

# Notable trends in the EU budget

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## Introduction

This article aims to provide an overview of the EU budget. The main topics here are the developments that have taken place over the years and the structure of expenditure for the immediate future, as laid down in the recent agreement on the “Financial Perspective” for 2007-2013. There will be no attempt to evaluate various suggestions made by politicians and academics for optimising the EU budget decision-making procedure, e.g. those put forward by the ECB (2005). In view of the complexity of the European budget rules, a detailed examination of more technical aspects is beyond the scope of the present article, so that only the fundamental principles will be explained.

The article is arranged as follows. The first section describes the specific characteristics of the EU budget and the expenditure and revenue structure. The second section goes into more detail on the two largest expenditure items, namely the common agricultural policy and the cohesion policy. The third section discusses the “Financial Perspective” for 2007-2013.

## 1. EU budget: characteristics and developments

### 1.1 Characteristics

Although the EU budget has many characteristics in common with the budgets of the Member States or those of other countries, it also has a number of specific features which are not found in national budgets.

#### 1.1.1 A balanced budget

In principle, the EU budget can never be in deficit. The EU is not authorised to borrow, and its spending therefore cannot exceed its income. There are only a few exceptions to that rule, permitting limited borrowing, e.g. for the purpose of providing macro-financial support to non-Member States.

#### 1.1.2 The European Parliament does not have exclusive power

In the Member States, as in most other countries, the Parliament has full power to determine the budget revenue and expenditure, but in the EU this is not the case, as the Council of Ministers and the European Parliament, which constitute the EU budget authority, share that power. The allocation of powers between the Council and the Parliament depends on the nature of the expenditure. A distinction is made between compulsory and non-compulsory expenditure, each making up about half of the budget. The first category comprises the expenditure resulting from the EU treaties, such as the bulk of the expenditure under the Common Agricultural Policy (CAP) or that relating to aid to developing countries. The non-compulsory expenditure consists primarily of expenditure relating to the cohesion policy and the operation of the administration.<sup>(1)</sup> The Council takes the final decision on compulsory expenditure while the Parliament has the last word on non-compulsory expenditure.

(1) The expression “non-compulsory expenditure” is somewhat misleading: under the labour laws, the payment of officials’ salaries is, to be sure, “compulsory”, while the structural fund expenditure forms an essential part of EU policy. Yet both items are regarded as “non-compulsory” expenditure because they are not mentioned in themselves in the EU treaties.

The annual procedure for drawing up and approving the budget is as follows:

- the European Commission (EC) draws up a preliminary draft budget which it submits to the Council;
- the Council examines the proposal at its first reading and may amend the preliminary draft by a qualified majority. Following approval by the Council, it acquires the status of a draft budget;
- the European Parliament may then, in a first reading, propose amendments to the compulsory and non-compulsory expenditure;
- after that, the draft budget goes back to the Council which, in the second reading, takes a final decision on the compulsory expenditure. The Council may, by a qualified majority, accept proposed changes put forward by the European Parliament and entailing an increase in the compulsory expenditure. Amendments not giving rise to any increase in that expenditure may be rejected by the Council by a qualified majority. The Council may also reject by a qualified majority the proposed amendments put forward by the European Parliament regarding the non-compulsory expenditure. However, the European Parliament may resubmit these last amendments when voting on the budget as a whole, and thus has the final say on the non-compulsory expenditure;
- the European Parliament has power, in the last instance, to adopt or reject the budget as a whole.

#### 1.1.3 A binding multi-annual financial framework

The EU expenditure is defined for a period of several years by the “Financial Perspective”, which lays down the maximum annual expenditure per heading. This fosters budgetary discipline and makes it easier to predict expenditure in the medium term. Prior to the introduction of this multi-annual financial framework, the annual budget negotiations in the late 1970s and in the 1980s increasingly led to sharp confrontations between the Parliament and the Council, which in 1979 and 1984 actually led to the rejection of the whole budget by the European Parliament. The first direct elections in 1979 gave the European Parliament greater legitimacy, starting the trial of strength with the Council. In that context, the Financial Perspective provided stability by curtailing freedom of choice during the annual procedure. However, the Financial Perspective cannot be regarded as a fully-fledged multi-annual budget, since the annual budget round is still necessary to set the actual amount of the expenditure and to allocate the maximum amounts per heading in detail among the various budget items.

The Financial Perspective is put into formal terms by an Interinstitutional Agreement between the three main European players, namely the European Parliament, the Council and the EC, and is an essential part of that agreement. The first Financial Perspective was incorporated in the “Delors I package” and related to a period of five years (1988-1992). All the subsequent Financial Perspectives covered a period of seven years (1993-1999 for the “Delors II package” and 2000-2006 for the “Agenda 2000”). In December 2005, the European Council reached a political agreement on the new Financial Perspective, i.e. for 2007-2013. On the basis of that agreement and following consultation between the EC, the Council and the European Parliament, a new Interinstitutional Agreement on the Financial Perspective 2007-2013 was approved in May 2006 by the Council and the European Parliament, on proposal of the Commission. It will enter into force on 1 January 2007.

#### 1.1.4 The EU does not have any actual revenue of its own

The EU cannot levy any taxes of its own, but is financed almost entirely by transfers from the Member States. True, since the 1970 budget reform, the Union has had so-called “own resources” as a source of finance. These are specific revenue categories to which the Union is entitled without any further decision by the national authorities, once they have been defined by a Council “decision on own resources” and ratified by the national parliaments of the Member States. However, the expression “own resources” is misleading, since the revenue is still collected by the Member States and then transferred to the EU. So in the end, these resources still consist of transfers from the Member States.

Since the 1970 budget reform, the method of financing the EU has been adjusted on several occasions; the latest decision on own resources was passed in September 2000. Via the December 2005 political agreement on the Financial Perspective 2007-2013, the European Council sought a new decision on own resources. This new decision is to take effect at the beginning of 2009 at the latest, applying retroactively to 1 January 2007.

Belgium has often advocated the introduction of a genuine European tax, e.g. an energy consumption tax, or the assignment to the EU of part of the revenue generated by corporation tax or taxes on savings income, the primary argument being that this would strengthen the link between the EU and its citizens while also obviating the need for the debate on the “budget balances” (to find out which Member States are net contributors and which are net beneficiaries, cf. below). However, a number of Member States are opposed to this proposal.

## 1.2 Principal developments

### 1.2.1 Volume

The latest decision on own resources, passed in September 2000, set a ceiling on the own resources of 1.24 p.c. of the EU's gross national income (GNI), a percentage which is to be maintained according to the European Council agreement of December 2005. In accordance with the principle of balance, this percentage also represents an absolute ceiling for the expenditure. However, the commitment appropriations laid down by the Financial Perspectives in recent years have been considerably lower, at between 1.07 and 1.11 p.c. of GNI, in order to leave scope for unforeseen expenditure or in case economic growth should fall short of expectations. The volume of payment appropriations in the annual budgets has even hovered around 1 p.c. of GNI, whereas the payments actually made have even still been lower, partly because of the non-execution of certain projects, particularly under the cohesion policy. In comparison with the relative volume of public expenditure of the Member States – averaging around 47 p.c. of GNI – the EU budget is therefore decidedly modest. In absolute terms, the Community budget – which comes to around 110 billion euro in 2006 – is also barely more than the general government budget of

Poland, and is actually less than that of small countries such as Austria and Belgium. This finding reflects the allocation of powers between the EU and the Member States. Over the years the total EU expenditure has nonetheless increased, both in absolute terms and in proportion to the cumulative expenditure of all governments in the Union.

### 1.2.2 Revenue

Apart from the relatively small and volatile amounts of “other revenues” (such as donations or taxes on the incomes of EU officials) and “amounts carried over from the previous year”, the EU is financed by what are called the “own resources”, which comprise the following major categories.

#### 1.2.2.1 “Traditional” own resources

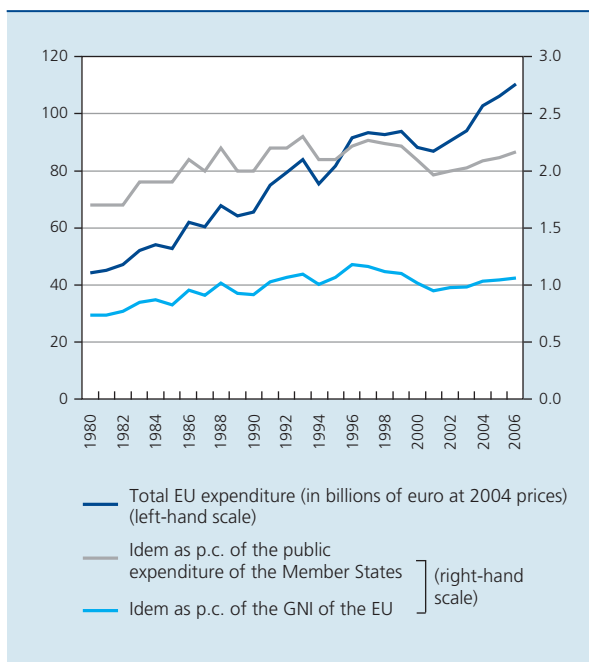
The traditional own resources consist mainly of agricultural duties and customs duties. These funds are collected by the Member States, which are allowed to keep 25 p.c. of the revenue to cover the collection costs; these resources are collected at the external borders of the Union and are based on tariffs laid down by the EU under its trade policy and the CAP. These traditional own resources are inseparable from the EU Treaty and can therefore be regarded as a kind of “natural” source of revenue.

Historically, these resources have been very considerable, but their volume has now declined sharply, dropping from almost half of the EU's revenue in 1980 to around 13 p.c. for the years 2005-2006. This is not due to any reduction in the basis of assessment, since progressive globalisation has led to a sharp rise in imports, but is caused solely by the systematic reduction in the tariffs applied, in the context of the liberalisation of world trade. This last factor is also one of the driving forces behind the gradual alignment of EU agricultural product prices with world prices. According to World Bank estimates, the (unweighted) average EU import levy declined from 8.7 p.c. in 1988 to 4.4 p.c. in 2003.

#### 1.2.2.2 VAT-based resources

This source consists of a percentage levied on the VAT base of the Member States. The same percentage is levied on a harmonised VAT base for all Member States. Harmonisation of the tax basis proved necessary because the goods and services covered by the VAT regulations may vary from one country to another. In principle, such a system is regressive in character, because consumption in proportion to GNI, and hence the harmonised VAT base, declines as the level of prosperity rises. Consequently, poorer Member States would pay a higher proportion of

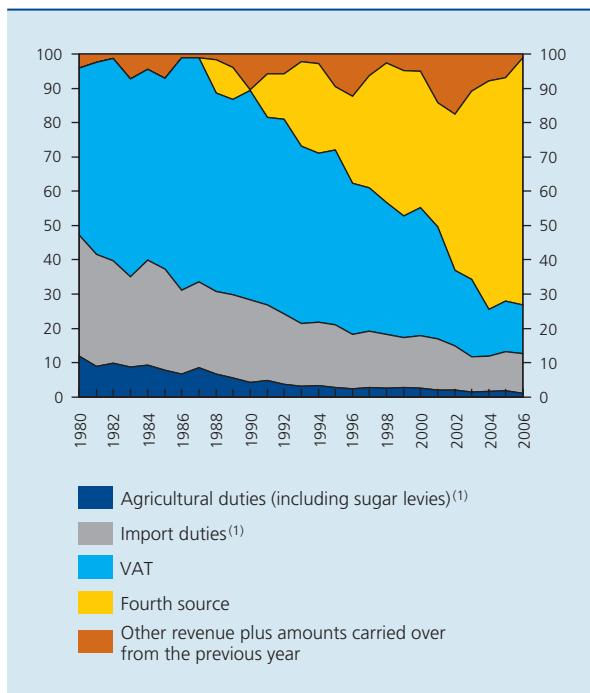
**CHART 1** DEVELOPMENT AND RELATIVE IMPORTANCE OF EU EXPENDITURE <sup>(1)</sup>



Source: EC.

(1) Payment angle, including expenditure by the European Development Fund.

**CHART 2** STRUCTURE OF THE EU'S REVENUE  
(Percentages of the total)



Source: EC.

(1) Excluding the compensation which Member States receive for collecting the agricultural duties and customs duties.

their GNI than the richer Member States. To counteract this perverse effect, the VAT base is limited to 50 p.c. of the GNI of each Member State. The maximum percentage for the VAT contribution on this harmonised basis is currently set at 0.50 p.c., but owing to a number of technical adjustments the real percentage applied is now only 0.30 p.c. As a proportion of the own resources, VAT-based EU revenues have declined from more than half in the early 1980s to 14 p.c. in recent years, as a result of the gradual reduction in the maximum transfer percentage. This fall was due to the efforts to make the contributions less regressive, and was therefore intended to help the poorer Member States.

#### 1.2.2.3 GNI-based resources ("fourth resource")

Since, in principle, the EU budget must always balance, a balancing item is required on the revenue side. In 1988, the "fourth resource" was introduced for that purpose, replacing the VAT source in that role. The object of this was to reduce the regressive nature of the contributions. The "fourth resource" consists of a contribution which the Member States have to pay in proportion to their share in the total GNI of the EU. The percentage of GNI payable is calculated annually such that no financing

deficit is recorded. For example, it is estimated that, in 2006, the contribution will come to around 0.7 p.c. of GNI. The share of the "fourth resource" in the total resources of the EU has increased sharply since 1988, amounting to over 70 p.c. of total revenue in 2006. Some people are calling for EU expenditure to be funded entirely on the basis of GNI, because the current allocation per Member State – taking account of the adjustments to the VAT base – is in fact little different from an allocation based exclusively on GNI, and it would be simpler.

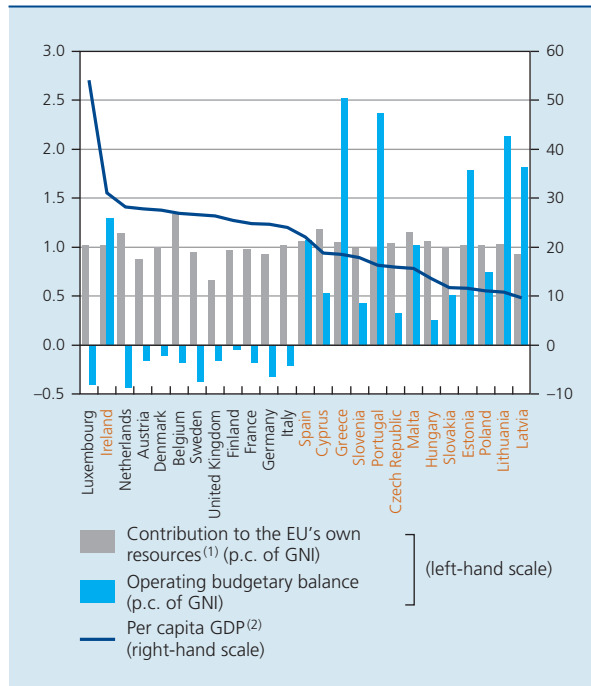
#### 1.2.3 The "British rebate" and the contributions per Member State

At the Fontainebleau Summit in 1984, the British Prime Minister of the day, Margaret Thatcher, had demanded a correction to the United Kingdom's contribution ("*I want my money back!*"), the main argument being that her country was paying too much in relation to its level of welfare and that a disproportionate part of the Community expenditure was devoted to the CAP, from which the British received little.

This adjustment (also known as the "British rebate") was introduced in 1985. The rebate is complicated to calculate, and there have been a number of changes since its introduction. For 2006 this rebate came to roughly 30 p.c.: without this adjustment, the United Kingdom would have had to contribute 19.4 billion euro, as opposed to the current figure of 13.7 billion. This reduction in the United Kingdom's contribution is charged to the other 24 Member States in proportion to their share in the total GNI of the EU. However, in the case of Germany, the Netherlands, Austria and Sweden, the contribution towards financing the "British rebate" is limited to one quarter of their theoretical contribution. The remaining three quarters are paid by the other 20 Member States.

At the time of the negotiation of the Financial Perspective 2007-2013, the British rebate was the subject of lively debate: the Commission and the other Member States wished to abolish this arrangement and replace it with a general correction mechanism, especially as the arguments put forward at the time are no longer valid. The United Kingdom is now one of the most prosperous EU Member States, as a result of strong economic expansion in the past few decades and the enlargement of the EU to include Central and Eastern Europe, entailing the accession of ten relatively poor Member States; moreover, spending on agriculture has become relatively less important. As a result of a hard-fought compromise, it was decided that the United Kingdom would keep its correction mechanism but would gradually contribute

**CHART 3** CONTRIBUTIONS TO THE EU'S OWN RESOURCES AND OPERATING BUDGETARY BALANCE OF THE MEMBER STATES  
(Payments, 2004)



Source: EC.  
(1) Taking account of the British rebate.  
(2) Purchasing power parities, in thousand euro.

more towards the costs of the EU enlargement, up to a maximum of 10.5 billion euro over the entire period of the Financial Perspective.

The contribution of the Member States to the EU's own resources, expressed in relation to their GNI, averages 1.03 p.c. but Belgium and the Netherlands pay a larger contribution. These two countries collect indeed a relatively large amount of customs duties and agricultural duties, since a substantial proportion of Community imports enters the EU through their ports. The United Kingdom's contribution towards the EU budget is lower in relation to its GNI, on account of the special British rebate.

France and Italy bear the major part of the cost of that British rebate, in contrast to Germany, which receives a reduction on the rebate. Thus, the German contribution to the financing of the British rebate in 2006 was just 0.35 billion euro, only slightly more than the approximately 0.28 billion euro paid by Belgium. For the same reason, the Dutch share is smaller than Belgium's, at 0.075 billion euro. The ten new Member States also contribute towards financing the British rebate; the fact that

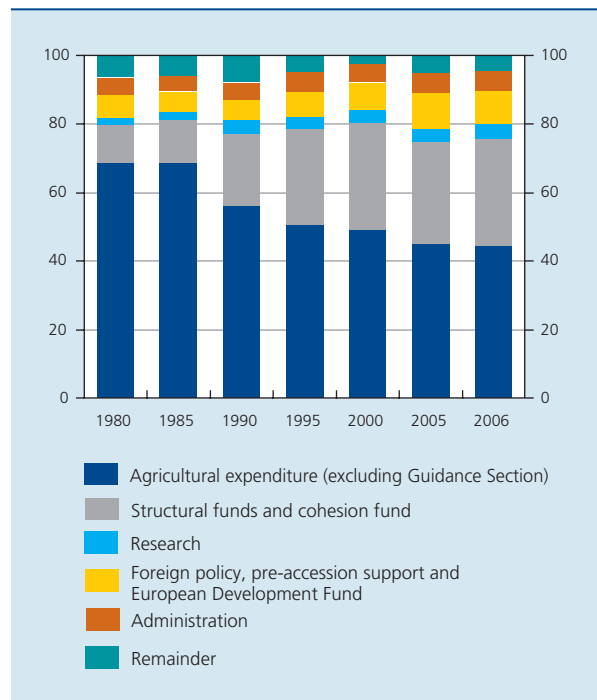
these countries, which are all significantly poorer than the United Kingdom, help to pay for the British rebate is a major criticism of the system.

1.2.4 Expenditure

Over the past twenty-five years, the EU's expenditure has been concentrated primarily on:

- agriculture, financed by the "guarantee" section of the European Agricultural Guidance and Guarantee Fund (EAGGF); spending on price support and farm incomes has traditionally made up the bulk of EU expenditure, but the trend is clearly downward: in the early 1980s, this expenditure represented almost 70 p.c. of the total EU budget, but currently accounts for only 44 p.c.;
- the structural funds and the cohesion fund (SCF): the reduced expenditure on agriculture over the years was largely offset by higher spending via the SCF. The share represented by these funds has risen from around 11 p.c. in the early 1980s to roughly 31 p.c. in recent years;
- foreign policy: taking a broad definition of expenditure on foreign policy, e.g. by including in that category the expenditure under the pre-accession strategy and the European Development Fund (EDF), it now represents

**CHART 4** STRUCTURE OF EU EXPENDITURE<sup>(1)</sup>  
(Percentages of the total)



Source: EC.  
(1) Payment angle.

- 10 p.c. of total expenditure, whereas in the early 1980s the figure was only about 7 p.c.;
- research and development: EU expenditure on research and development has risen from 2 p.c. to just over 4 p.c. of total expenditure;
- administration: in the past few decades, expenditure on the operation of the administration has made up a fairly constant proportion of the EU budget, at around 6 p.c.

In all, expenditure on agriculture and the SCF together has traditionally made up more than three-quarters of the EU budget. Furthermore, the main shifts in EU expenditure since 1980 have occurred in these two items, whereas the share of the other categories of expenditure has remained largely stable. The agricultural policy and the cohesion policy will therefore be described in more detail in section 2.

### 1.2.5 Net contributor and net beneficiary Member States

The “operating budgetary balances” – i.e., the difference between a Member State’s contribution to the EU and the share of allocated expenditure it receives from the EU, hence excluding administrative expenditure – indicate that in 2004, the latest year for which data are available, the richest Member States were generally net contributors to the EU budget, although the size of their net contribution was not proportional to their relative income position (cf. chart 3). This is due to the United Kingdom’s rebate and the fact that Member States with a relatively large number of farmers in their labour force (e.g. France) or with significant internal regional income inequality (Germany) receive relatively more from the EU budget via the CAP or the cohesion policy. The less wealthy EU-15 Member States, such as Spain, Greece and Portugal, are major net beneficiaries, principally via the SCF. All the new Member States are also net beneficiaries, notably the Baltic countries which are among the poorest Member States and receive a relatively large amount of support.

If the EU’s administrative expenditure is attributed to the Member States where it is effected (the “budget balances”), that makes a significant difference for the two Member States which are home to most of the European institutions, namely Belgium and Luxembourg. These two countries then become net beneficiaries instead of net contributors to the EU budget. Belgium, in particular, opposed the use of the budget balance concept, especially in the context of the negotiations on the Financial Perspective 2007-2013, and put forward the following main arguments against the calculation of these budget balances:

- the salaries of officials paid in Brussels are not spent entirely in Belgium;
- this argument is particularly valid in the case of pensions, which are largely paid to officials who have left Brussels;
- the payment of salaries, rents, etc. represents compensation for the use of scarce factors of production, and is not the same as a free transfer.

More general arguments have been put forward against the calculation of the “operating budgetary balances” and “budget balances”:

- the EU is based on solidarity, and it is inappropriate for each Member State to calculate its profit (the “fair return” principle) and to include this aspect in the budget debate;
- expenditure in one particular Member State may directly benefit another Member State, e.g. the construction of an airport in Greece by a German contractor;
- this attributable expenditure usually has indirect favourable effects on other EU Member States (“spillover”), e.g. by boosting imports.

## 2. The agricultural and cohesion policies

### 2.1 Agricultural policy

The CAP expenditure is financed by the European Agricultural Guidance and Guarantee Fund (EAGGF). This fund, set up in 1962, in the early years of the EU, comprises two sections:

- the Guarantee section of the Fund mainly finances expenditure on price support for agricultural products (the “common organisation of the agricultural markets”) and the accompanying measures, particularly those concerning rural development and veterinary measures;
- The Guidance section finances the other expenditure on rural development, which is incorporated in the expenditure on the cohesion policy (cf. below).

During its existence, the CAP has undergone some major changes, and the modifications are continuing. Below is a very brief account of the key aspects of those changes.

With the creation of the European Economic Community, the CAP acquired a very important role, notably in the context of a broad political agreement between Germany – which saw many advantages in the prospects of the customs union and single market – and France, which was pleased to transfer its generous agricultural support



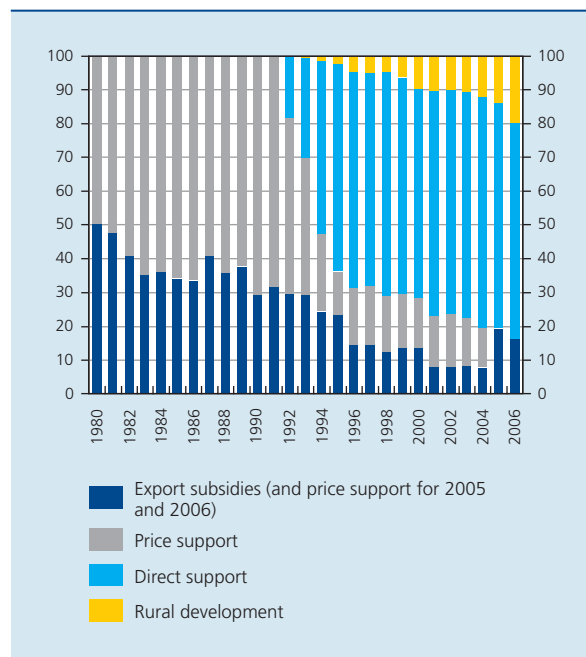
to European level. The aims of the CAP as stated in the EU Treaty (Article 33) – namely to increase agricultural productivity and assure the security of supplies (an aim inspired by the food shortages following World War II), to ensure a reasonable income for farmers and to stabilise markets, as well as ensuring reasonable prices for consumers – were achieved for a number of decades via a system of minimum prices for most agricultural products combined with “Community preference”, which means that high import duties and export subsidies kept the pricing of agricultural products within the EU’s common market isolated from the world market.

The aim of self-sufficiency was achieved fairly quickly, and in the long run the price guarantees actually led to surpluses, which absorbed an ever-increasing share of the EU budget. Despite the milk lakes and butter mountains, European consumers still paid higher prices than those prevailing on the world market.<sup>(1)</sup> Moreover, in the World Trade Organisation (WTO), the agricultural policy brought the EU into conflict with other members such as the US, New Zealand, Australia and Canada, and took opportunities away from developing countries, especially those dependent on exports of agricultural products. Finally, people became increasingly concerned about the adverse environmental impact of excess production.

In these circumstances, the CAP has undergone systematic reform since the beginning of the 1990s. The blueprint produced by Commissioner Mac Sharry in 1992 laid the foundations for a new policy, centred on limiting output-linked price support and replacing it with more direct income support. This was intended to bring agricultural production more into line with market demand, and to reduce the surpluses. The “Agenda 2000” reforms – approved in 1999 at the Berlin European Council – were the logical continuation of this change of direction in agricultural policy, against the background of the impending EU enlargement and in anticipation of a new round of WTO negotiations. The enlargement represented a huge challenge for the CAP, in view of the still considerable share of the agricultural sector in the then candidate Member States. Finally, the 2003 reform (Luxembourg, 26 June 2003) introduced the principle of “decoupling”, whereby direct income support or a single payment scheme was available on the basis of

(1) Since the main food producing countries pursue a policy of self-sufficiency, the world markets in foodstuffs tend to be “residual” markets where surpluses are dumped. Consequently, the prices on those markets are not entirely in line with the operation of a free market.  
 (2) At the Brussels Summit of 24 and 25 October 2002, which resolved the last obstacles to enlargement, an agreement was concluded whereby the agricultural policy would remain unchanged up to 2006 in exchange for a ceiling on the growth of expenditure between 2007 and 2013 of no more than 1 p.c. per annum. Direct support for farmers in the new Member States was to be introduced as follows: 25 p.c. in 2004, 30 p.c. in 2005, 35 p.c. in 2006, and 40 p.c. in 2007, thereafter increasing by 10 p.c. per annum so that, by 2013, the new Member States would be receiving the same direct support as those of the EU-15.

**CHART 5** EU EXPENDITURE ON AGRICULTURE<sup>(1)</sup>  
 (Percentages of the total)



Source: EC.  
 (1) Actual payments up to 2004, credit appropriations for 2005 and 2006.

historical references without any link to production, subject to compliance with certain criteria concerning respect for the environment, food safety and other aspects (“cross-compliance”). This new scheme came into effect in 2005 for most of the EU-15 Member States, including Belgium, and subsequently for the other Member States as well. Ultimately, the aim is to reduce direct income support too, in favour of rural development and other general support measures.<sup>(2)</sup>

This reform of the CAP is reflected in the scale and structure of the expenditure. Not only, as already stated, is the CAP expenditure declining as a percentage of total EU expenditure, its composition is also changing. Up to 1991, the support consisted solely of export subsidies and market or price support, but from 1992 onwards this was increasingly replaced by direct support, with the addition of rural development aid from 1995. In recent years, price support and export subsidies together have accounted for less than one-fifth of total agricultural expenditure.

The extent to which the EU still protects its agriculture, even after these reforms, can be compared internationally on the basis of the surveys published regularly by the OECD (OECD, 2006), on the basis of the “Total Support Estimate”, i.e. the sum of all the support received by agriculture in whatever form and for whatever purpose.

**TABLE 1** SUPPORT TO AGRICULTURE: AN INTERNATIONAL COMPARISON<sup>(1)</sup>

(Billions of euros, unless otherwise stated)

	Japan		EU		US	
	1986-1988	2003-2005	1986-1988	2003-2005	1986-1988	2003-2005
Financed by consumers .....	50.5	49.5	80.7	52.9	13.5	10.2
Financed out of taxes .....	12.9	14.3	25.0	68.4	46.4	75.5
Government revenues .....	-10.7	-13.1	-1.5	-0.6	-1.4	-1.5
<b>Total</b> .....	<b>52.7</b>	<b>50.7</b>	<b>104.2</b>	<b>120.6</b>	<b>58.6</b>	<b>84.2</b>
Percentage of GDP .....	2.36	1.35	2.77	1.23	1.35	0.87
	Canada		New Zealand		Australia	
	1986-1988	2003-2005	1986-1988	2003-2005	1986-1988	2003-2005
Financed by consumers .....	2.9	2.2	0.1	0.1	0.3	0.0
Financed out of taxes .....	4.0	4.4	0.5	0.2	1.2	1.6
Government revenues .....	0.0	0.0	0.0	0.0	0.0	0.0
<b>Total</b> .....	<b>6.9</b>	<b>6.6</b>	<b>0.5</b>	<b>0.3</b>	<b>1.6</b>	<b>1.6</b>
Percentage of GDP .....	1.77	0.80	1.71	0.38	0.82	0.32

Source: OECD.

(1) Measured on the basis of the "Total Support Estimate" concept, average over three years.

This support takes two forms: the part paid to the producer out of general resources – taxation – and the part financed implicitly by the consumer in so far as the agricultural policy involves relatively higher consumer prices. Government revenues generated by levies on agricultural products are deducted from this figure. This indicator has the advantage of being exhaustive and also permitting international comparison over time.

Comparison between two periods, namely 1986-1988 (before the CAP reform) and 2003-2005 (the most recent period for which statistics are available) for a number of major food producing and exporting countries reveals the following findings:

- total support is highest in Japan and the EU, whereas the agricultural policy in New Zealand and Australia is closest to a free market policy;
- the rate of total support (as a percentage of GDP) has fallen in all the countries mentioned, being cut by roughly half in Japan, the EU, the US and Canada. During the period considered, New Zealand made the most radical change of policy, drastically reducing its support for agriculture;
- in Japan and the EU, much of the support takes the form of "hidden" levies, primarily higher prices for consumers.

Given the high level of protection for the European agricultural sector in international terms, the question is to what extent the CAP has achieved its original objectives. Key factors in that connection are the trend in farm incomes and the extent to which food self-sufficiency has been assured by the CAP.

Measured on the basis of the total added value per full-time farm worker, the average farm income in the EU-15 has been volatile and, of course, that is largely due to fluctuating output and the volatility of certain prices, typical of the agricultural sector. Between 1993 (the year following the adoption of the Mac Sharry blueprint) and 1997, farm incomes increased systematically before leveling out. Overall, the increase between 1995 and 2003 averaged 0.5 p.c. per annum, much less than the average rise in all EU-15 incomes, which came to roughly 2 p.c. per annum. However, there were wide variations between countries: Belgium, Spain and Portugal were the countries where farm incomes showed the largest increase during that period, whereas Denmark, the Netherlands and the United Kingdom saw the sharpest decline. The reasons for these variations lie in the divergent production structures and epidemics such as "mad cow disease" (BSE) in the United Kingdom. Most of the new Member States also saw farm incomes decline during the period considered,



but since their accession in 2004, there has been a relatively steep increase in farm incomes, particularly in Poland, because the application of the EU guaranteed prices led to higher prices in those countries, and also because the direct income supplement is relatively significant there in relation to the low farm incomes.

The degree of self-sufficiency, defined as domestic production in relation to domestic consumption, has risen sharply. Immediately after World War II, the EU was still a net importer of many agricultural products, but nowadays it has long been self-sufficient in all the principal agricultural products. However, the question is to what extent that is due to the CAP, since the level of 100 p.c. self-sufficiency has been exceeded not only in the case of cereals, meat, milk, sugar and wine, which receive substantial aid under the CAP, but also for other agricultural and horticultural products.

## 2.2 Cohesion policy

As already explained, the financial resources assigned to the SCF represent a growing proportion of the EU budget. The accession of the new Member States has exacerbated the problem of income discrepancies and regional convergence within the EU, which would mean a growing need for finance for the SCF if the policy remains unchanged.

### 2.2.1 Objectives and instruments

Although the objective of greater cohesion between the Member States was endorsed right from the start of European integration,<sup>(1)</sup> one did not feel the urgent need at that time to provide explicit support for this aim via a regional policy, primarily because the founding members of the Union had already reached a relatively similar level of economic development. It is only since the 1980s, following the accession of a number of poorer, southern European countries (Greece in 1981, Portugal and Spain in 1986), that the EU has become increasingly concerned about its internal economic and social cohesion. While the creation of a single market held the promise of growing prosperity, there arose at the same time the question of how that prosperity would be shared among the various countries and regions. Following the Single European Act, the Treaty expressly included the aim of *reducing disparities between the levels of development of the various regions and the backwardness of the least favoured*

*regions or islands, including rural areas* (Article 158 of the Treaty). This formed the basis for a genuine regional policy in the EU, conducted also via the structural funds and, since 1994, via the cohesion fund.

The structural funds are used for three priority intervention objectives under the Financial Perspective for the period 2000-2006 (also known as "Agenda 2000"):

1. the development and structural adjustment of regions whose development is lagging behind. These are regions where the average per capita GDP is below 75 p.c. of the European Union average;
2. support for the economic and social conversion of regions facing structural difficulties, other than those eligible for Objective 1 support;
3. all measures to promote employment – notably concerning training – except in regions eligible for Objective 1 support.

These tasks are divided among four structural funds:

- the European Regional Development Fund (ERDF) mainly grants support to backward regions and regions undergoing economic conversion (Objectives 1 and 2);
- the European Social Fund (ESF) is primarily concerned with the European employment strategy (covering the three objectives);
- the European Agricultural Guidance and Guarantee Fund (EAGGF), "Guidance" section, contributes to the development and structural adjustment of regions whose development is lagging behind (by augmenting the efficiency of the structures of production, processing and sale of agricultural and forestry products) and to the development of rural areas (mainly Objective 1);
- the Financial Instrument for Fisheries Guidance (FIFG), which is less important, supports structural changes in the fisheries sector (Objective 1).

In contrast to the structural funds, which are aimed at regions, the cohesion fund is intended to strengthen economic and social cohesion between the Member States. Only the Member States whose per capita GNI is less than 90 p.c. of the Union average qualify for financial support. This fund was set up in 1994 to make it easier for the poorer Member States to continue making up the leeway in terms of public infrastructure while at the same time satisfying the Maastricht criteria regarding public finances.

The Financial Perspective for 2000-2006 earmarks around 233 billion euro (at 2004 prices) altogether for the structural funds and the cohesion fund intended for the EU-15. Following the accession of the new Member States, that budget figure was increased by around 24 billion euro. Rather less than two-thirds of the total financing was

(1) The preamble to the Treaty of Rome (1957) refers to the desire "...to strengthen the unity of their economies and to ensure their harmonious development by reducing the differences existing between the various regions and the backwardness of the less favoured regions."

**TABLE 2** STRUCTURAL FUNDS AND INSTRUMENTS PROVIDED BY THE FINANCIAL PERSPECTIVE 2000-2006(Billions of euros<sup>(1)</sup>, unless otherwise stated)

	Objective 1	Objectives 2 and 3	Cohesion Fund	Other	Total	<i>p.m. Resources in Financial Perspective 2007-2013 compared to those for 2000-2006 (percentage changes)<sup>(3)</sup></i>
EU-15 .....	150.1	50.9	19.7	12.6	233.3	-27
of which:						
Germany .....	22.0	8.8		1.9	32.8	-17
France .....	4.2	11.6		1.4	17.2	-19
Italy .....	24.4	6.9		1.4	32.7	-11
Netherlands .....	0.1	2.7		0.8	3.6	-52
Belgium .....	0.7	1.3		0.3	2.3	-7
<i>p.m. So-called four "cohesion fund countries"</i>						
Greece .....	23.1		3.4	1.0	27.5	-19
Spain .....	42.1	5.3	12.4	2.4	62.1	-41
Ireland .....	3.4		0.6	0.2	4.2	-72
Portugal .....	21.0		3.4	0.7	25.1	-15
New Member States <sup>(2)</sup> .....	15.0	0.3	8.5	0.7	24.5	

Sources: EC and Hennart F., Saintrain M. and Vergeynst T. (2006).

(1) 2004 prices for EU-15 and current prices for the new Member States.

(2) 2004-2006 for the new Member States.

(3) Estimate by the Ministry of the Walloon Region in Hennart F., Saintrain M. and Vergeynst T. (2006), table 16.

intended for Objective 1, while Objectives 2 and 3 and the cohesion fund each accounted for more or less one-tenth. The rest was intended primarily for financing Community initiatives and innovative actions via the INTERREG, URBAN, EQUAL and LEADER programmes. The Financial Perspective 2007-2013 specifies an amount of 308 billion euro (2004 prices) for the SCF.<sup>(1)</sup>

Since the end of the 1980s, in line with the cohesion policy objectives, most of the SCF resources have gone to the less prosperous regions in the south of the Union. Between 1989 and 1993, and between 1994 and 1999, all the regions of Greece, Ireland and Portugal met the criteria for structural support under Objective 1, as did large areas of Spain. Together, these four countries received around two-thirds of the resources allocated under Objective 1, the main component of the structural funds. During 2000-2006, the combined share of these four countries in the Objective 1 resources declined, partly because large regions of Ireland ceased to meet the criteria. Since the first half of the 1990s, Germany also received a substantial part of those resources, and

Italy is also traditionally a major beneficiary of such funds. Moreover, up to 2003, Greece, Spain, Ireland and Portugal were the sole beneficiaries of the cohesion fund (they were known as the four "cohesion fund countries"). Since January 2004, Ireland has ceased to qualify; in contrast, all the new Member States which joined the EU in May 2004 meet the cohesion fund conditions. In the light of the criteria for the allocation of the resources, it looks as if the share of the former EU-15 countries in the SCF will decline sharply under the Financial Perspective 2007-2013, in favour of the new Member States, including Bulgaria and Romania. Thus, according to the estimates of the Ministry of the Walloon Region, published by the Federal Planning Bureau (Hennart et al., 2006), the overall budget for the SCF for the former EU-15 under the Financial Perspective 2007-2013 will be 27 p.c. less

(1) A part of these new resources is intended for "phasing out" measures, notably 4.1 p.c. for the EU-15 regions which, owing to the statistical effect of the new accessions, are no longer eligible for assistance under the Convergence objective (per capita GDP less than 75 p.c. of the EU-15 average but more than 75 p.c. of that of the EU 25), and 3.4 p.c. for degressive transitional support for the regions which come under the current Objective 1 and which, in 2007, owing to their economic progress, no longer qualify for the Convergence objective ("phasing in" under the Regional Competitiveness and Employment Objective).

than under the Financial Perspective 2000-2006. Belgium would see the smallest reduction, at roughly 7 p.c. These shifts imply a significant fall in the share of the former EU-15: having totalled around 90 p.c. of the SCF under the Financial Perspective 2000-2006, that share is expected to drop to some 50 p.c. under the Financial Perspective 2007-2013 (Grybouskaite, 2006).

2.2.2 Convergence within the European Union

These developments concerning the SCF raise the question whether the EU has indeed achieved greater convergence in income levels and – if so – what has been the role of financial support via the SCF. Convergence can be measured in various ways. For instance, the per capita GDP of a region or country can be compared with the average. If this is applied to the four former cohesion fund countries, it is evident that the difference between the average income in the former EU-15 and that of those four countries has declined considerably, overall, as the years have gone by<sup>(1)</sup>, indicating a tendency towards convergence.

However, this change did not proceed steadily over time. Even before their accession to the Union, namely in the 1960s, the countries concerned, except Ireland, had caught up considerably, but their catching up

slowed down significantly during the crisis of the 1970s. Following accession to the European Community (1981), Greece experienced a marked fall in its level of prosperity relative to the EU average. Only since the new millennium has Greece once again started to catch up. In contrast, in Spain and Portugal the accession to the European Community in the mid-1980s marked the start of an accelerated process of catching up. Finally, for Ireland the turning point did not come until the late 1980s. That country, which had been a member of the Union since as far back as 1973, had seen hardly any improvement in its relative income level for decades, but in the 1990s it became a leading growth centre, so that by 2005 its per capita GDP was actually a quarter above the EU average.

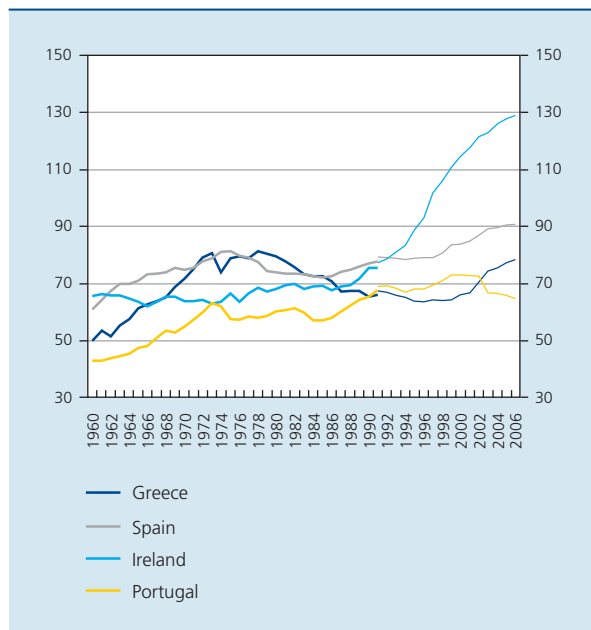
Formal accession was therefore evidently not an essential condition for growth to catch up, as is clear from the trend in incomes during the 1960s in three of the four countries mentioned above. Nor was accession to the Union sufficient to ensure convergence: indeed, the catching-up process accelerated in Spain and Portugal, but not in Ireland and Greece. However, it is also significant that the catching-up process in Spain, Portugal and Ireland since the end of the 1980s coincided with the growing importance of the structural funds in the EU budget.

Looking at the allocation of incomes between the regions, it appears that, during recent decades, the trend towards convergence has often been less marked than at national level in the four cohesion fund countries. In that regard, it is sometimes referred to a certain “trade-off” between national and regional convergence: owing to the growth poles effects in the initial phases of growth, countries which are in a catching-up phase may encounter widening regional disparity. Also, some interregional disparities appear to be very persistent (EC, 2000; Ederveen et al., 2002).

2.2.3 Role of the structural funds and the cohesion fund in the convergence within the European Union

Opinions differ as regards the contribution of the cohesion policy towards the convergence of incomes between regions. Naturally, if the SCF are to have any long-term impact, these resources must be allocated efficiently to providing support for the production potential, e.g. by improving the infrastructure, upgrading the skills of the workers or by research and development, and they must not cause any distortion in the operation of the market. Those who are sceptical about the common cohesion policy believe that this is not always the case.

CHART 6 PER CAPITA GDP IN THE FOUR COHESION FUND COUNTRIES <sup>(1)</sup>  
(Purchasing power parity, former EU-15 = 100)



Source: EC.

(1) There is a statistical break in the series in 1991.

(1) Throughout this section, per capita GDP is adjusted for variations in purchasing power. This adjustment is necessary because the level of prices in the less prosperous countries is normally below that seen in the wealthier countries.

For instance, they say that the financial support given to the former East Germany via subsidies excessively encouraged investment in sectors which are too capital-intensive in relative terms, and investments in buildings. These last investments did not favour productivity in the former East Germany. There is also the potential worry about “displacement effects”: national governments receiving support for certain backward regions tend to scale down their planned national investments so that, in the end, nothing extra would be invested in those regions. The obligation to apply the principle of “additionality” indicates that the EU is aware of this danger.

These prior considerations underline the need for a direct evaluation of the macroeconomic effects of the cohesion policy. While studies based on macroeconomic models generally conclude, in this connection, that the SCF have a positive effect on the GDP of the beneficiary countries, econometric analysis – in contrast – does not permit clear conclusions.

In order to assess the macroeconomic effects of the SCF, the HERMIN model – based on an existing model for the Irish economy – was developed (ESRI, 2002). This model estimated the effect of the SCF support granted between 1994 and 1999 for various countries, including Ireland, Greece, Portugal and Spain. A distinction was made between the immediate short-term demand effects and the medium and long-term supply effects. Regarding the latter, close attention was paid to the possible external effects which may influence the economy, e.g. via an increase in factor productivity, particularly as a result of improvements to the infrastructure and better training for the labour force. However, the estimation of those effects requires a number of crucial assumptions, e.g. concerning the return on the funds invested in education and training. In the case of the four cohesion fund countries, these simulations revealed a positive combined effect of the SCF on the GDP of the beneficiary countries between 1994 and 1999. That is not really surprising, since, according to that model, financial aid also has a direct effect on GDP via demand. Taking account of the amount of the financial resources used, the estimated relative increase in GDP resulting from the SCF, viewed cumulatively over the years 1994 to 1999, was considerably greater for Ireland than the funding granted as a percentage of GDP. In Spain and Portugal, the cumulative multiplier calculated in this way came to about 1, but in Greece it was only about two-thirds. Considered over a longer period, namely from 1994 to 2010, during which supply effects may also be reflected in additional growth after the funding has ceased, it is estimated that the SCF aid to Ireland will have been recouped about three times. In Portugal and Spain, this long-term multiplier comes to roughly 2.5 and 2

respectively, but in Greece it would only be just over 1, even after 17 years.

The HERMIN model was also used to produce an ex ante estimation of the macroeconomic effects of the SCF in 2000-2006 for a number of countries, including the four cohesion fund countries. Once again, the results point to positive joint demand and supply effects. The ex ante estimation based on the European Commission’s QUEST II model also reveals positive combined demand and supply effects, but they are considerably smaller because of significant differences in the basic assumptions. The QUEST II estimates nonetheless confirm that supply side effects are created in the longer term, which would be roughly of the same magnitude as the effects estimated on the basis of the HERMIN model (EC, 2000).

Ex ante estimates were also produced using the HERMIN model for the reform of the cohesion policy under the new Financial Perspective 2007-2013. According to these estimates, the GDP of some of the new Member States and accession candidates would be around 10 p.c. greater, or even more, in 2013 than without the SCF support (Bradley and Morgenroth, 2004). Thus, the money invested under the new cohesion policy would be recouped 1.5 or 2 times in most of the new Member States during the financing period 2007-2013, and – considered over 2007-2020, i.e. a period ending several years after the end of the financing period – the multiplier would actually be 2.5 or more. However, in the former East Germany, the Italian Mezzogiorno and particularly in Greece, the long-term return on the SCF would be considerably lower.

Other macroeconomic models developed for particular Member States also often arrive at the conclusion that the EU’s cohesion policy makes a significant contribution to growth and employment in the beneficiary countries. Yet the results of econometric research, which is less dependent on the initial basic assumptions, present a mixed picture: some studies point to positive but sometimes modest effects, while others indicate insignificant or even negative results (Ederveen et al., 2002). There are also considerable variations between countries and regions. A frequent conclusion is that the effectiveness of the SCF depends very much on a number of basic conditions, which means that the regional policy would be mainly beneficial in an environment conducive to growth. In this regard, Ederveen et al. (2002, 2006) conclude that regional aid produces positive effects primarily in open economies such as Ireland, whereas closed economies would gain far less from it.

The appraisal of the SCF is therefore not unanimously positive. Increasing the impact of the current European cohesion policy represents a major challenge. The fact that the European institutions have recognised the need to reorganise the SCF is clear from the reform of the cohesion policy specified in the new Financial Perspective 2007-2013, to be discussed in more detail below. However, it is by no means certain that those changes will be sufficient, and it is vital to continue the constant assessment of the cohesion policy.

### 3. The Financial Perspective 2007-2013

The initial version of the Financial Perspective for 2007-2013 – the fourth in the series – was presented to the European Parliament in February 2004 by the then President of the Commission, Romano Prodi. As already mentioned, the Financial Perspective reflects the general stance of EU policy over a fairly long period – currently 7 years – and determines the maximum amount per heading for each annual budget. The expenditure is allocated within each heading, at the time of the annual budget round. Hereafter, the EC's original proposal is first discussed. Since this proposal was not greeted with equal enthusiasm by all the Member States, the Luxembourg Presidency arrived at a compromise in mid-2005 which the European Council subsequently approved, in slightly modified form, under the British Presidency in December 2005. This agreement is explained in section 3.2. The final section describes the Interinstitutional Agreement concluded between the EC, the Council and the European Parliament on 17 May 2006.

#### 3.1 The Commission proposal

The proposal by the European Commission "Building our common future" (EC, 2004) defined three priorities<sup>(1)</sup>:

- *promoting sustainable development*. This refers primarily to the Lisbon Strategy (European Council, 2000) which aims to make the EU a leading knowledge-based economy. In addition, the cohesion policy must focus more than in the past on pursuing the objectives of that strategy since a properly targeted approach in this area will mobilise the Union's unused potential. Finally, natural resources require sustainable management. The new agricultural policy is to implement this by breaking the link between support and production;
- *citizenship, freedom, security and justice*. The second priority implements the conclusions of the Tampere European Council in 1999, which gave the EU more powers over immigration and asylum policy and in regard to the fight against crime and terrorism;

- *the EU in the world*. The third priority aims to allow the EU to play a greater role as a regional leader and as a global partner. This should bring the Union's political clout more into line with its economic importance.

In order to achieve these ambitious objectives in an enlarged Union, the Commission suggested gradually increasing the expenditure commitment, raising it to 1.23 p.c. of GNI by 2013. For comparison, approximately 1.11 p.c. of GNI was scheduled for 2006 (excluding the EDF expenditure; this had been included in the Commission proposal for 2013, but the Council and the European Parliament had later excluded it from the budget). The expenditure would thus remain within the absolute ceiling on the own resources with due regard, on the one hand, for existing commitments and the likely challenges ahead in respect of agricultural financing and the cohesion policy, resulting from the recent enlargement and that planned for the future, and on the other hand for the consensus achieved at the highest political level concerning the new impetus to be given to the Lisbon strategy. In addition, the Commission suggested to abolish the special rebate on the British contribution and replace it with a generalised correction mechanism guaranteeing all the poorer Member States a partial rebate.<sup>(2)</sup>

To highlight these priorities, the European Commission changed the current expenditure headings into the following categories:

1. Sustainable growth, divided into two sub-headings:
  - 1a: Competitiveness for growth and employment
  - 1b: Cohesion for growth and employment
2. Preservation and management of natural resources:
  - agriculture market-related expenditure and direct payments;
  - preservation and management of natural resources, excluding the CAP
3. Citizenship, freedom, security and justice
4. The EU as a global partner
5. Administration

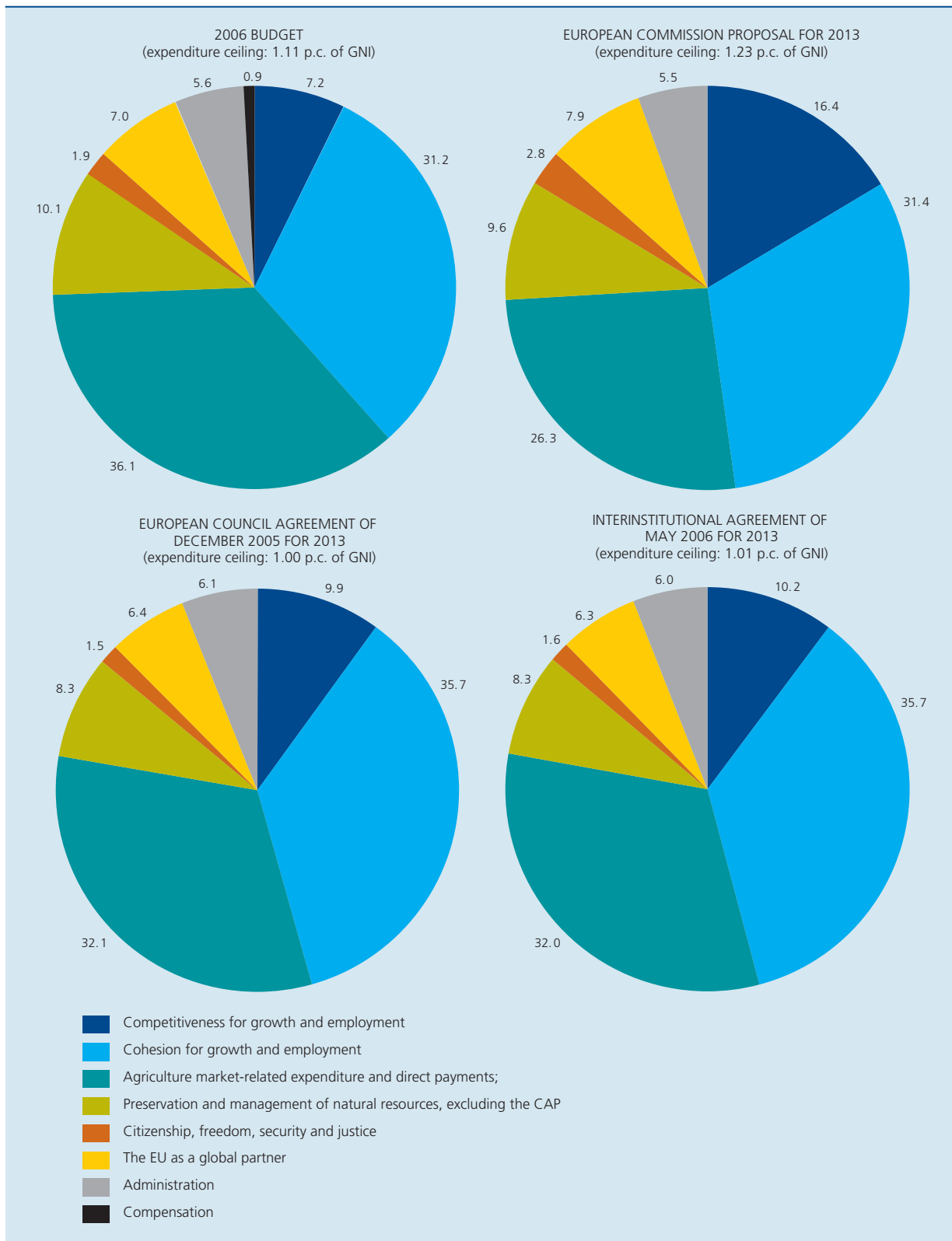
(1) These three priorities refer in fact to the "three pillars" of the EU as laid down in the Maastricht Treaty: the European Communities (economic affairs, EMU, etc.), the Common Foreign and Security Policy, and Justice and Home Affairs, although the European Commission reverses the order of the last two.

(2) The principle of a generalised correction had already been accepted at the European Summit in Fontainebleau (1984): "... any Member State sustaining a budgetary burden which is excessive in relation to its relative prosperity may benefit from a correction at the appropriate time." However, this principle has hitherto only been partially applied.

**CHART 7**

**COMPARISON OF THE EXPENDITURE BREAKDOWN: 2006 BUDGET, COMMISSION PROPOSAL, EUROPEAN COUNCIL AGREEMENT AND INTERINSTITUTIONAL AGREEMENT FOR 2013<sup>(1)</sup>**

(Percentages)



Sources: EC, Council of the European Union.

(1) Commitment appropriations, 2004 prices. All expenditure on administration was concentrated under the heading of that name, not divided among the other headings as was done by the Commission in its proposals; the EDF expenditure was also excluded, for ease of comparability.



The most notable development was the growing importance assigned by the Commission to expenditure on “Competitiveness for growth and employment” (Lisbon agenda), an item which would have expanded from 7 p.c. of the total commitment appropriations in 2006 to over 16 p.c. in 2013. This increase was at the expense of the amount allocated to agriculture, except for the expenditure on protecting the environment, i.e. in broad terms the price and income support, down from approximately 36 p.c. of total spending to around 26 p.c.

The “Cohesion for growth and employment” heading, though larger in absolute terms, was set to remain constant at around 31 p.c. of the total commitment appropriations. As already stated, the European Commission proposed a reform of the cohesion policy via the Financial Perspective 2007-2013. The aim is to focus the measures more on the Union’s strategic guidelines (Lisbon strategy and employment strategy), concentrating them on the least favoured regions and stepping up their decentralisation, making their implementation simpler, more transparent and more effective. To that end, the current three priorities will be replaced by the following objectives: “Convergence” (around 79 p.c. of SCF resources) – the aim being to accelerate the economic convergence of the least developed regions, particularly those with per capita GDP below 75 p.c. of the EU average following enlargement, and therefore close to the current Objective 1 –, “Regional competitiveness and employment” (around 17 p.c.), and “European territorial cooperation” (around 4 p.c.). The existing financial instruments will also be reduced to three, namely the ERDF, the ESF and the Cohesion Fund.

The share of the item “Preservation and management of natural resources, excluding the CAP” is down slightly in percentage terms, but higher in millions of euros, whereas the expenditure on “Citizenship, freedom, security and justice” and “The EU as a global partner” is increased in percentage terms.

### 3.2 The European Council agreement of December 2005

The Commission proposals were greeted with scepticism by almost all the Member States:

- the proposed increase in the budget encountered resistance from the six Member States which contribute most to the EU budget, namely Germany, France, the Netherlands, Austria, the United Kingdom and Sweden;
- the United Kingdom opposed the introduction of a generalised correction mechanism;

- France, in common with some other Member States, considered it very important to maintain the agricultural expenditure at a higher level than that proposed by the Commission;
- the redistribution of the SCF, intended for the poorest Member States, was criticised by a number of countries, including Belgium, which advocated a broad “phasing out” of the SCF over a long period.

The Luxembourg Presidency during the first half of 2005 suggested a compromise, but in the last instance it was rejected. However, the United Kingdom, which held the presidency during the second half of 2005, ultimately felt obliged to put forward a proposal which was not all that different from the Luxembourg compromise, except that the level of expenditure was lowered again slightly and many ad hoc elements were added which, though conducive to political agreement, made the Financial Perspective less transparent. In December 2005 the European Council concluded the following agreement:

- the expenditure ceiling was set at 1.045 p.c. of GNI for commitment appropriations and 0.99 p.c. of GNI for payment appropriations (on average for 2007-2013), excluding the EDF, which was separated from the budget (the EDF represents around 0.02 p.c. of GNI). In 2013, the final year of the Financial Perspective, the commitment appropriations would amount to just 1 p.c. of GNI, thus meeting the demand of the six largest net contributors;
- the allocation of the expenditure was revised in the direction of the existing expenditure structure: more spending on agriculture and the SCF than in the Commission proposal, and less spending on the implementation of the Lisbon objectives (“Competitiveness for growth and employment”);
- the expenditure cuts were allowed partly by reducing expenditure on rural development, which is one reason for the Flemish Region’s critics on the agreement;
- compared to the Commission proposal, the SCF is somewhat less concentrated on the new Member States, and the apportionment is more in line with the current allocation. In addition, a long “phasing out” period is provided in the case of the regions and Member States which would cease to satisfy the criteria for granting aid in the enlarged Union (Hainaut, for example);
- the British rebate is retained, but will be gradually reduced between 2009 and 2011 as regards the British financing of the costs of EU enlargement (the British nonetheless keep their rebate in respect of the CAP expenditure);
- while the uniform “call rate” for the VAT resource is set at 0.30 p.c., Austria, Germany, the Netherlands and Sweden receive a reduction in their VAT contribution;

an additional lump sum reduction is also granted to the last two countries in respect of their share in the fourth resource. Overall, the Netherlands gains the most from the revision of the own resources decision, since its contribution is down by an average of 22 p.c. per annum, or almost 1 billion euro (Federal Planning Bureau, 2006);

- a fundamental revision of the EU budget expenditure and revenue is planned for 2008-2009, which should permit renewed discussion of all the components of Community expenditure (including the CAP) and the British rebate.

### 3.3 The Interinstitutional Agreement

The Financial Perspective approved by the European Council came in for sharp criticism from the European Parliament, one reason being the small size of the budget and the fact that insufficient was done for the Lisbon objectives. In that sense, the European Parliament defended the Commission's original proposal. Following tough negotiations between the European Parliament on one side and the Council and the Commission on the other, a compromise was reached on 4 April 2006, after which a new Interinstitutional Agreement was signed by the three parties on 17 May. This differs from the December 2005 agreement on the following points:

- the expenditure ceiling is raised by 2 billion euro; a further 2 billion euro is released from the "Emergency Aid Reserve" by keeping emergency aid to developing countries out of the Financial Perspective, and by cutting expenditure on administration. The European Parliament can thus state that it has increased the total EU expenditure for 2007-2013 by 4 billion euro, half of that being spent on the Lisbon objectives, while the European Council only had to agree to increase the expenditure from 1 p.c. of GNI to 1.01 p.c. in the year 2013. The European Investment Bank also undertook to co-finance new financial instruments up to a maximum of 2.5 billion euro for expenditure relating to the Lisbon objectives;
- greater flexibility is built in for unforeseen expenditure, by increasing the maximum amount spent by a number of funds which are not subject to the expenditure ceiling, such as the "Solidarity Fund" (which supports EU Member States affected by a disaster) and the "Emergency Aid Reserve" already mentioned, and by creating the "European Globalisation Adjustment Fund" (which is meant to assist EU Member States affected by the impact of globalisation).

## Conclusion

The EU budget has a number of specific characteristics which make it different from the budgets of the Member States: in principle, it must never be in deficit, and there is a special decision-making procedure, in which the European Parliament does not have full power. The structure and maximum expenditure are specified for a 7-year period in the Financial Perspective; that for 2007-2013 was approved in May 2006. In relation to GDP and national budgets of the Member States, the EU budget is small, but it has grown over the years and recently stabilised at around 1 p.c. of GNI. Import levies and VAT-based transfers from the Member States are becoming less important as the source of finance for this expenditure, which is increasingly funded on the basis of the size of each Member State's GNI. The United Kingdom receives a special rebate. The poorer Member States are all net beneficiaries of the EU budget, while the richer countries are net contributors; however, if the EU's administrative expenditure in Belgium and Luxembourg is added to what those countries receive from the EU, then they become both net beneficiaries.

Historically, the Common Agricultural Policy was the largest EU expenditure item, but its importance is steadily diminishing in favour of expenditure on the cohesion policy. Since the beginning of the 1990s, a start has been made on a fundamental reform of the CAP, culminating in the 2003 decisions whereby support for farmers became more and more decoupled from production. European agricultural prices are also increasingly moving into line with world market prices.

Financial resources earmarked for the structural funds and the cohesion fund have significantly increased and now exceed 30 p.c. of the EU budget. The growth of per capita GDP in the four former 'cohesion fund countries' compared to the EU average suggests some tendency towards economic convergence in the Union. However, opinions differ on the contribution made by the cohesion policy towards income convergence between regions, and a significant challenge lies ahead in augmenting the impact of the current European cohesion policy.

The Commission's proposals regarding the Financial Perspective for 2007-2013 entailed an increase in expenditure to 1.23 p.c. of GNI by 2013, and placed the emphasis on sustainable development, with a steep rise in expenditure on the attainment of the Lisbon objectives. However, these proposals went too far for the Member States; protracted negotiations at European Council level led to a compromise in December 2005, setting an expenditure ceiling of 1 p.c. of GNI in 2013 and realigning

the allocation of funds more closely with the current spending structure.

Following difficult negotiations with the European Parliament, a new Interinstitutional Agreement was signed on 17 May 2006, which meant a slight raising of this ceiling and built more flexibility into the expenditure. It was also agreed to conduct a fundamental debate in 2008-2009, primarily on the expenditure relating to the agricultural policy and the correction mechanisms for certain Member States, in order to prepare for a radical reform of the next Financial Perspective.

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