2011:3

Daniel Tarschys (ed.)

The EU Budget

What Should Go In? What Should Go Out?

Sieps
Swedish Institute for European Policy Studies

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– SIEPS 2011:3 –

Report No. 3
May 2011

Publisher: Swedish Institute for European Policy Studies

The report is available at
www.sieps.se

Cover: Svensk Information AB
Print EO Grafiska AB
Stockholm, May 2011

ISSN 1651-8942
ISBN 978-91-86107-25-3

Preface

To avoid an endless bargaining about budgetary priorities, the European Union adopts multiannual financial frameworks. Previously regulated only by inter-agency agreement, this practice is now inscribed in the Lisbon Treaty. With the present framework terminating in 2013, the discussion about the next long-term budget is already heating up.

In each round of negotiations, the same arguments recur. A point often made is that preference should be given to truly common concerns. With only about one percent of the EU gross national product at its disposal, the Union cannot compete with the member states in meeting the everyday needs of its citizens. Instead, its particular focus should be on initiatives providing "European added value" or "European public goods". While this principle is widely supported, there is less agreement on its practical application and implementation. In discussing common endeavours, each member state has also an eye to its "net position" in the long-term budget.

What does a "European public good" look like, and how can the European orientation of the budget be strengthened? These are the central questions of the present volume, in which some chapters deal with the definition of the concept and others propose procedural and institutional innovations that might promote common European interests. The emphasis of the analyses is on the expenditure side of the budget, but some authors discuss also the linkages to the revenue side.

By publishing this volume, SIEPS hopes to contribute to the on-going debate on the future of the European budget and the role it should play in the development of the European Union.

Stockholm, May 2011
Anna Stellinger
Director, SIEPS

SIEPS carries out multidisciplinary research in current European affairs. As an independent governmental agency, we connect academic analysis and policy-making at Swedish and European levels.

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Daniel Tarschys is Professor Emeritus in Political Science at the University of Stockholm. In 1994-1999 he served as Secretary General of the Council of Europe. He has been a Member of the Swedish Parliament where he chaired the Standing Committees on Social Affairs and Foreign Affairs. In the 2000 Convention drafting the EU Charter of Fundamental Rights he was the Personal Representative of the Swedish Prime Minister. He has also been Vice President of the International Political Science Association (IPSA). Tarschys chairs the Board of Riksbankens Jubileumsfond and the Swedish Council on Medical Ethics. He has been a member of the Board of the Swedish Institute for European Policy Studies (SIEPS) and is now a member of its international academic council. His publications include Reinventing Cohesion: The Future of EU Structural Policy (2003) and The Enigma of European Added Value: Setting Priorities for the European Union (2005), both available at www.sieps.se.

Peter Wostner is Deputy Director of Government Office for Local Self-Government and Regional Policy, the managing authority for structural funds and cohesion funds in Slovenia. He has over eleven years of work experience in the field of cohesion policy as well as regional development. He has been the Slovene negotiator of the cohesion policy regulation package, programming documents and was a member of the negotiating team for the 2007-2010 EU financial perspective. He holds a PhD in Economics from the University of Ljubljana and is the author of a number of articles on EU funds and EU budgets, as well as regional development.

Table of contents

1 In Search of European Public Goods 8

2 European Public Goods: Which Selection Criteria for the Multiannual Financial Framework? 12
Daniel Tarschys

2.1 Knowledge-based governance 15
2.2 A European public goods test in three stages 21
2.3 Priorities vs. posteriorities 34
2.4 Conclusion: Norms matter 38
2.5 References 40

3 The Governance of European Public Goods 42
Stefan Collignon

3.1 Defining public goods 42
3.2 "European" public goods 44
3.3 Collective action problems 46
3.4 Incentive structures 48
3.5 Money as a common resource 50
3.6 The governance of European public goods 51
3.7 Conclusion 55
3.8 References 56

4 European Added Value for the EU Budget 58
Friedrich Heinemann

4.1 Criteria 59
4.2 Evaluation of different reform types 63
4.3 Conclusion 71
4.4 References 72

5 EU Budget, Selection Criteria and Fairness 74
Peter Wostner

5.1 The EU and global transformations 75
5.2 The European response 78
5.3 Selection criteria: On fairness and procedural innovation 80
5.4 Tentative conclusion 83
5.5 References 85

6 The Value Added of the EU Budget: Subsidiarity and Effectiveness 87
Arjan Lejour & Willem Molle

6.1 The subsidiarity principle...87
6.2 The budget...92
6.3 Assessing the budget: Does the EU do what it is supposed to do? 96
6.4 Effectiveness: Does the EU do what it is supposed to do well?........104
6.5 Conclusions and recommendations..106
6.6 References 109

7 Cohesion Policy in the Long-Term Budget........................111
Willem Molle

7.1 The objectives and instruments 112
7.2 The instruments 116
7.3 Evaluation of effects..120
7.4 Sustainability of the effects 123
7.5 References 126

Sammanfattning på svenska...127

1 In Search of European Public Goods

In the next few years we will have to decide on the next multi-annual financial framework of the European Union. This is a good reason to revisit the old issue, *what should the EU be doing?* The full answer to that question is not given by the budget. The Union achieves much by means other than spending, but budgetary allocations are nevertheless crucial, also in determining the efficiency of the regulatory instruments, the "soft law" and other forms of influence.

The Member States are ambitious in setting agendas and adopting action plans for the European Union, but they are less keen to provide funding for all these plans and objectives. The budget of the Union has long hovered around one per cent of our common GNI. If we seriously sought to attain all the goals laid down in the Treaties and the decisions of the European Council (including the Europe 2020 platform), that would easily swallow large parts, if not all, of our combined GNI. The grand objectives of the European Union overshoot by far the means put at its disposal.

This makes it imperative to establish sound selection criteria for Union funding. As the resources of our national and regional governments substantially exceed those of the European Union, we cannot expect the EU to assume responsibility for all types of public spending. So what should be its specific contribution? What should go into the EU budget, and what should go out? What can the EU do not only better but *much* better than the member states?

These questions are intimately linked to a whole raft of disputes over the scope and purpose of the European Union, its relations to the member states, the meaning of subsidiarity and the desirable division of labour in the emerging system of multi-level governance. They are also related to long-discussed issues about the budgetary process, the composition of EU revenue and the structure of the expenditure side.

There are many challenges ahead for the European Union. The chapters in the present volume focus on normative issues, exploring the concepts of European Added Value and European Public Goods. They also propose institutional and procedural reforms that might boost genuinely common interests in the budgetary process.

* * *

With the regulatory side of European integration assuming increasing importance, we must care about the quality of EU policy-making. *Daniel Tarschys* pleads for more attention to be paid to the Union's "internal agenda". Well-equipped institutions, good analytical capacity, suitable deliberative procedures and timely adjudication constitute important European public goods in their own right. For other spending items he suggests a three-stage test. The first step is to check compatibility with official EU objectives, and the second is to identify the beneficiaries of various expenditures. These are often multiple and overlapping. The wider the implications of a policy, the greater the probability of substantial European added value. Expenditures without return flows to specific member states may be particularly strong candidates for EU funding. In the third step, the time frame should be examined. Sustainable, long-term, investment-type, development-oriented projects should be given preference over ephemeral, short-term, consumption-type or predominantly redistributive undertakings.

Stefan Collignon explains the nature of European public goods against the background of the existing literature. He distinguishes between public goods with different underlying incentive structures, which require different forms of governance. He then argues that European public goods are those that affect all European citizens together. Early European integration was based on incentives to cooperate, but with the creation of the euro, common resource goods dominate policymaking and here cooperation failure is frequent. The solution to this problem is in setting up a democratic government to administer these goods. We must become aware of the far-reaching externalities that have emerged with European integration, requiring new forms of governance. The chapter concludes with a discussion of the federalist and republican approach to public goods and argues that the republican paradigm is superior.

Many policies with strong characteristics of European public goods (EPG) remain under-financed. *Friedrich Heinemann* explores possible reforms that could boost incentives to finance such programmes and investments. Different types of institutional changes are analysed. The scrutiny includes correction mechanisms, new (and true) own resources and, as an innovative element to the literature, approaches where member countries contract out certain provisions of public goods to the European level. Granting the EU level more budgetary autonomy does not address the current flaws in the system, says Heinemann. A more specific result is that the substitution of national contributions through true European own resources cannot strengthen the support for EPG in the budget. Carefully designed correction mechanisms perform better. Other approaches that would promote European added value orientation in EU spending are the sale of European services to the member states based on voluntary contracts and a more convincing protection against biased evaluations of EU programmes.

Will preparation of the post-2013 financial perspective be marked by inertia and the familiar reflexes in favour of the status quo? Such a scenario is increasingly hard to justify, according to *Peter Wostner*. The EU faces new challenges as a consequence of the world economic and financial crisis, the changing climate and the demographic evolution. The transformations in the world's economic geography call for a timely and decisive policy response in the developed world, and in the EU in particular. However, objective selection criteria alone cannot be expected to deliver, since the member states have a systematic disincentive to take them into account. Wostner stresses the importance of fairness and equity in decisions on EU spending. He argues for a modified EU budget preparation process in which the size of the budget would be determined as a result of the agreement on policies, instead of vice versa, as is the case now. This could relieve the negotiations of the *juste retour* problem.

Arjan Lejour and *Willem Molle* examine the value added of various items in the EU budget by two approaches. First, they assess the justification of EU involvement according to the subsidiarity principle. The main arguments for concentrating policies at the EU level are economies of scale and internalising the external effects of national policies. Diversity in national preferences and circumstances speaks against centralisation. The two authors propose a substantial increase in EU spending on R&D and innovation, environment and external policies. These increments can largely be financed by less spending on agriculture on market intervention and, in particular, income support. With respect to stabilisation, there are reasons for a bigger role for the EU but this need not imply large spending. Second, they consider of the effectiveness of the EU budget by checking the degree to which the Union has actually reached its goals. For many policies EU spending is additional to national spending, so its effectiveness cannot be assessed in isolation. In general the picture is satisfactory as far as output performance is concerned, but the long term impact is less clear due to methodological constraints.

The Commission has recently proposed reforms to its cohesion policy, notably the concentration of priorities and the creation of a common strategic framework and other measures to improve the quality of the expenditure. *Willem Molle* examines these proposals in the light of normative economics and past performance. He describes the present objectives and the available instruments to reach them and then discusses the degree to which the policy has actually delivered. How far do these goals, priorities and implementation mechanisms have to change in order to be able to face the challenges of the future? Critically assessing the proposals of the Commission, Molle recommends a strengthened programming device so as to enhance consistency between objectives. He also proposes making disbursements of funds conditional upon clear improvements in the administrative and institutional capacity of the beneficiaries.

2 European Public Goods: Which Selection Criteria for the Multiannual Financial Framework?

Daniel Tarschys

After many tense battles in the 1980s, the member states of the European Communities decided to make budget frames extending over several years. These used to be called "Financial Perspective(s)", in the singular or in the plural, and were for a long time regulated by inter-agency agreement only. Now this important strategic decision is inscribed into the Lisbon Treaty, where its name is "Multiannual Financial Framework" (MFF) and its duration is defined in article 312 as a minimum of five years.

For the Framework succeeding the present Financial Perspective, the starting date should be 1 January 2014. The end date could then theoretically be 31 December 2018, but a longer time span is normally assumed. The Europe 2020 formula hints at a 6- or 7-year period, but other options are also conceivable. In his State of the Union Address on 7 September 2010, Mr Barroso proposed a 10-year framework with a mid-term review, a 5 + 5 formula adjusted to the terms of the European Parliament. Both democratic considerations and the need for foresight speak in favour of this solution.

Whatever the time frame ultimately chosen, the upcoming decisions present a good reason to revisit several questions related to the EU household. Which items deserve to be included in the MFF? Which have outlived their usefulness and should be taken out? Which equity and efficiency considerations should guide our decisions?

The "in and out" questions are intimately linked to a whole raft of disputes over the scope and purpose of the European Union, its relations to the member states, the meaning of subsidiarity and the desirable division of labour in the emerging system of multi-level governance. They are also related to issues about the budgetary procedure, the composition of EU revenue and the structure of the expenditure side.

The need for selectivity stems from the scant resources at hand. Over the last few decades, the EU budget has hovered around 1% of the GNI. There are few signs that member states will favour a radical departure from this level. Whatever the magnitude of the next MFF, the need for discrimination is obvious.

The questions addressed in this paper are basically *normative.* Two other important strands in the discussion of the EU budget deal with the *origins* of our present predicament (analysed either historically or through public choice theory) and with various *exit strategies* from the current budgetary gridlock; given the interests and veto powers of various countries within the Union, how can we move forward towards a better budget? We will revert briefly to the latter question towards the end of this chapter.

The EU budget is small in two ways

In proportional terms, the EU budget is small and shrinking. During the period 1993-1999, the payment ceiling was on average equivalent to 1.18% of the EU GNP. For the period 2000-2006, it sank to 1.06% of the EU GNI (used as base from 2002). The political pressure to constrain the growth of the EU budget was even higher when the current Financial Perspective for 2007-2013 was negotiated, resulting in an agreement to restrict the average payment ceiling to 1.00% of the EU GNI. However, due to the impact of the economic crisis in recent years and the consequent drop in the absolute level of the EU GNI, the average payment ceiling for 2007-2013 currently corresponds to 1.07% of the GNI.

The actual execution in payments has remained significantly lower. The average level was 1.06% of the EU GNI in the period 1993-1999 (with a significant decreasing trend) and 0.94% in 2000-2006 (stable over the period), leaving in both cases an average margin of 0.2% below the MFF payment ceilings.

Thus, in the first place, *the EU budget is very small compared with national and sub-national budgets*. According to the Europe 2020 programme, the member state governments dispose of between 45% and 50% of their respective GDPs, while the OECD and World Bank statistics offer a spread extending a little down from that level. Even if the somewhat larger flow to the poorer countries is taken into account, EU money accounts for a very small fraction of their total public outlays.

In consequence, the share of common concerns that can be dealt with through EU funding rather than national government sources is quite limited. However, the relative significance of the EU budget is also shrinking in another respect. Within the EU system, there is growing reliance and emphasis on the regulatory sphere. Over the years, *the impact of the European Union on the economic and social life of its member states has increasingly come to be exerted through extra-budgetary instruments.*

No longer a political dwarf, the EU wields influence in a steadily widening number of policy areas. Union directives and regulations play an ever-growing role in framing national rule-making, jurisprudence and practice. Various methodologically rather shaky estimates of the proportion of national regulations related to EU norms are bandied about, and corresponding figures are sometimes given for the proportion of EU-affected decisions in local government; for Sweden, 20% has been suggested for the national level and 60% for the municipal level. The exact magnitude of this share is of little importance, but the many footprints of EU norms in national policy-making, administrative practice and everyday life testify to a persistent and continuous process of Europeanisation in most nooks and crannies of our societies.

All of this is not due to binding legislation. Besides “hard law”, there is also a significant impact of European “soft law” in various forms. References to EU declarations and recommendations have become stock arguments in all manner of national, regional and local controversy. The open method of coordination has provided new instruments for policy comparisons and the diffusion of best practices. Cooperation within the EU has stimulated mutual learning across member state boundaries. Various forms of ranking and rating are increasingly employed to spur increased efforts or stigmatise laggards, and the media often report on “good pupils” and “bad pupils” in the European classroom. A new measure of transparency is gradually transforming the policy landscape and affecting the action parameters of elected politicians and civil servants alike.

Noting that many EU achievements originate outside the budgetary domain, an important caveat must be added. In most cases, even non-budgetary forms of action require some material foundation. In examining the “in and out” question, the very first task to tackle is therefore to take a closer look at the *nexus* between the budget and the regulatory field, including its softer and more communicative surroundings.

The thesis in the first section of this chapter is that *the EU should not hesitate to make significant investments in its own capacity*, since this is probably the most promising and cost-efficient way of promoting common European interests. The search for European public goods (EPG) should depart from the insight that the EU is an outstanding EPG in its own right, with many multiplier effects. Therefore, its institutional health and agility are of prime importance for the pursuit of numerous collective needs. This leads to a much higher appreciation of various institutional support activities than is usually afforded, first of all the much-maligned bureaucracy of the European Union. Other sub-sections highlight the significance of policy-relevant research and of targeted measures to reinforce the democratic base of the Union.

The second section turns to other forms of EPG and presents *a three-stage strategy for assessing the various claims for EU funding*. A key argument here is that *conformity with official EU objectives*, while necessary, is *not* in itself a sufficient condition for a high ranking among claims for funding. There are literally hundreds of EU goals. With this plethora, the goal-contributory criterion is not selective enough. A further test must be undertaken regarding the *types of benefit* provided by the proposed programme or project. Finally, there is a need to assess the strength, longevity and *sustainability* of the intended effects of programmes and projects. In general, the EU budget should give preference to investments over consumption and to undertakings with long-term effects over expenditures with impacts of a transient character.

The concluding third section addresses the question of cuts. A perennial problem in debates on the EU budget has been the congestion of priorities. Elements of "European added value" have been detected in virtually any type of spending, and all kinds of item are justified by references to common goals. Yet if everything is a priority, nothing is. To spend wisely we must also be prepared to *set posteriorities*, in other words to identify policies with relatively weak claims to EU funding. We will often find that such claims are eloquently and skilfully defended by well-entrenched institutions and interests that for years have enjoyed support through the EU budget. In many cases there have also been significant historical achievements linked to such types of expenditure. However, the MFF should not be a monument to the past; it should pave the way for the future. Backward-looking arguments are therefore less convincing than forward-looking ones. Many operations and transfers characterised by "mission accomplished" or declining marginal returns should be terminated to leave room for new initiatives.

2.1 Knowledge-based governance

The "knowledge-based economy" formula figuring so prominently in the Lisbon Agenda has vanished from the Europe 2020 Platform, but its underlying idea survives in a strong emphasis on knowledge, innovations and smart growth. That European jobs and welfare can be secured only through massive and sustained efforts in education, training, research and skills in high-tech and high-quality services is a pervasive theme in the contemporary political discourse of the continent. The concept of knowledge lies at the very heart of the modern European project.

There are several ways in which this orientation should inform our imminent budgetary choices. First of all, it should lead to sufficient investments in the very *machinery* of the European Union. Populist resistance to bureaucracy should not prevent us from providing the European institutions with an appropriate analytical capacity. Second, there is a need for bold ambitions and both depth and breadth in European *research policy*. Third, there should be carefully crafted and well-balanced policies to promote European consciousness-raising and knowledge-building in the 500 million strong electorate, providing our common institutions with guidance and legitimacy. The argument to be developed in the third sub-section is that any political unit faces the imperative of galvanising its *constituency* and that this is a perfectly legitimate task for the EU as long as it is pursued with judicious moderation and respect for the pluralist foundations of a sound democratic society.

2.1.1 Investments in institutional capacity

In statistics it is still customary to distinguish “industry” from “services”, but in reality this borderline is fading away. Manufacturing depends increasingly on a bundle of services, with high knowledge components. The “value chain” often celebrated in recent treatises on economics signals a growing reliance on many forms of expertise and specialised skills. If this is true in the private sector it is even more so in the public sector, where at least the upper and middle echelons of the workforce are now made up of highly educated professionals. 21st century governance is going post-doc.

The contributions of these specialists are not always so well understood and appreciated. Bureaucracy has always had a bad name, and high-level bureaucracy does not inspire much more confidence than what is seen as paper-shuffling activities lower down. Populist politicians and tabloid newspapers revel in exposing bloated administrative machineries, and they are not alone in pursuing red tape and excessive formal requirements. Mainstream opposition parties and governments also have an eye for this target, and many reform agendas include a reduction of paperwork and the streamlining of public administration.

Without in any way denying the potential for rationalisation in the public sector, it is important to resist the simplistic anti-bureaucratic penchants in public opinion. Advanced economies require a great many “tools of government” that must be handled with skill and insight. That the core executives have expanded significantly at all levels of government reflects both a growing sophistication in dealing with complex social and economic problems and an increasing supply of expertise. This form of “bureaucratisation” is deeply rooted in the process of modernisation. It is also linked to the growth of multi-level governance and the expansion of stakeholder involvement in policy-making and implementation.

With the tilt towards an increasing amount of hard and soft law interventions, the European Union needs an extensive supply of expertise at every single stage of the regulatory cycle: research on fundamental problems and challenges, policy analysis, stakeholder inputs, preparation of legislation, comparison and confrontation of different perspectives, deliberation, communication, implementation, adjudication, follow-up and evaluation. Many of these components are also required to give guidance to the external action of the Union, destined to increase in scope through the European External Action Service (EEAS).

Looking back, it is quite obvious that the institutional machinery has played a decisive role in establishing the influential normative framework of the European Union and making it work. But it is also clear that the bottlenecks and shortcomings in this system have often reduced its potential impact. The long waiting times in the courts undoubtedly lead to great delays and economic losses. In the Commission, some DGs do not seem fully equipped to carry out the tasks that they are mandated to deal with.

The institutional capacity required to provide EU decisions with a sound analytical basis is not limited to the key bodies at the central level. It also extends to the core executives and some agencies of the member states and to the European organisations supplying inputs to the policy process. This wider circle of eurocrats not only makes important contributions to the provision of European public goods; eurocracy is in itself a European public good, with significant creative potential.

Investments in knowledge-based governance are a vital prerequisite for an efficient European Union. Resisting populist "bureauphobia" and giving due weight to the needs of rational policy-making are thus of great importance in the construction of the next MFF.

2.1.2 Investments in research

A depressingly regular sequence in previous budgetary rounds was the severe cut inflicted by the Council upon the Commission's proposal for a substantial expansion of research programmes. One key handicap of this budget chapter seems to be its failure to lend itself to net balance predictions. Nobody knows beforehand where research grants will land, but that should rather be greeted as a sign of health. When expenditures cannot be pre-assigned to particular countries, they will often be European public goods.

European research policy covers wide areas of learning, and parts of it are only weakly related to the challenges of European knowledge-based governance. It should also be recognised that domestically funded research may give quite significant inputs to European policy-making. Nevertheless, in spite of these two concessions we should not underestimate the potential of the EU research programmes to strengthen the information base and provide guidance to EU decisions in both the budgetary and the regulatory spheres. Regular reporting, self-evaluation and external evaluation reports shed valuable light on the results of policy interventions, but such analyses tend to answer only the questions asked by the policy-makers and programme owners. For a fuller picture of the foreseen and unforeseen side effects and the cross-cutting impacts of undertakings in several different areas, we need autonomous studies allowing scholars to formulate their own queries and pursue their inquiries along different methodological routes.

To be successful, knowledge-based governance must be embedded in a fertile environment of independent research. With a deficient understanding of causal chains in complex policy settings and the preconditions for effective action, we risk wasting precious resources in the budgetary sector and issuing badly conceived rules and recommendations. This danger increases with the magnitude of the political and geographical area. The diversity of traditions, cultures and societies in Europe necessitates substantial investments in comparative studies to facilitate the search for appropriate solutions. Whether we strive for harmonisation from above or just wish to improve the conditions for harmonisation from below through mutual learning, agreements and voluntary adaptation, there is a great need for better knowledge of social and economic realities throughout the continent. Though much of this information can be expressed in standard quantitative terms, there will always be room for alternative metrics and more qualitative approaches.

Besides *juste retour* considerations, the Council tradition of curtailing Commission proposals for a more ambitious European research agenda is also based on some scepticism as to the ultimate returns on research investments, and there is no denying that many such activities have few results to show in the short term. However, intermediary success indicators such as the number of publications in peer-reviewed journals do not tell the full story. Research has many educational and long-term effects, not least in providing analytical capacity for European governance. With the gradual accumulation of well-educated talent in the European institutions, we are likely to see even more of this impact in the future.

If the high cost of research is a cause of concern to our ministers of finance, they have reason to be even more concerned about the high cost of ignorance. Massive efforts to prevent warfare and restore peaceful conditions have been seriously hampered by a lack of understanding of the countries concerned; the former Yugoslavia, Iraq and Afghanistan are recent examples. Much could be done to provide Europe with better expertise on social, economic and cultural trends in different parts of the world.

The economic returns on research are inherently uncertain, with results and multipliers ranging from zero to astronomic. As a global actor, the European Union has every reason to invest seriously in its own understanding of both global issues and domestic problems in various third countries. This task cannot be entrusted to the EEAS alone. It also requires a wide-ranging independent analytic capacity provided by universities, research institutes and think tanks.

2.1.3 Investments in the European constituency

No organisation survives without caring about its membership. Voluntary associations achieve this by various means of communication, such as regular letters or publications. Interest organisations also provide packages of benefits to motivate continued commitment. Political units with compulsory inclusion, such as states, regions and communes, operate with a much more diversified register of instruments. At one end of the spectrum they engage in civic socialisation, including many years of obligatory education, and at the other end they maintain a set of fiscal and executive authorities to stimulate and enforce tax payments and compliance with legal rules and para-legal admonitions. In between, there are many instruments and agencies fostering cohesion, loyalty and support through assistance, services and enlightenment.

State-building and nation-building are intertwined processes. Occasionally, "we the people" proclaim a state and adopt a constitution, but the key agents behind such formative initiatives are often small groups of activists who must then proceed to reinforce their popular support. *Fatta l'Italia, dobbiamo fare gli italiani*, said Massimo d'Azeglio: once a state has been constituted it remains to create its people. New political units regularly engage in promoting national solidarity and strengthening their constituencies.

Many such efforts are well mapped. In his masterly *Peasants into Frenchmen: The Modernization of Rural France, 1870-1914,* Eugen Weber (1976) describes how an army of school teachers toiled to make the third French republic *une et indivisible*. The Soviet Union invested enormous efforts in shaping "Soviet man" and forging cohesion among its many recalcitrant nationalities. In the United States, children still start their school day by pledging allegiance to the American flag. For many countries in Europe, the state- and nation-building processes were more intense at various stages in the past than they are now, but recent waves of immigration have again raised some classical integration issues.

Nationalism is often frowned upon, and some of its extreme manifestations have no doubt had ghastly consequences. But the legacy of nation-building is multi-faceted. This process also set the stage for the welfare state and the social market economy, with their preconditions in legal compliance and large-scale fiscal extraction.

The relationship between individuals and the many communities in which they are included is sometimes described in terms of *identities*. Contemporary scholarship agrees that these are multiple and overlapping. Every person has many *part allegiances*, also extending to family roles, localities, professions, ethnic communities, religious groups etc. Eurobarometer surveys have long examined the extent to which citizens identify with their respective countries and with Europe. The latter dimension can be measured in several ways, not only through expressed opinions but also through reported activities.

Over time and across boundaries, there seems to be a feeble but slow increase in the part allegiance to the European Union. What explains this development? The question has not been fully explored but some partial explanations present themselves. The growing mobility, the shared communication space and the increasingly integrated economy may all have played their part. Many constitutive shifts in these directions have been unleashed or facilitated by EU decisions, thus confirming Robert Schumann's famous prediction that Europe must be made through concrete achievements creating real solidarity (*solidarité de fait*). The cohesion impacts of European integration stem much more from the full range of EU activities and rules than from the special chapter in the EU budget bearing this label.

In the EU budget, modest funds have been assigned directly to the task of explaining the European Union to its citizens, mainly through DG Education and Culture. However, proposals to expand the teaching, cultural and media activities to promote various dimensions of European consciousness regularly encounter strong reserves from quarters recalling that education is essentially a domain of the member states. Historical precedents are also invoked to caution against centrally funded projects reeking of *agitprop*.

There is a point in such objections, but it is also true that any survival-bent organisation must cultivate its own constituency. This holds in particular for the European Union with its extensive legislative competence, its albeit indirect extractive capacity and its considerable political ambitions. Such an organisation cannot be efficient unless the considerations underlying its activities are familiar to the citizens and assessed by them in various ways, not least through the elections. Extending knowledge about itself to the Europeans and promoting their involvement in the European political process is a perfectly legitimate task for the European Union, and in the long perspective even an existential necessity.

2.1.4 Conclusion: Minding the internal agenda

Bureaucracy is often regarded as a necessary evil. If it is mentioned at all in election campaigns, it is by candidates promising to curtail it and chase waste. The upper echelons of the administrative system are treated with similar disdain. Facing the voters, no parties ever pledge to reinforce the core executive or the parliamentary staff. In its Financial Framework proposals, it is an apologetic Commission that reluctantly requests some 5% of the EU budget for institutional needs.

This bashfulness is not called for. With the increasing weight of the legislative and communicative instruments and the declining relative importance of many traditional EU expenditures, there is every reason to invest heavily in knowledge-based governance. The participants in the various phases of the EU policy cycle provide important services with a high EPG content, all the way from the diagnostic and analytical stages to the phases of implementation and adjudication. In the next MFF, there is every reason to pay strong attention to this *internal agenda*.

2.2 A European public goods test in three stages

2.2.1 The grand values and grand objectives

Reflections around the purposes of European integration have accompanied the pre-history and history of the European Union. What is this project all about, what is its true vocation, its *Bestimmung*, its *finalité politique*? The European discourse is replete with attempts to answer such questions, often linked to positions on particular policy issues. The variety of views about the ends of the enterprise is matched by a variety of views about its shape and structure. Is the EU a federation, a quasi-federation, a confederation, a *Staatenverbund*, an association of sovereign national states, an international organisation *sui generis* or, in the formula coined by Delors, simply an "unidentified political object"?

The official instruments give some guidance. The goals of the European Union are pinned down in a hierarchically differentiated set of programmatic documents. On the supreme level we find the Treaties. Equally valid now is the Charter of Fundamental Rights, first issued as a solemn political declaration in 2000 but from 2009 given the same legal value as the Treaties.

One flight down there is a set of authoritative decisions on the long-term objectives of the Union established by the European Council, such as the Lisbon Agenda of 2000 and at present the Europe 2020 Agenda. More specific, multiannual platforms are established for action in the area of freedom and justice, the previous third pillar: the Tampere programme of 1999, the Hague programme of 2004 and the Stockholm programme of 2009. Medium-term action plans are also included in such instruments as the Baltic Sea Strategy, approved by the European Council in 2009.

Shorter-term agendas are set out in the annual work plans of the European Commission. A recent addition is the State of the Union speech by the President of the Commission, intended to be annual. A further place to look for authoritative objectives is the introductory section of legislative acts. In the EU, as in many member states, the key purposes of legal instruments are often summarised in brief preambles.

On the basis of this evidence, what are the objectives of the European Union?

If we start looking at the preamble of the Consolidated Version of the Treaty on the European Union after the Lisbon decisions, we find first a number of *values* to which the member states claim to be committed, listed in Table 2.1 below. On the basis of these values, there are goals that the member states wish to attain.

Table 2.1 Values and Goals in the TEU preamble

Values	Goals
• freedom (twice) • democracy (twice) • equality • the rule of law (twice) • the inviolable and inalienable rights of the human person (twice) • fundamental social rights • solidarity between peoples • respect for the history, culture and traditions of different peoples	• European integration (twice) • an ever-closer union (twice) • a Europe in which decisions are taken as closely as possible to the citizen • democratic functioning of the institutions • economic and social progress • sustainable development • reinforced cohesion • environmental protection • economic integration, accompanied by parallel progress in other fields • common foreign and security policy

The final aspiration is expanded a little further, as purporting to the framing of a common defence policy, thereby reinforcing the European identity and its independence in order to promote peace, security and progress in Europe and in the world.

Many of the above-mentioned ambitions are then repeated or further specified in article 3 of the Treaty of the European Union, listed in Table 2.2.

Table 2.2 TEU Article 3 objectives

Objectives
1. peace, its values and the well-being of its peoples
2. an area of freedom, security and justice
3. the free movement of persons, in conjunction with appropriate measures with respect to external border controls, asylum, immigration and the prevention and combating of crime
4. an internal market
5. the sustainable development of Europe
6. balanced economic growth
7. price stability
8. a highly competitive social market economy
9. full employment
10. social progress
11. a high level of protection and improvement of the quality of the environment
12. scientific and technological advance
13. combating social exclusion and discrimination
14. social justice and protection
15. equality between women and men
16. solidarity between generations
17. protection of the rights of the child
18. economic, social and territorial cohesion
19. solidarity among member states
20. safeguarding and enhancing Europe's cultural heritage
21. an economic and monetary union
22. the values and interests of its citizens
23. the protection of its citizens
24. peace, security, the sustainable development of the Earth
25. solidarity and mutual respect among peoples
26. free and fair trade
27. eradication of poverty
28. protection of human rights, in particular the rights of the child
29. the strict observance and the development of international law, including respect for the principles of the United Nations Charter.

Some of the subsequent articles flesh out and add details to certain of these objectives. An objective according to article 8 is to promote an area of prosperity and good neighbourliness with neighbouring countries. Article 21 underlines the Union's interest in developing relations and building partnership with third countries and bringing about a high degree of cooperation in all fields of international relations. Articles 42 and 43 give an extensive presentation of EU goals in the fields of defence, crisis management and security cooperation.

Turning then to the preamble of the Treaty on the Functioning of the European Union in its consolidated, post-Lisbon version, we find another slightly different list of principal objectives, in Box 2.1.

Box 2.1 TFEU principal objectives

- laying the foundations of an ever-closer union among the peoples of Europe,
- ensuring the economic and social progress of their States by common action to eliminate the barriers that divide Europe,
- strengthening the unity of their economies and ensuring their harmonious development by reducing the differences existing between the various regions and the backwardness of the less favoured regions,
- contributing, by means of a common commercial policy, to the progressive abolition of restrictions on international trade,
- pooling their resources to preserve and strengthen peace and liberty,
- calling upon the other peoples of Europe who share their ideal to join in their efforts and
- promoting the development of the highest possible level of knowledge for their peoples through wide access to education and through its continuous updating.

Other ambitions mentioned in this preamble are to improve living and working conditions and to engage in concerted action in order to guarantee steady expansion, balanced trade and fair competition. There is obviously a great deal of duplication among the fifty-six objectives amd values mentioned above. If the mapping is extended to cover the remainder of the Treaty of the Functioning of the European Union, which specifies the particular tasks in various policy areas, it is easy to arrive at a total of far more than one hundred objectives listed in the Treaties. These two foundational instruments of the Union provide eloquent illustrations of the phenomenon of "goal congestion".

If the combination of preambular recitals and objectives specified in the articles can be construed as a two-level architecture, the Europe 2020 Communication by the Commission presents a three-level goal structure. At the pinnacle there are "three mutually reinforcing priorities":

- *smart growth*: developing an economy based on knowledge and innovation.
- *sustainable growth*: promoting a more resource efficient, greener and more competitive economy and

- *inclusive growth*: fostering a high-employment economy delivering social and territorial cohesion.

To attain this triad of objectives by 2020, the Commission then proposes a series of "headline targets" corresponding to the SMART criteria:

- 75% of the population aged 20-64 should be employed.
- 3% of the EU's GDP should be invested in R&D.
- The "20/20/20" climate/energy targets should be met (including an increase to 30% of emissions reduction if the conditions are right).
- The share of early school leavers should be under 10% and at least 40% of the younger generation should have a tertiary degree.
- 20 million fewer people should be at risk of poverty.

Finally, it presents seven "flagship initiatives" to catalyse progress under each priority theme, listed in Box 2.2.

Box 2.2 Europe 2020 Flagship Initiatives

- *Innovation Union* to improve framework conditions and access to finance for research and innovation so as to ensure that innovative ideas can be turned into products and services that create growth and jobs.
- *Youth on the Move* to enhance the performance of education systems and to facilitate the entry of young people to the labour market.
- *A Digital Agenda for Europe* to speed up the roll-out of high-speed Internet and reap the benefits of a digital single market for households and firms.
- *Resource-efficient Europe* to help decouple economic growth from the use of resources, support the shift towards a low-carbon economy, increase the use of renewable energy sources, modernise our transport sector and promote energy efficiency.
- *An Industrial Policy for the Globalisation Era* to improve the business environment, notably for SMEs, and to support the development of a strong and sustainable industrial base able to compete globally.
- *An Agenda for New Skills and Jobs* to modernise labour markets and empower people by developing their skills throughout the life cycle with a view to increasing labour participation and better match labour supply and demand, including through labour mobility.
- *European Platform against Poverty* to ensure social and territorial cohesion such that the benefits of growth and jobs are widely shared and people experiencing poverty and social exclusion are enabled to live in dignity and take an active part in society (European Commission, 2010; European Council, 2010).

It goes without saying that further goals and tasks will be specified within each of these flagship initiatives. The pyramid of objectives is thus immensely rich at its top and open-ended at its bottom. Judging from its own strategic texts, of which only the most authoritative have been covered in this brief overview, the European Union is so charged with willpower and policy ambitions that it will never run out of steam, but neither will it exhaust its agenda. Apart from a few headline targets intended to be attainable, it is drawn to absolute and utopian goals ("stretch targets") rather than bleak realism.

This makes perfect sense from a political point of view. Inspiring the joint efforts of 27 member states and close to 500 million Europeans is no modest enterprise. The exercise of leadership in such a setting requires zest and a portion of rhetorical extravagance. The visionary language of the key inspirational texts is well adapted to their intended purpose. Smart growth, sustainable growth, inclusive growth – why not? These slogans have some punch.

Nevertheless, when it comes to using them in the budgetary process as criteria for project selection, they reveal their limitations. So do the many objectives of the Treaties. They simply cover too much to be useful as instruments of discrimination. If *any* investment or action contributing to the attainment of an EU-proclaimed grand objective or in tune with EU-endorsed common values is deemed to be a European public good, then the mass of projects with a claim for EU funding is virtually boundless.

This is confirmed by the huge volume of evaluation reports accumulated over the years, not least in cohesion policy, where few if any undertakings fail to produce some kind of European added value. The same tendency is patent in submissions for research grants within the framework programmes and a variety of other pleas for EU support. Pinning down the link between a specific project and one or several of the grand objectives is no major challenge to most applicants, evaluators and project owners. On this basis alone, European public goods seem to be as ubiquitous as the Good Lord himself.

A related problem with many of the grand objectives, and even more with the whole set of grand objectives taken together, is that they do not easily lend themselves to falsification. Karl Popper has taught us the importance of this particular touchstone. If compatibility with any of the 29 goals listed in article 3 of the Lisbon Treaty would constitute sufficient proof that a project is worthy of EU funding, then hardly any project would flunk the test. These are omnivorous goals, rejecting virtually nothing and swallowing virtually everything.

Summing up the first step

For this reason, the grand objectives and the common European values can serve only as *introductory* selection instruments. In a budgetary context, they provide merely the *first test* of any claim for funding. By setting out the main purposes and orientations of the European Union, they give some initial guidance to the policy process. A claim not passing this first screening does not qualify for further consideration, but the fact that a programme or project can be credibly deemed to be contributing to, say, (in alphabetical order) cohesion, climate change, economic growth, full employment, gender equality, social inclusion, solidarity, welfare or other such worthy objectives does not in itself constitute a sufficient ground for EU funding. It just opens the door for further scrutiny.

2.2.2 Analysing the benefits

If we are to believe Cicero, *cui bono?* was a question constantly asked by the wise judge Lucius Cassius. To whose benefit? Cracking this nut is essential in assessing the many claims for EU funding. Is the utility of an outlay private or public and, if public, is it national or European?

The answer is often a bit of each. But how large are the bits?

The distinction between *public goods* and *private goods* depends on how commodities or services are used. A good is considered to be public if its consumption by one individual does not reduce its availability and usefulness to others. This phenomenon was first explained by Paul A. Samuelson (1954) who defined as “collective consumption goods” those “which all enjoy in common in the sense that each individual’s consumption of such a good leads to no subtractions from any other individual’s consumption of that good”.

The key characteristics of public goods are non-rivalry and non-excludability. Two intermediate types between private and public goods are *club goods*, which are non-rivalrous but excludable, and *common pool goods*, which are rivalrous but non-excludable. The former category includes cable television and private parks; the latter satellite television and fish stocks.

When the neat theoretical concepts are applied to the real world, there seems to be an infinite number of mixed cases. There are essentially two reasons for this. One is the *inclusive character* of the larger units: what is good for an individual will under many circumstances also be good for his enterprise, his commune, his state and the European Union. We will come back to this question at the end of this section.

However, let us first look at the second explanation for mixed cases, which is rooted in the *diversity of benefits* brought about by different types of public spending. Many if not most public expenditures do not have merely one single set of beneficiaries, but a combination of positively affected stakeholders. One might perhaps go a step further: public expenditures seldom come about unless there is such a combination of actors promoting them. Many forms of public spending are based on alliances between demand-side and supply-side beneficiaries, forged by successful policy entrepreneurs.

Five separate forms of benefit stand out as particularly important.

1. *Consumer-recipient benefits*
   The most obvious beneficiaries of public activities are the defined target groups of particular interventions. Schools are intended to serve the pupils, hospitals the sick, roads the motorists and pedestrians. Many transfer payments by public authorities do not immediately fund consumption but do so indirectly, such as pensions and sickness insurance awards. This purpose of government spending is paid predominant if not exclusive attention in most discourses on public policy. Behind the primary recipients, there are often secondary groups that are directly or indirectly affected, such as parents, relatives and employers.
2. *Supplier benefits*
   A second group of beneficiaries is those involved in the production or transmission of the goods and services funded by the public purse: construction companies, teachers, health professionals. Large sections of industry and business have a stake in public procurement. The Marshall Aid programme was launched not only to kick-start the European economy after the war but also to keep wheels spinning in the United States. When the European Union explains the virtues of cohesion policy, it emphasises not only its impact in the recipient regions but also the additional demand created in net contributor states.
3. *Broker benefits*
   The implementation of huge public programmes depends on a stratum of agents facilitating and organising the stream of resources for appropriate projects. Local politicians have long experience in communicating with their regional and national authorities on such matters. More recently, many of them have developed a flair for fundraising in the emerging European system. “Bringing home the bacon” generates useful political capital. Broker benefits may also accrue to other groups involved in policy-making and programme execution, such as civil servants and consultants.
4. *Feel-good benefits*
   Empathy and altruism have their given place in governance. While some schools of policy analysis (not least the public choice persuasion) tend to see political actors as consistently self-centred and self-interested, there is plenty of evidence of initiatives inspired by a wider and loftier set of considerations. But the degree to which electorates are prepared to channel resources to needier groups varies along sev-

eral dimensions. It increases with some measure of kinship and with an intense awareness of a particular plight, produced most often through the media. There is also a greater readiness to contribute to relief in emergency situations, e.g. following natural disasters, than to lasting redistribution schemes purporting to redress enduring disparities. Ethnic homogeneity is known to increase the support for general and inclusive welfare arrangements.

5. *Preventive benefits*

   Many public actions serve to forestall dangers and neutralise threats. These could be seen as a special case of "consumer benefits", but as the consumers normally perceive no immediate gains there may be a good reason to treat this type of benefit as a separate type. Well into the nineteenth century, most public spending fell into this category through the predominance of military over civil expenditure. Today, risk prevention is again an expansive field but now covering a much broader spectrum of potential threats. Climate change is only the latest addition to the long list of public concerns. Risk prevention is problematic from a policy-making perspective, not least in that success rates are difficult to estimate. When a concrete threat is averted, it is not always clear whether the action was efficient or the risk exaggerated. Recent examples of policies marked by such uncertainty include the millennium computer bug and avian flu. In each case billions were spent to unknown avail.

Summing up the second step

How do we identify and rate European public goods? Two procedural problems were identified in the introduction to this section.

The first issue is the *Chinese box or Russian doll property of the benefits*: what is good for one individual will often also be good for the larger units to which he or she belongs. This will necessitate an attempt to assign weights. Is the measure under consideration primarily of importance to the target person? Or are there also significant effects extending to the nation state? That would make a case for national public funding. Or are there even impacts transcending the state borders? Are there externalities involved? The wider the implications of a policy, the greater the probability of substantial European added value.

The second problem is the prevalence of *multiple benefits*. Of the first two types discussed above, the gains for consumers or recipients should normally deserve more appreciation than the gains for suppliers. In both cases the interests served will often be predominantly private. The broker benefits may explain the positions taken by certain actors but will seldom add arguments in favour of particular expenditures. Within the feel-good category, there are often common concerns meriting serious consideration, but the multitude of such concerns will necessitate a high degree of selectiveness. In the fifth category we are likely to come across many policies yielding common European rather than national or private benefits. When preventive measures are funded by the European Union, a net flow back to member states or individuals can rarely be calculated. That in itself is a positive marker of a probable European public good.

2.2.3 Short-termism vs. long-termism

If a claim has passed the first test – compatibility with the principal values and grand objectives of the European Union – and then also the second test of exhibiting a sufficient element of "European public good-ness", a third check should be undertaken to make sure that the proposed investment or activity is likely to have enduring impacts and not merely transient effects.

This requirement follows from the small size of the EU budget. With merely 1% of GNI or thereabouts at our disposal, we must be exceedingly selective in our use of EU funds. This does not preclude a measure of redistribution between member states, but redistribution cannot be the principal aim of EU expenditures. There must also be solid allocative reasons to prefer one form of spending to another one.

Musgrave's (1959) famous distinction between stabilising, allocative and redistributive functions of public budgets is sometimes misunderstood to imply that outlays can be sorted into three neat boxes. However, what he taught us was that every piece of public spending has these three properties. When pensions are dismissed as mainly redistributive one forgets that they are also allocative through the spending decisions made by the pensioners.

All three Musgravian functions are no doubt important, but they are not equally important at each level of government. If local authorities play some role in stabilising the economy they do so mainly within frameworks established by national governments. With 1% of our GDP at its disposal, the European Union has no great capacity to promote economic stability through its budget. But the rate-setting competence of the European Central Bank (ECB) plays some role in that respect, as do other instruments that are likely to be strengthened as a result of the recent financial crisis.

What about redistribution, then? A commitment to fairness and solidarity has long prompted the European Union to transfer resources to economically weaker areas. Policies intended to further social inclusion and the catching up of less developed regions have served to give vulnerable groups their own place in European integration. An element of redistribution has also been present in the common agricultural policy. Though the achievements in these fields are far from negligible, the limited redistributive impact is nevertheless commensurate with the modest volume of the transfers within a small budget. Substantial efforts to equalise the standards of living between various age cohorts and strata of the population require the huge volume of resources available to the nation states through their public consumption and income maintenance schemes.

The spectacular difference in size between the EU budget and those of the member states goes a long way towards explaining why broad social redistribution cannot be a principal task of the Union. Not even in cohesion policy is the transfer element advanced as a principal motive for EU interventions. Instead, much more emphasis is placed on the objective of *structural development*. Resources are redirected to peripheral and economically weaker regions not in order to reshuffle assets in the short-range perspective but to upgrade their enduring productive capabilities. The accent has long been on investments yielding lasting returns rather than consumption yielding only immediate satisfaction.

A recent development in budgeting is a growing concern about time perspectives. Following the Brundtland report in 1987, the concept of *sustainability* surfaced in a great many policy areas. In dealing with their natural resources, governments are increasingly committed to furthering robustness and resilience. Grappling with the seemingly inexorable forces of climate change has become a key priority. In its Europe 2020 programme, the European Commission proclaims its commitment to sustainable growth, defined as "promoting a more resource efficient, greener and more competitive economy". In economic policy, the calls for "sustainable public finance" and "quality in public spending" have received much attention in recent years, and both the OECD and the European Commission have issued recommendations about suitable measures contributing to the attainment of this goal, such as pension reforms and prudent approaches to sovereign debt.

A commitment to sustainable development is often prominent in programmatic texts about EU cohesion policy. It is emphasised time and time again that the purpose of the various actions undertaken is to build stronger institutions and raise productive capacity. In reports about the results obtained, however, short-term achievements are often given more attention. A frequent success item is the number of "jobs created" or "jobs maintained". In reports covering an activity just concluded the lasting effects are of course difficult to predict, but if the desired result is enduring change, then early reports and evaluations have a limited value and studies with a different focus may be called for.

Gauging the outcomes of structural policy interventions in terms of added employment is problematic for several reasons. First of all the time frame is uncertain; how long does a created job persist? Second, there are often elements of a zero-sum game: some forms of job creation may correspond to job losses in other equally struggling areas. Gains in tourism will hardly redress European disparities if the same intra-EU sun-seekers are seduced to moving their holidays from Greece to Spain, or vice versa, or between different regions in the same country. Third, all short-term increases in regional employment are not equally benign. The recent housing bubbles in several European countries certainly created temporary jobs, but they provided no solid basis for longer-term growth.

Why are the effects of development-oriented policies so often reported in terms of such short-term victories? One reason is that decision-makers may be in a hurry to meet deadlines and show results before their possible re-election or reappointment. Another related explanation is the growing causal uncertainty in the policy landscape over time. Immediate results are more credibly linked to particular measures than long-term impacts, which tend to depend more on complex sets of actions and circumstances. Even in the short perspective there may be many views about the appropriate attribution of credit and blame, but as time goes by the contours of such answers dissolve into the mist of history. It is no surprise, then, that even decision-makers emphatically dedicated to the outputs and outcomes of the policy process tend to advertise their contributions in terms of inputs.

The very magnitude of the European budget gives particular weight to the allocative aspects of public spending and, within this zone, to expenditures with clearly long-term implications. If the redistributive element is strong and if the main accent is on short-term equalisation, then other forms of funding should normally be chosen. There may be exceptions to this rule, such as relief operations to remedy the sequels to natural disasters, but in general interventions with lasting consequences seem more worthy of European financing than measures with transient effects.

In the world of business, *short-termism* and *long-termism* have come to stand for different approaches to profitable activities. There is a growing consensus that remunerations awarded for quick achievements, such as bonus payments linked to annual results, may distort managerial incentives and stimulate various forms of creative accounting. While robust results over the long haul are more desirable, assessing such impacts is not easy.

Short-termism in the political sphere is based on a different set of incentives, but the risks of myopia and a preference for quick results are quite similar. A few rules of thumb seem warranted.

1. One is to be suspicious of success stories offering only short-term achievements. "Creating jobs" can be pursued in many different ways by national governments, but even when unemployment reaches tragic and dramatic proportions all over Europe, as it does now, this is not a task for the European Union. Neither is the promotion of "small and medium enterprises" a suitable mission. Whether such enterprises achieve more for growth and employment than big enterprises is in the first place an open question, and how they enter and exit the market is at any rate a function of many different framework-setting conditions. Direct European subsidies in support of specific enterprises are not called for. Stimulating the economy in general may require the provision of many types of public good, but only rarely will such supporting measures turn out to be legitimate European public goods. The Union has no comparative advantage in measures without a clear European dimension.
2. The small size of the European budget gives particular weight to the allocative aspects of public spending and, within this zone, to expenditures with clearly long-term implications. The importance of solidarity in the building of Europe does not lessen the need for careful discrimination of programmes and projects. If the redistributive element is strong and if the main accent is on short-term equalisation, then forms of funding other than European ones should normally be chosen. There may be exceptions to this rule, such as relief operations to remedy the sequels to natural disasters. Such interventions are also symbolically important, containing a strong dose of the "feel-good benefits" mentioned above. But in general interventions with lasting consequences seem more worthy of European financing than measures with ephemeral effects.
3. A third related rule of thumb is to favour investments over consumption. Even with significant multiplier effects, the latter type of activity is transient. With its limited budget, the European Union should concentrate on expenditures with lasting returns.

Setting out these principles is easier than applying them. In many areas the line between the two categories is blurred or fluid. In the old industrial society an investment was relatively easy to identify: it was a machine, a building or a piece of infrastructure. The modern service economy has made things more complicated. What is consumption and what is investment in health care and education? How does the construction of institutions compare with the construction of plants and offices? The borderland between investments and consumption is now full of ambiguities.

Summing up the third step

In the third step of the analysis, claims for EU funding should be assessed on the basis of whether their intended and foreseeable impact is lasting or passing. Sustainable, long-term, investment-type, development-oriented projects should be given preference over ephemeral, short-term, consumption-type or predominantly redistributive undertakings. This is not, to be sure, an argument against measures targeting the poorer member states, but to pass, such claims must produce much more than redistribution only. There must also be reasonable hope for enduring outcomes.

2.3 Priorities vs. posteriorities

In the wake of the financial crisis, most European governments are struggling with significant budget deficits. The MFF-makers planning for the period after 2014 will face many claims for austerity, redeployment and decremental budgeting. Yet any proposed cuts will also meet resistance, as every segment of expenditures has its own vocal defendants. Many governments are likely to combine a call for general restraint with advocacy of particular chapters in the budget.

Old alliances are now being revived. In preparation for the next Financial Framework, DGs have already begun to convene conferences of stakeholders, parliamentary committees have started to adopt admonitory resolutions, the Committee of the Regions and the Economic and Social Committee have issued preemptive turf-defending statements, a huge alliance of regions has voiced its concerns and many other combinations of interested parties are preparing for battle. The Commission's consultation on the Midterm Review provided an early opportunity to signal positions. The European Parliament has set up a 100 MEP strong ad hoc committee on future policy challenges (SURE) to consider the procedures, substance and duration of the next MFF.

Many familiar stock arguments reverberate in these early preludes to the forthcoming negotiation. References to Treaty goals abound, as do reminders of the need for Social Europe. Echoes of the Europe 2020 programme are also frequent. However, as indicated above, such arguments are not in themselves that compelling. The Treaty sets many tasks but does not specify the volume of investments and activities in any single area. The welfare state is embraced in all countries (under different names: the Rhineland model, *der Sozialstaat*, the social market economy, *l'état-providence*, the welfare society) and though the established systems differ in both structure and efficiency, no member state would seriously dream of dismantling its fundamental underpinnings. But funding the welfare state cannot be a European affair. It is the heaviest fiscal responsibility of any member state, and the sheer volume of the public services and transfers established to sustain it lies far beyond the capacity of the EU budget.

As for the Europe 2020 Platform, it is rich in ambitions. Priorities in general are plentiful in the European Union, so plentiful that many of them compete in vain for attention. Even top priorities cannot be given due weight unless items *not* deserving a place in the MFF are also identified.

This is where the concepts of *European public goods* and *European added value* come in. A many-headed chorus of politicians, scholars and publicists has expressed itself in their favour and there is little doubt that these twin principles command strong support, but the problem lies in their application. What exactly is a European public good? What does it look like? Where do we find it? With so many candidates in the beauty contest, which types of expenditure provide genuine European added value?

The lack of simple answers to these questions depends essentially on two types of overlap:

In the first place, no clear dividing lines separate private from public goods. Many tax-financed interventions benefit individuals but can simultaneously be construed as promoting the public interest. Furthermore, as we have seen above in II:2, there are several types of benefit. Identifying the private use value is normally not so difficult, but the prevalence of a public use value tends to be more controversial.

Second, there is similarly no clear distinction between national and European use value. What benefits Hungary may also benefit Europe as a whole, or at least the neighbouring countries.

The extent of these two overlaps can seldom be measured objectively as they are a function of political considerations. Defining particular concerns as common concerns is the very gist of budgetary advocacy. This is why the concept of public interest lies at the heart of so many political discussions.

Yet even if the "public good-ness" of a particular expenditure may be a matter of dispute, there are nevertheless more and less plausible arguments in favour of attributing high ratings on this scale of assessment. In looking more closely at the various claims for European funding, we will find properties hinting one way or the other. Such positive and negative clues do not provide clear answers but can at least serve as useful elements in the comparative assessment of projects and programmes.

An important *positive EPG indicator* is a wide distribution of returns. As we have seen above (section II:2), there are several types of benefit. When the returns land in one country only, their contribution to its short-range net position is relatively easy to calculate. In the case of infrastructural investments, there are often consumer/recipient benefits in one country and supplier benefits in another one, often a wealthier member state.

Such effects can also be included in net flow calculations, but for some other types of expenditure, more than two countries may be involved. Contributions to the trans-European transport networks (TENs) are intended to add missing links and increase the interoperability between different modes of transport. Regardless of where these investments are made they have cross-boundary repercussions for the extension of markets. Elite universities and research institutes draw students from several countries. In many other policy areas we will also find transnational implications of seemingly national policies.

Activities "out of area" also qualify as EPGs. Even if some member states may have a particular stake in ex-colonial settings or vicinity motives to favour particular relations, neighbourhood policy and development cooperation are clearly in the common European interest. The same goes for many aspects of environmental protection, including measures against climate change. Many forms of risk prevention inside and outside Europe can also be classified as typical EPGs. The is also true of relief operations in the wake of disasters and major accidents. Such interventions are undertaken in the interest of the victims, but as expressions of solidarity they give "feel-good" benefits to the donors as well.

A particular field dealt with above (section I:1) is the wide system of EU institutions, including the core institutions, the consultative committees, the agencies and the emerging EEAS. These bodies have multiple functions, ranging from analysis, foresight and hindsight to implementation and control of spending decisions, and their smooth interaction is an important precondition for the efficiency of EU programmes. However, they play an even more important role in the creation of EU hard law, soft law and cooperation agreements which are now evolving into a predominant power base of the Union. This is why "the internal agenda" will become so important in the years to come. To make the most of these instruments, the Union should not be shy to invest in its own machinery and its own constituency.

On the opposite side of the ledger we find a number of *negative EPG indicators* signalling that various claims for EU funding should be examined with great care. Many of these are located in the twin spheres of agricultural and structural policy, where there are considerable elements of private goods provision in EU spending. This does not preclude the simultaneous prevalence of collective benefits, but when substantial resources land in private pockets there must be very strong arguments in favour of EU funding, arguments extending far beyond the mere compatibility with broad-based EU objectives.

Some of these objectives are even so broad-based that they threaten to evaporate through their very extension. If the EU is supposed to support "rural development" (a part of CAP) and "urban development" (some structural programmes), what else is left? If "small and medium enterprises" are worthy of particular subsidies, what is wrong with big enterprises? If "employment" is targeted as a priority, is any economic activity sustaining labour demand ineligible for EU support?

The success indicators offered in reports on EU activities frequently raise questions about the longevity and sustainability of the effects. When data are provided about "jobs created" or "jobs maintained", the duration of such results is not defined. As the recent housing bubbles remind us, short-term gains in employment are not always benign. Though enduring impacts might be difficult to assess in policy evaluation, we should not lose sight of the long-term view. If structural interventions are to deserve their name, they should lead to structural change and not merely passing relief or compensation.

The Lisbon Treaty has enhanced the role of national parliaments in addressing subsidiarity issues, but the new mechanism focuses only on new proposals by the Commission. It is less appropriate for the MFF process, in which national parliaments are likely to play a more limited part. Yet the dividing lines between national and European funding are also of paramount importance in this discussion and deserve consideration when it comes to reviewing the stock of old commitments. Proposals for a greater share of national funding are often decried as attempts for "renationalisation", but this notion need to be taken with a pinch of salt. With their massively superior budgets, member states already cover most public expenditures, leaving only small fractions to the budget of the European Union.

To sum up this section: priorities abound, but to satisfy at least some of them we must also identify posteriorities in the present financial framework. To do so, we should accept that mere conformity with established EU goals is not a sufficient ground for funding. The claims must also yield a satisfactory degree of European public goods and have more than transient implications.

2.4 Conclusion: Norms matter

Inertia is a powerful force in budgeting. In spite of all the rationalist approaches that have been launched over the last half-century, ranging from programme and zero-based budgeting through new public management models to universal requirements of impact assessment, last year's budget still remains the best predictor of this year's budget. In the EU setting, shifts in emphasis between the multiannual frameworks have remained modest. Some modifications in the procedures for budgetary decision-making are now in place through the Lisbon Treaty and others will follow in a few years, but member states wishing to protect their conquests from earlier budgetary battles and accession negotiations are still well placed to resist any significant losses. So the deadlock remains. Net positions remain a preeminent concern of the member states.

An extensive amount of literature has sought to analyse how we arrived at the present budgetary design, chiefly through historical and public choice-based explanations (Laffan, 1997; Nuñez Ferrer & Emerson, 2000; Folkers, 2002; Blankart & Kirchner, 2003; Tarschys, 2003; Tarschys, 2005; Mrak & Rant, 2008; Heineman, Mohl & Osterloh, 2009). An often-told story is that compensatory measures were invented to soften resistance to various strategic steps in the integration process, paving the way i.a. for the internal market, the monetary union and many new accessions, and then survived long after they had fulfilled their function. As a consequence, the EU budget remains a repository for many geological layers of petrified policy, detectable only through archaeological excavation. Sapir (2004: 162) famously called it a historical relic: its "expenditures, revenues and procedures are all inconsistent with the present and future state of EU integration".

Another significant strand in the discussion seeks to propose *Realpolitik*-based exits from the current predicament. Given the established set-up of political forces within the Council, could procedural innovations, shifts in revenue composition and structural changes in the budget design produce better outcomes of future negotiations? A common idea is to separate allocative from (re)distributive issues. Suggestions include the division of the financial framework process into two stages (de la Fuente, Domènech & Rant, 2008) and the restructuring of the MFF into three chapters (Iozzo, Micossi & Salvemini, 2008). Heinemann, Mohl and Osterloh (2010) distinguish two types of strategy, one based on changes in the system of decision-making and the other called "incentive channelling reforms" aimed at attaining a greater proportion of public goods without expecting member states to abstain from their pursuit of favourable net positions. The purpose of the latter approaches is described as taming “the monster of juste retour” while taking its existence for granted (Richter, 2008; cf. Le Cacheux, 2007).

Against the backdrop of the strategic sophistication in these contributions, the blue-eyed normative approach chosen in this chapter may seem naïve. With member states continuing to play hardball in the Council, does a discussion of criteria and yardsticks really make sense?

I think so. There is a need to discuss EU spending not only in terms of political realities but also in terms of political principles. As was recalled above (II:3), Musgrave’s famous three purposes of the budget (stabilisation, allocation, distribution) do not stand for separate *types* of revenue and expenditure but for separate *functions* attached to all budget items. The distributive impact of the EU budgets may be analysed both ex ante and ex post, but redistribution is not the aim of EU spending. Its purpose can be nothing but efficient allocation, and no single item should ever be accepted unless it is likely to produce a satisfactory degree of European added value. Some emphasis on redistributive objectives may have been justified in the past, mainly in the context of temporary compensation packages, but these have accomplished their mission. With the challenges now in front of us and the shift of policy emphasis from the expenditure side to the regulatory side, there should be no more space in the EU budget for redistribution as a principal purpose of spending.

This is not at all to deny the importance of solidarity. Substantial resources should continue to be channelled to the poorer areas of the Union, but only on the basis of sound allocative considerations. Structural policy is not about transfers but about development. This should give an edge to transnational projects, institution-building, infrastructure and other long-term-oriented investments.

Norms matter. With so many pressing challenges ahead and so many urgent collective needs competing for our attention, we cannot afford to spend precious European resources on yesterday’s priorities or on policy interventions with a low EPG rating. Predominantly national concerns will have to be met from predominantly national sources.

The growing clout of European Union is increasingly a function of its hard law, soft law and communicative capacity. This reduces the relative role of the budget, but it is only by spending wisely, and not least on its own capacity, that the Union can gain a greater punch and impact.

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3 The Governance of European Public Goods

Stefan Collignon

European integration has been built on market integration. From free trade areas to customs unions, to the Economic Community and finally to the single market with the use of a single currency, deeper integration has been driven by rules that facilitated the exchange of private goods. However, little attention has been paid to the fact that European integration has also generated a thick layer of European public goods, which cannot be provided efficiently by markets, but need to be managed by public authorities at the European level. This chapter will discuss the nature of these goods and explain how they can be provided efficiently.

The debate about the best regime for managing public goods has largely been inspired by the theories of federalism, in particular fiscal federalism, which concerns the layers of government and the assignment of competencies to different jurisdictions in traditional nation states. However, as Desai (2003) rightly pointed out, the roles and functions of the state have changed considerably over the past three decades, and this requires new ways of thinking about public goods. This more evident in Europe than it is anywhere else.

This chapter will first explain the nature of public goods, in particular European public goods. It will then discuss the problems of collective action because of the underlying incentives of such goods and explain how the monetary union has changed the provision of European public goods. The last section will cover the governance of European public goods and suggest that a republican approach to efficiency problems is better than traditional federalist solutions.

3.1 Defining public goods

Although public goods have always existed, a rigorous definition of the concept goes back to Samuelson (1954: 387), who defined a public good as one "which all enjoy in common in the sense that each individual's consumption of such a good leads to no subtracting from any other individual's consumption of that good." Thus, the consumption of public goods is "joint". Recent economic theory has often discussed these "joint effects" resulting from public goods under the heading of external effects. External effects that confer appreciable costs or benefits to parties that are not fully consenting in reaching the decisions that led to the event in question are called externalities (Meade, 1973). According to whether these external effects increase or decrease the utility of the affected person, one speaks of positive or negative externalities. Pollution is a classic example of a negative externality, while the frequently celebrated synergies that result from European policies are positive externalities. In contrast to public goods, private goods can be parcelled out among individuals and consumption is "rival" in the sense that only one person can consume it. For example, if one person eats an apple (consumes a private good) the other person cannot do so. Hence, private goods are defined by their exclusive individual consumption, and total consumption can be found by summing all the goods that individuals in a group have consumed separately. How this group of individual consumers is defined is relatively arbitrary given that the group only determines the aggregate. Public goods, however, are characterised by the fact that *all* individuals together may consume *one and the same good*. For example, if two individuals walk down a street at night, they both together enjoy the streetlight. No one takes light away from the other; the light is no dimmer because many people use it simultaneously. In this case, the group of consumers is defined by the public good and the scope of its benefits. In logical terms, the distinction between private and public goods is a one-to-one relation between private goods and consumers, while for public goods it is one-to-many. We will see that this logical distinction has far-reaching consequences for the provision of private and public goods.

When economists differentiate between private and public goods, they do not only refer to rivalry and non-rivalry in consumption, but also to the so-called *exclusion principle* (Musgrave and Musgrave, 1973). This principle applies when a person's consumption is contingent on paying a price, which requires that private property rights are in place, thereby allowing the exclusion of a person who does not pay. For public goods in the strictest sense, this is not possible. Consider the famous example, first mentioned by John Stuart Mill, of a lighthouse showing the way for ships. Clearly, one cannot and should not exclude sailors from seeing the lighthouse because they have not paid for its maintenance. In the context of European public goods, non-exclusion means that European public goods affect all citizens in the EU together. The concept of European citizenship reflects this idea nicely insofar as it assigns equal rights and obligations to European citizens without constituting the citizenship of a super-state.

When a good is simultaneously rival and excludable, it is private; if it is non-rival and non-excludable, it is a pure public good (Cullis and Jones, 1998). Private goods are efficiently allocated by markets, but for public goods the market mechanism breaks down. In markets, consumers react to being charged the same unit price by choosing different amounts of consumption. Each buyer must reveal his/her preferences by bidding. Markets will satisfy all consumers who are willing to pay the marginal costs, and they will exclude those who are not willing or able to put up the money. The exclusion principle, which is the foundation of private property rights that allow the price mechanism to work effectively in markets, has often conflicted with the idea of distributive justice, and public goods have often been thought to remedy injustice because they cannot be rationed by price. This consideration is a frequent source for the demand of public goods in Europe, traditionally through the democratic institutions of member states, but increasingly also at the European level.

While all consumers are provided with the same amounts of public goods, irrespective of whether they have paid for them or not, public goods will only be supplied if *the sum* of each individual's contribution to pay for the public good covers the marginal cost of producing it. Some form of collective action is, therefore, necessary to ensure that individuals are forthcoming and that the rule for efficient provision requires that everyone contribute to the point where the private marginal cost of the contribution equals the social marginal benefit. However, consumers may only be willing to contribute according to the evaluations of their marginal benefits; if the sum of these contributions does not cover the marginal costs, the public good will not be produced. This makes the provision of public goods dependent on the honest and correct revelation of individual preferences and marginal benefits. As long as consumers of public goods can reasonably expect that their own contributions are too small to make a difference in securing the public good, they may act as free riders. However, if each consumer of the public good has this attitude, the provision of public goods will be suboptimal (Musgrave, 1996; Olson, 1971).

3.2 "European" public goods

This logic of public goods has two implications. The first is well discussed in the literature of public finance: a mechanism for preference revelation is needed. Voting on budgets can be such a mechanism. I will return to this argument below. However, the second aspect is crucial for defining what may be "European" about public goods because it implies that the size of the group of the potential consumers of a public good depends on the nature of the good itself. I will now discuss the definition of European public goods.

First, what do we call a "good"? For our purposes here, it suffices to say that an economic good is a reproducible thing or event that affects individuals' needs, desires and preferences positively or negatively. We include therefore tangible and non-tangible objects in this definition. Hence, we may call public goods not only physical things such as government buildings, roads, schools and armies, but also policies that affect people's lives, such as peace, national defence and the protection of property and law. In this sense, Europe's common agricultural policy, the single market, freedom of movement, competition and anti-trust policies and price stability and exchange rates are European public goods.

Second, when is a public good "European"? Most importantly, such goods are available for all European residents and they exclude non-Europeans. This is the case for fundamental rights such as the four freedoms, market regulation, non-discrimination, the use of the euro or public services provided by European institutions. However, there are also public goods that may originate in member states and then have external effects on citizens elsewhere. Building up human capital through education, securing external borders against uncontrolled immigration, fighting cross-border crime within the Union and even fiscal policy are such public goods. More broadly, Collignon and Paul (2008) classified policy areas such as European defence, foreign policy, internal security, industrial policy, macroeconomic stabilisation policy and the protection of climate and energy as European public goods. Verhofstadt (2006) came to a similar conclusion. Coeuré and Pisani-Ferry (2007) derived the "Europeanness" of public goods from the existing distribution of competences within the EU.

All these classifications are certainly subject to debate and disagreement. In fact, Kaul and Mendoza (2003) rightly made the point that the distinction between the private and the public are social constructs and, therefore, reflect concern for the public domain among all actors. I will argue below that the decision of what is or what is not a European public good must emerge from the democratic debates among citizens. Nevertheless, the nature of externalities is the crucial criterion for the definition and scope of public goods, and it is the European scope of externalities that makes public goods European.

We have said the consumption of a public good is characterised by the fact that each consumer enjoys benefits (or suffers disadvantages) from a given thing or event and that the group is defined by who is affected by them. It is therefore the nature and communality of public goods that defines the group of affected individuals.[1] In fact, the scope of a public good results from its degree of excludability and delineates what is a local, national, European or global public good. Private goods affect only the utility (costs and benefits) of one individual, whereas, for instance, people living in a local community cannot be excluded from consuming local public goods. European public goods, therefore, affect all European citizens together, and global public goods have inextricable effects for all of humankind. Tanzi (2008) insisted that globalisation has created global public goods as trade has increased, transport costs have fallen and communication networks have become denser, and this would "justify a global government if it existed" (p. 710). However, these arguments

[1] This does not exclude the possibility that a community defined by comprehensive doctrines (see Rawls, 1996) and homogeneous preferences may decide to create public goods that serve its doctrines.

are much stronger for European public goods, which have been generated systematically by successive steps of economic and political integration.

What's more, the communality of a public good is defined by the nature and scope of its external effects and not by the characteristics of the group of users. It is therefore not possible to say that the public good is defined by the quality and character of consumers or their tastes and preferences. For example, a streetlight is a public good because it can be "consumed" by anyone; it would be absurd to say that it is a Christian or Islamic public good because these are the groups of people who mainly use it. By contrast, a church or a mosque is a Christian or Islamic public good because that is the function such buildings are constructed to serve. Hence, a public good belongs to – or is the property of – all potential consumers for whom it fulfils specific functions; it is not the property of a group – its character, tastes or preferences – that defines what is theirs and what is not.

If we admit that policies are a form of public goods, the distinction between European and national public goods, therefore, must derive from the functions that European policies have for all European citizens. This is because all citizens are affected by them; national public goods have a more narrow scope insofar as they only fulfil a function for citizens living in a particular nation state. It would be a categoric mistake to think that national policies can be European or that European policies can be made by nation states. The implication is that the competences for governing European public goods must be defined top-down and not bottom up:[2] the scope and function of public goods defines who is affected.

3.3 Collective action problems

Providing public goods is never free from costs. If individuals want the benefit of these goods, they must pay for them. That much is clear. But are they willing to do so? Behind this question lurks the problem of incentives for collective action. The incentive problem of providing public goods efficiently has long been recognised. Hume (1740) recognised it 270 years ago[3] and

[2] This is a consequence of the logical structure of the relation between public goods and consumers being one-to-many. For, if the relation could be inverted to many-to-one, while externalities continue as one-to-many, public goods would become equivalent to the one-to-one relation of private goods. This is precisely what happens when subgroups appropriate public goods to serve their own preferences.

[3] "Two neighbours may agree to drain a meadow, which they possess in common; because it is easy for them to know each other's mind; and each must perceive, that the immediate consequence of his failing in his part, is, the abandoning the whole project. But it is very difficult, and indeed impossible, that a thousand persons should agree in any such action; it being difficult for them to concert so complicated a design, and still more difficult for them to execute it." Hume (1740: Section vii. Of the Origin of Government)

thought it justified the existence of governments. Dougherty (2001) showed that collective action problems were the main reason why the United States ditched the dysfunctional *Articles of Confederation* for the federal Constitution in 1787. The modern literature on public goods has linked the incentive problems of collective action to public goods through the concept of externalities.

In his famous book The *Logic of Collective Action*, Mancur Olson (1971: 44) argued that whether people are willing to pay for a public good depends on the size of a decision-making group. If the group is large, he argued, rational self-interested individuals would not contribute to a collective project, while in small groups self-interests may ensure its realisation:

> In a small group in which a member gets such large fraction of the total benefit that he would be better off if he paid the entire cost himself, rather than go without the good, there is some presumption that the collective good will be provided. … By contrast, in a large group in which no single individual's contribution makes a perceptible difference to the group as a whole, or the burden or benefit of any single member of the group, it is certain that a collective good will not be provided unless there is coercion or some outside inducements that will lead the members of a large group to act in their common interest.

One may easily deduce from this argument that with the enlargement of the European Union, its efficiency in providing public goods is diminishing (Collignon, 2003). Gridlock in the Council has been widely acknowledged (Tsebelis and Garrett, 2001; Schulz and König, 2000; Hix, 2008) and frequent Treaty revisions have been precisely designed to increase the efficiency of policymaking in a larger Union. Coercion with different degrees of constraints in the form of outside inducements, peer pressure and binding rules under the Stability and Growth Pact are the tools by which the EU has responded to Olson's problem.

However, in a careful analysis, Richard Tuck (2008: 12) dismissed Olson's argument:

> Olson believed this (…) because (on an analogy with perfect competition) any particular contribution to the common project makes no appreciable difference to the outcome and it is therefore irrational for me to make the contribution. The problem with his solution, however, is that if this is so, then on the face of it enforcing any particular contribution to the common project can make no appreciable difference in itself and is therefore (by the same reasoning) an irrational action for the enforcement agency to take.

Hence, more coercion, harder rules and binding or automatic sanctions will not necessarily overcome Europe's policy gridlock. The recent euro crisis was precisely caused by the lack of the enforcement of policy rules that Tuck described.

Tuck (2008: 13) rightly pointed out that Olson's problem resulted from an economic framework of perfect competition and separate agency. If we drop this assumption and "imagine individuals committing themselves to contribute to the common good on condition that other members of the group do likewise, (…) there is no difficulty in principle about ensuring that the commitments once made will be honoured. The difficulty lies rather in specifying the conditions under which the individual will bind himself to participate."

I will now show that a combination of the theory of public goods and that of strategic interaction can clarify these conditions, which enable people to cooperate. However, when we move to strategic interaction, the cognitive dimension of allocating resources to collective preferences also becomes important.

3.4 Incentive structures

Cooper and John (1988) presented a simple framework for analysing cooperation between many individuals that generates multiple equilibria or even no equilibrium at all. Their society consists of many identical individuals that choose to act in such a way that they maximise their utilities after taking the (optimal) choices of all others as given. How they make their decisions is called the reaction function. There is a cooperative equilibrium when the actions of one individual coincide with those of all others such that everyone's utility is maximised. It turns out that there are two possible reaction functions, one with strategic *complementarities* and another with strategic *substitutabilities*. In the first case, an individual's decision generates externalities, which cause everyone else to move in the same direction. Hence, the actions are complementary and actors cooperate in the interest of the common good. In the second case, an individual can increase his/her own utility by doing the opposite of what everyone else would like to do. In this case, namely strategic substitutabilities, cooperation breaks down.

The prisoner dilemma and free riding are typical examples of cooperation failure. However, even in the case of strategic complementarities cooperative strategies can fail if information is asymmetrically distributed. For, if we admit interactions between individuals occur, it is necessary that actors have information and knowledge about how the others will behave. If agents expect the others to behave in a certain way *and* expect that their cooperative behaviour generates benefits for themselves, they will choose to cooperate; otherwise they will not. Thus, multiple equilibria are possible: if cooperation is expected, it will happen; if it is not expected, it will not happen. Asymmetric information about agents' intentions can generate expectations of non-cooperation and, therefore, yield suboptimal welfare equilibria.

This model has often been applied to macroeconomic issues, but it is also highly relevant for analysing the provision of public goods. Thus far, we have discussed pure public goods, but we must now look at two hybrid forms, which form impure public goods. First, so-called *club goods* emerge when a good is non-rival in consumption, but it is possible to exclude certain groups of individuals from access to its benefits. For example, sports clubs provide joint benefits for members, but only if they pay their fees. From this perspective, the European Union and the Euro Area provide European club goods, because only those who fulfil certain criteria are admitted as members. Club goods exist even within the European Union when some member states do not participate in a given policy. For example, Schengen gives full freedom of movement only to citizens under the Schengen Agreement and the euro only benefits those who have no derogation or opt-out.

Second, so-called *common resource goods* exist, where the consumption of a good is rival (what one person gets, another does not), but the access to it is open and no consumer can be excluded. This applies particularly to limited resources (thereby rival consumption) to which consumer access cannot be controlled. Such common resources are often underpriced and lead to the "tragedy of the commons" (Hardin, 1968). Typical examples are the exploitation of oil wells or fishing in the ocean, but I will show below that with the creation of the euro common resource goods have become dominant within the European Union.

These hybrid features of common goods provide contrasting incentives for coordinated action. Club goods are inclusive in the sense that strategic compatibilities generate incentives to cooperate, provided the problems of asymmetric information are overcome. This can be achieved by appointing an impartial adjudicator that ensures that the information circulates freely and completely. In the European Union, this was one of the principal functions of the European Commission, which reassured member state governments that they had good reasons to expect their contributions to yield benefits that would increase general welfare and the approval by citizens. Hence, governments will cooperate in providing club goods. In the European policy context, this logic has often been expressed by statements such as this (Kok, 2004: 9):

> Actions by any one Member State (…) would be all the more effective if all other Member States acted in concert; a jointly created economic tide would be even more powerful in its capacity to lift every European boat. The more the EU could develop its knowledge and market opening initiatives in tandem, the stronger and more competitive each Member State's economy would be.

This kind of argument was successful in the early stages of European integration, because in those days European public goods were essentially club goods. For example, the creation of a customs union, up to the single market, could be justified in terms of welfare gains from cooperation. The synergy argument has also been used to justify the open method of coordination that was adopted following the Lisbon Strategy. Yet, this strategy has failed to achieve many of the intended objectives, just as the Stability and Growth Pact has not been implemented. The reason for these frequent coordination failures is that European public goods are now increasingly dominated by strategic substitutabilities, and governments have incentives to do the opposite of what is in the common interest. In this case, cooperation is bound to fail. This failure has often been blamed on nationalist egoism, but it should be clear that it has more profound systemic foundations.

The range of common resource goods and related policies has significantly increased since the Maastricht Treaty and the creation of the euro. In fact, money is a common resource good par excellence and I will now explain why the euro requires new forms of governing public goods.

3.5 Money as a common resource

In a market economy, money must function as the *hard budget constraint*. It is created by the central bank, which needs to keep money scarce in order to ensure that markets function efficiently. This is the principle behind central bank independence and the European Central Banks's (ECB) primary objective of maintaining price stability. If the ECB was not independent and governments could oblige it to give them money, the euro would become a soft budget constraint. Price stability would be lost and resources would no longer be allocated to their most productive uses. Hence, money supply is limited, and therefore "rival in consumption" (meaning money that is mine is not yours). By contrast, banks must always be liquid, which means their access to liquidity in the money market is free and unrestricted. However, the interest rate determines the conditions under which the banking system can obtain money and lend it into the "real" economy. This therefore reflects the relative scarcity of money as a common resource. These conditions are equal for all economic agents, even if banks and capital markets charge a premium for risk considerations. Therefore, money defines the Euro Area as an integrated economy and the euro is a public good.

Because money is a common resource good, the euro introduces strategic substitutabilities into the interactions of member states and creates political incentives for governments to free ride on their partners. This logic does not only apply to a currency union, but also to a common budget, which is defined in terms of a common unit of account. This is, of course, the case of the European budget, which is set in euro, even if the actual contribution by some member states must be converted by the given exchange rate. Each member state could increase its welfare if it could free ride on the contributions made by others. Margaret Thatcher famously claimed, “I want my money back” from the European budget, but the unwillingness of the German government to use taxpayers money to sustain financial stability in the Euro Area, and thereby provide stability as a European public good, is much more damaging than is Thatcher’s avarice.

Because the European budget dissociates funding and allocation, member states see their net contributions to the European budget as rivalling national expenditure; therefore, they have an incentive to minimise their contributions and to underfund the provision of European public goods such as research, technological development, the common agricultural policy and the institutional capacities of domestic and foreign securities. Similarly, in a monetary union “sovereign” borrowers are on par with any other debtors because they all face the hard budget constraint of monetary liquidity in the same manner. Given that any borrower has free access to the capital market, whereas total funds are limited, strategic substitutabilities generate an incentive to over-borrow, which drives interest rates up, or worse threatens financial stability. This behaviour can cause serious negative externalities, as we have witnessed.

3.6 The governance of European public goods

We can now draw some conclusions for the governance of European public goods. Such goods affect all European citizens collectively, although the contributions made for the efficient provision of these goods will depend on the incentives generated by different classes of public goods. Club goods can be provided by the voluntary contributions of member states, although this requires overcoming the obstacles of asymmetric information. Common resource goods, which are largely generated by the need for funding in the monetary union, require much more stringent forms of governance. Hence, differentiated forms of governing the provision of European public goods may be necessary.

Coeuré and Pisani-Ferry (2008: 22) claimed that “the desirability of a common policy depends on the degree to which member states agree with each other.” It should be clear that this is wrong. The statement contains the categoric mistake described above. The desirability of common policy derives from externalities, and member states are often an obstacle to achieve efficient solutions. However, the mistake is frequently made in European policy circles, where convenience often beats coherent logical thinking or, even worse, violates the fundamental norms of modern democracy.

What is at stake here is the concept of sovereignty. Pre-democratic ideas identified sovereignty with the ruler; the modern democratic concept locates sovereignty in the people, i.e. in the set of citizens who are affected by the externalities and policies related to a public good. The pre-democratic version claims with Hobbes that the people have surrendered or delegated their authority to the state or government;[4] the modern approach distinguishes between the *authority* of the people as principal and the *power* of governments as their agents that manage their public goods. From a democratic point of view, member states cannot be the principal that authorises the delegation of policymaking competences to the European level. Rather, the citizens must always own and consume the public goods.

However, this distinction between authority and power poses a number of questions. The first concerns ownership: who are the proprietors of public goods? Typically, ownership covers the right to receive certain benefits and the obligation to assume liabilities related to a given good. Hence, the owners of public goods are all the citizens who are affected by the benefits and externalities of such a good. It is precisely this right of ownership that makes citizens the sovereign and not governments. Yet, public goods have different scopes and functions. Any individual citizen is, therefore, simultaneously the owner of different public and private goods, some of them with local or national external effects, some with European or even global impacts. Because citizens are the owners of public goods, their authority is indivisible; but insofar as citizens consume different goods, it is divided. If we call *res publica* the set of all public goods, we must conclude that the republic can be "*une et divisible*".[5]

This raises the second question of how the principal can control the agent. If governments are the agents of citizens, there must be, as federalist theories claim, different governments that manage public goods with different scopes and functions for different groups and constituencies of owners. However, because federalism follows a bottom-up approach, it cannot define the competences of these different layers.[6] The federalist solution to the problem of

[4] Coeuré and Pisani-Ferry (2008) provided a neat description of different forms of such delegation, which they call either unconditional or supervised. Nonetheless, their vision is clearly Hobbesian and pre-democratic.

[5] Unitary state constitutions such as those in France and Italy claim that "la république est une et indivisible".

[6] The confusion is perfectly clear when federalism recurs to the so-called principle of subsidiarity of which Sinn (1994: 86) stated that "it places the burden of proof on those who want more centralization. However, apart from that it is empty and meaningless. It does not say anything about which of the government's functions should be centralized and which should be kept with lower levels of government."

assigning competences is to start with geographically defined subdivisions of the polity, in which some socially constructed conceptions of political identity prevail (Feeley and Rubin, 2008). Fiscal federalism describes this identity by the heterogeneity of given social preferences and concludes that the efficient provision of public goods should be decentralised to the level where the marginal benefit of collective action equals the cost preference frustration (Oates, 1972). However, political and fiscal federalism share the fundamental assumption of given preferences. They have no theory about how preferences can change and converge. Federalism is therefore not a theory that can explain how to manage public goods efficiently in the process of European integration with the important transformations it produces in societies.

If federalism fails, the republican paradigm is an alternative (Collignon, 2003, 2004, 2007). Here, citizens assume responsibility for their common property and the public goods they share, and appoint a government as their agent that manages their common concerns but remains responsible and accountable to the principal. It is this freedom of the principal to appoint an agent that justifies calling republicanism a form of self-government. The shared responsibility for the common good requires that interdependent citizens first deliberate and then realise the common good – their *res publica* – which promotes their individual interests and protects their individual rights (Honohan, 2002).

This participation in the process of deliberating and defining public policies is not only the cultivation of civic virtues that generates legitimacy for policy output; it also has the important consequence that policy preferences will converge, provided some minimal conditions, namely bounded rationality and connectedness, are fulfilled (Lehrer and Wagner, 1981; Collignon, 2008). With bounded rationality, citizens who know that they do not know everything with certainty will consult others, and this generates convergence to consensus. While bounded rationality may be a pervasive feature of society because knowledge is imperfect, the process of convergence to consensus can, of course, fail and cause conflicts when people self-righteously stop taking into account the views of others. Democratic processes and mechanisms to sustain them, however, can help prevent such communication breakdown, because the transparency of democratic deliberation obliges citizens to reveal their preferences. Furthermore, democratic institutions will accomplish connectedness precisely because every citizen must make a choice about the government he/she wants to see as his/her agent, and with bounded rationality citizens will discuss their choices before they vote. Hence, the republican approach provides a theory that goes beyond the limitations of fixed preferences, which underlay federalism and the pre-democratic ideas of sovereign statehood.

The implications of this republican paradigm are that the efficient provision of European public goods cannot be dissociated from the issue of democracy in Europe. The intergovernmental approach to governing[7] Europe's common resource goods reflects pre-democratic Hobbesian ideas, whereby once the people have conferred their authority to the sovereign, he may rule with absolute power. But with many sovereigns, this reply will inevitably cause cooperation failure. With the creation of the euro, such common resource goods have now become the dominant feature of European economic life and they call for an Economic government with full democratic controls.

However, there remains a third question. If public goods are defined by the scopes of externalities, there may be many functional levels for the government of public goods. This could lead to a system of functional overlapping and competing jurisdictions for the provision of specific public goods (Oates, 2001). Europeans discuss this under the heading of variable geometry or multispeed integration. The problem is that the complexity of European public goods creates excessive functional separation between different public goods and this makes democratic control practically impossible: who could envisage democratic elections for each agency that has to administer public goods with different scopes? Maybe direct democracy works in small republics such as Switzerland, but in the European Union it would be dysfunctional.

Parliamentary democracy was precisely invented to overcome this problem. Policy issues are bundled together and controlled by parliaments that represent the sovereign for a limited period of time. Hence, the efficient and democratic management of European public goods would require that citizens exert their ultimate authority as the sovereign by electing the European Parliament, which then controls the Commission as the agent of European citizens. In this way, public goods could be administered democratically without falling into the trap of inefficient intergovernmentalism or identitarian federalism.

[7] As Chancellor Merkel said, "The economic government is us", meaning it is member state governments.

3.7 Conclusion

It is time to become aware of the far-reaching externalities that have emerged with European integration. They need new forms of governance, and some even a government. However, the precise distinction of what counts as a European or a national or international public good, and what needs to be represented by a European government within the Union outside in the global context, will always remain subject to political deliberation and public choice.

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4 European Added Value for the EU Budget

Friedrich Heinemann

If one consensus has emerged from the decades-old reform debate on the EU budget it is that the budget up until now has paid too little attention to the provision of goods and services with a European added value. In its budgetary review paper, the European Commission (2010b: p. 4) summarises this consensual position to define its budgetary priorities: "the European dimension – where the EU can bring the highest added value – was not always the primary consideration." This view is also shared by academic treatments referring to the theoretical criteria of fiscal federalism (Alesina and Wacziarg, 1999; Alesina, Angeloni and Schuknecht, 2005; Heinemann and Begg, 2006; Gros, 2008; Begg, 2009). The bottom line of these and many other treatments is that because of several political/economic mechanisms the budgetary procedure is biased towards spending with an easily perceivable pattern of monetary national benefits. Consequently, policies remain under-financed, which allows the reaping of European economies of scale or corrects the national under-provision resulting from significant cross-border spillovers, i.e. which qualify as *European public goods* (EPG).

In spite of this consensus, the speed of budgetary restructuring remains slow. The budgetary negotiations on the multi-annual financial framework continue to follow the old reactions where national governments have an overriding criterion, namely the transfer of budgetary resources towards their constituencies. Given this frustrating experience, Heinemann, Mohl and Osterloh (2010) suggested searching for "incentive channelling" reform approaches in addition to mere "content-driven" approaches. Content-driven approaches derive roadmaps for a restructuring of the budget based on the EPG criterion that offer specific hints towards recommended shifts in the budget (Sapir *et al*., 2004; ECORYS, CPB and IFO, 2008) or that specify the criteria that should guide such restructuring (Tarschys, 2011). While these content-driven contributions to the reform debate are indispensable as a normative guidance, it is increasingly acknowledged that they alone cannot be successful. Resistance to far-reaching budgetary reforms is not the result of lacking intellectual insights but reflects political/economic constraints and incentives. Incentive channelling reform approaches, therefore, want to change institutions to reach efficient political/economic equilibriums given the exogenous preferences of veto players.

The recent Commission position on budgetary reform is a good example of this changing philosophy. According to the Commission's diagnosis, the current system of revenues contributes to the distorted incentives: "The current [financing] system is perceived as opaque and too complex, lacking fairness – notably with regard to corrections – and relying excessively on resources which are perceived as expenditures to be minimised by the Member States" (European Commission, 2010b: 26). According to this view, a "holistic vision of budget reform" (p. 2) covering both sides of the budget is necessary. The Commission hopes to limit the *juste retour* orientation of member states through a new source of revenue, which "should be collected directly by the EU outside national budgets" (p. 27). Concepts such as this – whether convincing or not – pay increasing attention to reforms that would alter incentives through institutional reform.

This contribution critically explores incentive channelling reforms. For that purpose, an analysis is presented that compares the narrow *juste retour* view with an EPG approach. On that basis, different types of possible incentive channelling reforms are analysed. The scrutiny includes correction mechanisms, new (and true) own resources and, as an innovative element to the literature, approaches where member countries contract out certain provisions of public goods to the European level and pay for it.

Several insights occur. Contrary to the above-cited Commission expectation, granting the EU more budgetary autonomy is not a promising incentive channelling reform. The flaw of the autonomy hypothesis is that a full European added value perspective must not be blind to the impact of EU policies on national budgets where part of the added value should materialise. A specific result is that the substitution of national contributions through new and true European own resources will not strengthen the political support for EPG in the budget. On the contrary, such a move might exacerbate inefficiencies if sensitivity to the cost side of the budget decreases. Carefully designed correction mechanisms perform better. Corrections that pre-define net positions produce a distribution pattern that is independent of the expenditure structure and, therefore, highly promising for correcting the bias for backflow-oriented EU policies. Other approaches that would promote European added value orientation in EU spending are the sale of European services to the member states based on voluntary contracts and new approaches to the evaluation of EU programmes.

4.1 Criteria

4.1.1 The narrow juste retour view

In the following, an analysis is presented which compares the narrow view of national agents preoccupied with their national *juste retour* with that of a fictitious benevolent European optimiser and his/her "European added value view". This comparison is helpful for analytical guidance on the most promising institutional innovations with respect to a larger weight for the European added value.

Juste retour thinking is characterised by a judgment of EU budgetary items solely on the basis of the resulting measurable financial burden from national payments to the European budget and the immediate measurable monetary benefits. Hence, the criterion from this narrow perspective of a country is its net balance, which is equal to the difference between the money returning to a country and this country's contribution to the budget.

In the logic of this criterion, a member country assesses, e.g., cohesion spending by comparing the Euros the country has to pay as its financing share for the structural funds with the Euros flowing back towards recipients located within its own national borders. Policies with a positive/negative net balance tend to be supported/rejected.[8]

The political/economic driving forces behind this narrow calculus have long been well understood and are not EU-specific. In any budgetary system, regional representatives will tend to support so-called "pork barrel" projects (Shepsle and Weingast, 1981; Weingast, Shepsle and Johnsen, 1981).[9] The underlying problem is that of the asymmetry between a regional pattern of beneficiaries and an overall financing source, the "common pool". Regional representatives are typically assessed by their voters on what they did for the region (and not for the overall jurisdiction). Consequently, public goods for the whole jurisdiction are disadvantaged compared with regional spending projects when it comes to negotiations on the overall budget.[10] Obviously, if this kind of reasoning dominates EU budgetary decisions this will not lead to an efficient provision of EPG.

4.1.2 The European aggregation

The narrow view's first limitation is the fact that a national criterion cannot determine the optimum level of an EPG. European reasoning must be based

[8] The politically relevant concept is that of "perceived" backflows. It may well be the case that certain money flows are not as relevant as are others and that they have, therefore, a lower weight in the assessment. Conceptually, this would amount to the calculation of a weighted sum of backflows into the national territory with the weights reflecting the political importance, for example with a larger weight for payments to a politically influential lobby group – e.g. farmers – than to poorly organised recipients – e.g. researchers obtaining funds from the framework programme.

[9] In the context of US budgetary policy, this term is used for projects whose benefits concentrate on an electoral district but whose financing originates from nationwide tax revenues.

[10] The common pool problem is highly relevant for the EU under its current institutional order (Heinemann, Mohl and Osterloh, 2008: p. 29).

on an aggregation of the effects in all member countries. Hence, a first step towards the reasoning of the European benevolent optimiser is to aggregate the member countries' net balances.

The Union claims to be based on the principle of solidarity, which, consequently, realises redistribution through the EU budget. Hence, a negative net balance of rich countries should not lead to a negative assessment of a European policy if this benefits poorer countries (and if this redistribution is indeed based on a consensually established redistribution formula). As long as the larger burden of one country is compensated for by a lower burden of another country this should not matter for the question of an efficient provision of public goods and services through the budget. Cross-country redistributive effects are an issue for negotiations on the fair burden sharing but not crucial for the efficient size of the budget.

4.1.3 The augmented net balance

Clearly, this aggregation extension does not go far enough. Thus far, the calculus is only about immediate budgetary payments and does not yet include European added value, which has no budgetary representation. European policies that clearly have an EPG character would perform poorly in light even of the aggregated net balance criterion. Spending on external policies (of the type that lead to payments flowing outside EU borders) enters net balances negatively through national contributions without any positive representation in the criterion. However, it is equally true that public goods with a wholly internal impact (e.g. providing institutions for the internal market) do not show up as benefit because they do not lead to a perceived backflow of budgetary resources.[11] Hence, they would enter the calculus with a clearly negative sign: as a cost through national contributions but with missing benefits.

Conceptually, this shortcoming can be remedied by including an additional item in the optimising calculus, which may be termed the "*equivalent national expenditure*" (ENE). This represents the equivalent national budgetary expenditure necessary to replace national public goods if the EU budget had no role. For example, for research policy, it represents the (sum of) national expenditures for research that would produce the same level of innovations as if no European research policy existed and nation states had the sole responsibility for this policy.[12] Its inclusion modifies the criterion of the aggregated

[11] Indirectly, budgetary backflows may be realised to a considerable extent, e.g., through tax revenues because of growth induced through a functioning internal market. However, these budgetary benefits cannot be identified as caused by EU policies.

[12] The innovative output with an exclusive national competency would also depend on the distribution of national research budgets across member countries.

net balances. To put it differently: The sum of member states' ENE represents the budgetary savings realised at the member state level if the European level takes over a certain responsibility. This item precisely reflects what the European Commission (2010b: p. 5) describes as the "European dimension" of spending, which "can maximise the efficiency of Member States' finances and help to reduce total expenditure, by pooling common services and resources to benefit from economies of scale." The resulting modified criterion, which takes account of the ENE dimension, can be termed the "augmented net balance" criterion.[13]

In light of this criterion, European policies that create an added value would now make the race: if they are provided through the EU budget, they will cause an increase in the sum of national contributions. However, this would be overcompensated by a larger sum of budgetary savings at the national level and thereby lead to an increase in the national sums of the augmented net balances.

This conceptualisation allows us to identify the two key obstacles preventing EPG acceptance. The first obstacle concerns the natural contrast between the isolated national view and the aggregation of European effects. Even if the full effects of EPG are felt at the national level, the benefits may be spread in an uneven way. The second obstacle is the low political relevance of the ENE item compared with the budgetary backflows and the national contributions. National governments tend to be guided by a reasoning on a narrow net balance criterion which ignores (or at least unduly underweights) the ENE item.

The first problem is of a less severe nature. If member countries were fully aware of the ENE dimension, incentives would work towards negotiating the financing of EPG, even in case of an uneven distribution of benefits. Member countries benefitting considerably would have an incentive to compensate other members to safeguard an efficient level of EPG. Hence, the augmented net balance criterion would then prevail.

The more severe problem is the ignorance of ENE consequences from European politics. Compared with measurable budgetary backflows, the ENE aspect of European policies is harder to quantify and has a poor political impact. It rather has the character of opportunity costs since member states forego potential gains by not financing specific EPG. Opportunity costs, however, do not have the same political relevance as direct "out-of-pocket" costs, as is known from behavioural economics (Tversky and Kahneman, 1986).

[13] This criterion abstracts from the genuine own resources that are levied by the EU directly such as revenues from tariffs. The European welfare maximiser would, of course, have to take account of these costs as well.

Thus, the selection process discriminates against EPG and favours the financing of pork barrels with a transparent regional or national pattern of benefit.

As a consequence, any incentive channelling reform should aim to strengthen budgetary reasoning along the lines of the augmented net balance criterion, which includes budgetary cost savings at the national level. In the following section, we will analyse how different types of reforms could modify the dissatisfactory budgetary reasoning of the status quo.

4.2 Evaluation of different reform types

4.2.1 Increasing budgetary autonomy at the European level

A first reform approach of a general nature aims to make EU budgetary decisions more independent of member countries' consent through whatever specific reform (for own resource innovations, see next section). From the perspective of the Commission and the European Parliament, a larger degree of autonomy from member states' finances is one of the key objectives that is regularly applied as a selection criterion for promising reforms (Commission of the European Communities, 1998, 2004b; European Parliament, 2007). In light of the above reasoning, such unqualified optimism is questionable.

Firstly, the high awareness of the cost side of the EU budget in terms of its financial burden at the national budgetary level is *not* at the heart of the diagnosed inefficiency. On the contrary, even in the full and efficient calculus of the augmented net balance criterion the cost side is, of course, fully included. Ignoring the cost side would lead to an inefficient expansion of the budget and to an overprovision of both pork barrels and EPG. For the efficient provision of EPG, the (sum of the national marginal) benefits must be balanced against the (marginal) costs in terms of higher overall national contributions. Cost ignorance would lead to overprovision. Thus, the crucial problem of inefficiency is not cost awareness (under the status related to national contributions) but the ignorance of the ENE consequence.

Secondly, the European optimiser is fictitious, and in the real political system of the EU no agent exists whose interests could be best described by augmented net balance criterion. While national agents may unduly underweight the ENE component, EU agents lack a genuine interest in the contribution and backflow components. These national consequences of EU spending must, however, not be ignored in a full optimising reasoning otherwise the risk emerges that, e.g., European bureaucratic interests in budget maximisation are not counterbalanced by cost considerations.

Apart from that, the lack of perception of the ENE component is most likely even larger for EU fiscal politicians compared with their national colleagues.

Potential cost savings for member countries' budgets should obviously have a larger weight in national reasoning compared with EU agents' reasoning, which has no direct advantage from national savings. If member countries' agents unduly underweight ENE, EU agents will certainly do so. Therefore, the distorting incentives in the current system cannot be promisingly addressed simply by increasing the budgetary autonomy of the EU level. On the contrary, a strong awareness of the national budgetary implications of EU policies is a precondition for the identification of the EU added value, and in this sense the strength of the status quo. The term "added value" implies that there should be value creation on top of a certain point of reference. An awareness of this point of reference is indispensable for identifying the added value.

Own resource innovations

This sceptical view of the merits of EU budgetary autonomy in general transfers to the more specific reform option of a larger degree of EU own resource autonomy.

The current revenue system is increasingly dominated by the GNI resource (resource in proportion to a member country's gross national income) with a share of 70 percent in 2009. There is also an increasing tendency towards a small and declining VAT resource share, with the rest financed from own resources or other revenues (European Commission, 2010a). A crucial feature of the current system is that it is de facto a contribution system where member countries finance the GNI (and the VAT) resource out of their national tax revenues. Thus, there exists a direct and strong link between the national and the European budgets. Savings in the EU budget leave the national budgetary authorities larger revenues at their disposal.

The Commission has recently re-intensified the debate on new own resources. While considering different specific new sources (such as EU taxes on the financial sector, an EU VAT and an EU energy or corporate income tax), a common characteristic of all suggested types is to lower the burden on national treasuries through a resource "collected directly by the EU outside national budgets" (European Commission, 2010b: 27). In previous reports, the Commission reiterated that such a move would help overcome the neglect of European added values: "A system based to a large degree on tax-based own resources … would also contribute to shifting the political discussion away from the narrow focus on national contributions towards the merit of EU policies and the general European interest" (Commission of the European Communities, 2004b: ch. 4).

A full debate on the pros and cons of alternative financing items is beyond the scope of this contribution (see, for example, Begg *et al*., 2008; Heinemann, Mohl and Osterloh, 2008). However, its merits in terms of the *juste retour* inefficiency can be analysed in the terminology introduced above.

In the net balance calculus this own resource innovation would affect the contribution item. With a radical move away from national contributions, these would be replaced by the overall proceeds from a European tax. For the European welfare optimiser this would not make any difference, he would weight the costs independently whether they would materialise through national contributions or through a European tax. Thus, he would arrive at the same optimum. Since the European optimiser does not exist in real life, the question is how the real players' incentives would be transformed. The impact on the reasoning of national agents depends on how they perceive their country's shares in the European tax. Two polar cases are possible.

In the one extreme, member countries would pay the same interest to their taxpayers' share in the European tax as they did before with respect to their contributions. The national contribution would simply be replaced by the national share in the EU tax. The only effects would be distributive if the European tax led to a different pattern of national burdens compared with the contribution system. This change would be equivalent to a new system of national contributions based on a new formula of burden sharing; no principle transformation of incentives would occur.[14]

At the other extreme, member countries would fully neglect the burden of the European tax if this tax were politically irrelevant at the national level (e.g. if its national incidence was non-transparent). In this case, the national contribution would cease to be relevant in the narrow net balance calculus and nothing would replace it. Member countries would then concentrate on an even more distorted criterion, which is simply the monetary transfer from the EU budget. In this extreme case, member states would simply welcome any expansion of EU policies that have a backflow component because these backflows are perceived as a "free lunch" in the absence of any negative consequences for the national budget. To give a specific example, even if money was perceived to fall "from heaven" into the EU budget, European farmers would not stop lobbying for a strong Common Agricultural Policy (CAP). The difference with this perception would only be that now even governments who are net payers into the CAP in the current system would no longer have an incentive to resist to farmers' wishes.

[14] This rebalancing of the national burden may have an impact on the demand for certain types of transfer policies depending on whether the main beneficiaries of a specific transfer policy experience a higher or lower share of the burden (Osterloh, Heinemann and Mohl, 2009).

Wherever on the spectrum these polar cases lay, the precise national perception of the EU tax component would materialise, and the new own resource solution would do nothing to overcome the national neglect for the ENE dimension of EU policies.

It may be possible that an EU tax could strengthen the cost awareness of EU players if these pay a political price for this taxation e.g. in elections for the European Parliament.[15] This does, however, not change the unequivocal result with respect to national players. An isolated reform of the own resource side would do nothing to address the current inefficiencies linked to the distorted national view of the EU budget. On the contrary, the possible ignorance of the cost side could even aggravate the problem. The unrestrained bias towards pork barrels on the expenditure side would now be accompanied by an expansionary bias because of a decrease in cost awareness. This expansionary bias would mainly benefit the backflow component and not the provision of EPG.

This pessimistic assessment of the incentive effects of an EU tax is underlined if one recalls the underlying fundamental common pool problem (see section 2). In that logic, the central institutional flaw was the asymmetry between the wide and dispersed financing of a European common pool on the revenue side and the clear national or regional pattern of beneficiaries on the expenditure side. The EU tax offers no solution for this problem. On the contrary, if the tax is less transparent than are national contributions it even weakens the cost awareness of pork barrel policies.

4.2.2 Correction mechanisms

Correction mechanisms are a reality for the EU budgetary system since the decision on the introduction of the UK rebate in 1984. In the reform debate, correction mechanisms have a rather poor reputation. Frequently, they are regarded as a symptom of a national and selfish view of the budget that should be abolished entirely.

With respect to the distorted incentives of member countries, the assessment is more differentiated. The effect of any correction mechanism is that it modifies the net balance arithmetic. Depending on the specification of the correction mechanism different incentive effects are possible. For example, the reform literature discusses mechanisms that would establish pre-defined net positions that depend on a country's prosperity (Padoa-Schioppa, 1987; de la Fuente and Domenech, 2001). Such far-reaching mechanisms have a

[15] It is an open question whether this type of voter control is equally effective at the European level for an EU tax as it is at the national level for a national tax. While it could be the case for the elected members of the European Parliament, it is unlikely to be so for the European Commission, which cannot be directly held responsible by the voters and taxpayers.

highly beneficial property. With a fully predetermined net position, backflows through EU policies would no longer have an impact on a country's effective net position since they would be neutralised by the correction. Less radical approaches include suggestions for a generalised correction mechanism (Commission of the European Communities, 2004a), which corrects net positions above a certain threshold, or for a generalised but limited correction mechanism (Heinemann, Mohl and Osterloh, 2008), which only addresses the net positions of specific policies. Both these variants would work by separating net balance outcomes from decisions on expenditure structure.

Therefore, these mechanisms would correct national incentives so that member countries would no longer be able to push their narrowly defined balances through their support for redistribution-intensive policies. This might be a step towards increasing national interest in European added value. With net positions determined, the only way for governments to reap advantages for their own national budgets would be to push policies with an ENE component. The trick is that the latter position is *not* neutralised by a correction mechanism, which only corrects flows between the European and national budgets but not advantages from European budgets that materialise through national cost savings.

Thus, against popular wisdom, properly designed correction mechanisms could form an element of a more efficient EU budgetary system. However, this should not obscure the fact that the current rebate system does not produce these desirable incentive effects because it is highly complex, non-transparent and the result of numerous ad hoc decisions with unsystematic privileges for several countries (such as temporary rebates for GNI resource payments, an arbitrary divergence of national VAT rates of call and so on).

4.2.3 Contracting approaches

Correction mechanisms can benefit EPG indirectly by decreasing the national interest in monetary backflows from the EU budget. The question is whether there are more direct approaches that could identify ENE and that might make this concept productive in the search for EPG.

A straightforward idea that is completely absent in the current literature is that the EU level "sells" its services to member countries through voluntary contracts. The idea is to take seriously the claim that EPG can help member countries save money because of European economies of scale or coordination failures. If ENE does exist, there should be room for arrangements where the European Commission sells certain contractually defined services to member countries. If Europe can provide services cheaper than those provided by member states, there should be room for voluntary contracts. The financing would originate from the savings in the national budgets. The resulting "contracted EU budget" could supplement the conventionally contribution-financed budget.

The contracting approach is most promising for types of public services where European free riding can be excluded and only those countries that are willing to pay benefit from a European service. It would not be necessary that all member countries become "clients" as long as a European added value materialises for a subgroup of member countries.

The contracting approach would assign the Commission an additional task: it would be responsible for marketing potential European services to member states. The general presumption that its activities lead to national cost savings would no longer be sufficient. On their "roadshows" through the EU capitals, Commission representatives would have to present convincing evidence that ENE really exists. Contracts could be negotiated for a limited time horizon. At the contract's expiry, partners could check the extent of promised savings and decide on a continuation. Examples for European services where contracting approaches might be imaginable include:

- *Climate policy*: Climate policy now has a clearly quantifiable unit, namely the reduction in tons of CO_2 emissions. The EU could sell member states the reduction of emissions for a certain price per ton and use the money for CO_2 emissions reduction measures. It would be completely irrelevant where (geographically) the EU realised the emissions reduction. It would, however, be essential that member countries received the credit for any reduction they financed. Member countries would then have an incentive to compare their (marginal) national costs for CO_2 reduction with the EU's offer and accept it if competitive.
- *Social policy*: Since its establishment in 1958, the European Social Fund (ESF) has financed programmes devoted to employment policies. Here, it is in competition with the national programmes. The European perspective might help foster the employment chances of problem groups. If this is the case, Europe could start selling these services to member countries instead of financing them fully through general contributions. The content of a contract, for example, could be to return to employment a certain percentage of long-term unemployed in a certain region or city. With the long experience of the ESF, the responsible Directorate-General should be able to commit to a minimum success rate (of course, with a well-defined margin of error) when it offers a certain programme with a defined budget to member states. Member states could then compare this offered success rate with its own experience of national programmes and make a decision.

- *Capacity building*: Tarschys (2011) correctly stresses the EU's role in building institutional capacity for efficient governance. If European bureaucrats have a comparative advantage, e.g., organising an efficient administration or implementing best practices (e.g. because of their better information on practices all over Europe), they could try to sell their knowledge to the national administrations through consultancy projects. This could become an important element of cohesion policy where economic benefits from structural fund spending depend crucially on good institutions in the recipient jurisdictions. Here the Commission stresses: "Cohesion can play an important role … by financing institutional capacity measures, promoting administrative reform, and fostering a culture geared to performance and results" (European Commission, 2010b: p. 14). Thus, it should have a product to sell.
- *Diplomatic services:* The new EU diplomatic service is to be financed from the EU budget. However, contracts could equally well play an important financing role. Diplomatic services such as catering for a country's citizens abroad are a clearly definable service with an obvious potential for sizeable European economies of scale. EU member countries know what they have to spend on these services through national embassies. Thus, they should be able to easily quantify their willingness to pay.

These examples indicate that there should be space for a voluntary and cost efficient expansion of the budget (if cost advantages for the EU provision of services are relevant). The contracting approach could be opened through a simple clause added to the multi-annual financial framework. This clause would stipulate that voluntary contracts between the European Commission and member countries are possible and define certain additional Commission activities as being financed separately through negotiable contributions from the contracting countries. The principle of equivalence pricing known from single purpose international organisations (Heinemann, Mohl and Osterloh, 2008) should be applicable for the contracted EU budget where countries pay flat prices per "unit" (e.g. number of citizens to be administered by EU diplomatic services or tons of CO_2 reduction). Equivalence pricing would be efficient (since it is oriented to the actual EU costs of provision) and transaction costs saved (no dispute over distribution involved). Although the EU is characterised by the principle of solidarity, this should not be an obstacle to equivalence pricing in the contracted budget since this is, by construction, beneficial for all financing countries.

4.2.4 Ways towards meaningful evaluations

The contracting approach would imply that the EU takes over the production of public goods where it has a cost advantage over the member state level. This reasoning, however, should also be forcefully present for the conventionally financed European budget.

Here, the transaction-oriented reasoning of the contracting approach must be replaced by careful evaluations of existing and potential European policies. Two shortcomings of the current evaluation practices of European politics and programmes should be addressed. The first deficiency is that European evaluations normally focus exclusively on the impact of the European programme under scrutiny. For example, for certain structural fund programmes the evaluation exercise asks whether a positive impact on growth or employment can be proven. A positive impact is, however, no proof of a European *added* value. European activity has an *added* value if its impact (for an identical budget) exceeds that of a comparable national activity. Therefore, such evaluations of European programmes should be based on the benchmark of similar types of national programmes[16] otherwise they are not justified under the dominance of the added value criterion. A mere positive sign is no indication that *ENE* is also above zero.

The second deficiency is that European evaluation exercises miss independence from the specific interests of European actors. The politically important evaluations of European policies are regularly performed by the Commission itself (such as the Cohesion Report[17]). The Commission has an obvious self-interest in defending its funds under administration and claiming successful use. Hence, it is not surprising that the results with respect to the overall justification of big EU spending programmes are most often presented in a favourable light. A step forward towards true European added value evaluations would be a new evaluation culture where the big reports (such as the Cohesion Report) would be produced jointly between European and national bodies with expert background studies financed jointly by both. This joint evaluation financing of the different federal layers would lead to results that

[16] This benchmarking is hard to realise for European policies with a pan-European character where no national equivalence exists. However, it is easy for large shares of spending from the structural funds or the second pillar of the CAP.

[17] For example, the Commission's Cohesion Report regularly claims certain positive effects of structural funds on growth and employment in the benefitting regions. This stands in contrast to academic work, which tends to return much more ambiguous results. Often, the claim that cohesion policy increases growth is based on ex ante simulation models in which, by definition, an increasing investment financed through regional policy increases growth. Econometric ex post tests are less enthusiastic (Heinemann *et al*., 2009) but so far have never had a serious impact on the politically important evaluations.

were less biased towards the interests of one federal layer. Such an approach would also make evaluation results a better guide of the policies and programmes of Europe that have much to offer.

4.3 Conclusion

For decades, the reform debate on the EU budget has been caught in an unproductive cycle. Reflective periods regularly stress that EPG do not receive the budgetary attention they deserve. When it comes to negotiating a new multi-annual framework, the old incentives continue to confirm an inefficient budgetary structure is in place.

There is a way out of this frustrating monotony, namely by using clever institutional adjustments that transform incentives. The list of incentive channelling approaches presented in this contribution was far from exhaustive. On the constitutional level, new decision making mechanisms and voting formulae could also change the equilibrium.

The present analysis has shown, however, that there exist degrees of freedom way below the constitutional reform that would push the system towards greater efficiency. A cleverly designed correction mechanism, innovative contracting approaches and a more neutral evaluation process would be particularly promising.

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5 EU budget, selection criteria and fairness

Peter Wostner

In 2005, the European Council agreed on the financial perspective for the 2007-2013 period. At the same time, heads of state asked the European Commission (EC) to prepare a budget review to carefully examine the justification of both expenditure and revenue sides of the EU budget and set the basis for a more thorough reform. This was a response to the general disappointment that in spite of the priority given to the Lisbon agenda, this was precisely the policy area where the greatest cuts were made. Moreover, the budgetary structure of the 2000-2006 period had been more or less preserved despite heavy criticism of the EU budget, which was described as being a “historic relic” (Sapir *et al*., 2003:162).

The budget review was delayed until the end of 2010 (EC, 2010a: 3), arguing that “the EU budget has proved itself as an effective tool to realise the EU’s aspirations”. This was the tone in which the whole document was written, prompting further disappointment about its low ambition. After all, the original, at least declared, intention of the heads of state was to make a serious attempt to *reform* the budget. However, given that negotiations were already under way, such a result was only to be expected.

By contrast, concerns were raised that negotiation on the post-2013 financial perspective will be yet another repetition of the previous cumbersome negotiation resulting in the status quo and lots of horsetrading along the way. Such a scenario is increasingly hard to justify given the consequences of the global economic and financial crisis, extreme global economic transformations in the last couple of years as well as other global challenges already spotted in 2004, like climate and demographic change. This has drawn renewed interest to the selection criteria that should be, in principle rigorously, used in the decision-making process of what should be included and to what extent in the EU budget.

Contrary to conventional wisdom, this chapter will argue that such an approach does not seem to have a good chance of success. In spite of different attempts to base decision making on selection criteria (e.g. the building block negotiation tactics by the Dutch presidency of 2004), there has been no progress along those lines. The discussion based on objective criteria, therefore, hardly appears useful since member states have a systematic disincentive to take them into account. It has been empirically shown that member states pursue another objective function, i.e. their net financial position versus the EU budget (e.g. Mrak and Rant, 2010; Heinemann, Mohl and Osterloh, 2010). And so long as this is the case, no genuine official discussion in the Council on the basis of the theoretically justified selection criteria will be possible.

Hence, the present chapter will argue for a modified EU budget preparation process, which would relieve negotiations of this *juste retour* approach. Furthermore, it will draw attention to the principle of fairness as one of fundamental principles of the EU budget. Arguments will be presented that such an approach is not less but eventually more "European" than is the present one.

The chapter is structured as follows. To understand the future needs of the EU budget, the global economic context will be examined in section 1 with particular attention paid to global transformations, which were less prominent at the time of the previous negotiations. This is necessary to underline the need for immediate joint and decisive action at the EU level. Section 2 will present the present EU strategy and look at the internal consequences relevant to the budgetary process. Section 3will detail how the budget is or rather should be designed to better reflect today's and tomorrow's realities. Section 4 concludes.

5.1 The EU and global transformations

The EU, as part of the developed world, might be losing its importance. This statement can clearly be looked at from a positive perspective, as the number of developing countries has engaged in a virtuous circle of growth and prosperity creation. This trend, however, represents both an opportunity as well as a threat. These are not only marginal shifts, but fundamental transformations to which the OECD refers to as "shifting wealth" (OECD, 2010) or *The Economist* as "the world turned upside down" (The Economist, 2010).

According to OECD (2010:15), the OECD's share of the global economy in purchasing power parity terms in 2000 amounted to 60%, whereas in 2030 it is expected to fall to 43%. This trend was started in the 1990s and has, if anything, even accelerated because of the global economic and financial crisis. The gap in "per capita" terms is still vast and it remains unclear to what extent or when it would be markedly narrowed (Brakman and van Marrewijk, 2007). But it is not the relative wealth as such that the EU might feel threatened about. Rather, it is the critical mass in absolute terms and the dynamics of change. As far as the former is concerned, just the integration of China, India and the former Soviet Union has brought 1.5 billion workers into the global economy (OECD, 2010: 47), and this has initiated a profound transformation in the developed world. According to OECD (2010: 48), "this shock alone may have depressed the world real equilibrium low-skill wage by 15%". The jobs started to move towards developing countries, while the West started to specialise in "knowledge-based, high value added activities" in line with the Lisbon strategy; basically, on the assumption that the EU would remain the brains of the world, while the East would do the hard manual and standardised work.

This assumption is, however, quickly losing ground. From the early 1990s to late 2000s, China not only increased its share of world steel production from 12.4% to 38.8%, but also increased its share of patent applications from 0.9% to 15.1% (OECD, 2010: 47). With 1.5% of GDP gross investments in R&D, China is admittedly still lagging behind the developed world, but its success in patents should not come as a surprise. According to UNESCO (2010), China increased its gross expenditures in R&D between 2002 and 2007 by 2.6 times – still noticeably lower than the EU (at app. 40% of its level) and the US (at app. 27%), but the gap is closing. And not only by China, but by other countries as well. From 2002 to 2007, two-thirds of the increase in the global number of researchers was in the developing world, an increase of almost one million (to 2.7 of the world's 7.2 million at the end of the period). Asia increased its world share of researchers by 5 percentage points, principally at the expense of Europe and the Americas (ibid.). In terms of the number of researchers in 2007, the US, the EU and China were on par, each hosting around 20% of the world's researchers. In 2002, 83% of R&D was carried out in the developed world, while in 2007 this share dropped to 76%. The gap in shares of scientific publications is larger but trends go in the same direction as the US and EU share each fell by app. 3 percentage points between 2002 and 2007, whereas China's share more than doubled.

The same can be observed in terms of human capital, which has the most robust impact not just on growth and prosperity (e.g. Mankiw, Romer and Weil, 1992; Florax, De Groot and Heijungs, 2002) but also on the location of advanced economic activity (e.g. Midelfart-Knarvik, Overman, Redding and Venables, 2000; Haaland, Kind, Midelfart-Knarvik and Torstensson, 1999). China and India each year produce five and three million graduates respectively, which represents an increase of four and three times compared with a decade ago (The Economist, 2010). Furthermore, in engineering or computer sciences, these two countries generate twice as many degrees as does the United States. It should come as no surprise then that companies are not only moving their production but also R&D and headquarter activities to developing countries. There are now 21,500 multinationals based in the emerging world. From the Fortune 500 list, 98 companies have R&D facilities in China and 63 in India, while Cisco is investing 1 billion USD on a second global headquarters in India, Microsoft's R&D centre in Beijing is its largest outside its American headquarters and Huawei, a Chinese telecoms giant, has become the world's fourth-largest patent applicant (The Economist, 2010).

These global transformations are changing the world's economic geography, with the developing world increasingly engaged in innovation processes causing disruption in the West (hence the term "disruptive innovation"). Again, disruption can be seen from a negative perspective as a threat for the relocation of industry and wealth to the East, but it can also be a trigger for positive changes based on wealth and knowledge creation effects. Before going in more detail on this issue, it is worth mentioning the newly recognised positive link between manufacturing capacity, growth and innovation, which has seemed to be particularly strong in the past 20 years (OECD, 2010, UNIDO, 2009) – contrary to the predominant economic doctrine of the 1990s and the first half of the 2000s. For now, the EU has managed to stabilise its share of the world's manufacturing value added (MVA) after a fall in the 1990s. At the same time, however, developing countries managed to increase significantly their share of world MVA from 24.3 to 29% between 2000 and 2005, more than two-thirds of which can be attributed to China (UNIDO, 2009). This is strategically important given that manufacturing continues to be the driver of innovation and technological change (OECD, 2006: 26): manufacturing still accounts for the predominant share of business R&D investment (accounting for between 60% in the US and 90% in Japan and Germany). Furthermore, China has overtaken both the EU and the US in the world share of high-tech exports with 16.9%, 15% and 16.8% shares in 2006, respectively (Eurostat, 2009).

The global distribution of manufacturing has distinct characteristics, which could also be interpreted as strategically important from a theoretical perspective. New Economic Geography (NEG) provides useful insights into the consequences of global (as well as internal) processes of economic transformation. There is now growing empirical evidence on the validity of NEG's assumptions, such as the importance of agglomeration economies, economic potential and knowledge spillovers (e.g. Combes, 2010; UNIDO, 2009). According to NEG and Paul Krugman's "home market effect", industries will be attracted to large markets/regions/countries because of costly trade, which will in turn result in higher real wages and/or higher returns to capital because of increasing returns (Baldwin and Martin 2003).

Indications of the relocation of economic activity to developing countries should thus be taken with all seriousness as such cumulative causation processes, once the threshold conditions are fulfilled, are hardly reversible.[18] Again, there are a number of significant opportunities and benefits in this process, but Europe is likely to be confronted with more significant outside pressures than those faced in the past. The process of globalisation since 1750 has worked in the West's favour; however, in the future its (relative) fortunes might be less favourable (Krugman and Venables, 1995). With high trade integration and the relocation of industry back to the periphery, the theory predicts convergence among the developed and developing worlds; however, this might, depending on the exact model and assumptions, be associated with stagnant (Baldwin and Martin 2003) or even reduced real income in the developed world (Combes, 2010).

This is simply to underline the importance of timely policy response in the developed world and the EU in particular since, even under the "ceteris paribus" assumption, the citizens of the EU will be faced with much greater reform needs than they (or their parents) were expecting, let alone have become accustomed to. Preparedness for change will thereby need to be given special attention, especially taking into account other global challenges such as climate change,[19] demographic change[20] and a secure energy supply. Indeed, according to Eurobarometer,[21] the expectations about "your life in general" for the year to come among EU citizens are becoming more pessimistic, with the share of those expecting a better life falling from 37% from mid-2007 to 24% in mid 2010, by far the lowest since 1995 when the question was first asked.

5.2 The European response

The European answer to these challenges is enshrined in the Europe 2020 strategy, which sets three overarching objectives of smart, sustainable and inclusive growth. As argued in the chapter by Daniel Tarschys, those orientations fall somewhat short of specifying concrete actions. Therefore, with some overgeneralisation one could argue that as far as the economy is concerned, priority should be given to further strengthening the single market

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[18] I intentionally take a narrow, European self-interested perspective, neglecting the obvious global developmental benefits such as reduced poverty levels.

[19] It is worth noting that adaptation and mitigation costs will not just be high but also that their size will be asymmetric across regions, with Southern and Eastern European regions feeling the greatest impact (EC, 2010c: 143).

[20] Nine out of ten European regions will see declining shares of working-age population by 2013 (EC, 2010c: 26).

[21] Results accessible through Eurobarometer's interactive search system at http://ec.europa.eu/public_opinion/cf/index_en.cfm.

and placing a greater focus on competitive capacity and innovation. As European Commissioner Olli Rehn puts it, "delivery is now the name of the game". He points out the need for further integration of the single market in the areas of services, energy and intellectual rights and calls for labour market and pensions systems reforms as well as reforms of tax and benefits systems. At the same time, he asks for greater investment in knowledge and innovation (Rehn, 2011). The proposed approach of a strengthened internal market now seems the only possible answer to these global threats because individual national and regional economies within Europe probably stand little chance if EU markets remain fragmented. Without economies of scale, big markets and the pooling of resources, European firms might well not be able to compete with other regions.

As can be seen, the majority of actions proposed could be described as structural reforms, which will require not only major flexibility and adaptation to the new circumstances by EU citizens, but also a fall in their personal well-being because of reduced (already acquired) benefits. Member states, by contrast, are in a weak position to cushion these downward pressures since only the stabilisation of debt relative to GDP will in most countries require "historical consolidation effort of anywhere from 6 to 9% of GDP" and "even more ... to bring debt back to sustainable levels" according to OECD.[22] The debt ratio, however, is set to remain on an upward path over the forecast horizon (EC, 2010b). If expenditure levels will be falling because of public consolidation, interest payments will rise, thereby further squeezing room for manoeuvre. Interest payments are forecasted to rise from 2.7 to 3% of GDP at the EU level between 2010 and 2012, but with much more significant jumps in some countries (from 3 to 4.4% in Ireland, from 6 to 7.4% in Greece, from 2 to 2.8% in Spain, from 2.9 to 4% in Portugal and from 1.4 to 2.1% in Slovakia).

The fiscal consolidation process will clearly have a negative impact on the size of both public investment (EC, 2010c) and so-called structural expenditure, which encompasses some current expenditures that could be economically described as productive investment (Wostner and Slander, 2009). This makes Olli Rehn's announcement of "greater investment in knowledge and innovation" an even greater challenge and further strengthens the strategic importance of the EU budget.

The discussion on the next financial perspective will thereby be characterised by greater risks and challenges than before, which will require significant ad-

[22] Speech by Angel Gurría, OECD Secretary-General, on 3 November 2010; http://www.oecd.org/document/11/0,3343,en_21571361_44315115_46310091_1_1_1_1,00.html.

aptation, the renouncement of acquired benefits and tolerance by citizens. At the same time, member states will have significantly diminished (economic) capacity to respond, making negotiations at the EU level extremely difficult.

5.3 Selection criteria: On fairness and procedural innovation

These circumstances should be fully taken into account for negotiations on the next financial perspective, including the necessary modification of the procedures.

The theory on what the EU budget should finance is actually fairly straightforward. The EU budget review paper argues that "the EU budget should be used to finance *EU public goods*, actions that Member States and regions cannot finance themselves, or where it can secure better results" (EC, 2010a: 5). Investments should be geared towards key policy priorities, where results can be demonstrated, taking into account the principle of solidarity (ibid.). These principles are based on the fiscal federalism theory, pointing out the importance of the heterogeneity of preferences, economies of scale, externalities and the theories of Public Economics and Public Choice. I do not intend to dwell on these principles as they have been presented on many occasions (refer, for example, to Ecorys, CPB and IFO, 2008).

The practice is unfortunately rather far from those principles. EU budget negotiations are characterised by *juste retour*, under which member states' negotiation objectives are primarily to defend their net budgetary positions (Mrak and Rant, 2009; Heinemann, Mohl and Osterloh, 2010). This should come as no surprise. Each policy has a distinct spatial pattern of financial disbursement across countries, which is highly predictable even if funds are distributed based on competitive calls for projects, because of different, again systematic, absorption capacities. A given country will gain greater (or at least perceived to be more tangible) marginal utility from any policy where it expects a high financial return, whatever its value added. This holds true for any given size of budget, since this determines the contribution by each member state. This logic becomes somewhat less clear with proper public goods, which, by definition, benefit the EU as a whole equally; however, there are few genuine European public goods. The majority of policies have some kind of localised benefits,[23] which is also why I prefer discussing the European value added, which can be demonstrated for a number of interventions even if they are not proper public goods.

[23] If a policy has localised benefits it can still have European value added. In fact, the majority of European value added policies also have localised benefits. Just think, for example, of the big research infrastructures or productive investments, unlocking development potential through cohesion policy.

Hence, as argued by Heinemann, Mohl and Osterloh (2010), any reform discussion that does not cover with expenditure and revenue at the same time is unrealistic. This statement is placed in a political/economic context as a kind of “second-best solution”. Begg *et al*. (2008: 14), for example, argued that “in a well-conceived EU budget there should be no need for correction mechanisms and that any continuing need for them is a second-best resulting from a failure to reconfigure the expenditure side appropriately”.

Given the discussion above, it is worth asking whether this is actually the case, as the financial burden for a given member state in such a “first-best world” according to Begg *et al*. (2008) would be unpredictable and possibly unfair. As long as the size of the EU budget is negligible and there is strong growth and countries with broader political interests, such an approach is clearly conceivable. However, this does not intrinsically make it fair or “European”.

By contrast, not only the principles of efficiency and equity, but also the principle of fairness[24] should be placed more at the heart of EU budget conception. Given the global transformations and other challenges, the EU needs to react without delay. This, as we have seen, will require profound structural reforms and increased investment in competitiveness and innovation. If people are actually to accept the renouncement of their acquired entitlements (or what are only perceived as their justified entitlements), they will need to have assurance that everybody, in this instance member states, will contribute in a fair way, i.e. according to their relative capacities. The idea that the whole EU is one entity is for the moment simply unrealistic: in the Eurobarometer survey in 2006, the last addressing this issue, only 16% of citizens often thought of themselves as Europeans, while 81% never or only sometimes thought in this way.[25] Hence, the solution on sharing the burden needs to take into account the consequences for member states. This should not be considered only as a political/economic argument. As has already been proposed in the fiscal federalism literature, Buchanan (1950) basically argued that if one is to accept “the federal political structure, with the existence of states as constitutionally independent units” (p. 585), then “units of equal fiscal capacity should be able to provide equivalent services at equivalent tax burdens” (p. 586). He goes further to argue that the equal treatment of equals is a central postulate of the democratic state and that thereby there should be a “balance between the contributions made and the value of public services returned”

24 As a matter of interest, the word “fair” or “fairness” appears seven times in the Budget Review paper (EC, 2010a), while, interestingly, only four times in the Fifth Cohesion report (EC, 2010c).

25 http://ec.europa.eu/public_opinion/cf/showtable.cfm?keyID=265&nationID=16,&startdate=1990.04&enddate=2006.09.

(p. 588). Buchanan's equity principle prevents that "if fiscal balance ... is not made equal for all areas of the economy, a considerable distortion of resources ... might result" (p. 599).

Fair (net) contribution should thereby be understood as a precondition for any kind of budgetary reform, which citizens, and in turn politicians, will be asking for. And considering the present uncertainties and pessimism, they will be asking for a fair participation already during the process of negotiations. In other words, there will be no reform towards greater efficiency nor greater equity dimensions in the EU budget without taking due account of the fairness principle. Alternatively, apart from possible marginal modifications, the structure of the EU budget will remain the same and inertia will prevail once more.

Interestingly, there have been numerous proposals as to how to solve this problem (refer to Heinemann, Mohl and Osterloh, 2010 for an overview) and some have even been around for a decade already (e.g. de la Fuente and Domenech, 2001). Even though the exact technicality is of secondary importance, my preferred modality is presented in Wostner (2008).[26] This proposal argues for the separation of the budget into two parts: a smaller one containing proper *European public goods*, which would be financed according to the capacity to pay (GNI) and a second containing *Expenditures with localised benefits*. For the second, much larger group, the budgetary procedure would be significantly different.[27] Before any kind of discussion on the size of a particular policy takes place, the decision would first be taken on the total *absolute* net budgetary position of each member state for this part of the budget. This would provide the *ex ante* assurance on the net financial burden, which would not only be easy to understand, but also be easy to politically negotiate since heads of states would not need to understand any complex formulas (making it almost impossible to negotiate without whole teams of experts, as is the case now). This would ease the discussion on which policies to finance and at what level of the *juste retour* problem. This is because whatever policies would be financed (decision taken in step two) countries' net financial positions initially agreed would be corrected for in step three. Thus, no one could financially gain in net terms because of the different structure of the

[26] The proposal was also integrated in the report of the Slovenian EU Budget Reform Taskforce from 2007 accessible at http://ec.europa.eu/budget/reform/issues/read_en.htm and later also broadly recapitulated in the official Slovenian position on the EU budget reform from 2009 (http://www.svrez.gov.si/fileadmin/svez.gov.si/pageuploads/docs/pregled_proracuna_EU/EU_Budget_Reform_SI_non-paper_EN.pdf).

[27] This group would broadly refer to the following present headings: 1a (Competitiveness for Growth and Employment), 1b (Cohesion for Growth and Employment), 2 (Preservation and Management of Natural Resources) and 3b (Citizenship apart from solidarity fund).

budget, since each member state's contribution would be fair (with unanimous agreement) and thereby everybody would only consider which policies bring the actual European value added. Needless to say, such an approach would mean that the size of the budget would be determined (at least to a much greater extent) as a result of the agreement on policies (step 2) instead of vice versa as is the case now, which certainly could be argued to be much more consistent with the "European way".

Unfortunately, such proposals have thus far not been taken too seriously, even though the "selfish" behaviour of member states is obviously built into the system. If this remains the case, then one can only realistically expect a repetition of the financial negotiations for the 2007-2013 period and the letter of the five heads of state from 18 December 2010 arguing for the reduced budget is probably illustrative enough. Hence, it would then logically follow that some kind of innovative procedural innovation along the lines described above is needed urgently, as the alternatives look rather bleak.

5.4 Tentative conclusion

In 2005, the European Council's decision for budgetary review was supposed to lay a new foundation for the next round of negotiations. A budget review paper was eventually published at the end of 2010 (EC, 2010a), prompting disappointment about its low ambition. At the same time, concerns were raised that negotiations on the post-2013 financial perspective will be yet another repetition of the last cumbersome negotiation process resulting in inertia.

Such a scenario is increasingly hard to justify given the consequences of the global economic and financial crisis, extreme global economic transformations in the last couple of years as well as other global challenges already spotted in 2004, like climate and demographic change. Global transformations are changing the world's economic geography, with the developing world increasingly engaged in innovation processes, causing disruption in the West. This calls for a timely and decisive policy response in the developed world, and the EU in particular, since the location of economic activity is a dynamic cumulative causation process, which, once the threshold conditions are fulfilled, is hardly reversible.

The EU's response, according to the European Commission, lies in structural reforms and a greater focus on competitive capacity and innovation, which will require not only major flexibility and adaptation to the new circumstances by EU citizens, but also a fall in their personal wellbeing because of reduced benefits and entitlements. The discussion on the next financial perspective will thereby be characterised by greater risks and challenges than before. At the same time, member states will have significantly diminished (economic) capacity to respond (and compensate possible losses) because of fiscal consolidation, making negotiations at the EU level even more difficult.

These circumstances should be taken into account for the negotiations on the next financial perspective. A discussion based on objective selection criteria can hardly be expected to deliver since the member states have a systematic disincentive to consider them. It has been empirically shown that member states pursue another objective function, i.e. their net financial position versus the EU budget. Moreover, as long as this is the case, no genuine discussion in the Council based on the theoretically justified selection criteria will be possible.

Hence, the chapter argues for a modified EU budget preparation process, stressing the importance of fairness and equity principles. According to Buchanan (1950), every federation's entity should contribute its fair share, in this case to the EU budget, taking into account the expected benefits and their financing capacities. Fair (net) contribution should be understood as a precondition for any kind of budgetary reform. Alternatively, it is hard to see people accepting the renouncement of their acquired entitlements in practice. Furthermore, in the proposed modified procedure, the size of the budget would be determined by agreement on policies instead of vice versa, as is the case now. Hence, the negotiations would be relieved of the *juste retour* problem.

This chapter concludes that there is no time to further delay the necessary procedural reforms. Even though the proposed modifications are sometimes awkwardly termed *correction mechanisms*, they would actually enable politicians to behave in a largely "European way". Hence, they should be understood as a step towards a stronger, not a weaker, Europe.

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6 The Value Added of the EU Budget: Subsidiarity and Effectiveness*

Arjan Lejour & Willem Molle

The new budget, covering the period 2013 to 2020, has been prepared after a complete review of EU spending and resources and an extensive consultation round.[28] One of the guiding principles for the new budget is the value added of EU spending (EC, 2010a); spending must offer clear and visible benefits for the Union and its citizens. In recent decades, the European budget has been used for a variety of purposes. Consequently, the guiding principles have not always been applied. The upcoming reform is a good occasion to review the whole set up and to make proposals that ensure that the budget better conforms to the normative elements. We know, of course, that putting them into effect will not be easy; economic sectors, regions and countries have their vested interests and will defend these. Moreover, financial resources are scarce and they have become scarcer during the economic crisis.

This chapter *aims* to assess the value added of the EU budget and to make some recommendations for change.

The chapter is *structured* as follows. In Section 2, we present the basic definitions used in the rest of the chapter; in particular, the subsidiarity and proportionality principles. In section 3, we analyse the structure of the EU budget and its additionality. After these general parts, we come to the assessment of the EU value added. To analyse value added we ask ourselves two questions. 1 Does the EU budget deal with subjects that can best be dealt with at the EU level. 2 Does it realise the intended effects of the policies through the input of financial support?

Section 4 will tackle the first question; section 5 the second question. In the final section (6), we draw some short conclusions and make some recommendations.

6.1 The subsidiarity principle

6.1.1 The legal foundation

The principle of subsidiarity was first mentioned in the European Single Act of 1986, dealing with the assignment of environmental policy at the European

* Parts of this chapter draw heavily on chapters 2 and 6 of Molle (2011) and ECORYS *et al.* (2008). We thank Iain Begg, Daniel Tarschys and other participants of the CEPS/SIEPS seminar on *The Next Long-Term Budget: What Should Go In? What Should Go Out?* for their comments.

[28] See EC (2008) for an overview of the consultation report. Reports on the review can be found at http://ec.europa.eu/budget/reform/reports_studies/index_en.htm.

or member state level. In 1992, the principle of subsidiarity was officially introduced in the Maastricht Treaty. The treaty of the EU formulates the subsidiarity principle as (Art 5.3 TEU):

> In areas which do not fall within its exclusive competence the Union shall act only if and insofar as the objectives of the proposed action cannot be sufficiently achieved by the Member States, either at central level or at regional and local level, but can rather by reason of the scale or effects of the proposed action be better achieved at Union level.

In the past, the practical application of the principle has given rise to much debate. So, to bring clarity the Lisbon Treaty grouped the policy areas by type of Union competence. These competences are presented in Table 6.1.

Table 6.1 Policy areas by category of Union competence

Exclusive competences	Shared competences (and special cases)	Supporting, coordinating or supplementary actions of member states
Competition rules for the internal market	Internal market	Industry
Monetary policy for member countries of EMU	R&D	Tourism
Customs Union	Economic policies	Youth and sport
Conservation of marine biology (fisheries)	Economic, social and territorial cohesion	Education, vocational training,
Common commercial policy	Environment	Culture
International agreements in areas of Union competence	Employment policies, social policy	Administrative cooperation
	Development cooperation	Health
	Agriculture and fisheries	Civil protection
	Energy	
	Consumer protection	
	Transport	
	Trans-European networks	
	Safety, public health	
	Freedom, security, justice	

Source: Molle (2011)

The principle of subsidiarity applies to any policy area in which the Union has no exclusive competence. Therefore, it makes no difference whether it is a shared competence or the competence to support, coordinate and supplement actions of member states. Lejour (2008) argued that support, coordination and supplementation limit the competences of the Union to more specific actions than do shared competences. Member states seem to have the prime responsibility in these policy fields, which is not automatically the case for shared competences.

6.1.2 The arguments for centralisation and decentralisation

For a practical application of the subsidiarity principle one has to look at the arguments that plead for the centralisation or decentralisation of government tasks. The main arguments come from the theory of fiscal federalism; additional arguments are provided by public choice and political economy theory.

The *fiscal federalism* theory (e.g. Oates, 1972, 2005) provides two reasons for decentralisation. The first is that differences in needs and in preferences will be better taken into account; implementation costs will be lower and the accountability of the institutions for their actions will be higher. The second is the latitude for innovation and experimentation. Competition between jurisdictions will bring forward the best solutions. Fiscal federalism theory argues that government tasks should be centralised if the higher government level, such as the EU, is better qualified than is the lower level because of economies of scale, externalities or transaction costs. Economies of scale are relevant if the production of a public good is subject to decreasing costs or increasing benefits with a larger size. An example is trade policy. Externalities can be present if policies have positive or negative external effects (also called spillovers) on other jurisdictions. This occurs, for instance, in cases where outsiders bear the cost of the non-observance of standards (e.g. pollution that is carried over national borders). Transaction costs are relevant because the diversity (heterogeneity) of national rules (e.g. on product specifications) burdens economic actors with high additional costs as well as a loss of competitiveness, so limiting this diversity is welfare enhancing.

The theoretical underpinnings of fiscal federalism do not always hold in practice. Governments do not have perfect knowledge and they do not always act benevolently in the interests of their constituencies. Therefore, the application of the subsidiarity principle in practice should take account of other theoretical insights as well. Pelkmans (2006), Ederveen *et al*. (2006) and Gelauff *et al*. (2008) among others have introduced these missing aspects, which come mainly from the political economy and public choice literature. They add the following reasons for the *centralisation* of government policies.

- The first is to limit system competition between national systems, which may have adverse effects; for instance, poor people from countries with limited social security and low tax systems migrate to countries with generous systems and high taxes, thereby increasing the burden on taxpayers in the latter country.

- The second best argument is another reason which comes into play when decentralised governments do not assume their responsibilities and leave important tasks undone; a less efficient central government is then better than no government (for instance, on environmental issues).
- The third argument is complementarity between policies. If a policy is centralised, it may induce the centralisation of policies that can only be made effective in conjunction. For instance, a central monetary policy may lead to macroeconomic conditions that are unfavourable to certain low-income countries, which entails the need for a central redistribution policy.

The political economy and public choice literature also provides reasons for *decentralising* government policies.

- The first reason is self-interest. Governments can be lobbied by important lobby groups that are defending their self-interests. They can also act in the interests of small elites and/or bureaucracy. This may happen at any level of government; however, when it occurs at the central level the negative aspects are larger and the capacity to change is lower. A particular case in point here is agriculture in the EU.
- A second reason is the common pool problem, which indicates the waste of resources that ensues if lower governments draw on centralised resources to provide local benefits. In that way, an overuse may be composed of EU resources co-financed by other member states to benefit only some member states. Again, the EU agricultural policy is a case in point.
- The third reason is the possibility of credible cooperation by member states; if the most concerned member states solve the problem effectively, there is no need for action by the EU.

These arguments are summarised in Table 6.2 on the next page. Weighing the arguments for and against centralisation can lead to a clear view about the assignment of policies. Examples are trade policies and monetary policy (of the euro area members) in matters of full centralisation (exclusive EU competence). In matters of full decentralisation (no EU competence), primary education and housing are examples of policies. In a number of cases, however, the outcome is not as clear cut. This will probably hold for many of the policy domains classified under shared competences in Table 6.1. The arguments about the subsidiarity principle could imply that a part of a policy domain will be centralised while another part is not. An example is the policy domain taxation. Indirect taxation (such as value added tax) is an EU matter to some extent because of complementarities with the internal market, whereas direct

Table 6.2 Making subsidiarity an operational concept

Theoretical foundation	Centralisation	Decentralisation
Fiscal federalism Public choice and political economy	Economies of scale Externalities Limits to system competition Second best Complementarity	Heterogeneity (diversity) of preferences Policy experimentation Self interest Common pool Credibility of cooperation

Source: ECORYS *et al.* (2008)

taxes (such as income tax) are a purely national matter. This outcome of the subsidiarity principle would at least reflect the logic of the classifying EU competences as in the treaty.

6.1.3 Proportionality: the choice of instruments

Besides subsidiarity, the same article in the TFEU formulates the principle of proportionality: "*the content and form of Union action shall not exceed what is necessary to achieve the objectives of the Treaties*." This principle prescribes that the least intrusive instruments need to be used. The budgetary instruments can be organised according to the level of discretion given to beneficiary member states (or to any other economic agent).[29] Discretion is low in case precise conditions and restrictions are put to its use. Discretion is high in case the use of the financial resources of the EU by member states is unconditional. The EU has opted for a low level of discretion in its application of the budget method. This is based on the low level of solidarity between member states and the need to justify outlays to taxpayers in all member countries, in particular in countries that are net contributors to the budget (principle of accountability). The main instruments are grants and loans.

With c*onditional grants* (also called specific purpose or earmarked grants), the EU decides on its policy objectives. Its grants target mostly member state programmes for investments in production factors (e.g. human capital) or in the production environment (e.g. infrastructure, institution building). These are mainly matching grants, based on the principle of additionality. The more the Union contributes, the more it sets conditions on the objectives and instruments. These choices are also made in view of effectiveness. Indeed, the financial participation of (the regions of) the member states in the financing

[29] See for a treatment of the economic advantages and disadvantages of each of these instruments, Costello (1993).

of programmes ensures that they will be selective in the choice of their proposals and attentive to quality delivery.

The *specific purpose loan instrument* is used in cases where there is a mismatch in time between the outlay and the income streams, such as an infrastructure project. Central governments and the EU can borrow at lower interest rates than can many other organisations. This advantage can be passed onto borrowers such as national or local governments or private investors for projects that are important to realise EU objectives. The use of the instrument by the EU is traditionally limited (e.g. Kuhlmann, 1993). The loan instrument has been mostly entrusted to the European Investment Bank (EIB). The EU budget covers the cost of guarantees and interest "subsidies" to the operations of the EIB.

The instrument of loans for macroeconomic stability is a special case. In fact, the treaty explicitly precludes such support. There are some minor loopholes in this general rule. One is in cases of serious balance-of-payments problems by a non-EMU member state. This facility was used in 2008 when the EU and IMF jointly provided large loans to Hungary, Latvia and Romania. The EU circumvented the treaty in 2010 to cope with the solvency crisis of Greece and Ireland by the creation of a special facility based on the intergovernmental method. This facility, termed the European Financial Stability Facility, guaranteed a substantial package of loans to the Greek and Irish governments. These loans are guaranteed by the member states of the EMU, which also have to cover the costs if the loans are not returned.

6.2 The budget

6.2.1 Objectives

The budget of a *national state* is generally of a considerable size, owing to the important financial consequences of many of its socio-economic policies. In the EU, the accumulated national budgets account on average for about 47% of total GDP. The EU budget is relatively small; it represents only 1% of EU GDP, so the total EU budget is about 2% of the national budgets (Bertoncini and Barbier-Gauchard, 2009). Consequently, the traditional three functions of the budget differ in the EU from those of a national state in the following respects:

- *Allocation.* With the relatively limited EU budget divided among a long list of programmes, the impact in most policy fields is meagre. Agriculture is the only field in which EU policy heavily influences developments. It does not only allocate but also redistributes money.
- *Stabilisation.* The EU budget is not an instrument of macroeconomic

policy; the treaty stipulates that each year the revenues and expenditures shown in the EU budget must balance. Anyway, the total size of the budget is too low for an effective macroeconomic policy.
- *Redistribution.* Although the expenses on EU regional and social policies have increased considerably over recent decades, the redistributive power of the EU budget is still limited compared with national budgets. The EU budget provides only transfers between member countries, based on specific purpose grants for the improvement of structural features of the economy.[30]

The implication of this state of affairs is that in many instances the EU budget can only play a supportive role with respect to allocation and distribution. Molle (2011) concluded that other governance methods such as regulation, coordination and national spending have to do most of the job. Only in selected cases does the EU produce a specific public good by using the financial method, such as energy research. The EU set up large centres for energy research when the safety aspects of nuclear power demanded a centralisation of efforts.

To help predict its own finances, the EU has since 1988 adopted financial frameworks for seven-year periods.[31] The present one covers the period 2007-2013. These financial frameworks specify three elements. First, they fix the level of total receipts and the contributions of each of the member states to these receipts. Second, they allocate resources over the various expenditure items, such as innovation and cohesion. Third, they give the maximum amount of spending per annum and per heading (that is ceilings for all budgetary headings and for certain subheadings).

Consequently, the structure of the EU budget is rigid. Member states have been reluctant to shift resources across years and headings (Buti and Nava, 2003). This does not need to be too much of a problem as long as the EU concentrates its budgetary expenditure on time invariant priorities that do not require frequent renegotiations. Apart from the limited budget, the rigid structure also excludes the use of budgetary instruments for stabilisation purposes as was the cases with the economic crises in 2009 and 2010.

[30] Aid to developing, neighbouring and accession countries constitutes the external dimensions of redistribution.

[31] The treaty on the functioning of the European Union specifies (art. 312 TFEU) the use of a multi-annual financial framework and (art. 314 TFEU) the elaboration of an annual budget and the procedure by which the annual budget has to be adopted. The choice for a multi-annual framework for expenditure helps efficiency by limiting annual fights and the cost of stalemates and uncertainty. This has not prevented the occurrence of such situations in the past. To avoid the need that the EU would have to stop its activities because the budget procedure is not finalised in time it can use every month 1/12th of the previous year's budget.

6.2.2 Structure

The use of the financial method (implying the provision of financial resources) has a particular role in the EU. The size of budget items at a member state level tends to give indications as to the importance of the various policy fields and thereby the priorities of objectives. In the EU, this is not the case; for many important policies, the EU budget is either absent (internal market, external trade) or small (innovation). These EU objectives can be met by other governance methods such as regulation and coordination. Table 6.3 presents an overview of the EU budgetary commitments in 2010, which total approaching €125 billion.[32]

The largest category is *Agriculture and fishery*. This category used to absorb a considerable portion (two-thirds) of the total budget, mainly through the European Agricultural Fund's outlays for guaranteed prices. A series of decisions have been taken to control agricultural outlays with the effect that their relative share has considerably decreased (to 41% in the 2010 budget).

The second largest category is *Cohesion for growth and employment*. Expenditures to reinforce social and economic cohesion have assumed increasing weight over the years. Much of the outlay is financed from the so-called "structural funds", such as the European Regional Development Fund and the Social Fund.

The other budget categories are much smaller. Many of the budget items can be grouped under the heading of *Competitiveness for growth and employment* (€15 billion). The main component of this heading is support to R&D and innovation and network industries, including Trans-European networks and the digital economy. It also includes education and employment.

Except for administrative expenditures, the only other large budget category is *External relations*. Under this heading falls development aid. In addition to the regular EU budget, the European Development Fund functions with a separate budget. This heading is now called "EU as a global player".

6.2.3 Additionality

The EU budget is only a small part of total public expenditure. However, Bertoncini and Barbier-Gauchard (2009) showed that the share differs by policy category (as depicted in the last column of Table 6.3). One can distinguish three situations.

- First, the EU budget is dominant (EU share amounts to some 70%).

[32] Although hardly comparable, because the EU is no federal state, it is important to note that in 1998 63% of all government expenditure in the US was conducted by the Federal Government (US GPO, 2008).

Table 6.3 Budget commitments in 2010

Function	Budget activities in the policy areas	Budget title	Commitments 2010: As % of total commitments	Commitments 2010: In billion euro	2006: As % of total government spending
Stabilisation	Macroeconomic	1	0.4	0.5	0.0
Equity	Social affairs and employment	(4)[a]	0.4	0.5	0.0
	Cohesion policy	13, 4	35.8	49.7	50.0
Allocation	Competitiveness and Single Market policies[b]	2, 3, 12, 14, 20	0.9	1.2	2.7
	R&D	8, 10	4.0	5.5	11.1[c]
	Education and culture	15	1.1	1.5	0.2
	Environment	7	0.4	0.5[d]	0.2
	Agriculture and rural development	5	41.6	57.8	70.8
	Fisheries and maritime issues	11	0.7	1.0	71.8
	Network industries (energy, transport, information society, postal sector)	6, 9	4.7	6.5	0.9
	Health and consumer policy	17	0.5	0.7	0.1
	Freedom, security and justice	18	0.8	1.1	0.2
	Defence	n.a.	0.0	n.a.	0.0
	Foreign aid and neighbourhood policies	19, 21, 22, 23	5.5	7.7	11.9
	Other / administrative	16, 24-31, 40	3.3	4.6	1.9
Total			**100.0**	**123.6**	**1.8**

[a] Excluding ESF funds.

[b] Including Internal Market, Taxation and Customs, External Trade, Competition and Enterprise and Industry.

[c] Note that the EU share covers FP7 (6.4%) and spending outside the community framework and coordinated national spending, such as the European Space Agency (3.1%), European Organisation for Nuclear Research (0.8%), Bertoncini and Barbier-Gauchard, 2009.

[d] The budget for environment does not include cohesion spending on environmental issues and agri-environmental measures included in the budget for agriculture. ECORYS *et al*. (2008) estimated that these spending items were about €5 and €2 billion in 2007, respectively.

Source: EC (2011) and Bertoncini and Barbier-Gauchard (2009) for numbers in last column

This is only the case for agriculture, including rural development and fisheries.

- Second, the EU contributes a significant share of total government spending. The first case here is cohesion policy that accounts for 50% of the total.[33] Other policy fields where the share of the EU is significant are development aid (12%) and R&D (11%).
- Third, the budget is almost an exclusive national involvement (EU share less than 1%). This is the case for all other policy fields in which the EU has the competence to act.

In many of the policy areas where the EU and member states have joint responsibilities, one sees the EU co-financing national programmes and projects. This basic idea of joint forces has been formalised in the principle of additionality, which states that the EU support should come alongside national efforts, not replace it. The putting into practice of this principle has not been easy. The Commission has tried to resolve the problems in two ways. The first way is by reformulating the principle in practical terms so that member states are obliged to show that they have maintained their expenditures at the same levels as in the previous period. A second way has been regulating the share of EU support in the financing of projects. For instance, in the poorest regions the maximum EU support that can be given is 75% of total cost; in developed regions, the cap reduces to 15-25%. There remains a danger of a vicious circle, however, in the sense that rich member states that have ample resources can put up lot of matching funds, while poor member states may be restricted in their absorption of EU funds by their lack of co-financing possibilities (Bouvet and Dall'Erba, 2010). The recent economic crisis worsens the absorption possibilities of poor member states.

6.3 Assessing the budget: Does the EU do what it is supposed to do?

The first step in assessing the budget is to check the value added by applying a subsidiarity test to all budgetary items. ECORYS *et al.* (2008) provided a detailed analysis to check the consistency of the present practice with the theoretical insights. Since 2007, the economic and policy environment has changed dramatically. The economic crisis, which started as a housing crisis in the US, has transformed into the EMU crisis because of high government (and private) debts and a weak banking system. In recent years, the EU has

[33] One has to note that employment-enhancing policies are included but that social security is not. The average figure of 50% corresponds de facto to the the amounts of Community cofinancing. The national public equivalent of the Community financing does not represent the entirety of national public spending on territorial cohesion (Bertoncini and Barbier-Gauchard, 2009).

also agreed on the Europe 2020 strategy, a successor to the Lisbon strategy, and developed its thoughts about a new EU budget. These developments could have affected the assessment of the budget categories.

The present article concentrates on topical policy areas as a consequence of economic circumstances (the crisis) or policy initiatives (Europe 2020;[34] the CAP towards 2020 and the budget review). In general, these are also the budget categories that the EU can influence in addition to national resources: R&D and innovation, stabilisation, environment, agriculture and rural development and external policies. Cohesion is presented in the contribution of Molle to this volume. For each category we discuss the budget and the arguments for and against centralisation and conclude.

6.3.1 Macro stabilisation

Stabilisation refers to policies designed to stabilise aggregate income and spending (i.e. GDP), as well as to stabilise unemployment levels. Stabilisation may serve to cushion the effects of (exogenous) economic shocks and/or it may have an anti-cyclical character. Two types of policy measures are available for macroeconomic stabilisation: monetary and fiscal. By establishing the EMU, many European countries chose to centralise the tools of monetary policy. The Community budget is not involved in monetary policy. For fiscal stabilisation policies, the budget has some reserves but it is too small to be effective. However, the funds involved with the “European Community guarantees for loans raised for balance-of-payments” can be substantial (with a ceiling of €12 billion, about 10% of the EU budget). During the economic crisis, the EU has used this fund to help Hungary, Latvia and Romania with their balance-of-payments problems. In addition, the IMF participates in these programs. A small part of the budget is reserved for funding interest subsidies on special loans following disasters, but this is limited to €0.5 billion.

Economies of scale in monetary policy become more important and the costs of the loss of the national policy instrument become less important as the internal market integrates further. From a normative point of view, monetary policy should remain at the level of the Union. In the past, this did not have budgetary implications but it could be different now the European Central Bank is buying government bonds to stimulate the liquidity of the market. For fiscal policy, the EU role is less clear. With fiscal policies there seems to be a trade-off between its complementarities with monetary policy (that plead for centralisation) and complementarities with allocation and equity

[34] The category of smart growth is present in R&D and innovation, sustainable growth in environment and inclusive growth in cohesion.

policies (that suggest decentralisation). Furthermore, there are complementarities with internal market developments that, on the one hand, diminish the need for central fiscal stabilisation interventions (since asymmetric shocks are more easily spread out), but, on the other hand, lead to diminished incentives for lower-level governments to pursue fiscal stabilisation policies (as its effects will more easily drain towards other member states). In short, there are clear spillovers but there is heterogeneity as well.

Public choice arguments on excessive government growth strengthen the case for the decentralisation of fiscal policies as long as common pool problems are curbed with a proper instrument (e.g. the Stability and Growth Pact (SGP), but there are other alternatives). Firstly, rent seeking from interest groups is more difficult. Secondly, and related to the first point, fiscal illusion is less easy because of the proximity of voters and taxpayers. Thirdly, competition between bureaucracies limits governments' taxation power and thereby their growth. However, the SGP has shown to be insufficiently strict. Indeed, even in good times many member states (including the largest ones) have transgressed the rules.

In spite of the problems with the SGP, many people have argued that member states are responsible for fiscal stabilisation policies, accepting possible spillover effects. Now the spillover effects of lax national fiscal policies have been magnified because of perceived contagion in financial markets, it seems clear that the role of the EU has to be increased at the expense of national autonomy. The European Council (2011) adopted a comprehensive package of measures to strengthen the economic governance and competitiveness. Economic governance is necessary for improving fiscal discipline and avoiding excessive macroeconomic imbalances, including a reform of the Stability and Growth Pact.

Owing to the EMU debt crisis the argument of complementarity with monetary policy has gained weight. The EU budget would have to be magnified to implement successful fiscal policies. Moreover, national stabilisation policies largely function by automatic stabilisers such as lower tax income and higher social spending in times of a recession. This would require a massive overhaul of responsibilities between member states and the EU, which is not at all plausible in the foreseeable future. Therefore the European Council (2011) has agreed to establish the European Stability Mechanism (ESM). The ESM will be the permanent successor of the European Financial Stability Facility and the European Financial Stabilisation Mechanism in providing external financial assistance to EMU member states after June 2013. The ESM will have a total subscribed capital of €700 billion. €80 billion will be in the form of paid-in capital provided by the EMU members. The other €620 billion will be a combination of committed capital and of guarantees from the EMU members.

In spite of the current debt crisis, magnified by financial spillovers, the arguments for diversity and public choice imply the need for decentralised fiscal policies. Consequently, the role of the EU budget on stabilisation is limited. However, the relevance of the EU budget for stabilisation could be enlarged if it is used to cover the costs of issuing European bonds. The Commission (2010a) suggests these kinds of bonds for investment projects, but this could be extended for bonds helping indebted countries. This would be an innovative way of creating leverage, but is has to be acknowledged that the EU budget will be far too small to guarantee the repayments of these bonds.

6.3.2 Smart growth with R&D and innovation

R&D and innovation are the main budgetary instruments of the EU to support the knowledge economy.[35] The financing of education is almost purely a national matter, and national barriers preventing the dissemination of knowledge and new ideas can be tackled by regulation. The European Commission's expenditure on research focuses on the seven framework programme (FP7). FP7 is an initiative under which various subsidies are granted for both public and private research. The budget of FP7 is €53.3 billion for the period 2007-2013. This amounts to an average yearly budget of €7.6 billion, which is substantial when compared with the €65 billion spent on public research by the member states of the EU15 in 2003.

FP7 consists of four programmes: Cooperation (€32.4 billion), Ideas (€7.5 billion), People (€4.7 billion) and Capacities (€4.2 billion). In addition, FP7 also has a budget for the Joint Research Centre (JRC) amounting to €1.8 billion and a budget for research on nuclear energy (EURATOM) of €2.8 billion. The Commission will spend more money on R&D than the €5.5 billion spent in 2010, because the research financed by the Structural and Cohesion Funds (€62 billion in the 2007-2013 budget period) and by various Directorates in their specific policy areas is not included.[36]

The subsidiarity test concludes that the role of the EU in providing funding for R&D is appropriate. In many cases, there are economies of scale in centralising R&D funding in areas such as EURATOM, JRC, Cooperation, Ideas and Capacities regarding infrastructure. In addition, the programmes Cooperation, Ideas and People internalise spillovers. Of course, these benefits of

35 http://ec.europa.eu/europe2020/index_en.htm.
36 See Molle (2011).

centralisation have to be weighed against diversity. However, as long as the member states have substantial R&D budgets, their country-specific needs and preferences can be financed. Given the economies of scale and externalities involved, it could even be argued in favour of shifting a share of national R&D budgets to the EU for these specific categories such as defence, space industry, exploration and infrastructure – where indivisibilities could be high and thereby substantial economies of scale achieved. To the extent that R&D funding is directed to small and medium-sized enterprises or specific regions, the role of the EU is less obvious. Economies of scale do not prevail, and the externalities of national policies are also absent.

R&D is the third largest policy area in the budget, and is pivotal in the European smart, sustainable and inclusive growth strategy towards 2020. It stimulates innovation in areas that cannot be copied by individual member states and pools expertise from various countries. The subsidiarity analysis suggests that these expenditures at the EU level should be increased.

6.3.3 Sustainable growth: environment

The budget for environmental policies is only about 0.4% of the total budget, which is mainly used for implementing community environmental policy and legislation. This policy consists of four programmes: nature and biodiversity, climate change, natural resources and waste, and environmental health and quality of life (EC, 2007). These are, however, not the only EU funds. Most funds are embedded in the Cohesion and Structural Funds, which reflects the Commission's integrated approach to environmental and regional policy. Furthermore, the seventh research programme has reserved about €8.4 billion for research on the environment, energy and transport between 2007 and 2013, of which the majority of themes funded relate to the environment (notably climate change).

The subsidiarity test indicates a clear role for the EU budget in environmental policies relating to nature and biodiversity and climate change. The main arguments for nature and biodiversity relate to the need to invest in preservation to address European/global spillovers. Climate change is a global problem, with important spillovers from national policies. Drastic action in one country partially mitigates problems in other countries. This leads to underinvestments at the national level in actions to counter climate change. In addition, there are scale economies in the EU taking up a role in international negotiations, such as the Kyoto Protocol. This requires a clear mandate for the European Union and involves coordinating and controlling the implementation of agreements afterwards. These measures typically involve regulatory and market-based measures such as the Emissions Trading Scheme, procurement, tax incentives and standards. Other environmental areas such as natural resources and waste can either be addressed via regulation or do not involve cross-border spillovers, such as environmental health and the quality of life.

In terms of budget size, the role of the EU in environmental policy is modest. However, given the economies of scale and spillovers in climate change and biodiversity, it could be effective. It could overcome the limited ambitions of some member states in these fields. However, this requires a higher degree of additionality of the budget in these policy areas.

The budget would only be substantially affected by additional spending for the adoption of new technologies. Centralisation would increase R&D efforts to a more efficient level as argued before. Currently, the EU spends about €1.2 billion each year on R&D. Estimates on required R&D spending are wide-ranging and amount to over €15 billion per annum on a global scale for combined public and private expenditures in this area (Stern, 2006). Considering that the EU produces about a third of the world's GDP, €5 billion would be a fair figure for the EU, the member states and the private sector combined.[37] Moreover, ECORYS *et al*. (2008) and EC (2010a) also plead for more investment in energy security and distribution.

6.3.4 Sustainable growth: agriculture

Nowadays, the EU classifies its Common Agricultural Policy (CAP) under the heading of natural resources. This was certainly not the initial objective of the CAP. The original goals were providing food security and income support for a shrinking agricultural sector. The accompanying policy instruments were high import tariffs and price intervention systems to support prices. The EU substantially reformed the CAP by reducing support policies (e.g. for cereals and beef) and by introducing (coupled) direct payments in 1992. These payments were *decoupled* from production through the implementation of "single farm payments" as the key element of the 2003 CAP reform. Simultaneously, rural development measures were introduced, which are co-financed by member states. Export and production subsidies and other measures (mainly direct intervention) were dramatically reduced from almost 80% of the CAP budget in 1991 to about 20% today. In the meantime, the CAP budget was reduced from 70% of the budget in 1985 to 42% in 2010 (Table 6.3).

Within the CAP budget, more funds have been transferred from the first pillar (Market Policies and Income Support) to the second pillar (Rural Develop-

[37] Nunez Ferrer (2010) reached a similar conclusion on EU environmental policy. The EU budget only has to be increased for R&D and needs complementary expenditures from national governments and business.

ment), although 81% of the funds are still allocated to the first pillar. This shift in funds mirrors a shift in objectives and priorities. The recent communication (EC, 2010b) on the CAP towards 2020 argues that a further shift towards environmental and climate change objectives is possible. However, the same communication also emphasises the important role of direct payments with respect to food security, employment and income in rural areas.

According to the subsidiarity test, path dependency seems to be the main argument for the current existence of direct payments and market interventions. The normative analysis concludes that market policies in agriculture should be abolished, but as long as they are there in Europe, they should be part of the activities of the EU and thereby a part of the EU budget. Arguments in favour of centralisation relate to scale economies in international negotiations and to negative spillovers from decentralisation negatively affecting the internal market. However, the consensus on the distorting effects of market interventions and the possible alternatives from regulation strongly question the proportionality of market interventions.

The case for centralising direct payments is less clear. Both normative and positive analyses argue for the decentralisation of such (personal) income support policies. There are no clear economies of scale nor is there any internalisation of externalities if these activities are conducted at an EU level. Furthermore, there are considerable differences in the preferences of Europeans on income support to farmers. Economic reasoning suggests that it is sensible to shift these policies to the member states.

Common pool problems for rural development policies and direct payments in particular, constitute a reason to concentrate spending at the member state level. At the level of implementation, this is already happening, although the principle of fiscal equivalence would suggest matching the financing. Some EU subsidies may be justified based on externality arguments related to non-market by-products (multifunctionality). Furthermore, the involvement of the EU could be useful to create platforms to exchange information, practices and results in these areas for regions to learn from each other. The budgetary implications of this last proposal are limited.

The main reason to uphold the current CAP budget is path dependency. The assessment provided strong arguments in favour of severely diminishing it in the near future, in particular with respect to direct payments. There is strong opposition by many farmers against this possible move. EU support is vital for them, and it is not clear that lower EU funding would be matched by increased national funding.

6.3.5 External policies: Global Europe and enlargement

The EU budget for foreign aid, neighbourhood policies and other foreign policies amounts to 5.5% of the commitments in 2010. This is nearly €8 billion (Table 6.3). A small part of this budget is used for participation in international organisations such as the UN, WTO and G8. These bodies negotiate on issues that involve multilateral and/or global spillovers in trade and other areas such as the non-proliferation of nuclear weapons, drugs policy and environmental policy. Nearly all the budget is spent on three different programmes: the enlargement process, the European Neighbourhood Policy (ENP) and development cooperation (DC). These programmes aim to integrate with some of our direct neighbours (enlargement) and to cooperate with other neighbours and our neighbours' neighbours (ENP) and distant parts of the world (DC). They typically aim to combine development policies with policies to spread values and norms.

The enlargement process and ENP concentrate on nearby countries and regions. Here, similar arguments as those for the internal market and related polices are valid. There are substantial economic spillovers that could be tackled at a higher government level by EU accession or intensified cooperation. There are also spillover effects with respect to the potential migration of environmental issues. Economies of scale are also relevant. With respect to other dimensions, Nuñez Ferrer (2007) argued that political stability, security and economic growth in neighbouring areas offer opportunities for the EU as a whole. Therefore, it makes sense to discuss the many regulatory issues concerning socio-economic, political and security dimensions at the central level. At a larger distance from the EU, the heterogeneity increases, but the ENP exploits the possibility of focusing policy on bilateral needs, which could differ by ENP country. The necessary funds are paid from the EU budget.

In development policy and humanitarian aid, scale economies and positive externalities are present. Free-riding behaviour calls for central action. Preferences within the EU diverge to some extent – certainly in the context of development assistance in the African, Caribbean and Pacific countries. Centralisation may be in the form of coordination, but the case for spending may be less costly. There is clear support for central actions. The best way to ensure this is to finance programmes through the EU budget. This ensures some degree of fair allocation across various beneficiary countries. The strongest argument for EU centralisation comes however from the very high cost that the present fragmented system puts on the beneficiary countries. A better coordination by the donors (EU, national) would solve part of their problem but the real solution would come from the integration of EU and member states actions in one programme that is coordinated with the ones of the major multilateral (such as the World Bank).[38] As such, the coordination of assistance will remain warranted to ensure effectiveness, prevent duplication and reduce the amount of tied assistance. Individual member states still have the freedom to do more. In fact, this is useful to ensure learning from alternative assistance projects.

For all three programs, the subsidiarity test suggests a centralisation of these policies because of economies of scale and spillovers. Enlargement and ENP are fully financed from the EU budget and recent developments could warrant more spending on ENP. With respect to development aid and foreign policy, the budget should be increased, but this could be a shift from national resources.

6.4 Effectiveness: Does the EU do what it is supposed to do well?

The EU has to prove that it spends its resources well by showing that its policy efforts have reached their objectives; in other words, that they have been effective Moreover, it has to show that no money has been wasted; in other words the policy has been efficient. An important distinction must be made between output and outcome evaluation. Output is in general measured in terms of the physical result of the project that has been financially supported. Checking effectiveness (matching output and objective) is usually straightforward. Checking efficiency (matching output and cost) is also relatively straightforward. However, while doing so one needs to take into account that the outlays of the EU are not the only input into the process. For a correct interpretation the co-financing of the member states and possible third parties has to be taken into account as well. Measuring outcome is in general more cumbersome. Even if the objectives are clearly defined, the problem remains to establish the link between the effect and the financial input. This is more difficult because the budget does not operate in isolation; it plays its role in combination with other governance methods.

6.4.1 Sectoral results

With respect to (fiscal) *stabilisation,* the EU budget is too small for effective actions on most aspects of stabilisation. Stabilisation can only be performed by the budgets of the member states. The EU budget could be useful to finance the costs of loans, but will never be sufficient to guarantee loans meant

[38] See for the problems the fragmented structure creates among others Easterly and Pfutze (2008).

to support indebted member states. For loans for infrastructure projects, this could be different. Regulation and coordination are far more important tools for the EU to support stabilisation in member states.

R&D is pivotal in the European smart, sustainable and inclusive growth strategy towards 2020. It stimulates innovation in areas that cannot be copied by individual member states and pools expertise from various countries. The target for public spending on R&D is 1% of GDP (a third of the 3% Lisbon goal). This target is not met because many member states spend insufficient amounts of public money on innovation and the EU budget is too small to compensate for this. From this perspective, the EU budget on R&D is ineffective, but the achievements given the limited budget are noteworthy. The EU spends a significant share of total government R&D spending and its spending seems to be effective (in terms of achieving subgoals), although this is hard to measure in terms of output. It also helps improve the competitiveness of the European economy in the longer term.

The effectiveness of the budget for *environment* depends largely on the effectiveness of regulation and coordination, which is hard to judge (see also Molle, 2011). With respect to the effectiveness of R&D on environmental issues, we refer to the preceding paragraph on R&D in general. The additionality of EU *environmental* spending is low; in particular R&D outlays are ignored. However, EU activities could be effective and could become even more necessary in the future to combat climate change and deal with energy security and the depletion of natural resources.

The EU *budget for agriculture* is large, but not clearly effective. Direct income support payments are not strictly conditioned to guarantee that only the poorest farmers of those hit by low prices receive a basic income. Much of these payments seem to reach other beneficiaries for whom income support is less necessary. One of the objectives of the new reforms (EC, 2010b) is to improve effectiveness.

The EU is also the appropriate government layer for many *external polices*, ranging from representation in international organisations, pre-accession, neighbourhood policies to development aid. The effectiveness of the *EU in development* expenditures directed to development aid is not beyond discussion. One main input indicator is the minimal 0.7% of GDP spending for development aid. The EU and its member states fall short of this indicator. The output indicators also unhelpful because they just state how many projects are supported by EU funds. Moreover, the coordination of development aid by the EU is ineffective because of coordination at the global level and the individual interests and preferences of member states. Although the effectiveness of development aid is often disputed, more efforts in pushing Europe as a global player seem to be warranted.

6.5 Conclusions and recommendations

6.5.1 Does the EU do what it is supposed to do?

The EU spends money on many different budget items. All these items are in concordance with the legitimate competences of the EU. However, they do not always correspond to the principles of the subsidiarity test. Some items would warrant to be increased; others seem to be about right while yet others merit a considerable decrease (see Table 6.4).

Table 6.4 Summary of the structural changes needed in the EU budget

Increase	No significant change	Considerable decrease
R&D and innovation Stabilisation Environment External (defence; representation in global organisations; development aid and neighbourhood policies)	Competitiveness and internal market Cohesion (convergence) Employment and social protection Health and consumer Freedom, security and justice Education and culture	Agriculture and rural development Cohesion (regional competitiveness)

The left-hand column presents the policy areas where more EU finance would be justified. For example, *R&D and innovation* is certainly a category on which the EU should spend more money because of economies of scale and the limitation of external effects. This could also help achieve the R&D target in the Europe 2020 strategy. In the middle column, we have indicated the areas where no change is needed. Finally, the right-hand column presents the policy areas that need less EU involvement. Here, a shift from the EU to the member states is actually needed, entailing a decrease in the EU budget.

Our analysis does not conclude on the magnitude of the change. To indicate a direction: a doubling of the financial resources in these areas of column 1 would require an additional €15 billion per year. This would increase the relevance of the EU budget with respect to R&D and external policies compared with national policies. In the present budget, this could be financed by lower spending on regional competitiveness (cohesion) and direct income payments (agriculture). These budget categories would still be the largest in the budget.

R&D, environment and energy networks and external polices are sustainable, long-term goals as Tarschys (2011) puts it. We would recommend more drastic changes in this direction for the budget periods starting in 2020 and 2027 (assuming that the seven-year framework is maintained). In this time period, R&D combined with ICT and infrastructure could become one of the main budget categories of the EU together with cohesion and environment. This would require a massive shift of the budget on natural resources from direct income payments to environment and rural development. This corresponds to the most drastic option that the EC presents with the CAP reforms (EC, 2010b). The budget for external policies would become the fourth most important budget item.

6.5.2 Does the EU do what it is supposed to do well?

The budgetary method is subject to systematic evaluation. In these evaluations, the usual distinctions are made between output and outcome. This means that one has gone to some length to specify the objectives and targets in quantitative indicators and define the inputs and outputs in the framework of projects and programmes.[39]

Overlooking the evidence of the effectiveness assessments in the various policy fields one gets a satisfactory picture as far as output performance is concerned. On the contrary, the measurement of outcome is less clear. Therefore, it is not possible to make any strong statements. However, three types of indications can be given as to the plausibility of the effects:

- *Positive*. For most policies, the evidence would indicate that it is highly plausible that EU resources have contributed to meeting the objectives; this is true for convergence, innovation (although not the public spending target of 1%) and environment.
- *Dubious*. Some doubts exist about the outcome effectiveness in the field of social policy. This is mainly because of the large number of small projects of a diversified nature.
- *Negative*. In one area, the assessments have produced a rather negative judgment, namely EU development aid.

[39] A strict way is Performance Budgeting. Until now, there are only a few cases where the EU and its member countries have been able to subject a significant part of their budget to this new method. The main reason for this limited success is that the system is difficult to put into practice (see e.g. van Nispen and Posseth, 2006). This needs a significant amount of information to be made available in a new format. For instance, for each budget article one needs to specify the legislative proposal, the relevant policy statements, the quantified objectives and the way the policy is to be managed (implementation). All this means more work for the administration to prepare, coordinate with other departments, administer and check. It is often at the stage of the first ex ante question as formulated in Table 6.4 that things get into difficulty as governments often only define in general and evasive terms their policy objectives.

Apart from output and outcome indicators, process-related indicators can be used. We then see that the introduction of the grant instrument has, in general, changed the *behaviour* of the partners in the direction of various EU policy objectives. This has been observed for longstanding policy areas such as innovation. It can clearly be seen in newer areas of EU involvement where coordination has had a limited impact, whereas programmes supported financially by the EU have seen a significant impact.[40] The strength of financial incentive instrument has even induced the EU to deploy it as its major objective (the Lisbon Strategy) in view of the lack of responsiveness of the coordination instrument. For the time being, there are unfortunately no good examples of evaluations of such support (Eureval, 2008).

6.5.3 Final considerations

In an ideal situation, one determines first the optimal amount of a public good to be delivered. Subsequently one assigns the task to deliver it to the most appropriate government level. Then, the optimal instrument is selected based on aspects as effectiveness and efficiency. We have tried in our chapter to come as close as possible to this ideal. It means that we show what the EU budget should be like if the EU would apply fully the principles of government it has solemnly adopted.

We know that the reality is different. Decisions on the division of tasks are often based on political motives, such as "do not give any more power away to Brussels". Decisions on the use of the budget method for different government tasks are not always based on normative principles either. National governments often interpret contributions to the EU budget as a cost item instead of a contribution to a European public good. The fear for a lack of *juste retour* often prohibits the obvious choice of doing the right things on the EU level. Many therefore argue that one should rather look at how decisions are taken in the real world. We know the argument and we know the relevant literature.

Yet we think that our approach has the merit of showing where the EU budget in the long term should go. In practice politicians will steer a course that deviates from the ideal one. However, in the end the basic factors we have highlighted will become dominant. It can take some time as the example of agriculture shows. However it will happen as many examples of EU public goods that have over time been integrated in the budget show.

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40 See e.g. in education, the literature cited in Souto-Otero *et al*. (2008).

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7 Cohesion Policy in the Long-Term Budget

Willem Molle

Cohesion is one of the largest budget items. It gives form and substance to the concept of solidarity by supporting the socio-economic development of the poorer member states. It has a long history in which it has shown to be capable of adapting its objectives and delivery structure to new challenges. Such new challenges will present themselves again and the EU will have to readapt its cohesion policy. Some indications about future change have been given by the Commission (EC 2010a). They concern mostly the concentration of efforts on a limited number of priorities, the set up of a common strategic framework and the improvement of the quality of the expenditure. The *objective* of this chapter is to assess these proposals in light of normative economics and past performance.

The structure of the present chapter follows closely the review principles by the Commission (EC 2010b) and the issues presented in the introductory chapter of this volume: first, a focus on priority objectives, next on obtaining results and creating value added. This will be worked out as follows.[41]

In the first part, we will describe the *objectives* and the *available instruments* to meet the objectives of cohesion policy. In the second section, we will detail the way cohesion has been defined to transform it from a vague political wish into an operational concept, the multitude of concrete objectives that the EU cohesion policy pursues and the rationale of EU involvement. In the third section, we deal with the instruments, the form through which the budget is made available, the financial means that have been attributed to the various objectives and finally the question of whether the size of the EU's effort is adequate.

In the second part, we will discuss the *degree to which the policy has actually been delivered*. Based on a large number of evaluation studies, we extract the value added of the EU effort in terms of cohesion. We find that these benefits come at a cost, and detail these in the same order as we do for the benefits. These benefits and costs (and the net value added) are defined in terms of territorial or social units. We translate these into perceived benefits for individual citizens.

In the third part, we question how far the objectives, priorities and implementation mechanisms have to change to be capable of facing *future challenges*. We first select the main priority objectives for the upcoming period. We next

[41] See for an elaborate systematic analysis of the policy, for detailed evidence on many aspects and for references to the relevant literature: Molle (2007). Certain parts of the present text have borrowed from this publication; in particular sections 2.6, 3.1 and 3.2.

make a critical assessment of a number of proposals of the Commission. Finally, we make two recommendations: to introduce a strengthened programming device to enhance consistency between objectives and to disburse the funds conditional upon clear improvements in the administrative and institutional capacity of the beneficiaries.

7.1 The objectives and instruments

7.1.1 Definition and measurement of cohesion

The European Union is confronted with large disparities in wealth (in income and access to social services). The functioning of the EU (internal market, EMU) may aggravate the disparities. Now, these disparities are felt as morally unjust and economically inefficient. They lead to social and political problems that endanger the internal cohesion of the EU. It is thereby a *public good* to decrease such disparities. So, a policy is needed to change the situation and bend the autonomous development processes in such a way that they lead to less disparity and more cohesion.

Cohesion is measured by the change in disparity from one period to another. A decrease in disparity (convergence) means improved cohesion and an increase in disparity (divergence) means less cohesion. In general, simple indicators are used to measure disparity such as regional GDP per head and (un) employment. Moreover, a series of other indicators capture the various elements of the plethora of side objectives pursued by the cohesion policy. We cite here the risk of poverty, health, access to broadband Internet and so on.

7.1.2 Objectives of the policy

The EU has set a number of objectives for its cohesion policy. The fundamentals have remained constant over time, although the specifics have constantly been adapted to new challenges. The main ones are:

1. Improve cohesion
   The treaty takes into account three dimensions: economic, social and territorial. In practice, the split is along other dimensions featuring the type of region and the gravity of its problem. This was translated for the present programming period as:
   - *Convergence of lagging regions*. Eligible regions have a GDP per capita that is less than 75% of the EU average.
   - *Competitiveness and employment of restructuring regions*. Eligible regions have a GDP per capita that exceeds this threshold of 75%. Unemployment in these regions is often high and infrastructure inadequate.

- *Territorial cooperation*. Eligible regions are characterised by deficient connectivity with other regions, often because of national borders.

2. Contribute to other EU objectives
   - Facilitate major advances in economic integration such as enlargement or the passing into higher stages of integration (e.g. the EMU).
   - Contribute to major EU policy targets such as allocation and stabilisation (see Box 7.1), the increase of competitiveness, the decrease of social exclusion or the stimulation of environmental sustainability. The latter has notably come to the fore with the so-called Lisbon Strategy launched in 2000 and the new Europe 2020 strategy (EC 2010c, d).

7.1.3 Why EU involvement?[42]

In principle, member states are first in line to cope with cohesion problems. However, there are sound reasons (related to the subsidiarity principle) why the EU also has to step in (e.g. Ederveen *et al*. 2003; Gelauff *et al*. 2008). The EU has been endowed by the treaties with the competence to pursue a policy to improve the cohesion situation. Given the joint responsibility of the EU and member states for the policy a certain division of roles is necessary. The EU thereby determines the objectives, architecture and operations of the delivery system but leaves to member states the application of the eligibility criteria and selection of projects within the EU priorities. The justification of the role of the EU is different for the various objectives defined in the previous section. In the following paragraphs, we will substantiate this by balancing the arguments for centralisation and decentralisation.

Convergence

Strong *fiscal federalism* arguments justify centralisation, or, in other words, EU involvement in the pursuit of convergence.

Economies of scale. The EU can mobilise and provide more funds at far better conditions than can poorer member states. Moreover, it can offer long-term predictability about the availability of resources to all beneficiaries. This means that investors will be more inclined to invest and thereby growth is likely to be enhanced. The EU also has the institutional capacity to monitor and evaluate convergence projects and the legal authority to impose governance conditions, which make sure the EU support is used appropriately by member states.

[42] The text of this section is a shortened and adapted citation of ECORYS *et al*. (2008). This report gives many references to further literature.

Externalities. We can distinguish between two types:

1. Positive. Stimulating the economy of designated regions can also increase production and income in other regions because of interrelations in the common market.
2. Negative. This could occur if regional support encourages foreign firms to establish a plant in that region, an investment that may be at the expense of other countries. The EU level of government can easier handle distortions in competition between regions.

Public choice arguments also imply the need for centralisation. These are mainly related to the other objectives mentioned in section 2.2, namely economically fragile member states asking for financial compensations to give their consent to further integration. This is largely an argument of *complementarities* between policies. Imagine that countries that find their incomes sinking below those of other member states are inclined to opt out. This would mean that the efficiency gains from market integration would be lost. A sort of compensation scheme would be warranted as long as the benefits in terms of market efficiency outweigh the cost of the scheme. Additional complementarities can also apply, notably to the factors mentioned in Box 7.1 on the next page.

The *counterargument to centralisation* is mainly heterogeneity. The diversity of regions is to be taken seriously since the underlying causes for low incomes per capita differ between regions and so do the solutions for creating paths towards convergence and competitiveness.

The *balance of arguments* for and against centralisation tips largely in favour of EU involvement because neither independent national actions nor voluntary cooperation would solve the problem effectively.

Regional competitiveness and employment objective

The EU set ambitious goals in the framework of the Lisbon and Europe 2020 strategies to develop a dynamic knowledge-based economy capable of sustainable growth that would foster employment and cohesion. At the beginning, this strategy was conceived outside the EU budget framework. Objectives were to be realised through the coordination of EU and national policies. It seemed that this was not enough to produce the desired results. National compliance was thereby to be reached by putting in place a more powerful instrument: money. As political discussions on the EU budget did not foresee such objectives, it was decided that the financial resources available for cohesion have to serve the Lisbon agenda. This is somewhat distorted as the activities still operate under the banner of cohesion policy. So, let us see to what extent the arguments for EU involvement in this policy hold.

Box 7.1 Relation of cohesion policy to the three classic functions of government

- *Allocation* (efficiency). The idea is that cohesion policy "helps towards the efficient allocation of resources by taking away bottlenecks and barriers to development" (Molle, 2007:105). If labour is immobile, the human capital of unemployed workers will not be utilised unless conditions for favourable investments are met. Moreover, training workers enables them to adapt to new market circumstances and help them utilise their human capital.
- *Stabilisation*. There is no role for cohesion in classical stabilisation policies. However, cohesion policy can act as a means for *fiscal* stabilisation because it provides the receiving member states with a stable source of income for a number of years. This helps stabilise investments over time in, for example, infrastructure. However, this support is conditional on national co-financing. For many cohesion countries crisis has struck, which makes the latter increasingly difficult to realise.
- *Redistribution*. Cohesion policies aim to provide more equity, but they do so via an efficiency measure. This equity argument has only gradually come to the fore in EU policies. In general, redistributed funds to poor regions could be used to provide a minimum level of public goods or social assistance. This is often the case in federal countries, but not in the EU. The absence of clear redistribution payments via general purpose grants matches with the existing low degree of intra-EU solidarity (Molle 2007). As an explicit means for income redistribution, such grants would be much more appropriate. For that reason, Begg (2008) concluded that cohesion policy is a rather clumsy way to redistribute income. However, income redistribution is not an explicit objective of cohesion policy.

Source: ECORYS *et al*. (2008)

Economies of scale do not apply here. Richer member states have the capacity to finance these policies themselves and to govern and monitor sponsored projects.

The *externality* argument is, though, valid: higher production and incomes in supported regions can have positive spillovers to other regions and other countries via trade. Nevertheless, these spillovers via trade and prices are relatively minor. Moreover, the EU can handle negative external effects by regulation. The EU has some positive effects in the sense that the cohesion policy has induced member states to take EU priorities seriously.

The *diversity argument* leans towards exclusive national involvement. In general, member states have a better knowledge of the specifics of their regions than does the EU and have better incentives to spend the money more effectively.

Public choice type arguments explain much of EU involvement. The history of the cohesion expenditure in the EU is paved with arguments to balance benefits for all countries and to equalise national payments to, and receipts from, the EU budget.

Support to regional competitiveness and employment is also *complementary* to other policies, in particular internal market policy and external trade policy. These policies limit the possibilities of member states supporting threatened industries. From a political point of view, it is then acceptable that groups or regions substantially affected by EU policies are compensated by a policy such as cohesion policy. Therefore, on balance the arguments for EU involvement are weak.

Territorial cooperation

Regions are the parts of different countries. Institutions, cultures, languages and often forms of governance differ. This hampers cross-border cooperation. However, such cooperation could be welfare increasing as some problems can only effectively be dealt with jointly.

Economies of scale are not important. Some problems can be solved by cross-border cooperation, for instance the provision of public services. As spontaneous cooperation is hampered by high transaction costs, stimuli from a higher governmental level is then needed to overcome this hurdle.

Externalities and complementarity of policies are more important as a justification of EU involvement. For instance, internal market policies are enhanced as cross-border cooperation facilitates the free movement of goods, services, capital and labour between regions.

The reasons for *decentralisation* do not carry much weight in the case of territorial cooperation and where they are present their effect can be mitigated. The diversity problem is limited because regions on both sides of a border tend to be less diverse than any two arbitrary regions. On balance, there are sufficient reasons to have the limited involvement of the EU.

7.2 The instruments

7.2.1 Several funds

The main instruments by which the cohesion policy is put into effect are:

1. The provision of financial means. The EU does this by allocating funds to the disadvantaged regions to improve their economic structure and to social groups to improve their employability and avoid their social exclusion. Both should lead to increases in competitiveness.
2. The setting of rules and the coordination of actions. As cohesion is a matter of shared responsibilities between the Union and national authorities, such coordination is vital for effectiveness. This applies

equally to national cohesion policies as to other EU and national policies, such as on the environment.[43]

The main instrument of cohesion policy is financial support paid from the EU budget. In a first step, a share of the budget (some 40%) is earmarked for cohesion. In a next step, money is allocated to the various cohesion objectives. Convergence regions (defined as those with an average wealth level of less than 75% of the EU mean) gain the lion's share (some three-quarters). They are mostly located in new member states and in the south Mediterranean. The remaining share is for regions elsewhere in the EU to improve their competitiveness and for territorial cooperation. This step also defines the allocation of resources across countries. In a fourth step, the types of programmes and projects eligible for support are selected.

7.2.2 Matching funds and objectives

The spending on cohesion operates a number of funds:

- *The ERDF* (European Regional Development Fund) is the largest fund with a cohesion objective. The ERDF focuses on economic development and sustainable jobs. It was established in 1975 to grant subsidies to stimulate investment and promote innovation, as well as to develop infrastructure in regions whose development was lagging behind, and to assist regions undergoing conversion or experiencing structural difficulties.
- *The ESF* (European Social Fund) focuses on employment and social inclusion. It was created in 1952[44] and supports measures aiming to achieve full employment (and employability), productivity, social inclusion and equal opportunities. In practice, this often involves education and training.
- The beneficiaries of the *CF* (Cohesion Fund) are the member countries with below EU average (actually 90%) GDP per head figures. The CF has a limited focus, mainly on transport and the environment. It was set up in 1994 to help countries deal with the effects of the EMU and the constraints of the SGP. It finances environmental, energy and transport projects in a framework that is different from the two previous funds (called structural funds); it delivers national rather than regional funding and the programming is simplified compared with the ERDF and ESF. The CF assists Trans-European Networks and environmental projects.

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[43] Another important aspect is the regulation of the external effects of national government behaviour; e.g. the EU has to set rules to limit internal competition of member states with state aids.

[44] By the Paris Treaty on the creation of the European Coal and Steel Community; since 1958 also operating for the other Communities created by the Rome Treaty.

These funds (together called Structural and Cohesion Fund; SCF) provide financial support to projects and programmes. The principle of additionality prescribes that major contributions to financing have to be made by national and/or regional governments. The EU contribution is higher in percentage terms the lower the wealth level of the region.

The various funds are oriented towards different goals that partly overlap. Table 7.1 gives an overview of their specialisation. The quantification of each subject is difficult to give; however, the main spending categories (together accounting for three-quarters of the 2007-2013 budget) were transport infrastructure, technology and innovation and environmental protection. Other aspects such as social infrastructure were less important.

Table 7.1 Fields of intervention of each of the structural funds

ERDF	ESF	CF
R&D, innovation and entrepreneurship Information society Environment Risk prevention Tourism Culture Transport Energy Education Health & social Infrastructure Direct assistance for small and medium-sized enterprises	Promotion & improvement of vocational training, education & counselling Research & innovation Promotion of a skilled, well-trained & flexible workforce Innovative & adaptable forms of work organisation & entrepreneurship Support career prospects & access to new job opportunities for women	Environmental projects on: 1. drinking water supply; 2. treatment of wastewater; 3. disposal of solid waste; 4. reforestation and erosion control; 5. nature conservation measures. Transport infrastructure projects

Source: ECORYS *et al*. (2008)

Many of the fields of intervention correspond to detailed objectives as mentioned in the treaties.[45] Moreover, one may observe here that a large percentage of the cohesion effort has been made on subjects that are directly relevant for the overriding EU objectives of the Lisbon and Europe 2020 strategies. In particular, the theme of innovation and knowledge economy serves the priority goal of increasing R&D spending. About €62 billion of the SCFs for the present programming period is estimated to be allocated to R&D and

45 Compare the entries to the objectives in Table 2.2 of the Tarschys chapter in this volume.

innovation. This exceeds the budget of the seventh framework programme for research.

7.2.3 Adequacy of resources

Cohesion policy is the second largest budget item of the EU. There are continuous pressures applied by potential beneficiaries to augment it. By contrast, there are also continuous efforts of net payers to slim it. The arguments in this debate are diverse. Academics have proposed some approaches that would bring some more rigour to the debate (Box 7.2). Based on their arguments, it seems as if the total effort of the EU in matters of spending on convergence is rather balanced; no strong reasons exist for either cutting or expanding the size of this budget item. However, in the end political horsetrading determines the outcome.

Thus, a systematic procedure has been followed, which is essentially based on political arguments. The amount allocated to cohesion has increased over

Box 7.2 How much money is required for cohesion?

The EU has decided to put in place a cohesion policy and to devote important financial resources to it. Unfortunately, the theoretical and empirical basis to determine the amount of money a country should spend on meeting cohesion objectives is thin. This is even more so for a group of countries such as the EU. Therefore, the decision is essentially of a political nature and depends on a matching of the demands of the recipients (needs) and the willingness to pay of donors.

The needs can be approximated by a normative method that evaluates the cost of bringing, for instance, the infrastructure level in the recipient country up to the level of the EU average. Normative elements here are the speed of the operation (say 10 years) and the degree of real convergence needed (EU average). This exercise can be complemented by an approximation of the capacity of a country to absorb the aid it receives. The size of this cap can be based on empirical economic studies. High support percentages tend to lead to three types of unbalances and insufficiencies:

1. Macroeconomic; high levels of aid lead to inflation, a loss of competitiveness (because of undue wage increases) and a series of distortions in segments of the economy and notably labour markets.
2. Fiscal; weak member states often have difficulties mobilising sufficient budgets to meet the EU requirements of co-financing.
3. Institutional; economically weak countries have limited capacity to manage effectively the process as described.

The EU has studied the level beyond which such problems occur and has set a cap for total support to cohesion countries of 4% of GDP per year. Willingness to pay might be approximated by evaluating the gains that richer countries draw from integration. In practice, however, it is difficult to determine the inter-country differences in advantages of integration.

Source: Adapted from Molle (2011)

time in absolute terms and as a share of EU budget. Total resources were €65 billion in the period 1988-1993 and gradually increased to €347 billion for the period 2007-2013. This increase was justified by the successive accession of relatively low-income member states.

7.3 Evaluation of effects

7.3.1 The bright side: EU added value

The EU evaluates systematically its cohesion efforts. These evaluations serve two main goals: to provide evidence to all stakeholders that money is well spent (accountability) and to provide lessons that ensure future policy, programmes and projects responds better to the stated goals than did those of the past (learning).

The principle motive for an EU cohesion policy is economies of scale. This implies that things would not have been achieved or would have achieved in a less complete or less efficient way had the EU cohesion policy not existed. In other words, value resulting from EU assistance that is additional to that which would have been secured by national and regional authorities and the private sector. Let us check first value added on the main objective of the policy and next on the side objectives (mentioned in section 2.2).

The EU has created value added in *matters of decreases in disparity* on each of the stages of the cycle:

- *Analysis of the problems*. In a number of cases, countries have failed to recognise the gravity of certain problems. The EU has contributed to a good assessment by making pan-EU surveys based on uniform definitions and leading to comparable figures.
- *Selecting the right intervention system*. The EU cohesion policy approach is appropriate as it attacks the main problems: the persistence of economic, social and territorial disparities. The actions of the SCFs concentrate on removing deficiencies on the supply side, namely the growth potential (competitiveness) of backward countries and regions and disfavoured social groups. In practice, the policy has reached the main target groups, but most of the support has been given to infrastructure and labour in the most disfavoured regions.
- *Mobilising substantial resources*. EU funds are much larger than countries would have been able to mobilise alone. Moreover, the EU requires co-financing for investing in projects. In this way, extra finances from public and private sources have been mobilised (and often secured in times of budgetary restraints)[46] so that total levels of investment have been enhanced.

[46] The multi-annual programming approach of the EU has introduced predictability about the availability of funds permitting beneficiaries to go ahead with projects that under the uncertainty of single year budgetary allotments would not have got off the ground.

- *Regulation and coordination*. The EU has prevented subsidy wars and a race to the bottom in terms of social and environmental standards.
- *Improving the quality of the implementation and delivery system*. The EU wants partnership and good governance. Consequently, many countries have improved their administrative structures and procedures. The strict rules about good governance have decreased the degree of fraud and corruption. The SCFs have contributed to the quality of institutions in many poor regions and thereby the quality of the regional investment conditions. EU regulations have contributed to strategic thinking and planning both at the national and regional level. The ownership of projects on low levels of organisation has improved the adequacy of the projects with the real needs of the region or group.
- *Evaluation of effectiveness*. Disparities on many scores have decreased over recent decades. The question is to establish how far the SCFs have contributed to this. Empirical studies have not led to unequivocal answers to these questions. The majority of studies find positive effects, whereas only a few find limited or even negative effects. This controversy is partly because of methodological deficiencies. A large amount of project-based evidence, however, suggests that it is plausible that the policy has been effective.
- *Enhancing learning effects*. The EU obligation to regularly evaluate interventions has made it possible to regularly adapt the system to new demands. It has also had important positive effects on the quality of the programmes and projects carried out. Moreover, the EU has fostered an exchange of knowledge about the understanding of the problems and the best ways to attack them. The EU experience has clearly influenced changes in national policy regimes that are now more geared to competitiveness rather than simple redistribution.

The evaluation of the cohesion policy on its *side objectives* is in general positive:

- *Stages of integration*. The cohesion policy has permitted the EU to realise the internal market and the EMU. The EU regimes in these diverse areas have stimulated growth in the countries that earlier had problems in terms of volatility of exchange rates, inflation and a lack of trust in the legal system.
- *The Lisbon/Gothenburg strategies*. The EU has instrumentalised the SCFs to contribute to the realisation of their goals (increases in competitiveness, jobs, innovation and sustainability). The resources earmarked for these objectives are often more important in financial terms than those devoted to the respective sectoral EU policies. However, the impact goes further in the sense that the EU cohesion programmes have stimulated national governments to develop strategic views on other

policies and improve their impacts. A clear case in point is environmental policy under the impetus of cohesion fund support.

7.3.2 The shady side: EU added cost

The value added items listed in the previous section do not represent the net effect of EU involvement. Indeed, a cost should be deducted. These notably concern losses in efficiency. For each of the stages in the cycle there are the following negative points:

- *Intervention system*. The improvement of the governance of cohesion has in many member states come at a considerable cost. This is notably so in some of the new member states.
- *Money mobilised* leads to two problems:
  1. Aid dependency of the beneficiaries. Member countries are inclined to regard the aid as a major source of income and have difficulty developing new resources for investment in productive and competitive activities. Where support by the SCFs leads to higher than normal factor prices this support constitutes a barrier rather than a stimulus for innovation and productivity.
  2. Welfare loss. The money transferred to the EU might have been more efficiently used in case it would have stayed at the disposal of the member state. The present system of mobilising and redistributing financial resources via EU funds could be simplified. This would remove the significant administrative cost involved and avoid the distortion of preferences that ensues because the EU imposes its criteria on the aid eligibility of projects, which does not always match the priorities of the country.
- *Regulation and coordination.* Some of the instruments of the EU are too constraining; for instance, investment subsidies in problem areas may be necessary to attract new jobs. By contrast, the less constraining instruments such as the open method of coordination are not capable of realising the side objectives of the EU cohesion policy such as quickly realising innovative dynamism and job growth.
- *Implementation and delivery system*. The EU system leads to two problems:
  1. Unclear division of responsibilities and lengthy and costly procedures for having projects prepared, the process monitored and the expenses justified. This disadvantage is notably negative for small projects that have intangible targets or where the contribution of the EU to total project cost is relatively small.
  2. Predictability has led to a lack of flexibility. Once the priorities and measures are decided, the character of the problem is different from

that initially assessed, meaning that the approach adopted is no longer adequate. Adaptation to such new facts is then difficult.

- *Learning effects*. One of the objectives of evaluation is learning. However, this may lead to irresponsibility on the part of those involved as they may attribute the running cost of mismanagement and mistakes on the (virtual) capital account of learning. Furthermore, although the EU's penalty for bad performance (the so-called performance reserve) can stimulate good performance and discourage bad performance, it may have the adverse effect on evaluation. Indeed, the risk of losing money because of poor performance may lead to unduly pressure being placed on evaluation to come up with results.
- *Synergies between EU policies*. The search for consistency between sectoral policies gives rise to heavy coordination costs. Moreover, as compromises have to be negotiated at several levels of government (vertical consistency) there is a real possibility of stalemates (see e.g. Molle 2009). Sectoral policies that can use adequate finances and instruments for their proper functioning may then be more cost effective.

7.3.3 Popular support for cohesion policy

The previous sections have indicated that the EU cohesion policy has net benefits and that these tend to be reaped by the major beneficiaries of the policy. These beneficiaries have been defined as administrative units (for instance regions in the case of the ERDF actions) and as social groups (for instance redundant workers in the case of ESF) It is generally assumed that the benefits for such units and groups are transmitted to individuals. For instance, one assumes that the training of unemployed to make them fit for jobs in new activities does indeed lead to increases in local employment. Likewise, one assumes that investment in infrastructure (that attracts new firms) does indeed create jobs for the population and improve individual wellbeing. These benefits are perperceived by the public as Box 7.3 on the next page shows.

7.4 Sustainability of the effects

7.4.1 Elements of continuity and change

For the coming period (up to 2020), it is clear that there should be a continuation of the policy to reduce disparities between different member states and regions; therefore, a continuation of the programmes that deal with convergence. However, the major challenges the EU has to confront and answer have been defined in the Europe 2020 strategy (EC 2010c, d). Therefore, it seems logical that future cohesion efforts have to be dovetailed with Europe 2020. This would mean that all other side objectives could be disregarded.

Box 7.3 Popular attitudes towards cohesion policy

The European Commission regularly surveys public opinion to assess the changing attitudes of citizens to cohesion. In the 1980s, support for international transfers was limited. While four out of five respondents to an EU-wide survey accepted that a fiscal contribution had to be paid for aid to regions in their own country, only one in three felt the same about aid to regions in other EU countries (EC 1983).

Later surveys (EC 1991a, b, 1992, 2002) showed considerable support for common EU policies for convergence (over two-thirds). There was also (albeit less) support for the various other objectives of EU cohesion policy.

In 2008, a new opinion poll (EC 2008) found that 85% of respondents approved of giving priority to the poorest regions in the EU. At the same time, 60% maintained that all regions should be beneficiaries of EU regional policy. About half of respondents were aware that the EU supported their city or region. Some 70% of the latter group thought that this support was beneficial.

Asked in which policy areas they would prefer to see their regions being supported by the EU 80-90% of the respondents mentioned 1) educational, health and social issues; 2) the protection of the environment 3) employment training and 4) support to small businesses. These policy areas tend to overlap with the present fields of intervention (see Table 1) but not the present distribution of resources.

This implies the following:

- Convergence. The majority of resources should continue to go to the convergence objective, taking into account as many Europe 2020 objectives as possible.
- Competitiveness.[47] A limited amount can be devoted (as a second best) to support competitiveness. In these areas, it is clear that only Europe 2020 objectives should be supported.
- Territorial. Past programmes on improving connectivity have shown their value added so can be continued. There is little relation here to Europe 2020.

7.4.2 Assessment of the proposals of the Commission

The EU system has a number of flaws (see section 3.2). The Commission (EC 2010a, b) plans to make improvements on strategic programming, thematic concentration, the conditionality of the support, the evaluation of impacts, the use of new financial instruments (not only grants but also loans), the streamlining of financial management and control systems and the strengthening of the institutional capacity of the recipients. All have their merits but two are particularly important.

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47 We recall the popular support for the cohesion policy to cover the whole territory of the EU (see Box 7.3).

The first concerns *consistency between the various policy fields*. The EU has tended to overload the cohesion system with a wide array of objectives. As Table 7.1 shows, these tend to overlap with many EU policy areas such as energy, transport and employment. The EU has tried to come to grips with the tensions between them by setting up coordination and programming devices. As these have shown to be too weak to be effective, a refocus is required. The budgetary method is a strong instrument to "induce" partners to comply with stricter EU priorities (Molle 2011). The corollary of this is better consistency between the selected priority actions. Therefore, we support the suggestions by the Commission to strengthen the instrument by creating the Common Strategic Framework. In accordance with the Integrated Guidelines, this would translate Europe 2020 objectives into investment priorities and concrete programmes.

The next concerns *administrative capacity*. The success of financial interventions is critically dependent on the quality of regional and national administrations. There are considerable differences between countries and regions in the quality of their governance. There is particular concern in convergence countries. At present, the technical and financial support that is given under the cohesion policy to countries and regions with deficient administrative structures is only limited (less than 1% of total cohesion resources). There is no relation between the relative size of the administrative capacity building efforts and the problems of governance quality. Therefore, we support the proposal of the Commission to step up EU support for the improvement of administrative capacity. However, we recommend (Molle forthcoming) going beyond the proposals of the Commission in this respect and imposing a strict conditionality:[48] in other words, make the allocation of SCF aid conditional upon significantly enhanced programmes for administrative capacity building.[49]

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48 Conditionality is not a new thing. International organisations (such as the IMF) rely on it for enhancing the effectiveness of their support. The EU has used conditionality for decisions on accession. More specifically, it has used conditionality in terms of compliance with the Lisbon strategy for cohesion policy decisions.

49 We thereby reiterate a suggestion made at the occasion of the previous recast of the cohesion policy among others by Ederveen *et al*. (2003: 54). They observed: "In this respect we may learn lessons from the World Bank. They conclude on the basis of an evaluation of foreign aid programmes that the main ingredient of effective financial support is that it is used as a catalyst for change in policy and institutions. In analogy to this, effective cohesion policy may require that funds are accompanied by conditions that improve the functioning of the public sector in the countries and regions that receive funds."

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Sammanfattning på svenska

Under de närmaste åren ska beslut fattas om nästa fleråriga budgetram för Europeiska unionen. Det finns därför goda skäl att återigen ställa frågan om vad EU ska göra. Budgeten i sig är visserligen inte det fullständiga svaret på den frågan, eftersom unionen åstadkommer mer genom normgivning än via medel från budgeten. Men de gemensamma utgifterna spelar en avgörande roll för effektiviteten i EU:s regleringar, icke-bindande instrument och andra former av inflytande.

EU:s medlemsstater stakar gärna ut nya mål för unionen, men de är mindre hågade att skjuta till de pengar som skulle behövas för att nå dessa mål. Budgeten har länge legat runt en procent av EU:s gemensamma BNI. Om vi på allvar skulle försöka uppnå alla de syften som har fastställts i fördragen och i Europeiska rådets beslut (inklusive Europa 2020-plattformen), skulle det svälja stora delar av – för att inte säga hela – vår samlade BNI. Europeiska unionens storslagna mål motsvaras alltså inte på långa vägar av de medel som ställs till dess förfogande.

Därför behövs det strikta urvalskriterier för EU:s utgifter. Eftersom det finns mycket större resurser nationellt än i EU kan vi inte vänta oss att EU ska ta ansvar för alla former av offentliga utgifter. Så vad bör unionens specifika bidrag vara? Vilka satsningar ska EU prioritera framöver och vilka tidigare prioriteringar kan trappas ner eller avvecklas? Vad kan EU göra inte bara bättre utan mycket bättre än medlemsstaterna själva?

Frågor av den här typen är tätt sammankopplade med en rad diskussioner om EU:s syfte och omfattning, relationerna till medlemsstaterna, betydelsen av subsidiaritetsprincipen och arbetsfördelningen i det framväxande flernivåstyret. Diskussionen rör också budgetprocessen som sådan liksom sammansättningen av utgifter och intäkter.

Många utmaningar väntar unionen i framtiden. Kapitlen i rapporten behandlar främst normativa frågor och utforskar begrepp som ”europeiskt mervärde” och ”europeiska kollektiva nyttigheter”. Men det föreslås också institutionella reformer och förändringar i budgetproceduren som kan ge större tyngd åt gemensamma intressen och behov.

Eftersom regleringar spelar allt större roll i integrationsprocessen måste vi främja kvalitén i EU:s beslutsfattande. *Daniel Tarschys* argumenterar för att större uppmärksamhet borde ägnas åt EU:s ”inre dagordning”. Välrustade institutioner, god analyskapacitet, bra former för policy-överväganden och utvärderingar är i sig viktiga europeiska kollektiva nyttigheter. För andra utgiftsposter föreslås ett trestegstest. I det första steget kontrolleras om en föreslagen utgift klaffar med EU:s officiella mål och i det andra steget identifieras de som drar nytta av olika utgifter. De är ofta många och olika grupper överlappar. Ju bredare en policy är, desto större är sannolikheten för att det ska finnas ett betydande europeiskt mervärde. Utgifter som inte medför återflöde till en eller flera medlemsstater är särskilt lämpliga kandidater för EU-finansiering. I det tredje steget granskas tidsramen: hållbara, långsiktiga och utvecklingsinriktade investeringar bör i allmänhet ges företräde framför projekt som är kortlivade, kortsiktiga, konsumtionsinriktade eller omfördelande.

Stefan Collignon utgår från litteraturen om europeiska kollektiva nyttigheter. Beroende på den underliggande incitamentsstrukturen krävs skilda styrningsformer. Han betonar att europeiska kollektiva nyttigheter påverkar alla EU-medborgare. Medan den europeiska integrationsprocessen i sitt inledande skede framför allt byggde på samarbetsincitament, har införandet av euron inneburit att politiken idag domineras av gemensamma nyttigheter där misslyckanden i samband med samarbeten är vanliga. Lösningen på det problemet är att upprätta en demokratisk styrelseform för att på ett effektivt sätt kunna administrera dessa nyttigheter. Det är viktigt att vi blir medvetna om de långtgående externa effekter som den europeiska integrationen har gett. Det kräver nya styrelseformer. Kapitlet avslutas med en diskussion om federala och republikanska demokratiska förhållningssätt till kollektiva nyttigheter, och författaren argumenterar för att det republikanska demokratiska paradigmet är överlägset.

Många politikområden som har starka drag av europeiska kollektiva nyttigheter är fortfarande underfinansierade och *Friedrich Heinemann* utforskar ett antal möjliga reformer som skulle kunna öka incitamenten för att finansiera europeiska kollektiva nyttigheter. I kapitlet analyseras olika typer av institutionella förändringar; inklusive korrigeringsmekanismer, nya och verkliga egna medel. Ett nytt uppslag är att medlemsländerna skulle kunna delegera hanteringen av vissa kollektiva nyttigheter till EU-nivån. Att ge EU en högre grad av budgetmässig självständighet löser inte de rådande bristerna i systemet, och att ersätta nationella bidrag med verkliga egna medel kommer inte att stärka stödet för en ökad finansiering av europeiska kollektiva nyttigheter. Noggrant utformade korrigeringsmekanismer är bättre. Andra metoder som skulle främja det europeiska mervärdet i EU:s utgifter är att sälja av europeiska tjänster till medlemsstaterna på basis av frivilliga avtal och ett mer tillförlitligt skydd mot partiska utvärderingar av de olika stödprogrammen.

Kommer förhandlingarna om den fleråriga budgetramen efter 2013 att präglas av tröghet och ryggmärgsreflexer till förmån för status quo? Ett sådant scenario blir allt svårare att försvara, menar *Peter Wostner*. EU står inför nya utmaningar till följd av den globala ekonomiska och finansiella krisen, det förändrade klimatet och den demografiska utvecklingen. Förändringar i den ekonomiska världsgeografin kräver beslutsamma politiska svar i den industrialiserade världen, inte minst i EU. Men objektiva urvalskriterier kan i sig inte förväntas ge resultat eftersom medlemsstaterna idag saknar de rätta incitamenten för att ta hänsyn till dem. Wostner betonar vikten av rättvisa och jämlikhet vid beslut om EU:s utgifter. Det krävs en reformering av budgetförhandlingsprocessen. Han föreslår att budgetens storlek ska bestämmas först efter det att man har kommit överens om politikens innehåll, istället för tvärtom. Det skulle kunna mildra problemet med att medlemsstaterna i första hand fokuserar på sina nettobalanser visavi EU-budgeten.

Arjan Lejour och *Willem Molle* försöker bedöma mervärdet av olika utgifter med hjälp av två angreppssätt. Dels utgår de från subsidiaritetsprincipen. Huvudargumenten för att koncentrera politiken till EU-nivån är stordriftsfördelar och de externa effekter som uppstår av den nationella politiken. Skilda nationella preferenser talar emot en centralisering av de nationella budgetarna. De båda författarna argumenterar för en avsevärd ökning av EU:s utgifter för forskning, miljö, utveckling och innovation samt utrikespolitik. Dessa ökningar kan i stor utsträckning finansieras genom en minskning av jordbruksutgifterna, särskilt marknads- och direktstöden. De granskar också effektiviteten när det gäller EU:s utgifter. I vilken utsträckning har unionen faktiskt nått de uppställda målen? Här är additionaliteten viktig, vilket innebär att stöd från EU inte får leda till motsvarande minskning nationellt. Lejour och Molle menar att utgifterna för miljö- och innovationspolitiken har varit förhållandevis effektiva, liksom utgifterna till unionens externa politik – med undantag för biståndet.

Europeiska kommissionen har nyligen förslagit en reformering av EU:s sammanhållningspolitik. Man vill reducera antalet prioriteringar, skapa ett gemensamt strategiskt ramverk och förbättra utgifternas kvalitet. *Willem Molle* granskar dessa förslag i ljuset av normativ nationalekonomisk teori samt utifrån tidigare erfarenheter. I vilken utsträckning har politiken gett verkliga resultat? Hur bör mål, prioriteringar och former för genomförande förändras för att kunna möta framtidens utmaningar? Utifrån granskningen av kommissionens förslag rekommenderar Molle att man förstärker förberedelsearbetet i de olika programmen, för att på så sätt öka överensstämmelsen mellan politikens olika mål. Utbetalningar av medel ska villkoras mot att stödmottagarna kan visa upp tydliga förbättringar när det gäller administrativ och institutionell kapacitet.

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Yesterday's priorities were yesterday's. With so many urgent needs competing for our attention and so many pressing challenges facing Europe, how can the EU make the best possible use of its resources? The next long-term budget should boost European public goods and investments with a high degree of European added value.

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