FUNDING THE EUROPEAN UNION

Making sense of the EU Budget

What is it for?
What should it be for?

by Professor Iain Begg

A FEDERAL TRUST REPORT ON THE EUROPEAN UNION'S BUDGET

Funding the European Union

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A Federal Trust Report on the European Union's Budget

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Summary and main conclusions

The EU budget invariably leads to heated debate and tough negotiations, yet the amounts concerned represent only a very small proportion of aggregate public spending in the EU (some 2.5 per cent) and barely 1per cent of gross national income (GNI).

The following are key characteristics of the EU budget:

- Since 1988, the broad structure of both the revenue and expenditure sides of the EU budget has remained stable.
- It is subject to the 'own resources ceiling', a rather convoluted expression for a cap on its size. Since the late 1990s, this ceiling has been fixed at 1.24 per cent of EU GNI, although the actual budget has been kept (deliberately?) well below the ceiling at just over 1 per cent.
- Some three-quarters of the EU budget has been devoted to just two areas: the Common Agricultural Policy (CAP) and 'structural operations' (also known as 'cohesion' policy – support for disadvantaged regions and groups).
- The funding of the budget has progressively shifted towards what is known as the fourth resource, a direct payment from national exchequers to the EU, whereas the EU revenue used to come from customs duties and a share of national VAT receipts.

The current aim is to try to reach an agreement in the last month of the Luxembourg Presidency of the EU, June 2005, on a new *Financial Perspective* (FP), the medium-term budgetary framework, for the period 2007-13.

The Commission has proposed a budget that would increase progressively to reach 1.15 per cent of GNI by 2013, prompting acerbic reactions from several of the finance ministers of richer Member States, six of whom had written pre-emptively to the Commission President to demand that the budget be capped at 1per cent.

Although the Commission proposals are presented with new headings and an apparent emphasis on growth, the detail reveals that EU spending will continue to be dominated by the CAP and cohesion policies, which would still account for some three-fifths by the end of the FP.

Issue likely to feature in the budget negotiations

The terrain for disputes on how the EU budget evolves is already evident. The most obvious divides are between those who would like to see a higher overall level of spending and those (principally among the net contributors) who want to impose tighter shackles.

Financing

The principal question about the funding of the EU budget is whether it makes sense to replace a system which, by and large, works by one that would conform better to the Treaty stipulation (article 269, TEC) that the budget should be funded by own resources. If particular taxes are to be assigned to the EU, they would ultimately have to add up to contributions from each Member State that were more or less the same as the current GNI dominated contributions. Increased complexity would, therefore, be introduced simply to achieve the same result and any improvements in transparency would be largely illusory. However, there are also compelling arguments for authentic own resources, both to improve the link between the tax-payer and the EU (to be consistent with accountability) and to obviate any risk that a Member State might, one day, threaten to withhold payment.

Policies financed by the EU budget

In theory, although CAP is a perennial question, it has been defused as an issue by the October 2002 agreement to freeze the ceilings for CAP spending at the value (in real terms) reached in 2006. However, some Member States want to reopen the question and there is also a possibility that the Doha round of multi-lateral trade negotiations could put pressure on the EU to reduce agricultural support. There are also demands for a greater orientation of the EU budget towards 'Lisbon' policies aimed at boosting the performance of the supply-side of the economy. To some extent, the Commission proposals relating to 'competitiveness' already go in this direction, albeit on a smallish scale. The proposed reorientation of cohesion policies, in which there is a Commission proposal for a *de facto* successor to Objectives 2 and 3 of the Structural Funds (described in the 3rd Cohesion Report as 'regional competitiveness and employment: anticipating and promoting change'), also uses Lisbon-ish language.

The UK rebate and generalised correction mechanisms

One of the more vexed questions in the EU is what the net contribution of each Member State should be. During the early 1980s, the cards were clearly stacked against the UK, leading to a succession of acrimonious meetings, usually resolved by short-term compromises aimed at lessening the UK's net payment. Eventually the *ad hoc* solution of the UK abatement was agreed as part of the Fontainebleau accord, the key point of which was that two-thirds of the *ex-ante* net payment would be returned to the UK, with the burden spread amongst the other Member States.

The proposal put forward by the Commission for a generalised correction mechanism is an attempt to answer the criticisms that, on the one hand, the UK has moved up the prosperity league table and ought to pay more; and on the other, that other net contributors are being unfairly treated. However, the proposed solution, though appearing to be politically astute, does not deal with the underlying problem, nor is it likely to avoid a UK veto.

Because gross payments to the EU are more or less proportional to the GNI of Member States, budgetary imbalances arise from collective decisions on what the EU budget should finance. The uneven incidence of such spending arises either deliberately, because the policy is designed to spend more in some Member States than others (cohesion policies, which favour countries with relatively low per capita GNI), or as a by-product of the design of the policy (agriculture where countries relatively specialised in the sector benefit) or the rules that govern allocation of scarce resources such as competition for funding (research policy, where the countries with the greatest capabilities are likely more often than not to be beneficiaries).

Logically, once a set of policies requiring public expenditure is decided the financial consequences ought to be accepted. But once Member States start to demand their money back, the policies then have to be cut back.

What *should* the EU do?

It would be easy in analysing potential reforms of the EU budget to contemplate little more than marginal tweaking of the proposals currently on the table, but if an EU budget were being developed from first principles, it would look very different. Analysis of budgetary questions is complicated by the fact that the EU is not a fully-fledged federation for which the supranational level acts as the top tier of governance.

Although economic theory provides valuable insights into what the EU budget might do in an increasingly integrated Europe in fulfilling functions taken by federal governments elsewhere, the EU is, in practice, a delegated agency responsible for a very limited range of public finance tasks, nearly all concerned with what theory defines as allocation.

Politically, there seems to be little room for any expansion of the EU budget and the pressure is even to reduce it as a proportion of GNI. But economically, the proportion of total EU public expenditure directly spent by the EU level is an order of magnitude smaller than in comparable federations. Theoretical models of inter-governmental fiscal relations would suggest a more extensive role for the EU budget across a range of governance tasks, notably in 'top-down' functions such as contributing to macroeconomic stabilisation or redistribution. However, such models tends to presume a greater degree of 'statehood' than currently exists for the EU. But as the EU becomes more deeply integrated the case for movement in this direction will surely become stronger.

Stabilisation

From the perspective of 'running the EU economy', the EU budget has virtually no impact, in stark contrast to the top level of governance in other monetary unions which generally have a prominent role in economic management. In particular macroeconomic stabilisation is usually a function of the highest level of government, although with large central government budgets in all EU Member States, there is already a substantial degree of 'automatic' stabilisation within countries. The gap in the system is that there is no top-down budgetary means of stabilising an entire economy that faces a demand shock. Despite the consolidation of EMU, there would still, today, be great resistance to conferring such a role on the EU level. The model so far adopted for EMU is to leave competence for fiscal policy to the Member States, but to constrain their autonomy through the Stability and Growth Pact (SGP).

Budgetary planning

The institution of the Financial Perspective is generally regarded as having been both an effective means of disciplining EU spending and to have helped to defuse some of the rows surrounding annual budgets. But the FP has also been condemned for being too rigid in allowing hardly any shifts between the broad headings of the budget, a criticism that, if the Commission plans are accepted will only be partly remedied. Other options might include making it into a rolling

FP that is updated more frequently and one which has more substantial, though transparent, margins for flexibility.

Given that a further enlargement of the Union is due to take place early in the next FP, a more compelling alternative might be to have a comprehensive mid-term review, well-prepared by convening a *groupe de réflexion* with a wide-ranging mandate to look into the future of the budget and to come up with credible proposals for the future of the budget. The next step might then be either to effect a transition during the second part of the current FP, with a view to implementing the new budget regime beyond 2013 or to initiate a major overhaul during the subsequent FP.

The danger facing the EU is that a deal that largely retains the *status quo* will somehow be cobbled together by the Luxembourg Presidency in June 2005, with only minor concessions and innovations, closing the whole issue for seven years. Then, in 2011, the same questions will arise, the same hand wringing will occur and the next generation of finance ministers will come out with much the same set and irreconcilable positions. If this Groundhog Day scenario is to be avoided, it is imperative that the EU leaders have the courage to take strategic decisions now about changing the shape and role of the budget.

Will they, for once, rise to the challenge?

Funding the EU

> *'Every one knows that a great proportion of the errors committed by the State legislatures proceeds from the disposition of the members to sacrifice the comprehensive and permanent interest of the State, to the particular and separate views of the counties or districts in which they reside. And if they do not sufficiently enlarge their policy to embrace the collective welfare of their particular State, how can it be imagined that they will make the aggregate prosperity of the Union, and the dignity and respectability of its government, the objects of their affections and consultations?'*
>
> *James Madison: The Federalist No. 46*

1. Introduction

The EU budget is one of the most hotly contested facets of European integration. In the early 1980s, the then European Community came close to paralysis as Mrs Thatcher battled for her 'money back'. Later in that decade, increasingly bitter disputes arose between the Member States and the European Parliament (the two budgetary authorities) over the content of the budget. In 1992, the Spanish government successfully led demands for a new *Cohesion Fund* as a compensation for proceeding with monetary union, while in 1999 four of the richer Member States ganged-up to secure their own forms of 'money back'. Then, in 2002, enlargement negotiations were nearly stalled over minor allocations from the budget as the new Members realised that they were due to receive less than they thought had been promised. Yet the paradox is that the amounts concerned represent only a very small proportion of aggregate public spending in the EU (some 2.5per cent) and barely 1 per cent of gross national income (GNI)[1] .

The temperature is rising again as the EU gears up to a new budget deal for the period from 2007-13. Proposals were put forward in February 2004 by the European Commission for a new *Financial Perspective* – the medium-term framework for EU expenditure – and immediately denounced by a cabal of Finance Ministers from the richer Member States. Indeed, six countries had struck pre-emptively by writing an open letter to Commission President Prodi in December 2003 insisting that the budget should be capped at 1 per cent of EU GNI. The day the Commission proposals for expenditure to rise to 1.15 per cent of GNI were published, Dutch finance Minister Gerrit Zalm summed up the view of his fellow diehards: 'onaanvaardbaar'. For those whose Dutch is rusty, Gordon Brown provided an instant translation, condemning the proposed increase as 'unacceptable' and adding that rather than the UK abatement being an issue, 'the real problem is the Commission's desire to increase overall spending by 25 per cent'. German Finance Minister Hans Eichel, too, clearly still resentful about the Commission's hounding of Germany for fiscal indiscipline, was also scathing about the proposals. He explicitly condemned the inconsistency between demands on Germany to cut its spending and the higher spending ambitions of the Commission, and also argued that no national budget could plausibly grow at the rate envisaged by the Commission[2] .

The timetable for agreeing a new Financial Perspective (FP) promises further fun and games. To allow for the preparation and enactment of accompanying legislation (for example revised regulations for the EU Structural Funds), the Commission asked for a deal as early as possible in 2005, a request that, on past experience, will not easily be honoured. Having the legislation in place is essential if Member States are to prepare suitable plans for using EU expenditure. Consequently, if the manoeuvring stretches into 2006, delays that might be deemed 'onaanvaardbaar' might well arise. The second half of 2005 will be a UK Presidency semester, probably also preceded by a UK general election in May, and with the added piquancy of being a period when many Member States will be completing ratification by referendum of the Constitutional Treaty. Given that the UK will probably hold a referendum on the proposed Constitutional Treaty in the first semester of 2006, it is now widely accepted that it will be politically very difficult for the UK to mediate an agreement, not least because the opportunities for mischief and mishaps are evident. It now looks as though the only window for agreement is probably in June 2005, the last month of the current Luxembourg Presidency.

In practice, the argument will be about very little. The Commission has asked for 1.15 per cent of GNI by 2013 and the paymasters want to stick at 1 per cent. Subsequent 'clarifications' suggest that the 1 per cent demand refers to a definition of the EU budget based on what is known as appropriations for commitments, whereas the Commission figure is appropriations for payments, so that the gap between the two sides could be higher than 0.15 per cent of GNI. Even so, who would bet against a compromise around 1.08 per cent, plus or minus 0.02 percentage points? Yet surely there ought to be a much more fundamental debate about public finance in the EU. The advent of full monetary union, even if not all Member States are signed-up to it, manifestly changes the economic policy environment. Moreover, there is no reason to expect a pattern of EU expenditure established when General de Gaulle was leaving the political scene in the late 1960s for an economically pretty homogeneous

membership totalling six countries, and only partly refashioned in 1988 under the Delors Commission, still to be appropriate for a much more diverse membership.

This report is intended as a contribution that both elucidates some of the key issues and puts forward ideas for possible innovations in the EU budget. It would be easy in analysing potential reforms of the EU budget to confine debate to the narrow terms of the budget since 1988 and to propose little more than marginal tweaking of the proposals currently on the table. Certainly, it is hard to see any political scenario under which more extensive reform could happen. However, there are plenty of models of multi-level public finances elsewhere that can provide insights into other directions that reform could take and it is worth looking at more radical options to consider what role the budget could fulfil in EU economic governance. If nothing changes, the chances are high that the same debates will be re-run seven years hence.

The report argues that in a system as complex as the EU, principles of public finance need to be brought to the fore and that the role of a central budget in economic governance deserves, at least, to be explored. From a public finance perspective, the EU is a quasi-federal system[3] that lends itself to analysis using the tools of fiscal federalism. Public finance decisions will often be shaped by the ability of any jurisdictions to internalise the costs and benefits of spending programmes or the tax-raising needed to fund them. A jurisdiction has an interest in taxing others to finance spending within its borders and, equally, in allowing others to finance programmes from which it benefits. Consequently, decisions about how to structure public expenditure need to take far greater account of relevant economic principles, such as efficiency and equity considerations, rather than being dominated by arguments about *juste retour*. Even though the word 'federal' evokes strong reactions in different political contexts, these should not exclude analytic use of federal principles in exploring options for the EU budget. Nor should the importance of minor changes today be under-estimated, because they may well pave the way for further incremental improvements in future.

The remainder of this introductory chapter recalls the institutional framework within which the EU budget functions and points to some of the key challenges raised. Chapter 2 reviews the economic theories adjudged to bear on the EU budget, then the third chapter attempts to draw out pragmatic inferences for how budgetary arrangements could (or should) evolve in the EU. In chapter 4, the focus is on the way forward for the EU, including discussion of possible administrative and practical changes. Conclusions and appendices containing a bibliography and notes on inter-governmental arrangements in selected federal systems complete the report.

The budgetary process and its current structure

In economic terms, the EU budget is a curious hybrid. It is much more than the sort of financing accorded to international organisations, even those as substantial and well developed as the United Nations or the IMF, where the revenue stream depends purely on national subscriptions from member countries. But neither is it that of an autonomous political entity which, even if it relies on other levels of government for substantial proportions of its revenues, at least has some direct link with a local electorate in relation to fund-raising. Notwithstanding the existence, since 1984, of a directly elected European Parliament, the EU lacks such a direct link because the EP has no direct competence in raising taxes. To invert a well-known phrase, the EU is close to being representation without taxation: it has no powers to select the taxes used to generate the revenue that funds it or to alter the rates of tax instruments currently assigned to it.

Since 1988, the EU budget has accounted for around 1 per cent of EU GNI and has been set within a stable legal framework that has a number of distinctive characteristics. But compared with established federations in which the federal level has substantial resources and plays an important part in macroeconomic policy, the *economic* significance of the EU budget is minor. Box 1.1 shows a chronology of the development of the budget.

Box 1.1 - Chronology of the EU budget

1971: Agreement to assign own resources and designation of customs duties and agricultural levies as EC resources.

1979: Introduction of the 3rd (VAT) resource.

early-1980s: Crises over UK demands to lower its net contribution to the budget.

1984: Fontainebleau agreement to abate UK net contribution.

mid-1980s: Inter-institutional disputes between Council and Parliament, eventually settled by the negotiation of the *inter-institutional agreement*.

1988: Introduction of the 4th (GNP-related) resource which guarantees EC revenue; general recasting of the budget (Delors I package) and introduction of the *Financial Perspective*; and reform of structural funds.

1992: Edinburgh European Council agrees new *Financial Perspective* (Delors II package); creation of *Cohesion Fund*.

1997: Initial Commission proposals ('Agenda 2000') for next *Financial Perspective*, including provisions for enlargement from EU-15 to EU-27.

1999: Berlin European Council agrees current *Financial Perspective*; provides for the VAT resource to shrink; ad hoc arrangements to abate net contributions of four more Member States.

2004: Initial Commission proposals ('Building our Common Future') for next *Financial Perspective*, to run from 2007-13

The legal framework

Although the funding at its disposal is the result of inter-governmental agreements, the EU budget does have a firm constitutional footing in Articles 269-277 of the Treaty. These articles assure the autonomy of the budget, notably by providing for 'own resources' and mean that the EU has (or should have) certainty about its entitlement to engage in public spending. It has a number of obligations assigned to it by the Member States, most notoriously, the implementation of the Common Agricultural Policy (CAP), which, despite repeated efforts to cut it back still consumes nearly half of the EU budget.

The creation in 1988 of the *Financial Perspective* (FP) established a medium-term framework for the budget by stipulating the pattern of expenditure for the years to come. The EU budget today is split into seven headings with pre-determined ceilings for allocations for each over the 2000-06 period. At a political level, the decisions by the European Council on the FP have largely settled the shape of the EU budget, but there are other significant steps in the process. The Commission has to put forward initial plans for future financing well before the expiry of the FP in force – Agenda 2000, published in 1997, fulfilled this commitment prior to the agreement of the 2000-06 FP. Once the political agreement has been reached, the Commission then has to put forward a proposal for an 'own resources decision' (ORD) that has to be taken by the Council. The own resources decision currently in force was agreed by the Council in September 2000[4] and came into force in 2002. It fleshes out the implementation of the budget agreement reached in Berlin in March 1999, notably by explaining how the EU's spending will be financed. In addition the ORD obliges the Commission to publish, by the end of 2005, a review in which it examines:

> ***the possibility of modifying the structure of the own resources by creating new autonomous own resources and the correction of budgetary imbalances granted to the United Kingdom as well as the granting to Austria, Germany, the Netherlands and Sweden of the reduction pursuant to Article 5(1).***

Since the demise of the Santer Commission, extensive administrative reforms have been undertaken in the way the Commission functions. In the budgetary arena, the principle change is that the Commission has been moving towards a system of Activity Based Management (ABM) and, from 2004, will engage in what is known as Activity Based Budgeting (ABB)[5]. This is described by the Commission as having as its main objective to ensure that the allocation of resources is a politically driven process whereby resources of all types are distributed in a manner that is consistent with pre-defined political priorities and objectives. Thus, priority setting, planning, budgeting, monitoring and reporting are processes which take place within one common conceptual framework where the Activity is the common denominator. While this goes some way to improve matters in relation to sound financial management it is early days.

The Financial Perspective and the own resources ceiling

The first FP covered the five-year period from 1988 to 1992 (sometimes referred to as 'Delors I'), while the two subsequent ones stretched to seven years. The main effect of the FP is to constrain the amounts that can be spent under each broad heading of expenditure. Thus, although there is an annual budgetary round which determines the detailed spending commitments of the Union, there is little flexibility between broad headings. As a consequence, it would be very difficult for the Union to alter its expenditure pattern significantly within the span of an FP.

The distribution for 2003 is representative, with spending dominated by lines 1 (CAP – 44.7 per cent) and 2 (Structural

Figure 1.1: Distribution of EU Budget, 2003 (%)

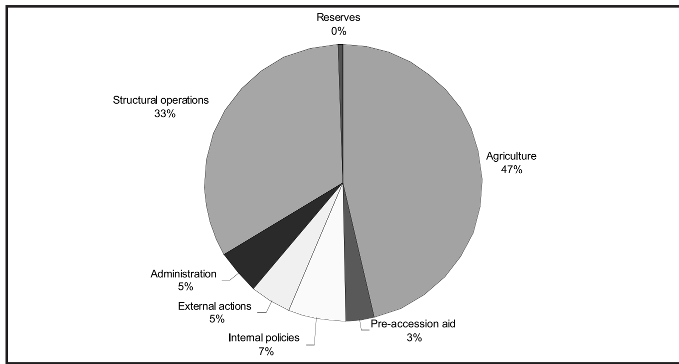
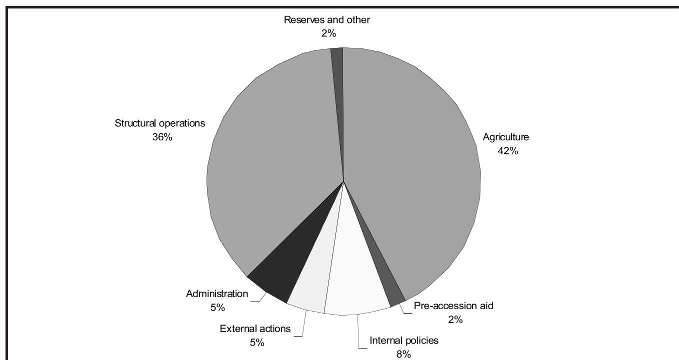


Figure 1.2: Distribution of EU Budget, 2005 (%)



Operations – 34 per cent). The remainder is distributed between: 'internal policies' (6.8 per cent), the bulk of which is research and much of which is on the 6th Framework Programme; 'external actions' (4.9 per cent), with development aid prominent; 'pre-accession aid' (3.4 per cent) to the 13 candidate countries; and 'administration' (5.4 per cent), with the balance going to reserves – see figure 1.1. The corresponding figures for the draft 2005 budget – the first full year after the landmark 2005 enlargement - presented in figure 1.2, show that a little more will be spent on internal policies, but this is mainly because pre-accession aid was internalised following the 2004 enlargement. The out-turn has consistently been well below the own resources ceiling, notwithstanding lower than expected economic growth from 2001-03.

A second element of the budget, agreed in parallel with the FP, is the 'own resources ceiling', a rather convoluted expression for a cap on its size. The ceiling is expressed as a proportion of Community GNI, which means that it is not a fixed number of billion euros, because the denominator of the ratio (GNI) will expand at a rate determined by the performance of the EU economy. For the current FP, the ceiling has been set at 1.24 per cent, the same ratio as had been attained by the latter years of the 1993-99 FP. However, as part of the agreement of the FP at Berlin in 1999, a rising proportion of expenditure was 'ring-fenced' for the then candidates for accession. It is also noteworthy that in virtually every year since the ceiling was introduced, the annual budget of the EU has been kept well below the limit, especially following the 1999 Berlin agreement. In the late 1990s, this appears to have been a deliberate ploy by the Commission to create room for manoeuvre in reconciling the demands of the current EU-15 for expenditure while providing funding to assist the accession candidates. As a result, total EU expenditure as a proportion of Community GNI reached a peak of 1.2 per cent in the mid-1990s, then tailed off to average just 1 per cent over the period 1999 and 2003. Per capita spending, despite growth in the real value of GNI and the additional demands of enlargement, was lower in 2003 than it had been seven years beforehand.

Financing: the own resources

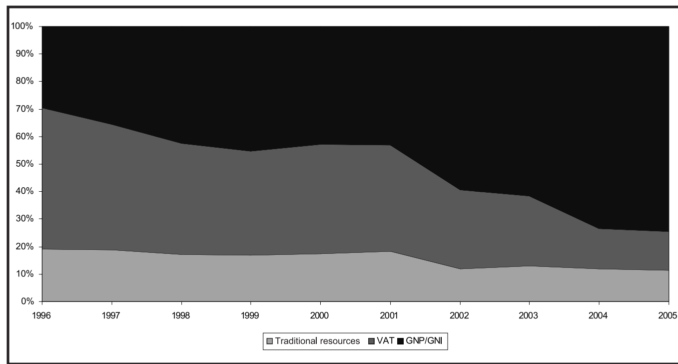
The system for financing the EU has also been broadly stable since 1988, with four revenue streams or 'own resources'[6]. These are:

- Agricultural levies and duties
- Customs duties
- A percentage of the proceeds of national value added tax (VAT), adjusted to take account of differences in the coverage of VAT
- A payment proportional to the GNI of each Member State

The first two are commonly referred to as the traditional own resources because they were first assigned to the Community budget in 1971. They can be rationalised economically on the grounds that the underlying policy areas (agriculture and the common external tariff) are Community competencies. Because of falling duties, the proceeds from these two taxes has been falling progressively, and in 2003 was down to barely 13 per cent of the total revenue. Given that the duties are collected at the point of entry into the EU of the goods on which they are levied,[7] however, anomalies can arise in determining which Member State actually pays these sums. The reason is that once goods enter the EU, they may be transhipped from the Member State of entry to another, and ultimately paid for by consumers in the later country. For obvious geographical reasons, this has been dubbed the Rotterdam effect.

The third (VAT) resource relies on a complicated formula to determine how much each Member State pays, but is approximately a set percentage of the yield of the tax, initially 1 per cent. The yield from the VAT resource fell as a proportion of the own resources ceiling during the 1990s, and was

Figure 1.3: Proportions of own resources



deliberately scaled down for the 2000-06 FP by a lowering of the take-up rate from 1 per cent to 0.75 per cent then to 0.5 per cent, as well as other adjustments. As a result it accounted for 25 per cent of EU revenue by 2003 and is expected to fall to just 14 per cent in 2005 (see figure 1.3)

The balance of the EU's revenue is collected from Member States via the GNI, or fourth resource. Its yield is flexible because, in essence, it makes up the difference between what the first three resources (and sundry other fees, charges and accounting adjustments) generate and total expenditure. It is a moot point whether the fourth resource can truly be said to be 'owned' by the EU level, or is, in fact, an inter-governmental grant. Similar doubts can be expressed about the VAT resource, and since these two resources account for a large and growing share of the total, it is an open question whether the provision in the Treaty for the budget to be funded by own resources is adhered to. Overall, the contributions of each Member State to the EU budget are roughly in line with their GNIs, although because of the opaque character of some of the arrangements, it is not a precise pre-emption.

Following pressure from the European Parliament, the Commission produced its review of the own resources system earlier than it was obliged to, in July 2004. The review notes that the system for funding the EU lacks transparency and observes that 'it is virtually impossible for individual own resources to satisfy all possible assessment criteria, but that a combination of resources could do so'. The Commission puts forward seven criteria for assessing own resources, and finds that the current system fares badly on three of them (visibility and simplicity; financial autonomy - increasingly; and contributing to the efficient allocation of resources). Though with some reservations, the system is adjudged to fare better on the other four (sufficiency, cost-effectiveness, revenue stability and equity of gross contributions).

The UK rebate and generalised correction mechanisms

One of the more vexed questions in the EU is what the net contribution that is the difference between payments into the budget and receipts from it - of each Member State should be. During the early 1980s, the cards were clearly stacked against the UK, leading to a succession of acrimonious meetings, usually resolved by short-term compromises aimed at lessening the UK's net payment. Eventually the *ad hoc* solution of the UK abatement was agreed as part of the 1984 Fontainebleau accord, the key point of which was that two-thirds of the *ex-ante* net payment would be returned to the UK, with the burden spread amongst the other Member States. Ever since, it has stuck in the craws of other Member States and is clearly seen among the new Members of the EU as no longer tenable. Yet if it were abandoned, the UK would be subject to an unacceptable share of the financing of the EU.

The current hybrid system is, therefore, possibly all that is politically feasible given how the EU budget has evolved, but it is manifestly a hotch-potch. Staunch integrationists also maintain that, because the benefits of EU membership are so substantial, they vastly outweigh the narrow financial costs or benefits of budgetary positions, a point of view to which the Germans, who have been the most significant net contributors to the financing burden since Fontainebleau, appeared to subscribe, at least until the costs of unification loomed large.

Although the UK has been robust in defending the abatement, it is worth noting that:

- First, even in the original 1984 decision, it was envisaged that other Member States might, in time, be offered a similar arrangement.
- Minor amendments to the formula were introduced at the Berlin European Council and fleshed out in the 2000 own resources decision to adapt the abatement in the light of changes to the VAT resource and to the collection 'fee' retained by Member States for the traditional own resources.
- Four countries are only obliged (since 1999) to pay a quarter of their ex-ante share of the UK abatement; they are: Austria, Germany, the Netherlands and Sweden. Before then Germany only had to pay a third of its ex-ante share.

What is at issue?

The new FP will dictate what role the EU budget plays in the coming years, during which the EU will change markedly as it absorbs new members and consolidates EMU in what will be a critical period in the Union's development if, or when, the new Constitutional Treaty comes into force. At one level, the

issues surrounding the EU budget are straightforward. They concern, principally, three questions:

- *How much should be spent overall?* For the immediate future the likely range is between the Commission proposals and the demand from the six for 1per cent. Longer-term, the question could become how total public spending is distributed between the Member State and EU levels, opening-up the question of whether a quantum change in the scale of the EU budget could be contemplated.
- *Who should pay for the spending?* For the Member States, the primary issue will be what the net contributions are, but it is also important to look at gross payments and how they impinge on different interests within the Union.
- *What should the money be spent on?* Underlying this question is whether EU spending continues to be on the two principal policy areas that have dominated the budget since the 1980s, or whether it shifts towards different priorities.

What are the bones of contention? First, beyond the banal observation that the EU budget exists to provide funding for common policies, how supranational spending should fit in to the overall structure of public finances and economic governance has not convincingly been appraised. Public expenditure is an important, if numerically relatively small, part of what the EU does, but the balance between the EU's spending and its regulatory or co-ordinating activities deserves attention.

Second, there is a mounting tension between the net contributors and the net recipients about how big the budget should be and the resources that flow to each country. A related issue is the UK abatement which, despite having been not unreasonable in the outcomes it produced since 1984, and its effectiveness in preventing unfair demands on Britain, clearly rankles with others. Indeed, one of the issues that has upset the new Members is that they had to start paying towards the UK abatement even before formal accession. The whole question is given added poignancy by the rows over the Stability and Growth Pact. Then there are disputes about whether there should be dedicated taxes to pay for EU spending or whether the shift towards inter-governmental transfers should be maintained, despite concerns that the lack of visibility undermines accountability and thus the legitimacy of the EU.

Fourth, the composition of EU spending has been challenged, with demands from many quarters for the budget to be orientated more towards growth, competitiveness and, more generally, the so-called 'Lisbon' agenda. A good example is the 'Sapir' Report, commissioned by Romano Prodi and first released in the summer of 2003 (Sapir, 2004), which advocated a radical re-focusing on the promotion of growth and better targeting of cohesion policies. Equally, it can be argued that there is a huge gulf between the EU's ambitions to be a major player in global economic, political and security arenas, and the paltry budget it has for external actions. The trouble, though is that it can be difficult to identify added value from spending at the EU level, rather than leaving it up to Member States and difficult issues arise about the criteria to adopt to allocate funding. A further difficulty is the limited information on whether EU spending is good value for money.

In addition, there are many aspects of the administration and monitoring of the EU budget that deserve attention. Fraud has been a running sore which, even though much of it occurs within the Member States and is out of the jurisdiction of the EU institutions, nevertheless undermines confidence in the Union. More technical issues that ought to be debated include the measurement and control of the budget, as well as the concepts used. It could also be argued that a core question about the budget is whether the provisions for scrutiny and accountability are sufficiently transparent.

The overall structure of public finances

Looking beyond the immediate FP agenda, there are wider issues about the future of EU inter-governmental fiscal transfers to consider. Many of these issues are being confronted in national systems, especially in relation to devolution or decentralisation. In a recent OECD survey of inter-governmental fiscal relations, Joumard and Kongsrud (2003) identify three main topics central to contemporary debate, although as in so much of the literature, the focus is on the relationship between (typically, a powerful) central government and sub-national tiers. Their three headings, which only partly resonate at EU level, are:

- On the spending side, how can sub-national government tailor the supply of public goods, which may have different constituencies, to local preferences while ensuring efficient provision and the fulfilment of distributional objectives?
- On the revenue side, how should financing schemes for sub-national governments be designed so as to allow them to respond to local preferences without creating efficiency concerns and compromising distributional objectives nationwide?
- From a macroeconomic perspective, how can sufficient co-ordination across government levels be engineered, using fiscal rules, co-operation arrangements or market forces, so as to ensure compatibility with national fiscal targets?

The ramifications of a multi-tiered transfer system have also been analysed by Bird (2002) who posits two ways of

looking at transfers: delegation and devolution. He defines the two approaches as follows:

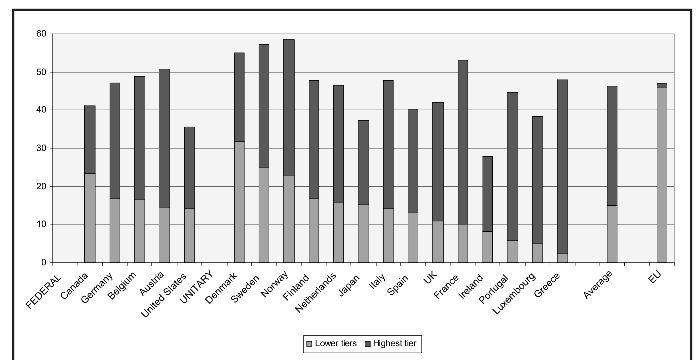
- **Delegation** refers to a situation in which local governments act as agents for the central government, executing certain functions on its behalf. In this case, the appropriate perspective is 'top-down', that is, from the viewpoint of a central government whose objective in decentralising might be to shift some of the political pressures resulting from deficits downward, or perhaps (as is often assumed in theory if seldom very visible in practice) to achieve its allocative goals more efficiently by delegating authority to local governments. The top-down approach implies that the main criterion for evaluating fiscal decentralisation should be how well it serves the presumed national policy objectives.
- **Devolution** refers to a situation in which local governments implement policy but also have the authority to decide what is done - or, to put it another way, 'local autonomy' prevails. The appropriate perspective is then 'bottom-up.' Those who take this approach often stress political values such as improved governance (through increased local political participation, for example) as well as allocative efficiency (through increased responsiveness to local preferences or the increased scope for dynamic innovation that may be afforded by a variety of competing local governments). If this is the relevant perspective, the appropriate criteria in designing transfers may differ sharply from those under the top-down approach.

This distinction is of some help in understanding the constitutional position of the EU, though it is by no means easy to determine the extent to which it undertakes delegated or devolved functions, or which of the tasks it carries out fall into which category. Nor can the EU be readily located within the public finance hierarchy usually implicit in such models. It is geographically at the peak of the hierarchy as the 'highest' level of government, but manifestly does not act as a Federal level of government, especially in relation to public expenditure, where it has instead (in Bird's terms) a delegated status. Indeed, the EU has less financial clout and, in public finance terms, has even less autonomy than a typical large local authority. It is striking that the mayor of New York controls a budget not that much smaller than the EU institutions.

The whole issue is clouded by the substantial differences among Member States in inter-governmental arrangements. The highest shares of revenue raised by sub-national governments are in the Nordic countries and in Germany, with the lowest in Greece, Ireland and the UK. Broadly, the pattern of public expenditure is similar: the biggest shares of public spending by sub-national governments are also in the Nordic countries and Germany, although the UK, the Netherlands and Ireland are higher on this count, and well above France, highlighting the scale of the net fiscal transfer from central to sub-national government. Generally, and not surprisingly, unitary states spend much more centrally than their federal counterparts. There is, however, a big difference between Canada and the US in the scale of federal level public spending, with the US behaving much as a unitary state, a key reason being the defence budget, although welfare is also important.

As figure 1.4 shows, all these countries are an order of magnitude different from the EU (viewed as a single political and economic entity). The chart shows a decomposition between the highest tier of government and lower tiers in proportions of public spending in a range of OECD countries, both federal and unitary. While the comparison between the EU and other polities is somewhat tendentious insofar as the EU is neither a federation nor a unitary state, the gulf between the EU and other polities is, nevertheless, striking. The US, especially, presents a stark contrast with the EU, with the federal level easily outweighing state and local government. Even if military expenditure were taken out of the equation, the federal government share would be a similar order of magnitude to the sub-national level.

Figure 1.4: Shares of government spending as a percentage of GDP (2001)



The explanations for the differences between countries in the national/sub-national split are very varied and depend on historical assignments of competencies for major headings of public expenditure, above all for social policies such as education and health. The OECD (2003) shows that there is also great diversity in revenue structures, although as a generalisation, there is a vertical imbalance in which central governments collect revenue in excess of their expenditure and provide inter-governmental grants to lower tiers. Nevertheless, and contrary to what might be expected, some unitary countries give substantial tax-raising powers to sub-national government, in some cases (such as Sweden) exceeding even the most devolved of federations.

Tanzi and Zee (1998) point out that the US differs in one fundamental respect from the EU which is that the Federal government in the US collects some two-thirds of tax revenues. The EU, in effect, collects none, as even the customs duties own resources are collected by Member States. Thus, despite the fact that the two economic blocs are similar in size and – assuming all or most Member States eventually accede to the euro – have a common currency, their fiscal systems remain very different. In addition, the fact that so many tax systems are federal tends to shape state tax systems, even though states have full constitutional autonomy. A trade-off tends to exist between the competitive *and* political pressures to harmonise taxes and the costs of shifting to a tax system that is contrary to the preferences of the state.

2. What can economic theory tell us?

The assignment of budgetary responsibilities among levels of government is never easy although the choice of where responsibility for public expenditure or tax powers should be assigned has been extensively studied in economic theory and in empirical studies. The decision about 'who does what' in a union such as the EU is essentially about provision of public goods in the widest sense of the term, that is not just quantifiable goods and services provided by the public sector, but also regulatory and other interventions that constitute part of the public sector's overall impact. In this latter sense, macroeconomic stability, a clean environment or the facilitation of knowledge creation can be seen as public goods, as well as roads or hospitals. Some insights into the character of the EU's public finances, the tasks assigned to the supranational tier, how they are organised and the directions in which they might evolve can be gleaned by drawing on economic analysis and practice.

In the economic theory of public finance, following Musgrave (1959), three functions of public finance are conventionally delineated: stabilisation, allocation and redistribution. Under each heading, differing assignments of responsibility can be envisaged, but certain principles have been developed that focus on the nature and purpose of the public goods and services being supplied. While fiscal federalism (FF) as developed, notably, by Oates (1972, 1999) is the most established branch of relevant economics, many other strands of economic (and, indeed, political science) research bear on the question. This chapter presents an overview of such research and attempts to relate it the circumstances of the EU and different dimensions of the budget.

It is important to start by observing that the EU is not simply an international organisation like the IMF or the United Nations for which annual dues are an appropriate form of funding. But although these formal distinctions greatly exercise political scientists, it can be argued that they matter less from an economic perspective. As Oates (1999) points out, in his overview of fiscal federalism, to economists the term federalism covers virtually all public sectors insofar as they all have 'different levels of government that provide public services and have some *de facto* decision-making authority (irrespective of the formal constitution).' However, the salience of FF is limited by the fact that the EU, as presently constituted is far from being a federal system. Oates goes on to suggest that the term 'fiscal federalism' may have been ill-chosen to the extent that it implies only a narrow focus on budgetary matters. He might also have observed that using the word 'federal' has connotations in the EU context that have also distorted the debate!

Fiscal federalism

Fiscal federalism starts from the presumption that an optimal assignment of competencies can be found in which account is taken, on the one hand, of the impacts (spillovers and externalities) of policies in one jurisdiction on others; and on the other hand of voter preferences and the legitimacy of decision-making. An answer is to match the provision of public goods to the geographical span of the taxpayers who finance the spending: the principles of 'fiscal equivalence' suggested by Olson (1968) and of 'correspondence' advocated by Oates (1972). Much of the fiscal federalism debate turns on the scope for economies of scale or scope from pooling policy and therefore bears on the elusive search for added value in EU level spending.

In the orthodox FF approach, a number of clear-cut propositions about 'who should do what' are advanced. The subject has, however, evolved in different ways (see, for example, Inman and Rubinfeld, 1997). At the heart of fiscal federalism is the notion that welfare can be increased by optimising the mix between local and higher tier provision of services. If, for example, non-residents are able to enjoy some of the benefits of a lower tier jurisdiction's spending, there will be an incentive to reduce provision. A higher tier, by contrast can internalise spillover effects and, in so doing, assure the optimal level of provision for the economic area as a whole, either by providing the services or by grants to the lower tier to counter the adverse incentives. As Borck and Owings (2002) note, 'welfare theory, however, does not fare well in empirical studies' and they cite a range of supporting evidence (see Inman, 1988; Grossmann, 1994).

Fiscal federalism, moreover, is predicated on the jurisdictions all belonging to a single nation in which there are national political processes at work. Such processes may facilitate or inhibit the realisation of efficient allocation of public finance from the perspective of the welfare of the nation as a whole, but the key point is that the political context of the nation matters: voters with disproportionate power (such as swing constituencies) can attract higher transfers (for example, Dixit and Londregan, 1998). In the EU, by contrast, this sense of 'nation' is far from present and this very different political context raises considerable doubts about the salience of fiscal federalism for analysis of the EU budget. But as noted above,

even if the EU is unlikely to become even an approximation to a federal level *politically*, it could well be assigned more extensive public finance tasks if these could be justified on *economic* grounds. A lack of EU statehood or state building need not, in other words, preclude a different mix of public finances.

Assigning public finance functions by level of government

How, then, should responsibility for public functions be apportioned so as to achieve the best results? A simple definition, offered by Cooter (2000: 103), is that the optimal mix of governments at different levels is 'where citizens enjoy the greatest satisfaction of their preferences'. However, unlike consumers of goods and services supplied by 'the market' who can switch from one supplier to another with relative ease, citizens have only a severely circumscribed ability to move to a more congenial jurisdiction.

It is, nevertheless, useful to separate the question of what public goods and services are supplied from the assignment of responsibilities to supply them. Deciding what public goods to provide depends on the characteristics of such goods and there is a rich literature that underpins those choices. At the heart of the rationale for public goods is the notion of market failure. There are several categories of public goods which, in turn, have different attributes.

A *pure public good* is one which can be shared completely and is thus *non-rivalrous* in the sense that the benefits of the good obtained by one individual do not detract from the benefits accruing to others. By the same token, no individual can be left out, so that pure public goods are also *non-excludable*. Common provision of security and defence is the example usually cited in this regard. The corollary of being non-excludable is, however, that individuals then have no incentive to pay, as they can free-ride. Because the government has the power to tax (Brennan and Buchanan, 1980) it is in a position not only to oblige all citizens (or at least those deemed to be liable) to pay taxes, but also to determine the scale of the spending. Free-riding will be minimised when the taxable population corresponds to the population benefiting from the spending. Since all citizens gain from pure public goods, the highest level of government should levy the taxes and determine (though not necessarily implement) the expenditure. In existing federations, this assignment for pure public goods tends to be accepted, although there are often disputes about the scale of programmes. Some public goods, however, do not fulfil the criterion of being non-rivalrous because of capacity constraints. Transport or leisure facilities exhibit this property, and it can be argued that a decentralised government will be better placed to gauge demand and to customise the supply.

Tanzi (2000) draws attention to a further aspect of public sector reform that bears on assignment of competencies between levels, namely the overall size of government. He asserts that the question of 'what kind of activities lend themselves to privatisation and what kind lend themselves to decentralisation' has not been posed in the literature, but ought to be more prominent because many of the public services that are candidates for decentralisation are also those for which privatisation may be a viable option. Interestingly, he also suggests that a smaller overall public sector might be concentrated at higher levels of government. At the same time, he notes that the more layers of government there are, the greater the amount of regulation because each level will seek to impose its own priorities: 'Each time one adds another layer of government - be this provincial or regional government - the number of damaging regulations is likely to increase.'

Tanzi also notes, from his long experience as an observer of public policy, that governments which are most constrained in revenue and spending tend to be more likely to resort to regulation to achieve their objectives. His inferences relate, above all, to local authorities and much of his experience is in developing countries, but it could be argued that, the sort of inverted public sector hierarchy found in the EU also conforms to his description. Another concern he raises is that decentralised governments are more open to corruption, either because the calibre of officials is lower or because institutions are less developed and provisions for accountability and transparency less effective.

Decentralisation or centralisation?

As many authors point out, there has been a widespread trend towards decentralisation of political power and the conferring of more extensive political power on sub-national governments. Tanzi (2000: 1) notes that

> *'a couple decades ago fiscal federalism used to be a topic of marginal importance in most countries and in the economic literature. The world was broadly divided in federal states and unitary states and there were hardly any countries that planned to move from one to the other of these categories. In recent years, however, perhaps as a result of globalisation and deepening democratisation, combined with rising incomes, centrifugal forces seem to*

> *have been put into action in many countries. These forces have generated growing demands for increasing degrees of fiscal decentralisation. It can be hypothesised that decentralisation is a superior good, the demand for which is likely to grow with per capita income.'*

The question then is which public functions, based on rational arguments, should be located at which levels of government.

The case for decentralisation

To sum up the arguments, the following can be identified as reason for preferring public expenditure to be delivered by lower levels of government:

- Better knowledge of the demands from citizens, or of what they are prepared to finance
- Capacity for voters to hold government to account when it is closer to them and for scrutiny by, notably, the media.
- Lesser probability of government failure, provided that transparency and accountability work
- Scope for tax competition so that the risk of overbearing government ('leviathan'), characterised by government failure, is reduced
- Ease of customising the policy and thus the public goods and services that flow from it
- Flexibility in changing a policy when conditions demand it

Rationales for centralising

In response to the question, 'why centralise?', the bases for answers are:

- Economies of scale and scope, or indivisibilities in public goods or services which mean that the central level is more efficient in the sense of being able to deliver the public good at a lower cost of production
- The pooling of risks in a context of asymmetries in the cycle of demand for public goods and services
- Non-excludability of public goods which result in their under-supply at decentralised levels
- Spillovers (both 'spill-out' and 'spill-in') from one jurisdiction to another of diverse kinds
- Avoidance of duplication
- Increased bargaining power

It is evident from a range of recent studies (reviewed in OECD, 2003) that although there is a growing recognition that decentralisation has advantages, the 'choice between central and local provision is not clear-cut and devolution has not proceeded evenly in the OECD area over the past two decades.' The OECD review highlights accountability as an attraction of decentralisation and also points to the advantages of competition between jurisdictions (which takes us right back to Tiebout, 1956), yet warns that because of co-ordination problems, decentralisation will not necessarily 'deliver efficiency gains in activities where small-scale operation increases provision costs or in cases where the benefits and costs of an activity are felt outside the supplying jurisdiction. The OECD notes, too, that 'nationwide policy objectives, notably those related to equity and macroeconomic stabilisation, may be more difficult to achieve with greater sub-national autonomy.'

While it appears administratively neat to assign particular public expenditure functions exclusively to a particular level of government, it is rarely easy to achieve. Defence is seen as quintessentially a national level function, whereas refuse collection is local. But for many public services, including much of social protection or economic development, a multi-tiered provision is the norm. Similarly, although principles can be advanced for assigning taxes exclusively to specific levels of government, these need not preclude the proceeds from any particular tax being assigned to more than one level. However, many taxes tend to be relatively more centralised than public expenditure, with the result that there is usually a built-in vertical imbalance in fiscal arrangements. As a result, one rationale for sharing is that the tax base may be very limited, especially at the more decentralised levels.

Prud'homme (2001) suggests four sets of criteria for determining the mix of spending among levels of government and the extent of decentralisation:

- *Economic efficiency* in two senses: whether the allocation of public goods and services matches desired levels; and whether the bundle of goods and services is efficiently produced.
- *Political efficiency* which he sees as having three main dimensions: allowing the preferences of the local level to be expressed; fostering democracy by creating an effective local level of decision that encourages participation; and acting as a counterweight to an over-powerful central government.
- *Macroeconomic stabilisation* and how it is affected by the structure of the fiscal system, with the expectation that more centralised systems are better at stabilising.
- *Redistribution* as a major function of policy. Prud'homme notes that on the whole, decentralised systems tend to aggravate disparities.

Prud'homme puts forward a grid of aspects of fiscal structure – reproduced as table 2.1 – in which each attribute is scored on whether it warrants decentralisation. He comes to the overall conclusion that the economic efficiency and, especially, political efficiency criteria, broadly favour a more

decentralised approach, whereas the macroeconomic stabilisation and redistribution criteria mainly support centralisation. But he observes that the conclusions depend, first, on country-context insofar as the income level, administrative tradition or, simply, geography affects the issue. The question that then arises is how to view these conclusions in the EU context.

Table 2.1 Assessing the case for decentralisation

Notes: Cells scored on a five point scale from ++ = favours decentralisation to – = favours centralisation

	Economic efficiency	Macro-economic stabilisation	Redistribution	Political efficency
Allocation of responsibilities	+	–	–	++
Allocation of taxes	–	+	+	++
Transfer systems	+	+	++	–
Central government controls	+	+	o	o
Election rules	+	- -	–	++
Overall	+	-	-	++

Source: Prud'homme (2001)

At first sight, the balance of arguments appears to argue against any expansion of the role of the EU level and to reinforce the presumption that many see behind the principle of subsidiarity that the pressure should be always to devolve. But even the most diehard advocates of devolution have to recognise that the principle cuts both ways. Moreover, the fact that decentralisation can engender difficulties is too easily overlooked. Prud'homme (1995) notes a number of potential flaws in the theory of fiscal decentralisation. The economic efficiency argument, he suggests, requires roughly even regional fiscal capacities. He also argues that the rationale for decentralisation of revenues is not the same as expenditures: and 'in many cases the problem is not so much whether a certain service should be provided by a central, regional, or local government, but rather how to organise the joint production of the service by the various levels'. The risk of 'capture' by vested interests may also be a problem for the local level.

Much, though, depends on the incentive structures facing governments at all levels and whether they are attuned to reconciling local and national objectives. According to the OECD (2003) 'incentive and enforcement problems apply, though in somewhat different form, whether central authority derives from a federal system or from nation states, as under the principle of subsidiarity'. The Stability and Growth Pact is cited as an example of 'upward devolution' in the fiscal arena, justified because complete autonomy for Member States would give rise to insuperable problems of co-ordination and free-riding. The precise terms of the SGP have, rightly, been heavily criticised, but the principle of fiscal co-ordination in a monetary union is still valid, especially when the supranational budget is not able to provide any form of stabilisation.

A key message which emerges is that institutional structures can often greatly outweigh any merits of drawbacks of the dichotomy between central and sub-national arrangements. The institutional set-up, in turn, is often more the result of inherited historical and political compromises, rather than a system designed to achieve a balance between equity, efficiency or other aims and principles. Nor are existing political or administrative boundaries always ideal and it is not difficult to think of functions that might well be more effectively handled by governments that spanned existing geographical domains, including across Member State borders. In the words of the old joke, 'you wouldn't start from here...'.

A further important point made by Prud'homme is that change should not be hurried and he quotes the Italian aphorism '*che va piano va sano, e che va sano va lontano*' to emphasise the point. Even more so in the EU context, this injunction resonates. A challenge, nevertheless, is to relate the extensive analyses of optimal forms of public administration to the highly specific form of the EU.

The aforementioned OECD report (OECD, 2003) notes that 'institutional diversity – often rooted in history – makes general conclusions about best practice in intergovernmental fiscal relations difficult to draw, but a review of country experiences in this area shows that the broad issues are similar across countries'. The report highlights distribution and efficiency issues on the spending side, the choice between own resources and inter-governmental grants on the financing side and issues of institutional design associated, principally, with budgetary discipline. An inference to draw is that many of the same issues must also be expected to arise at EU level, albeit with the hierarchy reversed in the sense that the EU level, in many respects, is akin to a local government in its subjugation to Member State controls.

Summing up the arguments, the OECD comments that 'the benefits of decentralisation, in terms of better responding to local preferences, thus have to be balanced against equity and stabilisation objectives, which are determined nationally' (OECD, 2003: 149). Careful thought also has to be given to co-ordination. Issues to be resolved in this context include how to frame agreements on service delivery between tiers of

government, and how to enforce any such agreements. Different forms of transfers and grants clearly have a bearing on incentives, as explained earlier.

Multi-level governance: a political science rationale

Multi-level governance approaches (MLG), as described notably by Hooghe and Marks (2001 and 2003), provide a way of looking at the EU as a system in which rather than assign explicit competencies to tiers of government, there is a pooling of powers and responsibilities. There is certainly evidence from a majority of Member States of a disposition towards 'a reallocation of authority upwards, downwards, and sideways from central states' (Hooghe and Marks, 2003). Yet the momentum for change is limited. Even though the whole process of drafting the EU's Constitutional Treaty has prompted an extensive review of EU governance, generally, the provisions on the budget in the new Treaty are disappointing in that not much has changed.

Hooghe and Marks (2003) note one general attribute of multi-tiered governance: 'dispersion of governance across multiple jurisdictions is *more flexible* than concentration of governance in one jurisdiction' and thus facilitates a more optimal mix of powers. Although the federalism/subsidiarity debate is usually about the geographical level of government, MLG can encompass both geographical jurisdictions and functional ones. Existing boundaries would not make sense for many policies or public goods such as environmental quality. Oates (1999) notes in this regard that the use of rivers as boundaries greatly complicates the management of the water resources as a public good. An answer may be functional rather than political boundaries. Hooghe and Marks refer to Type I and Type II governance, the former being essentially federal and nested, the latter allowing for proliferation and, perhaps inevitably, spatial over-lapping.

In such a system, a key dilemma is how to ensure efficient co-ordination. Questions also arise about whether institutions should be permanent or fluid: it would, for example, make sense for some policies designed to kick-start supply side reform (in accordance with the Lisbon strategy) to be carried out by temporary agencies of governance. A further extension of the notion of MLG might be to explore the circumstances in which expenditure or other forms of governance are optimal, as discussed above. So-called 'laboratory federalism' using block grants to support the innovation may be an effective way of promoting innovative measures. But Oates (1999) notes that 'there has been little in the way of a real theory of laboratory federalism to organise our thought and to guide empirical studies'. There is, however, an information externality in that the experimenter creates knowledge of use to others.

One dimension of MLG of relevance is that, to some extent, governments find it easier to work with external agents to deliver economic change because it can facilitate dealing with vested interests. In this regard, an external commitment might be thought of as helpful in stimulating structural change and one dimension is direct co-operation between supranational and sub-national authorities (by-passing central government). For the various 'soft' forms of co-ordination in the EU, especially the shortcomings revealed by the Kok report, an appropriate balancing of incentives and penalties might improve compliance, for example by imposing conditionality on receipt of funding from the EU budget. Similarly, providing funds through the EU budget to bodies outside the direct authority of the Commission could be a way forward. The idea of a European research council is one, but others could be envisaged.

Frey and Eichenberger (1999) put forward an interesting proposal which is that rather than trying to optimise between the merits of higher and lower tiers of government by seeking a clear division of labour between tiers of government attention should focus on 'functional, overlapping, and competing jurisdictions (FOJC)'. In short, they call for a system of 'horses for courses' with a range of public bodies responsible for providing different classes of public goods and services. In this way, they aim simultaneously to capture the benefits of competition between providers of public goods and to gain the advantages of agglomeration. But in the EU context there are bound to be complications. Taking this reasoning to its logical conclusion, a government's clientele, may not be defined geographically, but functionally, with a complex system of overlapping jurisdictions for different functions, implying a form of functional federalism, as opposed to a purely geographical one. Geography and function might coincide, but then again they might differ markedly. An obvious problem with FOCJ is that the transactions costs for citizens in voting on and holding to account the proliferation of jurisdictions would tend to make the approach implausible.

Fiscal federalism and revenues

Fiscal federalism is also about how to assign the revenues from different classes of taxes. As with spending, there are some fairly well-accepted principles. Thus:

- The highest level of government should be responsible for collecting taxes where there is potential for avoidance by tax-payers shifting their formal location. The reason is that location decisions taken purely for tax avoidance would distort the economy, a good example being taxes on multi-national businesses. In addition, taxing at the level of government that encompasses the activity would lessen the risk of tax competition between jurisdictions leading to a race-to-the-bottom. Such considerations underpin the notion of an EU-wide corporate tax.
- A related argument for centralisation is where the true incidence of the tax within the jurisdiction is very hard to identify. Residence-based income taxes can have this characteristic, since the income may be earned elsewhere, thereby depriving the area of production and favouring the area of residence.
- There is a case for centralisation of taxes that have a spatially very uneven yield because the relevant tax base is, itself, uneven. The justification here is that fiscal or legal factors might distort the market, but there is also a normative argument that light taxes on the rich who are able to avoid their national tax regimes would be inequitable. For example, the imposition of withholding taxes on yields from savings tends to reflect where the savings are deposited: consider why Luxembourg has prospered as a repository of German and Belgian savings and, at the same time, that those Germans and Belgians able to take advantage of the lighter tax regime benefit more than their compatriots who only effectively have access to indigenous savings banks.
- Where the tax base is immobile – typically property taxes – an argument for decentralisation applies, although even here, equity arguments can be adduced.
- For some other taxes, such as sales taxes, decentralisation tends to make sense, provided that the variability in rates is not too great and/or the transactions costs associated with border-hopping are high enough to deter avoidance. In the EU context, the argument for approximation of excise duties and value added tax has been made for precisely this reason.
- Finally, there are revenues which can be said to result directly from Community policies such as the common external tariff of the EU customs union or the activities of EU bodies, notably the European Central Bank. Customs duties are already assigned to the EU budget, though with a collection levy, whereas the seigniorage gains of the ECB (income which is linked to the right of the central bank to issue money) are distributed to members of the euro area, broadly in proportion to their economic weights.

Tax competition has long been a thorny issue at EU level, not least because a possible solution – tax harmonisation – is one of the great taboos. Tax reform is an equally thorny issue, so that it is interesting to consider how, or whether, the inter-governmental structure of public finances affects it. Tanzi (2000) suggests that decentralisation of the public sector can be an obstacle to tax reform because the need for consensus complicates agreement on a more efficient tax system.

Fiscal discipline

Fiscal discipline is, perhaps, one of the most acute problems in many polities. As the public sector has expanded across the world, both quantitatively in terms of share of GNI and qualitatively in the competencies it has acquired, the impact of the public sector on the economy has become ever greater. Government in the heyday of Madison and Hamilton was principally the agent for assuring security, whereas today's public spending is dominated by social expenditure of various sorts. If a government is insufficiently disciplined it can have an adverse effect on macroeconomic balance, the sustainability of public finances and price stability. In addition, there may be distributive implications insofar as indiscipline may systematically favour some groups – especially those able to exert the strongest political power – at the expense of others, while there are also issues to confront about the balance between current and future generations

There has been extensive debate about the structure of government and the overall size of the public sector, often focused around the *Leviathan* thesis put forward by Brennan and Buchanan (1980). An obvious fear about a larger EU budget is that it would feed the Leviathan beast by providing opportunities for the forms of rent-seeking behaviour identified in the literature as giving rise to a public sector that tends to expand. In essence, the presumption would be that a growing EU level public sector would not be offset by a decline at other levels. Indeed, much of the literature has emphasised the benefits of decentralisation of public spending as a means of checking the growth of government. Equally, the literature suggests that even if it is easier to hold to account, local government can be more prone to indiscipline. The key is how different funding mechanisms either reduce incentives for local governments to over-spend or forestall problems by restricting the scope for indiscipline. Rodden (2003), in a careful study, shows that it is not so much the fact of decentralisation as whether the lower tier is financed by grants (in which case it will tend to spend more) or directly by its own taxes (which curtails public sector growth) that determines whether government as a whole grows.

In most cases, local government receives net transfers from other levels, so that the principal challenge is how budget constraints can be made binding. A common solution is the enactment of rules that oblige government to balance its budget.

For example, nearly all US States have statutes that oblige them to adopt a balanced budget – unlike the position that obtains in the EU, where Member States continue to have fiscal autonomy, though the excessive deficit provisions of the Treaty exert a degree of discipline. Mechanisms for curbing the aggregate level of spending include obligation to raise matching funding for any expenditure financed by an inter-governmental transfer, a cap on spending or even the reserve power to take over the functions of any delinquent government.

An important consideration is whether inter-governmental arrangements make it possible for a particular tier or unit of government either to shift the costs of any of its policies on to others, or to secure benefits that have been funded by tax-payers elsewhere. Where the population is mobile and an authority is able to extract taxes from non-residents to fund policies for residents, there is clearly such a burden shift (Inman, 1999). Specific interests may be favoured because they are able to impose their will on the budgeting process.[8] If it is possible for an authority to accumulate debt, there may be a further channel for shifting the burden, to the extent that it can either renege on its debt or can expect to be bailed-out by other governments, whether directly or indirectly. If the unwinding of debt positions occurs over extended periods there may also be a longitudinal dimension to consider, with future taxpayers called on to pay the debt, including through indirect mechanisms such as higher interest rates consequent upon higher inflation.[9]

Block grants allow the lower tier most readily to structure public spending to reflect its own preferences, whereas hypothecated grants will tend to impose the supranational tier's preferences except insofar as the lower tier can then substitute in which case there is no difference. But a matching grant effectively lowers the costs of the supported public good, so that preferences are switched.

Fiscal discipline is, in addition, an issue from a macroeconomic perspective in that if government in aggregate consumes too high a proportion of national income, there will be repercussions for stability, inter-generational equity, and possibly for aggregate productivity. The first arises when, by raising its share of national income, government is unable to balance its income and expenditure, and has to resort to borrowing. If the national debt is then allowed to rise because the government borrows further to service the debt or to roll-over repayment of principal, the debt will tend to accelerate and may reach the point, if not necessarily of bankruptcy, but at which its creditworthiness deteriorates. Inter-generational equity concerns the distribution over time of the costs of financing government debt. If today's government boosts current consumption, it imposes a burden on tomorrow's tax-payers to pay the bill. Equally, if the current generation invests heavily in public capital, but does not allow the debt to rise, future generations will be spared the cost of the assets they enjoy. There is a literature on optimal debt which tries to disentangle these matters, but it is outside the scope of the present report. The salience in a multi-level system of public finance is that overall discipline depends on the autonomy afforded to different tiers of government.

Equity in public expenditure

The issue of equalisation and its impact on equity aims is an important consideration. Net public budgetary transfers can result in substantial flows within countries, typically increasing the disposable income of weaker regions in all Member States, while reducing that of more prosperous regions. Two distinct sorts of mechanism lie behind these transfers: explicit equalisation schemes that 'tax' richer regions to support poorer ones ('horizontal' transfers, of which the German *Länderfinanzausgleich* is the best known); and the interplay of national taxation and social charges, social protection payments and grants from central government to lower tiers ('vertical' transfers). In some countries, the differences come about largely on the tax side, while in others it is the distribution of spending which matters most.

All mature states have some means of directing resources to relatively impoverished constituencies within the polity. For most EU Member States, the commitment is usually to providing a core level of public services, irrespective of the ability to pay off the recipient. In federal systems such as Austria, Belgium or Germany, the mechanism is either block grants from the central government or explicit 'horizontal' payments from richer to poorer sub-national units. In unitary states, the mechanism is more likely to be central provision of services, but with per capita entitlements.

Such systems can have massive effects on disparities in living standards. To give just two examples of specific mechanisms:

- In Sweden, income tax is collected by the county level, but because incomes in different parts of the country vary substantially as a result of differences in the proportion of the population in employment and in average incomes, the yield of the tax is very skewed. To offset this, there is an equalisation scheme which 'taxes' richer counties and transfers part of the tax yield to the poorer ones. The scale of these transfers is huge, with the rich southern county of Skåne losing nearly 10 per cent of its GDP, and the two poorer northernmost counties gaining as much as a third.
- In Germany, the *Finanzausgleich* system is a horizontal equalisation scheme that transfers finances directly from richer

to poorer *Länder*. Following unification it has been complemented by top-down federal transfers in what has been known since 1995 as the *Solidarpakt* which has the explicit aim (see box 2.1) of ensuring financial capacity attains a level of 99.5 per cent of the national average.

In neither case are these the only transfers that support the living standards of poorer areas. Social security payments are generally much higher in poorer areas while total tax paid is lower. Thus, in the UK, nearly 30 per cent of Northern Ireland's income is a net fiscal transfer from other regions. How the money a region receives is used depends on the institutional arrangements which are very diverse across the EU. In Germany, what the Land government does with the resources is left to its discretion, though within constraints implied by national laws such as to provide education. In unitary systems central government typically decides on the level of a public service, then either directly funds, or transfers to local government, the money needed to provide the service. Consequently, the net transfer is the result of agreement to fund specific policies. Such top-down payments do not always reflect the relative prosperity of regions, for example (as in Italy) where some fairly prosperous regions receive high payments to eligible pensioners.

Box 2.1 The German equalisation system

The principal channels through which money is transferred between the *Länder* and between the federal level and the *Länder* in Germany is the German Financial equalisation system, the *Länderfinanzausgleich* which has its legal basis in the *Finanzausgleichsgesetz.* Following unification, the system developed in its current form when the separate systems in East and West Germany were merged in 1995 under the *Solidarpakt.*

These revenues are allocated between the federal level and *Länder* and among the *Länder* through a series of procedures. Much of the largest component of German government revenue (roughly 70 per cent) is *Gemeinschaftssteuern* (shared taxes), comprising income tax, corporate taxes and turnover tax. Income tax is split three ways, with 15 per cent going to the *Kommunen* level and the balance split between the *Länder* and the federal level; corporate taxes are shared equally between the *Länder* and the federal level.

Within the turnover tax, 75 per cent of the *Länder* share is apportioned by population, with the balances reserved for 'financially frail' states. This ensures that the fiscal resources of each *Land* are raised to at least 92 per cent of the average.

There is then a 'secondary' financial equalisation which corrects the primary tax distribution to guarantee equal per capita tax distribution among the *Länder*. For this, a financial strength measure (*Finanzkraftmesszahl*) compared with an equalisation measure (*Ausgleichsmesszahl*) then multiplied by the population number of the respective *Land*. Because of the special requirement of the city states, their population is weighted upwards by 135 per cent. If the equalisation measure exceeds the financial power measure, the *Land* is entitled to financial equalisation designed to raise its financial strength to 95 per cent of the average. This 'horizontal' equalisation operates by determining transfers to or from a *Land* calibrated according to the gap between it and the average.

A further stage then provides for transfers from the federal level to the *Land* designed to top up further for those *Länder* that are below the average or face special circumstances. These are of three sorts:

- Gap-filling grants (*Fehlbedarfsbundesergänzungszuweisungen*): guarantee the poor *Länder* the lifting up of their financial capacity to at least 99.5 per cent of average financial capacity of all *Länder*
- Compensations for special burdens *(Sonderbedarfsbundesergänzungszuweisungen*) to relieve small *Länder* of the costs of 'political management' and new *Länder* of special costs arising from unification (*teilungsbedingte Sonderkosten*) as well as Bremen and Hamburg for budgetary crisis (high public depths)
- Transitional grants (*Übergangsbundesergänzungszuweisungen*) for the poorer west German *Länder* since 1995, but designed to be degressive (minus 10 per cent per year)

The overall result is that the per capita revenues of each *Land* are almost completely equalised. However, there is still considerable discretion in spending.

3. Salience for the EU budget

> *'The conclusion is, that there must be interwoven, in the frame of the government, a general power of taxation, in one shape or another.'*
>
> *Alexander Hamilton: The Federalist No. 30.*

As the EU itself has developed and deepened, the budget has evolved from early beginnings in which it was largely administrative to assume the range of spending responsibilities it now has. In so doing, it is far from obvious that principles of public finance have had much influence on developments, although there have been periodic attempts at more fundamental reform. Nor is there any sign that there will be much change, even with the advent of the new Treaty establishing a Constitution for Europe (TCE), assuming it is eventually ratified. Moreover, many of the problems to which governments elsewhere are subject and which inform much of the debate on the political economy of public finance have little salience in relation to the EU budget. However, while acknowledging that the EU may be a special case in many respects, it is also important, in contemplating any possible reform, to recall that a sound analytic approach can provide useful insights into the potential for problems to arise and shed light on possible solutions.

Much ink has been spilled on the question of whether the TCE is a Treaty or a Constitution, though the more subtle legal minds reject the idea that there is a stark dichotomy. Ackerman (1997) maintains that there is, instead, a continuum between international treaties and federal constitutions, and thus between international organisations and federations and many legal scholars – not to mention eurosceptics – have observed that the EU has tilted a long way towards the federal/ constitutional form. Salmon (2000) notes that a key factor was the way 'the European Court of Justice succeeded, together with the (non-constitutional) courts in the member countries, in imposing an interpretation of the Treaty of Rome that implied the supremacy of European law over national law' in the policy areas covered, especially since the Single European Act in 1987. According to Weatherill (1995), the outcome is a hierarchy of laws similar in style to a federal constitution, especially in the promulgation of regulatory measures. It might have been expected that this would have ramifications for the budget.

Yet one of the ironies is that, in budgetary terms, the EU simply has scarcely moved in a federal direction, nor does the European Commission, for all the criticism thrown at it of over-bearing power, bear any resemblance to a federal-level government. The fact that the Council remains the most powerful of the EU institutions is a reminder that the inter-governmental (i.e. Treaty, rather than Constitution) dimension remains dominant. In the MacDougall report, published in 1977, the view was expressed that European integration leading to a federal union would not be viable without a Community budget of 5-7per cent of GDP. However, a budget of 2 per cent of GDP might have sufficed to reduce disparities among the then EC Member States. It is also worth noting that the MacDougall proposals related to a Community of nine Members with much smaller disparities than in the EU-15, let alone EU-25. Clearly the political challenges of an EU characterised by even greater disparities are much greater. Yet it is obvious that the EU budget was not assigned such a role in decreasing current income disparities, as might have occurred within a federal union. Instead it gradually acquired a rather more restrictive remit to promote the economic development of less-favoured regions.

Goodhart and Smith (1993) argued that MacDougall had failed to distinguish adequately between pure stabilisation and redistribution effects, and had also underestimated the political difficulties inherent in such a quantum change. Nevertheless, there have been other attempts to push the idea that the EU level should extend its role to other 'federal' functions, most notably in stabilisation. Pacheco (2000) surveys the literature on stabilisation and, although he finds that there are very diverse estimates, comes to the view that national budgets achieve upwards of 20 per cent stabilisation and concludes that the EU budget should not be expected to assume the same role as the US federal budget. He highlights the German *Finanzausgleich* as a viable alternative model. What is critical is to understand the nature of the shocks and to distinguish overall insurance from dealing with specific types of shocks.

Proposals for reform of the financing side of the union have, on the whole, been confined to limited debate on whether the EU should be funded by different revenue streams (including the possibility of using a carbon tax or corporate taxes), instead of the current mix of own resources. More fundamental questions of ability to pay or other economic rationales for using different sorts of funding mechanisms have been largely neglected. An important exception is the Padoa-Schioppa report (1987) which put forward a proposal for a progressive contributions system that would reflect the ability to pay of individual Member States. In some respects, the debate on net rather than gross contributions is about 'who pays', but theoretical models of public finance would still distinguish the two concepts, implying that the whole question should be looked at more carefully.

As regards the composition of EU spending, the Sapir report (Sapir, 2004) argued forcibly for a more profound change in the composition of the budget, but stopped short of discussing its scale. Many other commentators have also called for change over the years, although the growing importance within the EU on the 'Lisbon' strategy is providing a focus for new demands on the budget. Yet the paradox in all of this is that the budget seems remarkably resistant to change. Thus, it might have been expected that the conjunction of full EMU and enlargement would create an impetus for far-reaching reform of the budget in the new Constitutional Treaty. Instead, the provisions for the budget are virtually identical to those in the current treaty. As with fiscal co-ordination, the lack of new thinking in both the TCE and the Commission proposals for the next *Financial Perspective* is evident. Moreover, unanimity will still be required to change the budget which, in a Union of 25 and possibly as many as 33 members, make it even less probable that any change will happen.

Fiscal federalism and the budget

Hoeller et al. (1996: 8) sum up the salience of fiscal federalism thus: 'while useful in framing the discussion on the role of public finances in European integration, this literature has a number of important limitations, as it usually explores issues in mature federations with politically-sovereign governments.' Therein lies one of the most intractable problems surrounding the EU budget, which is that the *finalité politique* of the Union is not only far from settled, but is interpreted in different ways by different interlocutors. This has a range of ramifications in thinking about the actual or prospective role of the EU budget.

- First, it raises doubts about whether the supranational level commands sufficient support from the range of constituencies that make up the EU to allow delegation to it of tax-raising and spending powers.
- Second, in a Union characterised by diversity, it may prove to be difficult to agree on the catalogue of public goods and services that are shared in the sense of being provided by the supranational level. If one Member State wants agriculture to be subsidised and a second wants to promote common research activity, while another wants some form of redistribution, these preferences risk being incompatible. They might be capable of being rationalised in a more coherent polity, but struggle to be so in the EU.
- Third, many of the public goods which might be assigned to the highest level in a mature federation are, in the EU context, jealously guarded and often seen as defining features of Member Statehood. Defence is one such area where, despite the obvious economic efficiency benefits of pooled, federal-level provision, national imperatives preclude it. Social protection, similarly, has long been an area reserved for the Member State level. Since these, together with other social policies such as education, are typically the 'big ticket' items in public expenditure, it becomes very difficult politically to justify a change that would result in a quantum leap in the EU role.
- A fourth issue – logically separate from the choices of what policy areas to assign to the EU level, though inevitably the two become conflated – is who wins and loses from competing expenditure assignments. An expedient way of containing this is simply to limit the size of the supranational budget, and it can be argued that despite the regular tussles over net contributions, the problem is an order of magnitude smaller than in federations where wrestling in the pork barrel is routine.

Some public expenditure functions that nations might take for granted, whether for defence or for a range of social policies (including the redistributive components of social protection), become politically highly problematic at EU level. Not only is there an insufficient degree of cross-border solidarity, but there are also political vested interests to consider. It can therefore be argued that any attempt to establish an optimal allocation of public expenditure tasks among tiers of government in the EU, drawing on the theoretical models and insights discussed in the previous chapter, will inevitably be over-shadowed by political constraints. Nevertheless, the case for a more extensive EU role in all three branches of public finance deserves to be explored in more depth and it is important also not to stymie discussion of the economic case because of these political constraints.

EU grants to Member States

A core question about the EU is whether and to what extent there should be payments from the EU budget to Member States or regions. Here, FF argumentation can be of some help. According to Oates (1999), there are essentially three reasons for such grants:

- Internalisation of spillovers and externalities so as to ensure that the 'correct' levels of public spending are chosen. If a jurisdiction cannot reap the benefits of its spending, it will lack incentives to undertake it. Local provision makes most sense where there are no substantial spillovers.
- Fiscal equalisation to boost the capacity of a Member State or region which, because of its stage of economic development or current circumstances, is unable to raise sufficient funds.
- Improving the overall tax system by levying taxes in a less distortionary manner. In the EU context, it could be argued as well that distortions arising from spending (for example state aids offered by richer jurisdictions) also have to be taken into account.

Inter-governmental grants are usually either conditional – that is subject to some form of co-financing or an obligation to conduct the policy supported in a particular way – or unconditional in the 'no strings attached' sense. Where co-financing is required, the theory suggests that it should be linked to the degree of spillover, perhaps with the inter-governmental grant calibrated to match the extent of the spillover. It follows that such grants make most sense when the purpose is to compensate for the presence of spillover.

By contrast, Oates maintains that when the purpose is to achieve equalisation, unconditional grants are best suited to the task. The main justification for equalisation grants is equity, although from an allocative perspective, it can be argued that they can help to level the playing-field. Current EU cohesion policy contains both elements: the underlying aim is to boost the economic development of backward regions and to raise the competitiveness of weaker regions, but there is clearly also a benefit to current incomes (but see the caveat in endnote 4). However, as a number of recent contributions (see, for example, Midelfart-Knarvik and Overman, 2002; Barry and Begg, 2003) to the debate on EU cohesion policy indicate, there is also a concern that ill-judged policies may slow adjustment.

One important consideration is where the jurisdiction paying for the service cannot internalise all the benefits: in this case, the service will be under-provided, an example being transport or communication networks that cater to traffic from outside the jurisdiction. Unless, as with the various Alpine transit routes, the jurisdiction is able to levy user charges, its taxpayers can be expected to balk at financing public goods on which others can, literally, free-ride.

Oates (1999) observes that 'development policies that are sensitive to particular regional or local needs for infrastructure and even human capital are likely to be more effective in promoting economic growth than are centrally determined policies that largely ignore these geographical differences'. Yet weaknesses in local government or governance capacity are often a characteristic of less developed areas, so that even if diversity is desirable, external oversight of policy can be helpful. Targeting better governance of structural reforms is not necessarily confined to weaker regions, as the slow pace in some richer Member States demonstrates. Shah (1998) maintains that accountability has to be regarded as a key part of incentive structures.

Oates (2001: 142-3) sums up the problem succinctly: 'The sense that emerges from a traditional fiscal-federalism perspective on the emerging public sector in Europe is thus an uneasy one. It suggests that the central government is not well equipped to take a leading role in addressing Musgrave's redistribution and stabilisation functions.' Bureau and Champsaur (1992), similarly, argue that the EU is a long way from fitting the models of fiscal federalism and also that the manner in which subsidiarity is interpreted is inimical to the development of a system that accords better with fiscal federalism. They single out the unanimity rule, in particular, as an obstacle. What emerges from this overview is that the EU does not follow the dictates of conventional fiscal federalism in so far as it leaves stabilisation and redistribution largely to the Member States, but does try to engage in allocation decisions.

EU added value

Across the world, as Rodden et al. (2000) note, the 'basic structure of government is undergoing a major transformation' in which the transfer of responsibilities from central government to lower levels is widespread. One of the core principles underpinning fiscal federalism and much of the debate about decentralisation is that competition between jurisdiction is desirable to keep governments efficient. The Leviathan thesis and much of the public choice literature takes this a step further by focusing on the overall size of government.

The EU introduces a further dimension by offering the prospect of what might be called 'upward delegation'. The core to this is deciding in what circumstances the EU level adds value. Salmon (2000) suggests, however, that the conventional fiscal federalism approach may have weaknesses when it comes to analysing the EU because it stresses the wrong dimension of fiscal competition. He posits two forms of inter-governmental competition for comparing jurisdictions at the same level:

- *Mobility-based competition* in which jurisdictions compete for mobile factors of production – the notion of 'voting with your feet' – by offering lower taxes or higher public services for a given level of tax. Such competition tends to be associate with lower levels of public services.
- *Performance-based competition* which concerns the productive efficiency with which governments provide public services. Salmon maintains that such competition is more relevant to holding governments to account and can be a better basis for judging the choice between levels of government, as opposed to horizontal comparisons at the same level. Because the emphasis is on assessing how well a given jurisdiction performs on particular services, it does not preclude a higher aggregate of public provision. Salmon relates this form of competition to

tournaments or yardsticks, but another way of looking at is in terms of the peer-review and benchmarking processed embodied in the open method of co-ordination.

Salmon argues that performance-based competition is also highly relevant for comparing between levels of government, whereas mobility competition is not. However, he notes that different levels may well compete for a specific tax base. The question of who should do what is evidently one that is central to much of the debate on what is expected of the EU and thus what the EU budget should contain. Indeed, a number of the proposals for change concern assignment of competencies. Thus, calls for repatriation of agricultural policy or of regional policy, while primarily motivated by the quest to reduce the budget, also reflect the sense that the EU level is not or (in the case of regional policy for richer Member States) is no longer regarded as the optimal one for delivery of the policy. Conversely, the calls in the Sapir report and elsewhere for a greater emphasis at EU level on growth supporting policies is, at least in part, predicated on the assumption that the EU level can add value.

What should be covered by the EU budget is not just a matter of economic principles, but also calls for a more down to earth assessment of the circumstances in which there is added value from the spending taking place at the supranational level. In its elaboration of the proposals for the next FP, published in July 2004 (Commission, 2004d), the Commission argues that there are objectives and commitments that justify EU spending in a number of areas, and that a lack of connections; a lack of European perspective or a 'lack of synergy between objectives and actions' are all relevant considerations. In dealing with these, the Commission identifies three reasons to justify EU spending:

- **Effectiveness** which is portrayed as the ability of the EU level to deal with policy gaps that only the EU can fill. Examples here include networks or forms of human capital development that benefit more than one Member State. This largely accords with the arguments concerning spillover and externalities in fiscal federalism.
- **Efficiency** in the sense of reducing the unit costs of providing a service, thereby assuring value for money. The Commission, in this regard, highlights pooling of research and reducing duplication of provisions for immigration or civil emergencies.
- **Synergy** between the EU level and other levels of government do implies that the contribution of the EU level can be to ensure that the overall policy effort is greater than the sum of its parts. In essence, this rationale for EU spending implies that coherence can be improved and that the capacity for policy learning or enhancement can be boosted. There is a close parallel here with the presumption underlying the open-method of co-ordination that the EU level can facilitate efficiency improvements by other tiers of government, with cohesion, rural development and external relation cited as examples.

The budget and macroeconomic policy

Macroeconomic conditions play a substantial part in ensuring that countries are able to achieve and improve their potential growth rates and have a marked impact on core EU objectives such as the employment rate and the extent of unemployment in any Member State economy. Yet despite the assignment, under EMU, of monetary policy to the EU level, there are only limited mechanisms for assuring a suitable policy mix, even though in all other monetary unions there tends to be a fiscal counterpart of monetary policy at the highest level of government. In particular, there is no provision for the EU budget to impinge on macroeconomic conditions, except insofar as net transfers affect GNI or conditions imposed on net recipients affect policy choices.

The process of nominal convergence required for entry into stage 3 of EMU involved the stabilisation of exchange rates, the consolidation of public finances, and reduction of the rate of inflation which led to lower nominal long-term interest rates. Efforts to curb government borrowing have been a characteristic of all Member States in recent years, either (for the twelve euro area members), initially in order to meet the convergence criteria for EMU membership, then to abide by the terms of the Stability and Growth Pact, or (in the case of the other Member States) because of self-imposed rules. What is increasingly evident is that the debate on the budget cannot be divorced from macroeconomic questions. The links are of various sorts:

- Empirically, most of the reining-in in public deficits in recent years has been accomplished by reducing public expenditure rather than raising taxes. Typically, cuts in spending fall on areas that are easiest to change such as public investment or discretionary rather than statutory programmes. To the extent that public spending has been more carefully managed, it can be argued that the pressure on budgets may have led to greater efficiency, while part of the cuts in public spending is a direct result of the lower interest rates that have accompanied EMU. But it is also conceivable that the cuts in public spending have diminished the growth potential of some countries and in this regard the overall fall in investment rates is a cause for concern. Two of the euro area laggards exemplify the problem. German public investment was around 2.8 per cent of GDP during the early 1990s, but has dropped to 1.6 per cent since 2001 while in Italy the rate fell from around 3.5 per cent in the 1980s to 2.5 per cent on average in recent years. Given that one of the aims of EU-level spending is to promote growth, it might be argued that a macroeconomic function that the budget could perform would be to boost public investment.

- A second important link is that between the SGP and budget negotiations. As noted in the introduction, it has already surfaced in the immediate German response to the Commission proposals. There may, though, be a case for looking in more depth at how the SGP and national budgets inter-act. On the one hand, those Member States that are substantial net contributors to the EU budget will *ceteris paribus* find it more difficult to adhere to the SGP restrictions than those which are net recipients. Insofar as the purpose of the SGP is to promote sustainable public finances, there would be no reason to distinguish EU net contributions from any other form of public spending. But when golden rule argumentation is put forward to justify some slippage from SGP limits, it could be argued that the growth promoting elements of EU spending might be part of the equation.

- Public expenditure is a key factor in assuring social cohesion. Most governments commit themselves to high levels of service provision, common standards and universal access which mean that even in the weakest regional economies, the population can be assured of a standard of living that reflects social policy objectives. It is also important to note that there is a conceptual difference between expenditure that takes place 'in' a country or region and spending which 'benefits' a territory, wherever it takes place. Both are valid from different political economy perspectives, but for the most part the data that can be collected are confined to the location of the spending rather than its ultimate impact (McLean et al., 2003). In relation to the EU budget, the salience of this issue is that it bears on the true calculation of net contributions. Gretschmann (1998), for example, argues that the indirect effects often dominate.

What does EMU change?

A budget system conceived in the 1970s and developed in the 1980s for a limited range of allocative policies is now confronted by the very different environment of EMU. Although, following the 2004 enlargement, only twelve of the twenty-five Member States are full members of the euro area, it is highly probable that this arithmetic will shift significantly by 2010, the mid-point of the next FP, with at most a handful of Member States remaining 'out'. Moreover, the economic weight of the current twelve members is over 70 per cent of the EU total and all Member States share largely in the 'E' in EMU, if not the 'M'.

Consequently, development of the budget has to be seen through the lens of much deeper economic integration. In what follows, the focus is principally on full EMU, notwithstanding the fact that membership is incomplete at present. Four key fiscal problems that bear on the EU budget arise:

- The first is how macroeconomic stabilisation is arranged, given that the policy framework for monetary union leaves competence for fiscal policy with the Member States, even though there is a single monetary policy.

- Second, the single market – a major constituent of the 'E' in EMU – means that the regulatory environment is increasingly harmonised, with the result that differences in tax can become more telling obstacles to market integration. Yet tax harmonisation is not only off the agenda at present, but has little prospect of being accepted in the foreseeable future.

- A third issue is that cross-border transfers – hitherto exclusively under the label of cohesion policy and thus, at least formally, aimed at economic development rather than redistribution – may start to loom larger in a more closely integrated economy.

- A much broader fourth consideration is that the EU strategy for sustainable development (encompassing the Lisbon agenda) constitutes a new approach to the supply-side of the EU economy which may well warrant supranational funding of major growth-oriented initiatives.

The fiscal arm of macroeconomic policy relies on horizontal co-ordination of budgetary positions mediated through the Stability and Growth Pact and the Broad Economic Policy Guidelines, but has, latterly, been in some difficulty because of the SGP. The SGP was largely pushed through to assuage German fears that fiscal laxity elsewhere (especially in Italy) would lead to inflationary pressures that would be inimical to German preferences. The economic rationale for the Pact was threefold:

- To forestall fiscal laxity that might induce inflationary pressures and lead the ECB to impose tighter monetary policy.

- To encourage fiscal sustainability by keeping pressure on governments to aim for budgetary positions (close to balance or in surplus) that will gradually diminish the real stock of debt.

- To allow for the operation of automatic stabilisers so that when there are demand shocks, there would, ideally, be no need for discretionary policy. The margin between 'close to balance' and the supposedly hard 3 per cent deficit threshold is intended to provide the room for automatic stabilisers to work (Artis and Buti 2000, 2002).

The SGP (see Buti and Pench, 2004) comprises two Community regulations which constitute a preventative arm (surveillance of Member State positions to head off problems) and a dissuasive arm (the excessive deficit procedure which is invoked to oblige Member States that breach the 3 per cent limit to cut their deficits). However, the EU budget has no role in EU fiscal policy and it is also noteworthy that there is no explicit means of co-ordinating the aggregate fiscal position of the euro area members, nor of achieving a conventional policy mix between fiscal and monetary policy.

Stabilisation

The key area in which the EU budget could potentially play a role in macroeconomic policy, especially now that monetary union is a reality, is stabilisation. Under EMU Member States retain competence for fiscal policy, but are constrained by the Stability and Growth Pact (SGP), both in their own interest (to assure sustainable public finances) and to prevent potentially damaging spillovers to other Member States from ill-considered national fiscal policies. Stabilisation of national economies is achieved by the ebb and flow of Member State taxes and public spending at different points in the economic cycle and therefore requires that a sufficient margin is maintained to allow these 'automatic stabilisers' to do their job. By imposing a medium term rule of 'close to balance or in surplus' for public finances in conjunction with the 3 per cent deficit limit, the SGP tries to create such a margin. In this model, there is co-ordination of Member State action insofar as the Pact identifies and enforces good practice. But, as has become apparent, if Member States – especially the larger ones – flout the rules, the scope for fiscal policy to achieve stabilisation is greatly diminished.

The resort to co-ordinated fiscal policy was by no means the only possible route; indeed, the blueprint for monetary union in the Werner Plan set out proposals for the minimum action needed to achieve an effective economic and monetary union. 'For influencing the general development of the economy 'budget policy' assumes great importance. The Community budget will undoubtedly be more important at the beginning of the final stage than it is today, but its economic significance will still be weak compared with that of the national budgets, the harmonised management of which will be an essential feature of cohesion in the union.' [Section III]. While stressing the need to avoid excessive centralisation, the report calls for a 'centre of decision for economic policy [that] will exercise independently, in accordance with the Community interest, a decisive influence over the general economic policy of the Community. In view of the fact that the role of the Community budget as an economic instrument will be insufficient, the Community's centre of decision must be in a position to influence the national budgets, especially as regards the level and the direction of the balances and the methods for financing the deficits or utilising the surpluses'. [Section III] This model still leaves only a limited role for the EU budget in stabilisation, but at least acknowledges its potential contribution.

A third route, routinely followed in mature federations such as the US, is for the federal budget to be the principal vector for fiscal stabilisation. Americans may rail against big government in Washington, but it is clear that the existence of the very large federal budget allows stabilisation in two respects that distinguish the US from the EU. First, the federal budget can be used as a tool of economic management in times of recession, with discretionary spending (and, *a fortiori*, borrowing) reinforcing the action of automatic stabilisers. Many Europeans, since 2001, have looked with envy at the boost to demand from the build up of US federal spending under the Bush presidency, even though the persistence of these deficits is increasingly being seen as a policy problem. Second, federal spending can offset transitory demand shocks in parts of the monetary union. Estimates for the US suggest that the impact of the federal budget is to offset around a third of the negative impact of the shock. It is also important to highlight the risk-pooling aspects of federal level stabilisation, as relative buoyancy in one region can compensate for a downturn in another.

The EU level has no scope within the budget to engage in contra-cyclical policy, but also lacks an institutional forum in which any such decisions on stabilisation could be taken. Even limited stabilisation schemes such as that proposed by Italianer and Vanheukelen (1993) have made no headway. A more developed Eurogroup or Ecofin could become the answer, but is a long way from having the necessary characteristics.

4. Finding a way forward

The shape of the EU budget was settled in 1988 at a time when EMU was still an aspiration, the EU had twelve Members, and the concepts of justice and home affairs and an EU foreign policy were even more distant. Although it looks increasingly as though the EU budget will plod on along the same lines as it has since 1988, many questions still warrant attention. Federal solutions have long been canvassed (see, for example, Biehl, 1985; Spahn, 1992 and 1993), but have been resisted for just as long by the Member States. Yet in the economic rather than the political sense of the word federal, there is much to discuss in the increasingly integrated economic and monetary union that the EU has become.

Because the 2007-13 FP will be a period of transition in a number of respects (notably the progressive integration of the ten new Member States and the likely accession of three more, especially in the light of their incomplete entitlements under the CAP), a case can be made for regarding the current period as one in which it is prudent to postpone more radical change. But however compelling the case for postponement, the fact that there are manifest shortcomings will have to be addressed before long. This chapter, accordingly, appraises the various issues and considers how reforms could be advanced, even if only in an incremental manner. The contention here is that even if the timing is inauspicious, the strategic directions for reform deserve to be articulated and the obstacles to them identified. The first part of this chapter reviews options for the immediate future of the budget, focusing on the Commission's proposals for the 2007-13 FP and the alternatives. The chapter then goes on to consider more radical ideas for the EU budget and its role in the economic governance of the EU as EMU is consolidated.

The Commission's proposals for FP 2007-13

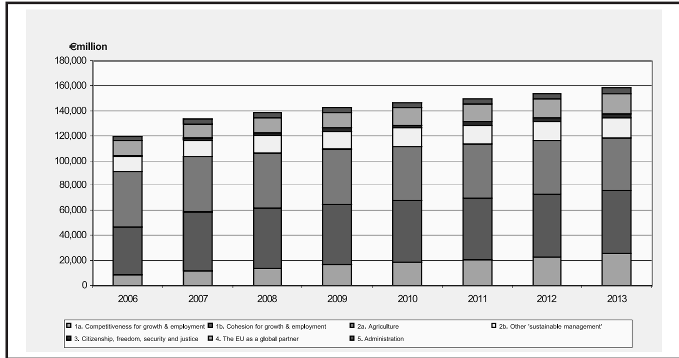
In keeping with precedent, the Commission had to come up with initial proposals for the next budgetary *Financial Perspective*, but in doing so it had to be sensitive to the range of strident, yet incompatible demands from the Member States discussed in the Introduction. Its Communication published on the 10 February 2004, supplemented by further documents produced in July 2004 set out the stall. The main changes put forward in the Commission's proposals for 2007-13 are to the size of the budget and to the broad headings of spending under the FP. Although no change in the own resources ceiling is suggested, the Commission foresees an average expenditure over the seven years of 1.15 per cent of GNI, 0.09 of a percentage point below the ceiling, but well up on the average for recent years. Because GNI itself is expected to grow, the upshot is a 25 per cent increase in the size of the EU budget between 2006 and 2013 – to the dismay of many finance ministers. The Commission also signalled support for a generalised correction mechanism to replace the UK abatement,[10] but seemed unwilling to propose new own resources.[11]

The Commission, as so often before, tries in the proposals for the next FP to emphasise that the aim of the budget is primarily to advance the 'political project', highlighting the importance of making enlargement work and reinvigorating the performance of the EU economy. It also articulates three over-arching priorities: sustainable development; European citizenship and the EU's role as global actor. The rhetoric is flowery:

> *The choices to be made on the next financial perspectives are not just about money. It is a question of political direction, to be made on the basis of a clear vision of what we want to do. These choices will determine whether the European Union and its Member States are able to achieve in practice what European people expect.*
>
> *This means a new phase for the Union's budget. It is not about redistributing resources between Member States. It is about how to maximise the impact of our common policies so that we further enhance the added value of every euro spent at European level.* (Commission, 2004: 4)

Five new headings relating more closely to the 'Lisbon' aims have been suggested, involving two main changes in the FP (see figure 4.1). The first budget line is no longer the CAP, but policies to promote competitiveness 'for growth and employment'. This is explicitly linked to the Lisbon agenda and can be expected to embrace an enhanced research budget, more money for trans-European networks and other building blocks for a more competitive economy (see box 4.1). It is projected to increase by 290 per cent by 2013, compared with 2006, the last year of the current FP (and by 210 per cent from 2007 to 2013). By and large, this is more of the same, although the planned increase in the ceiling for this sub-heading suggests some scope for other measures. The second is the introduction of a new heading covering 'Citizenship, freedom, security and justice', spending on which will increase by 260 per cent between 2006 and 2013 (220 per cent from 2007-13). Although it can be anticipated that the bulk of this spending will be on justice and home affairs, it also embraces such diverse items as EU culture and citizenship. For most of the other headings, more moderate increases are planned.

Figure 4.1: Structure of EU Budget, 2007-2013 Financial Perspective



The immediate reaction to these proposals by several Member States is, as the Dutch Minister of Finance stated, that they are unlikely to command unanimity. Much of the criticism has been about the increase in the size of the budget, with several of the net contributors adamant that the projected 25 per cent growth in real terms is unacceptable. The opposite view was put by Romano Prodi in a speech to the European Parliament, on the day the Commission launched its proposals, when he stated that 'some have argued that the Union budget should not exceed 1 per cent of Europe's GDP. In my view, the problem with this approach is that it puts numbers before the political project. It is like building a house by starting with the roof.'

Box 4.1 The Commission's 'Competitiveness' Objectives

In the Commission proposals, the focus on competitiveness is very strong and appears to represent a significant shift towards policies that will assist the achievement of the Lisbon strategy. Under this heading, financial support will be available, according to the Commission, for the following five ambitions:

- Promoting the competitiveness of enterprises in a fully integrated single market,
- Strengthening the European effort in research and technological development,
- Connecting Europe through EU networks,
- Improving the quality of education and training,
- Social policy agenda: Helping European society to anticipate and manage change.

If the plans are accepted, the allocation of funding under this heading will grow significantly over the seven years of the FP, rising from ¤ 12 billion in 2007 to nearly ¤ 26 billion in 2013. However, it is important to keep these aims in perspective, since even the final year amount would still be only 0.2 per cent of EU GNI. For comparison, one specific 'Lisbon' related aim is to contribute to raising the proportion of R&D spending to 3 per cent of EU GNI from its present level of 2 per cent. But even though the increase under this heading represents more than a doubling of funding, the net new money by 2013 would be only 0.1per cent of GNI, and only part of that would be assigned to R&D spending. Moreover, even with the increase, the ceiling available for this heading would still be only 60per cent of the CAP budget by 2013.

The proposed reorientation of cohesion policies, in which there is a Commission proposal for a *de facto* successor to Objectives 2 and 3 of the Structural Funds (described in the 3rd Cohesion Report as 'regional competitiveness and employment: anticipating and promoting change', also uses Lisbon-ish language. Its rationale, not an unreasonable one, is that 'strengthening regional competitiveness throughout the Union and helping people fulfil their capabilities will boost the growth potential of the EU economy as a whole to the common benefit of all.' But, again, the signals are that it is similar policies to those that went before, albeit with changes in the modalities of policy implementation.

Challenges for the next *Financial Perspective*

Although the door seems to be closed on much change in the EU budget, it is still useful to consider how the next FP might adapt.

The low budget ceiling

The budget ceiling has risen in steps from 1.0 per cent to 1.24 per cent of EU GNI, a figure which was first reached in 1997 and was retained for the current FP. From an economic viewpoint, having such a ceiling makes sense to the extent that it stipulates the share of the EU economy's resources that are assigned to the supranational tier of government. However, from the perspective of planning public expenditure it is more problematic for two reasons. First, since the denominator (GNI) of the ratio is a quantity unknowable in advance – that can, moreover, fall when recession hits or jump in boom periods – it follows that the numerator must also be subject to the vagaries of economic cycles. Second, some of the expenditure of the EU is automatic, notably the price support for agriculture. These rather technical concerns can be dismissed as little more than administrative difficulties.

But more searching questions can be asked about the rationale for having such a small figure for the EU tier's budget. In the EU Member States, total public expenditure ranges from around a third of GNI to well over half in Sweden. Of this, the lion's share is, typically, controlled by the central or federal

government, even if lower tiers are often the agencies through which the spending is done. In the MacDougall report (1977), echoing some of the discourse in the 18th century Federalist Papers, it was argued that account has to be taken of the character of integration: a minimalist budget may be sufficient if only markets are integrated, but monetary integration is a qualitative difference, while integrating security and defence (or social) functions would warrant a further quantum change.

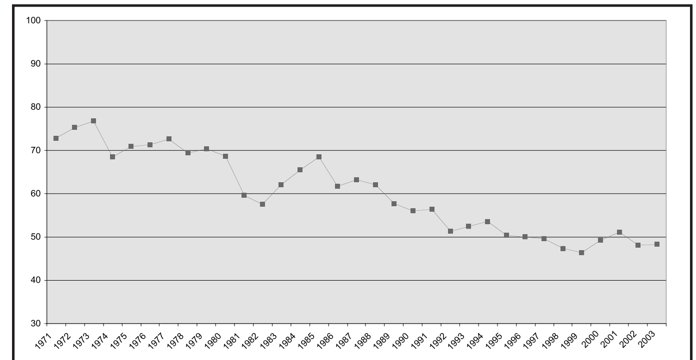
Composition of EU spending

Arguably, the CAP holds the key to rethinking spending priorities. It is a highly visible element of EU spending for the simple reason that it is the one area of sectoral policy that has largely been assigned to the EU budget. Other declining industries (such as ship-building, steel-making, textiles and clothing or coal mining) have, to varying degrees, been supported by governments over the years, but the EU level has made only limited contributions to such financial assistance, usually through special, time-limited schemes.[12] So long as there is a political commitment to support agriculture financially, there will be budgetary implications for public finances in general. CAP looms large in the EU budget because the latter is so small, but it amounts to just 1 per cent of aggregate public expenditure in the Union. Moreover, the deal struck to maintain CAP ceilings for the duration of the FP appears to exclude much change. It would require substantial concessions from countries like France for this issue to be re-opened, though if there were to be a willingness to negotiate, there could be a powerful catalytic effect conducive to progress on other contested issues.

Some have argued that the CAP is evolving to become more akin, for rural areas, to what the Structural Funds are for regions. Yet this is belied by the data. In the 2005 budget, in which it is still expected to absorb 42.5 per cent of the budget (see figure 4.2), the split is 86 per cent for the first ‘pillar’, which comprises support for plant (58.6 per cent) and animal (27.5 per cent) products, and just 14 per cent for rural development. But irrespective of the difficulties of reforming the CAP, it is worth going back to relevant principles.

A starting point is to assert that objective criteria should determine whether it is the EU level or the Member State level that carries out actions. In this regard, some insights can be garnered from the ideas discussed in chapter 2 as to whether the EU level is likely to offer greater efficiency or the prospect of genuine added value compared with the Member State level. Political constraints will inevitably intrude; apart from the usual political constraints on any expansion of EU funding

Figure 4.2: Spending on agriculture as a proportion of EU Budget



and actions, a problem can be that where an economic activity is located has effects on the local economy. That (usually) means that it is attractive to Member States to retain control of the activity, even if there is an objective case for the EU level. It is also important to note that some policies for which it can be demonstrated that there is added value from EU funding and actions may nevertheless be too politically sensitive to assign to the EU budget, however compelling the economic case.

Criteria to justify EU spending

A number of general propositions can be made. Such general principles may apply unevenly to particular policy measures or mechanisms, but can nevertheless be useful in shaping discussion. Some key factors and what they might imply in the EU context include:

- *Costs of producing public goods and services*. If there are opportunities for achieving economies of scale by concentrating the ‘production’ of public goods, or for avoiding duplication by pooling, the unit cost would be expected to fall. This may be true of research, especially basic research, and would justify enhanced EU action in this area. A similar argument can also be made with regard to external border controls, common foreign policy and other dimensions of security. Further, training and/or networking of the most highly qualified workers in the knowledge–intensive industries could be most effectively organised at European level.
- *Spillovers between countries and other externalities.* There are many examples of public goods that are produced by one jurisdiction, but which provide benefits to (or, in some instances, impose costs on) others. If the producing jurisdiction is unable to charge for such benefits and thus to recoup the cost of producing them, the tendency will be for the overall volume of public goods to be under-provided. Concrete examples at the EU level are transport and other networks that can only be justified by central (that is EU level) provision – TENs projects follow this logic, as do certain environmental projects.
- *Fiscal (and possibly also managerial) capacity.* It is generally accepted that when governments have to curb public expenditure, they find it easier to cut or postpone public

investment (where the pay-off is less immediate), than current public services. The EU level can add value in a purely financial sense by 'protecting' public investment: this is more than a cohesion perspective as it focuses on growth. It can also marshall managerial expertise that may be less easy to find at Member State level.

- *Leverage effect on private investment.* Effective public policies will often lead to complementary flows of private investment that promote growth and employment. Bearing in mind the criticisms of the Kok report and the direction signalled by the Commission for revision of the Lisbon strategy, the major gains for growth and unemployment under this heading may be expected to come from regulatory change, rather than direct financing of policies. But insofar as the EU level can ensure – in a way that Member States cannot so easily – that public investment projects (such as TENs) take place, it can help to build up EU economic potential and thereby increase leverage.
- *Innovative and experimental measures.* Even the public sector sometimes has to take risks by trying out new policies – echoing what has become known as 'laboratory federalism' – and this could be a context in which the EU level can try out new approaches. In relation to growth policies, the EU level is probably also in a good position to prompt Member States to try out policies that are not part of their usual repertory or to persuade them away from bad policies. Areas in which the EU level may be especially important are where an effective market solution is distant, or where a costly learning phase of the product cycle inhibits market solutions. Renewable energy technologies or other longer-term investments related to the EU's sustainable development strategy may be fruitful areas for EU action in this category.
- *Enabling and policing of growth initiatives.* The EU has formal competence for competition policy and in doing so has, since the 2003 Monti reforms, relied increasingly on working closely with national authorities. Yet in areas such as co-ordination of growth promoting measures in the Lisbon strategy, the Kok report implies that more might be done to render policy more effective. Task forces or new agencies to facilitate growth and employment might be justified. The Sapir report proposal to develop a European research council could be an example of such an approach.

While it would be easy to draw up a lengthy shopping-list of policy initiatives that could (and possibly should) be funded at European level based on the criteria described above, there is one awkward issue that needs to be highlighted. This is how any such projects should be allocated. For research the obvious answer is to base selection on excellence and there is an equally obvious fear that doing so would tend to favour richer regions and Member States that have the best endowments of scientific infrastructure. Similarly, for trans-European networks, it would make sense to invest where the greatest impact can be anticipated. The risk, however, is that such an approach would discriminate against the less competitive or poorer Member States who would, consequently, be inclined to oppose the strategy. Some thought may therefore be warranted on how to ensure breadth of coverage (possibly by some minimum quotas) or by linking cohesion policy more closely to growth and employment.

The amounts suggested by the Commission for the EU in the world are small, with commitment appropriations of just over 0.1 per cent of EU GNI proposed over the period 2007-13, and even then around a quarter of this figure will be the result of integrating the European Development Fund (EDF) into the main budget. This allocation is supposed to cover neighbourhood policy, wider promotion of sustainable development, development assistance and unspecified security tasks. These are extensive and potentially costly tasks, so that the fundamental question about the EU's role in the world is to what extent it achieves it by co-ordinating and complementing what Member States do, or can only do so by much more visible direct policies of its own.

EU revenues

The principal question about the funding of the EU budget is whether it makes sense to replace a system which, by and large, works by one that would conform better to the Treaty stipulation (article 269, TEC; and retained in article I-54 of the Constitutional Treaty) that the budget should be funded wholly by own resources. As the Commission recently observed: 'It could be argued that despite its weaknesses in terms of complexity, opacity, limited autonomy from national treasuries and the European Parliament's limited political accountability for its expenditure decisions, the present financing system has ensured a smooth financing of the EU budget' (CEC, 2004a: 41). The Commission acknowledges that taking recent trends to increase the share of the 4th resource to a logical conclusion by abolishing the current 3rd resource would greatly simplify matters, but adds that 'financing the budget by contributions of the Member States is adequate for an international organisation such as the United Nations, but it does not reflect the status of the European Union.'

A key concern is that 'the debate on fair burden-sharing among Member States and *'juste retour'* would be brought to the forefront of the European debate even more than at present. There would be virtually no visibility of the financing for EU citizens and it would risk precluding any future re-opening of the debate on fiscal revenue replacing national contributions.' In this spirit, the three potential resources – an earmarked share of VAT (despite the sense of going 'back to the future'),

corporate taxes, or environmental taxes – proposed by the Commission could all become viable and defensible means of paying for the EU. At issue is not just conformity with the Treaty provisions which, implicitly, would mean assigning tax instruments to the EU level, but also simultaneously giving more autonomy to the EU level and, by increasing transparency, helping to make it more accountable. These issues are strongly emphasised in the Commission's report on the functioning of the own resources system (Commission, 2004c) in which it argues, further, that 'because of the absence of any link to and visibility for EU citizens, and the increasing incentive to focus on narrow budgetary concept of 'juste retour', the current system should be reformed.'

The dilemma at the heart of this is whether the transparency and accountability advantages justify complicating the system. One line of argumentation is that if particular taxes are to be assigned to the EU, they would ultimately have to add up to contributions from each Member State that were more or less the same as the current GNI dominated contributions. It does not, after all, take much effort on the part of Member States to work out how much they are (or claim to be) paying through resources assigned to the EU level, such as customs duties. Thus, if there were a political will to establish genuinely owned resources, an equitable burden-sharing could be achieved.

Choice of tax base or taxes assigned to the EU

The economic theory of taxation has identified a range of criteria that can be used in assessing the case for using any particular tax. These include: economic criteria, such as whether the tax distorts markets or the distributive impact of its incidence; and administrative considerations, such as ease (and cost) of collection, or the stability and buoyancy of the tax base. Thus, a tax which is levied only on one sector of the economy would tend to distort spending towards other sectors of activity, while taxes that take no account of ability to pay (poll taxes) are widely adjudged to be unfair to the worst off members of society. Taxes bases which are affected by the economic cycle (corporate profits being an obvious case) will be much more susceptible to fluctuations in yield than those which are intrinsically more stable, such as property.

There might be other reasons for imposing a tax, such as a deliberate attempt to alter patterns of resource use. For example, a levy on energy production (one of the Commission suggestions) might be justified to achieve environmental objectives. Moreover, in appraising the case for using a tax as an EU own resource, further, more political criteria will come into play. Goodspeed (2002) suggests that enlargement will put pressure on income tax rates, because of divergent tax bases, and hints that this could partly be resolved by an EU-level income tax. If the revenue is difficult to apportion between territories, it makes sense to assign it to the level of government that encompasses the base being taxed. As an illustration, central banks derive a benefit - known as seigniorage - from their entitlement to issue currency, but it is not possible to identify whether this revenue accrues from a specific region or component of the economy covered by the central bank. Thus, it might make sense to assign seigniorage to the EU level, rather than the present system under which the European Central Bank distributes the gains to the national central banks. Corporate taxes can be seen in much the same way. The visibility of a tax and the transparency of the taxing arrangements are also thought to be desirable attributes of an EU own resource, as testified to by numerous European Parliament reports. Imposing a new tax, however, would be politically awkward, even if there were a sound rationale for it.

Why not an inter-governmental grant?

In purely economic terms, a sound case can be made for preferring grants. Their principal advantage is that once the 'subscriptions to the club' have been negotiated, both the paymasters (the Member States) and the EU authorities will know precisely what the respective cash flows will be, rather than having to wait to find out how much revenue is raised from particular taxes and whether it matches expenditure plans. The principal drawback is the lack of autonomy, although as the Member States have shown no disposition to allow the EU level to vary tax rates, it is a moot point, in practice, whether transfers mean a *de facto* loss of autonomy. One problem that a grant would obviate is that assigning any tax to finance the EU would require that the tax base in question be sufficiently harmonised in two regards: as between Member States and, if the link to citizens is to be improved, among individuals. This is not a particularly demanding technical exercise, though it would no doubt lead to tough negotiations; but politically, the issue of tax harmonisation is explosive.

Resolving the net contributions dilemmas

Even after the rebate was agreed at Fontainebleau in 1984, the UK remained for many years the 2nd largest net contributor after Germany and it is only since the 1992 reforms of the CAP that the Netherlands, especially, has become a significant

net contributor. In the period since Fontainebleau, UK Treasury sources[13] estimate that the UK has contributed a net ¤ 58 billion to the EU budget, compared with ¤ 29 billion from France. The issue has arisen at every subsequent budget negotiation, but has never gone further, though the Commission is now making the case that much has changed since 1984 and argues that the issue should therefore be re-opened and a generalised system of corrections introduced. A limited abatement was, in fact, granted to Germany in the form of a reduced obligation to contribute to the UK abatement. Then, in 1999, much the same deal was extended to the three other substantial net contributors: Austria, the Netherlands and Sweden. As a result, there are now three classes of Member States: the UK, which receives the full abatement as agreed at Fontainebleau in 1984, as a result of which (simplifying a complex scheme) it receives a rebate of two-thirds of its *ex-ante* net contribution; the four other net contributors who pay only 25 per cent of their *ex-ante* share of the UK abatement; and all the other Member States (including those who joined the Union in 2004), who contribute the balance of the UK abatement. Readers are forgiven in advance for any expressions of confusion.

The Commission concedes that the UK, in the absence of any correction mechanism, 'would probably remain the largest net contributor to the EU budget over the period 2007-2013'. But it also points out that Germany, Sweden and the Netherlands would have net contributions that 'have been and are expected to remain of a comparable order of magnitude ... all these three Member States are currently relatively less prosperous than the UK.' Details of the Commission's proposed generalised correction mechanism were released in July 2004. In essence, the scheme will refund two thirds of any net contribution in excess of 0.35 per cent of a Member State's GNI. This is much less generous than the current UK abatement and, in addition, a cap is proposed on the total amount that can be abated. Recognising that the new scheme would penalise the UK, a soft landing in the form of a diminishing annual payment to the UK is proposed. Illustrative projections suggest that over the period 2008-13, the net fiscal transfers will range from +4.44 per cent of GNI going to Lithuania and 4.43 to Latvia, to –0.51per cent of GNI from the Netherlands. Box 4.2 explains how the proposed scheme would work.

The UK's position has undoubtedly changed in two key respects. First, the UK has enjoyed a faster rate of economic growth over the last twenty years than the EU average. As a result, its relative prosperity has improved markedly since the Fontainebleau agreement was concluded. According to Commission data, UK GNI per capita in 2003, measured in purchasing power terms, was 11 per cent above the EU-15 average, compared with 9per cent below at the time of Fontainebleau. Germany, by contrast, has moved in the opposite direction, falling from some 10 per cent above the EU average in 1984 to 1.5 per cent below in 2003, reflecting the combination of its eastern enlargement (which reduced per capita prosperity at a stroke) and many years of relative economic stagnation. While there are some methodological caveats about how these data are measured, the extent of the relative shift cannot be disputed and the upshot is that the UK has become one of the most prosperous of the net contributors among the EU-15.

The second key development is that enlargement has meant that the new EU-25 benchmark for GNI per capita is some 12 percentage points below that for EU-15. While this is manifestly only a statistical effect rather than a real change, the EU-15 Member States are nevertheless significantly better-off than their new partners. There is also a political commitment to steer a disproportionate share of the EU spending to the new Members. The Commission calculates that because of this redirection of spending, the annual cost of the UK abatement – which has to be met by all other Member States – would be expected to increase by as much as 50 per cent.

Box 4.2 The UK abatement and the proposed generalised correction mechanism

Under the 1984 Fontainebleau agreement, the UK receives an abatement of 66 per cent of its net contribution. Although this is funded by all other Member States in proportion to GNI, four of them (Austria, Germany, the Netherlands and Sweden) only have to pay 25 per cent of their ex-ante contribution to the UK abatement. As a result, all other Member States have to 'fund' proportionally more of the UK abatement.

Under the proposed Commission scheme, if a Member State's net contribution exceeds 0.35 per cent of its GNI, it will receive an abatement at a rate of 0.66 per cent of the excess. In effect, therefore, the Member State would only have to pay $1/3^{rd}$ of its ex-ante contribution once past the threshold.

The abatement would be funded by all other Member States in proportion to their GNI.

However, the total abatement is to be capped at ¤ 7.5 billion a year.

In addition, a transitional period (a 'soft-landing') is proposed for the UK to mitigate the immediate financial burden of moving to the new system.

The impact for each Member State is shown in table 4.1 reproduced from the Commission press release.

As table 4.1 shows, without the abatement (column 1) the UK would make an estimated net contribution to the EU budget of 0.62 per cent of its GNI over the period 2008-13, more than any other Member State. As a result of the abatement its net contribution would fall to 0.25 per cent of GNI, at which level it would only be ninth in the ranking of net contributors. With the proposed reform it would revert to being the large net contributor (as a proportion of GNI), followed by the Netherlands, Germany and Sweden (column 3 of the table). Once the proposed transitional relief is taken into account, the UK's position is slightly improved, putting it just below the Germans and the Dutch in net contributions. Perhaps surprisingly, the Commission estimations point to only very marginal gains for the poorer Member States from replacing the current system by a generalised correction mechanism: their net receipts would be increased by barely 1 per cent. Instead, what the change largely does is to rebalance the burden among the richer Member States: without the transitional relief the net contribution of the UK doubles, while those of the other richer Members fall by around 10 per cent. This is hardly arithmetic that is likely to persuade the UK to forgo Maggie's legacy.

Moreover, in its elaboration of the future financing plans, the Commission pours cold water on the idea that curbing the size of the EU budget would ultimately attenuate net contributions. It notes that the October 2002 deal on agricultural ceilings and the expectation that cohesion expenditure to support the new Members (still the biggest components of the budget) would be unlikely to be cut, so that if the budget is to be reined back to 1 per cent of EU GNI, 'the reduction could only be achieved by drastically cutting the other non-agricultural expenditure going to the EU-15 and/or external expenditure that does not enter in the calculation of net balances.' The assumption that agricultural spending is ring-fenced may not be tenable, and to this extent the Commission assertion is open to question, but equally it is hard to escape the conclusion that any cuts from what is planned could well diminish EU spending in areas that the net contributors would be most reluctant to see diminished. This has the makings of an immovable object/irresistible force dilemma. But it is nevertheless clear that the issue will not go away.

Table 4.1 Estimated net budgetary contributions (average 2008-2013, per cent of GNI)

	Without Correction	Current UK Correction	GCM with -0.35% threshold & cap at ¤ 7.5Bn	Proposed GCM + transitional period
Belgium	1.32%	1.21%	1.26%	1.26%
Czech Republic	3.26%	3.17%	3.20%	3.20%
Denmark	-0.20%	-0.31%	-0.26%	-0.26%
Germany	-0.52%	-0.54%	-0.48%	-0.49%
Estonia	3.85%	3.76%	3.79%	3.78%
Greece	2.25%	2.16%	2.19%	2.19%
Spain	0.32%	0.23%	0.26%	0.25%
France	-0.27%	-0.37%	-0.33%	-0.34%
Ireland	0.56%	0.47%	0.51%	0.50%
Italy	-0.29%	-0.41%	-0.35%	-0.36%
Cyprus	-0.28%	-0.37%	-0.33%	-0.34%
Latvia	4.51%	4.40%	4.45%	4.44%
Lithuania	4.50%	4.41%	4.44%	4.43%
Luxembourg	5.89%	5.80%	5.83%	5.83%
Hungary	3.15%	3.06%	3.09%	3.09%
Malta	1.16%	1.06%	1.10%	1.09%
Netherlands	-0.55%	-0.56%	-0.48%	-0.50%
Austria	-0.37%	-0.38%	-0.41%	-0.41%
Poland	3.85%	3.76%	3.79%	3.79%
Portugal	1.60%	1.50%	1.54%	1.53%
Slovenia	1.40%	1.31%	1.34%	1.33%
Slovakia	3.36%	3.27%	3.30%	3.30%
Finland	-0.14%	-0.25%	-0.20%	-0.20%
Sweden	-0.47%	-0.50%	-0.45%	-0.46%
United Kingdom	-0.62%	-0.25%	-0.51%	-0.46%

Note: the sizeable net gains shown in this table for Belgium and Luxembourg reflect expenditure on EU administration which is disproportionately concentrated in these countries. It is often argued that this is money spent 'in', but not 'for the benefit of' the Member State and should not therefore be counted as part of the net contribution, though a counter-argument is that, because of population related spending, both countries do, in practice, benefit substantially from having the institutions on their territory. The point, clearly, is moot.
Source: Commission Press Release IP/04/908, 14th July 2004

Is all of this enough to justify an end to the UK abatement?

The Commission's proposal is an artful attempt to confront the perceived inequity of the continuation of the UK abatement. A Commission press release, dated July 14th 2004, argues that although the 2004 enlargement will entail a shift of expenditure towards the new Members, 'only the UK will be largely shielded from the extra cost thanks to the rebate, funded by all its partners including by the poorest Member States.' This statement is somewhat disingenuous in that it glosses over the partial abatements gained by the four other Member States in 1999 and the fact that the 'poorest' all receive substantial net inflows in spite of the UK rebate.

Two comments can be made about the proposed new system. First, it would be somewhat more fair than the current system, insofar as net contributions would be more closely aligned with relative prosperity, even though some striking anomalies remain. Ireland, despite its recent ascent up the league table of prosperity, would continue to be a substantial net beneficiary, to the tune of 0.50 per cent of GNI. Second, the UK, which has a cast-iron veto, has no obvious reason to accept the proposal, with the implication that it is likely to lead to an impasse. More fundamentally, the new correction mechanism, while a valiant attempt to deal with an intractable problem, does nothing to deal with the underlying anomalies. The imbalances arise because the decisions on EU policies give rise to an uneven incidence across Member States of EU expenditure. If the policies are well-conceived, they fulfil EU objectives and there is no *a priori* reason for them to be evenly spread across the Member States, so that differences in net contributions are inevitable. Thus, the choice of policies determines the net balances, but the corollary of any form of abatement is that the decisions on spending have to be revised to reflect the need to abate. If, instead, the principle were to be to achieve a net transfer to or from each Member State that is broadly *juste*, the answer would be to establish a system of block grants. The least prosperous Member States might expect a net gain of up to 5 per cent of GNI, whereas the club fee for the richer could be set at a net cost of, say, 0.35 per cent of GNI. A pure equalisation scheme of this sort would, necessarily, mean that direct EU level funding of policies such as the Structural Funds or the CAP would cease to be EU level expenditure policies, as the block grant would imply devolution. The EU level would, however, remain responsible for policing the rules through competition policy and controls on state aids.

Administrative issues

The medium-term framework afforded by the *Financial Perspective* is generally believed to provide an important discipline on the EU budget, but has latterly been seen as too rigid, insofar as it permits hardly any reallocation among the broad headings of expenditure. To counter this lack of flexibility, the Commission has come up with a proposal for 'a combination of existing instruments with a new *reallocation flexibility* to replace the existing 'flexibility instrument'.' The intention is to allow sums to be shifted from some headings to others, though without compromising multi-annual programmes such as those envisaged under cohesion policy. However, in what appears to be a recognition of the realities of *juste retour*, the Commission also states that 'these, of necessity, must be pre-allocated between Member States at the beginning of the period'. Thus, the Commission proposals go some way to remedy the problems by allowing for a greater degree of flexibility, yet what is envisaged remains pretty rigid, if only because of the length of the FP.

A long-standing distinction has existed between what has been called 'compulsory' and 'non-compulsory' spending in the EU budget. Formally (as described in the inter-institutional agreement) compulsory expenditure is 'such expenditure as the budgetary authority is obliged to enter in the budget by virtue of a legal undertaking entered into under the Treaties or acts adopted by virtue of the said Treaties.' Non-compulsory expenditure has the characteristic that the European Parliament is entitled to propose variations (within quite tightly drawn limits) in the amounts proposed annually by the Council and has the final say. However, in many cases it can be argued that there is nevertheless a treaty commitment: cohesion, after all is a treaty obligation and the instrument of the Structural Funds is defined in Art. 158. The dichotomy between compulsory and non-compulsory is not an especially sensible one and is widely criticised (see, for example, Molander and Gustafsson, 2003) who take the view that 'the only intellectually defensible position is that the distinction be eliminated'.[14] The difference between these two categories has less to do with any conceptual distinction than the straightforward political question of where power lies. This should disappear if the new Constitutional Treaty is ratified.

The distinction in the FP between appropriations for commitments and appropriations for payments is another of the curiosities of the EU system. Commitments are higher because they include margins for expenditure that might occur in later years rather than actual spending. It is an open question whether this rather arcane distinction matters. The

own resources ceiling of 1.24 per cent of GNI relates to appropriations for payments, with the corresponding figure for commitments deemed to be 1.31 per cent. Molander and Gustafsson (2003) argue that there is little point in continuing to distinguish between commitments and payments, suggesting the answer would be to move to a single 'cost-based approach'. They include this in an extensive shopping-list for accounting reforms and it is hard to see why not.

The Commission proposals for the next FP envisage a rise by 2013 to 1.15 per cent of GNI for appropriations for payments, but as high as 1.27 per cent for appropriations for commitments. On average, the gap between the two measures is 10.4 per cent over the seven years of the FP, though there is little by way of explanation in any of the documents published by the Commission. This disparity reinforces the case for looking afresh at why the two measures continue to be distinguished and how to interpret the way the gap varies: it ranges from barely 2 per cent in the second year of the new FP (2008) to 16 per cent two years later. In the *Agenda 2000* proposals issued in 1997 (and thus at the same stage in the previous cycle as the February 2004 proposals in the current round) for the 2000-06 FP, the difference between the two measures is, on average, only 3.2 per cent. The inference to draw is that the Commission has sought to build in a much greater negotiating margin this time, although the ploy has clearly been rumbled by the Member States most anxious to curb the scale of the budget.

One adjustment that is unlikely to elicit much opposition is a proposal to integrate what is currently known as the *European Union Solidarity Fund*, created in 2002 and outside the framework of the FP, into the EU budget. Its main purpose is to provide financial means for responding to major disasters or contingencies.

Beyond the immediate debates

The EU exerts its influence on Member States in three conceptually distinct ways. In the broadest sense, these activities constitute provision of public goods. They are:

- Regulatory interventions which set the framework for other economic actors, notably by shaping the EU internal market. The style of regulation and the associated tasks of assuring compliance and sorting out disputes are critical public activities. Although, in many policy domains, these activities have been wholly or partly turned over to the EU level, they do not entail public expenditure other than for administrative costs.
- Direct funding of public goods does require public expenditure to support the provision of these goods, hence the heads of expenditure outlined above and which have dominated EU spending since the late 1980s.
- Fostering co-operation among the Member States but with the backing neither of the hard laws (directives, etc.) that underpin regulatory activity, nor the leverage of direct financing. The onus in this instance is on the Member States to deliver the agreed catalogue of public goods by whatever means are appropriate.

The choice between these three 'modes of governance' is by no means set in stone and in any debate on the future financing of the EU, there is clearly room for re-balancing the mix of modes. To quote Buti and Nava (2003) 'the present EU budget is inconsistent with the current state and future prospects of European integration.' For Buti and Nava, the three principal flaws are that it is too heavily weighted towards 'a declining sector, agriculture'; it is too rigid; and it is of the wrong scale. However, by focusing on the modes of governance question, one can go further to ask not just how much should be spent and on what, but also whether the desired public good is being delivered by the most suitable means.

An ambitious medium- to long-term way forward, advocated by Buti and Nava (2003: 26), is to 'move towards a truly European Budgetary system where EU and national budgetary processes are closely aligned and an effective vertical coordination occurs in areas of common intervention'. What they propose is that rather than the national budgets being set virtually without reference to the EU level, the processes of producing national budgets and national stability plans should be much more closely co-ordinated with the EU budget. In their schema, 'Member States and EU institutions would decide together how to translate their common policy priorities into global budgetary commitments and how these commitments are shared between the national and the EU levels'. They cite as an illustration, the EU's commitments to pledge 0.7 per cent of GDP to development aid and (as part of the Lisbon agenda) to boost spending on R&D to 3 per cent of GDP and argue that all of the former and a sizeable chunk of the latter could be most efficiently carried out by the EU level.

While the proposal is a beguiling one, there are obvious drawbacks. First, such a system can probably only work effectively if all Member States are agreed that the area of spending is worthwhile and that the burden can be fairly shared. In the development aid case this could, indeed, hold: if all Member States are going to earmark 0.7 per cent of GDP for such aid, they should be indifferent to whether it is

the EU level or the Member State level that channels the spending and if it is the latter, then there should be greater potential for more efficient policy delivery, if only by avoiding bureaucratic duplication. In addition, there would be nothing to stop a more generous Member State spending more. However, if poorer Member States start to argue that a contribution proportional to GDP is unfair and that there should be some degree of progressivity, or if there are wrangles about what projects or recipients to support (especially when there is the prospect that the aid will induce exports from the donor countries, and such exports may be unevenly distributed amongst Member States), even in so straightforward a case, consensus could unravel.

Second, building the political agreement would be fraught for well-rehearsed reasons. A third, related concern is that there is a visceral distrust in so many Member States about the capacity of the EU level to conduct its spending efficiently and with probity. Even though the extent of fraud is relatively minor in practice and, in any case, far more often the fault of Member States rather than the Commission, it casts a long shadow.

5. Concluding comments

A nation cannot long exist without revenues. Destitute of this essential support, it must resign its independence, and sink into the degraded condition of a province. This is an extremity to which no government will of choice accede. Revenue, therefore, must be had at all events.

Alexander Hamilton: The Federalist No. 12

If the EU budget were being designed from scratch it certainly would not look like what was proposed by the Commission in February 2004. To put it the other way round, the proposals for the future financing of the EU and the scope of debate on what it should do have largely been shaped by the past, stretching back to the decisions taken in 1971 that put spending on the CAP at the heart of what the EU funds. Similarly, the scale of the EU budget has been largely fixed since the Delors I package that recast the budget in its current form. Neither the move to full EMU nor the doubling of the number of Member States has prompted a fundamental rethink – though many would assert that it should. Instead, the arguments today are about a fraction of a percentage point of GNI: should the budget grow to 1.15 per cent as the Commission proposed in February, or be held at or even below (depending on whether it is the payments or commitments aggregate) 1 per cent as demanded by the group of six? A substantially larger budget, as advocated over a quarter of a century ago in the MacDougall report, let alone EU level spending that approaches the top-level share of GNI of even the most decentralised of federal polities such as Switzerland, is widely regarded as unthinkable.

The reasons for this vast disparity are not hard to identify. A number of Member States remain profoundly suspicious of the EU level as a political entity, see no reason to cede spending competencies to it, and remain highly dubious about its capacity to be sufficiently disciplined to be entrusted with more money. Consequently, they want to restrict it to clearly defined expenditure and to debunk the idea that the EU should assume the sorts of functions that the federal level exercises in other polities. In essence, the rhetorical question, 'what is the EU for?' has yet to be convincingly answered and that ambiguity pervades discussion of the budget, putting the quotation, above, from Hamilton in context. It is confined to being an agent, arguably in the same way as, in many systems, local government has become the agent for implementing policies decided by the central government. As a result, it becomes easy just to quibble about adjustments at the margin, rather than to look afresh at what the role of the supranational level could or should be in European public finances. If it is correct to portray the EU as a government entity that is akin to a supranational local authority in its autonomy and scope of responsibilities, then the 'what is it for' question can partly be answered.

An answer to 'what could it become?' is more difficult, as it is ultimately trapped between an illogical status quo, an apparently unattainable ideal and ambitions beyond its means. Drawing on the discussion in chapter 2, it might be thought that a reconfiguration along federal lines would be the answer, not just for economic efficiency reasons, but also to enhance accountability and to improve choice for citizens. The point is emphasised by Frey (2000) in relation to devolving power when he asserts that 'the basic idea of federalism is that the preferences of individuals can better be met by decentralising government activity.' If the logic is extended, what might be called 'upward decentralisation' is clearly an important aspect of what the EU is about.

The advent of monetary union is plainly a significant development insofar as it obliges the EU – or at least the euro area[15] – to confront the challenges of integrated macroeconomic policy-making. A first key conclusion of this report is that a more radical review of EU public finances to reflect this substantially changed economic environment would now be timely. Yet it is by no means obvious what the best way forward is. EMU, like any macroeconomic system, requires policy machinery to ensure effective steering of the

economy and no-one would dispute the central role of budgetary policy in macroeconomic management. The disarray in the Stability and Growth Pact and the growing doubts about whether loosely co-ordinated national budgetary policies can be enough bring the whole question more sharply into focus. *Government économique* as advocated by the likes of Boyer (1999) may still be a controversial and (for now) implausible proposal, but deserves closer examination.

The key choices

As the EU becomes more deeply integrated, and despite the deeply-held *political* reservations, the *economic* case for a true 'federal' budget will become stronger, suggesting a more extensive role for the EU budget across a range of governance functions. Manifestly, it is unrealistic to expect change to occur rapidly or easy, but it is still instructive to explore the options and to speculate on how the apparent deadlock might be broken.

The obvious bid deal is CAP reform in exchange for and end to the British rebate. Even though the character of CAP spending has evolved considerably as a result of the MacSharry and Fischler reforms, and there is now a shift of emphasis towards rural development rather than pure support for agriculture, the level of real expenditure on the CAP has proved to be remarkably resistant to change. The deal to maintain the real value of agricultural ceilings until 2013 appears to prolong this tradition and a corollary is that unless there is a sea-change in the position of agriculture, very little can change elsewhere in the budget. Moreover, despite an appearance of moving towards rural development, the first pillar – price support and direct payments to farmers – of the CAP still accounts for over 80 per cent of the CAP budget. This is in many ways the nub of the problem: to begin a process of budget modernisation it is essential that some of the sacred cows be offered up for slaughter, but to stretch the metaphor, those for whom the cows remain sacred are not about to change their faith.

While it might be possible to generate a little room for manoeuvre by trimming the Structural Funds, especially in EU-15, the richer Member States have already indicated that the *quid pro quo* would be lower gross contributions. Small amounts could also be found by bearing down on administrative costs or by taking an axe to some of the diverse budget lines that currently make up 'internal policies'. But even a determined and ruthless approach to all of these would not even yield 0.1 per cent of GNI. Consequently, if the CAP cannot be cut and there is a case for broadening the scope of what the EU finances, the only realistic alternative is to increase the size of the EU budget. This is the point at which any discussion immediately grinds to a halt: going beyond the magic number of 1.24 per cent of GNI is, simply, regarded as heresy. Yet it need not be if it is acknowledged that a different, more optimally configured inter-governmental division of labour could conceivably mean that the public sector as a whole is able to produce public goods and services more effectively and efficiently, and without increasing the share of the public sector in GNI.

Immediate priorities

Where a convincing case can be made that the EU can add value, the obvious areas for additional spending at the EU level would be on growth related policies, on external action and on some aspects of internal security. The shortcomings in EU economic performance have been analysed in a succession of reports, the most recent of which was the Kok report on the Lisbon strategy (Kok, 2004). There is a fair degree of consensus on the underlying problem: EU growth has been too slow and needs to be boosted, going beyond the growth initiative launched in 2002. The diagnosis goes on to identify too much regulation, rigid labour markets and an array of other supply-side weaknesses. Re-orientation of the EU budget to underpin Lisbon objectives is, at least for some Member States, seen as a necessary change.

In addition, the EU is increasingly being called upon to punch its weight in the international community, a call that also has spending implications. With only 0.1 per cent of EU GNI envisaged for the 'EU as a global player' heading under the Commission proposals, it is evident that it cannot be that effective. This allocation is supposed to cover neighbourhood policy, wider promotion of sustainable development, development assistance and unspecified security tasks. These are extensive and potentially costly tasks, so that the fundamental question about the EU's role in the world is whether it achieves it by co-ordinating and complementing what Member States do, or by much more visible direct policies of its own. To put the development assistance and security issues into context, the target set by the UN for the Millennium Development Strategy is that developed countries should spend 0.7 per cent of their GNI on development assistance, a target which is a long way from being attained, other than by the Nordic countries. If the EU level were to contemplate making up such a gap by raising Community expenditure, a quantum leap in the size of the budget for external policy would be needed.

The UK position

For the UK, the budget negotiations will present an awkward political choice. On the one hand, the arguments being marshalled against a continuation of the Fontainebleau abatement are, objectively, now pretty compelling. Indeed, the propensity of UK ministers to berate other Member States for their lack of progress in structural reform (and the resulting slow growth) highlight the superior performance of the UK economy and support the case for the UK to contribute more. Among the new Member States there is particular dismay about having to pay towards the UK abatement, even if the reality is that they receive in one pocket much more than they have to pay out (to the UK) from another. On the other hand, as the House of Lords (2005) says again in a balanced report just published, the factors that gave rise to the unfair burden in the first place have not disappeared – notably the continuing high expenditure on the CAP which discriminates systematically against the UK. Moreover, all the simulations carried out by the Commission in relation to its generalised correction mechanism show that the UK would revert to being the largest net contributor, even with the proposed 'soft landing' arrangements.

It has often been said before, but still needs to be reiterated: unanimity means that the UK must agree to forgo the abatement and there is nothing the other Member States can do to change the position without the UK's agreement. That said, a 24-1 vote would be uncomfortable for the UK at a time when it is seeking to encourage other Member States to intensify structural reforms and, more generally, to increase its influence on EU decisions. But the UK also knows that it has a great bargaining chip and will want to use it to best effect.

The longer-term perspective

Although much of the current debate centres on the UK rebate and on the demands of the six to cut the EU budget, the longer-term role of the EU budget warrants attention. Political obstacles to EU spending on core social policies are likely to remain insurmountable, but the notion of social Europe remains a powerful one in many Member States. Indeed, one of the ironies of the discourse around ratification of the new Constitutional Treaty is that many are dismayed that Europe does too little, not too much. If this viewpoint were to prevail it would necessarily have budgetary implications at some point. Similarly, in the area of international development, there is a case for exploring the possibility of setting up an EU-wide International Finance Facility, like that proposed by Gordon Brown. This could operate at the EU level and see interest payments being made by the Member States.

From the point of view of ensuring that financing is adequate, the EU's system works well. Indeed, as the House of Lords report observes, the switch away from particular taxes to GNI-related payments, means that it is easier to calibrate exactly what each Member State pays. But this is only true in a pure book-keeping sense. What is less satisfactory about the system is its political dimension. Only Member State Finance Ministries, rather than individual tax-payers have a clear view of what is paid, so that the system lacks democratic accountability, hence the suggestion that the EU is close to being *representation without taxation*. Some also argue that inter-governmental transfers accentuates the focus on *juste retour.*

Gross contributions from Member States are currently proportional to GNI, but the case for some progressivity in payments ought to be explored. This could take the form of bands according to prosperity and might be one way of defusing the friction over net contributions. Ironically, a progressive system would work most easily with a pure inter-governmental transfer such as the current 4th resource.

Technical solutions to the problem of net contributions are pretty easy to find. The problem is how to decide on the political parameters to adopt or, to put it more bluntly, who should win or lose. Budgetary imbalances arise from collective decisions on what the EU budget should finance and the uneven incidence of such spending arises for three distinct reasons: either deliberately, because the policy is designed to spend more in some Member States than others (cohesion policies, which favour countries with relatively low per capita GNI), or as a by-product of the design of the policy (agriculture where countries relatively specialised in the sector benefit) or the rules that govern allocation of scarce resources such as competition for funding (research policy, where the countries with the greatest capabilities are likely more often than not to be beneficiaries). Trying to correct budgetary balances *ex-post* through correction mechanisms is an illogical approach to public finance – even if it has proved to be politically necessary. One tenable view would be that if the policies are justified and have been supported by all, then Member States should accept the financial consequences and not expect a *juste retour.*

Last word...

The 2007-13 FP already looks as though it has to be qualified as a transitional one in which very few substantial changes are introduced and, as a result, more fundamental reforms are simply postponed until the next time. Consequently, it is probably only in the FP beyond 2013 that more far-reaching changes can be introduced, although that is not a reason either to silence debate or to spurn the opportunity to develop a strategy now for modernisation of the budget. While this may seem politically expedient, the risk is that the full debate that should be going on will simply be closed down again until the same point in the next FP cycle, at which point it will all, again, look too difficult.

To forestall such an outcome, this report calls for a process aimed at securing far-reaching reform of the budget to be initiated now. A *groupe de réflexion* with a wide-ranging mandate should be established and given the task of proposing specific changes in all aspects of the EU budget. A mid-term review of the FP would also be a worthwhile innovation and should countenance significant recasting of the FP to reflect emerging priorities. More generally, what is needed is a willingness to accept that the budget is, as Marco Buti and Mario Nava put it, 'a historical relic' and to recognise that it is vital to devise an EU budget that plays its proper role in EU governance.

Musgrave (1997: 67) puts his finger on the dilemma confronting the EU budget in commenting that the choice of jurisdiction to carry out a particular public finance task can be summed up in 'the question, very much with us today, of how closely-knit a nation the member jurisdictions of the federation wish to form'. If we replace the word 'nation' by 'union' the question is highly relevant to the EU as it moves forward. Can we at last offer a convincing answer?

Appendix

Comparative experience

Federal systems for assigning public finance among tiers of government have, not surprisingly, evolved in very varied ways, and conform only partly to the ideal-types of fiscal federalism. None really provides a convincing model for the much looser form of integration of the EU, nor of what the EU might become with significantly deeper integration. Many of the problems to which governments elsewhere are subject and which inform much of the debate on the political economy of public finance have little salience in relation to the EU budget. But the experience of existing systems raises a number of well-rehearsed issues that might arise for the EU and in contemplating any possible reform, the potential for such problems to arise does, at least, have to be considered.

Germany

Some of the constraints in the German constitution oblige the federal level to ensure that inter-governmental transfers assure common standards of provision of public goods and services across the *Länder*, whereas in other systems, more responsibility is placed on the local level. In cases like the German one, the problems of control can be more acute.

As a large economy, similar in many ways to the EU in having the same order of magnitude in number (sixteen) and range of prosperity of its constituent States, Germany ought to be a model for how the EU might function as a fiscally federal system. The sub-national level undertakes the bulk of public spending and has well-defined exclusive competencies that could be said to reflect the dictates of fiscal federalism; there is an established system for equalisation; and tax assignment ensures that the residents of a jurisdiction have the means to hold government to account. The German system has, too, shown that it can accommodate a sizeable enlargement, though not without going through some soul-searching.

Rodden (2000:1) argues, however, that the German system 'displays few of the well-known virtues of fiscal decentralisation. On the contrary, the rising costs of German-style fiscal federalism are among the most important barriers to improved efficiency in the German public sector.' His view is that soft budget constraints, aggravated by the willingness of the federal government (often for short-term political advantage) to bail out *Land* governments that allow deficits to rise, led to a crisis in inter-governmental fiscal relations that would not easily be settled. The fact that Germany, since the early years of the euro, has consistently had difficulty in conforming to the obligations of the SGP reinforces this view, even though a number of reforms have been achieved.

The German system has the following key characteristics:

- A comparatively large public sector, with general government revenue averaging 45 per cent of GDP in the period 2001-5 (almost exactly the EU average, but slightly lower than in the late 1990s) and general government expenditure running at over 48 per cent.
- As a result, the general government deficit has been above the SGP 3 per cent threshold for a number of years and public debt, already above the Maastricht reference value of 60 per cent in the late 1990s, has risen a little further.
- The division of public spending among the tiers of government in recent years shows the federal level accounting for around 40 per cent and a little less for the *Land* level, while the local level spends around 20 per cent of public expenditure.
- Taxes are set at uniform rates for all *Länder* and then allocated according to carefully balanced formulae that reflect population and fiscal capacity; but only a relatively small proportion of taxes is 'owned' by lower tiers. This tends to limit the link between the jurisdiction and the populations, with negative consequences for accountability.
- Equalisation is a prominent feature of the system and functions through three distinct channels: tax sharing (vertical equalisation); the well-known *Finanzausgleich* which takes from richer *Länder* and redistributes to the poorer ones (horizontal equalisation); and federal expenditure programmes that favour poorer *Länder*.
- Overall, the German system ensures that public service provision is pretty uniform across the country, irrespective of the ability to pay of localities.

The various equalisation measures are extensive, assuring virtually complete equivalence of fiscal capacity across the *Länder*. As a result, there are limited incentives for efficient tax collection and there is, at best, only an indirect link between spending decisions and the burden of financing. Spahn (2001: 15) observes 'that the *Finanzausgleich* and the federal grants soften any hard budget constraint there may be at the state level, which entails economic inefficiencies and waste of public resources.' Spahn also argues that the system tends to raise general government indebtedness and notes that, contrary to what might be expected, the empirical position is that those länder which receive net inflows from equalisation, have nevertheless seen their indebtedness rise more rapidly than the net contributors. In similar vein, Spahn and Franz (2000) appraise the balance between solidarity and subsidiarity in German inter-governmental fiscal relations, and

conclude that the balance has now swung too far in favour of the former. This, they believe, would allow Germany to realise gains from a greater degree of competition among its jurisdictions – perhaps along the lines of laboratory federalism – helping to raise the overall efficiency of the public sector.

Canada

As Bird and Tassonyi (2000) observe, 'Canada is one of the most decentralised countries in the world.' The ten provinces, which vary in size by a ratio of a hundred to one, undertake most social policy, and have considerable autonomy in deciding on the mix and rates of taxes. The provinces are also able to borrow without restrictions from central government, a freedom that some commentators assert might harm overall fiscal discipline, although there is little sign that it does in practice. Despite the substantial autonomy accorded to lower tiers, there is a substantial net transfer from central government to the sub-national level, and a commitment to equalise resources available to different provinces. Bird and Tassonyi (2000) note that these transfers are not only largely unconditional, but for 'some provinces such transfers are more important sources of revenue than their own taxes...These are all factors that might be expected to induce the worst kind of opportunistic behaviour by provincial governments.'

A further characteristic of the Canadian system is that despite the legal right of provinces to tax as they choose, the federal government collects the bulk of income taxes and has latterly also become the agent for collecting sales taxes for a number of provinces. Bird and Tassonyi assess the Canadian system in the following terms: 'No doubt, the economic costs of taxation may be somewhat higher when both levels of government tap most major tax bases. To at least some extent, however, such costs appear to be accepted as part of the necessary price of maintaining Canada's version of federalism, which presumably has its own rationale – or necessity – given Canada's history.'

Canada, despite theoretically inauspicious circumstances, seems to have surprisingly robust fiscal discipline. But Bird and Tassonyi observe that 'the extent to which this conclusion may be generalised beyond the Canadian case, however, is by no means obvious. Indeed, it may be that if Canada has any lesson in this respect it is that what matters most may be not the method by which 'hardness' is sought but the setting (or, if one will, 'culture') within which it is sought. ... In the end, however, history plus democracy plus markets seems on the whole to have kept Canada's subnational governments, different though their paths may have been, more clearly on the path of fiscal prudence than the federal government.'

Australia

Australia has one of the most elaborated and carefully thought-out systems for assigning public finance among the tiers of government. However, it has been the subject of regular debate in Australian politics. The Fraser government experimented (1975-85) with revenue sharing as part of a new federalism approach, but this was abandoned because, according to Bird (1986) the states were suspicious of being at the mercy of unilateral decisions by the federal government. The current system is fairly centralised but comprises transfers to lower tiers of tax reimbursement grants and hypothecated payments for particular functions. Federal financial arrangements in Australia have preserved and secured state independence. The lower tier of government is far from being at the mercy of the Commonwealth. According to McLean (2002: 1) the Australian system 'attempts to achieve the highest degree of horizontal fiscal equalisation (HFE) found in any democratic' country and he also observes that the independent Commonwealth Grants Commission 'assesses needs for expenditure in exquisite detail. But the federation has no way of ensuring that the States spend the money on those services which have given rise to their needs assessments.'

It has the budgetary arithmetic that about two thirds of tax revenues accrues to the federal (Commonwealth) level, yet two thirds of expenditure is at the sub-national (state or local) level. It is also has the feature that around 60 per cent of tax is income taxes on individuals and companies. Commenting on the system, McLean observes that 'while the political question – the extent of equalization – needs to be determined by governments, it is generally accepted in Australia that an independent body is more likely to achieve an equitable distribution of grants than is a process of political bargaining by governments of different political complexions and different fiscal strengths'. The present Australian system developed because of the perceived unfairness of the previous arrangements. McLean quotes Spahn and Shah (2000: p. 65) who also commend the Australian system: 'Of all federal countries, Australia is best noted for its balanced emphasis on expenditure need and revenue means factors in determining state relativities for the distribution of unconditional equalization transfers.' McLean, notes that although there are problems in the Australian system, notably in relation to loans, as opposed to inter-governmental transfers, there is no doubt that the states are resilient and play an important role in Australia. The Commonwealth cannot ignore the states and cannot keep cutting back grants to them. It is forced to reach broad agreements with the states... to preserve political stability.'

The clear implication is that one of the options usually put forward for EU financing would need to reassure the Member

States that taxing powers would not seep upwards. As McLean (2002) describes it, 'the horizontal allocation of government resources among the Australian states depends on the distribution of the *states' own tax revenue;* on the distribution of *specific purpose payments;* on the distribution of the *general revenue grants (*respectively, tax-sharing funds); and on the distribution of loan money'. He also points out that the distribution of funding has been shaped by historical priorities and that these priorities have not always or necessarily reflected needs or relative prosperity. McLean characterises the Australian system as one of 'asymmetrical vertical grants' in which an important feature is that it looks at both expenditure *and* revenue needs in shaping transfers, in contrast to the German system which concentrates on revenue equalisation.

Switzerland as a model?

According to McKay (2000), of the systems of public finance in operation in federations, Switzerland comes closest to being a model for the EU because of the substantial autonomy of lower tiers of government and their prominent role in raising revenue. The fact that the EU is some fifty times as populous as Switzerland and much more diverse economically invites caution in the comparison, and the federal level does account for a substantial chunk of public spending. Overall public expenditure is split roughly three ways between the federal level (38 per cent), the cantonal level (33 per cent) and the communal level (28 per cent), but with very large differences between categories of public spending. The national level accounts for the great majority of spending on defence, agriculture and economic policies, pensions, sickness and invalidity benefits, and over half of transport. Intriguingly, it also has the highest interest bill. However, social assistance is devolved to the cantons and communes, confounding the dictates of fiscal federalism.

Some insights into the prospective evolution of EU finances can nevertheless be gained from looking at the operation of the Swiss system. Joumard and Giorno (2002) review recent debate on the system and analyse reform proposals. Four main drawbacks of the current assignment of spending responsibilities and inter-governmental transfers have prompted change. They are:

- Shared responsibility between tiers of government 'for an increasing number of spending programmes [which] has contributed to dilute each actor's responsibilities in achieving objectives.'
- A lack of incentives to greater efficiency in sub-national spending because of transfers from the federal level.
- Concern that fiscal equalisation has done little to reduce disparities between cantons, partly because the distinction between allocative and redistributive aims is too blurred.
- 'Sub-optimal provision of public services and/or a difficulty to seize scale economies' because spillovers between jurisdictions are insufficiently taken into account.

A proposed reform focuses on four priorities (see box 3.2, taken from Joumard and Giorno).

Box 3.2 The proposed Swiss reform of public finances

Disentangling cantonal and federal spending responsibilities. The reallocation of tasks has been mainly driven by greater emphasis on the subsidiarity and 'fiscal equivalence' (or user-decider pay) principles. The RPT reform would change spending assignments in twenty-nine areas. In particular, the Confederation would be competent for national roads, old age and survivors' pensions (first pillar) and invalidity pensions. The cantons would be responsible in other areas, including specialised care institutions for handicapped persons and housing policies in mountain areas. As a result, the responsibility for over 40 per cent of the spending programmes which are currently co-financed by the cantons and the Confederation would be transferred to only one administration level.

Improving the co-operation on spending programmes whose responsibility would still be shared by the cantons and the Confederation. Conditional grants would no longer be based on ex post actual expenses but on an estimation of standard costs (defined ex ante). In addition, many of the existing small conditional matching grants would be merged and folded into a broader envelope. The Confederation would set the strategic objectives (output) for these broader spending programmes while the cantons would be fully responsible on how to reach them. The main spending areas to which these new management principles would apply include: universities, regional public transport systems, airports, agriculture and forestry.

Reinforcing co-operation across cantons. To avoid that spillovers give rise to a sub-optimal provision of public services, the providing cantons would be entitled to claim a financial compensation from the other cantons whose residents are using its services. Such a compensation scheme has already been introduced for universities and local transport networks through voluntary inter-cantonal agreements. This new institutional setting would also reduce the opportunities to free ride on these forms of co-operation. Nine areas are concerned by this compensation scheme, including: universities, local transport systems, waste water management facilities and hospitals.

Reducing financial disparities across cantons. Fiscal equalisation supplements to the conditional matching grant system would be replaced by a financial equalisation scheme based mainly on the cantons' ability to raise taxes and by new block grants from the Confederation (reflecting geographic or social and demographic factors). In addition, two new grants from the Confederation to the cantons would be introduced to help the cantons meet an extra financial burden under specific circumstances, taking into account: a) geo and topographic factors (for mountain areas and/or those with a highly dispersed population); b) and socio-demographic factors (for those cantons where the old, poor, low-qualified and unemployed account for a large proportion of their population).

Endnotes

[1] Following changes introduced in 2002 to incorporate agreed new standards for national accounts, the headline total used as the denominator for assessing financial contributions to the EU is GNI rather than the more familiar gross national product (GNP) or gross domestic product (GDP). In practice, the change makes hardly any difference.

[2] In fact, Eichel is wrong: the UK budget over the period 1997-2004 has grown by almost exactly the rate requested by the Commission, and the UK is not alone in this regard.

[3] The terms 'union', 'federation', 'supranational' and 'federal' – all of which are employed in the relevant academic literature – will, for the most part, be used interchangeably to refer to the highest tier of government or governance. Although the sensitivities of the 'f-word' in the UK context are well-known, from an analytic perspective the precise formulation makes no real difference.

[4] Council Decision of 29 September 2000 on the system of the European Communities' own resources (2000/597/EC, Euratom) - OJ L 253, 7.10.2000, p.42.

[5] In economic terms, an 'own' resource is a tax that 'belongs' to a particular fiscal authority. Assignment of taxes in this way is, typically, determined by congruence between the tax base and geographical span of the fiscal authority. Thus, it is common for taxes on property to be assigned to the local authority in which the properties are located, whereas the source of the profits on which companies operations are taxed is nation-wide or, increasingly, international markets and the tax is, accordingly, levied at national level.

[6] For which the Member State receives a collection 'fee' that was raised from 10 per cent to 25 per cent of the proceeds under the current FP.

[7] Support for farming and the enduring nature of the CAP being a case in point.

[8] Such a prospect provides part of the rationale for the EU's Stability and Growth Pact.

[9] Open, in principle, to all Member States that are shown to pay 'too big' a net contribution.

[10] The Communication, somewhat delphically, concedes that 'the current financing system performs relatively well from a financial point of view', but still manages to canvass a new EU tax. Its preferred candidates are corporate taxes, a share of VAT to be shown separately from the national one or an energy tax.

[11] Examples are the RESIDER (steel) or RECHAR (coal) Community Initiatives under the 1994-99 Structural Funds.

[12] Informal discussion.

[13] Anyone intent on pursuing the Commission through the courts may, however, be relieved to know that although administrative expenditure is classed as non-compulsory, damages payable by the Commission are compulsory.

[14] While Denmark, Sweden and the UK continue to spurn the euro, the politics of developing any EU level stabilisation policy will inevitably be more complicated. However, most of the ten new members that acceded to the Union in 2004 are likely to become euro area members during the next Financial Perspective, some possibly as early as 2007, as a result of which the economic rationale will become more compelling. The discussion here acknowledges the political difficulties, but concentrates on the economic case.

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