

EU BUDGET PRIORITIES, EXPENDITURES AND RESOURCES

Options for EU Budget Reform

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The prospects for a major reform of the European Union (EU) budget look bleak. The positions of several “net contributing” Member States indicate that the room for manoeuvre might be the smallest since long-term budgeting –today known as Multiannual Financial Frameworks (MFF)– was introduced in 1988. In a joint letter to the President of the European Commission, José Manuel Barroso, in December 2010 five Member States¹ asked for the EU budget to be frozen in real terms at 2013 levels over the next MFF. The letter was motivated by the strain on Member States’ public purses after the recent financial and economic crisis² and is, as intended, likely to set the tone for the negotiation process. Furthermore, the lateness of the Commission’s budget review communication³ implies a missed opportunity to discuss reform without disturbances from the negotiations on the next MFF.

It is generally agreed that the challenges, which require measures and funding at the EU level are growing in both number and necessity and that a much higher degree of flexibility is needed to make the EU better equipped at “expecting the unexpected”. It is also generally understood, not least among economists, that the EU is misallocating its resources and that a budget reform could potentially increase the welfare of EU citizens and do more to aid the EU in achieving its policies.

However, if there is to be any hope of coming to terms with the current status quo of the EU budget, the reform process will have to take into account the political-economic constraints that are blocking reform. A number of proposals have surfaced in the literature in recent years with the common factor of attempting to alter Member State incentives with respect to funding for certain EU policies.

1. Finland, France, Germany, the Netherlands, and the United Kingdom

2. The austerity argument was also present in the run-up to the 2005 MFF negotiations, only then it was mainly related to France and Germany’s problems with respect to the Stability and Growth Pact

3. European Commission, “The EU Budget Review”, COM(2010) 700 Final, Brussels, 19 October 2010

Understanding the EU budget deadlock

The literature offers several models for analysing the evolution of the EU budget⁴ but, in the short space available, three factors deserve a specific mention. First, as Member States view their contributions to the common purse as rivalling with national expenditure, they tend to seek to minimise their contributions while promoting policies that maximise their receipts from the budget, rather than supporting policies that would be motivated by their own merits (see below). The tendency of making sure that budget receipts are proportional to budget contributions is commonly referred to as *juste retour*.

A second factor, related to the first, is the relationship between the Common Agricultural Policy (CAP) on the one hand and the UK rebate on the other. Their perpetuation –due to path dependencies, vested interests and the diffusion of corrections to other Member States– has maintained a strong link between the revenue and expenditure sides of the budget. Therefore, it is not conceivable that a revenue reform would be likely without also simultaneously reforming EU expenditure (and *vice versa*).

A third factor is the budget reform of 1988, which amongst other things introduced Interinstitutional Agreements (IIA) between the Commission, the European Parliament and the Council – consisting of long-term budgeting and ensuring budgetary discipline – and a new Gross National Income (GNI)-based resource.⁵ The reform was successful in so far as it brought down the level of conflict between the Council and the European Parliament during annual budget negotiations. Furthermore, it also ensured that financing of the budget would be both stable and sufficient.

At the same time, the reform also implied that there would be little room for change during the frameworks’ duration. However, the most important aspect in terms of affecting current prospects for reform is the fact that the MFFs are decided on the basis of the unanimity rule. Hence, a consensus is required for both revenue *and* expenditure. This has effectively cemented the status quo between net payers and the net receivers. Dana Puia has offered the following description:⁶

Net receivers object to any reallocation of resources away from their individual interests, whereas net payers, anticipating net receivers’ power to attract additional resources, veto any increase in their financial burden. However, net payers cannot enforce a decrease of their burden, as this would be objected by net receivers. This leads to a status quo that is a stable equilibrium.

4. For a recent overview, see Dana Puia “The Dynamics of Institutional Change and the Case of the Budgetary Negotiations”, PhD dissertation submitted in November 2009, University of Pittsburgh, 2010

5. The Delors packages I and II were also instrumental in securing agreement on Maastricht and Economic and Monetary Union (EMU) in particular, as the then new European Community (EC) Member States showed reluctance due to fear of losing out from the deepening of market integration. As a consequence, funding for regional policy increased substantially. The EU enlargements of 1995, 2004 and 2007 further accentuated the division between net receivers and net payers

6. Puia, *op. cit.*, p. 55

This insight also points to the conclusion that net payers would block a decision-making reform that aims to soften the veto power on either side of the EU budget, as they would otherwise lose their control over expenditure increases. In sum, the scope for EU budget reform is severely limited.

Revenue and expenditure reform in the EU budget review

As part of the EU budget review, two research teams were commissioned to examine EU revenue and expenditure, respectively. The Ecorys, CPB and IFO team of researchers who examined EU expenditure employed a subsidiarity test, in which economies of scale and cross-border externalities were weighed against heterogeneity of preferences and political economy considerations (such as the disciplining role of competition or the relative power of lobbies at national and European levels).⁷ Based on the results obtained, the authors recommended a shift towards three “policy packages”: climate change and energy resources; knowledge and innovation; and common security and foreign affairs. They also concluded that aspects of Cohesion Policy (especially in the richer Member States), the CAP’s income and price support, and a large share of rural development funds were not compatible with the test. In the latter cases, the authors recommended that funds be either reduced or reverted to Member States; or in the case of CAP market interventions that funds be abolished altogether.

The researchers who were commissioned to study options for revenue reform presented two “straightforward” and two “more controversial” proposals for the 2013+ and 2020+ periods. In the “straightforward” proposal for 2013+, the Value Added Tax (VAT) resource would be incorporated into the GNI-based resource, along with the introduction of some form of generalised correction mechanism. For the “straightforward” 2020+ scenario, the group proposed to introduce progressivity into the GNI-based resource and to phase out the correction mechanism. In the “more controversial” proposal for 2013+, they proposed to have at least 25% of the budget funded by true Community-owned resources (e.g. flight charges or revenues from the Emissions Trading System) and to introduce some form of progressivity into the GNI-based resource. In the “more controversial” 2020+ scenario, the European Parliament would be given responsibility over EU revenue, the European Central Banks (ECB)’s seigniorage would replace the GNI-based resource, and a fiscal equalisation mechanism would be introduced.⁸

It is perhaps not surprising that the European Commission chose an approach that is politically more sensitive than the one proposed by the Ecorys team. Although many of the latter’s

recommendations are mirrored in the budget review due to the strong emphasis on Europe 2020, the approach with respect to, for example, the CAP is one of continuing down the reform pathway into which the EU has already entered, rather than one of significant spending cuts. However, the cautious approach does not extend to the revenue section of the communication, where the Commission argues rather strongly in favour of tax-based own resources. Taxes are not only seen as a cure to the Member States’ addiction to *juste retour* (and as a long-term solution to remove the many corrections that are currently in place), but also as a means to increase budgetary autonomy, efficiency and transparency.

Aside from the difficulties described in the preceding section, one problem with the Commission’s approach is that discussion on revenue reform is inextricably linked to the distribution of expenditure and is at the very least dependent on an expenditure reform that is lacking in the communication. Furthermore, while the proposed taxes may possess many advantages, any pro- or counter-arguments pale in comparison with the fact that several EU Member States have very clearly spoken out against them. In view of the unanimity criterion, the implication is that a proposal to introduce new tax-based own resources is unlikely to succeed *regardless* of how the expenditure side of the budget may change.

Reform options designed to alter incentives

In contrast to the content-driven reforms described in the preceding section, the reforms that will be described below attempt to alter Member State incentives so that they refrain from giving preference to policies that maximise their receipts from the EU budget.⁹ However, the implicit assumption in these models is that the EU budget would be refocused along the lines of those proposed by the Ecorys team.

A first option for reform is to introduce a multi-stage procedure in the decision-making process.¹⁰ The first stage of the procedure would have the Member States agree on the level and mechanisms required to finance EU expenditure; and the desired level of redistribution. Based on this agreement, indicative net balances that are inversely correlated to income levels would be calculated for each Member State. Next, decisions would be taken on expenditure *without* taking national net balances into account. Finally, some form of correction would come into play, ensuring that the agreed level of redistribution is fulfilled. Since the final allocation is fixed, Member States would be more inclined to focus on policies, as opposed to net balances.

7. Ecorys, Netherlands Bureau for Economic Policy Analysis (CPB) and Institute for Economic Research (IFO), “A Study on EU Spending: Final report”, commissioned by the European Commission, Directorate General for Budget, June 2008. Available at: http://ec.europa.eu/budget/reform/library/issue_paper/study_EUspending_en.pdf

8. Iain Begg, Henrik Enderlein, Jacques Le Cacheux, and Mojmir Mrak, “Financing of the European Union Budget. Study for the European Commission, Directorate General for Budget, Final Report”, April 2008

9. For a more extensive survey that also includes other reform options, see Friedrich Heinemann, Philipp Mohl, and Steffen Osterloh, “Reforming the EU Budget: Reconciling Needs with Political-Economic Constraints”, *European Integration*, 32(1), pp. 59-76, 2010

10. Angel de la Fuente and Rafael Domenech, “The Redistributive Effects of the EU Budget: An Analysis and Proposal for Reform”, *Journal of Common Market Studies*, Vol. 39, No. 2, pp. 307-330, 2001

A second option is the generalised but limited correction mechanism (GLCM).¹¹ Building on the generalised correction mechanism (GCM) proposed by the Commission in its 2004 own resources report,¹² the correction mechanism would only come into effect for expenditure that was characterised by unacceptable distributive effects. Hence, the correction mechanism would not apply for expenditure where redistribution was deemed desirable (economic convergence) or where the benefits were non-allocated (EU-wide public goods). It is argued that, whereas a large share of CAP expenditure is highly controversial, the convergence objective in Cohesion Policy is less controversial, as it can be motivated by the fact that some Member States gain more than others from market integration.

A third reform option is the proposal to co-finance the first pillar of the CAP; more specifically, to co-finance the direct payments. Co-financing would not only imply additional room for spending on other policies, but it would also affect incentives for the Member States whose CAP receipts currently outweigh their contributions, in so far as they would be less interested in pursuing the policy.

These reforms are not immune from criticism. Even if the richer CAP benefactors start to question the policy in the face of rising costs and deteriorating net positions, the Central and East European (CEE) Member States are expecting to get their share of the funds in the coming years. This would be a strong counterargument against the GLCM proposal: it identifies the CAP as one of the main culprits, which essentially is tantamount to explicitly saying that funding will be reduced. On the other hand, it has been pointed out that a shifting of money from the CAP to the cohesion funds might appeal to the CEE Member States, as they would be better off from such a move.¹³ Moreover, the GLCM can be calibrated so that the distributive pattern of the budget is reproduced.¹⁴

The focus on the CAP would also seem to speak against the co-financing proposal. It could be argued that some Member States would find it difficult to finance the policy, and in view of how the CAP has been financed up until now, it may also seem rather unfair to begin a transition towards less beneficial funding requirements at this point in time. On the other hand, co-financing could be modified in various ways so as to mitigate this problem. For example, Núñez Ferrer proposed co-financing direct payments in relation to the average gross value added (GVA) per farmer.¹⁵ Since the productivity of farmers is generally lower in poorer Member States, CAP support would end up where the needs are greater and at the same time impose a heavier burden on the richer Member States, thus creating the right incentives. While there is no guarantee that co-financing of the direct payments would affect incentives

in terms of reducing the focus of Member States on juste retour, it would at least imply that money could be shifted towards, for example, Europe 2020 priorities.

The proposals described here are by no means mutually exclusive. For instance, the Slovenian EU budget review taskforce proposed combining the GLCM with the multi-stage procedure.¹⁶ This would imply the same separation of expenditure as in the GLCM proposal. However, while there would be a simplified and single-phased procedure for expenditure with non-allocated benefits, adoption of the remaining expenditure would be carried out according to a variation of the multi-stage procedure. With the addition of co-financing the direct payments according to GVA per farmer, so as to come to terms with the uneven distribution of funds and to free up additional resources for other expenditure, this proposal may offer a way out of the net balances trap and over time allow for a more thorough reform of the EU budget.

11. Heinemann *et al.*, *op. cit.*

12. European Commission, "Financing the European Union. Commission Report on the Operation of the Own Resources System", COM/2004/0505 final, 2004

13. See Valentin Zahrt, "A Guide to CAP Reform Politics: Issues, Positions and Dynamics", *ECIPE Working Paper*, No. 3, 2011. However, it should be noted that Cohesion Policy in the richer Member States will probably have to be retained to some degree in order to make it a European policy, rather than a policy that is exclusively for the CEE Member States

14. Heinemann *et al.*, *op. cit.*

15. Jorge Núñez Ferrer, "Can Reforming Own Resources Foster Policy Quality?", *SIEPS Report*, 2008:3

16. Begg *et al.*, *op. cit.*, p. 205. A summary of the taskforce report is available at: http://ec.europa.eu/budget/reform/library/contributions/o/20071218_O_1_FR_en.pdf. See also Angel de la Fuente, Rafael Doménech, and Vasja Rant, "Addressing the Net Balances Problem as a Prerequisite for EU Budget Reform: A Proposal", *CESifo Economic Studies*, 56 (2), pp. 221-250, 2008