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**Research Report**

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*by Christoph Harendt, Friedrich Heinemann and Stefani Weiss*

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# EU Budget Reforms: Where Can Europe Really Add Value?

*Christoph Harendt, Friedrich Heinemann and Stefani Weiss\**

## Abstract

The debate over the next EU budget is already heating up. In early May the European Commission will publish its proposal for the Multiannual Financial Framework (MFF) for the years 2021-2027. Judging by previous MFF negotiations, agricultural subsidies and regional transfers will continue to swallow a large share of the EU budget. In view of the acute legitimacy crisis currently faced by the EU, this spending structure calls for reform. The Commission has recommended using “European added value” (EAV) as a benchmark for EU budget reform, an approach that deserves support. But although EAV may be appealing, it urgently needs a sound definition and an empirical basis. A joint study by the Bertelsmann Stiftung and the EconPol network partner ZEW recently tried to pin down EAV and apply it to a broad range of policy fields.[1] The study investigates whether allocating competences more effectively between the European Union and its member states could boost the EU’s performance.

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The debate over the next EU budget is already heating up. In early May the European Commission will publish its proposal for the Multiannual Financial Framework (MFF) for the years 2021-2027. Judging by previous MFF negotiations, the large spending positions demonstrate a striking path-dependency, despite the glaring lack of convincing arguments for the dominant roles currently played by agricultural subsidies and regional transfers. Piling on pressure to reform is the only way to achieve far-reaching change. Why is there now such a pressing need for such re-forms?

Firstly, the EU faces an acute legitimacy crisis. Despite the recent recovery, several euro area countries are still feeling the social pain from of economic crisis and contraction. To make matters worse, conflicts and wars have erupted in regions close to Europe in recent years, forcing millions to flee their homes. Many voters were disappointed with how the EU handled these crises, reflecting the widely-held view that it has pursued the wrong policy priorities. Instead of preparing Europe for the challenges of digital transformation or global migration pressure, the EU has continued to spend far too much money on last-century issues like agriculture in recent decades. The United Kingdom's decision to leave the Union drastically demonstrates the dissatisfaction of its citizens – with the loss of Britain's net contributions boosting pressure to reform the EU budget.

The Commission has recommended using “European added value” (EAV) as a benchmark for EU budget reform, an approach that deserves support. But although EAV may be appealing, it urgently needs a sound definition and an empirical basis. A joint study by the Bertelsmann Stiftung and the EconPol network partner ZEW recently tried to pin down EAV and apply it to a broad range of policy fields.<sup>1</sup> The study investigated whether allocating competences more effectively between the European Union and its member states could boost the EU's performance.

## Methodological approach

The study analyses eight specific policies with respect to their preferable assignment. These eight specific policies cover a wide range of policy fields. The study applies a unified quantified approach and clearly defines ‘counterfactuals’. These counterfactuals are understood as con-

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<sup>1</sup> Weiss, Stefani, Heinemann, Friedrich, Berger, Melissa, Harendt, Christoph, Moessinger, Marc-Daniel und Thomas Schwab: How Europe can deliver: Optimising the division of competences among the EU and its member states, Bertelsmann Stiftung: Gütersloh 2017.

<https://www.bertelsmann-stiftung.de/de/publikationen/publikation/did/how-europe-can-deliver/>

ceptual alternatives to the allocation of competences under the status quo. As such, they either relate to a new European competence (if the policy is currently a national responsibility) or a new national competence (if the policy is currently assigned to the EU).

The testing applies the following criteria to judge the existence or non-existence of EAV from a European responsibility: free riding of member states on public goods provided by others, economies of scale through European provision, preference heterogeneity of voters across member states, the merits of intra-jurisdictional competition, and the interplay of competence allocation with the functioning of the European internal market.

For each criterion and policy, scores on a scale ranging from 1 to 5 are assigned, with a score equal to 3 indicating an indifferent position. Scores lower than 3 point towards a national allocation of the policy (a score of 2 indicates a weakly national preference, while a score of 1 points towards a clearly national allocation). Scores higher than 3 indicate that the policy field should be located on the European level (again, a score of 4 indicates a weakly European preference, while a score of 5 points to a clearly European competence allocation). A final score is calculated for each policy field based on a weighted average. The table below shows the resulting scores and the suggested allocation decisions.

Policies	<div> <div>Spillover effects</div> <div>Economies of scale</div> <div>Preference heterogeneity</div> <div>Internal market consistency</div> <div>Competition</div> </div>						Score	Decision
	Weight	0.2	0.2	0.2	0.2	0.2		
	Agricultural policy	1	1	3	3	2	<b>2.00</b>	<b>weakly national</b>
	Asylum and refugee policy	5	4	5	5	4	<b>4.60</b>	<b>clearly EU</b>
	Corporate taxation	4	4	4	5	4	<b>4.20</b>	<b>weakly EU</b>
	Defence policy	4	4	5	5	5	<b>4.60</b>	<b>clearly EU</b>
	Development aid	4	5	5	3	4	<b>4.20</b>	<b>weakly EU</b>
	Post-secondary and tertiary education	2	1	4	3	3	<b>2.60</b>	<b>weakly national</b>
	Railway freight transport policy	2	4	4	4	3	<b>3.40</b>	<b>indifferent</b>
	Unemployment insurance	5	3	4	3	4	<b>3.80</b>	<b>weakly EU</b>

## Key findings

1. For Common Agricultural Policy (CAP), the study concentrates on direct payments to farmers. The current EU responsibility is compared with a national counterfactual whereby income support is the responsibility of the national welfare system. The results point to significant free riding under the current European arrangement and hugely excessive costs resulting from ill-targeted income support. According to the study's findings, income protection through CAP exceeds the level defined by national minimum income support in 21 member states. Overall, the results indicate that national responsibility is clearly preferable to the current assignment.
2. For asylum and refugee policy, the status quo entails de jure a mixed division of responsibilities. De facto, however, member states largely decide their own policies. The study compares this arrangement to a counterfactual featuring a truly European provision of harmonised asylum services. It concludes that European responsibility would be clearly superior, as it would reduce massive free riding on the reception efforts of other member states. In addition, annual cost savings of between €5 billion and €12 billion (given refugee numbers like those experienced in 2015) appear realistic as a result of economies of scale.
3. Since Europe largely lacks responsibilities for direct taxation, the study focuses on corporate taxation for that policy field. The specific counterfactual scenario involves both a harmonised corporate tax base definition and an apportionment of corporate profits among member states according to a formula. The competence of tax-rate setting would remain at the national level. Taken together, the criteria indicate that there are disadvantages to having this remain a national prerogative. In addition to reducing inefficiencies in tax base competition, the European counterfactual would enable substantial cost savings in tax compliance. For example, tax compliance costs for a company with up to five foreign affiliates are currently 2.5 times larger than those of a purely domestic company. A uniform tax base could cut back this costs disadvantage.
4. For defence policy, the study lends support to current political initiatives for a "more Europe" approach. The counterfactual is a fully integrated European army with unified decision-making and a centralised provision of military equipment financed from the EU budget. The analysis finds a large number of indications that current fragmentation results in significant diseconomies of scale. For example, the armies of the EU member states currently deploy 89 different major weapon systems, while US forces use just 27. Moreover, the quantitative analysis of benefit- and burden-sharing shows the superiority of a European competence, as it would align benefits and costs for member states



- more effectively and would thereby decrease the extent of free riding. Furthermore, a European army would also give a boost to the internal market for defence goods.
5. Development policies are currently a shared responsibility. This situation is contrasted with a far-reaching European counterfactual in which development aid is fully financed and managed by the EU. As with defence and asylum policies, having development aid financed from the EU budget would reduce free riding on the efforts of other member states. Substantial economies of scale can be achieved by cutting back high administrative costs and reducing other inefficiencies associated with the current aid fragmentation. Moreover, voter preferences appear to be particularly homogeneous across member states.
  6. The study's results suggest that responsibility for higher education should remain at the national level. The European counterfactual to the current national responsibility is a model of EU financing that is de-centrally implemented by autonomous universities ('money follows students'). There is no evidence of European economies of scale. Free riding would increase compared to the status quo, under which national costs and benefits are largely aligned. Overall, the current approach of having the EU concentrate on mutual recognition of qualifications and fostering student mobility seems effective.
  7. In terms of railway freight transport, the study's findings are inconclusive. It compares the current shared competences with a European counterfactual of a single European-financed railway system without technical or operational barriers. Three criteria – economies of scale, preference heterogeneity and internal market consistency – weakly point to the advantages of a more European approach. However, European financing schemes would loosen the link between national costs and benefits, thereby increasing free riding problems.
  8. For stabilisation policies in the European Monetary Union, the potential merits of a European unemployment insurance scheme are screened. Here, instead of considering a counterfactual that relocates the competence of this policy field, a new European scheme that complements existing national unemployment protection in the euro area countries is considered. Current protection may cause free riding by other countries, which also benefit from the general stabilisation effects of such national insurances. The study's results confirm that this problem, which may lead to the under-provisions of unemployment benefits, could be resolved within a European scheme. Current unemployment insurance schemes are also very similar across EU members in terms of their basic design. So no major preference asymmetry would preclude a partial Europeanisation.

## Recommendations

Overall, this comprehensive, quantification-based assessment reveals that competences should be shifted to the EU level in five out of the eight policy areas covered by the study. Analysed in terms of European Added Value, there is no justification for the present EU budget structure. The Commission needs to launch the serious negotiation phase by ambitiously setting new priorities. In subsequent negotiation phases EU member state governments need to stop pandering to the narrow self-interests of recipient lobbies and put Europe's interests first.

## **EconPol Europe**

EconPol Europe - The European Network for Economic and Fiscal Policy Research is a unique collaboration of policy-oriented university and non-university research institutes that will contribute their scientific expertise to the discussion of the future design of the European Union. In spring 2017, the network was founded by the ifo Institute together with eight other renowned European research institutes as a new voice for research in Europe.

The mission of EconPol Europe is to contribute its research findings to help solve the pressing economic and fiscal policy issues facing the European Union, and thus to anchor more deeply the European idea in the member states. Its tasks consist of joint interdisciplinary research in the following areas

- 1) sustainable growth and 'best practice',
- 2) reform of EU policies and the EU budget,
- 3) capital markets and the regulation of the financial sector and
- 4) governance and macroeconomic policy in the European Monetary Union.

Its task is also to transfer its research results to the relevant target groups in government, business and research as well as to the general public.