

Per Molander and Allan Gustafsson

Coming of Age?

Economic Management
of the European Union

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PREFACE

Sieps, the Swedish Institute for European Policy Studies, conducts and promotes research, evaluations, analyses and studies of European policy issues, with a focus primarily on the areas of political science, law and economics. The Institute's mission is to act as a bridge between academics and policymakers and to contribute to increased interest in current issues in European integration and to the debate on the future of Europe.

The authors of this report, Per Molander and Allan Gustafsson, are international consultants in the field of public management and founders of the consultancy firm Mapsec. Molander holds a PhD in applied mathematics and has a long experience from policy analysis in the public sector. He was responsible for developing a new food policy for Sweden in 1988–90 and for a reform of the central government budget process in the mid-nineties. Gustafsson holds a PhD in economics from Stanford University and is an expert in public financial management, with a long experience from both developing and developed countries. From 1997 to 2001, he led the Vesta project at the Swedish Ministry of Finance aimed at introducing performance budgeting in the Swedish central government.

This subject matter of the report is the economic effects of institutional choice – how the decision-making rules of the European Union affect policy when it comes to expenditure levels and expenditure structure. It covers a wide range of issues, including constitutional problems raised by the Convention. The message of the report is that whereas the Union is coming of age in important respects – size, level of integration, not least the creation of a constitution – it is not so when it comes to economic management. By publishing the report, we hope to make a contribution to the continuing reform of the institutional and regulatory framework of the European Union.

Stockholm in October 2003

Mats Hellström
Chairman of Sieps

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COMING OF AGE? ECONOMIC MANAGEMENT OF THE EUROPEAN UNION

SUMMARY

With the adoption of a Constitution, the European Union will, at fifty, come of age. What started as a fairly technical form of co-operation has gradually assumed supranational competences in a number of areas. An internal market has been created for goods, services, labour and capital. The majority of members have entered the third phase of the EMU. The Union has grown from originally six to twenty-five members. But is the Union really coming of age in all respects? The report argues that when it comes to economic management, it is not.

Three fundamental questions are asked:

- Is it possible to increase the political legitimacy of the Union by strengthening the role of the European Parliament without jeopardising fiscal discipline?
- What institutional and procedural reforms would make it easier to arrive at a more economically rational composition of spending that respects the fundamental principle of subsidiarity?
- What would be a natural and coherent set of revenue sources for the Union?

The report presents reform proposals in three areas:

Decision-making

- The Council-as-gatekeeper solution to the problem of fiscal discipline should be downplayed in favour of modern methods, notably a strict top-down budget process.
- Qualified-majority voting in the Council should be extended to issues concerning own resources and the harmonisation of tax bases.
- In the long run, the Parliament and the Council ought to develop into assemblies representing the electorate (“one man, one vote”) and the Member States (“one state, one vote”), respectively.

Financing

- The Union should, as originally intended, be financed by own resources, the immediate ones being tariffs and import levies, and profits from the European Central Bank. Given that these sources of revenue are insufficient, they should be complemented by an EU VAT implemented on the basis of a tax-sharing arrangement and levied on a harmonised, actual VAT base in the Member States.

Financial management

- The multi-annual financial framework should be set on a rolling basis and the multi-annual and the annual processes merged.
- The move to accruals accounting should be followed through and limits on commitments and payments replaced by one set of limits (total envelope and appropriations) expressed in terms of cost.
- The Union should have full disposition over its collected resources and, within certain limits, have the right to borrow to finance investment and short-term cash-flow fluctuations.
- The introduction of activity based budgeting should be complemented by a strengthening of performance audits and other monitoring mechanisms that can provide a basis for recurrent and thorough reassessments of the efficiency and effectiveness of the Union's spending programmes, as well as their conformity with the subsidiarity principle.
- In order not to block reforms, the relevant paragraphs in the Constitution should be more generic than in the Convention proposal, leaving it to secondary legislation to define the exact modalities of the economic management of the Union.

1 INTRODUCTION

1.1 An overview of the problems

1.1.1 THE IDENTITY OF THE EUROPEAN UNION

The European post-war half-century has been a period of peace and relatively stable economic progress. Many factors have contributed to this, but there is little doubt that the integration brought about by the European Union has played an important role. What started as a fairly technical form of cooperation in the areas of trade policy, agricultural policy and nuclear research, has gradually assumed supranational competences in a number of areas. An internal market has been created for goods, services, capital and labour. The majority of member states have entered the third phase of the Economic and Monetary Union, based on a fully integrated monetary policy and a common currency. The Union has grown from originally six to twenty-five member states.

Against the background of an increasing range of policy areas and competences, critical voices have been raised against the unorthodox methods of political representation in the Union. Why is the directly elected parliament so circumscribed? If the Union resembles a state in important respects, why is it not also run as a state?

The European Council that met in Laeken in December 2001 convened the European Convention in response to these criticisms. The Convention was asked to draw up proposals on three subjects: how to bring citizens closer to the European institutions; how to organise the European political area in an enlarged Union; and how to develop the Union into a stabilising factor and a model in the new world order. The proposal from the Convention¹ – a draft treaty establishing a constitution for Europe – is an important step in the history of the Union, although many participants in the constitutional debate had hoped for more innovative proposals.

In important respects therefore, the Union is coming of age. The message of this report – and the reason for the question mark in its title – is that the relative maturity of the Union in some respects does not extend to the field of economic management.

1.1.2 POLICYMAKING AND POLICY REFORM

A second set of problems have to do with the substance of EU policies rather than its constitutional framework. Trade policy and the agricultural policy have both been the targets of an intense and long-standing critique. These policies are socio-economically costly to the member states, they are detrimental to economic development in many developing countries, and they harm international relations outside the trade policy area proper. There is no dearth of analyses establishing these facts beyond reasonable doubt, but the path towards policy reform has been stony and uncertain.

The foreign and security policy areas are other problematic domains for the Union. The failure to take a strong and unified position in the Balkan conflict illustrated the weakness of the Union in this non-traditional policy area and boosted activities aimed at filling this gap.

In a sense therefore, the Union has been doing both too much and too little to meet the expectations of its critics, although it must be recognised that the criticisms of various policy positions are not necessarily consistent. But the common feature in these and other problematic areas has been the difficulty of altering established policies or developing new ones even in the face of strong arguments for doing so. This lack of responsiveness derives partly from decision-making rules, and one of the prime objectives of putting a new constitutional framework in place ought to be to make the Union's decision makers more sensitive to rational arguments, as well as supplying the necessary means for implementing the policies thus arrived at.

1.1.3 THE PUBLIC FINANCE CHALLENGE

The Union budget corresponds to a modest one-per-cent-plus of the member states' GDP and so would not appear to be a public-finance problem. Nonetheless, the Member States face deep financial problems in the decades ahead, a problem that will necessarily spill over to the Union. A handful of factors, both internal and external to the Union, can be expected to

generate pressure on the EU budget: enlargement, integration, aging populations and increasingly mobile tax bases.

Enlargement

The cost of enlargement has been computed in a number of different studies². Karlsson's estimates are of the order of a few tenths of a per cent of the GDP, depending on policy choices and scenario assumptions. These estimates refer to the direct effect of enlargement, given current policies. Such a *ceteris paribus* assumption is not realistic, however. The inclusion of the new Mediterranean states in the 1980's increased the GDP spread within the group of member states, but the enlargement now underway is yet more far-reaching in this respect. Some of the new member states have per-capita GDP levels corresponding to one half or one third of the current average. In the medium to long term, the wider income spread can be expected to generate claims for increased transfers between the member states through the Union's budget.

Integration

The inner logic of the EU will most likely lead to deeper integration, both generally – in order to strengthen the legitimacy of the Union – and among groups of member states (flexible integration). The second type of integration will not affect the budget of the Union³, but the first will. The history of the Union provides instructive examples of this inner expansionary drive. One example of this, albeit not directly related to spending, is the Court of Justice's changing approach to human rights. In an early case⁴, the Court of Justice took a fairly distanced position vis-à-vis such issues, claiming that its only concern was with Community law. Ten years later, the Court had modified its position somewhat, referring in the Stauder case to "the fundamental human rights enshrined in the general principles of Community law and protected by the Court"⁵. In the following year, this doctrine had developed further, as illustrated by the case of *Internationale Handelsgesellschaft*⁶. The Court now claimed that the protection of human rights "*whilst inspired by the constitutional traditions common to the Member States, must*

be ensured within the framework of the structure and objectives of the Community". A further sharpening of the commitment was made in the Nold case in 1974, where the Court declared, "*Fundamental human rights are an integral part of the general principles of law the observance of which the Court ensures*"⁷.

This example shows how a central Community institution in its quest for legitimacy in the eyes of the member-state citizens incorporated a legal principle hitherto considered external to Community law. This tendency to broaden a mandate is strong, and operates in many fields. More recent examples can be found in the field of social policy.

Aging populations

Whereas the above factors are inherent to the Union and its own policy formation, a number of factors put a strain on the public-sector budgets of the member states. The main factor is the problem of aging populations. Demographic change over the next two or three decades is expected to increase public budgets by typically 5 to 6 per cent of GDP in OECD countries⁸. In some member states, notably the Mediterranean countries, the situation is even more difficult.

Increased mobility of tax bases

The increasing mobility of tax bases makes it more difficult to levy taxes at rates above the mean. Mobility is very high for financial capital, medium-high for machine capital, and relatively low for labour. But even if labour is not (yet) very mobile, jobs are⁹. Estimates of the magnitude of the losses involved are difficult, but typically range between one and a few per cent of GDP.

By conclusion, even if the budget of the Union corresponds to only one per cent of the GDP, it will in not too distant a future compete for public finance resources that are becoming increasingly scarce. The processes used for decisions about the Union's policies, expenditures and revenues – the budget process in a wide sense – will therefore become increasingly important.

1.1.4 TRANSPARENCY

Transparency (and its close relative, accountability) has become a catchword for much of the debate and the reform work going on in public administrations across the world's democracies¹⁰, and the Union has had its share of this debate. Some reforms have been made in recent years, but severe deficiencies remain. That discussions on legislation in the Council of Ministers are not public is a matter of concern. Likewise, the public access to documents, even if improved in recent years, is generally deemed inadequate.

1.1.5 SUMMARY OF QUESTIONS ADDRESSED

The focus of this report is on the public finances of the European Union. But it is unavoidable that a discussion of the rules and institutions coupled to this area very soon enters the constitutional domain. The analysis will revolve around the following group of questions:

- Any serious attempt to reduce or eliminate the “democratic deficit” will require a re-definition of the roles and powers of the Union's main institutions. In particular, the role of the European Parliament must be strengthened. An argument sometimes advanced against such changes is that fiscal discipline would be weakened. A core question is thus: Is it possible to increase the political legitimacy of the Union by strengthening the role of the European Parliament without jeopardising fiscal discipline?
- The debate about the finances of the Union has centred on the net contributions of the member states, at the expense of a discussion about what the Union ought to be doing. A second core question that we address is therefore: What institutional and procedural reforms would make it easier to arrive at a more economically rational composition of spending that respects the fundamental principle of subsidiarity?
- The question of how to finance the Union is contentious. The current system of revenues is a patchwork developed without any underlying common principle of design. What would be a natural and coherent set of revenue sources for the Union?

1.2 Presuppositions

This report is written on the basis of a number of presuppositions which we assume to be part of the basic ideological consensus in the member states. These are:

- *Democracy and transparency*: Union policies must be developed under basic rules of democracy. The current intense debate in the Convention and elsewhere about the future of EU institutions has to a considerable extent been triggered by arguments related to democracy and accountability. Transparency is central to the design of public institutions.
- *Subsidiarity*: The subsidiarity principle is one of the core principles of the Union's. It states that decisions should be made at the "lowest possible" level and is supported both by democratic arguments and arguments of economic rationality. What is implied in practice is that the burden of proof rests with the person who argues for initiatives at higher levels.
- *A European perspective*: The Union as such is not questioned and any discussion about how to solve the problems confronting it must be made from a European perspective. No credible agenda for reform can take as its starting point particular national interests.
- *Economic rationality*: Economic management of the Union should be based on the principle of economic rationality, i.e. its resources should be allocated in accordance with political goals and used efficiently. An economic-rationality perspective does not per se preclude other motives behind human actions; rather, the goal of the exercise is to design institutions that help to bridge the gap between such motives and collective rationality.
- *Fiscal discipline*: Fiscal discipline is one particular but important aspect of rationality. EU budget processes must be designed to ensure a high degree of fiscal discipline.
- *Safeguarding of national interests*: There are legitimate national interests and special arrangements may be called for when the decision-making processes of the Union are designed.

- *Efficiency of the decision-making process*: The decision process should be designed to deliver decisions in a timely manner. Complexity and lack of clarity not only slow down decision-making but also threaten political legitimacy.

It must be realised that the above objectives are partly conflicting. A trade-off may be necessary between the stress on a European perspective and the legitimate defence of national interests; the interest of making EU institutions and policies visible to the citizens may at times come into conflict with the goal of economic rationality, etc.

1.3 Plan of the report

As a prelude to discussions about the Union's policy-making processes, chapter 2 presents a bird's-eye view of its policies. Chapters 3 and 4 analyse the universal problems of public policy-making and multilevel democracies respectively, and reviews current institutions and practices against a general background of institutional solutions to these problems. Special emphasis is given to the problem of maintaining fiscal discipline and to decision-making in bicameral structures.

Potential sources of revenue are surveyed and evaluated in chapter 5. A general message from this chapter is that some current arguments in the debate are tenuous when the financing problem is viewed from the perspective of the single citizen of the European Union.

Chapter 6 deals more in detail with the principles and instruments of financial management. This chapter is somewhat more technical than the others, but we believe that technical aspects of budgeting and accounting are important in an evaluation of a political decision-making system.

The Convention proposal for a constitution is at the centre of the current debate on the Union's future. Given the considerable overlap between our discussion and the Convention proposal, it is natural to comment on the proposal and to indicate where improvements could be made. This is the content of chapter 7.

In chapter 8 finally, we summarise our policy conclusions and present our answers to the three fundamental questions posed above.

2 CURRENT EU POLICIES – A BIRD’S-EYE VIEW

In the introduction we asked the question what institutional and procedural reforms would be conducive to a more rational composition of spending which respects the fundamental principle of subsidiarity. Before trying answer that question, we present a bird’s-eye view of the Union’s policies as reflected in its regulatory work and in its expenditure programmes.

2.1 Policy goals

Using a classical, high-level classification, government functions and public expenditures can be divided into three main classes: those aiming at improving *allocation of resources*, those aiming at *redistribution*, and those aiming at *stabilisation*. To some extent, these three categories overlap. Redistributive measures may enhance efficiency and thereby serve an allocative purpose. On the other hand, transfers are associated with dead-weight losses in the system of taxation, so a trade-off is necessary.

Conversely, most programmes aimed at improving the allocation of resources have redistributive effects. Furthermore, many publicly produced services are private rather than collective. Charges for such services are normally below cost, so there is a redistributive effect the size of which depends on actual patterns of use.

In spite of the overlap, the above classification can serve as an instrument of analysis when looking at what is explicitly presented as the main justification for EU policies and spending programmes.

2.2 Instruments: Regulatory measures

Policies materialise in either regulations or expenditure programmes. Generally speaking, the effects of EU regulatory interventions have been stronger than the effect of its expenditure programs. The customs union, the creation of an internal market and, more recently the introduction of a single currency

have had a deeper impact on the economic development of the member states than the Union budget, for the simple reason that the budget is rather limited in size. A necessary qualification is of course that there is in some cases a strong interdependence between regulations and expenditures. For instance, controlled prices in the agricultural sector could not exist without export subsidies. A further qualification is that the precise effect of EU regulatory policies is difficult to estimate, as it requires a picture of the counterfactual situation outside the Union.

The internal market has contributed to economic development via specialisation and economies of scale. The growth record of the Union has perhaps been a disappointment to some, as the ratio between Union and US GDP per capita levels has remained at about 70 per cent since 1970. The increase in productivity has been higher than in the US, but it is outweighed by a decrease in labour input.

Growth has furthermore been uneven. In a study of the EU expansion and growth record, Deardorff and Stern¹¹ have concluded that the main beneficiaries from integration seem to be large countries and some small countries that entered the Union at an early stage. But part of this may be explained by the fact that integration is still far from complete and moreover uneven across member states, as revealed by recurrent Commission surveys of implementation¹².

As for *redistribution*, Union policies seem to have had an equalising effect on the GDP per capita across member states. Inequality between countries fell by about one third in the period 1980–2000¹³. Ireland and the *Länder* in eastern Germany, in particular, seem to have benefited from the integration. There is, however, evidence that inequality has increased *within* Member States¹⁴.

Concerning stabilisation finally, the stability and growth pact has had an obvious beneficial effect on the macroeconomic policies of the member states. As for the EMU, it is still somewhat early to judge the effects.

2.3 Instruments: Expenditure

The table below shows the public expenditures of the member states and the Union according to the standard functional classification of public expenditures (COFOG).

Table 2.1. The budgets of the Member States and the EU in per cent of GDP (2000).

	Member States % of GDP	EU % of GDP
General public services	5.8	0.1
Defence	0.8	–
Public order and safety	1.8	0.0
Economic affairs	3.9	0.6
Environmental protection	0.7	0.1
Housing and community services	1.0	0.0
Health	5.6	0.0
Recreation, culture and religion	0.8	0.0
Education	5.0	0.0
Social protection	19.2	0.3
Total net of transfers to the EU	44.7	

Source: Sapir et al. (2003), based on material from the Eurostat and the European Commission.

It is obvious from the above table that it is only in the fields of economic affairs, concretely agricultural policy, and social protection – regional policies fall into this category – that the Union budget makes a significant imprint on the total public spending in Europe. This is not to say that Union expenditure is unimportant; its effect should be judged in conjunction both with other Union policies and with member state policies, and there are a number of modes of interaction depending on the policy field.

Stabilisation has never been an objective of the EU budget. The EU budget is simply too limited to have any visible effect on the business cycle. We therefore limit our discussion to the allocative and redistributive aspects of EU expenditure.

2.3.1 ALLOCATION AND SUBSIDIARITY

Subsidiarity in practice

The principle of subsidiarity requires that the Union take action only in so far as the objectives of the proposed action cannot be sufficiently achieved by the member states and can therefore by reason of scale and effects or the proposed action be better achieved by the Union.

Textbook examples of such activities are policies to deal with trans-boundary pollution problems or international organised crime, and the development of integrated transport systems. To the extent that external security becomes a central component of EU policy, this will also be an area where the subsidiarity principle applies.

When it comes to social or incomes policies, on the other hand, there is little or no evidence that better results can be achieved at the Union level. The responsibility for achieving an equitable distribution of income still remains with the member states, and should do so for the simple reason that the level of cohesion of each member state is much higher than that of the Union. Member states can tailor their policy instruments much better to the specific conditions of each state.

The example of agricultural policy

The main arguments for EU intervention in the agricultural sector have been related to efficiency, food security and social policy. The Treaty mentions increased productivity and reasonable prices (efficiency), security of supply, and the standard of living of producers and market stabilisation (social policy).

Efficiency is normally guaranteed by the market mechanism however, and should not call for any particular government action other than the maintenance of a competitive market. Furthermore, with the waning of traditional security policy threats, food security has lost much of its relevance. The weaker requirement of “security of supply” is satisfied by the market.

What remains is social policy. This is the responsibility of the Member States, although the Union may support and com-

plement member state activities in some of areas. Structural adjustment in connection with the contraction of the agricultural sector might be such an area – for instance facilitating transition to other sectors by labour market training programmes – but the distribution of the burden of structural adjustment programmes is an issue separate from the steady-state division of responsibilities for agricultural policy.

In summary, the arguments for Union involvement in the agricultural sector are weak¹⁵. The loss of relevance of food security arguments has reduced the agricultural policy system to a system of transfers between consumers and tax-payers on the one hand and agricultural producers (not only at the primary level) on the other.

2.3.2 REDISTRIBUTION

Basic issues

Virtually all public policies have redistributive effects. There is nonetheless a difference between programmes that have unintended redistributive effects and those which are designed with some redistributive aspect in mind.

The Common Agricultural Policy is an example of the first situation. While redistribution is not among the stated objectives of the CAP, the redistributive effect is very strong, involving farmers on one side and consumers and taxpayers on the other. Whatever redistribution has taken place between member states is, at least as far as policy declarations go, unintentional.

By contrast, cohesion funds have an explicit redistributive objective. The same is true for redistribution schemes at the municipal and regional levels in many countries. The objective is to equalise access to public services across sub-national public entities by compensating for differences in tax bases and such differences as may exist on the demand side, for instance due to demographic factors.

A digression: Redistributive effects of US federal programs

Debates about net contributions are not unique to the European Union. In the mid-1970's, US Senator Daniel P. Moynihan initiated a series of annual reports on the geographical distribution of federal revenues and expenditure¹⁶. The initiative followed a heated debate on the repartition of expenditure on interstate highways. One of the main findings is that the pattern is relatively stable over time, being determined to a large extent by demographic factors and stable differences in economic structure. The main source of variation is changes in defence spending resulting from changes in security policy.

Now, if the objective of such an analysis is to determine the welfare effects of federal policies, this sort of calculation is obviously inappropriate. Whereas the value of social security transfers may be well approximated by the actual sums transferred, this is not true for collective services such as defence. The value imputed to a defence programme may differ from individual to individual depending on political convictions and personal income, but where the defence budget is spent is irrelevant from the point of view of the consumer of the collective good.¹⁷ Similarly, expenditures on foreign aid or central government administration cannot be imputed to a particular geographical area.

The conclusion from this example from the American scene – which is highly relevant to the EU policy debate – is that revenue and expenditure that can be apportioned to a particular geographical set the stage for a “fairness” discussion. By contrast, if expenditure programmes are intrinsically collective, and if the federal level has truly collective sources of revenue of its own, there will be less discussion of this sort.

The redistributive effect of EU spending programmes

The two major spending programmes of the EU budget, Agriculture and Structural measures, have different redistributive effects. The Cohesion Fund, which is part of Structural measures, has been designed with a redistributive aim in mind and spending logically correlates negatively with income. For the 17

macro-regions normally used in regional policy discussions, the correlation between Cohesion Fund disbursement and GDP levels per head was -0.6 in the year 2000¹⁸. Even so, the unanimity rule of voting has the effect of distributing cohesion spending more evenly across the member states than would be the case if it were guided by needs alone.

The CAP and internal spending programmes, by contrast, covaries positively with income. If CAP spending and other internal spending programmes are added to cohesion spending, the coefficient of correlation between spending and GDP changes from -0.6 to -0.2 ¹⁹. This is in part due to the distribution of agricultural productive capacity across the Union, in part to the bargaining that goes on in the Council in order to reach unanimity.

Towards a larger European Union

The transition to a larger union with a much wider income spread creates a situation for the member states that is new in many different respects. The disparity between high-income and low-income countries in the present union, apart from the outlier Luxembourg, is very moderate when compared to the enlarged union. Most new member states have a lower GDP per capita than the hitherto lowest-income states. The following table illustrates the income spread in the enlarged union with 25 member states.

The average GDP per capita in the group of new members is 45 per cent of the current average. With respect to redistributive policies, this leads to the question what will be the regime adopted for an enlarged union. What is the political support for redistribution across the enlarged Union? What mechanisms of equalisation will be most important?

As in the previous history of the Union, the most important mechanism of equalisation will be market integration and trade. Inexpensive labour will attract investments to the new member states, technologies will spread, and larger markets make it possible to benefit from economies of scale.

Table 2.2. Income spread in the enlarged European Union (EU-25). Index for GDP per capita, adjusted for purchasing power, in 2001 (EU-25 = 100).

EU-15	Per Capita GDP index
Luxembourg	215
Ireland	129
Denmark	126
Netherlands	126
Austria	122
Belgium	119
Finland	114
France	114
Germany	113
Italy	113
Sweden	112
United Kingdom	111
Spain	92
Portugal	76
Greece	71
<i>EU-15</i>	<i>110</i>

New Member States	Per Capita GDP index
Cyprus	81
Slovenia	79
Czech Republic	65
Malta	60
Hungary	58
Slovakia	52
Estonia	44
Poland	43
Lithuania	42
Latvia	37
<i>New Member States</i>	<i>50</i>

Source: European Commission, AMECO data base.

A second important effect of Union membership will be the modernisation of the public administration in the new member states. This process of institution rebuilding was already started with the early preparations for accession under the auspices of the OECD Sigma programme including twinning arrangements between new and current member state administrations.

These integrative and institutional effects will dominate, but judiciously designed EU programmes can contribute to an equalisation of living conditions in an enlarged Union. EU spending programmes differ in several respects from rule-based market integration or administrative streamlining, however. They are visible and scrutinised in the annual budget process. In consequence, they are subject to all restrictions that go with negotiation processes in the Council and the Parliament. The voting power of current and new member states in these fora was fixed in the Nice agreement, but it is early to tell precisely what political coalition patterns will emerge from the agreed voting arithmetic.

The principle of solidarity and equalisation of living conditions is laid down in the Treaty as well as in articles 2 and 3 of the Convention proposal for a constitution. But the concrete effects of such declarations are of course in the final instance determined by the political support for resource transfers.

Logically, a Union characterised by larger income disparities should call for more redistribution. A case could be made for systems of equalisation, where tax bases are equalised and transfers are determined on the basis of differences in factors beyond the control of the member state. In principle, transfers should be made in the form of budget support. Such a redistribution mechanism would be very transparent and it would be clearly in line with the principle of subsidiarity. As convincingly argued by, for example, Tarschys²⁰, most of the structural policy interventions carried out by the EU would best be financed and executed by the member states' governments themselves.

Given the intensity of the net contribution debate, however, it seems unavoidable that the extent of transparent redistributive

policies will be severely constrained also in the future in spite of the Union's ideal of integration and solidarity. What could change this scenario is a reform of the financing of the Union. The more the Union is financed from sources pertaining to the Union's own activities, such as duties and levies and ECB profits, the less visible and hence probably more politically acceptable could be the redistributive effect. On the expenditure side of the budget, redistributive effects are probably more acceptable if they are side-effects of the supply of European-level collective goods.

2.4 Summary

From a general welfare point of view, the regulatory policies of the European Union, such as its trade policy and the creation of an internal market, are more important than the Union's expenditure programs. This is not to say that the budget is unimportant; in isolation or combined with member state policies, EU programs can have far-reaching effects on resource allocation. Redistributive effects are limited and appear to be mostly unintended. The most important effects of this kind, originating in the CAP, are regressive (that is, they reinforce income disparities instead of reducing them).

If there is a political will to reduce income disparities across the enlarged Union, there is a strong case for concentrating the Union's activities to collective services with a growth-enhancing effect, and to finance these activities as far as possible by "own" resources in the proper sense of the word.

3 FUNDAMENTAL PROBLEMS OF FISCAL POLICY

The institutional arrangements of the Union are marked by the specific historic circumstances under which they have developed. A critical question is whether these arrangements are adequate as the Union enters a new phase of its development.

In this chapter we will look at a set of general phenomena and problems that affect public policy-making and how these problems are addressed in the Union. The chapter is somewhat more theoretical than the rest of the report, and the reader who is interested mainly in the policy conclusions can go directly to section 3.7.

3.1 An overview

Fiscal policy-making, and more generally public policy-making, faces a number of universal problems that arise from the particular nature of collective decisions. Because they are inherent to the problem of making decisions in this environment, all developed societies have created institutions to deal with them on a routine basis. These institutional solutions reflect different political traditions and trade-offs, but there is in most cases room for genuine improvement that would make all parties better off. Such institutional innovation need not materialise, however, given the inherent inertia of institutional arrangements.

A budget process is much more than a single decision in parliament. Preferences are not given but shaped in a deliberative process, and they reflect partly conflicting objectives among decision-makers. Members of parliament have limited knowledge about the issues they decide on, and there is a great deal of uncertainty as regards important variables affecting the budget (growth, consumption, savings, inflation etc.). Such complicating factors must be taken into account when analysing the effects of a set of budget institutions.

Among the handful of universal problems presented below, some are specific to collective decision-making (preference aggregation, prisoners' dilemmas, principal-agent problems),

whereas others (long horizons, uncertainty) haunt individual decision-making as well.

- *Aggregation of preferences among fully informed individuals:* Even under unrealistic assumptions of fully informed decision-makers, problems arise when preferences are to be aggregated to form a collective decision.
- *Prisoners'-dilemma situations:* Prisoners'-dilemma problems, or common-pool problems, stem from a gap between individual and collective rationality. One particular result is that, in the absence of institutional countermeasures, expenditure levels will be too high.
- *Decision problems with long horizons:* These problems arise because of a potentially indeterminate trade-off between current and future benefits and costs.
- *Decisions under uncertainty:* All decisions, individual as well as collective, are fraught with uncertainty. Uncertainty is often ill-structured, and human decisions often turn out to be at variance with standard rationality theory even when such theory is applicable.
- *Principal-agent problems:* Both decision-making in representative democracies and implementation assume a certain division of labour between a principal and an agent. Information about the current state of affairs is incomplete and asymmetric.

Institutions serve the purpose of solving or at least reducing these problems: managing aggregation problems by well-designed voting procedures, defending collective interests, assuring that reasonable time is devoted to deliberation, and maintaining accountability in order to promote the interests of principals over agents.

3.2 Preference aggregation among rational individuals

The simplest way to model a budget decision in a parliament is to picture it as the decision about how much to spend on each

of a relatively large number of activities – typically 1000. Each decision-maker (MP) is assumed to have a preferred budget decision. She prefers one alternative to another if the former is in some sense closer to her own. The budget decision consists in finding an alternative that is supported by a majority and represents a stable equilibrium.

It was realised already by Condorcet in the late 18th century that such an equilibrium need not exist even in the simple setting of three voters and three alternatives. The modern theory starting with Kenneth Arrow generalised and refined Condorcet's observation, and a large number of "impossibility theorems" have now been proved²¹. It can be shown that the existence of an equilibrium depends on the numbers of decision-makers (MP's) and the number of policy dimensions (budget appropriations); loosely speaking, the higher the number of policy dimensions, the less likely is the existence of an equilibrium given the number of decision-makers²². When the number of dimensions is reduced to one, stability prevails²³.

This theory may appear to be mainly of academic interest but is nonetheless relevant to real-world issues. In real-life, voting in parliament is individual only in principle, given that parties govern voting on most issues. The number of actors would equal the number of parties in the first approximation, assuming that parties behave like monoliths (which is of course an oversimplification). Votes on different issues are not uncorrelated; some coherence is ensured by ideology, which eliminates a large number of completely erratic combinations. The important message is that reducing the number of dimensions of the budget decision is an alternative for reducing the risk of instability.

Another approach to deal with potential instability is to impose a voting order that singles out a winning alternative, normally at the price of being dependent of the agenda-setter's preferences. In the context of budget decisions, the government proposal is the benchmark, and there may be one or several alternatives to this proposal depending on the parliamentary

situation. One way of organising the vote is to pose the opposition alternatives against one another in order to find out which has the widest support, and then to pose this alternative against the government's proposal in a final vote.

Institutional remedies

If straightforward voting among several hundred alternatives may lead to chaos in parliament, the obvious countermeasure is to reduce complexity. Given that all appropriations must be voted, the solution is to proceed sequentially in a top-down approach: a first vote on the total expenditure level is followed by a vote on envelopes for various policy areas, and the procedure concludes by votes on single appropriations. At each level, any counterproposal has to respect the previous vote on the corresponding aggregate. In this way, collective discipline can be maintained.

Party discipline is another important real-life mechanism for curbing tendencies to anarchy. In the simplest situation, parties can be grouped along a left-right scale, in which case there will always be a winning alternative as far as the aggregate spending level is concerned. But experience shows that maintaining discipline within party groups is far from a trivial problem; parties are not monoliths.

EU practices

The conditions for reaching decisions in the Council of Ministers, the Parliament and the Commission are very different. The general character of the deliberations in both the Council and the Commission make it difficult to refer them to any particular standard model of preference aggregation. The requirement on unanimity in Council decisions makes every member of the Council supreme and puts him or her in a position to demand compensation for supporting an alternative. Consequently, it paves the way for "log-rolling" between Member State representatives – bilateral support for proposals that would otherwise not survive the decision process.

The situation in the Parliament is very different. This assembly

is closer to standard national parliaments, but the pattern of organisation follows classical party lines to a lesser extent than in most national parliaments. Ideological patterns overlap with national loyalties, which weakens the influence of both.

The rules of procedure of the European Parliament define the framework for voting in parliament. Rule 130, on the order of voting on amendments, stipulates that “the amendment that departs furthest from the original text shall have priority and shall be put to the vote first”. Further, “Where there is doubt as to priority, the President shall decide”. Determining which amendment is furthest from the original proposal is a difficult task, given the problem of defining a “distance” in policy space. From this and other passages, it is clear the regulatory framework confers substantial power on the President – a solution that is fairly unusual in general and one that can be questioned on grounds of legitimacy.

The specific procedure followed for budget decisions relies on the mechanism of power division between the Parliament, the Council and the Commission (see below under 4.3.4). It is noteworthy that a top-down approach is not formalised in the framework, apart from separation of the budget restrictions into a multi-annual financial framework and annual budgets that have to conform to this multi-annual restriction.

3.3 The budget decision as a prisoners’ dilemma

In many situations, there is a gap between collective rationality and individual or group rationality. Benefits from public undertakings can be designed so as to accrue to limited groups, whereas costs are distributed over all taxpayers. There is a temptation to argue for proposals favouring one’s own group knowing that the net benefit will be positive. If everyone acts according to his own narrow interest, the outcome will not be efficient; we are faced with a common-pool problem or a prisoners’ dilemma²⁴. Unless a norm or an institutional arrangement in some way compensates for this asymmetry, there will be a bias towards overspending in the public sphere.

Logically, there are three solutions to the prisoners' dilemma. The situation may be such that the players involved consider it in their long-term interest to cooperate. If not, they must decide to act against their own perceived interest, either by following a norm or by being forced to choose cooperatively. There is a widespread belief that continued interaction is in many cases sufficient to ensure cooperation²⁵. This belief is based on generalisations from two-party interaction that seem difficult to defend, however²⁶. In general one would therefore have to resort to norms or rules in order to ensure co-operative behaviour.

There is a voluminous empirical literature on factors that foster cooperation in dilemmas of this character. The framing of the decision situation is important²⁷. Repeated decisions exhibit a higher degree of cooperation, as expected²⁸. Groups as decision-makers tend to cooperate less than individuals²⁹. It is an important fact for the design of institutions that physical proximity, information and possibilities for communication seem to enhance cooperation³⁰; face-to-face interaction is thus conducive to cooperative behaviour.

Studies of single factors such as the above-mentioned may be drawn upon when designing the institutional environment in which collective decisions will be taken. Real-life, rather than experimental, studies of long-standing cooperation confirm that factors such as these play an important role³¹. Creating a common arena where individual or group choices are exposed and have to be defended in public leads to what Goodin refers to as preference laundering³². Transparency is thus a general instrument that helps to maintain a generalised observer's perspective and makes it more difficult to promote narrow group interests.

Institutional remedies

Prisoners'-dilemma type situations are of course but special cases of the general problem of preference aggregation. Some of the solutions to the latter problem therefore carry over to this particular category. Specifically, the top-down approach to budget decision-making is one of the most potent mechanisms

to impose an order on the process leading up to a decision. The necessity to finance counterproposals to the budget from an expenditure envelope of a given size imposes some discipline on the debate, making it more difficult for party groups or single MP's to seek popularity by promoting proposals tailored to the interests of small groups.

As indicated above, internal norms or exogenously given rules, possibly supported by sanctions, are important in maintaining cooperative policy equilibria and thus reduce the risk of overspending. The Maastricht criteria play this role in fiscal policy-making at the member-state level.

Other arrangements, such as extending the domain of responsibility of parliamentary standing committees, may strengthen a generalised observer perspective³³, thereby reducing the tendency to overspend.

Separation of powers affects public expenditure levels. The expenditure ratio is substantially lower in presidential regimes than in parliamentary systems³⁴. Separation of powers has the effect of blocking initiatives either to increase or decrease expenditure; it maintains the *status quo*.

EU solutions

In the European Union, the central mechanism for curbing expansionary tendencies and maintaining budgetary discipline is the division of power. The Member States, via their representatives in the Council of Ministers, act as gatekeepers. The default mechanism in the legislative procedure based on co-decision is to drop the proposal if the Council and the Parliament cannot reach an agreement – a rule which will keep down expenditure levels, given that virtually all expenditure systems have to be based on a legal act.

The monopoly of the Commission in putting forward proposals is also a restraining mechanism. The effect of this monopoly, however, is tempered by the fact that the Treaty confers the right to Parliament and to the Council to request a proposal from the Commission (arts. 192 and 208, respectively). The potential in-

ter-institutional conflict generated by this right is resolved only by the default alternative of dropping any proposal not supported by both the Council and the Parliament.

As indicated above, division of power is a rather blunt mechanism for maintaining budgetary discipline. What it really does is strengthening *status quo*. In the early years of expansion this may have proved salutary, but it can constitute a serious impediment as the organisation faces a range of new challenges, not least as a result of the enlargement. The difficulties of reforming Union policies and expenditure systems that are clearly at odds with general principles of economic rationality and sound management bear witness of this potentially sclerotic effect.

There are consequently strong reasons to consider mechanisms for increasing the flexibility of policymaking while maintaining the desired fiscal discipline. The top-down approach to budgeting represents the major alternative in this respect, combining flexibility of policy substance with an overall constraint on the global budget envelope. The necessary proviso is that both branches of the budgetary authorities, i.e. the Council of Ministers and the Parliament, subject themselves to the discipline of a formal top-down procedure. In order to secure the long-term stability of such a framework, it should form part of a constitution for the Union.

3.4 Long-term effects

Any decision with long-term consequences should be based on a trade-off between future costs and benefits. Empirical research indicates, however, that many people do not maximise their long-term welfare in a systematic way; there is a tendency to overvalue short-term benefits and to underestimate long-term costs³⁵. As long as only one single individual is involved, this may not be a serious problem. In collective decision-making it may become a serious problem, however, because of the generally uneven distribution of costs and benefits over time. In the fiscal area, the risk of fiscal illusion is a matter for concern³⁶

– benefits are visible as short-term gains, whereas long-term costs are diffuse. What complicates the matter further is that future generations do not take part in the decisions, while they may be affected by today's policy choices. The classical *demos* problem reappears here in a version that cannot be resolved via a simple extension of the right to vote.

The choices associated with the design of budgetary institutions reflect classical dilemmas of self-binding. The individual or the collective may gain in the long run from sacrificing some freedom of action in the short run³⁷.

Self-binding may play an important role in political decision-making³⁸. For example, a medium-term commitment to a measurable target helps to manage fiscal policy in the short run. Self-binding is influenced by the electoral periods. Longer terms give the incumbent more freedom of action but at the same time strengthen accountability. The latter effect is stronger than the former and the relationship between the length of electoral periods and government debt is negative³⁹.

Institutional countermeasures

To counter the myopia of decision-makers many countries have installed more or less formalised, more or less binding multi-annual restrictions as part of their budgetary institutional framework. Members of the EU have, for example, been helped by the Stability and Growth Pact in this process.

Promoting farsightedness in the Union

The multi-annual framework provided by the financial perspective is the main instrument for extending the horizon of budgetary decision-making. Given the importance of this framework, it should form part of a constitution (as suggested in the Draft Treaty). In chapter 6 we discuss the design of this framework in more detail.

3.5 Uncertainty and ignorance

Decision-making in the public sphere is fraught with uncertainty. Behavioural responses to policy change, long-term

versus short-term effects, partial versus aggregate effects are examples of general uncertainty problems that are important to policy decisions. Judgement under uncertainty is known to suffer from systematic errors because people tend to rely on a limited number of heuristic principles. Sometimes genuine misconceptions are a source of bias⁴⁰. There is evidence of a certain asymmetry of perception, resulting in a tendency to assign relatively greater weight to losses than to gains. In the political sphere, this leads to a *status quo* bias⁴¹.

Voters and politicians lack basic knowledge about important issues because these issues are not perceived as central to the fields on which they have chosen to focus – “out of sight, out of mind”. Unless decision-making procedures force them to improve their knowledge, they may be able to manage quite well. Lacking basic knowledge, the decision-maker cannot be expected to form coherent preferences. Again, institutional arrangements may contribute to the conscious formation of preferences, thereby eliminating important lacunas.

The general antidote to uncertainty and ignorance is information. But availability of information is not the main problem; there is in general no dearth of information that prevents political decision-makers from developing or defending sustainable fiscal policies. The question is rather to what extent the procedures used force decision-makers to acquire new knowledge and develop a deeper understanding of the implications of the various alternatives open to them.

Handling uncertainty in practice

There are two qualitatively different approaches to the problem of uncertainty. One is obviously to try to reduce it, the other, to take countermeasures in the form of flexibility and contingency planning.

To integrate salient information into the decision process, it may be necessary to institutionalise both the production and the dissemination of such knowledge. This may be accomplished, as in the U.S. case, with the aid of a Congressional Budget Office

for information *ex ante*, and using audit and evaluation institutions for information *ex post*. The decisive condition in this context is whether there is a designated recipient of the information in question whose task it is to react to the information put forward. In the absence of such an addressee, the information produced may have little or no effect on actual decision-making.

The problem of asymmetry in the way gains and losses are perceived is somewhat different by nature. As the main effect is to strengthen the status quo, the most important countermeasure is to question current policies systematically. A full-fledged annual zero-base budgeting procedure is not a feasible alternative, but recurrent attempts to reconsider policies should be made.

Contingency planning can take many different forms. In the fiscal policy area, the simplest way to handle the irreducible uncertainty in economic forecasts is to introduce a budget margin, to be used for purposes not foreseen at the time of the budget decision. There have to be strings attached to such a margin lest it be considered as a free resource to be spent on diverse purposes.

EU practices

The general rules on information content and analysis of budgetary consequences of Commission proposals follow normal standards in public budgeting. A potentially serious deficiency of the decision-making system is that both the Parliament and the Council of Ministers are short of analytical capacity. The Council Secretariat is not equipped to provide autonomous analysis of Commission proposals, so the Council is dependent on the capacity of Member State administrations. The Parliament is totally dependent on the Commission for supplementary analysis of proposals. The best remedy would be to create a form of “Congressional Budget Office”, with the mandate of assisting both the Parliament and the Council in analysing proposals from an economic point of view.

As for contingency planning and reserves, the lack of flexibility in the budget of the Union – for instance in connection with an

unexpected security policy crises – has long been recognised. The margin provided in the financial perspective is significant. However the dual nature of a budgeting system relying on both commitment and payment appropriations creates some uncertainty as to the actual margin for manoeuvre.

3.6 Principal-agent problems

The fact that democracy in most modern nations is representative reduces the practical problem of collective decision-making substantially. On the other hand, representative democracy creates a principal-agent problem⁴². Theoretically, politicians (the agents) should perform during the electoral period what the electorate (the principal) has chosen, but reality is more complex than that. Politicians have other incentives than just translating the preferences of their voters into collective decisions at the national level. Bonds to partisan groups or personal career ambitions may interfere with the political mandate.

The principal-agent problem permeates the whole public sphere. Voters delegate power to political representatives in parliament. In parliamentary systems, these in turn elect a government (or possibly a Prime Minister, who then selects a government). The government has an administration at its disposal to develop and implement policies. Each link in this chain represents a potential problem because of incomplete contracts (in a general sense) and asymmetric information. The formulation of the task to be performed always suffers from lack of precision, and the agent always knows more than the principal does, both about the current state of affairs and about his own performance.

In general terms, it is fairly easy to formulate what is needed to cope with the principal-agent problem – a clearly formulated *contract*, complete and reliable *information*, and effective mechanisms of *accountability*. Implementing this programmes is far from an easy task, however. Contracts between voters and politicians are necessarily incomplete, even if attempts at more concrete and measurable commitments are sometimes made.

Good feedback mechanisms can to some extent compensate for inadequacies in the other two respects. Elections every four or five years are a strong but somewhat blunt instrument; the more permanent threat of a vote of non-confidence or internal audits and dismissal of high officials is more effective in this respect.

Institutional countermeasures

Transparency is obviously a key concept when dealing with information asymmetries between principals and agents. Efficient reporting systems, evaluation and audit may be efficient tools assuming that the information is produced independently and in the principal's perspective. But information is not enough; a sufficiently rich repertoire of sanctions and rewards must be in place if the principal is to be able to create the right incentives at the level of the agent. A difficult problem in the area of public finance is that economic sanctions run the risk of affecting a third party rather than the intended agent.

EU solutions

The relationship between the electorate and the political level is obviously one of the weak points of the current Union framework. The Council members make their decisions in a not very transparent environment, and their decisions often bear little relation to the programmes on which their parties were elected in the member states. Commissioners are selected by a less than transparent procedure. The Parliament members are the only political decision-makers directly accountable to the electorate. The tendency is towards increased accountability, however. The Commission has become increasingly dependent on the Parliament. Efforts have been made to increase transparency in recent years, and the Convention proposal also contains elements that would strengthen accountability.

The link between political decisions and implementation is in a sense stronger than in most public administrations, given the direct responsibility for implementation. Increasingly, the Commission transfers the implementation to agencies, which is probably rational given the workload of the Commission, but it is a

process in which the relation between the two parties has to be designed with great care in order to maintain accountability across this link of the policy-making process.

3.7 Summary

As can be seen from the overview, the Union has developed a range of mechanisms for coping with the fundamental problems of fiscal policy-making. Some of these methods are standard, whereas others are specific to the Union. As the Union now enters a new phase of its development, several of the traditional mechanisms appear inadequate, in particular:

- The basic method for maintaining budgetary discipline has been the division of power, with the Council as the ultimate guarantee against expansionary tendencies. The *status quo*-reinforcing effect of this mechanism is becoming increasingly problematic, as the need for reallocation of resources within given budget envelopes increases.
- The best solution to this problem is to increase the flexibility of the policy formation process while maintaining budgetary discipline by means of a formalised top-down budget process including the multi-annual financial framework. The legal framework defining such a process should be laid down in the Constitution.
- The capacity for autonomous analysis of law proposals and other initiatives should be strengthened by creating a budget office supporting the Parliament and the Council.

4 PROBLEMS IN MULTI-LEVEL STRUCTURES

In the previous chapter we discussed general problems affecting public sector policy decisions. In multi-level democratic structures, a number of additional problems arise:

- *Division of responsibilities*: Which tier should have the responsibility for a particular task?
- *Financial power*: What are appropriate sources of revenue for the different tiers? How should the powers of taxation be distributed? Is there a need for some system of equalisation?
- *Conflict resolution*: What are appropriate mechanisms for resolving conflicts between the different tiers?

4.1 Division of responsibilities: The principle of subsidiarity

Basics

The debate on relations between state and local powers is similar in many respects to the discussion about Union versus national competencies. Countries differ widely with respect to the autonomy that they grant to sub-national levels, and it is quite natural that a similar range of perspectives can be found in the current debate about the Union's future.

In some countries municipalities are entitled to manage only what has been explicitly assigned to them by the state, whereas, for example, in the Nordic countries the definition of what is the legitimate municipal sphere is much more generous. The requirement specified, for instance, in the Swedish local government act is that the activities are of general interest and that there is a link to the area or the members of the municipality. Activities managed by the state, by other municipalities or by county councils are also explicitly excluded.

It is possible to distinguish three different degrees of autonomy:

- The subordinate level is obliged to take on specific tasks assigned to it by the state, and is entitled only to those.
- The subordinate level is obliged to take on specific tasks

assigned to it by the state, and is entitled to take on others subject to some general restrictions (such as in the example given above).

- The subordinate level is entitled to define its own sphere of activity subject only to conformity with the constitution and other relevant national laws.

The real value of functional autonomy is of course decided by the degree of financial autonomy accorded to the subordinate level (see the following section), as any real-world activity requires resources.

The theory of fiscal federalism, which has been developed as a tool of analysis for multilevel public-sector structures, can be based either on a top-down or a bottom-up approach. The top-down approach is natural in the case of state-local relationships in unitary states, where the immediate problem is to decide what policy programs decided at the national level should be decentralised to local or regional levels. Typically, the subordinate level may be given some freedom of design and the full responsibility for implementation. By contrast, the bottom-up approach is natural when a federal or confederate structure is created by a group of autonomous states, such as has been the case in the United States and the European Union.

Irrespective of approach, the principle of subsidiarity has gained wide acceptance as the basis for assigning responsibilities. In fact, the principle is nothing but a straightforward application of economic rationality, based on a bottom-up approach. Individual actors or groups making decisions in a social context are assumed to have the capacity to find efficient solutions, unless there are positive or negative external effects that would lead to an inefficient outcome. In such situations, there may be a case for state intervention subject to the condition that the welfare gains from such intervention exceed the costs of intervention.

In practice, however, any application of the principle is fraught with problems of interpretation. It is easy enough to categorise

military defence as a national responsibility and refuse collection as a local one. Other important public services are less clear-cut. For education and health care, arguments can be found in both directions depending on the importance attached to uniformity and minimum quality standards. For this rather large residue of services, some default rule is needed. When the discussion is about the division of responsibilities between national governments and regional or local levels, the residual power remains naturally with the national level. Similarly, in the EU context the residual power remains with the Member States according to the principle of conferral.

*EU practices*⁴³

Many of the classical arguments in the debate about public-sector hierarchies can be utilised in the current discussion, recognising of course the difference that the Union has been formed by its Member States and that it is as a result, historically speaking, “subordinate” in both a functional and a financial sense. The Union has only the competencies that the Member States have decided to confer on it.

This is mirrored in the current regulatory framework, which is strict as far as financial commitments go. Any undertaking with budgetary consequences requires a legal basis, and as the previous section illustrated, the Council has an effective veto power when it comes to decisions about new legislation. Further, the control that the Member States exert over the financial perspective is an effective constraint on aggregate commitments.

The requirement of accountability is central to any democratic system and calls for a very clear division of power within the public-sector hierarchy. But this requirement of accountability must be balanced against other requirements, and a certain lack of clarity will always prevail. There seems to be no way of resolving this tension once and for all by some form of legal invention. It is noteworthy that the European Court of Justice has, so far, not in any of its cases relied exclusively upon the principle of subsidiarity – in spite of its inclusion into the

Treaty and rather expansionist inclinations of the Court. Discussions in the EU Convention on an extended role for the principle, however, indicate that it may eventually form the basis for emerging legal practice in this area⁴⁴. The idea is to let the national parliaments act as the guardians of last resort of subsidiarity.

The principle of subsidiarity appears as a fundamental principle in the basic treaties:

- Decisions are to be taken as close as possible to the citizens in accordance with the principle of subsidiarity (preamble to the EU treaty and art. 1 of the same treaty);
- The Union shall respect the national identity of its Member States (art. 6 of the same treaty);
- The Community shall take action “only if and in so far 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” (art. 5 EC treaty).

The principle is further developed in a protocol to the EU treaty. The protocol cites three criteria for judging whether this condition has been fulfilled:

- Does the action have trans-national aspects that cannot be satisfactorily regulated by the Member States?
- Would action by Member States or lack of action conflict with the requirements of the Treaty?
- Would action at Community level produce clear benefits?

The Draft Treaty follows a fairly conservative road when measured against the above general criteria. After an enumeration of general values and objectives, the text lists exclusive and shared competencies, which consequently limits the sphere of activity of the Union. On the other hand, the flexibility clause (art. 17) opens up the possibility for further action, subject to rather stringent unanimity conditions.

4.2 Financial power: Vertical transfers and taxation

Basics

When it comes to *financing* national multilevel public hierarchies, the picture is no less varied than as regards the functional aspects. A number of countries enshrine the local powers of taxation in the constitution. Other solutions are based upon tax-base sharing, transfers from the state to the local level, fees and other revenues. The Nordic countries are characterised by a relatively high degree of local financial autonomy, but even within this group there are variations. One can distinguish between three main categories of autonomy:

- The state decides on the sources of financing of sub-national activities and sets a ceiling on the expenditure side.
- The state decides on the sources of financing, but leaves open the tax rate.
- The sub-national level decides on both the sources and the tax rates.

In order to assess the degree of autonomy in a particular situation, it is of course necessary to take into consideration to what extent local activities are in fact prescribed by the state, and to what extent such activities are partly or wholly financed by the state.

Any government entity entrusted with the task of implementing a programme must have the necessary means at its disposal. The two main sources of revenue in multilevel structures are taxation and vertical transfers. A common source of problems in multilevel structures is that the link between the power to decide and the power to finance is not sufficiently strong. Important examples are unfunded mandates (tasks assigned by the superior level without adequate financing) and bailout problems (situations where national governments step in to solve the financial problems generated by sub-national governments). The central problem of multilevel institutional design is thus to ensure that such a link is maintained. If a higher tier assigns a

task to a lower tier in the structure, there must be some means to assure that the latter has the financial means of carrying out the task, either by taxation or by transfers. Likewise, autonomy at the subordinate tier must be associated with financial accountability.

The financial autonomy of the Union

As will be clear from the discussion in chapter 5, the current system of Union revenues is not the result of careful design *ab initio* but rather an ad-hoc solution that has evolved over time in order to cope with unforeseen financial problems. The Convention proposal is again fairly conservative as it places the full authority of the “limit” of the Union’s resources with the Council. The Council shall decide unanimously after consulting the Parliament. In contrast, the “modalities” should be decided by the Council with the consent of the Parliament. The text does not specify how this consent should be arrived at, or what happens in the event that consent is not obtained.

The current discussion about the appropriate level of autonomy of the Union reflects the standard arguments for and against the financial autonomy of sub-national entities. What are the appropriate sources of revenue for different tiers? How should powers of taxation be distributed? If a higher tier assigns a task to a lower tier in the structure, there must be some means of assuring that the latter has the financial means of carrying out the task, either by taxation or by transfers. In the case of large economic disparities between the lower-tier entities, some system of equalisation may be called for.

It is obvious that the original idea of “own resources” is no longer respected. This is a result both of the development of traditional own resource flows and of in-built difficulties such as the principle of annuality and the requirement for annual balancing of the budget. We will return to this discussion in chapters 5 and 6.

4.3 Bicameral systems

Basics

The Council and the Parliament are normally referred to as “the two arms of the budgetary authority”, reflecting a division of power between the institutions. In the vernacular of constitutional analysis, the two institutions form a bicameral system even though it is not phrased in this way in the founding treaties. Using standard terminology, the Parliament is the lower house or house of representatives, elected directly by the citizens of the European Union, although the distribution of seats is far from proportional. Pursuing the analogy, the Council corresponds to the upper house or senate, where membership in national governments qualifies for participation. Decisions in the financial and other areas require some form of consent or at least consultation between the two chambers. As a result, the design of an institutional framework for the Union faces the same difficulties and trade-offs as a classical bicameral system. Beside the Council and the Parliament corresponding to the two chambers of a bicameral parliament, there is also the Commission that enters as an important third party. In some respects, the Commission is similar to a traditional government – for instance by being accountable to the Parliament – but there are also important differences.

Bicameral systems are common in democracies⁴⁵. The two main arguments normally put forward in favour of these systems are i) the desire to achieve a different form of representation than that which results from uniform representation across the electorate, and ii) a perceived need to create a division of power between various political interest groups in society. Deviations from the democratic standard of “one citizen, one vote” may be justified for reasons of territorial division – as in federal states – or on ethnical, linguistic, corporatist, or religious grounds. Other arguments in support of an upper house are that the procedures involved in internal settlement introduce time-lags that permit reflection and deliberation, and that upper house members often represent some particular form of expertise.

Electoral systems vary substantially across parliamentary systems. In some democracies, the two chambers are elected in very similar ways. In others, the lower house is elected directly in general elections, while the upper house may be elected indirectly from some particular community or group of communities. To further increase the continuity and restraining effects of having two houses, electoral periods may be different and elections held on different dates.

Decision-making in bicameral systems

Against the background of a dual representation, a number of procedural design problems have to be solved in bicameral systems. The basic question is what should be meant by the term “majority” in a parliament that is not based on equal representation of the voters. In bicameral systems where the territorial dimension is the origin of the dual representation, such as in federal states and in the European Union, there is a simple translation of the classical concept: “majority” means majority of voter representatives and majority of territories (states, regions or whatever is appropriate)⁴⁶. Situations may of course occur where a proposal is not supported by a majority in both chambers.

There are different ways of implementing or approximating this form of majority rule. A common method is to use one chamber for territorial representation and the other for proportional representation, and to require consensus between the chambers for a proposal to be accepted. The U.S. Congress is of course the paradigmatic example of this model. An alternative solution is to give the representatives from different states of a number of votes that depends on the state of origin; this model is represented by the EU Council of Ministers, although the culture of consensus dominates the Council and so has made the precise distribution of votes less critical. A third method is to send a different number of delegates from different states but not in proportion to the number of voters in each state. This is the design principle behind the European Parliament.

What may appear somewhat strange about the EU institutions in an international comparison is their hybrid form. The

“natural” solution – corresponding to the U.S. Congress model – would be to let the citizens of the Union be proportionally represented in the Parliament and the states be represented in the Council on the basis of “one state, one vote”. Instead, a non-linear representation of voters is used in both the Council and the Parliament. Furthermore, the trade-off between electorate and member state representation is not the same in the two assemblies; the representation in the Parliament is more proportional to the size of the electorate than the representation in the Council. There is no transparent design procedure behind this solution; some of the figures in the Nice agreement were in fact determined at the negotiation table. This creates a complicated pattern of potential coalitions within and between the two assemblies.

A second design parameter is what procedure is to be applied in each of the chambers when they form their respective opinions. Simple majority is the standard, but qualified majorities are of course possible. Current procedures refer to qualified majorities in various situations both in the Council and the Parliament.

There exist a number of different methods of reaching consensus – or at least a decision – in situations where the two chambers in their initial deliberations arrive at different opinions:

- Some constitutions require that a proposal be introduced in one particular chamber, which is considered to give some advantage in the decision process.
- A common procedure is to create a conciliation committee with equal representation from the two chambers, whose task it is to negotiate a solution that is believed to be acceptable to the two chamber majorities.
- Some systems rely on a shuttle (Fr. *navette*), i.e., the proposal is sent from one chamber to the other until hopefully the process converges. The number of times that the proposal can be passed between the chambers varies from once to (in principle) an unlimited number of times.

If the above methods have been exhausted without leading to a conclusion, two situations can occur. Either it is possible to drop the proposal altogether, or else some decision has to be reached. In the former case, it is possible to give any of the two chambers veto power, temporary or permanent. Another possibility is to give one chamber (normally the lower house) the possibility of imposing its will on the other, but only provided that a qualified majority of the chambers supports the proposition. What these two rules have in common is that they may lead up to a situation where no decision is taken, that is, the proposal is dropped.

In case a conclusion has to be reached – for instance because a budget decision is needed – a few different options are open. One is to let the two chambers vote together as one chamber. This requires that the number of votes in the two chambers be of the same order of magnitude. A similar but more general rule is to let the *intensity* expressed in each of the chambers be decisive. For instance, a two-thirds majority in one chamber could defeat a simple majority in the other. If the two chambers are of equal size, this reduces to the previous rule. Alternatively, recourse is taken to some external default mechanism, which may be, for instance, a prolongation of the *status quo* or a default alternative supplied by a third party.

A basic fact to be recognised in any discussion on design is that the default alternative is decisive for the working of the system. Intermediate procedures such as a conciliation committee are important in creating an atmosphere of cooperation, but the behaviour of both parties during negotiations is influenced by the knowledge about what will happen in case they cling to their respective positions. The power balance is therefore to a large extent determined by the way the default procedure is shaped.

Nonetheless, a committee of conciliation can be relatively powerful in some situations, and is sometimes referred to as the “third chamber”. This is the case in particular if the compromise solution worked out by the committee is voted under closed rule, that is, if each of the two chambers has to accept it without further amendments or decline.

Current EU practices: General rules

The current set of decision-making procedures in the Union is complex⁴⁷. There are four main legislative procedures – *co-decision*, *assent*, *cooperation* and *advisory opinion* – but combinations with various micro-rules concerning qualified majority, unanimity, consultation etc. raises the total number to close to thirty. The *co-decision* procedure has gradually become the most important, reflecting the increasing relative political legitimacy of the Parliament. It can be summarised as follows:

- The Commission submits a proposal to the European Parliament and to the Council. The Parliament delivers an opinion.
- The Council states its opinion on the Commission's proposal and the Parliament's amendments if any. If the proposal and the amendments are approved, the act is adopted. In other cases, the Council forwards its common position to the Parliament.
- The Parliament gives a ruling on the common position within three months. If it agrees, the act is adopted. If it rejects the common position, the act is not adopted.
- If Parliament proposes amendments, the text is forwarded to the Council and the Commission, which delivers an opinion about the amendments. If within three months the Council adopts all the amendments, the act is adopted. The Council votes by qualified majority on the amendments supported by the Commission, otherwise unanimously.
- When Council and Parliament disagree, a conciliation committee is formed with the task of working out a compromise. The committee work and the subsequent process have to be finalised within three months; otherwise, the proposal is dropped.

The *assent* procedure requires the agreement between Council and Parliament and thus resembles the co-decision procedure. It was introduced in the Treaty on the European Union to cover a number of cases that were not covered by the latter procedure. (We refrain from going into the details).

The *cooperation* procedure can be summarised as follows:

- The Commission presents a proposal to the Council and the Parliament. The Parliament states its opinion.
- The Council adopts a common position on the basis of qualified majority.
- If the Parliament concurs with this position, the act is adopted. If the Parliament rejects the position, adoption of the act requires unanimity in the Council.
- If Parliament proposes amendments, the Commission re-examines the proposal. The Council may adopt the re-examined proposal by qualified majority, or make further amendments on the basis of unanimity.

The *advisory opinion* procedure resembles the cooperation procedure in that it gives the Council the right to overrule the Parliament's position. As in the cooperation procedure, the Commission may intervene and modify its original proposal to take into account the Parliament's opinion. In this case, the Council has to reach unanimity in order to be able to ignore the amendments.

Voting on the budget

The budgetary procedure of the Union is regulated by art. 272 of the EC Treaty, but current practices are the result of several subsequent changes codified in the Inter-institutional Agreement.

The Commission presents a preliminary draft budget to the Council and the Parliament, which is examined in two readings by both parties. The Parliament's powers differ depending on whether so-called compulsory expenditure or non-compulsory expenditure is discussed. In the former case, the Parliament's influence is more or less limited to an expression of opinion; in the latter, it has the last word subject to certain important restrictions (ceilings, maximum rate of increase). Under the current classification, about 50 per cent of the expenditure is considered to be compulsory. This ratio has been in steady decline for a

number of years, but more because of a relative increase in non-traditional expenditures than as a result of rule changes. The basis of the classification is article 272 of the Treaty, which refers to expenditure “necessarily resulting from this Treaty or from acts adopted in accordance therewith”. A reasonable interpretation would be that obligations to third parties would be considered as compulsory, but practice is very far from this reading. In reality, the established budget headings have come to define the categories in question.

Inter-institutional cooperation in the form of a dialogue between representatives from the Commission, the Council and the Parliament has come to play an important role in the annual budget cycle.

Because the rules for legislation and for budget adoption differ in important respects, there may be a temptation to use the budget process to introduce new legislation. This is precluded by the inter-institutional agreement of 1999, which establishes that appropriations in the budget must be based on a basic act in the form of a regulation, a directive or a decision. There are a few minor exceptions to this rule, such as pilot schemes and preparatory actions.

An important article of the Treaty (art. 270) stipulates that the Commission must ensure that the necessary budgetary means for any new proposal are available within the general budgetary envelopes laid down in the financial perspective.

Discussion

The power balance generated by the proposed constitution depends on a number of critical design parameters. First, there are the rules for reaching an opinion within each of the two arms of the budgetary authority – weighting of votes, simple majority, qualified majority or unanimity. Second, there are the rules for merging these two possibly diverging opinions into one collective decision. Third, there may be different rules for different policy areas. It is not uncommon in bicameral parliaments that special rules obtain in financial matters.

Starting with the problem of vote weighting, it was pointed out above that the present allocation of weights is the result of a somewhat haphazard negotiation process. Furthermore, different scales apply to Council and Parliament. The most reasonable long-term goal would be to let the representation in the Parliament be based on the principle of “one man, one vote” and in the Council on “one state, one vote”. Because of the spread of population sizes, the parliamentary rule would have to be subject to the restriction of at least one representative per country.

Next, internal majority rules have to be decided. In the perspective of increased flexibility and need for policy adjustment, it seems reasonable to extend the principle of qualified majority voting to some areas where the Convention proposal clings to unanimity. In the field of economic management, decisions on revenue sources and the harmonisation of tax bases are of particular importance; we return to these questions in chapter 5.

What bicameral decision-process alternatives are considered relevant to the Union in the short and medium term depends very much on what balance of powers between the Council and the Parliament one considers reasonable, and what role one is prepared to give the Commission in case the other two parties fail to reach a decision. For new legislation, a no-decision outcome is acceptable, but for budgetary purposes some form of solution is necessary. The default alternative of prolongation of the previous budget is but a temporary solution. This is true also for the financial perspective; it may be possible to keep the overall envelope for a long time, but the desired breakdown into headings cannot be expected to remain stable for very long.

If prolongation is not considered a viable alternative, there are a number of other alternatives open, leaving aside the alternative where one party is in a position to impose its will on the other party. One option is to let the Council and the Parliament vote together. In order to produce a reasonable balance between the two, the Council vote must be counted according the weights

assigned in its internal voting. The Nice agreement set the number of votes in Parliament to 732 and the corresponding number for the Council to 345. Counting this way, a reasonable balance would obtain, with some dominance for the Parliament. A variant that is closer to the *status quo* is to let the degree of consensus (synonymous with the intensity of opinion) in each of the chambers affect the outcome. Currently, voting on the budget is based on qualified majority in the Council and simple majority in the Parliament. But the Parliament is given more influence if it is able to summon a qualified majority for a certain position; this is the three-fifths alternative that appears both in the current treaty and in the Convention proposal.

A second option would be to give the Commission a more prominent position in case of a stalemate between Council and Parliament. Given that both a legislative process and a budget cycle starts with a Commission proposal, there is always the possibility to let this proposal be the default alternative.

A third option would be to let the Commission act as an arbitrator between Council and Parliament. To some extent, this is already the case, as current procedures envisage the possibility of the Commission making amendments to accommodate differences of opinion between the other two parties. In order to reduce the risk of the other parties taking extreme positions, it is possible to rely on *final-offer arbitration*⁴⁸. The idea here is to let the two parties negotiate for some time and then let both of them put forward one final alternative. The mediator – in this case the Commission – is then forced to choose either of the two alternatives, without amendments. The method has been used in the labour market with some success but does not seem to have been tested on a large scale in a political context. This is a somewhat unorthodox, but feasible solution.

Both these latter alternatives suffer from a problem of legitimacy; the Commission may easily be perceived as party to the conflict.

The long-term solution sketched above is one where the Parliament and the Council develop into assemblies that represent the electorate and the member states, respectively. For the near and

medium term, it is important that compromises between this long-term ideal and the *status quo* do not block the road towards solutions closer to the long-term ideal. Starting from a situation where the Council has the final word on revenues and total envelopes, the Convention has chosen to give the Parliament more influence over budgetary matters while leaving the control over revenues and envelopes in the hands of the Council. A somewhat less definitive solution would be to allow intensities of opinion to affect the outcome, as outlined above. In revenue matters, the votes of the Council would carry substantial weight, whereas parliamentary influence would be limited. Conversely, the weight assigned to parliamentary votes could be greater in matters related to expenditure structure.

It is a complicated matter to design a credible and acceptable path from the *status quo* to a future equilibrium with more evenly distributed influence for the two arms of the budgetary authority. A timetable makes the transition process credible, but building a timetable into the constitution is a somewhat awkward solution. In any case, the problem of adjusting the weights in an appropriate way has to be solved simultaneously with the more fundamental issues related to the roles of the Parliament and the Council, respectively.

Within the foreseeable future, it is equally natural to give the final word on the revenue sources to the Council; these decisions are anyhow taken seldom and without a direct link to the annual and multi-annual budget decisions.

4.4 Conflict resolution

Whatever division of responsibilities between the levels is arrived at, in any real-world context borderline cases will appear that are not unambiguously settled by the basic legal texts. For this reason there is a need for some mechanism to resolve conflicts. There are political and legal aspects to conflict resolution, and there have to be fora for debating both these dimensions of the conflict. In the Union, the normal interaction between Council and Parliament takes care of the political dimension.

The legal dimension of dispute settlement is covered by the Court of Justice. The Court has on occasions been called upon to settle disputes over competences between the Council and the Parliament⁴⁹. Concerning one of the most central dimensions of potential conflict – subsidiarity and its interpretation in real-life situations – it should be noted that the Court has so far not based any of its verdicts exclusively on the principle of subsidiarity. Against this background, the subsidiarity test mechanism proposed by the Convention is an interesting innovation. If such an institution were put in place, the Court would be responsible for developing legal practice in the field.

4.5 Summary

The discussion about a constitution for the Union could profit more from experiences from existing bicameral systems. It seems that all existing options have not been explored, in particular when it comes to the overall principle of representation.

In the long run, it is reasonable to imagine that the parliament and the Council develop into representatives of the electorate and the Member States, respectively. The fundamental principle underlying the apportionment of votes would be “one man, one vote” and “one state, one vote”, respectively.

In the short and medium term, steps towards the long-term solution could be taken by unifying budget-related decision procedures as far as possible, and by integrating the Parliament in these decisions. Short-term compromises concerning the relative influence of the Council and the Parliament should be designed so as not to form obstacles to different trade-offs in the future. A solution where the Council has the decisive influence over revenue sources and total envelopes and the Parliament relatively more influence over the expenditure structure of the budget can be accomplished by assigning appropriate weights to the votes of the Council and the Parliament. Such weights could then be adjusted if there is political support for a reallocation in the future.

5 FINANCING THE UNION IN THE FUTURE

In this chapter we discuss issues involved in and the options for financing the Union in the future. The discussion is carried out against the backdrop of a short description of the road towards the current system. An analysis of the constraints imposed by and the opportunities for reform offered by the Draft Treaty is carried out in chapter 7.

5.1 The road towards the current system

During the period 1958–1970, the activities of the Community were financed exclusively by contributions from the Member States, i.e. in the way international organisations like the institutions of the UN family are financed.

A new system, introducing the notion of “own resources” came into force in 1971. The intended two groups of own resources were customs duties and agricultural levies on the one hand and revenue derived from a harmonised VAT-base on the other. Customs duties and levies, the so called traditional own resources (TOR) were implemented immediately while the introduction of the VAT-resource was delayed until 1979 due to difficulties in defining the base for the VAT assessment.

The intention was that own resources would eventually supplant the Member State contributions thus enhancing the financial autonomy of the Union. For various reasons this vision has never materialised. Customs duties and levies have declined and now make up only about 20 per cent of total revenues.

The yield from the VAT source has declined because of a) the reduction the call rate from 1.4 per cent to 0.5 per cent, b) the introduction of a cap so that the notional VAT base on which the VAT-source is calculated never exceeds 50 per cent of GDP, and c) the UK rebate.⁵⁰

Over the same period Community expenditure increased substantially mostly as the result of sharply increasing CAP outlays. To cover the short-fall, the Council in 1988 decided to introduce a fourth resource based on the Member States' GNI.⁵¹

Thus from having the financed the entire budget in 1988, TOR and VAT-based resource only financed 56 per cent in 2002 and will, if nothing changes, cover only 25 to 30 per cent in 2006.

It may furthermore be questioned whether the VAT-based source can really be considered an own resource in the true sense of the term given that a) it is not a tax or linked to actual tax collection but based on a notional VAT-base and that b) for some countries it is capped. It is thus in practical terms similar to the GNI-based fourth source. In other words, the financing of the Community has for all practical purposes reverted back to the pre-1971 situation with the Union being almost entirely dependent on contributions from its Member States.

This development, which arguably runs counter to the general development of the Union, has engendered a heated debate on what would be a desirable way to finance the activities of the Union. The quest for reform comes predominantly from the Commission and the European Parliament unified in the conviction that the Union should be financed by truly own resources.

On the other side of the debate are some Member States that rather argue that the present trend is positive and that the GNI-based financing should be the mainstay of the Union's resources.

5.2 Arguments for financial autonomy

A number of arguments have been advanced explaining why financial autonomy is a desirable feature of the management of the Union. Those arguments have almost uniquely referred to the financing of the Union in the sense that it should be autonomous – in a not always very well defined sense – in relation to its Member States. It will be argued below that there are other, perhaps equally important aspects of autonomy that ought to be considered.

Transparency

The most frequently used argument for financial autonomy is that it would increase the transparency of the activities of the

Union. Michael Schreyer, Member of the Commission responsible for the Budget puts it this way: "An important aspect is that of transparency and a direct link to the taxpayer. Today, the taxpayer does not know how much he pays to the EU budget. This merely opens the door wide to speculation. Who knows, for example, that the EU budget accounts for only 2.24 percent of total government expenditure in the EU? Not only do people have a false idea of the size of the EU budget, they often also have a view of which individuals, which Member States contribute to the EU budget, and how much they contribute, which does not correspond to reality."⁵²

On the surface of it, the need for transparency may appear a strong argument; in practice it becomes a bit tenuous. If the desired end-result is that citizens of Europe have a reasonably good idea of how much the activities of the Union cost and how much they contribute, that can be achieved in different ways. One way is simply to use all communications channels available to inform the European public. Furthermore, the message would probably be easier to put across if the Union were a hundred percent financed through contributions by Member States rather than from a more or less complex array of "own resources".

The degree of transparency would probably only be greater if, as suggested by some, it was indicated on each sales receipt how much VAT was paid to the Union and if the latter were the only source of revenue to the Union. However, it is neither realistic nor desirable that the Union be financed entirely from VAT. If, as suggested in the draft constitution, the Union is to be financed fully from own resources, it would have to be from a set of sources some of which, like seigniorage and import duties, would not be immediately visible to the citizen. The latter situation would not be very different from the financing of national and local governments and the same types of pedagogical difficulties vis-à-vis the citizens would apply.

Legitimacy

The legitimacy argument is a stronger one. What it boils down to is, really, how the Union is viewed; is it an international

organisation like the different institutions of the UN system, or is it the top-tier of a multi-tier government structure? The traditional answer – that it is neither, but a unique creation with no parallel – is becoming less and less tenable.

For those who see the Union as the top-tier of a European government structure, it is an anomaly that its directly elected parliamentary body has no say over revenue. Sylvie Goulard and Mario Nava⁵³ of the Group of Policy Advisers of the European Commission make the point that the European Parliament is the “only parliament in the world that debates expenditure but has no competence to determine the revenue that must be collected in order to finance that expenditure”.

At the same time it must be recognised that it is not uncommon – rather it is the norm – that one level of government exercises some degree of control over the total resource envelope of another level of government. This certainly applies to national governments vis-à-vis local and regional governments, but the notion can easily be extended to the relationship between national and supra-national governments.

The present arrangement – which would not change substantially if the Draft Constitution were adopted as it stands (see further below) – where the European Parliament has no say whatsoever on the volume and composition of revenues must, however, be considered an anomaly. Vesting, as presently, the authority over revenue totally with the Council of Ministers and requiring consensus can, effectively, make the Union hostage to any one single national government.

A move to a decision-making process where revenue is decided upon in the same manner as, and in parallel with, expenditure would certainly enhance the legitimacy of the EP but also of the Union as such. It must be pointed out that it is still possible to build in safeguards against any possible irresponsible expansionism on the part of the one or several Union institutions. Such safeguards are discussed in chapter 6.

Responsibility

It has also been argued that giving the EP a say on revenue would make it act more responsibly when it comes to deciding expenditure; it would have to answer to the electorate for the revenue that would have to be collected to finance it. The strength of the argument depends on the extent to which the electorate is aware of the financial burden imposed on it and the degree to which it cares. The first question is related to the degree of transparency of Union financing. If, as suggested above, the burden on the European citizens is necessarily and naturally to large extent indirect, the electorate may not be particularly sensitive to revenue hikes – particularly at the present, after all, rather low levels. Thus, although there may be some truth to the argument, putting too much faith in this presumed effect would probably be unwise, at least not without complementary checks and balances.

Subsidiarity

It has been argued that “Subsidiarity only exists if each level of government is autonomous”.⁵⁴ The term “autonomous” in this case needs to be qualified, however. If taken to mean that each level of government must have the resources necessary to carry out the responsibilities that in a transparent and democratic process have been “assigned” to it, then it is true. It cannot mean, however, that each level of government autonomously decides what its responsibilities are and what direct or indirect tax burden it is to impose on the citizens under its jurisdiction. What is needed is rather a coordination of the process in which this division of responsibilities is worked out – implementing the subsidiarity principle – and the process by which the financing of these responsibilities is decided.

Therefore the subsidiarity argument should perhaps be re-phrased and instead make the seemingly obvious point that all levels of government – and in particular the elected bodies at each level – should have a say in the process of assigning responsibilities as well as the authority to raise the necessary resources required to assume those responsibilities.

5.3 The meaning of autonomy

It has been suggested above that there are several dimensions to financial autonomy. Here we will discuss four: a) the right to levy taxes, b) the responsibility for administering revenue collection, c) the right of disposition, and d) the right to borrow.

5.3.1 THE RIGHT TO DECIDE ON TAXES

The question of the right to levy taxes is a multi-faceted issue. Who should hold: 1) the right to decide on the total resource envelope, 2) the right to determine the revenue base, 3) the right to request the harmonisation of a tax base, and 4) the right to set the tax rate?

The right to decide the total resource envelope

The present arrangements as regards the decision on the financial perspective and the yearly commitment and payments appropriations effectively denies the institutions of the Union any autonomous power over the total resource envelope – and probably justifiably so. One can imagine that if given a free hand to determine the total resource envelope of the EU budget, possible expansionist ambitions on the part of the Commission and/or unholy alliances of national or other types of vested interests in Parliament could lead to a ballooning of the budget.

The problem is that restraint is exercised for the wrong reasons. It is not the result of a democratic process in which one arrives at a view of what would reasonably befall on the Union, given subsidiarity – and what consequently would be a reasonable resource ceiling. Rather, restraint is the result of understandable, but rather short-sighted ambitions of some Member States to minimise their net contributions. These ambitions are, however unfortunate, understandable, given that the present composition of expenditure is very far removed from what from a subsidiarity perspective could reasonably be considered to be the responsibilities of the top-tier of a European government structure. Given the questionable rationality of the present composition of EU-expenditure – the present instinctive reaction on the part of many Member States to hold down its total volume is quite understandable.

One way to break the present gridlock and pave the way for a coordinated review of expenditure and revenue could be to a) eliminate the division into compulsory and non-compulsory expenditure (which is proposed in the draft constitution), b) do away with the requirement for unanimous decisions regarding resources (which has not been proposed) and c) decide on expenditure and resources simultaneously and following the same procedures (which is not proposed either).

Any possible expansionist tendencies on the part of the Commission and the EP could be held at bay by a) the proposed subsidiarity-control process involving the national parliaments proposed in the draft constitution and b) an orthodox top-down budget process.

The right to choose the revenue bases

In the end, it is the citizens of Europe that finance the expenditure of the EU budget. They do it either directly or indirectly. Even the GNI-based contributions in the end are borne by the citizens, either as tax-payers to the extent the contributions to the EU-budget are additional, or as consumers of government services, to the extent the contributions crowd out the latter. The notion, often advanced, that the Member States finance (a part of) the budget ignores the basic concept of incidence, i.e. who in the end bears the brunt of a tax, levy or charge.

The choice of revenue bases, however, affects how different citizens of the European Union contribute to the financing of the EU-budget. The question is: what is a reasonable process for making that decision? The EC treaty gives the Member States through the Council of Ministers monopoly power over the decision, a monopoly retained in the Draft Constitution. Given that any decision on the matter requires unanimity, any single member state can block the introduction, elimination or change of a revenue base. The European Parliament, elected directly by the citizens that finance the Union, is only to be consulted according to the Draft Constitution.

*The right to decide on the composition of revenue
and to set the tax rate*

The questions asked as to the choice of revenue bases are equally relevant to the choice of the composition of revenue and to setting of tax rates, where that applies.

Presuming that there exists a process in which an appropriate total level of expenditure and a matching level of revenue are arrived at, the appropriate rate ought to be part and parcel of the normal budget process. The difference would be that decision would be more long-term and linked to the medium-term financial framework rather than to the annual process; the EU budget will never be a counter-cyclical fiscal instrument. Furthermore, because revenue collection will always largely depend on the national tax administrations, frequent changes in rates are impractical.

The right to request the harmonisation of a tax base

Tax bases can move – to a greater or less extent and for a variety of reasons; land cannot but financial capital certainly can. A tax base, because it is more or less mobile, is also more or less sensitive to differences in taxation levels in different countries. A tax base movement, be it individuals, financial capital or goods, immediately affects tax yields and if it is a corrective tax, the effectiveness of that tax. In the longer term it affects income and growth in the countries and thereby tax revenues of the affected countries yet further. The greater the degree of mobility, the greater is the pressure to harmonise.

Harmonisation can take two forms: spontaneous and coordinated. *Ceteris paribus*, there are normally benefits to lower taxes, which easily leads to tax competition; one can expect spontaneous harmonisation to lead to lower average rates than when harmonisation is achieved through a coordinated process.

For equity reasons it is important that the base on which any European tax is levied be harmonised; not from a national perspective but from the perspective of the citizens of the European Union. When the mobility of the tax base is high, it is also in

the interest of the national governments that they be harmonised. For political reasons, however, it may be difficult for a national government to take the initiative towards such harmonisation as some – read important voter groups – will always lose in the process. It may thus be convenient to be able to refer to decisions on the matter taken at the EU-level.

It must be remembered that harmonisation of tax bases does not necessarily imply the harmonisation of tax rates. An EU-tax can perfectly well piggy-back on national taxes, for example VAT. What in the latter case would need to be harmonised would be which, if any, goods and services should be exempt from VAT.

Conclusion

The present situation in which the resource envelope is decided independently of and before the discussion of expenditure must be considered a rather odd arrangement. Equally odd is the exclusion of the elected parliament – representing the citizens of the European Union that in the end have to foot the bill for the Union – from having an effective say on anything concerning the resources.

On the other hand, it is equally difficult to advocate that each level in a multi-tier government structure should act completely independently of the other levels. The attribution of responsibility for public sector services and the authority to finance them ought to be made in a structured process involving all levels of government. Full autonomy for the institutions of the Union is thus not desirable, neither as regards revenue, nor as regards expenditure. It certainly would not be politically possible.

Rather than autonomy, it is a question of finding a process that strikes a balance between the European Parliament's desire to have a real say about the revenues of the Union and the need for restraint and for coordinating with the national and local levels of government. Such a balance is better achieved by a single, simultaneous and uniform decision-making process for revenue and expenditure – rather than by the present, dichotomous process. How a decision-making process that would increase

legitimacy, responsibility and accountability, foster rationality and ensure fiscal discipline could be structured is further discussed in chapter 6.

5.3.2 THE ADMINISTRATION OF REVENUE COLLECTION

Should the Union be autonomous in terms of the administering of revenue collection? Can it? As the discussion in section 5.5 below on the potential revenue sources of the Union's will argue, it is neither desirable nor likely that the Union would be financed from one single source, nor that the revenue from that source would accrue solely to the Union. To the extent that the Union would be financed from taxes, most, if not all, of those taxes would be shared with national governments. For practical reasons and because the share of the taxes going to the Union most likely would be the minor one, the Union should rely on the national tax administrations for collection.

The one exception would be the collection of duties and levies. As will be argued below, duties and levies are preferably treated as one hundred per cent Union revenue. It would then also be logical that the collection of these revenues be the responsibility of the Union. The most radical option would be to simply transfer the customs authorities of the Member States to the Union. Such a transfer should also have considerable benefits – because of better coordination – in the other tasks incumbent on these authorities, notably the control of trans-border flows of goods. A first step on the way to transferring all national customs authorities to the Union could be for the Union to outsource the customs collection services to the existing national authorities. The other responsibilities of the national customs authorities could still be financed by the national governments.

5.3.3 THE RIGHT OF DISPOSITION

The increasing importance of the GNI-based source implies that the portion of resources that the Union truly controls has shrunk commensurately. The GNI-based contributions are not guaranteed but rather serve to top up total revenue so as to match

forecasted expenditure; the yearly contribution by the Member States is adjusted on the basis of in-year projections of the total volume of payments.⁵⁵ It is immaterial that some of the revenue accrues directly to the Union when the totality does not. In other words, rather than disposing of its own revenue the Union is, effectively, under strict financial guardianship of the Member States.

In chapter 6 it will be argued that the execution of the EU-budget must be made more flexible – without jeopardising financial discipline. The move to accruals accounting and budgeting is logically accompanied by a move to cost-based budget constraints (=appropriations). The Union could be allowed to borrow up to a (low) ceiling and to carry over financial resources from one year to the other. A change in the same vein would be that the Union have the full right of disposition of its resources. If, as both the current treaty and the Draft Constitution stipulate, the budget is fully financed by truly own revenue, topping-up is not an option, and the Union would automatically have the full right of disposition of its revenue.

If however the GNI-based contributions would continue to be a source of revenue, firm commitments as to the yearly contributions should be made and respected. Contributions should be committed on a rolling basis within the medium-term framework. If it is apparent that the Union cannot usefully spend available resources, the contributions can be lowered, but they should not be lowered for the current year.

Similar adjustments can and should be made also if and when the budget is fully financed from truly own resources. The equivalent of lowering contributions would be to reduce the tax rates. The proposed rolling multi-annual financial framework would provide the vehicle for such adjustments.

Carry-overs

Making the sources of financing of the Union truly own resources implies carry-over at the Union level. Carry-over at the institution or activity level is a slightly different but similar story.

In an accruals framework appropriations can either be given in the form of cost constraints or in the form of cash contributions. The first form means that an institution, for an activity for which it is responsible, is given the authority to incur costs up to a certain limit. Carry-over in this context means that the institution is allowed to utilise this authorisation in the following year or possibly even further into the future. In principle the receiving institution should, when incurring costs record to which vintage of the appropriation it should be attributed. The carried over appropriation could also be added to next year's appropriation.

A simpler approach is to give appropriations the form of a cash transfer of the budgeted amount to the responsible institution. Any unused funds at the end of the year are simply carried over to the next and would be at the full disposal of the institution. This arrangement would be the equivalent at institution level of making the Union's resources its truly own resources.

The same types of checks and balances would necessarily also have to exist. In the budgeting process, the budget authority must of course take into consideration and assess the reason for unused financial resources in an activity. Is it because of a simple delay in execution of, say, a regional investment project, a delay that will be caught up with the following year? Is it a permanent reduction in the level of activities or a temporary one that will never be regained? The outcome of this type of deliberation would then affect the appropriation for the following year. Such a case-by-case review as part of the budgeting process could be backed by a general clause that a year-end balance surpassing x per cent of past year's total payments should be returned to the Treasury.⁵⁶ The suggested approach introduces a deliberate lag in the adjustment process to avoid irresponsible December spending but also the need for cumbersome in-year management measures to carry out adjustments that are perfectly justifiable.

5.3.4 THE RIGHT TO BORROW

The natural flip-side of the carry-over coin is the right to borrow. That right is presently denied the Union. The fear is pre-

sumably that the Union by borrowing would effectively preempt financing decisions by the Member States; the Member States would be forced to bail out an irresponsible Union. The price of this constraint is potential inefficiency in execution, in the form of payment delays, and unnecessary costs for capital assets used by the Union administration. An example of the latter is that the Union is forced to choose bids for the supply of office space on the basis of the lowest yearly charge rather than on the lowest cost.

There are two types of borrowing that would be relevant to the Union, short-term to handle short-term cash-flow constraints and longer-term for the type of investment referred to above. Borrowing as a fiscal policy instrument is not relevant. The Union should not have that role and the size of the Union budget is too small anyway to have any impact. Given that the bulk of the spending is discretionary, the swings in the budget balance would be much more limited than for member-states' governments.

Even so, there is no question of giving the Union an open-ended mandate to borrow. Constraints on Union borrowing should be tight. The constraint would best be set on average net financial debt. Short-term debt could be allowed to exceed that by a margin to meet short-term cash-needs. The limits could be set in relation to total yearly payments. Exactly what would be appropriate limits would have to be analysed in greater depth; five per cent, ten per cent? Another option is to link the limit on long-term borrowing to the level of fixed capital and apply the so-called "golden rule" that borrowing should not exceed fixed capital.

All borrowing should be handled by an EU central treasury function and on-lend, at a cost, to the different EU institutions.

5.4 Sources of financing for the Union – issues and criteria

The discussion of what would be appropriate sources of revenue for the Union is not a new one. A number of papers, some com-

missioned by the Commission, have been written on the subject. What this section can offer is, we hope, some new angles on the issues questioning some established “truths” on the way.

The discussion covers four aspects – allocative efficiency, administrative efficiency, stability, and fairness.

5.4.1 ALLOCATIVE EFFICIENCY

Allocative efficiency can be analysed in four different dimensions: excess burden of taxation, externalities, mobility of the tax base, and harmonisation.

Excess burden

All taxes give rise to distortions in the allocation of resources in the economy by introducing “wedges” between the prices confronting buyers and sellers in different markets. Income taxes for example introduce a wedge between the demand and supply price of labour. Taxes on capital earnings introduce a wedge between the interest paid by banks and interest effectively earned by depositors. The distortion arises because the tax wedges affect buyer and seller behaviour, and the effect is proportionally greater the higher the tax.

The question whether excess burden is an issue in the financing of the Union depends largely on whether the latter puts an additional burden on the citizens of Europe or not. If EU expenditure is merely a substitute for national or local expenditure then there is less of a problem; but if it leads to a higher total burden, there is definitely one.⁵⁷ Here again is an argument against total autonomy of the Union, at least as regards its total expenditure and revenue envelopes, because it could possibly lead to an increase of the total tax burden.

Externalities

All taxes change relative prices between goods and between markets and thus influence the behaviour not only of the taxed subject but also of other economic subjects. Different corporate taxes in different countries affect corporate investment decisions, different vice taxes affect purchase patterns, etc.

There is also another type of externalities that have a bearing on the financing of the Union – externalities in production and externalities in consumption. The most obvious ones are negative environmental externalities – pollution – where the burden is largely borne not by the polluters but by others. They are of relevance because taxes can be a means to correct the allocative distortions that these externalities introduce.

There are thus two types of externalities to consider when deciding on appropriate sources of finance of the Union: negative external effects that taxes can help to correct and the external effects of the taxes themselves.

Corrective taxes seek to improve allocative efficiency by influencing relative prices so as better to reflect true opportunity costs. Corrective taxes can also be an important source of finance but their main purpose is to correct allocative distortions. Corrective taxes should be levied at the level at which the externalities are felt, or as closely to that level as feasible. In some cases the externalities affect the entire world, as is the case with carbon dioxide emissions. But, if a world CO₂ tax is not possible, a European tax may be a second best.

The case for harmonisation

The increased pressure to harmonise taxes comes with the general globalisation of the world economy and only partially stems from the closer integration of Europe. However, the degree of pressure to harmonise different taxes should be taken into consideration when analysing the different options for financing the Union. All other things equal it is better to opt for tax bases where the external pressure on and the benefits from harmonising taxes are the greatest. Where the need and rationale for harmonisation is obvious, decisions at the EU level linked to the financing of the Union could serve as a midwife to such harmonisation, overcoming possible political blockages at the national level.

There are two dimensions to tax harmonisation: harmonisation of the tax base and harmonisation of the tax rate. From a

mobility perspective it is the joint effect of the two that is important.

From the point of view of the potential financing of the Union, the two dimensions of harmonisation need to be kept apart. If the mobility of a tax base is moderate and if an EU tax were to piggy-back on a national tax applied to that base – for example VAT – only harmonisation of the tax base is really necessary.

If, however, the rationale for harmonising a tax is very strong and if the tax were to be levied uniquely as an EU tax, for example a CO₂ tax, it would be necessary to harmonise both the base and the rate.

5.4.2 ADMINISTRATIVE EFFICIENCY

Another dimension to look at when analysing different options for selecting a revenue base for the Union is the cost of collecting the revenue, be it in the form of a tax or some other type of revenue. Given the limited volume of potential own resource revenue collected by the Union, any taxes would certainly have to be collected by national tax authorities and for the most part piggy-back on national taxes. A non-tax resource like ECB profits can of course be collected at an even lower cost.

5.4.3 STABILITY

It is certainly desirable that the total flow of financial resources to the Union is stable. The proposal above, that the Union have the right to borrow, does not negate the need for a stable flow of financing. The right to borrow is only intended as a means to accommodate limited fluctuations in cash in- and outflow. The greater are the fluctuations, the greater is the difficulty in assessing what is a sustainable level of expenditure. On the other hand, stability in total does not necessarily imply that every single flow needs to be stable.

5.4.4 FAIRNESS

It is easy to agree that the financing of the Union shall be “fair”. The question is what is read into fairness. In much of the debate, and even in some of the more analytical work carried

out, it has been explicitly stated or implied that the fairness is something that applies to the member states. This national perspective has led to the heated discussions on “net contributions”.

It has been argued, for example, that a uniform European VAT would be unfair because the proportion of consumption is higher and therefore the VAT-base proportionally broader in lower-income countries than in higher-income countries. If instead the consumption of the individual citizens is seen as the tax base, such an argument is irrelevant.

Fairness should therefore relate to the tax contributions of individual citizens. Individuals in identical circumstances should be treated identically in their tax liability; what has been termed “horizontal equity” should apply. Logically the same approach ought to apply to any possible tax collected for the Union, be it VAT, a vice tax, personal income tax, corporate tax, an environmental tax, or any other type of tax.

Presuming that a certain volume of EU expenditure needs to be financed, the citizens of Europe will have to bear the financial burden of it in one way or another. The question is how.

Redistribution

In national tax debates, fairness is sometimes interpreted to mean that higher income-earners should pay proportionally more than lower income-earners; a principle termed “vertical equity”. Given the limited volume, at least in comparison to that collected for the national, regional and local levels, it is questionable whether such progressiveness is at all relevant when it comes to EU taxes.

Given the limited size of the EU budget relative to those of the Member States, it is clearly better to achieve any redistribution for which the Union is the proper instrument through the expenditure side. The latter is also the position of the Commission.

Rebates

The present system of rebates – the original to the UK and the subsequent compensatory ones to Austria, Germany, Nether-

lands, and Sweden – introduces an important element of “unfairness” when looked at from the individual contributors’ perspective. Because of it, the proportional contribution of citizens having the same level of real income in different EU countries is not equal, i.e. horizontal equity does not hold.

There are two root causes of the rebates:

- a pattern of EU expenditure that sits very uncomfortably with the subsidiarity principle and thus is difficult for many member states to feel enthusiastic about, and
- the view that equity should apply to member states rather than to individuals.

The result is the rather fruitless “net contribution” debate, the sign of a political gridlock that effectively blocks a rational and comprehensive process of reviewing EU expenditure.

5.5 Assessment of possible revenue sources

5.5.1 DUTIES AND LEVIES

Customs duties and agricultural levies, the “traditional own resources” (TOR), constitute an EU resource *par excellence*. It is directly related to the original nature of the EU as a customs union. It is fair in that it affects all EU citizens equally; the tax base is harmonised and the rates are the same.⁵⁸ The yield is relatively stable. Administrative procedures for its collection are well established and a steady flow of funds is ensured by the automatic payment procedure.⁵⁹

The yield from customs duties would, most likely, increase with a lowering of tariffs, as the rise in volume of imports would more than compensate for the reduced rates. Beyond a certain point, and depending on the success of ongoing and future trade negotiation rounds under the auspices of the WTO, duties and levies are, however, bound to meet an ever smaller share of the Union’s financing needs.

5.5.2 VAT

As will be argued below, VAT is a very natural tax base for the

Union but the present VAT-based own revenue system has been distorted by the different restrictions introduced during the course of the years.⁶⁰

In the discussions about this resource much ado has been made about its purported “regressiveness”.⁶¹ It has been postulated that VAT is regressive in the sense that the VAT tax base is proportionally higher in lower-income member states than in higher-income member states and that a uniform European VAT would therefore fall more heavily on the former. But, as already indicated above, it is all a matter of perspective. There is a negative correlation between aggregate consumption in relation to GDP and GDP – although the reason for this is open to discussion. The fundamental question is, however, whether such regressiveness is at all relevant. VAT is not a tax on nation-states but in the end on the consumption of individuals. For instance, if Luxemburg has a large VAT base compared to its GDP, it is because a number of individuals work and consume in Luxemburg while being residents in neighbouring countries. From the individual point of view, it is immaterial whether the contribution to the Union goes via the country of residence or another country.

The pressure to harmonise VAT is moderate reflecting the importance of transportation in the total cost of goods. Nevertheless, following the Council Directive 91/680/EC, VAT base harmonisation is now substantial. Where differences remain, harmonisation of the base could probably be achieved without major political difficulties. Given such a harmonisation, a EU VAT based on an actual VAT base would fully meet the horizontal equity criteria; taxpayers at the same income level in different Member States would contribute equally to the EU budget, and they would do so regardless of where in Europe they purchased the goods and services.

The present arrangement, whereby the VAT “own resource” is calculated on a notional VAT base and where, on top of it, that notional VAT base is capped at 50 per cent of a Member State’s GDP, could thus be eliminated. Nor would there be a need for a

more general a compensation mechanism of the type discussed and proposed on different occasions by the Commission and the European Parliament.⁶² The EU VAT should simply be levied on the actual VAT base.

From an administrative point of view, VAT is a convenient source of finance since an EU VAT could and would have to be designed to piggy-back on national VATs. It would thus be a system of tax sharing, funnelling VAT collected by national tax authorities directly to the Union without passing via the national budgets and the national treasuries (or their equivalent). The fact that national VAT rates differ between member states and within member states between categories of goods and services constitutes no problem.⁶³ The EU VAT could simply be levied at a single rate on all goods and services. There is no reason why, as suggested in the aforementioned report from the European Parliament, there should be two different tax rates. VAT is not used as a vehicle for redistribution at national level and there is no logic in assigning that role to it at the European level.

An unadulterated EU VAT could fully replace the present GNI-based contributions; thus it should not require any change of the respective VAT rates in the Member States. It would, for instance, in the case of Sweden, simply mean that out of the 25 per cent levied on most goods and services, of the 6 per cent levied on food and books, and the 12 per cent levied on certain services, x percentage points would go to the Union.

A European VAT would be very transparent, if, as suggested by many, the share of the VAT levied going to the Union is indicated on every receipt.

A drawback of replacing the GNI-based contributions, and thus the elimination of the topping-up provided by the latter, by an EU VAT (and other income or production related sources) is that it would increase the variability in the resource flow to the Union. However, such increased variability could be handled through the borrowing and carry-over mechanisms suggested above.

5.5.3 EXCISE TAXES ON DEMERIT GOODS

Most countries within the Union levy taxes on goods that by society are considered a vice or a luxury such as alcohol, tobacco and perfume. Taxes on these types of goods are important sources of revenue but they also have a corrective purpose, internalising the negative externalities associated at least with alcohol and tobacco.

Because of the relative ease with which these goods can be transported, the pressure to harmonise the tax on these types of goods is strong. Deep-rooted differences in society's view on these goods, in particular alcohol, militate against complete harmonisation, however. On the other hand, harmonisation is not necessary from a revenue perspective. An EU tax on these types of goods could perfectly well be levied as a piggy-back tax in the way suggested above for VAT. Whether such a tax would be appropriate or not is more a question of how many and what mix of revenue sources the Union should have. An argument against would be the additional costs involved in administering an extra tax.

Fairness cannot really be seen as an issue when it comes to vice taxes, as one of the purposes of the tax is to correct a market failure by making the consumer of the demerit goods bear society's cost for the consumption.

5.5.4 ENVIRONMENTAL TAXES

The majority of present EU Member States apply environmental taxes of one kind or another. The share of such taxes in relation to the total tax burden is, however, limited albeit rising. According to Eurostat, such taxes amounted to a little less than 7 per cent of total taxes and contributions in 1997.⁶⁴ Contrary to popular belief, environmental taxes in a broad sense have also been introduced and play a similar role in the new member states. All of them levy taxes or charges on motor fuels, most on other energy products and a good number on air emissions of NO_x and SO_x.

While environmental taxes are used extensively, there is a great variety both in terms of the design of the taxes and the rates at

which they are applied. In terms of fiscal importance, energy taxes dominate. As much as 95 per cent of environmental tax revenue comes from the energy and transport sectors. The rest is made up of taxes on emissions, chemical substances, products, waste and natural sources.

No environmental taxes are applied at the European level despite innumerable initiatives by the Commission to this effect. Several attempts have been made to introduce a combined CO₂ and energy tax, for example. Prior to the Earth Summit in Rio de Janeiro in 1992, the Commission prepared a concrete proposal for its introduction but no consensus could be reached in ECOFIN. A Council decision on a proposal by the Commission for a minimum energy tax was blocked by Spain. Proposals for other possible EU taxes, such as on solvents, fertilizers, pesticides, cadmium and pollution caused by aviation have not got off the drawing board. Other attempts aimed at broadening the range of instruments intended to address environmental concerns and foster sustainable development have been bogged down after years of discussions. In summary, the success of the Union in putting into practice its professed concern for the environment has so far been very limited.⁶⁵

The failure of the Union in this respect is so much more disconcerting given that most individual states see the rationale for environmental taxes – evidenced by having introduced them of their own volition – and given the obvious collective benefits of concerted and coordinated action in this area. The negative external effects that environmental taxes seek to address in very many cases go beyond national borders which justifies lifting decisions on them to the supra-national level. In some cases, like a tax on CO₂ emissions, the ideal situation would be to lift decision-making to a global level. But short of that, the European level is a natural second-best solution.

The single most important stumbling-block preventing environmental taxes at the European level is the requirement that all decisions on revenue be taken unanimously by the Council of Ministers. Ubiquitous fears that environmental taxes would

negatively affect the competitiveness of one or the other industry of a particular Member State, combined with the right of veto will most likely prevent any advancement in this area. Realising this, the Portuguese presidency proposed introducing majority voting for environmental tax issues, but with no success.

If, however, the unanimity principle were to be abandoned as part of a more general overhaul of decision-making regarding the budget, harmonised environmental taxes could and should be an important component of a fiscal package for the Union. Its role would not predominantly be one of generating revenue for the general operations of the Union. Much of the revenue would probably have to be earmarked for measures on the expenditure side to complement with carrots the stick-effect of the taxes. Such measures would most likely be necessary in order to gain political acceptance in the Member States that would be most affected by the taxes.

5.5.5 PERSONAL INCOME TAX

Of the different revenue sources for the Union that have been discussed, personal income tax is probably the least appropriate one. The pressure to harmonise is very limited because of low labour mobility. Together with property tax, it is part of a shrinking set of resources over which national (and local) governments have full discretionary power. Harmonisation of income taxes would rob national governments of the tool necessary to finance expenditure that, for historical reasons and because of political preferences, deviate from the norm in the Union.

A co-occupancy (piggy-back) tax is also difficult to conceive of given the broad range and complexity of national tax schedules in terms of personal and family exemptions, allowances etc., differences that would make harmonisation very difficult.

5.5.6 CORPORATE INCOME TAXES

Companies are increasingly mobile, and the pressure is mounting to harmonise corporate income tax in order to avoid tax competi-

tion within the Union. Today, however, base harmonisation is virtually non-existent and the route towards it may prove difficult despite the obvious collective benefits associated with it. An EU corporate income tax is thus not realistic in the short run, but it could be in the medium and long term, when the external pressure has led to the necessary base (and rate) harmonisation.

If at that time the Union would opt for such a tax, it would have to be implemented as a co-occupancy tax as the total revenue from it would far exceed the financing needs of the Union. As a co-occupancy tax it would be easy to administer. It would meet the horizontal equity criterion but it would not be immediately visible and transparent to the citizen of the European Union.

5.5.7 ECB PROFITS

The European Central Bank is a European institution but it is owned by the member states' central banks. Its paid-up capital is € 4.1 billion and foreign reserves transferred to it from the member states' central banks amounted to the equivalent of €50 billion. Capital contributions and reserves have been provided according a formula taking into consideration the population and GDP – each with a 50 per cent weight – of participating member states. Member states' central banks are remunerated on their claims in respect of the foreign reserve assets transferred by them to the ECB.⁶⁶

The regular income of the ECB is derived primarily from investment earnings on its holdings of foreign reserve assets and its paid-up capital and from interest income (seigniorage) on its 8 per cent share of euro banknotes in circulation.

According to the present statutes, out of any net profit of the ECB, 20 per cent may be transferred to a general reserve fund (subject to the latter not surpassing 100 per cent of the capital). The remainder shall be distributed to the shareholders of the ECB in proportion to their paid up shares.

Given that the Member States are the owners of National Central Banks, the net profits of the ECB are effectively, albeit in two steps, transferred to the national governments. Pre-

sumably, the Member States participating in the EMU could forfeit this redistributed net profit of the ECB in favour of the Union. It is important, however, that a reallocation of ECB profits from Member State governments to the Union in no way reduces or is seen to reduce the independence of the ECB.

Given that the ECB is a truly European institution having its profits accruing to the Union would appear very natural. A complicating factor would be member states not participating in the third phase of the EMU. A reasonable arrangement is that they should contribute the equivalent of what their central banks would have received as distributed profits, had they been full members of the EMU.

ECB net profit in 2002 amounted to € 1.2 billion. Transforming ECB profit into an own resource financing for the Union would only meet a small share of the latter's financing requirements. For symbolic reasons, however, it would make good sense to have the profits of this truly European institution accrue to the Union. If total seigniorage – most of it today accrues to the national central banks that are part of the European System of Central Banks – were to accrue to the Union, it would constitute a non-negligible source of revenue to the Union.

5.5.8 WITHHOLDING TAX ON INTEREST INCOME

With the integration of the world financial markets, the mobility of financial savings is very high, eroding the tax base for those Member States that tax capital gains. Some countries in the Union have no withholding tax, which directly affects those that do. It is therefore in the direct interest of the latter group of countries that harmonisation is achieved in terms of the tax base and the tax rate, as well as in the principles guiding the provision of information on financial income earned.

Several obstacles to such harmonisation exist, however. The EU countries benefiting from the in- or through-flow of tax-evading capital continue to resist reform, in particular the imposition of a European withholding tax. The agreement reached in November 2000, to either impose a withholding tax on interest income earned by foreigners or to provide information about foreigners'

interest income to their national tax authorities did not cover investments in equities, for example. Of the fifteen members, three chose to impose a withholding tax on interest earned by foreigners but at rates that reduce but do not eliminate the attractiveness of bringing capital to these countries. Furthermore, the introduction of withholding taxes on interest income earned by foreigners is not the same as harmonisation in the sense described above. It does not create a base on which to levy a European tax on interest.

The latter type of harmonisation may come one day, in which case a piggy-back European tax on interest would be conceivable. For such a harmonised tax to be efficient, progress also need to be made in eliminating tax havens elsewhere in the world; tax havens that otherwise would attract a large portion of the volatile capital now flocking to some of the member states.

5.5.9 GNI-BASED CONTRIBUTIONS

The present GNI-based contribution by member states is the preferred choice of those wishing to see the European Union as merely a union of nation-states. It undoubtedly meets many of the criteria against which potential sources of financing of the Union should be judged; it is horizontally equitable, it is easy to administer and it is perfectly stable.

The argument against it is that it puts the Union under a stifling tutelage of the Member States. This form of tutelage is not conducive to accountability and responsibility on the part of the EU institutions, and it has a negative effect on the whole economic management of the Union. Saying that, however, is not in any way tantamount to suggesting that the Union should have unconstrained taxation powers. It is rather a question of *how* the Union should be constrained. The latter question is discussed in greater detail in the next chapter.

5.6 Summary

- In the EC Treaty, a position reiterated in the Draft Constitution, it is stated that the Union should be financed wholly from

its own resources. This is no longer the case, as the GNI-based contributions now accounts for some 60 per cent of total financing. It is important that the original principle be restored.

- Financial autonomy of the Union should not be understood as an unconstrained right to tax. Rather it ought be defined as the right of disposition of the resources that would accrue to the Union on the basis of financing decisions taken as part of the medium-term financial framework. Such a framework would establish ceilings for expenditure or cost and set the parameters for the financing necessary to execute such a programme.
- Two types of revenue sources are in nature truly European and ought to accrue directly to the Union: duties and import levies, and ECB profits. A lowering of tariffs and import levies would increase the yield from the former sources. Appropriation of the seigniorage would require that all issuing of euro bank notes were the exclusive responsibility of the European Central Bank.
- These truly European sources cannot cover more than a portion of the financing needs and would consequently have to be complemented by one or several revenue sources that the Union, for administrative reasons, would have to share with the Member States.
- In the medium term, the one source for which base harmonisation can be achieved with relative ease is value added tax. An EU VAT is easy to collect as a piggy-back on national VAT. It will be more than adequate to meet the Union's financing needs, and it can easily be made transparent to the citizens of Europe. An EU VAT should be levied on the actual, harmonised base with no capping. It would thus constitute a straightforward system of tax sharing with the Member States.
- In the longer term, a Union VAT could be complemented by an EU corporate income tax if the collective benefits of harmonising taxation in this area have prevailed over limited short-term national interests.

- To complement these taxes, but with the primary objective of reaching EU policy goals in the environmental arena, a set of EU environmental taxes could be levied on trans-boundary pollution sources. Examples of such sources are emissions of CO₂, NO_x and SO_x.
- In order to arrive at the proposed composition of revenue for the Union, it will no doubt be necessary to reform the decision-making process. The present principle that any decision concerning revenue requires unanimity in the Council of Ministers effectively preserves the *status quo*. Qualified majority voting should be extended to the choice of revenue sources and the harmonisation of tax bases.

6 INSTITUTIONS, INSTRUMENTS AND PROCESSES

We now turn to the core of the financial management framework – the multi-annual framework, the annual budget, and budgeting and accounting principles. Part of this regulatory framework has been integrated into the draft constitution presented by the Convention. At this stage, it is important to ask what should be given constitutional status and what should be referred to secondary legislation. Given the difficulty of changing a constitutional text, it is particularly important not to lay down rules and practices that may prove dysfunctional in the near future.

For easy reference, the main components of the current legal framework are presented in an appendix at the end of this report.

6.1 The need for a legal basis

The joint declaration of the Parliament and the Council of 30 June 1982 requires a legal basis beside the budget for the utilisation of appropriations for any “significant action”. In theory, this should limit other expenditure to pilot schemes and preparatory actions. The inter-institutional agreement of June 1999 caps the total amount of appropriations committed to such actions. In practice, it has occurred that preparatory measures have been artificially prolonged into the operational stage. Nonetheless, the restriction imposed by the above declaration implies that pure expenditure initiatives, unsupported by legislation, will have a low probability of survival.

The need for a legislative basis in turn ensures some level of generality of the rules governing the expenditure system in question. In this way, it becomes more difficult to promote narrow regional or sector interests. The requirement of a firm legal basis is consequently an important instrument for maintaining a reasonable degree of budgetary discipline.

6.2 The multi-annual financial framework

The current financial perspective (EU-15), valid for the period 2000–2006, establishes:

- total appropriations for commitments under 7 main headings, some of which are broken down into separate limits on expenditures for policy areas;
- total appropriations for payments (not disaggregated) in absolute value (1999 prices) and in relation to GDP;
- appropriations for payments pertaining to the accession process;
- a ceiling on appropriations for total payments in absolute value and in relation to GDP;
- a margin for unforeseen expenditure in relation to GDP (covering both unforeseen expenditures and lower-than-expected growth rates);
- a total own resources ceiling fixed in relation to the GDP.

An adjacent financial framework for EU-21 defines the policy areas pertaining to enlargement within the bounds specified by the financial perspective. The bounds on appropriations for payments are specified in relation to the GDP projected for the enlarged union.

6.2.1 LEGAL BASIS

Given the importance of the financial perspectives, their current uncertain legal status is not satisfactory. The basic framework should be included in the Treaty/Constitution, as is also provided for in the Convention draft constitution.

Further, the French tradition within which the EU financial management has developed makes a very sharp distinction between annual decisions, which are legally binding (*“loi de finances”*), and multi-annual decisions such as the financial perspectives, which are not. In the perspective of upgrading the multi-annual framework, this traditional distinction should be downplayed if not eliminated.

6.2.2 OBJECTIVES AND PRIORITIES

The time horizon of the multi-annual framework is long (at least 5 years), and it is natural to ask whether the categories used in the financial perspective are the most appropriate given current and foreseen overall EU policies. By fixing ceilings not only for the total but also for the main headings for the entire period, there is a risk that decision-makers impose too much of a straitjacket on the expenditure structure. This is particularly true in periods of change, such as can be envisaged in a Union with ten new Member States. The price paid for relative stability is that resources spent on dysfunctional expenditure systems are effectively granted immunity from reform, except on the occasions when a new financial perspective is to be negotiated. For this reason, it might be preferable to fix only the total envelope for the whole period and to fix the subdivision into main categories only for the following year or two.

A related issue is the inclusion or non-inclusion of a budget margin, i.e. an explicit slice of the total envelope that is not earmarked for a purpose but intended as a buffer to account for forecasting errors and pure contingencies. At present, such a margin exists and is rather large – of the order of 10 per cent – but this stems from the dual character of the budget, being based on both commitments and appropriations. If, as proposed below, a transition were made to a unified basis for budgeting and accounting, there would be a need for a more standard type of margin, that is a non-earmarked slice of the budget defined on the same basis as the budget in general (for instance, cost). As uncertainty increases over time, so should the budget margin. A reasonable magnitude of the budget margin could be 1 per cent of the total envelope for the first year, increasing to perhaps 4 or 5 per cent for the fifth year of the financial perspective. Exactly what would the appropriate size of the budget margins would have to be based on a statistical analysis of historical data.

6.2.3 TIME FRAME

Expenditure ceilings are used in several OECD countries but differ in design. The main differences are:

- *Fixed versus rolling:* In countries such as the UK and Sweden, the expenditure ceilings in use are rolled over every year. Unless previously adopted ceilings are changed, this amounts to adding a third year every time the ceiling is renewed. In the Netherlands by contrast, an expenditure ceiling is fixed at the beginning of each electoral period by the parties forming the government coalition.
- *Length:* The length of the expenditure ceilings normally varies between 3 and 5 years.

The main advantage of a rolling ceiling is the continuity assured. The price is political legitimacy in case of a change of government, as the in-coming government inherits a ceiling based on the political priorities of the previous one. The Dutch ceiling has a more explicitly political character, as a platform for the incumbent government.

In the context of EU, the choice of a fixed period seems less appropriate. The financial perspective is not the expression of political priorities reached by a group of decision-makers forming a government. On the contrary, the composition of the Council changes constantly as a result of elections in the member countries. Against this background, a rolling financial perspective would appear a more natural choice.

The first Financial Perspective spanned five years (1988–92). The second one covered a seven-year period (1993–99), as does the third one. The respective periods were not chosen on the basis of an evaluation of the pros and cons of longer or shorter periods but were rather the result of political compromises, to make the associated policy reforms more acceptable. A return to five years would seem reasonable, in particular if it were combined with a transition to a rolling framework, thus extending the effective horizon to five years from the current “average” three-and-a-half.

6.3 The annual budget

6.3.1 INPUTS VERSUS OUTPUTS AND OUTCOMES

The EU system of financial management has inherited the basic features of the French or Latin tradition. Some of its weaknesses are a legalistic perspective and an over-emphasis on inputs. Internationally, there is now a re-orientation towards outputs, reflecting a deeper concern for allocation and efficiency issues. These changes come together with an increased focus on citizen's perspective, transparency and accountability.

The Union financial management framework has not been unaffected by this trend. The new Financial Regulation, adopted unanimously by the Council in June 2002, reflects a true concern for output measures and a gradual move to activity-based budgeting has been initiated. The announcement in early 2003 that the Union has in principle decided to make the transition to accrual based accounting also testifies to an interest in modernising the principles underlying its financial management. But formal rules are of limited value unless they permeate decision-making at all levels, including the political one. It is doubtful whether the EU institutions have fully realised the implications of the initiated reform.

6.3.2 OPERATIONALISING SUBSIDIARITY

The principle of subsidiarity is a sound economic principle with wide support. In fact it is difficult to find anyone arguing against the principle as such. Simple as it may be in theory, it is difficult to apply in practice. Apart from a handful of very clear-cut cases, arguments both for and against higher-level involvement can be found, and it is matter of political judgement to decide which arguments carry the greatest weight. What importance will be attached to subsidiarity aspects in practical policy-making will therefore to a considerable extent be decided by the routines associated with such decision-making.

As indicated in chapter 4, a basic subsidiarity test of legal initiatives has been suggested by the Convention. The design is somewhat unusual, but the basic idea is sound and the system

could probably function as intended. One problem is that only new initiatives will be put to the test; existing policies can and should be questioned along the same lines.

Subsidiarity tests at the appropriation level are currently being introduced into the new financial management framework. One element of the new activity-based budgeting procedure is that for every project proposed, there must be a justification of why there is a need for the Community to intervene at all. The outstanding question is how to ensure a proper and thorough review of these justifications by the budget authorities. There is an obvious risk that the procedure in practice will amount to little more than producing a strained *raison d'être* to satisfy the formal requirement.

A good audit report may sometimes touch upon the deep issue of the rationale for Union involvement (or, more generally, state involvement), but not all auditors are able to formulate questions at that level. The French tradition that still dominates the auditing culture in the Union tends to focus on the legal aspects of economic management. What is needed is a procedure for recurrent evaluation of existing policies with enough political clout to affect policy-making at the higher levels. The task falls most naturally on the Court of Auditors, which will have to adapt its long-term focus and capacity building to the demands of subsidiarity- and citizen-oriented public management.

6.3.3 BUDGETING AND ACCOUNTING PRINCIPLES

The above mentioned Financial Regulation sets the new legal framework for sound financial management of the EU Budget. This ordinance requires the Commission to complete its shift to accrual accounting for its general accounts by 2005. The new Financial Regulation lays down an accounting framework based on a “dual” system. According to the regulation, the general accounts would be based on accruals accounting, whereas the budget implementation would remain “cash-based”, that is to say record receipts and payments.

The introduction of accruals accounting in the form of “general

accounts” is a step in the right direction. But, sitting on two chairs, effectively doubling the set of accounts for an indefinite period, instead of going all the way, seems less well-reasoned. The same mistake has been made by some countries, including Sweden. But it has been avoided by other reformers such as the UK, which made the full transition in two years.

Maintaining cash-based budgetary accounts in parallel with accruals-based general accounts unnecessarily complicates the accounting process. It complicates things for the readers, most importantly the decision-makers in Parliament and in the Council, as they have to understand the differences between the two sets and their importance. It is difficult to give both sets, in particular the general accounts, adequate attention in the political process. Experience from Sweden has shown that, while the general accounts are very much used as a management tool by the agencies themselves and in the relationship between the agencies and the ministries to which they answer, they have not found a clear role in the relationship between the government and parliament and in the general political process. The primary reason for this is that the immediate decision-making is linked to, and followed up in, the budgetary accounts and not in the general accounts. The same thing is likely to happen in the Union.

A continued focus on the traditional cash-based budgetary accounts furthermore undermines the initiated shift of focus of the budgetary process from inputs to outputs reflected in the introduction of activity-based budgeting (ABB) discussed above. ABB is one of the building blocks for an economic management that is concerned with efficiency. The other is an accounting and budgeting system that captures real resource use (=accruals) rather than cash flow.

Rather than simply grafting a set of general accounts based on generally accepted accounting principles on to a traditional system, the structure of the budget and the set of budgetary constraints used (appropriations etc.) should be changed in order to arrive at one single comprehensive and logically consistent system of economic management.

Budget constraints

For a logically consistent management system it is fundamental that the budget constraints used are compatible with and can be followed up directly in the accounts. In an accruals-based accounting system is recorded any event that changes the net worth of the accounting object. An event that diminishes net worth constitutes a cost; one that increases it constitutes revenue. For purchased resources consumed during the year, the cost arises when the legal obligation to pay is established, normally at receipt of invoice. For capital goods consumed over several years, the cost is the depreciation charge. For subsidies and other transfers, the cost is normally recorded when the cash transaction is recorded.

In addition to events that affect net worth, accruals-based accounts also record events that change the composition of assets or liabilities, such as, for example, the payment of an invoice that has already been recorded as a cost. The norms for when and how these different events are to be recorded and valued are defined by a slate of national and international authorities and institutions, the pinnacle of which, as far as public institutions are concerned, is the Public Sector Committee of the International Federation of Accountants (IFAC).

For budget constraints to be compatible with the principles of accruals accounting they should refer to events that are recorded in the accounts. Two alternatives exist, in principle: the recording of cost or the recording of payments. Constraining on the basis of payments, that is expressing appropriations in terms of payments, has the disadvantage that the type of information that is relevant to management – the economic nature of the payment, the programme, project or activity to which it pertains, etc. – is not recorded in normal accruals-based accounts; it is only recorded when the cost is registered.

The most appropriate basis for the core budget constraints – appropriations, as well as the aggregate ceilings – is cost. The latter would be the accrual equivalent of the aggregate of the sector ceilings presently set in the Financial Perspective.

Commitment appropriations

A natural corollary of moving to an accruals budget and accruals-based budget constraints would be to eliminate the present duplication of budget constraints, i.e. the use of commitment appropriations as well as payment appropriations. The two could be replaced by one single form of appropriations: the suggested cost appropriations.

In a budgetary system where a multi-annual financial framework is given a central role and where this framework is backed up by the proposed general stipulation that *“the Union shall not adopt any act which is likely to have appreciable implications for the budget without providing an assurance that the proposal or measure in question is capable of being financed within (...) the multi-annual financial framework,”*⁶⁷ there is strictly no need for a separate constraint on commitments, at least if the term “assurance” is taken to mean a solid investigation of the economic consequences of the proposal in question. As part of the multi-annual framework, forward projections of the costs of all permanent activities as well as of multi-year programmes, projects and activities should be made and matched against the overall cost ceilings for each year of the proposed five-year financial framework. To begin with the global cost ceilings should, as suggested above, include a flexibility margin. If there is still a risk of aggregate cost surpassing the total cost limit in a particular year, the budgetary authorities should be required to cancel or reschedule activities in order to stay within the ceiling.

Cost appropriations should be set on activities and would, when followed up directly in the accounts, permit a direct comparison between resource use and the results indicators established as part of the ABB approach.

Constraints on surpluses and on borrowing

In a system where the core constraint is set on costs, there is a need for flexibility as regards cash flow. Payments in a particular year can be higher or lower than cost. The discrepancy may result from short-term lags and leads in the execution of payments associated with recurrent activities, but they may also

result from investment expenditure deviating from aggregate depreciation. To handle these deviations, the Union must have the right of disposition of surplus financial resources as well as the right to borrow, both short and long term.

These rights must, however, not be unconstrained. As already suggested above, both types of situation could be controlled by constraints based on net-worth, i.e. the difference between assets and liabilities. If the so-called “golden rule” were to apply, the Union would not be allowed to have an outstanding stock of financial debt surpassing the total value of its assets. To accommodate short-term year-end fluctuations, the band could be widened to for example ± 5 per cent of the revenue of the fiscal year. Constraints on net worth can be tracked directly in the accounts.

The presentation of the budget

An accruals-based budget should be presented in the same way as the accounts so as to permit an easy ex-ante and ex-post comparison, that is, there should be a budgeted *profit and loss* statement, a budgeted *balance sheet*, and a budgeted *cash-flow statement* all expressed in economic terms, i.e. of the types found in the chart of accounts. In addition there should be a table with the costs associated with the Union’s activities grouped into appropriated categories and possibly separate identification of the cash-flow associated with capital investment.

All budgets should be presented for the five years of the multi-annual financial framework, albeit with considerably less detail for the latter years.

Comprehensiveness

There are a few remaining exceptions to the principles of universality and unity of the budget:

- the European Development Fund;
- borrowing and lending operations, although the general budget carries the burden of guarantee for these operations;
- the activities of the European Investment Bank;

- some of the decentralised agencies who have their own budgets, but who draw their revenue from a subsidy appearing in the general budget;
- special arrangements prevailing in the areas of the second and third pillars;
- exceptions to the non-assignment rules occurring some areas;
- a number of purely technical exceptions to the gross budgeting principle;
- “negative revenue” appearing in the own resources field, where Member States are reimbursed for the collection of customs duties and agricultural levies (currently 25 per cent).

Most of these appear unproblematic from a best-practice point of view. There is currently a movement towards orthodoxy in this respect, by integrating some of the above-mentioned exceptions into the budget. The last exception, however, is unnecessary and also lies in the way of an open discussion of administrative procedures and rationalisation in the field of own resources collection (see section 5.3.2).

6.3.4 COMPULSORY VERSUS NON-COMPULSORY EXPENDITURE

The distinction between the two categories of compulsory and non-compulsory expenditure has a long tradition. It has been difficult to change, as it affects the division of power between the Parliament and, in this case, the Commission. Logically, the taxonomy seems difficult to defend. Apart from the situations where the Union is tied by a formal and legally binding contract – which are few in number and altogether represent limited amounts – commitments are political and more or less binding. Agricultural expenditure has traditionally been considered to be compulsory, whereas administrative expenditure has been non-compulsory. From a judicial point of view, the hiring and firing of officials is surrounded by more restrictions than the subsidisation of farmers. The only intellectually defensible position is that the distinction be eliminated.

6.4 Roles and competences of the Commission, Council, and Parliament

The functioning of the economic management system depends on formal and informal rules as well as administrative capacity. In the case of the Union the general characteristics are:

- The Commission has a near-monopoly on investigative capacity; both the Parliament and the Council secretariat are weak in resources for this purpose. In principle, the Council members should rely on the capacities of their respective home administrations as coordinated by the Coreper members, but this is far from a perfect arrangement.
- The Commission has the unique power to initiate legislation within the first pillar, thus *a fortiori* power over the budget. This role has no equivalent in other governmental structures.
- The Council of Ministers and the *Coreper* committee are the fora where national interests are articulated and compromises are worked out. The composition of the Council is determined by the issue at hand; the ministers of agriculture decide on issues of agricultural policy etc. A weakness from the financial point of view is that it is somewhat unclear when the financial aspects of a certain issue are important enough for the ministers of finance to get involved. In principle, the socio-economic aspects should be defended by the ministry of finance of each Member State, but the ministers of agriculture in Council are poor defenders of this broader interest, in particular given the closed character of the meetings.
- The Parliament is the only directly elected body, a fact that confers political legitimacy. On the other hand, its resources for analysis and scrutiny are limited, and in most cases it has to rely on the Commission for this purpose.

The dominant budget authorities are the Parliament and the Council. The Commission monopoly of initiative is moderated by the fact that the Commission cannot ignore a strong opinion in the Parliament nor in the capitals of the Member States. The fundamental design problem in budgetary matters is therefore

how to balance the Parliament and the Council in a way that respects both the superior political legitimacy of the directly elected MP's and the national interests of the Member States as represented by the Council members.

But the specific aspect of defending fiscal discipline and economic rationality is a matter apart. The potential conflict between group interests and the general citizen's interest calls for some institutional countermeasure no matter what division of power between Parliament and Council is decided upon. It seems that both the Council and the Parliament are in need of the equivalent of the Congressional Budget Office in the US to decide when an issue is important enough to require the involvement of the ministers of finance in the Council and the finance committee in the Parliament. The Council secretariat and the scarce analytical resources of the Parliament are inadequate for this purpose.

Several parties have expressed the fear that a more important role for the Parliament in budgetary matters would jeopardise budgetary discipline. This need not be the case. In the Parliament, politics tends to be less deeply immersed in national interests, as the organisation of interests to some extent follows classical right-left party lines. It may turn out that costly or inefficient policies might be more easily reformed in the parliamentary context. Whether this is true or not, budgetary discipline can be safeguarded by

- maintaining a strong influence of the Council on the overall envelope and a strict borrowing restriction (see section 4.3 for various alternatives), and/or
- following a strict top-down procedure when voting in Parliament, voting first on main headings and then requiring that alternative proposals be financed within the same heading.

It must be recognised that fiscal discipline and economic rationality is not only about keeping a check on expenditure levels. How public resources are used is as important as how much. If a procedure more conducive to reform can be put in place, it may be worth a slightly higher expenditure level. Whether it is

will depend very much on the issue and the geometry of interest groups involved.

6.5 Budget follow-up and audit

6.5.1 REPORTING ON OUTPUTS AND OUTCOMES

A *sine qua non* for a successful shift from an input to an output focus in the economic management of the Union is a system of well structured reporting on outputs and outcomes built around sets of results indicators tailored to the particularities of each and every activity of the Union. An ambitious start has been made as part of the introduction of activity-based budgeting, but it needs to be developed. Most importantly, following up and acting on performance indicators must be made part of the management culture of the Union and of the political processes in the European Parliament, in the Council of Ministers and in the Member States.

In results-oriented management, there is always a risk that performance is measured too close to activities, yielding information that is important to managers but at best uninteresting to political decision-makers. If this is to be avoided, reporting focused on immediate outputs needs to be complemented by a broader and more profound analysis of the effects on society. Sometimes these higher-level effects can be captured in simple indicators – for instance related to health or unemployment. Practical experience from countries where management by results is in use shows that such indicators can indeed become politically relevant and very powerful instruments of policy-making. Procedures and routines also need to be developed for a structured dialogue between political decision-makers and management.

6.5.2 AUDIT AND EVALUATION

The constant monitoring built around appropriate sets of performance indicators must be complemented by independent in-depth evaluations and performance audits produced by the Court of Auditors or by external independent experts. Political failure does not necessarily take the form of mismanagement of

resources at the grass-root level or financial irregularities. Classical audit focusing on such aspects is indeed important for the maintenance of fiscal discipline, but recurrent, sector-wide evaluation is a prerequisite for identifying policy failures at a higher level.

A second important requirement for the successful use of audit and evaluation is the existence of an addressee. Reports from the Court of Auditors are widely disseminated and read, and they play a role in the formal annual discharge procedure in the Parliament. If the Parliament so desires, the Commission is required to report back to the Council and the Parliament what measures have been taken as a result of the audit report. Nonetheless, this procedure requires an agent in Parliament that takes the initiative. There is empirical evidence indicating that the existence of a distinct addressee and an automatic formal procedure for follow-up of measures taken has a beneficial effect on the workings of the system of audit and evaluation⁶⁸. Requiring the Commission to deliver information about remedial measures taken as a result of previous audit reports in its Annual Report could therefore be a means to strengthen the audit function.

Yet another way to strengthen the role of audit would be to integrate the system of legal sanctions into the Union's own legal framework. At present, the Union lacks a penal code. By consequence, legal proceedings following upon fraud or financial irregularities are handled in Brussels or Luxembourg according to Belgian or Luxembourg law. It would seem natural to create a procedure whereby such matters are handled by the Union's own Court of Justice. Penalties could still be handled by member states on an outsourcing basis.

6.6 Summary

The prominence given to the multi-annual financial management framework in the economic management of the European Union is sound. Important steps towards a modernisation of accounting and reporting principles have also been taken. None-

theless, current practices as well as those envisaged in the Convention proposal suffer from a number of deficiencies.

- The general movement towards increased focus on outputs and results should permeate the whole system of financial management, including communication with the political community.
- A general transition from the current dual basis of commitments and payments to a cost-based approach should be made, both in the multi-annual financial framework, the annual budget and the reporting system.
- The distinction between compulsory and non-compulsory expenditures cannot be defended and should be abolished.
- The multi-annual financial framework should be defined on a rolling basis.
- The audit and evaluation function can be strengthened by creating a system for recurrent, in-depth evaluation of sector policies, by designating an addressee for audit reports, and by requiring the Commission to report automatically on remedial measures taken as a result of previous audit reports. The Court of Justice could be given the responsibility for the legal proceedings following fraud or financial irregularities.

7 COMMENTS ON THE CONVENTION DRAFT TREATY

7.1 General comments

The Convention submitted a draft treaty for a European constitution to the President of the European Council on 18 July 2003. In the areas that concern the economic management of the Union, the draft treaty largely limits itself to incorporating the principles established in previous treaties and to codifying much of current practices where they deviate from the formal rules.

A more far-reaching ambition is noticeable in relation to the European Parliament, where the draft treaty seeks to strengthen the position of the European Parliament in the decision processes of the Union, thereby taking seriously a long-standing criticism concerning the “democratic deficit” of the Union. For example, the draft treaty proposes a shift to the “normal” legislative process in about 80 situations where hitherto other rules have obtained. In approximately 10 other situations the process rules have been altered in other ways, most important of which in connection with the annual budget procedure.⁶⁹

In other areas the draft treaty is rather conservative, effectively freezing the status quo. While referring to “sound financial management”, it would in practice solidify in a constitution principles which by modern standards would be considered far removed from best practice. A number of rather technical aspects regarding the economic management have been included in the proposal. It would be better to keep the wording in the Constitution generic and leave the technical aspects to secondary legislation.

Including the multi-annual financial framework in the Constitution will undoubtedly increase its status but the opportunity to make the framework a truly integral part of the budget process has not been seized. For the most part, the Convention has contented itself by simply transferring the text from existing treaties with only minor changes. The proposal reflects the many compromises that have been made during the preparation

of the draft treaty. As a result, many of the basic problems concerning the division of power between the major institutions remain unresolved, and the final outcome of the proposed changes may not necessarily be that the democratic deficit – if measured by the influence of the directly elected parliament – is reduced.

The proposal that qualified majority voting in the Council take the place of unanimity would eliminate the possibility of one member state vetoing proposals that have broad support. On the other hand the elimination of unanimity would make it easier for the Council of Ministers to come to a decision and thus strengthen its position vis-à-vis the Parliament.

Furthermore, the draft treaty effectively solidifies the present dichotomy in the budget process whereby resources and resource use are decided upon separately, the decision on resources being the prerogative of the Council of Ministers. This separation is unfortunate and makes reform of the Union budget – to make it more in line with the basic principle of subsidiarity – more difficult. The reason is that the present gridlock, involving most importantly the CAP and the rebate issue, will need to be disentangled in a comprehensive process.

The remainder of this chapter presents comments on the articles that are particularly important to economic management issues and where modifications appear necessary if the Union is to live up to its ambitions to follow the principles of modern sound economic management.

7.2 Specific comments

Article 52:

2. The revenue and expenditure shown in the budget shall be in balance.

Comment

Sound financial management does not require that the budget must be in balance every single year. As we discussed above,

the budget balance will – particularly if financed by truly own resources over which the Union has full right of disposition, as we recommend that it should – naturally deviate from zero in one single year. What is important is that the budget be in balance in the medium term. The Union should neither build up net assets nor consistently be in debt.

Article 52:

5. With a view to maintaining budgetary discipline, the Union shall not adopt any act which is likely to have appreciable implications for the budget without providing an assurance that the proposal or measure in question is capable of being financed within the limit of the Union's own resources and the multi-annual financial framework referred to in Article 54.

Comment

This clause contributes to budgetary discipline. The strength of this requirement depends on what is implied by the word “assurance”, which is not unequivocal. A better alternative would be to require a formal investigation showing that the budgetary restrictions are indeed satisfied.

Article 53: The Union's resources

1. The Union shall provide itself with the means necessary to attain its objectives and carry through its policies.
2. Without prejudice to other revenue, the Union's budget shall be financed wholly from its own resources.

Comment

The wording of Article 53:1 reflects the view that it is the responsibility of the Union to find the necessary financial resources. In other words, the Union should not be financed by the Member States. In concrete terms, it is a rejection of the so-called fourth source, i.e. the GNI-based contributions.

In Article 53:2 the part “*without prejudice to other sources*” has presumably been added so as not to exclude GNI-based contributions. A logical inconsistency is thereby introduced in the phrase; if the budget shall be financed *wholly* from its own resources it cannot also be financed by other revenue. The addition also contradicts the preceding paragraph, which effectively excludes Member State contributions.

Article 53: cont’d

3. A European law of the Council shall lay down the limit of the Union’s resources and may establish new categories of resources or abolish an existing category. That law shall not enter into force until it is approved by the Member States in accordance with their respective constitutional requirements. The Council shall act unanimously after consulting the European Parliament.

4. A European law of the Council shall lay down the detailed arrangements relating to the Union’s resources. The Council shall act after obtaining the consent of the Parliament.

Comment

The stipulation in Article 53:4 that any decision on types of revenues and on a limit of the Union’s resources require unanimity, plus the approval of the Member States, will render policy changes very difficult. In practice it thus negates the ambition stated in the preceding paragraph that the Union should be financed wholly from its own resources.

Article 54: The multi-annual financial framework

2. A European law of the Council of Ministers shall lay down the multi-annual financial framework. The Council of Ministers shall act after obtaining the consent of the European Parliament, which shall be given by a majority of its component members.

Comment

The article provides a framework for the multi-annual financial framework, which is to be based on a European law of the Council Ministers, requiring qualified majority in the Council and consent from the European Parliament (acting on a simple majority of its members). The article is silent on what happens if a qualified majority cannot be reached in the Council, or if consent from the Parliament is not obtained. From Article III-308 it is clear that the idea is to resolve the situation by prolongation of the framework for the preceding period, but this is a temporary stop-gap, not a comprehensive solution of a basic constitutional dilemma.

Article III-308

1. The multi-annual financial framework shall be established for a period of at least five years in accordance with Article I-54.

Comment

This article elaborates the basic rules for the multi-annual financial framework. The text is, however, silent on the basic issue of rolling versus fixed-term ceilings, which is more important than whether the ceiling is fixed for four, five or seven years.

Article III-308 cont'd

2. The financial framework shall fix the amounts of the annual ceilings on commitment appropriations by category of expenditure and of the annual ceiling on payment appropriations. The categories of expenditure, few in number, shall correspond to the Union's major sectors of activity.

Comment

Given adequate control mechanisms as part of the multi-annual framework, the control mechanism represented by commitment appropriations is superfluous. Furthermore, the introduction of accruals accounting ought to be followed by a move to cost

appropriations in order to obtain a consistent and simple system of economic management of the Union. It is therefore inappropriate to fix in the Constitution the exact design of the mechanisms used to constrain the budget; the paragraph ought to be more open-ended.

Article III-310

5. The Conciliation Committee, which shall be composed of the members of the Council of Ministers or their representatives and an equal number of members representing the European Parliament, shall have the task of reaching agreement on a joint text, by a qualified majority of the members of the Council of Ministers or their representatives and by a majority of the members representing the European Parliament within twenty-one days of its being convened, on the basis of the positions of the European Parliament and the Council of Ministers.

Comment

The article lays down the basic modalities of the budgetary procedure – process rules and timetable. As such, it appears reasonable. The traditional distinction between mandatory and non-mandatory expenditure has been abolished, which is a step forward. On the other hand, the article suffers from the same deficiency as noted above – it does not resolve the basic dilemma of division of power if the Council does not reach a qualified majority or if the Parliament does not reach the three-fifths majority of the votes cast necessary to overrule the Council.

Article III-312

In accordance with the conditions laid down by the European law referred to in Article III-318, any appropriations, other than those relating to staff expenditure, that are unexpended at the end of the financial year may be carried forward to the next financial year only.

Comment

The paragraph implicitly assumes a continuation of the present set of control instruments which is unfortunate, given the decision to move to accruals and its implications.

Article III-314

[...]

The Commission shall also submit to the European Parliament and to the Council of Ministers an evaluation report on the Union's finances based on the results achieved, in particular in relation to the indications given by the European Parliament and the Council of Ministers pursuant to Article III-315.

Comment

Even if the term "results" is used in the paragraph, the emphasis is on finances. Focus on performance and the citizen's perspective is not reflected in the text.

Article III-315

4. At the request of the European Parliament or the Council of Ministers, the Commission shall report on the measures taken in the light of these observations and comments and in particular on the instructions given to the departments which are responsible for the implementation of the budget. These reports shall also be forwarded to the Court of Auditors.

Comment

The paragraph requires the initiative of the Parliament or the Council. Preferably, the requirement of reporting should be made intrinsic to the process.

Article III-321

3. Without prejudice to other provisions of the Constitution, the Member States shall coordinate their action aimed at protecting the Union's financial interests against fraud. To this end they shall organise, together with the Commission, close and regular cooperation between the competent authorities.

Comment

As a general framework for combating fraud, the proposal is reasonable. Its main deficiency is the lack of a consistent procedure for pursuing illegal or irregular activities in the Union's own institutions. At present, the legal procedure in connection with such activities is handled by the Belgian or Luxemburg judicial system. This appears to be an anomaly, since it would be more consistent to let the Union's own court assume responsibility for this procedure.

8 POLICY CONCLUSIONS

In this concluding chapter, we pull together the various policy conclusions that have been presented in previous chapters. These proposals fall into two main categories. The first comprises a number of reforms that we believe to be well founded no matter what role one envisages for the Union in relation to its Member States. The second group of proposals concern the contentious issues of power division between the Member States and the Union, between the Council and the Parliament, etc. For this second category, several alternatives are presented, corresponding to a fairly wide span of views along the federation-confederation axis. The proposals are grouped into constitutional issues (§8.2), financing (§8.3), and micro rules of budgeting and accounting (§8.4). We start the discussion by surveying what we believe to be the main problems of economic management of the Union.

8.1 Overview of the problems

In chapter 1, we presented a set of fundamental objectives which ought to guide the development of the economic management of the Union. We return to each one in turn.

Democracy

There is a longstanding discussion about the democratic deficit, maturing now in concrete proposals for a stronger influence for the Parliament in budgetary matters. Given the right procedural framework – more specifically a strict top-down voting order and binding restrictions on borrowing – such a shift need not put budgetary discipline at risk. Further, whatever role is given to the Council in the future constitution, it is necessary to open up Council discussions to the public. Even if the Council and the Parliament are not formally viewed as the two chambers of a bicameral parliament, this is what the structure in fact boils down to. That legislative processes be open is a very basic democratic requirement.

Subsidiarity

There is need for a constant questioning of the rationale for Union interventions – a test of subsidiarity in a wide sense – both in the preparation of new legislative initiatives, as a recurrent exercise in evaluation, and in the annual budget cycle.

A European perspective

Defending the European perspective against national or sub-national interests is in many respects the same problem as defending national collective interests against group interests in national legislatures, and institutional solutions to the dilemma can be sought along similar lines. The European perspective has suffered greatly from the net-contribution dispute that has haunted EU financing discussions since the mid-1980's. Finding a road back towards the original ideas of a Europe without borders requires reforms of both policies and methods of financing. Policies must focus on collective services that are more efficiently provided at the European level. Similarly, revenue sources should be sought as far as possible among genuinely European revenues and taxable resource flows. In this way, the partition of inflows and outflows into national contributions and benefits and the instinctive and confining calculations of net contributions would become difficult or impossible.

Safeguarding of national interests

The discussion about national interests has to a large extent revolved around the division of power between Council and Parliament and voting rules within the Council. But nations are not monoliths, and more often than not the invocation of national interest serve as a cover for narrow group interests. The Convention proposal on a subsidiarity test where national parliaments rather than governments are the actors is interesting, as it lays bare the potential disagreement about what constitutes the national interest.

Economic rationality and fiscal discipline

The main problem of the EU financial management system is not one of budgetary discipline as measured by expenditure

ratio or deficit. The problem is rather on the allocation and efficiency side. The over-emphasis on inputs and legal aspects leaves little room for an analysis of socio-economic or productive efficiency. The attitude is now changing, reflecting an international trend towards results-based management and increased interest in policy evaluation.

Efficiency of the decision process

The main problem of the current decision-making processes is their strongly conservative effect on policy-making. The requirement for consensus in the Council reinforces the status quo. It also makes redistributive efforts less efficient, as the consensus requirement tends to diffuse scarce resources over large areas in an effort to produce “something for everybody”. In the expansion phase of the Union, this conservative force has *de facto* contributed to fiscal discipline, but as the Union now matures, the dysfunctional effects of the decision-making system threaten to outweigh the positive effects.

Simplicity

As is clear from the analysis in earlier chapters, current decision-making procedures and management principles are unnecessarily complex. The Convention has made important steps toward a simplification of the rules, but the process can doubtless go further by unifying decision-making procedures even more than what has been suggested by the Convention.

8.2 Institutional alternatives

8.2.1 REACHING A DECISION

In a unicameral parliament, there is no reason to distinguish between budgetary and other decisions. The same procedure applies to budget decisions and to new legislation. In bicameral parliaments, the situation is different, given that the chambers are normally based on different principles of representation, and it is not uncommon that different sets of rules apply in financial and other matters.

Starting with problem of general legislation, we see basically three alternatives. In the first two, the Council and the current Parliament are considered as two chambers of an extended parliament. Proposals for new legislation is discussed simultaneously in the two chambers and voted upon according to the internal voting orders of each chamber. In case of disagreement, a conciliation committee is formed to negotiate a common position with the support of the Commission. Where the two alternatives differ is how a situation where no common position can be arrived at is resolved.

- In the *first alternative* the two chambers vote together using, for example, the weights defined in the Nice agreement (345 and 732 votes, respectively). This is a common solution in countries where the two chambers are considered to have largely the same political authority. If not, the weights can be adjusted accordingly.
- In the *second alternative* the Commission's proposal would become the default alternative. Alternatively, the Commission would play the role of mediator between the Parliament and the Council. A problem with this solution is that the Commission would sometimes be considered as party to the conflict.
- The *third alternative* would be for proposals for new legislation to be treated according to the legislative procedure proposed by the Convention.

Turning now to the financial sphere, there are similarly a few main alternatives, which can be grouped according to the number of degrees of freedom accorded to the Parliament.

- In the most advanced alternative, the Parliament and the Council would be given full powers of taxation, and the joint decision of the two arms of the budgetary authority would be based on a general procedure as outlined above.
- A second alternative is to give the Council the unique right to decide on revenue sources – tax bases and other – whereas the Parliament and the Council would jointly decide on tax rates and expenditure.

- A third alternative, fairly close to the *status quo*, is to let the power over both the revenue sources and the total envelope remain in the Council, whereas the Parliament is given authority over the expenditure structure.

The third alternative has the drawback of separating the discussions about revenue and expenditure, but seems to have gained some acceptance in the current debate. The Convention draft constitution is more conservative in requiring a three-fifths majority for the Parliament to exercise authority over the expenditure side of the budget.

8.2.2 MAJORITIES AND QUALIFIED MAJORITIES

The current system of voting relies on a fairly complex combination of nonlinear relationships between the population figures and the number of votes in the Council and number of representatives in the Parliament, respectively. Furthermore, the mechanism of qualified majorities in the Convention proposal uses a number of different definitions (different percentages, percentages of number of MP's versus number of votes, etc.). It would be desirable to reduce the number of mechanisms. A simple compromise between national interests and the classical rule of "one man, one vote" would be to take as a starting point that basic legislation should require the assent of a majority of Member States as well as a majority of the European citizens as represented in the two institutions, the Council of Ministers and the Parliament⁷⁰.

Qualified majority could also be defined on this basis; for example two thirds of member states and two thirds of the members of parliament.

8.2.3 CHECK ON SUBSIDIARITY

The impact of the subsidiarity principle can be strengthened at different levels:

- The subsidiarity aspect of proposed Union activities should be reviewed by Member State parliaments according to the proposal from the Convention. The Court of Justice is the

institution responsible for the legal analysis and deliberation pertaining to the subsidiarity condition.

- The Commission should be entrusted with task of not only justifying Union activities at the micro level in the budget proposal but to also systematically evaluate larger policy areas from a subsidiarity perspective. The Court of Auditors should develop its capacity in the same direction.

8.2.4 COMPATIBILITY WITH THE CONSTITUTION

The Court of Justice remains responsible for checking the compatibility of new legislation with the constitution. The right to take issues related to this condition to court should be fairly widely defined.

8.2.5 CHANGES TO THE CONSTITUTION

Changes to the constitution should require a qualified majority in both chambers. The precise meaning of “qualified” will have to be negotiated.

8.3 Financing the Union

The Draft Treaty stipulates that the Union shall be financed by own resources, but the decision-making procedures suggested to apply to anything concerning revenue would make it difficult to achieve that. As shown in chapter 5, revenues from sources immediately linked to the Union itself cannot be expected to satisfy the needs, so some supplement from other income sources is necessary.

8.3.1 CHOICE OF TAX BASES AND TAX ADMINISTRATION

* The traditional own resources, tariffs and import levies, are the natural bases to start with. It should be noted that the gradual shrinking of this revenue is to a considerable extent due to the Union’s policies in the trade area. A more liberal trade policy would partly restore the contributions to previous levels.

- A second natural source of financing for the Union is European Central Bank profit. This presupposes that all issuing of

euro bank notes are the exclusive responsibility of the European Central Bank. It is important that making ECB profits accrue to the Union rather than to the member states does not in anyway limit the autonomy of the Bank vis-à-vis the Union.

- VAT is the most natural complementary source of revenue. The tax should be implemented as a tax-sharing arrangement with national tax authorities and levied on the actual VAT tax base.
- Environmental taxes tied to trans-boundary pollution sources such as fossil-fuel combustion could be levied primarily to achieve policy objectives in the environmental area. The net revenue would probably be limited, as much of the revenue would have to be used to subsidise investment aimed at limiting pollution.
- The Union should be responsible for the administration of the first two sources. This does not necessarily mean that it should create its own new administration; the levying of taxes and fees could still be performed by national authorities on a contract basis.

8.3.2 BORROWING

Without jeopardising fiscal discipline, the Union could be permitted to borrow to cover fluctuations in revenues and expenditures up to a limit set by the Parliament and the Council.

8.4 Instruments

8.4.1 MULTI-ANNUAL FINANCIAL FRAMEWORK

The Financial Perspective is presently the key instrument for maintaining budgetary discipline in the medium and long term. The legal basis for the Financial Perspective has been inter-institutional agreements. The European Convention has proposed incorporating its renamed equivalent, the Multi-annual Financial Framework, (MFF) in the new Constitution – a well-justified proposal, given its importance.

As regards the role, design and decision-making related to the MFF, the Convention has largely limited itself to transferring the provisions regarding the Financial Perspective. This is unfortunate as it, if the text is adopted as it stands, would lock in a number of aspects of present financial management in the Union that, by modern standards, cannot be considered best practice. Our recommendation would be to make the relevant text in the constitution more generic, leaving it to secondary legislation to establish the more technical aspects of the MFF. The same should be done with the articles dealing with the annual budget.

Preferably, the MFF and the annual budget should be given the same status and the processes of deciding on them merged into one. Given a rolling MFF, the decision-making on the five years – the up-coming one (the traditional annual budget) and the subsequent four years of the MFF should be decided on in one single process and according to the same rules and procedures.

Time span

The time span suggested in the Draft Treaty, five years, is reasonable. Most expenditure ceilings in use vary between three and five years. The Union budget does not contain large transfer programmes subject to business cycle variations, which makes the five years suggested in the Convention seem appropriate.

Periodicity

The Union is not led by a government that has been elected on the basis of a particular political programme. The commissioners are picked from various political backgrounds, and the composition of the Council constantly changes with the outcome of Member State elections. Rather than to establish the ceiling for consecutive periods it would be natural to design the MFF as a rolling instrument. This would on the one hand ensure a healthy continuity and on the other give the Union greater flexibility and the chance systematically and constantly to review the composition of the budget.

Adjustment for inflation

A nominal expenditure ceiling is a means of expressing commitment to a low-inflation policy. This is particularly important in countries with a high expenditure ratio, in which the public expenditure level itself is large enough to affect macroeconomic variables. For the Union, with expenditures corresponding to one or a few per cent of GDP in the foreseeable future, this seems less relevant as an argument. Given the difficulty of macroeconomic forecasting, in particular over a period as long as five years, a real expenditure ceiling, which is adjusted for the rate of inflation, appears as the more logical choice.

Object

The global constraints set as part of the MFF should refer to resource use (costs) rather than to the financial resources made available to finance the activities of the Union.

Level of detail

Constraints should be set for the global envelope and by sectors as appropriately defined. In order not to constrain allocations unnecessarily, the level of detail for the latter years should be relatively low. The decision-making should be top-down; first the global ceiling then the sector ceilings.

Basis

The present dual system of commitment ceilings and payment ceilings should be replaced by one single set of ceilings set on the basis of cost.

Flexibility

The flexibility given by the proposed gradual refinement of the budget should be complemented by a budget margin that should increase for every year of the five-year period.

8.4.2 ANNUAL BUDGET DECISIONS

Top-down budgeting

A strict top-down budget decision procedure should be used in Parliament in order to ensure fiscal discipline. The design of

such procedures is fairly straightforward, and there is ample experience from countries to draw on.

- The decision sequence should start with decisions on the total envelope and headings.
- All counterproposals put forward in Parliament should be financed within the same heading.
- A supervisory role should be given to the Budget Committee. To ensure that the above restrictions are respected, measures should be taken to equip the Budget Committee with the necessary analytical capacity.

Carry-overs and borrowing

The current framework requires a balanced budget on an annual basis and prohibits borrowing. As shown in chapter 5, this leads to inefficient capital management and also presupposes the rather cumbersome ex post balancing via the GNI contribution. The possibility to balance the budget over a number of consecutive years instead of annually would not jeopardise fiscal discipline provided that the powers of borrowing were limited by constraints, determined by the member states via the Council and the Parliament. These constraints could be designed in different ways. One would be to set a limit in terms of net-worth.

The Union should also, within some limits, have full disposition of its financial resources including the right to carry-over unused financial resources to the subsequent year. To constrain the possibility of the Union of accumulating unneeded financial resources, a limit could be set based on positive net-worth. Anything above this limit should be returned to the Member States.

8.4.3 BASIS FOR BUDGETING AND ACCOUNTING

The introduction of accruals accounting in the form of general accounts is a step in the right direction. But the decision to maintain a separate set of budgetary accounts is questionable. Accruals accounting should be used throughout. All budget con-

straints, both in the multi-annual framework and in the annual budget, should be expressed in terms of cost, so that they are compatible with accruals and can be followed up directly in the general accounts.

8.4.4 PRESENTATION OF THE BUDGET

The budget should be the mirror image of the accounts. In addition to the standard budgeted *profit and loss statement*, the budgeted *balance sheet*, the budgeted *cash-flow statement*; the budget should present a break-down of cost by policy area, programme and activity.

8.4.5 EVALUATION, AUDIT AND FEEDBACK

The role of the Court of Auditors can be strengthened in several ways:

- The increased focus on results calls for a partial reorientation of the Court's activities, from concern with conformity with the rules to more sophisticated attempts at evaluation of outputs and outcomes.
- The current procedure in Parliament regulates the receipt and processing of audit reports but is less stringent regarding monitoring and follow-up. Preferably, the annual report from the Commission should include a mandatory section on what remedial measures have been taken as a result of the Auditors' comments.
- The responsibility for taking legal action in case of irregular or fraudulent behaviour should be transferred to the European Court of Justice.

8.5 What to do and what to avoid

In the introductory chapter, we formulated three questions all related to the complex issues of democratic decision-making and economic management. We summarise our answers below:

- *Democratic deficit and fiscal discipline*: It is, indeed, possible to strengthen the democratic dimension of the Union's institutions without jeopardising fiscal discipline. Discipline can be

maintained using other and more modern methods, relying on top-down procedures for budgetary decisions, a strengthened role for the Budget Committee and Budget Offices tied to the Council and the Parliament respectively. The medium-term financial framework should be defined on a rolling basis.

- *Policy orientation:* The Union has taken important steps towards modernising its principles of financial management, notably results-based reporting and the decision to move to accrual-based accounting, which indicate a greater concern for policy output. At a more fundamental level, there is a need for recurrent evaluations of larger policy areas as a basis for policy reorientation. The core issue in this context is whether the principle of subsidiarity is respected in the design of Union policies.
- *Financing the Union:* The systems of revenues can be made to harmonise better with the Union's functions and institutions. The most basic sources are tariffs and import levies, and revenues from the Central Bank. The next two most logical sources of revenue are VAT and environmental taxes.

What appears to be most acute at present is to avoid fixing rules and practices in the Constitution which are dysfunctional or do not correspond to best practice. Abandoning the rule of unanimity in the Council in issues related to revenues and harmonisation is necessary in order to improve the decision-making capacity of the Union. Furthermore, the constitution should leave open the possibility of a rolling multi-annual financial framework. The transition to a cost-based system of budgeting and accounting should not be hampered by referring in the text to the categories of "commitments" and "payments". These matters are preferably regulated in secondary legislation. The most important reform in the medium term is to establish a new system of own resources – one that reflects the intention of the Treaty by according a reasonable degree of financial autonomy to the Union. In this context, a limited borrowing facility is well justified.

In the longer term, the distribution of voting power in financial and other matters should also be open to reform. Rules of this kind are notoriously difficult to change, but the Intergovernmental Conference could declare its intention to simplify and streamline the basic design principles.

APPENDIX: LEGAL INSTRUMENTS IN THE PUBLIC FINANCE FIELD

The three normative sources are treaty provisions, secondary legislation and inter-institutional agreements.⁷¹

EC Treaty provisions:

- *Basic principles:* art. 268 (unity, universality and equilibrium), art. 270 (budgetary discipline), art. 271 (annuality and specification), art. 277 (unit of account);
- *Financing:* art. 269 (own resources and procedure for deciding about such resources);
- *Budget process:* art. 272 (procedure and respective powers), art. 273 (provisions for delayed decisions);
- *Execution:* art. 274 (sound management, Commission's responsibilities and powers), art. 275 (accounting), art. 276 (discharge procedure), art. 278 (currency issues);
- *Audit:* art. 279 (procedure for Council adoption of audit regulations), art. 280 (anti-fraud measures).

EU Treaty provisions:

- Special measures for financing the second and third pillars.

Secondary legislation:

- *Own resources system:* The first regulation was adopted in 1970 and has been amended on several occasions since. Specific regulations define the arrangements for collecting the VAT contribution (CR 1553/89) and the computation of the GDP basis (CD 89/1130/EEC).
- *Financial regulation:* Following art. 279 EC, the Council has adopted a number of successive regulations after consulting the Parliament and the Court of Auditors. The current version is dated June 2002 (CR 1605/2002). An adjacent Commission Regulation (2343/2002) lays down the corresponding rules for subordinate bodies that are legal personalities.
- *Budgetary discipline:* CR (EC) No. 2040/2000 lays down rules of budgetary discipline mainly for the agricultural

sector and provides the legal basis for the reserves under heading 6 of the financial perspective.

- *Guarantee fund for external actions:* Borrowing and lending operations outside the Community are guided by the CR 1149/1999. Risks involved are covered by a fund corresponding to 9 per cent of the loans granted.

Inter-institutional agreements:

The multi-annual financial framework and the rules on budgetary discipline have been laid down in a series of inter-institutional agreements between the Parliament, the Council and the Commission. The court of Justice has not so far ruled on the legal status of these agreements.

NOTES

- ¹ The Convention proposal that will be referred to in what follows is the report CON 850/03, dated in Brussels 18 July 2003.
- ² See among others Baldwin et al. (1997), Karlsson (2002), with further references.
- ³ Convention (2003), Art. III-327.
- ⁴ Case 1/58 Stork (1959) ECR 43.
- ⁵ Case 29/69 Stauder (1969) ECR 419.
- ⁶ Case 11/70 *Internationale Handelsgesellschaft* mbH (1979) ECR 1125.
- ⁷ Case 4/73 Nold (1974) ECR 491.
- ⁸ OECD (1999)
- ⁹ Andersen and Molander (2003), chapter 2.
- ¹⁰ IMF (2003), OECD (2002).
- ¹¹ Deardorff, A.V, Stern, R.M. (2002).
- ¹² European Commission, (2001).
- ¹³ Puga (2002), quoted in Sapir et al. (2003).
- ¹⁴ Sapir et al. op. cit.
- ¹⁵ Larsen et al. (1994).
- ¹⁶ Leonard, H.B., Walder, J.H. (2000). The report on the fiscal year 1999 contains a retrospective study of changes in the flows to and from the states.
- ¹⁷ The production of the public good it should be done at the lowest possible cost. Any additional cost caused by a deviation from that principle, for example because of lobbying by a region, should be borne by the beneficiary of explicitly recorded on the redistribution “account”.
- ¹⁸ Sapir et al. op. cit., p. 58.

¹⁹ Idem.

²⁰ Tarschys (2003).

²¹ Some early results are Plott (1967) and McKelvey (1976); for a survey, see Nurmi (1998).

²² Schofield (1980) showed that the non-existence of equilibrium was typical in a sense that can be made mathematically precise. More recently, Banks (1995) has corrected earlier proofs and shown that if the number of policy dimensions n exceeds $(p+1)/2$, where p is the number of decision-makers, there is in general no majority rule equilibrium. A straightforward application to budget voting in a typical parliament, where the number of appropriations is normally between 500 and a few thousand and the number of MP's ranges between 100 and perhaps 500, would lead us to expect a no-equilibrium situation.

²³ This is the classical median-voter outcome first derived by Black (1958).

²⁴ See e.g. Hallerberg & von Hagen (1997).

²⁵ Axelrod (1984).

²⁶ Molander (1992); see also Binmore (1998) for critical remarks.

²⁷ Eiser & Bhavnani (1974), Marwell & Ames (1981), Frank et al. (1993).

²⁸ Slusher et al. (1974).

²⁹ Pines (1976).

³⁰ Sensenig et al. (1972), Swensson (1967), Fox & Guyer (1978).

³¹ Ostrom (1990, 1992); Bromley (ed.) (1992).

³² Goodin (1986).

³³ Hall & Grofman (1990).

³⁴ Persson and Tabellini (2003).

- ³⁵ Akerlof (1991); further references can be found in Elster (2000).
- ³⁶ Buchanan & Wagner (1977).
- ³⁷ The hackneyed metaphor is about Ulysses and the sirens (Spinoza 1670, VII.1; Horkheimer & Adorno 1947; Elster 1984).
- ³⁸ For illustrations in the area of constitutional design, see Elster (2000).
- ³⁹ Grilli et al. (1991).
- ⁴⁰ For a survey, see e.g. Kahneman, Slovic & Tversky (1982).
- ⁴¹ Kahneman & Tversky (1979); Weaver (1986).
- ⁴² See e.g. Dixit 1998.
- ⁴³ For a comprehensive analysis of the problem of division of power and subsidiarity in the context of the Union, see Begg, D. et al., (1993)
- ⁴⁴ See the Convention draft proposal for a Constitution, Protocol on the application of the principles of subsidiarity and proportionality.
- ⁴⁵ For overviews, see Lijphart (1984) and Tsebelis and Money (1997).
- ⁴⁶ Baldwin et al. (2001).
- ⁴⁷ For an overview, see Convention (2002).
- ⁴⁸ Stern (1975), Neuhauser and Swezey (1999).
- ⁴⁹ Case C-295/90 ECR I-4193.
- ⁵⁰ The design of the present VAT-source is described in greater detail in section 5.5.2 below.
- ⁵¹ The same Council also decided to introduce an overall ceiling on the total amount of own resources that could be called to finance Community spending.
- ⁵² Schreyer (2003).

⁵³ Goulard and Nava (2003).

⁵⁴ Ibid.

⁵⁵ At the end of the year there may still be a discrepancy between revenue collected and expenditure, but this discrepancy is normally small.

⁵⁶ It is perhaps also worth pointing out that cash transfers to the accounts of the respective EU institution responsible for executing the budget would not have any negative effect on cash management provided that all the institution/activity accounts are part of a Union group account. In such an account, the individual accounts are nominal. Interest paid or interest earned is calculated on the net of the balances in all component accounts.

⁵⁷ Excess burden also depends on the composition of taxes as some taxes are associated with a higher excess burden than others.

⁵⁸ Given that duties and levies constitute a truly European resource it must be considered a bit odd that some member states include duties and levies collected by their customs authorities in calculations of their net contribution.

⁵⁹ The Community's entitlement to these resources is established as soon as the amount due is communicated to the importer by the competent department of the member state. The entitlements established are entered into the accounts of the Union, then credited, as the revenue is collected, to an own resource account at the National Treasury or its equivalent. Given that in fact, duties and levies are such a natural source of financing of the Union, one can ask why the payments need to go via the national treasuries and why, at all, the customs authorities are still national institutions. Customs control is a public good that, from a subsidiarity perspective, would best be exercised by the Union.

- ⁶⁰ The revenue is not derived from the actual tax base but calculated on a notional base taking into account the remaining differences in the national VAT tax bases. Furthermore the notional tax based is capped at 50 per cent of a member state GDP.
- ⁶¹ See, for example, European Commission (2002), p. 107.
- ⁶² In the “Draft report on a new system of own resources for the European Community”, Rapporteur Horst Langes, Committee of Budgets, proposes a complex equalisation mechanism whereby the total contributions by the member states at year-end would be calculated and compared with an established benchmark. If total contributions surpassed the benchmark, the country would be refunded and vice versa.
- ⁶³ The only problem is when goods or services are fully exempt from national VAT. Such exemptions would have to be eliminated or the EU VAT levied at a token 1 or 2 per cent.
- ⁶⁴ European Environment Agency (2000).
- ⁶⁵ In article 2 of the amended EC treaty adopted by the Amsterdam European Council it is stated: “*The Community shall have as its task (...) to promote throughout the Community a harmonious, balanced and sustainable development of economic activities, (...) improvement of the quality of the environment, (...) and economic and social cohesion and solidarity among Member States.*” In Article 6 of the same treaty it is the point is emphasised further: “*Environmental protection requirements must be integrated into the definition and implementation of the Community policies (...) in particular with a view to promoting sustainable development.*”
- ⁶⁶ In 2002 that remuneration amounted to € 1,141 million.
- ⁶⁷ European Convention (2003).
- ⁶⁸ Ahlbäck (1999).

⁶⁹ We are grateful to Hans Hegeland at the informal Convention secretariat of the Swedish Parliament for supplying an overview of the changes proposed.

⁷⁰ Baldwin et al. (2001).

⁷¹ Commission (2002).

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The European Union is growing, and integration is deepening. But is the Union coming of age in all respects? This report argues that when it comes to economic management, it is not.

Per Molander and Allan Gustafsson are international consultants in the field of public sector management, with a long experience from developed and developing countries. They have both worked in the Swedish Ministry of Finance, leading major budget reforms.

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