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policy brief

The EU budget: A way forward

By John Peet

★ Tony Blair will struggle to strike a deal on the EU budget before the end of his EU presidency in December 2005. The two biggest bones of contention are the common agricultural policy (CAP) and the British budget rebate. Blair is prepared to negotiate on the British rebate only if France agrees to more reform of the CAP.

★ On the CAP, the EU should agree to start a review in 2008 with the explicit remit of reducing farm spending before the end of the next budget in 2013. At the same time, the CAP – now paid 100 per cent by the EU – should shift towards 'co-financing' through national budgets.

★ Such CAP reforms would automatically reduce the British rebate. But Britain should be ready to give up its rebate in favour of a 'generalised corrective mechanism' that links a country's contributions to, and receipts from, the EU budget to its relative prosperity.

Many of the bitterest arguments in the European Union have been about money. That is partly because the budget is inherently a zero-sum game: more for one country means less for others. But it is also because, although the budget is small (just over 1 per cent of EU GDP, equivalent to 2 per cent of EU-wide public spending), it gives rise to sizeable flows of money in and out of finance ministry coffers.

All EU governments need to agree to the Union's 'financial perspectives' (the EU's medium-term frameworks for spending), and budget negotiations have become increasingly fraught in recent decades. The last two financial perspectives were settled only because Germany made big concessions. The Edinburgh summit of December 1992, which fixed spending for 1993 to 1999, reached agreement only after Helmut Kohl offered a lot more money to the four poorest countries (at the time Spain, Greece, Portugal and Ireland). And in Berlin in March 1999, EU governments struck a deal for the 2000 to 2006 budget only after Chancellor Gerhard Schröder deferred to President Jacques Chirac, who insisted on partly reversing cuts to the CAP that his own government had previously accepted.

So it should be no surprise that the EU budget for 2007 to 2013 has provoked such a fierce row. It was optimistic of Jean-Claude Juncker, Luxembourg's prime minister who held the EU's rotating presidency at the time, to aim for a settlement at the EU summit. He may have hoped that, in the wake of the French and Dutch rejections of the constitutional treaty, his fellow leaders would make an extra effort to show that the EU was still able to function. Yet there was no willing volunteer this time round to make the sacrifices that Germany had frequently made in previous budget negotiations. And although the summit breakdown led Juncker to declare that the EU was in "deep crisis", that seems decidedly overstated. No financial perspective has ever been settled 18 months in advance; most have been agreed only in the spring preceding their coming into force.

The battle lines over the budget were drawn even before the European Commission made its own proposals for the next financial perspective in mid-2004. In December 2003, the six biggest net contributors to the budget (Germany, Britain, France, the Netherlands, Sweden and Austria) demanded that the budget be held below 1 per cent of EU GDP, despite the imminent arrival of ten new member-states in May 2004 and the likely accession soon afterwards of Bulgaria and Romania.

In the run-up to the June 2005 summit, some net payers began to hint that they might accept a somewhat bigger budget, but only with conditions.

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Both Germany and the Netherlands wanted to see their net payments cut. President Chirac, whose first big political job was as a French agriculture minister, remained implacable in his opposition to CAP reform. He stuck firmly to an agreement that he had reached with Schröder in October 2002 to maintain CAP spending unchanged until 2013.[1] The other EU leaders in the European Council later endorsed the deal, despite the misgivings of, among others, Tony Blair. While ruling out CAP reform, Chirac tried to focus the budget discussions on the 'British cheque'. Yet Blair was just as determined to hang on to the rebate, first negotiated by Margaret Thatcher at the Fontainebleau summit in 1984. The rebate returns to the UK some two-thirds of its net contributions to the EU budget.[2] It is enshrined in an EU treaty called the 'own resources decision', so it can be changed only with the unanimous agreement of all EU countries and after ratification by national parliaments.

[1] The agreement allows CAP spending to rise by 1 per cent a year in nominal terms, implying a small fall in real terms. Proponents of CAP reform say that the deal sets an upper limit for CAP spending but does not guarantee fixed amounts.

[2] Strictly, Britain gets back 66 per cent of the difference between its GDP-based contribution to the EU budget and its 'allocated expenditure', one year in arrears. This difference is slightly smaller than the UK's net contribution, since the UK also pays a share of customs duties and agricultural levies into the EU budget, and allocated expenditure excludes some items, such as EU foreign aid.

For the other 24 countries, the British rebate is an irresistible target. Chirac and Schröder called for it to go immediately after the French and Dutch referendums, in part to divert attention from the No votes. Not surprisingly, Blair was quick to quash speculation that he might be flexible. On June 8th he told the British parliament that "the UK rebate will remain and we will not negotiate it away. Period." The following day, after Chirac called for Britain to make a "gesture of solidarity for Europe", a defiant Blair shot back that Britain had long been making such a gesture: during the past ten years, he said, "even with the British rebate, we have been making a contribution to Europe two-and-a-half times that of France". At the EU summit shortly afterwards, Blair insisted that, if the British rebate were to be put on the table, the CAP should be as well.

The Commission's proposals

In its budget proposal for 2007 to 2013, the outgoing Commission under Romano Prodi was generally timid. It largely ignored the advice of its own expert group chaired by economics professor André Sapir. The Sapir group had concluded that the EU budget was "an historical relic" that did little for Europe's economic growth. It recommended that a reformed budget should be divided into a fund for economic growth (including research); a convergence fund, which would include all current EU regional aid, and would be concentrated in the new, relatively poor member-states; and a restructuring fund that would help industries, including the farm sector, to adjust. The EU should reduce the portion of the budget it spends on agricultural support to just 15 per cent, compared with around 40 per cent now.[3]

[3] André Sapir and others, 'An agenda for a growing Europe: Making the EU system deliver', European Commission, July 2003.

The Commission's budget proposals were much more conservative than Sapir's suggestions, although that may have been in part a simple recognition of political realities. Commissioners accepted without question the October 2002 Chirac-Schröder deal to maintain spending on the CAP. And rather than steer regional aid to the new members, they allocated over half of structural fund spending to the 15 old ones – even though all but two have incomes per head above the EU average. One of only two new elements in the Commission proposal was an increase in spending on "policies for growth and competitiveness", a token gesture to the Sapir report. But the CAP and the structural funds would still account for the lion's share of the budget, namely 33 per cent and 36 per cent of the total, respectively, over the 2007 to 2013 period.[4]

[4] Iain Begg, 'The EU budget: Common future or stuck in the past', CER, February 2004.

The other new element concerned the British rebate. The Commission declared that it was outdated, especially as Britain has moved so far up the EU league table of relative prosperity. It also acknowledged that some other EU countries have as good or better a case for special treatment. The 1984 Fontainebleau conclusions envisaged that other countries besides Britain might benefit from rebates "at the appropriate time". Accordingly, the Commission proposed replacing the British rebate with a considerably less generous 'generalised corrective mechanism' for all EU countries.

The main bones of contention

The big areas of disagreement over the budget at the June summit fell into four broad areas:

★ The size of the budget

The gap between the six big net payers and the Commission's proposal – backed by the net recipients – is bigger than it first appears. The reason is that there is usually a sizeable difference between spending allocations (called 'commitment appropriations' in EU jargon) and the money that the EU actually pays out.[5] The minimalists wanted commitments to future spending capped at 1 per cent of EU GDP, which implies actual payments of 0.94 per cent at most. The Commission's original proposal to spend 1.14 per cent was for actual payments, which meant that for commitments the Commission wanted the budget to reach as much as 1.24 per cent of EU GDP. In terms of money, the gap between the Commission and the minimalists is worth

[5] Commitments cover multi-year spending programmes, not all of which will result in actual cash disbursements, for instance because regional aid projects might slip.

some €215m a year, or roughly €1.5 billion over the seven-year period.

The European Parliament, in a report of June 8th 2005, proposed that the difference between the two camps should broadly be split, by setting the budget ceiling for payments at around 1.07 per cent. At the June summit, the Luxembourg presidency produced a compromise that leant rather closer to the minimalists, setting payments at around 1 per cent. With most net contributors now hinting that they are prepared to be more flexible, the EU should be able to reach agreement on some splitting-the-difference deal.

★ The allocation of regional funds

Aid for poorer countries and regions – paid through the EU structural and cohesion funds – amounts to almost 40 per cent of total EU spending. The main beneficiaries pre-enlargement were Spain, Portugal and Greece, with Ireland still receiving sizeable, albeit declining, amounts. All the richer members also get at least some money from the structural funds for their poorer regions. Many economists (and the UK government) argue that in the enlarged EU the structural funds should be targeted at the poorest countries. Yet the Commission's proposal suggested that the 'old' members would still get roughly half of the structural fund allocation from 2007 to 2013. The Luxembourg presidency suggested shifting more money towards the new members, but it still left as much as 40 per cent of all structural fund spending in the old member-states. This approach seems illogical, given that only Portugal and Greece are now below average in terms of GDP per head.

Supporters of the Commission's structural fund proposals make three unconvincing arguments in favour of continuing to grant money to the richer member-states. The first is that most countries have at least some regions with GDP per head below 75 per cent of the EU average (the eligibility threshold for most structural fund money). But there is no reason why help for poorer regions in rich countries needs to come from the EU, rather than from national exchequers. The second argument is that the EU can only engender positive feelings if all members gain at least something back from the structural fund budget. Yet people in the EU are aware that they ultimately pay for the EU budget through their taxes; most are not impressed by receiving a few crumbs back. The third argument is that the new members, with their inefficient bureaucracies, cannot 'absorb' much larger sums from the EU. That is why the EU has decided to cap overall structural fund spending in the new member-states at 4 per cent of their respective GDPs. But worries about 'absorption capacity' in the East are an argument for cutting the total size of the structural funds to match what can usefully be spent, not for diverting the extra cash back to the richer countries.

★ The EU farm budget

EU farm spending still gobbles up more than 40 per cent of the entire EU budget, although farming accounts for less than 3 per cent of EU output. Considering its size, agricultural spending was remarkably little discussed in the run-up to the June summit. The reason is that nobody saw fit to question the Chirac-Schröder deal from 2002. Blair admittedly had challenged Chirac's assumption at the time that this meant no further talks about CAP reforms until 2013 – occasioning one of the more notorious of the two men's rows, with Chirac haughtily declaring that he was "not used to being spoken to like that". But even the British did not seriously seek to reopen the CAP in this year's budgetary negotiations – until it became clear that the other 24 were serious about threatening the British budget rebate. Given his position now, it is hard to explain why Blair endorsed the CAP agreement in October 2002. Some officials claim that he feared that Chirac might otherwise have reneged on the planned eastward enlargement, but that was surely unlikely.

One reason for discussing the CAP despite the October 2002 deal is that, even if its share is shrinking, it remains the biggest component of the EU budget. In the final Luxembourg compromise proposals, agricultural spending would still amount to 40 per cent of the total in 2013. Any forward-looking discussion of the budget ought to re-examine its biggest single item. Another reason to debate agriculture is that it is a central component of the current global trade talks in the 'Doha development round'. If the EU wants Doha to succeed, which as the world's biggest trading block it must, it will have to give up more of its farm protection. Thirdly, the new member-states from Central and Eastern Europe (and Romania and Bulgaria, which are set to join in 2007 or 2008) are not yet full beneficiaries from CAP spending; but they will be by the time of the next financial perspective in 2014. This makes it more urgent to reshape and reform the CAP now, before they too become proponents of the status quo.

Contrary to the perception conveyed by the British government, the CAP has in fact been significantly reformed in the last few years.[6] The key feature of these reforms is a gradual shift from production-linked subsidies to direct income payments to farmers.

[6] *Julie Wolf, 'The future of European agriculture', CER, November 2002.*

Such a shift does not necessarily save public money. On the contrary, because it is consumers who carry part of the costs of keeping farm goods prices artificially high, a switch to direct income payments may add to the costs of the CAP – one reason why finance ministries are not all that keen on it. The proponents of reform argue that shifting EU support from obscure market intervention to direct income support invariably raises the question as to why the EU should pay so much money to farmers, as opposed to say, miners or car-makers. Since more transparency creates new pressures for reform, most farmers dislike the switch to income support.

The case for national farm payments

The shift towards direct payments raises questions about the financing of the CAP. As long as farm support comes through production subsidies, financing must take place at the EU level because farm products are traded freely within the EU's single market. So without EU spending, the Dutch government might end up having to buy up surplus output that has come from France, just to keep local farm prices high. But it is much easier to envisage direct income payments being partly or wholly financed by national budgets. Indeed, because countries have different levels of income, it may make more sense to finance such payments at national level. National discretion would permit richer countries, and those with strong agricultural lobbies, to offer more help than poorer countries, and those with less politically vocal farmers.

It is important to note that partial national financing (known in EU-speak as 'co-financing') does not mean the re-nationalisation of agricultural policy. The Commission would continue to administer the CAP, and nationally financed income payments would have to be policed to ensure that they do not distort the single market, just as industrial subsidies are now. Indeed, the new members are already co-financing some of their CAP payments under an interim deal.[7]

[7] Since the EU decided to gradually 'phase in' market support (called 'pillar one' payments) to East European farmers, the new members wanted the right to pay extra money to their farmers from national budgets. But they are not keen on a general move towards co-financing because their budgets are already severely stretched.

Naturally, the biggest beneficiaries of CAP spending, notably France, are passionately opposed to transferring financing to the national level. Indeed, the original bargain of the European project was that German industry won unfettered access to the French market in exchange for German help for French farmers. But the logic of France's defence of full EU financing of the CAP is now little different from Britain's protection of the rebate. In effect, the CAP can be seen as the French rebate – with two differences: it is bigger (France received €10 billion of CAP receipts in 2003, compared with the €4.5 billion Britain gets back through the rebate), and it damages third parties, notably EU consumers and farmers in developing contries. If, say, half the CAP were financed nationally, that would save Britain some €2.5 billion a year, over half the present value of the rebate.[8]

[8] Co-financing would cut the UK's contribution to the CAP in half, from €9 billion to €4.5 billion. British CAP receipts would also be cut in half, from €4 billion to €2 billion.

★ The British rebate

The close analogy between the CAP and the British rebate helps to explain why, just as Britain is the biggest critic of the CAP, France is the biggest opponent of the British rebate. Chirac seems determined to press for at least a freeze in the value of the rebate, as the Luxembourg presidency proposed at the June summit, and preferably for its total phasing-out. Blair is equally adamant that CAP reform must be part of any negotiations on the rebate.

As it happens, the case for the British rebate in its present form has become weaker. Without any rebate, Britain would still bear a disproportionate budgetary burden, just as it did in the 1980s when Thatcher demanded her "money back". The reason is that Britain still receives relatively small CAP and other payments from the EU budget. But at least the revenue side of the budget is less unfair than it was. Most EU money today comes from payments based on the size of a country's GDP, whereas in earlier years a bigger chunk came from customs duties, which meant that countries with more open trading systems, such as Britain, paid more. And the imbalance from the CAP is rather less painful now that its share in the budget has fallen to around 40 per cent, from over two-thirds at the time of Fontainebleau.

Britain is also a lot wealthier than when the rebate was first agreed. In 1984 Britain was the third poorest member, richer only than Ireland and Greece. Now it is, by some measures, the third wealthiest, having overtaken France, Germany, Italy and the Netherlands. Indeed, Germany and the Netherlands (and Sweden, which joined the EU in 1995) now pay bigger net contributions than the UK, both per head and as a share of their GDP, despite being poorer on a per capita basis. If the rebate remains unchanged, Britain would eventually pay less into the budget than France and Italy.

The financing of the British rebate has also provoked argument. At Fontainebleau, EU countries agreed that Germany would pay only two-thirds of what its full contribution to the rebate should be. In 1999, a similar 'rebate on the rebate' was extended to Austria, the Netherlands and Sweden. The result is that a disproportionate share of financing the rebate falls on France and Italy. It also produces the tricky problem that the ten new member countries, all far poorer than Britain, contribute towards the 'British cheque'. Although they are net beneficiaries from the budget, the newcomers hugely resent having to return money to London. So the rebate has become a sticking point in the UK's relations with the East Europeans, which are usually quite close.

All this hostility towards the rebate led the Commission to suggest replacing the British rebate with a 'generalised corrective mechanism' for all EU members. The mechanism would refund two-thirds of a country's net contributions if these went above a certain threshold, namely 0.35 per cent of the country's GDP. And the total amount of all rebates would be limited to a maximum of €7.5 billion per year. For Britain the mechanism would mean a much smaller rebate than the current one (which is calculated on the total UK net contribution, not only that above 0.35 per cent of British GDP). As a result, Britain's average annual net budget contribution from 2007 to 2013 would rise from around 0.25 per cent of GDP to about 0.51 per cent, making the country once again the biggest single net contributor. Germany, the Netherlands and Sweden would all get small corrections of their own payments. All other EU countries would benefit from this generalised corrective mechanism, compared with a budget that left the UK rebate untouched.

Nevertheless, there has been little enthusiasm for a generalised mechanism. Britain in fact proposed such a general scheme in the early 1980s. Its hostility to one now is firmly grounded in the (almost certainly correct) perception that, no matter what its parameters, any generalised mechanism is likely to yield less for Britain than the Fontainebleau rebate. Germany, the Netherlands and Sweden, the three countries whose budget burdens are comparable to or worse than Britain's, are still interested in the idea, but they seem to have put more effort into trying to scrap or phase out the British rebate and winning special deals of their own, than devising an acceptable and durable system for net contributions.

The way forward

The June summit has shown that reaching agreement on the budget for 2007 to 2013 will be extremely hard. The respective French and British positions are entrenched. The EU finds it much harder to reach unanimous agreement at 25 than at 15. Many participants blamed Blair for the summit failure. Yet even in the final stages of the summit, as many as five countries voted firmly against the Luxembourg compromise: Britain, the Netherlands, Sweden, Finland and Spain. For a deal to be struck now, all sides will need to give some more ground, especially the French and the British.

Britain, which holds the EU presidency in the second half of 2005, is best placed to move first. Blair is right to insist that the case for a British rebate remains strong; and he is right too that the main source of the UK's problem with the EU budget is the CAP. Budget negotiations should thus logically start with the CAP; and only after a satisfactory agreement move onto the rebate. Blair has already conceded that the rebate should be on the table. Two days after the summit he declared that it was "an anomaly that has to go", the opposite of his insistence two weeks earlier that the rebate would "remain. Period." In advance of the summit, he also let it be known that Britain was prepared to forgo that part of the rebate that is financed by the EU newcomers. This concession would cost Britain some €500 million a year but remove the presentational problem of poor countries seeming to give money to a richer one.

One problem with Blair's position is, however, that he has so far made no specific proposals for either CAP or wider budgetary reform. Both after the summit and in his much-praised speech to the European Parliament on June 23rd, he relied largely on the assertion that it made no sense to spend so much of the EU budget on a declining industry. Yet the reason the EU spends disproportionate amounts on agriculture is that the CAP is the only policy that is almost entirely financed at EU level. Blair's criticisms also failed to acknowledge the substantial reform of the CAP that is already in train.

★ Two ways to reform the CAP

The way forward for CAP reform is twofold. The first is to keep up the momentum of the present reforms, so that after support has shifted from production towards direct payments to farmers, a start can be made on reducing the size of the budget. The Commission reckons that the present budgetary ceiling, as agreed in 2002, will itself require cuts in direct payments of some 5 per cent by 2013. If the EU included Romania and Bulgaria within the ceiling – the only concession that Chirac seemed ready for at the summit – this might necessitate additional cuts of perhaps 8 to 9 per cent. Blair could propose that a CAP review start in 2008, with the explicit goal of achieving larger cuts in direct payments towards the end of the forthcoming budget. He could force such a reduction in direct payments (called 'degressivity' in EU jargon) through insisting on lower ceilings for CAP spending for the next budget. His case would be helped if Britain were to revive the idea of a ceiling on payments to individual farmers, a reform that British ministers blocked in 2003 in the interest of the UK's largest farmers.

The second change to the CAP would be more dramatic, namely a general move to national co-financing. Chirac will be loath to make any concession at all on this, but there are arguments that might help to persuade him. One is that any such change will not kick in until after he leaves office in 2007. A second is that increasing amounts of CAP money will flow to the new members in Central and Eastern Europe, so that by the end of the next budget in 2013, France may have become a net contributor to the CAP. And, like other net contributors, it would then in fact benefit from national co-financing.

The clinching argument that could help to shift Chirac is, of course, that without co-financing he may get nothing on the British rebate. As noted above, a shift towards co-financing of the CAP would itself cut the rebate sharply. But Britain should offer to cut the rebate further to secure wide-ranging CAP reform, including the scrapping of farm export subsidies and farm import tariffs. The first Luxembourg presidency proposal to freeze the rebate at its average 1999 to 2004 level before phasing it out was neither logical nor fair. Horse-trading might produce a more acceptable compromise, but it would still be essentially an arbitrary cut in the rebate's value.

A better way forward would be to couple radical CAP reform with replacing the British rebate with some kind of 'safety net', as the UK originally proposed before Fontainebleau. Such a scheme should not follow the Commission model, with its arbitrary parameters, its failure to include countries like Denmark, Ireland and Luxembourg that enjoy excessive net benefit, and its omission of any link between a country's relative prosperity and its payments and receipts. A tidier model would be similar to Germany's system of redistribution among its states (the *Finanzausgleich*). Under this system, richer states transfer money to poorer ones. A similar scheme for the EU would consist of a system of rebates and extra payments based on countries' relative prosperity. It would turn Luxembourg and Ireland – the two richest EU members that are, bizarrely, net recipients of EU funds – into net contributors; it would protect poorer new members that are in danger of becoming net contributors, such as Slovenia or Cyprus; it would spread the budget burden for those in the middle more fairly; and it would end the charade whereby all countries look at new spending policies, such as research funding, purely in terms of whether they are net recipients.

The precise parameters of any such safety net would be a matter for negotiation. The EU could phase it in gradually. It could initially be linked to current levels of net contributions and receipts, by splitting the difference between them and what countries would pay and receive under the safety net model. Unless the EU agrees on a new scheme of rebates and contributions for all countries, the British will have little incentive to abandon their own rebate. If Britain insists on the rebate, France will refuse to accept co-financing and other forms of CAP reform. Even if EU governments ended the current budgetary stalemate through further late night horse-trading, another mighty row would be inevitable before any future budget can be agreed.

★ Time for a deal

The budget is one of the top two items on the agenda for the British EU presidency. Blair is hoping to reach an agreement at the summit in Brussels in December 2005. To let it drift into the Austrian presidency in the first half of 2006 would make it harder for the Commission and the new members to prepare budgets and projects for 2007. If the budget is still not agreed during the Finnish presidency in the second half of 2006, the 2007 budget might have to be drawn up on the basis of the 2006 one, which the Central Europeans would howl about because they fear that they might miss out on some structural fund money.[9]

[9] The EU could help the new members by seeking an early agreement on structural fund allocations for them, so that they can start putting in applications for projects.

Blair is also right to be wary of the usual fudged Brussels deal put together in the early hours of the final summit day. He is right to insist that the EU discusses further changes to the CAP, both in terms of its financing and size. And he is right to call for a fundamental re-examination of the EU budget, to see if it could be spent in a way that corresponds more to the industries of the future, for instance by expanding research spending. Moving the CAP to co-financing, which is the norm for most other EU spending policies, is long overdue in any case. Such a reform makes much more sense now that most farm support is being switched from production-linked subsidies to direct income payments. But it would also help to create more room within the budget for spending in new growth-enhancing areas.

Co-financing of agriculture would also lead to a big fall in the unadjusted British net budget contribution, thereby automatically cutting the size of Britain's budget rebate. But the rebate remains an anomaly that, like the CAP, ought to be up for renegotiation. The best answer is not just to trim it, but to replace it with a general safety net that protects all large net contributors. This system would have to be more intelligently designed than the generalised corrective mechanism proposed by the European Commission, in particular by linking each country's net contributions and benefits to its relative prosperity. Such a system should bring to an end once and for all the EU's perpetual rows over who pays for its budget.

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