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

NOTRE EUROPE

MAY 2009

* CEPS policy brief, no. 159/2008

There is something of a paradox in what has happened with the debate on the EU budget reform: one year ago we were all intensively engaged in the production of proposals and ideas on how to reform the European budget. Now that the crisis has placed fiscal policy back into the public policy agenda, the interest in the EU budget has faded away.

And yet, the need to equip the EU with an effective budget appears more evident now than ever before, at a moment when the Union is confronted by a systemic crisis which demands a strong and united response. The crisis cannot serve as excuse to stop the debate on the reform of the EU finances. On the contrary, it invites us to accelerate the debate, to progress towards solutions, to shift from generic declarations of intent towards concrete worked-out reform proposals.

The paper by Iozzo, Micossi and Salvemini (*A New Budget for the European Union*?) is a welcome first step in this direction. It provides a realistic but ambitious blueprint for a comprehensive reform of the EU budgetary system. In particular, the paper proposes a radical change in the structure of the budget as well as some modifications in the decision-making process. The latter are less significant but nevertheless important. Too often, proposals to reform the EU budget are made by mainstream economists whose sole concern is to improve efficiency in resource allocation. Iozzo, Micossi and Salvemini hit the nail on the head when pointing out that efficiency-correcting reforms are necessary but may lose much relevance if EU budgetary decisions remain disconnected from citizens' demands. They are right in stressing the importance of 'politicising' discussions on budgetary allocations, and the changes they propose in the decision-making system go in this direction.

The paper's main proposal is to separate the financing and negotiation of different types of EU expenditures (redistributive spending, the provision of EU public goods and long-term investment projects). The logic for this reform is straightforward. As is well-known, one the main problems in EU budgetary politics is that member states' redistributive concerns dominate budgetary negotiations. One can blame national governments for putting their interests first and we can try to convince them to be more EU-oriented, but we know that this has little effect. Besides, as the authors rightly point out, member states' distributive concerns are to a certain extent legitimate, given that part of EU spending has an explicit redistributive goal. Rather than trying to eliminate distributive considerations from EU budgetary negotiations, what seems more realistic and logical is the solution proposed by the authors: isolating redistributive budgetary negotiations from the rest and creating different incentive structures for the adoption of different types of EU spending decisions.

In reality, the idea of separating the financing and negotiation of different budgetary items is not entirely novel: it has been suggested by various authors before (see for instance Begg and Heinemann: 2006, Wostner: 2007)[1]. There are however two elements that distinguish the Iozzo et al proposal from other versions of the idea. First, the introduction of an EU tax to supply resources for the provision of EU public goods, and second, the creation of a third chapter funded through Community bonds and devoted to financing long-term investment projects of European interest. These two elements make the Iozzo et al proposal more coherent and complete than previous proposals to break down the budget into separate chapters.

Finally, while we fully agree with the authors on the virtues and potentialities of this proposal, there are two aspects that, in our opinion, merit some reflection. One is the way CAP spending is treated, and the other is the method proposed to finance chapter one. We address these points in order.

1 Begg, I; Heinemann, F. (2006), "New Budget, Old Dilemmas", CER briefing note, 22nd February, London.; Wostner, P. (2007) "On the character of the EU nd its budget: look into the future", working paper series, Nov 11 2007, paper available at SSRN:http;//ssrn.com/abstract=1025384

On how to treat CAP spending

Iozzo, Micossi and Salvemini propose to place CAP pillar one spending into chapter one (redistributive spending). From a conceptual point of view, this decision is unquestionable. As the authors argue, today's CAP is mostly redistributive in nature. Yet, from a strategic point of view, this might not be the best option. Placing the bulk of CAP into chapter one will undermine the prospects of a major shift in the nature and rationale of CAP.

Among CAP experts, there is an overwhelming consensus on that the current CAP system will not survive after 2013. Not only there is increasing pressure to reduce the relative size of CAP budget, but many member states which were traditionally "pro-CAP" and resistant to change (such as France) are now accepting the need to re-define the rationale and objectives of the EU agricultural policy. However, even if there is a favourable climate for reform, a radical change of the CAP cannot be taken for granted. CAP beneficiaries have still a strong capacity for mobilisation and, while there is much political pressure to cut CAP spending, the cause for a 'new' allocation-based CAP has far fewer supporters.

If we place CAP spending into chapter one, we might rule out the possibility of a major re-definition of CAP in the near future. Any attempt to convert CAP into an allocation-based policy will be conditioned on a reform of the structure of the EU budget, thus requiring not only the approval of the Ministers of Agriculture but an agreement in the European Council and the European Parliament. Apart from the institutional obstacles, there are the political obstacles. The mere fact of placing CAP into chapter one will reinforce its redistributive character. The countries benefiting from CAP will fiercely oppose a shift of the CAP to chapter two, as this would mean a worsening of their budgetary positions in chapter one. Given the enormous pressures for cutting CAP spending, they will be probably forced to accept a general reduction of CAP spending, but it is difficult to envisage more than that. If we keep CAP in chapter one we are favouring the maintenance of a redistributive CAP, even if cheaper than the current one.

An alternative option is to place CAP spending into chapter two (public goods). From a conceptual point of view, this would be still an acceptable option. While CAP is usually portrayed as pure redistributive spending, the fact is that farmers' payments have a dual nature; they serve as instruments of income support but also as incentive mechanisms to re-dress environmental externalities linked to agricultural activity (through the so-called "cross-compliance", that is, the obligation for farmers receiving those payments to comply with certain EU environmental standards).

From a strategic point of view, placing CAP pillar one into the second chapter would facilitate a radical reform of CAP. Of course, the simple fact of putting CAP into the "public goods" chapter will not automatically provoke this reform. Yet, it might induce it by forcing a change in the modes of allocating CAP spending. In effect, one of the automatic consequences of placing CAP into chapter two is that it rules out the possibility of allocating 'ex ante' CAP spending among countries (as it is the practice now). If placed in chapter two, the resources for CAP will have to be allocated ex-post according to criteria related to its "public good" characteristics. One might envisage transition periods and a heated debate on what constitutes the public good nature of CAP (with some member states restricting it to the correction of environmental externalities and others defending the need to take into account social public goods such as the maintenance of rural communities). But what seems certain is that member states will be forced to abandon the current practice of distributing 'ex ante' the funding for the CAP.

On how to finance chapter one

Iozzo, Micossi and Salvemini propose to finance the first chapter through the system suggested by De la Fuente et al (2007)[2], whereby MS negotiate their net balances in advance, and once these are fixed, they discuss on the allocation of EU spending. Afterwards, a system of horizontal transfers would compensate MS from any deviations from the pre-fixed budgetary positions

Through it offers some advantages (transparency and clarity above all), the use of this mechanism might have some negative effects. In particular, fixing net balances in advance will create unexpected distortions in decisions on EU cohesion spending. Imagine a net-beneficiary country (i.e. a “cohesion country”) which succeeds in guaranteeing a certain budgetary return. Once the net return is pre-fixed, the country has two options – either fighting in the subsequent negotiations to receive this return in form of EU cohesion spending (submitted to strict rules of co-financing, objectives, “lisbonisation” etc), or simply letting its budgetary position worsen. In this latter case, the country will receive the guaranteed compensation in form of cash (thus not subject to any rules). In the two cases the amount of money will be the same. Yet, the second option is clearly preferable from the perspective of the member state, as it can spend the money as it wishes. In their paper, De la Fuente et al anticipate this problem. To prevent this from happening, they propose subjecting the use of the cash from compensation transfers to some conditions. However, this would eliminate the perverse incentive only if its use is subjected to the same conditions as those that govern the use of EU cohesion spending. But then, at this point, what would be the difference between negotiating net balances and negotiating directly the amount and distribution of EU cohesion spending?

2 De la Fuente, A. Domènech, R. and Rant, V. (2008), Adressing the net balances problem ad a prerequisite for EU budget reform : A proposal, paper presented at the BEPA conference on EU public finances, 3-4 April 2008

Another argument which is used by De la Fuente et al in favour of fixing net-returns in advance is that it isolates distributional concerns from the rest of budgetary negotiations: once the net balances are fixed, it is argued, MS can freely “discuss how much money the EU needs and how it should be spent without the distraction of worrying about how such decisions will affect its own finances” (De la Fuente et al 2007). This is an argument that makes sense if referring to the negotiations of the whole budget, but does not apply if we use the pre-fixed net returns system only for negotiating that part of EU expenditure which is explicitly redistributive.

To sum up, there are no clear advantages from using the De la Fuente system to finance chapter one. On the contrary, there are grounds to believe that the use of this system might entail negative side-effects on EU cohesion politics. Against this evidence, one might wonder why the authors do not simply maintain the existing GNI-based contributions system to finance chapter one. After all, what can be more transparent and fair than making countries pay according to their relative wealth?

With the support of the European Commission

Education and Culture DG

‘Europe for Citizens’ Programme