FUTURE FISCAL ARRANGEMENTS OF THE EUROPEAN UNION

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1. Introduction

Since 1988, the EU budget has been set within a stable legal framework that has a number of distinctive characteristics. In the preceding twenty years, the budget had been one of the most hotly contested political battlegrounds.\(^1\) There were protracted disputes, on the one hand, between the Member States, with the UK especially anxious to lower its net contribution; and, on the other hand, between the European Parliament and the Council over decision-making, as the directly elected Parliament sought to flex its muscles. Regular crises in raising sufficient money were also a persistent problem.

An agreement reached at the 1984 Fontainebleau European Council resolved the UK question by introducing the now infamous abatement.\(^1\) Subsequently, however, other Member States have also become substantial net contributors and have become increasingly insistent on finding ways of reducing their commitments. Various *ad hoc* compromises have been used to curb these perceived excesses, with the results that the legal position has become ever more messy, while also rendering the principles behind the budget increasingly opaque.\(^2\)

The conflict between the institutions about the budget reached a peak in the mid-1980s, despite an attempt in 1982\(^3\) to resolve the differences. Then, at the Brussels European Council in 1988, a new system of financing and structure of spending was agreed, along with a medium term expenditure framework – the *Financial Perspective* (FP) – and a cap on total outlays: the

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1. For a good account of these political problems, see Laffan, *The Finances of the European Union* (St. Martin’s Press, 1997).


own resources ceiling. Shortly afterwards, the guerrilla warfare initiated by
the Parliament was ended by an “inter-institutional agreement” (IIA) which
provided a means of mediating between the Council and the Parliament. Its
purpose is to regulate the annual budgetary round, so as to allow the two
arms of the budgetary authority to avoid the sort of impasse that had devel-
oped in the 1980s when the Parliament repeatedly rejected the draft budget.
The IIA is now agreed shortly after the FP: the latest was agreed in May
1999 between Parliament, the Council and the Commission, and replaced
the one agreed in October 1993 for the preceding FP.

Today, the EU budget amounts to just over 1% of Community Gross Na-
tional Income (GNI), with nearly half the spending going on the Common
Agricultural Policy (CAP) and around a third on “structural operations” –
policies designed to boost the competitiveness of weaker regions and vulner-
able social groups. Year on year and across programmes, there is very little
flexibility and the budget has no meaningful role in the macroeconomic
management of the EU economy. With full monetary union having been
achieved and the Union enlarged from 12 to 25 members, much has changed
since the 1988 framework was established. As a result, the adequacy of cur-
rent budgetary arrangements is open to doubt and a fresh look at the aims
and functioning of the EU budget is warranted.

What are the bones of contention? First, beyond the banal observation that
the EU budget exists to provide funding for common policies, there has not
been a convincing appraisal of how supranational spending should fit in to
the overall structure of public finances and the aims of the EU. Public expen-
diture is an important part of what the EU does, even if “the current EU bud-
get is inconsistent with the present state and future prospects of European
integration”, as argued by Buti and Nava. But the balance between the EU’ s
spending and its regulatory or co-ordinating activities deserves attention.

Second, there is a mounting tension between the net contributors and the
net recipients about how big the budget should be and the resources that flow
to each country. A related issue is the UK abatement which, despite being
not unreasonable in the outcomes it produces and its effectiveness in pre-
venting unfair demands on Britain, clearly rankles with others. Indeed, one

4. Reproduced as an annex in Commission, Community Public Finance: The European
budget after the 1988 reform (OOPEC, 1989).
5. Interinstitutional Agreement of 6 May 1999 on budgetary discipline and improvement of
the budgetary procedure, O.J. 1999, C 172/1.
7. Points stressed by Buti and Nava, “Towards a European budgetary system”, EUI work-
of the issues that has upset the new Members is that they had to start paying towards the UK abatement even before formal accession. The whole question is given added poignancy by the rows over the Stability and Growth Pact, with Germany especially irked to be told to cut its own budgetary deficit while being asked to stump up more for “Brussels”. Then there are disputes about whether there should be dedicated taxes to pay for EU spending.

Fourth, the composition of EU spending has been challenged, with demands from many quarters for the budget to be orientated more towards growth, competitiveness and, more generally, the so-called “Lisbon” agenda. A good example is the “Sapir” Report, commissioned by Romano Prodi and published in the summer of 2003, which advocated a radical re-focusing on the promotion of growth and better targeting of cohesion policies. The trouble, though, is that it can be difficult to identify added value from spending at the EU level, rather than at the level of the Member States. A further difficulty is that there is only limited information on whether EU spending is good value for money, and there are the perennial problems of fraud, waste and mismanagement.

The outgoing College of Commissioners is keen to push forward reforms of the budget that reflect not only the consolidation of economic and monetary union (EMU) and enlargement, but also the various structural policy initiatives encompassed in the Lisbon strategy. On 10 February 2004, it published its proposals for the future financing of the Union, eliciting an immediate and predictable barrage of criticism. It can be anticipated that in the course of 2004 and 2005, there will be much hand-waving and posturing as the Member States approach the European Council at which the Financial Perspective for the period 2007–13 will be agreed.

Some of the reforms sought are wholly incompatible with each other: for example, the EU level cannot be expected to fulfil the demands of those

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9. The set of targets for improving the underlying performance of the EU economy, including the often-repeated aim of making the EU the most dynamic and knowledge intensive economy in the world by 2010, agreed at the 2000 Lisbon European Council and taken forward in successive spring Councils. Specific aims include raising the employment rate in the EU to 70% from its present level of about 64%, and increasing investment in research and development from 2% to 3% of GDP.

10. “An agenda for a growing Europe: making the EU economic system deliver” Report of an Independent High-Level Study Group established on the initiative of the President of the European Commission [The “Sapir” Report] (Brussels, European Commission). The report has, on the whole been well-received by countries sympathetic to the Lisbon aims, such as the UK.

11. The Eurostat scandal, which broke in 2003, is only the latest in a long line.

Member States that want higher cohesion-related expenditure while maintaining the level of agricultural support and cutting overall expenditure. There can, too, be inconsistencies within national positions. There is wide support among the richer Member States for more spending on “Lisbon”-related policies, and a recognition that this requires selection of excellent projects. Yet Member States continue to agitate for a _juste retour_, even if the value added is less evident. Six of the richer Member States (Austria, France, Germany, The Netherlands Sweden and the UK) had already made a preemptive strike in December 2003 by writing a letter to Romano Prodi demanding that the budget be capped at 1% of EU gross national income. Earlier still, France and Germany had managed to push through an arrangement to maintain the budgetary ceilings for CAP spending until 2013.\(^{13}\)

This paper examines the current arrangements for the EU budget, highlighting some of the least satisfactory areas, and appraises suggestions for reforms. The next section considers what can be inferred from economic theories, notably fiscal federalism, about the EU budget. Section three looks at the current arrangements and examines the Commission’s February 2004 proposals. Section four then considers the facets of the budget adjudged to be most problematic. A concluding section explores possible solutions.

2. **Principles of budgeting in a multi-tiered fiscal system**

The assignment of budgetary responsibilities among tiers of government is never easy. In the economic theory of public finance, following Musgrave,\(^{14}\) three functions of public finance are conventionally delineated: stabilization, allocation and redistribution. Under each heading, differing assignments of responsibility can be envisaged, but certain principles have been developed that focus on the nature and purpose of the public goods and services being supplied. Among the theoretical approaches that can be considered to bear on the assignment of tax and spending responsibilities between tiers of government are fiscal federalism, certain aspects of public choice theory and work on incentives in government.

The theory of fiscal federalism as developed, notably, by Oates\(^{15}\) arguably comes closest to underpinning analysis of the EU budget, but its salience is

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Budget

limited by the fact that the EU, as presently constituted, is far from being a federal system. Fiscal federalism starts from the presumption that an optimal assignment of competences can be found in which account is taken, on the one hand, of the impacts (spillovers and externalities) of policies in one jurisdiction on others; and on the other hand of voter preferences and the legitimacy of decision-making. An answer is to match the provision of public goods to the geographical span of the taxpayers who finance the spending: the principles of “fiscal equivalence” suggested by Olson\(^{16}\) and of “correspondence” advocated by Oates.\(^{17}\) Much of the fiscal federalism debate turns on the scope for economies of scale or scope from pooling policy and therefore bears on the elusive search for added value in EU level spending. Some insights into the character of the EU’s public finances, the tasks assigned to the supranational tier, how they are organized and the directions in which they might evolve can be gleaned by drawing on economic analysis and practice.

There is plenty of evidence in the literature on the importance of transfers from the federal level in stabilizing economies, although disagreement on the magnitudes. Braun et al.\(^{18}\) argue that the nature of the federation is crucial in discussing what budgetary policy can do, especially in relation to stabilization. They distinguish between what they call the “power-separation system” in Canada in which the federal government can act unilaterally, but may be hampered by the lack of concertation with the Provinces, and Germany’s “power-sharing system” where, although it must act more cooperatively to stabilize the economy, “the compulsory negotiation system distorts the use of fiscal policy instruments by distributive bargaining”. Eichengreen notes that the stabilization afforded by Member State policies is, typically, on a par with what is achieved by transfers from the federal level in the US. He therefore argues that so long as automatic stabilizers are free to operate, there is no real case for an EU budget that fulfills the same role. If, or how, the Stability and Growth Pact is reformed will, clearly, have a bearing in this regard because it will influence how much latitude Member States will have to make use of automatic stabilization.

Turning to redistribution, Brown and Oates\(^{19}\) argue that there are good reasons for assigning responsibility to the highest tier of government, pre-


\(^{17}\) Oates, op. cit. *supra* note 15.


cisely to avoid the problems of taxpayers and welfare recipients voting with their feet. In today’s EU, plainly, redistribution is also done predominantly by Member States; indeed, it is only indirectly rather than through explicit targeting that EU spending has a redistributive effect. Principally because of competition among countries for mobile resources, Wildasin\textsuperscript{20} suggests that one consequence of enlargement (notably as a result of immigration and other steps that promote integration of factor markets) will make it harder for Member States to maintain highly redistributive fiscal systems, implying that the function should gravitate to the higher (i.e. EU level), the more so as the degree of integration increases. On the other hand, Wellisch,\textsuperscript{21} in a comprehensive study, comes to the view that decentralization of public spending is optimal for allocative policies.

2.1. Theory and practice

It would be difficult to claim with any conviction that the present organization of the EU’s finances reflects a coherent conceptual model of public finances.\textsuperscript{22} Fiscal federalism is predicated on the coherence of the political system in which it is practiced, and is about balancing efficiency and equity in an optimizing manner. Whether in a federal system or in other polities in which there are substantial budgetary flows between central and sub-national tiers of government, many of the tenets of fiscal federalism can only plausibly apply if there is a sufficient degree of political commitment. It is difficult to argue that the EU, at present, has that commitment. An obvious point is that the fiscal scale of the supranational tier is smaller by an order of magnitude than that of federal governments elsewhere: despite the promises by successive US presidents to prune “big government”, the US federal budget is some twenty times as large as that of the EU level.

In principle, both the Structural Funds and the CAP are allocative expenditures since their function is to bolster a sector (agriculture) or to promote the competitiveness of weaker regions in order to assure improved long-term economic performance. In practice, the distinction is less clearcut, because of the scale of net resource transfers that result: these have obvious redis-

\textsuperscript{22} Similar conclusions were reached about tax co-ordination and competition by Bratton and McCalhery, “Tax coordination and tax competition in the European Union: evaluating the code of conduct on business taxation”, 38 CML Rev., 677–718.
tributive consequences and can also assist in stabilization. Nevertheless, the fact remains that the EU is not trying to engage in redistribution as such. Hence, one of the public finance functions that would be assigned to the “federal” level if the approach of fiscal federalism is followed is not at issue. Indeed, competence for welfare-related policies is jealously guarded by the Member States and only tentative steps towards policy integration under the (largely inter-governmental) open method of co-ordination have been essayed.

What emerges from this overview is that the EU does not follow the dictates of conventional fiscal federalism in so far as it leaves stabilization and redistribution largely to the Member States, but assigns allocation – which the theory says should be pushed downwards – to the supranational level. Even limited stabilization schemes such as that proposed by Italianer and Vanheukelen have made no headway. It can also be argued that the manner in which subsidiarity is interpreted is inimical to the development of a system that accords better with fiscal federalism. As in so many other respects, this suggests that the *sui generis* character of the EU means that it is an institutional rather than a theoretical logic that shapes the budget.

3. The budgetary process and its current structure

In economic terms, the EU budget is a curious hybrid. It is much more than the sort of financing accorded to international organizations, even those as substantial and well developed as the United Nations or the IMF, where the revenue stream depends purely on subscriptions from member countries. But neither is it that of an autonomous political entity which, even if it relies on other levels of government for substantial proportions of its revenues, at least has some direct link with a local electorate in relation to fund-raising. To invert a well-known phrase, the EU is close to being representation without

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23. Although net receipts from the EU are not sensitive to cyclical fluctuations, they provide a degree of stabilization to the extent that they represent a guaranteed flow of public spending in the economy. In the late 1980s and early 1990s, the combination of CAP and structural policy receipts yielded a net transfer to Ireland peaking at over 6% of GDP.

24. Thus, Art. 136 EC emphasizes national diversity, while Art. 137(2) EC highlights cooperation as the way of pursuing the policy.


taxation: it has no powers to select the taxes used to generate the revenue that
funds it or to alter the rates of tax instruments currently assigned to it.

Although the funding at its disposal is the result of inter-governmental
agreements, the EU budget does, however, have a firm constitutional footing
in Articles 268–280 of the EC Treaty.27 These articles assure the autonomy
of the budget, notably by providing for “own resources”,28 and mean that the
EU has (or should have) certainty about its entitlement to engage in public
spending. It has a number of obligations assigned to it by the Member States,
such as the implementation of the CAP. Operation of the budget is enshrined
in the five key principles of annuality, balance, unity, universality and speci-
fication.29

3.1. The Financial Perspective and the own resources ceiling

The creation in 1988 of the Financial Perspective established a medium-term
framework for the budget by stipulating the pattern of expenditure for the
years to come. The first FP covered the five year period from 1988 to 1992,
while the two subsequent ones stretched to seven years. The main effect of
the FP is to constrain the amounts that can be spent under each broad head-
ing of expenditure. Thus, although there is an annual budgetary round which
determines the detailed spending commitments of the Union, there is little
flexibility between broad headings. Consequently, it would be very difficult
for the Union to alter its expenditure pattern significantly within the span of
an FP.

A second key element of the budget is the “own resources ceiling”, a
rather convoluted expression for a cap on its size. The ceiling is (now) ex-
pressed as a proportion of Community gross national income (GNI) which
means that it is not a fixed number of billion euros, because the denominator
of the ratio (GNI) will expand at a rate determined by the performance of the
EU economy. In the current FP, the ceiling was retained at 1.24%, the same
ratio as had been attained by the latter years of the 1993–99 FP.30 However, a

27. For a comprehensive study of the development of the legal framework for the period up
to the start of the current Financial Perspective, see Régnier-Heldmaier et al., Les finances de
l’Union européenne (Éditions de l’Université de Bruxelles, 1999).
28. Art. 269 EC.
29. For an elaboration of the meaning of these, see the appendix.
30. Up to 2002, the ceiling was expressed as a percentage (1.27%) of Community Gross
National Product; the change to 1.24% of Gross National Income does not materially alter the
resources available and in practice the two concepts provide virtually identical measures of
national prosperity. The change was to reflect a shift to a revised methodology for the estima-
A rising proportion of expenditure was “ring-fenced” for the candidates for accession.

Although the agreement made by the European Council\(^{31}\) on the FP establishes the framework for financing the EU budget and has to be regarded as the primary political decision on the EU budget, the terms are formally set out in the “own resources decision” which provides greater detail on the implementation. This decision stipulates the ceiling for own resources and prescribes how the money is to be raised. The current decision, agreed by the Council in September 2000,\(^{32}\) came into force in 2002 and is designed to ensure that the funding available remains compatible with expenditure commitments.

A distinction exists at present between compulsory and non-compulsory expenditure, with the former defined as “such expenditure as the budgetary authority is obliged to enter in the budget by virtue of a legal undertaking entered into under the Treaties or acts adopted by virtue of the said Treaties.”\(^{33}\) However, in a revealing aside, a Commission document explaining the budget states that the distinction “is essentially political”.\(^{34}\) Thus, of the two major items of Community spending, the Common Agricultural Policy is deemed to be compulsory, whereas spending on the Structural Funds is not. The salience of the distinction lies in the power of the Parliament \textit{vis-à-vis} the Council to impose an increase. The Parliament can increase the amount of non-compulsory expenditure following the adoption by the Council of a first draft budget, and has the final say on non-compulsory items, but has to maintain the increase within a limit calculated by the Commission from economic indicators. In practice, this limit approximates to the increase in nominal GNP.\(^{35}\) The distinction between compulsory and non-compulsory expenditure will end if the proposals of the Convention on the future of Europe are adopted,\(^{36}\) although what is retained is the obligation for there to be “the prior adoption of a binding legal act providing a legal basis for Union action and for the implementation of the expenditure”.\(^{37}\)

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31. The current FP was agreed at the Berlin European Council in March 1999.
33. Para 30 of the 1999 IIA, see note 5 supra.
35. Nominal GNP is total national product at current prices, in contrast to real GNP which has inflation removed. If the economy grows by 2% and there is inflation of 2.5%, nominal GNP will be just over 4.5% higher.
36. Title VII: the union’s finances.
37. Art. 52(4).
The EU budget today is split into seven headings with pre-determined ceilings for allocations for each over the 2000–06 period. The distribution for 2003 is representative, with spending dominated by lines 1 (CAP – 44.7%) and 2 (Structural Operations – 34%). The out-turn has consistently been well below the own resources ceiling, notwithstanding the lower than expected GDP growth from 2001–03.

3.2. **Financing: The own resources**

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

- agricultural levies and duties;
- customs duties;
- a percentage of the proceeds of national value added tax (VAT), adjusted to take account of differences in the coverage of VAT;
- a payment proportional to the GNP/GNI of each Member State.

The first two, commonly referred to as the traditional own resources, were assigned to the Community budget in 1971. They can be rationalized economically on the grounds that the underlying policy areas (agriculture and the common external tariff) are Community competences. Because of falling rates of duty, the yield from these two taxes has been eroded, and in 2003 was down to just 12.5% of the total revenue. Given that the duties are collected at the point of entry into the EU of the goods on which they are levied, anomalies can arise in determining which Member State actually pays these sums. The reason is that once goods enter the EU, they may be transshipped from the Member State of entry to another, and ultimately paid for by consumers in the latter country. For obvious geographical reasons, this has been dubbed the Rotterdam effect.

38. The remainder is distributed between: “internal policies” (6.8%), the bulk of which is research and much of which is on the 6th Framework Programme; “external actions” (4.9%), with development aid prominent; “pre-accession aid” (3.4%) to the 13 candidate countries; and “administration” (5.4%), with the balance going to reserves.

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

40. For which the Member State receives a collection “fee” that was raised from 10% to 25% of the proceeds under the current FP.

41. The Netherlands collects almost twice as much pro rata from customs duties as the EU average.
The third (VAT) resource relies on a complicated formula to determine how much each Member State pays. The VAT resource was the main component of EU finances from its introduction in 1979 until the early 1990s, but the yield from it fell as a proportion of the own resources ceiling during the 1990s, and was deliberately scaled down for the 2000–06 FP by a lowering of the take-up rate from 1% down to 0.5% in 2003. As a result it raised just over a quarter of the EU’s financing by 2003.

The balance of the EU’s revenue is collected from Member States via the GNP/GNI, or fourth resource. Its yield is flexible because, in essence, it makes up the difference between what the first three resources (and sundry other fees charges and accounting adjustments) generate and total expenditure. It is a moot point whether the fourth resource can truly be said to be “owned” by the EU level, or is, in fact, an inter-governmental grant. Similar doubts can be expressed about the VAT resource, and since these two resources account for a large and growing share of the total, it is an open question whether the Treaty provision for the budget to be funded by own resources is adhered to.

Among the changes introduced for the current FP, two effectively push more of the funding burden on to the fourth resource. The allowance for collection costs for the two traditional own resources was raised from 10% to 25%, a change that was principally aimed at curbing the net contribution of the Netherlands. Second, the maximum VAT call-in rate was to be reduced by stages to 0.5%, halving it from the rate that had applied hitherto. Because these changes would have afforded the UK “windfall” gains, resulting from the structure of its economy, further “technical adjustments” were made to offset the gains for UK. An outcome of these changes is that the inconsistency of treatment of Member States has become still more pronounced, indicating that the imperative of achieving politically acceptable net positions has been allowed to over-ride legal consistency.

3.3. The February 2004 Commission proposals

The main changes put forward in the Commission’s proposals for 2007–13 are to the size of the budget and to the broad headings of spending under the FP. Although no change in the own resources ceiling is suggested, the Commission proposal foresees an average over the seven years of 1.15% of GNI, 0.09 of a percentage point below the ceiling, but well up on the average for recent years. Because GNI itself is expected to grow, the upshot is a 25% increase in the size of the EU budget between 2006 and 2013 – to the dismay

42. As agreed at the 1999 Berlin European Council.
...of many finance ministers. The Commission also signalled support for a
generalized correction mechanism to replace the UK abatement, but
seemed unwilling to propose new own resources. Five new headings relating more closely to the “Lisbon” aims have been
suggested, involving two main changes in the FP. The first budget line is no
longer the CAP, but policies to promote competitiveness “for growth and
employment”. This is explicitly linked to the Lisbon agenda and can be ex-
pected to embrace an enhanced research budget, more money for trans-Euro-
pean networks and other building blocks for a more competitive economy.
The second is the introduction of a new heading covering “Citizenship, free-
dom, security and justice”, spending on which will nearly treble in real terms
between 2006 and 2013. This category is mainly about putting into practice
the various components of what used to be known as justice and home af-
fairs, complemented by policies to support EU culture and citizenship.
Closer examination suggests that it is much the same mix as before, albeit
in new livery. Thus, the new growth heading brings together what used to be
“structural operations” and the lion’s share of what used to be “internal poli-
cies” – notably the research budget, with the balance composed of a range of
other lesser policy initiatives. Agricultural support is now a component of
“sustainable management and protection of natural resources”, yet the ex-
penditure ceilings for farm subsidies will mean that there is only a negligible
decline in the flow of resources to the CAP over the next decade.
In presenting the new package, European Commission President Romano
Prodi stressed its political purpose and noted that its aim is “to create the op-
erational framework for governing the major changes that the Union will un-
dergo in the years ahead”. He also tried to counter the arguments of the six
richer countries by stating that “some have argued that the Union budget
should not exceed 1% of Europe’s GDP. In my view, the problem with this
approach is that it puts numbers before the political project. It is like build-
ing a house by starting with the roof”.

43. Open in principle, to all Member States that are shown to pay “too big” a net contribu-
tion. The Commission did not, however, unveil its preferred formula.
44. The Communication, somewhat delphically, concedes that “the current financing sys-
tem performs relatively well from a financial point of view”, but still manages to canvass a new
EU tax. Its preferred candidates are corporate taxes, a share of VAT to be shown separately
from the national one or an energy tax.
4. The issues to be negotiated

While the room for manoeuvre appears to be very limited, there are several facets of the budget that are bound to feature in the forthcoming negotiations. First, should the EU level aspire to do more than devote most of its expenditure to agricultural policy and structural operations? There is unlikely to be support, in the foreseeable future, for moving beyond the present ceiling of 1.24% of EU GNI (compared, it should be noted, with national budgets averaging some 47%). The new members, unsurprisingly, would prefer to see the budget maintained at or above its present level as a proportion of GNI, while the net contributors have made their position clear, but a quantum shift is implausible. This would rule out any role for the EU level in macroeconomic stabilization policy, let alone redistribution, despite the observation that the lack of a top-level fiscal policy contributes to the inflexibility of economic management of the EU.

Even if the budget is restricted to allocative expenditures as at present, how can it be kept small enough to pacify the steely-eyed finance ministers of the net contributors, yet be spread around enough to satisfy the many demands on it? In particular, can it realistically contribute towards the Lisbon goals, as suggested in the Sapir report and, guardedly, in the Commission proposal? The Lisbon strategy has, up to now, functioned under the open method of co-ordination (OMC), a procedure under which Member States pursue common objectives, but are free to adopt forms of implementation that suit their national circumstances and institutional frameworks. Yet neither “hard” nor “soft” co-ordination has so far had entirely satisfactory outcomes. It can be argued that one way of motivating governments to conform is to offer incentives via the EU budget, but even with the proposed new budget line targeted at competitiveness, the sums available will only reach 0.2% of GNI by 2013 under the Commission proposals.

A third challenge is how to cope with demands for juste retour. In the settlement reached at the 1999 Berlin European Council for the period 2000–

46. To put this another way, the EU level accounts for just 2.5% of public expenditure in the Union, far below what the least well-resourced level of government (central, regional or local) spends in any Member State.

47. For example, a “Reflection paper of Hungary on the financial framework post-2006” from the Hungarian Government, 19 Feb. 2004 states that “the ceiling after 2006 should not be set at a lower level in terms of percentage of the EU GNI than the current ceiling as of 1.24 percent”. This echoes sentiments informally expressed to the author by Polish officials.

06, Austria, the Netherlands and Sweden were allocated special payments from the Structural Funds. Such “side-payments” cannot be the basis for a coherent budget. A generalized correction mechanism, as advocated by the Commission, has its merits in curbing gross inequities, but reinforces the narrow focus on net financial contributions. Hard choices may have to be made about supporting policies that have genuine EU added value or, if their incidence is strongly in favour of some Member States to the exclusion of others, ensuring that they respond to overt EU level political aims such as fostering economic convergence.

A further challenge is whether the basis for transfers between Member States should change radically to accommodate and reflect the accession of new Member States, recognizing that enlargement will inevitably add to the difficulty of achieving unanimity. In particular, it is clear that there will be a pronounced need for public investment in the candidate countries, yet they will be subject to the full rigours of the Stability and Growth Pact. Should the Cohesion fund approach (supporting countries) be preferred to the Structural Fund emphasis on regions? Is an equalization scheme on the lines of the German *finanzausgleich* so far beyond the pale as most commentators believe?

4.1. The low budget ceiling

Although the budget ceiling is now 1.24% of GNI, actual expenditure in recent years has remained well below the ceiling, partly because of deliberate attempts to leave a margin for enlargement. From an economic viewpoint, having a ceiling makes sense to the extent that it stipulates the share of the resources produced by the EU economy that are assigned to the supranational tier of government. But more searching questions can be asked about the rationale for having such a small figure for the EU tier’s budget in light of the advent of EMU and the expansion of the Union.

4.2. How could own resources evolve?

Own resources are appealing to any budgetary authority for the simple reason that they provide greater certainty about expected revenue and control over the revenue generating process. By contrast, if an authority is dependent on grants, typically from another tier of government, it will always have the fear that political decisions might deprive it of all or part of its resources. The US, for example, has withheld its “dues” from international organizations such as UNESCO partly to express disapproval of policies that the organization was following. It can, moreover, be argued that the current system
of EU own resources is largely a fiction, because such a high proportion of the budget is funded by the 3rd and 4th resources, both of which are effectively inter-governmental transfers rather than authentic own resources. Is this acceptable?

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

If the revenue is difficult to apportion between territories, it makes sense to assign it to the level of government that encompasses the base being taxed. As an illustration, central banks derive a benefit – known as seigniorage – from their entitlement to issue currency, but it is not possible to identify whether this revenue accrues from a specific region or component of the economy covered by the central bank. It might make sense to assign seigniorage to the EU level, rather than the present system under which the European Central Bank distributes the gains to the national central banks. In the same vein, Goodspeed suggests that enlargement will put pressure on income tax rates, because of divergent tax bases, and hints that this could partly be resolved by an EU-level income tax. Corporate taxes can be seen in much the same way.

There might nevertheless be reasons other than tax theory for imposing a tax, and in appraising the case for using a tax as an EU own resource, further, more political criteria will come into play. For example, a levy on en-

49. Notwithstanding the fact that Art. 269 EC is very clear.
50. Based on rough calculations reflecting historical experience, seigniorage might account for 0.2–0.3% of EU GNI, meaning it is the same order of magnitude as the yield from the current VAT resource. It arises roughly in proportion to the size of the economy and the inflation rate and, for the latter reason, is sometimes known as an inflation tax. So long as EU and euro area membership do not coincide, however, using seigniorage may be awkward.
nergy production might be justified to achieve environmental objectives and has, indeed, regularly been canvassed as an option for the EU.\textsuperscript{52} The visibility of a tax and the transparency of the taxing arrangements are also thought to be desirable attributes of an EU own resource in the interests of conferring a greater legitimacy on EU spending, as testified to by numerous European Parliament reports.\textsuperscript{53} An income tax or a particular expenditure tax which made clear that the proceeds were to go directly to the EU level would be most attractive from this respect and VAT has the potential to be adapted to show both a national and an EU component.\textsuperscript{54} Other options could also be considered, although it is generally agreed that introducing a new tax will always be politically hard, even if there is a sound economic efficiency rationale for it.

4.3. Why not an inter-governmental grant?

A sound case can be made for preferring grants. Their principal advantage is that once fair “subscriptions to the club” have been negotiated, both the paymasters (the Member States) and the EU authorities will know precisely what the respective cash flows will be, and can plan expenditure accordingly. Use of grants also means that at least one side of the net contribution calculation can be carefully calibrated. The main drawback is the lack of autonomy and the associated legitimacy deficit, although as the Member States have shown no disposition to allow the EU level any say over tax rates, it is a moot point, in practice, whether transfers mean a \textit{de facto} loss of autonomy.

4.4. Net contributions

The more vexed question of net contributions will not fade away easily. Until the early 1980s, the cards were clearly stacked against the UK, leading to a succession of acrimonious meetings, usually resolved by short-term compromises aimed at lessening the UK’s net payment. Eventually the more enduring, though still \textit{ad hoc}, solution of the UK abatement was agreed as part of the 1984 Fontainebleau accord. Although the precise mechanism is, inevita-

\textsuperscript{52} E.g. Carraro and Siniscalco, \textit{The European Carbon Tax: An Economic Assessment} (Kluwer Academic Publishers, 1993); see also supra note 44.


\textsuperscript{54} In the US, e.g., it is common to find a city sales tax levied alongside a state tax, with both clearly identified on the invoice.
bly, rather complex, the formula effectively means that two-thirds of the *ex-ante* net payment would be returned to the UK, with the burden spread among the other Member States. Germany, however, was accorded a relief on its contribution to the UK abatement and this arrangement was extended in 1999 to the three other major net contributors (Austria, the Netherlands and Sweden). Simplifying again, these four Member States are required to pay only 25% of their *ex-ante* contribution to the UK abatement, obliging the other Member States to pay higher shares. Nearly all the imbalance arises on the expenditure side of the budget, principally because of big differences in per capita receipts from the CAP and Structural Fund spending.

Staunch integrationists maintain that, because the benefits of EU membership are so substantial, they vastly outweigh the narrow financial costs or benefits of budgetary positions. The case is put strongly by the Commission in a regular publication on the structure of spending: “constructing estimates of budgetary balances is merely an accounting exercise of the purely financial costs and benefits that each Member State derives from the Union. This accounting allocation gives no indication of many of the other benefits gained from EU policies such as those relating to the internal market and economic integration, not to mention political stability and security.” It is a point that has been picked up by some of the new members who are hostile to the idea of a general correction mechanism.

### 5. A way forward?

In thinking about the future of the EU’s fiscal arrangements, many of the features that currently characterize the EU budget deserve scrutiny, yet most

55. This has odd incentive properties for the UK which, if it receives one euro, loses 67 cents via a lower abatement. Especially where co-financing from the national budget is required, this can make it correspondingly less attractive to pursue Community funding. E.g., a one million euro project under the Structural Funds would require half a million of co-financing which, when the loss of abatement is taken into account, rises by a further 330 thousand. In the end, the Community contribution is just 17% rather than 50%, a ratio that may well undermine the case for the project.

56. Detailed figures on how much each Member State contributes, broken down by each own resource, and receives, disaggregated by line of expenditure, can be found in European Commission, *Financial Report 2002* (Office for Official Publications of the European Communities, 2003).

57. The Hungarian paper (cf. *supra* note 47) states that “in Hungary’s view, the Member States’ net position itself does not reflect the real economic benefits and obligations of membership ... [and a generalized correction mechanism] would mean a regressive contribution system”.

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of the points at issue could be changed without fundamentally altering the
law underpinning the budget. Federal solutions have long been canvassed, but
have been resisted by the Member States. But even without Treaty
changes, there are strategic choices to be made for the next round of the own
resources decision and the IIA. Some of the difficulties surrounding the bud-
get are, in practice, easy to solve as technical questions, albeit likely to en-
gender heated disputes. Thus, identifying prospective own resources and
ensuring that they meet a range of criteria would not greatly challenge the
imagination of most economists: Begg and Grimwade, for example, ap-
praise a range of possible taxes to use and, as noted above, the Commission
has identified three favoured options.

Finding answers for net contributions will be more tricky, since most
Member States will insist that they are hard done by. Even so, it can be done.
De la Fuente and Domenech argue for a budgeting rule that would work by
initially relating net contributions to relative prosperity, and then fitting allo-
cations under EU programmes to it. Padoa-Schioppa also put forward such
an automatic rule, albeit with a different formula. A concern about such
rules, though, is that they can make sense as accounting formulae, but then
become very difficult to relate to EU policies and prospective changes in
them. This political dimension has to be settled first. One answer may be to
give greater weight to the use of loan instruments, the most significant of
which at present is the European Investment Bank.

On the question of what the EU level should do, Frey and Eichenberger put
forward an interesting proposal which is that rather than trying to opti-
mize between the merits of higher and lower tiers of government by seeking
a clear division of labour between tiers of government, attention should fo-
cus on “functional, overlapping, and competing jurisdictions”. In short, they
call for a system of “horses for courses” with a range of public bodies re-
sponsible for providing different classes of public goods and services. In this
way, they aim simultaneously to capture the benefits of competition between

providers of public goods and to gain the advantages of agglomeration. But in the EU context there are bound to be complications. Taking this reasoning to its logical conclusion, a government’s clientele may not be defined geographically, but functionally, with a complex system of overlapping jurisdictions for different functions, implying a form of functional federalism, as opposed to a purely geographical one. Geography and function might coincide, but then again they might differ markedly.

Oates sums up the problem succinctly: “the sense that emerges from a traditional fiscal-federalism perspective on the emerging public sector in Europe is thus an uneasy one. It suggests that the central government is not well equipped to take a leading role in addressing Musgrave’s redistribution and stabilization functions.” However, he hesitates to call for a larger EU budget on the grounds that it would add to rather than substitute for national public spending. Instead, he favours enhanced co-ordination allied to decentralized decision-making.

Now that the open method of co-ordination has become the favoured approach to supply-side co-ordination, Oates’ suggestion is worth taking further in the context of the “Lisbon” agenda. It would, however, have to navigate the stormy waters of tax harmonization. It can also be argued that there ought to be ways of re-assigning public expenditure functions without necessarily increasing the aggregate size of the public sector. The challenges are, therefore, political more than administrative or constitutional, but no less urgent for that. That the likely outcome for 2007–13 is largely the status quo rather than more extensive reform is, consequently, a disappointment. If the foregoing analysis is correct, enlargement ought to provide the trigger. Will we dare to pull it?

**Appendix: The principles governing the budget**

The EU budget has long been subject to five key principles which, since the advent of the single currency, have been added to by the stipulation that it be denominated in euros. These principles are described in an official guide to the budget as follows:

“The principle of *unity*, laid down in Article 268 of the Treaty, means that all the Community’s revenue and expenditure must be brought together in a single document.

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The principle of universality is based on two rules: the rule of non-assignment, which states that budgetary revenue may not be allocated to particular items of expenditure, and the gross budget principle which states that all revenue and expenditure must be entered in full in the budget without any adjustment against each other.

The annuality principle means that budget operations relate to a given budget year. This makes it easier to control the activities of the Community executive. The Community has to reconcile this principle with the need to engage in multiannual operations, which account for a growing proportion of the budget. The answer to this dual requirement is provided by the entry of differentiated appropriations, which consist of commitment appropriations and payment appropriations.

Commitment appropriations cover the total cost in the financial year of the legal obligations entered into in respect of operations to be carried out over a period of more than one financial year. The payment appropriations cover expenditure, up to the amount entered in the budget, resulting from the commitments entered into during the financial year and/or previous financial years. Non-differentiated appropriations, on the other hand, are to cover operations which should in principle be completed (both commitment and payment) in a single budget year.

The principle of equilibrium requires estimated revenue for a financial year to be equal to the appropriations for payment of that year. No funds may be borrowed to cover a budget deficit. A surplus is entered as revenue in the following year’s budget and any unforeseen additional expenditure incurred in the course of the year must be financed by an amending budget which will redeploy appropriations within the budget adopted or call in additional resources.

Specification of expenditure means that each appropriation must have a given purpose and be assigned to a specific objective in order to prevent any confusion between appropriations, at both the authorization and the execution stage, and thus to ensure that the budget as established is quite unambiguous, and that it is executed in accordance with the wishes of the budgetary authority."
