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The Purse of the European Union:

Setting Priorities for the Future

Contributions by Iain Begg, André Sapir and Jonas Eriksson

Sieps
Swedish Institute for European Policy Studies

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PREFACE

On 12 September 2007 the European Commission launched a "broad consultation with interested parties at local, regional and national levels, as well as at the European level, to stimulate an open debate on EU finances". The Swedish Institute for European Policy Studies (SIEPS) has chosen to respond to the Commission's invitation in two ways: first, by publishing reports that cover important issues related to the EU budget and, second, by arranging seminars on the theme of the EU budget review.

In the light of this SIEPS on 26 October 2007 devoted its annual conference, "The Purse of the European Union: Setting Priorities for the Future", to the EU budget review. The speakers at the conference were, in the order of presentations, Ms. Cecilia Malmström, the Swedish Minister for EU Affairs, Professor André Sapir, Université Libre de Bruxelles and BRUEGEL; Professor Iain Begg, European Institute, London School of Economics and Political Science; and Mr. Göran Färm, Member of the Committee on Budgets of the European Parliament. The conference was chaired by Professor Daniel Tarschys, Stockholm University.

This occasional paper contains transcripts of Professor Sapir and Professor Begg's speeches, along with an introduction by Jonas Eriksson, SIEPS, that outlines the challenges ahead and discusses the relation between economic theory and the Union's finances.

SIEPS conducts and promotes research and analysis of European policy issues within the disciplines of political science, law and economics. SIEPS strives to act as a link between the academic world and policy-makers at various levels.

Jörgen Hettne
Acting Director, SIEPS

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1 INTRODUCTION

Jonas Eriksson

1.1 Background and challenges ahead

In December 2005, the Heads of State or Government of the then 25 European Union (EU) Member States agreed on a new Financial Framework for the years 2007-2013. Unsurprisingly, the main cleavage was yet again to be found between the Common Agricultural Policy (CAP) on the one hand and the UK correction on the other. At the same time, the dividing line between net contributors and net beneficiaries sharpened considerably after a group of six net payers in December 2003 had insisted that EU expenditures should not exceed 1% of the EU GNI.[1] While the European Commission's proposal went through basically unaltered in substance, the size of the budget was substantially reduced: from the proposed 1.24% to 1.045% of the EU GNI (and raised to 1.048% in the Interinstitutional Agreement; see European Union 2006). The deal also comprised several side-payments to a number of Member States in order to adjust their net positions. In other words, the negotiations were dominated by net balance rather than policy concerns.

One of the paramount factors that broke the negotiation deadlock was the agreement to put the entire budget under scrutiny halfway through the 2007-2013 Financial Framework. UK Prime Minister Tony Blair demanded the review as a *quid pro quo* for reducing the UK correction (see for example BBC 2005), which in turn aimed to facilitate a fundamental overhaul of the budget in general, and the CAP and the UK rebate in particular. This not only solved, or at least postponed, the differences between French President Jacques Chirac and Prime Minister Blair, it also implied that there would be an opportunity to discuss and fundamentally reform the budget at a later stage. The review clause (European Council 2005, p. 32, point 80) states that

> [t]he European Council… invites the Commission to undertake a full, wide ranging review covering all aspects of EU spending, including the CAP, and of resources, including the UK rebate, to report in 2008/9. On the basis of such a review, the European Council can take decisions on all the subjects covered by the review. The review will also be taken into account in the preparatory work on the following Financial Perspective.

Hence, the review purports to leave no stone unturned. A Communication that marked the official launch of the review process was published by the Commission on 12 September 2007. The Communication, or "consultation paper", reflects the sentiment in the review clause with regard to both title

[1] See joint letter to Romano Prodi, President of the European Commission, from the Prime Ministers of the United Kingdom, the Netherlands and Sweden, the President of France, and the Chancellors of Germany and Austria, on 15 December 2003; http://www.number10.gov.uk/output/page5000.asp.

Table 1 The European Commission's questions for the budget review

1.	Has the EU budget proved sufficiently responsive to changing needs?	General issues
2.	How should the right balance be found between the need for stability and the need for flexibility within multi-annual financial frameworks?	
3.	Do the new policy challenges set out (**in the communication; see below**) effectively summarise the key issues facing Europe in the coming decades?	Expenditure/ institutions
4.	What criteria should be used to ensure that the principle of European value added is applied effectively?	
5.	How should policy objectives be properly reflected in spending priorities? What changes are needed?	
6.	Over what time horizon should reorientations be made?	
7.	How could the effectiveness and efficiency of budget delivery be improved?	
8.	Could the transparency and accountability of the budget be further enhanced?	
9.	Could enhanced flexibility help to maximise the return on EU spending and political responsiveness of the EU budget?	
10.	What principles should underpin the revenue side of the budget and how should these be translated in the own resources system?	Revenue
11.	Is there any justification for maintaining correction or compensatory mechanisms?	
12.	What should be the relationship between citizens, policy priorities, and the financing of the EU budget?	

Source: European Commission (2007); adapted from Szemlér and Eriksson (2008).

and content in so far as it is open-ended. The consultation paper promises to let the review be "one of openness and no taboos" and the approach chosen is to refrain from presenting proposals; instead, the Commission lists a number of current and future challenges that may have budgetary implications. As such, the Communication does not map out the road ahead but rather serves as an invitation to Member States, Union citizens and various organisations and research institutes to inject ideas into the Commission's internal work on the review. The communication lists twelve questions which are enumerated in Table 1.

Table 2 Policy challenges/areas for consideration during the budget review

1. **Social dimension**: adjusting to structural change in the light of globalisation 2. **Competitiveness**: scientific and technological progress 3. **Economic transformation**: from industrial to knowledge and service economy 4. **Demography**: low birth rates with an ageing population create strain on the public finances 5. **Solidarity**: promoting economic development in less developed regions	Structural/growth policy
6. **Climate change**: responding to greenhouse gas emissions, etc.	Environmental policy
7. **Agriculture**: new challenges to rural and marine environment from demographic changes and climate change	Agricultural policy
8. **Energy**: to create and maintain secure, sustainable and competitive energy	Energy policy
9. **Migration**: to create and maintain secure borders and migration management	Migration policy
10. **Security**: responding to crime and terrorism; and threats related to environment and health	Security policy
11. **External dimension**: responding to the need for a European presence worldwide and approaching problems globally	Foreign policy

Source: European Commission (2007)

While it is fair to say that the list honours the idea of carrying out a wide-ranging review, this is at first glance even truer concerning the policy challenges alluded to in the third question in Table 1: the Commission has included eleven policy challenges that are broadly captured by seven partly overlapping policy areas. An attempt to compress, summarise and categorise these potential calls on the purse is given in Table 2.

A closer look at the challenges and policy areas listed in Table 2 reveals that the Commission starts out from what is either currently high on the EU's agenda or already part of the EU's expenditure and does not explicitly initiate discussions on other issues. We will not delve deeper into the issues here as they are discussed at some length in subsequent chapters. However, suffice it to say that a different starting point from a topical approach might have resulted in a different list of challenges and policies.[2]

1.2 Prospects for reform

> And it ought to be remembered that there is nothing more difficult to take in hand, more perilous to conduct, or more uncertain in its success, than to take the lead in the introduction of a new order of things. Because the innovator has for enemies all those who have done well under the old conditions, and lukewarm defenders in those who may do well under the new.
>
> (Niccolò Machiavelli, *The Prince*.)

It is frequently emphasised that the EU budget is small in comparison with federal budgets, for example the German or US counterparts, but the reccurent theme of rows every seven years over the EU's coffers may lead one to believe that both its economic and political importance is immense. To say that its economic impact is significant would be a serious exaggeration: the EU budget represents only *c.* 2.5% of the Member States' budgets, or 1% of the EU GNI. Hence, it is not so much the lack of economic impact that fascinates students of the EU budget; it is rather the interplay between different actors – and the institutions, rules and procedures that govern this interplay – and what the EU could and should do with its money that continue to spawn research. Ultimately, this raises existential questions about what the European Union is and what it should be doing.

Whether the budget review 2008/9 will result in far-reaching reform is still very much an open question. The problem as such can be divided into the three categories of revenue, expenditure and institutional reform, but the fact that they are so intermingled may give rise to a negative prior assessment so far as the reform process is concerned. Above all, the path dependency is very strong because of the institutional setting, in which the dominant actor with regard to the expenditure headings in the Financial Frameworks is the European Council. Since decisions are taken unanimously on a budget that has a strong bent towards redistribution, a *quid pro quo* approach is almost guaranteed to dominate negotiations. As a result, any change will be incremental.

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2 To name but two, albeit perhaps naïve, examples: first, the existence of the Economic and Monetary Union will continually keep open the question of whether the EU needs a common stabilisation policy (for recent publications in this vein, see Hishow (2007) and Dullien and Schwarzer (2007); see also Aghion *et al*. (2008), who propose that the EU budget should finance national reforms to mitigate structural problems among the euro countries). Second, the growing cooperation on defence – a public good with substantial economies of scale – may increasingly put pressure on Member States to pool resources in this area in the future.

This is why the present Financial Framework does not differ much from the first framework that covered the years 1988-1992: the CAP and Cohesion Policy still swallow more than two-thirds of the funds.[3]

Moreover, Member States do not let go of advantages gained in the past without compensation, even when the rationale for doing so is compelling. The most contentious issue by far is the already mentioned conflict between the CAP on the one hand and the UK rebate (and the rebates on the rebate) on the other. Removing them in tandem may seem an obvious solution, but although the UK's rebate is caused to a great extent by reasons stemming from the CAP, the reverse is not true: the CAP has a rationale of its own and was part and parcel of the EEC from the very beginning of the integration process.

1.2.1 EU revenue and expenditure

The fact that there is a strong redistribution function in the budget adds weight to the *juste retour* phenomenon, i.e. that a Member State's contribution to the EU budget should be proportional to the amounts received. Furthermore, the pronounced link between revenue and expenditure in the EU budget flies in the face of good governance, since the revenue and expenditure sides of the budget ought to be as delinked as possible. The reason is that the choice of revenue source should not influence spending decisions.

Indeed, the Community's revenue, the so-called "own resources", were originally based on the idea that the Community rather than the Member States should "own" its money and thus that the budget should enjoy a high degree of autonomy. This is arguably not the case today. The GNI-based Member State contribution, introduced by the 1988 budget reform, was designed as a residual that would cover for the remaining revenue needed to finance EU expenditure. Although it still functions as a revenue source that varies according to the incumbent year's expenditure fluctuations – thus ensuring financial sufficiency – it currently represents *c.* 69% of EU revenue. If the VAT resource is added to this, the Member State contributions represent *c.* 84% of EU revenue (see Figure 1 on page 21).

There has been an ongoing discussion about how best to bring financial autonomy to the Union, in particular different options for a common EU tax. Such a tax *could*, if properly designed, increase efficiency in the Single Market[4] – in the view of some observers also improve transparency and legiti-

[3] Due to a series of reforms that began in the early 1990s, the path dependency in the case of the CAP has weakened and agricultural expenditure for the years 2007-2013 has been frozen at the level decided for the year 2006, but it is quite obvious that the reform pace is far too slow to appease certain Member States, the UK and Sweden in particular.

[4] As noted by Professor André Sapir (see Chapter 2), an EU tax such as the CO_2 tax could introduce incentives into the economy that would reduce carbon dioxide emissions.

macy[5] – while at the same time alleviating the *juste retour* problem. However, the feelings at Member State level towards any EU tax are at best lukewarm, and in some Member States outright hostile.[6] The most likely outcome would seem to be a system in which the Member States pay their contribution to the EU coffers based entirely on their GNI, keeping only the common external tariff in place.

As noted above, the question of how the EU should be financed and what it should spend its money on cuts into a more existential discussion about what the European Union should be doing. Musgrave (1959) suggested that public economic policy has three objectives: to allocate resources efficiently (allocation branch); to distribute income and wealth among the population (distribution branch); and to maintain high levels of employment and output and to contain inflation (stabilisation branch). The theory of fiscal federalism then contends that macroeconomic stabilisation and income redistribution should lie in the hands of central government, while allocation should mainly be the responsibility of local government (Oates 1972 and 1999). The recommendation in the former two cases is based on certain restrictions that local governments face when the production factors can move freely across state borders (Oates 1999), while it is assumed that local government is better able to allocate resources efficiently in response to local preferences. At the same time, however, the theory also recommends that certain public goods that would otherwise receive insufficient funding due to either externalities or economies of scale (e.g. defence, internal security, external aid, environmental policies, etc.) may also be better left to a higher level of government.

However, there are a number of caveats to a straightforward application of the theory to the EU. It has been pointed out by Begg (2005, p. 6) that an "[a]nalysis of budgetary questions is complicated by the fact that the EU is not a fully-fledged federation" but rather, "in practice, a delegated agency responsible for a very limited range of public finance tasks, nearly all concerned with what theory defines as allocation". A second and almost as strong objection is that migration within the EU is fairly insignificant, implying that agents will neither respond to spending decisions in neighbouring Member States, nor will they choose to exit as a response to spending decisions in their own Member State. Moreover, theoretical developments – such as second generation fiscal federalism and political economy considerations – modify the conclusions from the early models (see for example Persson *et al.* 1996)

[5] The proposition that an EU tax may improve transparency is contested *inter alia* in Heinemann *et al*. (2008) but defended in, for example, Rubio (2008).

[6] A common denominator among Member States who strongly oppose an EU tax is the implications such a tax carries, i.e. it would be seen as a significant step towards a United States of Europe.

Table 3 Important terms defined

Term	Explanation and problem
Public good	A "public good" is characterised by the fact that no one can be excluded from consuming it (non-excludability) and that consumption of the good will not diminish the amount available for consumption for others (non-rivalry). Examples of public goods are defence, the legal system, etc. There are also examples where a good exerts non-rivalry but not non-excludability (e.g. cable television) and the other way around (e.g., in some instances, public parks), i.e. they are neither purely private nor purely public. The main problem as far as public goods are concerned is free-riding, as consumers have incentive to consume the good without contributing to its production.
Externality	A cost or benefit generated by one agent in its production or consumption activities that affect other agents – for whom the cost or benefit is "external" – in the economy. Externalities can be both positive (e.g. innovations that benefit other agents than those who have funded them) and negative (e.g. pollution).
Economies of scale	The production of certain public goods which are typically characterised by high fixed costs, e.g. defence, space technology, etc. and would in many cases not be produced, or produced inefficiently, were it up to local government or the market to provide them.

Sources: Schotter (2001); and Pelkmans (2006)

and a more extensive use of economic theory has added additional insights (see Figueira 2006). In sum, this means that the traditional Musgrave/Oates framework, which has dominated the economic analysis of the EU and its budget, tends to give the EU a greater role than allowed for by both political reality and a more extensive use of economic theory.

A number of studies[7] have attempted to adapt economic theory to the peculiarities of the European Union, above all relating to the strong links between theory and the subsidiarity principle.

7 See for example Persson *et al*. (1996), Inman and Rubinfeld (1998), Tabellini (2002 and 2003), Rattsø (2003), Buti and Nava (2003), Sapir *et al*. (2003), Begg (2005), Gros and Micossi (2005), Figueira (2006) and Nuñéz Ferrer (2007). See above all Pelkmans (2006), who develops a functional subsidiarity test.

Article 5 EC states that:

> In areas which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity, only if and insofar as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community.

The protocol then stipulates a number of guidelines when examining whether Member States are better able to achieve the objectives of the proposed action – *inter alia* transnational aspects – and the linkage to what the fiscal federalism theory has to say with regard to allocation is fairly obvious. Although the cited references reach different conclusions on what the EU should spend its money on, where applicable the majority conclude that certain existing expenditure would arguably fail a subsidiarity test. This is especially the case with the CAP but also with aspects related to Cohesion Policy in the richer Member States.

1.2.2 Institutional and procedural aspects

It is thus clear that the EU budget is to a much greater extent the consequence of past side-payments and political equilibria than a budget that would follow from a subsidiarity analysis and adherence to current and future policy priorities. Since agreements have to be reached unanimously in the European Council, either the Commission has to devise a clever package if substantial changes are to go through, or parts of the system itself have to be reformed.

Although the 1988 reform introduced stability and legitimacy to the budgetary process,[8] it did so in favour of flexibility.[9] While it is true that the post-reform budget no longer causes the EU decision-making system to grind almost to a halt over petty sums, a system that changes incrementally only every seven years is ill prepared to deal with current and future challenges. The pressures from the many effects of globalisation require the EU to be able to switch swiftly from one priority to another. On the other hand, a higher degree of institutional flexibility may paradoxically lead to a situation resembling the budget battles of the 1980s, which would rather imply budgetary *in*flexibility. However, at the very least, it would seem rational to reduce the length of the Financial Frameworks to five years so that they can be aligned with the European Parliament and the Commission's respective terms of office, as has been proposed by several observers (see for example Begg 2007).

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8 That is to say, the concept of legitimacy as such is located at Member State – rather than citizen – level.

9 See Lindner (2005) and Enderlein *et al*. (2005) for interesting discussions with a more positive slant.

1.2.3 Momentum for change

As far as the review process is concerned, there are always many challenges on the agenda – both internal and external – and previous attempts at budget reform have not fared well.[10] In addition, the Chairman of the Committee on Budgets of the European Parliament has questioned the wisdom of subjecting the budget to a fundamental overhaul before the next Commission has taken office (see European Parliament 2007).

All of the above having been said, several Member States have opted to keep momentum going as the pressure to act in a number of areas is mounting (e.g. in areas such as the policy priorities listed above). Moreover, French President Sarkozy has in his statements implied that France might be willing to discuss CAP reform[11] and the next trio of EU Presidencies (France, the Czech Republic and Sweden) have committed themselves to the review process. In addition, a forthcoming survey of the Member States' positions (for details, see Szemlér and Eriksson 2008) shows some convergence on a number of issues.[12] In the final analysis, it will be in the hands of the Member States themselves to ensure that the review process will also result in a successful reform of the EU budget.

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[10] For example, the Berlin Agreement in 1999 contained a review clause on EU revenue but, although the Commission reported in 2004, the attempt at reform failed utterly.

[11] This is perhaps not surprising: France's net contributions to the common budget have increased and will continue to do so, one consequence of which is that France's share from the CAP is converging on its contribution to the UK rebate. According to Szemlér and Eriksson (2008), the new guardian of the CAP is Poland. However, even Warsaw seems prepared to accept fundamental changes to the system.

[12] Notably, there is strong support for the Competitiveness heading (1a).

2 SPEECH BY ANDRÉ SAPIR

2.1 Introduction

When approaching the EU budget there is not only the expenditure side to consider, which obviously attracts the most attention, but also the revenue side, the process and how we deliver the funds. I have chosen to try to cover the entire spectrum, because I think that all these topics are intertwined and they are very hard to separate from one another. It is not true that you can speak of the revenue side independently of the expenditure side, so I will try to address all three topics. Nonetheless, I am very much aware of Iain Begg's presentation which will delve further into expenditure, so if you find that I touch upon some of the elements in expenditure too quickly there will be opportunity for discussion later.

I will start from the following viewpoint: in reality there is generally a great deal of scepticism surrounding the EU budget and I believe that there are two reasons for this. One of them has to do with the structure of the budget. A budget with too much focus on agriculture does not correspond well with the concept of a forward-looking budget. Second, I believe that there is also often a discussion about the effectiveness of the funds that have been allocated as regards meeting the objectives that have been set, whatever the objectives may be and whatever has been decided. Is the budget actually effective; is it value for money? I think there is some scepticism there as well which I believe is the reason why reform is needed. There is a need for reform on the expenditure side; there is a need for reform on the revenue side; and there is a need to ensure delivery and effectiveness. That is why I want to address all three topics.

2.2 The two logics of EU expenditure

Now, let me start with expenditure. I think there are really two logics that you can use when thinking about the expenditure side. The first logic – one which has enjoyed legitimacy in the past which just may not be there anymore – would be side-payments to facilitate deals. Clearly the process of integration is in essence a political economy that generates winners and losers, since the process of integration is a great economic and social transformation. In other words, it is not only a political project; it is also an economic and social project. Therefore, you can partly view the EU budget as a way to grease the wheels in order to help this process of winners and losers move forward.

The budget is there for the process of integration itself, to make it successful and to ensure that everybody is on board. That is why I call it the side-payments logic and that certainly was very much the logic in the early days of integration. You can also view the CAP and the British rebate as part of this logic. When the Southern enlargement took place the budget was both restructured and enlarged according to the same logic and the side-payments logic is also present today with the Eastern enlargements. One of the essences of the budget is thus to make the integration process both possible and successful. I do not think that you should knock this down; the question is rather how much of the budget should be about side-payments? My view is that the share should be much reduced, although I also believe that we neither could nor should eliminate it entirely.

The second logic – which in a sense is more appealing to an economist – is to think of European public goods. European public goods need to be financed at the EU level and there are a number of them out there. The first one, which in a sense I have already mentioned, relates to the process of integration, i.e. to the Single Market. What I mean is that when we think of the question “What is the basic public good of the European Union?” in economic terms, the answer is the Single Market. Hence the elements of side-payments can themselves to some extent be viewed as part of the public goods logic.

However, the public goods we think of today relate primarily to EU objectives, which are set at the European level. This would include the Lisbon Strategy, which was set in 2000 and is not only still with us today but has been very much renewed as a process. The Lisbon Strategy really relates to the world we are living in today – to the economic and social challenges of Europe for the 21st century – which in turn essentially relates to the changes that have been caused by the globalisation process.

The second public good is energy and the environment and again we can see in the discourse at the EU level that globalisation is always present, where energy and environment are key issues. I would also add a third public good. The Europe of today with its greater disparities is very different from the Europe of the past and it needs to function. This is in itself an objective and could therefore be viewed as a public good. In other words, the side-payment logic is not always very easy to differentiate from the public goods logic.

However – and this is in a sense a political statement – it is above all really an issue of the narrative for Europe. The budget is part of this narrative, whether you like it or not. A budget with 40 per cent of the funds allocated to agriculture is not an excellent narrative for a Europe turned towards the future. We cannot have a discourse where we are talking about the challenges of tomorrow – which relate to globalisation, the environment, energy, enlargement, etc. – and then have budget with little relationship to this narrative. The budget is a financial projection of our political goals and common challenges. I believe that this is very important.

There is an important caveat when framing the budget within in these two logics – the side-payments logic and the public goods logic – since there is really no agreement on what constitutes an EU public good or what exactly is meant by redistribution. Some would argue that redistribution comprises the Common Agricultural Policy and the Structural Funds, yet I believe that parts of the Structural Funds are clearly public goods. The reason is that the nature of Europe of today is such that it requires these funds. In other words, public goods are not only to do with, for example, defence, security or research, they are also about some elements of distribution that are needed as an essential part of the integration process. It is very useful to use the side-payments and public goods logics but nonetheless you need to exercise some caution and not stretch the argument too far.

2.3 Economic theory and the EU budget

Now, let me come to the fiscal federalism aspect. I think it is always necessary when discussing the budget to not only talk about the billions of euro spent every year, but to put it in terms of the relative size of the budget compared to other budgets: how does it relate, not only to the EU GDP, but to *all* public spending in Europe? To me this is a fundamental issue. I find it much more relevant – again from an economic and not a political viewpoint – to relate it to the total pie of public expenditure in Europe. Even though I am aware of the difficulties involved, at some stage you do need a consolidated approach to public expenditure in Europe.

This is why you have to look at fiscal federalism, i.e. the question of who should spend on what at which level? You have this discussion in Sweden just as we have it in all our countries. What is it you should spend at the local level, at the regional level, at the national level? We need the same discussion at the European level. What is it we should spend at the EU level? What is it we should spend at the national level? Now, we have this discussion and we call it value added, but after we have said value added we sort of stop there. The term value added is very easy to use but we need to take a harder look at it and start by looking at the accounts. However, the fact of the matter is that we lack a system with a consolidated budget, where you can look at all public expenditure in Europe and on which levels they are spent. We have some elements, however, which are shown in table 4 below.

So while we know that the EU budget is 1 per cent of EU GDP, we should at the same time remember that it is about 2.5 per cent of all public expenditure in Europe. This is to me a fundamental element since it represents only a very small proportion of all public expenditure. Hence, we have to be very selective since politically it does not seem possible to reach agreement on a budget that is greater than 1 per cent. One logic would be to establish the expenditure that should come from the European level, add it up and decide that this should be the size of the budget. In other words, we should establish the public goods and elements of redistribution that we want to see at the European level, add them up and accept that they represent so many per cent of the EU GDP.

However, this is clearly not the way in which this issue is being approached politically. Instead it is determined that 1 per cent is roughly what we the nations of Europe are willing to spend altogether and then it is decided how this one per cent should be spent. This is perhaps not the most coherent approach but it represents the political reality and it should be taken into account. Given that we are only willing to spend about 2.5 per cent of our total public expenditure in Europe through the EU budget, what should the EU budget be used for?

I would like to show you some figures that come from a French colleague at the Centre d'Analyse Stratégique,[13] who has tried to look at some of the expenditure categories in order to find out a) how much is being spent through the EU budget; b) how much is being spent through the national budget; c) what is the total; and d) what is the share of the EU budget in the total?

Table 4 Aggregate Public Spending, Selected Categories of Expenditure, 2005 (per cent of EU GNP)

Category	EU Budget	National Budgets	EU Total	EU Budget/ EU total
Agriculture	0.39	0.16	0.55	**70.9**
Research and Development	0.04	0.63	0.67	**6.0**
Education/Training	0.01	5.24	5.25	**0.2**
Public Development Aid	0.03	0.32	0.35	**8.6**

Source: Bertoncini (2007)

The table shows that 70 per cent of all spending on agriculture is funded via the EU budget and this represents 0.39 per cent of EU GDP. In other words, most of the expenditure in Europe devoted to the agricultural sector comes from the EU budget rather than via national budgets. There was a logic to this

[13] Centre d'Analyse Stratégique is a centre associated with the French Prime Minister.

relationship in the past but whether or not that logic is there today is certainly one of the key issues. The corresponding figure for R&D is only 6 per cent; for education and training only 0.2 per cent and for public development aid it is about 9 per cent (although there is the issue of where we put European development aid). I think we need corresponding figures for all types of expenditure and then we need to look at which types of expenditure should be at the national level and which should be at the EU level.

We know that there are three Musgravian budgetary functions: redistribution, allocation and stabilisation. I fully share the view that we should have redistribution between richer and poorer countries, since it makes sense to have a redistribution function when there are great income disparities in the EU. At the same time, however, all other forms of redistribution – between regions or between individuals – should be left at the Member State level. The reason for this is both the size of the EU's budget and the fact that it does not make sense to have a redistribution of funds to poor regions in richer countries. I believe that that type of redistribution should be taken out of the EU budget for all the rich countries, so that the redistribution of funds should only be between countries. I have already mentioned that European public goods should come out of the EU budget, while national and local public goods should come out of the Member States' budgets – and we know that we are not using any of the EU budget funds for stabilisation.

Let me just remind you of the insights in the Sapir Report, where we advocated a better EU budget and labelled the current budget a relic of the past with much too much emphasis on agriculture. We never attacked the Cohesion Policy as such, nor did we attack the Structural Funds. What we did attack was the way funds were allocated and we felt that there was too little focus within the Cohesion Policy and that much too little were allocated to public goods. The key, in our view, has always been the question of the narrative: the budget should really be an instrument – much more so than it is today – to deliver on the objectives. I believe that one of the problems that we have in Europe is that while we have summit meetings that are in themselves successful, they continue to add on new objectives. We added the Lisbon Strategy and we added objectives concerning the environment and energy, but where are the resources needed to deliver on those objectives? This is one of the problems and one of the disconnects that we have in Europe: we continually add on new objectives but we do not organise ourselves so that we can deliver on those objectives. The budget is clearly a key element in this sense.

I would like to repeat that there is very little money in the EU budget compared to all the public funds at the national government level, where 97.5 per cent of all public money is at the national level and only 2.5 per cent is at the European level. So how should these 2.5 per cent be used? It should be focussed in order to deliver and there should also be a clear marking of what you are trying to achieve. One of the problems we have in the EU is that we mix objectives within instruments. That is why we in the Sapir Report said that one of the priorities should be growth, with a growth fund designated for growth. There is also the issue of the convergence of the new Member States for which there are the Structural Funds, but at the same time the Structural Funds have been "lisbonised" and, as a result, one is neither here nor there. Are the Structural Funds about convergence or are they about meeting the objectives of Lisbon? This is the result of a political compromise but political compromises have a cost. I think therefore that you should have very clear objectives and not mix objectives. That is why in the Sapir Report we said that we need one fund that is allocated to one objective – convergence – and then we need policies to help the convergence process.

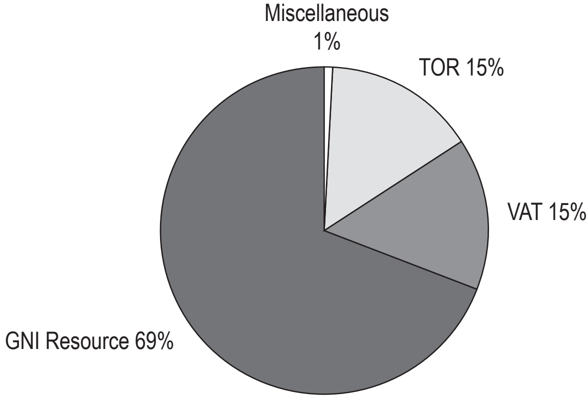
When we speak of Lisbon we immediately think of knowledge, research and excellence. We have this discourse about excellence and we need more excellence in research and innovation. But the reality – and it may be a painful reality – is that we cannot spread R&D and innovation resources to encompass every region in Europe. So, yes we need catching up, but at the same time we do need to have excellence and we also need money for restructuring, which I think is very important.

2.4 EU revenue

Let me now turn to the issue of revenue. My starting point – and I will try to maybe tune that down a bit – is this: if we want to change the structure because the structure does not reflect the current or the future objectives of the European Union and the priorities that have been set, then in order to achieve that change in the structure of expenditure we need to change the structure of revenue. That is my starting point and the starting point is about *juste retour*, this is what the discussions are about. The discussions are rarely about achieving common objectives, at the end of the day the political discussions are about "what is it I put in with one hand and what is it I get back in the other hand", where every country is trying to get as much back as possible in order to ensure the lowest level of net contributions as possible.

I think that the *juste retour* problem is very much exacerbated by the fact that most of the revenue, 84 per cent, comes from direct national contributions rather than from the traditional own resources. We know that the traditional own resources today represent only 15 per cent of the revenue. Most of the revenue now comes from the GNI and VAT resources, which are essentially cheques that Member States hand to the EU budget. So governments sit in a

Figure 1 Breakdown EU Revenue, 2007



Source: DG Budget

very strong position in the discussions. Money is fungible and you can label it agriculture, you can label it Structural Funds or you can call it objective 1, 2, 3 or 4, but at the end of the day, the finance minister who is handing the cheque is looking for a cheque in return. So the label really makes no difference.

The logic of *juste retour* is engrained in the way the budget is financed. One logic would be to say: “Well, if you really want to have a different approach to the expenditure you need a different approach to the revenue”. The question is how do we shift to the traditional own resources in the chart? In other words is it possible to increase the traditional own resources at the expense of the others? It is not a question of increasing the total pie, it is rather about increasing the *share* of traditional own resources at the expense of others. Now, once you do that you very quickly get into a discussion of an EU tax and immediately you generate a huge amount of hostility, at least in some countries (and I suppose that Sweden would be one of those countries). So I see here a dilemma, because in a sense there is a danger in putting forward ideas about an EU tax. If it will come to that at some stage in the debate – this “open”, “no taboos” debate – and we start talking about an EU tax, some say that the whole debate will be high-jacked by the tax discussion. It will no longer be possible to speak about what is really important – i.e. the expenditure – everything will become a political and an ideological debate about whether we are trying to construct a federal Europe and an EU tax would be a symbol of that.

On the other hand, I see a danger in *not* putting forward ideas for expanding the share of traditional own resources, for the reason that I mentioned earlier, namely that if we are going to stay with the current system of financing the budget, we will stay in the logic of *juste retour*. You cannot have a situation where the Member States negotiate in their own interests and at the same time have a budget that is for the common interest. There can only be one or the other, it is not possible to pursue the common interest while at the same time allowing Member States to fight for their own national interests. Somehow there is a disconnect there.

So I see the two dangers of on the one hand talking about an EU tax and falling into the ideological debate trap and on the other of *not* tackling the issue of revenue, because not tackling the issue of revenue will not allow you in the end to change the system of budget negotiations towards a more common view. Is there a solution to this dilemma?

Well, how would you label the common external tariff? The common external tariff is an own resource that has largely been reduced in size and that is very good since it means that we have arrived at a more free-trading position on the part of the European Union. We do not call the common external tariff an EU tax but in fact it is an EU tax in the sense that it is not at all GNI-based. Now, my view is that this was a good method, so I certainly would never use the label EU tax for political reasons but I think indeed that politically that reflects the current state of the European Union, which is a union of states. I think there is probably a majority of states that want to continue this way for the moment and I think that the moment has not come – maybe the world will be different in 20 years' time – to introduce an EU tax with all the implications that this has, for example with regard to the role of the European Parliament.

Nonetheless, I think that the system with a common external tariff is the right one. I do not like the GNI-based system at all, so I am looking for other possibilities of that sort and I am very surprised that in this audience – where so many people have talked about the environment – nobody has brought up CO_2. I would not label it a European tax, I would call it a CO_2 tax. A CO_2 tax would be there to tackle the European budget problem, it would tackle a real problem and I think that everything that we have been discussing here is about tackling real problems. We want to start from policies and transform the union into a union of people rather than a union of states. We want to have a budget that enables us to respond to policies. It therefore seems to me that a CO_2 tax would be the right way to go about this and then you have to see how much of that goes to the EU budget. There are myriads of technical issues, but I think they can be tackled.

2.5 Effectiveness in EU spending

Now, let me come to my final point, which is about effectiveness. Effectiveness is value for money, so once we have decided that money should be spent on certain items we also want this money to achieve the objectives that have been set out. If you remember the two logics that I indicated earlier – the side-payment logic and the public good logic – the side-payment logic is very easy: you give money to people. You are not trying to see whether you are achieving anything, the objective is to give them money. That is the exact objective itself. You do not need to see whether the infrastructure, the R&D or anything else that you are financing are really delivering. The objective is to give a cheque to people or to regions or to groups; that is the logic of the side-payment. There is an issue of distribution and there is some grease to be put on the wheels. Well, you hand over a cheque – which is the grease – and it is working. So there is essentially no need to ensure effectiveness. You can look at the EU budget and the 80 per cent of the CAP and Cohesion Policy, you take money and then you redistribute it and it works smoothly, if that is the logic.

Now, if you look at this logic and say, "am I getting some of the public goods that I want; am I getting some convergence for the new Member States?" then you start to move into a totally different logic which is much more difficult to deal with. Are you actually delivering on some of the economic objectives on your famous public goods, whatever they may be? I think that if we are moving more towards the logic of public goods, it also means that we have to rethink the effectiveness of the budget. We cannot just think of handing out cheques and saying, "yes the cheque has been written and handed out", be it to a person, a region or a group that it was meant for. We have to ask ourselves whether we are actually delivering on the policy and this is much harder. For instance, it means that we have to put accountable agencies into place. I was delighted to see what happened within the field of research with the creation of the European Research Council, which I think was an excellent move in the sense that it is an agency with a very clear task. When you have a very clear task entrusted to an agency, you can hold this agency accountable. You can see that it does not have five objectives to meet, it is not trying to meet efficiency and redistribution goals at the same time and there is a very, very clear and narrow mandate to do certain things; to finance excellence in research. Then you can evaluate at a later stage to see whether it has indeed met the objective that it set out to meet.

In any event, I find that we need more assessments of policies. The Minister for EU Affairs spoke about the cohesion report for the Structural Funds and about the CAP health check, but I am not satisfied with the processes as they are, because they are not carried out by independent bodies. That is why we need a role for the European Parliament and the European Court of Auditors; they need to get into this game. They need to ensure that there are indeed independent bodies and they need to be independent from the Commission, because the Commission is in charge of expenditure. The Commission has a very hard time – in a sense the DG Budget is detached from the process – but the DGs that are in charge of expenditure are very close to the process and partly captured by some of the vested interests. This is normal; it happens in every government and is not an issue of the EU level.

So we need independent bodies to evaluate the policies and it cannot be the Commission itself that evaluates the policies that it is implementing. With Sweden's great experience of independent bodies and accountable agencies I think that the Swedish Presidency, if I may say so, should really bring something very strong to the table. Because at the end of the day, once we have decided on the budget – after this every seven-year "bataille royale" to decide on the allocation – what really matters for the delivery is how effectively and how cost-effectively the system works.

3 SPEECH BY IAIN BEGG

3.1 Introduction

I have been asked to say something very briefly at first, before I come on to the topic of EU expenditure, about the way in which the midterm review is happening. I am leading a study – one of two studies – that is being done for the European Commission. One of the studies is looking at the expenditure side and the other is looking at the revenue side. Because I am looking at the revenue side, I am not at liberty to discuss the results and I will, therefore, talk about expenditure.

What is happening is these two studies will feed into the consultation process, which is going on at present, and to which you are encouraged to respond. It closes on the 15th April. After that there will be a highly political conference at the end of May. Following that is a period between July 2008 and February 2009 when everything will be decided. Now, that may sound like a very long period, and the reason that it is such a long period is that nobody quite knows which EU Presidency is going to grab hold of it. Will it be the French? This is a possibility because Sarkozy has been making all kinds of noises about it and he may want to accelerate the process and try to settle it before the end of 2008. Or will it fall to the Czechs, who are very worried about it, and want to say no and stay away from it? And if they do not do it, guess whose lap it ends up in?

I think the most likely is that the French want to seize hold of it, so that means that in the July to February period it is this end of that period rather than the far end of it where a lot of the action is going to take place. So if you want to start your lobbying, fill in the consultation form and get involved now, because it will not wait for you.

3.2 Approaches to EU expenditures

So having said all that by way of introduction, what I want to concentrate on is one or two things that André did not say. On the expenditure side, how should we actually be spending their money – or maybe that should be our money? Not easy questions to answer, because if you think about it, there are all sorts of ways of conceptualising what is going on here, some of which you have already heard. We need to think about – and some people think the only question that is relevant (and here I can speak as a true Brit) – how much money it is? If you open your ears around London you will now be hearing figures of 0.6-0.7. They are probably quite strongly supported in Stockholm those figures. “We do not want to spend much money on the EU budget, so we should be pushing it down rather than up”, that is a first line of argumentation. And yet if I listen to my, shall we say, Polish friends, sometimes they will be saying, "this is ridiculous, we shouldn't be arguing about pennies in the budget, we should be thinking much more strategically about the big things that Europe should be doing", and so looking at a bigger budget. So the first discourse is simply on the scale of the budget.

Then there is a second line of argumentation about net balances: who obtains how much from it in net terms? You pay in, you receive, and here it is very much about the famous Margaret Thatcher story of "I want my money back!" and swinging your handbag to make things happen.

Then a third line of argument is that the European budget has all these virtuous things we talk about in it. We read in Article 2 of the present Treaty that the EU is about ensuring stable growth, economic and social cohesion, a high level of employment and all these wonderful things that are what the EU is supposed to do. In this respect the word solidarity often comes up. The reason we are spending EU money is partly to do with solidarity. That may be the same thing as what André was saying about side-payments, but I think solidarity as a principle goes a bit beyond just bribing people. It is also about taking responsibility for them. So this is, if you like, the most positive spin to put on it, solidarity in European construction is what it is all about.

Or maybe we should be using a different word ending in "ity", and argue that the debate should really be about subsidiarity, pushing spending down to the lowest level and only as a last resort using the European level to spend the money. That gives us the difficult question that if we only knew what value-added meant then it would be quite easy to define subsidiarity. However, the trouble is we do not have a very clear conception of added value.

And yet, at present we attempt to achieve all of these different things with this mere 1 per cent of EU GNI or what André showed in the calculation, 2.5 per cent of EU public expenditure. If you look at that level of public expenditure, "low government" Americans spend something like 20 per cent of GNP at the central level. Now, of course we are not the United States of Europe, we are more a United Europe of States, which is a different conception entirely. But contrast that 1 per cent at EU level with 20 per cent in a supposedly small government in a federal country like the US and even bigger figures in Canada or in Australia, and much bigger figures I have to say to you in Sweden, where I was once giving a talk when I said: "Sweden spends 55 per cent of its GNI on public services", I was immediately interrupted by the person sitting to my left, who said: "No, it's 56!" That was Carl Bildt.

3.3 EU added value

Let me try to define what added value might be. Here I think we can rely first on fairly routine economic arguments. If there are evident ways in which you can gain from spending at European level, you get economies of scale and you are able to spend more efficiently across borders. The standard argumentation is there. Then you have the various market failure arguments to deal with: if you spend in one country, it spills over into another country or if you do not spend in one country, you could have a negative “externality” stretching from one to the other. These are things that every economist in the real world understands as normal.

A second category of arguments is to say that some countries simply lack fiscal capacity. This is true of the lowest income Member States. If they lack fiscal capacity you can add value by underpinning that fiscal capacity. Every country does this. For example, Stockholm pays out to Norrbotten via the equalisation system of the local income tax (the residents of Skåne pay even more than the residents of Stockholm per capita by the way) and this means that you get intergovernmental transfers to support the fiscal capacity of less well-off regions. It is a fiscal capacity argument as well as a side-payment or redistribution argument. And then you have the various aspects of the management of resources that you need to reconsider. You want to support public investment because equalising public investment is a way in which you get economic and social cohesion. This justifies spending in the new Member States.

It is a more open question whether it justifies spending in the poorest regions of the richer countries. Should eastern Germany be a European problem or a German problem? Open question – you cannot answer it. Is the South of Italy an Italian problem or a wider problem for the rest of us? Well, if Southern Italians migrate to other countries because they have a lack of opportunity in their own areas then it does become a European problem. It is a normative issue. You can answer it every way you want and there is no single best answer.

Now, here I have actually surprised people by suggesting that there are occasions where spending at the European level is more efficient than spending at national level. The former European Commissioner Pascal Lamy once made the argument that half a euro spent on research at European level is worth more than one euro spent in either Germany or France, because they are inefficient at spending in those countries.

But it is always possible that you can spend more efficiently by concentrating expenditure than by focussing it in a single country, so there you get an argument for moving expenditure upwards. It is possible that within Member States you get locked into particular ways of doing things, so if you want to innovate in public expenditure – and even try to experiment occasionally – sometimes the European level is a better place to do that because it breaks old traditions. That may be a weak argument but it is one that we should not dismiss.

Then added value comes in from an entirely different direction, which is that on occasion you can see that it makes sense to spend at European level because there is a European interest in that area. Underlying EU policies are part of this. Then I think we have an open question about whether once you are locked into something like agriculture or cohesion: can you just turn the tap off over-night or do you have to continue with it, perhaps on a descending scale, for an indefinite period? We see this in the Structural Funds where all the countries which used to receive large amounts from the Structural Funds have been given a glide path out of it. They gently lose the money, like Ireland, instead of being told overnight the money stops. This may also be a part of added value at European level.

3.4 Criteria, principles and objectives for EU spending

Then we come to the question, with all these sorts of things in mind, what now should we be spending the money on, and on what basis? It is never easy to work out what principle you apply to the money you are spending. This is something I want to try to elaborate on, although some of it has already been introduced by the previous speakers.

The simplest is to say "what is the minimum the EU needs to do?" Silence in the room. I think there are irreducible levels of expenditure on straightforwardly regulatory activity in which the EU engages. You cannot run the policing of the Single Market without a minimum administrative budget, and then you can think of all the other things, some of which are new ones which the EU aspires to do and which it is paradoxically under-funded to do at present, like the Common Foreign and Security Policy elements or even some of the Justice and Home Affairs agenda. So if you can conceive all of these as in the broadest sense regulatory you will need money simply to administer these projects. At present that is 5 or 6 per cent of the EU budget. This could even double if you wanted to take on more of the administrative regulatory tasks, which we always seem to want to load on the EU level. So that is the minimalist approach.

Then we should recognise that there are things in the Treaty. You cannot get away from the fact that a Common Agricultural Policy is in the Treaty. We have agreed to it. If we have agreed to, it we must bear the consequences of agreeing to it. We have left it in the Treaty and we have not taken away the articles that give it its legitimacy. Therefore, we face an obligation still to spend money on agriculture. Now, we could spend less and there is nothing in the Treaty that says that 40 per cent of the EU budget needs to be spent on agriculture, but we do need to support it somehow. It could be through regulations; I will come back to that later.

Then we have what André has already discussed at some length, which is the idea of public goods though we need to ask what are public goods in this sense? Well, we have all the trans-European networks as forms of infrastructure. We can think of softer infrastructure to do with financial stability, which might be a very topical issue. You want to ensure that there are means of assuring safe payments like the European Central Bank's target system, and we might need a small amount of money for something like that. But there are other ways in which you deal with it.

In some cases, the classic interpretation of research and development is if you cannot appropriate the benefits from research and development you will spend less on it. So by spending at European level you internalise the benefits to a greater degree than if it was done by a single company or within a Member State. This makes an argument, not always the soundest of arguments, but at least the beginnings of an argument for spending at EU level. You want to try to appropriate, contain within your boundaries the benefits of expenditure you make.

And then, fourth, we do need to think about the distributive aims and pose the question: at EU level, should we only be distributing among Member States or does the social dimension come into it to some degree where the EU takes a degree of responsibility for distributing among social groups? These days the Social Fund is primarily about training. It was initially conceived of as being for transfers to Italy in the 1958 settlement but the Social Fund now is mainly about training programmes. Training is an obligation or something we are looking for in all of the EU Member States. Should there, therefore, be some EU engagement in this or should we just simply leave it all for the Member States or even sub-national levels to deal with? Open questions again, and it is very hard to draw a line, saying this sort of training should be at European level, that sort should be national, and this should be left to the counties. It may be that in some of the tertiary education, with the attempts to promote mobility between countries, social policies at European level become justified. And yet someone says that this is really tourism for students, so we dismiss it. So there are open questions there, yet again.

On many of the new policy areas it is actually quite hard to see how you can conceive of undertaking them without having a European level to it. Climate change almost by definition crosses borders. If it crosses borders maybe it should be dealt with at a global level, but at least the EU level is a first approximation to the global level, where we can agree on common EU policies. You will have a strong justification there for spending at the EU level on these sorts of areas. The same applies to some of the security issues that are now coming to the fore. Should there for example be a common EU border police? That might be difficult because not every country – and I can mention one or two – is in Schengen but at least the Schengen border is a hard border, why therefore, should the Poles and the Hungarians pay for the external border to the East and not those countries which benefit from it and do not have any external border, like Austria? That would justify having a European level to it.

If we think about the sorts of principles we use for spending, the one that essentially operates at the moment is the *juste retour* or "fair return" approach, and this has a number of ramifications to it. The first is that it necessarily means that we are looking to give something to everybody. You cannot say that a policy should only work for a particular Member State and that, I think, is something that citizens tend to welcome. If the EU is invisible to you, you do not want the EU as much as when you can see blue flags, whether it is in Austria or Ireland or even in the North of Sweden. But what it does tend to do is to say the principle for spending should be territorial and not the quality of the expenditure. So you are distorting your expenditure priorities by operating this approach and making sure that spending goes where it is visible and not where it is either needed or gives the best return. That is the corollary of this fair return philosophy.

I think as well there is a bit of tension that arises when you consider that it is finance ministries who sign the cheques and send the money to Brussels, but it is other actors within a country who receive the returns. In Sweden, the Northern counties receive more, because they are designated for Structural Funds assistance. The older Länder in the East of Germany received more, because they are designated. It is the farmers who receive more so the agricultural ministers or the economic development ministers will say: "We welcome more EU spending because that comes in to us." Whereas in the governments, the finance ministers will be saying: "Well, we see the money going out, but we don't see it coming back." This dichotomy between actors is part of the political economy of how this functions. This is aggravated when you consider that most of the expenditure now is through this direct payment – the GNI resource – because that accentuates the fact that finance ministers see only what is going out and not what is coming in.

The second approach, and this is one which you might think is one of the most virtuous; you spend where you get the most return. You use the principle of excellence in public expenditure. It is certainly the case that if you are supporting research you should only ever support research on the basis of the excellence of the research. This is the standard approach adopted by research councils everywhere. They peer-review proposals to try to concentrate on paying for only the best quality research. The trouble with this is that if you are approaching it from, say, eastern Poland you would say: "Our universities really are not competitive with the Southern Swedish universities or the British universities. We are not going to get any of this money, therefore we will oppose it." This geographical unevenness could mean that all the research money ends up going predominantly to three or four Member States and that means that the others are going to object. There would tend to be a correlation between the richer Member States, which are able to invest more in the research infrastructure and they will then be able to get the research money. So you get your excellence but you will not get the territorial evenness and this is seen by many as a threat to cohesion. What this raises is how far to go in making allowances for cohesion while building up research capacity elsewhere – I am only applying this to research, but you could equally apply it to other policy areas – how much do you allow for the cohesion element in making this case? Yet again, a difficult and tense issue.

Then you have the side-payments approach for which the purpose is inevitably deeply suspect. What it is really about is bribery. If you vote in support of the single currency in 1992, you will be rewarded with the Cohesion Fund. To support a single market in 1986, the Structural Funds were doubled in size. These are things which may smooth the way to normal politics in Europe. Europe is all about deals. If you want the deals to happen you must pay the bribes. Very unprincipled as a basis for expenditure but I think that you can see there is a tension between these three broad approaches that I am outlining.

The Commission's consultation paper stresses the idea of making public expenditure in Europe respond to policies. First decide on the policies then decide on your expenditures. If you put policies first, what policy areas in Europe are most prominent? Well, Lisbon – the partnership for growth and jobs – is at the heart of much that is going on in the EU economic governments at present. This means that what we are trying to do is to use the economic strategy to boost productivity and to ensure that more jobs are created; in other words, to make the European economy function better. You would say that if that is the priority, then that should also be where the public expenditure at European level is going. There is an evident logic here.

You know about the famous target (which of course Sweden exceeds and we take our hat off to you in this), that Europe as a whole is supposed to spend 3 per cent of GDP on research and development. Apart from the Finns and the Swedes nobody meets that target and there is very little prospect of anybody meeting it by the target date 2010. So you might think therefore that allocating more to research and development in the EU budget is a way forward but the figures that André presented earlier showed that a tiny fraction of European research is actually funded at the European level. It is not going to make any difference to this 3 per cent target because it will raise the present level of 2 per cent to 2.06 per cent. That is not going to transform EU research and development. So we could make a decision to spend much more heavily on research at the European level, not least because of the appropriability issue, but we have not really had the courage to do that so far.

The same applies to the labour market where we see document after document stressing the importance of lifelong learning. We see document after document saying we have a skills deficiency in many Member States (not Sweden again of course) and we see document after document saying we must have more effective active labour market policies. I think we can see there that there is a demand for policy intervention, posing yet again the question of which level of government should take the lead on it. Is skills and lifelong learning something purely for Member States or should we countenance at least some European involvement in it, which comes back to the social policy issues?

The second big strategy at European level is that we have articulated – first at the Gothenburg economic council in 2001 and repeated in 2006 – that Europe wants to put forward a strong strategy for sustainable development. Allan Larsson and I have been doing some work on this and we see an incompatibility already between the two levels – the Lisbon strategy and the sustainable development strategy – but there is one thing that unites both of them: there is hardly any money in either and without money it can be quite difficult to promote such far-reaching policies. And in sustainable development, once again: the social dimension is very prominent in the texts, but it is very hard to see it applied in practice.

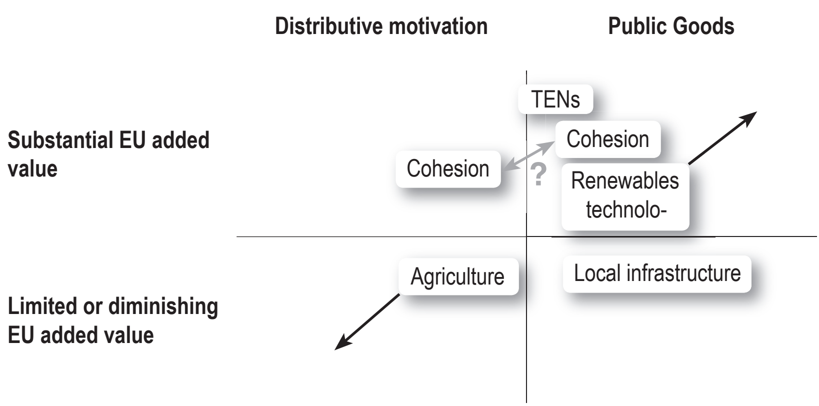
Then we have the energy policy for Europe, which was agreed this year in the 2007 Spring Council. Energy policy implies all sorts of things. We want to invest in new technologies for renewables, where we have this very ambitious target; we want to invest in new technologies for energy saving, and all of this does not come cheaply. You are not going to invent a new technology for renewables overnight with a tiny budget. So in these things, yet again, we have huge spending needs and yet it is hard to see that the means being allocated – whether at European level or even at Member State level – would be suitable for the tasks that are in mind. If you read through the list of policies you could easily tick off and say, “well, that needs 2 per cent of GDP, this needs another 3 per cent, and that needs another couple of per cent”, and you would reach an EU budget of about 7 per cent of GDP (which is by the way what the McDougall report of 30 years ago first advocated) but we are stuck with 1 per cent. So I think we do have a big gulf here between the ambitions at European level and the means available.

This does not mean that I am standing here, especially as a Brit, saying that we should increase the EU budget by a factor of seven, but what I am trying to set out to you is that we have huge ambitions at European level for which the resources simply are not there, and this means sometimes that we have to be a bit more realistic about what the EU can do.

3.5 Key policies and their motivation

Now, I have tried to think about putting all this together by saying that there are policies for which we can identify a substantial EU added value. Some of them may be distributive in their motivation; some may be the public goods motivation, if we accept this dichotomy.

Figure 2 Key Policies 1



Now, on the Cohesion Policy: if you accept one of André’s arguments you would say: “The Cohesion Policy is a distributive policy. It’s transferring money to the Poles, the Czechs, the Lithuanians, and the Latvians. It comes out of our pocket and it goes to them, it’s pure distribution.” But other people would say: “No, it’s not; it’s actually a public good because it develops parts of the EU economy, which would otherwise be less developed and that is good for all of us because it spreads prosperity and that prosperity washes back to us." There are completely unsettled arguments about whether spending on Cohesion Policy – which is building roads etc. in Central and Eastern European Countries – actually means business for Swedish and German companies: the money comes back to us so there is this common interest in it. You have to make your choice there, where does cohesion sit in this kind of framework?

Trans-European networks – and I think this is pretty unambiguous – are in most cases public goods and they add value at European level. If you build a highway across Austria it is not just for the benefit of the Austrians. Indeed, if it were only for the benefit of the Austrians, the Austrians probably would not build it in the first place. Now we are talking about a road from Helsinki to Athens, the Eastern corridor: would that help in economic development terms? Well, it probably would. Would it be value for money? That is much more contentious. These are the sorts of things where you can see there is an added value and there is an EU level public good (you will notice here that I abstract from the question of value for money in this).

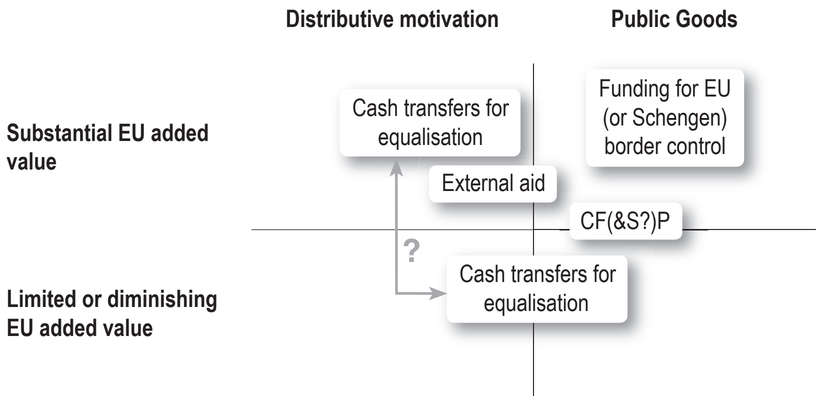
Local infrastructure: if you build a road from Stockholm to Kiruna, does that make sense at European level? Not really... A few elk can come down to visit Stockholm, but I do not think that makes sense at European level. So even though it scores well on the public good element, local infrastructure is very hard to justify.

Agriculture might have started life as an EU level public good because in the 1950s, believe it or not, we were worried about food security. We invented an agricultural policy to ensure that Europe could feed itself. But these days I would say that agriculture has moved in the direction indicated by the arrow in Figure 2: if it ever had an added value it has lost it and it has now become very much a distributive policy. It subsidises farmers' incomes and even with the health checks and all the reforms it is likely to continue going in that direction.

But renewables technologies, new energy technologies, is something that is going in the other direction, and I think it is fair to say that this is something we see as for the future, because it is part of a sustainable development. Sustainable development resonates as something we want to support. So you can see different directions in which different expenditure priorities are going.

Let us consider some others, such as cash transfers. I mentioned earlier the Swedish model where you have huge cash transfers from local authorities in some parts of the country to others. Should that be something to be counte-

Figure 3 Key Policies 2



nanced to European level, should there be a pure cash transfer from very rich Luxemburg to very poor Latvia? Is that something that we will accept – in which case we would put it as distributive but as an EU added value – or, again, is this something we should only contemplate within Member States?

Think of some of the other things, such as border control. The border control could be for the EU or just for the Schengen countries and would make sense at European level for the reasons I have talked about. It is a public good; we all want to keep out the Ukrainian hordes. It is something which is added value because we believe it is something that the EU could do very well if it was organised and there is also the equity element that is unfair to some countries to impose the burden of exercising that border control. And yet, there is always sensitivity to it. Each country wants to retain responsibility for its own security, so there is a political overlay to all of this.

Concerning external aid, where the motivation is distributive: is it something that the Swedes should be able to decide for themselves – and I think you have the highest proportion of GNP spent on aid – or is it something that Europeans collectively ought to do, so that we can all feel virtuous in the way the Swedes do? Again, this is something which is highly contentious.

Common Foreign Policy (maybe Common Foreign and *Security* Policy, I am not sure about the "S" in this) is something which we seem to have agreed to in signing the Lisbon Treaty. Can it be done on a shoestring budget or a non-existent budget, as at the moment? Probably not… So it is something that we can see as a potential EU public good and we should go in that direction.

These are just some of the things that I think could come onto the agenda now for more extensive discussion.

3.6 Issues for discussion on the future of the EU budget

Let me conclude just by highlighting some things that we might pick up in the discussion. One is a deceptively simple question: if you are going to implement a policy at European level; how do you do it? The choices here are three: first, regulatory, which is most of what the EU does. Second, coordination, which is a mode used in many European policy areas. Lisbon is a form of coordination, the Stability and Growth pact is a form of policy coordination, and you can look at the whole array of employment and social policies where everything is done through variations on the open method of coordination. That is where the EU is adding its value. Or the third option is to spend and this becomes a stark choice that I think we need to confront in considering what the EU does; which policy mode it chooses.

Second – and I have hardly said anything about agriculture – we ought to consider whether the spending model ought to be reformed. André showed you the figures: most agricultural policy in the EU as a whole is financed at European level. Whether or not you love the Common Agricultural Policy – and I do not expect many in this room to subscribe to that notion – it is there. If we do not reform the Common Agricultural Policy we can still alter how much it costs the EU budget by co-financing it. Is co-financing something that we should consider for such policy areas? Believe it or not, we already use co-financing extensively on Cohesion Policy. We say to the richer Member States: “You must co-finance 50 per cent of the cohesion budget”, one reason, again, why it makes things more difficult for finance ministries. They pay to the EU budget and then they have to pay to co-finance something, so they are paying twice for Cohesion Policy; and then there is somebody else that gains the benefit. That is how they can often see it in political economy terms. But co-financing for agriculture is something we might well consider as an option since with 50 per cent co-financing you would half EU expenditure and still retain precisely the same policy. You may separately want to reform the policy but co-financing is a way of cutting the cost to the budget.

Then this vexed question that André already posed: how effective is spending? Recently I went through an exercise on Cohesion Policy, where I tried to look at a wide range of evaluations of Cohesion Policy, posing the simple question: does it work? I found three answers: “yes, it works”; “there is no effect whatsoever”; and “maybe it works”. These answers depended on the methodologies used. The econometric exercises were pretty unambiguous in saying that there was no discernible effect from Cohesion Policy. The economic modelling exercises, which are different from the econometric in trying to look at the whole macro-economic impact of the policy, indicated an effect of 1 or 2 percentage points. The improvements in methodologies of policy come out with quite strikingly strong evaluations. Now, admittedly some of them were done by the Commission, or for the Commission, but you do see this rather puzzling business of three different verdicts to the same question depending on what perspective you take. So there is a note of caution about how best to evaluate policy.

The fourth question for debate: if we do want genuinely to have this notion of subsidiarity, how do we actually test for it? Subsidiarity is about doing things at the lowest conceivable level and you only push up to a higher level if you can make a convincing case that it is done better at the higher level, implying that the thrust is to push downwards in policy-making. But we accept in most Member States that quite a lot should be done at national level and not pushed down to local level. I think we need a new debate about pushing upwards. I do not think we have had that debate properly, and it is something that should be engaged better. This really takes us into the very difficult territory of who does what in an integrated system and that ultimately leaves us with the question – a question that we always seem to come to in this kind of debate – what do we actually want the EU for?

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