



Refocusing the EU budget – an institutional view

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EU budget development since the Treaty of Rome

Motivation

Approaches to EU budget analysis in the literature

The theory of incomplete contracts and the EU budget process

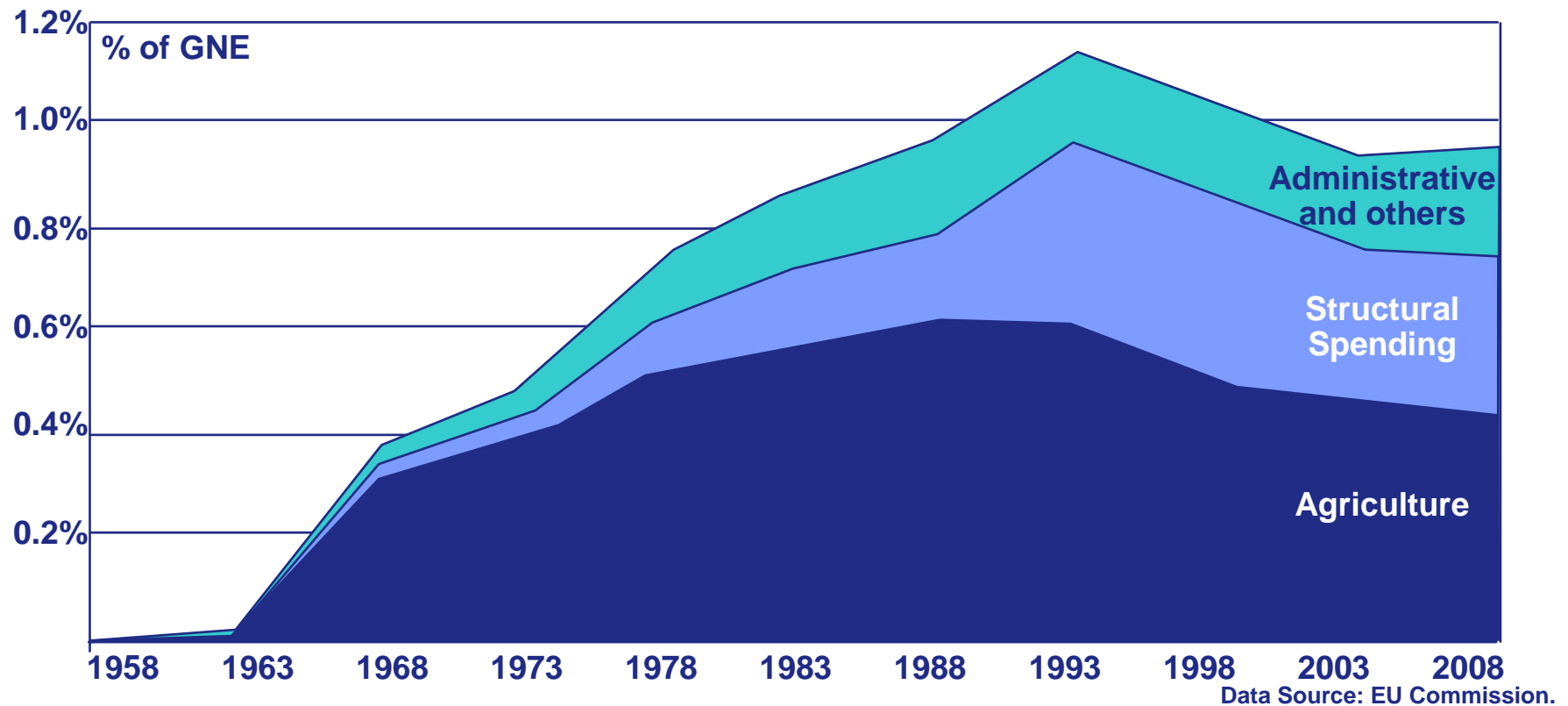
The evolution of redistribution through the budget

A way out of the current budget gridlock

Conclusion

The EU budget continues to be dominated by spending for the structural and the agricultural fund

EU budget development



While large parts of the budget are spent for redistributive purposes, welfare-enhancing spending on public goods on the EU level plays only a minor role.

A historical public choice analysis can offer important insights on the feasibility of reform proposals for the misallocated budget

Motivation

- Far-reaching agreement that a refocusing of the EU budget would be beneficial (e.g. Boege- and Sapir-Report).
- But how did we end up with an inefficient budget - spent mostly for agricultural and structural programs?
- We apply a public choice analysis to discuss:
 - How the current budget deadlock developed historically,
 - Why a reallocation of the budget is so difficult to achieve and
 - How much potential for change the Lisbon treaty offers.

Based on our historical institutional analysis we argue for an additional budget within an improved process of enhanced cooperation to overcome the deadlock and enable more spending on public goods on the EU level.

Our goal is to broaden the perspective of the existing positive approaches

Approaches to budget analysis in the literature

- **Descriptive approaches:**
 - How is the budget spent and financed?
 - How were the budget rules designed and how have they changed?
- **Normative approaches:**
 - How large should the budget be?
 - How shall the budget be spent and financed?
- **Positive approaches:**
 - How can we explain the development of net payment positions based on voting rules and voting weights within the decision processes of the institutions of the EU?

We want to expand the scope of positive approaches by integrating a “historical dimension”, by stressing the role of exit threats and by a separate discussion of the revenue and the expenditure side.

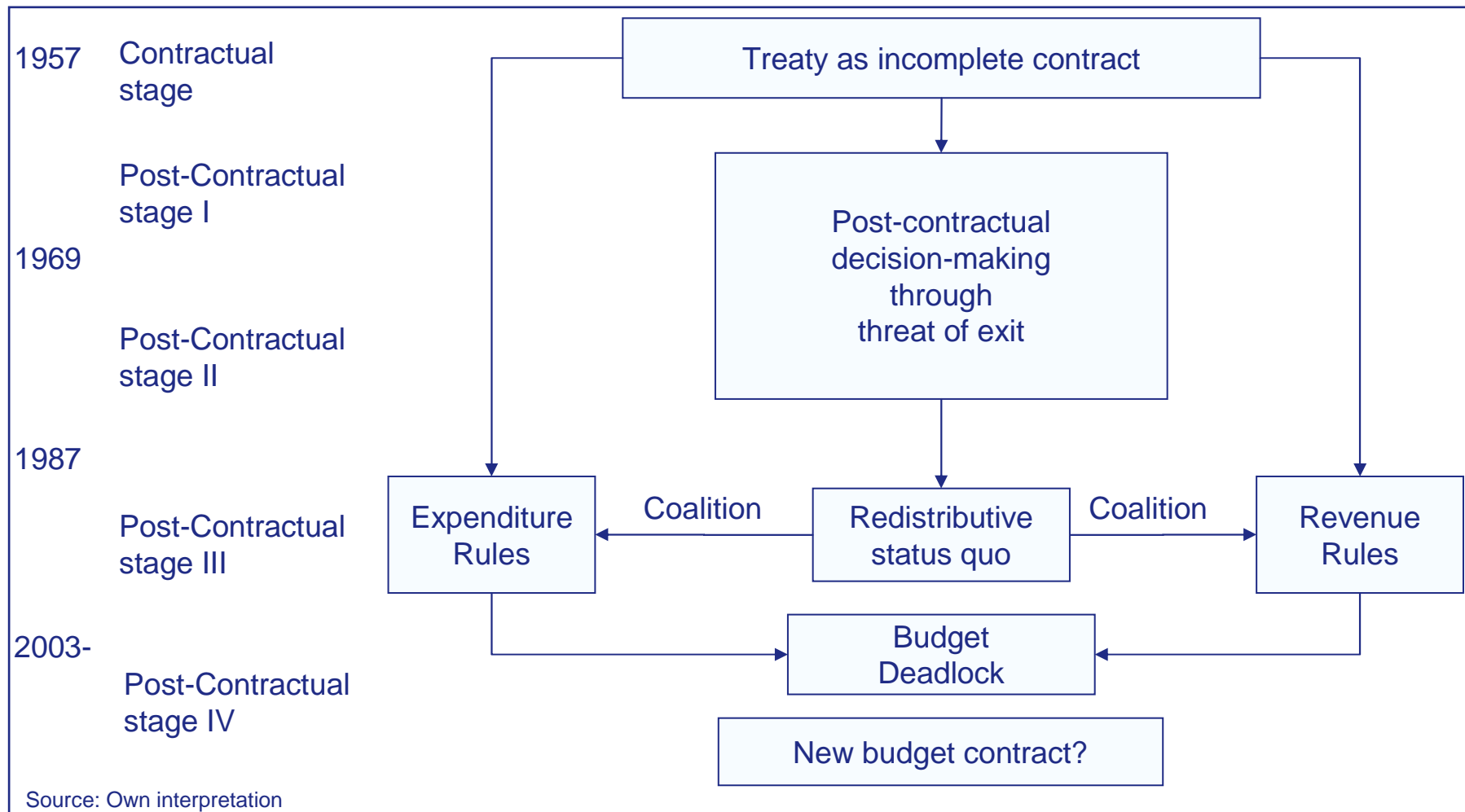
The theory of incomplete contracts serves as a vehicle to widen the scope of a positive analysis of the EU budget development

An approach based on the theory of incomplete contracts

- The *theory of incomplete contracts* (Buchanan (1975) or Brennan/Buchanan (1985)) stresses the importance of insufficient specification of *regulations on the contractual level*.
- Application to the EU: we cannot solely focus on the application of decision rules (and voting power) agreed upon on the contractual level but need to expand the general approach as Member States have the ability to threaten to harm the Union by terminating their contractual ties with the EU.
- Credibility of an exit or a non-entry threat will be strong in the early stages of a contractual arrangement, as long there is not much to lose by terminating membership (undeveloped market ties).
- Credible exit threats will lead to large concessions for Member states especially if important negative consequences for the other members of the Union are likely.

Based on the theory of incomplete contracts we can distinguish five different stages of the budgetary process in the EU

Budgetary rules and budgetary outcomes 1957-2009: roadmap



A historical public choice analysis can show how a general budget gridlock developed

Budgetary rules and budgetary outcomes 1957-2003

- The Treaty of Rome of 1957 is a typical incomplete contract.
- In the post-contractual stages I (from 1958 to 1970) and II (from 1971 to 1986), redistribution did **not only** take place according to the rules agreed in the Treaty, but also through exit threats to enforce redistributive goals.
- With progressing co-operation and close inter-firm ties in the Common Market, threats became increasingly less credible in the post-contractual stage III and threat as an instrument of influencing the budget was increasingly substituted by the formal rules of the Treaty.
- But based on the status quo which resulted from the developments in the post-contractual stages I and II, the formal rules of the treaty generate opposing coalitions:
 - The expenditure side is dominated by net receivers, the revenue side by net payers, and both groups exert veto power.
 - The result is that of a budget deadlock dominated by redistribution.

Exit threats were important especially during the the post-contractual stages I and II

Central episodes illustrating the importance of exit threats I

Phase I (1957-69):

- **France**´s attempt to expand agricultural support programs (1965)
 - Agricultural budget characterized by very „incomplete“ contractual regulations.
 - Re-introduction of the unanimity rule and strong expansion of agricultural spending after 1965 pushed through by exit threats.

Phase II (1970-87)

- **UK** abatement(1973-84)
 - Britain opposed the financing rules based on low reflow from the agricultural budget.
 - Yearly abatements in between 1973 and 1984 and a permanent abatement pushed through based on exit threats.

Exit threats were important especially during the the post-contractual stages I and II

Central episodes illustrating the importance of exit threats II

- Concessions to **Spain, Portugal and Greece** (80ies)
 - Important concessions for Spain, Portugal and Greece at the time of their accession in 1984/85 and the expansion of the Common Market.
 - Financial transfers especially by the structural funds (a doubling of spending in the 80ies).
 - Affinity to communist/socialist systems increased credibility of non-entry threats and thereby bargaining power.

Importance of exit-/non-entry threats:

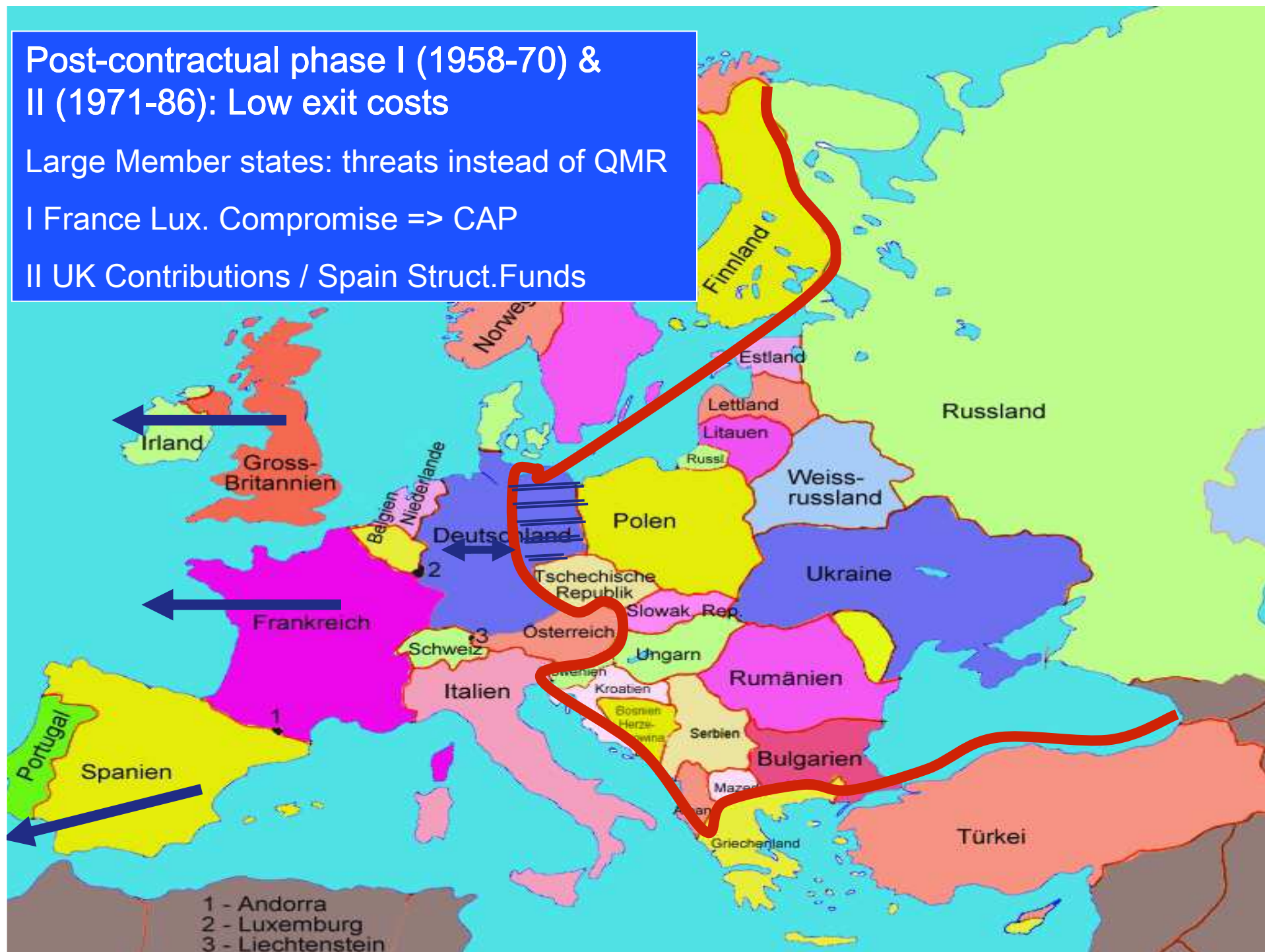
- Threats have strongly affected the two most decisive developments of the Community budget:
 - The expansion of agricultural spending.
 - The expansion of the structural funds.
- How would the budget look like today without these threats?

Post-contractual phase I (1958-70) & II (1971-86): Low exit costs

Large Member states: threats instead of QMR

I France Lux. Compromise => CAP

II UK Contributions / Spain Struct.Funds



Continuing market integration made exit threats less credible and facilitated the implementation of qualified majority rules

Post-contractual stage III (1987-2003)

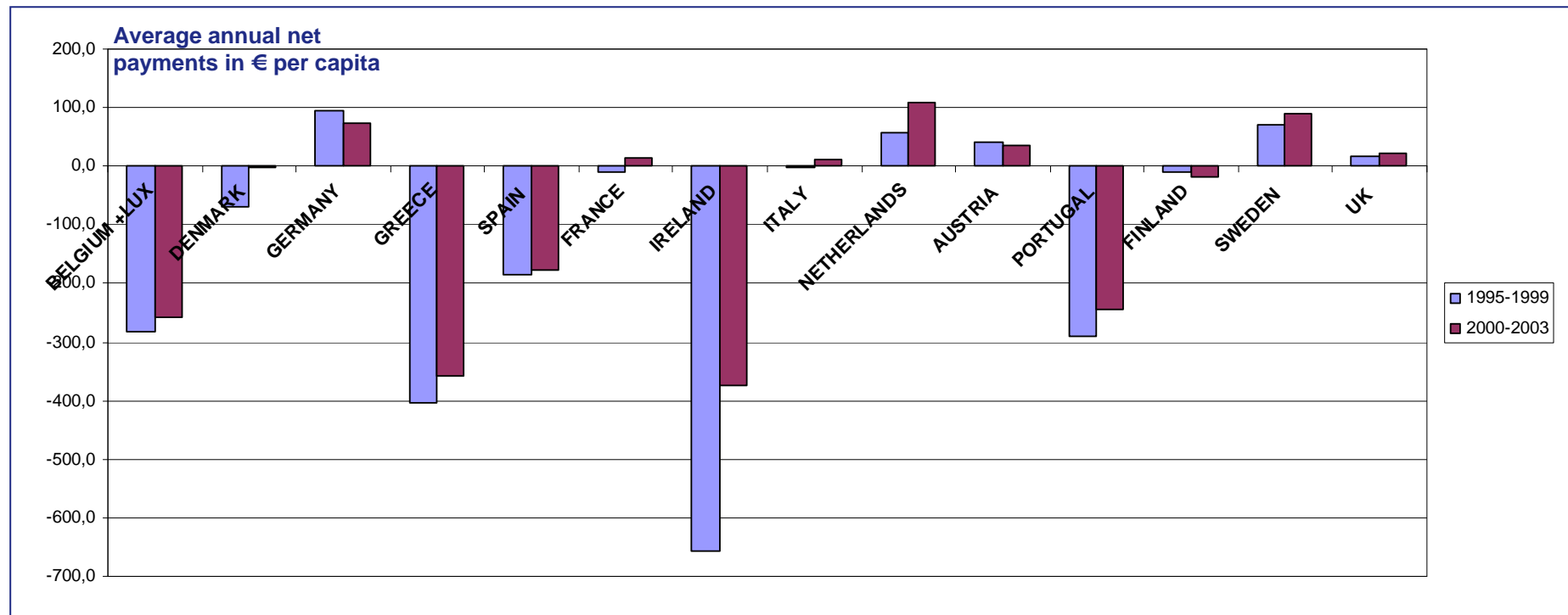
- The economies of Member States grew closer together increasing exit costs.
- Sweden, Finland and Austria became members of the Union in 1995, but as their outside options were very limited, they were not able to negotiate special concessions.
- As adherence of the Members was secured, it became possible to depart from the Luxembourg Compromise of 1966 and to return gradually to the collective decision rules of art. 148 § 2 of the Treaty of Rome (1957):
 - Single European Act of 1987 (extension of qualified majority rule to the issues of the Single Market).
 - Compromise of Ioannina of 1994 which maintained qualified majority
 - Treaty of Amsterdam in effect since 1999 which allows qualified majorities for Council decisions in important parts of budget policy.

.Based on the introduction of rules of qualified majorities we would expect a more frequent change of coalitions and the net payment positions.

The application of qualified majority rules had very limited effects on the net payment positions of EU member states

Post-contractual stage III (1987-2003)

Average annual net payments per head before (1995-1999) and after (2000-2003) the Treaty of Amsterdam in Euro per capita



Net payment positions are strikingly stable from 1995 to 2003. Of all Member States of the EU 15, none changes from a net recipient to a net payer or vice versa after the treaty of Amsterdam.

In our view this results from stable coalitions of net payers and net receivers on the expenditure side ...

Post-contractual stage III (1987-2003)

Votes of net receiver states, net payer states and break even states under the rules of the Treaty of Amsterdam 1997 – 2003, EU 15

| Groups of Member States | Number of votes | Total votes | Blocking minority | Qualified majority |
|--------------------------------|------------------------|--------------------|--------------------------|---------------------------|
| Net receiver states | 34 | 87 | 26 | 62 |
| Net payer states | 33 | 87 | 26 | 62 |
| Break even states | 20 | 87 | 26 | 62 |

Source: Own calculation.

Net receiver and net payer states have similar interests with respect to the budget and are therefore the most likely groups to form coalitions.

... which together with the unanimity requirement on the revenue side block a reallocation of spending

Post-contractual stage III (1987-2003)

- Unanimity requirement to change the status quo on the revenue side of the budget.
- No chance for the net-payer states to change the status quo on the revenue side.
- No option for a unilateral termination.
- Any concession is irreversible.
- Net-payer states can only apply their veto to prevent further budget increases.

Tyranny of the status quo: One vote is sufficient to prolong the status quo on the on the revenue side of the budget (**asymmetric unanimity rule**).

The enlargement of the EU is unlikely to have broken up the redistributive gridlock

Post-contractual stage IV (2004 to Lisbon)

Votes of net receiver states, net payer states and break even states under the rules of the Treaty of Nice 2004 – 2013 EU 27

| Groups of Member States | Number of votes | Total votes | Blocking minority | Qualified majority |
|--------------------------------|------------------------|--------------------|--------------------------|---------------------------|
| Net receiver states | 196 | 345 | 91 | 255 |
| Net payer states | 91 | 345 | 91 | 255 |
| Break even states | 58 | 345 | 91 | 255 |

Source: Own calculation.

Net receiver states will increase their blocking minority, even if some of the accession states and of the break-even states may become net payer states as a consequence of accession and net payers will remain weak. Only the strain on the resources of the budget is likely to increase.

... and the coalitions on the expenditure side are expected to remain stable under the Treaty of Lisbon

Lisbon and beyond (2009-)

Votes of net receiver states, net payer states and break even states under the Lisbon Treaty (EU 27)

| Groups of Member States | Number of votes | Total votes | Blocking minority | 65% of the population |
|--------------------------------|------------------------|--------------------|--------------------------|------------------------------|
| Net receiver states | 20 | 27 | 4 | 194.7 < 320.4 |
| Net payer states | 5 | 27 | 4 | 176.5 < 320.4 |
| Break even states | 2 | 27 | 4 | 121.7 < 320,4 |

Source: Own calculations.

Commitment to the multiannual framework has to be seen on the background of the presented annual budget deadlock

The multiannual financial framework since 1988

- The financial perspective includes especially longer-term spending programs, but generally the principle of annuality of the EU budget remains (based on the Treaties) fully applicable.
- The “normal“ budgetary rules pre-determine the agreement under the (non-enforceable) financial framework as the ordinary annual budget procedure remains to be the fall-back position for the member states.
- Or the other way around: The application of unanimity on the level of the financial framework can only be understood on the background of the budget deadlock (a qualified majority for either net payers or net receivers would be likely to blow up the financial perspective).
- The unanimity requirement of the financial perspective remains asymmetric, as termination of the financial perspective would barely harm net receivers.
- Altogether the financial perspective does not break up, but cements the identified budget gridlock further. This is unlikely to change if the financial perspective is made enforceable.

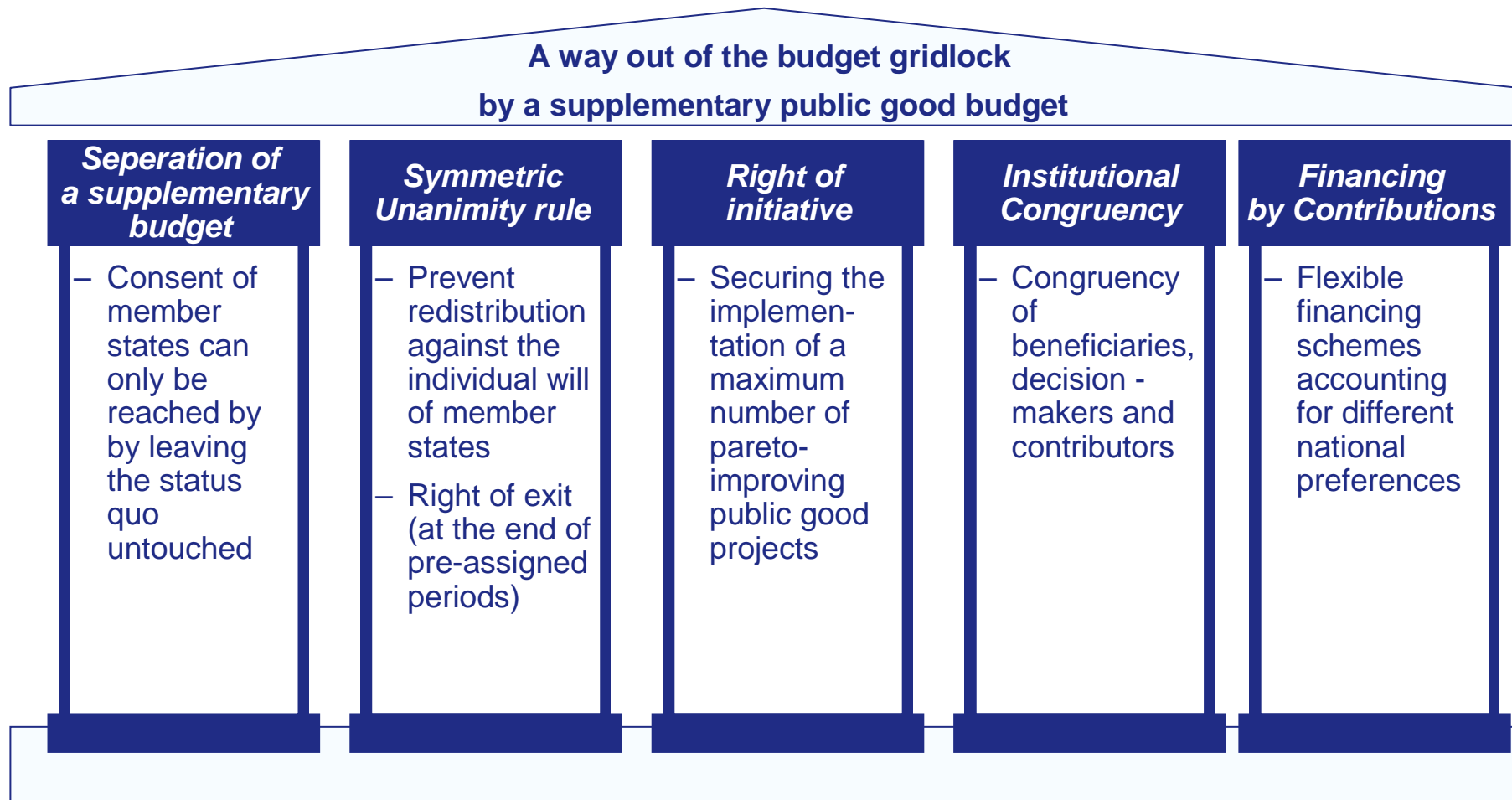
An implementable reform proposal needs to start from the status quo and to focus on pareto-improvements

Reform proposals need to be implementable

- There is no authority which could push through a reform of the budget against the will of the member states.
- Normative reform proposals, which do not take the member states' interests (given the status quo) into account, have no chance of implementation.
- Therefore we want to propose a reform which:
 - does not try to „force through“ a change in the status quo (the status quo of the existing budget will remain the same),
 - creates an option to increase the provision of public goods by a supplementary budget and thereby opens a „window of opportunity“ for the member states
 - is based on the existing institutional framework and applies an improved process of enhanced cooperation.

Five conditions are of central importance to facilitate an increase of the provision of public goods within the EU

General conditions to be implemented by a reform proposal



The procedure of enhanced cooperation seems to be a good starting point for the implementation of a supplementary budget

A supplementary budget within the institutions of the EU

Options for enhanced cooperation based on the Treaties:

- Liberalisation of the conditions for enhanced cooperation within the treaties of Nice and Lisbon (reduction of the requirements for starting a process of “enhanced cooperation” and introduction of the “passerelle system”).
- Nine or more member states could start projects aimed at the supply of additional public goods.
- “Passerelle-system” allows for the application of a symmetric unanimity rule.
- Projects could be financed based on contributions.

Necessary changes of the procedure:

- Abolishment of the “last resort” status.
- Right of initiative for all member states and reversal of the burden of proof: the Commission would have to prove that a process of enhanced cooperation has negative consequences for some member states
- Abolishment of a minimum requirement of participating member states
- Abolishment of the mandatory agreement of the European Parliament.

We want to open a window of opportunity to facilitate a refocusing of the EU budget by an institutional improvement

Conclusion

- We are currently in a situation of budget deadlock on the revenue as well as on the expenditure side of the EU budget
- Whether a member state is a member of the net-payer coalition or a member of the net-receiver coalition depends largely from its ability – in the early years of the community – to improve its payment position by credible exit or non-entry threats.
- The existing coalitions prevent any change of the status quo and this is unlikely to be altered by the Lisbon Treaty.
- Based on these findings we try to offer a „window of opportunity“ which could be opened to increase the provision of public goods.
- Such a „Window of opportunity“ is a supplementary budget based on an improved procedure of enhanced cooperation.