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Financing the EU budget – Present Situation and Perspectives

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The European Council agreed on the new medium-term planning for financing the European Union between 2007 and 2013 in December 2005.[1] The financial planning involves decisions on the level and structure of future expenditure and on the rules how this expenditure is to be financed.

EU expenditure

The annual ceiling for EU budget expenditure ("payment appropriations") is currently 1.24 percent of the gross national income (GNI) of all member states. The member states' financial contributions can be set and collected only up to this amount. In 2004 the total sum actually spent amounted to €100.1 billion, which, as in previous years, was 0.98 percent of GNI, significantly less than the annual ceiling (Tables 1 and 2). While this represents a 10.6 percent increase in total expenditure compared with that of 2003, most of the increase was due to the EU enlargement on 1 May 2004. Almost 7.5 percentage points of the growth of nearly 11 percent of the allocable expenditure burden shared by the individual member states were due to the new member states.[2] However, the increase in expenditure resulting from enlargement was considerably restricted by virtue of an agreement on transition regulations. For example, a ceiling of €22 billion was set for structural aid to the new member states for the years between 2004 and 2006. Moreover, the farmers there received just 25 percent of the usual direct payments in the first year (30 percent in 2005). The full amount of financial support will not be paid until the end of a transitional period of ten years.[3]

Expenditure may be subdivided into three main categories (Figure 1). Agriculture, despite a significant

* This article is a condensed and updated version of Deutsche Bundesbank (2005), pp 15. The authors are economists at Deutsche Bundesbank, Economics Department, Public Finances.
[1] However, the European Parliament failed to agree to this proposal in January 2006.
[2] For the statistics see European Commission (2005).
[3] Owing to these measures, net transfers to the new member states in 2004 were limited to a total of approximately €3 billion.

Table 1

Total EU expenditure and receipts (funds for payments)

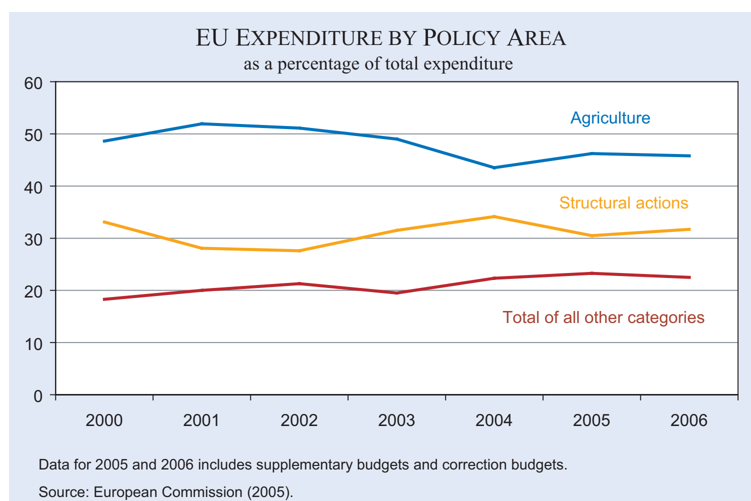
in € billions unless shown as a percentage

Item	1999	2000	2001	2002	2003	2004	2005[a]	2006[a]
Expenditure								
Agriculture	39.8	40.5	41.5	43.5	44.4	43.6	48.5	51.0
Structural actions	26.7	27.6	22.5	23.5	28.5	34.2	32.4	35.6
Internal policies	4.5	5.4	5.3	6.6	5.7	7.3	8.0	8.9
External policies	4.6	3.8	4.2	4.4	4.3	4.6	5.5	5.4
Reserves	0.3	0.2	0.2	0.2	0.1	0.2	0.4	0.5
Pre-accession strategy[b]	–	1.2	1.4	1.8	2.2	4.5	4.6	4.0
Administration	4.5	4.6	4.9	5.2	5.3	5.9	6.3	6.7
Total	80.3	83.3	80.0	85.1	90.6	100.1	105.7	112.0
Percentage change from previous year	–0.5	3.8	–4.0	6.4	6.4	10.6	5.5	6.0
Memo Item: percentage of GNI	1.00	0.98	0.91	0.93	0.98	0.98	1.00	1.01
Receipts								
Traditional own resources[c]	13.9	15.3	14.6	9.2	10.9	12.3	13.9	14.2
VAT-based own resource	31.3	35.2	31.3	22.4	21.3	13.9	15.6	15.9
GNI-based own resource	37.5	37.6	34.9	45.9	51.2	69.0	68.9	80.6
Other receipts[d]	4.2	4.7	13.5	17.9	10.1	8.3	7.3	1.3
Total	86.9	92.7	94.3	95.4	93.5	103.5	105.7	112.0
Percentage change from previous year	2.8	6.7	1.7	1.2	–2.1	10.7	2.7	6.0
Balance for the financial year	6,6	9.4	14.3	10.3	2.9	3.4	0.0	0.0

[a] Budget (funds for payments) for the EU 25. 2005: Amending budget 1,2,3,4,5,6,7 and 8 included. – [b] Including compensation payments for the new member states. – [c] Net, i.e., less the refund paid to member states for collection expenses. In the financial year 2002 the lump-sum refund paid to member states for this purpose was raised from 10% to 25% of the amount member states contributed to the EU. – [d] Including residual surpluses from the previous financial year.

Source: European Commission (2005) and own calculations.

Figure 1



Data for 2005 and 2006 includes supplementary budgets and correction budgets.
Source: European Commission (2005).

reduction from just over 49 percent in 2003 to 43.5 percent in 2004, continued to account for the largest share of total EU expenditure (€43.6 billion in 2004 compared with €44.4 billion in 2003). Furthermore, rising expenditure on structural actions was also significant (just over 34 percent, or €34.2 billion compared with €28.5 billion a year earlier). Just over 7 percent (€7.3 billion) was spent on "internal policies" – such as education, energy and environment or trans-European networks. Pre-accession aid for the new member states accounted for 4.5 percent.

In regional respects, the EU budget is disproportionately spent. The United Kingdom, the Netherlands, Sweden and Germany receive relatively little funding as a percentage of their respective GNI.[4] By far the biggest recipients of EU funds, however, are the Baltic states as well as Greece and Portugal. A further breakdown of the expenditure side illustrates, for example, that, of the old member states, the (in relative terms) largest recipients of agricultural subsidies and structural funds are still Greece, Portugal, Ireland and Spain. Ireland received 1.5 percent of its GNI in the form of agricultural subsidies in 2004 – surpassed only by Greece. Even though Ireland is now one of the most prosperous of the EU member states in terms of GNI per capita, it still receives far more than the average amount of structural funds, albeit considerably less than the three southern European countries.

Financing

The EU's expenditure is largely covered by its own resources (Figures 2 and 3).[5] These include traditional own resources which consist primarily of customs duties (2004: just under 12 percent of total income), value-added-tax-based own resources, which is collected from the member states on the basis of a harmonised assessment base (13.5 percent), and GNI-based own resources (just over 66.5 percent).[6]

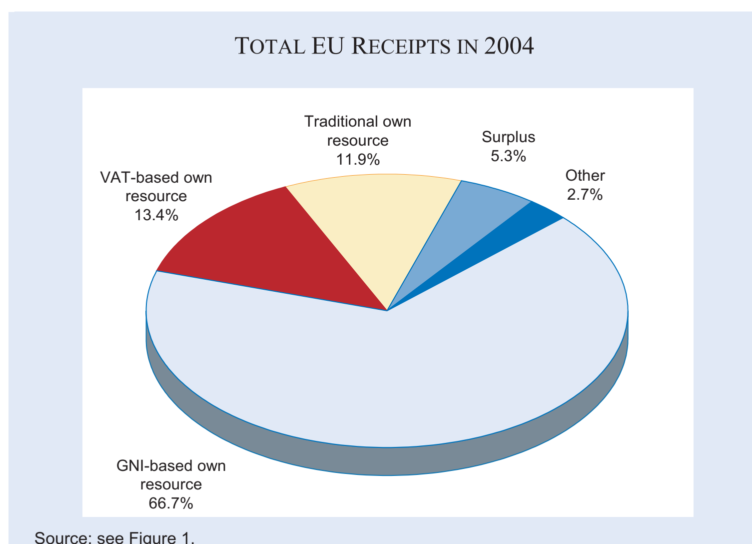
The United Kingdom receives a refund of 66 percent of its actual net contribution (excluding traditional own resources) as a result of an agreement which was concluded in 1985. The contribution made by the other member states to finance this correction is

[4] As the ten new member states did not join the EU until 1 May 2004, only two-thirds of each member state's GNI was used in the EU budget as a basis for determining the amounts of VAT-based own resources and GNI-based own resources that they had to contribute. By analogy, only two-thirds of the new member states' GNI is taken into account here.

[5] Financing the EU budget by borrowing is legally forbidden. Planned receipts and expenditure must be completely matched. Any surplus is to be shown on the receipts side in the following financial year. Any unforeseen expenditure requires an amendment to the budget.

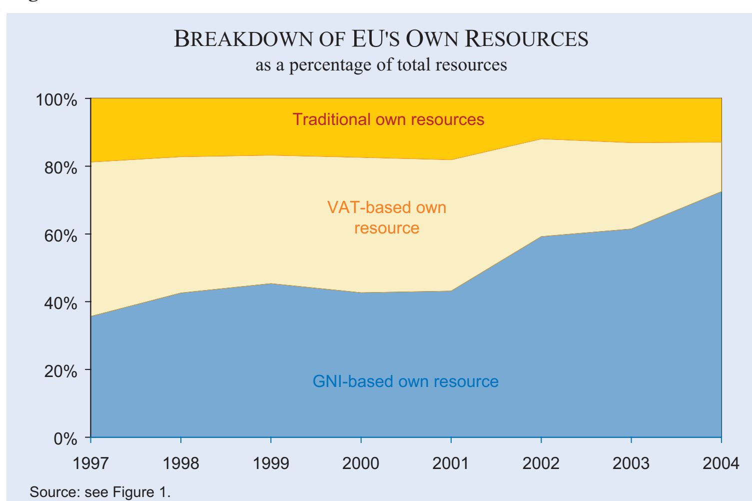
[6] The reduction in VAT-based own resources and the simultaneous increase in GNI-based own resources that have occurred since 2002 are the result of an agreement reached by the European Council in March 1999 (Agenda 2000). This initially lowered the maximum levy rate for VAT-based own resources from 1.0 percent to 0.75 percent (2002 and 2003) and then from 2004 to 0.5 percent of the harmonised VAT assessment base (see Figure 3).

Figure 2



Source: see Figure 1.

Figure 3



Source: see Figure 1.

again based on their national GNI. Since 2001, Germany, the Netherlands, Austria and Sweden have been paying only 25 percent of the resultant correction contributions with all other member states paying a correspondingly larger amount.[7] In absolute terms, the correction in 2004 meant just over €5 billion in financial relief to the United Kingdom.[8]

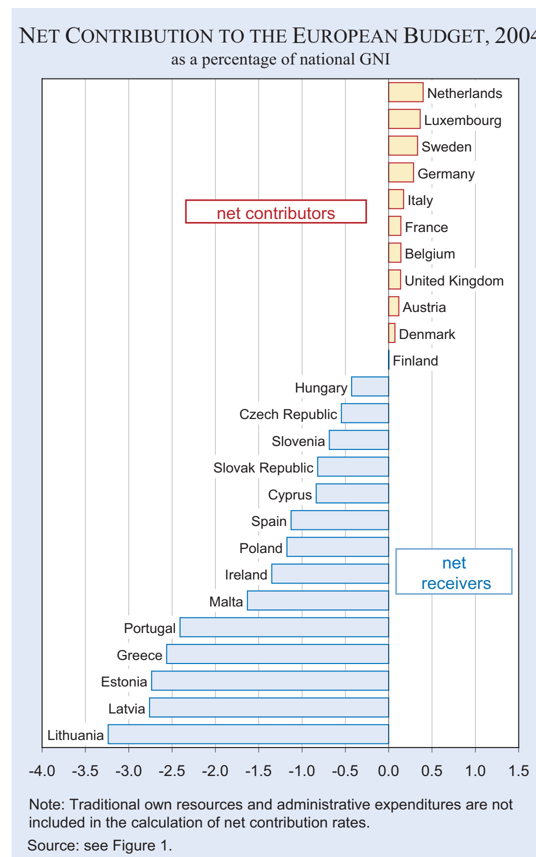
Net contribution

With a net contribution of 0.4 percent of its GNI the Netherlands was the largest net financier of the EU budget in 2004 in terms of economic strength followed by Luxembourg (just under 0.4 percent of GNI), Sweden (just over 0.3 percent) and Germany (0.3 percent). The largest net recipients, on the other hand, were the Baltic states, Lithuania, Latvia and Estonia, as well as Greece and Portugal (Figure 4).

Obviously the expenditure side determines the respective net position, whereas the budget contribution is raised largely proportionally to national wealth in terms of GNI. The advantageous net receiver position of the new member states in 2004 is not so much a result of the traditional areas of EU budget expenditure as of the pre-accession bridging aid granted to the accession countries (almost 1.1 percent of the GNI of the ten accession countries).

Although the figures for net contributions are informative and play an important political role, they should be put in perspective. Inaccuracies arise because some of the receipts – such as customs duties (as part of the traditional own resources), which are concentrated in a few countries with major ports, especially the Netherlands and Belgium ("Antwerp-Rotterdam effect"), and also various types of expenditure, such as expenditure on administration that is heavily concentrated in Belgium and Luxembourg – cannot be allocated to specific member states with any certainty and are therefore neglected.[9] The EU also makes payments within the framework of its external actions, which do not accrue to EU member states and therefore do not represent allocable expenditure. Therefore, the figures presented here exclude the traditional own resources on the receipts side as

Figure 4



Note: Traditional own resources and administrative expenditures are not included in the calculation of net contribution rates.
Source: see Figure 1.

[7] Previously, Germany alone had been relieved of one-third of its actual payments under the correction agreement in favour of the United Kingdom.
[8] In 1999 (Agenda 2000) the European Council decided that the commission had to undertake a general review of the financing system by 1 January 2006. The commission suggested a general correction mechanism to avoid unusually large net contributions by member states. However, in the European Council conclusion on the financial perspective 2007 to 2013 no agreement on a general reform of the system was found.

[9] For the informative value of net contributions see Deutsche Bundesbank (1999), p. 65.

well as the cost of administration and external actions on the expenditure side.

EU budget in 2005 and 2006

The budget for the year 2005 (Table 1) provides for expenditure of €105.7 billion, which is equal to 1.0 percent of EU-25 GNI. Given an increase in total expenditure of 5.5 percent, expenditure on agriculture and rural development will be €4.9 billion (or 11 percent) higher than in the previous year's budget. This is due not only to the increase in direct assistance for the new member states but also to the effects of the reform of the Common Agricultural Policy, according to which there is to be a particularly sharp rise in the funds available for developing the countryside. In the overall budget plan for 2006 a further rise in expenditure on agriculture of more than 5 percent to €51.0 billion out of a total expenditure volume of €112.0 billion (or 1.01 percent of the EU 25 GNI) is planned.[10] The funds allowed for structural actions in the 2005 budget plan were almost 5.5 percent below those in the previous year. In contrast to the plan for 2005, expenditure for structural actions is again to be raised by 10 percent to €35.6 billion in 2006.

Planning for the years 2007 to 2013

How the member states' linkage to the EU budget continues to develop is determined essentially by the new financial perspective for 2007 to 2013.[11] According to the agreement achieved by the European Council in December 2005, payment appropriations which have to be met from the member states' contributions should start at a maximum of 1.06 percent of GNI in 2007 and 2008 but are planned to decrease later on to 0.94 percent in the final year 2013 (Table 2). On average, payment appropriations will amount to 0.99 percent of GNI between 2007 and 2013. Over the planning period, the total figure for expenditure of EU 27 is €862.4 billion in appropriation commitments (1.04 percent of EU GNI).

[10] See Table 1 for figures related to the former categories. As new categories are implemented, the figures become difficult to compare.

[11] The financial perspective is a multi-annual financial framework for EU expenditure. It is therefore of a binding nature in that the expenditure ceilings for the individual headings are to be observed. The financial perspective is unanimously agreed by the European Parliament, the Council and the Commission ("Inter-institutional Agreement"). Detailed budgetary plans are to be approved for each of the years in question.

According to the UK Presidency's proposal, expenditure on internal policies (citizenship of the union) and external actions (EU as a global player) is to rise between 2007 and 2013 by an annual average of almost 9.5 percent or just under 4.5 percent, respectively. From a financial point of view, however, this is of minor importance compared with the expenditure earmarked for agriculture and structural actions.

Common Agricultural Policy

In the new financial perspective, expenditure on the common agricultural policy (CAP), which still absorbs the lion's share of the EU budget, is to form the largest section under the new heading "preservation and management of natural resources". In real terms, expenditure on the CAP is to decline slightly although the direct payments to farmers in the new member states that are unrelated to output are to rise continually over the coming years. This means that until 2013 the budgeted share of expenditure on the agricultural sector should drop to 40.5 percent, which would then be clearly below the share of funds spent on general structural actions (45.5 percent).

This downturn in expenditure in the agricultural sector is based on the Luxembourg resolutions on the reform of the CAP of June 2003. The key element of this is the decoupling of direct payments from production. Another element of the reform is the linking of direct payments to the observance of additional specifications ("cross-compliance"). The subsidy is paid only if the farmer maintains certain minimum standards, mainly with respect to environmental protection. The purpose of the strengthened rural development policy[12] ("pillar 2") under the reformed CAP is to help to achieve these objectives. Furthermore, provision has been made to redirect funds from the areas of market policy and direct payments ("pillar 1") to rural development ("modulation").

The accentuated market orientation that is enshrined in the Luxembourg resolutions and is to be achieved by changing over to direct payments that are not linked to production and by reducing intervention prices could help to weaken the misguided incentives to deploy excessive resources.[13] However, more radical measures would be appropriate within

[12] The (new) rural development policy was excluded, by virtue of the Commission's proposal on the financial perspective, from the "structural actions" and allocated to agriculture.

[13] See OECD (2004).

Table 2

Financial perspective for the EU budget, 2007 to 2013

2004 prices

Item	2006[a]	2007	2008	2009	2010	2011	2012	2013	Total
	in € billion								
1 Sustainable Growth	47.7	51.1	52.1	53.3	54.0	54.9	56.4	57.8	379.7
– *Competitiveness for Growth and Employment*	*7.9*	*8.3*	*8.9*	*9.5*	*10.2*	*11.0*	*11.8*	*12.6*	*72.1*
– *Cohesion for Growth and Employment*	*39.8*	*42.8*	*43.3*	*43.8*	*43.8*	*44.0*	*44.6*	*45.2*	*307.6*
2 Preservation and Management of Natural Resources	56.3	55.0	54.3	53.7	53.0	52.4	51.8	51.1	371.2
of which: Market Related Expenditure and Direct Payments	42.9	43.1	42.7	42.3	41.9	41.5	41.0	40.6	293.1
3 Citizenship. Freedom. Security and Justice	1.0	1.1	1.2	1.3	1.4	1.6	1.7	1.9	10.3
4 EU as a Global Player[b]	8.3	6.3	6.6	6.8	7.1	7.4	7.7	8.1	50.0
5 Administration[c]	6.7	6.7	6.9	7.1	7.2	7.3	7.5	7.7	50.3
6 Compensations	1.1	0.4	0.2	0.2					0.8
Total Appropriations for Committments	121.2	120.6	121.3	122.4	122.8	123.6	125.1	126.6	862.4
Total Appropriations for Payments	112.0	116.7	119.5	111.8	118.1	115.6	119.1	118.6	819.4
	as a percentage of GNI								
Committment Appropriations	1.09	1.10	1.08	1.06	1.04	1.03	1.02	1.00	1.04
Payment Appropriations	1.01	1.06	1.06	0.97	1.00	0.96	0.97	0.94	0.99
Margin Available	0.23	0.18	0.18	0.27	0.24	0.28	0.27	0.30	0.25
Own Resources Ceiling	1.24	1.24	1.24	1.24	1.24	1.24	1.24	1.24	1.24

[a] Expenditure for 2006 in accordance with the current 2000-06 financial perspective broken down for comparison in accordance with the new expenditure structure. – [b] It is planned to integrate the European Development Fund into the EU budget in 2008. – [c] Excluding the European Commission's administrative expenditure, which is covered by the first four expenditure items.

Source: Council of the European Union (2005).

the framework of a comprehensive reduction in subsidies, even if international competition is distorted by the subsidies of other countries. A more open approach to the world market would make it easier, not least for less developed countries, to gain market access for their agricultural products.

Structural policy

While agricultural expenditure is expected to decrease slightly in real terms up to 2013, the funds earmarked for general structural actions (to be known as "sustainable growth" in future) will increase significantly. Its share of the budget is to grow from 42.5 percent in 2007 to 45.5 percent in 2013. The funds planned for the subsection "competitiveness for growth and employment" (almost 7 percent of total EU expenditure in 2007; notably education and research promotion, and trans-European networks) are to be increased by an annual average rate of 7.5 percent to a share of 10 percent in 2013, a decision which has to be seen not least in connection with the Lisbon strategy. Expenditure in the subsection "cohesion for growth and employment" (formerly "structure and cohesion fund") is planned to increase on an annual average of 1 percent. Its share of total expenditure is to remain over the planning period at about 35.5 percent. The increase in the funds for structural policy is due mainly to the increasing integration of the ten new member states and the expected accession of Bulgaria and Romania during the planning period, which will mean an accentuation of the economic heterogeneity of the member states.

EU enlargement has meant a discernible decline in the average per capita GNI. Even so, if the existing assistance criteria – especially the regional per capita GNI of less than 75 percent of the EU average – are applied, few of the present development regions will have to forgo payments from the structural fund. Only a relatively small number will probably exceed the 75 percent threshold on statistical grounds alone. However, regions in Spain and eastern Germany, in particular, could be affected. Owing to EU enlargement, the total number of low income ("Objective 1") areas has risen significantly. Moreover, transitional regulations are planned which, on the one hand, restrict the level of subsidies to be paid to the recently acceded countries on the grounds that they presum-

ably will have a limited absorption capability and which, on the other hand, ensure that those regions already enjoying assistance funds can expect to do so in future. Accordingly, subsidies to the "old" member states, which are to continue receiving half of the funds from the structural fund, will decline only slightly in real terms.

The aim of the European structural policy is to assist regions with below-average economic strength and thereby foster convergence within the EU. As in all statutory promotion measures, however, there is also the danger that undesirable incentives are created and that a transformation to a more efficient structure (with respect to the allocation of capital and labour) is thereby impeded. Sometimes, too, there appears to be insufficient consultation on the various European development objectives, and there is the danger of assisting some regions several times over. It therefore seems sensible to submit the EU's regional policy to a critical examination, too.

Conclusion

The debate on EU finances has essentially raised questions about the extent of centralisation, redistribution within the European Union and the tasks to be performed at the European level. The principle of subsidiarity enshrined in Article 5 of the EC Treaty argues – in cases of doubt – in favour of the fulfilment of tasks at national level and therefore advocates restricting the volume of the EU budget. The objective of strictly reviewing individual elements of government expenditure and, in particular, of consistently limiting subsidies in order, ultimately, to achieve a consolidation of public finances and a reduction in the persistently large contribution burden within the EU should also apply to the EU budget.

The planned curb on agricultural subsidies is a step in the right direction. However, further reforms in this area are appropriate. Making the agricultural sector more open to international competition would be a case in point. One measure that could lead to a general reduction in subsidies and further limit the extent of the EU budget could possibly be financed jointly by the member states in a regulated manner.

In structural policy, too, greater attention should be paid to a transparent and efficient use of resources. With regard to supporting the catching-up process in the economically weaker member states, a strengthening of investment spending is especially important. Nevertheless, in this area too, attention has to be paid to the risk of promoting ultimately uneconomic structures and of resources simply being rechannelled. It is also typically the case that it is very difficult to reduce subsidies once they have been installed. A stronger focus on assistance for member states with generally weaker economies might improve the targeting of resources since the other countries would no longer take the indirect course of financing via the EU budget.

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