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Jorge Núñez Ferrer

Can Reforming Own Resources Foster Policy Quality?

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PREFACE

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

The present report, by Jorge Núñez Ferrer, analyses how the own resources system can be reformed to foster better decision-making in relation to policy-making in the EU. It is argued that a combined strategy of policy reform and changes in the own resources system is necessary and the report therefore proposes to finance the Common Agricultural Policy (CAP) in a different way. To this end the report presents two systems as possible ways forward. The first system is a modified version of national co-financing of direct payments, while the second system focuses more on the Gross Value Added (GVA) of production. According to the author the proposed systems would break the interplay between EU policies, allow a refocusing of negotiations on the budget and mitigate the distorting effects of the net balance considerations of the Member States.

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

Jörgen Hettne
Acting Director, SIEPS

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For four years he worked as an expert on the enlargement and evaluator of EU expenditure policies on agriculture and the Structural Funds. Lately he has been working as consultant and adviser for a number of countries, especially for Bulgaria, first as an independent consultant and then as a member of the UK twinning team in the Ministry of Finance, where he was a key adviser on the preparation of the National Strategic Reference Framework for the Structural Funds. He has recently published papers on EU policies and particularly the budget for various organisations, including the European Parliament, as well as completed a major report for CEPS on reforming the EU budget entitled "The UK rebate and the CAP – Phasing them both out?"

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LIST OF ABBREVIATIONS

AWU	Agricultural Working Unit
CAP	Common Agricultural Policy
COM	Common Market Organisation
DG	Directorate General
ERDF	European Regional Development Fund
EU	European Union
GDP	Gross Domestic Product
GNI	Gross National Income
GVA	Gross Value Added
UK	United Kingdom
VAT	Value Added Tax
TENs	Trans European Networks

SVENSK SAMMANFATTNING

En fundamental princip för hur statens budget bör fungera är att intäkts- och utgiftssidorna ska vara så åtskiljda som möjligt, eftersom detta medför att allokering av utgifter sker på basis av politiska prioriteringar. I exceptionella fall kan medel på ett transparent sätt öronmärkas – som exempelvis att intäkter från en miljöavgift används för att täcka kostnader för att reducera miljöfarliga utsläpp - men överlag bör systemet utformas så att intäktskällans påverkan på beslut om offentliga utgifter minimeras.

Spänningar mellan regioner är ett ofta förekommande fenomen i federala system. Inom EU, där förhållandet istället gäller suveräna stater accentueras dessa spänningar. Detta får till följd att det finns en stark länk mellan EU-budgetens intäkts- och utgiftssidor. Eftersom EU har en liten budget ger dispyterna kring resursfördelningen inom unionen upphov till komplexa rabatter och andra arrangemang som är baserade på högst tveksamma grunder.

Efterfrågan på en grundläggande reform av EU:s så kallade egna medelsystem har dykt upp flera gånger genom åren. Den mekanism som styr EU:s medeltillgång är komplicerad och svårgenomtränglig. Den har vidare fördärvats av korrektionsmekanismer som har sitt ursprung i de obalanser som har uppstått till följd av problem relaterade till uppbörden av egna medel, såväl som till avarter i allokeringen av dessa medel. Snedvridningar som är orsakade av indirekta rabatter baseras på hänsynstagande till nettobalanser, vilka i sin tur är kopplade till omfördelningseffekter på utgiftssidan. Förekomsten av komplexa justeringar på intäktssidan inverkar på kvaliteten på de beslut som tas om unionens utgifter; och vice versa. Därmed uppstår en ond cirkel av ad hoc-artade lösningar, där vissa medlemsstater använder intäktssidan för att undvika att betala för utgifter de inte vill ha; medan andra medlemsstater använder utgiftssidan för att kompensera för en utgiftsfördelning som de egentligen inte samtycker till. Resultatet blir att EU:s budget i själva verket omfördelar inom, snarare än mellan länder och regioner.

Föreliggande rapport fokuserar på hur egna medelsystemet kan reformeras för att främja en bättre beslutsprocess avseende unionens utgifter. Analysen tar hänsyn till hur den nuvarande beslutsprocessen fungerar i realiteten samt till de krafter som ligger bakom nettobalansgrälen. För att det ska vara möjligt att skapa ett mer effektivt system måste både de bakomliggande orsakerna till dessa dispyter – liksom deras effekter på intäktssystemet – adresseras.

EU:s samförståndskultur i beslutsfattandet påverkas starkt av nationella intressen och denna realitet innebär att ett helt oberoende finansieringssystem är osannolikt i den nära framtiden, det vill säga under den närmast följande budgetplanen. Det innebär dock inte att det är omöjligt att åstadkomma förbättringar. I rapporten konstateras att ett grundläggande problem är att utgifterna inte längre återspeglar EU:s behov. Att korrigera snedfördelningen av EU:s utgifter försvåras av de politikområden budgeten finansierar idag, liksom utseendet på det nuvarande egna medelsystemet.

Det behövs därför en kombinerad strategi, där både utgiftsstruktur och finansieringssystem reformeras. Till att börja med finns ett behov att till fullo utvärdera alla politikområden och deras specifika åtgärder. Utvärderingen bör baseras på etablerade budgetprinciper som subsidiaritet, proportionalitet och europeiskt mervärde. Detta skulle kunna bana väg för en initierad diskussion om politiska prioriteringar och fokusering av utgifter. Sunda politiska prioriteringar är inte bara lättare att rättfärdiga; medlemsstaterna är sannolikt mer villiga att finansiera de utgifter som sunda prioriteringar ger upphov till, även när det är svårare att påvisa att det egna landet drar direkt nytta av dem. Ett visst mått av altruism kan förväntas inom EU eftersom fördelarna av medlemskapet inte företrädesvis handlar om återflödet från den gemensamma budgeten, utan snarare om ekonomiska möjligheter och politisk stabilitet och säkerhet.

Rapporten ifrågasätter huruvida det är möjligt att sjösätta flera av de reformförslag som för närvarande diskuteras, åtminstone i en nära framtid. Bland annat analyseras olika nettokorrigeringsmekanismer, liksom mer okonventionella ansatser som försöker att ta hänsyn till svagheter i den nuvarande beslutsprocessen; framför allt förslag om att etablera medlemsstaternas nettobalanser i förväg. Dessa förslag kritiseras för att de förstör den lilla flexibilitet som trots allt finns i det nuvarande systemet. Idag är den fasta parametern EU:s budgettak och inte medlemsländernas nettobalanser.

Utgångspunkten är att de flesta politikområden är i överensstämmelse med subsidiaritetsprincipen, åtminstone när det gäller deras grundläggande mål. Därmed bör fokus ligga på kvaliteten hos nuvarande utgifter, snarare än på en grundläggande reform av egna medelsystemet. Samtidigt identifieras ett stort problemområde: den gemensamma jordbrukspolitiken (GJP) har den svagaste motiveringen av samtliga utgifter i EU:s budget, i synnerhet sett i ljuset av den regressiva fördelningen. Den reform som föreslås i denna rapport fokuserar på behovet att bryta den underförstådda kohandeln mellan å ena sidan tillväxt och "territoriell sammanhållning", och å den andra jordbrukspolitiken, för att på så sätt ändra beslutsaktörernas nettobalansmotiv i beslutsprocessen.

I denna rapport föreslås därför att jordbrukspolitikens finansiering reformeras. Två olika system presenteras som möjliga kandidater. Det första förslaget är en modifierad version av nationell samfinansiering av direktstöden, vilket skulle dirigera fördelningen av EU:s utgifter mot de medlemsstater där det genomsnittliga bruttomervärdet (BMV) av produktion per enhet är lågt, och baserat enbart på produkter som täcks av den gemensamma organisationen av marknaderna (GOM). Notera här att samfinansieringen inte baseras på den nationella bruttonationalinkomsten (BNI), utan på den specifika sektorn. Stöd där BMV per produktionsenhet är högt måste delvis täckas av medlemsstaterna själva. Även om det inte innebär några förändringar för politiken som sådan, skulle det ändra beslutsfattandet i GJP och fästa blicken på dess interna fördelningseffekter, snarare än på dess växelverkan med andra politikområden.

Det andra alternativet fokuserar mer på produktionens bruttomervärde. Medlemsstaterna har börjat finansiera direktstödet i relation till den nationella jordbruksproduktionens bruttomervärde, återigen enbart för produkter som täcks av GOM. Eftersom jordbruksproduktionens bruttomervärde som andel av BNI oftast är högre i fattigare länder införs ett tak – baserat på BNI-andel eller någon annan tänkbar begränsning – på bidragen från dessa länder.

De två föreslagna mekanismerna har som mål att bryta växelverkan mellan EU:s politikområden. De kan vidare motiveras med EU:s budgetprinciper och den gemensamma jordbrukspolitiken och därmed tillåta ett skifte av fokus i budgetförhandlingarna. Hänsynstagande till nettobalanser kommer att kvarstå även efter en sådan reform – det hör till sakens natur att dessa är inbyggda i medlemsstatsförhandlingarna – men nettobalansernas förvrängande inflytande kan mildras om de förslag som förs fram i denna rapport blir verklighet.

EXECUTIVE SUMMARY

One fundamental principle of good governance for public budgets is that the revenue and expenditure should be separated as much as possible to ensure that allocation is based on policy priorities. Exceptionally, resources can be transparently earmarked, such as revenues from an environmental levy being allocated to cover the costs of reducing pollution. A public revenue system overall is supposed to minimise its involvement in spending decisions.

One can observe some recurrent tensions in federal states regarding the level of transfers between different territorial units. In the EU, where the relationships are between sovereign states, such disputes are much more pronounced. As a consequence, the revenue and expenditure sides of the EU are strongly interlinked. Given the limited expenditure items in the EU budget, disputes on the redistribution of funds have the unfortunate consequence of generating many arrangements which are based on questionable interventions or complex rebates.

Demands for fundamental reform of the system of own resources have regularly resurfaced over the years. The resources mechanism of the EU budget is complicated and opaque, corrupted by correction mechanisms generated by imbalances originating in resource collection and expenditure allocation over the years. Distortions caused by direct and indirect rebates in own resources are based on net balance considerations, linked to distributional effects of expenditure. The mere existence of complex ad hoc corrections in the resources affects the quality of policymaking on the expenditure side and vice versa. This generates a vicious circle of ad hoc corrections where member states use the resources to avoid paying for policies they dislike while others use expenditure to compensate for expenditure distributions with which they disagree. As a consequence, most of the EU budget is effectively redistributed within rather than across countries and regions.

This paper concentrates on how the own resources system can be reformed to foster better decision-making on the policy side. It will do so, however, taking into account the present decision-making reality and the forces that are at the root of the net balance disputes. Unless the causes of the disputes and the impact these have on the resources are addressed, there is little chance of creating a more efficient system.

The EU's consensual system of decision-making, strongly influenced by national interests, is a reality which makes the existence of a fully independent fiscal resource system improbable in the near future, i.e. the immediate financial perspective. This does not mean that there is no improvement possible. This paper identifies as a problem the fact that the expenditures no longer reflect the needs of the European Union well. Correcting the misallocation of expenditure is hampered by the nature of the policies financed and the own resources system.

A combined strategy of policy reform and changes in own resources is necessary. First of all there is a need for a full evaluation of all policies and their individual measures based on budgetary principles, such as subsidiarity, proportionality and EU value added. This should pave the way for an informed discussion on policy priorities and focusing of expenditure. Good policies are easier to justify and member states are likely to accept financing them even if national benefits are hard to measure. A level of financial altruism can be expected in the EU, as the benefits of membership in terms of economic opportunities, political stability and security are generally recognised.

The paper questions the possibility to implement, at least in the foreseeable future, many of the proposals presently discussed. Fiscal resources and generalised correction mechanisms are briefly reviewed. It then focuses on less conventional approaches incorporating the weaknesses in the decision-making process, especially proposals to fix net balances in advance, but criticises them as introducing new rigidities which do not presently exist. The budget ceiling is the only fixed parameter, not directly net balances.

The paper considers that most policies are, at least in their basic objectives, in line with the subsidiarity principle, and rather than reforming own resources radically, the focus should be on policy quality. It identifies, however, a problem with the Common Agricultural Policy (CAP), which has the weakest foundation as EU expenditure, especially given its scarcely justifiable and regressive distribution. The reform proposed in this paper focuses on the need to break the implicit horse-trading between growth and territorial cohesion related policies and the CAP, changing the policy-makers' net balance motivations in the decision-making process.

The paper thus proposes to finance the CAP differently, and presents two systems. The first is a modified version of the national co-financing of direct payments, which would de facto direct the distribution of EU expenditures to those countries where the average Gross Value Added (GVA) of production per farmer is low, based only on products covered by the Common Market Organisation (CMO). Note that co-financing is not based on Gross National Income (GNI), but on the sector. Subsidies were GVA per farmer are high have to be partially covered by the member state. This does not change the policy, but would change the policy decision-making in the CAP, and focus more on its internal distributional effects rather than its interplay with other EU policies.

The second option focuses more on the GVA of production. Member states have to finance direct support in relation to their national GVA of agricultural production, again only products covered by the CMO. As the GVA of agricultural production takes a higher share of GNI in poorer countries, a ceiling on contributions by poorer member states is imposed, based on either their GNI share or another limit.

The two mechanisms proposed have the objective of breaking the interplay between EU policies, which can be justified by EU budgetary principles and the Common Agricultural Policy, allowing a refocusing of negotiations on the budget. Net balances considerations will continue to exist and are intrinsic in negotiations between member states, but their distorting influence can be mitigated by these proposals.

1 INTRODUCTION

One fundamental principle of good governance for a public budget is that the revenue and expenditures should be separated as much as possible, ensuring that allocation is based on policy priorities. Exceptionally, resources can be transparently earmarked, such as revenues from an environmental levy being allocated to cover costs of abating pollution. A public revenue system overall is supposed to minimise its involvement in spending decisions.

One can observe some recurrent tensions in federal states on the level of transfers between different territorial units. In the EU, where the relationships are between sovereign states, such disputes are much more pronounced. As a consequence the revenue and expenditure side of the EU are strongly interlinked. Given the limited expenditure items in the EU budget, disputes on the redistribution of funds have the unfortunate consequence of generating many arrangements which are based on questionable interventions or complex rebates.

The demands for fundamental reform of the system of own resources have regularly resurfaced over the years. There are practical and political reasons for such demands. From a practical perspective the own resources are complicated and opaque, corrupted by correction mechanisms originating partially from imbalances in resource collection and expenditure allocation over the years. Distortions caused by direct and indirect rebates in the own resources are based on net balance considerations, linked to distributional effects of expenditures. The mere existence of complex ad hoc corrections in the resources affects the quality of policy-making on the expenditure side and vice-versa. This generates a vicious circle of ad hoc corrections where member states use the resources to avoid paying for policies they dislike while others use expenditure to compensate for expenditure distributions with which they disagree. As a consequence, most of the EU budget is effectively redistributed within rather than across countries and regions.

This paper concentrates on how to reform the own resources system to foster better decision-making on the policy side. It will do so, however, taking into account the present decision-making reality and the underlying forces that are at the root of the net balance disputes. Without addressing the causes of the disputes and the impact these have on the resources, there is little chance of creating a more efficient system.

2 MERITS AND LIMITATIONS OF THE PRESENT OWN RESOURCES

The own resources of the EU, even if not fully "owned" by the EU as understood by the Lamassoure report (European Parliament, 2007), has a number of important positive characteristics. It guarantees a budgetary balance, it guarantees long term stability and predictability, it is relatively simple and cost effective, and ensures a certain equity of contributions in its basic form (before rebates). These are most of the desired characteristics for an EU own resources system, with the exception of transparency. Even here, however, the EU budget is more transparent than most national budgets.

The present own resources system, however, fails particularly on the important principle that public expenditure requires the allocation of resources to be independent of the regional source, which lies at the heart of the own resources distortions. This principle is quintessential to ensure that expenditure is efficiently attributed to expenditure generating European value added. For the EU budget, the origin of the resources and allocation of funds are strongly linked, creating an important barrier to meaningful reforms. The relationship is so strong that according to the game theorists Kauppi and Widgren (2005), net balances can be predicted in advance, whatever the policy mix, based on the explicit and implicit voting power of member states. Thus while efficiency of policies can be improved in the allocation of funds within countries, redistribution of funds across countries is subject to the limitations imposed by net balance considerations, regardless of resource or expenditure policy.

The latest negotiations on the Financial Perspectives were dominated by net balances alone, to such an extent that the quality of policies seemed to be irrelevant in the decision-making process. This presents a real difficulty when reviewing the future role of the EU budget resources and expenditure.

As the EU budget has only a limited number of expenditure items, and simple lump sum returns to member states are not possible, disagreements on the geographical incidence of funding have been increasingly resolved on the resources side. The UK rebate, the reduced contributions of other member states on this rebate, the special reduced rates of contribution of the VAT key for some member states, and increases in retention of custom duties, all directly or indirectly originated from a disagreement on the financial incidence of policies.

Net balance concerns have also had large distortive effects on the quality of expenditure policies. New objectives with little theoretical foundation were introduced to compensate certain member states for low receipts from the agricultural budget (e.g. Objective 6 funding for areas with low population density above a certain geographical parallel or in 2005 a large list of questionable exceptions in the Financial Perspective agreement).

For the new member states, particularly stringent agricultural quotas and support limitations were imposed using semi-objective criteria taking advantage of the difficulties of the economic transition. This has created clear distortions, with price support pushing for example for large increases in milk products, while quotas impose much lower limits to production. Similarly, co-financing of direct payments by the new member states has introduced double standards in the policy. First, it has de facto allowed the national co-financing of the CAP, breaching the present rules of the policy, and second, it has exacerbated the regressiveness of the policy, making the poorest member states with limited budgetary resources co-finance the costs, indirectly contributing in excess to the EU budget. Despite all the arguments and reasons for the arrangement, it does not change the fact that the new member states have had to accept a co-financing concept which for the moment has been rejected by the old member states.

Net balances of net contributors can be interpreted as the willingness of member states to pay for the EU expenditure policies (see Núñez Ferrer, 2007a). A radical reform of the own resources system would be subject to member states accepting to dissociate their contributions from the incidence of the policies. To achieve this there is a need for member states to accept the objectives and distributional effects of policies financed, i.e. their willingness to pay has to equal the efficient expenditure needs of policies.

As a recent paper by Wostner (2007) clearly states, EU policies are not based on their merit, value added or justification based on the subsidiarity principle. In consequence member states do not weigh the pros and cons of policies based on their value added, but on the financial return. Net contributors seem today, in fact, rather reluctant to finance the budget and a political economist may well conclude that the negative net balances are just the costs acceptable to member states to avoid a major crisis in the EU. Most net contributors are highly suspicious of the benefits to themselves and the EU of all expenditures falling on other member states, including cohesion funding. Under these conditions, any reform that reduces the ability of member states to play with their level of contributions is difficult. It is telling that one of the most seriously debated reforms of the own resources today is not the creation of independent regionally arbitrary[1]

[1] Regional arbitrariness in the EU refers to the impossibility of reasonably attributing the base of the tax to a particular member state, as in the examples of custom tariffs and cross-border pollution.

resources, but the abolition of the VAT resource and the nearly exclusive use of the GNI key, a resource which can be capped, trimmed or "rebated" easily.

This is unfortunate, but it has to be taken into account that any radical own resources reform will necessarily be linked with an important expenditure reform. How to do so is a difficult question and will require, most of all, strong political goodwill by member states. It is difficult to present any realistic options for a radical reform, as the decision-making system, as well the nature of the budget expenditure and resources clearly encourage the status quo. This paper discusses options to encourage reforms.

3 ARE REAL OWN RESOURCES A VALID OPTION?

Many EU officials, MEPs and analysts consider that the best way to ensure the separation between resources and expenditure would be to create fiscal resources which are regionally arbitrary and cannot be pinpointed to any specific location, so called "real own resources". This is difficult, as regional arbitrariness is generally a theoretical attribute of a resource, while the financial actual point of collection of contributions can generally be easily identified. EU custom duties are a clear example. These are regionally arbitrary, because the point of entry does not indicate where the product will finally land within the EU and which consumers will actually pay for the border tariffs; the resource is however collected in specific customs offices and is geographically identifiable. The Netherlands thus disputes the right of the EU to collect these duties and not integrate them in net balance calculations.

Nevertheless, the most recurrently presented options for the own resources are linked to the introduction of a taxation element under the questionable argument that this would eliminate net balance disputes, allowing focus on policy quality. A number of fiscal resources have been presented by the European Commission's Own Resources Report in 2004. Looking at budget decision-making, such a reform is now improbable, and can present surprising new hidden complications, including tax corrections and rebates, based on the fairness of the incidence of the tax at the geographical level (see Núñez Ferrer, 2007a). Fiscal resources may be part of a new system of resources, but will have to be accompanied by a change in the policy-making system.

4 ARE GENERALISED CORRECTION MECHANISMS A WAY FORWARD?

In addition to fiscal resources, the European Commission (2004) has also proposed the introduction of a generalised correction mechanism. The proposed mechanism is a complicated system designed to grant automatic rebates to member states whose negative net contributions exceed a certain percentage of national GNI. While the mechanism undoubtedly has some advantages, it does not offer any particular benefit to the net contributors over the present system. It also does not address the concerns about the origin of the problems, i.e. the expenditure policies. For example, the UK would lose a large part of the rebate while not gaining any change on the expenditure side. In addition, it would introduce rebates as an automatic response to net contributions regardless of the merits of the policies financed. Should member states be allowed to obtain a rebate on policies that are the result of a consensus agreement? One should also add that there is no guarantee that the generalised mechanism would please net contributors and would avoid additional ad hoc measures for specific countries.

4.1 An alternative "reverse" generalised correction mechanism

There is an alternative approach developed in Núñez Ferrer (2007a). It is in fact possible to consider a "reverse" GCM, where a net contribution *floor* is imposed on wealthier countries, eliminating low and positive net balances for those countries with a GDP per capita above the EU average. If every country with a GDP per capita above the EU average were to have a net balance of 0.35% of their GNI in 2013, the author estimates that this would reduce the contributions of other member states by €8 billion.[2] The redistribution of expenditure would reduce the contributions of other member states by 0.1% of their GNI. For the UK, this system would have an almost equivalent impact on its contributions in 2013 as the present financial perspective agreement. It would also remove from the wealthier large CAP recipients any net balance consideration when deciding on policy changes. While such a system is unlikely to be agreed, the political implications are excellent food for thought. The % of net balance of wealthier member states could also be progressive, depending on the GNI per capita. The net balances of the beneficiaries would be determined by the policies and not be fixed in advance.

[2] Administrative expenditure has been excluded from the calculation to avoid penalising Belgium and Luxembourg for housing the EU institutions.

5 MORE REALISTIC APPROACHES TO THE OWN RESOURCES REFORM

Leaving aside the ideal systems of resources, some academics have accepted the "intergovernmental nature" of the EU. The decision-making system is the result of the political structure of the EU. Wostner (2007) even considers that it is questionable to consider systems which challenge the consensus nature of the Union, by introducing voting systems such as qualified majority to get agreements through. Consensus agreements are harder to achieve, but ensure wider political acceptability of decisions.

De la Fuente and Domenech (2001), Gros and Micossi (2005), Begg and Heineman (2006), Heinemann (2007) and Wostner (2007), concentrate their studies not on changing the type of resources, but on changing the incentive structure that draws member states into net balance discussions at the detriment of policy quality.

5.1 Changing the incentive structure by fixing net balances

One of the boldest "realistic" systems is offered by De la Fuente and Domenech (2001). Their system just accepts that net balances are a fixed reality which simply will block any reform which does not fully incorporate the member states' desires on their final net balance. In this proposal net balances are fixed in advance. Member states thus negotiate (as they in practice do already) their net position. The difference is that they do not consider the policy mix in their decision. Policies are then free to be changed, as long as the net balances are left untouched. Financial lump sum transfers to guarantee the right outcome are possible.

Unfortunately, such a proposal is still unrealistic and in fact potentially detrimental. While member states indirectly set their net balances, there is an element of flexibility. There is no legal boundary for member states to reform a policy, which de facto changes the allocation of funds per member state. While substantial financial shifts between budgetary headings require renegotiating the budget, financial shifts between geographical areas within a budget line are possible. The present budgetary procedure does de facto only fix the budget ceiling, but ultimately does not fix or guarantee net balances. Given their transparent nature, lump sum transfers are unlikely to be accepted, thus there would be a pressure to guarantee net balances through resources mechanisms or policies. In this case, even the already limited transnational redistribution possibility of rural development funds modulated from direct payments[3] would be practically impossible under

[3] 20% of modulated funds.

this proposal. Furthermore, it would also eliminate the possibility, during the period of the Financial Perspectives, of just reducing the expenditure under one heading, as this most likely would affect net balances. In fact, pre-calculated net balances often diverge from actual ones without member states claiming that their rights have been infringed. Net balances are also often the result of variable implementation quality.

Of course, given the use of multiannual programmes agreed by member states, decisions which would cause large shifts are very unlikely, but they remain possible in theory. Fixing net balances in advance thus just closes the little flexibility that exists within the present system, hampering reforms during the period of the financial framework.

5.2 Separate financing of budgetary items

Wostner (2007) expands De la Fuente and Domenech's proposed system, by integrating the idea presented in Begg and Heineman (2006) and Heinemann (2007) to separate the budget into redistributive and allocative elements.

What this entails is that those funds that are not allocated ex-ante to specific regions and countries are financed by shares of GNI and not included in any net balance calculation. Redistributional funds should then be treated differently and negotiated taking into account fixing net budgetary positions ex-ante, as De la Fuente and Domenech have proposed.

According to Wostner, the idea is to finance, with a pure GNI key, the following specific Headings, which are European public goods:

– The globalisation adjustment fund
– Freedom, Security and Justice
– Solidarity fund in the framework of the citizenship funding
– EU as a global player
– Administration

Wostner correctly points out that such expenditures have no meaningful place in any net balance consideration.

The remaining budget is then negotiated based partially on the idea of predetermining the net balances. The way the expenditure of the different policies is fixed is based on different criteria depending on either the group of measures financed (CAP and cohesion policy), or past absorption capacity (competitiveness policy). Predetermined net balances will influence the policy mix and the allocation of funds, i.e. poorer member states with low absorption capacity for competitiveness funds would receive more regional funds and so forth.

While the idea of treating different items in the budget separately has appeal, this proposal fails to understand the nature of the interplay between the policies and justifies the odd implicit horse-trading amongst policies. The proposal attempts to reduce net balance disputes, but still integrates inflexibilities like De la Fuente and Domenech's net balance fixation, i.e. policy reforms during the financial perspective period are hampered as net balances are fixed in advance.

Furthermore, Wostner's proposal defines regional policy and agricultural policy as redistributive policies financed together and promotes the present horse-trading mechanism. This would not be reasonable, as it mixes territorial support with sectoral support, using the CAP to counterbalance regional policy. Now, the difference is that the Commission would have to play around with the policies and funds to fit the net balances. It would in fact perpetuate the CAP's regressive nature and affect the rationale of regional policy. What matters, and this is overlooked in this approach, is that with the exception of agricultural policy, the other policies can be considered as good candidates for having an element of supranational financing (see Núñez Ferrer, 2007a and Figueira, 2008, for the subsidiarity test by policy area).

6 INCREASING THE POSITIVE INCENTIVES FOR POLICY QUALITY

Proposals that de facto fix net balances are based on the assumption that member states would always have a rather narrow view on the budget, i.e. they cannot agree on redistributive policies that ultimately do not benefit them. They assume that member states are indifferent to policy quality or who benefits ultimately within their countries. A net balance agreement in advance would let the EU institutions decide second best policy mixes independently from member states' interests. This is a rather negative view of the member states' capacity to agree on wider considerations.

In this paper it is assumed that the rationale of the policies is too weak to justify the more altruistic behaviour of member states, i.e. to justify higher net contributions. The negative net balances of the main contributors seem to reflect the value member states attribute to the policy mix and the need of a continuing functioning of the European Union. The obsession with net balances reflects present reality, but member states are aware that they derive large benefits from the European Union beyond budgetary payments.

This idea that well designed policies will change the behaviour towards net balances by member states, clashes with the present trend in academic literature. Most of the literature considers member states to base their decisions on pure self-interest and based on net balance considerations determined by voting power. While the behaviour corresponds closely to the present structure of the budget, it is possible to imagine that with a significant improvement in policy rationale a more positive attitude by member states might be expected. The idea of this paper is to encourage better policymaking by breaking the deadlock caused by net balance considerations, financing in a separate manner the Common Agricultural Policy. These reforms could refocus the attention of member states on the policies.

This paper considers that apart from the European public goods indicated by Wostner, expenditure aimed at growth and cohesion is a broadly accepted European objective and should not be subjected to net balance considerations, at least not at the present scale. The same is to be considered for environmental actions of European or global importance, such as mitigation and adaptation to climate change (still largely absent).

The separate design of different policies, without properly taking into account their interdependence, is affecting policy quality. Growth at EU level and regional policy are not necessarily a trade-off, as is the case with the present policies, but would require policy coordination and integration (see Baldwin *et al.*, 2003). Increasing the focus on trans-European networks and transfer of knowledge (interregional technology spillovers), while reducing the present excessive focus on regional level infrastructure, can increase growth in the whole EU economy and reduce interregional disparities. However, this would require a major review of the present policy foundations. Nevertheless, it has in fact started with the reinforcement of the trans-European networks and the push to increase Lisbon-focused expenditure programmes. The interplay between actions for competitiveness and for regional convergence need to be further developed.

A central underlying reason for the net balance disputes originates in the CAP. While generally the rationale for assisting poorer regions is politically accepted, the distribution of the benefits of the agricultural policy is not. The reason is that the policy is out of touch with needs, and the mechanism to finance it blocks meaningful reviews of the policy.

This paper proposes financing direct support for agriculture differently. The CAP is in fact more a sectoral state aid than a territorial redistributive policy. As such, the financial allocations fall on territories with very different fiscal capacity to support the sector, and its regressive nature ensures that most of the support lands on wealthier regions. This means that while regional policy tends to fall on countries and regions where the public budgetary means are weaker, the opposite is true for agriculture.

Unlike funds oriented to competitiveness measures, the CAP is also not helping the overall growth of the EU to justify such allocation; the opportunity costs of the CAP are higher.

Perversely, given the regressive nature of the policy, it has been used by some member states as a net balance corrector. Regional policy has also then been used by other member states to counterbalance lower receipts. It is interesting to point out that the first European Regional Development Fund (ERDF) programmes introduced in 1975 were devised partially for the UK, to counterbalance the lower support it was receiving from the CAP, but these were not sufficiently important to avoid the introduction of the rebate a few years later. Not surprisingly, for wealthier member states where receipts from the agricultural policy are proportionally lower, rebates or specific regional expenditure programmes have been invented.

As a regressive sectoral policy the CAP should be financed differently, in a way that the costs for a member state better reflect the domestic benefits of the policy.

7 REFORM PROPOSAL

There is a broad agreement by all member states that the budget should focus on the following needs:

- assisting the internal market by developing the trans-European networks;
- assist the poorer areas of the EU to converge on the EU average income levels;
- pool resources to foster the competitiveness of Europe, in particular by fostering R&D and SME development

In addition to these there is a broad agreement that the budget should be active in areas such as mitigation and adaptation to climate change, or to assist in mitigating the impact on sectors, regions and industries of asymmetric shocks caused by global economic conditions.

The net balance disputes are strongly influenced by specific factors of the financial redistribution, mainly the distribution effects of the CAP and the lack of solid rationale of some regional funding actions. These should be addressed.

It is proposed that:

1. All budgetary policy actions (at the level of specific measures) should be systematically reviewed based on their merits as an EU policy, analysing their rationale and value added. The evaluation criteria should be clearly defined and straightforward.
2. A reform process is prepared based on the efficient achievement of EU objectives taking into account the need for a coherent and efficient integrated policy approach.
3. Reconsidering the financial system separating the budget into two components:
   a) expenditure for European public goods and a growth and cohesion orientation; and
   b) sectoral support (i.e. agricultural support).

This paper concentrates on point 3. Point 1 is addressed more formally in Figueira (2008) and to some extent in Núñez Ferrer (2007a and b). Some issues on policy reforms will be discussed in the next sub-section, but are discussed in detail in Núñez Ferrer (2007a).

7.1 Improving policy coherence and policy integration

The EU budget has been developed based largely on specific objectives and problems at the time of their introduction. Often, measures were introduced to finance specific needs in particular member states, without those needs representing a good candidate for EU intervention according to the subsidiarity principle.

One of the main problems of these policies is that they lacked solid sunset clauses or appropriate review systems. The idea of introducing a culture of solid evaluation and reviews is recent and under development, but in the meantime, old policies have survived for decades with a large number of patches to correct for the worst side-effects.

The CAP has changed significantly, but the distribution of support has largely remained linked to a situation in the agricultural sector which does not relate to today's needs (see Núñez Ferrer and Kaditi, 2007). For regional policy, a weak theoretical basis for the interventions, lack of efficient reviews, poor programming and inefficient division of responsibilities has allowed the funds to be inefficiently allocated. Impacts of structural operation have varied depending on national political and administrative agendas and structures. Furthermore, its distribution seems to be indirectly linked to the incidence of the CAP.

The nature of the EU has changed, as it faces increasing internal and external challenges with limited resources. Policies need a deep review, taking stock of the situation and the challenges for the EU, with reforms to address them efficiently. This requires eliminating a pure net balance approach to the EU budget, and a reform of the own resources system may help.

7.2 Why separate agricultural expenditure?

The CAP is a sectoral policy, which supports, on weakly based foundations, specific agricultural structures and activities with different intensities. A large part of the support lands on producers with large capital endowments in regions with functioning markets and financial institutions. This fund directly benefits the areas where it lands. Contrary to some fundamental principles of redistribution policies, the financial capacity of farms and regions is not taken into account.

Furthermore, while actions to foster competitiveness or interregional transfers for cohesion can be argued to be in line with the role of a supranational budget (even if reforms are needed), this cannot be said for the sectoral support for agriculture, especially the way it is distributed.

Policy discussions on the merit of supporting one product rather than another have been scant. Only since the ceiling on CAP expenditures was imposed has there been some discussion on which activities to support to the detriment of others. Nevertheless, the fact that there is an implicit cross-subsidisation between different farming activities that benefits farm structures differently, often based on policy inertia rather than needs, is rarely discussed. Member states only partially question the distribution of the policy within the sector, and correct the inconsistencies through other policies or rebates.

This paper proposes to change the financial allocation of direct payments and thus will analyse the impact of direct support. Rural development expenditure needs reviewing, but should be part of an overall review of interventions to foster economic growth and environmental protection in the EU, as coordination with other policy instruments is more important than "accompanying" the CAP.

Figure 1 on the next page shows that direct support receipts in 2005 per farmer[4] and Gross Value Added (GVA)[5] per full time equivalent farmer re regressive.[6] This regressiveness is shown in various other ways in Baldwin (2005 a, b), Núñez Ferrer (2007a) and Núñez Ferrer and Kaditi (2007), at farm level or with GDP per capita at the national level. Support accumulates on specific areas based on policy inertia rather than needs. Decoupling of support from production has reduced distortions in production decisions, but the financial geographical incidence of support has remained largely static, at least at the national and often at regional level. This is mainly due to net balance considerations rather than needs. This has strongly affected budgetary disputes and has unduly shifted the attention from policy quality to net receipts.

It is interesting to see a relation between the contributions to the direct payments and the receipts per farmer (Figure 2 on page 29). If the estimated contributions and direct payment receipts are divided per farmer there is a clear correlation between the two, i.e. direct payments are to an important extent a self-financing exercise with few trans-national transfers.

In Table 1 on page 30 the expenditure on direct payments for 2005 have been singled out and net contributions of member states to these payments have been estimated using a pure GNI-based contribution (it is assumed that the CAP is financed by their GNI based contributions). Germany, the UK, the Netherlands and Sweden are large contributors to the payments,

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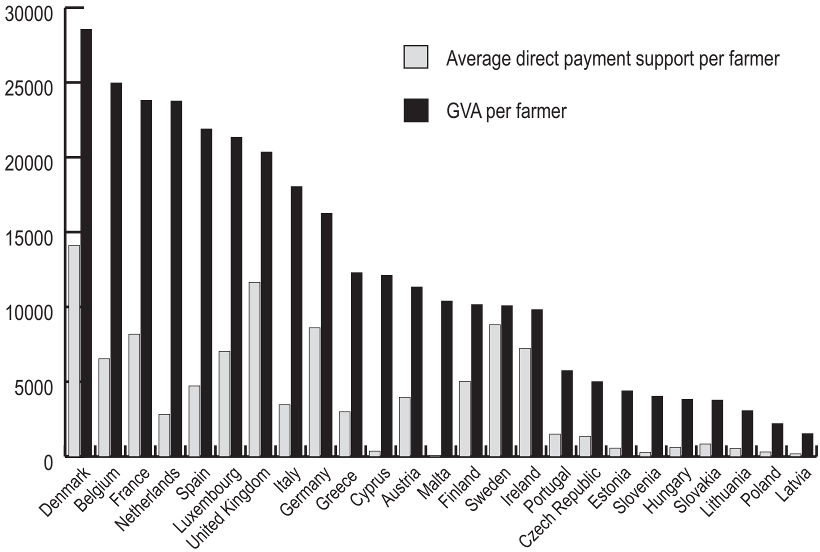
[4] Full time equivalent using Eurostat's Agricultural Working Unit (AWU) definition.

[5] Based on an estimation of the Gross Value Added of Agricultural Products subject to the Common Market Organisation.

[6] The direct payments in the new member states are partially co-financed by them, exacerbating the regressiveness, but it persists significantly even after full integration of the direct payments.

Figure 1 Average direct payment support and GVA per farmer in €, year 2005



Data source: own estimations based on Eurostat data and DG Agriculture and Rural Development, "Agriculture in the European Union – Statistical and economic information 2006"

but there are large beneficiaries such as France or Ireland with a high GDP per capita. This is not surprising, however, given the policy structure.

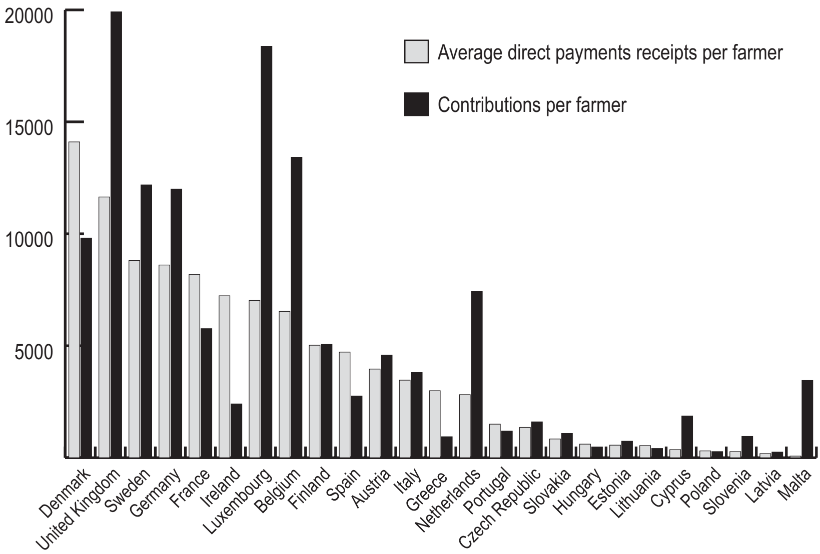
If redistribution among member states is not justified and distorts other parts of the budget, then the policy should be financed otherwise.

7.3 Variable co-financing of direct payments

The first option is quite straightforward and reconsiders the well-known possibility of national co-financing by member states, but with a slight difference. Co-financing will be required at different rates depending on the level of GVA per farmer of the products subject to the CMOs; products not covered are excluded, as this has important implications and would introduce unfair treatment.

Co-financing is a clear option, is already done and for the wrong reasons. New member states have had to finance a share of the direct payments, despite their lower national public budgetary resources. As the agricultural

Figure 2 Average direct payments receipts and contributions per farmer from the direct payments in €, year 2005



Data source: Eurostat and DG Budget, EU Budget Financial Report 2006

sector in most of the new member states has a higher weight in GNI than in other member states, the proportional effort has been high.

The bulk of direct payments are clearly directed to wealthier countries with the "right" eligible agricultural structures which often consist of the most competitive and successful producers. Given that the benefits of the support is localised, it is reasonable that the financial burden of the policy is at least partially borne by the recipient country. Given the policy structure, it is questionable that a significant part of the expenditure can be considered to be based on EU fiscal need. The needs of the agricultural sector are not reflected in the distribution of support.

It would be reasonable to consider that countries contribute to the direct payments in relation to the average GVA per farmer. This would ensure that EU support is directed more to support farmers in countries where productivity is lower, which in general tend to be the poorest member states, but not necessarily so. It would at least focus finance fully in areas of greater need.

Table 1 Direct payments receipts and member state contributions, 2005, million €

	Estimated contribution to the direct payments based on GNI	Share of contributions (= share of GNI)	Receipts from direct payments	Share of receipts from the CAP direct payments	Net receipts	Net receipts as % of GNI to the direct payments
Belgium	939	2.79%	458	0.68%	-482	-0.16%
Czech Republic	251	0.75%	212	0.32%	-39	-0.05%
Denmark	639	1.90%	918	1.36%	280	0.13%
Germany	6990	20.74%	5014	7.44%	-1976	-0.09%
Estonia	28	0.08%	21	0.03%	-7	-0.07%
Greece	570	1.69%	1820	2.70%	1249	0.67%
Spain	2725	8.09%	4667	6.92%	1942	0.22%
France	5434	16.13%	7708	11.44%	2274	0.13%
Ireland	402	1.19%	1209	1.79%	807	0.61%
Italy	4411	13.09%	4015	5.96%	-395	-0.03%
Cyprus	41	0.12%	8	0.01%	-33	-0.25%
Latvia	35	0.10%	25	0.04%	-10	-0.09%
Lithuania	63	0.19%	82	0.12%	19	0.09%
Luxembourg	73	0.22%	28	0.04%	-45	-0.19%
Hungary	251	0.75%	316	0.47%	65	0.08%
Malta	14	0.04%	0	0.00%	-14	-0.30%
Netherlands	1460	4.33%	554	0.82%	-906	-0.19%
Austria	753	2.24%	651	0.97%	-102	-0.04%
Poland	627	1.86%	702	1.04%	7	0.04%
Portugal	439	1.30%	554	0.82%	114	0.08%
Slovenia	86	0.26%	25	0.04%	-62	-0.22%
Slovakia	107	0.32%	83	0.12%	-24	-0.07%
Finland	487	1.44%	483	0.72%	-3	0.00%
Sweden	925	2.74%	669	0.99%	-256	-0.08%
UK	5950	17.66%	3479	5.16%	-2472	-0.13%
TOTAL	**33701**		**33701**			

Data source: Eurostat and DG Budget, EU Budget Financial Report 2006

Most importantly, however, national co-financing of direct payments would reduce the incentives of wealthier main beneficiaries with a productive agricultural sector to defend their CAP-related financial returns. In the following example a system based on variable co-financing is set up, going from 0 to 60 % depending on the GVA per farmer in the country. Total employment in AWU equivalents is used (it would be possible to reduce it for employment in products not covered by the CMO, but for simplification this is not done here).

Table 2 on the next spread shows the results in which co-financing kicks n at 10% when average GVA pre agricultural employee is at € 12,000.[7] Co-financing increases at a rate of 10% up to 60% for a GVA over € 22,000 per farmer. This system would reduce the costs to the EU budget of the direct payments by more than a third (€ 13 billion). It would reduce the financial burden to the EU budget and also the contributions of the most vociferous net contributors: the UK, Sweden, Austria and the Netherlands. Total national costs (including co-financing) would not fall enough to compensate the UK for its rebate in any case. This is not the primary aim, but rather to change the financial incentives in the CAP policy decision-making process.

Of course co-financing rates could be based on national GNI, but that would change the nature of the policy. Here the idea is to ensure that the EU budget is not regressive in relation to the situation in the farming sector. It is based on the idea of ensuring that support from the EU budget is aimed at areas in need. It shifts the burden of supporting the wealthier agricultural sector to the member state. It is interesting to note that while the incidence of the policy is exactly the same, it really changes radically the perception of the EU role. The EU budget expenditures increase in fairness more than through a generalised co-financing system. Such a system does not exclude the introduction of modulation of payments or of payment ceilings on larger farms. It would in fact rather promote such actions. Variations, including national co-finance based on actual size of payments to farms, can also be envisaged. The results would reveal large policy inconsistencies without altering the level of support, and would change perceptions and hopefully decision-making.

[7] This is an average of the national averages. It is arbitrarily chosen and is used for illustration only.

Table 2 Results of a co-financed direct payment system based on GVA per farmer, million €

	GVA per farmer, €	Co-finance share	Direct payments	EU financed	National financed	Contribution EU budget direct payments	Difference in EU budget contribution	Total national expenditure	Difference in total national cost
Belgium	24965	0.6	458	183	275	568	-364	842	-89
Czech Republic	5007		212	212	0	152	-97	152	-97
Denmark	28544	0.6	918	367	551	386	-247	937	304
Germany	16254	0.3	5014	3510	1504	4223	-2706	5727	-1202
Estonia	4392		21	21	0	17	-11	17	-11
Greece	12289	0.1	1820	1638	182	345	-221	527	-39
Spain	21891	0.5	4667	2333	2333	1646	-1055	3980	1278
France	23807	0.6	7708	3083	4625	3283	-2104	7908	2521
Ireland	9819		1209	1209	0	243	-156	243	-156
Italy	18043	0.4	4015	2409	1606	2665	-1708	4271	-102
Cyprus	12104	0.1	8	7	1	25	-16	25	-15
Latvia	1532		25	25	0	21	-14	21	-14
Lithuania	3068		82	82	0	38	-24	38	-24

	GVA per farmer, €	Co-finance share	Direct payments	EU financed	National financed	Contribution EU budget direct payments	Difference in EU budget contribution	Total national expenditure	Difference in total national cost
Luxembourg	21339	0.5	28	14	14	44	-28	58	-14
Hungary	3824		316	316	0	152	-97	152	-97
Malta	10391		0	0	0	9	-5	9	-5
Netherlands	23757	0.6	554	222	332	882	-565	1214	-233
Austria	11330		651	651	0	455	-292	455	-292
Poland	2203		702	702	0	379	-243	379	-243
Portugal	5745		553	554	0	265	-170	265	-170
Slovenia	4033		25	25	0	52	-33	52	-33
Slovakia	3771		83	83	0	65	-42	65	-42
Finland	10156		483	483	0	294	-188	294	-188
Sweden	10083		669	669	0	559	-358	559	-358
UK	20349	0.5	3479	1740	1740	3595	-2304	5334	-564

Data source: own calculations, Eurostat and DG Budget, EU Budget Financial Report 2006

Box 1 Summary of the proposed variable co-financing system

- Member states co-finance the direct payments according to the size of the average GVA per farmer in the country.
- When the GVA exceeds a certain threshold (here 12,000€), an escalating progressive rate from 10% to up to 60% for a GVA over 22,000€ is introduced.

7.4 Contributions to the EU budget based on GVA per farm

Another possibility is for member states to finance the CAP based on the productivity of their agricultural sector. To a certain extent the productivity of the sector is correlated with the support, and as the bulk of support lands in the wealthier areas and farms benefitting the member state without much rationale, it seems reasonable to consider that contributions in relation to the benefits would be a reasonable mechanism.

The proposal here is relatively simple: the best way to have member states discuss the merits and distribution of the CAP policy is by financing it as if it was based on a levy on the farm sector.[8] What kind of levy? For 2005, the cost of the CAP direct payments represented the equivalent of 30% of Gross Value Added of the EU's agricultural production (only products subject to EU CMO).

It would therefore seem possible to finance the CAP by a transfer proportional to GVA. Unfortunately, such a system would penalise countries where the GVA of the agricultural sector represents a higher share of GNI, and reduce payments in countries where GNI contributions would be higher. The effect is that this penalises poorer member states. Their contributions to the CAP would be higher than with a GNI contribution. It is thus proposed that for countries with a GDP per capita[9] below the EU average, contributions cannot exceed a contribution based on a GNI share. The wealthier member states would then have to finance the shortfall with a contribution based on their shares of EU GNI. The results are presented in Table 3. Other options are possible – like a contribution equivalent in value to a progressive levy system based on the GVA per employee or per farm – but are not developed here.

[8] This is an extended version of a mechanism proposed in Nuñez Ferrer (2005).
[9] Average real GDP at PPP is used here. Other measures could be envisaged.

What would such a system bring? It would make member states pay based on the situation in the agricultural sector and expose more clearly the link between the distribution of CAP support and its incidence. It would increase the contributions of countries with high receipts and high GVA, reducing the incentives to protect the old distribution to maintain net balances. More importantly, it will weaken the link with expenditures of other parts of the budget. The CAP is financed separately, and even if the other parts of the budget are affected by budgetary negotiations, there will be a clear link between contributions and expenditure in the agricultural sector.

The result of the proposed system is at first sight surprising and puzzling, but reflects fully the problems on the expenditure side of the policy and the bias towards certain sectors. The system is not intended to fiddle the resources to hide the inconsistencies of the CAP, but to gear financial discussions to concentrate on the actual sector it subsidises. The CAP would of course still be mainly a self-financing exercise where large producers of the most supported products actually recover most of the payments or more due to the way funds are allocated primarily to the most productive regions.

Countries with low GVA in the CAP-protected products will pay less, and this is clear in the impacts on Germany, the UK, Sweden and Finland. Also their lower share of agricultural GVA as a percentage of GNI would reduce their contribution. The UK would lose the rationale for the rebate as it would pay €2.6 billion less and even become a net beneficiary (of the CAP direct support). France would have to contribute more, but not excessively.

The hardest hit would be Italy, with high GVA in products which are subject to CMOs but are weakly supported. The same would have occurred in other Mediterranean countries, if the correction system had not been introduced, exempting them from losses. Without the correction, France would still have been a net beneficiary. In fact, most of the correction comes from Spain and Greece, with high value added production and low receipts from the CAP. Italy, having a similar farm structure as these other Mediterranean countries, cannot benefit from the correction. The bias of support is thus made very clear.

The results are less enticing than using national co-financing, but can be further developed by taking into account variables such as the number of farmers as a share of employment or the share of agricultural GVA in GNI, to construct a more viable financial system based on the agricultural sector.

Table 3 Payments based on GVA per farmer, million €

	CAP direct payments expen-diture 2005	Est. share of GVA of EU agri-culture	Payments based on GVA	Correc-tions	Final Payments based on GVA	Net receipts from direct payments	Difference in net receipts
Belgium	458	1.54%	519	229	748	-291	191
Czech Republic	212	0.69%	233	0	233	-21	18
Denmark	918	1.64%	552	156	708	210	-69
Germany	5014	8.35%	2812	1706	4518	496	2472
Estonia	21	0.15%	49	-21	28	-7	0
Greece	1820	6.59%	2219	-1649	570	1249	0
Spain	4667	19.08%	6431	-3706	2725	1942	0
France	7708	19.78%	6665	1326	7991	-283	-2556
Ireland	1209	1.45%	488	98	586	624	-184
Italy	4015	18.43%	6211	1076	7287	-3272	-2876
Cyprus	8	0.23%	79	-38	41	-33	0
Latvia	25	0.19%	63	-28	35	-10	0
Lithuania	82	0.41%	138	-75	63	19	0
Luxembourg	28	0.08%	25	18	43	-15	30
Hungary	316	1.75%	591	-340	251	65	0
Malta	0	0.04%	13	0	13	-12	2
Netherlands	554	4.12%	1388	356	1744	-1190	-284
Austria	651	1.64%	554	184	737	-86	16
Poland	702	4.45%	1499	-873	627	75	0
Portugal	554	1.87%	630	-191	439	114	0
Slovenia	25	0.32%	109	-22	86	-62	0
Slovakia	83	0.33%	111	-3	107	-24	0
Finland	483	0.86%	290	119	409	74	78
Sweden	669	0.67%	227	226	453	216	472
UK	3479	5.36%	1806	1452	3258	221	2692

Data source: own calculations, Eurostat and DG Budget, EU Budget Financial Report 2006

Box 2 Summary of the proposed GVA system

- Member states pay for the cost of the direct payments according to the share of GVA of their agricultural sector in the EU.
- Poorer member states (with a GDP per capita below the average) do not contribute more than with a system based on GNI.
- The shortfall is paid by the wealthier member states based on the shares of their GNI in the EU.

7.5 Objectives of a separate financial system for the CAP

The main objective is to change the policy decision-making system, by separating the financial impacts of the policy distortions from other EU policies. It should reduce the implicit relationship between regional policy and the CAP for example, hopefully pushing towards a reform ensuring that support for agriculture is redirected to actual problems, linking actual costs of reaching objectives and farmers ability to pay as part of the financial support structure.

What about the other expenditures? The other expenditures have a role to play as EU expenditures and are broadly in line with the subsidiarity principle. Member states will finance them either through a GNI key or another method they agree to. The importance is to review the rationale of these policies rather than the method of how these are financed. It should be possible to reach a consensus on well grounded policies.

8 CONCLUSIONS

The persistence of inefficiently structured policies which do not address real problems in the EU fosters net balance considerations. The own resources system, being based on practically one resource (VAT resource is a close proxy to the GNI resource), encourages a concentration on the balance between receipts and contributions.

To ensure that the net balance considerations are reduced there is a need for a thorough review of the policies. This paper calls for a review of all policies and especially for the appropriate coordination of different interrelated policies, such as the interplay between the TENs, knowledge and technology transfers and regional development actions. Reforms are however hampered by the net balance considerations of member states. This paper considers that the presence of the CAP has a large influence on policy quality and the financial distribution of other policies. While policies aimed at European Public Goods and cohesion can be considered good candidates for support at EU level, the lack of a territorial focus of the CAP makes it a bad candidate for a commonly financed policy.

For the CAP direct support, given its sectoral nature and the inefficient policy structure, the recommendation is to finance it separately to reduce the net balance interplay between the agricultural policy and other areas. The policy benefits more farm structures in less need of support and avoids addressing the problems of the sector today. Thus two different systems of financing the direct payments are presented, both linking the GVA per farmer to the level of EU support and the level of national contribution.

Proposal 1:
A variable co-financing of direct payments based on the productivity per farmer. Countries were the GVA per farmer is high have to co-finance the direct payments. Rates vary depending on the level of GVA.

Proposal 2:
Financing the CAP based on the GVA of the agricultural sector in the country. Member states finance the CAP in relation to the GVA. Poorer member states have their contributions capped to the level of a system based on GNI.

In both cases these financial systems will not by themselves improve much the situation, and initially support for agricultural sector would remain equal. However, deviations from a support system that concentrates on less productive farming areas are borne by the member state, not the EU budget. This should encourage a change in the policy discussions on the CAP and push for a deeper reform in line with more pressing needs reducing the waste and regressivity of the policy.

The possibilities presented here are just two basic illustrations but can be further developed to ensure that the method of financing the CAP does not foster its status quo, promotes a more efficient policy, and does not affect the rationale of other EU policies. Ultimately, a change in the dynamics of CAP decision-making would open the door to a more efficient policymaking and financial redistribution in the other budgetary headings.

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