



# Policy Brief

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## A bigger bang for our euros: how to reform the EU budget

*By Fabian Zuleeg and Sara Hagemann*

### Background

Every six to seven years, the EU starts a new round of budget negotiations to decide how much to spend on what policies. These negotiations are always difficult and usually end in last-minute horse trading between EU governments, with a last-gasp deal concluded well after midnight on the final day of the summit.

As that debate starts once again, prompted by the budget review ordered by EU leaders, many fear the same thing will happen again prior to getting agreement on the 2014-2020 Financial Perspective. There is, however, a window of opportunity during this review to initiate serious budget reform – and the Union cannot afford to miss this chance.

#### **A substantial review?**

The last budget deal, for 2007-2013, was a close call: many doubted that an agreement could be reached at all, the negotiations were difficult and protracted, and both the process and the outcome left almost

everyone dissatisfied, with reform in many areas stalled by the need to achieve a consensus.

It will be even more difficult next time around, as the negotiations on the new EU multi-annual budget for 2014 onwards will, for the first time, require the consent of (at least) 27 Member States.

Both to pre-empt the start of the detailed haggling over specific amounts and to address the need for extensive reform in the next budget, the European Commission has been tasked with carrying out a mid-term budget review in 2008/09. The annual budgeting round, usually a non-event, has also become more significant as it is seen as a testing ground for raising some of the key issues ahead of the post-2013 negotiations.

The EU budget is, of course, relatively small compared to national budgets: it accounts for only about 1% of EU GDP, which translates into about 2.5%

of national public spending. But there is a great deal at stake. National politicians and populations pay close attention to how their governments 'perform' in EU budget negotiations, the deal covers seven years and the total amount of money on the table is considerable: almost €820 billion in the 2007-2013 budget.

Obviously, the issue of who gets how much also tends to focus minds. A recurring theme of EU budget debates is the question of *juste retour* – whether the net balance of a country's contributions and receipts from the budget is perceived as 'fair' – exemplified by the controversy over the British rebate, granted in 1984 after Margaret Thatcher argued that the UK was not getting enough back from Brussels, which significantly reduces its net EU expenditure.

#### **Income and outcome**

The EU budget has been set through multi-annual financial frameworks since 1988. These establish general

levels of expenditure for each main policy area and the overall budget ceiling relative to Member States' GNP, as well as the structure of revenues. Within these multi-annual frameworks, specific revenue and spending amounts are then agreed on an annual basis.

EU expenditure is dominated by two policy areas: agriculture (including support for farmers

and rural development) and regional funding (which aims to help the poorest regions in Europe to catch up with the rest). Together, these account for around 80% of the budget. Recently, the Union has also begun spending more on competitiveness (mainly research), which accounts for another 7%. The rest mainly funds justice and home affairs' policies, external relations, development and

humanitarian aid, and the Brussels' bureaucratic machinery.

The EU's revenue comes from a mixture of traditional own resources (customs duties and agricultural levies), a contribution from VAT receipts and a payment from Member States based on Gross National Income (GNI), with the last of these now dominant, accounting for almost 70% of the total.

## State of play

Eastward enlargement and recent economic developments in many Member States make large-scale reform of the EU budget essential to enable the Union to function more effectively. Furthermore, the Union and its Member States will face many difficult challenges in the future which the current budget is not equipped to deal with. There is also some unfinished business left over from previous budget negotiations.

### Conflicting demands

One of the functions of the EU budget is to support the new Member States in Central and Eastern Europe, helping them to improve their overall economic performance. In the last round of negotiations, their ability to influence the outcome was restricted: agreements had been made with them prior to accession, so both direct aid for agriculture and regional funding were effectively capped before the budget talks began. Next time round, however, the new Member States – which now also include poorer Romania and Bulgaria – will not be under any such constraints.

Developments in key national economies have also changed Member States' attitudes towards the EU budget. Germany has already made it clear that, partly due to sluggish economic growth

following reunification, it is no longer willing to 'bankroll' the Union. Consequently, the EU budget has shrunk, falling significantly below the maximum 1.24% of overall GNI specified in the Treaties. At the same time, the UK economy has become significantly stronger and, as funding has shifted away from agriculture, it is now less disadvantaged in terms of EU receipts – but the rebate has remained.

The move away from agricultural spending in recent years to focus more on regional funding and new policy challenges such as security, innovation, competitiveness, energy and climate change means the share of the budget spent on agriculture (excluding rural development) will continue to fall, down from almost 36% in 2007 to about 32% in 2013. However, even with significant reform, about one-third of the EU budget will still be spent on agricultural policies.

The future of agricultural spending is uncertain. Some countries argue that this should be left more to national governments, effectively 'renationalising' the Common Agricultural Policy (CAP). However, it is worth remembering that almost all agricultural expenditure occurs at the EU level; it is indeed a quintessential supranational public policy. While its share of the EU budget is high, its overall

share of public spending in the Union is below 1%. No doubt its 'quality' can still be significantly improved, but transferring it back to the national level could increase overall spending on the sector and, possibly, distort market conditions and impact on global economic integration.

### Fighting over the Brussels' pot

The 'no holds barred' review of the budget called for by EU leaders after the 2007-2013 negotiations has now begun, with the Commission publishing a discussion paper and asking stakeholders to submit their views by mid-April.

This paper stresses the over-arching aim of the review: to have a fundamental debate well in advance of the negotiations on the next financial framework. The Commission itself intends to present its proposals towards the end of 2008 or by early 2009 at the latest.

The review aims to address the following themes:

- what new policy challenges does Europe need to address? Over what time frame? With what specific added value?
- What principles should guide EU revenue-raising? Are rebates and correction mechanisms justified? Should EU financing be closer to the citizens, for example through a visible tax?

- How should the EU budget be governed and is it responsive enough to changes?
- How can EU budget procedures balance flexibility and stability better, increase accountability and transparency, and deliver results more efficiently and effectively?

The fundamental issues are therefore on the table. The key question now is to what extent Member States are willing to consider far-reaching reforms on each of these points.

### Red lines

A number of governments already have 'red lines' which will be difficult to address:

- for many of the net contributors, increasing the size of the budget is simply not up for discussion if they will be asked to pay for it;
- the UK only seems willing to consider the rebate in the context of a wider reform and, possibly, a more generalised correction mechanism;
- support for agriculture is still crucial for France, although President Nicolas Sarkozy has signaled some room for negotiation;
- regional funding is very important not only for the new Member States, but also for many regions in wealthier and older ones;
- many Member States oppose the idea of a genuinely independent EU revenue-raising mechanism (or 'tax');
- any budget reform must be accommodated in the context of the Lisbon Treaty, as no further treaty changes are on the horizon;
- Member States want to retain a large degree of control over outcomes. They also often argue that negotiations must take place behind closed doors so they can 'horse-trade' more freely.

Such 'red lines' and preferences should not be allowed to set the agenda for the review. Modernising the EU budget requires leadership and vision: no one should have any 'sacred cows' at this stage in the debate, including those who support deeper European integration. The point of departure should not be to automatically ask for more money and more powers for the Union, without seriously considering whether this is really necessary to achieve the desired results.

## Prospects

The budget review will give everyone with a stake in the outcome an opportunity to debate the most contentious issues. These should include the overall process by which the EU budget is determined, adopted and implemented, given the increasing difficulty in getting agreement in recent years.

So what should the review's key objectives be? Below, we suggest five guiding principles which should guide the review, with a view to influencing the next budget negotiations.

### *1. Ensure the budget is driven by policy priorities*

A rational approach would be to start by identifying and assessing general trends and developments affecting Europe as a whole, including demography, globalisation (in terms of trade, investment and migration), security and climate change. The next step would be to identify the policy challenges arising from

this, consider what responses may be required, and assess what should be done at EU level and what should not. Finally, the appropriate EU policy instruments and budgetary resources should be allocated in line with this.

The EU also needs more flexibility to address issues as they arise, while at the same time maintaining the overall stability of expenditure. Making greater use of the flexibility instrument (which allows the Commission some discretion in allocating a small proportion of the budget) and ensuring that it can be used quickly and simply, would make the budget more responsive while maintaining the stability of a multi-annual scheme.

### *2. Use the best available tools*

There needs to be more open thinking about the adequacy of the current EU tool kit, which consists mainly of legislation and public expenditure. Possible alternatives and complementary instruments should be explored,

such as stronger cooperation and coordination mechanisms, self-regulation, taxation and private-sector funding.

The choice of policy instruments, in other words, should be driven by what is most effective rather than being narrowly and exclusively defined by current EU competences. For example, introducing a general 'EU tax' just for the sake of strengthening the supranational level would not be acceptable to many citizens and governments (and could even backfire, making the Union unpopular with voters). However, an EU-wide environmental tax, aimed at correcting market failures, might become necessary to combat climate change and help the Union meet its commitments.

### *3. Focus on delivery*

To focus on delivering the EU's key objectives, the Union should only act in areas where it can demonstrate added value. Consequently, periodic reviews of spending in all areas are needed,

with spending phased out where it does not bring the expected results.

More attention should also be paid to leveraging effects. In most areas, the EU budget is small compared with national spending and can only add value if it influences the way national funds are spent or demonstrates that it fills important gaps.

Reassessing the EU's distinctive role should also ensure a better match between the budget and the Union's policy ambitions. The current budget is not large enough to act as an EU-wide fiscal instrument for redistributing wealth or counter-cyclical spending. On the other hand, driving forward delivery and implementation of existing policies can add real value. Many of the most important common EU policies, starting with the single market, do not require significant levels of funding; focusing on regulatory and other non-spending instruments can be more effective.

#### 4. Be more open

To foster more rational debate, expenditure must be decoupled from revenue. This would shift the focus from the traditional *juste retour* discussion to one in which the emphasis is on what Member States contribute and on what basis. EU spending should not be driven by pre-determined 'shares' for individual Member States, especially since funding to promote excellence and the functioning of the single market makes such calculations impossible (for instance, EU funding for an infrastructure project in one Member State may well benefit a company from another).

Budget negotiations must also become more transparent. Stakeholders – including EU institutions, national parliaments and regions – should know what specific objectives and interests Member States are pursuing. This might encourage governments to display even greater intransigence, but at least it would force them to play their cards more openly. Greater transparency must start with the budget review itself: government submissions should be out in the open so that if they fail to reach agreement on much-needed reforms, then at least the public would know whom to blame.

#### 5. Align the political and budget cycles

Last but certainly not least, attention should be paid to the duration of the multi-annual budgetary cycle and the way it interacts with the EU's 'political cycle'. Is seven years the most appropriate time frame? If we look ahead, in 2013/14 we may well have an outgoing Commission proposing a new EU budget to an outgoing European Parliament, with dubious implications in terms of both legitimacy and accountability.

The aim should be to align these cycles, so that each Commission and Parliament would be required to deliver a five-year budget – preferably in the middle of their respective terms, after both institutions have settled in and before a renewal of their mandates begins to dominate their thinking.

#### What next?

All those with a stake in the outcome of this debate should contribute by setting out their ambitions for the Union as a

whole, and making concrete proposals to translate these into reasonable and feasible provisions. This is more likely to happen at the very end of 2008 or early in 2009, as the focus until then is likely to be on ratifying the Lisbon Treaty.

Delivering, in sequence, both the new EU Treaty and forward-looking guidelines for the new EU budget could be an important turning-point for the European integration process. To this end, everyone should focus on how to equip the Union better for the future, rather than on narrow preoccupations with national *juste retour*. If they do not, the most likely outcome will simply be a slightly altered version of the current *status quo*.

Politicians and policy-makers have shown some willingness to discuss the big questions in this budget review. If they are serious about equipping the EU with the means to deliver on its ambitious common objectives and priorities, they must demonstrate their readiness to tackle the most difficult issues, including putting even those they consider core to their national interest on the table.

For everybody to win in the long run, compromises will be unavoidable. Otherwise, we will soon be back to square one, without adequate discussion of the necessary reforms before the negotiations on the next budget begin.

*Fabian Zuleeg is a Senior Policy Analyst and Sara Hagemann is a Policy Analyst at the European Policy Centre. The EPC is launching a project to consider the issues raised in this paper.*

