

Feld, Lars P.

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## European public finances: much ado about nothing?

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**PHILIPPS-UNIVERSITÄT MARBURG**  
Fachbereich Wirtschaftswissenschaften

**Lars P. Feld**

**European Public Finances: Much Ado About Nothing?**

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Prof. Dr. Lars Feld  
Philipps-Universität Marburg • FB Wirtschaftswissenschaften •  
Abteilung Finanzwissenschaft • Am Plan 2 • D-35037 Marburg  
Tel. ++49-6421-2821702 • Fax ++49-6421-2824852  
E-Mail: [feld@wiwi.uni-marburg.de](mailto:feld@wiwi.uni-marburg.de)

## **EUROPEAN PUBLIC FINANCES:**

### **Much Ado About Nothing?**

by

LARS P. FELD

PHILIPPS-UNIVERSITY OF MARBURG PUBLIC FINANCE GROUP,

AM PLAN 2, D-35096 MARBURG (LAHN), GERMANY

FELD@WIWI.UNI-MARBURG.DE

### **Abstract**

Starting from the economic theory of federalism, this chapter surveys the development of EU revenue, spending and off-budget activities, discusses the redistributive impact of EU finances on member states, and budgetary decision-making procedures. The analysis is guided by a political economics perspective on the interaction between the different players in EU decision-making and the institutional restrictions they face. This involves the interests of the Commission, the Parliament as well as those of the single countries in the Council. They are restricted by the system of member states' contributions to the EU and the balanced budget requirement, but also by the budgetary procedures that determine individual decision-making powers.

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*Nunc tibi gaudeo, nunc tibi lugeo,  
tristor, anhelio ...*\*

Bernhard of Cluny (12<sup>th</sup> century) ‘*De  
contemptu mundi*’

## 1. Introduction<sup>1</sup>

The discussion of European public finances appears to be well reflected by this introductory quote meaning: ‘*Sometimes I feel pleasure about you, sometimes I mourn you, cry, sigh ....*’ When new negotiations on the EU financial perspective start, governments mourn that their country does not receive enough funds from the EU to compensate for its contributions to the EU budget.<sup>2</sup> In the course of these negotiations, they leave the impression of being close to crying when they defend their position against the other European governments. In the end, the compromise is accepted with sighing. But afterwards each government is pleased by the funds received from Brussels, be it agricultural subsidies or structural funds. At least governments appear to be pleased for the sake of selling the compromises to their electorates.

Academics follow suit by criticizing the use of funds at the EU level, in particular the inefficient system of inter-country and interregional redistribution in the EU. Some scholars argue for example that a major task of the EU consists in the provision of European public goods like defense or law and order (TABELLINI, 2003). The SAPIR ET AL (2004) report proposes the use of EU funds to finance growth promoting policies. Others contend that a European fiscal policy is necessary in order to accommodate asymmetric shocks after the establishment of the European Monetary Union (EMU) since the exchange rate instrument does not exist any more (ITALIANER and VANHEUKELEN, 1993). Some economists even make a case for a personal income redistribution from the poor to the rich European citizens at the EU level.

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\* Quoted according to ALDOUS HUXLEY, *Music at Night*, 1931, German translation: ‘*Anmerkungen zur Freiheit und zu den Grenzen des Gelobten Landes*’, in: ALDOUS HUXLEY: *Seele und Gesellschaft, Essays III: Diagnosen und Prognosen*, Piper, Munich 1994, p. 27.

1. In the following, I use the abbreviation EU also for historical descriptions of when it still was the EC.  
2. See *Charlemagne: Europe’s heavyweight weakling*, THE ECONOMIST Vol. 367 (8327), 2003, p. 34, *Kommision steht vor Milliardenpoker*, FRANKFURTER ALLGEMEINE ZEITUNG No. 228, 1 October 2003, p. 14.

Some foundation for the normative claims of economists is provided by the economic theory of federalism (OATES, 1972, 1999). From that perspective, the responsibilities of the EU may indeed be seen in the provision of EU wide public goods, income redistribution between rich and poor individuals and macroeconomic stabilization. For normative reasons, these are the areas where a supra-national level finds its role. Aside the four freedoms to secure the common market, the EU does however not provide European public goods, nor does it redistribute income between individuals and conducts fiscal policy for stabilization purposes. Instead the EU is redistributing funds between countries or regions via agricultural subsidies and the structural funds in a highly inefficient way that also contradicts normative precepts for individual income redistribution. The ultimate goal of the EU budget appears to be a redistribution between countries rather than individuals, which is perceived as the chasing of net payoffs from the EU budget by single member countries (HEINEMANN, 2002).

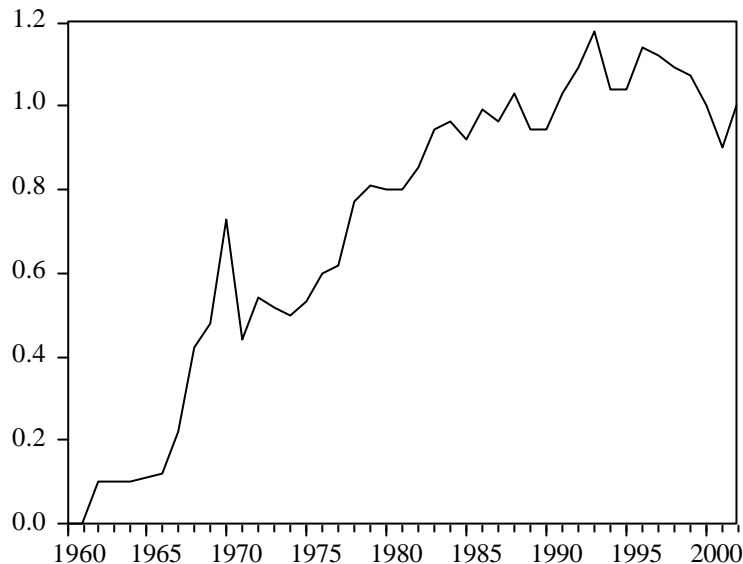
Of course, these perceptions may not be sufficiently differentiated. There are indeed arguments worth considering. First of all, it should be noted that the EU budget cannot be easily compared with national budgets. *Figure 1* shows the development of EU spending since 1961. While the budget started from close to 0.0 percent of EU GNP in 1961, it has risen to about 1.0 percent in 2002. In 1993, EU spending peaked at nearly 1.2 percent. But compared to member states' budgets which usually cover between 40 and 50 percent of national GNP (EUROPEAN ECONOMIC ADVISORY GROUP, 2003, p. 50), these figures seem to be negligibly low. With such a small budget, no major EU policies in the three areas – provision of public goods, redistribution and stabilization – should be expected.

As BLANKART and KIRCHNER (2003) argue, the size of the EU budget is nevertheless considerable from the perspective of smaller member states. For example, Denmark's budget including social security in 2000 was of about the same size as that of the EU in the same year. Moreover, looking at regional incidence of EU funds, it becomes evident why a struggle between member states occurs. Greece receives nearly 4 percent of its GNP in the form of transfers from the EU. In Ireland, that number was nearly 7 percent in the beginning of the 1990's and still is about 2 percent. Portugal also receives EU transfers of about 2 percent of GNP.<sup>3</sup> Finally, the growth of EU finances is as marked as that of member states. In fact, the size of the EU budget relative to GNP nearly tripled in the three

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3. See *Table 5* below for the net financial flows of member states.

decades between 1965 and 1995. From that point of view, European finances adopt the role they are given in public discussions. There is not merely ‘much ado about nothing’.



*Figure 1: EU Spending in Percent of EU GNP, 1961 to 2002*

*Source: European Commission (2000, pp. 38; 2003, pp. 132)*

Second, several EU policies financed from the budget may have been intended as means to correct market failures. For example, the Common Agricultural Policy (CAP) supposedly corrects failures in agricultural markets stemming from large fluctuations of weather and climatic conditions. Also most structural operations were created in order to increase cohesion in the EU or to cope with particular structural problems of member states. Still, there is nearly a consensus among economists that these goals are at best imperfectly achieved and that political forces drove these policies towards a mere redistributive exercise.

In this article, European public finances are analyzed by focusing on the EU budget. The analysis is guided by a political economics perspective on the interaction between the different players in EU decision-making and the institutional restrictions they face. This involves the interests of the Commission, the Parliament as well as those of the single countries in the Council. They are constrained by the system of member states' contributions to the EU and the balanced budget requirement, but also the budgetary procedures that determine their individual decision-making power. It is argued that political economy reasons have been the driving force for EU finances in the past and will dominate in

the future.<sup>4</sup> Any successful proposal to reform EU finances, be it on normative grounds in order to provide the EU with the funds to correct EU wide market failures, redistribute income and conduct fiscal policy, or on positive grounds in order to cope with Eastern enlargement in the long run, must consider the decision-making processes that help European players to realize their specific goals.

The plan of the chapter is as follows: In *Section 2*, the economic theory of federalism is summarized in order to assess the rationale for an EU budget from a normative point of view: What is the reason for fiscal centralization to, fiscal harmonization by and fiscal coordination at the EU level? In *Section 3*, revenue and spending of the EU is described. A positive point of view is adopted in *Section 4*: Given that normative arguments do apparently not guide the assignment of revenue and spending competencies in the EU, political economy arguments explain the existence and persistence of EU financial structure. The EU budget is used to compensate the groups in member countries that lose from European integration. The EU provides ‘side-payments’. In addition, the decision-making powers of the Council and the Parliament influence budgetary outcomes. Budgetary decision-making is therefore extensively discussed in *Section 5*. *Section 6* summarizes the main results, offers perspectives on future developments of EU finances and discusses routes for potential reforms.

## **2 Why Should There Be an EU Budget?**

A framework to assess EU finances is provided by the economic theory of federalism (ALESINA, ANGELONI and ETRO, 2001). Although the EU is not a federation yet, the economic theory of federalism is useful to discuss the assignment of competencies, of spending and revenue to different government levels.

### **2.1 Efficiency Considerations**

The basic idea of the assignment of taxing and spending competencies in the economic theory of federalism is the ‘correspondence principle’ proposed by OATES (1972). Accordingly, public goods and services should be provided to the citizens financing them and deciding about them. The ‘principle of fiscal equivalence’ (OLSON, 1969) is similarly guided by the geographical incidence of the

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4. This is obvious in negotiations about the financial perspective (see Section 4) as the politically most important decision on EU finances which fixes the total amount of EU spending for five subsequent years and also attributes some weights to the different policies pursued by the EU budget. The financial perspective is resulting from a struggle between net beneficiaries and net contributors to the EU budget.

benefits and costs borne by citizens. If these principles are followed, individuals choose their place of residence according to their preferences in a process of ‘voting by feet’ (TIEBOUT, 1956) such that individual demands are processed using locally available knowledge and information about citizens’ preferences. Public services are provided and financed at minimum frustration costs of those citizens that have demands for higher or lower levels of public services than actually provided. This allows to consider the heterogeneity of preferences between EU member states to the largest possible extent. A centralized decision system instead leads to an inefficient and hence unnecessary uniformity in the provision of public goods under these conditions. This reasoning leads to OATES’ (1972, p. 30) ‘decentralization theorem’ of fiscal federalism: in a world of mobile individuals with different preferences, only decentralized provision and financing of public goods, both at the lowest possible level of government, are compatible with economic efficiency.

Numerous reasons exist why decentralization might fail to yield optimal policies. The reasons can be largely traced back to violations of the principle of fiscal equivalence. First, regional externalities (spillovers) lead to a deviation of the geographical incidence of benefits and costs of public service provision. Nonresidents may receive some of the benefits from public services without paying an adequate tax price such that positive benefit spillovers occur. This might for example be the case if public hospitals in France are used by Spanish residents. French hospitals are to some extent financed by general French taxes that are not paid for by Spanish residents. This leads to distortions such as crowding. Negative benefit spillovers occur for example in cases of environmental damage such as cross border pollution. In addition, cost spillovers exist if nonresidents pay some of the taxes of other jurisdictions. If the shares of multinational corporations are distributed widely among internationally residing shareholders, the government of a single country has incentives to tax them at higher rates than domestic firms because the shareholders of the multinational firms do not influence domestic politics. To the extent that this tax exporting succeeds, the government is able to provide public services at higher levels than preferred by their residents.

Second, fiscal competition is working against these effects of tax exporting. If production factors like capital or skilled labor are highly mobile and a jurisdiction levies a higher personal or corporate income tax than its neighboring jurisdictions, its mobile citizens or firms emigrate (or move their capital there) in order to enjoy a lower tax burden. Doing so, mobile factors reduce the tax burden of resi-

dents and firms in the state or community they move to and increase the tax burden in those jurisdictions they emigrate. These changes in tax burdens are usually not considered by public authorities in these jurisdictions in deciding on the level of public goods and services such that these are provided at a lower than ‘optimal’ level. Since there is a local loss from taxation that does not correspond to a social loss, the cost of public services is overstated and jurisdictions will tend to under-spend on state and local public services. BUCHANAN and GOETZ (1972) call this effect a fiscal externality.

Third, this flight of ‘good’ taxpayers is particularly relevant if public goods are characterized by increasing returns to scale with respect to the number of users. The main reason is that in a system of competition between jurisdictions public goods would be provided to them at marginal cost prices which do not cover the higher inframarginal production costs. Mobile production factors do hence not contribute to cover fixed costs of public goods’ provision. Thus, the community would incur a loss if a competitive marginal tax price was set (SINN, 1997). Consequently, no public goods would be provided, especially no pure public goods, which are costless *in use* due to the non-rivalness in consumption, or immobile factors have to bear the tax burden fully, which implies a considerable distributive problem.

Since the effects of fiscal externalities and cost spillovers potentially compensate for each other (SØRENSEN, 2004), coordination or harmonization of fiscal policies appear to be useful if positive or negative benefit spillovers are observed or economies of scale in consumption can be exploited. In other words, no action of a higher level of government is indicated if none of these mechanisms obtains. An EU-wide public good widely acknowledged as such is the provision of the four freedoms, free movements of goods, services, labor and capital, in order to secure the common market. The EU has achieved the common market partly by forcing member countries to abolish trade distortions and mobility restrictions, partly by imposing the origin principle of mutual recognition of regulations. This does however not lead to major spending projects. TABELLINI (2003) additionally suggests to centralize law and order policies at the EU level because organized crime transcends national boundaries such that negative benefit spillovers can be observed. According to that analysis, such spillover effects, but also economies of scale prevail for foreign and defense policy, internal security, border patrols, immigration and partly also environmental policy (FELD, 2004).

## 2.2 Income Redistribution

In the case of individual income redistribution by tax-transfer schemes, the role for centralized fiscal policy appears to be more obvious. Suppose for example that Germany adopts a progressive income tax designed to achieve a significantly more egalitarian distribution of income than exists in Portugal. If rich (German) and poor (Portuguese) households are mobile, such a program would create strong incentives for the wealthy Germans to emigrate to Portugal because they pay lower taxes there (keeping other things equal). Similarly, higher transfers in Germany induce immigration from poor Portuguese citizens to Germany. In this scenario, national redistribution induces sorting of the population with the richest households residing in the communities that redistribute the least by income taxes. Decentralized income redistribution becomes difficult. At the EU level, this problem is reduced, because mobility between the EU and the rest of the world is lower than within the EU.

There are not many theoretical arguments against this line of reasoning. Most of them rely on imperfect mobility of individuals. Many observers argue that cross border mobility in the EU is low today such that these problems do not occur. However, there is more recent evidence that this perception is not totally correct. TANI (2003) finds that Europeans are more mobile than suggested by the previous literature and that there are very similar reactions of workers to changes in macroeconomic conditions in the U.S. and the EU suggesting that there is considerable mobility. Moreover, it suffices that migration is affected by taxes and transfers at the margin only. The more mobile people become, the better the supposed mechanism will work and the less possible decentralized redistribution will be.

According to BUCHANAN (1975) there are arguments why a voluntary redistribution occurs. At the constitutional stage all individuals have an incentive to agree to income redistribution because they are fundamentally uncertain about their future income, health and employment positions. At the post-constitutional level, the rich might agree to income redistribution by the government because they are interested in a public insurance scheme against fundamental privately uninsurable risks for themselves and their children, and against exploitation by the majority of the poor residents as well as against increasing crime rates. Particularly the second reason is important: the rich pay a premium for obtaining social peace. However, voluntary income redistribution alone will certainly not suffice to finance European welfare states.

Although these arguments appear to provide a reason for centralization of income redistribution at the EU level, there is an alternative institutional solution proposed by SINN (2003) which only requires a coordination among EU member states. If income redistribution follows a nationality principle, centralization is not necessary. The nationality principle requires that citizens decide at a certain age, for example 18 years, to join the redistribution system of a certain country. There might be an explicit or implicit contract according to which individuals may obtain the public transfers only at the conditions of that state but also has to pay income taxes fixed in that state for a certain minimum time period, for example ten years. For that time period, this individual obtains the combination of tax-transfer schemes fixed at the time joining a particular redistribution system irrespective of whether he or she has migrated to another country with a different redistributive system. In such a system, the EU does not need to be involved in large scale income redistribution.

### **2.3 Political Economics Arguments**

These arguments for centralization, harmonization or coordination of member states' fiscal policies in the provision of public goods and of income redistribution have to be modified if a central assumption in the economic theory of federalism does not hold. If governments don't do what they ought to from that normative perspective, but follow their own self-interests, fiscal competition yields beneficial outcomes. In a European Union with decentralized competencies to conduct fiscal policies, citizens avoid excessive taxation by migration. Without competition between member states, public services cost too much. There are no incentives to keep costs low if tax bases can be exploited to the largest extent possible. Because the restrictions from migration are uncomfortable to politicians they have incentives to build cartels to get rid of locational competition. The EU provides a forum for such a potential collusion of national governments. If governments of European countries behave as national Leviathans in the sense of BRENNAN and BUCHANAN (1980), fiscal centralization at the EU level will only create a European Leviathan and is counterproductive. Governments lacking the virtues assumed by the traditional theory of fiscal federalism will be tempted to use coordination to shield themselves from the consequences of bad policies. From a political economics point of view, the restrictions imposed by decentralized government activities are thus beneficial.

With respect to redistribution policies, the bottom line of these opposite arguments is that a centralization or harmonization of income redistribution, income taxes and transfers, at the EU level is too

far-reaching. Even the coordination of national income redistribution according to a nationality principle provides unsustainable incentives for national governments to exploit those that subscribe to a redistribution system while they are young during the period fixed in the (implicit or explicit) contract. A weak nationality principle that only extends to the transfer side of income redistribution may be indicated. It could take the form of the residence requirements common in the U.S. until 1969 and again since 1996 according to which immigrants to a U.S. state are eligible for welfare payments if they work at least two years in their place of residence before they apply for welfare. Instead of welfare, this principle could also apply to national social security systems in the EU.

Contrary to the traditional arguments of the economic theory of federalism, centralization of public services at the EU level beyond the already existing competence for providing the four freedoms and the common market appears to be exaggerated. Coordination is however indicated in national defense and security as well as environmental policy because of international spillovers and economies of scale. The reason against a pure centralization of defense and internal security to the EU level can again be found in a political economics argument. Such a centralization would concentrate powers too strongly in the hands of a single EU government. Many federations, such as the U.S., Germany or Switzerland, at least divide the power for internal security among the central, regional and local levels of government in order to obtain a vertical division of powers. Nevertheless, a coordination of national police activities, perhaps also an EU security task force to cope with organized crime or international terrorism could be helpful. However, NATO already coordinates defense at the international level. There are good arguments why defense is a public good exceeding even the geographic jurisdiction of the EU. It can indeed be questioned to what extent the EU should play a particular role in the NATO even after all discussions that emerged during and after the Second Iraq War.

With respect to environmental policy, coordination obtains for cross-border pollution. Often, agreements without EU interference might suffice to internalize these externalities. Other international environmental problems have to be resolved at the global level because they have a wider geographical jurisdiction than Europe. Global warming is a case for an international treaty. The EU could help to coordinate the positions of the different European governments in order to increase their bargaining power at the global level. However, these examples indicate that international public goods need not necessarily be European public goods such that solutions beyond the EU could be found. Perhaps a

case for the coordination of environmental taxes at the EU level could be made although it would not necessarily imply an assignment of environmental taxes to the EU level.

## **2.4 Macroeconomic Stabilization**

The standard reason for centralization of fiscal policy for stabilization purposes in the economic theory of federalism is an openness argument: Small local jurisdictions cannot conduct decentralized macroeconomic policy because of a too high openness (exports and imports in percent of GDP).<sup>5</sup> Fiscal policy would strongly affect other jurisdictions, but benefit the community only to a small extent. It is obvious that this argument strongly hinges on the size of a jurisdiction and is thus a matter of scale. At the regional level, decentralized fiscal policy is already possible as the U.S. states indicate. Providing a survey on the estimates of the federal stabilization effect in the U.S., ARDY (2001) states an agreement among the studies that around 20 percent of the fluctuations of gross state product are offset by federal taxes and transfers in the U.S. Private capital markets are more important to cushion macroeconomic shocks in the U.S. Estimates for EU member countries indicate that national stabilization is offsetting between 20 to even 40 percent of changes in regional incomes.

There may also be a role for EU fiscal policy if fiscal transfers from the EU to member countries are a useful supplement to the common monetary policy when asymmetric shocks in Europe occur. Suppose for example that Italy is more strongly hit by increases in crude oil prices than France because Italy uses fossil fuels more strongly for energy production. After such a shock, Italian products are relatively more expensive than French goods. The demand for Italian products abroad decreases and the effects of the shock are even augmented. Without monetary union, Italy could devalue in order to smooth this asymmetric shock such that prices of Italian products abroad become cheaper. Because of EMU, the exchange rate instrument is not available any more such that either adjustments in the real economy or fiscal transfers from the EU to Italy have to accommodate asymmetric shocks. These fiscal transfers are designed as a temporary relief for the country affected by an asymmetric shock in a similar fashion as exchange rate adjustment only provides temporary relief.

ELFFINGER and DE HAAN (2000, p. 137) argue however that the presence of an EU fiscal policy as insurance against asymmetric shocks provides incentives for member states to reduce their fiscal dis-

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5. Since the EU already conducts monetary policy, only fiscal policy is considered in this paper.

cipline. As in the case of exchange rate adjustments, in the medium or long-run, there is no way to avoid real adjustment after macroeconomic shocks. The resulting unemployment can only be coped with by factor mobility or reductions in real wages. Italian experiences with a devaluation-inflation-spiral during the eighties and nineties indicate that societal groups nevertheless hope to avoid these real adjustments and keep nominal wages high by creating additional inflation. Similarly, the same groups would demand fiscal transfers from the EU and their national governments in order to avoid real adjustments. National governments have also incentives to exploit EU funds for such an insurance against asymmetric shocks (PERSSON and TABELLINI 1996, 1996a). In order to appear eligible, countries would have to provide evidence for the existence of a shock, but also that they cannot cope with it on their own. High public debt levels or budget deficits are indicators that help to signal the need for EU fiscal action. In order to avoid such a cascade of wrong macroeconomic incentives, a case against EU fiscal policy is made. Moreover, the main macroeconomic problem in Europe consists in inflexible labor and goods markets as well as in social security systems increasing labor costs. Keynesian stabilization policies are less relevant then, because the demand side view is dominated by a supply side view. Finally, there is already considerable fiscal policy coordination in the EU by means of the Stability and Growth Pact such that further coordination is not indicated. In sum, there is not much room for a centralized EU fiscal policy or a further coordination of fiscal policy at the EU level.

### **3 Revenue and Spending of the EU<sup>6</sup>**

In sum, there is some role for the EU to provide European public goods and services, but no role for income redistribution and fiscal policy. Does the actual assignment of revenue and spending competencies in the EU follow the economic theory of federalism?

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6. EUROPEAN COMMISSION (1995) provide descriptions of history and development of EU finances.

### 3.1 The System of ‘Own’ Resources<sup>7</sup>

The EU does not have an own power to tax in any notable sense. Taxation powers are not centralized in the EU and coordination of tax policies only takes place to a moderate extent. Rather the system of ‘own’ resources of the EU is characterized by contributions from the member states. From 1958 to 1970, the EU, like other international organizations, was exclusively financed by such contributions. At 21 April 1970, the newly introduced EU system of ‘own resources’ contained three different revenue sources: First, levies on agricultural and sugar trade which are transferred directly to the EU since 1971. Second, customs duties on trade with third countries for which a common system was stepwise introduced between 1971 and 1975. Third, budget-balancing resources accruing from a proportion of the Value Added Tax (VAT) on the basis of a uniform VAT base throughout the Union. The common VAT base was introduced until 1979. After financial crises in the first half of the eighties, the introduction of a new ‘fourth’ resource finished the period of uncertainty of EU finances.<sup>8</sup> The ‘fourth’ resource is based on a topping up of the revenue available from the other sources and is determined each year during the budgetary procedure in the light of the total amount available from all other sources of revenue related to total GNP of all member states. The Delors I package imposed an overall ceiling on the resources taken up by the Union. It rose to 1.2 percent of EU GNP in 1992, remained at that level in 1993 and 1994, was raised to 1.21 percent in 1995 and increased stepwise to 1.27 percent in 1999. It will remain at that level according to the Agenda 2000 decisions of the Berlin summit, the Copenhagen summit in 2002 and the 2004 proposal of the Commission despite of Eastern enlargement.

Agricultural levies and customs duties are often called the traditional own resources (LAFFAN, 1997, p. 41). Customs duties arise from the common commercial tariff and other tariffs on trade as a result from EU trade policy which is itself embedded in the WTO (including GATT) agreements. The policy goals formulated in these negotiations determine the revenue that the EU can obtain from that tra-

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7. The European Coal and Steel Community (ECSC) had its own operating budget since the Treaty of Paris in 1952. The Commission (High Authority) was allowed to impose levies on coal and steel production until the expiry of the Treaty in 2002. The European Development Fund (EDF) is also financed by contributions from the Member States, but is off-budget. See EUROPEAN COMMISSION (2000), pp. 19. Both, the ECSC and the EDF are not discussed in the following.

8. In 1979, the phase of the European financial crisis started with a rejection of the budget by the European Parliament. In June 1988, the struggle between EU institutions was resolved by the Delors I package that contained several institutional measures, like the financial perspective, a reform of the spending structure and the introduction of the ‘fourth resource’. See BIEHL and PFENNIG (1990).

ditional own resource. Agricultural levies accrue from the Common Agricultural Policy (CAP). Although customs duties have replaced agricultural levies since July 1995 as a result of GATT agreements, some apply in the sugar market arrangement in order to offset the difference between market and guaranteed prices. They comprise production levies which force producers to contribute to market support and storage levies which finance the storage cost equalization system (EUROPEAN COMMISSION, 2000, p. 17). The traditional own resources provide the EU with real autonomy in collecting revenue at the EU level. According to the EU decision-making process, the EU obtains these resources from its own policies. The tariff base and rates as well as the levies are determined at the EU level.

The VAT resource is to be assessed differently. The VAT is an indirect tax on consumption that is levied in all member countries on a harmonized basis. In order to understand the calculation of the VAT based resource it is useful to distinguish between the statutory VAT base which is harmonized to a large extent,<sup>9</sup> the actual VAT base which also depends on the bundle of goods and services and hence on the specific economic structure of member states, and the harmonized tax base which is relevant for computing VAT transfers to the EU.<sup>10</sup> The VAT resource is computed as a share of member countries' VAT revenues. The EU does not impose an own VAT or levy surcharges on member states' VAT revenues. It has no power to set tax rates of the VAT. The EU obtains contributions from the member states that are computed on the basis of the harmonized VAT base. The payments of member countries are obtained by applying a specific rate to the harmonized VAT base that was 1 percent until 1985, 1.4 percent until 1995 and 1 percent until 1999. In 2002 and 2003, the rate amounts to 0.75 percent and, from 2004 onwards, to 0.5 percent (HEINEMANN, 2001, p. 217).<sup>11</sup>

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9. VAT rates are harmonized to a lesser extent such that they might still vary between member states.

10. The harmonized base is obtained by a complicated method that considers the VAT base and rate differences across member states (FOLKERS, 1998, pp. 594). The harmonized VAT base is computed as the sum of (according to the EU rules) liable revenue at the stage of the final consumers. These modified revenues are divided by a weighted average tax rate which is necessary due to the tax rate differentiation of member states. The harmonized VAT base is capped at 55 percent of GNP of each member state because the VAT tax base is not considered a fair basis of the financial contributions to the EU, in contrast to a GNP based resource.

11. The calculation of the VAT resource is further complicated by the U.K. rebate which is a little far-fetched to outline in detail here. See EUROPEAN COMMISSION (2000a, Art. 4) for its calculation and FOLKERS (1998) for an economic assessment. Meanwhile the reason for the U.K. rebate, relatively small benefits from the CAP, is obsolete because the British benefits from the CAP are only about 2 percentage points below its share in the contributions without correction. Further rebates were granted to Austria, Denmark, Finland, Greece,



**Table 1**  
**,Own‘ Resources of the EU in Million Euro (in Current Prices), 1971 to 2002**

Years	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
Agricultural Levies	713.8	799.5	510.3	330.1	590.1	1163.7	1778.5	2278.9	2143.5	2002.3	1747.4	2227.8	2433.9	2950.0	2179.1	2287.0
Duties	582.3	957.3	1986.3	2737.6	3151.0	4064.5	3927.2	4390.9	5189.1	5905.7	6392.4	6815.3	7234.6	7623.5	8310.1	8173.0
VAT	–	–	–	–	–	–	–	–	4737.7	7258.5	9187.8	12000.5	13691.0	14565.9	15218.9	22223.4
Fourth Resource (GNP based)	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Miscellaneous	1033.2	1360.7	2417.7	2075.7	2644.0	2956.5	2969.4	5783.0	2821.2	1265.8	1590.4	1038.5	2369.7	943.0	2377.0	983.8
<b>Total</b>	2329.3	3117.5	4914.3	5143.4	6385.1	8184.7	8675.1	12452.8	14891.5	16432.3	18918.0	22082.1	25729.2	26082.4	28085.1	33667.2

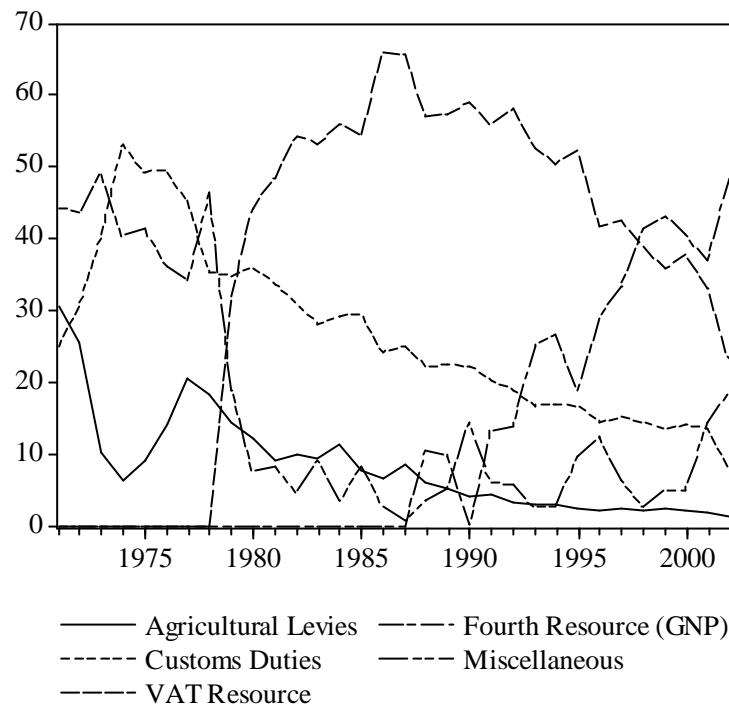
Years	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Agricultural Levies	3097.8	2605.8	2397.7	1875.7	2486.6	1987.8	1929.9	2074.1	1944.6	1821.5	1925.3	1955.1	2151.7	2155.7	1775.6	1259.4
Duties	8936.5	9310.2	10312.9	10285.1	11475.4	11292.4	11055.6	11178.0	12508.6	11762.2	12247.0	12155.6	11705.9	13111.5	12813.6	7954.6
VAT	23463.5	23927.6	26293.4	27440.1	31406.2	34659.3	34489.9	33254.5	39183.2	33962.9	34222.5	33118.0	31163.4	35121.6	31250.0	22382.2
Fourth Resource (GNP based)	–	4445.8	4519.0	94.9	7468.3	8322.2	16517.9	17682.2	14191.2	23549.1	26898.2	35020.5	37509.8	37580.4	34878.8	46095.8
Miscellaneous	285.5	1554.0	2376.8	6773.3	3412.9	3450.1	1679.5	1813.3	7249.5	10179.4	5254.7	2280.5	4372.7	4755.2	13571.2	17736.4
<b>Total</b>	35783.3	41843.4	45899.8	46469.1	56249.4	59711.8	65672.8	66002.1	75077.1	81275.1	80547.7	84529.7	86903.5	92724.4	94289.3	95434.4

Source: EUROPEAN COMMISSION (2000, pp. 42; 2003, pp. 134).

The fourth resource is simply computed as a residual revenue source. The EU may obtain up to 1.27 percent of each country's GNP if the amount is not yielded by the other own resources. EU revenue is completed by miscellaneous revenue such as contributions from the member states (in particular during the seventies), deductions from the salaries of EU employees (tax and social security contributions), revenue from administrative services, interest on late payments, fines and any surplus from earlier years. These amounts of miscellaneous revenue can be substantial. As *Table 1* indicates, it exceeds agricultural levies since 1990.

*Table 1* informs about the development of EU own resources from 1971 to 2002. In the 1970's, the EU was mainly financed by agricultural levies, customs duties and contributions from the member states (under the miscellaneous heading). Revenue from the traditional own resources increased until the 1980's: In the case of agricultural levies, the increase was nearly threefold from 1971 to 1979. Customs duties more quickly became the more important revenue resource until 1979. The stepwise introduction of a common system for customs duties between 1971 and 1975 is reflected by the figures in *Table 1*. From 1971 to 1974, the revenue from customs duties nearly doubled each year while the increases until 1976 were smaller, but still substantial. While the absolute revenue amount raised by agricultural levies has been slightly reduced until 2002, that of customs duties steadily increased until 1995, remained at about that level until 2001 and dropped in 2002.

The relative weight of the traditional own resources has however declined since 1978. This is first due to VAT revenue whose introduction was completed in 1979. It quickly became the most important revenue source of the EU. As *Figure 2* indicates, its revenue exceeded that of customs duties already in 1980 and passed the combined revenue of the two traditional own resources a year later. In 1986 and 1987, VAT revenue covered about two thirds of EU total revenue. This has changed after the introduction of the fourth, GNP based resource. With the exception of 1990 and 1995, revenue from the fourth resource has increased. In 1998, it became more important than the VAT resource and covered 48.3 percent of EU revenue in 2002. In that year, revenue from agricultural levies amounted to 1.3 percent, that from customs duties to 8.3 percent, revenue from the VAT resource to 23.5 percent, and miscellaneous revenue sources to 18.6 percent (EUROPEAN COMMISSION, 2000).



*Figure 2: EU Revenue Categories in Percent of Total Revenue, 1971 to 2001*

*Source: European Commission (2000, pp. 42; 2003, pp. 134)*

This development of EU revenue clearly indicates that the term ‘own resources’ is economically misleading. Agricultural levies and customs duties as those resources for which the EU has the exclusive decision-making power comprise less than 10 percent of EU total revenue. The VAT resource and the fourth resource that cover the remainder of EU revenue imply no taxing powers, however. They are only contributions from EU member states to the common budget. Although the EU has a legal claim to obtain these resources, it cannot autonomously change tax rates or tax bases. The EU has to be satisfied with what member states contribute.

### 3.2 Off Budget Debt Issuing

In addition, the EU faces a balanced budget requirement. Art. 268 of the Treaty establishing the European Community excludes the issuing of debt. Nevertheless, the EU uses several external financial instruments to get resources on financial markets and thus circumvents the balanced budget requirement by off-budget activities (*Table 2*). Total external EU borrowing has increased from 3.9 Billion Euro in 1980 to 38 Billion Euro in 2002. Historically, the EU has used five different instruments (EIJFFINGER and DE HAAN, 2000, pp. 119). The first instrument is based on the Treaty of

Paris and allows EU loans to support restructuring in the coal and steel industry. A similar instrument is found for research and investment in nuclear energy under Euratom. Third, member states can obtain EU loans in times of balance of payments crises. Fourth, the New Community Instrument (NCI) is aimed at economic restructuring by providing loans to investment by small and medium sized firms. These instruments have become more or less unimportant. The most notable activities are those of the European Investment Bank (EIB Group) which amounted to 38 Billion Euro in 2002 (GWOSC, 2001).

The EIB is the EU's bank for economic development and was already established by the Treaty of Rome. Most of its financing is spent for regional development projects, such as the Channel Tunnel or the Great Belt link in Denmark. The operations of the EIB in financial markets are conducted for structural policy reasons and are often justified by capital market imperfections (ELJFFINGER and DE HAAN, 2000, pp. 119). Private financial institutions may sometimes not be willing to fund private projects with uncertain profits. The EIB passes on the benefits from its creditworthiness to private and public investors. The EIB has much lower default risk than several of the projects that are funded by granting loans such that specific projects can be financed by incurring lower interest rates. Simplified, the EIB borrows money on financial markets to grant loans to member countries or specific industries in member countries. The costs of these instruments are mainly administrative costs of the EU and a distortion of capital markets that occurs to the extent that EU borrowing does not cure capital market imperfections. Although the absolute amount of EU borrowing sounds high, it is again negligible in terms of EU GDP: Less than a half percent of EU GDP is borrowed, compared to Italian debt of more than 100 percent of GDP for example. Moreover, the EU Treaty precludes the use of EIB financing for general operational expenditures of the EU. Supplementing the basic balanced budget requirement of the EU by some flexible instruments for regional development appears to be an acceptable solution.

There is some discussion in the literature as to whether the EU should have the power to incur public debt. GWOSC (2001) and GWOSC and VAN DER BEEK (2003) consider arguments for and against EU debt. First, there is the EU's potential to overcome short-term liquidity constraints that may be due to a temporal divergence between revenue and spending. In the fiscal years 1983 to 1987, the EU would have needed a VAT rate of 0.2 percentage points higher than budgeted in order to meet

its budgetary obligations. ACKRILL (1998) argues that this situation partly resulted from financial malpractices. Second, EU debt provides a precaution against cases of emergency, such as natural disasters. Third, EU debt redistributes fiscal burden across generations. European projects, like the Trans-European-Networks, entail benefits for future generations such that there is also a normative reason for demanding financial contributions from that group. Fourth, the EU should have a possibility to incur debt if it has further responsibilities in the macroeconomic stabilization of Europe. The currently available instruments of indebtedness can be used to accomplish the first three goals to some restricted extent while the fourth reason for EU indebtedness is widely denied by many national representatives and economists. Since the GDP resource always balances the EU budget it is hardly affected by the business cycle such that the stabilization arguments do not necessarily apply in the EU.

Moreover, economists frequently object against EU debt from a political economics point of view because the EU neither has the legitimacy to issue debt because sovereignty is with the member states, nor is it sufficiently controlled in incurring debt (BLANKART, 1996). Political actors at the EU level have incentives to abuse such a power to incur debt (ALESINA and PEROTTI, 1995; FREITAG and SCIARINI, 2001; FELD, 2002). EU politicians would have incentives to enter into an exchange with interest groups in order to obtain personal favors. In addition, larger budgets imply higher power, prestige and pay to the Commission according to the economic theory of bureaucracy. GWOSC and VAN DER BEEK (2003) therefore suggest to allow the EU to incur public debt only under clearly defined constitutional restraints in order to finance extraordinary spending and smooth taxes across time. The need to grant the EU the right to issue debt very much hinges on the allocation of responsibilities in a future EU. Without extended competencies in the financing of European infrastructure or stabilization policies, the EU currently disposes of sufficient instruments to cope with temporal fiscal stress. This assessment is different when the EU finally becomes a federation with far-reaching competencies in very different political fields.

**Table 2**  
**Community Borrowing and Lending from 1980 to 2001 in million EUR (in Current Prices)**

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	
<b>Loans raised</b>												
ECSC	1004	325	712	750	822	1265	1517	1487	880	913	1086	
Balance of payments	–	–	–	4247	–	–	862	860	–	–	350	
Euratom	181	373	363	369	214	344	488	853	93	–	–	
NCI	305	339	773	1617	967	860	541	611	945	522	76	
European Investment Bank	2384	2243	3146	3508	4339	5699	6786	5593	7666	9034	10996	
<b>Community – Total</b>	<b>3874</b>	<b>3280</b>	<b>4994</b>	<b>10941</b>	<b>6342</b>	<b>8168</b>	<b>10194</b>	<b>9404</b>	<b>9584</b>	<b>10469</b>	<b>12508</b>	
<b>Loans granted</b>												
ECSC	1031	388	740	778	825	1010	1069	969	908	700	993	
Balance of payments	–	–	–	4247	–	–	862	860	–	–	350	
Euratom	181	357	362	366	186	211	443	314	–	–	–	
NCI	197	540	791	1200	1182	884	393	425	357	78	24	
European Investment Bank <sup>(*)</sup>	2724	2524	3446	4146	5007	5641	6678	6967	8844	11507	12605	
<b>Community – Total</b>	<b>4133</b>	<b>3809</b>	<b>5339</b>	<b>10737</b>	<b>7200</b>	<b>7746</b>	<b>9445</b>	<b>9535</b>	<b>10109</b>	<b>12285</b>	<b>13972</b>	
	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
<b>Loans raised</b>												
ECSC	1446	1474	908	644	386	298	474	–	–	–	–	–
Balance of payments	1695	1209	4969	402	409	156	195	403	108	–	–	–
Euratom	–	–	–	49	–	–	–	–	–	–	–	–
NCI	49	–	–	70	66	–	–	–	–	–	–	–
European Investment Bank	13672	12974	14224	14148	12395	17553	23025	30098	28355	29038	32172	38016
<b>Community – Total</b>	<b>16862</b>	<b>15657</b>	<b>20101</b>	<b>15312</b>	<b>13256</b>	<b>18007</b>	<b>23694</b>	<b>30501</b>	<b>28463</b>	<b>29038</b>	<b>32172</b>	<b>38016</b>
<b>Loans granted</b>												
ECSC	1382	1486	918	674	403	280	541	–	–	–	–	–
Balance of payments	1695	1209	4969	402	409	156	195	403	108	–	–	–
Euratom	–	–	–	–	–	–	–	–	–	40	40	–
NCI	39	9	30	–	–	–	–	–	–	–	–	–
European Investment Bank <sup>(*)</sup>	14438	16140	17724	17682	18603	20945	26148	29526	31800	36033	37776	39618
<b>Community – Total</b>	<b>17554</b>	<b>18844</b>	<b>23641</b>	<b>18743</b>	<b>19415</b>	<b>21381</b>	<b>26884</b>	<b>29929</b>	<b>31908</b>	<b>36073</b>	<b>37816</b>	<b>39618</b>

Source: EUROPEAN COMMISSION (2000, pp. 46, 2002a, p. 164, 2003, p. 184), EIB (2000, 2001, 2002)

**Table 3 (1)**  
**EU Spending (Outturn in Payments) in Million Euro, 1965 to 1977 (in Current Prices)**

Spending Categories	Budget Year												
	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977
EAGGF Guarantee Section	28.7	50.7	340	1259.7	1668.6	3108.1	1755.6	2485.6	3614.4	3459.8	4327.7	5636.7	6587.1
Structural Funds, of which:	4.6	22.1	81.1	58.5	70.8	95.4	118	136.9	259.1	281.8	375.3	623.8	685.5
-EAGGF Guidance Section	–	–	–	34	51.3	58.4	61.5	53.2	10.8	37.8	76.7	112.1	113
-ERDF	–	–	–	–	–	–	–	–	–	–	150	300	400
-ESF	–	–	–	24.5	19.5	37	56.5	83.7	248.3	244	148.6	211.7	172.5
-Cohesion Fund	–	–	–	–	–	–	–	–	–	–	–	–	–
-FIAP	–	–	–	–	–	–	–	–	–	–	–	–	–
Research	–	–	–	73.4	59.2	63.4	64.9	76.3	70.1	110.3	115.9	127.2	180.8
External Action	–	0.9	0.8	1	1	1.4	0.4	71.8	63.3	358.5	250.9	202.8	194.1
Administration	43.3	50.9	53.7	94.7	104.3	115.3	137.8	173.6	245.3	306.2	364	430.7	501.6
Repayments and other	–	0.6	0.5	0.6	0.9	1.6	130.4	178.1	253	309.8	383.1	541.6	586.8
General Budget – Total	76.6	125.2	476.1	1487.9	1904.8	3385.2	2207.1	3122.3	4505.2	4826.4	5816.9	7562.8	8735.9
<b>EDF</b>	106.7	108.3	104.6	106.5	115	145.6	154.4	131.5	157.8	172	208.5	248.6	244.7
<b>ECSC</b>	35.7	31	37.7	32.4	45.7	45.6	49.8	51	40.5	58	76	84.2	95.5
<b>Euratom<sup>(1)</sup></b>	120	129.2	129.5	–	–	–	–	–	–	–	–	–	–
<b>Grand total</b>	339	393.7	747.9	1626.8	2065.5	3516.4	2411.3	3304.8	4703.5	5056.4	6101.4	7895.6	9076.1

(1) The Euratom budget was incorporated in the general budget in 1968.

Source: EUROPEAN COMMISSION (2000, pp. 28; 2003, pp. 126).

**Table 3 (2)**  
**EU Spending (Outturn in Payments) in Million Euro, 1978 to 1989 (in Current Prices)**

Spending Categories	Budget Year											
	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
EAGGF Guarantee Section	8679.3	10387.1	11291.9	11063.7	12259.8	15785.8	18330.4	19727.8	22118.1	22950.1	26395.2	24401.4
Structural Funds, of which:	1388.7	1515.5	1808.5	3566.8	4570.1	4081.3	3220	3702.9	5664.7	5859.6	6419.3	7945.1
-EAGGF Guidance Section	325.6	286.5	314.6	539.9	650.8	575.3	595.6	685.5	771.2	789.5	1140.9	1349
-ERDF	525	699	793.4	2406.5	2905.4	2306.6	1412.5	1610	2456.7	2560.1	2979.8	3920
-ESF	538.1	530	700.5	620.4	1013.9	1199.4	1211.9	1407.4	2436.8	2510	2298.6	2676.1
-Cohesion Fund	–	–	–	–	–	–	–	–	–	–	–	–
-FIAP	–	–	–	–	–	–	–	–	–	–	–	–
Research	266.9	267.6	364.2	311.6	437.3	1345.5	1660	677.9	775.4	964.4	1129.5	1517.5
External Action	313.2	443.7	603.9	738.4	891.2	901.3	996.5	963.8	1057.3	809.2	768.1	1044.3
Administration	686.6	775.6	829.9	941.8	1048.2	1108.2	1212.9	1304.8	1533.9	1696.9	1906.1	2069.8
Repayments and other	707.1	831.2	958.9	1103.7	1263	1283.9	1661.6	1490.1	3526	2807.8	4403.6	3779
General Budget – Total	12041.8	14220.7	15857.3	17726	20469.6	24506	27081.4	27867.3	34675.4	35088	41021.7	40757.1
<b>EDF</b>	401	465.3	481.9	663.7	647.2	718.8	703	698	846.7	837.9	1196.3	1297.1
<b>ECSC</b>	67.3	87.5	115.6	139.7	184	207.7	255.2	267.9	298.1	308.9	277.2	229.9
<b>Euratom<sup>(1)</sup></b>	–	–	–	–	–	–	–	–	–	–	–	–
<b>Grand total</b>	12510.1	14773.5	16454.8	18529.4	21300.8	25432.5	28039.6	28833.2	35820.2	36234.8	42495.2	42284.1

(1) The Euratom budget was incorporated in the general budget in 1968.

Source: EUROPEAN COMMISSION (2000, pp. 28; 2003, pp. 126).

**Table 3 (3)**  
**EU Spending (Outturn in Payments) in Million Euro, 1990-2002 (in Current Prices)**

Spending Categories	Budget Year												
	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
EAGGF Guarantee Section	25604.6	31103.2	31254.5	34935.8	32952.8	34490.4	39324.2	40423	39068	39468.6	40437.3	42182.4	43201
Structural Funds, of which:	9591.4	13971	18378.3	20478.5	15872.1	19223.3	24624.1	26285.1	28624.1	30377.4	25524.3	22620.4	27480
-EAGGF Guidance Section	1825.3	2085.4	2857.9	2914.2	2476.5	2530.6	3360.3	3580	3521.5	3774	1390.7	1343.1	1553
-ERDF	4554.1	6306.8	8564.8	9545.6	6331.2	8373.6	10610.3	11521.4	11779.2	14006.5	2751.4	8496.7	10199
-ESF	3212	4030	4321.1	5382.6	4315.4	4546.9	6031.6	6143.4	7602.8	7245.8	2340.0	4222.4	6646
-Cohesion Fund	–	–	–	795	851.6	1699.3	1872.2	2323	2336	2731.7	1682.2	1983.4	3148
-FIAF	–	–	–	–	395	248.1	421.6	486.9	407.7	571.9	335.3	201.1	348
-Completion of earlier programmes	–	–	–	–	–	–	–	–	–	–	14638.0	4376.2	3200
Research	1790.3	1706.3	1903.2	2232.5	2480.8	2477.9	2878.7	2981.6	2968.7	2629.2	3151.2	3141.0	3603
External Action	1430.6	2209.6	2140.6	2857.5	3055.2	3406.2	3855	3822.6	4159.7	4729.5	4889.8	5773.5	6104
Administration	2332.9	2618.7	2877.6	3319.1	3541.7	3870.3	4011.1	4195.5	4171.3	4111.4	4484.4	4686.5	5147
Repayments and other	3313.1	1901.8	1935.9	960.1	1370.5	3079.3	2339	2111.3	1886.4	2175.6	1961.9	2256.9	2315
<b>General Budget – Total</b>	<b>44062.9</b>	<b>53510.6</b>	<b>58490.2</b>	<b>64783.4</b>	<b>59273.1</b>	<b>66547.4</b>	<b>77032.2</b>	<b>79819.1</b>	<b>80878.1</b>	<b>83491.6</b>	<b>80448.9</b>	<b>80660.7</b>	<b>87825</b>
<b>EDF</b>	<b>1256.5</b>	<b>1191.3</b>	<b>1941.7</b>	<b>1353.6</b>	<b>1781.6</b>	<b>1563.7</b>	<b>1317.4</b>	<b>1213</b>	<b>1439.6</b>	<b>1275.4</b>	<b>1548.2</b>	<b>1717.0</b>	<b>1902</b>
<b>ECSC</b>	<b>288.6</b>	<b>314.3</b>	<b>412.2</b>	<b>596.4</b>	<b>424</b>	<b>297.5</b>	<b>255.3</b>	<b>459.8</b>	<b>184.9</b>	<b>184.6</b>	<b>135.0</b>	<b>189.6</b>	<b>130</b>
<b>Euratom<sup>(1)</sup></b>	<b>–</b>	<b>–</b>	<b>–</b>	<b>–</b>	<b>–</b>	<b>–</b>	<b>–</b>	<b>–</b>	<b>–</b>	<b>–</b>	<b>–</b>	<b>–</b>	<b>–</b>
<b>Grand total</b>	<b>45608</b>	<b>55016.2</b>	<b>60844.1</b>	<b>66733.4</b>	<b>61478.7</b>	<b>68408.6</b>	<b>78604.9</b>	<b>81491.9</b>	<b>82502.6</b>	<b>84951.6</b>	<b>82132.1</b>	<b>82567.3</b>	<b>89886</b>

(1) The Euratom budget was incorporated in the general budget in 1968.

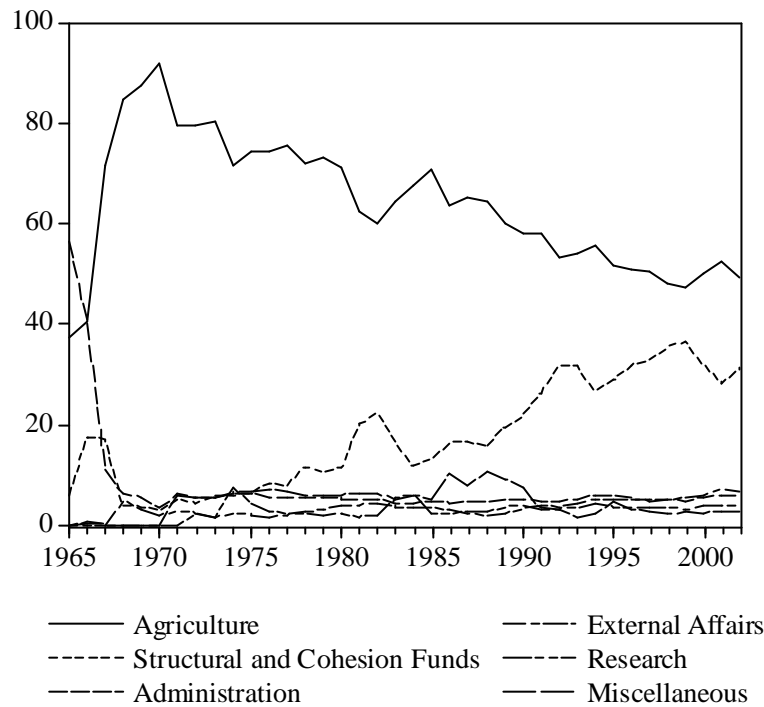
Source: EUROPEAN COMMISSION (2000, pp. 28; 2003, pp. 126).

### 3.3 Spending for European Policies

The revenue discussion indicates that the Commission and the Parliament do not have much influence on the total amount of EU spending. It is mainly set by the (European) Council in the financial perspective. The level of spending is more or less predetermined by financial resources granted by the member countries. The EU institutions only decide about the structure of expenditure. Legally, EU expenditure is classified as either compulsory (CE) or non-compulsory (NCE). Compulsory spending can be defined as that for whom “the principle and the amount of the expenditure are prescribed in the Treaties establishing the Communities, or in legal documents enacted on the basis of the Treaties.” (EUROPEAN COMMISSION, 1995, p. 109). Compulsory spending is legally predetermined in the sense that the EU, once responsible for a certain policy, spends the amount that is necessary to fulfill the legal obligations in that policy area. Non-compulsory spending is however pretty much directly controlled by the EU because it can decide the total amount of spending on a policy to a large extent autonomously and allocates that sum between alternative claims. It should nonetheless be considered that the distinction between compulsory and noncompulsory expenditure is artificial and mainly a negotiated compromise between the Council and the Parliament. It is moreover likely to be overcome if the Convention proposal for the new constitution is adopted.

By far the most important compulsory spending is undertaken for the Guarantee section of the Common Agricultural Policy (CAP). *Table 3* and *Figure 3* indicate, that agricultural spending strongly increased from 38 percent in 1965 to 92 percent of total EU spending in 1970 and slowly decreased in importance to 49.2 percent in 2002. The CAP is created in order to cope with possible failures in agricultural markets such as large price fluctuations which are supposed to result from a relatively low price elasticity of demand and large fluctuations due to weather and climate changes at the supply side. EU spending for the CAP in the first place originates from a guarantee and intervention scheme that offers minimum prices at which intervention agencies buy up excess domestic supply. These intervention prices are legally fixed such that they force the EU to adjust spending accordingly. The MacSherry reform of 1992 reduced intervention prices of the Guarantee section of the CAP, but introduced or extended compensatory policies like the ‘set-aside policy’ where farmers can obtain compensation payments if they leave land idle, or direct income compensation to farmers. Other elements of the reform were an early retirement scheme for farmers and aid to farm-

ers adopting environmentally friendly methods (EIJFFINGER and DE HAAN, 2000, p. 116). These measures were not designed to shift EU spending strongly from compulsory to non-compulsory components.



*Figure 3: EU Spending Categories in Percent of Total Spending, 1965 to 2002*

*Source: European Commission (2000, pp. 28; 2003, pp. 126)*

Non-compulsory spending mainly consists of the three so called structural funds: the European Regional Development Fund (ERDF), the European Social Fund (ESF), and the Guidance section of the European Agricultural Guidance and Guarantee Fund (EAGGF). In addition, the Cohesion Fund should facilitate the nominal convergence of Southern European member states on the eve of EMU. In the early years of European integration, structural funds were unimportant. The EU was relatively homogenous in income. Only Southern Italy, the Mezzogiorno, was supposed to receive payments from the social fund since 1968. With each enlargement, regional disparities increased such that structural policies gained importance to mitigate resistance against further integration in Europe. The creation of the European Regional Development Fund which has operated since 1975 is a reaction to the enlargement by the U.K., Ireland and Denmark in 1973. The increases of the ERDF in 1981 and 1989 are also resulting from subsequent enlargements by Greece in 1981, and Spain and Portu-

gal in 1986 (with a larger time lag in becoming budget relevant due to an extended transition period). There was also a scaling up of spending in 1996 to accommodate the entry of Austria, Sweden and Finland in 1995, but the share of the budget more or less remained. Finally, the Cohesion Fund was introduced by the Maastricht Treaty in order to help states with a per capita income of less than 90 percent of the EU average to catch up to the richer economies in the EU. Spain, Portugal, Greece and Ireland have gained from this more recent development.

Spending from the structural funds follows the three European regional policy objectives (EUROPEAN COMMISSION, 2002, p. 249): 1. Development and structural adjustment of backward regions; 2. Conversion of regions, border regions or parts of regions seriously affected by industrial decline; 3. Adjustment and modernization of education and employment policies and systems; (as a supplement to the first goal) Improvement of the competitiveness of fishery structures as well as consideration of sustainable development of resources. Objectives 1 and 2 are aiming at regional development and convergence, while objective 3 particularly focuses on education. If a project qualifies for funding under at least one of these goals, the EU provides resources as a matching grant, i.e. under the requirement of co-financing by the national or regional authorities. The EU share might increase up to 85 percent in the case of the Cohesion Fund. Spending under the structural funds is thus conditional on certain projects or regions according to the detailed mandates of the three objectives and co-financed such that a scheme of matching grants similar to other fiscal equalization systems in nation states obtains.

A further look at *Table 3* and *Figure 3* reveals another interesting pattern of EU spending. The two main expenditure categories, spending for the guarantee section of the EAGGF and for the structural funds, have largely increased over time with only minor fluctuations in the case of agricultural spending. The relative decrease in the importance of the CAP as indicated by *Figure 3* is thus mainly the result of a relatively stronger increase in spending for structural funds. The CAP reforms have only achieved a reduction in growth rates of compulsory spending. The spending increases under the structural funds are however a consequence of a development independent from agricultural policies. Given the strong increases of the ERDF after each round of enlargement, it could be conjectured that achievements in European integration such as enlargements might play a role for additional structural spending.

The remaining spending categories, for administration, external affairs, research, and repayments and others, cover between 3 and 7 percent of total spending in recent times and are thus relatively unimportant. Remarkably and although low in relative terms, growth rates of administrative spending amounted to 11 percent on average between 1965 and 2002, while it was still 8.3 percent on average between 1990 and 2001. While the low relative weight of administrative spending from total EU spending contradicts the folk feeling of the large European bureaucracy, the growth rates suggest that this perception is not totally misplaced. In addition, the main administrative burdens of the EU are carried by the national administrations. For example national customs administrations exclusively execute EU law, but do not count as part of the EU administration. The EU administrative spending thus strongly underestimates the true administrative costs of the EU.

### **3.4 The Financial Perspective in the Light of Eastern Enlargement**

Given these strong restrictions on EU finances, the question emerges what will change due to Eastern enlargement. Will the adoption of the CAP and structural policies to Eastern European accession candidates not strain the EU budget too strongly? Given the pressure that an adoption of current EU policies by the new entrants will induce and the reluctance of current member states to subsidize Eastern Europe to an unprecedented extent, an opportunity for fundamental reforms of the old distortionary policies emerges.

This hope is clearly exaggerated. *Table 4* contains the revised figures for the financial perspective of the EU for the years 2002 to 2006 in 1999 prices and from 2006 to 2013 in 2004 prices. The financial perspective indicates that the ceiling of the EU budget of 1.27 percent of EU GNP will not be surpassed barring unforeseen extraordinary developments. Obviously, Eastern enlargement does not have a strong impact on EU finances in the first years. The adjustments of the current member states in agricultural and structural policies are relatively modest because the inclusion of the new members in these two policies as of 2004 also starts moderately. Their eligibility for EU policies increases stepwise over time such that potential adjustments of agricultural or structural policies are postponed to the future.

**Table 4a**  
**Financial Perspective (EU-25) 2002-2006 in Million EUR in 1999 Prices**

	2002	2003	2004	2005	2006	2006 in 2004 prices
Agriculture	43900	43770	44657	45677	45807	56015
Structural Funds	30865	30285	35665	36502	37940	47582
Internal Policies	6150	6260	7877	8098	8212	1381
External Actions	4570	4580	4590	4600	4610	11232
Administration	4700	4800	5403	5558	5712	3436
Appropriations for Commitments – Total	93955	93215	102985	105128	106741	120688
Appropriations for Payments – Total	94220	94880	100800	101600	103840	114740
Appropriations for Payments in % of GNP	1.11%	1.10%	1.08%	1.06%	1.09%	1.09%

Source: EUROPEAN COMMISSION, <http://europa.eu.int>, Press releases and EUROPEAN COMMISSION (2004).

**Table 4b**  
**Financial Perspective (EU-25) 2007-2013 in Million EUR in 2004 Prices**

	2007	2008	2009	2010	2011	2012	2013
Preservation and Management of Natural Resources (incl. Agric.)	57180	57900	58115	57980	57850	57825	57805
Sustainable Growth	59675	62795	65800	68235	70660	73715	76785
Citizenship, Freedom, Security and Justice	1630	2015	2330	2645	2970	3295	3620
EU as a Global Partner	11400	12175	12945	13720	14495	15115	15740
Administration	3675	3815	3950	4090	4225	4365	4500
Appropriations for Commitments – Total	133560	138700	143140	146670	150200	154315	158450
Appropriations for Payments – Total	124600	136500	127700	126000	132400	138400	143100
Appropriations for Payments in % of GNP	1.15 %	1.23 %	1.12%	1.08%	1.11%	1.14%	1.15%

Source: EUROPEAN COMMISSION (2004).

The newly proposed financial perspective as of 2007 onwards reflects however that the Commission aims at getting additional resources for enlargement.<sup>12</sup> The Commission's goal apparently consists in including the new entrants stepwise in the EU policy programs without changing the financial positions of current member states too strongly. In order to achieve that, appropriations for payments relative to GNP have to increase from 1.08 percent in 2004 to up to 1.24 percent afterwards such that the ceiling of EU finances is hit. Opposition by the net contributors against this proposal has already formed. In particular Germany opposes these plans by arguing that its problems to comply with the Stability and Growth Pact will be exacerbated if it has to pay 33 billion Euro in 2013 instead of the 22 billion Euro it is supposed to contribute in 2004. It remains to be seen how this conflict is resolved.

#### **4 Why Is There an EU Budget? Or Problems and Hard Choices**

The size and structure of the EU budget in *Section 3* reveals that EU spending is not designed according to the normative arguments of the theory of fiscal federalism.<sup>13</sup> This verdict does however not hold with respect to the system of own resources. Since the EU is supposed to secure the common market, the assignment of customs duties to the EU level is justified. The VAT and GNP based resources are contributions by the member states and hence not subject to an analysis of the power to tax. At the spending side, there is however no indication that the EU provides potential EU-wide public goods like defense or internal security beyond first coordination efforts. Environmental protection is coordinated at the EU level by environmental regulation. On the other hand, there is no normative justification from the economic theory of federalism to conduct agricultural policies at the EU level. The argument that the CAP is created in order to smooth large price fluctuations is unsustainable in liberalized world markets where regional shocks to food productions are uncorrelated and tend to cancel each other out (EIJFFINGER and DE HAAN, 2000, p. 114). Protecting the agricultural sector from international competition is neither an EU wide public good, nor would there be many negative transnational spillovers of agricultural policy if member states subsidize their agricultural

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12. The figures for 2006 in 2004 prices as presented in *Table 4a* correspond to the new components of the budget proposed by the Commission and presented according to *Table 4b*.

13. This analysis supports the verdict by ALESINA, ANGELONI and SCHUKNECHT (2002).

sectors autonomously and stick to the common market. If France subsidized its agricultural sector more heavily than Germany, German consumers could obtain high quality French agricultural products at lower prices while the costs are borne by French taxpayers. There is hence an argument to decentralize agricultural policy in the common EU market (SAPIR ET AL., 2004).

Structural policies do deserve a much closer look however. Structural funds could perhaps be assessed as being justified from the normative theory of fiscal federalism if, first, they were designed for macroeconomic stabilization at the EU level in particular as an insurance against asymmetric shocks or if, second, they are means to conduct regional redistribution in order to achieve a convergence of living conditions between the rich and poor European regions. As mentioned before, national fiscal policies of EU member countries compensate for about 20 to 40 percent of changes in regional incomes. The additional interregional transfers granted by the EU could add to that as a means to accommodate asymmetric shocks at the margin.

*Table 5* contains figures about the operational budget balance for each member country between 1992 and 2002 indicating each country's consolidated net flows of revenue provided to and spending received from the EU level including agricultural spending.<sup>14</sup> These figures are the official Commission indicators of the EU budget's national incidence as discussed by ARDY (1988). Politically, these net contributor and beneficiary positions of member states are strongly debated whenever adjustments of EU finances are to be made in the financial perspective. The data show that the EU budget has unambiguous regional redistribution effects. In relative terms, the Netherlands, Sweden, Luxembourg, and Germany, are the main net contributors in 2002 closely followed by Italy, the U.K., France, Austria, Belgium and Denmark. Although the financial burden of Germany, the U.K. and the Netherlands appears to be large in absolute terms, it is still low in percent of national GNPs exceeding 0.5 percent only at maximum. In contrast, Greece, Portugal, Ireland and Spain are net beneficiaries with high financial net transfers relative to their national GNPs. In the case of Ireland, it fell from 6.86 percent 1993 to 1.5 percent in 2002. Portugal received transfers of 3.5 percent of GNP in 1993 and still gets 2.14 percent in 2002. Spain reached a peak of EU transfers in 1995 with 1.75 percent and still receives 1.29 percent of GNP in 2002. Finally, Greece had to accept a reduction of transfers from 5.2 percent in 1993 to 2.4 percent of GNP in 2002.



**Table 5:**  
**„Operational“ Budgetary Balance (after UK correction) in Million ECU or EUR (in Current Prices) and in Percent of GNP**  
**Based on the UK Rebate Definition<sup>(1)</sup>**

	<b>1993</b>		<b>1995</b>		<b>1996</b>		<b>1997</b>		<b>1998</b>		<b>1999</b>		<b>2000</b>		<b>2001</b>		<b>2002</b>	
	Mecus	%	Mecus	%	Mecus	%	Mecus	%	Mecus	%	Mecus	%	Mecus	%	Meuro	%	Meuro	%
<b>B</b>	137.0	0.07	355.8	0.17	16,5	0.01	-395.7	-0.18	-406.5	-0.18	-314.6	0.13	-214.1	-0.09	-629.5	-0.25	-256.4	-0.10
<b>DK</b>	420.0	0.38	437.6	0.35	273,4	0.20	131.0	0.09	7.1	0.00	122.6	0.08	240.5	0.15	-229.0	-0.14	-165.0	-0.09
<b>D</b>	-10644.8	-0.65	-12207.8	-0.66	-10405.9	-0.56	-10552.9	-0.58	-8044.2	-0.43	-8494.0	-0.44	-8280.2	-0.42	-6953.3	-0.34	-5067.8	-0.24
<b>GR</b>	4109.3	5.19	3535.9	4.00	4039.0	4.13	4360.5	4.09	4735.7	4.36	3818.0	3.27	4433.3	3.66	4513.2	3.52	3387.9	2.39
<b>E</b>	2751.6	0.67	7489.7	1.75	5970.2	1.28	5782.8	1.20	7141.1	1.40	7382.4	1.35	5346.8	0.91	7738.3	1.23	8870.8	1.29
<b>F</b>	-1222.8	-0.12	-1587.8	-0.14	-822.2	-0.07	-1284.3	-0.11	-864.5	-0.07	30.0	0.00	-739.4	-0.05	-2035.4	-0.14	-2184.2	-0.14
<b>IRL</b>	2503.4	6.86	2061.1	4.82	2421.8	4.61	2814.4	4.43	2379.2	3.38	1978.7	2.38	1720.8	1.77	1203.1	1.15	1576.7	1.50
<b>I</b>	-1734.4	-0.21	-396.3	-0.05	-1693.0	-0.18	-229.6	-0.02	-1410.6	-0.14	-753.9	-0.07	1210.1	0.11	-1977.9	-0.17	-2884.5	-0.23
<b>L</b>	-105.0	-0.84	-64.6	-0.45	-45.8	-0.31	-54.3	-0.33	-76.6	-0.44	-85.0	-0.44	-56.6	-0.28	-144.1	-0.74	-48.9	-0.25
<b>NL</b>	-292.1	-0.11	-725.9	-0.24	-1295.0	-0.41	-1087.5	-0.34	-1539.8	-0.45	-1827.0	-0.50	-1540.3	-0.39	-2256.8	-0.54	-2187.7	-0.51
<b>A</b>	-	-	-886.5	-0.50	-264.5	-0.15	-779.8	-0.43	-629.2	-0.34	-628.8	-0.32	-447.8	-0.22	-536.4	-0.26	-226.3	-0.11
<b>P</b>	2498.6	3.50	2592.2	3.19	2839.1	3.28	2717.3	2.97	3018.9	3.09	2858.2	2.72	2168.5	1.95	1794.2	1.53	2692.3	2.14
<b>FIN</b>	-	-	-118.6	-0.13	72.6	0.08	39.8	0.04	-102.4	-0.09	-194.8	-0.17	274.5	0.22	-150.4	-0.11	-5.7	0.00
<b>S</b>	-	-	-757.2	-0.45	-587.9	-0.30	-1097.7	-0.54	-779.9	-0.38	-897.3	-0.41	-1059.5	-0.45	-973.3	-0.43	-746.6	-0.29
<b>UK</b>	-1460.2	-0.18	-3077.4	-0.36	-518.3	-0.06	-242.6	-0.02	-3489.3	-0.28	-2826.7	-0.21	-2985.9	-0.19	707.5	0.04	-2902.8	-0.17
<b>Total</b>	<b>-3039.3</b>	<b>-0.05</b>	<b>-3412.6</b>	<b>-0.05</b>	<b>0.00</b>	<b>0.00</b>	<b>121.4</b>	<b>0.00</b>	<b>-60.9</b>	<b>0.00</b>	<b>167.8</b>	<b>0.00</b>	<b>70.8</b>	<b>0.00</b>	<b>70.3</b>	<b>0.00</b>	<b>-148.2</b>	<b>0.00</b>

Source: EUROPEAN COMMISSION (1999, p. 94; 2000b, p. 121; 2001, p. 126; 2003a, p. 126).

(1) This definition excludes administrative expenditure.

Although these transfers appear to be non-negligible from the recipients' perspective, they are far from any effective European insurance against asymmetric macroeconomic shocks. VON HAGEN and HAMMOND (1998) mention estimates that the EU budget would need to amount to at least 7 percent of GDP instead of the current 1 percent in order to provide such an insurance. Macroeconomic stabilization does not drive EU budgetary outcomes.

It then remains to be discussed whether the strong interregional redistribution between EU member countries indicated by the net fiscal flows in *Table 5* is a kind of fiscal equalization between member states. The role of fiscal equalization according to the economic theory of federalism is much debated in the literature (HEINEMANN, 2001). In addition to macroeconomic considerations, grants from the EU to the member states may be provided in order to internalize spillovers and thus increase efficiency. After the discussion on the existence of EU wide public goods in *Section 2*, it is obvious that the role of the EU is much more coordinating than equalizing. The actual flows of EU funds to Southern Europe and Ireland indicate that redistributive goals instead of internalization of externalities are underlying it. With respect to income redistribution, the economic theory of federalism focuses however on interpersonal income redistribution as a task for higher levels of government. Interregional redistribution may only be justified as an intermediate objective in order to achieve a more equal individual income distribution. Interregional redistribution is then supposed to provide similar levels of public infrastructure across regions in order to guarantee similar starting conditions for private individuals in the different regions. Suppose that a Spanish region like the Extremadura suffers from strong structural problems such that it has insufficient financial abilities to accommodate structural change on its own. Since even the rich Spanish regions like Madrid lag behind richer regions in Germany like Bavaria, they cannot afford to provide sufficient funds for enabling a convergence of regional development of the Extremadura to richer regions in Spain and Europe. In that situation, regional transfers from the EU to poor regions in Europe could speed the convergence of income between regions.

This convergence effect is much discussed in the literature because the EU explicitly aims at regional convergence by using its structural funds. DE LA FUENTE and VIVES (1995) find that, in the case of Spain, redistribution by the ERDF has been statistically significant, but economically unimportant due to the small size of the program. According to THOMAS (1997), regional convergence of income in

the EU hinges on the consideration of Greek regions. The Greek growth performance has been disappointing despite the high amount of EU grants received. In a careful study of regional convergence in the EU, BOLDRIN and CANOVA (2001) conclude that convergence of income levels per capita between EU regions does not take place and that structural funds and the cohesion fund do not improve that situation.

This rather pessimistic assessment is challenged by DE LA FUENTE and DOMÉNECH (2001) who analyze the redistributive impact of the EU budget for the period 1986 to 1998 on a country basis. Then, the redistributive impact of fiscal flows in the EU appears to be much more considerable, in particular relative to the size of the EU budget. Moreover, it has tended to increase over time and it is mainly driven by structural funds. ESPASA (2001) corroborates these results by estimating progressive redistributive effects of net fiscal flows in the EU. MIDELFART-KNARVIK and OVERMAN (2002) provide again evidence that structural funds were relatively unsuccessful for convergence processes, but helped Ireland to catch-up by re-enforcing its comparative advantage. In sum, the structural funds do not appear to achieve income convergence between *regions* in Europe in general although they are designed to do that. Instead they redistribute income from the rich to the poor *countries* without however clearly distinguishing between them such that rich countries still get funds for their poor regions. Put differently, the most important reason for the existence of the EU budget consists in revenue redistribution between member countries by giving something to everyone.

Why does this kind of income redistribution between countries take place? Can it be explained by political considerations if normative arguments are not tremendously convincing? The experience with budget negotiations in the Council or the European Council reveals that the financial perspective of the EU is the main instrument by which European finances are determined. The financial perspective however is a major piece of political vote trading. In that process governments decide upon the money available to the EU and the relative size of the most important spending programs by aiming at certain net financial positions of their individual member state. Each explanation of the actual size and structure of the EU budget has to consider this log-rolling exercise as a starting point. An important example for the prevailing political game is the U.K. rebate which is based on a complicated abatement mechanism. Because the U.K. joined the EU as a net contributor with a totally different agricultural regime, it aimed at a reduction of its contributions since 1974. After realizing that the U.K.

receives much less from than it pays to the budget, Mrs. Thatcher insisted during the 1980's that she wanted "her money back" and succeeded in 1985. Agenda 2000 and the enlargement summit of Copenhagen ensure that the U.K. does not disproportionately gain from changes in the financial system that are due to Eastern enlargement. This rebate is nevertheless paid for by the other net beneficiaries. In turn, they have started to insist in the current discussions on the financial perspective that they should be included in similar abatement mechanisms.

The EU budget therefore appears to be less guided by clear policy objectives than by member states' redistributive concerns. BEGG (2000) and FOLKERS (2001) convincingly argue that the EU budget serves as a compensation device for potential losers of EU integration. In addition, it should be expected that those interest groups in the member states who are best organized will be better able to defend their interests than the real losers. Indeed, ALESINA and WACZIARG (1999, p. 34) contend that the budget adopted this function in the beginning of the integration process when the French government, under pressure by French farmers, demanded the CAP as a side-payment in exchange for approval of the creation of a Common Market in the Treaty of Rome. The creation of the cohesion fund on the other hand appears to be the compensation for Spain to join EMU. And the discrete increases in spending for the structural funds after each enlargement of the union provide additional descriptive evidence for that conjecture. The underlying reason for a compensation mechanism obtains from the effect of economic integration on the different national economies.

The driving force of European economic integration is the creation of the common market by introducing the four freedoms, free movements of trade, services, capital and labor. Entry barriers of domestic markets that were formerly protected from competition had to be lifted in that process such that those who obtained economic rents from protection and reduced competition had potentially great losses from European integration. Those national groups, like for example French farmers, have high abilities to lobby the national government in order to defend their rents or to obtain compensation payments. They were obviously successful in receiving compensation from the EU budget. This process also explains why some rich countries were net beneficiaries of the system at some point in time and why countries of average wealth carried the main financial burden. For example, Denmark slightly gained from the EU budget until recently while Germany can only be considered a country of average wealth after unification. In that case, the strong resistance of Danish voters against further

steps of integration called for a political compensation whereas Germany appeared to be happy for a while that the European partners accepted reunification. All in all, the EU budgetary system is therefore not in line with usual criteria of economic fairness but rather of political economy.

## **5 The EU Budgetary Process**

The analysis of the negotiations between member states preceding each financial perspective is still not the end of the story. Although the financial goals of the member states are very important for the determination of the size and the structure of the EU budget, continuous changes in budget outcomes in the EU also result from the interaction between Council and Parliament in the budgetary procedure. It is thus important to look into the annual budgetary process because that annual process generates a consistent flow of the side-payments undertaken between member states in order to keep integration going on at the political level.

The budgetary procedure is established by Art. 203 of the Treaty which sets out a precise timetable and procedure for drafting the annual budget (EUROPEAN COMMISSION, 1995, LAFFAN, 1997). Decision making power on budgetary matters is divided between the Council and the European Parliament (EP). The budget cycle starts with preparatory works of the Commission followed by conciliations among the three EU institutions concerned with budget making (inter-institutional dialogue). The Commission drafts a Preliminary Draft Budget for submission to the Council. During the first reading in the Council, each EU member state has a possibility to propose amendments that the Council accepts or rejects by qualified majority voting. It is then sent to the Parliament for a first reading. The Council receives the budget for a second reading and sends it back to the Parliament. The Parliament has the final say in the budgetary process by adopting or rejecting the budget overall. The Council however determines compulsory spending and the Parliament non-compulsory spending. This power distribution is a permanent source of conflict between the two institutions (LAFFAN, 1997, p. 70).

FELD, KIRCHGÄSSNER AND WECK-HANNEMANN (2002) show that the Parliament indeed has a strong impact on the size of non-compulsory spending while the impact on compulsory spending is divided between the Council and the Commission. The Commission has hence possibilities to exploit its role as an agenda setter with respect to compulsory expenditure. Budget outcomes at the EU level therefore are the result of the interaction between Council, Parliament and Commission taken the fi-

nancial perspective as given. BLANKART (2001) also suggests that the different positions of member states in the Council and their actual relative influence on voting outcomes according to the weighted voting scheme have an impact on budget outcomes. In qualified majority decisions in the Council, smaller states face a relatively higher representation than they deserve according to population. They therefore receive relatively more EU funds as compared to relative income measured by their share of EU GDP, while the larger states receive relatively less. Redistribution of EU funds does not simply follow the guideline that the rich pay for the poor but depends on actual political influence. RODDEN (2002) analyzes the impact of the Council and the Parliament on net fiscal transfers per capita in the EU between 1973 and 1999 more thoroughly. According to his estimates, EU budget outcomes – *ceteris paribus* – depend positively on the voting power of the Council and the Parliament. Without distinguishing between compulsory and non-compulsory spending and for the whole time period, Council voting power appears to have a slightly larger impact on the budget in quantitative terms than the Parliament's voting power. This is no surprise given the strong influence of the financial perspective on the size of the budget. Distinguishing time periods, the impact of the Council dropped in favor of the Parliament after the enlargement by Greece. However, the Council regained its influence after the enlargement by Spain and Portugal while it has declined again since. Aside the political economy variables, a country's agricultural share of employment and population size affect EU transfers positively, while GDP per capita is negatively correlated with net fiscal flows per capita.

The political decision making procedures for the determination of the budget are thus non-negligible in explaining its size and structure. Both increases in the Council's and the Parliament's voting power positively affect net transfers per capita from the EU. None of these institutions has a dominant position vis à vis the other in the annual budgetary process, while the Council dominates the decisions on the financial perspective. It is very instructive that the two most important spending categories, agricultural spending which is mainly dominated by the Council due to its classification as compulsory, and structural funds which are mainly dominated by the Parliament due to its classification as non-compulsory, have both increased over time although their relative weights have been changed in favor of non-compulsory spending. The political interests represented by the member states in the Council obviously did not suffer from actual reductions in agricultural subsidies. It remains open to further shifts in decision-making procedures or further steps of enlargement how this balance of powers is affected and subsequently changes budget outcomes.

## 6. Concluding Remarks

European finances are much more complicated and interesting than the mere size of the budget of 1 percent of EU GNP suggests. Much ado about nothing is a misplaced assessment of EU finances. While the revenue side restricts budget size due to the balanced budget requirement and the system of own resources that is largely based on member states' contributions, the EU determines the structure of spending. Compulsory spending, i.e. agricultural expenditure, is strongly influenced by the Council and the Commission, and non-compulsory spending, i.e. the structural funds, is mainly determined by the Parliament.

In reviewing the structure of revenue and spending, the question emerges why a European budget is actually needed. Theoretical guidelines, like those from the economic theory of federalism, suggest that, aside the provision of the internal market, EU wide public goods or a need for coordination at the EU level may exist with respect to defense and internal security, perhaps also to environmental policies. The European Convention suggests to attempt at further coordinating these policies, but is far from proposing any dominant competence of the Union. Instead, the EU conducts agricultural policy by providing subsidies to EU farmers and structural policies in order to achieve a redistribution of income between member countries. Although there is not much success of the structural funds in achieving convergence among poor and rich European regions in the EU, this redistribution scheme is still maintained. Macroeconomic policy goals do also not guide the fiscal flows between member states. In this paper, the size and the structure of EU spending is therefore explained by political reasons. The EU budget mainly plays a role in balancing the gains and losses from European integration (BEGG, 2000). In the negotiations on the financial perspective, member states demand compensations for each step of European integration that imposes adjustments costs of internal national or regional markets in which economic rents due to the lack of competition can be reaped. Some authors like TABELLINI (2003), BLANKART and KIRCHNER (2003) or HEINEMANN (2001) consequently criticize that the EU mainly engages in inter-country redistribution while the provision of EU wide public goods is neglected.

HEINEMANN (2001) proposes a compensation fund to solve this undesired situation. The compensation fund would conduct inter-country redistribution under the exclusive control of the member states while the Commission can concentrate on the provision of EU wide public goods. BLANKART and

KIRCHNER (2003) suggest to circumvent the redistribution game with respect to new EU policies by introducing a voting by veto procedure. New EU policies would be decided by an alternative budgetary process where the project survives that has not been vetoed up to the last voting round. BUTI and NAVA (2003) suggest a European Budgetary System according to which EU policy makers set the spending priorities for the Union, and the Member states as well as the Commission decide how to allocate spending on individual items between the EU and the member states. While the first two proposals contradict the principle of unity of the budget that extends to a uniform budgetary procedure, the third proposal is most critical because it would provide the EU with a general control of national budgets and hence enormously centralize the budgetary policy. Such a centralization is not warranted, because neither EU wide public goods, nor redistribution, nor macroeconomic stabilization provide a rationale for that much power of the EU.

The constitutional draft proposed by the Convention does not have an immediate impact on EU public finances. It does not propose such far reaching additional spending competencies of the EU, nor does it say much about additional own resources or coordination of taxation. It only suggests to abolish the distinction between compulsory and non-compulsory spending and to increase coordination among member states in cases of tax fraud. As seen from *Table 4* in *Section 3*, enlargement will also not terribly affect spending or revenue.

What are the chances for additional EU resources? EUROPEAN COMMISSION (1998) discusses several alternatives for EU taxes. They range from personal or corporate income taxes to ecological taxes or a surcharge on the national VAT. Quite a few authors have contributed to that discussion. BUCHANAN and LEE (1994) and BLANKART and KIRCHNER (2003) want to keep the current system of contributions under some modifications. BIEHL (1985) suggests a surcharge on member states' income taxes as a revenue source for the EU based on the that the tax with a high potential for income redistribution should be centralized. The problem with progressive income taxes is found in a political economy argument. The EU would obtain additional revenue from bracket creep and general income increases without having the obligation to request explicit agreement by European citizens. It is evident that this development would provide incentives for EU decision-making bodies to increase the importance of the EU level over time perhaps against the preferences of citizens. Indirect taxes do not have this character. For additional revenue, the permission of voters needs to be

demand in the democratic process if the EU possessed a power to levy indirect taxes. SCHNEIDER (1993), KIRCHGÄSSNER (1994), FELD and KIRCHGÄSSNER (1996, 2003) and FELD (2004) suggest to consider a surcharge on the VAT of member states as EU tax, but that it should be decided via referendums in order to force the EU to demand explicit permission for tax rate increases from citizens. GOULARD and NAVA (2002) also propose a surcharge on the VAT of member states, but want to give the EP more decision-making power.

The most recent proposal has been made by the SAPIR ET AL. (2004) report. With respect to revenue, the report argues for a direct link with EU-wide tax bases such as capital income. The authors refrain however from unambiguously suggesting an own EU capital income tax such that this proposal is mainly supporting arguments for a stronger orientation of member states' contributions at GNP. With respect to spending, the report suggests a switch to three funds, a growth fund, a convergence fund and a restructuring fund. The growth fund is supposed to finance growth promoting strategies in the EU which comprise the main focus of the report. The convergence fund is supposed to conduct redistribution within the EU by more strongly targeting low income countries than regions. This would lead to a concentration of money. Finally, the restructuring fund should serve as a complement to national funds for example to co-finance active labor market policy. The main 'crux of the biscuit' in this proposal is the fact that the restructuring fund implies "a very sizeable reduction in the amount devoted to agriculture" (SAPIR ET AL., 2004, p. 164). As PELKMANS and CASEY (2004) conclude, the political feasibility of such a proposal is strongly affected by the same interest groups that have blocked major reforms in agricultural policy already for decades. The prospects for a consideration of this budgetary proposal do thus not look bright.

GALLOWAY (1999) emphasizes the importance of package deals to achieve reform of EU finances in the case of Agenda 2000. In fact, the current system of redistribution in the EU is the result of such package deals. The fiscal restraints imposed on the EU budget appear to be crucial in constraining the redistribution to particular interest groups as well as the inter-country redistribution. Today – with the EU budget paid for by national contributions – EU budget discipline means lower national contributions. National governments hence experience an immediate return from limiting EU spending increases. This would be different when the link between the national and the EU budgets is cut through the introduction of an EU tax. Future reforms of EU finances will however be package deals

as well. Historically, revenue systems of contributions of member states do not appear to be stable in quasi-federal states. A European federation may finally obtain the power to tax. Hopefully, it is decided with the right decision-making procedures such that EU policy follows the preferences of its citizens. It appears that the discussion of European public finances will remain characterized by Bernhard of Cluny's (12<sup>th</sup> century) quote from '*De contemptu mundi*': "*Sometimes I feel pleasure about you, sometimes I mourn you, cry, sigh ....*".

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Koordinator:

Prof. Dr. Wolfgang Kerber, Abt. Wirtschaftspolitik, Am Plan 2, 35032 Marburg,

Tel. 06421 / 28 239 21, Fax 06421 / 28 239 36, E-Mail: kerber@wiwi.uni-marburg.de

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