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Trapped in its own past: the EU budget in economic governance

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Key Points:

- If the negotiations on the next Financial Framework fail in spite of the neutral Luxembourg Presidency acting as an honest broker, the Union would be faced with an institutional crisis that would add to the problems in ratifying the Constitutional Treaty.
- The incompatibilities between the different Member States' positions make an only marginal shift from the status quo the most likely outcome.
- Given the pressures from a group of six net contributors who want to scale back the EU budget, the most probable scenario is that the overall budget will be lower than the Commission had proposed and that some of the increases for specific policies will be whittled down. The next Financial Framework for the EU would not differ much from the last one agreed in Berlin in 1999.
- As long as the Member States regard the Union as a club to which they pay subscriptions, they will expect a *juste retour* in the form of Community spending. Community policies then risk becoming vehicles for ensuring that club goods and services are distributed equitably, rather than being justified because it makes sense from an economic efficiency standpoint to assign these functions to the Community level.
- The historical determination of the EU budget with its focus on a narrow range of supply – side policies, precludes any real role in the Union's economic governance. On the contrary, the same issues will surface in six years time when the next circle starts.
- What is now needed is a full reappraisal of the purposes of an EU level budget and the setting in motion of procedures to bring about an extensive change in what ought to be a key instrument of EU economic policy-making.
- To break the cycle two ways forward are suggested: to build-in a mid-term review to the Financial Perspective, rather than locking-out change for seven years, and to establish a wide-ranging review of the EU budget beyond 2013 by the appointment of a *groupe de reflexion* with an unrestricted mandate to look into all aspects of the budget.

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By the end of the week, the negotiations on the next *Financial Framework* for the EU, covering the period 2007-13, are due to reach a conclusion. That, at any rate is what all (or most) parties hope and their optimism is under-scored by the fact that there is no obvious 'plan B'. Yet if the negotiations do fail, the Union would be confronted by an institutional crisis that would add to the malaise resulting from the problems in ratifying the Constitutional Treaty. The Luxembourg Presidency, which will chair the European Council in June 16/17, is seen as able to be neutral in the decisions and thus in a good position to broker a deal. By contrast, the next two presidencies – the UK and Austria – are among six Member States that have articulated a strong demand to reduce the scale of the budget by some 20-25% compared with the proposals put forward by the Commission in February 2004 in *Building our Common Future.* As such, they will find it much more difficult to reconcile the competing claims for reform of the budget.

This paper, while acknowledging that the negotiations will be dominated by the usual search for delicate compromises that leave every Member State only slightly aggrieved, argues that it is time to look beyond these narrow issues. The most probable outcome, whenever it is agreed, will be an EU budget that largely preserves the status quo, and it is politically unrealistic to believe that radical as opposed to trivial change is feasible. Nevertheless, it has to be recalled that the broad character of the EU budget was established nearly twenty years ago, for a more homogenous EU comprising 12 Member States and at a time when monetary union was no more than an ambition. The next section of the paper briefly reviews the issues that are likely to feature in the negotiations, as well as some that will not. The paper then discusses what role the budget could play in an increasingly integrated EU, and explores how such a shift could be engineered. Concluding comments complete the paper.

The short-term issues

The main challenges confronting the EU budget are, by now, well-known, not least because they tend to resurface every time a new agreement has to be reached. Indeed, a Martian public finance specialist who had last visited planet earth in the months before the 1999 Berlin agreement would find it easy to engage immediately in today's debate. Some countries argue that their net contribution to the budget is too high and that this has gone on for so long that a new solution is needed, especially to the perceived anomaly of the UK abatement. Most countries deplore the continuing dominance of the Common Agricultural Policy (CAP) in the EU's expenditure, but no-one can see an easy way of curbing it. The Member States, on the whole, are keen to prevent any increase in the economic significance of the budget, despite advocating policies from which they might expect to achieve a somewhat higher share of EU expenditure. Nor is there any real enthusiasm for altering the way the EU is funded, despite a general concern that the progressive shift towards the fourth resource makes accountability more difficult and, arguably, is at odds with the principle of 'own' resources written in to the Treaty (Art. 269 TEC).

Following the 2004 enlargement of the EU, there are new challenges and expectations, notably the implicit commitment to the new members to restore the funding for economic development (cohesion policies) that was whittled down at the 2002 Copenhagen summit. The re-launch in March 2005 of the Lisbon strategy also enters the equation, since the commitment to a 'Community Lisbon Programme' announced (paragraph 39.c) in the conclusions of the 2005 spring European Council implies spending on Lisbon-related measures. However, beyond identifying these as being 'in the interests of growth and employment, taking account of the need for policy convergence' it is a matter for speculation what will actually be supported. Efforts are now underway to portray the Structural Funds as Lisbon-friendly, and much of what is under the heading of 'competitiveness for growth and employment' is considered to be Lisbon-related. The latest indications are, though, that both these areas will be cut if the Luxembourg Presidency's attempt at brokering a compromise succeeds.

There is, on the whole, agreement that the Union needs to spend more on two areas. The first is what is now called 'citizenship, freedom, security and justice', much of which will go on assuring the internal security of the EU, though even the Commission proposals envisage this budget line rising to barely 2 percent of the total by 2013. Second, the proposed new budget line for 'The EU as a global partner' brings together not only EU external security, but also development assistance and other tasks. Again, however, there is a gulf between proposed means and likely demands: the Commission proposals would assign roughly 10 percent of the budget to this policy area, equivalent to just over 0.1 percent of EU Gross National Income (GNI). Yet on just one component of this policy area, the contribution of EU Member States, collectively, to international development aid, the gap between the actual figure of just over 0.3 percent of GNI and the UN target of 0.7 percent is four times what the budget will assign for all 'external' policies. Only Denmark, Sweden, Luxembourg and the Netherlands are exceptions because they are already above the target of 0.7 percent.

In a recently released briefing note (May 5), the Commission mounts a defence of its proposals by arguing that a cut to 1 percent could only be achieved by making hard choices about policy priorities. The debate is complicated by confusion about the arithmetic. The group of six initially let it be believed that it was calling for appropriations for payments to be held at 1 percent (and thus 0.24 percent of GNI below the own resources ceiling) although the letter to Prodi in fact referred to the (then) current level of spending rather than explicitly stating 1 percent. Subsequent informal clarifications signalled that the demand referred to appropriations for commitments, and since the latter are typically higher than payments, the gap between the six and the Commission proposals (for appropriations for payments to increase to 1.15 percent of GNI by 2013) is larger than at first sight.

According to the Commission briefing note, it implies 'a 20% cut from the Commission proposal for 2007-2013: € 198 billion over the period, or € 28 billion a year in terms of commitments'. While it is inevitable that the customary horse trading will whittle down the gap, the Commission is surely right to argue that it cannot be achieved by cuts at the margin in major spending commitments or by dropping peripheral policies. Instead, as the Commission demonstrates, the strategic choice is likely to lie between persevering with traditional policies such as CAP (for which, it should be recalled, a deal has already been done) and cohesion (where the new members believe they have been given firm promises), and supporting the Lisbon agenda.

The Commission has also proposed a generalised correction mechanism which would have the effect (according to a simulation by the Commission) of cutting the net contributions of four of the members of the group of six and would also benefit Italy, but would mean an increase of 0.2 percent of GNI in the UK's net contribution. Yet the change would scarcely alter the net position of the new members, several of which were dismayed to find that they had to pay towards the abatement. Nor can the UK which, after all, retains a veto, be expected to support the change, though it faces an intriguing political calculation of what is at risk from a 24:1 stand-off. Equally, the UK knows it possesses a very powerful bargaining chip.

Broader considerations

Many of the problems in the immediate negotiations stem from an ambivalence about the underlying purposes of the EU budget. A persuasive explanation for why net contributions are so contentious is that so long as the Member States view the EU as a club to which they pay subscriptions, they will expect a *juste retour* in the form of Community spending. Community policies then risk becoming vehicles for ensuring that club goods and services are distributed equitably, rather than being justified because it makes sense from an economic efficiency standpoint to assign these functions to the Community level. The result is the often Kafkaesque manoeuvring to 'bend' spending to ensure that some countries receive a little more. Witness the range of corrective devices agreed at the Berlin European Council meeting to attenuate the net contributions of Austria, Germany, the Netherlands and Sweden. But it is also more insidious: it is the choice of policies which determines net contributions, yet to correct the imbalances it is the same policies that then have to be curbed. This runs contrary to the usual approach to public expenditure which is to start by deciding what policies matter then raising the revenue needed to enact them.

In this regard, the Commission's generalised correction mechanism may be a somewhat fairer system than the current UK abatement and the partial abatements conferred on four other Member States. A key measure to reduce the net contributions of the four mentioned Member States is that they only pay 25 percent of their ex-ante contribution to the UK abatement: a sort of rebate-squared. But the proposed correction mechanism does not deal with the underlying problem, namely the uneven incidence of spending. Rather, such correction mechanisms are unsatisfactory fudges: in essence they start with decisions on policy, and then subvert those decisions. *Juste retour*, in other words, is allowed to influence decisions based on political priorities and economic criteria about what the EU should do.

More fundamental questions about the function of a 'federal'-level budget in an economic and monetary union are simply off the agenda. Both theory and practice elsewhere suggest that there are good grounds for having at least some capability for budgetary stabilisation policy at the same level of governance as monetary policy. There are also sound reasons for assigning particular supply-side policies to the supranational level. However, there is no evidence that such considerations enter the debate on the EU Financial Framework.

It will not be easy to find a solution to these dilemmas. Many Member States undoubtedly find it convenient to confine the haggling to the difference between 1 percent and 1.15 percent, or to the merits of a little more on research, a little less on the CAP or restrictions on eligibility for cohesion policies. Battles about net contributions or being seen to win support for favoured policies are strategies that allow national politicians to claim victories. But what is lost in the process is any disposition to look outside the narrow confines of the immediate negotiations.

Consider net contributions again. In nation-states, very large redistributions occur, both across geographical boundaries and between social groups, as a result of the inter-play between tax and expenditure systems, often with relatively little transparency. Residents of rich areas know they subsidise those in poorer areas, but rarely by how much. Even where there is an explicit horizontal scheme such as Germany's *Finanzausgleich*, it only captures a proportion of the net transfers. The principles behind such transfers are not that complicated: equity and ability to pay. Equity, broadly, is the presumption that residents of a polity should be entitled to similar levels of public services, even if the local economy in which they live is less prosperous than other parts of the same polity. The ability to pay principle relates the contributions to public finances to the prosperity of the contributor and generally aims to charge progressively more to the richer. But in the EU, gross contributions are calibrated to be equal proportionally to income: everyone pays, roughly, 1 percent of GNI.

Is change feasible?

At one level, all this is readily explicable: the EU is neither a state nor a federal tier of government, as in the US or Germany. Consequently, what might be logical from a narrow economic perspective (top-down stabilisation policy, for example) is not just beyond what is politically acceptable, but invites alternative solutions. Part of the rationale for the plethora of co-ordination processes in the EU is that they substitute for having a single authority at EU level responsible for major economic portfolios.

The question that then arises is whether there is a means of breaking the cycle. The Constitutional Treaty has little to offer in this regard because the relevant articles from the Treaty on European Union have been transferred virtually unchanged. Paradoxically, though, most of the seemingly intractable problems around the budget could be resolved pretty straightforwardly and without resort to major constitutional changes. Whether it is finding novel means of funding the Union, developing a mechanism to correct excessive net contributions or deciding on policies that should be administered at EU level, a range of technical solutions could be envisaged.

An illustration is how to establish how much each country should pay into the budget and expect to receive in return. Applying the ability to pay principle, Member States could easily be grouped into three or four bands that would determine their gross contributions to the budget: these could, for instance, be set at 0.7 percent, 1.0 percent and 1.3 percent of the respective Member State's GNI based on thresholds for prosperity. Then, target receipts for each Member State from different policies could be set, as happens already with the undertaking to the new members that they will receive up to 4 percent of GNI from cohesion policy. The combination of these revenue and expenditure limits could then replace the current obsession with net contributions. Negotiations would, no doubt, be just as tough, but the advantage would lie in having an overall net position that was the direct result of political agreement, rather than the much more haphazard incidence of policies.

The trouble though is that there is no easy way for more imaginative thinking on the budget to catch a political wave. Instead, the current seven-year cycle comprises two years of posturing and demands, last minute agreements at a hotly contested European Council at which horse-trading and side payments dominate, followed by five years of running the system and stoking-up grievances. In this model, strategic thinking about the purpose of EU spending and about the role of supranational budgetary policy in the overall economic governance of the Union has no opportunity to break into the political agenda.

To avoid the cycle repeating itself, two ways forward can be advanced:

1. The first suggestion would be to build-in a mid-term review to the Financial Perspective, rather than locking-out change for seven years. For various reasons, the coming period is one of transition, with a further enlargement scheduled for 2007/8 and the prospect of negotiations with several additional prospective candidates, so that such a break-point would be prudent in any case. To assuage the fears of those who fear indiscipline, the scope for change might be narrower in the review than the whole Financial Perspective, with some ground rules about what can or cannot be re-opened.
2. The second suggestion is that there should be a wide-ranging review of the EU budget, focusing on its role in EU economic governance and that the Member States announce a commitment to a fresh approach, based on the review, beyond 2013. Such a review might consist, in the first instance, of the appointment of a *groupe de reflexion* with an unrestricted mandate to look into all aspects of the budget. The review would then be taken forward by exchanges among the EU institutions with a few to preparing a blueprint for a political decision in 2011/12. It is essential that nothing should be off-limits in such a process if it is genuinely to be effective, but also important that it be seen as politically necessary in a way that allows enough of the parties concerned to support it.

Concluding comments

The incompatibilities between the different national positions make the most likely outcome a marginal shift from the status quo with the concomitant risk that none of the underlying issues will be settled. The corollary is that precisely the same issues will resurface in six years time when the next cycle starts. Given that the character of the EU budget was largely settled in 1988, for a

Union of 12 Member States, this would be decidedly unfortunate. By 2013, the number of Member States will be at least 27 and the euro will be a teenager. Is it, then, realistic to restrict the EU budget to 1 percent of GNI spent mainly on just two supply-side policies?

On the face of it, the detail of the latest budget proposals from the Commission (released on April 6) promise significant changes, with spending on CAP due to shrink marginally by 2013, the cohesion budget set to rise by a third, while that on 'competitiveness for growth and employment' is set to increase by nearly 200 percent, with large increases on research spending and on transport and energy. Big jumps are also envisaged for the 'EU as a global actor' and for the heading of 'citizenship, freedom, security and justice'. Given the pressures from the group of six, the most probable scenario, however, is that the overall budget will be scaled back and that some of these increases will be whittled down. As a result, the next Financial Perspective would not differ that much from the one agreed in Berlin in 1999 that is currently in force.

While many will, no doubt, claim that significant progress has been made, the argument of this paper is that adjustments at the margin, even if some of the planned big increases in expenditure on selected budget lines (such as for transport) survive the negotiation process, will not fundamentally alter the character of the budget. In particular, this outcome would maintain the focus of the budget on a narrow range of supply-side policies, but would preclude any real role in the economic governance of the Union. Instead, what is now needed is a full reappraisal of the purposes of an EU level budget and the setting in motion of procedures to bring about extensive change in what ought to be a key instrument of EU economic policy-making.