CENTRE FOR EUROPEAN REFORM
policy brief

The European Union budget 2014-20: More boldness needed

By John Peet and Stephen Tindale

★ The EU budget has always been the cause of bitter arguments. The negotiations for the new long-term budget framework that are getting under way in 2012 are likely to be even tougher, as they are taking place against a backdrop of fiscal austerity in most member-states. The Commission's own proposals are in essence more of the same. This will not do.

★ The EU's farm policies should be reformed substantially, in particular by stopping lump-sum payments to big farmers. Such a reform would free up more resources for a simplified and greener regional policy as well as for more spending on research and development, measures to strengthen the EU's external border controls to protect Schengen, cross-border infrastructure, and foreign and defence policy.

★ Britain, France and Germany should enter this round of budget debates without any of their usual preconditions on protecting the British rebate, preserving the common agricultural policy and holding down overall spending. The euro crisis makes it more pressing that the EU budget should do more for growth.

The European Union has spent most of its energies over the past two years managing the eurozone crisis. Even with calmer financial markets that priority seems sure to continue throughout 2012. Yet looming ahead is another potentially divisive issue: the next Multiannual Financial Framework, which is meant to fix broad parameters for the EU budget for the period from 2014 to 2020. The Danish EU presidency, which took over on January 1st, has described the budget as one of its top priorities. Yet its hopes of reaching the outlines of an agreement in the short interval between the French presidential election in the late spring and the end of its presidency in June seem unrealistic. More likely the argument will continue until the end of the year and even into 2013.

A forward-looking EU that has just gone through a wrenching economic and financial crisis might be expected to want a modern, updated budget that does more to promote growth. Even though the EU budget is relatively small, at around 1 per cent of total EU GDP or 2 per cent of total EU public spending, it would be possible to design it in such a way that it contributes to improving the EU's economic performance. Yet in practice the member-states have always seen the EU budget in zero-sum terms, opposing any changes that threaten either to reduce their receipts or to increase their payments. That has led to a powerful inertia in the system that has always tended to keep the budget much the same as before, with a heavy emphasis on farm support and structural-fund spending.

Historically, many of the biggest arguments between EU governments were over the budget. From the outset, a key part of the European bargain was the use of German cash to subsidise French farmers. Margaret Thatcher famously wielded her handbag to demand a better budgetary deal for her country (which would otherwise have emerged as the biggest net contributor despite being one of the poorer member-states). She initially secured a series of one-off lump sums and then, in 1984, a permanent rebate of two-thirds of Britain's net contribution.

This was by no means the end of the budget battles in Brussels, however. Since the Single European Act of 1986, these have mostly been fought over a series of Multiannual Financial Frameworks, beginning with an agreement that became known as the Delors I package for the period 1988-92. Debates on successive frameworks have always been heated. France has fought hard to protect the Common Agricultural Policy (CAP); Spain has proved especially adept at securing additional structural money for regional development; Britain has fought tooth and nail to preserve its rebate; some (but by no means all) German chancellors have been resigned to footing the bill in order to secure an agreement; and so on.

This policy brief looks at the history of recent EU budget negotiations and at previous attempts to make reforms. It then considers the Commission's current proposals, and suggests a more radical approach: a big reduction in CAP spending, switching structural-fund support more to poorer countries, and increasing spending on foreign policy and on innovation.

Background to the 2014-20 Multiannual Financial Framework

The EU's previous budget framework, covering the period from 2007 to 2013, was agreed only after a ritual and long drawn-out squabble between Britain's Tony Blair and France's Jacques Chirac in 2004-05. Without consulting Blair (or indeed the European Commission and other EU leaders), Chirac had already struck a deal with Germany's Gerhard Schröder to keep CAP spending broadly unchanged through these years, annoying Blair who wanted to reduce it. At the same time, Chirac led the charge for a steep cut in the British rebate, which he considered to be unjustified given that the UK had become wealthier than France.

At successive EU summits in 2005, and for many months in between, the two leaders traded insults over the EU budget, leading Luxembourg's perennial prime minister, Jean-Claude Juncker, who held the rotating EU presidency in the first half of that year, to talk of the EU being "in deep crisis" (the draft EU constitutional treaty had also just been rejected by the French and Dutch, adding to the gloomy mood). Eventually Blair, who in the second half of the year found himself occupying the EU presidency, conceded ground on preserving CAP spending more or less as it was and accepted a small trimming of the British rebate to ensure the UK paid its share of the costs of enlargement to the east. A solution was facilitated by Angela Merkel's appearance on the scene in late 2005, as she offered a couple of extra billions to grease the negotiations. But Blair made his concession only in exchange for an agreement to a mid-term budget review, to be conducted by the European Commission well before it proposed the next financial framework for 2014-20.

This mid-term review, which led, belatedly, to a Commission paper[1], proved a predictable disappointment. Many worthy ideas were floated in the paper – including the need for more emphasis on research and development, the case for aligning the budget better with the 'Europe 2020' strategy (the aim of which is to turn Europe into a more prosperous and innovative region), and an emphasis on the need for a European added value criterion – that money is better spent by the EU than by national governments – to justify EU spending. It also argued that the EU should find "ways to spend more intelligently." But the paper steered clear of the politically awkward conclusions that this line of thinking might lead to.

[1] European Commission, 'The EU budget review', October 2010.

For example, the UK House of Lords EU Committee rightly argued in its inquiry into the mid-term review that most CAP spending would fail any sensible test of added value.[2] But the Commission's paper did not suggest slashing or renationalising a chunk of agricultural spending. Nor did it draw the obvious conclusion that structural funds are not always spent intelligently or in ways that contribute to meeting the objectives laid-down in Europe 2020. A similar fate had befallen the previous Commission's 'Sapir report' of 2003, which had suggested big and mostly sensible changes to the EU budget that were promptly shot down by the powerful vested interests dependent on maintaining current spending programmes.

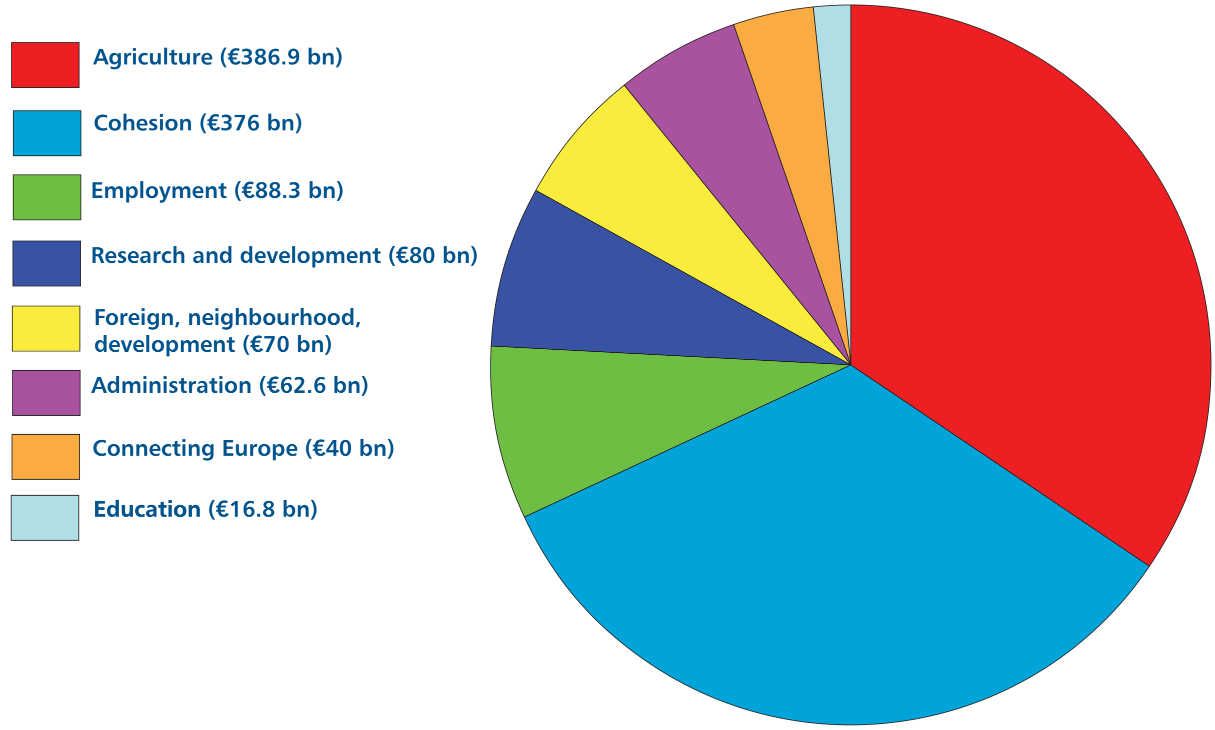
[2] UK House of Lords, 'EU financial framework from 2014', HL paper 125, April 2011.

A mixed response to the Commission's proposal

Not surprisingly in the light of this mid-term review, the Commission's proposals for the 2014-20 financial framework, which were published on June 29th 2011, proved to be another disappointment.[3] True to form, the Commission was cautious about proposing radical changes. Although it suggested some cuts in the CAP, farm spending would still account for some 36 per cent of the EU's total budget. The structural funds would account for roughly the same share. With administration accounting for another 6 per cent or so, this left little room for increasing spending on some of the priority areas identified by the Commission, such as supporting Europe 2020, research and development and innovation, or cross-border infrastructure. The Commission proposals also offered little in response to new budgetary demands, such as handling immigration, dealing with the Arab Spring or indeed responding to the euro crisis.

[3] European Commission, 'A budget for Europe 2020', June 2011.

Commission proposals for division of EU spending 2014-20



The initial response from member-states to these proposals was at best lukewarm. Many governments focused on the total size of the budget, and on the Commission's plans for new sources of revenue. Even before the proposals had been put forward, the leaders of Britain, France, Germany, the Netherlands, Austria and Sweden had written a letter to the Commission demanding a freeze on EU spending. The European Parliament urged the opposite, demanding an inflation-adjusted increase of at least 5 per cent, which would raise the size of the budget to some 1.1 per cent of EU GDP.[4] The Commission's proposed financial framework purports to split the difference, with a budget that remains flat in real terms. But it does this by the sleight of hand of inventing a whole new category of spending "outside the multiannual financial framework". If this additional category is added back, the Commission's proposals are closer to the Parliament's desired 5 per cent increase than to the freeze wanted by the main net contributors.

[4] *European Parliament Committee on Policy Challenges, 'SURE report – EU Budget 2014-2020: freezing is not an option', May 2011.*

As for revenues, most of the commentary (and not just in Britain) was hostile to the Commission's plans for new 'own resources' (revenues that the EU obtains directly through taxes and levies), rather than negotiated transfers from the EU capitals. The Commission's two suggestions were to impose a new financial transactions tax and to have a new VAT resource, more under the control of Brussels than of national capitals. Both ideas ran into plenty of opposition from national exchequers, keen to keep control over their own budgets.

These initial arguments over the budget's size and over plans for new revenues suggest that the next battle over the EU budget will be especially bitter. The most obvious reason for this is the gloomy macroeconomic climate. The EU as a whole is flirting with recession this year, and some countries are seeing sharp falls in GDP. The euro crisis continues to be the main preoccupation of EU policy-makers, with emergency summits now often taking place once a month. Everywhere public spending is being cut, in some countries by unprecedented amounts. All this makes both political leaders and public opinion across Europe exceptionally hostile to higher EU spending.

A second reason is that the Commission under José Manuel Barroso is weaker than its predecessors. In the Delors days, it usually fell to the Commission to broker the necessary compromises on the budget. Now, that role is likely to fall to the European Council President, Herman Van Rompuy, and he will not find the task easy. That is partly because of a third point, the increased influence of the ten Central and Eastern European countries. In 2005, only eight of them were in the club and as relative newcomers they sat mainly on the sidelines of what turned into a Franco-British argument. Now, the ten will be a powerful voice against budgetary austerity and in favour of higher spending, both on the structural funds and on the CAP.

The fourth factor making this budget round exceptionally hard to negotiate is the European Parliament. Under the Lisbon treaty, it now has equal standing with the Council (representing national governments) on budgetary matters; its consent is required for whatever the Council decides on the financial framework. Unlike most national parliaments, which are more mindful of taxpayers' interests, the European Parliament has a strong bias towards more spending, partly because it has no direct role in raising the taxes to pay for it. This compounds another feature of the EU as a whole, which is that it lacks the equivalent of a national finance minister whose job is to stamp down on the ambitions of spending departments.

The CAP needs further reform

The Commission's proposals would leave the CAP essentially unchanged. Spending on agriculture would for the first time take a lower share of the budget than cohesion spending (mainly the structural funds), but only just. The Commission has proposed a few minor reforms to the CAP, some of which are sensible and worth supporting. But 'single farm payments' to farmers simply for being farmers, which are not necessarily fair or in line with EU objectives and account for around three-quarters of CAP spending, would remain.

The so-called Fischler reforms of 2003 made farm support less intrusive and less trade-distorting. The butter and beef mountains of yesteryear are long gone. But the CAP still needs substantial improvement. It remains environmentally damaging and is still an obstacle to international trade liberalisation. All farmers receive subsidies, not just those on low incomes who might need them. Corruption is widespread. And farms in western Europe continue, perversely, to receive greater support than farms in Central and Eastern Europe.

The Commission would like to equalise benefits to east and west European farmers. It has proposed further moves towards payments only on the basis of hectares farmed rather than production – continuing the direction of the MacSharry and Fischler CAP reforms. This would be advantageous for east European farms that are less productive than their west European counterparts. But the Commission is proposing that the payments per hectare should be made uniform only by 2019. And full convergence of all CAP payments would have to wait until the next budget framework – after 2020.

The Commission has also proposed a €300,000 limit on the amount a single farmer or organisation can receive every year. This would help redress the absurdity that four-fifths of CAP payments now go to a quarter of European farmers – those with the largest farms. The British royal family, for example, reportedly receives over half a million euros each year.[5] The Duke of Buccleuch, Europe's largest landowner, gets several million. Subsidising such large landowners is hard to justify at any time. In the current economic circumstances it is impossible.

[5] *Louise Gray, 'EU reforms will cap money for large landowners', Financial Times, October 12th 2011.*

Regulation, not subsidies

One justification put forward by defenders of the CAP is that subsidies are needed to promote environmentally friendly farming. For the past decade this argument has been couched in terms of wildlife protection, but the Commission is now presenting it as climate protection. Agriculture accounts for less than 10 per cent of EU greenhouse-gas emissions. But the EU is committed to a 90 per cent reduction in emissions by 2050, so agricultural emissions will have to be reduced. Land also acts as a 'carbon sink', soaking up some emissions. Some forms of land use provide much better sinks than others. Grassland, for example, is better than arable land. The Commission proposes that all member-states must spend at least 30 per cent of CAP payments in their country on wildlife and climate measures, including maintaining permanent pasture, field margins, hedges, trees and landscape features.

The CAP cannot achieve its wildlife and climate goals – including the current cross-compliance rules which require farmers to follow certain environmental rules in return for subsidy – without regulation. So it is a legitimate question to ask whether subsidies are also needed, or whether regulation could work quite well without them. Several studies, including some by European institutions,[6] have suggested that the subsidies have not been effective in delivering on the policy objectives. Business is generally required to meet environmental regulations without being paid for its trouble. Why should farms be treated differently?

[6] *European Environment Agency, 'Ten messages for 2010 – agricultural ecosystems', June 2010.*

The EU should treat agriculture in the same way as other sectors by requiring it to support environmental and climate public goods without subsidy, and by restricting subsidies to those farmers who actually need financial support. Future CAP payments should go only on income support and rural development.[7] Such a focus would allow the EU to reduce overall CAP spending, with less going to farmers in western Europe and more to farmers in eastern Europe.

[7] *Christopher Haskins, 'A chance for further CAP reform', CER policy brief, February 2011.*

To achieve this, the Commission should put forward more radical proposals, including:

★ a faster move away from production and area-based subsidies, with payments to large and successful farms phased out and payments to small farms needing subsidy to survive as businesses retained;

★ more experiments with co-financing, with richer countries that wish to keep higher subsidies paying for a bigger share themselves; and

★ an increase in grants to projects promoting non-farming business activity in rural areas.

The politics of CAP reform are notoriously heated, with France and Ireland leading the defenders of the CAP, the UK and Sweden leading the reformists, and Germany siding quietly with France. The Commission's proposals try to steer a middle course. French and German farmers would see a small reduction in payments. Farmers from smaller EU countries, notably those in Belgium, Denmark and the Netherlands which tend to gain handsomely from the CAP, would see a larger reduction. And British farmers would get a small increase.

Early 2012 may not be an ideal time to put forward more radical proposals that will inevitably pitch Paris against London. Nevertheless, the Commission should still do so. An incoming French president may find it easier to shift ground on CAP at the beginning of his presidential term, especially now that France is poised to become a net contributor to the policy, so these EU budget negotiations are well-timed in that respect. Moreover, food prices, especially of grains, have been very high recently, so farmers have less reason to moan about not being able to cope without subsidies. Against this background, it is fair to ask: if the CAP cannot be substantially reformed in a climate of public-spending cuts, wage reductions and high food prices, when can it be?

Simplifying the structural funds

Regional policy spending is channelled through three so-called structural funds: the European Regional Development Fund, the European Social Fund and the Cohesion Fund. In the current budget period, the EU has allocated €347 billion to regional policy. For the next one, the Commission proposes an increase to €376 billion.

In theory, the structural funds are a good example of what European co-operation should be about: redistributing income and wealth from richer to poorer parts of Europe. As well as showing solidarity, such transfers are meant to help boost economic growth in poorer regions.

However, there is little empirical evidence that the structural funds have helped regional development. And structural funds, like the CAP, have been plagued by mismanagement and corruption. The European Court of Auditors' annual reports conclude that these programmes are riddled with "material error". In 2009, some €700 million, more than a third of the total, had been mis-spent. Mostly, such mis-spending was due to the complexity of the system: national and local authorities in 27 countries manage some 2 million projects according to ludicrously complicated rules. But some €109 million of the mis-spending was due to suspected fraud.[8]

[8] *Cynthia O'Murchu and Stanley Pignal, 'Net that fails to catch €700m errors', Financial Times, November 30th 2010.*

In its October 2011 proposals for the future of structural funds,[9] the Commission recognised the need to simplify their administration. It wants the EU to focus on a smaller number of policy areas, in line with the Europe 2020 strategy, and to support fewer schemes. But the EU should go further. It should also make the disbursement of structural funds conditional on good governance arrangements, to reduce the risk of mismanagement. And EU governments should accept that it is quite consistent with the principle of subsidiarity for them to be required to spend some of their allocations of EU money on specific EU-priority programmes, rather than to choose their own spending priorities.

[9] *European Commission, 'Proposal for a regulation on specific provisions concerning the European Regional Development Fund', October 2011.*

The Commission's proposals do contain some additional requirements on what member-states and their regions spend the money on. For example, the Commission proposes that more developed regions should be required to spend at least 20 per cent of their receipts on energy efficiency and renewables. But less developed regions would have to spend only 6 per cent.

The EU is right to suggest that poorer regions be allowed to spend a lower proportion on renewables. Renewables are good for the world's climate and for energy security, but they are not yet cheap. However, the same does not apply to energy efficiency. Improving the energy efficiency of existing buildings is the most cost-effective way to reduce greenhouse-gas emissions, one of Europe 2020's main goals. Saving energy is particularly important in poorer regions, where people suffer disproportionately from higher energy bills. In addition, energy efficiency projects are good local job creators. Hence, the obligation to spend a certain share of structural fund money on energy efficiency should apply also to the poorest regions. The Commission, however, is proposing to exclude the European Social Fund – which is targeted at poorer regions – from the calculation of total structural fund money that must be spent on energy efficiency and renewables. Under Commission proposals, the Social Fund will contain a quarter of total structural fund money, and has as its central objective the creation of employment.

In the current budget, around half of the money spent on transport has gone on road construction, and a third on railways. Some parts of Europe need new roads. But most do not. Structural fund rules require that the income potentially generated after construction be taken off the total grant, making it harder for railways (and toll roads) to obtain grants. This preference for toll-free roads makes the EU's climate targets harder to achieve, so should be changed.

The Commission has also proposed a new 'Connecting Europe' fund to invest in the improvement of European transport, energy and communications infrastructure. Of the envisaged €50 billion, €40 billion would come from a separate budget line and €10 billion from the structural funds. Through co-financing, the new fund is intended to attract additional public investment (for example from the European Investment Bank) as well as private money (perhaps from pension funds). About half the money would be allocated to transport infrastructure. But the money would be better spent on information and communications technology infrastructure in poorer EU countries, on constructing an EU-wide energy market and on preparing for the addition of large amounts of renewables to the European power sector.

The EU needs to make another urgent change to structural funds, namely to stop paying funds to relatively poor regions in the richest member-states. Economists (and some Commission officials) have long advocated focusing cohesion money on the poorer EU countries. The richer countries could decide themselves whether and to what extent they want to support their own regions. But they have always insisted that some of their budget contributions be recycled via Brussels back to their own less advantaged regions. Many politicians claim that such transfers are needed for political legitimacy and fairness. Yet this recycling is perverse and inefficient. There are better ways to ensure that richer countries gain some benefits from the EU budget.

More money for innovation and foreign policy

In its overall budget allocation, the EU needs to reduce spending on the CAP substantially so that it can protect structural funds while increasing spending on foreign policy, migration, research and development and innovation. Yet only €96 billion is earmarked in the Commission's proposal for external affairs. Although the biggest increase is foreseen for neighbourhood policies, the money will not be enough for the EU to implement the ambitious new neighbourhood policy that it started drawing up in the wake of the Arab Spring. The €8.7 billion foreseen for dealing with migration is also inadequate to preserve the Schengen area of free movement. EU spending is necessary to strengthen the EU's external borders, particularly Greece's border with Turkey. Spending is also needed to manage North African migrants more efficiently and humanely.[10]

10 Hugo Brady, 'Saving Schengen: How to protect passport-free travel in Europe', CER, January 2012.

The Commission proposes increasing the amount allocated to R&D and innovation from €55 billion in the last financial framework to €80 billion in 2014-20. This is welcome but still inadequate for a continent whose future prosperity will depend on staying at the technological frontier. Energy technologies urgently need more research and development. The Commission published a Strategic Energy Technologies plan in 2007, but member-states have predictably been unwilling to provide the necessary funding.

Areas to cut

Which areas of spending should the EU cut? Administration accounts for only around 8 per cent of the EU budget (6 per cent is listed under administration costs in Commission documents, but there is some more administration spending in other budget lines, including the CAP), so the Commission is correct to describe the argument that all the money is wasted on Brussels bureaucrats as a myth. Nevertheless, the Commission accepts the need to cut administration costs, so it has adopted a plan to reduce staff numbers by 5 per cent in 2013-18, to increase the retirement age of officials and to make staff work longer hours. This would save around €1 billion. A further €1.25 billion could be saved in the next budget period by ending the wasteful commute of the European Parliament between Brussels and Strasbourg.[11] As well as delivering cost savings, this long-overdue step would help MEPs to become more effective. But the Commission has not proposed this; an understandable omission given the inevitable French opposition and the fact that the monthly week in Strasbourg is written into EU Treaties.

11 The Brussels-Strasbourg Seat Study Group report, 'a tale of two cities', February 2011, calculates an annual cost of €180 million for the Strasbourg commute. This amounts to €1.26 billion 2014-20.

The EU could make more substantial savings by cancelling its participation in the international nuclear fusion project, or ITER. The total budget for this project has almost tripled since 2001, and is now €16 billion, although the main construction programme has yet to start. The EU will have to pay €6.6 billion of the total cost. In 2010, the Commission awarded ITER €1.4 billion, from unspent parts of the EU budget and the research programme. In its financial framework proposals the Commission suggested that ITER should be placed "off budget" because the total amount of expenditure is unpredictable each year. That is certainly correct. But the question of on or off budget accounting is very much second order: far more important is that it is simply not worth the cost. Even if it works eventually (which is far from certain), ITER will not generate electricity for the grid until 2040 at the earliest, so fusion will contribute little to efforts to control climate change or to increase energy security.

Revenues: Where the EU gets its money from

Unlike national governments, the EU cannot run a budget deficit. The treaty obliges it to balance expenditure and revenue. Today, the European Union gets more than 75 per cent of its revenue from member-states' contributions. Some 12 per cent comes from customs duties and sugar levies, and 11 per cent from a complex VAT-based system under which member-states collect that VAT but are then obliged to pass on a prescribed amount to the Commission. This enables the receipts to be defined as EU 'own resources' – money that the Union collects directly for the EU budget.

The Commission has proposed modernising the VAT system and introducing a new own resource, a financial transactions tax (FTT). The new VAT approach may seem uncontroversial – simplifying the existing situation – but it is nevertheless likely to be opposed by governments that are wary of any form of tax harmonisation, including Britain and Ireland. The FTT has no chance of being adopted by the 27, since several countries are against it. Any taxation proposal has to be passed by unanimity and the UK government has made it completely clear that it will oppose anything which it believes will damage the City of London, Europe's main financial centre.

A tax on financial transactions or carbon?

An FTT sounds like an appealing idea – taking money from rich banks and using it for socially useful purposes. Hence, its widespread name, the 'Robin Hood tax'. Unfortunately, it is much harder to make it effective in practice than to argue for it in theory. Since financial transactions can be carried out from any place in the world, a European tax would simply lead to more transactions taking place in the US or Asia. In addition, much of the costs of the tax are likely to be passed on to end-users.

The French president, Nicolas Sarkozy, is the main proponent of a European FTT – with or without UK participation. Wolfgang Schäuble, Germany's finance minister, has also argued that the eurozone should press ahead with an FTT if the UK refuses to take part. France has encouraged the Commission to design an FTT that would capture transactions that take place outside the eurozone if they involve the single currency. But if there is merely a eurozone (or even eurozone-plus) FTT, it would surely raise little money because it would divert financial activity elsewhere – for example to Britain, Switzerland or even to Asia. That was the experience with America's interest equalisation tax in the 1960s as well as with Sweden's 1980s FTT.

Before it published its budget proposals in June, the Commission was also considering proposing a carbon tax. Jacques Delors spent much of his time as Commission president promoting the idea of a carbon tax, but the requirement for unanimity in the Council meant that no progress was made. Today, there would still be no chance of unanimity in the Council in favour of a carbon tax. Poland, which generates 90 per cent of its electricity from coal, would surely veto it. The UK government, despite having turned a UK energy tax into a carbon tax, would also oppose the policy at an EU level, on the dubious grounds that all 'European taxes' should be opposed.

So the Commission was sensible not to come forward with a carbon tax proposal. To reinforce its climate policies, the EU should instead strengthen its cap-and-trade scheme, the Emissions Trading Scheme (ETS). This puts a price on carbon emissions by capping the amount of carbon dioxide that European industry is permitted to emit, but has so far had little practical effect because the price has been too low. EU governments will not find it easy to reach an agreement to strengthen the ETS: Poland and other coal dependent countries would be opposed, and Germany's exit from nuclear power means that it will burn more fossil fuels. Yet the Commission stands a greater chance of forging agreement on improving the ETS than of introducing a carbon tax. The Polish government is keen to see structural funds increase, so the Commission could informally tell Warsaw that it would improve its prospects of structural fund receipts if it supported a stronger ETS. A stronger ETS would also increase the revenue of governments in key countries, notably Germany.

The tricky question of rebates

Perhaps the most controversial part of the Commission's budget proposal is its plan for rebates. The Commission complains, with some justification, about the obsession of many countries with 'net balances' – how much each country pays into or gets out of the budget. One justification it cites for suggesting new revenue sources is to move away from this thinking, often called pejoratively *juste retour*. It proposes to scrap all the present complex formulae for rebates, including the UK rebate, and to replace them with simple reductions in the payments that each country makes on the basis of its gross national income (a part of 'own resources').

Under the current system agreed at Fontainebleau in 1984, Britain receives an annual rebate of 66 per cent of the gap between its share of contributions and receipts, based on the spending allocated to member-states. Under the compromise agreed by Tony Blair in 2005, this formula now excludes spending in the Central and East European countries, to avoid the charge that Britain was not bearing its fair share of the costs of enlargement. Several other countries have been given rebates of their own. Austria, Germany, the Netherlands and Sweden all get a rebate on their share of the British rebate. These four countries also benefit from a temporary reduction in their VAT-based and national income-based contributions. And the Dutch gain from retaining a bigger share of customs duties on goods imported into Rotterdam even though their ultimate destination (and hence the ultimate payer of the duties) is Germany.

The Commission has provided little detail about the lump-sum scheme that it suggests should replace this complex web of rebates. What is certain is that it would make the payments more transparent and thus more open to attack; and that the sums involved would be lower than the present British rebate, in particular. For this reason Britain, but perhaps also the other four beneficiaries from rebates, may fight to preserve the present system. Indeed, just as in 2005, the implicit bargain that may eventually be struck is to keep the British and other rebates as they are, in exchange for Britain and its allies giving up on their attempts to reform and cut CAP spending.

A much more sensible approach would be to establish some form of generalised corrective mechanism that would measure net payments into and out of the EU budget and relate them directly to GDP per head. Adjustments could then be made so that richer countries all paid in and poorer countries all received money. The Commission suggested something along these lines in 2004 when it proposed the current financial framework. This time round it comes out against a generalised mechanism, arguing that an (unspecified) system of lump-sum rebates is better as they can be temporary and also that they serve to discourage *juste retour* thinking.

Yet the lump-sum system is unlikely to find favour with any of the likely recipients. And a generalised mechanism, which would operate rather like the German system that redistributes income from richer to poorer states within the federal republic (*Finanzausgleich*), would be clearer, more transparent and easier to justify than the present ad hoc system of rebates. Indeed, a corrective mechanism which transferred resources fairly from richer to poorer countries could take out of the current system the entire obsession with net benefits from individual policies.[12]

12 *John Peet, 'The EU budget: A way forward', CER policy brief, September 2005.*

At present any discussion of changing the UK rebate in this way would run straight into a British veto. But if the British government were willing to put the rebate on the table, and to contemplate a generalised corrective mechanism even if the immediate effect were to increase the UK's net payments into the budget, it could find firmer allies in the battle to reform the overall budget by cutting farm subsidies, redirecting structural-fund money to poorer countries and raising spending on other areas with greater added value. After his EU treaty 'veto' at the December 2011 summit, David Cameron needs to show that he can be a constructive player in the EU. If he were to lead the charge for a modernised and reformed EU budget, even at the price of a lower UK rebate, he might find new supporters in Europe.

From lowest common denominator to creative compromise

EU budget negotiations have a tendency to be reduced to the lowest common denominator. Because they also take the form of a zero-sum game – a gain for one country means a loss for another – they naturally tend towards minimal changes. The classic example is that Britain leads the charge for CAP reforms and France the fight to scrap the British rebate; the outcome usually is that the British reluctantly accept a continuation of the CAP and the French live with an extension of the British rebate. And both solemnly promise that next time they will seek more radical changes to the budget.

Yet a bolder and more ambitious approach might be conceivable this time round. The French elections this spring, allied to the knowledge that for the first time ever France will be a net contributor to the CAP, ought to make it easier for an incoming president to concede ground on agricultural spending. David Cameron's desire to mend fences with his EU partners after his treaty veto, plus the knowledge that more flexibility on the UK rebate could buy significant changes to the CAP, ought similarly to encourage him to strike a more creative bargaining position. All sides to the negotiation should recognise that, in these straitened times, a more up-to-date budget that placed proper emphasis on value for money might actually cost everybody less than the current arrangements.

Getting there will be fiendishly difficult. However hard the Danes push the budget dossier in the few weeks after the French presidential election, they are unlikely to reach a deal. The next Cypriot presidency will be controversial in its own right, due to the continued division of Cyprus. The eurozone crisis is likely to absorb most of the energies not just of national leaders but also of the two permanent presidents in Brussels, Barroso and Van Rompuy. The European Parliament is unlikely to help: in general it is positioning itself against the Council as a whole and in favour of more spending across the board, hardly a stance that will help to produce creative compromises. And if no deal is done at all, member-states will be well aware that the budget would simply continue on its present basis, which might suit some of them quite well.

The right way forward would be for the leaders of Britain, France and Germany, the three biggest players, to make clear that they are willing to debate everything in the budget in a radical manner and without preconditions. This would mean the British putting the rebate on the table in exchange for a generalised corrective mechanism. It would mean France allowing the CAP to be reconsidered from scratch, including a commitment to phase out single farm payments and to explore co-financing and a ceiling on payments to individual farmers. And it would mean Germany being willing to move beyond an insistence on holding down all budget lines to consideration of a modest expansion of non-agricultural spending, especially in areas such as research, cross-border infrastructure and external relations. If a debate on these lines is to be held in time, the three countries need to agree to start it immediately after the French election. If the EU wants to be taken more seriously in the world, it needs to equip itself with a more modern budget.

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