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A BETTER PROCESS FOR A BETTER BUDGET

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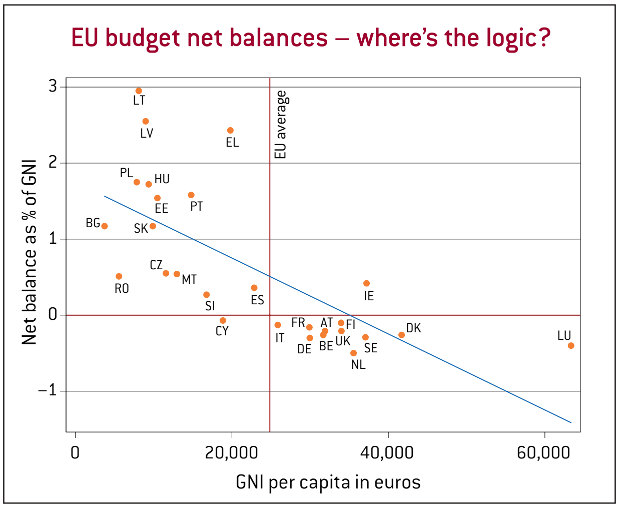
SUMMARY European Union budget negotiations often focus on member states' financial net balances, rather than on spending with EU-level added value. But net positions are an unreliable guide to sound EU policy. Changing the budget process is a precondition for any significant reform; the stubborn link between net balances and spending decisions will not be broken until the decision-making procedure changes. This will improve the quality of EU budget spending.

POLICY CHALLENGE

Net balance debates are a political reality, so the question is how to deal with net balances in the least damaging way possible for spending efficiency. Our proposal provides a practical solution to the present fixation on net balances, while taking account of members states' constraints. The proposal has two main features: i) the separation of EU public goods and redistributive expenditures in the EU budget, with public goods defined unanimously – and upfront – by the EU Council and financed according to GNI shares; ii) negotiation of net balances to determine redistributive expenditures. While not immediately leading to large compositional changes in the EU budget, our proposal makes explicit the trade-offs between spending on EU public goods and redistribution. By increasing transparency, it would create the right political environment and incentives to move towards more EU public goods.


EU budget net balances – where's the logic?

Source: European Commission

'The current budget is more the expression of different deals and attempts by governments to claw back in receipts as much of their contribution as possible than a coherent set of measures.'

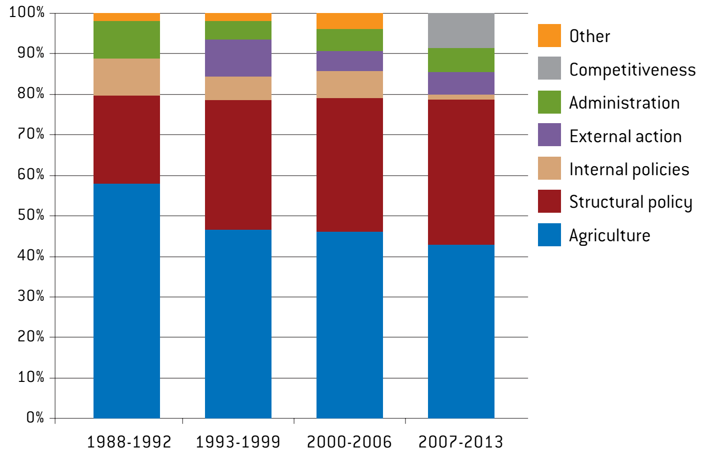
The Sapir Report (2004)

THE EU BUDGET[1] is the main financial instrument of the EU and authorises EU-level revenue and spending. It is just one of several EU instruments, less important than regulation and coordination. Since not all policy areas require a budgetary dimension and only some are EU tasks, the EU budget is relatively small. In 2008, it amounted to €129 billion or one percent of EU gross national income (GNI). While small overall, the EU budget is significant for certain areas like agriculture and cohesion policy (Figure 1). Smaller amounts are spent on a wide range of other areas, including culture, development, environment, research, energy and internal security.

Important revenue and spending decisions are not made yearly but in periodic multiannual financial frameworks (MFF) agreed unanimously by member states. These commitments have been associated with various milestones of the EU integration process: the single market (1988-1992), Economic and Monetary Union (1993-1999) and, more recently, eastern enlargement and the Lisbon Strategy (2000-2006 and 2007-2013). In some respects, the EU budget has been responsive to these challenges, for example the expansion of cohesion policy to facilitate participation of less well-off member states in the single market. But in others the EU budget still falls short. The Lisbon Strategy is a case in point. In spite of extensive relabelling, currently only one tenth of the EU budget is spent on items directly related to Lisbon ('Competitiveness' in Figure 1). Three quarters of EU spending in the past 20 years has been consistently directed towards agriculture and structural policy, leaving little room for new priorities.

This detachment of EU spending from political priorities is related to the nature of the decision-making process and excessive focus on net financial balances, ie the difference between EU spending allocated to a particular member state and its contribution to the EU budget (Figure 2). Net positions tell us nothing about the effects of EU policies – not even about the distribution of these effects across countries – but they are nonetheless a driving force in negotiations. Former UK premier Margaret Thatcher's 'I want my money back' epitomises this issue (see Section 3 for a fuller discussion of the UK rebate). Net balances are problematic for net contributors since, all else being equal, they would clearly prefer to pay less than more, but net balances also influence the overall size of the EU budget and affect the composition of spending.

Figure 1: Breakdown of expenditure in EU multiannual financial frameworks



Source: European Commission

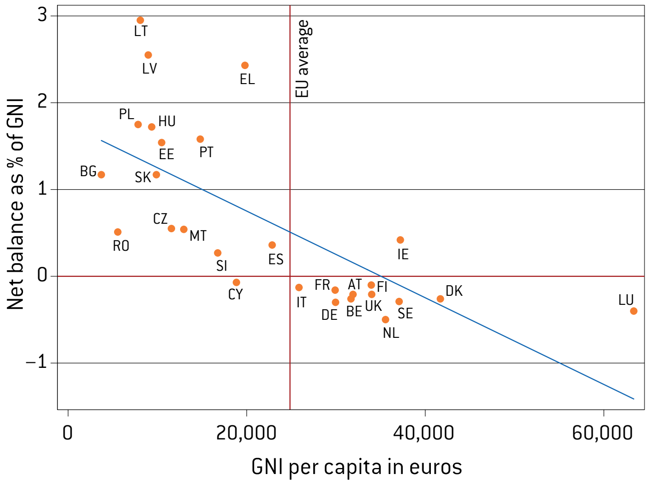
Since its beginnings, the EU budget has been used to accommodate countries seen to be losing out from integration. The Common Agricultural Policy (CAP), for example, is the result of a 1960s Franco-German compromise linked to the benefits accruing to German industry from the common market.

Member states care more about the EU budget's impact on their accounts than which policies it is allocated to. This narrow focus on net balances has led to inadequate attention being paid to what should be the core of the EU budget – EU public goods – where EU spending can improve the welfare of the Union's citizens and the effectiveness of EU policy.

Yet while net balances cannot be ignored, most of the discussion

[1] This policy brief draws on Neheider, S. and I. Santos (2009) 'Reframing the EU budget decision-making process', *Journal of Common Market Studies* (forthcoming).

Figure 2: EU budget net balances, 2007



Source: European Commission

has focused on correction mechanisms that adjust member states' net contributions according to selected criteria such as income per capita. But this only addresses the issue of fairness. What is at least as important is to refocus the debate on policies.

We propose, in line with other authors, to separate public goods from the rest of the budget. Contrary to other schemes that define EU public goods in advance, however, we leave this decision to the negotiation process. Policies that attract unanimous support should be considered public goods. Reflecting member states' ability to pay, these should be financed proportionally to GNI, while all remaining policies are pooled in a second group where net balances are negotiated.

This is an appropriate time to discuss EU budget reform. The 2005 agreement to conduct a critical review of EU finances by 2009 shows member states' dissatisfaction with the status quo. Additional pressure arises from the need to design a substitute for the Lisbon Strategy by spring 2010 that better aligns EU policy goals and spending. The European Commission's conclusions on the review are expected in 2010. A discussion of the EU budget decision-making procedure should be included in this review.

In what follows, we start by discussing the role of net balances in budgetary negotiations and how what amounts to 'financial gerrymandering' has a detrimental effect on the quality of EU spending. Section 2 discusses EU budget decision-making and existing reform proposals. Finally, we put forward our own reform proposal and assess its impact on net balances.

1 NET BALANCES

The discussion on the EU budget boils down to two issues. First, defining what EU public goods are (Box 1, overleaf). Second, agreeing on the desirable extent of redistribution within the Union. Disagreements among member states on both issues have led to disputes about net balances.

Net balances are a fundamental part of budgetary negotiations and spending decisions. In the 1970s, more than three quarters of the EU budget went to agriculture, causing a major conflict with the UK. After ten years during which the concept of net positions was discussed explicitly for the first time, the UK rebate was introduced in 1984 and has been followed by further corrections for Germany, the Netherlands, Austria and Sweden.

The issue of side-payments remains acute. This is particularly apparent in cohesion policy. The current financial framework

Table 1:
Additional provisions cohesion policy 2007-13, final agreement stage 2005

Member state	Additional provision (€ millions)	% of member state's total cohesion receipts, 2007-13
Austria	150	11.5%
Czech Republic	200	0.8%
Estonia	50	1.5%
France	100	0.8%
Germany	300	1.3%
Hungary	140	0.6%
Italy	1400	5.5%
Latvia	80	1.9%
Spain	2150	6.8%
Sweden	150	8.9%

Note: These additional allocations are those which go beyond those in the Luxembourg presidency's final proposal. Sources: Authors, based on DG Regio, Eurostat and Council of the European Union (2005): Financial Perspectives 2007-13, December 2005.

includes many instances of payments going beyond the original allocation based on the specific socio-economic characteristics of regions. Table 1 shows additional allocations under the heading of cohesion policy added in the final negotiating phase of the 2007-2013 MFF. These side-payments account for 1.5 percent of total cohesion receipts for the period, but their magnitude varies across countries, representing as much as 11.5 percent in the case of Austria.

These side-payments arise both from disagreements about spending decisions and pervasive incentives entrenched in the decision-making procedure. In the next budgetary negotiations, due to start in 2011 at the latest, the issue of net balances and side-payments will re-emerge, since member states disagree on the direction that the EU budget should take. This applies especially to the two policies that absorb the lion's share of the EU budget: cohesion and agriculture (Table 2).

Preoccupation with net balances in the EU budget is inevitable. It is important to recognise that these balances are only one mechanism through which member states bargain their way through EU negotiations. But explicitly acknowledging the net balances issue in budgetary negotiations is a must.

2 REFORMING EU BUDGET DECISION-MAKING

As in budgetary negotiations in national parliaments, where interests diverge and there is often no link between taxes and expenditure, the EU budget is subject to the 'common pool problem'. Drawing funds from a general budget to provide public goods that benefit directly only a small constituency triggers pork-barrel politics. In the EU, this translates into each member state perceiving that an increase in spending on targeted policies will provide their

BOX 1: AN EFFICIENT EU BUDGET

What the EU budget should look like depends on which tasks ought to be centralised at the EU level. For this, the theory of fiscal federalism provides key guidelines, even if the EU is not a federation.

Fiscal federalism is concerned with allocating powers across government levels (Oates, 1999). A central government has four main tasks: maintaining a single market, stabilising the economy, providing public goods and carrying out redistribution. Given the EU's limited fiscal powers, its focus has been on the first task. The EU budget, at one percent of EU GNI, plays a limited role in providing public goods and redistributing wealth.

In terms of public goods, the EU should focus on areas with major transnational spillovers and economies of scale, namely basic research, transport, climate change, defence and foreign policy, in some of which the current mandate of the EU is limited. There is a strong argument to be made that redistribution from richer to poorer member states is also necessary, since major gains are to be made from stability and growth throughout the EU. Interpersonal redistribution, on the other hand, is better left to national governments where powers of taxation lie.

Yet the EU budget today is very much disconnected from these principles. Few spending categories pass the EU value-added test. Most spending is essentially about interpersonal or interregional redistribution, with the CAP and structural funds representing 42 percent and 29 percent of the EU budget, respectively[2]. Expenditures with a clear EU dimension, such as transport, energy networks and research, account for less than a tenth.

Table 2:
Member states' positions in the 2008/2009 budget review

		CAP	
		Wants change	Wants status quo
Structural funds (not cohesion fund)	Wants only poorest regions eligible	Czech Republic Denmark Netherlands Sweden United Kingdom	Bulgaria Cyprus Estonia Finland* Hungary Ireland Latvia* Lithuania* Luxembourg* Portugal Romania* Slovakia
	Wants all regions eligible	Italy Malta	Austria Belgium France Germany Greece Poland Spain

* In favour of poor regions in all countries receiving regional funds, including those in richer member states. Source: Authors, based on DG Budget (2009): Public consultations.

[2] For a more detailed discussion, see Santos, I. (2008) 'Is structural spending on solid foundations?' *Bruegel Policy Brief* 2008/02.

citizens with more resources at only a fraction of the cost. For instance, Germany – with approximately 17 percent of the EU population – receives a benefit of around 17 cents for each euro efficiently spent on EU-wide projects compared to a benefit of a full euro from money spent in Germany. For small countries, the additional cost of EU-financed pork barrels is basically zero. These costs keep falling as the number of member states rises.

Specificities about the EU – especially the requirement for unanimity – further exacerbate this common pool problem. While the European Parliament and the Commission participate in designing MFFs, the major decision-maker is the European Council. This body decides by unanimity on the financial framework, which is subsequently endorsed by the other two institutions (Box 2). Under this voting system, 'success' depends on landing as much money as possible for your own country, regardless of EU-wide concerns. Moreover, the current process marginalises the Parliament and the Commission, although the pending Lisbon Treaty does strengthen the role of the former and institutionalises the to-date informal MFF.

BOX 2: DECISION-MAKING ON THE MULTIANNUAL FINANCIAL FRAMEWORK 2007-13

March 2004: Commission's proposal

2004: Irish and Dutch Council presidencies examine the Commission proposal

Jan-June 2005: Negotiations start under the Luxembourg presidency

June 2005: European Parliament resolution on Commission proposal

June 2005: European Council fails to agree on MFF

December 2005: Under UK presidency European Council agrees on a financial framework for 2007-2013. The agreement adjusts the UK correction to account for enlargement and mandates a mid-term review of all EU finances. Compared to the Commission's proposal, the overall budget is reduced from 1.14 percent of GNI to one percent, CAP spending is barely changed and spending for competitiveness (excluding cohesion spending) and the EU's external agenda fall by over 58 percent.

January and April 2006: Parliament, Council and Commission negotiate an inter-institutional agreement on the MFF.

May 2006: After initially rejecting it, the European Parliament adopts the inter-institutional agreement, which is then signed by the three institutions.

The MFF has been successful in ensuring a smooth annual budgetary procedure by making the latter largely irrelevant. Three weaknesses remain. First, decision-making powers lie with the Council where each country has a veto. Working around the many incompatible interests is obviously difficult and the unanimity requirement results in rare and gradual change. Second, the period of validity of each MFF does not coincide with the Commission's tenure or the parliamentary cycle, thus reducing accountability. Lastly, no independent mechanisms exist for performance assessment. This leaves the EU budget disconnected from the evolving goals and needs of the Union.

In short, the existing decision-making procedure encourages excessive focus on net balances, distorts spending decisions and has a status-quo bias. Without reform, it is difficult to foresee how the vicious cycle of net balances and distorted spending can be broken.

Several proposals to address these shortcomings have been put forward. Three are of special relevance for this policy brief: de la Fuente *et al.* (2008), Heinemann *et al.* (2008) and Iozzo *et al.* (2008)[3]. These proposals have two main features in common. First, they recommend a correction mechanism along the lines of the 2004 European Commission proposal, providing a refund of a part of a member state's net contribution in excess of a certain percentage of GNI per capita or a similar hard criterion. Second, they differentiate between EU public goods expenditures and those whose primary purpose is interpersonal redistribution, as proposed by the Sapir report.

Categorising EU expenditures in fact dates back to the beginning of European integration and the Treaty of Rome (Table 3).

[3] For a more detailed discussion of this literature see Neheider, S. and I. Santos (2009).

Table 3:
Financing shares in the Treaty of Rome

Member state	Administration (% of total)	European Social Fund (% of total)
Belgium	7.9	8.8
Germany	28	32
France	28	32
Italy	28	20
Luxembourg	0.2	0.2
Netherlands	7.9	7

Source: Treaty establishing the European Economic Community (1957)

Administrative expenditure and the European Social Fund, the two components of the budget at the time, were viewed distinctly. For the former, considered a public good, member states accepted the principle of sharing the burden proportionally to GNI; for the latter, the Italian and Dutch shares were reduced. This financing mechanism is equivalent to singling out public goods.

The three recent proposals described above have two main limitations. One, by proposing correction mechanisms they bet on net balances capturing all effects important for fairness and neglect the role of non-financial factors in budgetary negotiations. Hence, correction mechanisms do not get to the core of the problem. Two, these proposals do not create the necessary incentives to improve the quality of EU spending.

Our proposal also starts from a categorisation of EU spending but differs from the cited works in the way net balances are arrived at. We try to affect budgetary outcomes more directly and provide a solution that accommodates political and financial constraints. We discuss the details of our reform proposal below.

3 OUR PROPOSAL

We have argued that reforming the EU budget requires changes in the institutional setting and process. In this section, we propose a new decision-making procedure and simulate its effects on net balances.

We propose separating the budget into a public-good part and a redistributive part. Starting from the current MFF, member states decide unanimously which expenditure categories (or parts of expenditure categories) are to be considered category 1 or EU-level public goods. All remaining expenditures go into category 2. Unanimity reveals a common preference that a specific policy should be an EU task.

Moreover, we propose that category 1 – EU public goods – be financed proportionally to GNI[4]. Since policies in this category will have been unanimously considered EU public goods, there can be no exceptions. For category 2 expenditures, net balances are fixed member state by member state.

Our proposal therefore has four steps:

1 Decide unanimously which expenditures should go into category 1 and which into category 2;
2 Establish overall spending ceilings for category 1 and category 2 separately;
3 Establish spending ceilings for each policy heading in category 1 (net balances in category 1 are irrelevant);
4 Fix net balances for category 2 and establish spending ceilings for each policy heading in category 2.

Only a few items of expenditure might initially be considered public goods (administration and external policies, for example), even if the ideal list would be much longer, as discussed in Box 1. The rationale behind our proposal is that making a clear upfront distinction between types of spending will increase pressure to move towards more EU added value, not immediately but over time. Any new policy would go into category 1 as, by definition, it will have been agreed upon unanimously.

While we propose a unanimous decision on the categorisation of expenditures (step 1), the decision on spending levels, at least for category 1, should be made by qualified majority voting (QMV). We recognise, however, that QMV may not be feasible in the short term. As a politically acceptable alternative, unanimity might apply throughout - as long as the sequencing of decisions outlined above is adhered to.

Decisions on net balances and the structure of category 2 spending should be part of an iterative process. After step 2, member states know their financial contribution to the overall category 2 expenditure, but net balances are only defined once the spending

[4] Although an EU tax is a desirable EU goal, there is currently little appetite for it. Only Belgium, Luxembourg and Poland seem to support the introduction of an EU tax, although a few other member states are open to the idea in principle (DG Budget 2009: Public consultations). For reasons of feasibility, we do not consider this option here.

structure is decided. Adjustments to net balances to reach the politically agreed levels can take place on either the spending side, on the revenue side (ex-post rebates) or both. Today, adjustments are made both through rebates and on the spending side as Table 1 indicated. We propose to leave this way of adjusting net balances as it is, since we see category 2, at the margin, as pure financial transfers.

How are net balances in category 2 arrived at? We leave this outcome to the political process and stay away from linking net balances directly to a specific rule associated with relative income or any other economic indicator. We propose to use current net balances as a benchmark or starting point for negotiation of new net balances. These net balances may look random as they are not directly related to objective indicators such as relative wealth. But, as we have argued in this policy brief, this is hardly the case as they are only one component of broader negotiations among member states on the integration process. In this way, instead of starting from net balances our proposal ends up with them, and leaves enough room for negotiations that go beyond EU budget matters.

In sum, our proposal, while not automatically leading to large compositional changes in the EU budget, makes the trade-offs between EU policy spending and redistribution explicit. By increasing transparency, it creates incentives to move towards more EU public goods as it becomes harder to justify other expenditures.

We consider next the effects of this reform on member states' net balances[5]. As an illustration, we include the following budget headings as public goods: 'Competitiveness for growth and employment', 'Cohesion Fund', 'Citizenship, Freedom, Security and Justice' and 'EU as a global player'. This leaves the structural funds and expenditures for the 'Preservation and Management of Natural Resources' (mainly CAP) in category 2. This illustration can only be indicative, since the categorisation exercise itself is to be subject to negotiation. For the purpose of this illustration, we also leave unchanged the overall size of the EU budget, although this may be open to discussion.

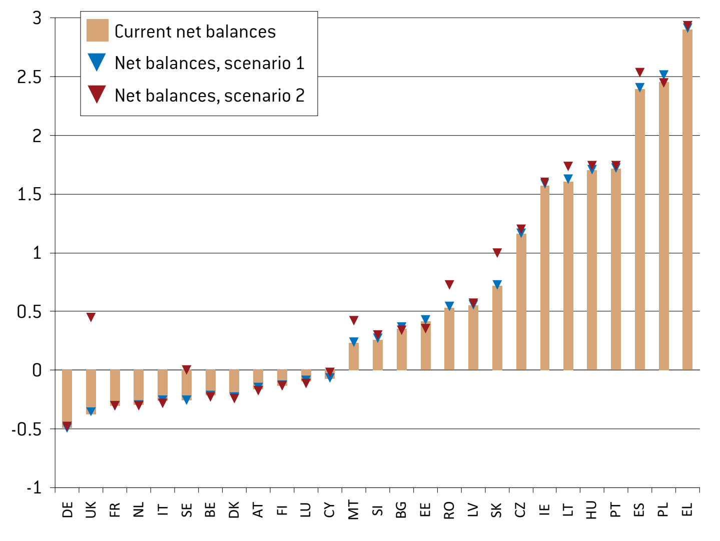
This simulation leads to few changes in net balances. Starting from the current MFF, the resulting changes are less than 10 percent of net balances for 25 member states and less than five percent for 22 (Figure 3, scenario 1). There are both winners and losers. In relative terms, Cyprus is the big winner (+11 percent) and – predictably – the UK loses out the most (-14 percent). The relative loss of the UK is less than with other proposals, however. In the 2004 Commission proposal the UK's negative net balance doubled.

'Financial gerrymandering' has a detrimental effect on the quality of EU spending.'

As discussed above, the aim of our proposal is to create incentives to focus increasingly on expenditure on EU public goods. We therefore simulate the impact on net balances of decreasing CAP spending by 10 percent and shifting these resources to category 1, for example to research (Figure 3, scenario 2). This shift also implies major changes for the UK, which would become a net beneficiary as long as the UK rebate is left unchanged.

The introduction of the UK rebate

Figure 3: Impact of the proposal on EU budget net balances, 2007, % of GNI



Source: Authors, based on European Commission

[5] We follow the Commission's calculation of net balances, leaving out administrative expenditure and including corrections.

in 1984 – and its continuation – was based on the fact that the CAP accounts for a large slice of the EU budget, but the UK benefits less from it than other countries because of the UK's relatively small farming sector. In addition, the UK was in 1984 much less well-off than now.

But these conditions are not immutable. On the former, our example shows that a larger focus on EU public goods would eliminate any justification for the UK rebate. Moreover, over the past 25 years, the share of the CAP has decreased from 65 percent in 1984 to 42 percent today, while the UK rebate has actually increased in real terms from roughly €2 billion to €5 billion (in 2005 prices). But the UK is today among the richest member states, both compared to the EU27 average income per capita (57 percent higher) and compared to countries such as France (17 percent higher). Therefore, it would be sensible for the UK to trade a larger financing share of the EU budget for a change in decision-making procedure and expenditures.

> *'The window of opportunity for assessing the merits of institutional changes is closing rapidly.'*

This points to a possible intermediate solution: phasing out the UK rebate by excluding public goods from the net balance calculation.

Our proposal makes explicit the different character of EU policies. On the one hand, some clearly have the features of public goods. On the other hand, there are spending programmes the underlying objective of which is manifestly redistributive. Our scheme seeks to facilitate reform of the EU budget, allowing for an increasing share of EU public goods. For this, we have purposely stayed within the constraints of the current political and economic environment. As such, our proposal is by no means a first-best solution.

In short, the proposal put forward in this policy brief is designed to provide a practical solution which accommodates different national interests while striving for an increased focus on EU public goods. Going forward, disagreements among member states are likely to remain.

It is therefore imperative to focus now on the necessary institutional reforms from which policy changes may emerge. Here, we have put forward one option that could serve as a starting point. The window of opportunity for assessing the merits of institutional changes is closing rapidly with the EU budget review process stalled and with budgetary negotiations on the next financial framework expected to start in less than two years. The ongoing economic crisis adds to the need for decisive leadership and resolve. It is time for action.

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