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SUMMARY

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Summary of the report

Fiscal Federalism, Subsidiarity and the EU Budget Review

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There is widespread agreement that the EU budget is out-of-date, ill-suited to the emerging demands on the EU and, worse, trapped by path dependencies that severely circumscribe the options for change. Its role in economic governance is unsatisfactory and bears little resemblance to that of central government in nation-states, whether federal or unitary, a state of affairs that reflects the continuing ambivalence about 'what the EU is for'.

In even the most decentralised of federal systems, the central government is responsible for a sizeable proportion of public expenditure and taxation, and has a pivotal role in the administration of public finances. These functions of central government have been extensively theorised and analysed in the academic literatures on fiscal federalism and multi-level governance and it might therefore be expected that they could be helpful in reforming the EU budget. Indeed, the 1977 MacDougall report provided a blueprint for an EU budget with such a federal structure, based on the theories.

In practice, however, the subsequent development of the budget – last substantially re-shaped in 1988 – has been limited. It has remained at around 1% of EU GNI, continues to spend the bulk of its resources on just two main policies (agriculture and cohesion), and is financed predominantly by direct contributions from the Member States rather than authentic own resources.

With a major review of the budget in progress and announced as being bound by no taboos, it is timely to revisit the theoretical principles behind it and to consider whether they offer any insights into how reform should proceed. This paper reviews the messages from this academic literature and confronts them with the realities of the EU in an attempt to shed light on possible reform trajectories.

Different disciplinary standpoints lead to different views on how to analyse the EU budget. The political science literature on multi-level governance has been predominantly concerned with issues of legitimacy of the EU level as a budgetary authority, whereas economic analysis rooted in variants of fiscal federalism has looked mainly at the economic efficiency and distributive consequences of different possible mixes of competencies.

Fiscal federalism concerns the division of labour between tiers of government in policy-making, instead of being confined to fiscal arrangements in federations. Earlier contributions (first-generation fiscal federalism) focused on the normative case for assigning responsibilities to different tiers of government and for shaping the interactions between levels of government. What has become known as second-generation fiscal federalism complements the earlier work by looking at the incentives facing policy-makers, how to prevent government failures, and exploring the institutional structures that offer the best prospects for efficient and effective government.

Several key propositions emerge. First, all the theoretical models presume a strong central government that has to mediate between a plethora of sub-national governments. The theory suggests that stabilisation policy and re-distribution should largely be assigned to central government, whereas allocative policies should be pitched at the level of government that is best able to match the scope of the policy with the jurisdiction it covers. For allocation, the trade-off is between advantages of decentralisation in catering to the preferences for public goods of citizens in a particular territory against the possible advantages of centralising the provision of the public goods from economies of scale, the internalisation of externalities and other considerations.

Although fiscal federalism and related theories can offer some insights into whether a particular funding instrument should be 'owned' by a specified level of government, these insights do not, ultimately, translate into the factors that are upper-most for the EU. Similarly, even where there are obvious benefits from centralising spending at EU level, political sensitivities dictate that certain policies have to be reserved for the national level, with a logic of sovereignty to the fore. The upshot is that for many major policy areas, a supposedly objective approach to assigning expenditure to the EU level is simply not applicable. What can be observed about the EU is that it is given responsibility for producing different sorts of public goods (or for trying to curb public 'bads') that the Member States would not produce on their own.

In essence, the principle of subsidiarity, which asserts that a policy should be located at the lowest level of government at which it can be efficiently delivered, relies on much the same reasoning as fiscal federalism. In exploring how the EU budget might be reformed, a possible approach is to use a subsidiarity test to identify the policies that should be assigned to different levels of government.

Such an approach was adopted in a recently completed study by a consortium led by the Ecorys consultancy. It concluded, somewhat predictably, that agricultural spending should be returned to the Member State level, while there should be increased EU level spending on, notably, policies to counter climate change, on EU external action and on research and development. Perhaps surprisingly, the study does not find a persuasive case for increased EU spending on competitiveness-related policies or on internal security, even though these are two areas in which the EU has become a more prominent actor in recent years.

Arguably, the supranational level is qualitatively different from typical central governments. In this regard, the fact that the EU is set up as a union of citizens and of Member States is one of its most distinctive features. In particular, it implies that the accountability of the union is to Member States as much as to citizens. It also means that, in shaping the budget and in the political economy of decision-making on public finances, the Member States have a pivotal role. In addition, it is highly salient that migration – the basis for the notion of 'voting with your feet' that partly underpins the incentive properties of fiscal federalism – is a very weak mechanism in the EU.

Consequently, anyone looking to the economic and political theories to provide compelling guidance on how the EU budget should be reformed is going to be disappointed, because there is simply too big a gap between the political realities of the EU and the sort of fiscal constitution that would emerge if the models were even partly applied.

First, the size of the budget is a constraint because, so long as the budget is set at about 1% of GNI, entire categories of public spending are effectively excluded from consideration, irrespective of political or efficiency arguments for shifting them upwards. Typically, federal budgets account for 10% or more of GNI and even the much smaller 'federal-light' budget of 5%-7% discussed in the MacDougall report looks like fantasy.

Even if a moderate increase to 1.3% or 1.5% of GNI is contemplated, there is no easy way to use theoretical models to arrive at an objective list of what should be in the EU budget rather than at other levels of government. The Ecorys report made a rigorous effort to apply its extended subsidiarity test and reaches plausible conclusions about the relative merits of assigning different classes of public spending to the supranational level.

Yet it is dealing in shades of (dark) grey, rather than black and white, insofar as a credible case can be made for a variety of different 'packages' as the focus of the budget: the three discussed in the report are 'climate change', 'knowledge and innovation' and 'common security and foreign affairs'. Each has its merits, but the key point is that they are alternatives, and choosing one rules out the others.

In addition, the EU budget manifestly still has a role to play in smoothing the (bumpy) road towards European integration by transferring resources between Member States as part of grand bargains. These may be parcelled up inside policies that have worthy objectives (cohesion as a public good), but are inevitably susceptible to the pork-barrel politics of juste retour thinking. As the negotiation of the Obama fiscal package showed yet again, such side-payments are the price to be paid to attain wider objectives, and an implication is that a sizeable share of the budget will continue to be required for payments of this sort. This need not mean the CAP lasts forever, but it does mean – especially with so low proportion of GNI available for the budget – that the room for manoeuvre will remain limited in switching towards authentic EU public goods that tick the right boxes on objective tests.

In these circumstances, and to dispel counsels of despair, the challenge will be to put forward eye-catching proposals for EU spending that is legitimated by being associated with major EU initiatives. A concerted response to climate change is an obvious one, especially if it simultaneously addresses energy security. But others could be envisaged, so that what is needed is a debate on an underlying narrative for the budget. The eventual answer will not, however, be found in the theoretical literature, but will instead emanate from hard political choices about what we want the EU to be and do.

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