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

STEFFEN OSTERLOCH

JULY 2009

Steffen Osterloch is research fellow at the Centre for European Economic Research (ZEW) in Mannheim.

* CEPS policy brief, no. 159/2008

The paper “A new budget for the European Union?” by Alfonso Iozzo, Stefano Micossi and Marai Teresa Salvemini is a very interesting contribution to the ongoing discussion about the reform of the EU budget. In particular, they leave the conventional track of just normatively discussing “a new budget” by numerating its desirable elements based on economic theory. This has already been studied extensively by economists, with the probably best-known occurrence in the Sapir report (Sapir et al., 2004); the most comprehensive work in this regard has only recently been published in form of a study on EU spending commissioned by the Commission (Ecorys, 2008). From these works can be drawn that a broad consensus seems to exist that a new budget is certainly needed, with less emphasis on redistributive expenditures, and more on functions for which the European level is better suited than the national level. This may be the case due to economies of scale or spill-overs, and often appears in the debate as “European added value”.

While the desirable features of a “new budget” seem to be apparent, the remaining question is how this “new budget” can be obtained. For this purpose, the authors propose “a new structure for the EU budget”, from which more preferable fiscal outcomes should result from the political process. In doing so, they contribute to a growing literature which is focussed on changing the budget indirectly through changes of the environment of the future negotiations on the budget. These changes are intended to set the right incentives so that a new (and better) budget then automatically emerges from the negotiation process. This approach is principally reasonable for at least two reasons:

1. Although no researcher likes the “juste retour” mentality of national representatives in the negotiations, it is undoubtedly a major factor in the negotiations on the EU budget (as it is also the case in budget negotiations in national federal systems, since locally elected representatives have an interest in channelling funds to their jurisdictions). These approaches, such as Iozzo et al. (2008), take these national concerns seriously and intend to influence the incentives so that a more suitable budget emerges even given the existence of these “juste retour” interests. Thus, they arrive at more realistic reform options than those who demonize the “juste retour” thinking, but do not offer a solution for it.
2. The “optimal” budget of the EU is by no means static, but it changes consistently over time. This has most recently been demonstrated by the emergence of the discussion on new challenges for the European budget, such as climate change. Consequently, it is a reasonable approach to modify the structure of the budget in such a way that the expenditure side can easily be adjusted to changed expenditure needs in the future.

The major challenge of such incentive channelling reforms to the EU budget is the following: how can the incentives of the national representatives to call for the spending for redistributive purposes be reduced, and the incentives to spend for public goods be increased? The authors address this issue with a combination of two mechanisms which have already found some consideration in the literature: the separation of the budget, and a generalized correction mechanism (GCM), which is, however, only applied to a part of the budget (Chapter One).

The effect on the incentives of the national representatives is straightforward: in Chapter One, any unilateral increase of funds allocated to a member state would improve the country’s net balance and worsen the net balance of the other member states, so that the country would have to pay back at least part of these additional funds. Consequently, the incentive to strive for these (redistributive) expenditure categories decreases. This is not the case for the (public good) expenditure within Chapter Two, which

stays uncorrected. Hence, the incentives to call for this kind of expenditure increase compared to those of Chapter One.

However, the combination of these two elements gives high relevance to the allocation of spending items to the two chapters. In this regard, it is surprising that the authors differentiate between direct payments to farmers and market related expenditures, given the fact that the latter is also intended as (indirect) income support for farmers and is thus redistributive. This differentiation, however, would create strong incentives for the net recipients of CAP payments to shift CAP spending to the market-related expenditure which stays uncorrected, thus counteracting general efforts to reduce the market-related expenditure.

By and large, the Iozzo et al. proposal is similar to that of Heinemann et al. (2008), who also propose the application of a GCM only to a limited space of spending categories. However, their motivation is a different one and, consequently, both proposals result in a different allocation of expenditure categories to the two chapters. Iozzo et al. (2008) intend to correct any expenditure which is redistributive, whereas Heinemann et al. (2008) propose to exclude those expenditure categories from the GCM where redistribution is *intended*. Obviously, out of those categories which are included in Chapter One of the Iozzo et al. proposal, this primarily affects the Structural Funds. These clearly redistribute from the richer to the poorer member states. This redistribution, however, is principally intended as it is based on the solidarity between the member states.

If a GCM was applied on this policy area, any further negotiations on redistribution via the structural policy were rendered unnecessary, as the overall redistribution would solely be determined by the parameters set by the correction mechanism. The advantage of this procedure is obvious: the redistributive function of the budget will become much more transparent and the negotiations on redistribution much simpler, since the member states' net balances will only be determined by their income. But one has to provide for the fact that today's distribution of structural funds is not identical to a redistribution based on national income figures. This is today only the case for the Cohesion Fund. The lion's share, which is the Convergence Fund, is allocated according to regional figures. Thus, any differentiation of aid intensity between countries beyond their differences in national income would not be possible anymore, so that the whole regional policy would eventually be transferred into a quasi-Cohesion Fund. This, however, would drive the redistributive consequences of many current components of regional policy irrelevant, such as the Territorial Cooperation Objective or the support for sparsely populated or peripherical regions, where support is today paid irrespective of national prosperity. As a consequence, member states could lose interest in these elements of structural policies. Moreover, guaranteeing net balances to member states may have negative consequences for the incentives of recipients of structural policies. For these countries, EU regional policy programs become less attractive, since these improve their net balances. Then, it might be more appealing for these countries to forgo investments based on structural funds, so that the national net balance worsens and direct transfers from the GCM increase. This could then be spent for consumptive purposes rather than investment measures which have an EU value added.

Financing

Concerning the financing of the budget, one might counter that the proposal reaches the opposite of what it claims to do. In particular, as we have discussed elsewhere (see Osterloh et al., 2008) in greater detail, it is not undisputed that an EU tax will be an improvement at the current stage of development of the EU. To be more specific with this criticism of an EU tax, I present my points according to the principles given by Iozzo et al. (2008):

Simplicity: The proposal does not stand for a significant increase in simplicity compared to the situation today, but rather the contrary. GNI resources, generalised correction mechanism, VAT surcharge, duties and levies, 2 balancing items and proceedings from EU loans: this variety and multiplicity of instruments is much more complex than the situation today.

Independence: Although it would not go through national budgets anymore, an EU VAT would still be raised by national tax administrations. This would make "juste retour" calculations as possible as today, and would not give much more independence to the European level.

Transparency: The proposal at hand would not make EU citizens aware of what they pay into the EU budget, but rather give them a wrong impression of their actual contribution to the EU. This is the fact because the EU tax only finances the Chapter Two expenditure and thus only a share of the overall EU budget. Therefore, transparency would not increase.

Subsidiarity: An EU tax based on VAT would indeed be redistributive compared to a financing based on national prosperities, such as GNI proportionality. Poorer member states and countries with a major share in tourism have higher consumption ratios and would, thus, have to pay a higher share of their income to the EU.

Beyond this normative discussion, one should also be aware of the fact that it is not imaginable that there will be unanimous support in the member states for an EU tax in the near future (note that Mrak et al. (2008) find in the member states' views articulated in the consultation phase that there were 10 member states which were "prepared to discuss" new own resources, but 12 which were completely against it). This negative prospect which exists at the political level at the moment should surely not prevent researchers from putting forward such prospective propositions for the discussion. But one should always be aware of the danger that such details which are definitely unacceptable for some of the relevant actors in the negotiations can easily overshadow any innovative and realizable proposition.

Accounting for this inconvenience, I would propose to be less specific concerning the financing of Chapter Two, particularly because I regard the new structure of the budget as the major innovation of the paper, and not the financing. It would be easier to sell the idea of a split budget if the proposal gave more leeway to the financing. This might be done by emphasizing that a financing with GNI resources is equally imaginable in the short run and that this could later easily be shifted to an EU tax, in the case that the political will in favour of an EU tax would arise in the future.

References

Ecorys, CPB, IFO (2008), *A Study on EU spending*, Final Report, Rotterdam.

Heinemann, F., P. Mohl and S. Osterloh (2008), *Reform Options for the EU Own Resources System*, ZEW Economic Studies, Bd. 40, Heidelberg.

Iozzo, A., S. Micossi and MT. Salvemini (2008), *A New Budget for the European Union?*, CEPS Policy brief no. 159, Brussels.

Mrak, M., V. Rant and U.Vajgl (2008), *The Consultation Phase of the EU Budget Review: Member States' Views*, presentation held at the EU-CONSENT Workshop "First Les-sons from the Budgetary Review", Mannheim, November 24-25, 2008.

Osterloh, S., F. Heinemann and P. Mohl (2008), The EU Tax Revisited: Should there be One? And will there be One?, *Zeitschrift für Staats- und Europawissenschaften (ZSE) / Journal for Comparative Government and European Policy* 6 (6), 444-475.

Sapir, A., Aghion, P., Bertola, G., Hellwig, M., Pisani-Ferry, J., Rosati, D.,Viñals, J. and Wallace, H. (2004), *An agenda for a growing Europe: The Sapir report*, Oxford University Press.

With the support of the European Commission

Education and Culture DG

'Europe for Citizens' Programme