

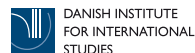


Think Global – Act European

The Contribution of 14 European Think Tanks to the Spanish, Belgian and Hungarian Trio Presidency of the European Union

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BUDGET

The EU Budget Reform: Agenda for and beyond the Next Trio Presidency

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After the Lisbon Treaty came into force, protracted institutional debates have ended and the Union could now focus on its policies at last. One of the main issues the EU will be dealing with during the upcoming years is the reform of the budget. First of all, the EU will have to adopt a new financial perspective for the period of 2014-2021. Furthermore, the 2005 deal on the perspective 2007-2013 contained the condition of a fundamental review of EU spending with a special focus on reform of the CAP. Under this condition the United Kingdom agreed to the phasing out of its rebate and the retention of agricultural subsidies at the current level of more than 40% of the EU budget. The first phase of the CAP reform took place in 2008 with the so-called 'health check' of agricultural spending. It was decided to abolish dairy quotas, bolster rural development and cut direct subsidies. This deal will expire in 2013 when an in-depth reform will have to be adopted.

Positions of the Commission and the Trio Presidency

The second Barroso Commission has already announced its plan to make the budget reform one of its top priorities. In its 2020 vision, the Commission outlines its basic stance on the issue of CAP reform. This will be further developed in a white paper dedicated to the new EU budget. The Commission insists agriculture has its place in EU expenditure but must undergo adjustments in order to be modernised for 21st century needs and in response to challenges such as food security, water scarcity or climate change. The Commission launched a public consultation procedure and organised a high-level conference dedicated to EU budget reform. A number of European think tanks are following the issue (CEPS, Notre Europe, etc.). The results of the public consultation reflected a general perception of needs and expectations regarding policies of the European Union. It found that the EU budget should mainly cover competitiveness (research and development), energy security and the environment (climate change).

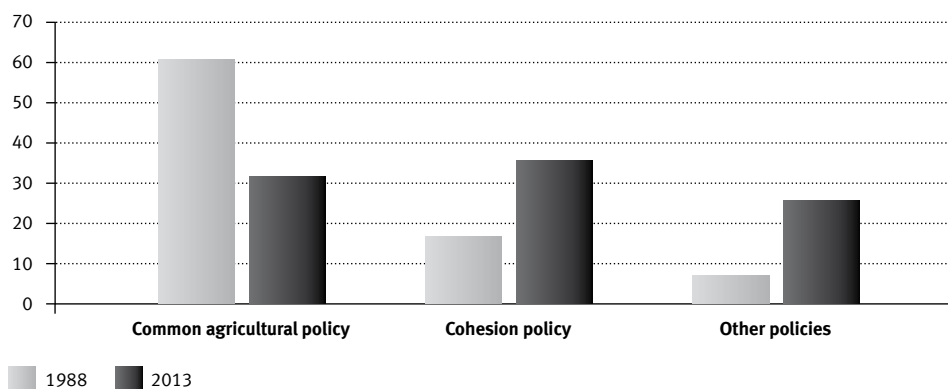
The budget reform will be a challenge for the current Trio Presidency as well. The three Presidencies are supposed to lead the debate on behalf of the EU Council on the Commission

reform proposal. Nonetheless, the concrete negotiations on the budget reform will not take place before mid-2011, when the Commission is due to present its proposals for the next financial perspective. The Spanish Presidency is expected to launch a discussion on a new 'Lisbon Strategy' and its interconnection with the current economic crisis. Such a debate could affect budget reform discussions to a large extent as the Spanish Presidency may try to link the two issues together. Discussion on future competitiveness strategy is likely to put the main emphasis on research and development and the knowledge-based economy as preconditions for sustainable growth in Europe; similar arguments are used in the budget reform debate. On the other hand, the Hungarian Presidency, the last of the Trio, will probably stress the importance of regional policy, as all new member states oppose cuts in this kind of spending from which they profit greatly.

Pitfall of the budget debate

The EU budget is generally considered outdated. The structure of its expenditures reflects national desires to get back as much as possible from the EU budget (the logic of *juste retour*) and does not reflect the real needs of Europe's economies and societies. There is an 'evergreen discourse' that with reform, more money should be allocated to R&D, infrastructure or internal and external security, while less or no money to agriculture or regional development. Such a critique, however, omits the fact that the proportion of CAP expenditure has been constantly decreasing.

Expenditures structure in 1988-2013 (% of total)

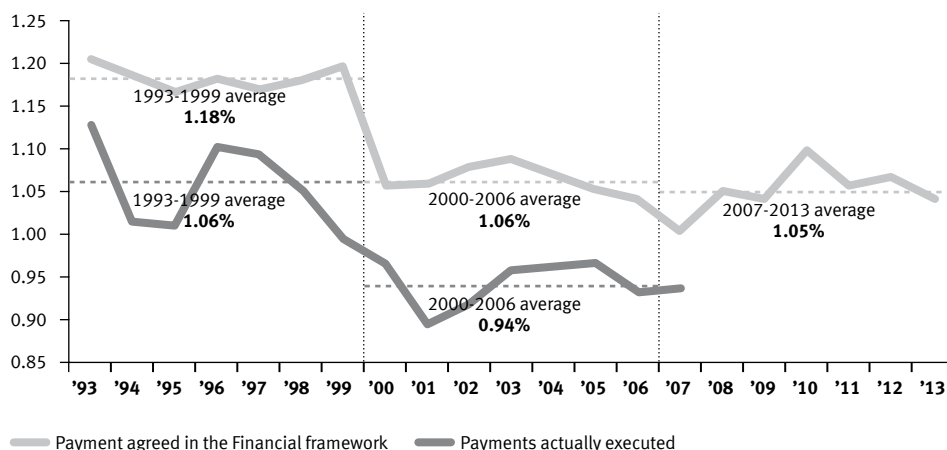


Source: European Commission

On the other hand, solidarity between the rich member states and the poorer ones should be embedded in the EU budget. This principle, however, has been substantially weakened by the above-mentioned logic of *juste retour* and by the decreasing trend of the overall EU budget figure in relative proportions. While there is a cap for the EU budget proportion (1.27% of

the Gross National Product), there is no bottom limit which would provide more long-term stability to EU financing. Progressive decreasing of the budget in both absolute and relative terms is a real threat, especially in a time of economic crisis.

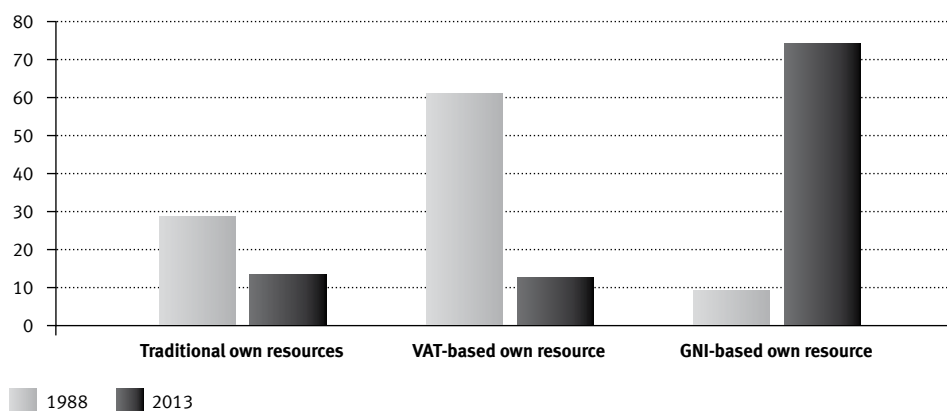
The size of the EU budget (% of EU GNI)



Source: European Commission

The income side of the budget will need to be reformed, too. The system of traditional own resources (import duties) and VAT-based (Value Added Tax) own resources has become very complicated and obscure with so many correction mechanisms. The general trend (evident for some time already) is to abandon the own resources system and finance the budget only from GNP-based national contributions.

Revenues structure in 1988-2013 (% of total)



Source: European Commission

Some suggest introducing a European tax, which would provide resources to the budget, bring citizens closer to EU and make them more sensitive to EU issues. Such an impact on citizens is, however, very arguable: most people still do not see tangible benefits of the EU membership and the media often give an image of the EU as an institution producing a large amount of useless regulation. If a special direct European tax was imposed on citizens, those citizens might become even more discontent with the EU.

Similarly, Daniel Gros from the Centre for European Policy Studies suggests that the financial perspectives should be synchronised with the European Parliament mandate so that the EU's only directly elected body would gain more importance in people's eyes and thus benefit from increased elections turnout. On the other hand, the European Parliament has gained substantial budgetary powers and its role in this area is further reinforced by the Lisbon Treaty, while positive impact on elections turnout has not been noticed.

Although all the main recipes for a better EU budget are known and generally accepted, the debate follows a Catch-22 logic. Everybody knows what must be done, but the deal will nonetheless be difficult and it will probably take the form of a compromise reconciling all national interests (seeking to get back as much money as possible). The vicious circles cannot be broken unless political will is found from all countries over the idea of a fundamentally different EU budget. Net contributors should accept the prospect of 'no money back' (at least in the short-term) and the net beneficiaries should embrace the view of less solidarity of the rich with their poorer regions. Above all, there are France, Poland and Romania, and politically influential farmers who must be willing to give up their generous agriculture subsidies. However, none of those actors will surrender easily and the 2011 reform is thus threatened from the very beginning. Furthermore, a new conservative government in the United Kingdom may turn into a real obstacle to any kind of compromise. British pressure for reform of the budget will be enormous, but the 'Thatcher logic' of "I want my money back" could easily prevail in the minds of British government officials. Although Tony Blair and Gordon Brown accepted the phasing-out of the British rebate in 2005, it is possible that the Conservatives would revoke the decision.

Is there a way out of the deadlock?

The EU budget represents 'only' 1% of the EU's GDP. It is, however, a substantial amount of money which can make a difference and produce tangible results. Undoubtedly, the budget needs a reform and this reform will be difficult to achieve. An increased role of the European Parliament, now empowered by the Lisbon Treaty to give assent to all expenditures, could be a promising factor, hinting that the upcoming negotiations could extend beyond the so-far predominant (and antagonistic) national interests.

In order to avoid another halfway reform, the EU's main actors (Commission, Parliament and the member states) need to adopt a holistic approach towards budget issues. Package

deals are likely to lead nowhere as well as dogmatic economic attitudes arguing in favour of the complete replacement of redistributive policies by investments. What has to change is the very reasoning about the EU budget. So far, the criteria for allocations have been too political. The CAP was set up to respond to a political demand by France, and all other ‘costly’ policies – notably regional and cohesion policy – were added as a sort of compensation for those predestined to exploit them. Politicisation of the EU budget decision-making, locked up by the purely national interests, is the first thing to blame for an EU budget that does not correspond to real needs. Nonetheless, political logic should not be replaced by pure economic (or neo-classical economic) logic. The latter would mean all EU money being allocated to R&D (Research and Development) and new technologies, to the detriment of less developed countries and regions, and the solidarity element disappearing. Such a scenario is unlikely to happen given the strong national preferences in redistributive policies.

This paper argues that the best way to handle the EU budget reform is to embrace the ‘fiscal federalism’ logic as a main criterion for EU funding.

POLITICAL CRITERIA	PUBLIC ECONOMICS	FISCAL FEDERALISM
		
Conformity with EU policies?	Public failure or equity?	Positive cross-border externalities?
Political acceptability?	Regulation, taxation or funding?	EU public goods?
	Cost-effective in practice?	Economics of scale and scope?
		Wide income dispersion between EU countries?

Source: Copenhagen Economics

Such an approach is an analogy of the ‘subsidiarity principle’ in EU regulation. It consists of evaluation of expenditures on the basis of the added value at the European level. All expenditures should be assessed from the point of view of the advantages of pooling capacities and spending at the EU level (e.g. positive cross-border externalities). Coherence with other kinds of EU actions has to be taken into account, too. The fiscal federalism approach would therefore downsize agricultural payments because those have already been nationalised and there is no added value of a common budget in this area. On the other hand, regional policy makes sense with regard to fiscal federalism if cross border regions are targeted in the first instance. Similarly, support to infrastructure should place emphasis on trans-European networks etc. Such an assessment should be carried out for all EU expenditures, even at the cost of completely redesigning spending structures within EU policies.

Key recommendations for the Trio Presidency:

- Adopt the fiscal federalism approach and re-assess all expenditures in relation to the European-level added value
- Keep a solidarity element in the EU expenditures
- Introduce a bottom limit for the GNP proportion of the EU budget (e.g. 1%)
- Connect the budget debate with the new 'Lisbon Strategy' discussions
- Abandon traditional own resources and VAT-based resources together with all correction mechanisms
- Respect the expectations of EU citizens regarding EU policy outcomes