The 2008/2009 review of the EU budget: Real or cosmetic?

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The European Community budget is, arguably, among the least satisfactory elements of EU economic governance and one which, moreover, has proved to be remarkably resistant to change since it was last subjected to major reform in 1988. In the intervening period, there has been no radical development, despite the increase in membership of the union from 12 to 27, completion of the internal market, and the extension of EU ambitions in external policy from development to international security. Monetary union has gone from a distant prospect to a euro that will be well into its adolescence by the end of the current Multi-annual Financial Framework (MFF) in 2013, which is formerly known as the Financial Perspective – FP.

It is noteworthy that in the extensive reform of economic governance that took place in 2005, it is the budget which emerged least altered, despite the fact that it underwent a presentational makeover that, for example, saw "structural operations" re-defined as "cohesion for growth and employment", albeit with much the same level of resources. While the seemingly vast capacity of the EU to fudge deals cannot be ignored in looking to the future of the budget, it is hard to see how the present system can survive beyond the present budgeting period of 2007 to 2013. In an intriguing paradox, the long periods involved seem to make reform more difficult, rather than giving ample time for reflection.

It is against this backdrop that the EU is now gearing up for a review of the budget, due to take place in 2008/2009, and supposed to be subject to no taboos. All headings of expenditure are to be examined and the terms of reference also make clear that the UK rebate is to be on the table, offering some hope that things might change, despite the disappointing outcome of the 2005 deal (Begg and Heinemann 2006). Consequently, the review offers the first opportunity for many years for the EU budget to be re-thought from first principles, at least selectively. More importantly, it can help to shift the agenda for what the EU budget should do.

But is there the political will to enable it to be a catalyst for change? This paper describes the flaws in the budget that the review is intended to address, discusses options and concludes with a number of proposals for reform.

What is at issue?

There is widespread agreement about the shortcomings of the budget, well-captured in the jibe of Buti and Nava (2003, 1) that it is a "historical relic". The biggest element of expenditure has long been support for agriculture, a declining sector of economic activity, while the other major component of spending is for cohesion: policies aimed mainly at the economic development of lower-income regions and Member States. Together, agricultural and cohesion have accounted for some three-quarters of EU spending over the last three decades, including the 1999 to 2006 spending period that has just ended. All other EU policies, as well as the administrative costs of the Union compete for the remaining quarter, equivalent to just one quarter of a percentage point of EU GDP.

Although many facets of the budget look different or have acquired new labels, it is striking how little changed the budget of 2007 is from those of the late 1980s. Some might dispute this assertion, but as Table 1 shows, in practice the main features have evolved only to a limited extent. It is still almost the same size as a proportion of EU GDP; it continues to be dominated by expenditure on agriculture and cohesion; and the UK rebate is as hotly contested as ever. Politically, the most telling change is that there are now more net contributors than twenty years ago, but the proliferation of back-door rebates has made the whole picture more blurred and the solutions found ever more ad hoc.

An important issue is how big the EU budget should be. Over the last two decades, it has hovered around 1 percent of EU GNI. At this level it is just 2.5 percent of aggregate public spending in the EU which means that the room for genuine manoeuvre in the budget is, inevitably, severely circumscribed. Nor does the budget have any role in stabilisation policy, as is the norm for the highest tier of policy-making elsewhere (even in the US, the federal government

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Table 1

Budget features compared

Facet of budget	1988–1992 (FP)	2007–2013 (MFF)	Comment
Own resources ceiling	Rising to 1.2% of GDP	1.24% of GNI	Marginal increase, but offset by lower take-up
Actual expenditure commitments, average over FP	Planned: 1.17% of GNP Out-turn: 0.99%	Planned: 1.05% of GNI	There has been a tendency for the out-turn to under-shoot
Share of CAP spending, % end of FP/MFF	51.4%	32.0% direct payments, with an additional 8.2% on other elements	Major changes made in 1992 and 2002 in the character of the CAP, but real level of spending maintained
Share of cohesion spending, % by end of FP/MFF	30.2%	35.6%	Shift from "cohesion 4" to recently acceded members
Administration costs, % end of FP/MFF	4.7%	6.0%	Increase partly caused by re-definitions
Formal abatement	UK	UK	Relatively minor changes in formula
Implicit "rebates"	DE	DE, NL, AT, SE	Increasingly messy and opaque arrangements
Share of funding from inter-governmental transfers	VAT: 58% (average) GNP: 9% (average)	VAT: 16% (2007) GNI: 69% (2007)	Switch from VAT resource to GNI resource, but de facto both transfers

Source: Author's elaboration.

accounts for over 20 percent of GNP), and it does not explicitly contribute to the re-distribution of income through social transfers, as might be expected from the highest level of governance in a fiscal federation (Oates 1999). That said, the budget plainly does have a distributive effect insofar as it transfers resources to farmers – increasingly, after successive reforms of the Common Agricultural Policy (CAP), in the form of direct income subsidies rather than the much reviled production subsidies – and to the regions eligible for cohesion spending, in the form of targeted public investment.

Instead of being a source of EU level public goods, some critics argue that the budget is dominated by re-distributive expenditure. Indeed, Blankart and Kirchner (2003) argue that the institutional arrangements for settling the budget predispose it towards redistributive policies, echoing the pork barrel mentality familiar in the US congress. Moreover, there is little scope for using straightforward economic principles to determine how spending at EU level would "add value". Worse, the issue of added value only rarely surfaces in the acrimonious negotiations around the budget. Instead the focus of attention has, especially in the last two settlements (1999 and 2005, although this orientation dates back to the wielding of the handbag by Mrs. Thatcher in the early 1980s), been on how much the respective heads of government and finance ministers have been able to bring back as a *juste retour*. As Le Cacheux (2005) aptly describes it, the obsession with net contributions "poisons" the whole debate.

Timing and context

There will be three stages to the review: an initial 'key issues' paper from the Commission to launch a period of consultation; the publication of firm proposals by the Commission, probably late in 2008, drawing on background research and the outcome of the consultation process; then the usual wrangling about what should be agreed. It is important, though, not to harbour illusions about what the 2008/2009 review will change. In particular, it is unlikely to result in much alteration of the existing MFF – seen by too many as a 'done deal' that cannot be unpicked thread by thread without the whole garment disintegrating. Nor does there seem to be much enthusiasm for change on the funding side of the budget, not least because the present system of own resources that funds the EU budget has one great virtue, namely that it ensures that the EU obtains the money it needs. Any switch to a "tax for Europe" or any other revenue source would create a degree of uncertainty in this regard.

The rigidities in the system of decision-making (not least the requirement for unanimity), path depen-

dency and the power of vested interests make reform of the EU budget an uphill task. There is, nevertheless, a potentially auspicious conjunction of scheduling in the next three years. 2009 will see the end of the mandates of the current Commission and European Parliament. Under the provisions of the re-launched Lisbon strategy, new triennial National Reform Programmes are due to be formulated in 2008 and launched in 2009 and the parallel Community Lisbon Programme will also need to be renewed. In addition, there is or is likely to be new political leadership in key larger Member States. A "health-check" – which could in effect be a review – on the CAP is also envisaged. Hence, there is a window of opportunity for more extensive change than has been feasible in recent rounds. This suggests that the principal ambition of the review should be to shift the terms of the debate for subsequent funding periods (that is, beyond 2013) and to provide a roadmap for the reform of the budget.

The revenue side of the budget

Although the Treaty (Art. 269, TEC) stipulates that the EU should be funded by own resources, only a small proportion (currently just under 15 percent) of the revenue comes from instruments that are genuinely European, namely the levies and duties imposed at European level – the "traditional" own resources (ToR). Starting in 1979, the bulk of the EU's revenue has come from, initially, a proportion of the proceeds of national value added tax, complemented after 1988 by a fourth resource calibrated on national income (now GNI). These two resources are, in a legal sense, own resources because they are formally incorporated in the Inter-Institutional Agreement between the European Parliament, the Commission and the Council. But in an economic sense, they are inter-governmental transfers, rather than readily identifiable revenue sources. This has a number of ramifications.

Because the GNI resource is residual in that it rises or falls to match the EU's expenditure commitments, there is no risk of the EU "running out of money" as happened in earlier periods. The corollary is that the major political decisions about the EU budget concern the EU's expenditure, with the revenue adjusting passively. This is not, as it might be in other circumstances, a recipe for fiscal laxity, since the overall cap on the budget, together with the ceilings for different headings of expenditure effectively impose a hard budget constraint. But it does distinguish the EU from other governments which have to balance revenue raising with expenditure in a more systematic way. A second feature of the system is that it is easy to predict how much each Member State will contribute s a proportion of national income. The current system is, broadly, proportional, with each Member State expected ex-ante to pay-in roughly 1 percent of its GNI, although the various abatement mechanisms alter the actual payments.

What could be on a reform agenda?

The mandate for the reform of the revenue side of the budget refers to "resources, including the UK rebate". The former can be interpreted either as a call for minor revision of the existing own resources or, at the other extreme, as an invitation to assign genuinely "owned" taxes to the EU level. An obvious simplification of the existing system would be the abolition of the VAT resource by consolidating it into the GNI resource, recognising that the distinction is artificial.

Introducing new taxes for Europe would be much bolder, yet already seems to be a step too far politically, despite the fact that it has consistently been on the EU agenda since the 1988 budget reform. In interviews, Dalia Grybauskaite, the EU Budget Commissioner has made clear her opposition to opening-up this question now, although a report by a prominent member of the European Parliament (Lamassoure 2007) has made a strong case for moving in stages to a new system in which there are explicit EU taxes. The Commissioner's fear is, in part, that if the review attempts to tackle too many topics, it will succeed with none of them.

Possible criteria for an EU tax include standard tax principles (including equity – especially between Member States – economic efficiency, sufficiency and cost of collection), assurance that the new instrument would not add to the aggregate fiscal burden (revenue neutrality), and political considerations such as a link to EU policies, visibility and transparency. No conceivable EU tax will ever be ideal and there are bound to be problems of various sorts in any tax that might be envisaged to "pay for Europe". But designing one that fulfils enough of the relevant criteria is not an especially daunting challenge and many conceivable options have been discussed over the year (see Cattoir 2004; Le Cacheux 2007). Collecting a tax at EU level may even diminish

anomalies or externalities resulting from its collection at Member State level, such as arbitrariness in which Member State levies taxes on bases that are in fact pan-European profits, for example.

The problems arise at the political level. Opponents of an EU tax claim, *inter alia,* that:

- It would increase the overall tax burden – which it plainly would not if revenue neutrality is respected.
- Citizens would question why they were paying for the EU – which is, in fact precisely the point of the transparency and visibility argument for having a tax.
- Introducing a "new" tax is a political non-starter – a claim which has no empirical support.
- Because the present system of own resources assures adequate funding, the maxim "if it ain't broke, don't fix it" should apply, especially when a tax for Europe would inevitably create new problems and anomalies – a standpoint that has its merits, but which is also a recipe for inertia.

Expenditure

There are several explanations for the current mix of spending in the EU, few of which reflect underlying principles of public finance. The most clear-cut is the Treaty base which stipulates that there shall be a common agricultural policy (CAP) and funding for cohesion through the Structural Funds. However, the scale of expenditure on these two sets of policies is a political choice and the way they are distributed among Member States partly to give "money back". There is also a Treaty base for research funding and various other internal policies, while the Union manifestly could not function without administrative outlays. Here, too, the level of expenditure is a matter of political choice. For other key components of EU economic governance such as macroeconomic stabilisation, the Lisbon reform agenda or sustainable development, the legal base is much weaker. Yet with the Commission placing the (Lisbon) Partnership for Growth and Jobs at the heart of its political work programme, it might have been expected that it would feature prominently in EU expenditure over the coming years.

Heading 1 of the 2007 to 2013 MFF is, indeed, identified as money to be spent on growth and employment and, in its more sanguine pronouncements, the Commission claims that as much as 40 percent of the EU budget is aimed at this objective. However, this claim can be made only by including the cohesion budget as part of growth and employment. This is not without justification insofar as the economic development of less competitive regions contributes to aggregate EU competitiveness, but the fact remains that cohesion spending is about countering the market forces that result in polarisation and is paid for by, implicitly, taxing richer regions.

But what the budget does not do systematically is to allocate resources to genuinely European public goods, for which there is an evident added value from producing them at supranational problem. Spill-over arguments could, for example, be adduced to support EU wide infrastructure networks or research, and it would not be hard to make a case for higher spending on internal security. As a result, the question that ought to be behind that of "how big should the budget be" namely, "when is it better to spend at EU level", is scarcely posed, let alone answered.

What are fair contributions to the EU budget?

There are three different ways of measuring how much each Member States pays in to the EU budget, each telling a different story: ex-ante gross payments; payments after allowing for abatements and other adjustments; and net contributions. All have become increasingly devoid of principles over the years because of ad hoc adjustments. Corrections designed to contain net balances include the "fee" paid to Member States for collecting the two traditional own resources (increased to 25 percent in 1999, largely to give money back to the Netherlands); differing take-up rates for VAT instead of a single one; and, in the 2007 to 2013 MFF, a reduced take-up rate of the GNI resource for the Netherlands and Sweden. Together with the formal rebate for the UK and the reduced contribution to the UK rebate offered to four Member States (which increases the burden on the remaining twenty-two), all of these manipulations mean that the actual payments to the EU of five of the richer Member States are, in fact, lower as a proportion of GNI than the poorer Member States.

The effect of these corrections is to increase the share of GNI paid-in by other countries. At the richer end of the spectrum, France has had to pay most

in this regard. But the fact that the recently-acceded countries also have to pay more has been a source of dismay. In addition, the payments have to be made quarterly, whereas receipts from many of the multi-annual programmes, such as the Structural Funds, tend only to be received with a lag and are subject to certain conditions. The upshot is that a country such as Poland may face a less favourable cash-flow in the short-term. These revenue arrangements have caused friction, with the recently acceded Member States dismayed to find that they have to pay "upfront" for the British abatement.

Nevertheless, the key issue is net contributions, which are the difference between abated gross payments into the EU budget and expenditure received from it. The net contributions arise almost entirely on the expenditure side of the budget, albeit for differing reasons. CAP spending has an uneven geographical incidence because it automatically favours countries with large farming industries, while its distributive impact has – so far – been unpredictable, favouring large farmers in some circumstances and low-income ones in others. Cohesion policy is deliberately targeted at lower income or competitively weak regions, and can thus be seen as a policy that has more explicit equity-related aims. Spending on other policies reflects diverse objectives. Thus, the research budget is supposed to be allocated principally on the basis of excellence, which tends to favour Member States (and, within them, specific regions) with well-developed research capacities – usually richer ones.

Overall, therefore, the distributive impact of the EU budget is partly intentional and partly a by-product of the way policies are designed and implemented. The tension at the core of this system for allocating spending is that more attention tends to be paid to how much a country receives rather than whether the policy is well-conceived from the perspective of the EU as a whole by producing public goods.

Proposals and conclusions

The 2008/2009 review of the EU budget is an opportunity to achieve an irreversible shift in the economics and politics of the EU budget, but success cannot be taken for granted and it would not be at all surprising if the ended without firm agreement on how to move forward. There seems little prospect that the review will result in anything other than marginal changes in the 2007 to 2013 MFF. But it will have served its purpose if it establishes a clear and principled blueprint for the future shape of the budget. Offering credible ways forward or clarifying the options in seven key areas would constitute real progress. They are as follows.

- *The rigid ceiling of 1.24 percent of GNI for the budget, and the de facto ceiling of just over 1 percent should be abandoned in favour of a "policies first" approach.* There is plainly no political will to endow the EU level with fiscal resources comparable to the federal or central level in other polities, but that need not preclude a somewhat larger budget, provided that it can be justified. The current own resources ceiling reinforces the sentiment, first, that payments to the EU are tantamount to a club fee and, second, that the primary objective in budget negotiations should be to maximise "money back". In this logic, the main function of the ceiling is to contain the common-pool problem and thus limit the distributive transfers from the budget. But in the process, little thought is given to what public goods the EU should provide.
- *A robust means of showing that there is added value from funding public goods at the EU level has to be put in place.* This should be based on analytic concepts, such as externalities and economies of scale, and adapted to the unique institutional circumstances of the EU. A key test should be whether spending at EU level improves the quality/efficiency trade-off of public spending, and the presumption should be that assigning a spending competence to the EU level should result in either the same or lower level of total public spending. Where there are reasons (such as national sensitivities) for retaining a particular public good at national level, the rationale should be made explicit.
- *A substantial reduction in the share of the CAP* would nevertheless free resources (and, perhaps more importantly, create political room for manoeuvre) for other purposes, alter the arithmetic of net contributions and have a positive effect on the EU's position in the Doha Round negotiations. The details are bound to be contentious, but there are essentially two ways of achieving the outcome, bearing in mind that an agricultural policy remains a Treaty commitment: co-financing of the existing CAP from national exchequers or further changes in the CAP itself that reduce its budgetary demands.

- *A coherent and transparent system for funding the budget is needed, with an end to ad hoc arrangements.* Again, there are two approaches: fund the budget entirely from intergovernmental transfers from Member States (with some reflection on whether fairness should be achieved by keeping the payments purely proportional or having a degree of progressivity); or establish "owned" taxes for Europe. The inter-governmental transfer approach has the undeniable merit that it works and (unless the possibility of reneging, as has occurred sporadically for international organisations, arises) will continue to work to assure adequate resources. Taxes for Europe would be messier, but more in keeping with the Treaty and with accepted norms of accountability.
- *Net contributions should no longer be abated.* Instead, it should be incumbent on Member States to accept that once the major decisions on expenditure are taken, the distributive consequences should be accepted. Inevitably, this would lead to Member States holding out for policies that favour them, but the overall impact should be to make scrutiny of policies more intensive.
- *If a case can be made for purely re-distributive transfers among Member States, it might as well be through an explicit fiscal equalisation.* The political problems associated with schemes such as the German Finanzausgleich are well-known, but they offer a more coherent and politically open means of settling the question than each finance ministry showing up for the periodic MFF negotiations with an increasingly elaborate Excel spreadsheet into which the latest proposals are fed so as to work out net balances.
- *The political and budgetary cycles should be better aligned.* It is an open question whether the optimal combination would be for the budget to be mid-point to mid-point of the five-yearly cycle for the Commission and the European Parliament or precisely aligned. It is difficult to see why the budget should be on a seven-year cycle.

An immediate reaction to this list is sure to be that it exemplifies the old joke about the economist on a desert island confronted with a tin of food, who answers the question "how do we open it?" by stating "assume a tin opener". But even if some of the forgoing proposals seem fanciful, the sceptical reader is invited to write down on a blank sheet of paper what would be included if an EU budget were designed from first principles. The difficulty facing the budget is the continuing uncertainty about what the EU is supposed to be, an uncertainty that makes it hard to define what sorts of public goods the EU should provide. The answer may only be implemented a decade or more hence, but will the 2008/2009 review be far-sighted enough to provide a roadmap to it?

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