

Review of the EU Budget

Federal Trust Submission to European Commission - EU Budget Review 2008

Introduction

Many commentators and some national governments believe that the review of the European budget currently taking place will usher in an era of radical change for the Union's financial affairs. There is indeed a widespread sense among governments and voters that the European Union's budget is today largely a product of its past history, lacking contemporary legitimacy and only approximately related to the Union's present needs and challenges. Few would deny the appropriateness of a fundamental reconsideration of the intellectual and political basis on which the European budget currently stands. This submission is a contribution to such a reconsideration. It is divided into three parts: a summary review of the principal political premises which frame the budgetary debate; a brief analysis of current political and academic proposals for budgetary reform; and a package of reforms which, taken together, seek to address many of the voiced concerns about the Union's current budget.

Five General Principles Underlying the Debate

1. Most EU governments, particularly those from the bigger and more prosperous member states, are now much more inclined than they were twenty or even ten years ago to consider in their approach to the European budget the statistical relationship between their country's contribution to and its direct financial benefit from the EU budget. Any proposal which is likely over time to worsen this relationship for any individual country will be met with the greatest scepticism from the country in question. This attitude is rooted in both economic and political considerations. Economic growth in many long-standing members of the Union has slowed considerably since the 1980s. Higher net national payments to the EU budget mean less money to devote to pressing domestic challenges such as healthcare and education. It is on their success or failure in dealing with these questions that the electoral future of national politicians largely depends. Nor are national politicians any longer willing (or probably able) to advocate to their national electorates higher net contributions to the European Union simply in the interests of European solidarity. Other national governments and publics have in recent years followed the British example from the 1980s of seeking rebates on their net contributions to the European budget. No reform of the European budget will be politically conceivable for the foreseeable future in which the calculation of likely net contributions of the individual member states is ignored.

EDITOR'S NOTE

This is one in a series of regular *European Policy Briefs* produced by the Federal Trust. The aim of the series is to describe and analyse major controversies in the current British debate about the European Union.

We welcome comments on and reactions to this policy brief. Other Policy Briefs are available on the Federal Trust's website, www.fedtrust.co.uk.

Brendan Donnelly (Director, Federal Trust)

2. It does not follow, however, from the argument of the preceding paragraph that all or even most member states of the Union seek a “juste retour” from the European budget, if by that phrase is meant a precise equality between every country’s payments into and receipts from the European budget. The great majority of member states accept the proposition that the poorest member states should be net beneficiaries of the EU budget. The consequence of this is that the bigger and richer countries in general accept that they should be *to some extent* net contributors to the EU budget, as is the UK after its rebate. The extent of this contribution from wealthier states is and will remain a matter of controversy. Wealthier states will naturally wish to place limits on their per capita net contribution, and the domestic political advocacy of these contributions will be rendered much easier if it can be shown that it is primarily the poorer members of the Union who benefit from the net contributions of the richer member states.

3. Most member states, particularly those which are net contributors, are incomparably more reluctant than they were twenty years ago to see increases in the relative size of the European budget. This is partly due to domestic economic pressures, but partly also due to general doubts about the efficiency and effectiveness of European spending. Those countries that are reconciled to being net contributors are now much more eager than ever to be reassured that the budget to which they are net contributors is well spent, both in its day-to-day management and in terms of the political and economic rationale underlying its activities.

4. Although previous budgetary settlements were undoubtedly a reflection of the political and economic circumstances of their own time, they reflect a delicate balance of priorities, constraints and imperatives under which the individual member states act. Though the political figures may have changed in the intervening period, the spirit of the previous negotiated arrangements is the starting-point for the mindset of current political leaders. It is not possible to proceed with-

out some degree of continuity flowing from the previous budget settlements. In particular, national governments will be reluctant to accept that social or economic sectors which in their countries have benefited from the workings of the Union’s budget until now should be deprived of those benefits in anything other than the long term.

5. The governments of many, probably most, member states of the European Union believe that their national electorates accept or can be persuaded to accept at least existing, or even marginally higher levels of European spending if a plausible case can be made that the policy area covered by this spending will be more effectively, and ideally more cheaply, pursued at the European level rather than at the national level. There are policy areas, such as foreign and defence policy, environmental policy, industrial research, transport and cross-border infrastructure, where the European component of future effective policy-making is widely accepted by national electorates. A budget which better reflected this acceptance than the current structures would be politically much more congenial and accessible to voters throughout the European Union than the present arrangements.

The Current Budget Debate

There is tension, even contradiction, between certain of the preceding principles. Numerous proposals to reform the EU budget have been presented by a variety of academics, committees and member governments. This section groups those suggestions loosely into five groups of proposals, from the analysis of which the report later draws specific elements into a package of recommendations.

1. Proposals to increase significantly the overall size of the budget

Increasing the overall size of the budget could undoubtedly facilitate reform, creating scope to re-orientate expenditure between current areas of expenditure or towards entirely new policy initiatives. The EU budget spends a relatively small proportion of GDP given the range of na-

tional policies that have a potentially European dimension. An intellectually respectable case can certainly be made for the proposition that the current and likely future range of European policies can only be rationally pursued on the basis of a much larger central budget for the Union.

As a matter of political reality, however, proposals to increase the size of the budget are unlikely to receive support even from a majority of member states (much less from all of them), especially given the current composition of expenditure. National governments face tight budget constraints at national level and must contain deficits over time within the limits of the Stability and Growth Pact. The distinct tendency of the Union’s budget in the past decade has been for the member states to contain its size well below its theoretical limit of 1.27% of EU GDP. There are no conceivable circumstances in which a political consensus could be found in the foreseeable future for any significant upward revision of the European Union’s existing budgetary resources.

2. Re-nationalisation of elements of budget expenditure

A complete re-nationalisation of certain policies, in particular agricultural support, has been proposed by some to address the unequal burden of the European budget for net contributors. Previous agricultural reforms have shifted CAP spending from production support to direct income payments, creating a more transparent system, for which financial support could equally well come from national exchequers as from the EU. Re-nationalisation would free a large proportion of the EU’s budgetary expenditure to dedicate to new policy areas, but with the added advantage that it would potentially render less haphazard the current net contributions among wealthier member states.

Whatever its virtues, this proposal is unlikely to feature as part of the next budget package. Full-scale re-nationalisation of agricultural support would risk undermining the internal market in agricultural

products, with different structures of governmental aid to farmers, differing time-tables for this aid, and differing inflation rates, reinforced in some cases by currency movements. Re-nationalising farm payments would inevitably encounter great resistance from current beneficiaries of agricultural expenditure, whether from industrial groups, member states or individual farmers, who might fear a reduction in overall levels of support. Moreover, the recent entrants to the EU are not yet receiving the highest level of agricultural payments (as there is an ongoing transitional arrangement) and could be expected strongly to oppose full scale re-nationalisation.

3. Co-financing of budget expenditure

An extension of co-financing between the EU budget and national exchequers has been proposed for certain elements within the budget, in particular as part of a major restructuring of agricultural expenditure. This could be a useful reform for three reasons. Firstly, it would ensure a more equitable distribution of expenditure within the Union, because certain wealthy member states currently benefit disproportionately from direct payments to farmers. Secondly, it could be part of an overall new budgetary settlement whereby all or most wealthy member states end up as small net contributors, thereby giving scope to abolish the complex and opaque rebates system. Thirdly, it would make available significant resources to devote either to common policy goals or to increase the proportion of the EU budget spent in the poorer member states.

Since co-financing would not of itself change the level of overall expenditure on agricultural support nor endanger the continuation of the European dimension to agriculture; this reform would be less likely to be disputed by the agricultural sector. In addition to this, commodities prices, in particular global food prices, have recently been strong, and are expected to remain so for some years at least, a circumstance which presents a window of opportunity for fundamental reform of the EU's agricultural payments system.

4. Reform of rebates system

Rebates granted to the main net-contributor member states have been over the past twenty years an important concession to those member states that believed that the implicit budget bargain was unfairly structured to their disadvantage. This system has resulted in a complex payment structure that is little understood except by those with a specific interest in the field. A number of proposals have been made to abolish the system, and pressure in this direction has increased with the Union's expansion to 27 member states.

However, the small number of member states most directly affected is increasingly unwilling to bear the brunt of the cost of the European budget. Domestic political forces monitor closely the balance of net contributions, in such a way that it is politically unsustainable for a small number of member states to fund a large proportion of the EU budget. In isolation, the rebates system is unlikely to be discontinued, specifically because the net contributors believe the current budget to be unfairly structured. There might however be scope to link the issue of rebates with far-reaching expenditure reforms that result in most or all wealthy member states ending up as modest net contributors.

5. Re-orientation or a re-balance of expenditure across current policy areas or to entirely new areas

The current structure of budget expenditure does little to address the contemporary concerns of Europeans, a defect which adds to the sense that the EU is a remote project, doing little for the ordinary citizen. A fundamental overhaul of expenditure to address some of those concerns could have both symbolic and tangible effects on the relationship between the EU and its citizens.

The most substantive proposal for reforming expenditure has been made by the group of experts chaired by Andre Sapir in 2003. The Sapir Report (2003) has proposed re-orientating the EU budget towards meeting the 2010 Lisbon objective to create a dynamic knowledge-based

European economy. The report argues that the budget should be sub-divided into three discrete funds, focused on: growth and research; income convergence across the EU; and re-training for those workers adversely affected by economic change. The Sapir Report also recognises that should the overall size of the budget remain unchanged, agricultural spending would need to be radically reduced or perhaps wholly re-nationalised. As already argued, the last change (wholesale renationalisation) would be politically problematic, but the underlying philosophy of the Sapir report, namely that the goals of the European budget should be demonstrably "European" goals, is a politically highly attractive one. The proposition that the European Union's citizens in general would benefit from Europe-wide research projects, from greater income convergence and from retraining for those made unemployed by the economic pressures of enlargement and globalisation is one that might well find a receptive audience among politicians and electors throughout the Union.

Recommendations and Analysis

Recommendation 1:

The starting-point for a contemporary European budget should be the underlying philosophy (if not necessarily all the detailed suggestions) of the Sapir report, namely that the European budget should revolve around European solutions for European problems. In particular, a review should be conducted of the European Union's existing budgetary structure with a view to establishing those areas of present or future expenditure which are of 'general European interest' and those which are only of 'sectional European interest'. Those former policies would be those which promise to promote benefits tending to increase the welfare of the citizens of the European Union as a whole. Policies of 'sectional European interest' would be those which benefit only some parts of the European economy, whether geographically or otherwise defined.

Examples of policies of 'general interest' might be initiatives on the environment, elements of CFSP, foreign and pre-accession aid, research and development projects with spill-over benefits, the development of the common market, jobs and growth, and the management of migration. The CAP and cohesion policy would clearly fall within the 'sectional' character of expenditure. It should be the goal of the EU budget in the long term to move towards a budgetary system dominated by 'general' rather than 'sectional' European policies. 'Sectional' policies may have their legitimate place within policies of 'general' interest, but they must demonstrably contribute to the overall realisation of these policies.

Recommendation 2A:

Payments for preservation and management of natural resources (agricultural payments) should be co-financed, as cohesion policy is currently. Both policies involve a direct benefit to a member state, region or collective group within one member state, which is not shared equally across the Union as a whole.

Recommendation 2B:

In tandem with the extension of co-financing to agricultural payments, the complex system of rebates should either be abolished or substantially reduced to the absolute minimum necessary to avoid glaring anomalies.

The implications of recommendations 2A and 2B need to be examined together, since they constitute the fundamental financial aspects of proposed reforms from the perspective of key national governments. Meeting the financial concerns of these governments is an indispensable precondition for any durable reform of the present EU budget. The major implication of these recommendations would be to free a large proportion of EU budget expenditure (in the region of 18-20%), at least some of which would be available to spend on new, politically attractive and economically rational areas of European initiative. It should be stressed that poorer member states with large agricultural sectors would not necessarily lose by this proposed change since they

could expect to receive a substantial proportion of the restructured budget expenditure. It should also be stressed that, at least initially, not all the available new resources would need to be incorporated into the European budget. This incorporation would depend on the development by the Union of worthwhile policies of 'general' European interest on which the resources could be deployed.

A second implication of these twin recommendations would be to establish a greater balance in net contributions to the EU budget among all of the wealthy member states. This would reduce the extent to which certain wealthy member states with large agricultural sectors disproportionately benefit from current budget expenditure. Those member states would tend under the new system to gravitate towards the desirable position of becoming modest net contributors. If all or most wealthy member states were to end up as modest net contributors, there would be much less justification for a system of rebates within the budgetary arrangements. The abolition of the rebate system, or at the very least its radical curtailment, would of itself be a very welcome consequence of the proposed extension of co-financing to agricultural payments.

The precise impact of extending co-financing to agricultural expenditure on national budgets merits, however, in this context, further discussion. If national exchequers maintained under a co-financing system the same overall level of financial support for their agricultural sectors as they have enjoyed until now, this proposed reform would increase the level of public expenditure in those wealthy member states with larger agricultural sectors, which would in its turn significantly impact on their national budgets. The extent to which these national budgets would suffer a net financial loss (under this recommendation) would of course be lessened by the removal of the system of rebates, since it is those states that anyway largely fund the current rebate system. Furthermore, other benefits would flow from increased European expenditure in areas of new pri-

ority which might in future lower domestic expenditure on those policies in the countries affected. The real financial value of EU agricultural payments has in any case been falling over time and is likely to continue to do so. The burden of agricultural co-financing can reasonably be expected to be a diminishing one.

Despite these mitigating factors, on balance the wealthy member states with large agricultural sectors would face increased national budget expenditure as a result of recommendations 2A and 2B. In order to facilitate the adjustment to extended co-financing on European agricultural expenditure, this proposed reform might well need to be phased in over a number of years, thus allowing national budgets to adjust over time. This gradual process of adjustment necessary for the implementation of significant changes to the Union's budget is one powerful reason for Recommendation 3 below, which seeks to change the current system of the Union's medium-term financial planning, which is unnecessarily inflexible.

Recommendation 3:

The current system of the 'Medium Term Financial Perspective' (MTFP) should be reformed to facilitate necessary changes in the Union's budgetary arrangements, not least consistent increases in the proportion of the EU budget spent on policies of 'general European interest'. No single Medium Term Financial Perspective should last longer than three years.

Under the present budgetary system of the Union, every seven years a new Medium Term Financial Perspective is adopted; a process which substantially determines the Union's financial architecture throughout the next seven years. This is an incomparably longer time horizon than that adopted by any national government, and militates significantly against substantial budgetary reform or even refinement. After seven years, disequilibria in the Union's budget tend to become self-sustaining rather than self-correcting. The system is also vulnerable to the hazards of highly personalised negotiations in the European Council, when temporary alliances or congruence of in-

terest can set the terms of the European budget for many years to come beyond any real prospect of alteration. A shorter period for future MTFPs would ensure greater flexibility, and enable those participating in the financial negotiations to review progress towards desirable budgetary goals more regularly.

Above all, more regular reviews of the MTFPs would allow the continuing re-allocation of the Union's resources towards 'general interest' areas of highest political priority. These areas should reflect contemporary concerns of European citizens and member governments, in policy areas with a publicly demonstrable European dimension. This paper argues that policies to benefit the environment, to promote jobs and growth across the single market and to reinforce the Union's external role would be the most appropriate and politically relevant focal points for the future budget of the Union. A newly focused budget would send an important symbolic message that European leaders are listening to the concerns of ordinary citizens, and are responding by setting aside new resources to fund policies that help to secure a safer, more prosperous and environmentally sustainable future.

Recommendation 4:

It should be a specific goal of the new budgetary system that expenditures and national contributions should over time reflect a modestly redistributive philosophy for the Union's budget. When new financial perspectives are drawn up, the expected pattern of national contributions and expenditure should reflect this philosophy for the future and look to correct unexpected or perverse outcomes in the previous period.

The fourth recommendation is designed to ensure a continuing focus on the progressive and redistributive dimension of the EU budget when agreeing the multi-annual financial perspectives. If implemented, the reform package suggested in this paper would in any case devote more expenditure to 'general interest' policies, while spreading the net costs of the EU budget more widely. This development

should of itself lessen the political focus on the "juste retour" accruing to individual member states. However, the issue of respective national contributions is likely to retain high political significance, so that ensuring the budget's progressive dimension should not be left to chance. The workings of both 'general' and 'sectional' EU expenditure in the budget should be designed and reviewed in such a way as to reflect the modestly financially progressive principle, whereby poorer countries (in terms of relative levels of per capita income) are normally net beneficiaries, and the richer countries are normally net contributors, particularly in the longer term.

Conclusion

The above recommendations, taken as a package, would substantially alter the composition of the EU budget, in a manner consonant with the outlined principles drawn from the current political and economic debate. A clearer purpose for the budget, primarily to fund 'general interest' policies that benefit the majority of EU citizens, would emerge. This package would retain, and probably in the short term reduce, the current size of the budget. The net cost of the package would be spread between the wealthy member states with larger agricultural sectors, and those in receipt of rebates. The expenditure side would also be restructured to include new policy goals, but with careful consideration of the impact of these new policies on poorer member states. This focus on new, politically attractive policy goals is of crucial importance to building a coalition across member states and European institutions that favours substantial reform, ideally along the lines of proposals set out in this paper. Agreement, however, on theoretically desirable policy goals for the future European budget will not of itself suffice to promote reform. A politically and institutionally plausible "roadmap" is necessary to sketch out the implementing changes necessary for such reform to become politically plausible in the European Council. Any discussion of abstractly desirable goals for the Union's budget, how-

ever sophisticated, needs to be firmly grounded in an equally sophisticated analysis of the political and economic calculations which will lead 27 national leaders eventually to endorse reform. This submission has been an attempt to help the Union's national leaders to make these calculations in a way they would find palatable.

Brendan Donnelly and Mark Nevin