Reaction to Iozzo, Micossi and Salvemini, *A New Budget for the European Union?**

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Iozzo et al (2008) do a great job in identifying the main issues in the EU Budget's expenditures, revenues and decision-making process and put forward an innovative proposal to address these shortcomings. The authors' proposal relies on dividing up the EU budget expenditures in three categories - redistributive, EU public goods and capital expenditures – and having a differential funding structure for each expense class. In doing so, the authors try to link closer together the expenditure and revenue sides of the EU budget and reduce the detrimental effects of net balances on expenditure quality. The paper further recognizes the constraints imposed by the political process in the EU budget where indeed many expenditures are redistributive in nature. It is ambitious in that it foresees the creation of an EU tax and effectively joint issuance of bonds and, in terms of economic efficiency, points at the right direction. Its practicality and its final effect on the distribution of expenditures are less obvious, however.

In this note, I focus on the merits of a division of EU expenditures on several categories – broadly speaking public and redistributive expenses -, the correction mechanism proposed and the practicality of the proposed reforms. I leave aside, therefore, the specific issues of the design of a EU tax and a Commission's bond.

A number of proposals to reform the EU budget have in the past stressed that changes on the decision-making process is a necessary condition for more efficient EU finances. The Sapir-report, already in 2003, highlighted the need to differentiate between expenditures on EU public goods and those on other categories deemed mostly redistributive (Sapir et al. 2003).

Actually, a categorization of EU expenditures dates to the very beginning of the European integration process. As far back as the Treaty of Rome, the financing of the EU budget differed by category of spending (Table 1).

Table 1: Financing shares as laid down in the Treaty of Rome

Member state	Administration	European Social Fund
Belgium	7,9	8,8
Germany (West)	28,0	32,0
France	28,0	32,0
Italy	28,0	20,0
Luxembourg	0,2	0,2
Netherlands	7,9	7,0

Source: Article 200 of the Treaty establishing the European Economic Community (1957)

While in the minutes from foreign ministers' negotiations on the Treaty of Rome[1] it is not clear exactly how the burden sharing was decided, it is evident that administrative and European Social Fund expenditures, the two components of the budget at that time, were viewed distinctly. For administration expenditures, member states accepted as a principle to share the burden proportionally to their capacity to pay (GNI). For the European Social Fund, the relative contributions of member states were adjusted for redistributive purposes. In particular, a lower Italian and Dutch contribution share to the European Social Fund was counterbalanced by larger shares of the other big member states.

The financing mechanism for the EU budget decided in the Treaty of Rome parallels a separation between expenditures related to public goods and the rest, with administration – clearly an EU public good – being financed by national contributions proportional to GNI and the other policies reflecting a largely solidarity rationale.

However, a policy that at one point in time is considered a public good, may not continue being so in the future. This has been the case, for instance,

1 Conference of Foreign Ministers, Brussels, 12 February 1957, provided by the Historical Archives of the European Union, Florence, CM31 NEGO 96.

of the CAP. While initially financed as a public good, i.e. roughly proportional to GNI, over time was financed in a more ad hoc manner, even during the time of national contributions (Table 2). In other words, different circumstances may call for different definitions of public goods. This also highlights the fact that while the border between public goods and distributive expenditures is fairly clear conceptually, in practice it is much less so.

Table 2: Financing shares of the CAP 1962 to 1970

Member state	1962-1965[1]	1965/66	1966/67	1967-1969[2]	1970
Belgium	7,9	7,95	7,95	8,10	8,25
Germany (West)	28,0	31,67	30,83	31,20	31,70
France	28,0	32,58	29,26	32,00	28,00
Italy	28,0	18,00	22,00	20,30	21,50
Luxembourg	0,2	0,22	0,22	0,20	0,20
Netherlands	7,9	9,58	9,74	8,20	10,35

[1] A minor adjustment was made based on net imports from third countries;
[2] This does not include tariff revenue.
Source: Peffekoven, R. (1994, p. 48)

The categorisation of expenditures in the EU budget, as in Iozzo et al. (2008), has also been taken as the starting point for more recent proposals. Of particular relevance to analyze the current paper are de la Fuente et al. (2008) – which this paper follows closely - and Heinemann et al. (2008). The main issues all three papers try to solve is that of fairness of net balances and the resulting distribution of EU expenditures. All three groups of authors put forward a version of a correction mechanism, inspired by the proposals of the Commission (European Commission 2004)[2]. The closest to the spirit of the general correction mechanism is Heinemann et al. (2008), but De la Fuente et al. (2008) is the base of the Iozzo et al. (2008) proposal.

2 This mechanism looks to cap the maximum net contributions of member states to the EU budget, expressed as a percentage of national GNIs. It does this through a partial reimbursement of their net contributions; if the threshold decided upon is exceeded, a percentage of every additional euro spent is refunded to the country. All member states, except the beneficiary country, contribute to these rebates. In essence, this proposal represents an extension of the existing UK correction.

De la Fuente et al. (2008) design a broader correction mechanism than that of Heinemann et al. (2008) by aligning net balances with relative prosperity. They propose a system of horizontal transfers across member states as determined by differences in real income per capita. This is also what Iozzo et al. (2008) propose. De la Fuente et al. (2008) leave open, however, the possibility of adjusting transfers to achieve a larger degree of cross-country distribution, since their original scheme leads to redistribution towards richer member states compared to the status quo. In addition, their scheme envisages a different source of finance for EU public goods, with either equal per capita sharing all across the EU or in proportion to member states' output. Yet, once overall net balances are fixed, the financing becomes largely irrelevant.

While addressing the fairness of net balances, this proposal risks changing little of the incentives to spend more on EU public goods. This proposal would lead to more EU public goods if net balances were determined by financial considerations only. However, the mere fact that net balances vary across countries with the same level of GNI per capita goes to show that they serve as compensation for other non-pecuniary benefits and/or interests. For example, under a correction mechanism, member states with influential agricultural lobbies might prefer a large Common Agricultural Policy, even if this is not in the interest of the EU as a whole and despite having a separate category only for these "redistributive" expenses. That is, taking a limited financial view of net balances, these correction mechanisms on the revenue side might lead to alternative compensations and adjustment arrangements to the detriment of the same public goods' expenditures that the system is meant to promote.

Iozzo et al. (2008) adopt the proposal by de la Fuente and co-authors but propose a different financing. In particular, they strive for the economically efficient solution to finance EU public goods with an EU tax, leaving the rest of the budget to be financed by GNI contributions (and capital expenses by the issuance of bonds by the European Commission). While an EU tax is theoretically attractive and is a desirable goal for the EU, there is little appetite for it currently.[3]

While capping net balances and addressing the fairness issue of financial contributions, De la Fuente et al. (2008) and Iozzo et al. (2008) risk falling short on two accounts. First, they minimize the importance of non-financial factors in determining net balances; de facto strengthening the role of net balances. Second, these proposals do not create the necessary incentives to actually change the composition of expenditures, which is the ultimate aim of any budgetary reform. The most important contribution of Iozzo et al (2008) is, however, its argument for why it is important to separate expenditures in different categories and how this immediately would call for a change in the financing of the EU budget. While one can disagree on the specific procedure that is practical and desirable, the direction of reform is clear.

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3 Only Belgium, Luxembourg and Poland explicitly support the introduction of a new EU own resource, like an EU tax, although a few more member states are open to the idea in principle. Bulgaria, the Czech Republic, Denmark, Germany, Ireland, Lithuania, Malta, the Netherlands, Slovakia and Sweden overtly oppose it (DG Budget 2009).

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