CENTRE FOR EUROPEAN REFORM
briefing note

THE EU BUDGET: COMMON FUTURE OR STUCK IN THE PAST?

By Iain Begg

The EU's common budget is small and rather rigid. Most of its outlays are determined years in advance, and most of them go on just two policies, namely support for farmers and poorer regions. Yet the EU budget invariably attracts acrimonious debate and close scrutiny out of all proportion to its economic significance. The next budget round – kicked off by the European Commission's release, on February 10th, of its own proposal for future EU financing – will be no exception. Already, the member-states are digging in their heels about who will pay and how much, and who will benefit during the next medium-term budget plan (known in EU-jargon as the 'financial perspective') that will run from 2007 to 2013 inclusive.

It is important to put these budget squabbles into perspective. In 2003, the EU's common budget amounted to €99.7 billion, the equivalent of only 1 per cent of the member-states' combined gross national income (GNI). National budgets in the EU typically amount to 45 per cent or more of national income. Many people also believe the EU spends most of its budget on an oversized and opaque bureaucracy. But the 2004 administrative budget of the European Commission, at €3.8 billion, is smaller than the budget of the mayor of London (£2.8 billion, or just over €4 billion). And the total cost of running all EU institutions, including the Commission and the European Parliament, is still less than the budget of the mayor of Paris (€6 billion). Even by 2006 – when the number of EU members will have grown from 15 to 25 and the population of the EU will have increased by some 70 million – the budget will have risen only risen marginally, to €115 billion.

The political and economic context

As always, the member-states approach the budget negotiations with shopping-lists of wholly incompatible demands. Everyone agrees that the Union should only spend money if and when there is an added value from doing so at EU level. Yet all countries have their own views on what constitutes added value. And when it comes to budget allocations, the overriding objective for most member-states is not to further the common good but to secure a *juste retour* – to ensure that the EU spends as much of 'their' money as possible on policies that benefit them. All member-states are in favour of spending more on boosting growth and competitiveness. All agree that the EU must help the poorer newcomers in Central and Eastern Europe to catch up with western income levels. All demand that the EU rise to the challenges of securing its external borders, policing immigration and punching its weight in global affairs. But at the same time, all the existing member-states cling ferociously to the money they are currently getting from the EU budget, while several insist that the overall size of the budget cannot rise. Resolving these incompatible demands will be fiendishly difficult, since each EU member-state can veto the whole budget.

The battle over the next financial perspective started long before the Commission released its proposal in February. As early as 2000, Spain used the negotiations on the Nice treaty to make sure it retained its veto on the allocation of regional subsidies for the 2007-13 period. Spain is currently the biggest beneficiary of the structural and cohesion funds for regional development. In 2002, France and Germany engineered an agreement designed both to limit future farm spending (as demanded by the Germans, who pay for the lion's share of the EU budget) and stave off more radical reforms of the common agricultural policy (very much in the interest of the French who benefit handsomely from current CAP rules). In December 2003, six of the richer member-states – Austria, France, Germany, the Netherlands, Sweden and the UK – wrote a letter to Commission President Romano Prodi, demanding that the overall EU budget should be capped at current spending levels of 1 per cent of EU GNI, despite enlargement. Because it came just days after the collapse of the constitutional treaty negotiations, many analysts saw this letter as a clear signal to Poland and Spain to 'stop blocking the treaty or we cut off the money'. These two countries, whose intransigent position on EU voting rights contributed to the failure of the treaty negotiations, stand to gain most from the next EU budget. And all this relates to spending that will only *start* in three years' time.

Most of the battle lines in the current budget fight are well established. First, there is the usual tension between the net contributors and the net recipients about how big the overall budget should be, hence the letter from the six richer countries to Prodi. Second comes the question of who receives what from the budget. Related to this is the controversial issue of the UK rebate (or 'abatement' as it is formally known), a mechanism through which the EU refunds two-thirds of the UK's 'excess' contribution to the EU budget. Although the rebate is not unreasonable in the financial outcomes it produces, it clearly rankles with other EU members.

Third, many politicians, officials and economists have challenged the composition of EU spending, most recently in a report drawn up by a group of independent experts chaired by the Belgian economist André Sapir. Fourth, there are disputes over how the EU should finance its budget. Should it have its own taxes or rely on transfers from member-states' budgets? Finally, many Europeans worry about whether EU spending is good value for money, especially since every incidence of fraud or waste attracts fierce condemnation. In the new round of budget negotiations, these questions are compounded by the rows over the stability and growth pact, with Germany especially irked to be told to cut its own budgetary deficit while being asked to stump up more for 'Brussels'. Moreover, the negotiations will be sharpened by the arrival of ten new members, who could gang up to demand radical changes.

The size of the EU budget

The most bloody battle may well be over the size of the EU budget in the enlarged EU. For several years, actual spending has been well below the agreed cap of 1.24 per cent of GNI (referred to as the 'own resources ceiling', it previously stood at 1.27 per cent of GDP, but was changed to reflect a new national accounting methodology). The European Commission has deliberately kept spending low to appear moderate and sensible – a strategy that may now backfire by making it easier for finance ministers to portray any future increases as unwarranted. The European Commission has proposed to increase the size of the budget during the next financial perspective, taking into account the larger number of member-states and widespread demands for the strengthening of new EU policy areas, such as internal and external security. But at an average of 1.15 per cent of GNI, it would still be well within the established 1.24 per cent ceiling. Since GNI itself will grow, the Commission's proposal foresees total spending rising gradually from €115 billion in 2006 to €143 billion by 2013 (at 2004 prices).

Many in the new member-states accuse the EU of trying to get enlargement on the cheap. Those that currently benefit from EU money – poorer countries and regions as well as farmers – also want to see a larger budget, fearing that they will receive less, as money is increasingly channelled to the new member-states.

For the net contributors, however, even the increase proposed by the Commission is too much. The British chancellor, Gordon Brown, was quick to condemn it as "unacceptable", adding that rather than the UK rebate being an issue, "the real problem is the Commission's desire to increase overall spending by 25 per cent". Gerrit Zalm, his Dutch counterpart, read from the same script by also describing the Commission's proposal as "unacceptable". German Finance Minister Hans Eichel, still resentful about the Commission's hounding of Germany for fiscal indiscipline, was equally scathing about the proposals. He explicitly condemned the inconsistency between demands on Germany to cut its national budget and the higher spending ambitions of the Commission. He argued that no national budget could plausibly grow at the rate that the Commission has proposed.

In fact, if one bears in mind that the increase is stretched out over eight years, Eichel is wrong. In the eight-year period covering 1997 to the projected values for 2004, five of the 15 member-states (including the UK) increased their national public expenditure (excluding interest payments, which do not apply to the EU) by 25 per cent or more. The average for the EU-15 is lower, at 16 per cent, principally because the slow GDP growth of two of the largest economies, Germany and Italy, has been reflected in slow expansion of public expenditure.

Where does the money go?

There is a growing recognition among member-states that the EU budget has lost its way. Yet this insight is unlikely to have a decisive impact on the upcoming budget round. The Sapir report described the EU budget as a relic of the past and advocated a radical overhaul. Sapir and his colleagues would re-orientate most EU spending towards the promotion of growth and competitiveness and away from the current focus on farmers and poorer regions. However, given the strength of entrenched interests that EU spending has created, the Sapir proposals stand no chance of being accepted. Although the Commission proposal borrows language from the report by stressing growth and convergence, it ignores key elements of the approach that Sapir advocated, especially the plea to look beyond *juste retour*.

In addition, there is an underlying uncertainty about the appropriate role of EU spending in a Union of 25. Central governments have a pivotal role in economic management, and their budgets are a key instrument for this. The US federal government, for example, has a budget 20 times larger than the EU's. In the EU, with its multi-layered system of policy-making, the role of the central budget is less clear. EU money is the mainstay of certain policies, in particular the CAP and regional development, but it has no meaningful role in others. Three-quarters of the budget goes on farmers and regional policies of unproven economic value. But the EU spends very little to achieve its declared goal of becoming the world's most competitive knowledge-based economy by 2010 (the so-called Lisbon reform agenda). Unlike national budgets, EU spending plays no part in macroeconomic stabilisation and it has only a moderate, indirect role in redistribution from rich to poor.

The new budget proposals in detail

Since 1988, the financial perspective has been the cornerstone of EU spending. It sets firm limits on how much the EU can spend on each broad policy area, leaving detailed amounts for individual policies to be negotiated in the annual budgetary round. Once the member-states have agreed on the perspective, there is only limited room for manoeuvre in the annual budgets. The Commission's February proposal seems at first sight to break with the tradition of the previous fifteen years by simplifying the structure and promising greater flexibility. The Commission has suggested five new headings relating more closely to the Lisbon agenda of supply-side economic reforms. However, closer examination suggests that these headings are, by and large, the same mix of policies as before, albeit in new livery. The accompanying table shows the proposed new structure and planned spending under each heading as a proportion of overall commitments.

The new heading entitled 'sustainable growth' brings together what used to be called 'structural operations' – that is, support for the economic development of disadvantaged regions – and the lion's share of what used to be 'internal policies' – more than half of which was the EU's research budget. Agricultural subsidies are now a component of 'sustainable management and protection of natural resources'. However, although the proposal relegates agricultural support to a sub-category, the Franco-German deal of 2002 will mean that there is only a negligible decline in the flow of resources to the CAP over the next decade. The deal will maintain ceilings for agricultural spending at around their present levels, while continuing to shift expenditure away from subsidies and towards income support for the poorer farmers. As a result, the CAP will remain the biggest spending item until 2013.

The two key changes in the new financial perspective are more apparent than real. First, in the Commission's proposal the promotion of competitiveness 'for growth and employment' takes a prominent position, a re-focusing that is explicitly linked to the Lisbon reform agenda. Spending under this heading can be expected to include an enhanced research budget, more money for trans-European networks in transport, energy and communications and other building blocks for a more competitive economy. By and large, this is more of the same. Second, the Commission has suggested a new spending line for 'citizenship, freedom, security and justice'. It wants the EU to treble the amounts available under this heading in real terms between 2007 and 2013. But the new spending line is mainly about putting into practice the various components of what the EU now refers to as justice and home affairs, complemented by policies to support EU culture and citizenship.

Rebates for other net contributors?

The EU budget receives most of its money from member-state contributions that broadly depend on the size of their national economies. But the distribution of the money is not related to how large or wealthy a country is because EU expenditure takes place through specific EU policies, in particular the CAP and structural funds. Countries with relatively more farmers and poor regions therefore benefit disproportionately from the budget. Those countries that have few eligible regions and smaller agricultural sectors, but are well off (such as the UK, Germany, the Netherlands or Sweden), end up paying much more into the budget than they get out. In the case of the UK, the imbalance became so pronounced as to be politically unacceptable. Margaret Thatcher's renowned handbag helped the UK to obtain a special rebate scheme in 1984. But other rich member-states resent the UK's special treatment. And the way the rebate is financed creates additional resentment from poorer member-states. In 1999, the other big net contributors – Austria, Germany, the Netherlands and Sweden – negotiated a deal that allowed them to pay less towards the UK rebate than one would expect on the basis of their GDP. As a result of this formula, the new member-states will have to contribute disproportionately to the UK rebate, despite the fact that they have much lower levels of income.

To resolve this dilemma, the Commission has proposed a generalised correction mechanism for all countries with large net contributions. Provided the EU finds a workable formula, such a mechanism would be more equitable and politically palatable than the current situation. But it would be politically acceptable to the UK only if it left the UK with a net position (after correction) that is similar to the current one. The Commission has yet to unveil its specific mechanism for abatement, but whatever it is, it is bound to be controversial. There are statistical problems and quirks in identifying who actually benefits from any particular line of spending. But EU experts should be able to resolve these and work out a correction mechanism that is broadly fair for all member-states.

What are we fighting for?

It is already clear that EU member-states will go through a negotiating marathon before they can all agree on the next budgetary framework. But the expected ferocity of these battles is puzzling, given that there is so little to discuss. In several respects, the EU budget is already hemmed in. The deal to retain ceilings for agricultural spending until 2013 means that unless there is an unprecedented breakthrough in world trade negotiations that sweeps away farm subsidies, the CAP will remain a big component of spending. Some finance ministers seem to think that these 'ceilings' imply scope for spending to drop below the agreed upper limits. But it is the ceilings that are counted in the financial perspective, not what might in the end be spent. Similarly, the combined expectations of the new members and of the regions of EU-15 that currently benefit from the structural funds makes it unlikely that the EU will reduce spending on regional development to below what the Commission proposes. Add in the amounts for EU tasks in justice and home affairs, aid to the developing world and the administration of the EU, and it become clear that there is scarcely any room for manoeuvre.

Ironically, therefore, it appears that the only spending item that member-states could conceivably trim is that focused on competitiveness. Yet this is precisely the spending item that the richer member-states – those that want a lower overall budget – are most keen on.

Another thorny issue is how to fund the EU budget. The EU receives money directly from three different sources, namely levies on agricultural imports, customs duties and a share of national VAT receipts. The first two, known as 'traditional own resources', make up only a small (and shrinking) share of EU budget income (12.5 per cent of the total in 2003). The receipts from VAT now account for roughly one-quarter of EU budget revenue. The remainder of the money (some 60 per cent) comes from transfers out of national budgets. The EU calculates the overall size of the transfers as a residual between planned expenditure and receipts from the other sources. How much each member-state is asked to pay then depends on the size of its economy.

Although the Commission has put off the question of budget financing for now, it will invariably crop up in the new budget round. The EU institutions want the budget to rely more heavily on genuine 'own resources' – taxes explicitly assigned to the EU level. The member-states resist this because they want to retain control of the purse-strings.

An assessment

The battle-lines are being drawn for the next budget round. Tempers are heating up following the Commission's opening shot in February. But it is important for the EU to remember what is really at stake. The Commission's proposal offers little that is new or innovative. Despite the new labels, the expenditure items are largely more of the same. By 2013, spending on the CAP and on cohesion policies will be 0.75 per cent of EU GNI, compared with a like-for-like figure of 0.79 per cent in 2006, at the end of the current financial perspective. Although the shift towards competitiveness and growth is a sensible and welcome one, there is a disparity between ends and means. According to the Commission's proposal, the allocation for policies to promote growth and competitiveness will double, to reach €25 billion by 2013. But that still only amounts to 0.2 per cent of EU GNI while agricultural subsidies would still be 0.34 per cent. Given that the Lisbon targets call for R&D spending alone to rise from its present 2 per cent of EU GDP to 3 per cent by 2010, the sums appear paltry.

It looks as if the EU will once again put off the much-needed root and branch reform of its budget – unless those member-states that are unhappy with the Commission proposal act decisively. Since the next financial perspective runs until 2013, real reform would be off the agenda until the next decade. This would be a shame. The budget proposals that are now on the table will not prepare the EU for future challenges. The new budget negotiations could turn out to be yet another missed opportunity.

The Commission has asked the member-states to reach an agreement on the financial perspective during the first half of 2005, to allow sufficient time to prepare the plans and regulations needed to implement the budget. But the entrenched positions of many member-states will make an early agreement difficult. The negotiations may well drag on into the second half of 2005. By then, the UK – with its entrenched position on the rebate – will have taken over the EU's rotating presidency, in what will almost certainly be a general election year. Buckle your seat-belts.

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Planned expenditure under the Commission's 2007-2013 financial perspective (per cent of total budget expenditre)

Policy heading	2006*	2007	2008	2009	2010	2011	2012	2013
1a. Competitiveness	7.3	9.1	10.4	11.7	12.9	14.1	15.3	16.3
1b. Cohesion	32.1	35.6	34.9	34.3	33.6	32.9	32.5	32.2
2a. Agriculture	36.2	32.6	41.7	40.6	39.5	38.5	37.5	36.5
2b. Other 'sustainable development'	10.2	10.2	10.3	10.3	10.2	10.1	9.9	9.8
3. Citizenship, security etc	1.1	1.2	1.5	1.6	1.8	2.0	2.1	2.3
4. EU as a global partner	9.3	8.5	8.8	9.0	9.4	9.7	9.8	9.9
5. Administration	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8

* The Commission has recalculated the figures for 2006, the last year of the current financial perspective, to compare them with the proposed new structure. A one-off adjustment of €1.04 billion in administrative expenditure in 2006 has been left out of the 2006 column, so that it adds up to less than 100 per cent.