.

- Developing a European Union Crisis Reserve to finance the response to crises, such as the current migration crisis, as well as events with serious humanitarian and security implications. This Reserve would be funded by recommitted appropriations from all MFF headings. Such a reserve, if large enough, could reduce the need for trust funds.

Only the first action has been approved, and the other two proposed reforms have been rejected. The most problematic aspect of flexibility for LRAs is the potential reallocation of funds to other priorities, e.g. the migration crisis. Without the internal trust funds and Crisis Reserve, the EU's limited financial capacity may create problems for LRAs. Until now, flexibility has been used to defend regional policy, by shifting commitments to later years to avoid recommitments, or bringing forward funding to finance the Youth Employment Initiative (YEI) (but reducing future available funding). There is, however, the possibility that flexibility will be used to transfer funding from the Cohesion Policy envelope to other areas. This is an aspect that runs counter to the \opinion of the COR (2016), which clearly warns of the lack of resources to achieve EU objectives and the risk of using the funding for territorial cohesion and other high value-added headings to cover additional needs. While flexibility is encouraged, a call was made to increase the budget ceiling for unforeseen needs.

3 Potential impact of proposals for simplification

This section highlights the changes to the financial rules that potentially have an impact, both positive and negative, on local and regional authorities (LRAs). Wherever possible, the nature of the impact is described. The position of the European Court of Auditors (ECA, 2017) and also the Opinion of the Committee of the regions (COR, 2017) have been taken into account, as well as the information received by the Managing Authorities (MAs) in the member states.

See Box 1 for the author's view of the most relevant reforms proposed to LRAs.

Box 1. The most relevant reform proposals affecting LRAs

Simplification

- Simplification of auditing, assessment or authorisation procedures
- Lump-sum payments, unit costs and flat-rate financing
- Performance-based payments
- Eligible cost expansion
- Removal of the non-profit principle (Art. 125 of the current financial Regulation)
- Simplification and harmonisation of the conditions to award grants without a call for proposals

Complementarities and synergies amongst European instruments
Flexibility

Joint Action Plans

In the financial Regulation, most of the proposed changes aim at simplifying procedures for beneficiaries, via several actions under Titles V and VIII and amendments to the regulations of the different funds.

3.1 Simplification of audit, assessment or authorisation procedures

Having endured complex and multiple audits for some time now, due to the different rules applied by different funds as well as the separation of national from EU audits, beneficiaries have long awaited a simplification of these procedures. At this stage, it is important to offer a clarification about the current EU auditing system: the European system is divided into internal and external audits. The internal audit system refers to the rules and procedures in force for local authorities, member states and the European Commission aimed at monitoring the effective implementation of the EU funding programmes. Conversely, the external audit system refers to the independent control exercised by the ECA aimed at ensuring the legality and regularity of EU spending programmes.

The proposed amendments to the financial regulations would solely intervene on the structure of the internal audit system, thereby modifying the way in which local authorities report on EU funding. The current system of conducting an internal audit for EU funding programmes can be defined as '**multi-layered'** and '**fund-based'**. It means that audits for EU funds may be repeated by local, national and European authorities, while beneficiaries of multiple funds may be audited multiple times. Such a costly repetition of work, coupled with the existence of inconsistent rules, is claimed by MAs to have created significant dysfunctionalities, unreasonable costs and negatively affected the performance of EU funds. In this regard, the proposed interventions aim at improving the cost-effectiveness and the accuracy of the auditing system.

In the past, several European institutions have expressed their support for the adoption of a more efficient and coordinated system of internal auditing. In this regard, attention has been drawn to the so-called single audit system. As expressed by the ECA (2013): "the term 'single audit' refers to a system of internal control and audit which is based on the idea that each level of control builds on the preceding one". As an external auditor, the ECA is not involved in the single audit.

All in all, the implementation of a single audit system is about efficiency and cost-effectiveness of the national auditing system. It is based on a standardised set of documents to be delivered to the competent authorities, namely the government departments in charge of the funds. The adoption of a single audit system can potentially reduce local authorities' reporting obligations, fosters the consolidation of the procedures and streamlines the audit rules across the different funds. The purpose is to decrease administrative burdens for both local auditing bodies and auditees, while concentrating additional controls on the projects where these are most needed.

Besides several resolutions stressing the relevance and the suitability of a coordinated auditing model for the EU funding system, in 2006, Art. 73 of Council Regulation No. 1083/2006 sets the ground and provides the legal basis for the adoption of a single audit system. The provision reads: "The Commission shall cooperate with the audit authorities of operational programmes to coordinate their respective audit plans and audit methods and shall immediately exchange the results of audits carried out on management and control systems in order to make the best possible use of resources and to avoid ***unjustified duplication of work***". It continues by stating that "in determining its own audit strategy, the Commission shall identify those operational programs for which the opinion on the compliance of systems under Article 71(2) is without reservations, or where reservations have been withdrawn following corrective measures, where the audit strategy of the audit authority is satisfactory and where reasonable assurance has been obtained that the management and control systems function effectively on the basis of the results of audits by the Commission and the Member State."

The Commission has adopted international auditing standards for internal and external audits, as required by the audit Directive of 2006 (Directive 2006/43/EC). For internal audits, the EU uses the Institute of Internal Auditors' standards, which draw on standards internationally. For external audits, the Commission and the ECA apply the International Standards on Audit (ISA) and the International Standards of Supreme Audit Institutions issued respectively by the IFAC (International Federation of Accountants) and INTOSAI (International Organization of Supreme Audit Institutions).

The ISA series deal with the entire auditing system. They define audit bodies' responsibilities (200 series), audit planning procedures (300 series), internal control systems (400 series) and audit evidence (500 series). Moreover, ISA series regulate the "use of the work of others" (600 series), audit reporting procedures (700 series) and define the application of audit standards in specialised areas (800 series).

The ISA 600 series and the related practice ISSAI 1600 series are of particular interest for this paper. These series, indeed, set clear rules for the "use of the work of others", and establish external auditors' responsibility when using internal auditors' work.

In 2010, the above-mentioned standards on the “use of work of others” were adopted by the ECA and incorporated into the Court Audit Policy and Standards. Accordingly, ECA auditors may decide to rely on the work performed by others, including other auditors, internal auditors and external experts. When the Court uses the work of others, “it applies adequate procedures to provide assurance that they have exercised due care and complied with relevant standards” (ECA, 2011, p. 9).

In particular, in verifying the reliability of internal audits or the work of an expert, the auditor must verify whether: “1) (S)he has an adequate knowledge of the audit field to be able to make an informed assessment of the quality of the work of the internal auditor or expert; 2) The internal auditor or expert has the required professional competence in the context of the specific assignment; 3) The work of the internal auditor or expert is adequate and the working methods are suitable for the Court’s purposes in the context of the objectives of the audit task concerned” (ECA, 2011, p. 9).

Respecting the audit cross-reliance principle (in Art. 173) means adopting the single audit system. This, in turn, would require the coherent and effective application of the relevant internationally agreed standards regulating the “use of the work of others” by all statutory bodies taking part in the internal EU audit system. The Commission today may rely on the opinions of the audit authorities if the internal controls in place function effectively (when the error rate is below 2% and system audits are satisfactory). This means that the Commission can grant the ‘single audit’ status to the auditing authorities of an Operational Programme (OP). In such a case, the EU does not perform its own ‘on the spot’ check.

Rather than reducing the burden and cost of auditing, however, advances in the introduction of the single audit system have had the opposite effect. Karakatsanis and Weber (2016) describe the process that has led to the present situation. The European Commission relies on the assurances provided by the managing, certifying and audit authorities in the member states.

In 2014, 57% of the OPs were considered to comply with the requirements, but the ‘single audit’ status does not lead to tangible results for beneficiaries (Karakatsanis and Weber, 2016). Only a quarter of the Managing Authorities have requested the ‘single audit’ certification, also because in countries with many OPs, with some following the single audit approach and others not, it does not make much sense for the national central auditing authorities to do so.

The European Court of Auditors has expressed its position about the Single Audit system in Opinion No. 2/2004 and in its Special Report No. 16/2016. In both cases, in supporting the development of the Single Audit system in the EU, the Court has remarkably noted that internal audit systems must balance the cost of controlling with the benefits that multiple checks can bring in terms of risk mitigation. In practice, this seems not to have been the case.

The benefits of lower costs and less frequent duplication of audits expected by the ‘single audit’ principle did not materialise – at least for the Cohesion Policy. Audit activities at national level have drastically increased because the reforms have been coupled with higher demands and increases in the number of sample checks carried out (Karakatsanis and Weber, 2016). There is a need to review how the Single Audit system can be more widely introduced in practice.

The reforms, including those in the mid-term review/revision seem promising, but they are not a big departure from the present situation. The EU’s internal audit standards are largely aligned with international standards, which is also the case in many member states. The issue is also how to make it interesting for the national auditing bodies to join the Single Audit system, so that LRAs would also benefit from a simplification of auditing procedures. According to the MAs, the reforms primarily simplify life for the European Commission, but do not seem to really focus on the authorities in the member states.

The amendments proposed in the financial Regulation (see Box 2) for the common provisions Regulation (CPR) have been of interest to the Committee of the Regions, which presented a draft Opinion to the financial rules in March 2017.

As the REFIT (2016) submission of the COR to the High-Level Group on Simplification of ESI Funds warns, delegated legislative acts and guidance documents may reintroduce the complexities that the reforms intended to remove. The Opinion of the Committee highlights some cases, which de facto risk leading to this situation. The production of delegated acts and guidelines is designed to help authorities to implement the programmes, but if numerous rules as well as exceptions to the rules are created, the guidelines become a burden rather than an aid.

Box 2. Mid-term review/revision proposals in the area of audits for the Financial Regulation

Article 122
Cross-reliance on assessment

The Commission may rely in full or in part on assessments made by itself or other entities, including donors, insofar as these assessments were made with regard to conditions equivalent to those set out in this Regulation for the applicable method of budget implementation. To this end, the Commission shall promote the recognition of internationally accepted standards or international best practices.

Article 123
Cross-reliance on audits

Where an audit based on internationally accepted standards providing reasonable assurance has been conducted by an independent auditor on the financial statements and reports setting out the use of the Union contribution, that audit shall form the basis of the overall assurance, as further specified, where appropriate, in sector specific rules.

Article 126
Financial framework partnerships

(…)
2. The financial framework partnership agreement shall specify the forms of financial cooperation, the common objectives of the cooperation as well as the principles governing such cooperation between the Commission and persons and entities implementing Union funds pursuant to point (c) of Article 61(1) or beneficiaries. These agreements shall also reflect the extent to which the Commission may rely on the systems and the procedures of the persons or entities implementing Union funds pursuant to point (c) of Article 61(1) or beneficiaries, including audit procedures.

An example is the absence in the amendments in Art. 265 to Regulation (EU) No 1303/2013 (Article 127) of any real simplification leading to the recognition of accounting standards, which goes against what is stipulated for a single audit procedure in Art. 122. The amendments should also declare how the recognition based on international auditing standards will take place. It is important that the EU concentrates its auditing efforts in areas where weaknesses arise and deploys its resources where there is a need to improve standards, rather than using resources to audit functioning audits. Art. 149 of Title VI of the proposed financial Regulation in fact already mentions the following:

> The Commission shall assess in accordance with the principle of proportionality and with due consideration for the nature of the action and the financial risks involved, that the entities and persons implementing EU funds pursuant to point (c) of Article 61(1): (…)(c) are subject to an independent external audit, performed in accordance with internationally accepted auditing standards by an audit service functionally independent of the entity or person concerned;

If this is the case and the auditors have performed an audit according to internationally accepted auditing standards, why should the EU impose further controls, which is contrary to proportionality? The COR is correct in highlighting the need to limit the number of audits to a minimum, and the proposed implementing regulations seem to be failing to follow the concept of cross-reliance of the proposed Art. 122 of the financial Regulation.

The COR is also correct to present an amendment noting that: "(…) audit activities shall be sufficient to enable the audit authority to draw up a valid opinion in accordance with the Article 62(5) of the Financial Regulation". In fact, the Commission would only need to require assurances whenever it has justifiable grounds to doubt on the quality of the standards implemented.

In this latter case, the EU would be better served by adopting a clearer system for recognising auditing standards. In fact, the reforms proposed to the auditing standards do introduce a number of aspects highlighted by the High-Level Group on simplification, but stop short of taking this thinking all the way through the proposed reforms. They state the right points in the financial Regulation, but then revert back to the present system through implementing regulations and other delegated acts. The more the rules become burdensome, the higher the risk of 'errors', which in turn reduces the trust in the EU budget. If the errors have no bearing on the EU budget and arise via 'interpretations' caused by excessive legal complexity, this is not a positive feature.

On the basis of the review carried out and the information collected for this report, it is clear that one of the key issues to address is why the single audit system is not being adopted more widely and why it has resulted in costlier procedures and a heavier auditing burden. A principal barrier to the adoption of the single audit system is the recognition of audit procedures mainly by OP. National systems tend to have unified auditing standards and having some OPs in the single audit system and not in others by a decision of the Commission is not consistent with the way in which national internal audit systems are set up.

Another aspect that has been raised by the managing authorities is the persistence of a lack of legal clarity in the auditing rules, particularly for the financial instruments. The Commission's expectations for auditors also seem to lack precision, which means that the conformity of the audit can be open to interpretation. This causes difficulties for national auditing authorities and increases the number of controls and corrections performed and ultimately the costs.

The issues raised in this report have also been highlighted in the COR Opinion on the financial rules of May 2017. The Opinion highlights the lack of real simplification and proposes a tailor-made audit strategy based on the proportionality principle and taking into account past auditing performance.

3.1.1 The Parliament's position – a conservative approach

The European Parliament has expressed its reservations concerning the concept of a single audit. In its first reading of the draft European Parliament Legislative Resolution, the Committee on Budgets (08.06.2017) proposed several amendments to the Single Audit, which are listed in Table 5, with a short assessment. The European Parliament's amendments impede the introduction of a single audit system, because it wants to limit the recognition of auditing standards only to certain categories of funding (where co-financing is lower than 50%) which shows a generalised mistrust of national auditing systems. The European Commission already has the power to examine the conformity and quality of audit systems any time and to audit any operation in which there is a concern. The imposition of obligatory audits and non-recognition of standards based on the co-financing rate are unnecessary and costly burdens in countries that meet high auditing standards.

Table 5. Proposed amendments to the Single Audit by the European Parliament

Amendment 218 deletes the proposed Art. 122 (cross-reliance on assessment). The justification claims that the provision goes against the principle of sound financial management.	This deletion is against the spirit of simplification, ignoring the recommendations by the HLG on simplification. What is important is to establish the necessary structures to ensure that the correct standards are applied and how to treat countries and regions in which the standards are not well implemented. Encouraging a continuation of the present system is not a solution. The Parliament's amendment proposes to add that "***the Commission and the***

	Court of Auditors should promote the use of internationally accepted standards". This is equivalent to not adding this amendment, for what is the purpose if not to avoid parallel auditing?
Amendment 219 proposes to restrict Article 123 on the grounds that the provision goes against the principle of sound financial management. The bold italic text shows the amendments. "Where an audit based on internationally accepted standards providing reasonable assurance has been conducted by an independent auditor on the financial statements and reports setting out the use of the Union contribution***, and where that Union contribution accounts for less than 50% of the total funding available,*** **that audit** ***may, subject to a decision of the authorising officer responsible***, form the basis of the overall assurance, as further specified, where appropriate, in sector-specific rules. ***Exceptions may be made for research institutions***. To this end, the Commission and the Court of Auditors shall promote the recognition of internationally accepted standards or international best practices. Information already available to the managing authority shall be used to the extent possible to avoid asking beneficiaries for the same information more than once."	The first amended text presents the odd concept that an auditing body that is recognised for implementing high standards will apply less stringent procedures for a higher rate of co-financing. Either auditing is certified and trustworthy or it is not.
Amendments 225-229 modify the proposed Article 126 (Financial Framework Partnership). Additional safeguards are introduced.	The proposal highlights the need to focus on reaching the objectives and not remain blocked at the level of financial implementation.

In paragraph 126 (2), proposed by the Commission, the EP has tabled the following amendment: ***(a) ensure the quality of implementation, and that the objectives of the Union intervention are reached, and*** (b) ***reflect*** on the systems and the procedures of the persons or entities implementing Union funds pursuant to point (c) of Article 61(1) or beneficiaries ***to reach those objectives***, including audit procedures.	The difficulty with such a provision is the problem of asking auditors to perform the role of evaluators. The skills to assess the appropriateness of financial systems and procedures are not the same as for an evaluator to assess the achievement.

3.1.2 Lessons from single audit systems

A single audit system is in place in the Netherlands, as mentioned above, and also in the US (described in Boxes 3 and 4). An analysis of those systems may be helpful to understand whether it can serve as a successful model for other countries and possibly open the way to implement the single audit system at the EU level.

Box 3. The single audit system in place in the Netherlands

In 2004, the Dutch government decided to streamline the public benefits system in force at the time by transferring the competence over a range of benefits from the national government to the local authorities. For the rest of the benefits, which were granted directly from the central government's budget, the Dutch government implemented a new and integrated system of audits, namely the Single Information Single Audit (SISA).

The system has been developed by adopting clear guidelines and standards for each auditing step, basing the next step on the previous one. As the name suggests, the SISA system is composed of two main elements. The Single Information refers to a standardised report compiled by the local authorities, containing a specific set of information about all the funds under their competence. The Single Audit refers to the annual audit process performed by the local audit bodies on each of the funds controlled by the local governments.

The ultimate objective of the SISA system is to increase the cost-effectiveness of the national auditing system by consolidating the information to be transferred from the local authorities to the central government. The entire process consists of three steps and involves four main stakeholders, namely the central government, the local authorities, Statistics Netherlands (the national institute of statistics) and the Minister of the Interior.

- Each financial year, the central government sets the amount of resources available for the specific funds under the competence of the local authorities.
- The local governments are then asked to submit, through a dedicated web portal, the information required by the SISA system to Statistics Netherlands by July 15th each year. At this stage, the Statistics Bureau verifies the completeness of the information provided and reports within seven working days its finding to the Ministry of the Interior. In case of violations of the reporting rules, the Ministry has the power to warn and/or impose proportionate sanctions on the local governments.
- The competent departments of Statistics Netherlands test the accuracy and the reliability of the information provided by the local authorities during the 'Single Review' and give their final response.

Through this process, the SISA system improves the overall effectiveness of government auditing. It increases the quality of national account controls and prevents the duplication of work, which currently characterises the European audit systems. Moreover, the SISA system allows the consolidation of the information to be delivered to the Ministry of the Interior, concentrating the entire auditing process into two months (15th May-15th July). In conclusion, the SISA system effectively prevents the duplication of work, decreases the cost of control and auditing and reduces the administrative burden on auditees.

Box 4. The Single Audit system in place in the US

The Single Audit system in force in the US requires any entity receiving federal grants for $750,000 or more to prepare a financial statement and the Schedule of Expenditure of Federal Awards (SEFA), and to submit (via a dedicated website) the audit reporting package to the Federal Audit Clearinghouse (FAC). The Single Audit system, also known as A-133, was firstly introduced through the Single Audit Act in 1984, later amended in 1996. It is a standardised audit system under the control of the Federal Office of Management and Budget (OMB) aimed at ensuring that public grants are used for the specific purposes of each federal fund.

Entities under the obligation to perform A-133 audit encompass, amongst others, states, cities, institutes of higher education, Indian tribal governments and non-profit organisations. Every fiscal year, beneficiaries of federal funds are required to perform the A-133 audit according to the requirements set by the OMB A-133 Compliance Supplement. In 2013, the latter was superseded by the Uniformed Guidance 2 CFR 200, subpart F.

Audit requirements are chosen by each Federal Agency, updated annually, and collected for the use of the beneficiaries into the Compliance Supplement, annexed to the Uniformed Guidance 2 CFR 200. Audit requirements are fund-specific and tailored to the purpose of each of the federal funding programme.

The audit for the recipient organisation must be performed by a certified auditor, whose responsibilities are listed in par. 200.514 of the Uniformed Guidance. In particular, the auditor must control the quality of the financial statement, report on the SEFA, understand and test the internal control system of the organisation, report the findings, follow up the previous audit findings and complete and sign the audit reporting package.

The auditor will also assess the level of risk of the projects, whose grants emanate from the national federal budget. The higher the level of risk, the greater may be the additional controls required by the federal agency in charge of the fund. In conclusion, the Single Audit system in force in the US allows each federal agency to compile standardised and detailed information on the use of its own resources, and to focus additional checks where those are deemed necessary.

3.2 Lump-sum payments, unit costs and flat-rate financing

Art. 175 of the proposed reforms in the review, excerpts of which are reproduced in Box 5, can be potentially important for beneficiaries, including local authorities, reducing bureaucracy. Lump-sum payments can be offered for smaller claims for a maximum of 7% of the total direct eligible costs for the action in the case of indirect costs, which can be increased in agreement with the Commission.

Box 5. Provisions under Article 175 of the Financial Regulation, *Lump sums, unit costs and flat-rate financing*

(…)
(2) Where possible and appropriate, lump sums, unit costs or flat rates shall be determined in such a way as to allow their payment upon achievement of concrete outputs.

(6) The authorising officer responsible may authorise or impose, in the form of flat rates, funding of the beneficiary's indirect costs up to a maximum of 7% of total eligible direct costs for the action. A higher flat rate may be authorised by a reasoned Commission decision.

The proposals are quite reasonable and offer options on how to determine the rates. It also allows their use for more than one programme, which means that there is no need to re-justify the method for each programme.

Art. 176 also allows for single lump-sum payments for an action as long as it complies with the rules in Art. 175 on the size of the payment. These changes should be welcomed by the LRAs. The Court of Auditors (2017) also seems to consider the proposal acceptable.

But the legislation also reintroduces 'complexity', first by retaining the Commission's power to adopt delegated acts ***concerning*** the definition of the flat rates in Art. 68 paragraph 8 of the Common Provisions Regulation (966/2012). Secondly, it presents a new legal uncertainty by proposing in Art. 61(3) that the "audit authority shall ***satisfy itself*** that the flat rate has been established according to (…)". The COR (2017) correctly highlights those as creating legal uncertainty, leaving the acceptance or not of certain practices open to the opinion of the Commission official in charge and auditor in charge.

The Commission has not put in practice what the HLG on simplification has called for. By maintaining a loophole to produce delegated acts, the simplification in the new financial Regulation is partially negated, leading to the same situation today as exemplified by the report of the Dutch authorities (Interprovinciaal Overleg, 2015). The latter documents precisely how this small paragraph has completely dismantled simplification in the area of lump-sum payments. How can change be effected if the same problems are allowed to continue?

The COR (2016) has also voiced concerns on the proposed amendment in paragraph 2 on staff costs in the same article. It seems a minor issue, but again it reflects a sign of detachment from reality. The amendment proposes that "the total hours declared per person for a year shall not exceed the hours used for the calculation of the hourly rate". This is set at 1,720 hours. The COR correctly notices that this requires verification of the work or people outside the project, if this is for the overall working hours in a year, which is unrealistic, burdensome and difficult to verify.

But this is not the core issue. It is again an addition to a new unnecessary rule, as member states already have legislation in place on working hours and it is unnecessary to introduce further controls. It is also important to note that many projects are multiannual and staff may change and work may be reassigned.

The amendment goes counter to the notion of simplification and introduces further bureaucratic burdens based on a timesheet mentality, which often is not reflected in the actual operations on the ground. The text adds another layer of requirements and also the potential for misinterpretation, as it does not specify if the amendment would operate at project level or in total.

Ultimately, the changes add nothing; the EU should strive for output and results-oriented auditing rather than process and hours worked per day. It also sets a precise number, while legislation on working hours is not precisely the same across all member states Workers may also decide to shift, for example, vacation time, thus while overall the number may be 1,720 hours on average, it may not fit in a single year.

3.2.1 The European Parliament's position

Unfortunately, the concerns of the Committee of the Regions have been overridden. The European Parliament has instead opened the door to further complications by proposing the amendments shown in bold italics in Table 6.

Table 6. Proposed amendments from the European Parliament

Proposed wording	Comment
To Art. 175 (2): 2. Where possible and appropriate, lump sums, unit costs or flat rates shall be determined in such a way as to allow their payment upon achievement of concrete outputs ***and results, provided that appropriate measures have been taken to ensure the adequateness of the respective amounts with regard to the required output***. ***The precise criteria for the required output shall be negotiated between the Commission and the beneficiary and be specified in the grant agreement, on a case-by-case basis and as the circumstances require.***	The concept that the European Commission will negotiate the criteria for each grant agreement on a case-by-case basis and the further checks required open again the door to further guidelines, delays and complications, which the simplifications were supposed to remove.

3.3 Performance-based payments

The new proposal introduces a new form of payment in the Financial Regulation (proposed Art. 121, para 1e), based on achieving results, as shown in Box 6, and not on simply justifying costs. This is an improvement on the present performance reserve based on fund absorption as a measure of success. This is in line with the objective of the budget to be results-oriented. The beneficiary has an incentive to be efficient in order to receive the funding, and local authorities are motivated to ensure that the strategy is coherent.

Box 6. proposed Art. 121 of the Financial Regulation, *Forms of Union contribution*

1. (e) financing not linked to costs of the relevant operations based on:
   i) either the fulfilment of conditions set out in sector specific legislation or Commission Decisions or
   ii) the achievement of results measured by reference to the previously set milestones or through performance indicators;

This is an interesting reform with important implications for LRAs. It reduces the bureaucratic burden, but will also require producing promised outputs in order to be fully financed. On balance, the proposal should be supported by

LRAs, as it offers simpler and faster support. This proposal actually integrates the simplified payments system, which was introduced for the Joint Action Plans (JAPs) in section 3.7. However, it also transfers the risks of projects and financial losses fully on to the MAs.

The Explanatory Memorandum provides a good description of the objective of Article 121:

> *Allowing for payments based on conditions fulfilled, output or performance in all management modes (e.g. payments per resettled refugee in the AMIF funds or the support for young farmer setting up, Article 121). In such cases, the financing of projects is delinked from the reimbursement of the costs incurred by the recipients of EU funds: it depends directly on the results delivered on the ground. What matters is either the fulfilment of certain conditions as set out ex ante in the basic act or Commission Decisions and/or the achievement of results measured through performance indicators (ex-post). Such system enhances ownership/commitment by the recipients of funds to achieve results. They allow a significant reduction of the administrative burden and of the cost of controls. Controls can indeed be limited to verifying whether the conditions/agreed results have been met and the administrative burden. This in turn limits the risk of legality and regularity errors. It has been advocated by the European Court of Auditors under the name "entitlements".*

With this system, the painstaking auditing of the project procedures can be reduced, as the most important aspect is the delivery of results. It is important not to be complacent, however, for the regulations at this stage do not explain how the procedures will be simplified under this condition of reaching results. It is in fact easier to introduce the results-oriented approach to financing than to reduce the regulatory burden on beneficiaries. There is a real risk that the beneficiary will continue to be subjected to the same burdensome controls as today *and* at the same time be subjected to the 'payment for results' rule. The delinking may not be achieved in practice.

This approach linked to results can have its own risks. A position paper by Germany's Managing Authority, Federal ESF (2016), highlights that the performance reserve[14] itself has complicated the programming process and even damaged the programme, as it reduced the flexibility of EU funding. The performance reserve leads to projects being designed not to rely on the reserve in the future, i.e. downsizing the ambitions, but to also avoid difficult projects

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[14] The performance reserve consists of 6% of the national financial allocation under the ESI Funds, which is only released if pre-defined targets are met.

that may reduce the chance of accessing the performance reserve. In other words, it inhibits ambition.

From the Managing Authority's point of view, there is pressure to run the project to fulfil the necessary requirements for securing the funding and thus there is a bias to take on less risky endeavours. To achieve the targets, the authorities may use 'creaming', i.e. selecting easy objectives to achieve the targets. The example presented involves funding to tackle social problems through social innovation, an area where reliable indicators are difficult to find. It is easier to help the young unemployed to get a job than to reintegrate the long-term unemployed into society. In terms of achieving demonstrable numerical results, it is better to focus on the young short-term unemployed. The fact that part of the funding is not guaranteed reduces the size of the interventions to avoid losses if the goals are not achieved and the funding is blocked.

These concerns are raised generally by most authorities. The programmes are then dominated by indicators and not by innovative thinking and broader, longer-term objectives.

One of the recommended approaches is to combine both the quantitative and qualitative indicators, which gives a fuller picture of the effects of the measures undertaken.

3.3.1 Potential perverse incentives introduced by performance-based payments

Concerns have been raised for projects where the indicators are not clear-cut and the benefits for society cannot be easily measured. There are some main categories of the unemployed, the short-term and often young unemployed, female unemployed, unemployed migrants and the long-term unemployed. If programmes focus on long-term unemployed or groups with higher difficulties to enter employment, this method may discourage MAs from applying this method.

The regional authorities are concerned with the impact of introducing performance-based payments as presented in the explanatory memorandum of the proposed Regulation, which considers that payments should be based on units of success, i.e. number of migrants offered a job, trained, etc. In the area of unemployment, those who find employment more quickly are the young, single and educated male. To be able to ensure the highest financial absorption, the rational choice for MAs across Europe would be to focus on the group of unemployed youth to show higher success rates, but it also discourages taking more innovative approaches, rather than following well-known systems. A measure such as the number of persons trained would favour easier training programmes, rather than more sustainable and targeted ones. The programme would also move away from tackling more complex problems where the results are more difficult to achieve, in this case assisting the long-term unemployed.

Thus, while the principle of performance-based payments is interesting, it is important to devise methods that take into account the less flashy but important programmes addressing societal problems. The European Commission should identify the relevant key performance indicators and demonstrate how to avoid a move towards the low-hanging fruits, by showing success in less relevant areas.

3.4 Eligible cost expansion

The newly proposed Financial Regulation introduces the possibility to add the value of volunteer work as an eligible item for co-financing (see Box 7). This proposal could alleviate the co-financing burden for local authorities, but the proposal is not universally accepted. The Court of Auditors Opinion 1/2017 does not support the measure and finds this unnecessary, claiming that it would increase the risk of error. The main concern is the difficulty in verifying the volunteer work and the incentive this provision gives to use such volunteer work to reduce the cost. This concern may resonate with the Council.

Box 7. Article 180 of the Financial Regulation, *Eligible costs*

1. (b) where the estimated eligible costs include costs for volunteers' work referred to in paragraph 8 of Article 175, the grant shall not exceed the estimated eligible costs other than the costs for volunteers' work.

Not surprisingly, the European Parliament has reacted and proposes to limit the practice to non-profit organisations by adding to the paragraph in recital (131) of the Regulation: "*Only genuine volunteer work, namely that where there are no apparent issues of exploitation or vulnerability, should be covered. In order to address the risk of for-profit businesses hiring a disproportionate number of volunteers to reduce personnel costs, it should only be possible for non-profit beneficiaries to declare personnel costs for the work carried out by volunteers.*"

In addition, volunteer work would need to have a value of 75% of the total estimated grant for other costs.

3.5 Removal of the non-profit principle

The Commission has removed Art. 125 of the current financial Regulation, which does not allow grants to have the purpose or effect of creating profit with the exclusion of several exceptions.[15] In its Opinion No 1/2017 (p. 14), however, the European Court of Auditors opposes this change. It notes that the Commission rarely exercises its right to recover profits, probably hinting at the fact that such a rule is not very stringent and de facto only applies in blatant cases.

This removal of the non-profit clause could have an impact on national and local authorities, if the grant, for example, covered infrastructure that may also generate a profit due to demand changes, such as the installation of new metered parking areas or municipal energy infrastructures, such as electric charging stations. It is a complex procedure to disentangle the profit-making share of a project originating from the grant provision and one that makes the project proposals more cumbersome.

The Court, however, challenges the Commission's justification for the change that this clause is not necessary, as the revenue-generating projects should be financed by financial instruments. According to the Court, the clause should remain in the legislation to ensure that grants are not requested for revenue-generating projects and it does not affect at all the position that those projects should be financed by financial instruments. The European Parliament (2017) report on the mid-term review/ revision also rejects the elimination of the non-profit rule.

It is not easy to apply this rule to projects. The Commission also promotes the combining of grants and financial instruments, where an allegedly non-revenue generating part of a project is covered by a grant while the financial instrument covers the part that is potentially profitable. It is, however, not an exact science

[15] Grants shall not have the purpose or effect of producing a profit within the framework of the action or the work programme of the beneficiary ('no-profit principle'). The first subparagraph shall not apply to:
(a) actions the objective of which is the reinforcement of the financial capacity of a beneficiary, or actions which generate an income to ensure their continuity after the period of Union financing provided for in the grant decision or agreement;
(b) study, research or training scholarships paid to natural persons;
(c) other direct support paid to natural persons most in need, such as unemployed persons and refugees;
(d) grants based on flat rates and/or lump sums and/or unit costs where these comply with the conditions set out in Article 124(2);
(e) low value grants.
Where a profit is made, the Commission shall be entitled to recover the percentage of the profit corresponding to the Union contribution to the eligible costs actually incurred by the beneficiary to carry out the action or work programme.

to determine ex-ante what is profit-generating and what is not in a project with a high-risk or low-revenue potential.

Again, these rules create a burden of proof and a may render it difficult to combine grants and financial instruments. It is unrelated to efficiency, effectiveness and value added of projects. Ultimately the main aim is to create economic development and develop high value-added results with social impact. The latter is of much greater importance than penalising a project because the commercial value was higher than expected.

A solution to this situation is to act in a similar fashion as public-private partnership concessions, where the operators must pay a fee for the concessions taking into account demand. There are models to address this issue rather than blocking in advance projects whose non-profitability cannot be ascertained.

3.6 Simplification and harmonisation of the conditions to award grants without a call for proposals

There is an extension to the provisions to grant exceptions to the requirement for tendering where the supplier of services is de facto a monopoly, i.e. there are no other possible contractors for the area of competences and region where it is required (Box 8). It also allows this for those contracts where the technical competencies required can only be fulfilled by one entity. This is an interesting provision for LRAs, as it eliminates the problem of tender requirements when they are impractical.

While this is a useful provision, it is surprising that the Court of Auditors has not issued an opinion in its report (1/2017), as this may open the door for cases of clientelism unless the justification can and is verified. Given the number of operations, there is a possibility that breaches are not detected. Of course, transparent publication of the awards and a system allowing competing contractors to challenge the decision are generally in place, as is also the case for awards made under tendered procedures.

In fact, the European Parliament has flatly rejected the need for such a simplification.

Box 8. Proposal for Art. 188 of the Financial Regulation, *Exceptions to calls for proposals*

Grants may be awarded without a call for proposals only in the following cases:
(a) for the purposes of humanitarian aid, emergency support operations, civil protection operations or for crisis management aid;
(b) in other exceptional and duly substantiated emergencies;
(c) to bodies with a de jure or de facto monopoly or to bodies designated by the Member States, under their responsibility, where those Member States are in a de jure or de facto monopoly situation;
(d) to bodies identified by a basic act, within the meaning of Article 56, as beneficiaries of a grant or to bodies designated by the Member States, under their responsibility, where those Member States are identified by a basic act as beneficiaries of a grant;
(e) in the case of research and technological development, to bodies identified in the work programme referred to in Article 108, where the basic act expressly provides for that possibility, and on condition that the project does not fall under the scope of a call for proposals;
(f) for activities with specific characteristics that require a particular type of body on account of its technical competence, its high degree of specialisation or its administrative power, on condition that the activities concerned do not fall within the scope of a call for proposals. Where this particular type of body is a Member State, the grant may also be awarded without a call for proposals to the body designated by the Member State, under its responsibility, for the purpose of implementing the action.
(…)

3.7 Joint Action Plans

The proposed financial Regulation mentions the need to promote joint action plans (JAPs), which are regulated in Chapter III of the common provision Regulation (CPR). The concept of the joint action plan is to allow member states to apply a results-based approach to achieve goals in their programmes, towards an objective under the scope of the Investment for Growth and Jobs (IGJ) or the European Territorial Cooperation (ETC). It can be supported by one of more funds (ESF, YEI, ERDF or Cohesion Fund). It is not to be used for infrastructure.

The JAP was started in this MFF as a pilot project encouraging managing authorities to submit a single programme that would combine different funds to develop an integrated action, increasing policy coordination while simultaneously focusing on specific results. The interesting factor of the JAP is that the financial management is exclusively based on lump-sum payments and unit costs. The JAP has clearly been developed with training and social innovation programmes in mind, and is particularly suitable for YEI.

Despite the appealing simplified costs approach, the JAP has not been taken up, for the principal reason that the guidance for the joint action plans was published in 2015 for the MFF 2014-2020, once the programming period had started. Experience has shown that it is very difficult to retrofit a new programme structure into an ongoing programming period. There is a mismatch in the timing of the programming and the adoption of regulations and guidelines.

There is a minimum size requirement for a JAP action: the public contribution paid by the beneficiary authorities must be at least €10 million or 20% of the public support of the programme. Exceptions are allowed for pilot programmes, halving the financial requirement.

The reforms of the Financial Regulation will facilitate the development of JAPs, but the reforms cannot address the difficulty in coordinating the different administrative bodies locally to implement such integrated strategies. At this stage, it is too difficult to take any position on the JAPs.

The beneficiaries of the JAP must be public law bodies, which in fact would mean the local authorities, either the MAs themselves or another intermediate body. But this would not preclude the implementation from being carried out through other bodies under the responsibility of the authorities. This does not actually represent a departure from existing practice, particularly in the case of unemployment support programmes. The guidelines (European Commission, 2015) provide examples on how to prepare a JAP.

Most of the programming requirements do not depart markedly from existing practice in terms of designing the intervention logic and objectives, but they do reinforce the Commission's requirements to specify measurable objectives and present clear measurable indicators. After all, the point of a JAP is to finance per unit of achieved result. This means clearly specifying the number of people reintegrated into the job market, for example. The JAP also calls for a description of the approach and programme orientation.

The JAP requires that specific results are produced, which means that the programme's success will not be judged on basis of the activities in the programme (e.g. persons retrained), but rather on the programme's impact on the participants (persons finding a job after the training or gaining a specific qualification). If results cannot be quantified, the use of the JAP is discouraged.

The project can have intermediate milestones, i.e. the costs may be recovered for achieving specified milestones. However, one of those milestones must set a minimum threshold, e.g. a certain number of unemployed individuals obtaining a professional qualification (target 10,000, minimum 2,500). If the threshold is not achieved, the beneficiary will receive no support.

In addition, payments are results-oriented. This means that for the participant who achieves a milestone (successfully passing a skills test), but fails to secure a job in the reintegration activity, or to sustain a start-up activity over a certain period of time, only the costs incurred up to the skills test milestone will be recoverable.

3.7.1 JAPs specific payment systems

JAPs allow for simplified cost options and lump-sum payments, but they also permit specific additional payment systems and variations. Lump-sum payments are not capped and payments are based mainly on proof of outputs having been achieved and less on management of the funds.

However, audits will assess the methods used to calculate the simplified costs in the JAPs approval, but will not perform this again later. While this simplifies the process the beneficiaries must follow, it also closes the door for changes if the costs do not match in practice the initial calculations, placing the risks again fully on the MAs. Amendments are allowed, but guidelines only mention amendments on the intervention logic, which does not seem to include the possibility to alter the cost calculation.

3.7.2 Assessment of JAPs

A JAP is just a format of implementation to facilitate the uptake of SCOs, lump-sum payments and performance-based payments framed in a way as to encourage its use for the YEI. The concerns raised regarding the individual components also apply for the JAP.

A JAP facilitates payments, but it creates strong uncertainties over those payments if the results are based on detailed measurable performances. It also opens the door to difficulties and delays in fund recovery if achieving a target is particularly challenging, such as the long-term unemployed finding a job. The time frames are also an issue, as well as monitoring post-completion results. For example, one JAP presented as a potential indicator that a start-up created by a participant would be supported for a certain period before the costs would be reimbursed. What would be considered a reasonable length of time? When would the Commission consider the support to have been successful? What performance would the start-up need to achieve? Can the lack of success of the start-up be attributed to the its performance, or could this be a result of a change in economic circumstances? The proposed performance-based payments do not seem to be a realistic requirement in many cases. In fact, it is also not compatible with the EU's objective of promoting innovative SMEs, which are by nature taking additional risks.

The JAPs do, nevertheless, introduce a welcome degree of simplification and eliminate much of the financial controls, focusing on output performance. However, social funds and particularly the YEI target socially disadvantaged individuals, who are more difficult to integrate in the market. The JAP is not well suited for authorities, particularly those with limited budgets, handling social problems. There is a high risk that outputs may not be achieved in a crisis period or because the participants are difficult cases. In short, long-term unemployed or handicapped would make MAs rationally reluctant to adopt such a system.

The difficulty or potential impossibility to adapt the simplified costs calculation to changing circumstances may also be a barrier. The simplified cost is based on an output unit, which means that while the programme may be amended, the output and cost of the unit cannot be revised. Reprogramming without simplified costs thus leaves some programme participants more leeway.

There simply has been scant uptake of the JAPs. This has been partly due to the late publication of the guidelines, but when an MA was asked why JAPs were not implemented, the answer was that they are cumbersome and similar results can be achieved by just using the simplified cost and payments options available, without requiring the setting up of a full JAP.

4 Complementarities and synergies amongst european instruments

A key objective of the European Commission is to promote coherent integrated programmes that efficiently develop the endogenous growth potential of the regions supported by the EU budget, all in line with wider EU objectives. The strategic planning requirements that countries undergo, as called for in the common provisions Regulation (1303/2013) and the Country-Specific Recommendations, ensure that strategies follow increasingly coherent development paths. The need for policy integration is accompanied by the need to improve the coherence between the different policies and the compatibility between the EU and its supporting instruments and their procedures.

A wide array of programmes and financial instruments is available at EU level for regions and countries to finance and develop projects: the European Structural and Investment Funds, the Cohesion Fund, the Rural Development Fund, the EU’s Competitiveness and Innovation Funds, Horizon 2020 and COSME. The Connecting Europe Facility can also to some extent support the development, implementation and running of integrated energy, transport and ICT investments.

The EU is also expanding the use of financial instruments supported by the EIB, with the European Fund for Strategic Investments (EFSI) being the most powerful instrument. It is one of the stated objectives of the EU to improve the use of combined funds into single projects.

One of the most important reform of the EU budget was the expansion of EU budget operations by financial instruments. This expansion has been promoted by an increase in the allocation to those instruments in central management and also by allowing managing authorities to set up financial instruments themselves in any area they deem necessary, as long as these fall into the thematic objectives of the Structural Funds and are in line with the State aid rules. The financial instruments must undergo an ex-ante assessment before being set up. The Managing Authorities also have the option to transfer the funds to the European Commission to have them managed centrally. Thus, the financial instruments will be operating in the country, but based on the ex-ante assessments of the European Investment Bank.

4.1.1 Difficulties in combining funds - the case of grants

The European Commission wants to encourage complementarity of funds, which can be highly beneficial in accelerating and securing the impact strategies. In fact, in many areas, integrated projects are of key importance, such as those targeting urban development. Complex multi-sectoral plans can benefit from '**parallel financing**', when projects that complement each other are backed by different EU funds or from '**consecutive financing**', when different EU programmes intervene in a project lifecycle at different points in time.

While the combination of different funds is encouraged, in practice **the regulatory framework makes it close to impossible to achieve thorough coordination**. This difficulty is compounded by a lack of simple procedures and common standards from the side of the European Commission, making combined integrated programmes an exceptional feat. Even when some integration is achieved, this only happens in regions with a very strong administrative capacity, with structures of coordination amongst different national and local government departments. Even in regions with dedicated structures to coordinate efforts for certain policy priorities, such integration is rare.

In such a landscape, the impact of EU financial resources can be limited. Providing the right assistance and rules for **enhancing synergies between EU programmes** should become one of the primary concerns of EU policy-makers to generate a scaling up and replication.

Nevertheless, examples of parallel financing are numerous, as long as the projects are designed independently from one other, such as co-financing a transport infrastructure, which in turn accesses another co-financed project, such as e.g. a port.

For consecutive financing where a new project is developed as a follow-up to others, the situation is more problematic, unless again the projects are largely independent of each other. The idea of highly integrated consecutive projects financed from different funds is difficult to realise. One of the most coveted cases by the European Commission is to promote the replication and deployment of successful innovations financed by the Horizon 2020 research programme grants to be subsequently supported to access the market. This sequential financing from different sources is far than simple.

The Commission's encouragement to explore synergies, pursue coordination and complementarity among different EU funding schemes is not backed by well-developed guidance on how to do this. Over recent years, the Commission has taken important steps towards clearing up the rationale for linkages and synergies between different funding sources,[16] but the focus remains very much centred on the interplay between Horizon2020 and equity and loans for innovative businesses by Innovfin and ESIF with little or no attention to other relevant programmes and instruments. See the box below.

Box 9. Combination of sources: Impacts of different definitions and procedures of funds for one project.

The REFIT platform's opinion (2016) presents the difficulties that projects typically face. It cites a case study involving the project 'Energy Store', which is based on a sponsored research programme that aspires to deploy the means to store wind energy. To test this innovation in the context of a Living Lab, 19 partners joined together and applied for Interreg ERDF funding to the relevant MA.

The MA assesses whether the project meets all requirements with respect to state aid with DG Competition, which has its own set of rules on this matter that are different from those of DG Regional Policy, which runs the Interreg programme. This is a very complex procedure, because the MA needs to assess the percentage of aid not at the project level, but at the level of each of the individual 19 partners based on the activities they perform, in line with the state aid rules for research, development and innovation. The result needs to pass the state aid procedure in DG Competition.

The approval process does not end with the success of getting it through DG Competition, however, because subsequently the public procurement rules kick in. This happens in case the grant is used to finance a public contract, which is often the case in demonstration projects. These are now multiplying with the interest in helping R&D outcomes to reach the market, by targeting the investment gap between proof of concept, the demonstration and replication. The procurement process must be verified by the MA.

This entire process should be undertaken under the n+2 principle, i.e. the funds must be disbursed within a two-year period of time from the start of the contract, which may not happen under the delays imposed by the procedures, entailing a risk that the project may have to return the financial support.

The MA in this case has thus to apply the fund rules, the public procurement rules and the state aid rules. Each of the rules are applied by different DGs with not only different procedures, but a different definition of the activities. Innovation, for example, is interpreted in different ways by each of the three DGs.

[16] See for instance European Commission (2014), Enabling synergies between European Structural and Investment Funds, Horizon 2020, and other research, innovation and competitiveness-related Union programmes – Guidance for policy-makers and implementing bodies, Directorate-General for Regional and Urban policy and European Commission (2016), EU Funds working together for jobs and growth – Synergies between the R&I Framework Programmes and the European Structural & Investment Funds, Directorate-General for Research and Innovation.

In addition, the rules of the DGs and the objectives of the EU may at times contradict each other. For example, DG Research and DG Regio encourage a living labs approach, as one of their policy objectives. However, state aid rules do not allow such activities to be funded, or at least only in a very restricted manner. Since 1 July 2014, one provision has exempted such projects from state aid rules, but unfortunately this exception is subject to very narrow requirements that make it difficult to benefit from it. In addition, this exception is also not applicable if the investment builds infrastructure that would have been financed anyway in a three-year period. These conditions are difficult to justify.

The consequence is that some activities are promoted by some DGs and discouraged by others. This is the result of asymmetric policy developments, in which decisions are taken sectorally and the interlinkages are subsequently ignored. Under the present rules, some of the highest barriers may be the EU rules themselves. There is a need for more coherence, common terminology on what constitutes innovation and a consensus on when and how public procurement and state aid rules should apply.

It is notable that the Treaty allows aid to promote the execution of an important project of common European interest (TEU, Article 107, 3 b), but this is rarely granted even for projects in the energy sector of an innovative nature. Thus, while the EU considers innovation in the energy sector a priority, it is hampered from using state aid in this area.

The proposed legislation has some provisions aiming at making the procedures simpler, by, for example, using only the procurement rules for financial instruments and ESFI when grants are combined with those instruments. But the legislation seems to be still a declaration of intent, because the implementing and delegated legislation needs to be reformed, while the regulatory framework of all funds needs to be streamlined.

According to the Interprovincial Overleg (2015), state aid rules should not apply to pilot projects aimed at encouraging innovation. At a minimum, a simplified procedure already applied to financial instruments could be introduced.

4.1.2 Expanding the use of financial instruments and mixing them with other funding

LRAs have faced difficulties in combining different funds and the adoption of such an approach has accordingly been rare. A first problem arises from the situation in which similar or complementary instruments under direct and indirect management operate according to different sets of rules, for example the financial instruments under direct and indirect management. Other difficulties arise in the combination of funds such as the use of EFSI in projects including ESI Fund grants.

In brief, specific attention should be devoted to:

- Easing the implementation, audit and reporting systems for integrated urban projects by making use of different financing sources, e.g. adopting fully standardised procedures, and

- Creating a one-stop shop application procedure, not by fund, but by type of project. Advice should be given on how to make a multi-fund application.

To facilitate the adoption of the financial instruments and their combination with grants, the European Commission has set up the fi-compass platform,[17] but the regulatory complications cannot be solved through advisory bodies alone. Some barriers are inherent to the design of the funds. One of the complications faced has been the different rules for grants and financial instruments, but these differences are unavoidable given their very different natures. When used in combination, however, different sets of eligibility and management rules for the same project make little sense (see Box 10). Title V of the proposed financial Regulation introduces a number of simplifications to avoid unnecessary burdens.

Box 10. Proposal for Article 208 of the Financial Regulation, *Rules of implementation*

2. Where financial instruments are combined within a single agreement with complementary support from the Union budget, including grants, this Title shall apply to the whole measure. The reporting shall be carried out in accordance with Article 242.

Where a financial instrument is established for the purpose of implementing Article 39 of Regulation (EU) No 1303/2013with a contribution from a budgetary guarantee of the Union, this Title shall apply with the exception of Article 201(1). It shall be implemented in accordance with Article 61(1)(c).

Thus, one of the key proposals is to ensure that when a combination of funds is used, e.g. direct and indirect managed funds, grants and financial instruments of ESIF, only one set of rules will apply. Generally, the rules of the main element will apply. In case of a combination of ESI Funds and with financial instruments, the rules of the latter will apply (Article 122 (2)).

[17] For more information, see https://www.fi-compass.eu/

This is an important provision, simplifying the project proposals and approval considerably and has a positive effect for LRAs. There is, however, a long way to go to allow grants, FIs in shared and central management and EFSI to be easily combined.

The European Parliament has proposed an amendment adding the condition that the rules of the financial instrument will follow the sector-specific rules of the Regulation. This proposal moves against simplification and a single framework for all funds.

4.1.3 State aid rules for shared and centrally planned FIs and EFSI

There is a perceived problem of unfairness between the FIs that are centrally managed and those in shared management, the first not requiring state aid rules controls and the latter having to do so. The guidelines for the 2014-2020 period apply to all FIs and not only to equity capital or SMEs exclusively, as was the case before. The rules are an incentive for the member states to use the General Block Exception Regulation (GBER), which gives increased flexibility to member states to grant state aid without prior notification and approval by the Commission (Nicolaides, 2014).

The need to apply state aid rules or ensure that they fall under the GBER in FIs set by MAs is a very important requirement. This is based on the past experience of banks using EU support to de-risk their ongoing operations, instead of expanding lending. It is important that the support reaches the final beneficiaries, i.e. the lenders, and that it does not distort the market.

The European Commission also offers off-the-shelf financial instruments that have a very simple design, with terms and conditions specified to ensure that the model is ready-to-use. These instruments have the state aid pre-cleared, and thus do not need notification. Their main aim is to provide standard terms and conditions for a set of predefined financial instruments that can be set up and implemented by MAs.

There have been complaints that centrally managed financial instruments are exempt from state aid rules. This is, as the ECA explains, because the support is granted by the EU and not a Member State is not fulfilled (ECA, 2016). Nevertheless, it is the position of the EIB and European Commission that these instruments are well managed, based on tested structures and follow the principle of additionality, ensuring that the aid does not distort the markets unduly. There is no doubt that the instruments of the EIB are not designed with the objective of giving undue advantage to any national sector, but there is a need to be observant that the instruments do not crowd out other forms of financing. While such instruments were easy to defend during the crisis, this is becoming less clear now that the economy is showing an uptake.

State aid rules are important, but a recent analysis of some 40 ex-ante assessments of financial instruments shows that in the design phases of FIs the State aid implications are often neglected and of low quality (Núñez Ferrer et al., 2017).[18]

As a way around state aid rules, the CPR Arts 96(1) and 38(1) allow for ERDF Operational Programmes to contribute to centrally managed SME FI initiatives. The existing ex-ante evaluation and assessment at EU level for centrally managed FIs allow the member states to skip the preparation of both a programme ex-ante evaluation and the ex-ante assessment for the instrument.

When transferring the funds, however, the instruments will only be a single national programme fund, but regional allocation can be negotiated, when necessary, in the funding agreement.

The funds for the centrally planned instruments will be exempt from the performance framework and performance reserve.

4.1.4 Auditing inconsistencies in grants and FIs

Two problems have emerged when reviewing the present situation and the proposals. The first is the fact that the auditing requirements of grants and financial instruments are too similar, while the various ways in which EU funding is used are very different. Auditing of grants means auditing the financial chain leading to a clear purchase based on an investment plan. In the case of guarantees or equity for businesses, the 'expenditure' cannot be traced in the same manner, especially in the case of loans to SMEs managed by local banks. How can the link of the expenditures in loans be linked to the EU funding? How can the funding be monitored? Complications have already emerged in which the European Commission's auditors require national auditors to trace financial instruments expenditures to a level that does not correspond to the reporting obligations of the financial institutions using the guarantees.

When MAs transfer the funding to centrally planned FI SME facilities, there is no need for an ex-ante assessment, which checks for example the conformity with state aid rules. This seemingly simple rule may, however, potentially lead

[18] Of course, State aid implications are addressed only for financial instruments under shared management, as there are no issues pertaining to State aid for centrally managed programmes.

to a dilemma: the funding originates from the OP and thus responsibility for the funds remains in the hands of the national audit authorities. The latter will naturally be concerned with how they can hold the EIB or European Investment Fund (EIF) responsible, if they reach a negative assessment of the financial instruments' set-up and/or its implementation.

4.1.5 Are different eligibility criteria for grants and FIs acceptable?

It is a frequent complaint that the differences in eligibility criteria allow for projects rejected under ESIF rules for not being in line with EU objectives to be subsequently approved for EFSI support.

A rejection of grant support should not necessarily be considered grounds for not using FIs, because the rejection may simply be for eligibility criteria that are unrelated to the fitness of the project with EU objectives. For example, a project may be rejected for grant support simply because the project is not covered in the operational programmes, or because the grant requested is too high for a revenue-generating project. If the revenue-generating part of the project is too low to attract normal private investors, FIs can be considered.

If the grant support was rejected because an evaluation considered that the project was inconsistent with EU objectives or inappropriate given the national strategy of the country or region where it would take place, then it is reasonable to expect that FIs should not support the project. This does not preclude the possibility that the project developers would sufficiently address such issues before submitting a new funding request.

A solution to prevent beneficiaries from shopping from one fund to another would be to require project proposals to state if demand for support had been previously rejected, the grounds for the rejection and what actions have been taken to address the causes.

4.1.6 The most promising areas in which to combine grants and FIs

There is no general rule that precludes or excludes combinations of grants with FIs, but using the new Art. 122 to combine grants and FIs in the same project is seen by MAs as excessively complex. An easier way in which is to use grants and FIs separately in a project, such as in the case of the ELENA projects, where technical assistance grants pave the way for loans. This was also done for trust funds in the external action budgets, but may not be the best option for many projects.

There could be some rare instances in which a project could benefit from an FI, while a specific part of it was covered by a grant to bring it to bankability. But in that case, the project would be entering a very complex regulatory sphere, particularly if its profitability is, after the separation, higher than expected, thereby calling into question the use of an FI in the first place. Where should the line be drawn?

In most cases, it seems reasonable to separate parts of a large project into stand-alone grant projects rather than mix the instruments. This could, for example, involve separating a public building with a social objective from more commercial private buildings in the same project.

The combination of grants and FIs in one single project is far from simple and MAs are not the right bodies to handle such situations in most EU countries.

Cases of grant and FI combinations are rare, particularly successful ones. One of the most documented (also because it is one of the rare ones) is the case of the CAP Troisième Révolution Industrielle Nord-Pas de Calais in France.[19] Key difficulties include complexity, the need for high administrative capacity and full involvement of the private sector.

4.1.7 Are MAs and regions the right entities to set up FIs?

Unfortunately, the answer to this question is 'no', because the effectiveness and costs of the financial instruments are higher, the larger the guarantee funds supporting the FIs.

FIs are best when the risk spread is wide, which means that FI funds should have a varied portfolio and be widely spread out geographically. Thus, a single large guarantee fund for SMEs across Europe open to SMEs active in many areas of activity is preferable by far to small FIs covering a limited range of specialised activities. An appropriate comparison would be insurance funds, the narrower the geographical coverage and type of risk, the higher the risk for the insurance company.

Thus, the most appropriate solution for MAs in the areas covered by central instruments is to transfer the funds for those FIs to the EU-level instruments.

[19] https://www.fi-compass.eu/publication/case-studies/case-study-cap-troisi-me-r-volution-industrielle-nord-pas-de-calais-france

However, these do not yet cater well for the regional FIs, as the EU only develops national-level FIs and there is no guarantee that there will be a focus on regions in need. The avenues to negotiate some kind of regional dimension are open, but there is little guidance on how MAs influence the kind of FIs created 'nationally'. The transfer to the EU level is also limited to SME support and there is a need to consolidate and streamline EFSI, COSME and InnovFin instruments, which cover similar or the same beneficiaries with different rules. Each of these issues needs to be addressed for the next MFF post-2020 and rather urgently as the time available to take carefully reasoned decisions is diminishing.

Below are presented a set of lessons learned from the 2007-2013 period and for the current period, based on our review of the financial instruments set up by MAs. These lessons stem from a review of financial instruments performed for the European Parliament (Núñez Ferrer et al., 2017).

1) Clear, market-oriented and flexible eligibility rules

Implementation of the financial instruments in the previous programming period 2007-2013 was impeded by the initial lack of clear regulatory provisions related to the implementation of financial instruments under Structural Funds. The publication of a comprehensive COCOF guidance note on the implementation of financial instruments in 2011 clarified the majority of questions relating to the eligibility of expenditure. It was later amended (in 2012) to address the urgent need for financing on working capital, which, for instance, continues to constitute the bulk of demand in the current economic context. The new regulatory framework for the 2014-2020 period generally represents an acceptable basis for the future implementation of decentralised financial instruments.

2) Flexibility

Given that eligibility and state aid rules may hamper final recipients from benefitting from FIs, it is important to limit the eligibility rules only to those that are strictly necessary and to try and preserve for the instruments as much flexibility in meeting demand as possible. It is also important to allow for an easy re-allocation of resources from the non-performing to performing instruments, by grouping them under a fund of funds structure at regional or national level.

3) Suitability of the selected FIs

The role of FIs in the deployment of funds is crucial to maximise the benefits of instruments' portfolios such as: i) utilisation of public resources, ii) leveraging of private resources and investors, iii) deployment of the instrument in accordance with the contractual obligations to ensure transfer of benefits to the beneficiaries with transparency and iv) accountability and compliance with national legislation and EU regulations. The selection of the FIs should be carried out in the framework of all the above considerations with full impartiality, and based on a thorough assessment, including technical expertise and know-how.

4) Availability of funds

During the previous programming period, all funds were available at the beginning of the operations. This ensured that the holding fund manager could enter into agreements and deploy financial instruments of varying risk profiles and of duration exceeding the programming period. This could be achieved without any additional conditions that could reduce the benefits transferred to the final beneficiaries, diverge from market practice or trigger additional legal provisions. In the 2014-2020 period, the new concept of tranching of ESIF payments presents an additional operational aspect to the implementation of FIs, which should be carefully evaluated.

5) Combination with grants

As the new regulations allow the combination of grants with financial instruments, it is up to the implementing bodies to decide if grants and instruments should work as an embedded or connected product(s) and potentially be managed by the financial instruments manager, or if the grant element would better work as an external component to be managed separately (perhaps in collaboration with a grant-focused authority). How this would be achieved, however, could not be determined in any detail.

6) Appropriate evaluation of financial results

An accurate evaluation of the results of financial instruments can only be made after the instruments have been wound down, returns fully generated, any losses incurred and the equity funds closed out. It is well known that such instruments have a slow start and most equity gains or guarantee portfolio losses occur towards the end of their lives. Furthermore, the indicators used in the FIs evaluation must be different from those used in grant evaluation.

7) Capital relief

In the previous programming period, the intermediaries expressed interest in the applicability of regulatory capital relief under guarantee and debt products. The provision of regulatory capital relief should be carried out in a way that is compatible with national legislation and the capital markets regulatory framework in close connection with legal experts and the national regulator, respectively.

It is expected that the provision of regulatory capital relief will remain a key element for the future implementation of debt products under ESIF. For that reason, it should be considered at the stage of the Funding Agreement negotiations whether its provisions would be compatible with this objective. In accordance with the Basel regulatory framework, the benefit of the capital relief can be fully utilised when the entity providing the guarantee enjoys the maximum credit rating.

8) Transfer of benefits

Most of the instruments that are deployed through banks as FIs incorporate an element of support that is directed at the final beneficiaries. Continuous monitoring and sophisticated reporting through contractual arrangements with the FIs are required to ensure that the full benefit is transferred to the SMEs in a transparent and uninterrupted manner.

9) Attracting quality fund managers

Small regionally-specific funds rarely manage to attract top talent, as far as concerns fund managers, due to their size and limited scope. To counterbalance that, equity instruments could offer an attractive fee/carry ratio. This approach would require a careful balancing act between the interests of fund managers and private investors, and must in any case retain the ‘alignment of interest’ principle. A more attractive carried interest[20] might make investors less interested, and so such incentives might only be possible with regard to public participation in the fund. Careful judgement on what would constitute appropriate levels of management fees/incentives and implementation costs remains a difficult balancing act to follow.

[20] Carried interest: Share of profits of an investment paid to the investment manager in addition to its share in the project.

10) Local and committed teams

Strong local teams, or international teams with substantial capacity on the ground, have been shown to help an equity instrument achieve the impact sought by ESIF funding, especially from a developmental perspective.

Box 11. Specific lessons from using Financial Instruments from UK regions – the case of SME support

Whilst the UK has significant experience in setting up and implementing a variety of financial instruments, a new type of structure was developed with the EIB Group and implemented with four different regional authorities in the 2007-2013 period. The lessons have been well documented compared to other assessments.

This new structure involved EIB lending to the regional structure to boost the critical mass of capital alongside allocated ERDF funding. These leveraged JEREMIE Holding Funds were implemented in Wales, the North West, the North East, and the Yorkshire & Humberside region.

As this was a new concept, understandably the EIB Group looked closely for any lessons that could be learned from the process and undertook an internal mid-term review. From this exercise, certain lessons were learned which have influenced the views of the Group and, hence, impacted certain aspects for the 2014-2020 period. These can be briefly summarised as follows:

- To ensure that an appropriate diversified investment strategy is adopted for such structures to be in a position to meet loan-servicing contractual obligations, a minimum critical mass of these structures is required. The EIB Group estimates this to be at least GBP 100 million.
- To ensure an appropriate level of predictable reflows from the underlying financial instruments to service the debt element of these structures, at least 50% of the capital should be allocated to coupon-bearing, or similarly predictable, financial instruments.
- To maintain the overall critical mass of capital in the structure dedicated for investment in financial instruments, any expected management fees and similar costs need to be covered by sources of funding outside the structure itself. This is to ensure that costs do not erode the critical mass of funding available to the underlying funds and, hence, reduce diversification and the ability to generate repayments.
- To maintain the required levels of implementation diligence and timely focus on deliverables, appropriate levels of independent corporate governance are required.
- To respond to differences in implementation success of the underlying instruments and to accommodate any unforeseen changes in economic conditions, a flexible approach to capital allocation at the Fund of Funds level is recommended wherever possible.

- To avoid any unintended difficulties in the implementation and resultant utilisation of capital commitments within the underlying instruments, the central authorities are asked to consider carefully the impact of any national initiatives.

Additional feedback received directly from financial intermediaries involved in the implementation in the current programme includes the following points, some of which have been rectified within the new regulations for the 2014-2020 period:

- The biggest factor perceived at limiting the impact of the existing activities has been the sector restrictions imposed on the investment scope. In particular, the exclusion of the “retail” and “business to customer (B2C)” sectors have hindered the provision to a greater number of enterprises.
- The restriction preventing investments that are categorised as “management buy-outs” (MBOs) are regarded as further limiting factors.
- The formal European Commission definition of SMEs can be too restrictive with the upper limits on medium-sized enterprises preventing investments that are needed.
- The ESIF period end dates prevent the possibility to create follow-on investments into successful businesses, thereby undermining the potential to create positive returns to investors.

5 Conclusions

The EU budget is not a static instrument of EU policy; rather, it has undergone many important reforms since the turn of the century. **But some of these reforms have led to 'gold-plating',** as a counter-response to the accusation that the budget is being mismanaged. A main finding of this report is that past reforms have made the implementation of programmes and the achievement of goals excessively complex.

This process of gold-plating has occurred at the same time that the budget has been subjected to new unprecedented challenges. As a result, the budget has not only become **more complex in the number of activities it performs, but also more difficult to implement**. Attempts to simplify the EU budget since 2012 have paradoxically led to more complexity.

The new proposals aim at simplification and at facilitating the use of different EU funds in an integrated and coherent manner, i.e. to allow the funds to be more easily combined. But **the mid-term review/revision, in all its complexity, fails to ensure that the simplification proposals will lead to simplification in practice. The legislative package creates** the threat that newly delegated acts will be issued and that a new set of guidelines will in turn be created for each new simplification. It is unclear for some stakeholders whether the simplification is intended to allow them to implement their programmes in a more efficient and effective manner or whether they are solely for the benefit of the European Commission.

Moving forward to a **single audit** system is an important step in the right direction, but this should proceed in a coherent manner. **The single audit must be based on standards and trust in the national authorities, not seen as a means of facilitating the introduction of even more controls**. The proposals do not go far enough and the amendments proposed by the European Parliament show a general level of mistrust in national auditing systems that needs to be addressed.

The proposals for both **lump-sum and performance-based payments** could be a positive addition to the budgetary tool kit, but the actual proposed implementation and the amendments presented by the European Parliament again show that **the necessary institutional level of trust is missing**. Their implementation is likely to be more burdensome than the normal mechanisms. The way in which the performance-based payments are designed **may even induce the authorities to eschew difficult cases where the risk of failure is higher, or to refrain from using innovative programmes at all**.

On **achieving complementarity and synergies between European instruments,** the proposed reforms still fall short in addressing fundamental problems for combining funds. Much still needs to be done towards harmonising the methodologies and terminology employed amongst the directorates general involved. Many funds could be merged to avoid the operation and management of multiple funds to support the same activities. In general, there is a serious need to harmonise the ways in which the various funds work.

It is unlikely that the Commission's proposals will revolutionise the implementation of the EU budget, and the amendments proposed by the European Parliament will further limit the impact. It is likely that t**he final result will bear little resemblance to the recommendations issued by the High-Level Group on simplification f**or the current programming period, many of which have subsequently been taken up in the HLG's post-2020 recommendations.

The concerns raised by this report are also reflected by the COR's 2017 Opinion on the Financial Rules.[21] **There is a paucity of real simplification and the problems created by a lack of synergies between funds, programmes and ESIF are far from being resolved**.

True simplification will need an authentic single audit system, easy mechanisms to streamline the use of different funds and financial instruments and an effective plan for increasing national governments' trust in local and regional authorities to avoid the accumulation of excessive rules and controls.

Many of these aspects have also been highlighted in the CoR's Opinion above, reflecting the experience of and challenges encountered by local and regional authorities in implementing the current regulatory framework applicable to ESIF. The Opinion also includes a series of recommendations for simplification in the post-2020 programming period.

In fact, the mid-term review patches extensively the present MFF to allow it to continue functioning, but it is not sufficient for the post-2020 period. It is necessary to rethink the logic of the structures and seriously introduce a correct level of proportionality based on past performance of the managing authorities. Unfortunately, time is short until the next MFF, but the EU needs a better, higher-performing and better-adapted budget for the challenges of the future.

[21] See the CoR Opinion at http://cor.europa.eu/en/activities/opinions/pages/opinion-factsheet.aspx?OpinionNumber=CDR 5838/2016

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