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Susanne Neheider

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Autor; Korrespondenzadresse

Dipl.-Volkswirtin Susanne Neheider

Technische Universität Berlin, FAK VII – Wirtschaft und Management
Institut für Volkswirtschaftslehre und Wirtschaftsrecht, Fachgebiet
Finanzwissenschaft und Gesundheitsökonomie
Sekt. H 51, Strasse des 17. Juni 135, 10623 Berlin

Tel: 0049-30-314 29 419

E-Mail: S.Neheider@finance.ww.tu-berlin.de

Wirtschaftswissenschaftliche Dokumentation

Strasse des 17. Juni 135, Sekt. H 56

D-10623 Berlin

www.ww.tu-berlin.de

ausleihe@ww.tu-berlin.de

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Susanne Neheider

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Abstract

About 75% of the EU budget are transfer expenditures that go to the agricultural sector and to regional policies. This has long been criticised but the structure of the EU budget has barely changed over the last decades. The EU finances are mainly based on a unanimous agreement between the heads of state or government of the EU member states. During budget negotiations, horse trading or logrolling is a common practice. Negotiators combine expenditure positions and arrangements on the revenue side in different ways until they find a package deal which provides each member with a net utility gain. The paper shows that this is rational under the given constraints yet not necessarily efficient.

Zusammenfassung

75% der Ausgaben des EU-Haushalts haben umverteilenden Charakter und fließen an die Landwirtschaft und in die regionale Strukturpolitik. Obwohl dies seit langem kritisiert wird hat sich die Struktur des Haushalts über die letzten Jahrzehnte kaum verändert. Das EU-Budget geht in erster Linie zurück auf eine einstimmige Entscheidung der Staats- und Regierungschefs. Bei den Verhandlungen hierzu sind Stimmentausch bzw. Stimmenhandel, der sprichwörtliche Kuhhandel, gang und gäbe. Verschiedene Programme auf der Ausgabenseite und Sonderregelungen auf der Einnahmenseite werden solange auf unterschiedliche Weise miteinander kombiniert bis jeder Verhandler einen positiven Nettonutzen aus den Verhandlungen davonträgt. Der Beitrag zeigt, dass dies unter den gegebenen Umständen rational ist, jedoch nicht unbedingt zu einem effizienten Ergebnis führt.

1. Introduction

About 75% of the EU budget are transfer expenditures that go to the agricultural sector and to regional policies. Even though this has long been criticised, the structure of the EU budget has barely changed over the last decades. The EU budget is mainly determined by a unanimous agreement between the heads of state or government of the EU member countries. During negotiations, they mainly focus on their countries' net positions, and activities dubbed horse-trading are common practice during the budget negotiations. My paper presents a brief summary of the decision-making process on the EU's finances and shows how spending programmes as well as adjustments on the revenue side are used as side payments to ensure consensus. I will argue that these often condemned practices can be rational under given constraints because they allow the adoption of projects which produce an unequal distribution of gains and losses.

In the Public Choice literature, logrolling or vote trading has been discussed extensively. Yet the debate focuses mainly on logrolling in legislative bodies that take decisions on a majority basis. In negotiations on the EU budget where unanimous decision-making prevails, vote trading however is organized mainly in package deals. After a brief review of the logrolling literature on majority vote, I will use a simple example to extend the analysis to package deals in unanimous decisions in order to show the rationale behind them. If direct side payments are impossible negotiators might combine different expenditure positions until they find a deal that secures everyone a net utility gain. Such a package deal however does not ensure a Pareto-efficient solution.

2. The EU budget: complex compromise and package deals

2.1. The making of EU budgets: complex compromise

The making of budgets in the EU can be divided into two processes: the annual budgetary process and the decision on the multi-annual financial framework. The annual budgetary process involves the Commission and the two arms of the Budgetary Authority, which are the Council of Ministers and the European Parliament. During the 1980s, the annual budgetary process was marked by conflicts between the Council of Ministers and the European Parliament. In 1988 this was resolved by the so-called Delors I settlement. It included a multi-

annual financial framework determining the maximum amount of financial resources from 1988 to 1992 and an “Interinstitutional Agreement” to settle relations between the institutions responsible for the annual budget. Due to positive experience with Delors I, the procedure has been retained (Laffan 1997: 62-70).

The multi-annual financial frameworks or Financial Perspectives have to be agreed upon unanimously by the heads of state or government. They comprise total spending, the maximum spending within the different headings for each year, allocation rules, and rules for the revenue side. Annual budgets can only be shaped within the ceilings and agreements laid down in the Financial Perspective (European Communities 2000: 10-11). The Commission presents a proposal for the Perspective and, after debate in the Council of Ministers, key decisions are taken in the European Council, the body of the heads of state or government. Subsequently the proposal has to be approved by the European Parliament. However, refusals of the Council’s agreement by the European Parliament have proven to change the Perspective only slightly and the Commission, despite its role as an agenda setter, has frequently had to accept major changes of its draft.

Although the adoption of multi-annual financial frameworks has brought relative peace in budgetary issues between the Council of Ministers and the European Parliament, negotiations on the Financial Perspective have themselves proven to be long and difficult. From the first consultations within the Commission to the final adoption of the Financial Perspective 2007-2013 three years passed (Dür/González 2007). Political debate about the budget and the main focus during negotiations seem to revolve around the member states’ net positions, although calculating net contributions is a difficult and controversial task (Willecke 2005).

What seems to dominate the negotiations is finding a package that offers each member an acceptable net position rather than efficiency aspects of the spending programmes or alleged political objectives like those laid down in the Lisbon Agenda. In order to find a deal so that the necessary unanimous consent can be reached, both the combination of expenditure in different policy areas and adjustments on the revenue side are used which results in a highly complex system. On the expenditure side above all regional policy serves to adjust net contributions. On the revenue side, the well-known UK rebate is only one of many adjustment mechanisms.

2.2. The structure of the EU budget: a result of package deals

The lion's share of the EU budget are transfer expenditures and go to the agricultural sector and to regional policies. From the 1970s to the beginning of the new millennium about 80% went to these categories (European Communities 2000). With still about 75% now (European Commission 2007) the dominance prevails. The provision of EU-wide public goods that one would expect to constitute a major part of the expenditures from the standpoint of fiscal federalism (Henke 2006) plays only a minor role.

The adoption of the Common Agricultural Policy (CAP) in the founding treaty was the result of a bargain between Germany and France. Farming was one of the most important sectors in France and the country was interested in securing an export market for agricultural products. Germany on the other hand wanted to gain access to the highly protected French market for industrial goods. Organizing state aid to farmers on the European level enabled a deal on the integration of markets that both countries desired (Laffan 1997: 5).

Later, mainly regional policy was linked to new integration projects in order to arrange bargains. When the Treaty of Rome was signed in 1957 no regional policy had been planned. The catching-up of poorer regions was entrusted to the positive effects of economic integration. Great Britain, which entered the European Communities in 1973, faced a considerable burden due to the Common Agricultural Policy. It had to contribute a large share to the budget but got little in return farming played only a minor role in the country. To partly compensate this burden, the European Regional Development Fund (ERDF) was established in 1975. This marks the beginning of regional policy activities at the European level.

Accordingly, regional policy transfers served as compensation for negative effects resulting from integration. Integration milestones such as enlargements or new treaties frequently produced winners and losers, with losers threatening to veto the respective plans. Expanding or reshaping regional policy activities was often used to avoid such vetoes. The first major expansion of regional transfers was connected to the accession of Portugal and Spain in 1986. Greece had become a member five years earlier and threatened to veto the enlargement. This was prevented by granting Greece a considerable raise in regional transfers.

The implementation of the Single Market which was laid down in the Single European Act in 1986 coincided with the doubling of structural funds between 1987 and 1992. The poorer member countries asked for financial assistance to help them cope with possible disadvantages from the integration of markets. The commitment to the European Monetary Union in the 1993 Maastricht Treaty induced the next major change of regional policy. Some countries were on the verge of obstructing the EMU, fearing constraints imposed by the convergence criteria. Again, regional policy transfers helped to bring about consensus. In 1992, the Cohesion Fund was established as a new instrument to provide funds to member states with a per capita income level of less than 90% of the average.

The most recent example is the agreement on the Financial Perspective for the years from 2007 to 2013 adopted in December 2005 by the European Council. In contrast to the other categories, the regional policy heading “Cohesion for Growth and Employment” includes numerous additional provisions. Besides the transfers allocated according to general allocation rules within regional policy these include discretionary agreements on additional transfers. Extra money goes to single regions as well as to member states and to old and new members alike. It comprises lump-sum payments ranging from €75 million for Bavaria up to €2 billion for Spain as well as additional per head payments and other exceptions from the general rules (Council of the European Union 2005).

These additional provisions hint at the role of regional policy transfers as side-payments to ensure the unanimous consent necessary for decisions on the Financial Perspective. They also fit in the picture of new regional policy instruments and the increase of resources when significant integration projects that require unanimous agreement are adopted. Tabellini (2002: 18) concludes that “[...]the main goal of structural and cohesion funds was redistributive: not to increase economic efficiency, but to redistribute the benefits of integration among countries, providing side payments so as to facilitate compromise in bargaining situations.” Dewatripoint et al. (1995: 87) emphasize: “If Structural Funds are used inefficiently inside countries, they nevertheless serve a second important purpose, namely to facilitate side payments across countries so as to redistribute the gains from cooperation and to preserve political viability.”

Compensation, however, is not only an issue on the expenditure side of the budget. The budget imbalances persisted and even aggravated for the British as spending on agriculture

increased continually. After long debate and several annual adjustments to reduce the British net contribution, a permanent rebate was installed for the United Kingdom at the Fontainebleau European Council in 1984. The financing of the rebate is spread among the other member states, yet not equally. Germany was first to be granted a reduced contribution rate for the UK rebate. Later on, the contributions of Austria, Sweden and the Netherlands were also reduced.

Further rebates and transitional provisions were granted to Denmark, Finland, Greece, Ireland, Austria, Sweden, Spain and Portugal after their accessions (Wissenschaftlicher Beirat beim BMWi 1999) as well as to the new member states that joined the Union in 2004 and 2007. Reductions of the general contribution rates derived from the member states' VAT base and Gross National Income (GNI) have also been agreed on repeatedly. From 2007 to 2013, Austria, Germany and the Netherlands are granted reductions in their VAT contribution rates. Sweden and, again, the Netherlands benefit from lump-sum reductions in their GNI contributions (Council of the European Union 2005).

3. Vote trading in theory

As section 2 demonstrated, compensation of losers from integration projects is an important feature of the EU budget. The following section analyses the rationale behind these compensatory provisions. For this purpose, the theory on logrolling in majority votes is presented in a first step. I use this approach for constructing a simple example on the functioning of vote trading in unanimous decisions in Section 3.2. Section 3.3. reviews aspects that would have to be addressed in a possible extension of the analysis.

3.1. Logrolling and majority decision making

Bernholz (1973 and 1974) has defined the conditions for logrolling in the following way, also used by Mueller (2003: 108) and Stratmann (1992: 1163 and 1997: 323):

$$X P \neg X \text{ and } Y P \neg Y, \text{ but } XY P \neg X \neg Y$$

X and Y are alternatives in a vote. P denotes a strong preference relation, defined as social preference according to the applied voting rule. Thus, when the simple majority rule is used,

$X \succ P \neg X$ holds when alternative X gets at least $\frac{N}{2} + 1$ votes, with N denoting the number of voters. Neither of the two alternatives X or Y will pass if voted on separately. However, if the two alternatives are combined, both get a majority. This is getting clearer in the following example (see also Mueller 2003: 105):

Voters	Alternatives	
	X	Y
A	-2	-2
B	6	-2
C	-2	6

Table 1: Logrolling with positive net utility

The numbers denote the utility changes for the three voters when the alternatives are realized. If the voters vote according to their preferences neither of the two alternatives will gain a majority. The utility gain of the losing voter, however, would be bigger than the aggregated utility loss of the majority that rejects the alternative. Assuming the possibility of cardinal utilities and interpersonal utility comparisons, both X and Y are Pareto-improving according to the Kaldor-Hicks-criterium. The voter with the utility gain could compensate the losers for their losses as long as his utility gain is at least 4. The large utility gain of the losing voter compared to the relatively small losses of the two voters forming the majority is not taken into account when the simple majority rule is used and voters vote sincerely according to their preferences. Simple majority compares only ordinal utilities.

If voter B promises voter C to vote for alternative Y under the condition that voter C votes for X, both alternatives pass. Thus B and C would agree on a vote trade. Not to vote according to their preferences on one of the alternatives allows them to ensure that their most preferred alternative wins. For the individual voter, vote trading is rational as long as the utility gain from the acceptance of his preferred alternative is at least as big as the utility loss he has to bear when voting for the other alternative.

The above shows the key aspect of vote trading: differences in preference intensities are taken into account. Logrolling allows to measure preferences cardinally. This aspect is at the centre of the normative potential that vote trading has (Stratmann 1997: 324).

A similar vote trade could take place in the following example, which is slightly but decisively different from the example in table 1.

voters	alternatives	
	X	Y
A	-3	-3
B	5	-3
C	-3	5

Table 2: Logrolling with negative net utility

Again, voters B and C could agree on a vote trade here. However, the aggregated utility change is negative now and the alternatives are Pareto-deteriorating according to the Kaldor-Hicks-criterium. But as long as the utility gain is sufficient to compensate the votes necessary to obtain a majority, vote trading is possible and both alternatives may win. Herein lies what is considered to be the danger of vote trading. The voters constituting the majority enjoy a utility gain, yet society’s net welfare change is negative. Riker and Brams (1973) call this the “paradox of vote trading”.

The losing minority (voter A) now has the incentive to offer another vote trade to voter B. If B votes against Y, A would vote for X. This, again, might induce voter C to propose yet another vote trade to A. The two could vote against both X and Y. This actually corresponds with the result without vote trading, which would again lose against the agreement between B and C described above with the objective of getting both alternatives adopted (Mueller 2003: 107). Hence this logrolling situation has the potential to produce a cycle. Bernholz (1973) has proven that a logrolling situation implies a potential cycle. Each majority vote with a possibility of trading votes is characterized by intransitive group preferences.

Logrolling in majoritarian votes has sparked a controversial discussion in the literature about whether a vote market works. Buchanan/Tullock (1962) and Coleman (1966) are optimistic, whereas other authors have proven the nonexistence of a vote trading equilibrium in a decentralized market (see e.g. Bernholz 1974, Ferejohn 1974). Therefore, Koford (1982) and Philipson/Snyder (1996) propose an organized vote trading market.¹

¹ Empirical evidence on logrolling in the U.S. Congress is provided by Stratmann (1992).

Alternative voting procedures, e.g. point voting, that also allow to take into account differences in preference intensities, have been developed in preference revelation literature (see Mueller 2003: 159-181 for an overview). Casella (2005) suggests a voting mechanism for committees that meet regularly. Members are allowed to store their votes for the future in case they abstain, allowing them to execute a higher influence on the outcome of decisions that are of vital interest to them.

3.2. Package deals and unanimous decision making

Buchanan/Tullock (1962) is one of the first economic analyses of vote trading and considers vote trading in majority and unanimous decisions alike. The theoretical and empirical literature on logrolling that picked up this subject later and of which the previous section was a brief summary has concentrated on majority voting and defined vote trading in the form of logrolling for this case. Buchanan and Tullock (1962: 276-281) consider vote trading within the unanimity rule as well. Obviously, the “I vote for you if you vote for me” logrolling agreements work only for majority voting. In unanimous decisions, vote trading induces some other compensation mechanism, e.g. open buying and selling of votes.

Reconsider the examples in tables 1 and 2. Without vote trading, none of the alternatives could win in either case. If unanimity is required, rational decision makers will accept decisions only if they do not imply a net cost to them. The need for consensus gives each voter a veto. When monetary side-payments are allowed, both alternatives pass in the case of table 1. Each alternative provides a net utility gain which gives the negotiation scope for compensation or rather for buying the necessary votes within a vote trading agreement on each alternative. As X and Y each have a net social utility gain, they will be realized – no matter if they are put to vote separately or jointly. Given the utility distribution of table 2, no vote trading agreement will be found. Both alternatives fail, regardless of a separate or joint vote, and regardless of any imaginable vote trading mechanism.

In case monetary side-payments are ruled out, a different compensation mechanism might be used to reach unanimous consent – that of a package deal. In table 1, if projects X and Y are put to vote separately, they will both lose. If put to vote jointly, they still lose because of voter

A's veto. But if the two projects are combined with a third one, this constellation might result in a net utility gain for voter A. Table 3 gives an example:

	Alternatives		
voters	X	Y	Z
A	-2	-2	5
B	6	-2	-3
C	-2	6	-3

Table 3: Package deal when open vote trading is prohibited

With the inclusion of alternative Z, each voter gets a net utility gain. The sum of each row is positive and the package will gain unanimous consent. Alternative Z, however, is inefficient and reduces the utility gain compared to direct side-payments. A pure redistributive project with a utility balance of zero would, of course, produce the same effect as monetary side-payments. Yet it is worth noting that the package deal, despite the fact that it allows the realization of alternatives X and Y, is no guarantee for reaching the Pareto frontier. In the best case, it is possible to combine efficient projects, but in the worst case the package will contain inefficient projects, too.

3.3. General aspects of unanimous decision making

The theoretical starting point for analysing package deals in multilateral negotiations is the literature dealing with unanimous decision making or implying consensus, e.g. in bargaining models. This section gives a brief survey of literature a more profound analysis of package deals could be based on. Normative and positive aspects of the general desirability of the unanimity rule compared to other decision-making rules have to be addressed as well as problems caused by strategic behaviour during negotiations. Furthermore, the question on how utility gains are distributed among negotiators, i.e. which point on the Pareto frontier will be chosen, is a normative question yet depends also on the bargaining process and bargaining strengths of the parties involved.

As the unanimity rule gives every agent the possibility to veto a decision, Buchanan and Tullock (1962), in line with Wicksell, conclude that the unanimity rule ensures a Pareto-optimal outcome. Therefore they attribute a special role to this rule. They distinguish two

types of costs related to decision making: external costs to those who do not approve of a decision and costs of decision making (e.g. bargaining time). External costs decrease with the share of voters needed for approval and are zero at unanimity. Decision making costs increase with the proportion of voters needed for approval and are highest when unanimous consent is required. Minimizing the sum of these costs indicates an efficient, yet not a Pareto-optimal, voting rule. Accordingly, departing from the rule of unanimity is rational only because finding a consensus might cause very high decision making costs. Or, in other words, in the absence of decision making costs it is always rational to choose the rule of unanimity.

Decision making under the unanimity rule may be costly not only due to mere bargaining time. Especially when every voter has a veto, incentives to behave strategically, that is to misstate ones preferences in order to maximize the net utility gain, may be strong. This problem is related to a wide range of literature, especially to mechanism design for the purpose of preference revelation (Mas-Colell et al. 1995: 857-918).

The bargaining process including strategic behaviour itself is modelled in extensive non-cooperative game theory models. These “divide a pie”-games model the distribution of a net gain via a bargaining process of offer and counteroffer between two players. The first player makes an offer about how to divide a gain which can be accepted or rejected by the second player. In case the latter rejects the offer he can make a counteroffer, which can again be accepted or rejected by the first player. The game can be modelled with a finite or infinite number of periods (the latter being known as the Rubinstein-game). These models typically include a discount factor to capture opportunity costs of time and can be extended to comprise the possibility of a breakdown of negotiations as well as the possibility of opting out. The extension of this type of games to more than two players, however, has proven to be very difficult (Osborne/Rubinstein 1994: 117-131).

Axiomatic bargaining identifies outcomes of a bargaining problem. The bargaining process itself is not modelled. As a normative theory it predicts the outcomes of a bargain given certain norms and the preferences and opportunities of the players. The restriction of solutions to Pareto-efficient outcomes is a common feature of all axiomatic bargaining models. Thus, they predict which point of the Pareto frontier may be chosen. The best-known concept in axiomatic bargaining is the Nash solution, which can also be interpreted as a social welfare function. The point on the Pareto frontier chosen in the Nash solution depends on the position

of the threat point that gives the outcome when players fail to agree (Myerson 1997: 370-389).

Maggi/Morelli (2006) analyse the application of majority and unanimity rule from a viewpoint of self-enforceability. They argue that the unanimity rule is more likely to be used in international organizations when decisions are not self-enforceable.

4. Conclusion

Sections 3.2. and 3.3. give a very basic outline of the theoretical aspects of package deals. Nevertheless, they allow drawing a number of conclusions. The example in table 3 has shown that without the possibility of direct side payments, package deals are a possible yet not necessarily efficient way to trade votes. Within EU budget negotiations, direct monetary side-payments may be classified as impossible as well. Even if they are not explicitly banned, it is hard to imagine that heads of state or government would officially categorize money for example as “transfer necessary to avoid the veto of country x”. Thus, package deals may well be necessary to reach an agreement and to realize utility gains. Policies like the EU regional policy may well have the character of alternative Z in table 3. Whether the EU’s regional policy has growth effects and supports cohesion, which are its main alleged aims, is a highly debated issue and shall not be discussed here. Assuming that the EU’s regional policy is necessary to reach a package deal, its success however cannot only be measured by its alleged aims regarding cohesion. If it was a zero sum game, it could still be judged as efficient in the sense that it enables the realization of utility gains stemming from other integration projects.

Nevertheless, inefficiencies due to a trade-off between efficient spending (e.g. to support cohesion) and the necessity to reach consensus need to be considered. Regional policy transfers, which are conditional matching grants, are officially justified by criteria related to cohesion. At the same time, as has been argued, these transfers must also satisfy the obvious need for vote trading. This does not automatically have to coincide. On the other hand, the use of conditional regional transfers to trade votes, instead of e.g. unconditional redistributive grants, may have special functions within vote trading. Conditional grants might reduce the incentive to behave strategically in negotiations. Fenge/Wrede (2004) argue that conditional matching grants are partly a response to externalities caused by the EU’s revenue system.

In further analysis, the following aspects need to be addressed as well. The division of costs incurred by the alternatives is neglected in the example of table 3 in Section 3.2. However, for the EU finances, this is an important aspect of the negotiations as both adjustments on the revenue side and on the expenditure side are used for compensation. Further, one has to assume that bargains are a result of individual preferences of heads of state or government. The question on how these are linked to the preferences of EU citizens needs to be addressed.

In my paper I have shown that the so called horse trading in EU budget negotiations can be explained rationally. Under given constraints, when direct side payments are impossible, package deals enable the realization of integration projects that provide a net, yet unequally distributed, utility gain. Thus, compensation is an important task of the EU budget. Package deals, however, do not ensure that compensation is organised efficiently. Alternative decision making procedures might help to improve the situation.

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