

THE EU BUDGET
THE UK REBATE AND THE CAP –
PHASING THEM BOTH OUT?

CEPS TASK FORCE REPORT

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BRUSSELS

This report is based on discussions in the CEPS Task Force on the EU Budget: The UK Rebate and the CAP – Phasing them both out?. The Task Force met from October 2005 until June 2006. Participants in this CEPS Task Force included senior executives and officials from a broad range of government institutions, non-governmental organisations and industry. A full list of members and invited guests and speakers appears in the final appendix.

The members of the Task Force engaged in extensive debates in the course of several meetings and were invited to comment on earlier drafts of this report. Its contents contain the general tone and direction of the discussion, but its recommendations do not necessarily reflect a full common position agreed among all members of the Task Force, nor do they necessarily represent the views of the institutions to which the members belong.

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FOREWORD

The EU budget and the common agricultural policy (CAP) are two of the most complex subjects to master in EU affairs. The mechanisms of both require detailed knowledge for anyone who cares to begin to understand either of them.

For 17 years as an MEP, I lived and breathed both subjects and no doubt managed to bore my colleagues every time I spoke about them. Whilst the EU has 23 official languages, the language of the budget is so esoteric that it is the 24th EU language and one that very few understand.

As for the CAP, over those 17 years, whenever a student asked me for a subject title for a dissertation I would suggest, “Who makes the decisions for the CAP?”. The process of this decision-making is like the novel, *The Secret Garden* – a place where only a few can enter and understand. Put these two subjects together and add the UK rebate, plus the fact of net-contributor member states having stricter and tighter domestic budgets and not wishing to contribute more to the EU, then it all makes for a fascinating scenario.

Both subjects beg the question of *quo vadis* EU. The speech of the then UK Prime Minister Tony Blair to the European Parliament in June 2005 asked what the EU aspires to be. He offered up the UK rebate if the emphasis of EU spending could be changed to reflect a 21st century Europe. And that meant radical changes to the CAP amongst other things. So far, there has been no reciprocation to offer up the CAP.

The budget of a Parliament should reflect its political priorities and so should the budget of the EU. The question asked was what those priorities are.

We now have a financial perspective up to 2013 with a review promised in 2008. This report can be and should be a major contributor to that review. The work of the Task Force was extremely thorough and CEPS needs to be congratulated for this initiative. But most of the praise has to go to Jorge Núñez Ferrer for the amount of research, time and effort that he has devoted to this work.

This report is a work of major significance, which recognises reality and what needs to change if the EU is to meet the challenges of this century. I recommend it without hesitation and hope that it will play no small part in the review of 2008.

Terry Wynn,
Task Force Chairman
November 2007

EXECUTIVE SUMMARY

The structure and rationale underlying the EU budget is the subject of intense debate: the appropriateness of its resources, size and objectives are contested by citizens, politicians and academics alike, with widely diverging opinions. Given the inability of the member states to agree on policy reforms, decision-making over the EU budget has been reduced to a mathematical contest, with member states using budget headings as tools to achieve specific net balances. The links between policy rationale, need and financial requirements to achieve specific goals have become highly disrupted.

In December 2005, the European Council invited the Commission to undertake a full review of the EU budget and to report its findings in 2008–09. This CEPS Task Force report assesses the budget in terms of the policies on which EU resources are spent, and the interaction between the quality of expenditures and the resources mechanism. The report identifies the misallocation of resources as a central cause of the net balance disputes and rebate mechanisms that plague the system and undermine its fairness.

Findings and recommendations for EU expenditure

The allocation of EU expenditures should be revisited. Any reforms, however, should ensure that expenditures incorporate a set of important principles. A substantial body of research has analysed the optimal role of the EU budget and the characteristics it should have. Moreover, the EU has enshrined certain precepts for the use of funds in the EU Treaties. Drawing from these sources, this report lists fundamental principles on which expenditures should be based:

- Value for money – in terms of efficiency and cost effectiveness in attaining the objectives
- Subsidiarity

- Additionality
- Proportionality

In addition to these principles, expenditures from the EU budget should also focus on *European public goods*, more specifically those that are underfunded and deemed to provide *European added value*. Intervention at the EU level should support the EU's political and economic objectives, and do so efficiently. Actions should be in line with the need to foster overall growth in the EU and with the Lisbon strategy. When important objectives do not allow promoting growth, interventions should at least minimise any negative effects, i.e. reduce all opportunity costs to a minimum.

Using these principles as a framework for evaluating expenditures, EU policies often score very badly. They are ineffectual even in achieving their own objectives. The following conclusions are drawn for the main EU policy areas – the common agricultural policy (CAP) and rural development, regional policy, competitiveness, and internal and external security.

- The CAP market support policies fail to address their objectives in a cost-effective way and the distribution of support is distorted and unjustifiable. Payment levels primarily relate to yields from decades ago and have little relevance to the objectives they are supposed to target (either good farming practices or income support). With respect to adding value, the policy wastes resources to such an extent (with similarly large opportunity costs) that it may be considered negative. The same could be achieved with fewer resources – or much more with what is available. The added value for the EU of having an agricultural policy in the first place is an issue of debate.
- The rural development policy is developing into an instrument with a potentially important impact on rural economic development and environmental protection, but it is still in its infancy. Its role is not yet well defined, and it is still mainly designed as an accompanying measure for the agricultural policy and thus excessively influenced by solely agricultural interests. Rural development means much more than agricultural support, particularly given that the economies of rural areas rely greatly on non-agricultural factors (such as infrastructure and services) and the presence of other sectors.
- Regional policy has been generally in line with its goal of promoting cohesion. Its performance, however, has been uneven and some of its objectives have evolved for political or net balance reasons rather

than economic ones. In any case, performance of the regional development funds depends largely on the merits of the strategy and programmes of the member states, which have varied considerably. The impact of budgetary expenditures is profoundly affected by the quality of national policies. The creation of new expenditure lines and the expansion of other ones in favour of competitiveness, employment, and research and development (R&D) have little significance for the EU economy if member states' fiscal, regulatory and labour market policies are suboptimal or even counterproductive.

- Innovation is recognised as a key factor for the growth and future sustainability of the European economy. It is well documented that the EU spends less as a share of GDP on R&D than the US or Japan. The European Commission has proposed a substantial rise in funds for research and investments leading to increased competitiveness. But finance from *public* funding as a share of R&D is already higher than it is in the US or Japan, which raises the question of whether the problem lies more in a lack of the right incentives for private R&D investment.
- Given the importance for the EU of ensuring the security of its citizens, increasing its presence abroad and helping to foster stability in the EU's neighbourhood, the amounts allocated to these budget headings are far from sufficient.

Recommendations concerning EU expenditures

- The CAP needs radical reform. The continuation of such a policy requires at the very least that support be brought in line with the objectives to be achieved. Payments should not be all embracing, but more specific, reflecting the particular circumstances and costs. Farm income support should be tied to farm household income, and other payments to the costs of achieving the objectives. Farms with a high turnover should not be supported for mandatory good farming practices.
- It is important that rural development policies are improved and their scope is broadened. They should support the entire rural economy. This recommendation does not exclude support for agriculture and food – agri-environmental programmes and food safety are important – but the scope of the policies and the eligibility

criteria should be revisited. Policies not aiming at agri-environmental actions should focus on areas in need. A territorial approach should be developed, in which poorer areas receive the bulk of support. This is a concept already applied in regional policy. The policy also has to be freed from the CAP and the links to the distribution of direct payments must be completely severed.

- The eligible activities for expenditures under regional policy should be revisited. Conditionalities should be strengthened and regional fund allocations should include performance-related criteria that are stronger than the present performance reserve, which is based on the absorption of funds rather than the quality of execution or the actual achievement of results.
- The EU and its member states should review the tax and regulatory frameworks for R&D, and consider whether these make the environment too hostile for stimulating private investment and private initiatives. It is also important that the new competitiveness heading does not soon become a tool to redirect funds deducted from the CAP towards protecting net balances. Competitiveness funds should be allocated according to needs and the search for excellence and not by net balance considerations.
- Funds for external actions should be increased considerably.

Findings and recommendations for the EU's system of traditional own resources

Problems in the system for deriving the EU's traditional own resources can be traced back to distortions on the expenditure side of the budget. It is there that reforms have to be undertaken first. Further changes in the resources system such as an automatic, generalised correction mechanism may even cause the situation to deteriorate, first by institutionalising rebates as a way to avoid reforms in expenditures, and second by the risk that the mechanism itself is likely to be distorted further. If member states continue to challenge the quality and cost of the policies, then corrections may arise beyond any that an automatic mechanism may introduce

Recommendations for the own resources system

- The most practical solution identified would be to introduce a very limited number of taxes (based on exiting taxes in addition to those from which traditional own resources are derived) with a marginal

contribution to ensure that contributions equal member states' shares of gross national income. A 'real' VAT resource with a marginal contribution would be the simplest solution under such a system.

Findings and recommendations for decision-making on the budget

The EU must reconsider the decision-making procedure for the financial perspectives. Under the present system, the decisions taken on the financial perspectives are very suboptimal, and the role of the European Parliament is ambiguous and too weak. The draft Reform Treaty codifies the procedures for the financial perspectives, but the European Parliament still has a secondary role.

Recommendations for decision-making

- The responsibility of the European Parliament should increase for the contents of the financial perspectives and the resources needed to fulfil the agreed aims. This shift can be achieved if Parliament endorses the European Commission's proposal for the multi-annual financial perspectives *before* the proposal is presented to the Council. Such a move would increase the accountability of the European Parliament for the level of resources requested and the policies proposed.

INTRODUCTION

The European Council declaration of December 2005 invited the Commission to undertake a full review of the EU budget and to report its findings in 2008–09. Indeed, the EU budget is the subject of intense debate: the appropriateness of its resources, size and objectives are contested by citizens, politicians and academics alike, even if the opinions of the various stakeholders diverge widely.

Reports by the European Court of Auditors, academic studies and even the Sapir report (Sapir et al., 2003) commissioned in July 2002 by the then European Commission President Romano Prodi, also criticise the goals, implementation and added value of the EU budget. Consequently, the contributory solidarity of member states has practically disappeared. Reluctant net contributors agree on a suboptimal policy mix apparently dictated mainly by political pressures and the wish not to cause a breakdown of EU structures.

Support for the expenditures of the EU budget is running thin. Meaningful policy discussions were virtually non-existent during the negotiations on the latest financial perspective. Net balance considerations seemed to dominate negotiations to an overwhelming extent. It is normal that net balances play a role and these are a recurrent feature in public spending disputes in federal states; thus, net balance considerations are impossible to avoid in a budget formed by contributions from sovereign states. It is widely accepted, however, that the influence of net balance considerations has become excessive.

Reducing net balance disputes will depend on expenditures being based on commonly agreed objectives and commonly agreed levels of funding. In a heterogeneous structure such as the EU, with very different national interests, finding a common denominator is extremely complex.

The budget of the EU is essentially a unique intergovernmental agreement among sovereign states to pool a limited share of their resources

to address agreed problems at the European level. What the optimal objectives and levels of expenditure are remains a difficult question to answer. In theory, the best expenditure objectives are those for which spending by a supranational structure is more efficient than national expenditures. The theory of fiscal federalism lists the kinds of expenditures that would be most advantageously allocated to a common budget. Yet in practice, a common budget for a body like the EU cannot be based on the efficient, first-best choices of the theory. The EU is given the degree of competence that is *politically* acceptable and feasible, which entails a budget that only finances some areas the theory assigns to a supranational body and includes expenditures fiscal federalism would not allocate to such a body.

Any analysis of the budget has to take into account the political realities of the EU as well as formal theorems in order to be relevant and offer practical, even if radical, solutions. That being said, and despite the political nature of the EU, the EU budget should abide by some basic principles. Some of them can be found in the EU Treaties, while others should govern any public expenditure measure, national or supranational.

This report presents a list of such principles, which provides the structure for an evaluation of policies funded by the EU budget and their performance in achieving their stated aims, along with a discussion of their shortcomings. These guiding principles also serve as a framework for considering future reform options.

The report is divided into four parts:

- Part I concentrates on the budget expenditures. It assesses the appropriateness of the objectives and expenditures based on fundamental principles that should guide the EU budget.
- Part II reviews the own resources system.
- Part III discusses the decision-making procedures with particular attention given to the Interinstitutional Agreement.
- Part IV examines the implications of the 2007–13 financial perspectives agreement on the distribution of the budget and the net balances.

PART I. EXPENDITURES: PRINCIPLES, OBJECTIVES AND PERFORMANCE

The EU budget is a multinational financial instrument created to support the political and economic objectives of the EU. Despite the political nature of the EU and its objectives, the effectiveness of a common budget still depends on a number of precepts of good governance, such as the right delegation of responsibilities among different territorial levels, the correct allocation of resources to efficiently and cost effectively fulfil the objectives, and the proper level of control. Failure to give due regard to these precepts reduces the effectiveness of policies, wastes resources and ultimately increases the chance of disputes among the contributors to the common budget, especially in periods of particular pressure on national public resources.

The optimal division of competence among various levels of governance has been analysed in the past using the theory of fiscal federalism. Authored by Musgrave (1959), fiscal federalism assesses the best level of governance for different policies. The theory has been subsequently adapted for the institutional realities of the EU by a number of analysts,¹ because the EU cannot be considered just another level of governance, as is the case with the federal government of the US.

All the studies come to similar conclusions on what should be the guiding principles for EU expenditure priorities. These should be taken into account in any reform that aims at better achieving common EU objectives. This part of the report looks at how well EU intervention and resource allocation reflects these principles, and assesses EU policies against the stated goals.

¹ See, for example, Persson et al. (1996), Tabellini (2003), Gros & Micossi (2005), Sapir (2003), Buti & Nava (2003) and Figueira (2006).

1. Fundamental principles for policies financed by the EU budget

The EU budget has very limited resources, with which it is expected to support the construction of the European Union project. Even admitting that the EU is primarily regulatory in nature, some actions at the EU level require substantial funds. Given that the EU budget is limited in size, it is of paramount importance that expenditures enable the attainment of objectives *efficiently* and that actions are *cost effective*. These are simple *value-for-money* guidelines, which imply such activities as regular evaluations.

Apart from these rather obvious (if not necessarily fulfilled) requirements the EU Treaties and rules mention other specific principles: subsidiarity, additionality and proportionality.

Subsidiarity. The Maastricht Treaty of 1992 enshrines this principle as a crucial characteristic of any EU policy or budget item. The EU should only act when it is better suited to do so compared with lower levels of governance. This approach is in line with fiscal federalism theory in terms of competence distribution. The wording of the Treaty excludes from this principle those areas in which the EU has exclusive competence, such as the common agricultural policy (CAP).

Additionality. EU financial intervention should not substitute for national funding that would have been disbursed in the absence of EU intervention, nor should EU funding reduce aggregate national public spending. This rule is required for the cohesion policy, but it should apply in general, unless EU resources pool all national financial resources for a policy, which is the case for market support measures in agriculture.²

Proportionality. According to EU law, the EU may only act to exactly the extent that is needed to achieve its objectives and no further.

Finally, and in addition to these principles, economists have put very strong emphasis on the need for expenditures to focus on market failures, where a *European public good* is underprovided if left to lower levels of governance. Moreover, and implicit in the previous point, these actions should foster *European added value*. The return on the investment should be higher than in the absence of EU intervention.

² There are the notable exceptions that 'confirm the rule' of transitory co-financing of direct payments for new member states.

As for the nature of European added value, economists generally argue for an economic return that increases the aggregate welfare in the EU. For the purpose of this study, it should be borne in mind that the returns for some policies are not necessarily welfare enhancing for the whole of the EU, nor are they always verifiable. One such case is the cohesion policy. It is difficult to quantify the opportunity costs of the cohesion policy in terms of welfare loss or gain at the EU level. Nevertheless, actions should clearly enhance welfare in the specific area in which they are applied compared with no intervention.

2. Objectives of the budget

As noted above, studies on the EU budget often use the fiscal federalism theory to analyse the appropriateness of EU expenditure. This theory, however, was formulated for federal states and fits oddly with the realities of a multinational structure like the EU. Various authors have adapted the theory, but still often apply rather ad hoc interpretations of what the budget should do in the EU.

This report acknowledges the existence of objectives enshrined in the EU Treaties and subsequent decisions by the EU, regardless of their fit with the theory of fiscal federalism. At the same time, the report examines whether these objectives and the mechanisms to achieve them are in line with the principles stated in section 1. It further looks at whether the mechanisms enable the fulfilment of the EU's objectives efficiently. Principles such as subsidiarity in any case originate from fiscal federalism.

The declarations in the EU Treaty (Title 1, Art. 2) determine the EU's objectives:³

The Union shall set itself the following objectives:

- to promote economic and social progress and a high level of employment and to achieve balanced and sustainable development, in particular through the creation of an area without internal frontiers, through the strengthening of economic and social cohesion and through the establishment of economic and monetary union, ultimately including a single currency in accordance with the provisions of this Treaty,

³ See the Treaty establishing the European Community (EC Treaty or TEC) consolidated version as amended by the Treaty of Nice, OJ C 321 E, 29.12.2006.

- to assert its identity on the international scene, in particular through the implementation of a common foreign and security policy including the progressive framing of a common defence policy, which might lead to a common defence, in accordance with the provisions of Article 17,
- to strengthen the protection of the rights and interests of the nationals of its member states through the introduction of a citizenship of the Union,
- to maintain and develop the Union as an area of freedom, security and justice, in which the free movement of persons is assured in conjunction with appropriate measures with respect to external border controls, asylum, immigration and the prevention and combating of crime,
- to maintain in full the *acquis communautaire* and build on it with a view to considering to what extent the policies and forms of cooperation introduced by this Treaty may need to be revised with the aim of ensuring the effectiveness of the mechanisms and the institutions of the Community.

Following the logic in Figueira (2006), the elements in these broad objectives can be summarised under the broad aims below:

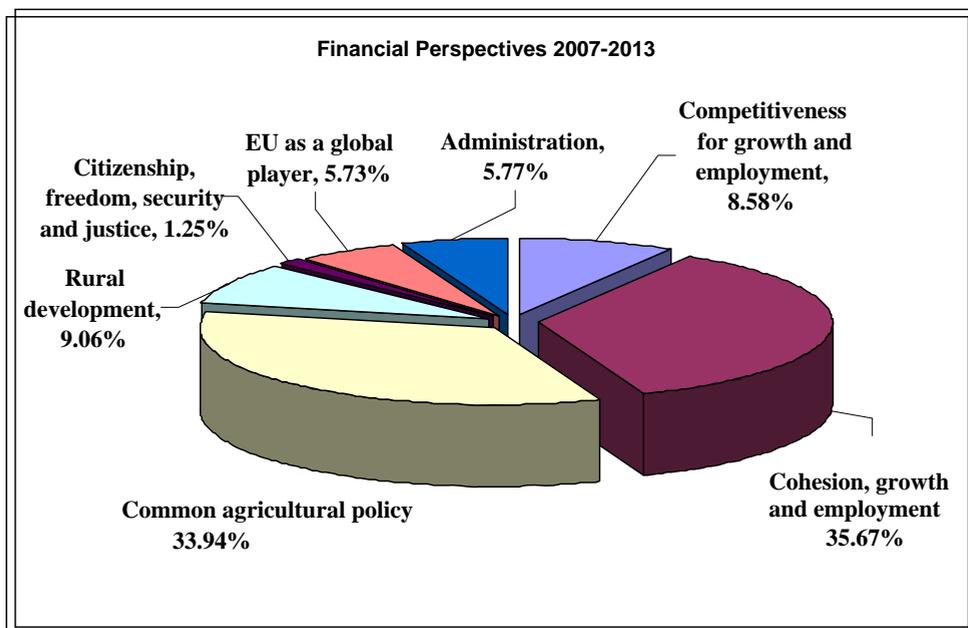
- Economic growth (“economic progress”);
- Sustainable growth (“balanced and sustainable development”, “employment” and “social progress”);
- Cohesion or convergence (“economic and social cohesion”);
- External security (“common foreign and security policy including the progressive framing of a common defence policy”); and
- Internal security (“the rights and interests of the nationals of its member states”, “area of freedom, security and justice”, including “free movement of persons”, “external border controls”, “asylum and immigration” policies and the “prevention and combating of crime”).

In addition to these broad aims, other more specific objectives are spelled out in the EU Treaties and subsequent decisions. One of the most notable lists of objectives is for the CAP (Art. 33 of the Treaty), which can be interpreted as part of the social cohesion objective with redistributive effects across sectors (from industry and services to agriculture) and individuals (from consumers and taxpayers to farmers).

The present EU budget is a result of the past interpretation of the way to achieve the stated objectives and the ‘imaginative’ use of the budget as a tool to reach compromises on the process of integration among member states. Many items have emerged as a bargaining tool to achieve agreements, such as the cohesion funds to compensate for the alleged negative effects of the single currency, or even the CAP as a compensation for France by Germany for the asymmetric effects of market integration.

The budget structure has concentrated mostly on redistributive policies based on (sometimes-questionable) equity criteria. The EU and its position in the world have changed substantially in the meantime. Concerns about the competitiveness of the EU and environmental protection have climbed to the top of the EU’s agenda. Until recently, the EU has not regarded growth-oriented policies, for example, as a key aspect of the budget, except in the area of convergence. Similarly, environmental sustainability was not seen with the urgency of today. Yet, the shift in the priorities of the EU has not been matched by changes in the composition of the budget (Figure 1).

Figure 1. EU budget composition, financial perspectives for 2007–13



Source. Calculations based on the Interinstitutional Agreement between the European Parliament, the Council and the Commission on budgetary discipline and sound financial management, OJ 2006/C 139/01, Brussels, 14 June 2006.

The fact that the CAP and cohesion policy are still the dominating features of the budget could be explained by the limited size of the budget. These two policies had evolved during a period of European integration, when budgetary expansion had been possible. After the limit in the member states' willingness to pool resources had been reached, there has since been little flexibility for additional resources for other policies. There are clear indications that the present budget concentrates the resources on a very narrow portion of the EU's objectives. Table 1 presents a list of the present policies and the financial shares of the main components of the 2007 budget.

Table 1. Expenditure headings and instruments of the EU budget and funding shares, 2007

EU policy	Policy headings	Share of budget (%)
Competitiveness 7.43%	• Education and training	0.71
	• Research	4.35
	• Competitiveness and innovation	0.32
	• Energy and transport networks	0.79
	• Social policy agenda	0.16
Cohesion 35.3%	• Convergence	27.91
	• Regional competitiveness and employment	7.11
	• Territorial cooperation	0.87
Preservation of natural resources 44.51%	• Agricultural expenditure and direct aids	33.75
	• Rural development	9.80
	• Environment	0.16
Freedom security and justice	• Security policy, migration policy	0.47
	• Health and consumer protection	
	• Rapid response	
Citizenship	• Culture	0.47
	• Media	
	• Public health and consumer protection	

Table 1, cont.

EU as a global partner 5.38%	• Pre-accession instrument	1.03
	• Neighbourhood policy	1.11
	• Development cooperation	1.74
	• Humanitarian aid	0.55
	• Democracy and human rights	0.08
	• Common foreign and security policy	0.16
	• Stability instrument	0.08

Source: European Commission, 2007 budget figures.

There is apparently a mismatch between the EU's objectives and the distribution of finances. Furthermore, not all the objectives of the EU need financial intervention, and if required, not necessarily from the EU budget. Thus, based on the principles stated in section 1, it is necessary to investigate the following points:

- Are the interventions financed by the EU efficient in achieving the objectives stated in its policies?
- Should the EU budget intervene as a financial tool where it does?
- Are the resources appropriate?

3. Quality of EU budget interventions

The initial interventions of the EU budget were linked pro forma to certain objectives and only vaguely connected with a theoretically optimum distribution of responsibilities. The EU budget was essentially an agreement to support certain areas to make integration politically acceptable. The budget redistribution mechanism was therefore of a political rather than economic nature.

In fact, the allocation of resources is largely based on a fixed geographical distribution with little reactivity to changing needs. It does not incorporate any stabilisation mechanism related to economic changes, and any revision must be based on a rigid, multi-annual multilateral agreement. As the EU increasingly faces global challenges for which a pooling of a limited amount of resources for flexible interventions is necessary, the mismatch between needs and the budget structure is widening.

3.1 Overall budget objectives and resource distribution

Taking the list of objectives from the EU Treaty, we should expect the distribution of funds to correspond to the priorities presented. The objectives aim at economic growth, sustainable growth, cohesion or convergence, and external and internal security.

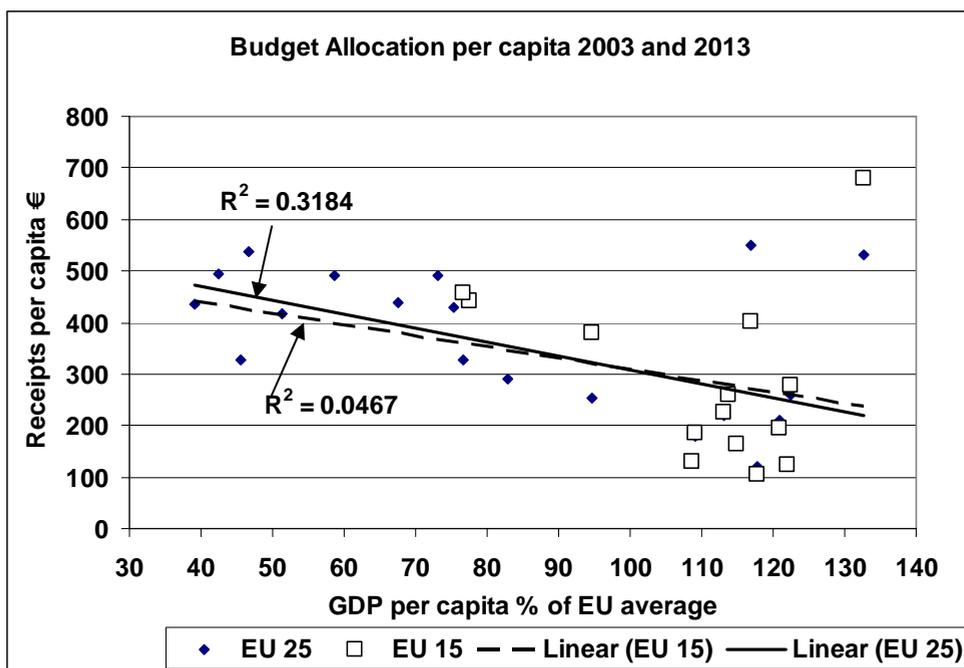
Economic growth. Most interventions fostering economic growth are not linked to the budget and while the need to encourage research and development (R&D), education, transport and energy networks in the EU requires some financing, the level of EU intervention is questionable. As the Kok report (European Commission, 2004a) clearly states, economic growth is first and most importantly in the hands of the member states and in the structural reform of their economies. For the EU, the task mostly pertains to the completion of the internal market. It is only in the latest financial perspective that promoting growth at the EU level has a more substantial budget, although again, the role of the EU budget in this area can only be limited and is still open to debate.

Sustainable growth. Economic progress has to be achieved with due regard to the need for sustaining or strengthening social cohesion and environmental protection. According to the theory of fiscal federalism, while social cohesion is better served at the national level, there is a strong argument for EU intervention on environmental protection. Social cohesion is nevertheless addressed in the structural funds through the European social funds. For the environment, measures are scattered across different funds, with infrastructural and other actions being financed under several headings. There is, however, little coordinated environmental action nor is there a clear environmental budget line. The heading of preservation of natural resources could have been expected to have a major environmental protection component, but that is not the case. Of the budget for natural resources in 2007, 77% is allocated to direct payments in agriculture compared with 22% to rural development and only 0.4% to the environment. Some environmental aspects are present in the agriculture and rural development policies, but these are predominately related to agriculture and not to the major challenges of energy efficiency for example. There is a need to assess whether the EU budget should not be more active in the area of the environment.

Cohesion or convergence. Fostering cohesion and convergence are the key objectives of the EU budget with most of the budget dedicated to achieving them. Indeed, agricultural policy is often referred to as part of

cohesion policy, to reduce income disparities among social groups. The budget distribution should be very influenced by these two policies, with financial flows directed towards problem areas in the agricultural sector and towards poorer regions or countries. Productivity levels in the agricultural sector tend to be lower in poorer countries, and rural development problems tend to be worse in poorer areas, especially in the new member states. The budgetary distribution seems nonetheless rather unrelated to GDP per capita, owing to the regressive distribution of the CAP. In 2003, for the EU-15 the correlation between the two was nearly 0 (Figure 2). With enlargement, the 2013 budget is expected to see an increase in the correlation between receipts and GDP per capita, but it is still unexpectedly low.

Figure 2. Budget allocation per capita, 2003 and 2013



Source: Based on European Commission figures for 2003 and own calculations for 2013.

Internal and external security. Both of these items are rather minor in the budget, and the EU has failed to live up to the challenges ahead. A pooling of resources and joint action can produce very important improvements in these areas, yet both policies are rather weakly funded. Efforts towards the objective of creating a common defence policy have failed, while the member states have been reticent to increase the role of the EU in other areas despite the strong rationale for doing so.

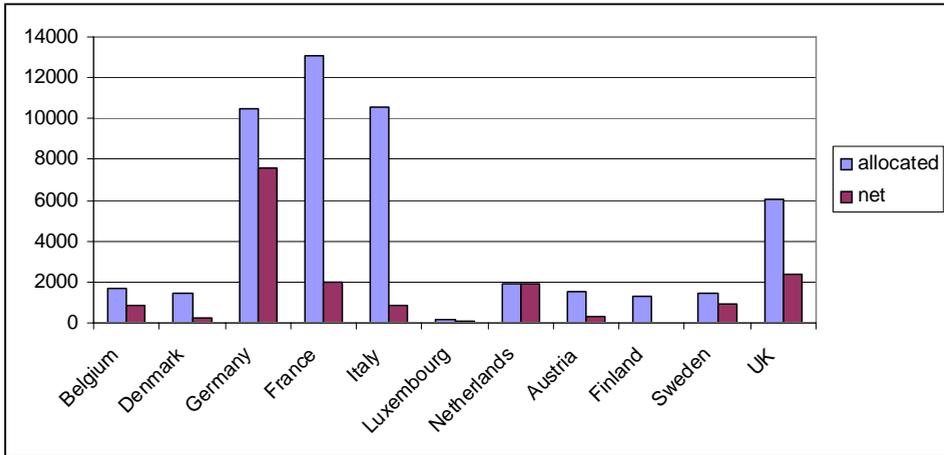
3.2 Interplay between net balances and policy quality

Among all the objectives listed in the Treaty, the present focus of the EU budget is on social and economic convergence through the CAP and the cohesion policy. The EU has marginally used the budget as a tool for overall economic growth and the application of its finances to internal affairs and external action has been rather limited.

The distribution of EU funds, however, is out of line with cohesion objectives, which may well be a central cause of the disputes over the budget. The rationale for the expenditures is weak. Furthermore, the member states seem to use the budget to ensure that contributions are limited and receipts are maximised, adapting measures and introducing others to reach net contributory equalisation. The redistributive nature of the policy with names or regions attached to funds has induced the member states to decide the distribution of the funds based on ‘pork barrel’ politics, undermining the quality of interventions.

Baldwin (2005a) describes how receipts from the EU are so high for all the member countries, that the budget is essentially a *national* redistribution mechanism. The net contributions have been *less than the receipts even for the wealthiest EU member states*, such that in 2003 they received in excess of 50% of their gross contribution back from the EU budget, with the notable exception of the Netherlands, for which the amount was similar (i.e. the Netherlands received approximately 50% back) (Figure 3).

According to game theorists Kauppi & Widgren (2006), the budget distribution can be fully explained by the power of the member states in the EU. Regardless of the policies introduced the net calculation of receipts and expenditures for each member state remains stable. Under these circumstances, net balances completely govern the budget, which is very close to what has been observed.

Figure 3. Receipts versus net contributions (operational expenditures only)

Note: The net balances are represented in absolute terms.

Source: Data derived from the European Commission.

Consequently, if one takes the relationship between net balances and voting power as a rule, the budget will have extreme difficulty in ensuring that the policy mix is optimal while achieving the ‘exogenously’ pre-determined net balances. A failure to obtain the ‘correct’ net balance using expenditure policies would then trigger the need for changes in the resources. This situation has clearly been the case.

On the one hand, the influence of member states’ voting power in determining their contributions and receipts has most likely affected the quality of policies negatively. On the other hand, the quality of the policies also affects the willingness of member states to finance them. In a mutually reinforcing, vicious circle, while net balances constrain the ability to reform budget policies, the ensuing less-favourable policy compromise induces net contributors to concentrate even more on limiting their net financial contributions.

One can conclude that the policy mix of the EU budget is suboptimal and encourages a net balance approach to EU expenditure allocation. The question is what areas of EU expenditure give rise to this lack of policy quality, which is addressed in the analysis below for the different budget headings.

4. Performance of the policies financed

4.1 Agricultural policy and rural development

The CAP and the rural development policy constitute 98% of the budget heading for the preservation of natural resources. Indeed, the name of this EU expenditure heading is highly misleading, as 76% of the funding is composed of direct aids to farmers, 22% mainly to rural development (farm-oriented investments and agri-environmental measures) and a pittance to environmental programmes. Given the enormous priority of the environment for the future, it is rather unfortunate to see it having such little relevance. Because of the cross-border nature of pollution, environmental actions quintessentially need to be solved at the multinational level. Even admitting that convergence policies and R&D have some environmental aspects and that much of the EU's action is regulatory, spending on the environment is surprisingly low. Given the challenges posed by climate change and the need for adaptive and mitigating practices, there are reasons for substantial budgetary allocation in this area. This section evaluates the CAP and rural development policies separately.

4.1.1. *Common agricultural policy*

The CAP faces the greatest criticism of all the budget items. The CAP is one of the largest items in the budget, absorbing 36% of EU funds in 2006 and 34% in 2007 (excluding rural development funds). The policy is widely accused of being very inefficient in attaining its own objectives and distortive. Many analysts question the need for the policy in the first place. The CAP is also often portrayed as the origin of the net balance disputes.

Moreover, there is hardly any independent evaluation of the CAP that does not reveal large inefficiencies. Table 2 presents a summarised picture of the CAP's performance against its objectives as formulated in Art. 33 of the EU Treaty.

The CAP clearly fails to achieve its objectives efficiently and cost effectively. It is not surprising that there are many doubts about the need for an agricultural policy in the EU. In terms of the principles for intervention, Table 3 presents a further evaluation of the policy. It is difficult to argue that the CAP should be run and financed by the EU.

Table 2. Performance of the CAP in achieving its objectives

Objectives	Quality of intervention, achievement of objective
To increase agricultural productivity by promoting technical progress and by ensuring the rational development of agricultural production and the optimum utilisation of the factors of production, in particular labour	Highly inefficient. The CAP has been very successful in increasing production, rather than productivity. The costs of production have risen, fuelled by subsidies and price support, which have driven capital and other input costs higher. There is an exceedingly poor link between the objectives and the price-support and direct-payment systems.
Ensure a fair standard of living for farmers	Highly inefficient. Funding has generally been targeted at market support policies (including direct payments), which are highly distortive and inefficient. Most of the support has fallen on large commercial farms. No means testing or real cost studies have been used to assess the level of support needed. Those most in need of support and who are claimed as the main target groups (the small family farms primarily dependent on agriculture), especially in depressed areas, benefit little.
To stabilise markets	Working but with large externalities. Assessing performance depends on interpretation of the term 'stabilise'. Prices for farmers in Europe have stabilised, but at the cost of distorting the prices of other markets and destabilising world markets.
To assure the availability of supplies	Excessive/wasteful. The availability of supplies was soon assured and then exceeded, creating the infamous surpluses that needed dumping or destroying. The situation has improved strongly in the last decade, but there is still a degree of distortion and of dumping on the world market.
To ensure that supplies reach consumers at reasonable prices	Failed. Given the inefficiency of the policy in attaining its objectives, high prices for consumers are unreasonable.

Table 3. Score on the principles of intervention for the CAP

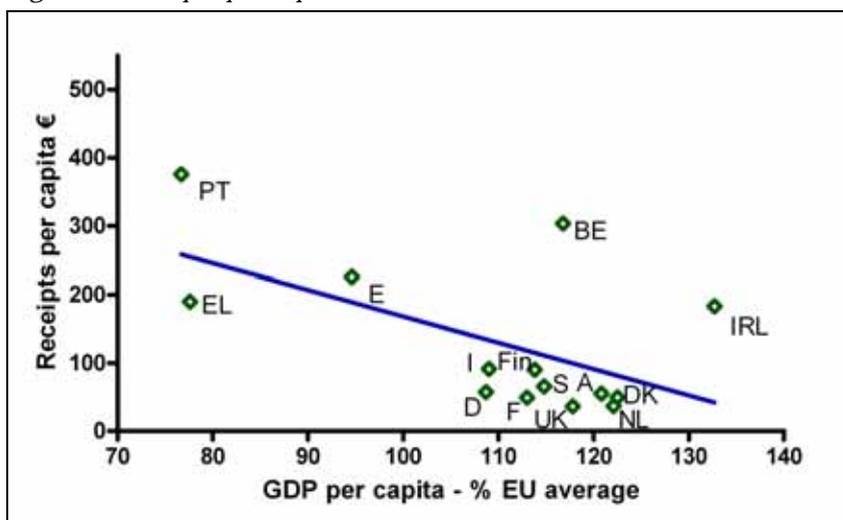
Compulsory	
Subsidiarity	Failed. Proponents of the policy consider that the policy fulfils this criterion because the CAP is necessary for the single market of agricultural products. There is, however, no reason for the EU to be using EU funds to support agriculture. A single market can be guaranteed through regulations. There are state-aid rules for other sectors that could be applied.
Proportionality	Failed. As the objectives of the policy have been poorly attained and drawn heavy criticism about the fairness of funding allocations, it fails to fulfil this criterion. In any case, most funds are distributed without any actual cost assessment related to accomplishing the objectives. The levels of payments are directly or indirectly linked to decades-old yields per hectare and the number of some farm animals.
Additionality	Does not apply. Governments have pooled their resources. National financial allocations are not possible.
Value for money	Failed. The policy is highly inefficient and costly.
Highly recommended	
European public good	Failed. According to fiscal federalism theory, there is hardly any reason to support agriculture at the EU level. While agricultural land and the preservation of rural areas and their environment can be viewed as a public good, intervention through the price-support and direct-payment CAP policies is far from cost effective.
European added value	Failed. The policy does not add value to Europe in economic terms. At the political level, its contribution today can even be regarded as negative owing to the negative implications of the policy for the EU budget.

The CAP does indeed play a controversial role in the distribution of funds through the EU budget. Because of the way it is designed, it benefits countries with the highest yields from specific products, and within these

countries the largest and often wealthiest producers, as it overwhelmingly consists of direct payments that are still allocated according to historical yields per hectare.⁴

Given that cohesion policy is related to GDP per capita and is progressive in nature, the CAP must primarily be benefiting wealthier member states. This result seems to be confirmed by analysis when CAP expenditure distribution is excluded (Figure 4). The regression analysis shows a much stronger negative link between GDP per capita and budgetary receipts. This relationship is not perfect, as support is limited by a gross national income (GNI) ceiling⁵ and distribution is at the regional and not the national level.

Figure 4. Receipts per capita and GDP without the CAP, 2003



Source: Own calculations, Eurostat database.

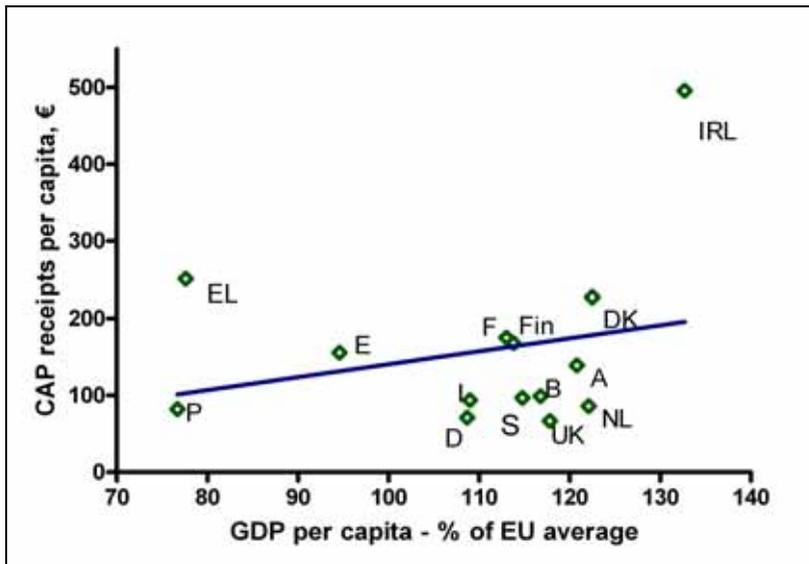
⁴ The payments per farm are not necessarily based on the historical farm yields, as often regional or national averages are used. Nevertheless, farms in historically high yielding countries and/or regions still receive higher payments and larger farms more than smaller ones. Direct payments indirectly and unofficially continue to compensate for the intervention price reductions in the years 1992 and 2000.

⁵ Structural and cohesion funds cannot exceed 4% of the GNI of the recipient country, with the exact ceiling determined by the GDP per capita income as a percentage of the EU average.

The highest yields are generally found in the most developed countries. Also, cattle are highly supported and concentrated in specific member states. Consequently, the largest payments tend to end up in the wealthiest countries. Belgium, Denmark, France and Ireland are major beneficiaries, to the extent that a prosperous country such as Denmark has been a net beneficiary of the budget since the year 2000 and Ireland is expected to remain so for the foreseeable future.

The regressivity of the policy becomes apparent when the CAP direct payments are plotted in relation to the GDP per capita of member states (Figure 5). The regression analysis shows, however, that the correlation between GDP per capita and CAP receipts is extremely low – nearly random – and Ireland introduces a strong element of bias.

Figure 5. CAP receipts per capita and GDP per capita, 2003



Source: Own calculations, Eurostat database.

The regressivity at the national level described earlier is also strongly evident at the farm level – a similar and not surprising relationship can be found between CAP receipts *per farmer*⁶ and the net value added per farm

⁶ In the analysis, agricultural working unit (AWU) – a full-time equivalent worker – also applies.

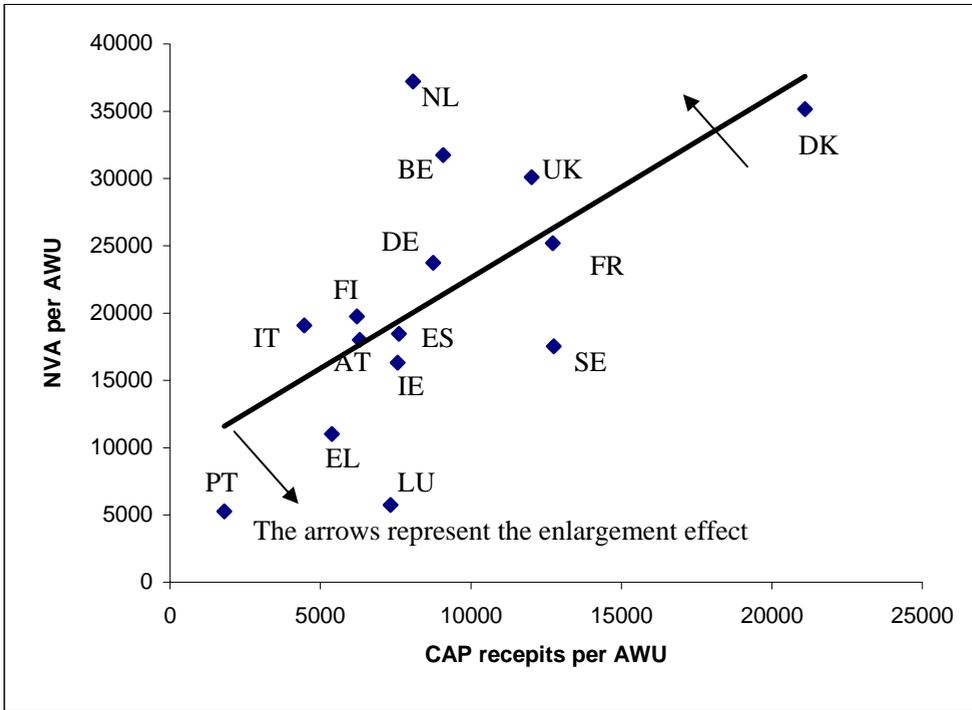
in Table 4 and Figure 6. It is clear that this regressivity has been exacerbated by enlargement and it will grow even stronger after the full introduction of the CAP payments in the new member states, as production per hectare was low in the years prior to enlargement.

Table 4. Regressivity of CAP payments (EU-15), 2003

Farm size (measured by farm value added, in €)	Number of beneficiaries (farms)	Average payment per recipient (in €)	Cumulative payments (largest farms to smallest, in %)	Cumulative number of recipients (largest farms to smallest, in %)	Cumulative payments (smallest farms to largest in %)	Cumulative number of recipients (smallest farms to largest, in %)
> 500,000	10	413,258	0.1	0.002	100.0	100.0
> 300,000 and < 500,000	20	380,465	0.2	0.01	99.9	100.0
> 200,000 and < 300,000	100	238,819	0.5	0.03	99.8	100.0
> 100,000 and < 200,000	2,400	123,679	5.1	0.5	99.5	99.9
> 50,000 and < 100,000	20,550	65,721	25.9	5.0	94.9	99.4
> 20,000 and < 50,000	84,320	30,928	66.0	23.3	74.1	95.0
> 10,000 and < 20,000	90,430	14,400	86.1	43.0	34.0	76.7
> 5,000 and < 10,000	80,290	7,202	94.9	60.4	13.9	57.0
> 2,000 and < 5,000	71,300	3,382	98.7	75.9	5.1	39.6
> 1,250 and < 2,000	27,380	1,602	99.3	81.8	1.3	24.1
> 0 and < 1,250	83,590	519	100.0	100.0	0.7	18.2
Total	460,520	14,113.51	–	–	–	–

Sources: Baldwin (2005b), based on data from "Agriculture in the EU – Statistics and economic information", European Commission, 2004, Table 3.6.1.10.

Figure 6. CAP receipts versus net added value per AWU, 2003 (EU-15 country averages)



Source: Own calculations, Eurostat data.

It is important to note that these figures do not account for the fact that in a number of EU countries, farm activities are not the sole or even the main occupation of the farmers and members of the household, thus a low income from agricultural activities is not sufficient to justify income support. The OECD (2003a and 2006) has presented an initial picture of farm household income; in various EU member states the income was found to be above the national average.⁷ A large share of EU farms have more than one income source, yet the income support of the policy has always been in relation to income from farming alone. That is not the way financial social assistance is usually offered to citizens, for which means testing usually includes total household income when assessing the need for support.

⁷ See Appendix 1 for an analysis of farm household income.

The large share non-agricultural income among agricultural households reported by the OECD should also be taken as a clear signal that sustaining agriculture in rural areas is equally (if not more) dependent on measures aiming at developing alternative sectors in such areas. In other words, the health of the farm and non-farm economies in rural areas is inextricably linked (see OECD, 2003b and 2006).

In the rural areas of new member states with high poverty levels, non-agricultural households often suffer from greater degrees of poverty than do farming households. According to Eurostat, in 2004 the CAP increased the incomes of farm households in the new member states by 50%. This effect was observed despite the merely partial introduction of direct payments. Even with all the reforms, price support still accounted for roughly half the value of the total (Wichern, 2004) prior to the latest reform.

Defenders of the CAP often dismiss redistribution concerns by claiming that the allocation of funds depends on needs and objectives and therefore it is not related to GDP per capita or farm sizes and wealth. This argument would be acceptable if the CAP performed well against its 'own' objectives. In theory, the CAP should follow the objectives of the EU Treaty as specifically devised for the sector (Art. 33), and it is questionable whether direct payments that are still linked to yields in the 1980s are the right tool to achieve them.⁸ Even accepting the special place of agriculture in the EU, the CAP is highly inefficient in reaching the objectives set.

The latest CAP reform, undertaken as part of the mid-term review (MTR), was indeed a very radical reform, making a large step forward to decouple the agricultural support from production – a process that had started with the MacSharry reforms in 1992. These reforms are undoubtedly important and merit due recognition. Necessary reforms do not mean sufficient reforms, however. The MTR reinforced the EU's position at the World Trade Organisation (WTO) negotiations and reduced market distortions in the EU, but has left largely intact the distribution pattern of support at the national, regional and farm levels.

The assessments of the performance of the CAP in Tables 2 and 3 (excluding the rural development heading) illustrate again that the policy

⁸ Even if the distribution of payments *within* countries has to a certain extent shifted away from historical yields, the allocation of the level of support to each country is still largely based on these parameters, which persists owing to the net balance implications of any change.

appears to have largely failed to achieve many of its objectives effectively, if at all. Particularly damaging for the CAP has been the significant negative externalities it has created for other markets, especially for the world market of agricultural products. There is no environmental objective for the CAP in the EU Treaty, but the detrimental implications of the policy on the environment have been important. Protection of the environment is becoming an integral part of the CAP, but it is still a regulatory by-product often regarded as just a tool for making the direct payments presentable, which is done through the cross-compliance obligations for direct payments (the Statutory Management Requirements and for keeping land in Good Agricultural and Environmental Condition).

The results indicate that the present CAP, which concentrates on support through direct payments, should generally be phased out and redesigned. Some limited aspects could be retained such as financial assistance to poor farmers (based on the means testing of household incomes). Environmental support could be linked to regulatory systems and rural development programmes. Direct financial support should be granted in a manner that better reflects the estimated costs of accomplishing the policy's objectives. Support should not be linked to unrelated historical yields. Farms with large turnovers should not be granted any direct support.

4.1.2. Rural development policy

As a response to the failings of the CAP, a shift has been taking place that has seen the growing importance of the rural development policy, which can be considered in line with the policies on convergence and sustainable growth. The rural development policy has a large number of measures that can be classified under three objectives:

- a) restructuring the farm sector and improving its competitiveness,
- b) improving the environment and
- c) assisting the economic development of rural areas.

The first objective absorbs the largest portion of the funds. The second and third objectives are dominated by farms and farming activities, which indicate that the rural development policy is essentially a farm policy, still viewed by many as an integral part of the CAP rather than the start of a new approach to addressing the overall challenges of rural areas, including but not exclusively the agricultural sector.

The dominance of farm-linked assistance is against the recommendations of most academic research and work by the OECD (1996, 2001, 2003b and 2006; Saraceno, 2003). Most studies hold that rural development is better achieved by holistic actions targeting all activities in the rural economy. Even in the most rural of the EU's regions, employment in agriculture does not match that in services and industry. The decline in rural areas is generally attributed by the above-noted studies to declines in rural infrastructure quality and services, not in farming.

Table 5 shows the distribution of rural development funds by objective in 2003. Very few funds can be deemed to target territorial development. Some improvements will occur with the new regulations for rural development, but these still only require that a minimum of 10% of the funds are directed towards holistic actions for rural development that are not farm-oriented. This is an important change, but rather modest.

Table 5. Distribution of EU funds by function (EU-15), 2003

Function	EU funds (€ million)	% Share	Total public expenditure (€ million)	% Share
Sectoral agriculture	3,830	89.22	8,523	88.01
Territorial, semi- sectoral and forestry	749	16.35	1,162	11.98
of which:	569	12.42	119	11.73
territorial and forestry				
of which:	314	6.86	783	7.71
territorial alone				
Total	4,578	100	10,746	100

Source: European Commission (2006); a further breakdown is given in Appendix 2.

The shortcomings can be partially ascribed to the pressure to use the rural development policy as a method for shifting direct payments into WTO-compliant and taxpayer-acceptable support for farms, in an attempt to keep the distribution of support among beneficiaries close to that for direct payments. To a certain extent, this was the original motive for creating and reinforcing pillar II of the CAP in the MacSharry and the Agenda 2000 reforms. This narrow perspective of rural development therefore assumes that a reduction in direct payments should be offset by

an equivalent increase in rural development support. Some rural development support has in fact been accused of financing agricultural practices that were being followed anyway.

The view of rural development as a tool for the general economic revival of rural areas is gaining ground, but the distribution of funds remains dominated by the CAP. The present restrictions imposed on the distribution of rural development support serve as proof – requiring that the share of rural development funds modulated from direct payments remains largely in the region from which they originate (80%). As a consequence, modulated funds will continue to fall on those areas with the most productive farms, which are mainly in the richest regions. This outcome is likely to cause rising tensions in future budget negotiations, as modulated funds from direct payments to much wealthier regions of the EU can be several times higher than in the poorest rural areas.

Further evidence of the misallocation of resources can be found in the June 2003 report from the European Court of Auditors,⁹ which severely criticised the distribution of funds for less favoured areas (LFAs). It faulted the lack of a justified methodology for selecting the beneficiary areas. Member states apparently refused to offer information about the methodology used, which increases the suspicion that the designation of areas is not based on relevant socio-economic indicators. The disparity of classifications may also lead to differential treatment of beneficiaries in different member states.

Despite the embedded socio-economic objectives of supporting LFAs, the consistency of the support with economic cohesion objectives is poor. ESPON (2006) indicates that LFA payments are not more intensive in areas with a lower GDP level or higher unemployment. The somewhat political nature of the way in which LFA areas are defined and the flat-rate character of payments may have created an element of over-compensation in areas where disadvantages compared with non-LFAs are minimal, and one of under-compensation in the most severely disadvantaged regions.

Yet, contrary to the regulation proposed by the European Commission, the eligibility criteria for LFAs were not touched. This is unfortunate, but the Council agreed to revisit this policy in 2008 with a view to reforming it in 2010.

⁹ See *Special Report No. 4/2003 concerning rural development: Support for less-favoured areas*, European Court of Auditors (2003).

Finally, apart from the distributional and performance issues (see also Table 6), there is a patent limitation to the future size of the rural development policy. It is difficult to conceive the creation of a rural development budget comparable in size to the CAP or the cohesion funds. Furthermore, the co-financing needs for rural development are a serious problem.

Table 6. Performance of rural development funds in achieving their objectives

Objectives	Quality of intervention, achievement of objective
Improving the competitiveness of the agricultural and forestry sectors	Mixed/inconclusive. Evaluations are inconclusive on the global impacts of the actions.
Improving the environment and the countryside	Mixed/weak. It is biased towards agri-environmental measures that often involve ‘landscaping’ rather than protecting the environment. A number of actions finance activities that would be undertaken anyway. Support for LFAs has been severely criticised by its aleatory distribution and the very feeble rationale underlying its implementation.
Improving the quality of life in rural areas and encouraging diversification	Weak. It is still centred on farming, while a successful rural development policy should target all sectors. Yet, the inclusion of the Leader approach in the rural development programme and some broadening of the scope for actions in non-farming sectors are important.

In addition, the demarcation between rural development and structural funds will grow more troublesome, and there are already difficulties in the member states with respect to absorbing the funds. It is clear that the redistribution of support among countries, regions, rural areas and farmers is a crucial issue to address in future budget discussions.

On the principles for intervention at the EU level, rural development is an improvement on the CAP but still fails to fulfil the necessary criteria for EU intervention, as Table 7 shows. It needs additional reforms to become a well-targeted policy.

Table 7. Score on the principles of intervention for the rural development policy

Compulsory	
Subsidiarity	Pass. But the policy could improve in the way it targets those interventions that are better performed at the EU level. It is a distributive policy among regions.
Proportionality	Failed. The policy is not well devised to attain its targets to promote the economy in rural areas. It is still highly skewed towards agriculture in its social and economic objectives. It is affected by political impositions unrelated to the objectives, in particular for the allocation of funds among regions.
Additionality	Partially applies. The rule of additionality applies in principle, although it is difficult to control in practice. For some actions, such as agri-environmental support, the policy sometimes finances pre-existing activities and works as an income supplement.
Value for money	Failed. Owing to inefficiencies in allocating the rural development funds and the farm bias in the objectives, it does not fulfil this criterion. There are hardly any income criteria for support. Eligibility is based on the 'rurality' of areas, with rurality vaguely defined.
Highly recommended	
European public good	Partially. Strictly environmental actions and those measures aimed at income diversification may be deemed a European public good. Questions remain about the correct level of competence in some areas.
European added value	Partially. Some aspects of the policy, especially in the environmental, food safety and development fields may be regarded as value enhancing. But the policy needs to be better designed.

The rural development policy could play an important role in the spatial planning of the EU. It should become a rural dimension of what the structural funds do on a larger scale at the regional level. Eligibility criteria should be more clearly defined, with a 'territorial approach' for many of the funds (examples are given in Saraceno, 2003 and Gonzalez Regidor, 2005). As rural areas are part of regions, a coordinated approach will be

needed when both funds target the same area, but they should be able to co-exist, as the scales of operations are generally different. In fact, a holistic rural development policy is rather a convergence policy, but rearranging budget headings would cause havoc in the fine-tuning process for phasing out part of the CAP to reinforce rural development.

4.2 Cohesion or convergence policy

The main concern of the EU expenditure policies has until recently been ‘redistribution’ in the name of cohesion, now re-branded as ‘convergence’. Even the philosophical background of the CAP is originally based on the need to counterbalance the income disparities between the farming community and the industrial and services sectors. The cohesion policy is composed of structural funds (European regional development funds or ERDF and social funds or ESF) aimed at regions with a low GDP per capita (75% of the EU average) and cohesion funds for countries with a GDP under 90% of the EU average. It was thus designed to assist such regions and countries lagging behind economically to catch up and to avoid deepening centre–periphery income disparities. It was also thought that the single market and later monetary union would primarily benefit the wealthier member states.

As a redistribution mechanism between wealthier member states and poorer countries and regions, this policy is a natural candidate for a common supranational budget. Nevertheless, the performance of the funds, the rationale of a number of measures and the eligibility criteria have been issues of intense debate.

4.2.1. Outcomes of the policy

The results of the EU’s efforts in this area have been mixed; some cohesion countries and regions have shown strong tendencies of catching up, while others have lagged behind. In both cases, it is difficult to pinpoint the importance of the structural funds. Studies tend to agree that the EU funds have mobilised investment in excess of a base scenario without EU support, but the actual influence on the growth rates is controversial (Bradley et al., 2004; de la Fuente, 2002).

The cohesion funds were expected to even out regional disparities in the EU. The third cohesion report (European Commission, 2004c) declares that studies show that some convergence across the EU among countries has occurred, owing to the so-called ‘beta convergence’: the observed inverse relationship between GDP per capita and growth, which allows

poorer countries to catch up. Independent studies confirm this, but the impact in the last programming period of 2000–06 was weaker than during the 1989–94 programming period, somewhat undermining the ability of the report to easily defend regional policy. This weaker growth has caused scepticism about the merits of regional policy. Against this criticism it is possible to argue that the 1990s saw several global economic crises, first caused by Russia and then by the Asian markets. Regional policy may have cushioned the weakest EU regions from decline, which also has its merits. It is actually difficult to judge the base scenario.

In addition, growth rates diminish as regions become wealthier for two reasons. The first relates to magnitude, as small increases in wealth in nominal terms are higher in percentage and real terms. This stems from a combination of a generally smaller GDP, which makes every extra increase larger in percentage terms, and the usually lower price levels in the poorer regions, which ensure that every euro invested and every euro returned has a higher value in real terms. Prices and the cost of capital and labour rises in those regions that become wealthier. The latter consequences increase the complexity and longer-term maturity of ‘second round’ investments. Investments suffer from decreasing marginal returns, and once a region’s basic investments with rapid returns are completed, every additional investment tends to become more costly and require a longer maturity period. Some more complex investments for the long term, such as investments in the education system, may not have a significant effect during the time span of single financial perspectives, but may be crucial for the future.

The latest reforms in the cohesion policy, calling for a redirection of funds towards actions in line with the Lisbon agenda, also reflect the decreasing marginal returns on infrastructure. Once the basic infrastructure is in place, the returns from investing in more of the same may have little or no additional impact. Recognising this, the earmarking of cohesion funds for competitiveness-oriented investments makes sense.

Another criticism of the cohesion policy, as the latest cohesion report admits, is that the divergences in GDP per capita among regions have not narrowed, i.e. the so-called ‘sigma’ convergence. There is some evidence that it has even worsened (ESPON, 2006). Regional growth has concentrated in some regions. This trend has triggered the criticism that regional policy is failing to deliver. This argument is flawed and short-sighted, however. It is economically irrational to expect that regions with

different development potential can equalise their GDP per capita, with the result of seeing Andalusia or Algarve approaching the GDP per capita of, for example, Cataluña. Regional growth potential is limited by the location's endowments and patterns of demand for those endowments. There are some regions with more endogenous growth potential than others and it is therefore normal that growth is uneven. Furthermore, as Martin (1998) reports, financial and other assistance to businesses in wealthy member states is often higher than the total assistance in the poorer regions including that by structural funds, which reduces the ability of EU regional funds to generate a catching-up effect.

While investments in poorer regions in Europe make sense, unjustified over-investment can have higher opportunity costs for the wealthier regions from which the transfers come. Beyond a certain investment mass, returns in the convergence regions may be negligible while lost opportunities elsewhere may not. The cut-off point is an issue of dispute and has grown in controversy with the economic slowdown in the EU in the past decade.

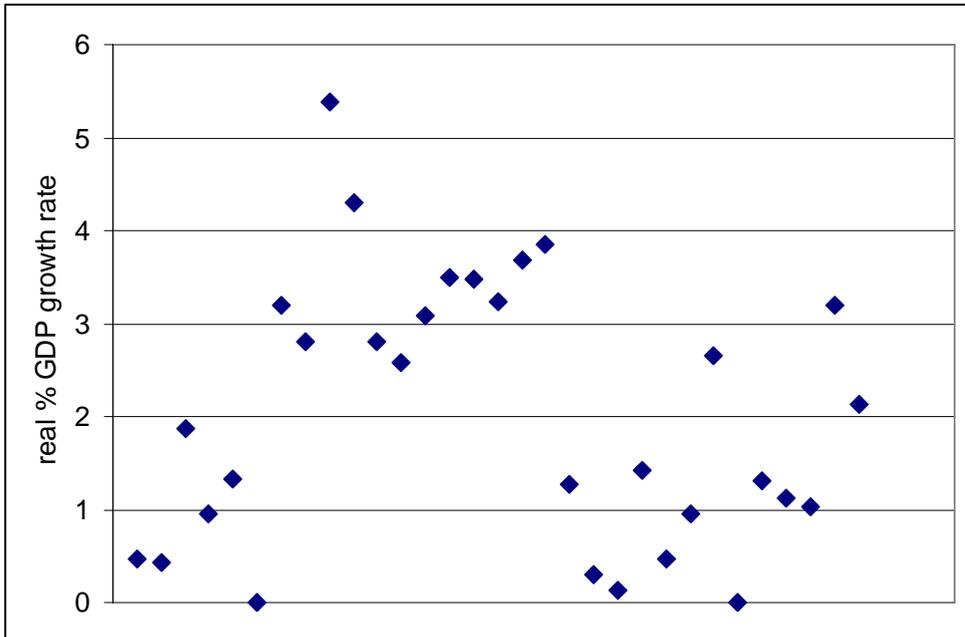
Regional and cohesion funds have suffered from the side effects of the pork-barrel approach to funding allocation. One of the most notable cases is the former Objective 6, which became part of Objective 1, and in turn allowed support to be given to regions with a low population density over a certain geographical latitude. This move is often regarded as having been compensation for Sweden and Finland in view of their lower CAP benefits. They are now no longer eligible for convergence funds.

Cohesion funds are also considered the result of pressure by Spain to be compensated for the adverse effects of the internal market on Spain. They were conceived only for the period until the introduction of the single currency, but they have lingered for political reasons. This does not mean that cohesion funds are not useful, but that the decision to continue them was not taken based on efficiency criteria.

Despite all the weaknesses of the policy, there is in any case an interesting indication that the structural funds or the EU in general has positive effects on regional economic development. Plotting real GDP growth rates for all Objective 1 regions (Figure 7) during the period 2001 to 2004 indicates that none of them has seen their GDP per capita decrease, and what is more important, with two or three rare exceptions, nominal GDP growth was above the average inflation rate. This is probably an indication that the regional policy approach of the EU generally works, as

one would expect more ‘declining’ regions to worsen. Regional policy planning and investment has likely dampened decline where it loomed, and fostered economic growth; the EU’s regional policy support and the multi-annual programming approach is probably an important factor in this result, even if such a statement is difficult to prove.

Figure 7. Average real GDP per capita growth rates, all Objective 1 regions, 2001 to 2004



Source: Data derived from Eurostat.

One of the main weaknesses of the policy is simultaneously one of its greatest strengths, in that the planning and implementation process depends heavily on the national and regional authorities. The commitment of member states’ administrations to the success of the investments and the quality of interventions is of paramount importance.

The European Commission’s power in the project selection process for the majority of the funds is limited. Most of the implementation and control occurs at the national level. This clearly leaves to member states the control over the performance of the funds. In addition, the Commission’s culture of ensuring the ‘absorption’ of funds as one of the key measures of

success has fostered their suboptimal use in the pursuit of fast expenditures. The uneven performance of funds can often be traced to the lack of implementation quality in the member states.

There has been a shift in the Commission's position on this issue, with more emphasis on integrated planning and recently the requirement to earmark expenditures for Lisbon-oriented initiatives. The performance of the funds, however, is still mainly in the hands of the member states. The Commission has little authority during implementation to check the quality of the projects approved. It only has blunt legal instruments to act in cases of fraud – for blocking the funds and bringing a member state to the European Court of Justice if the fraudulent operations are not effectively pursued at the national level.

Research on the performance and value added of the structural and cohesion funds is largely inconclusive (Table 8). Some argue that the overall value added may be negative owing to the opportunity costs. Nevertheless, there are signs that the success of the structural funds is closely related to the quality of programming, and it probably has had positive effects in countries like Spain and Ireland for this reason.

Table 8. Performance of the cohesion policy in achieving its objectives

Objectives	Quality of intervention, achievement of objective
ERDF aims at reducing disparities between the levels of development	<p>Inconclusive. Convergence among regions has not been achieved, but this is not a realisable objective, as poorer regions often lack the endowments to match the growth rates of richer regions. What is important is how the regions would have fared in the absence of the EU's policy.</p> <p>The ERDF is still largely encumbered by distributional problems with the allocation of the funds by country – an approach that is dominated by politics.</p>

Table 8, cont.

ESF aims at improving productivity, increasing job rates and social inclusion and cohesion	Mixed/weak. It is unclear what the role of the EU should be. Often the effects of measures are weak and ineffective because of national policies, such as rigidities induced by labour market legislation.
Cohesion funds assist the eligible member states to catch up with Europe's wealthier regions	Positive/mixed. Some countries have developed quickly, while others are still lagging behind. The effectiveness of the policy depends on the implementation quality in the recipient country.

Theoretically, structural and cohesion funds score well on the principles for EU intervention (Table 9), but the problem of the policy lies in the individual policy actions. An analysis and re-evaluation of the quality and appropriateness of certain eligible measures should be undertaken.

Table 9. Score on the principles for intervention for the cohesion policy

Compulsory	
Subsidiarity	Pass. It is a transnational redistributive policy and thus supranational in nature. Programming and implementation of the funds are correctly in the hands of the recipient countries and regions. In the areas of evaluation, auditing and control, however, the roles of the national administrations and the EU should be reviewed.
Proportionality	Weak. The structural funds and cohesion funds still need to be improved to enable them to achieve their objectives. It is unclear if the policy can or should achieve the objective of reducing interregional disparities.

Table 9, cont.

Additionality	Pass. This quality is a fundamental obligation for the policy and evidence suggests that it is adhered to in principle.
Value for money	Weak. There are indications that the policies could be improved.
Value for money	Weak. There are indications that the policies could be improved.
Highly recommended	
European public good	Pass. The development of poorer regions is in the interest of the EU.
European added value	Weak. Intervention in the poorest countries and regions is generally thought necessary. The value added of €1 invested in the poorest region is held to exceed the value in a richer region. That being said, the opportunity costs for wealthier but still eligible regions are questionable.

4.2.2. Indirect benefits of the cohesion policy

Regional policy has also been attributed indirect benefits. The subsidiarity principle clearly ascribes the obligation of preparing the development plans to the regional–national level, with success very much in the hands of the beneficiary regions and countries. This tactic has encouraged the development of better multi-annual, strategic planning exercises and important administrative reforms in member states. Even if not perfect, these changes have been healthy. The learning element embedded in the preparation of the strategic documents and programmes should not be underestimated. These tasks induce a change in the attitude towards the economy for public administrations, forcing them to become more proactive. Even in wealthier member states, the existence of regional funds have allowed the regions some emancipation from central government, enabling them to develop strategies of their own, often better attuned to regional needs. The importance of this process even in traditionally richer, centralised countries like France has been documented by Cole (2003).

EU procurement rules, while cumbersome, have pushed forward the standardisation of all procedures. They require a certain administrative

capacity and efficiency, and contribute to an improvement in transparency and fraud reduction. Therefore, despite all the misgivings of several member states on the misallocation of EU funds, the level of corruption related to EU funds is generally thought to be less compared with much public expenditure in member states. This point is important in respect of the new member states, where the control of public finances is generally poor and EU standards impose discipline. Despite possible losses, the long-term effect is likely positive, speeding up the process of integration.

4.2.3. Future of the convergence policy

Should the EU be involved in regional policy? The answer as far as interregional redistribution is concerned is yes. Solidarity aspects of the EU are better handled at the EU level. The EU can play a role in fostering the growth of its poorer regions. Yet, the cohesion policy has come under scrutiny, and some analysts find that many of its actions are not justified.

According to the Sapir report (Sapir et al., 2003) and as endorsed by some net contributors, there is a question about the need for regional policy to intervene in wealthier countries with eligible regions, leaving it to richer countries to finance their development. This position has some rationale from a purely economic point of view. Wealthier member states not only have more means to invest in their regions, but also their level of social support is generally higher. Additionally, net contributors could substitute the EU funds to the region with the money they would save by having to contribute less to regional policy.

This argument, however, is generally rejected by the regions concerned, which do not see the national government investing in the region with an equivalent intensity. Regions also appreciate the empowerment EU regional funds gives them to define their own priorities. From a political point of view, there is also an important equity question: refusing support to poorer regions in wealthier countries runs counter to the principle of equal treatment among EU citizens, in that citizens in a similar situation (in terms of GDP per capita in PPP) are treated differently because of their location.

Yet the merit of this last point is debatable as similar GDP per capita in a region does not de facto mean a similar interpersonal situation. Regions with a similar GDP per capita in PPP say nothing about the comparative state of infrastructure, social security intensity or public service provision in the regions.

In any case, the introduction of national wealth as an addition to the regional GDP per capita criterion for eligibility would fundamentally change the nature of the policy. It would lose its EU-wide character. The choice cannot be decided based on an economic rationale alone and it has heavy political connotations.

Any radical changes in the cohesion policy of the EU should be taken with the recognition that it has been one of the most interesting and important components of the budget and of EU integration in general. The EU's cohesion policy is unique for an intergovernmental association of countries, even if preceded by the example of the Marshall Plan. Changes have to be undertaken with care, but it needs improvements, particularly

- an increase in policy coherence and growth orientation, and
- an increase in the national responsibility for expenditures.

Increase in policy coherence and growth orientation

There is growing opinion that a successful use of structural funds requires much more than a carpet development of infrastructures and needs well-developed strategies and goals. The 'Irish miracle' and the exceptional growth in some Spanish regions for example, have been driven as much by the administrative capacity to absorb funds as by entrepreneurship and well-defined actions.

Policy coherence is crucial. Rigid national labour-market policies, burdensome fiscal policies or ill-defined social policies can limit the effectiveness of investments. When the framework conditions are right for growth, structural funds have assisted in fuelling it. Studies attribute to the structural funds an important contribution in countries like Ireland and Spain (Bradley et al., 2001; de la Fuente, 2002). The lack of strong performance in some regions of southern Italy for example, or in Greek regions (Leonardi, 1995), despite heavy support, can be greatly put down to a lack of coherent strategy and suboptimal national policies. This is clearly a valid message for all other areas of intervention, such as rural development or R&D.

The present dispute on value added and the strategy for growth is thus justified. It has already prompted the Commission to require a more

strategic focus¹⁰ in line with the new requirement for member states to prepare National Reform Programmes, which also attempt to induce more long-term economic planning and require an increase in the synergies among all policy actions.

Increase in the national responsibility for expenditures

In addition to policy coherence, governments should be encouraged to take an approach that is more strategic, to consult the stakeholders better and to produce programmes in partnership with the real drivers of economic development – private-sector entrepreneurs. Evaluation and the ability to redirect the strategy and funds according to circumstances during implementation are also important. The proactive involvement of the Commission services, the administrations and stakeholders must be fostered.

A driver of excellence could be a periodic reassessment of funds to be allocated to member states and regions based on performance. Rather than encouraging the absorption of expenditure through measures such as the ‘performance reserve’, the level of support could be conditional to sufficient tangible impacts on the economy. The present performance reserve is limited to rewarding programmes with additional funds based on efficiency indicators, which tend to be dominated by absorption-capacity objectives. Instead of focusing on the release of additional funding as a positive encouragement, there is a need for a financial threat for the lack of tangible impacts. This is to ensure that funds are correctly spent with the aim of facilitating economic growth. Support should be time-limited and the amount of future funding based on the extent to which objectives are achieved. It would be unfortunate if cuts in regional funds were implemented across the board, penalising successful regions for the underperformance of others. There is an additional imperative to make regional authorities accountable for their performance.

Finally yet importantly, there is a need to review the evaluation, auditing and control of funding allocations. The evaluation process should

¹⁰ For the structural funds, the Community Strategic Guidelines document lists the guidelines for support, which require more coherent, long-term strategic planning by the member states. See European Commission, Communication on Cohesion Policy in Support of Growth and Jobs: Community Strategic Guidelines, 2007-2013 COM(2005), 0299 Brussels, 5 July 2005.

be in the hands of an independent agency, as the European Commission suffers from a strong contradictory pressure to ensure the ‘absorption’ of funds, which jeopardises its ability to press for the quality of the intervention planned *ex ante* or to act on weak results *ex post*. For auditing and control, the EU institutions have the final responsibility for the correct use of the funds, while the member states are responsible for implementing the policies, managing the appropriations and monitoring them. In this system of shared management between the EU and the member states, there are issues surrounding the division of competences and the attribution of accountability for the expenditures. Cipriani (2006 and 2007) closely examines the incoherent aspects of these arrangements, in which competence is widely devolved for implementing the EU budget while full accountability is lacking.

4.3 Support for competitiveness

The EU is facing growing challenges to its international economic position. Growth in the EU has been sluggish; it has performed weakly compared with the US and has encountered increasing competitive pressure in international markets. The world market expanded considerably in the 1990s, as the Soviet Communist bloc collapsed. The period saw the introduction of large players, including China and India with their vast supplies of cheap labour (skilled and unskilled), creating a global downward pressure on wages. These changes have brought the controversial outsourcing problem (the importance of which has been widely exaggerated), but have also given rise to new competitors in areas in which the EU had felt relatively safe.

The EU had based its expectations of economic growth on the conventional belief that high-tech products are the reserve of the most developed countries. The EU had even expected the new member states to be solely competitive in labour-intensive, low and medium value-added industries. With the basic technologies becoming cheaper and with telecommunications and transport systems developing rapidly, China, India and some of the new member states started investing in the development of knowledge-intensive industries. Today India and China

produce more engineers than do Europe or the US,¹¹ and they have invested in the development of advanced regions the size of European countries. It is interesting to note that when India's government took the decision in 1992 to develop high-technology centres, this step was dismissed by many as an eccentricity doomed to fail; instead, it was a success (Sachs, 2005). Europe now finds itself under competitive pressure at all product levels.

Until recently, the resources of the EU budget were concentrated on cohesion and problem areas. Successful ventures were assumed to be self-generating and self-sustaining. Investment for companies was mostly limited to cohesion regions and industries in decline (Objective 2). The idea of fostering research and companies in the frontline of the market was an anathema for a budget developed for cohesion.

With a declining working population and the growing loss of some of the main 'absolute' comparative advantages,¹² the EU needs to improve its competitiveness while maintaining the value of its products. These aims require significant investment and effort if the EU is to retain its economic position and the living standards of its citizens.

The EU has introduced a number of measures for promoting the competitiveness of Europe and its capacity to face the challenges ahead. The EU budget is expected to intervene in the most appropriate form, bearing in mind the subsidiarity principle, and hence support those actions that are better served at the supranational level.

Recognising the need to foster the top as well as the bottom of the market (given the role the top plays in supporting the bottom), the European Commission proposed for the next financial perspective to bring existing pilot programmes on research, support for start-ups and connectivity across Europe to the forefront of EU policy intervention. A large and distinct budget was created under the new heading of

¹¹ There are some doubts about the actual quality of the skills attained by many of the graduating engineers, however. As reported by a number of news sources, a study recently commissioned by the Indian National Association of Software & Service Companies has found that only one in four engineering graduates is employable.

¹² High-tech consumer products were concentrated in the US, Japan and Europe. This group could once be said to have possessed an 'absolute' comparative advantage in front of the rest of the world, but that is changing.

competitiveness and employment. This heading finances those policies equivalent to the present Objective 2, but also R&D and trans-European transport corridors and the connectivity of energy networks.

The new financial perspective also reinforces actions that are deemed important for the future competitiveness of the EU. The competitiveness heading increases and expands the EU's interventions for the development of SMEs, education and lifelong learning programmes and the Trans-European Networks (TENs). The European Parliament managed to increase funding for programmes that are linked to competitiveness and employment by €4 billion. It increased by €2.5 billion the funds of the European Investment Bank to support SMEs and European transport networks. While investment in competitiveness is certainly a positive idea, the role of the EU funds is not clear. The value added of intervention at the EU level is still under debate.

4.3.1. Intervention for SMEs

From a theoretical point of view, the EU can play a role in assisting the development of SMEs when it is part of a European restructuring process. SME development also depends on national incentives and regulations.

Public financing for SME development can generally have the effect of substitution for private financial sources. Still, the latest comprehensive evaluation financed by the European Commission claims that the policy has significantly added value, and that without this intervention 75% of the SMEs assisted would never have formed (European Commission, 1999). A recently completed evaluation of some of the programmes for SMEs (Renda, Schrefler & van Dewal, 2006) concludes that this is indeed an acceptable EU policy even if there is scope for improvement (see also Table 10). There is not yet enough research in this area to support any strong argument for or against SME support in non-convergence areas of the EU.

A thorough revision of the schemes to assist SMEs should be undertaken to ensure that the EU is not substituting its assistance for that of national or private funding institutions. There are sometimes puzzling concerns that EU schemes for SMEs are not taken up in some regions because national schemes are easier to use. In those cases where there is no underprovision of national funding, the EU schemes simply should not be offered. Furthermore, national support is already regulated by EU state-aid rules. Only in countries or regions that lack provision owing to inadequate state resources should EU intervention be granted.

Table 10. Score on the principles of intervention for SME assistance

Compulsory	
Subsidiarity	Unclear. EU support should be limited to areas in which state resources are too low to provide assistance.
Proportionality	Unclear. The level of intervention needed at the EU level is an issue of open debate.
Additionality	Unclear. There is a risk of substitution of private finance or state aids.
Value for money	Unclear
Highly recommended	
European public good	Pass if well devised
European added value	Pass if effective

4.3.2. Research and development

Innovation is recognised as a key factor for the growth and the future sustainability of the European economy. It is well documented, however, that the EU spends less as a share of GDP on R&D than the US or Japan (Table 11). The European Commission has thus proposed a substantial rise in funds for research and investments leading to increased competitiveness. But finance from public funding as a share of GDP is higher in the overall share of gross domestic expenditures on R&D (GERD). As a percentage of GDP, it is even higher than in Japan, which indicates that a significant part of the problem probably lies with private financing, which is considerably lower in the EU.

Table 11. Gross domestic expenditures on R&D (GERD) as a % of GDP, 2003

	EU-25	US	Japan	China
Expenditure as a % of GDP	1.93	2.59	3.15	1.31
Growth in GERD (annual real growth 2000–03, %)	2.4	0.4	2.2	18.6
Share of public expenditure in GERD, 2002 (%)	34.0	31.0	18.0	–
Share of public expenditure in GERD, as % of GDP, 2002	0.66	0.80	0.57	–
Share of private expenditure in GERD, as % of GDP, 2002	1.27	1.79	2.58	–

Source: European Commission, key figures 2005 and own calculations.

While nobody argues that R&D does not need to increase, the source and type of R&D investments are important issues for debate. Is increasing R&D through the EU budget thus sensible at all? Is an increase in public spending on R&D actually a solution at all? Given the level of private R&D investment in the US and Japan, the EU and the member states should look hard at the existing regulations and policies. Why is Europe lagging behind? Is it because of a lack of public funding or an excessively rigid and innovation-unfriendly policy framework? Regulation, rigid labour markets, bureaucracy and unsuitable fiscal regimes may well be the underlying reason for Europe's stragglng performance. Even with greater public expenditures, the situation is unlikely to improve if the inefficiencies that are at the root of the private sector lethargy remain – with a rise in public spending at best representing a less than optimal solution. The possible allocative inefficiencies from decisions that are not market-led could easily reduce the value of any public funding increase.

Moreover, the EU's approach to R&D may well be ineffective and even counterproductive. Gros & Micossi (2005) are very critical about the strategy for R&D investment through the EU budget, judging it wasteful and politically influenced, and they recommend a substantial change in the rules.

Nevertheless, some actions can be considered of EU interest, for which EU funding has seen positive outcomes. The EU has been experimenting with different pilot projects since 1994, including the Regional Innovation Strategies and Regional Technology Transfer initiatives. In the programming period 2000–06, these initiatives evolved to form a central strategic goal, which is to develop the European research area. The European Framework Programmes and pilot programmes for regional cooperation and for innovation (such as the PAXIS programme) have grown stronger year by year.

There is evidence that EU funding in R&D has been successful where critical mass and cross-border benefits exist despite the sums representing less than 6% of total EU spending on R&D. It has helped to prevent duplicated and fragmented research where coordination and economies of scale are important. While there is broad agreement that the role of the EU budget could be stronger, there is not a consensus about what size it should be or the specific purposes for which it should be used. The potential for the misallocation of resources is significant, and experimenting with the EU budget does not address the fundamental problem of a negative business environment in Europe and the ensuing low R&D activity.

Generally, EU funding directed at R&D and at fostering competitiveness should be allocated according to excellence. Countries or regions should not be able, as is the case for agricultural, rural and structural funding, to capture a predetermined budget allocation for their country. With today's discussions so concentrated on net balances, the interest of member states in supporting an increase in funding for this heading has been weak. There is a high risk that the larger pie, the more likely it will be divided on a political basis, undermining its effectiveness.

Well-targeted interventions for R&D are potentially clearly in line with fiscal federalism and all the principles for EU interventions. Yet the actual performance of R&D spending is mixed, partly because of a lack of funds. At this stage, it is incorrect to judge the potential of the funds based on the limited interventions of the past. Nonetheless, the potential for misallocation has to be taken very seriously with respect to extending the scope of the funds. In addition, public authorities have a mixed record in picking the most successful ventures.

There are, however, areas where EU funding would be undisputedly beneficial if well allocated – in spending to address global challenges and long-term needs, such as reductions to greenhouse gas emissions beyond 2030. Funds for adaptation to climate change and mitigation technologies, for the EU and non-EU countries (especially developing ones), cannot be provided by market forces alone. Markets are unable to offer the incentives for such long-term technological needs (see Fisher et al., 2007).

The EU budget can provide important leverage funding, to induce further investments in the public and private sectors (see Table 12).

Table 12. Score on the principles for intervention for R&D policy

Compulsory	
Subsidiarity	Pass. There is a clear role for research funding at the EU level to reduce duplication and increase economies of scale. Large EU-wide and global challenges are better dealt with supranationally.
Proportionality	Unclear. The optimal funding at the EU level is unclear. But for some challenges such as climate change and mitigation technologies, the needs have been estimated.
Additionality	Pass. Officially, funding R&D is held to be additional, but substitution effects should be checked. EU funds should not reduce costs that firms would incur anyway. Grants for researchers may substitute employees.

Table 12, cont.

Value for money	Pass. This assessment is given with reservations, however. R&D financing by the EU level can potentially lead to important economies of scale. Yet the private sector in the EU clearly lacks dynamism. The value of changing the market incentives to unleash private R&D efforts may be greater. Eliminating indirect regulatory barriers between member states to encourage private transnational and corporate R&D is recommended. Still, for long-term global challenges, EU funding is important.
Highly recommended	
European public good	Pass. This view applies to research that the market would not have provided.
European added value	Pass. This assessment applies to global challenges such as transnational pollution and long-term challenges.

4.3.3. *Trans-European Networks*

TENs are viewed as a fundamental ingredient for efficient, developed markets. The objectives are reasonable as ideas: to ensure that transport connections enable cross-border trade, to facilitate connectivity across countries for energy, to stimulate competition among providers and to provide energy security. The fund assists in the creation of TENs by financing transport and energy connectivity, but is this necessary?

TENs for transport are also financed by the cohesion funds in countries with a GDP per capita under 90% of the EU average; thus, the budget in the competitiveness heading is for those not benefiting from cohesion funds. The advantages of funding transport connections in wealthier member states through the budget are questionable and may conflict with the additionality criterion. In these cases, the need for EU funds should be reassessed.

Regarding energy markets, it is true that they are dominated by national players, which have underinvested in connectivity to other countries. There is no economic incentive for the energy suppliers, which often have a monopoly or near monopoly in their country, to connect to foreign grids. The EU can open these markets by financing the required infrastructure for connectivity. For gas, the main argument is energy

security. Special pipelines ready to shift to other suppliers could be built. There is indeed a case in favour of EU action in both areas, but further cost-benefit analysis should be undertaken (Table 13).

Table 13. Score on the principles of intervention for TENs

Compulsory	
Subsidiarity	Pass. Yet, this view would not always hold for transport funding.
Proportionality	Unclear
Additionality	Pass. But it may fail in wealthier member states.
Value for money	Pass. The possibilities to build up economies of scale are substantial; however, for energy security, there is a need to evaluate costs and benefits better.
Highly recommended	
European public good	Pass
European added value	Pass

4.4 Security and external action

Security, defence and external action are important areas of intervention in which the EU would be better placed to act. The financial allocation is far from enough and the policies are too underdeveloped.

On external action, the EU budget does not reflect the ambitions of the EU abroad, nor does it provide the necessary means to fulfil its present objectives.

The EU has critical interests in engaging with its neighbourhood. The political stability and economic development of neighbouring areas bring opportunities for the EU and are of major importance. The EU is seen by most of its neighbours as an ideal to emulate. Membership is sought, with countries engaging in lengthy, difficult and expensive reforms to secure trade access or approach and adopt the EU *acquis*, which is heavily loaded with costly political and economic requirements.

The EU's influence in its neighbourhood is principally based on persuasion rather than power. Access to Europe's markets, the benefits of closer relationships and ultimately membership have changed the political

geography of Eastern Europe at a record-breaking speed. These changes are also largely related to the EU's introduction of conditionalities to its programmes (PHARE, TACIS, CARDS, etc.). Yet its influence spreads beyond its neighbourhood, through its international aid programmes. Despite the reliance of the EU on support through association agreements, pre-accession programmes and aid to secure stability, influence and future trade partnerships, the external action budget of the EU is still very limited. The economies of scale that can be achieved through external action at the EU level are very significant, while the EU's weight in global security affairs is meagre without a pooling of resources.

In addition, the EU is criticised for its lack of resources to handle external programmes. The EU actually relies heavily on external consultants with varying success. The member states, however, paradoxically refuse to allow the EU administration to increase in line with the responsibilities they have bestowed on it.

As for internal security, the member states have been remarkably unwilling to extend the EU's involvement in this field. Gros & Micossi (2005) are surprised that in an area in which citizens are clearly demanding more coordinated action, so little interest is being shown. The fact that this heading is so underfunded partly stems from the political reluctance to shift resources from the CAP and structural funds to internal or external actions (Table 14).

Table 14. Score on the principles of intervention for security and external action

Compulsory	
Subsidiarity	Pass
Proportionality	Unclear. But by having separate and often incompatible national structures, expenditures are higher than is necessary for the present standards.
Additionality	Pass. There is strong potential for action beyond that possible for member states in isolation.
Value for money	Pass. The potential is substantial, but the tendency of member states to maintain high national control over supranational ventures can be damaging, as in the example of EADS.

Table 14, cont.

Highly recommended	
European public good	Pass. Security is an important public good. Stability in third countries is very important for the long-term security of the EU.
European added value	Pass. Security and stability provide inestimable added value to the EU.

5. Conclusions on the expenditures

The EU budget is changing in nature. What began as a tool primarily designed to compensate the agricultural sector and later regions and member states for perceived inequalities in the evolution of the single market, is changing into a tool to foster growth in the EU and face other, growing global challenges.

The budget is now in a transitory state and will continue to be so for some time. It has travelled a long way from the days when expenditures were mostly concentrated on dumping or destroying agricultural production surpluses. With the single market and the single currency, the needs of the EU have altered and new ones have arisen, including a response to globalisation.

The budget is increasingly required to play a role more in line with these new challenges, and the pressure is mounting to depoliticise it. The interventions should thus follow the criteria for public and supranational budgets outlined in this report. Fulfilling these criteria is in addition to incorporating the attributes of subsidiarity, additionality and value for money. Furthermore, as a European budget it should target European public goods that generate a European added value. Policies should reduce the waste of resources and when important objectives are not able to foster growth, they should at least minimise any negative implications on growth.

These steps require important changes in the budget. With respect to the CAP, the payments should better reflect the costs to achieve the objectives. Payments should be made much more efficient and concentrate on areas and farms in need.

Concerning the structural funds, the policies should be revisited to increase their growth orientation. Their effectiveness depends strongly on the quality of the national strategies. The allocation of funds should be based on performance in the use of those funds.

Regarding the competitiveness funds, there is a risk of misallocation of resources. In the case of R&D, the strong focus on public funding (at either the EU or national level) is too narrow. The main deficiency is the low share of private funding of R&D, which most probably stems from regulatory bottlenecks. The EU's R&D funding should concentrate on global and long-term technological challenges, such as adapting to and mitigating climate change in the future, where markets are too uncertain to attract private investment.

The EU needs more resources for security and external action, as the EU is not able to live up to its ambitions in these fields. Cooperation and the pooling of resources in these areas are among the most-effective optimisation strategies, if well designed.

PART II. THE OWN RESOURCES SYSTEM

The own resources system of the EU draws much criticism. The most repeated accusations are that the system is unfair, that it is opaque and that it is not really ‘own resources’, because it largely consists of direct transfers from the member states. This part of the report describes the structure of the own resources system and its development, with specific attention given to the UK rebate. It assesses the merits and flaws of the present system, alternative proposals for deriving EU revenue and essential elements to consider in any reforms.

6. Summary of the own resources system

There are three main resources for the EU:

- 1) *Traditional own resources (TOR)*. These are the original first resources, largely composed of common customs duties and a small amount of agricultural and sugar levies. These are regarded as fully owned by the EU owing to the geographical arbitrariness of the final consumption.¹³
- 2) *VAT resource*. This resource is based on value-added tax receipts. It was established in 1980 to cover the insufficiency of the TOR and conceived as a tax on consumption. It is calculated on a notional harmonised VAT base, as in reality VAT diverges significantly among member states. Prior to 2007, the VAT ‘rate of call’

¹³ The well-known ‘Rotterdam effect’ is a good example. Rotterdam, being a major point of entry for goods to the EU raises a substantial share of the total customs receipts of the EU. With the exception of a 25% retention for ‘administrative costs’, the duties are owned officially by the EU budget and not by the Netherlands. Hence, the EU does not regard the receipts from customs duties as part of the Netherlands’ national contribution for the calculation of the country’s net balance, despite the insistence of the Netherlands on doing so.

contribution to the budget was set at 0.5%. The new financial perspective cuts the cap to 0.3% of GNI from 2007 onwards, with deeper cuts for Austria (to 0.225%), Germany (to 0.15%) and the Netherlands (to 0.1%). These reductions further reinforce the GNI equivalence of the VAT resource. This resource has also seen a ‘cap’ imposed on the base at 50% of each member state’s GNI, because it was considered regressive (generally poorer member states have a higher share of consumption in GNI due than richer member states, although this is also the case for the UK because of its specific market characteristics). The effect is that for many countries,¹⁴ the VAT contribution is equivalent to the next resource, directly based on GNI.

- 3) *The GNI resource.* As costs soon exceeded the TOR and VAT resources, a resource based on the GNI of member states was created in 1988 to cover the ‘residual’ (now the largest) share of the budget. The Netherlands and Sweden are to benefit from reductions in their contributions to this resource for the 2007–13 period of €605 million and €150 million respectively, i.e. lump sum rebates.

The system of own resources ensures that the EU can cover the necessary expenditures and that contributions beyond the TOR and before any rebates are generally in line with the GNI of member states (in terms of their contributory capacity).¹⁵

6.1 History of the UK rebate

In the 1980s, the UK – whose agricultural sector has a different structure to that of other member states – found itself a large net contributor to the budget, despite being one of the poorest members in the then European Community of nine countries. The European Community’s expenditures were principally composed of agricultural spending. The UK rebate was largely a reaction to the regressiveness of the CAP policy and the

¹⁴ The European Commission report on own resources (2004b) notes that for 2005, 13 out of 25 member states had a VAT base exceeding 50% of their GNI.

¹⁵ Baldwin (2005a) does not consider this system an equitable one, as the payments are not progressive (rich countries do not pay more as a share of GNI, as in normal taxation systems). Nevertheless, a progressive system would increase the negative net balances of net contributors even more and would therefore be impracticable.

disproportionate support for specific products in the agricultural sector, as well as the UK's relative lack of prosperity at that time.

The basic mechanism was decided in Fontainebleau in June 1984¹⁶ and given effect by the Council Decision of 7 May 1985.¹⁷ The contribution of the UK to the Community budget is reduced by an amount equal to 66% of its net balance.

The UK's contributory imbalance is calculated as being the difference between the amount paid by the UK (excluding the contributions that are 'owned' by the EU, the TOR) and the amount of expenditure from the EU budget that has taken place in and for the benefit of the UK, excluding external actions, but interestingly including administrative expenditure.

The calculation is complex, with adaptations introduced to either counterbalance the effects of changes in the system, such as the introduction of a resource based on GNI, or the transformation after enlargement of external expenditure into internal expenditure. The adaptations for the current own resources system are summarised below:

- The calculation of the amount of the refund is as if the budget were still fully financed under the pre-1988 system, based solely on VAT.
- There is a reduction of the resulting amount of the rebate by the 'savings' (the so-called 'UK advantage') the UK derives from the modifications introduced in 1988 and 1999. Technical adjustments neutralise windfall gains resulting from the progressive reduction of the VAT key and the increase in the retained share of the TOR.
- The system of financing the UK rebate has been altered in an ad hoc fashion. In 1999, changes were made to enable Germany, the Netherlands, Austria and Sweden to reduce their contribution towards the rebate by 25% of the unadjusted amount, thereby

¹⁶ The general principle of the Fontainebleau Agreement is that "any Member State sustaining [a] budgetary burden which is excessive in relation to its relative prosperity may benefit from a correction at the appropriate time" (European Council, Conclusions of the Session of the European Council at Fontainebleau, 25-26 June 1984).

¹⁷ See Council Decision 85/257/EEC, Euratom of 7 May 1985 on the Communities' system of own resources, OJ L 128, 14.5.1985.

shifting the burden onto the remaining member states (Art. 2(3) of the Own Resources Decision, 2000).¹⁸

- The UK's rebate is also adapted to avoid undue increases caused by changes stemming from enlargement. The calculation of the UK rebate excludes an amount equal to pre-accession expenditures (and thus external action) in the candidate countries before enlargement. These expenditures have since become EU internal expenditures under cohesion and rural development funding (Art. 4(f), Own Resources Decision, 2000), but remain outside the rebate formula.

6.2 New system for the period 2007–13

For own resources, the final agreement¹⁹ is very complex. The UK maintains the present rebate, and accepts the exclusion of all expenditure for the new member states (with the exception of the CAP) from the calculation of the rebate. This adjustment is to be phased in from 2009 and be fully introduced in 2011. In addition, the maximum amount of *additional funding* by the UK cannot exceed €10.5 billion over the period 2007–13, compared with the contributions under the present mechanism. It is important to note that the UK has proposed the cut in the rebate in such a way as to maintain the rebate on the expenditures for the EU-15, as well as on the CAP and part of the rural development funds in the new member states. Furthermore, the agreement clearly states that this should continue after 2013.

As noted above, in 2007 the VAT rate of call has been cut to 0.3% of GNI, with deeper cuts for Austria (to 0.225%), Germany (to 0.15%) and the Netherlands (to 0.1%). The Netherlands and Sweden are also to benefit from reductions in contributions for the 2007–13 period of €605 million and €150 million respectively.

7. Assessing the present own resources

Despite many misgivings, the current system has certain important advantages, which makes it difficult to find comparable alternatives:

¹⁸ See Council Decision 2000/597/EC, Euratom of 29 September 2000 on the Communities' system of own resources, OJ L 253, 07.10.2000.

¹⁹ See Council Decision 2007/436/EC, Euratom of 7 June 2007 on the system of the European Communities' own resources, OJ L 163, 23.6.2007.

simplicity and cost effectiveness (of the basic system before rebates and concessions), long-term stability and predictability, a guarantee of budgetary balance and a distribution of the burden among member states closely proportional to GNI.

Additionally, from the point of view of fairness of the contributions, the present sources of financing (TOR, virtually harmonised VAT and GNI contributions) score well. These contributions are strongly correlated with the contributory capacity of the member states as expressed in national income. The UK rebate and other concessions to individual member states affect this relationship and undermine the fairness of contributions. At the same time, the origin of these corrections is to be found in the distributional implications of expenditure policies. Member states do not openly challenge the notion of contributions based on the share of GNI, but rather those deviating from it.

Fairness of own resources is thus intrinsically linked to the existence of EU expenditure policies that all member states accept to finance in full. As the then UK Prime Minister, Tony Blair, made perfectly clear in the speech to the European Parliament in June 2005, changes in the UK rebate are only negotiable in exchange for reform of the expenditure policies, with a clear reference to the CAP. Fairness in own resources is in this sense directly connected with expenditures.

Nevertheless, it is also true that over the years the UK rebate has become excessive owing to various factors. The first was the existence of an implicit assumption when the rebate mechanism was developed in 1984 that the relative wealth of the UK would stay constant. It is a curious contradiction that while the rebate has over the years accumulated a number of intricate corrections for policy changes, TOR adaptations, etc., no provision has been made to counterbalance the possible reversal of fortunes for the UK, i.e. its transformation from one of the poorest to one of the wealthiest EU member states.

As contributions are closely related to wealth, the UK contributions have increased, *simultaneously increasing the size of the rebate*. The rebate has also further grown with cohesion expenditures, of which the UK is not a main recipient. The UK has not challenged its contribution to regional policy, thus undermining the rigid position it has held over the years on the rebate. Projections into the future show that the UK is set to become one of the smallest net contributors, while being one of the wealthiest member states under the old system (Table 15). With the budget for the agricultural

policy remaining relatively stable, the increase in the rebate cannot be defended based on the cost of the CAP.

Table 15. Net balances with and without the rebate, Commission proposal (% GNI)

Net budgetary balances <i>before</i> the rebate, est. average 2008–13		Net budgetary balances <i>after</i> the rebate, est. average 2008–13	
UK	-0.62	Netherlands	-0.56
Netherlands	-0.55	Germany	-0.54
Germany	-0.52	Sweden	-0.5
Sweden	-0.47	Italy	-0.41
Austria	-0.37	Austria	-0.38
Italy	-0.29	Cyprus	-0.37
Cyprus	-0.28	France	-0.37
France	-0.27	Denmark	-0.31
Denmark	-0.2	Finland	-0.25
Finland	-0.14	UK	-0.25

Sources: European Commission (2004b), Table 3, p. 21 and Table 4, p. 23. (annual averages, 2008–13 based on the Commission’s original financial perspectives proposal – see European Commission, 2004d).

In addition, the fairness of the rebate is increasingly questionable as more net contributors reach a net position similar to that of the UK. As noted earlier, the Fontainebleau Agreement of 1984 describing the principles of the rebate, states that “any Member State sustaining [a] budgetary burden which is excessive in relation to its relative prosperity may benefit from a correction at the appropriate time”. If the net balance is excessive for the UK, then, according to the wording of the Agreement, other countries should benefit from a rebate under similar circumstances.

7.1 Justification for the rebate today

The EU has changed considerably since the rebate was introduced in 1984, and the UK rebate is under constant attack. It is said that the rebate is not justified because the UK no longer suffers any extraordinary, negative net balance before the rebate. On the other hand, the UK still claims that the rebate is justified. To a certain extent, both arguments are defensible.

The UK retorts that the reason for the rebate is not the excessive net contribution, but the distortions in the expenditure that have prompted it; these are still present in the CAP. Other net contributors would therefore be less deserving of a rebate, as they have been supporting the policy mix and are often large recipients of CAP funds. This point is *grosso modo* correct – because of low CAP receipts the UK would pay significantly more than any other member state as a percentage of GNI without the rebate.

Some ad hoc measures are in place, reducing the payments of the main net contributors to the UK rebate (a sort of rebate on the rebate), and there are new changes in the rate of VAT call and TOR contributions, designed to lessen the burden for some net contributors in the future.

7.2 Reforming the own resources system

Despite some weaknesses, the basic structure of the own resources system is fair and sustainable, but the multiple rebates and concessions that litter it are not. The ad hoc measures to benefit one or another country make the calculations of the contributions both opaque and extremely complex. Each budget discussion adds new formulae to benefit specific member states. The dispute over the rebate and the accumulation of distortions indicate the unsustainable nature of such changes. This means that the resources system is increasingly unstable and shifting away from a mechanism based on objective criteria.

The European Commission presented in its 2004(b) report on own resources the GCM as a solution. This mechanism is a complicated system designed to grant automatic rebates to member states whose negative net contributions exceed a certain percentage of national GNI. Details of the system are presented in appendix 3. While the mechanism undoubtedly has some advantages, it does not offer any particular benefit to the net contributors above the present system. It also does not address the concerns about the origin of the problems, i.e. the expenditure policies. For example, the UK would lose a large part of the rebate while not gaining any change on the expenditure side. In addition, it also would introduce rebates as an automatic response to net contributions regardless of the merits of the policies financed. Should member states be allowed to obtain a rebate on policies that are the result of a consensus agreement? One should also add that there is no guarantee that the generalised mechanism would please net contributors and would avoid additional ad hoc measures for specific countries.

In any case, it is also possible to consider a ‘reverse’ GCM, where a net contribution floor is imposed on wealthier countries, eliminating low and negative net contributions by those countries with a GDP per capita above the EU average. By the estimations of the author, if every country with a GDP per capita above the EU average were to finance a minimum of 0.35% of GNI in 2013, this would reduce the contributions of other member states by €8 billion (administrative expenditure has been excluded from the calculation to avoid penalising Belgium and Luxembourg for housing the EU institutions). The redistribution of expenditures would reduce the contributions of other member states by 0.1% of GNI. For the UK, this system would have a nearly equivalent impact on its contributions in 2013, as with the system agreed. It would also remove from the net contributors any net balance consideration when deciding on any expenditure, such as the CAP. While such a system is unlikely to be agreed, the political implications are excellent food for thought.

There are also calls to have the own resources more widely financed by direct fiscal means (i.e. taxes). Such a system would, according to the proponents, eliminate the rebates and increase the visibility of the EU budget for the citizens. A partial introduction of a tax system combined with a GCM has also been proposed, but simple calculations show that taxes that do not closely follow the GNI per capita distribution and can also cause incompatibility problems with the GCM (see appendix 4 for an illustration of such a case).

The claim that direct tax-based resources would reduce net balance disputes is debatable, as the geographical origin of the tax collection point would be clear and would always be an issue of dissent, regardless of whether the item taxed fulfils the regional arbitrariness criteria or not.²⁰ This is the case already with the customs duties, i.e. the Rotterdam effect. In addition, tax resources need to fulfil specific criteria to become a functioning own resource and face significant technical difficulties in doing so.

On visibility, national taxation systems are rarely very visible, and the importance for the EU budget of such visibility is disputable. Visibility can also be achieved by allowing member states to identify an EU

²⁰ Regional arbitrariness in the EU refers to the impossibility of reasonably attributing the base of the tax to a particular member state, as in the examples of custom tariffs and cross-border pollution.

component in a national tax (i.e. 2% of VAT, x% of income tax and so forth), whose yearly aggregate represents roughly the value of the transfer to the EU. Member states need not use a share of the same taxes. This would better represent the actual cost to citizens, as a visible tax (e.g. VAT) only covering part of the budget would not reflect the value of the contribution. Misinforming citizens by making only half of the contribution visible is not the objective.

Proposals to just grant rebates through the expenditure side have usually been dismissed. Apart from the obvious bad image of such transparent transfers, one of the main arguments against them is that it would increase the size of the budget, while obscuring the real contribution of member states. That is not necessarily so. It can be countered that with respect to transparency, such an approach would make the rebates or 'reimbursements' clear and illuminate the currently opaque reductions through rebates and alterations of the TOR, VAT or GNI. The basic own resources could then be based on common rules for all, as rebates would be undertaken through transfers from the budget. As to increasing the budget size, the budget ceiling would not be breached if such transfers were not counted as part of EU budget expenditures for its calculation.

7.3 Alternative fiscal resources for the EU budget

Reasons for changing the own resources system to introduce a stronger link between the EU citizen and the EU budget have been amply documented. Undoubtedly, there are justified reasons to increase the accountability of the EU budget for the citizens, as well as to clarify its functioning, i.e. improve the visibility.

A large number of studies have been dedicated to analysing the positive and negative qualities of various taxation systems to provide the EU budget with the necessary resources.²¹ A number of taxes have been identified as most appropriate for the budget: a real VAT tax; excise duties on tobacco, alcohol and mineral oil; CO²/energy taxation; a corporate income tax; a communications tax; a personal income tax; a withholding tax on interest income; and most recently the introduction of a Tobin tax – a tax on short-term foreign exchange dealings. Nobel prize-winner James Tobin

²¹ See European Commission (1998 and 2004b), European Parliament (1997 and 2007), the UK House of Lords (1999 and 2007), or academics, e.g. Begg (2000).

proposed to reduce through this tax large international currency movements by foreign exchange speculators. This last idea has not taken hold; not only it is regarded as impractical for the EU, but also the tax is advocated for global transactions to raise funding for development countries and not for use by the EU for its own budget.

It is not the intention here to reanalyse the merits of each taxation system but to concentrate on the problems and requirements faced by a system based solely on one or various of the taxes presented. Taxes at the EU level should fulfil certain criteria. These are stability, predictability and sufficiency; budgetary balance; a harmonised tax base; tax proportionality; fiscal neutrality; low additional administrative costs; and appropriate mechanisms to fix the taxation rates. It is not possible for one single tax to fulfil them all, but the combination of tax resources should be able to do so.

Stability, predictability and sufficiency

The present system has the positive feature of an automatic guarantee of resource predictability and adequacy. As the VAT and TOR resources already show, taxes are prone to suffer from yearly variations and differential impacts. A system based solely on taxation would have the drawback of being affected by cyclical variations, changes in consumer behaviour or the influence of economic slowdowns.

There is also a problem with taxes connected to EU objectives, such as an environmental tax. As the taxes are supposed to induce behavioural changes on the part of citizens or entities (or both), a successful tax may be detrimental to the budget. For example, if a CO²/energy tax were to be successful in reducing energy consumption, then the yield of the tax would diminish, reducing its contribution to the own resources.

The GNI key would remain a necessary tool, but changes in the yield of a tax in one country would affect the GNI contributions of other member states. Finally, the taxes may have major political implications.

Budgetary balance

The EU budget is required to be in balance. Using taxes as sole resources, the EU budget would have to be allowed to run surpluses or deficits – a point that would require a Treaty alteration. A direct fiscal resource that manages to raise the exact funding necessary to ensure a budgetary balance is not possible. There are bound to be deviations between appropriations

and expenditures. A GNI key for adjustments to the contributions of the member states would remain necessary, with the problems already mentioned above.

Tax-base harmonisation

The EU is characterised by the heterogeneity of fiscal systems, which creates a serious barrier to introducing an EU fiscal resource. Tax rates and tax bases in the member states diverge considerably. The tax rate and base differentiation is not only a political barrier. Economic efficiency also calls for differential tax systems for different economic circumstances. EU taxes would require equalising the bases and rates for equity reasons, with potentially detrimental effects on some member states. It is important to account for the overall welfare effect on the EU when choosing a fiscal resource.

Tax proportionality

A resource based on a national tax would be expected to be proportional to the country's wealth, unless the tax fulfils the regional arbitrariness criteria *acceptable to all member states*. Harmonising tax bases does not ensure that proportionality would automatically be fulfilled, owing to the heterogeneity of member states' economic structures and consumption patterns. The final impact would depend on the taxation method selected.

The only tax that is proportional across countries is on income, as long as there is a harmonised base, which is not the case at present. The European Commission's (2004b) report and recently one by the European Parliament (2007) identify VAT as a simple and easy tax to enforce, fully harmonising the base (transforming the presently virtual bases into real bases). Yet history shows that this is not as easy as it may sound. The VAT resource has been diminishing in importance and it has been capped because of the unequal incidence of the tax. Rebates and adjustments would likely soon follow. VAT is also affected by consumption patterns and other fiscal policies (including under-reporting and fraud).

There have also been proposals for linking the tax to common objectives of the Community, such as a CO²/energy and transport tax or excise duties on alcohol or tobacco, some of which are proposed in the Commission's own resources report of 2004(b). The bases are easier to harmonise, in a similar spirit as the common customs tariffs. But the previously explained problems connected with uneven impact in different

member states would remain, reinforcing (instead of weakening) the debates on net budgetary balances. Any system chosen would suffer from proportionality problems with a high probability of triggering fairness disputes.

Fiscal neutrality

Any EU tax would be a substitute for a transfer by the treasuries of the member states to the EU budget. It is necessary to make sure that new fiscal resources do not increase the overall tax burden on the member states. In the case of a new tax, it would be necessary for a member state to reduce the tax burden on other items to match the yield of this resource. Monitoring compliance would be difficult.

Fixing tax rates

Budgetary agreements would become more complex, as the European Council and Parliament would not only have to reach an agreement on the level of expenditure in the EU, but also on the rate of taxation.

Administrative burden

In most cases, the introduction of taxes would increase the administrative burden and costs of financing the own resources. Only a tax system based on a share of an existing tax can be contemplated. It may be the case that the administrative, political and economic costs associated with running a tax-based own resources system are too high to make it a worthwhile initiative.

7.4 What system of own resources for the future?

As mentioned at the start of this section, the current system has certain advantages, which should be seriously considered before introducing any change, i.e. simplicity and cost effectiveness, long-term stability and predictability, a guarantee of budgetary balance and a distribution of the burden among member states closely proportional to GNI. Changes in the own resources should be undertaken with extreme care to avoid trading off these qualities without obvious benefits that work in practice.

Furthermore, the main problems of the own resources have their origin on the expenditure side. As long as member states do not agree on the policies and their distributional effects, any own resources system, tax-based or not, will suffer from 'corrections'. There is no resource system that

can silence the complaints of net contributors as long as there are disputes about the objectives and impact of expenditure policies. Under a tax-based system there is even a risk of a greater number of corrections, as countries feeling unfairly affected by the taxes may request compensation in one form or another. These compensations would not necessarily be restricted to excessive net contributors.

Consequently, the own resources system should be kept simple, even if some further limited, fully endorsed and carefully chosen tax-based elements may be introduced (such as environmental taxes). If countries have reasonable grounds to view their net contribution as excessive, a correction could be agreed openly through the expenditure side. This cost could be excluded when setting the ceiling of the EU budget expenditures, as it would be a *de facto* rebate.

The introduction of further fiscal resources, if agreed, should be undertaken with great care. In theory, such a system may have many advantages from the point of view of accountability and transparency, but the practical difficulties – operational and political – are often underestimated in the literature. An analysis of the situation leads to the following conclusions:

- Simplicity and cost-effectiveness argue in favour of an existing tax or taxes.
- Long-term stability and predictability rule out taxes that may react unpredictably to cyclical swings in member states' economies.
- To guarantee that the budget balances, taxes should be stable and predictable with the existence of a source of marginal finance such as GNI contributions to cover any shortfall.

It is highly recommended to avoid taxes that do not have a close link to national wealth, otherwise 'correction mechanisms' would soon likely follow, such as further caps in the contributions or rebates, which would have to be covered by expansions in the marginal GNI finance. The history of the 'virtual' VAT contributions is a telling example of the consequences of even small deviations from a proportional resource based on GNI.

A fiscal system could preserve the positive aspects of the present system while reinforcing the link with the contributors, strengthening accountability and increasing visibility. Yet no single fiscal resource can do so alone; hence, a possible solution could be a mix of tax-based resources combined with marginal GNI contributions. The tax-based resources

should be produced by a uniform levy on a statistically harmonised existing base or bases. The marginal GNI contribution could be adapted if necessary to ensure *that the contributions of the member states reflects the economic wealth of the member states*, i.e. their shares in EU GNI. So GNI contributions would be altered to compensate for deviations in the taxes from the contributory capacity, in particular for those taxes that do not fulfil the regional arbitrariness criteria. The marginal GNI contribution would fulfil two necessary requirements. The first is to keep the budget in balance and the second is to preserve the proportionality of contributions. Such a system would be simple to administer and ensures equitable treatment at the member state level. Equity as among citizens would in any case depend on the tax mix.

Still, the basic own resources system is unlikely to change radically in the foreseeable future, owing to the small size of the budget and concerns over fiscal sovereignty. The small size excludes complex and costly tax collection systems, and the need for a balanced budget requires the continuation of a GNI-based resource to cover any residual needs. Crucial criteria for the resources are sufficiency, predictability and equity, which are already features of the present system before any corrections and concessions. Improvements in the EU's public finances are first and most importantly to be found on the expenditure side and should be a priority.

One tax is increasingly presented as the most simple to implement – one based on real VAT. A forthcoming CEPS book by Cipriani (2007) discusses at length the merits and limitations of the VAT resource, claiming that the regressiveness of the tax, although amply discussed, has not stopped its wide use in member states. Even the European Parliament does not consider this possible regressivity a barrier. A report by the Budget Committee calls for the use of existing taxes in the future system of own resources, for which a direct VAT contribution is a key candidate (European Parliament, 2007).

It is generally stated that poorer countries have higher consumption as a proportion of income, with the effect that the VAT base is relatively larger. Gros & Micossi (2005) even dismiss the notion of regressivity in the VAT resource, showing that data do not corroborate this position, with VAT returns as a share of GDP in rich countries often exceeding those of poorer countries (Table 4, p. 11). There is, however, a flaw in the argument, as countries do not have the same national VAT rates: for example, Sweden, with a large VAT/GDP ratio, has a very high rate of 25%. The real

question is whether a given percentage of the VAT rate for the EU budget represents a larger share of GDP in poorer countries than in richer ones.

The same data by Gros & Micossi (2005) show that the share of private consumption in relation to GDP tends to be higher in poorer countries. Taking into account the different VAT rates, the relative regressivity of a VAT resource for the EU becomes visible. More specifically, 1% of the VAT value tends to lie closer to 0.4% of GDP in the poorer member states compared with the richer ones, where it tends to be under 0.35%. The exception again is the UK, in which, owing to the particularities of its consumer market, a 1% VAT also represents 0.4% of GDP. A VAT resource has many desirable features but it would require a corrective GNI key as proposed earlier, rebalancing member states' contributions to better reflect member states' contributory capacities. This step would guarantee that the regressivity is accepted.

PART III. DECISION-MAKING FOR THE FINANCIAL PERSPECTIVES

This part focuses solely on the decision-making mechanism related to the approval of the financial perspectives and it does not delve into the annual approval of the yearly budgets. These multi-annual frameworks were first introduced in 1988 with the aims of providing a stable and foreseeable budgetary framework and of avoiding the recurring yearly budget disputes that had plagued the European Community.

8. Reaching agreement on the multi-annual framework

Decision-making on the financial perspectives has been mainly under the control of the Council once the Commission has presented the proposed framework. The European Parliament has not been formally granted a strong say in the determination of the resources, because the Parliament has no formal power on setting the level of contributions by the member states.

Also, in the decision-making on resources the European Council has often overstepped the formal powers it has by introducing policy alterations for expenditures that normally require codecision with the European Parliament. It is a commonly held view that the existence of multi-annual frameworks has reduced the power of the Parliament in the budgetary debate.

The financial perspectives are not a formal part of the Treaty, but an agreement regulated by the Interinstitutional Agreement (IIA) and are based on stability needs that govern the yearly budgetary process (on areas not covered by the Treaty) and on the basic rules and procedures of decision-making set by the IIA.

The decision-making procedure for the financial perspective has characteristic features that have caused strains among the institutions, and especially between the Council and the Parliament. The relationship between the Council and Parliament in the latest financial perspective negotiations was set up in the IIA of 1999.²² The European Commission prepares the financial perspective and presents it to the two arms of the budgetary authority, the Council and European Parliament. While the European Parliament can propose amendments to the financial perspective, the Council controls the decision-making procedure and has generally not paid due attention to positions taken by the European Parliament. In theory, the Council decides unanimously only on the resources, over which Parliament has no say. As already mentioned, however, the Council has overstepped this rule, such as deciding on funding for housing for regional policy.

The negotiations among member states are highly politicised and dominated by member states' net balances and domestic interests, presenting for the presidency a real difficulty in incorporating the Parliament's position. This was blatantly clear in the latest negotiations, where credible threats by the Parliament of rejecting the financial perspective did not affect the Council's negotiations in a visible fashion. The negotiations were already so stalled that the Council was unwilling or even unable to take account of the European Parliament's concerns. It is only after a Council decision that the European Parliament has a real opportunity to intervene.

The European Parliament, while acknowledging the merits of the multi-annual frameworks, has resented the lack of power in deciding the outcome. The Council decisions are usually taken late in the running financial perspective period, placing the Parliament in a dilemma. Fighting for substantial changes in the budget becomes a near political impossibility, as any delay in the final approval of the financial perspective could cause problems in starting the programmes in the first year of the programming period. For 2000 to 2006, the delays in the budgetary agreement resulted in about half of the structural funds for the first year not being committed. To

²² See European Parliament, Council and Commission, Interinstitutional Agreement between the European Parliament, the Council and the Commission of 6 May 1999 on budgetary discipline and improvement of the budgetary procedure, OJ C 172/01, 18.06.1999.

avoid the strong potential of decommitments, a large share of the uncommitted funds was distributed across the remaining six years.

The draft Reform Treaty revises the relationship between the Council and the European Parliament, but the procedure remains similar, whereby the Parliament can only give its consent after the Council has adopted the regulation, i.e. reached a decision on the multi-annual financial framework. The draft Treaty has integrated the wording of the IIA into the provisions (Chapter II, Art. 270(a)).²³

Presently, the European Parliament's weapon if it finds the financial perspective unacceptable is to revert to the annual procedure and invoke Art. 272 of the EU Treaty on the maximum rate of increase in the budget. It allows the Parliament to set, with a high degree of discretion, the expenditures for the year. Under such circumstances, Parliament has a wide margin for setting increases based on its interests. Such an action, however, is equivalent to a political earthquake and could cause considerable strains between the Parliament and the Council. In theory, the Council could even disagree with the Parliament's budgetary demands and reject the financing of non-compulsory expenditure, such as for regional policy.

Nevertheless, despite the aforementioned limitations, the European Parliament has managed to de facto increase its influence. Using the menace of rejection of the budget, it has managed not only to rearrange some of the expenditure programmes (on which it should have co-decided anyway), but it has also managed to alter the total allocation of funds, increasing the contributions of the member states. The latter change was not revolutionary, but changing the level of contributions of member states, rather than rearranging the funds agreed, is not part of its formal powers.

²³ More specifically, the draft Treaty states: "The Council, acting in accordance with a special legislative procedure, shall adopt a regulation laying down the multiannual financial framework. The Council shall act unanimously after obtaining the consent of the European Parliament, which shall be given by a majority of its component members." (See Conference of the Representatives of the Member States, Draft Treaty Amending the Treaty on European Union and the Treaty Establishing the European Community, CIG 1/1/07, REV 1, Brussels, 5 October 2007, retrieved from <http://consilium.europa.eu/uedocs/cmsUpload/cg00001re01en.pdf>.)

The European Parliament correctly required the inclusion of an important change in the new IIA entering into force in 2007,²⁴ eliminating the differences in the treatment of compulsory and non-compulsory expenditures, thus imposing co-decision on all expenditure items. Parliament has also been able to include in the Council Decision on the EU budget for the 2007–13 financial perspective that the review clause includes the position of the European Parliament in the budgetary debate.

The situation is unsatisfactory, because Parliament, as a representative body elected by European citizens is able to neither set the expenditure priorities nor decide on rises in the level of resources. It is important that Parliament assumes responsibility for the priorities of the EU. For example, Parliament should be required to endorse the Commission's proposal for the financial perspective before the Council discusses them. In this way, the European Parliament would have control over the contents of the financial perspective and become responsible and accountable for the initial budget proposal, which it should be as the political body responsible for its implementation. It would become 'co-owner' of the financial perspective and thus an important force to reckon with for the Council. The Council would nevertheless retain its power as decision-maker, but would be negotiating a financial perspective that is not solely an administrative product of the European Commission. The Parliament would still be required to approve the budget once the Council has reached an agreement. Pressures would be similar as in the last agreement.

Gros & Micossi (2005) propose letting the Council only decide on the level of contributions, and for the Parliament to set the expenditure priorities, i.e. distribute the money among the headings. This approach is difficult to conceive, as member states would not agree to finance a blank box.

²⁴ See European Parliament, Council and Commission, Interinstitutional Agreement between the European Parliament, the Council and the Commission on budgetary discipline and sound financial management, OJ C 139/01, 14 June 2007.

PART IV. NET BALANCE EFFECTS OF THE LATEST BUDGET AGREEMENT

This final part analyses the impacts of the latest decisions affecting net balances and illuminates the dominating role net balances have in the decision-making process. The final agreement on the financial perspective for 2007–13 reached between the Council and the Parliament is quite complex and unfortunately messy, i.e. full of ad hoc financial concessions to member states without a strong rationale behind them. These include direct top-ups, changes in co-financing rates for the structural funds, increased financial allocations to specific regions and the possibility to finance housing in the countries and regions under the convergence policy. After the forceful intervention by the European Parliament, the final agreement reaches 1.048% of EU GNI for commitment appropriations compared with the 1.045% of the Council outcome (Table 16). Obviously, an increase in spending by 0.003% of GNI will not affect the EU economy much despite all the deserved credit to the European Parliament for achieving this increase.

For own resources, the final agreement is very complicated. The UK maintains the present rebate under the new arrangements outlined in section 6.2. The new agreement also reduces the VAT-based contributions for all member states, with an additional sweetener for the principal net contributors (Germany, the Netherlands, Sweden and Austria), who get even larger ‘discounts’ on VAT contributions. This is equivalent to an indirect rebate, shifting some of the costs onto other member states. The GNI contribution is the residual after VAT and TOR contributions. The VAT cut offered to these net contributors is accordingly financed by all the member states. In addition, specific ad hoc provisions have been agreed granting reductions in the contributions of the Netherlands and Sweden.

Their present reduced contribution to the UK rebate is maintained. (Part II of this report presents the results in more detail.)

Table 16. Commitment appropriations, 2007–13 (€ million, 2004 prices)

	Commission proposal	Luxembourg compromise	Council agreement	EP agreement	% Change to Council agreement	% Change to Commission
1a. Competitiveness for growth and employment	121,687	72,010	72,010	74,098	2.9	-39.11
1b. Cohesion for growth and employment	336,308	306,508	308,119	308,041	-0.03	-8.4
2. Preservation and management of natural resources	400,294	377,801	362,105	371,344	-2.55	-7.23
3. Citizenship, freedom, security and justice	14,724	11,000	10,270	10,770	4.7	-26.8
4. The EU as a global player	62,770	50,010	50,010	49,463	-1.09	-21.2
5. Total administrative expenditure	57,670	50,300	50,300	49,800	0.1	-13.6
Total commitment appropriations and % †	993,453	867,629	852,814	863,516	1.25	-13.08

† The totals do not incorporate compensation for candidate countries or flexibility reserves, and therefore are slightly lower than the total budget.

Source: European Commission.

9. The new agreement – Impacts on net balances

How does the budget agreement affect the net balances of the member states and the UK? A model adapted for this purpose estimates the net balances in 2013. The 2013 estimates give a snapshot of where we are heading, rather than how. Tables 17, 18 and 19 and Figures 8 and 9 present the results of the estimations.

The author's estimations are based on 2004 expenditures adapted for the new budget, such as the sugar policy reform or tariff changes. Some calculations are based on the new budget expenditures but are distributed according to the shares in 2004, such as for administration. For structural

and rural development operations, the author has introduced the Commission's published tables on the allocation for 2013.²⁵

For own resources, TOR receipts have been reduced in accordance with expectations estimated in Kernohan, Núñez Ferrer & Schneider (2005), based on probable tariff implications. VAT receipts are reduced in proportion to the new VAT call after allowing for its growth in line with expected GNI growth. The GNI key contributions have been calculated using growth projections based on Commission estimates using the growth rates for the own resources report of 2004(b). All have been calculated using 2004 prices.

The results in Table 17 show the net balances in 2013 under three scenarios:

- 1) the Commission's original financial perspective proposal (with the old rebate system);
- 2) the agreed budget without any rebates or new concessions;
- 3) the agreed budget under the old own resources system for comparison; and
- 4) the budget agreement under the new own resources system outlined in the Council's December 2005 Presidency Conclusions on the budget.²⁶

For the net balances, the changes between the Commission's proposal and the agreed financial framework have been significant. Some have to be read with caution. First, the budgetary amounts are very different, and estimations on absorption capacity may diverge between the author's calculations and the Commission's net balance estimations (European Commission, 2004b).

²⁵ See the document "European Support for Cohesion, 2007–2013", on the Commission's website (retrieved from http://ec.europa.eu/budget/library/documents/multiannual_framework/2007_2013/tab_cohesion_2007-013_en.pdf); see also the document "European support for rural development" on the Commission's website (retrieved from http://ec.europa.eu/budget/library/documents/multiannual_framework/2007_2013/tab_rural_dev_2007-2013_en.pdf).

²⁶ See European Council, Presidency Conclusions of the Brussels European Council of 15-16 December 2005, DOC/05/4, 17 December 2005.

Table 17. Net balances in 2013 (€ million)

	Commission FP old own resources	New FP no rebates	New FP old own resources	New FP new own resources
Belgium	4,954.09	2,726.57	2,432.35	2,450.39
Czech Republic	3,674.72	3,612.72	3,524.93	3,520.24
Denmark	-700.53	-608.62	-807.26	-795.29
Germany	-14,055.95	-12,010.40	-12,396.68	-11,609.49
Estonia	472.04	628.52	618.04	617.08
Greece	3,830.89	2,771.64	2,572.43	2,603.85
Spain	197.59	1,150.02	248.61	396.40
France	-8,302.32	-5,140.57	-6,889.84	-6,624.35
Ireland	808.39	504.40	350.22	372.99
Italy	-6,528.05	-3,522.39	-4,894.24	-4,842.71
Cyprus	-51.95	63.51	48.76	47.88
Latvia	692.01	876.45	862.05	859.64
Lithuania	1,250.99	1,462.17	1,436.36	1,433.02
Luxembourg	1,745.40	1,315.05	1,291.88	1,295.70
Hungary	3,802.81	4,101.77	4,011.61	4,005.04
Malta	85.47	151.18	146.72	146.66
Netherlands	-3,124.18	-2,987.87	-3,071.35	-2,086.13
Austria	-628.10	-806.93	-849.72	-817.84
Poland	10,673.04	10,234.01	9,998.27	9,985.61
Portugal	2,374.51	1,893.67	1,750.31	1,781.68
Slovenia	532.20	555.92	525.31	524.20
Slovakia	1,717.05	1,833.73	1,792.32	1,789.43
Finland	-508.87	-280.86	-439.68	-427.89
Sweden	-1,741.25	-1,610.56	-1,664.18	-1,395.71
UK	-7,315.34	-13,087.21	-6,649.65	-9,250.61
Bulgaria	1,472.86	1,167.26	1,138.10	1,131.16
Romania	4,672.46	5,029.83	4,937.33	4,912.04

Source: Own calculations.

The agreement benefits the Netherlands and Sweden substantially. It markedly reduces their net balance, complemented by lower VAT contributions and additional cuts to their contributions.

According to the estimations, some EU-15 net beneficiaries are significant losers. Spain becomes a net contributor. The final agreement nevertheless cushions the fall over the years by reducing more gradually the cohesion funds compared with the compromise position by the Luxembourg presidency.

An interesting effect of the entire set of changes, with VAT reductions and cuts on contributions, is the overcompensation of Germany and the Netherlands for the UK rebate. Under the present resources system without the rebate, Germany would have paid net €12,010 million, €384 million less than the estimated contribution with the UK rebate. Under the new proposed resources system, Germany is to contribute €787 million less compared with the old own resources system, which is €400 million less than in a system *without* the UK rebate. Similarly, the Netherlands and Sweden are overcompensated (see Tables 18 and 19, Figures 8 and 9).

Table 18. Net balances as a % of GNI, selected net contributors, 2013

	Previous rebate system	Final agreement
Germany	-0.48	-0.45
Spain	-0.02	-0.04
France	-0.33	-0.32
Italy	-0.30	-0.30
Netherlands	-0.55	-0.37
Austria	-0.30	-0.29
Sweden	-0.46	-0.39
UK	-0.28	-0.39

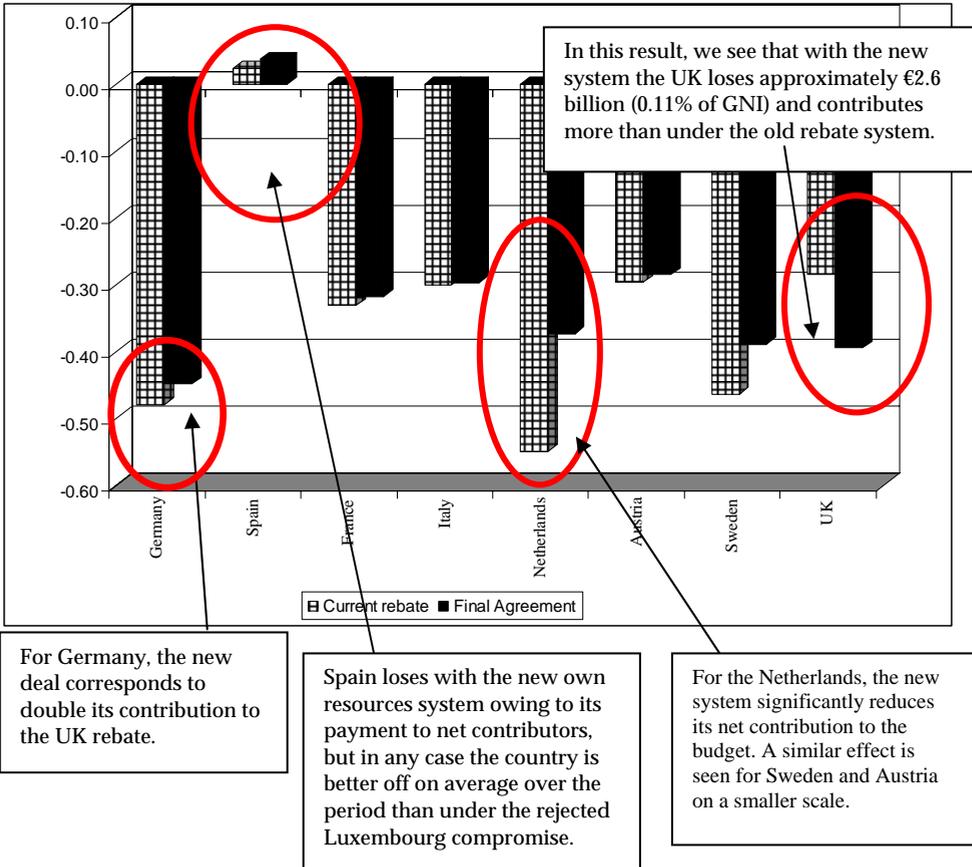
Source: European Commission and own calculations.

Table 19. Net balances (€ million)

Net budgetary balances before any rebate, 2013		Net budgetary balances 2013, based on the new agreement	
Netherlands	-2,988	Netherlands	-2,086
Germany	-12,010	Germany	-11,609
Sweden	-1,610	Sweden	-1,395

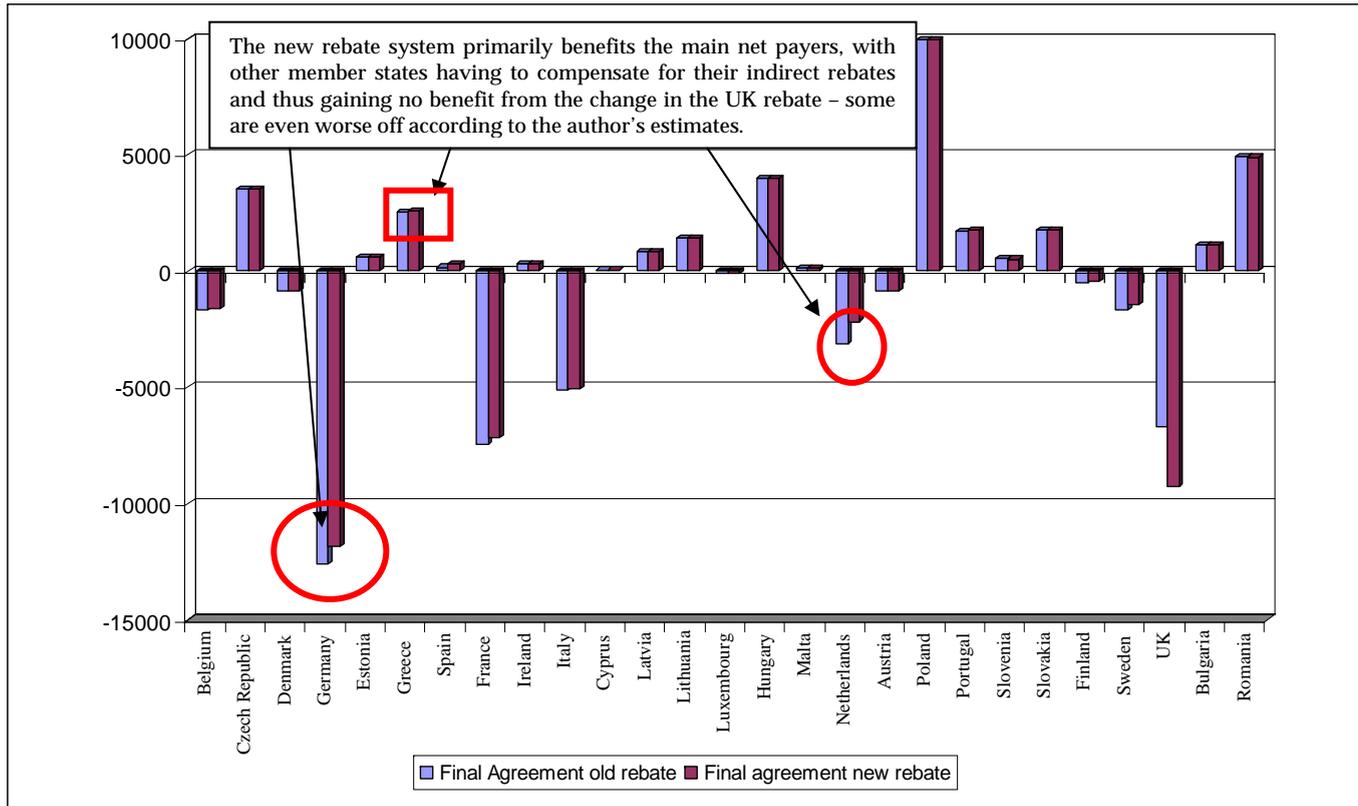
Source: Own calculations.

Figure 8. Net balance comparison under the old and new rebates, 2013 (% of GNI)



Source: Own calculations.

Figure 9. Net balance comparison, 2013 (€ million)



Source: Own calculations.

The Netherlands is clearly receiving a large hidden rebate of its own. The net balance under the previous own resources mechanism *without* the UK rebate would have been *higher* by nearly €900 million for the Netherlands. This amount is slightly less than the current contributions from customs duties but more than the author's estimated 2013 TOR contributions in 2003.²⁷ This 'rebate' is not justifiable even on the grounds of excessive contributions from customs duties. The same holds for Sweden, with respect to an excess of €200 million (Tables 18 and 19). As Figures 8 and 9 show, the impact of the new, reduced UK rebate deal on other member states is negligible compared with the old rebate mechanism, as these countries have to offset the lower contributions of Germany, the Netherlands and Sweden.

The analysis of the net balances unfortunately shows that budget distribution decisions are not only highly dominated by crude net-balance considerations, but that the readiness of net contributors to finance the policies they have agreed upon is diminishing. In the past, cuts for net contributors have usually been limited to reducing their contribution to the UK rebate, but now these also reduce their share in financing actual policies.

The real question is if there is any sign of improvement in the rationale of the EU budget compared with the previous financial perspectives. While overall changes have been small, some decisions indicate that a positive shift in direction is taking place on the expenditure side. Whether this is going to result in any real improvement on resources in the future will depend on the 2008–09 review

10. Conclusions on net balances

The combined effects of tampering with expenditures and own resources to adjust net balances are making the budget more complex and opaque. The latest decision on the budget shows an increasing unwillingness of the wealthier member states to finance EU policies, as demonstrated in the rebates and concessions on contributions through VAT and customs duties. This reluctance indirectly shifts the financial burden onto poorer member states. Some net contributors receive 'rebates' that exceed their contribution

²⁷ Contributions in 2004 from customs duties were €1,047 million (European Commission data). The estimated total TOR (customs duties plus agricultural and sugar levies) was €860 million.

to the UK rebate. This is a sign that member states do not regard the policies as worth financing in full even in the absence of the distorting UK rebate.

The need to 'fix' net balances is clearly a limiting factor when needing to reorient the EU budget. The relation between contributions in proportion to the share of EU GNI and the need to reform expenditures ultimately leads either to large inefficiencies in expenditures or to significant distortions in the resources system, or to both.

Without a combined reform of the expenditures and the own resources system, the credibility of the budget and its ability to intervene in areas of real value for the EU are considerably reduced. The analysis in this report draws the conclusion that the improvement in the rationale of expenditures and an increase in the quality of interventions should occur in tandem with an elimination of distortions in the resources mechanism.

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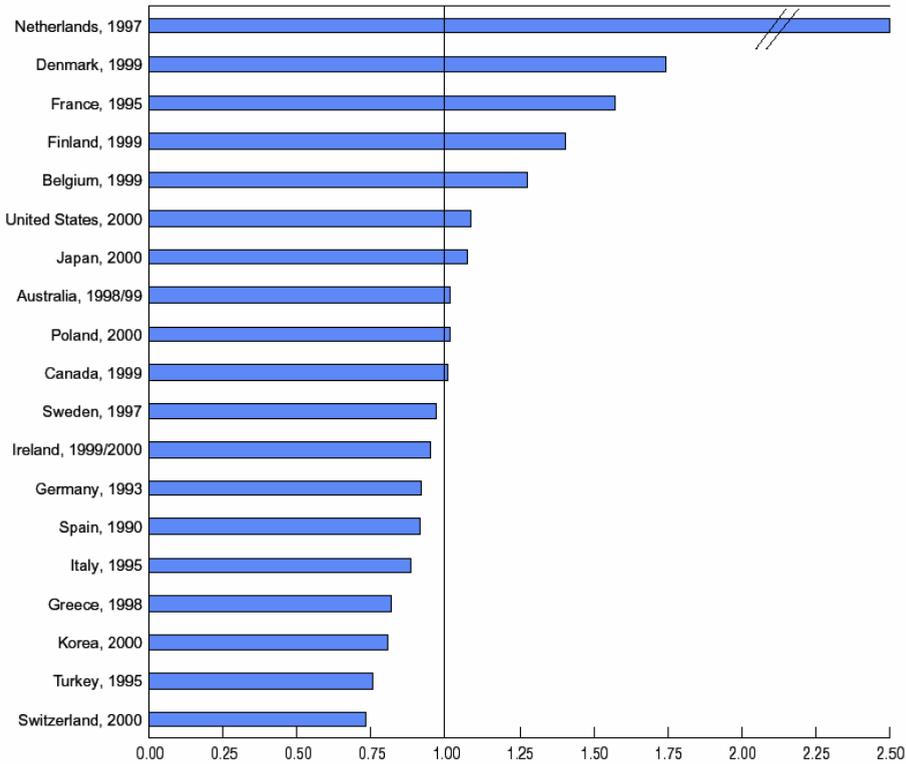
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APPENDIX 1. FARM HOUSEHOLD INCOMES IN OECD COUNTRIES

Public income-support policies are usually based on means testing, which in general take into account total household income. That is not the case for direct agricultural payments in the EU, which originate from support targeted at production. If direct payments claim to be income support, a level of means testing is necessary given their volume.

According to the OECD (2003a and 2006), in some countries farm household incomes are considerably higher than the national average. It is interesting to note is that in most cases where farm household income is the highest, the share of non-farm income is low, which calls into question the general opinion that financial returns in agriculture are low, but rather that the income problem is principally a farm structure issue (Figure A1.1). Unfortunately, farm household-income data is out of date, and the OECD has not updated this information. On the other hand, the data show that the situation in which farm household incomes have comparable wealth to the average household is not a new phenomenon.

Small farms are less prone to disappear than it is commonly believed when agricultural support falls, because many farm households have diverse sources of income. Data based on farm incomes, which do not incorporate additional non-farm incomes, draw a very erroneous picture of farmers. Rural depopulation stems from many factors beyond agricultural incomes, such as lack of access to services. A look at how important the share of non-agricultural incomes is in OECD countries is sufficient to realise that farming is by far not the only activity possible in rural areas. In the EU, farmers in Denmark, Finland, Ireland, Sweden and the UK earn a higher share of income from non-farm activities; for many countries, the share is not much less than 50% (Figure A1.2).

Figure A1.1 Total income of farm households as a ratio of all/other households

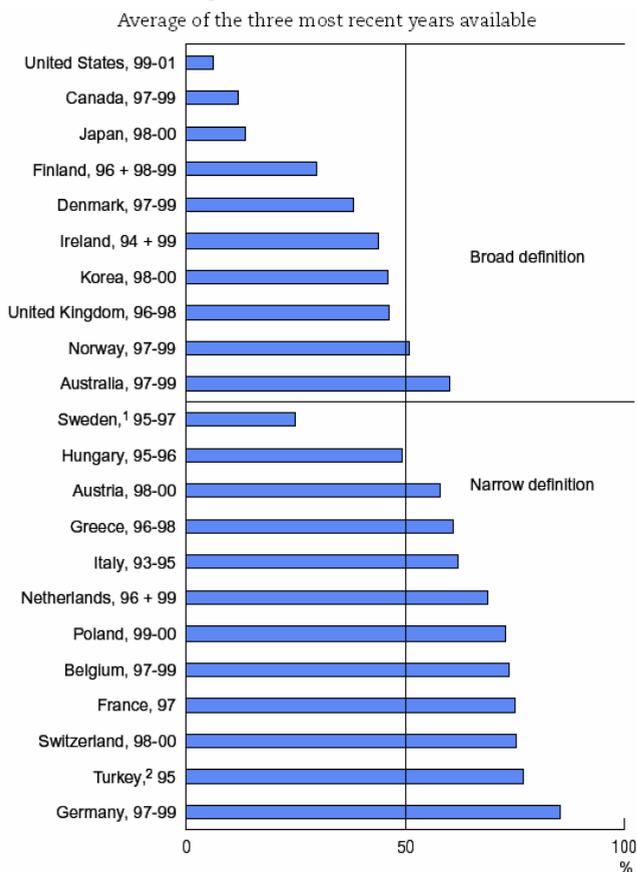
Note: All households are included except for Japan, for which the data concerns workers' households, and for Korea, for which it concerns urban households.

Sources: OECD (2003a), calculations are based on national statistics and the Eurostat database (Eurostat, 1999 and 2002).

The farm poverty assumption has also been reinforced by the candidate countries and in particular Poland, which insists on the need for social support. Yet, according to the World Bank (2001), the average farm household income in this country (including income from non-farm activities and social benefits) was significantly higher than that of other rural, non-farm households – even years before EU accession. Nevertheless, this data hides the fact that there is a very strong degree of income polarisation in agriculture. Farms with fewer than 7 hectares are very poor and derive 80% of their income from the pension system. The viable and richer farm households possess more than 15 hectares. Figure A1.2 on average incomes also confirms that in Poland, the average income of farm households was higher than the national average in 2000, and the CAP has substantially increased farm incomes in the new member states, by 50% in

2004 according to Eurostat data. This rise occurred despite the only partial introduction of direct payments. In fact, even with all the reforms, price support still accounts for roughly half of support (Wichern, 2004).

Figure A1.2 Percentage share of farm income in total income of farm households



¹) Income from independent activities

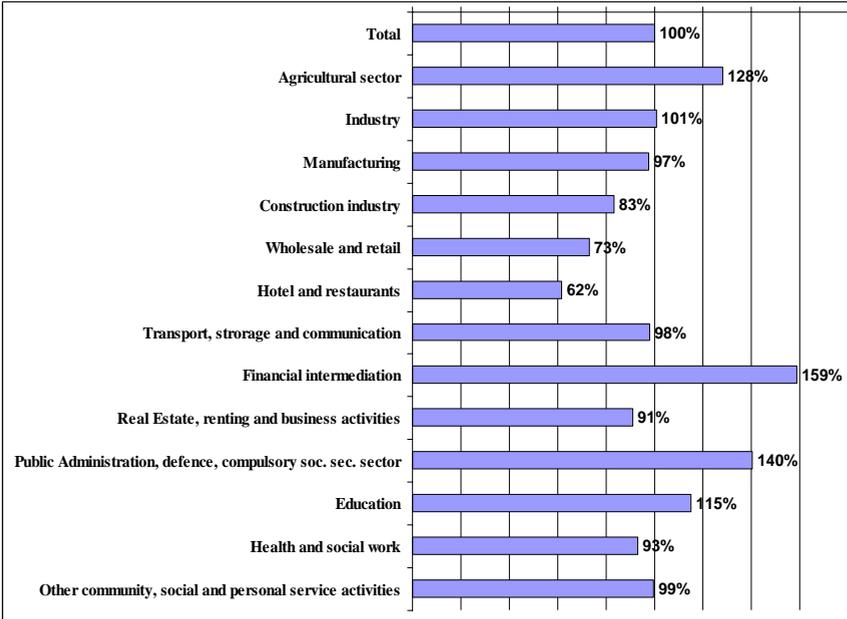
²) Agricultural households in rural areas

Source: OECD (2003a), calculations based on national statistics and the Eurostat database (1999 and 2002).

Furthermore, statistical data at the regional level in the new member states often reveal that poverty among non-farmers is as acute if not worse than for the semi-subsistence farmers. For illustration, taking the very rural and poor Polish area of Podkarpazkie in 2005 (data from the Statistical Office Rzeszow), Figure A1.3 shows that gross incomes are often lower

than in farming, with farming households earning more than the average. Moreover, the discrepancies surrounding the disposable incomes of farms are even greater than the data shown, owing to the more beneficial tax and social security terms.

Figure A1.3 Gross income by economic activity in Rzeszow, Poland, 2005



Source: Statistical Office Rzeszow (online database).

The data for gross income distribution are surprising, but the worst discrepancies lie within the agricultural sector itself. The higher average incomes stem from the exceptionally high receipts of the larger commercial farm households. There is no doubt that among the poorest and most deprived citizens of the region there are many small and semi-subsistence farmers. But these farmers are not yet the target of the bulk of support. CAP support is still related to the size of the farms or number of farm animals. A clear consequence of this situation is that in most countries the farmers who receive the lion’s share of CAP support are on average better off than the rest of the population.

APPENDIX 2. FINANCIAL ALLOCATION OF RURAL DEVELOPMENT FUNDS BY MEASURE IN 2003

Table A2.1 Financial allocation of rural development funds (2003)

Title	Measure	Function	EU funds		Total public funds	
			(Total)	(% Share)	(Total)	(% Share)
Investment in agricultural holdings	General investments	Sectoral – agriculture	308,008	6.73	936,304	9.23
Setting-up of young farmers	Set-up aid	Sectoral – agriculture	123,466	2.70	262,755	2.59
Training	Vocational training support	Sectoral – agriculture	27,881	0.61	68,657	0.68
Early retirement	Pension income support	Sectoral – agriculture	69,630	1.52	186,038	1.83
LFAs and areas with environmental restrictions	Compensatory payments for LFAs	Sectoral – agriculture	947,945	20.71	2,344,320	23.11
	Compensatory payments for areas with environmental restrictions	Sectoral – agriculture	3,835	0.08	7,279	0.07

Table A2.1, cont.

Agri-environment	Support for environmentally friendly practices and animal welfare	Sectoral – agriculture	1,761,190	38.47	3,249,440	32.03
Breeds in danger of being lost to farming	–	Sectoral – agriculture	14,545	0.32	23147	0.23
Improving processing and marketing of agricultural products	Investments to improve processing and marketing channels	Sectoral – agriculture	247,337	5.40	517,992	5.11
Forestry	Improve forest management	Territorial	153,087	3.34	379,150	3.74
	Afforestation of agricultural land	Sectoral – agriculture	254,430	5.56	406,977	4.01
Promoting adaptation and development of rural areas	Land improvement	Sectoral – agriculture	8,043	0.18	17,310	0.17
	Land re-parcelling	Sectoral – agriculture	93,072	2.03	232,906	2.30
	Set-up of farm relief and farm management services	Sectoral – agriculture	5,843	0.13	13,528	0.13

Table A2.1, cont.

Marketing of quality agricultural products	Sectoral – agriculture	35,667	0.78	66,818	0.66
Basic services for rural populations	Territorial	65,779	1.44	128,148	1.26
Renovation and development of villages and protection and conservation of the rural heritage	Territorial	95,461	2.09	275,565	2.72
Diversification of agricultural activities and activities close to agriculture to provide multiple activities or alternative incomes	Semi-sectoral – close to agriculture	61,591	1.35	163,262	1.61
Agricultural water-resources management	Sectoral – agriculture	74,475	1.63	245,679	2.42
Development and improvement of infrastructure connected with the development of agriculture	Sectoral – agriculture	76,096	1.66	163,923	1.62

Table A2.1, cont.

Encouragement of tourist and craft activities	Semi-sectoral – close to agriculture	35,176	0.77	79,826	0.79
Protection of the environment in connection with agriculture, forestry and landscape conservation as well as with the improvement of animal welfare	Semi-sectoral – agriculture	83,042	1.81	190,162	1.87
Restoring agricultural production potential damaged by natural disasters and introducing appropriate prevention instruments	Sectoral – agriculture	31,603	0.69	185,812	1.83
Financial engineering	Sectoral – agriculture	1,309	0.03	805	0.01
	Total	4,578,008	–	10,146,307	–

Source: European Commission (2006).

APPENDIX 3. ANALYSIS OF THE GENERALISED CORRECTION MECHANISM

In 2004, the European Commission proposed a possible, constrained GCM for the Community's own resources (European Commission, 2004b). According to this system, member states whose net contribution to the EU budget exceeded a given negative net-balance threshold as a percentage of GNI would be eligible for a rebate of 66% of the sum over this level. This approach follows the rationale of the system for the UK rebate, with the exception that the UK's threshold is 0%, which makes it valid for the whole net contribution. Member states obtaining the rebate also have to participate in the reimbursement of the rebate amount.

The contribution to the rebate by the beneficiaries is necessary to avoid an excessive burden for other member states. This means that in some very specific cases, a member state benefiting from the constrained correction mechanism could end up paying more than it receives.

The mechanism also introduces further constraints. The volume of the rebate could be too large, increasing the burden beyond the costs of the UK mechanism. Thus, a maximum available refund volume (MARV) is also proposed. If the rebate exceeds this level, the rebate level would be reduced accordingly.

Proposed rebate levels

The basic rules for the UK rebate are being applied to the categories of expenditure and resources that will be used for the rebate calculation. As such, the equivalent of the old headings of agriculture, structural operations, internal policies and administration are to be used and TORs are to be excluded.

The rebate mechanism proposed attempts to avoid unduly increasing the burden on countries that are contributors to the rebate. The selection of the negative net-balance GNI threshold and the MARV are decisive parameters to ensure this. In general, even if the effects are not completely linear for all countries, lower (negative) thresholds for the net balance

would grant rebates to more net contributors as well as create a higher overall rebate. Higher (negative) thresholds on the other hand reduce the rebate volume and the number of beneficiaries.

With the need to limit the costs of the system, the document proposes a threshold of -0.35% of GNI and a MARV of €7.5 billion. This MARV is presented by the European Commission as based on the rebate for the UK if the present system were maintained for the period 2007–13. The difference in respect of the UK rebate is that it now represents the sum of the rebates to all beneficiaries and not only the UK. Furthermore, as all countries pay for the rebate in proportion to GNI, the actual cost of the rebate for the non-beneficiary member states is less than under the unchanged UK rebate mechanism. According to the author's own estimations, the actual value of the rebate for the UK would fall substantially to approximately €2-2.5 billion compared with the €4-5 billion applied in the 2003 budget, but the balance between the net contributors and their contributory capacity based on GNI per capita is improved.

What is interesting to note is that the GCM would cost less to the non-beneficiary member states than the present system. This result stems from the disappearance of the arbitrarily determined, ad hoc 'rebates' from which the 'excessive' net contributors benefit. These opaque 'rebates' have increased the contributions for all the other countries substantially.

Conclusion

The GCM is an improvement on the UK rebate mechanism and it eliminates the distortions caused by the disproportionate rebate level of the UK rebate. The new GCM potentially benefits the net beneficiaries compared with the contributions under the old and present systems. The net contributors from the other side show comparable negative net balances as with the old system (they lose their special ad hoc concessions). The GCM, however, acts more in line with the Fontainebleau Agreement, which is the basis for the UK rebate.

The financial benefits to the net contributors are not an improvement on the present system, which has probably reduced their interest in the GCM considerably. The correction mechanism also does not address the fundamental problems on the expenditure side, nor does it guarantee that the net contributors would not ask for further 'corrections'.

APPENDIX 4. INCOMPATIBILITIES BETWEEN CORPORATE TAXATION AND A GCM

Given the small size of the EU budget as a percentage share of the EU's GNI, small deviations in tax revenues among member states or slight structural differences in the composition of the economy and therefore the size of the sector taxed can have a strong impact on the distribution of the contributions. With member states disputing their net balances at the level of a fraction of a percentage of GNI, any difference among member states has strong repercussions. The GCM may not be able to offer an acceptable solution to the net budgetary imbalances if the resources have a different cross-country distribution than the GNI.

A small illustration of the issues raised by the correction of net balances caused by the resource distribution is presented in the Table A4.1. This illustration shows a union of five countries. Countries A and B are identical in GNI and have the same budget receipts from the union. Countries C and E are also identical in GNI and have the same budget receipts from the union. Country D has a net contribution of 0.

With a GCM set at a threshold of -0.02% of GNI, under a system of resources based on shares of GNI, country pairs A and B, and C and E are affected in exactly the same manner, either positively or negatively. Each pair of countries shows an identical net contribution at the end of the process. Country D sees its net balance deteriorate slightly because of its contribution to the rebates.

In the case in which the resources are levied through a tax that does not reflect the correct share of GNI, the outcome can be markedly different.

Table A4.1 shows tax incidence deviations of only a fraction of GNI, causing markedly different contributions and net balances to the GNI-based resources for the identical pairs of countries A and B, and countries C and E (in GNI terms), while country D is also in a worse position than with the GNI-based contributions. Changes in the rates of correction and thresholds for triggering the correction mechanism may partially alleviate the discrepancies, but the situation is complex. The size of the rebate can easily grow large and suffers from large variations with small changes in the tax-based contributions of the countries, and the outcome will for some countries be worse than under the GNI system and even under the present UK rebate system. It is difficult to conceive a tax-plus-correction combination that can be acceptable for the member states.

In this illustration, the identical countries A and B show not only very different net balances, *but also one is highly negative, while the other has become significantly positive!* The correction narrows down the discrepancy yet is far from approaching any situation similar to horizontal equity. Less extreme, but still strong is the discrepancy between countries C and E. Country D shows a very strong negative imbalance, which is partially offset by the GCM. Still, the negative net balance of countries A and D is considerably worse than with the GNI-based resources.

Under a system of taxes that does not reflect the GNI shares very well, the equity criteria for member states cannot be fulfilled even after the introduction of a GCM. Taxes have to reflect very closely the GNI shares of the member states or they have to be treated as the present TOR, as completely independent resources of the EU not subject to correction.

The illustration may look too abstract or unrealistic, but such effects are to be expected for some taxes. This author has performed simulations for the EU-15 using actual corporate tax information, in which this problem occurred. The corporate income tax proposed by the Commission is such a case. Corporate incomes in the EU have shown distinctly different results in the EU. Furthermore, the UK's corporate sector has been performing better over a period well beyond the present seven-year cycle of the financial perspectives, which shows an element of structural differences among member states. It is inconceivable to have one country continuously contributing more under the reasoning that the operations of its corporations are regionally arbitrary.

Table A4.1 Simplified illustration of a tax effect (based on a budget of €100 million and total union GNI of €60 billion)

	Countries					
	A	B	C	D	E	Total
GNI	15,000	15,000	12,000	6,000	12,000	60,000
% Expenditure share	20	20	25	10	25	100
Budget exp. receipts	120	120	15	15	15	285
GNI-based resource						
% Share of GNI	25	25	20	10	20	100
GNI resource	25,000	25,000	20,000	10,000	20,000	100,000
Expenditures	20,000	20,000	25,000	10,000	25,000	100,000
Net balance	-5,000	-5,000	5,000	0	5,000	–
Net balance, % GNI	-0.33	-0.33	0.42	0.00	0.42	–
Rebate mechanism for GNI-based resource						
Threshold GCM 0.2	-0.2	-0.2	–	–	–	–
Excess, % GNI	0.13	0.13	–	–	–	–
Rebate, % GNI (correction 0.66)	-0.09	-0.09	–	–	–	–
Rebate amount	-1,320	-1,320	–	–	–	-2,640
Financing the rebate	-660	-660	-528	-264	-528	-2,640
Net balance after correction	-4,340	-4,340	4,472	-264	4,472	–
Final NB based on GNI	-0.29	-0.29	0.37	-0.04	0.37	–
Tax-based resource						
% Tax contribution	30	15	18	14	23	100

Table A4.1, cont.

Tax-based resource	30,000	15,000	18,000	14,000	23,000	100,000
Net balance (tax res)	-10,000	5,000	7,000	-4,000	2,000	0
Net balance tax-based resource	-0.67	0.33	0.58	-0.67	0.17	-
Rebate mechanism for tax-based resource						
Threshold GCM 0.2	-0.2	-	-	-0.2	-	-
Excess, % GNI	0.47	-	-	0.47	-	-
Rebate, % GNI (correction 0.66)	0.31	-	-	0.31	-	-
Rebate amount	4,620	-	-	1848	-	6,468
Financing the rebate	-1,617	-1,617	-1,293.6	-646.8	-1,293.6	-6,468
Net balance after correction	-6,997	3,383	5,706.4	-2,798.8	706.4	0
Final NB based on GNI	-0.47	0.23	0.48	-0.47	0.06	-

Source: Own data.

APPENDIX 5. LIST OF TASK FORCE MEMBERS, INVITED GUESTS & SPEAKERS

Chairman: Terry Wynn

Former MEP, Chairman of the Budget Committee and Vice-Chairman of the European Parliament's temporary committee on "Policy Challenges and Budgetary Means of the Enlarged Union from 2007–2013"

Rapporteur: Jorge Núñez Ferrer

Associate Research Fellow, CEPS

Members

Carl Asplund
Counsellor, Economic and Financial
Affairs, Permanent Representation of
Sweden to the EU

Anders Ladefoged
Head of the Trade Policy Department
Confederation of Danish Industries

Kylliki Linnamagi
Estonian Permanent Representation
to the EU

Richard McLean
UK National Parliament
Representative (House of Lords)
European Parliament

Jose Núñez Cervera
Director
European Affairs
Coca Cola

Wladislaw Piskorz
Minister Counsellor
Polish Representation to the EU

Silvano Presa
Head of Unit
Financial Framework and Own
Resources, DG Budget
European Commission

H. Onno Ruding
Chairman
CEPS Board of Directors

Walter Max Schmitt
Head of Agriculture Representation
of Bavaria to the EU

William Sleath
Head of Unit
General Secretariat of the European
Commission

Edward Smith
First Secretary
UK Permanent Representation
to the EU

Gianluca Spinaci
Unit for Policy Analysis, Studies and
Interinstitutional and Legislative
Planning Committee of the Regions

Maeve Whyte
Director
UK National Farmers Union Brussels

Dessislava Yougova
Information Specialist
The Library
European Parliament

Invited Guests and Speakers

Jean Pierre Baché
Former Director of Own Resources
DG Budget
European Commission

Christine Ber
Deputy Head of Unit
Unit A.1, General Coordination
DG Enterprise and Industry
European Commission

Petar Chobanov
Executive Director
Agency for Economic Analysis and
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Adriaan Dierix
Deputy Head of Unit
Unit E1, Coordination of structural
reforms and their macroeconomic
implications
DG for Economic and Financial
Affairs, European Commission

Nicola de Michelis
Deputy Head of Unit
B2, Conception and analysis,
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DG for Regional Policy
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Peter Ptassek
Deputy Head of Department
Directorate for the Budget,
Agricultural Policy and Financial
Affairs of the EU
German Ministry of Foreign Affairs

José-Ramón Tiscar Ramirez
Unit M1, Political aspects, private
investment and links with the EIB
DG Research and Development
European Commission

Ignacio Felpeto Santero
Deputy Director
Delegation of the Regional
Government of Castilla-La Mancha

James Spence
Head of Unit
Relations with the European
Parliament, the Court of Auditors
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Reinhilde Veugelers
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Roger Waite
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