



A Memo on the European Budget

by Stefan Collignon

With the enlargement of the European Union by ten new member states, budget negotiations over the next Multiannual Financial Framework are inevitably going to become more complicated and complex. This is not only so because with the new member states the heterogeneity of the European Union increases in terms of economic conditions, per capita income, policy preferences and cultural values and orientations, but also because the complexity of negotiated solutions between member states increases exponentially with the number of negotiators. Sustaining the European Union's capacity to act therefore requires not only new financial engineering, but also a fundamental rethink of the European Union's economic governance and of the financial means and resources necessary for achieving its objectives. I will first deal with the status quo and then trace some possible ideas for reform.

I. The "Acquis" and its Difficulties

1) The European Budget

The European Union budget rules are enshrined in articles 268 to 280 of the Treaty of Amsterdam. The blocked European Constitution dealt with them under Title VIII. Both operate from the principle that revenues and expenditure must be kept in balance. The budget is proposed by the Commission, and approved unanimously by the Council after consulting the European Parliament. The annual European Union budgets are constrained by the Multiannual Financial Framework, an inter-institutional agreement between European Parliament, the Council and the Commission, whereby the main budgetary priorities are agreed in advance over a

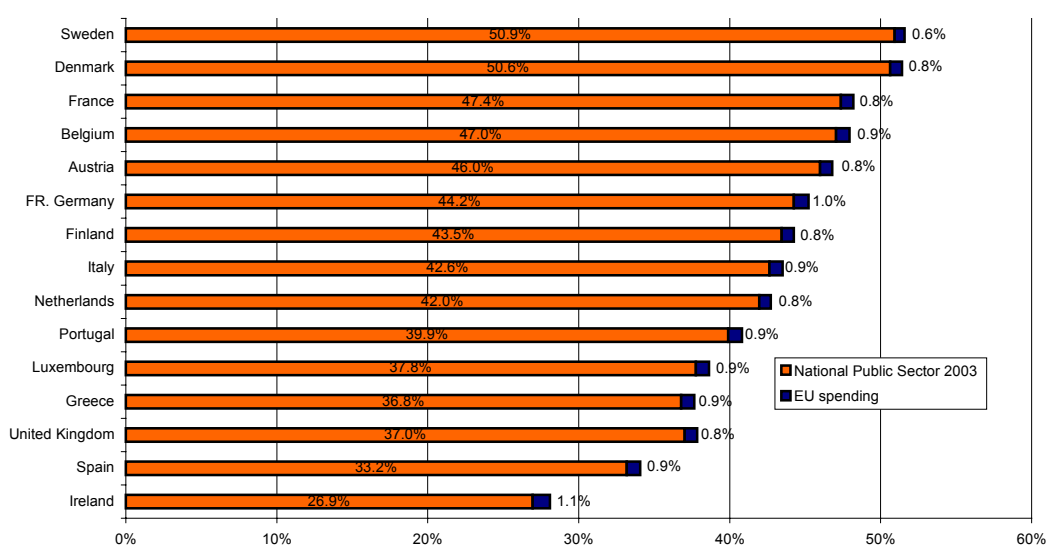
period of five years and enshrined in a framework called the Financial Perspective. The last Financial Perspective (Agenda 2000) was agreed in Berlin in 1999 and runs until 2006. The Financial Perspectives indicate a maximum expenditure under each of the established headings in terms of million of euros and as percentages of Community GNP. Between the authorised own resources ceiling and actual payment appropriations there is a margin for unforeseen expenditure that provides room for adjustment in the resources available for the Community. In recent years actual expenditure has usually remained around € 1 billion and well below the ceilings of payments agreed under the Framework.

The main headings for community *expenditure* of € 77.2 billion in 2003 were as follows:

- 1) Agriculture: 45%
- 2) Structural and cohesion funds: 34%
- 3) Internal policies: 7%
- 4) External action : 9%
- 5) Administration of all institutions 5%

The European budget is insignificantly small relative to the sizeable public expenditure by nation states. As a consequence, the integrating force of the EU budget is marginal at best.

Figure 1. Total Public Spending as percent of GDP



On the *revenue* side the European Union has three main sources of funding:

- 1) Traditional own sources (agricultural duties, sugar levies, customs duties, etc.) : 11.9% ;
- 2) A percentage of common VAT base: 28.8%;
- 3) Payments from member state Treasuries to the European Union budget based on gross national product: 59.1%.

In addition there is a correction of British budgetary imbalances (the UK rebate) with a net effect of 0.2% of EU GNP, although this rebate is unequally financed, with France and Italy paying more than half. Hence more than ninety percent of the European Union budget is financed via national contributions linked to national Treasuries, rather than from taxes levied on a European Union-wide fiscal basis. This arrangement makes the European budget highly vulnerable to nationalistic discourses of “*juste retour*” and “I want my money back”. This system therefore risks to systematically undermine European integration and weaken the European Union’s capacity to act on behalf of the collective public interest, given that collective action problems increase with the size of members in a group. The blocked constitution stipulated in art. 53 “the Union shall provide itself with the means necessary to attain its objectives and carry through its policies.” Doubts are justified that the present system is capable of doing this.

Furthermore, it has been argued that the potential effects of applying the Common Agricultural Policy at the established terms to the new accession countries would quickly destabilise the European budget. For this reason a fixed ceiling has been agreed at the Brussels European Council in 2002.

2) *Aims and objectives of the European budget*

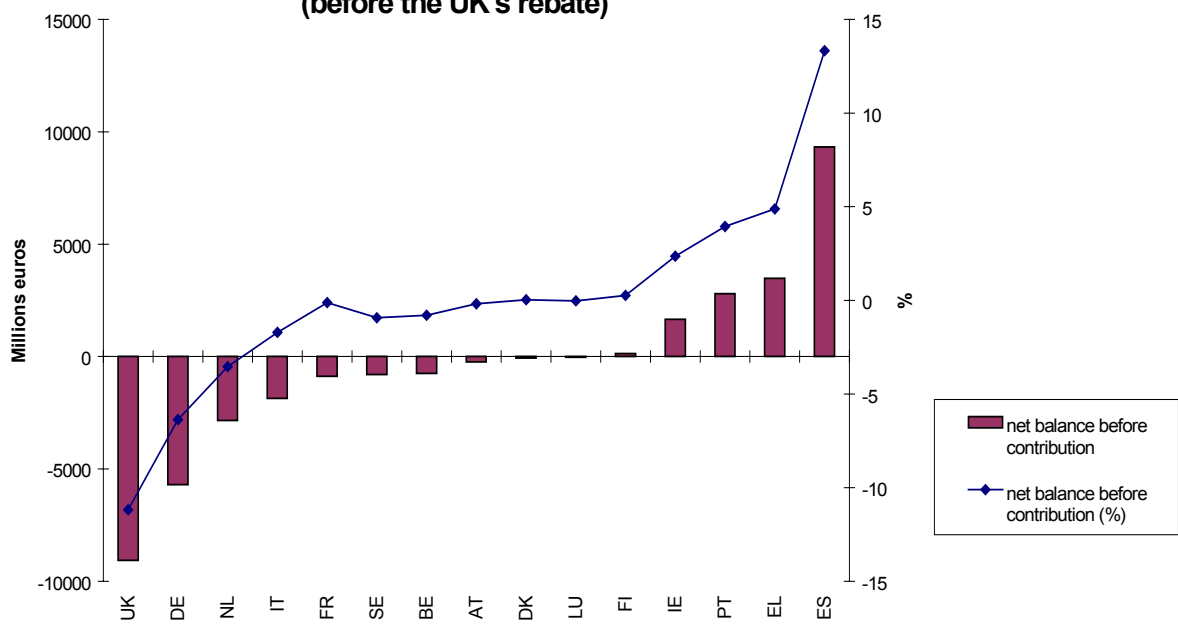
The aims and objectives of the EU budget can be assessed with respect to the three classical functions of public finances: the allocation, redistribution, and stabilisation function.

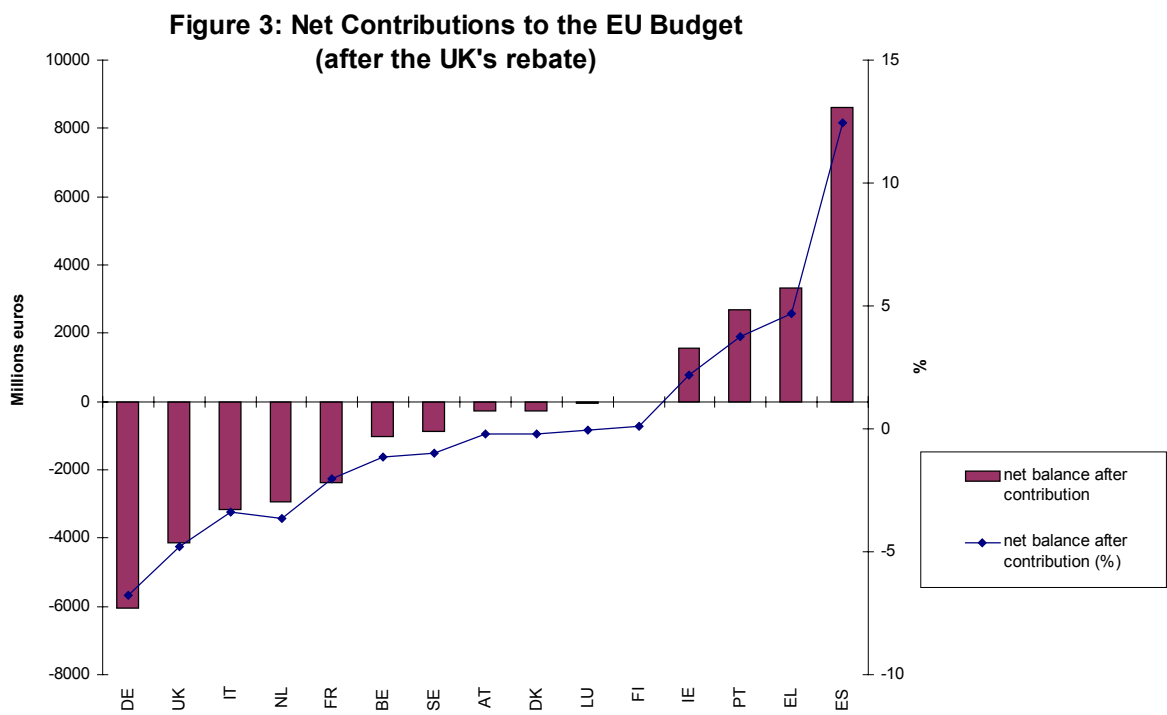
The *allocation function* of public goods is essentially in the domain of national governments who spend approximately 50 percent of GDP. The small part of public goods allocated by the Union is focussed on agricultural and structural aid. The purpose of the Common Agricultural Policy was to facilitate structural change in a period of rapid industrial change after World War II and to preserve food security. The first motive may have lost its importance in recent decades, but it will remain

relevant in accession countries. The second motive is gaining in importance as food supplies in a rapidly growing world population will become scarcer.

The *redistribution function* is mainly exercised through the operations of the Structural funds and Cohesion funds. Their purpose is to facilitate cohesion, meaning the catch-up growth in low per-capita-income countries of the European Union. They have national and regional dimensions, which is of a particular interest when national Treasuries are trying to reduce their net contributions. As a consequence the redistribution function in the European Union, works primarily through the net contribution of member states. 11 countries pay net transfers to the three poorest member states (Greece, Portugal and Spain) and to Ireland, which has moved from one of the poorest to now being the third richest country after Luxembourg and Denmark.

**Figure 2: Net Contributions to the EU Budget
(before the UK's rebate)**





Again, this system makes it sensitive to nationalistic and communitarian discourses (“we pay for them”), rather than integrating citizens into the larger Union. The redistribution function does not have regressive income tax effects, which are prevalent within most member state countries. There is an inherent injustice in this

system: why should a low-income single mother in Germany pay for benefits accruing to a Portuguese or Greek millionaire?

Finally, the *stabilisation function* of public finances also operates in the European Union, especially in EMU. Given the fact that most of public spending occurs through national budgets, this function works primarily through national policies. Yet, as the theory of fiscal federalism has clearly established, macroeconomic stabilisation is a public finance function that needs to be exercised at the centralised level of a monetary economy. Consequently, the stabilisation function of public finance is today enshrined into the Stability and Growth Pact, with all its problematic features, and not in the domain of the EU-budget.

3) Budget Process

The major budgetary event in the European Union is the negotiation of the Financial Perspective given that this sets the ceiling for six subsequent annual budgets. However the fact that revenue is nearly exclusively supplied by member states and the European Union has only very limited amounts of own resources, leads to three detrimental consequences:

- 1) The unavoidable tendency to balance net transfers across member states and the unanimity rule in budget policy decisions gives every country a considerable amount of leverage. EU therefore privileges *veto players*. Also, as the fallout from the failed Brussels summit on the European Constitution in December 2003 shows, budgetary decisions may often become linked to other political events.
- 2) *Log-rolling* is a frequent phenomenon because member states find it difficult to achieve consensus on a single item. They therefore trade one set of policies against other financial flows (ex. Structural funds against CAP). But given the heterogeneity in structural conditions, this may lead to encrusted coalitions that can hold-up the policy processes in many fields.
- 3) The present budgetary system provides a bias in favour of nationalism and European disintegration rather than strengthening the European Union institutions and making them capable of acting coherently with their own resources. The reason is that in a large group of independent and voluntary cooperating partners, *collective action* problems and temptations for *free-*

riding become dominant. As a consequence, funding decisions are not taken at the European level in the interest of the Union, but they are dominated by partial national interests.

II. Ideas for Reform

1) Refocusing the European Budget

The present European Union budget procedure is inconsistent with the current state and future prospect of European integration (Buti and Nava 2003). Three failures are most evident:

- 1) Spending is heavily tilted towards the support of a declining sector, agriculture.
- 2) It is almost impossible to reallocate spending across time and across policies.
- 3) The budget's size is unrelated with the goals of the Union.

It is imperative to transform the European budget into an instrument that provides the Union with the means, to pursue its objectives so that economic policy of the Union is consistently defined and put into practice.

Several proposals have been made to refocus the European budget. At the centre stand requests to reduce the role of *Common Agricultural Policy* in order to make room for other tasks and objectives. The welfare loss of the Common Agricultural Policy for the average European Union citizen is 150 euros per annum in terms of direct budget transfers plus 250 euros in terms of price distortions with respect to the world market. It is often argued that agriculture would be better dealt with as a national policy given the structural differences in the economies of member states. However, while it is true that the CAP has been motivated by facilitating structural change after the war, one should not under-estimate the fact that it also helped to integrate and Europeanise one of the potentially most reactionary and nationalistic sections of Europe's population. Rather than defending local interests, farmers had their interest "in Europe". This argument may have lost force with the shrinking farm populations in the richer EU-countries, but it may become again highly relevant for integrating parts of the population in accession countries. Furthermore, the

protection of food sufficiency and security may well have a price that is worthwhile paying in the long run, in an age where genetically modified food is suspicious to many Europeans and health hazards are quickly spread across the globe.

A similar argument applies to *structural funds and cohesion policies*. No doubt improving living conditions of European citizens especially in the less developed parts of the European Union is one of the major objectives and justifications of European integration. Efforts to facilitate economic catch-up are therefore consistent with and justified by the broad policy objectives of European unification. However the fundamental question is whether regional policies should be conducted in terms of nationalistic/communitarian or individualistic/liberal principles. Today, convergence is the major instrument in the redistribution function of public finance at the European level. What is the appropriate level for redistribution policies? Should it be across countries or regions or rather across citizens? A modern approach would recommend the redistribution policies across citizens, as reflected in progressive tax systems. However, given that the dynamics of economic development inevitably create agglomerations of economic centres, which may also be affected by negative shocks, regional policies may supplement the distribution policies focused on individual income. A nationalistic approach claims that efficiency may be better obtained by allocating money at the national rather than European Union level (principle of subsidiarity). This approach overlooks the fact that often regional inequalities in Europe are as much within countries as they are between countries. The only argument in favour of a national bias is that this is the only existing institutional framework where democratic options can be exercised. But even this is doubtful, as I will show below. One way out would be the creation of a democratic European Constitution, which would open the way for making democratic decisions at the European level. The nationalistic argument would then lose its weight.

The European budget will also need to be profoundly refocused with respect to *new tasks*. New areas are enlargement, a common foreign and security policy, establishing an area of freedom, security and justice and promoting sustainable growth. With the exception of enlargement, most of these policy areas are insufficiently reflected in the discussions of the European budget. Especially the common foreign and security policy will require larger investment and expenditure on peace keeping and developing modern weapons and communication systems. Protecting external frontiers, asylum and immigration policies are also tasks of

common interest and the public expects the European Union to assume responsibility in these matters. Finally, since the Lisbon summit improving economic growth has been related to the development of an integrated knowledge society. A target was set to spend 3 percent of GDP for research and development. The EU is still far away from this target and the European community budget could play an important role in facilitating the achievement of this objective.

2) Fiscal Federalism

It is useful to think of any policy as a public good. Fiscal federalism is a theory to determine which collective good should be provided by which level of government. The fundamental principle of fiscal federalism states that the benefits and incidences of specific policies should be judged with respect to where the citizens live that are affected by these policies. Local public goods are affecting people only at the local level, national public goods concern all people across the country, European public goods are those which affect all European citizens. In recent years it has become customary to discuss European constitutional issues in the context of assigning competencies rather than goods to different levels of administration and government. But the competence question only makes sense if it is judged by the incidence of benefits to citizens. With respect to the budgetary process this implies that the European budget must start with the objectives of the European Union and define the policies that it wishes to pursue. It should then raise the necessary financial means. This then requires a debate whether the financial means and objectives are properly balanced. In other words, the approach cannot be to start with a limited amount of finance (for example 1.02% of GDP) and then allocate these funds to possible objectives. The principle of fiscal equivalence stipulates that the consequences of policy choices by one jurisdiction must not interfere with those of another, i.e. that they do not cause unaccounted externalities. This may justify occasionally reallocating certain functions of government spending to a national or regional level. But the main problem in the European Union today is the opposite: national government decisions have consequences in other jurisdictions which need to be internalised either through voluntary cooperation amongst governments (intergovernmental approach) or, failing that, through centralisation and delegation to a European institution.

However which functions are to be centralised depends partly on the nature of public goods (Collignon 2003). There are some public goods, called *inclusive* public goods, where the nature of externalities is such that they create an incentive for governments to coordinate. This is typically when network externalities are creating a positive sum gain. This may be the case of many of the knowledge society objectives formulated in Lisbon. However a large range of other public goods (*exclusive* goods) are subject to the logic of collective action. The incentives inherent in these goods are such that free-riding will inhibit their optimal provision. Each country will individually have an interest to do the opposite of what might be collectively desirable. Under these circumstances there is a need for centralisation in order to ensure coherent provision of public goods that raise general welfare.

The literature of fiscal federalism has shown in particular that the *stabilisation function* of public finances requires full centralisation. This poses new questions for the viability of the Stability and Growth Pact. However, from the point of view of budget process discussed above, it is also becoming apparent that the present system is turning the European budget itself in an exclusive public good. Instead of leaving the ultimate decision on the European budget with national governments who fail to cooperate, or do so only insufficiently, it may be necessary to delegate the budget process to the European level. This would imply that in order to prevent gridlock and inefficient finance solutions, the European Commission should propose a budget that will subsequently be legitimised by the European Parliament as ultimate authority rather than by the Council. Thus, art. 54.2 in the blocked Constitution should be changed to say that not “the Council of Ministers shall lay down the limits of the Union’s resources”, but the European budget laws for the Multiannual Financial Framework and the annual budget “shall be adopted by the European Parliament with the participation of the Council of Ministers.” This of course means the European parliament would have the power to raise taxes and to raise financial resources. The present process whereby the European Parliament is only able to vote and decide on the small part of non-compulsory expenditure is totally inadequate for the tasks of the Union and incompatible with democracy. The parliament needs to be given full budgetary authority on both income and expenditure side.

This does not imply that national governments do not have a role in the European budget making process. In fact as Buti and Nava (2003) have suggested, it may be

recommendable to establish a properly integrated European budget system. So far European Union and national budgets have remained separate. Fiscal policy in the European Union is the outcome of two non-coordinated sets of instruments: the European Union budget on the one hand and individual national budgets of fifteen or soon twenty-five member states. However, stronger coordination of these different budget policies are recommendable both from the point of view of stabilisation policy as well as from the point of view of supporting the general objectives of the European Union. For example, the objective of increasing research and development to three percent of gross domestic product may well require a combined approach of national and centralised European expenditure for costly technology projects. The appropriate tool to create such integration of a European budget system would be to develop the Broad Economic Policy Guidelines and to integrate the Multiannual Financial Perspectives with the national Stability Programs. This would allow coherent European-wide stabilisation policies that take into account the allocation function of public finances through national governments, while simultaneously defining a consistent aggregate policy stance that matters for stabilisation purposes. In Collignon (2003) I have also shown that by defining the aggregate fiscal policy stance on the European wide basis, different mechanisms of allocating budget shares to national governments can be found. One of them being the method of assigning tradable deficit permits as public authorities at different levels.

3) *Democracy*

The European Union is built on the principle of democracy. However the progress of European integration of over half a century with its strong intergovernmental component has turned the European Union into a form of governance that has more resemblance with the *ancien régime* than with a modern democracy. In a modern democracy citizens are the ultimate authority. Yet, in the European Union most policies, including budget decisions, are subject to the scrutiny and accountability to governments rather than to citizens. It is not true that representation through democratically elected governments automatically turns the European Union into a democracy. For in a democracy, citizens must have an opportunity to express their collective preferences for relevant policies and to change these orientations at

regular intervals. This is not possible in the European Union, given that the European Parliament has only limited budgetary power while the essential decisions are taken at the Council. The Council is in essence an “eternal parliament”, without general elections. Changes can only take place as and when *national* elections occur, but the entire group of citizens that is affected by *European policies* can never express and decide on its preferences. This has as little to do with democracy, as a parliament that never calls general elections and only replaces its members through by-elections.

If the European Union wants to be able to take effective decisions to increase the welfare of its citizens and to maintain its capacity to act within the union and internationally, it will need to have a proper government that is accountable to European citizens for the policy objectives that it pursues. Such a European government needs to have the means and the authority to decide on the resources that are necessary to implement its objectives. In this respect it may be recommendable to introduce a *European tax*. The tax base should be related to the transfer of goods and services within the European Union and could possibly be a proportion of VAT. Even if the tax is collected by national governments, the tax base must be independent of national treasuries. The tax raising authorities must be accountable to the constituency of European citizens although it is imaginable to impose a maximum ceiling on such tax raising powers.

Conclusion

The budget negotiations about the next Financial Perspective will prove more difficult than ever before. Today’s budget system carries the risk of reinforcing the centrifugal forces in the EU. The Union’s financial governance raises fundamental constitutional issues. A full political union is required to overcome them. These ideas may still appear far going and utopian. However they are not only consistent with the theory of modern democracy to which all European citizens and member states seem to subscribe, but they are also a necessary step in order to ensure that that the European Union will be able to pursue its objectives and maintain its internal coherence and legitimacy. Failure to progress in this direction is likely to lead to the gradual and systematic disintegration of fifty years of European integration. Europe

now has the option of progressing to a European Republic or falling back into a period of warring states.

References

Buti, M. Nava, N. 2003. *Towards a European Budgetary System*; Mimeo.

Collignon, S. 2003. *The European Republic. Reflections on the Political Economy of a Future Constitution*; The Federal Trust/Kogen Page, London