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# A Better Budget for Europe: Economically Efficient, Politically Realistic

## Abstract

Dissatisfaction with the EU budget has grown steadily over the past three decades. During that time, economists have produced a large number of studies which attempt to find the optimal structure of spending for the budget, based on theories of *fiscal federalism*. Those studies have provided invaluable insights into how EU money should be spent.

They are often ignored, however, by policymakers. For many, the EU budget is all about politics; finding a spending structure that allows all Member States to reach agreement so that the EU can continue with its most important activity: not spending, but regulation.

Both groups are right. The expenditure of the EU budget must be determined both by an economic analysis and by a political decision. The economic analysis should be used to select which areas of spending can be done efficiently at the EU level. But the decision on which of those areas should benefit from EU funding must be based on political criteria.

This European Policy Analysis proposes a method for analysing the EU budget which combines economic, political and legal aspects. This integrated and multidisciplinary approach was lacking in the previous literature on the EU budget. The objective is to offer a basis for a realistic and comprehensive analysis of how the budget should be structured.

## Why go Beyond Fiscal Federalism?

Most studies on the EU budget are based on economic theories of fiscal federalism. These theories assess which policies can be done more cost-efficiently at the EU level than at the national level. They conclude that these policy areas have 'European Value Added' (because EU citizens get more value out of them if they are done at the EU, rather than national, level) and therefore should be carried out under the EU budget.

This analysis is no doubt correct – but it is incomplete. It does not take into account the fact that the EU budget

is not the same as a single country's budget: it is only a relatively small sum of money, which national governments make available to be spent at EU level.

Given that the EU has grown to be much more than a simple international organisation, we have naturally begun to see the EU budget as much more than an international organisation's budget – but it is not. While the powers of the EU have grown exponentially, its budget has not; it is still very small, and there is no willingness from the great majority of EU countries to make it any bigger.

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The EU budget is therefore not large enough to be allocated to all the areas in which EU public spending could theoretically be more efficient than national spending – at least not on a scale large enough to allow it to have any significant impact. Moreover, for a political union such as the EU, the decision to centralise policies should depend not only on efficiency considerations but also on whether it is seen as legitimate to reduce national sovereignty over those policies.

So what is the right approach? An analysis of how the EU budget should be restructured must still include fiscal federalism, to assess which areas of public spending can potentially be done more efficiently by the EU budget. This should be completed, however, by the use of other fields of literature, to take into account the aspects that make the EU budget different from a national budget, including its smaller size, and the political issues relating to the transfer of sovereignty to the EU level.

This paper proposes a methodology based on insights from four fields of literature: public economics, political science, the economic and political literature on the concept of subsidiarity and fiscal federalism (see Figueira 2008, for a more detailed exposition of this methodology).

## Why is Politics not enough?

Before describing the methodology proposed, it is worth considering the arguments of those who doubt the need to structure the EU budget according to academic analyses.

Although policymakers would never admit to it publicly, many believe that the EU budget is too small to be worthy of an economic analysis. They argue that the benefits of EU integration are much larger than the EU budget. So, instead of spending it efficiently, it is best to use it, and if need be waste it, in such a way that Member States can reach much more important political deals.

This argument holds some truth. The EU budget is indeed relatively tiny, and how it is spent has only a small direct impact on the welfare of citizens all over Europe. The benefits of EU integration, both the quantifiable, such as the Single Market, and the non-quantifiable, such as political cooperation, are considerably larger. It can therefore make sense to dedicate part of the EU budget to easing integration.

Achieving that objective, however, does not mean wasting 100 billion euros per year. On the contrary, if the budget is used efficiently, this can in itself ease integration. Using EU money to support the EU policies can allow them to be designed and implemented more efficiently. And, given that the EU budget has become so visible in the national media, making it more efficient would give a boost to public support for the EU.

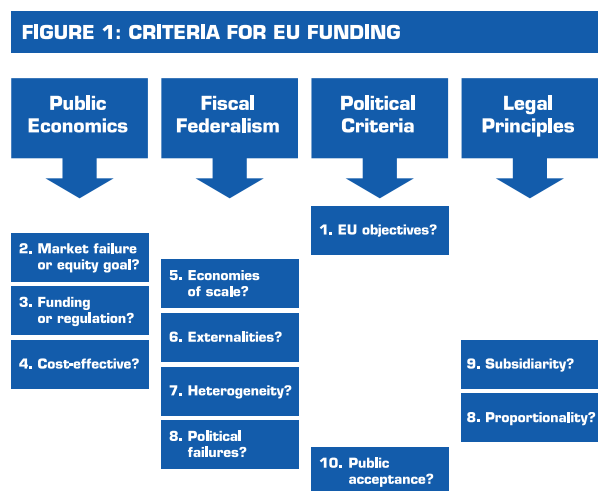
But, above all, to willingly waste taxpayers' money to reach political objectives should not be seen as acceptable. Such courses of action – based on a belief that the EU is misunderstood by citizens and therefore it becomes acceptable to do in Brussels what could never be done at the national level – only contribute towards the public's distrust of the Union. Moreover, difficult as it may be to reach a deal between different countries, to achieve it by bribing countries with EU money is certainly not the most cost-efficient way.

Instead, the political issues concerning the EU budget should be integrated in the analysis of the budget. These include: the need to reach an agreement between the different countries; the desirability (or otherwise) of using the EU budget as a tool to help political integration and/or to increase the popularity of the EU; and whether it is legitimate to decrease national sovereignty over a certain spending programme. The methodology proposed in this paper incorporates those issues through a multidisciplinary analysis.

## A Comprehensive Analysis

The method proposed combines the insights of economics of the public sector, fiscal federalism, political criteria and legal principles to analyse the EU budget.

The end-result has been summarised in the following graph.



The scheme shows the eleven questions that should be asked to assess whether there is a case for a certain policy area or spending programme to be funded by the EU budget. The four types of analysis will now be explained in turn.

## Fiscal federalism in (slightly) more detail

Fiscal federalism is the branch of economics that analyses which functions of a government are best performed at a centralised (or EU) level and which are best done at a

decentralised (or national) level. It says that that a certain policy should be done at a more central/EU level if this can make the policy more cost-efficient.

That can be due to economies of scale (some policies are more efficient if done together by the pooling of the resources of all Member States, rather than individually by each country) or to cross-border externalities (some policies have an impact not only on the country where they are implemented but also on its neighbours, so it is more efficient to design them together). If, however, there is a significant heterogeneity of preferences (that is, if the people in the different countries have very different preferences for the policy in question) it should be done at a more decentralised/national level.

Fiscal federalism has been the theory of choice among EU economists, not only when analysing the EU budget but also when looking at any issue relating to which policies should be the responsibility of the EU, or the question of *what the EU should do*. Seminal studies applying fiscal federalism to the EU include Alesina and Wacziarg (1999) and Persson, Roland and Tabellini (1996).

With regard to what concerns the EU budget, the insights from fiscal federalism include the following. The EU budget should be used to provide public goods with large economies of scale: for example, defence policy, internal security (including protection against organised crime, or border patrols) and aid to developing countries. It should also be used to fund policies with positive externalities: for example, research and large transport infrastructure. On the other hand, it should not be used to fund policies with big heterogeneity problems: for example, the EU countries' welfare policies (see, for example, Buti and Nava 2003).

The so-called 'second generation' of fiscal federalism adds to the first generation by considering political failures also – policymakers do not always act in a benevolent and/or efficient way. Studies assess whether these inefficiencies are minimised at EU or at national level.

## Political Criteria: what do we want from the EU budget?

As argued above, the EU budget should be analysed not only in terms of economic efficiency but also in terms of the political issues that surround public spending at the EU level.

Firstly, for a political union such as the EU, the decision to centralise policies should depend also on whether it is seen as legitimate to reduce national sovereignty over those policies. Figueira (2007) proposes to complete the analysis based on fiscal federalism with insights from the political science literature on the legitimacy of the EU (an example of that literature is provided by Lord and Magnette 2001). Legitimacy can be assessed through several factors, such

as public opinion and the accountability of the policy-making process. When this analysis is applied to different areas of EU spending, it shows that some areas of public spending may be efficient at the EU level, but their transfer would create problems in terms of legitimacy.

Another political issue to take into account is that of the objectives of the budget. As mentioned before, many believe that the EU budget should be used as a bargaining tool to achieve compromises between the Member States. Others believe that the EU budget should be used as a way to increase the popularity of the EU, with its funds being spent on areas that are visible and important to citizens. These considerations have played an important role in shaping the EU budget, yet they have not been included in analyses of the budget.

## Public Economics: completing the Economic Assessment

Public sector economics is the branch of economics that theorises and assesses the activities of the government. One of its sub-fields is fiscal federalism. So why is there a need to add a section on public economics to the fiscal federalism analysis?

Fiscal federalism focuses on comparing the efficiency of policymaking at two different levels of government. It therefore does not take into account other economic issues that should be analysed in relation to the EU budget.

Firstly, to assess whether there is a need for government intervention in a certain area, public sector economics uses what is sometimes called an 'intervention test'. The government can intervene for two reasons: either to correct market failures (efficiency reason) or to ensure social justice (equity reason). This distinction is often forgotten in analyses of the EU budget. Yet it is useful – for example, assessment of the EU cohesion policy only in terms of efficiency is misleading, because one of its stated goals is solidarity between the Member States.

Secondly, even when government intervention is needed, there may still not be a case for public funding, since the most appropriate form of intervention could be public regulation. Studies based on fiscal federalism generally ignore this issue – but it is a very important consideration in the analysis of the EU budget. In several policy areas the EU has a value added in relation to national governments, but its intervention should be in terms of regulation, not funding.

Thirdly, the spending programme must be cost-effective, in that its benefits must be superior to its costs. It can happen that there is in theory a case for funding at EU level but in practice the amount available is too small to be useful.

## Subsidiarity: the Legal Perspective

The last column focuses on the legal principles. According to the EU treaty, EU action is justified if it respects the principles of *subsidiarity* and proportionality.

The concept of subsidiarity means that the EU should only take action in areas where it can be more efficient than the national governments. More specifically, the EU Treaty says that, unless a certain policy is an exclusive competence of the Union (for example, trade policy or monetary policy), the EU should only intervene in that area if it can do so in a more efficient way than the Member States.

The concept of *proportionality* means that, if the EU does intervene, the intervention should be limited to what is necessary to achieve the objectives of the treaty.

What do these legal conditions imply for the EU budget? The budget should only be allocated to a certain policy area *either* if it is an exclusive competence of the EU *or* if the EU budget can be more efficient than the national budgets in funding that policy area. Moreover, if so, the funding should be proportional, or limited to what is necessary to achieve the objective.

These two concepts provide additional guidance on which policy areas should be funded by the EU budget. There is much relevant literature from the fields of economics, political science and law. For example, Pelkmans (2001) offers an economic analysis of subsidiarity, and suggests a five-step test for applying the principle in practice.

## The Methodology in Practice

The previous sections have raised a number of issues that need to be taken into consideration in relation to EU finances. There is a need for further debate on each of those aspects.

To apply the complete methodology to the EU budget, it will be necessary first to select the areas of public spending to be analysed, and then apply the eleven steps to each area. This will show whether, on the basis of this assessment, a certain area of spending should exist in the EU budget or not.

As regards the identification of the areas, most studies take as a starting-point the current structure of the EU budget, and analyse each of the existing five headings of expenditure. This, however, could result in an initial bias, as it uses the current allocation of funding, so the reasoning could be influenced by the status quo.

A more radical approach would be to consider all areas of EU action, identify those that involve public intervention in the form of spending, and take the resulting list as a starting-point for the analysis. Going even further, it would be possible to attempt a listing of the objectives of the EU based on the Treaty, see which of those would require public spending, and use that list as a starting-point.

Figueira (2008) applied a shorter version of this method to the EU budget. The analysis identified four policy areas where EU funding could be most useful: research policy,

international transport, cohesion policy and home affairs. It pointed out that, among these areas, the ones with the largest budgetary implications are research and convergence, as EU home affairs and international transport policies have smaller budgetary implications. Therefore it was suggested that most of the budget should be allocated to research and convergence policies, and the remaining should be divided between home affairs and transports.

A forthcoming SIEPS report will apply the complete methodology in detail, to obtain concrete proposals on how the EU budget should be restructured.

## Conclusion

Just as the EU is a new type of political entity, its budget is also something very different from a national budget. It therefore requires a different type of analysis. While fiscal federalism is invaluable as the basis for this analysis, it needs to be completed to take into account other criteria that are equally relevant for the determination of the optimal structure of the EU budget.

It is hoped that the methodology proposed will contribute towards a more realistic and complete analysis of the EU budget. The political concerns surrounding the EU budget are legitimate – once they are incorporated into the analysis, instead of being an obstacle to reform, they can contribute towards a reshaping of the budget that truly benefits EU citizens. ●

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