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The EU budget: an agenda for reform?

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"Nobody wants to pay more, some want to pay less, nobody wants to get less and we all have to spend more for enlargement."
Jean-Luc Dehaene, Belgian prime minister, December 1998

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The nastiest arguments in the European Union, as in any family, are the ones about money. *Communautaire* sentiment soon evaporates when prime ministers start to haggle over the budget. Lady Thatcher knows that as well as anyone. She first wielded her handbag against other EU leaders in December 1979, in Dublin, when she famously demanded "my money back". She then felt no compunction about obstructing most other European business until she finally won Britain a permanent budget rebate at Fontainebleau in 1984.

The Copenhagen summit of December 1987, which was supposed to reach agreement on the first "Delors package", Jacques Delors's five-year plan for the EU budget, collapsed in chaos. A special summit had to be held in Brussels the following February to settle it. The second Delors package, covering the years 1993 to 1999, nearly fell apart at the Edinburgh summit of December 1992. But the then German chancellor, Helmut Kohl, saved that meeting from failure—as he had done in Brussels in February 1988—by reaching for his cheque-book.

This time round failure is also a strong possibility. The new German chancellor, Gerhard Schröder, currently holding the presidency of the EU, wants to hammer out a final deal at a summit meeting in Berlin on March 24th-25th 1999. That would give enough time for the European Parliament to approve the deal and to pass relevant legislation before the end of the year. But it is a highly ambitious timetable, not helped by the huge differences between member-states' initial negotiating positions (see appendix).

The rationale for the budget package—known as Agenda 2000—is to prepare the EU's finances and policies for the period 2000-06, which is scheduled to include the accession of the first new members from eastern Europe. Since the existing agricultural and regional policies could not be applied to the East Europeans without breaking the EU's budget, a crucial task for Agenda 2000 is to reform those policies.

The most sensitive political issues in the current negotiations revolve around one existing member, Germany. It pays much more into the EU's coffers than any other member—around €140 per head in 1997 (see table on page 8). Helmut Kohl, the cheque-book chancellor, has gone, and the younger generation of German politicians is keen to cut back their country's contribution to the EU budget. The rising star of the German right, Edmund Stoiber, has attacked Mr Schröder for not fighting hard enough for German interests in the budget negotiations. Thus the principal task of the Berlin summit will be to find ways of easing Germany's financial burden. That will not be easy: the other governments are extremely reluctant to give up money to the Germans or to anyone else.

There are various solutions to Germany's problem on the table. One possibility is to hand over some of the costs of EU agricultural subsidies to national governments—so-called "co-financing" of the Common Agricultural Policy (CAP)—but this is vehemently opposed by France. Germany would also benefit from the "stabilisation" of budget expenditure, a proposal to curtail spending on existing EU programmes so that it is no higher in 2006 in real terms than the €96 billion that will be spent in 1999. But budget stabilisation runs into opposition from others, notably the four "cohesion"

countries—Spain, Portugal, Ireland and Greece—that are large net recipients from the EU.

Germany would also gain from a scheme to replace contributions to the EU budget based on members' VAT receipts with contributions based on the size of their GNP. But that would incur the wrath of countries that stand to lose from it, such as Italy and Belgium. Another solution could be a "generalised correction mechanism", giving all net contributors a rebate similar to that enjoyed by the UK, but that would be too expensive to be viable. Best of all would be a corrective mechanism that acts in a progressive way, giving rebates to countries according to their relative prosperity. That, however, isn't even up for discussion. Each of these options is analysed in more detail below.

The negotiating process promises to be tortuous. If a deal is not concluded in Berlin, the inevitable bad blood among EU partners would not be the only unhappy consequence. Since the European Parliament has to approve any budget package, and it will be busy preparing for its June elections, a deal on the budget might then have to wait until autumn. And that would further delay the EU's preparations for eastern enlargement.

But even if the March deadline is missed, there will have to be an agreement at some point before early 2000, when the new budget is due to come into effect. The least likely outcome is a package deal that involves concessions from all sides and far-reaching reforms. More likely is a bad deal—notably with a minimal revision of the CAP—which merely postpones awkward choices and essential reforms for a few years.

If the CAP does not fit

The first bone of contention at the Berlin summit will be reform of the Common Agricultural Policy, which currently makes up just under half of total EU spending. There have been high hopes of agriculture reform in the past that have not always lived up to expectations. This time, however, there is some optimism. As the Commission has argued for the past 18 months, there is little real alternative to its proposals. The most important of these are cuts in support prices—of 30% for cereals, 20% for beef and 15% for milk—with partial compensation for farmers through increased direct income subsidies. These plans are consistent with, and build on, the reforms introduced in 1992-93 by the then Commissioner Ray MacSharry. They also represent the only direction in which the EU can move if it is to negotiate successfully in the world trade talks that are due to begin later this year. Moreover, agriculture ministers will be under some pressure to agree these reforms among themselves, for if they do not, the entire package may be taken out of their hands and settled by heads of government and foreign ministers or—even worse from their point of view—by finance ministers.

More contentious is the Commission's proposal to renew for another seven years the system of milk quotas, that would otherwise expire in 1999. The system works by allocating specific quotas to EU countries, providing a guaranteed market at a fixed price for their milk products. Britain opposes renewal, believing that its large and efficient dairy farms would survive without quotas. It claims that, thanks to the support of Denmark, Italy and Sweden, it has a blocking minority to prevent their renewal, or at least to ensure a phase-out in the longer term.

Winners and losers from CAP co-financing
(annually by 2006; current prices; before UK correction; "-" implies budgetary loss)

Winners	€ m	% of GNP	Losers	€ m	% of GNP
Germany	678.2	0.03	France	-648.5	-0.04
UK	429.6	0.03	Spain	-528.2	-0.07
Netherlands	168.8	0.03	Greece	-451.7	-0.30
Italy	134.5	0.01	Ireland	-195.8	-0.23
Belgium	110.7	0.03	Denmark	-100.6	-0.05
Sweden	62.3	0.02	Portugal	-23.9	-0.02
Luxembourg	11.6	0.05			
Austria	43.8	0.02			
Finland	22.8	0.01			

Notes: €1=around 70p; assumes 25% CAP co-financing, and the acceptance of the Commission's CAP reform proposals; the UK rebate would reduce Britain's figure by around two-thirds.
Source: European Commission.

From the perspective of the EU's future financing, however, there are two more important issues to settle, which go under the off-putting labels of co-financing and degressivity. Co-financing means that member countries would partly pay for the agricultural subsidies that go to their own farmers. The Commission, in a paper published in October 1998, suggested that national governments might foot a quarter of the bills directly. There are plenty of precedents: most EU regional subsidies are paid only if national governments co-finance sometimes as much as 50% of a project's cost, while subsidies to hill farmers are paid on a similar joint basis. General CAP price support, however, has always been financed 100% at EU level. And the strongest opponents of the Commission's idea, the French, are determined to keep it that way. Supported by Spain, they fear that once the EU accepts the principle of co-financing, the proportion of CAP costs that is in the long run devolved to member-states can only grow. The more the CAP is "re-nationalised" in this way, the more that taxpayers will ask governments to justify special treatment for farmers. The result, they fear, is that co-financing will lead to the beginning of the end of the CAP, which is a result their strong farming lobbies would not tolerate.

These arguments are mostly nonsense. Clearly co-financing has to be monitored at EU level to ensure that it does not distort the market; but in the Commission model that would not happen, since the level and terms of compensatory payments would continue to be set in Brussels. In fact, paying different levels of income support around the EU might actually be a good idea: why should a farmer in the poor Pelopponese, for instance, get the same income subsidy as one from wealthy Bavaria? France's philosophical objection to co-financing is reinforced by the fact that it would cost the French a packet—just as it would benefit the Germans. France pays roughly 17% of the CAP's costs, but draws out nearly 25% of the payments; while Germany pays in 28% and draws out only 14%.

Other losers from co-financing would include the Danes and Spaniards; the British, Dutch and Swedes would all gain (see table above). As these are the countries with painfully high net budget contributions, the introduction of co-financing might seem thoroughly sensible.

Yet French opposition, especially from President Jacques Chirac, whose fondest memories are said to be of his period as agriculture minister, will be very strong. To divert attention away from co-financing, the French have advocated degressivity, meaning that the level of compensation payments would gradually be phased downwards to all but the poorest farmers. This too seems sensible, not least because if such payments are not cut over time, new entrants to the EU—and especially Poland—will claim that their farmers too should receive them. And since a quarter of the Polish workforce is engaged in farming, that would surely bankrupt the CAP once and for all.

Degressivity would also help to solve another big problem with the Commission's planned farm reforms: their budgetary cost. The trouble is that, as the CAP moves away from paying farmers through higher food prices to paying them through direct income support, its cost to the EU budget increases. The proposed reforms in effect shift the burden of supporting farms away from consumers to tax payers. Degressivity, however, by phasing out direct income support, would reduce the EU agricultural budget over time. For this reason, degressivity is gaining support across the EU from countries that want to see the overall EU budget reduced. Even Germany, which had initially opposed degressivity in order to protect its less profitable farms, has now softened its stance.

Structural squeeze

The Commission is keen to prune the growth of spending on existing policies, to free up cash for enlargement. Rather than reduce the level of overall CAP expenditure, however, the Commission proposes to streamline the existing structural funds, which account for almost 40% of total EU spending.

(The other candidates for cut backs are much smaller and anyway less easy to chop: internal policies are subject to control by the European Parliament, which likes to increase spending on its pet projects; external funds include pre-accession aid to eastern Europe, which it would be unpolitic to cut; and the Commission has a predictable reluctance to cut administration costs.)

Specifically, the Commission proposes reducing the current seven "objectives" under which structural funds are allocated to three. Additional resources would be saved by enforcing the criterion for much sought-after "objective one" status more rigorously: only regions that have a per capita GDP of under 75% of the EU average would qualify for funds. There is broad support for these measures. Everyone agrees that it is absurd to persist with a situation in which the EU has so many objectives and so many different funds that over half the EU population lives in regions that are covered by the structural funds. Despite this, some countries are seeking to massage their figures to get more cash for particular regions and sub-regions. Britain, for example, is seeking objective one funding for the Highlands and Islands, which would go down well in the run-up to the Scottish parliamentary elections. It is also seeking structural funding for Northern

Ireland "to support the peace process". Neither region would qualify for objective one funding under the 75% rule.

EU budget: expenditure
(Commission projections for 1999, Commission proposals for 2006; €m; constant 1999 prices)

	1999	2006
Agriculture (guideline)	45,210	51,610
—of which, to new member-states	0	3,400
Structural operations	39,030	32,470
—of which, to new member-states	0	12,080
Internal policies	6,390	7,600
External action	6,870	7,900
Administration	4,720	5,300
Reserves	1,190	350
Total (commitments)	**103,410**	**105,230**
Total (payments)	**96,380**	**104,560**
% of GNP (payments)		
Total	1.23	1.13
Available for enlargement	0	0.11
Reserve margin	0.04	0.03
Own resources ceiling	1.27	1.27

Source: European Commission, published in House of Commons research paper 98/56

The cohesion fund also comes out of the "structural operations" section of the EU budget. Countries that have "cohesion status"—defined as having per capita GNP less than 90% of the EU average—receive funds for environmental and transport infrastructure projects. Although the Commission does not propose changes to the cohesion fund, some money will be saved by Ireland's expected graduation out ofcohesion status.

The cohesion countries, being the poorest, grumble that the structural funds should not be cut back to pay for the costs of EU enlargement. It is the richest parts of the EU, they argue, that should pay more. But they face a greater threat than the loss of some structural funds to their regions. Net contributor countries such as Germany and Britain (which stand to benefit from any measure that reduces the size of the overall budget) argue that countries which are part of EMU should not receive cohesion funding, because it could distort the single market. If adopted, such a measure would mean that Spain and Portugal (as well as Ireland) would lose their cohesion status, leaving only Greece, which is for now outside EMU.

Spain has hit back strongly, arguing that being part of EMU makes cohesion funding even more important—to provide the necessary transport infrastructure, for example, that would enable the single market to work effectively. Maintaining the cohesion status that it won at Edinburgh in 1992 is the Spanish government's priority. And this is not just about cash. Because cohesion payments are made through Madrid rather than to the autonomous regions, cohesion status boosts the power of the national administration over the regional governments.

Budget blues

Putting aside quibbles over the status of particular regions, and the special case of Spain, the real point of the arguments about structural funds is their impact on net budget contributions and receipts. And it is this that will be the subject of the most acrimonious discussions at the forthcoming summit meetings.

The financing of the EU budget is enshrined in a text known, somewhat portentously, as the Own Resources Decision. This provides for revenues to be drawn from a tax on food imports from outside the EU, a general customs duty, a levy based on value-added tax receipts and a GNP contribution, with the total constrained by an overall ceiling on the budget of 1.27% of EU GNP. The text has the force of a treaty. This means that it can be revised only by unanimous agreement among member-states, and that any revision has to be ratified by every country's parliament before it enters into force. These are stiff tests to meet. Indeed, old hands in Brussels say that it is easier to pass an entirely new EU treaty than to open up the Own Resources Decision. That is one of the strongest reasons why the Commission, in its Agenda 2000 and future-financing papers, came down on balance against making any changes now. However, it did hint that, were there a political decision to open up the Own Resources Decision, enlargement might be an appropriate time to do so.

The problem is that the combination of the EU's revenue and spending patterns produces such odd, even perverse, results. To gain an idea of how perverse, and of how much trouble this can cause, it is only necessary to consider the history of Britain's budget battles. To an extent the original Own Resources Decision, adopted before Britain joined, was deliberately skewed to Britain's disadvantage. The idea of the Six was that West Germany, whose powerful industry drew substantial benefits from Europe's large market, should be saddled with the biggest bills for supporting European agriculture, which then took up over three-quarters of all spending. Not by chance, this also meant that Britain, which had a relatively small and efficient farm sector and also imported a lot from outside Europe, would be a heavy net contributor. The European budgetary picture after 1973 was simple enough: the Germans and British would pay, but everybody else would benefit.

The EU budget: winners and losers, 1997
(net contributions: "-" indicates a net contributor)

	€ m (after UK rebate)	€ m (before UK rebate)	€ per capita (after UK rebate)	% of GNP (after UK rebate)
Winners				
Spain	5,537.2	5,756.9	140.8	1.19
Greece	4,314.5	4,360.5	410.2	4.07
Ireland	2,800.8	2,822.0	765.0	5.07
Portugal	2,675.4	2,714.8	270.9	3.07
Belgium	1,712.0	1,809.7	168.1	0.79
Luxembourg	715.0	721.7	1,698.3	4.82
Denmark	93.8	156.5	17.8	0.07
Finland	1.4	46.7	0.3	0.0
Losers				
Germany	-11,456.1	-10,962.5	-139.6	-0.62
France	-1,757.2	-1,197.6	-30.0	-0.14
Netherlands	-1,224.0	-1,079.1	-78.4	-0.38
Sweden	-1,195.0	-1,109.6	-134.0	-0.62
Austria	-873.9	-791.5	-108.1	-0.48
UK	-658.5	-3,117.3	-11.2	-0.06
Italy	-564.0	-131.2	-9.8	-0.06

Note: Of the many different ways of calculating budget balances, this table uses the "UK rebate" definition. Other methods yield slightly different results.
Source: European Commission (CER calculations).

Thanks partly to residual war-guilt, and also to their relative wealth, the Germans were prepared to live with this. But Britain, relatively low down Europe's prosperity league, was never likely to. Even in the Heath government's White Paper on British entry in 1971, a line was firmly drawn: the other member countries, the White Paper said, hoped the British budget burden would diminish as CAP spending fell and regional spending increased, but should an "unacceptable situation" materialise, it would be dealt with. The Wilson government of 1974 made the budget a centrepiece of its renegotiation of the terms of entry, securing a so-called "financial mechanism" to reimburse Britain, but in practice it was so fudged that it never worked. For a time thereafter transitional arrangements held down the British budget contribution, but by 1979 it had become

clear that, unless something were done, Britain would emerge as the biggest net contributor to the European budget.

The stage was thus perfectly prepared for the arrival of Margaret Thatcher's government. Her performance at the Dublin summit in December 1979 has become legendary. The patrician Valéry Giscard d'Estaing and the haughty Helmut Schmidt were horrified by her vulgar insistence on getting "my money back". But as she continued to bang the table at subsequent summits, they and their successors were forced to offer a British rebate: first of all a series of cash sums, but by 1984 a permanent mechanism known as an abatement, which reimbursed 66% of the difference between the British contribution to VAT-based revenue and the amount of EU expenditure in the UK. The Germans, in an early sign that they might not be willing to remain Europe's paymaster forever, won a concession that they would pay only two-thirds of their normal share towards this British abatement.

Corrections for everybody?

The budget problem that now afflicts the Agenda 2000 discussions is twofold. First, the German net contribution has become so large that the Schröder government is determined to cut it, if necessary by securing a rebate of its own. And second, several other countries, notably the Netherlands, Sweden and Austria, consider that they too are paying excessive net contributions. All four have accordingly cited a clause in the Fontainebleau summit conclusions on the British rebate, which declared that any member-state with a budget burden that was "excessive in relation to its relative prosperity" was entitled to have it redressed.

The Commission has duly come up with some ways in which these countries' problems could be addressed. It proposes three possibilities: co-financing the CAP, replacing VAT levies with a much larger GNP contribution and a "generalised correction mechanism". A budget freeze in real terms—not a Commission proposal, but likely to be supported by a majority of member-states—would also help the net contributors.

The implementation of all of these might do enough to satisfy the Germans. Co-financing of 25% would cut nearly €700m off their net contribution. A budget freeze, which would mean devoting roughly €200 billion over the 2000-06 period to the structural funds, in place of the Commission's planned €246 billion, would lop off a further €1 billion. Replacing the VAT levy by a GNP contribution would save the Germans €700m. The Dutch, Swedes and Austrians would also stand to benefit. A generalised correction mechanism would be the biggest prize of all, giving all four a taste of the rebate that currently benefits Britain alone.

Yet all these proposals will encounter strong opposition from other countries. Co-financing, as already noted, will be fiercely resisted by the French and Spanish. A budget freeze would run into trouble with the four "cohesion" countries—as well as with the European Parliament, which likes to bump up expenditure on the non-agricultural parts of the budget over which it has considerable power. The GNP/VAT substitution would upset Italy, which stands to lose over €1 billion a year, and Belgium, which would

lose more than €250m. Both countries have high savings ratios and so have a higher GNP than is suggested by their levels of retail spending and VAT receipts.

The alternative is the much-touted generalised corrective mechanism, which would sort out, once and for all, "unfair" budget burdens. The case for some such mechanism is easy to make. The great European project has already wasted several years (from the late 1970s to the mid-1980s) in wrangles over budgetary burdens, in that case because Britain had a well-justified grievance. Now it is poised to go through just such another period. Moreover, all federations—and whatever one's views about the future of the European Union, it already has many characteristics of a federation—have a mechanism that transfers income from richer to poorer regions. In most cases, these transfers happen automatically through the operation of a large federal-level budget. In some countries, including Germany, Canada and Australia, there is an explicit system of transfers. Yet in the EU, not only is the central budget too small for automatic transfers to be made, but its revenue and spending pattern often makes the transfers that do take place perverse. For instance, Denmark and Luxembourg, the two richest countries in the Union, draw net benefits from the budget; Sweden and Britain, both of which are below average in income per head, are net payers.

There is a respectable, if little-known, history of suggestions for some variety of automatic corrective mechanism. A report for the European Commission in 1977 by the then chief economic adviser to the UK Confederation of British Industry, Donald MacDougall, suggested a substantial expansion of the European budget to facilitate large-scale income transfers. The report pointed out that this would be especially necessary in the event of a single European currency. In 1981 Sir Geoffrey Howe, the then British chancellor of the exchequer, made a speech in The Hague in which he proposed a "safety net", based on relative prosperity as measured by GDP per head, that would automatically adjust net contributions and benefits. Two years later, even the French suggested such a scheme, which they called *écrêtement des soldes* (literally, lopping off the balances). In 1988 a Commission group of experts chaired by Tomasso Padoa-Schioppa, now on the executive board of the European Central Bank, also argued for a generalised compensation system.

The most radical form of a generalised correction mechanism would apply the equivalent of the UK rebate to all five countries (the "unconstrained mechanism" in the table below). A simulation run by the Commission shows that, were this to apply in 1999, it would leave Germany €5 billion better off than it is now, with significant gains also for Austria, Sweden and the Netherlands. Less drastic is a modified formula put forward by the Germans, Dutch, Austrians and Swedes: a threshold for net contributions of 0.3% of their GNP, after which a 66% British-style rebate would kick in (the "constrained mechanism"). Applying this to the four countries of the net contributor camp, and also to the UK in place of its existing rebate mechanism, would still leave Germany better off by €2.7 billion.

Although there is a logic behind both these proposals (if a correction mechanism is permissible for the UK, why should it not be permissible for other countries in a similar situation?) neither is likely to fly. They will founder on the fact that in saving a considerable amount of money for the net contributor countries they will cost money for

everyone else. Not only would the cohesion countries squeal at the thought of spending money on reimbursing the richer countries, rather than on their less fortunate selves, but the UK stands to lose significantly. A straight application of the British rebate to all five countries would increase Britain's net contribution by around €1.8 billion, as the costs are redistributed. The modified formula proposed by the German camp would leave the UK significantly worse off—to the tune of €3.1 billion in 1999 compared to the status quo—since it would cease to obtain a rebate on its net contributions for the first 0.3% of its GNP.

Winners and losers from a generalised correction mechanism
(the change to a country's net contribution compared to no mechanism; €m; 1999 projections)

	Present mechanism (ie UK only)	Unconstrained mechanism	Constrained mechanism
Germany	-1,008	4,110	1,669
Netherlands	-311	112	-123
Austria	-173	68	-54
Sweden	-189	185	50
UK	4,952	3,126	1,819
Cost to other 10 countries	-3,271	-7,601	-3,538

Note: The first column represents the status quo, showing Germany's net contribution increasing by €1 billion as a result of the UK's rebate. The remaining two columns show Germany's net contribution decreasing, and the UK receiving less than at present, although it will still receive a rebate.
Source: European Commission.

But there are other variants of the general correction mechanism that might in time draw wider support. In an ideal world, any rebate or correction should be varied according to relative prosperity. A country that was below the average in income per head, but was making a net budget contribution, should clearly receive a bigger rebate—perhaps even one of 100%—than a richer counterpart. Similarly, a poor country that was a substantial net beneficiary should perhaps not suffer any correction at all; but a country of above average prosperity that was nevertheless, in net terms, drawing money from Brussels, should clearly have its benefits cut substantially—perhaps even to zero.

What are the arguments against such a system? They boil down to two. One is that some countries would suffer, notably France, Denmark, Italy, Belgium and Luxembourg (though in these last two cases it would depend to a large extent on whether EU administrative spending is treated as a benefit to host countries or ignored in the calculations). But the reason for this is that, given their relative prosperity, these

countries are either paying too little into or drawing too much out of the budget. Any method of correcting this inequitable situation is bound to hurt.

The second objection is that drawing up a generalised correction mechanism would encourage a narrow, accounting view of the EU budget, and perhaps of the EU itself. Proponents of this view conjure up the spectre of the *juste retour*, a derogatory label for the desire to get back whatever one puts in; they also believe any mechanism would be un-*communautaire* because it would mean that member countries would lose any interest in developing common EU policies.

These arguments are not just wrong: they are the opposite of the truth. In fact, it is because the net transfers engendered by the EU budget are so perverse that countries start to fret about a *juste retour*; it is because of the absence of any corrective mechanism that they consider new policies purely in terms of their net costs and benefits. If instead an automatic system were to take care of these costs and benefits, all countries would be more interested in assessing EU policies on their merits.

Unfortunately, however, we are not living in an ideal world. We cannot wipe the slate clean and start again. The solution to the Agenda 2000 conundrum will be a second-best, imperfect outcome, depending more on the legacy of the past than on a serious attempt to find the ideal way to finance the future. Varying the net contributions according to relative prosperity of member-states is, more's the pity, not even part of the current summit agenda. Yet in the end it is likely to be the only solution to the EU's perennial budget squabbles.

Britain's dilemma

One thing that is firmly on the agenda, despite the UK government's insistence that it should not be, is Britain's budget rebate. As Tony Blair has said, because the problem (of Britain's otherwise excessive net budget contribution) remains, so, therefore, must the solution. There are few countries that disagree with this, recognising that if Mr Blair came home having given up Maggie's rebate it would be hugely damaging politically.

However the EU's enlargement to the east has thrown up an anomaly in the operation of Britain's abatement. At present, the substantial programmes of EU assistance to eastern Europe fall outside the terms of the British rebate—which means that Britain pays its full share of their costs. But when some of these countries join the EU, collecting what will presumably be larger transfers from Brussels than now, the costs will fall inside the part of the budget on which the rebate is calculated. The effect, if nothing is done, will be for Britain to pay significantly less than other countries towards new member-states. Commission figures show that if the rebate remained unchanged, Britain's share of EU spending on the new member-states would, by 2006, be worth around 0.05% of its GNP per year, that is about €650 million. The others, having no rebate, are due to pay an average of 0.15% of their GNPs, which for Germany is over €3 billion a year and for France around €2 billion.

The result is a strong feeling across the EU that Britain is unwilling to pay its fair share of the costs of enlargement. Out of the EU-15, 14 member-states want Britain to pay more (see appendix), and around 10 or 11 are happy to say so publicly. In a negotiating

situation in which each side will have to compromise if a deal is to be done, Britain will come under strong pressure to concede at least some of the costs of enlargement and thus allow movement on the rest of the package.

This would not be the first time that the terms of the rebate were changed in the light of unforeseen circumstances. When in 1988 the own resources ceiling was raised, the UK agreed to modify the abatement so that Britain's net contribution remained the same. If this change had not been made, Britain would have gained disproportionately from the extra cash made available. There is therefore some precedent for the case that, because the EU's eastern enlargement could not have been foreseen at the time of Fontainebleau, Britain should accept a trimming of the rebate to help pay for it.

The British government, meanwhile, argues that there is no reason for the correction mechanism to be altered. It has never previously mattered what each pound contributed to the EU pot was spent on, it points out. It is not that Britain is spending less on enlargement, but rather that the UK gets some of its contribution reimbursed because it would otherwise be paying too much for all EU policies, be they on agriculture, structural funding or whatever. Furthermore, despite being the fifth largest net contributor to the budget in per capita terms, it is only about the eleventh most prosperous member-state. So the government claims that the rebate remains justified and says that it will not consider any outcome that would weaken it.

Yet unfortunately for the UK, it has almost become a matter of principle amongst the other governments that an agreement will depend on compromise on all sides. And they believe that the enlargement issue provides enough of a political justification to demand that Britain's compromise be on the rebate.

And indeed, if an overall deal depended on it, it may be in Britain's interests to move. The UK warns that excluding the cost of enlargement from the calculation of the rebate could cost it as much as £1 billion (€1.4 billion) annually by 2006. Might that be a price worth paying to achieve other objectives? The Commission estimates that the whole CAP reform package, including 25% co-financing, would only save the UK just over £100 million (€146 million) by 2006, although this would rise substantially if accompanied by degressivity. If the contributions based on VAT revenue were totally replaced by GNP contributions, Britain would gain around £100 million more. Budget stabilisation could deliver another £300m. Furthermore, the alleged £1 billion cost to Britain could be too high, since it depends on a number of assumptions by the Commission which could prove unrealistic, such as over-optimistic growth rates and the assumption that the EU will gain five new members in 2002. So while it may not be in Britain's financial interests to pay all its "enlargement bill", it could be advantageous for the UK to indicate that the rebate is up for discussion, if that would trigger important concessions from other countries.

A good deal?

Any attempt to predict the final deal is complicated by the dynamism of the negotiation process: allegiances will shift right up to the end. Yet there are some clues on the shape that a far-reaching agreement might take. Each of the main players has an issue that is crucially important, on which it will not willingly concede. France is determinedly

against co-financing of the CAP. Spain will not accept giving up its cohesion status before its economy grows beyond 90% of the EU-15 average. Britain cannot lay itself open to media accusations that it has abandoned or reduced the rebate. Germany must secure a deal that shows its electorate it is no longer prepared to bankroll the rest of the EU. Other countries have their own conditions. If a deal can be reached that satisfies these basic concerns, then the rest of the pieces may fall into place with relative ease.

Time adds a further dimension which may help the negotiators. The political agreement that is reached does not have to come into effect immediately. In fact, much of it could start to apply only at the moment of enlargement, which is unlikely to happen before 2003-04. This could increase the ability of governments to sell unpopular decisions at home: matters of principle are easier to concede if they are only phased in slowly and/or accompanied by generous transitional arrangements.

Unpopular measures are also easier to sell if they serve a good cause, and there is a broad political consensus across the EU on the merits of enlargement. For this reason, there appears a real chance that there will be movement on the matters of principle, so long as they come into effect only at the moment of enlargement, whenever that might be.

Solving Germany's problem

When sketching out what a far-reaching deal might look like, it makes sense to start with Germany's complaints. The final agreement, after all, will have to go some way towards addressing them. Of the Commission's three possible solutions to Germany's net contribution problem—CAP co-financing, making countries' contributions more closely linked to GNP and a generalised correction mechanism—the front runner would appear to be replacing VAT contributions by GNP contributions. France is staking everything against CAP co-financing, to the extent that it has proposed degressivity as a compromise alternative. A generalised correction mechanism of the type discussed by the Commission would hurt too many countries to be acceptable at present.

But a move to a greater GNP resource would attract the opposition of Italy (see table below), which at present pays less to the EU than its wealth suggests it should. Belgium would also stand to lose. And everyone would reject it unless it were accompanied by Britain giving some ground on the rebate, since a financing system based on GNP would negate part of the rationale for a correction mechanism. Britain would therefore be likely to oppose it too, since the rebate is worth far more than any gains from an increased GNP resource. Yet if the rebate were only altered at the point of enlargement rather than immediately then perhaps Britain could be persuaded to take on a greater share of the enlargement costs. This would probably be a sufficient concession to pacify everybody else, and might even be enough to induce Italy to accept GNP contributions.

Winners and losers from replacing VAT with GNP contributions
(1997 data; "-" indicates a budgetary loss; excludes UK correction)

Winners	€ m	Losers	€ m
Germany	708	Italy	-1,236
UK	332	Belgium	-266
France	159	Denmark	-71
Spain	98	Finland	-45
Austria	93		
Portugal	79		
Sweden	72		
Netherlands	42		
Greece	20		
Ireland	8		
Luxembourg	7		

Source: European Commission.

Solving Britain and Italy's problems

Whether Britain and Italy agree to compromise will depend on what they in turn are offered. Both would like to see a reformed Common Agricultural Policy ("reform of the CAP" has long been in the UK Labour Party manifesto); a deal could therefore depend on the acceptance of the Commission's proposals for CAP reform. Degressivity could also play a part in the deal, since it is strongly advocated by Britain and regarded with an open mind by Italy. Perhaps France might even be persuaded to concede the principle of CAP co-financing (although were this to happen it would probably apply only to a slither of agricultural funds rather than to the 25% proposed by the Commission). Both countries also want to see the end of milk quotas; the blocking minority they have with Sweden and Denmark against the Commission's proposals to extend them might therefore achieve that target. The UK would benefit from stabilisation of budget expenditure. Italy too could see some advantages in it. And both would also find it easier if the change to a GNP-based resource happened only at the moment of EU enlargement.

All these points taken together would probably give Britain enough for it to justify paying part of its "enlargement bill". Depending on the detail, Italy could also gain enough to justify conceding the principle of a greater GNP resource, and still be able to present the outcome as a victory.

The rest of the jigsaw

Most other member-states would be happy with a reduced CAP bill and budget stabilisation. The exception is the cohesion countries, who would stand to lose from both. The remainder of this "optimal" deal will therefore have to be structured to give them, too, something they can portray as a victory. Spain is likely to accept, albeit reluctantly, the Commission's proposals to cut food prices if it can maintain its cohesion status until its wealth grows to 90% of the average of the existing EU-15. Along with the other

cohesion countries—notably Ireland—Spain would also be pacified if the streamlining of structural funds was phased in slowly. That would enable national governments to claim that they had secured generous transition arrangements to protect regions that no longer qualified for funding.

Were a political agreement along these lines to prevail, the immediate effect on the budget would be slight. In the first few years under the new budget, price support to farmers would be cut slowly, to be replaced by direct payments, while structural funds (not including cohesion funding) would diminish, as the criterion for obtaining objective one funds was enforced rigorously. The milk quota system would probably be phased out. The money saved from all these changes would be spent on pre-accession aid to eastern Europe. Then, when the EU started to take in the first east European countries, a new Own Resources Decision would come into effect, replacing the VAT resource with a higher emphasis on GNP contributions. The correction mechanism in favour of Britain would be altered slightly, so that Britain paid more towards the cost of enlargement.

From around 2004, farmers in the original EU-15 would start to feel the pinch from degressivity of income support payments. This would come at a bad time; they would also face increased competition from farmers in eastern Europe. Ireland's transition out of cohesion funding would be near completion, and Spain would probably start to experience a reduction in cohesion funds, assuming its wealth has risen beyond the cut-off point of 90% of EU-15 GDP.

No real alternative

This is one scenario. It is probably the best possible outcome (although it is not the most likely) and it is certainly the one that the Commission wants to see. Of course there are other scenarios as well. The most likely is that there will be no deal at all in March. After all, budget negotiations in the past have ended in stalemate. It is true that some effort has been made to impose a credible deadline: heads of government made a political commitment at the Vienna summit of December 1998 to get a deal by March 25th. The German presidency has been keen to point out the dangers of delay: if a deal is not reached before the European Parliament elections in June 1999 it would lead to unnecessary uncertainty since the political priorities of the new Parliament (which has to ratify the budget agreement) would not be known. A delay would also prevent the allocation of new structural funds, which would cause pressure on national governments from interest groups in poorer regions. But this is unlikely to be sufficient to make the deadline appear credible. When it comes to it, any negotiator forced into a corner can simply refuse to give in, knowing there is time to revisit the subject.

But even if the March deadline is not met, and a deal is postponed for up to a year, the underlying economic and political forces will remain. The pressures that will determine the end-game are in place, even if the time at which they come into play is not yet clear.

The most likely scenario, whether it happens in March or later, is a sub-optimal deal. Britain may well refuse to cede on the rebate, judging that preserving it in its entirety for the foreseeable future is the only thing worth worrying about. Similarly Italy might also refuse to accept opening up the Own Resources Decision. Perhaps all the member-states might decide to avoid getting embroiled in a deep discussion on EU financing, preferring

to deal only with the expenditure side of the budget. In this scenario, Germany might have to make do with budget stabilisation (or near-stabilisation) to reduce the projected level of its net contributions. The deal might then include a "rendezvous" clause that would allow governments to reconsider opening up the Own Resources Decision in the light of enlargement, later on in the budget period.

In this sub-optimal deal, many of the hard decisions would be postponed. Heads of government might specify some broad principles that should apply to this later wrangling, but they would shy away from determining its outcome. The result would then be a new battle, just as intense, a few years down the road. In the long term this may not be as bad as it would initially seem. Perhaps, in the intervening years, officials and politicians alike may come to see the merits of a longer term solution such as the one we have advocated, namely a generalised correction mechanism that gives rebates according to countries' relative prosperity.

But in the short- to medium-term, a failure to agree a deal would be damaging. By considering only the immediate financial interests of their own countries, heads of government are in danger of losing sight of the bigger picture. Budget negotiations are not, as is commonly assumed, a pure zero-sum game. If the final deal does not address sufficiently the challenges that the EU will face in the next few years, then everybody will end up worse off. What EU leaders must realise is that an unsatisfactory deal will not only do their own reputations no good, but also be bad for the EU as a whole.

February 1999

APPENDIX: INITIAL NEGOTIATING POSITIONS (as of January 1999)

	Austria	Belgium	Denmark	Finland	France	Germany	Greece
Budget stabilisation	support strongly	—	—	—	support	support strongly	oppose strongly
Co-financing of the CAP	support	support	oppose	—	oppose strongly	support	oppose strongly
Larger GNP resource	support	oppose strongly	oppose	oppose	support	support	—
Generalised correction mechanism	support	—	—	oppose	oppose	support	—
Commission's CAP reforms	partially support	support	support (excl. milk)	support*	partial support	support	support*
"Degressivity"	oppose	—	support	—	support	oppose	oppose
Commission's structural fund reforms	support	support	support	support*	support	support	support
UK rebate should be discussed	support	support	support	support	support	support strongly	support

"—" indicates a neutral, open or intermediary position; *although seeks exemptions for particular areas.

	Ireland	Italy	Lux.	Neth.	Portugal	Spain	Sweden	UK
Budget stabilisation	oppose	oppose	oppose	support strongly	oppose strongly	oppose strongly	support strongly	support strongly
Co-financing of the CAP	oppose	support	support	support	oppose	oppose	support strongly	support strongly
Larger GNP resource	—	oppose strongly	—	support	—	—	—	oppose
Generalised correction mechanism	—	oppose	—	support	oppose	oppose	support	oppose
Commission's CAP reforms	—	support (excl. milk)	partial support	oppose	—	oppose weakly	support (excl. milk)	support (excl. milk)
"Degressivity"	oppose	—	oppose	—	—	—	—	support strongly
Commission's structural fund reforms	—	support	support	support*	oppose	oppose	support*	support*
UK rebate should be discussed	support	support	support	support	support	support	support	oppose strongly

"—" indicates a neutral, open or intermediary position; *although seeks exemptions for particular areas.