Die Stiftung für liberale Politik

Friedrich Naumann Stiftung

STIFTUNG Marktwirtschaft Frankfurter Institut

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Conference Report

# Reform of the EU Budget

## Financial Challenges to the European Union

*Speakers on the photos*

*Dalia Grybauskaité, Ph.D. and*
*Prof. André Sapir, Ph.D.*
*Dr. Silvana Koch-Mehrin, MEP and*
*Prof. Iain Begg*
*Dr. Karen Horn (Moderator) and*
*Prof. Dr. Michael Eilfort*

*Contributions*



What are the main economic and political areas in which the European Union should play an active role and – consequently – engage itself financially? And how should the necessary financial resources be raised? So far, the political answers to these questions, which have emerged in the historic process of European integration and have led to the status quo of the European budget, are not convincing – neither from a political nor an economic point of view.

For decades, the European budget and its financing have been the source of continuing controversy among the member states of the EU. The negotiations between the head of states and later between the Council and the European Parliament on the financial framework 2007–2013 have provided the most recent example. Finally a political consensus for the next couple of years was found at the end of the year 2005, but this compromise surely does not provide a suitable long-term fiscal basis for Europe's future.

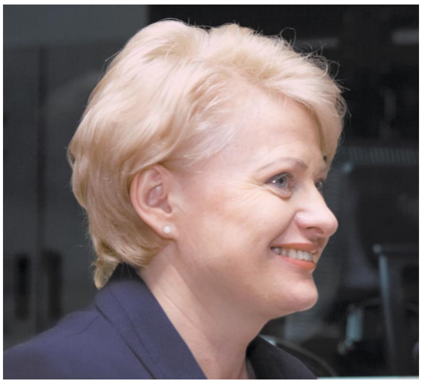
Taking the ongoing heated debate regarding the EU budget as starting point, the liberal Friedrich Naumann Foundation and the Stiftung Marktwirtschaft (Foundation Market Economy) jointly invited well-known experts to discuss the reform of the European budget and its financing, in order to better meet the challenges resulting from an ever more globalised world. The discussion was chaired by Dr. Karen Horn, business editor with the Frankfurter Allgemeine Zeitung.

## Welcome

Prof. Dr. Michael Eilfort, director of the Stiftung Marktwirtschaft, highlighted in his welcoming speech the need for reforms, especially regarding the historically-evolved structure of EU expenditures. “The subsidies to the agrarian sector and the Common Agricultural Policy (CAP) are still a major source of irritation, not only for economists: 43 % of expenditures go to a sector which contributes only 3 % to the Gross Domestic Product (GDP) and provides only 5 % of the jobs“, criticised Prof. Eilfort. “In contrast, only 9 % of the budget is designated for the strengthening of economic competitiveness“. But a mere increase of the overall budget volume would not be an advisable solution to foster long-term economic growth in Europe, cautioned Eilfort. Instead, he emphasised that the central building blocks of the European success story – such as the internal market or competition policy – have been relatively cheap achievements from a budgetary point of view. Moreover, these accomplishments also show that striving for economic development and prosperity is not a zero-sum game, in which the gain of one party is the loss of the other. Relating this insight to the EU budget, Eilfort concluded that the concept of "net national payment positions" is ill-conceived and misleading. If the EU were able to achieve the goals of the Lisbon Strategy via a more intelligent use of the taxpayers' money, the citizens of all member states would profit, regardless of possible displacements in the net payment positions.

With regard to the revenueside, Prof. Eilfort advocated more transparency and a less complex way of financing the EU budget without special privileges for single member states.

# Long-term Perspectives for the EU Budget



*Dalia Grybauskaité, Ph.D.*

*is the European Commissioner responsible for Financial Programming and Budget*

At the beginning of her presentation on the "Long-term Perspectives for the EU Budget", Dalia Grybauskaité, Ph.D., European Commissioner responsible for Financial Programming and Budget, gave a short description of the economic and financial status quo of the European Union. She emphasized that the European economy as a whole is not performing very well, and that major challenges to society – such as demographic developments – are not yet adequately addressed by the EU. In her opinion, the best economic strategy would call for a shift towards a more innovative economy.

According to Grybauskaité a look at the European budget clearly reveals that its current structure is not a mirror of the essential economic priorities constantly invoked by politicians: Only a small fraction of financial resources goes into 21$^{st}$-century-priorities such as research, innovation or investment. Given the fact that over 80 % of the budget is absorbed by policy areas originating in the middle of the last century, total financial resources of less than 1 % of GDP clearly are not sufficient to meet the new economic challenges resulting from globalisation and rapid economic change. At least the Commission has been able to negotiate a minor shift towards modernisation in the EU budget for the financial framework 2007–2013. In the coming 7 year time period, the expenditures for strengthening competitiveness, economic growth and employment are due to grow by 69 %, albeit from a very low base level. In contrast, the commitment appropriations for the Common Agricultural Policy (CAP), which according to the financial framework for the next 7 years will still amount to 371.3 billion Euro, represent a decrease by 8 % due to the continuing effects of the CAP-reform agreed upon in 2002.

This development indicates, argued Commissioner Grybauskaité, that the EU is, after all, moving in the right direction, even though at a very slow pace. The Commissioner emphasized that negotiating even the small improvements in the financial perspective 2007–2013 had been an extremely difficult task, given the inflexible and heterogeneous positions of the member states. Reaching a compromise had in itself to be seen as a success, since the EU at least proved its capability to act together. Thus financial and political paralysis, with adverse effects on “old“ member states as well as on the enlargement process, was able to be prevented.

But aside from this minimal achievement, Commissioner Grybauskaité pointed out her disappointment with the course and the results of the negotiations concerning the new financial framework. In spite of the reform-oriented political rhetoric and promises that most government leaders had displayed before the negotiations, practically all of them exhibited an amnesia-like loss of memory during the actual inter-governmental talks in the European Council in December 2005, preventing long-needed changes to the historically evolved budget.

## Reforming the Budget!

Hence a much further-reaching reform of EU finances continues to be a vital necessity in the coming years, requiring a critical and simultaneous analysis of expenditures, revenues and the budgetary decision-making process. The revision-clause, included in the financial framework in order to prevent another frustrating, battle-like round of negotiations on the next financial framework, is a gleam of hope.

Grybauskaité argued for a reformed European budget that would conform to the following criteria:

> It would be more flexible in order to respond to changes in the dynamic world.

> Expenditures would match declared political priorities. This clearly requires a fundamental change in the structure of spending, focussing on newly-decided policies.

> It would have a less complex and more transparent way of generating the necessary revenues. This calls for radical changes in the current system of own resources in the direction of clarity and simplification, including the removal of exceptions like arbitrary “rebates on rebates“.

> It would have a decision-making process that would avoid the deadlocks which have occurred regularly in budgetary talks due to unanimity-requirements.

The Commissioner emphasized that in the coming months the Commission will prepare the necessary financial review in an ambitious manner without any taboos, in order to provoke a wide and fundamental debate. In the course of this discussion all stakeholders – especially EU member states, the European Parliament, think tanks, citizens – will be invited to provide constructive input.

She concluded that reforming the European budget will not be an easy task, due to a very complicated political context. Not only various elections in member states and on the European level but also further enlargement, and especially the ongoing discussion process concerning the European Constitution and the political priorities of the EU, would create a multitude of interdependencies and interactions with the financial reform process of the budget. Therefore the final outcome could not yet be predicted.

*Photo at the bottom*

*Conference room in the European Parliament at the Paul-Henri-Spaak-Building in Brussels*

# Financial Tasks for the European Union: Are We Ready for the Future?

*Dr. Silvana Koch-Mehrin*

*is a Member of the European Parliament for the Free Democratic Party (FDP)*

Dr. Silvana Koch-Mehrin, MEP, Deputy-Leader of the ALDE Group in the European Parliament, criticised the Financial Perspective 2007–2013 negotiated between member states in December 2005. "This is a bad deal for Europe", argued Dr. Koch-Mehrin, since the current budget is mainly oriented towards the past. "Europe will not become the most competitive and future-oriented region in the world if the budget does not provide an adequate basis for that".

For the purpose of evaluating the financial agreement, Dr. Koch-Mehrin specified five criteria which a forward-looking financial constitution of the EU needs to fulfill:

According to her, the budget should be
> comprehensible,
> transparent,
> future-oriented,
> reflect economic reality and
> limit the overall expenditures.

Her verdict was disillusioning: None of these goals would be reached by the new financial perspective for the years 2007–2013. For example, cementing a 40 % budget-share of the Common Agricultural Policy (CAP) and providing only 10 % for competitiveness up until 2013 is not only economically flawed but clearly shows that political priorities have been wrongly set, claimed Dr. Koch-Mehrin. Instead of trying to find ways to increase the budget, a drastic change of the financial structure is necessary. Therefore she has high expectations on the upcoming review of the EU budget in 2008/2009 to correct these aberrations and to focus the budget on the above-mentioned criteria. This is especially true after the spirited and reform-oriented speech of the previous speaker Commissioner Grybauskaité.

## Reform perspectives

A first requirement of any budget reform should be a fundamental increase in transparency in order to reveal the true cost of EU policies to the citizens. Dr. Koch-Mehrin admonished that currently no cost-benefit analysis is feasible for the citizens. Therefore the European Transparency Initiative is a first step in the right direction. Publicising the recipients of EU funds would make it possible to see where exactly the money is spent. Other steps, including simplifying the highly complex and largely incomprehensible system of own resources would have to follow. These measures are essential to regain public confidence in the European Union.

Dr. Koch-Mehrin showed herself convinced that a future-oriented budget needs to include much stronger priorities for growth and competitiveness. This would necessarily imply more funding for research and development as well as education and fewer subsidies to CAP and structural policy.

"Politicians tend to forget that they are dealing with the taxpayers' money", cautioned Dr. Koch-Mehrin. There-



fore she argued for an upper limit to the budget of 1 % of Gross National Income (GNI) in commitment appropriations. Of course, this limitation – like any other – would imply that member states could not always demand policies of the EU which are not financially feasible. But with a fundamental change in the current structure of expenditures, there would certainly be enough money for future-oriented policies.

## A simple system of own resources

Regarding the system of own resources, she proposed the following, easy to handle two-tier approach: The traditional own resources, i.e. mainly customs duties, would be retained, since there are various good reasons not to leave these revenues to the member states. In addition, each member state would pay the same percentage rate of the GNI with an upper limit of 1 %. Today's resources, based on the harmonised value added tax base, would be abolished, as would be any kind of rebate.

Such a system would have significant advantages:
> It would be fair in the sense that every member state would bear a financial burden according to its ability to pay;
> it would be transparent and easy to understand and
> it would leave hardly any room for “dirty“ backroom deals.

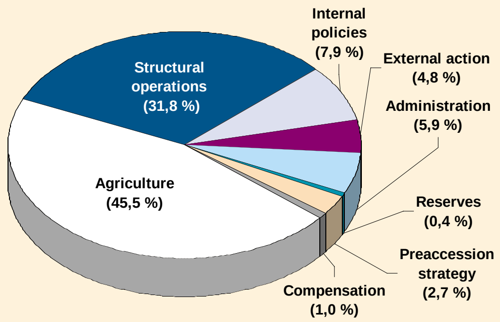
Dr. Koch-Mehrin concluded her speech emphasizing that a constructive debate concerning the goals and ideas of the European Union would be necessary in order to further the European integration process.

# Facts about the EU Budget 2006

## Expenditures

The EU budget currently amounts to 112 billion Euro per annum for payment appropriations and to 121 billion Euro for commitment appropriations. The main areas of spending are illustrated in the following figure.

### Payment appropriations 2006



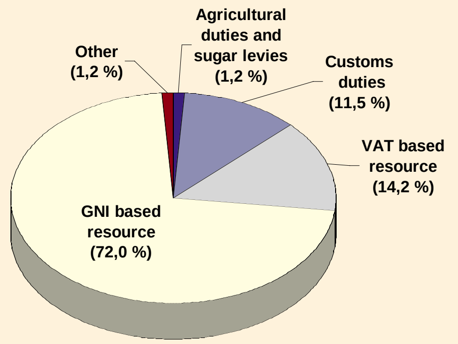

Source: European Commission

## Revenues

The EU budget is largely financed by so-called own resources, which can be divided into the following categories:
> Traditional own resources (TOR), which include agricultural duties and sugar levies as well as customs duties. TOR are collected by member states on behalf of the EU. They retain a 25 %-compensation for collection costs.
> A resource based on value added tax (VAT), which is levied on the harmonised VAT bases of member states. These payments can be seen as financial contributions. In order to prevent that less prosperous member states are unduly burdened, the VAT base is capped at 50 % of each member states' Gross National Income (GNI).
> A resource based on the Gross National Income (GNI) of member states. This GNI-based own resource – which can also be seen as intergovernmental transfers – acts as a residual resource. Each year its rate is adjusted to ensure a balanced budget on the EU level.

In addition, the system of own resources is severely complicated by the so-called mechanism for correcting budgetary imbalances in favour of the United Kingdom.

### Revenues 2006




Source: European Commission

# Making the Best out of Europe's Money

*Prof. André Sapir, Ph.D.*

*is Professor of Economics, ECARES, Université Libre de Bruxelles and Senior Fellow at BRUEGEL*

There are two different ways to address the necessary reforms in the EU budget in order to make the best out of Europe's money, emphasized Prof. André Sapir, approaching the subject of his speech. Either you take the existing financial volume of the budget as more or less given and try to change things for the better within this financial framework. Or you start without any restrictions from a blank sheet and ask what would be an optimal allocation of tasks at the European Union level.

To be politically realistic, he would choose the former approach – a strategy he and his fellow authors followed in writing the so-called Sapir Report "An Agenda for a Growing Europe". The decision to take this more limited approach was mainly due to a prevalent and pronounced scepticism about the EU budget, leading to the political judgement that "we are not going to change the structure by asking for more money". This negative verdict was also prompted by the questionable effectiveness of spendings, regarding those items that have been designated politically as responsibilities of the EU.

Concerning the various economic challenges the EU should address, Prof. Sapir reminded the audience of the limited magnitude of the EU budget which is approximately 1 % of the GDP and 2.5 % of the total public expenditure in Europe. Therefore the EU budget must not be seen in isolation from the national budgets of the member states. Rather, clear priorities regarding the assignment of tasks between the different levels of government in Europe are necessary.

## Against entitlements

According to Prof. Sapir this inevitably leads to the Common Agricultural Policy (CAP). The present system of channelling the money to the agricultural sector via the EU leads to a lack of transparency and prevents any political debate involving voters on how much money one should allocate to agriculture. "What is the rationale that income support for one particular group should come out of the EU budget, and income support for all other citizens should go via the national budget?" asked Sapir. But agriculture is only one example of a much more general problem in the EU as well as in the member states: "We have created a system of entitlements that keeps us wedded to the past, and we do not realise that the world around us is changing", criticised Prof. Sapir.

Indeed, the multi-annual character of the financial framework for the EU budget could have the potential to facilitate a more rational allocation of resources away from day-to-day short-term politics, in order to tackle at least some of the obvious economic challenges. Prof. Sapir advised the EU to concentrate on areas with economies of scale, externalities and spillovers as potential fields of activity. But to generate a productive political discourse on those topics, politicians would have to become serious about their ongoing rhetoric of "Lisbon, Lisbon, Lisbon".

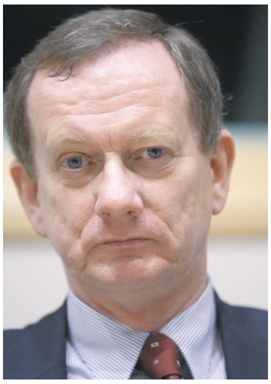
## An independent controlling body

In addition to the indispensable improvements in the structure of the budget, Prof. Sapir also emphasized the need for a more effective method of spending. The relevant question has to be: "Does a specific item of expenditure really contribute to the targeted goals?" In this regard he strongly advocated an evaluation, not by the Commission but by an independent controlling body, possibly the European Parliament itself or a body attached to the parliament.

# A Tax for Europe?

*Prof. Iain Begg*

*is Visiting Professor at the European Institute, London School of Economics*



Since the 1970s the budget of the European Union has been mainly financed by means of so-called own resources. These can mainly be seen as financial contributions of the member states coming out of the national budgets. Prof. Iain Begg, visiting professor at the European Institute, London School of Economics, challenged this procedure and argued instead that the EU should have the possibility to raise a tax of its own.

Although the present system of own resources works reasonably well, since it is raising the necessary revenues for the EU budget in a sufficiently flexible way and – leaving aside the rebates – achieves equity among the member states at the revenue side, Prof. Begg brought forward several arguments in favour of an EU tax. Such an explicit tax would not only be more consistent with Article 269 TEC (Treaty establishing the European Community), it could also help to improve the link between tax payers and EU policies, by making the costs of the EU more visible and thereby improving the democratic legitimacy of the EU. Last but not least, an EU tax might even offer a way out of the "juste retour trap", i.e. out of the constant disputes on the net payment positions of the member states, which are encouraged by the present system due to the accentuation of national boundaries. At the moment, member states primarily support EU policies that bring them money back and not policies that are good for Europe as a whole.

## Criteria for an EU tax

Regarding the criteria for an EU tax, Prof. Begg referred to standard tax theory: On economic grounds a good tax should avoid distortions in the market and assure equal treatment among member states and individuals. In order to be easy to administer, it should have low collection costs, generate the necessary revenues and should not be susceptible to fraud or tax evasion. Political criteria would suggest a tax which has an European connection, e.g. to the single market, and which does not meet overly strong tax resistance in the member states. Moreover when imposing an EU tax, effective tax incidence as well as national tax preferences and particularities of the national tax systems should be taken into account.

According to Prof. Begg designing a tax for Europe would not be a big technical challenge: Several alternatives which would provide sufficient funds, could be easily devised. He stressed that any switch from the current system of own resources to an explicit EU tax should be done in a way which is fiscally neutral, meaning that the member states should lower their national taxes by an amount corresponding to the new European tax. Widespread fears that an explicit EU tax would increase the overall tax burden for the citizens, since member states would keep their national tax rates constant, were dismissed by Prof. Begg as illogical. "All you do is to re-allocate the funding of a set of public functions from one revenue stream to another." If this leads nevertheless to an increase in the overall tax burden, it would be an explicit political choice, which – in a democracy – could be politically sanctioned by the voters.

## Political Problems

Although technically relatively easy, the implementation of a particular European tax would still be an exceptionally difficult political problem, since some people would inevitably lose out relative to others and relative to the status quo. "There is no way of avoiding it", stated Prof. Iain Begg. Moreover, it is unrealistic to assume that these changes in the financial burden caused by a tax would have no effects on the expenditureside. Especially those who are hit quite severely by the tax will exert pressure in order to receive special privileges. Prof. Begg concluded that the real challenge is one of political will, rather than tax ingenuity. For more than twenty years every successive financial perspective has mentioned the possibility of an EU tax without the politicians having the courage to address this difficult topic.

## Possible European Taxes

Regarding real-world options for an EU tax, Prof. Begg reminded the audience of the three in his view perfectly credible proposals made by the Commission two years ago. These included corporate taxes, an identifiable form of VAT similar to US sales taxes and some form of energy taxes. Other ideas for an European tax would include, for example, central bank seigniorage, excise duties, a tax on information and communications technologies (ICT) such as a tax on mobile phones or a tax on air travel.

Each of these taxes would have special advantages as well as drawbacks and, conceivably, some of them would not be sufficient in order to finance the whole budget of the EU. But according to Prof. Begg, most of the problems could be solved quite easily. Therefore he concluded, that the introduction of a tax for Europe is mainly a political decision and a question of political will.

*Photo on the right side*

*EU Commissioner Dalia Grybauskaité and Dr. Silvana Koch-Mehrin, MEP, accompanied by Dr. Danuté Budreikaité, MEP and representatives of the organising think tanks*

***Publishing details***

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# Conclusion

*Dr. Wolf-Dieter Zumpfort*

*is Vice-Chairman of the Board of Directors of the Friedrich Naumann Foundation*

In his concluding remarks, Dr. Wolf-Dieter Zumpfort put the debate on the reform of the EU budget and of a tax for Europe in the wider context of developing a constitutional treaty for Europe. Although the current ratification process seems to be in disarray, it nevertheless has initiated a discussion on Europe's constitutional future. This in itself is a sign of progress. According to Dr. Zumpfort, EU finances have to be treated as a constitutional matter, and any reasoning on this matter has to be linked with the most important question for liberals: the scope of governmental power. He argued that an EU tax would lead in the wrong direction, since he saw no mechanism that could prevent an increase in the overall tax burden for the citizens. Therefore it is better to let the member states control the money flows to Brussels.

He also rejected the common belief that the problems of the European Union could be solved with more money and more competencies at the EU level. Instead, he emphasized that already today too many things were regulated in Brussels. Therefore he advocated that the EU should strictly adhere to the principle of subsidiarity. "Everything else only leads to wastefulness and the erosion of freedom". He concluded his remarks with a quote from Will Rogers: "It is a good thing that we don't get all the government that we pay for!"