Jacques Le Cacheux, The poisonous budget rebate debate

Caption: In this study, Jacques Le Cacheux, a specialist in Community public finances, proposes a critical analysis of the concept of 'net balance'.
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European Budget: The poisonous budget rebate debate

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Foreword

The financial negotiations that have just ended in stalemate over the forthcoming European medium-term perspectives for the period 2007–2013 have revealed how important "net national budgetary balances" have become in determining member states' negotiating stances on issues such as, for example, the British cheque. In the Netherlands, opponents of the Constitutional Treaty successfully brandished the spectre of the country's excessively large "net contribution payment", Sweden, Spain and even Finland have also been struck by this contagious disease, judging from the recent stiffening of their negotiating positions. And that without referring to the case of several new member states whose eyes are riveted to these figures. "Net balance" calculations have thus become a central issue in the affairs of the European Union.

Yet on closer inspection the figures suffer from crippling deficiencies, which should rule out their use except in marginal cases and even then only it they are handled with the greatest care.

Such is the message conveyed by this study, which Notre Europe commissioned from Jacques Le Cacheux, the eminent specialist in European Community public finances.

The author's close examination of the underlying budgetary, economic and political basis of net balance calculations reveals just how fragile, volatile and even meaningless the figures can be. As readers, we cannot fail to share the author's doubts after his exposition. But why has the unjustified use of these figures spread to the extent that they now systematically undermine discussions and negotiations which should be focusing instead on the medium-term funding allocations to Community policies and the fairest way of contributing financially to them?

The answer to this question lies in the enduring fortunes of an idea that is as appealing as it is erroneous: the concept of a "fair return". It purports to show that European construction is a zero sum game in which monies "paid" or "received" by member countries should balance each other out when weighed on the Budget scales.

With this new study by Jacques Le Cacheux, Notre Europe has, I hope, taken another step towards fulfilling its mission of promoting continued European integration on intellectually solid ground, putting setbacks and crises behind it and rejecting the easy options of illusions and mystification. Thanks to this work we now know that net balances belong to the realm of illusion!

Pascal Lamy

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Summary

The "net national balances" on which European governments base their stance in the financial negotiations on the forthcoming medium-term European budget are the product of a questionable accounting approach to the economic and financial relationships between member states of a Single Market pursuing common policies. Initially funded through "own resources", the European budget has become increasingly dependent on national contributions, which, for the past twenty years, has led to demands for "fair returns". Yet the recent and past history of federations and other groupings of individual states offers numerous examples of the dangers of this kind of "accounting logic". The conventions which determine this type of calculation are fairly arbitrary, while even minor changes to allocation criteria cause significant variations in these balances. But more fundamentally, it is the underlying

economic reasoning behind these estimates that is at fault: levies and, to an even greater extent, expenditure have repercussions on member state economies. As a result, a geographical cost-benefit analysis of Community policies in an economic and monetary union does not show what the net balances alone would appear to indicate. The pitfalls of budgetary negotiations dominated by opportunistic strategies and national self-interest can be avoided by taking note of what happens in existing single or federal state systems and by dissociating spending decisions from financing decisions.

Every one knows that a great deal of the errors committed by the State legislatures proceeds from the disposition of the members to sacrifice the comprehensive and permanent interest of the State, to the particular and separate views of the counties and districts in which they reside. And if they do not sufficiently enlarge their policy to embrace the collective welfare of their particular State, how can it be imagined that they will make the aggregate prosperity of the Union, and the dignity and respectability of its government, the objects of their affections and consultations?

James Madison, *The Federalist*, no. 46, cited by Begg (2005)

After the setbacks to ratification of the European constitutional treaty in France and in the Netherlands, the June 2005 European Council was not able to reach an agreement on the future of the European budget, the current version of which runs until 2006. Yet when the European summit of 22 and 23 March 2005 in Brussels adopted a reform of the Stability Pact along the lines of what the German and French governments were requesting, the way had seemed clear for a compromise on the future medium-term budget (2007-2013) of the European Union (EU) of 25 member states or, more probably, 27, since Bulgaria and Romania, which have just signed accession treaties, will more than likely have joined the Union by then. The European Council meeting on 22 -23 March had endossed the idea of a stronger cohesion between the Pact and a European budget serving the interests of the Lisbon strategy. The persistent focus on national net balances during negotiations over the European budget is behind this new disappointment. The “accounting logic” one finds, notably in the language of the governments of the Union’s richest countries, has so distorted the negotiation process that the unanimous agreement needed could only have been reached only on the basis of a minimum standard. The resulting casualty would have been the funding of common policies that are nevertheless universally acknowledged as necessary to take the process of market integration, which is already well advanced, a stage further and introduce the planned new phase in opening up external trade. However, this is the major difficulty of collective action, as already observed by Olson (1965) who wrote that it is practically impossible to avoid the “logic of collective action” being dominated by strategies of non-cooperation, the most evident and pernicious manifestation of which is “accounting logic”. The obsession with net balances, maximising them in the case of those that benefit from them, and minimising them in the case of those who are net contributors, in the end diverts attention away from the real challenges of collective decision-making, e.g. common policies and financial solidarity. Admittedly, many governments justifiably adopt a demanding approach towards the management of the EU budget because of the context of slow growth and the persistent budgetary difficulties with which they have to contend. At the same time, it encourages an inappropriately strict attitude towards the European budget which could lead to decisions that are not in its members’ general interests.

Discussions on the medium-term budget have, so far, been largely dominated by considerations of the “net balances” and “net contributions” of a certain number of member countries, the governments of which consider that their share in the funding of common expenditure is excessive, or else, which amounts to the same thing, that expenditure by Europe favours the other members too much and that fiscal “virtue”, as defined in the Stability

Pact, forbids such disparities. The governments of the six largest net contributors wrote in January 2004 to the President of the Commission to demand that the total budget be maintained below 1% of gross national income (GNI), rather than the 1.25% ceiling of the Union’s[(1)] (GNI). The group of experts appointed by the Commission to examine the future of the European budget (Sapir *et al*., 2004), the Commission itself, in the recommendations published in spring 2004 (EU Commission, 2004) and, more recently, the European Parliament, in the report by the ad hoc committee on the forthcoming budget (EU Parliament, 2005), have all more or less taken this constraint on board, by proposing a financial limit for the total European budget of between 1% and 1.15% of GNI, i.e. well short of the ceiling. The compromise formula presented by the Luxembourg presidency on 15 June did not go beyond a 1.06% of gross national income (GNI) ceiling for commitments and a 1% GNI ceiling for payment appropriations. Yet, the Union has substantial funding requirements, given its enlargements in 2004 and in the future and if it is to attain the ambitious objectives

of the Lisbon strategy and adequately fund the new policies envisaged by the European constitution treaty.

This study offers a critical analysis of the concept of “net balance” or “net national budgetary contribution”, the way it is used and the economic and political philosophy supposedly underpinning the concept. The first section is devoted to a rapid overview of different examples taken from historical and contemporary experience and which illustrate the dangers of this approach. The second section details the accounting conventions used to calculate “net balances” and exposes the wide range of conclusions, which can be drawn from the different possible definitions. In the third section, we analyse the economic effects of indirect taxes and budgetary transfers between regions or member countries of an economic union and a single market and we conclude that the ultimate benefits or costs are never distributed according to the accounting logic of net balances. The fourth section sets out a number of arguments in favour of financial solidarity inspired by a Community-based economic policy and political philosophy and the “mutual benefits” provided by integration.

I - The emergence of a concept

It is always possible to become embroiled in calculating “net contributions” in any situation where individuals, regions or States operate a common budget. Resorting to this type of calculation is not, however, as common as one would expect. In the majority of collective undertakings, this failing is avoided because of the financial solidarity rule and the belief that the pursuit of shared objectives entails the allocation of sufficient resources to the Community budget. This is often facilitated by simple and straightforward financing procedures.

Insufficient own resources historically and the rise in national contributions

The European budget was instituted with the introduction of the Treaty of Rome, which clearly enunciated the principle of financial solidarity. Initially, the European budget was very small, with the bulk of spending earmarked for the common agricultural policy (CAP). The price guarantee element designed to support the market prices of a small number of agricultural products regulated at that time by common market organisations (OCM) was itself not very costly because of the supply situation which had shaped CAP. Coupled with the principle of Community Preference and a trade protection system of variable levies (restitution payments) on extra -community agricultural imports (exports), the chronically insufficient supply of staple agricultural produce in the European Economic Community (EEC) of the Six ensured enough internal demand to maintain prices above world market levels. By virtue of the Community initially being a massive net importer of agricultural produce and in a still highly protectionist world trade context, the proceeds from “own resources” which the treaty’s architects had assigned to the European budget was at the time sufficient to cover the small amount of Community expenditure. The bulk of the budget receipts came from agricultural import levies and customs duties on manufactured imports. However, if the net balances had been calculated at the start of the 1960s, something which no one at the time ever thought of doing and which the Secretary General of the European Commission, Emile Noël, had long banned the Commission from doing, they would have proved to be substantial and situated at opposite extremes. Germany was then the main importer of agricultural produce and a still relatively modest producer of the staple commodities most heavily subsidized by the CAP (milk and cereals), whereas France was a beneficiary of CAP expenditure from the outset of European integration and was only concerned to a limited extent by import levies. Yet it was clear that the mechanisms underpinning both receipts and expenditure were favourable to the pursuit of a common objective, namely supplying the Community’s food market, and that the budgetary transfers involved were justified.

Chart 1. European budget expenditure 1962-2006: aggregate amounts and breakdown in a % terms
[…]

Chart 2. European budgetary revenue 1970-2006: aggregate amounts and breakdown
[…]

Chart 3. European budget 1971-2004: breakdown of revenue

[…]

Growing tensions over the European budget starting in the early 70s were the result of a combination of three separate trends: the continued liberalisation of international trade under the impetus of the GATT agreements with an accompanying reduction in customs duties on manufactured imports; the appearance and subsequent accumulation of European Community surpluses of several agricultural commodities (Le Cacheux and Mendras, 1992), the budgetary consequences of which were dwindling revenue from variable import levies and a surge in expenditure on internal price supports to finance supply withdrawn from the market, namely storage and export subsidy costs on surplus agricultural produce; and, thirdly, the first enlargement which, in 1973, saw the accession of three new members –Denmark, Ireland and the UK– the latter at that time being a relatively modest agricultural producer and a very large net importer of agricultural produce from several former Commonwealth colonies, e.g. Australia and New Zealand. Whereas the levies on British imports paid into the European budget were larger than those of its partners, the UK enjoyed only a modest percentage of Community expenditure, still mainly agriculture-based and growing fast during that period. One of the reasons for setting up the European Regional Fund was to allow the new member state, which felt discriminated against under the existing expenditure structure, to receive more from the European budget.

To offset the shortfall in receipts from the shrinking traditional "own resources" element (customs duties and import levies on agricultural goods) as Community expenditure at the same time increased, new "pseudo own resources" were created at the end of the 1970's, namely VAT revenue and the contribution based on each member state's GDP. These were calculated to cover the remainder of the financing need jointly borne by the member states and, as a percentage of the total, increased sharply from the end of the 1980s and now represent nearly three quarters of European budget revenue. As both items were approximately proportional to GDP and were paid into the European budget by each member state's Treasury, it became tempting and easier than before to calculate a national contribution and to derive a net balance, given that most expenditure (mainly agricultural and structural) could easily be broken down by country and was therefore geographically identifiable.

Chart 4. Each country shares of European budget revenue (2002)
[…]

Chart 5. Each country shares of EU operating expenditure (2002)
[…]

The first net balance calculations and the concept of a "fair return"

Thereafter, the imbalance affecting the UK worsened because expenditure on agricultural price support spiralled out of control, with the currency upheavals of the 1970s adding to the price distortions that were further magnified by dollar depreciation. The new British government, which came to power in the April 1979 general elections at a time when the warning signs of what was to become the second oil shock were appearing, decided to pursue a policy of reducing tax and social security charges to balance its budget and mounted an offensive on the UK's contribution to the European budget. For the first time, the government of a member country openly challenged the principle of financial solidarity and calculated its net contribution amount. This was Mrs. Thatcher's famous "*I want my money back!*" demand, threatening at the same time to paralyse the Community, which still functioned according to the unanimity rule, if she did not get her way. The long standoff ended with a compromise at the Fontainebleau Summit in 1984, when the governments of the other member states, led by Germany and France, agreed to a UK budget rebate. The now famous "British cheque" went some way to offsetting what was considered that country's excessively large net contribution payment compared with income levels that were then well below the community average (Chart 6). Furthermore, the structural funds, from which the UK derived more at that time than from the CAP, experienced an initial phase of sharp growth (Chart 1).

Chart 6. Average per capita income of the UK population, 1973-2003 (EU = 100)
[…]

Table 1. Correction factor and UK net balance, 2000-2004 (billions of current euros)

	2000	2001	2002	2003	2004	Average
Correction	3.43	7.30	5.03	5.48	4.66	5.18
Net balance after correction	-2.99	+0.71	-2.90			

Source: Laffineur and Vinçon, 2004.

Chart 7. 2003 National Contributions and GDP in euros, (EU15)
[…]

Chart 8. National Contributions as % of GNI, 2003 (EU15)
[…]

Subsequent enlargements, notably those of 1981 (Greece), 1986 (Spain and Portugal) and 2004 (Central and Eastern European countries, Cyprus and Malta), brought countries into the EU the economic of which development was significantly below the Union's average. The effect was to accentuate the polarisation of net balances both because these new entrants benefit to a greater extent from certain types of expenditure (structural funds) and because, with the underlying trend of a decline in traditional "own resources" offset by a rise in "pseudo own resources" since national contributions are proportional to GDP (Chart 5), they pay less than the other states into the European budget. By mechanically lowering the average income per capita in the Union, the accession of poorer member states has automatically raised that of the older members, notably the UK, whose structural fund entitlement is declining and national contribution to the European budget is increasing. The growth in the structural funds and, subsequent to the Maastricht Treaty in 1992, cohesion fund set up for member states with a per capita income below 90% of the European average (to help the relatively less developed regions of the EU to catch up) is causing net balances to widen further.

Chart 9. Net balances in 2001-2003 (EU15)
[…]

After two decades of the "British cheque", it now transpires that the UK, whose per capita income has more than made up its lost ground (Chart 6), is nearly always among the top net contributors (Chart 9 and Table 1). However, the "rebate" which it obtains reduces its budget contribution to an amount well below that of the other countries of a comparable economic development level (Charts 7 and 8). At the same time, demands for a "fair return" spread to all net contributor members. During the financial negotiations over the future 2000-2006 budget ("Agenda 2000") at the Berlin summit (spring 1999), this group called for a redistribution of the financial burden of the "British cheque", with France assuming a bigger share and Germany, Austria, the Netherlands and Sweden a little less than before (Chart 8). These countries now want a spending cap of less than 1% of GDP. In an effort to get the governments of net contributor countries to agree to a minimal (1.15% of the EU's GDP) increase in the size of the budget in the financial negotiations covering the new 2007-2013 budget, the Commission offered to freeze, then gradually reduce the "British cheque" and to replace it by a general correction mechanism. Any country whose net contribution exceeds 0.3% of its GNI would have 2/3rds of its net balance refunded. Others (Lefebvre, 2004a) have proposed an alternative consisting of a general correction coefficient to net contributions applied by capping all positive net balances, e.g. at 0.5% of GNI.

The experience of a certain number of other federations and redistributions between regions in existing states

There are historical precedents of recourse to payments by member states after "own resources" funding of a Community budget quickly proves inadequate. Solutions to problems of inadequate revenue and financial burden-sharing appear to be a crucial factor in the ultimate outcome of experiments in regional and/or federal integration. The German Zollverein (customs union) in the middle of the 19th century, which foreshadowed the political unification of the German states and creation of the German empire, was, in its initial form, very similar to the EEC, having, initially, a small, common budget funded exclusively by

customs duties levied at the customs union’s borders. Thereafter, political unification advanced quickly and the empire’s Parliament secured the right to approve federal taxes[(2)] followed by direct taxation of personal[(3)] income.

The Austro -Hungarian empire is a less fortunate example, as it illustrates the shortcomings and dangers of deciding to clearly identify national contributions to the common budget of a supranational state. The compromise agreement of 1867, signed by the Austrian and Hungarian kingdoms, specified the rights and duties of each, the decision-making procedure and each country’s representation in the empire’s common institutions. At the same time, it limited the empire’s budgetary powers and divided up the funding of a common budget between the two constituent entities, with each paying a contribution. The budget was funded through “own resources”, i.e. customs duties paid at the empire’s external borders, and was supplemented by national contributions, with Austria providing 70% and Hungary 30%. Moreover, the joint budget had to be balanced and borrowing was forbidden (Flandreau and Le Cacheux, 1996). The tension and quarrelling caused by this institutional system unquestionably undermined the political cohesion of the empire and prevented it from financing an adequate offering of “collective goods”, particularly in the area of defence, or ensuring a minimum level of economic solidarity. At the same time, the economic growth rates of the two kingdoms appeared to diverge stubbornly during several periods in the late 19th and early 20th centuries (Hungary’s average economic growth being stronger during those decades).

The history of European federations during the 20th century teems with examples of political tensions and major crises leading to their break-up. The sharing of the funding burden and clear disparities in the “net balances” were undeniably explanatory factors in this regard. A good illustration is the Yugoslav federation and the acrimonious disputes between the republics – in which the richest, Slovenia, figured prominently – over the shared financing of joint expenditure and permanent budgetary transfers between republics throughout the 1980s. The outcome of these conflicts, of which the financial dimension was obviously not the sole aspect, was secession by constituent republics and war between the largest of these at the start of the ensuing decade. A few years later, the albeit peaceful partition of Czechoslovakia was also partly due to a dispute over budgetary redistribution between the two, now independent, parts of what had, until then, been a federal state since 1968. Similarly, although they had not always been prominent in the quarrels between republics, financial and budgetary issues played a significant role in the break-up of the Soviet federation (see BERD-BIRD-IMF-OECD, 1991)[(4)].

Nor are Europe’s present-day democracies always free from controversy or tension over net transfers between regions inside single states or between federated states inside federations. In Italy over the past two decades or more 5, the federalists and the Northern League have periodically expressed views challenging central government decisions on net flows of public funds between the more developed Northern and Central regions and the Mezzogiorno. In Belgium, the issue of net budgetary flows between Flanders and the Walloon region was also one of the reasons for the transformation of the kingdom into a federal state and the cause of frequent disputes between the Flemish and Walloon communities. In Spain, extensive decentralisation as a result of the democratisation process, followed by several consolidations since then, are at the heart of disputes which erupt from time to time over net inter-regional transfers. Likewise, in Germany, in the years following unification, several of the richest Länder, including Bavaria, took the federal government to task because of the excessive share which they had to bear in financing the budgetary transfers to the new eastern Länders[(6)].

It seems that the mechanisms determining central budgetary expenditure and revenue in both federations and in single States always generate permanent transfers of differing sizes either between federated states or between regions. This is because the rules for contributions to the central budget are geared to contributory capacity, while expenditure is distributed geographically according to other criteria or mechanisms. It was possible to obtain an order of magnitude for this type of process from a large number of studies in the 1990s on the stabilising and redistributive properties of central budgets in monetary unions. In a study systematically drawing on previous estimates of transfers within the American federation, Zumer (1998) showed that permanent transfers between regions are everywhere on a major scale. It also emerges from the brief recap of historical examples cited above that the quarrels over net budgetary balances and transfer amounts between federated states or between regions are nearly always accompanied by tensions or even

withdrawal resulting in secession or the break-up of the state entity in which the disputes arise.

II. The arbitrary nature of the methods used to calculate budget balances

Calculating the net budgetary balances of member countries of an integrated market or of an economic and monetary union may seem easy, but it is not in fact as straightforward as it looks. The apparent simplicity and intuitive nature of the calculations have a certain intellectual appeal. This impression proves to be incorrect on closer analysis. Calculating a nation's net contributions to the European budget – or net national budgetary balances – consists in totalling all the payments made by that country's State Treasury to the Union's budget – revenue from common "own resources" collected on its soil and contributions from its national budget voted in parliament – in the debit column and the total expenditure in favour of the country or its residents – payments to farmers, expenditure by regional and structural funds in favour of different regions, etc., in the credit column. In reality, however, budget balance calculations are based on questionable revenue and expenditure allocation assumptions and there are so many possible outcomes that interpreting them is very difficult.

Allocation of receipts

Allocating European budget receipts to the different member states can be fairly arbitrary, particularly as regards the geographical breakdown of "own resources". The same is true of customs duties and levies on extra -community agricultural imports which are paid into the European budget by the government of the member state whose customs and excise service collects these taxes, i.e. the government of the country which is the entry point for the goods which are subject to duty. A boost (purely in bookkeeping terms) to revenue artificially increases contributions to the European budget by certain States with ports serving as entry points for this type of import. Rotterdam and Antwerp in the Netherlands and Belgium are two main examples of such "ports of entry" into the Single Market. Together they account for a large percentage of total extra -community imports irrespective of final destination and of excise duties levied on this type of import. According to a study by the European Commission, nearly 50% of goods on which excise duty is levied at the ports of Antwerp and Rotterdam are destined for other European Union countries 7. Who would consider giving Le Havre or Marseille credit for contributing VAT to the French national budget on imports entering France via these ports?

Funding the European budget through national contributions via the main sources of European budgetary revenue (charts 2 and 3), namely VAT and national GDP contributions, poses a different set of problems and the amounts in question are equally subject to differing interpretations. The GDP contribution, which in 2005 represents more than 70% of total European budget revenue, is calculate d each year on the basis of a closing balance. The amount to be funded after receipts from other "own resources" is divided up among the different member states according to a predetermined percentage of GDP. These GDP -based contributions are then factored into the national Finance Bills of the individual countries, are approved by the national Parliaments and are remitted by the governments on the basis of European expenditure forecasts. This gives rise to a considerable amount of jockeying for position by both national governments and the European Commission and to the manipulation of statements and declarations, which do not always reflect the truth. The various governments in recent years have nearly always overestimated their projected payment to the European budget in the initial Bill, which they put to the vote in their respective Parliaments. The Commission, meanwhile, has generally done its utmost to contain expenditure to below the corresponding credit allocations in order to convey an image of proper stewardship of the funds entrusted to it. As a result, a certain percentage – often nearly 10% in recent years – of the contributions initially approved by national Parliaments has in the end been reimbursed to national budgets.

Allocation of expenditure

The geographical breakdown of Community expenditure also exhibits differing degrees of arbitrariness. The Commission has even abandoned trying to allocate some categories of expenditure, such as certain administrative expenses or spending related to common external policy, to individual member states. Despite the highly questionable nature of this exercise, the calculation of net balances is still firmly rooted in

assumptions about the geographical allocation of Community expenditure. Some types of expenditure, e.g. agricultural, are fairly easy to assign to a beneficiary country. It should be pointed out that we are dealing here with the initial direct impact which has no bearing on the geographical location of the ultimate beneficiary or beneficiaries of this expenditure. For example, do support prices for a particular agricultural activity actually benefit the farmers remunerated for their output or the suppliers of inputs – fertiliser, seed, animal feed, machinery, etc. (see below)? For many European programmes, even this exercise in geographical breakdown or allocation to a particular country in terms of direct impact is dependent on a set of highly arbitrary and therefore highly questionable conventions. The arbitrary nature of the geographical allocation of European expenditure can be illustrated by European programmes such as Socrates -Erasmus, under which exchanges of students between member countries of the Union are organised and financed and also by PHARE and Tacis, aimed at financing technical assistance to candidate countries or neighbouring non-member countries. Do student exchanges benefit the state of origin of students leaving to study in another member state or the latter country? Does technical assistance for future EU members or third-party countries, nearly always provided by western European companies or experts drawn from the Fifteen, benefit exclusively or even mainly the countries that receive it?

We see how difficult if often not impossible it is, to break down expenditure by beneficiary member state except in very special cases, which are quite rare anyway given the numerous and strong linkages that the framework features. Net national balances therefore differ significantly for some countries depending on the chosen classification of expenditure: geographical or other breakdown. The way common administration expenditure – a substantial proportion of which is incurred by Belgium and Luxembourg –is allocated drastically reduces the net negative balances of these two countries, transforming them into net beneficiaries of the European budget (Table 2 and Lefebvre, 2004a)[8]. But does such allocation mean anything? What would be said if there was a common defence system? How would the beneficiaries of a defence budget be identified?

Table 2. Net budget balances according to two different ways of allocating Community expenditure, 2003

	Net budget balances (2003)	
	"British cheque" definition (including administrative expenditure)	"Operational" definition (excl. Administrative expenditure)
	% of GNI (after British cheque)	
BE	0,59%	-0,28%
DK	-0,14%	-0,11%
DE	-0,40%	-0,36%
EL	2,17%	2,20%
ES	1,14%	1,19%
FR	-0,15%	-0,12%
IE	1,37%	1,38%
IT	-0,10%	-0,06%
LU	3,99%	-0,26%
NL	-0,47%	-0,44%
AT	-0,19%	-0,15%
PT	2,67%	2,71%
FI	-0,05%	-0,01%
SE	-0,40%	-0,36%

Source: European Commission.

Accounting principles and divergent results

As could be expected given the preceding sections, different accounting methods and principles give significantly divergent results. Merely including, or excluding, administrative expenses in the calculations

considerably alters the final result (Table 3, see Lefebvre, 2004a; Gaillard and Sutour, 2004).

Table 3. Net national contribution payments and bilateral trade balances of net contributor countries, 2003.
[…]

Given the uncertainty caused by the accounting conventions and such widely divergent results, interpreting the figures provided by the different protagonists is not easy, with each country seeking to gain the maximum advantage from them according to its situation and circumstances. These indicators therefore cannot in any way be considered a measure of an individual country’s net gains or costs under the EU budget. At best, they provide a very partial and arbitrary indication of the budget’s repercussions on the ground. As might be expected, the rankings of net contributors and beneficiaries vary each year, regardless of whether they are measured in absolute terms expressed in euros, or in per capita terms, or as a percentage of GDP or GNI, etc. Yet each of these benchmarks would have some justification if the concept of "net balance" had an economic basis, which the next section in this report disputes.

Chart 10. Net balance s by country expressed in different units (2003)
[…]

II. Critical analysis of net balances from an economic standpoint

More questionable than the arbitrary nature and potential range of accounting principles underpinning the calculation of a country’s net balance is the concept of the net balance itself. Tax levies, which fund any budget, and expenditure, which is in turn financed by the same budget, have knock-on effects on the economy. As a result, actual tax burdens and actual final expenditure benefits are never those portrayed by public accounting methods in isolation. In fact, most European integration processes and Community policies financed by the EU budget belong to what economists call "Pareto improvements"(9)- that is, they generate 'mutual benefits'. If by chance some countries or regions are losers on one particular issue, the overall net gain is, so to speak, sufficient to offset their losses. These processes are therefore "positive sum games", with the sum of the winners’ gains always representing more than the losses suffered by the losers.

The impact of indirect taxes in a single market

The impact of indirect taxes within a set of more or less competitive markets is a complex issue. There is, generally, a difference between what can be called the "immediate" or apparent impact and the final impact, i.e. the actual distribution of the financial burden of the tax charges once all the relative price adjustments have been made. Thus, for example, in a small open economy the national choices of which do not influence world demand and by extension world prices of traded goods, any indirect tax, e.g. customs duties, VAT, excise tax, is borne entirely by the domestic consumers. Customs duties charged by a major economy, on the other hand, are partly borne by the exporters of the rest of the world, since the resulting decrease in demand for the goods taxed in the major economy reduces international demand leading to lower world prices for these goods.

What holds true for national contribution payments to the European budget also holds true for the indirect taxes which fund them. Who bears the actual financial burden of the customs duties levied at the main entry points on the EU borders? Markets for the products in question being competitive, consumers throughout the EU shoulder the cost. To take a recent example - who benefited from the quota protection maintained by the EU on textile imports from Asia until January 1st, 2005? The answer is all textile producers with unrestricted access to the European market: the European textile industry, of course, and probably to an even greater extent countries with special trade agreements with the EU, e.g. Morocco, Tunisia. Regardless of their country of residence, European consumers, in the meantime, had to pay slightly higher prices, if it is assumed that the textile market is reasonably competitive. They should therefore benefit now following the recent liberalisation of imports. Detractors of the Common Agricultural Policy (CAP) used a similar argument many times. They denounced the induced cost to the consumer, particularly in non-agricultural commodity producer countries. It is surprising that they should often be the ones to resort to net budgetary

balance measures, oblivious to the obvious contradiction between the two approaches, one economically justified and the other not.

Adding liquidity to markets and knock-on effects on demand and growth

One of the direct effects of intra -country transfers is to add liquidity to the beneficiary's market, which, among other categories, benefits the corporate sector in contributor countries. Subject to an appropriate choice of expenditure, the resulting incremental spending in beneficiary countries will in aggregate terms have a direct knock-on effect on growth in beneficiary countries and an indirect knock-on effect in contributor countries.

Expenditure financed by European policies, particularly that which is funded by the structural and cohesion funds, is generally earmarked for infrastructure investment projects, particularly in transport. These projects are usually awarded through European-wide tenders (the public contracts code requires the process to be open to all bidders within the Union) to European companies which may be from other countries that are net contributors. In its third Cohesion Report, the European Commission estimates that 20 to 25% of such contracts in the "cohesion countries" (Spain, Greece, Ireland, Portugal) are won by large corporations, particularly construction companies, based in contributor countries.

At an even more aggregated level, in an internal market where the bulk of trading activity is between European partners, the demand triggered in the beneficiary countries by European expenditure is partly directed at companies in contributor countries. These companies therefore benefit from the enhanced demand. the effect is theoretically strong in the case of spending by the structural and cohesion funds. Firstly, this expenditure usually entails additionality clauses, which require the national governments and local authorities to supplement the resources provided by the EU. Secondly, the funding goes to countries and regions having a lower than average per capita income. So their marginal propensity to spend is probably higher than in contributory countries (Le Cacheux, ed., 1996; Jouen, 2005).

Demand in beneficiary countries is more liquid as a result of these budgetary transfers, and in most cases this makes it possible to finance large trade deficits on a long-term basis (see Table 4). Meanwhile, the intra -Community trade surpluses of the main contributor countries reflect, at least partially, the incremental demand for their exports. This releases the member countries with below average economic growth from the external financial constraint that threatened them, with a further possible relaxation of that constraint as European public sector financing attracts private capital flows and foreign direct investment. This seems to have happened in the successful catch-up by the "cohesion countries" in recent decades. Synergies between public and private funding10 place beneficiary countries on a higher growth path whenever the expenditure has positive repercussions on the productivity of productive private capital in these countries. One of the knock-on effects of this process is increased demand for trading partners' goods and the increased economic growth of these partners' national economies.

If we make reasonable assumptions about the multiplier effect of public spending within the framework of the European Union macroeconomic model, generous structural policies towards countries that lag in terms of economic growth - especially the ten new members that joined the EU on May 1st, 2004 (particularly the CEEC countries) and also Bulgaria and Romania that are preparing to do so - are likely to have major knock-on effects on the exports and on the production capacity and productivity of beneficiary countries and consequently on the income of their residents. These effects are likely to generate incremental economic growth in these countries and induce sufficient additional growth in the other EU member countries for the resulting extra public revenues – with indirect tax rates held constant – to be enough to finance additional transfers to the beneficiary countries. In other words, the additional expenditure would be self- financed[(11)].

Chart 11. GDP of 'Cohesion Countries', 1994-2005 (EU15 = 100)
[…]

The timescale dimension

When the positive fall-out for the growth profile of member countries benefiting from budgetary transfers is factored in, the configuration of net balances at any given moment does not appear fixed, provided the structural policies are effective. The countries which lag behind in development terms should, given the rules for national contributions (basically proportional to GDP) and the eligibility criteria for most European budgetary expenditure (also calculated in terms of GDP usually per capita GDP, in terms of the EU average), catch up as a result and subsequently themselves become contributors to the European budget. The examples of Ireland, the progress of which has been the most spectacular, and of Spain, can be mentioned in this connection.

A parallel comparison using a cross sectional and diachronical analysis over time of national tax and public expenditure systems and their consequences on individuals shows that if EU national economies are characterised by "life cycles" or "stages of growth" (see Rostow) then the structure of the European budget implies a changing distribution of net balances over time.

Additionally, the European budget can also provide insurance by protecting against cyclical fluctuations and by the Union assuming the cost of certain exceptional expenditure items. In the former case, the central budget both in a single and a federated state system acts as a built-in stabilizer against a specific economic shock or, more generally, asymmetric growth of national economies, as illustrated in numerous recent works on economic stabilisation in monetary unions founded upon the theories of "financial federalism" and "optimal currency zones" (see particularly Zumer’s recap of empirical results, 1998). In both cases, budget mechanisms spontaneously lead to wide swings in annual net balances. For example, Germany's net balance in 2002 shrank significantly compared with previous and subsequent years (see Table 9) because of summer floods. Any potential automatic economic stabilization is hardly noticeable in the EU budget’s case, as the effects would barely be felt because the budget is so small and because the structure of revenue and, even more of budgetary expenditure , shows little sensitivity to economic conditions and so rules out any stabilizing role.

Collective European “goods” and their financing

Adopting the reasoning behind the "financial federalism" theory as applied to the concept of European integration and described in the MacDougall Report (European Commission, 1977), we can draw up a list of "European public goods" on the basis of what is essentially a political choice. An effective supply of these “goods” is only possible if collectively organised and financed by mandatory contributions. There are many feasible methods but they must give member state governments enough incentive to pro vide a sufficient supply of collective “goods” of adequate quality to satisfy the preferences of the “club” of participating countries (Buchanan, 1965). The basis for pooling certain instruments of intervention and regulation in policy areas such as currency, trade, foreign affairs and defence, border police and immigration is to be found in the recognition of the collective nature of these EU “goods” either because major economies of scale obtained by pooling lead to efficiency gains or else because joint financing is necessary, as the benefits to individual member states of common policies cannot be accurately evaluated. Nevertheless, an analysis on the basis of "the logic of collective action" (Olson, 1965) indicates that the encouragement of opportunistic free-rider behaviour, compromises the provision of the proposed collective “goods” if adequate financing is lacking (see also Oates, 1999; Le Cacheux, Collignon, 2004).

In all these cases, some scope for substitution between EU and national expenditure, exists so that the supply of a collective “good” at the European level and its financing through levies on member states, regardless of the exact methods used, should lead to an overall net savings in public resources for the entire Union.

The Union’s apparent choice of a decentralised federalism in the name of the principle of subsidiarity taken to its logical limits, as seems to be the case today, is an original option and feasible in certain conditions. It has implications, though, for the structure of the European budget and its funding (Le Cacheux, 2004b). Under this option, the European budget would become a genuine instrument of the Union’s political action whereas the member States would themselves provide collective “goods”, e.g. defence, on a decentralised basis. In this case, the main expenditure items would be financial incentives (subsidies) paid to national governments and/or regions (as is the practice today in European regional and structural policies) to

encourage them to adopt expenditure op tions in conformity with the Union's collective preferences in the provision of European "collective goods" (e.g. defence, research, any public policy fostering EU growth, see Le Cacheux). As it would be designed to lower the marginal tax cost of the public expenditure that the Union is trying to encourage (according to "Pigouvian"[12] principles), such expenditure would be conditional on additionality arrangements. The concept of national net balances, already somewhat irrelevant in the current European budgetary context, would under such circumstances lose all justification.

IV - Financial solidarity: basis and implications

The economic and political logic for European integration and the collective management of Community policies is inspired by the theory of collective goods and taxes. From it we can deduce a number of basic principles as regards the funding of budgets such as that of the EU.

Common budget, common policies and public "goods"

The idea that certain actions, policies, goods and public or collective services are better done acting jointly than separately for a variety of reasons (see the discussion in the preceding section of this document) is key to the decision to pool resources in order to finance common policies and create a common budget in an institutional environment heavily influenced by subsidiarity. The principle of subsidiarity itself stems from the concept of "community added value", which narrows the scope of joint action to sectors and activities where the EU is more effective than the member states acting independently would be. As it is clear that the various sources of revenue and the various items of expenditure under a common budget are governed by specific rules, have complex economic consequences and entail various incentives, the way funds are levied must be clearly dissociated from the geographical distribution of budget expenditure, which is rarely attributable in the final analysis to any particular agent and therefore to any member state (see also, the recommendations of the *Sapir Report*, 2004[13] on this subject).

As the founding fathers of the American Constitution (Madison, 1788) and later, Tocqueville (1835), in his comments on the American Federation and its economic and political effectiveness, pointed out, the contributions of individuals and/or of federated States to a Union budget can only be determined by a political institution that enjoys true legitimacy and genuine decision-making power. In the United States, Congress had *unlimited* power to raise taxes from the outset. What makes the EU system difficult14 to operate is the combination of contribution payments calculated for each individual nation and decision-making on a unanimous basis by all the member states15. Indeed, as Wicksell demonstrated long ago (1896), while the unanimity rule safeguards individual members' interests at all times, thus ensuring compliance with what could be called the " principle of integrity ", it is practically always at odds with collective decision-making, as agreement is possible only on the basis of the arrested common denominator (Buchanan and Tullock, 1962; Laurent and Le Cacheux, 2005). To be effective and fair, decisions on the European budget and its financing should take their cue from the rules established by John Rawls (1971), namely that general principles and decision-making procedures for budgetary expenditure and its funding should be determined from behind a "veil of ignorance". First, in other words without knowing the resulting economic condition for each member state, which is tantamount to simulating unanimity and then complying with the budgetary choices made by these institutions.

There are two, sometimes contradictory, approaches to determining any budget's resources: contributory capacity and equity, on the one hand, and incentivisation, on the other. The former implies that the contribution of each member of a public or private organization or institution, e.g. a club, to funding common tasks considered beneficial for the community is dependent on its financial situation, which is usually assessed on the basis of current income. The latter approach makes payments to a common budget dependent on individual choice, particularly choices about consumption, that may bear no relation to the contributors' economic resources. Each member's total contribution is determined by a combination of these two approaches. The same very much applies to the determination of expenditure. Some expenditure reflects an "economic" approach usually involving incentives, while other expenditure reflects a "distributive" (mostly redistributive) approach.

Similarly, on the expenditure side, the basis on which the amounts are decided is very diverse, with the national dimension prevailing only on rare occasions. Expenditure apportionment under the Common Agricultural Policy or R&D policy is governed by various criteria that are supposed to reflect the objectives which these policies pursue and not primarily the distribution of expenditure between Member states. In the absence of this, the danger is one of adopting criteria for deciding common expenditure that have little to do with the stated policy objectives. The most striking example of this anomaly occurred when changes to the criteria for allocating EU structural funds were skilfully negotiated at the 1999 Berlin Summit solely for the purpose of arriving at a net balance configuration acceptable to all (see box). Because of the unanimity rule, negotiations that concentrate on net balances alone nearly always end up with another round of expenditure allocation the only of which purpose is to correct the net balance of an individual member state that considers it has been unjustly treated by a compromise that was shaped by decisions on expenditure(16). At the 1999 Berlin Summit, all the member states except Denmark and France had to be awarded last minute made-to- measure “compensation” in this way. More recently, a thousand million additional euros were awarded to Poland in 2002 at the time of accession negotiations (see the conclusions of the Copenhagen Summit).

Structural fund calculations the « Berlin Formula

At the 1999 Council meeting in Berlin, the member states decided upon a particularly complex method for calculating annual aid payments to eligible regions in 4 steps:
- calculation of the difference between the regional GDP per capita and the European average –
- determination of a regional disparity indicator: 1.05% for regions where GDP per capita was lower than 64% of the EU average; 1% for regions with a GDP/inhabitant of between 64% and 67%; 0.5% for regions with GDP/inhabitant of above 67% (but lower than 75%);
- determination of a national prosperity coefficient: 5% for countries with net per capita income belong 75% of the EU average; 4% for countries with net per capita income between 75% and 90%, 3% for countries with net per capita income higher than 90%; above average unemployment in regions eligible under the convergence objective.
Annual aid for eligible regions = difference between the regional GDP per capita and the Europe an average X regional disparit coefficient X national prosperity coefficient + 100€ for each unemployed person above the average for the regions eligible under the convergence objective.

Avenues to explore regarding the European budget

In order to dispel the misleading appearances and to avoid the anomalies and many distortions characterising negotiations dominated solely by net balances calculated using arbitrary conventions and nearly always flawed economic logic, it is essential that discussions on European budgetary questions successfully dissociate funding from expenditure appropriation. Spending should be defined in the light of the objectives of the EU’s various Community policies.

As for the basis for funding operations, it is probably advisable to distinguish what is desirable from what is possible. It seems unlikely that the EU’s financial autonomy can be increased by providing it with truly dynamic own resources over which it has some decision-making powers through its Parliament in the near future. In short, a European tax, however desirable, does not appear to be around the corner (SGES, 2005). Attention should therefore be directed firstly at the way national contributions are determined. Changes in the procedure are needed to prevent the issue of the joint funding of Community expenditure degenerating into bargaining over each member’s contribution to the kitty.

Appointed by the Council to make recommendations on European budget resources, the Commission had put forward a proposal along the lines of the separation recommended here on the eve of the Berlin Summit (1999). It suggested that national contributions be calculated according to each country's capacity to pay, i.e. on the basis of each member State’s GNI. At the moment, contributions are proportional to GDP, which is not quite the same thing (17).

Whilst this method of determining national funding, which perhaps enjoys the most support, could be viewed as a substantial improvement on the current situation, it is nevertheless unlikely to be a permanent solution to the problem of financing common policies, especially if these become increasingly numerous and ambitious. Moreover, retaining the system of national contributions, regardless of the mode of calculation

used, makes the concoction of "net balances" easier and enables national governments to pursue their individualistic strategies further. We have tried to show here how harmful these are to the pursuit of the Union's common objectives.

Longer term, the emphasis will undoubtedly have to be on genuinely providing the Union with its own resources, implying one or other form of European tax, if it is to be given the capacity to pursue common policies and provide collective goods and services. This means that member states will be relieved of having to fund national contributions to the Union budget or policies for which the responsibility will have been transferred. They will be able to reduce their national tax levies commensurately or by an even greater proportion given potential economies of scale. What would constitute a good European tax? This question has been the subject o f much thought (Sterdyniak et a l, 1991; Le Cacheux, 2004a; European Commission, SGES, 2005) and there is a long list of possible candidates. Apart from the need for equity, economic logic dictates that a European tax should be as compatible as possible with the mechanisms of the Single Market and refrains from distortion competition. It could also contribute to the continued pursuit of common objectives, such as preserving the environment. On these criteria, the best candidates would seem to be a European tax on corporate profits, a European VAT or a European tax on the consumption of fossil or other fuels (18).

Conclusion

As we demonstrated above, European integration is not a zero sum game. The fact that there is a Community budget means that some redistribution is unavoidable unless the budget is reduced to nearly nothing. The calculations and reasoning on which negotiation stances are based, particularly the well-publicised issue of "national net budget balance" calculations, appear to be flawed, firstly because of arbitrary, changeable and therefore often questionable accounting methods for calculating contribution payments as well as expenditure secondly because the logic of "net contributions" flies in the face of economic analysis which dictates that the actual financial charges and economic benefits of taxes and transfers are never what they appear to be at first sight and finally because the "net contributions" logic is based on the erroneous assumption that European integration generally, as well as , more specifically, common policies financed by the European budget, are "zero sum games" in which gains on one side necessarily mean losses on the other. Yet the integration process is founded on the principle that it is in fact a "positive sum game", as trade becomes liberalised and as a large domestic market opens up, the benefits of which have been clearly demonstrated by economic analysis (but which, for some, may engender losses that need to be compensated on a collective basis) and also as common policies delivering gains for all are implemented. These policies can take the form of either economic policies, which promote growth across the entire Union, or policies for supplying "European collective goods" in areas as diverse as trade, foreign affairs and national security, or any other area to which Europeans would want the EU to extend its competencies in the future.

[…]

(1) The capping of European budget's total resources was adopted in 1988 under the "Delors I" Package as a way of halting the apparently excessive growth of the European budget. It was initially set at 1.27% of GDP, which corresponds to 1.25% of GNI.
(2) The same happened in the United States after the adoption, in 1788, of the American Constitution, a point emphasised by Tocqueville (1835), who saw it as an essential ingredient of the success and dynamism of the American federation.
(3) A factor that probably proved decisive in the funding of fast-growing national or federal budgets was the widespread introduction, between the middle of the 19th and early 20 th centuries (1842 in the UK, 1914 in France) of direct taxation of individuals' total income levied at their place of residence. Not as geographically identifiable as indirect taxes, e.g. customs duty and other transit levies, tolls, etc., general income tax on individuals has, in the places where it was adopted, undeniably helped to reduce disputes over the sharing of public expenditure funding. See Schremmer, 1989, in particular.
(4) The control of natural resources, the income which they generated and taxes levied on the income were a t the heart of the conflicts within the Russian Federation, notably as regards Tatarstan and Chechnya.
(5) See Harasty and Le Cacheux, 1994.
(6) Several studies estimating the "net balances" of the different Länder were published in Germany during the 1990s. See: DIW, 1996.
(7) Verbecke, Haralambides, Van Klink, Veenstra and Winkelmans, 1998. The authors emphasise that this figure is obviously an understatement as it excludes goods, which undergo only slight reprocessing in Belgium or the Netherlands, before re -export to other European Union countries.

[8] "Operating Balances" are obtained by taking into account "attributable" expenditure as well as "operational" expenditure, i.e. excluding common administrative spending.
[9] From Vilfredo Pareto, an early 20th century economist who formalised this analysis and showed that many economic transactions present these features.
[10] A recent study (DREE, 2004) suggested that the share of public and private cofinancing of programmes under the structural funds in the new member states slightly exceeds 80% during the period 2004 -2006. Estimating a ' rate of return ' at French companies of slightly less than 10%, the study concludes that the "return" for the French economy should be around 2 billion euros for the period.
[11] For a description of this scenario as it applies to the CEEC, see Le Cacheux, ed., 1996. Admittedly this assumes that expenditure projects financed by structural funds are carefully screened to properly ensure the enhanced growth potential of the beneficiary countries. Less optimistic scenarios reminiscent of what has happened in Italy under the Mezzogiorno for several decades or in post-unification Germany naturally lead to less optimistic conclusions about the self-financing nautre of these transfers. But in all cases, there has been a positive effect on demand and, by extension, on the exports of partner countries in those cases where the countries in question have experienced under-employment. Several empirical studies in the last few years have tried to es timate the effects in the case of regional European policies. Apart from the surveys by the European Commission in the Cohesion Reports , we also mention Martin 1998; Fayolle and Lecuyer, 2000; Dall'erba and Le Gallo, 2003. The latter study explicitly tasks account of "neighbouring area effects" i.e. spill over effects into areas adjoining those which benefit from transfers.
[12] The British economist Alfred Pigou, working in the first half of the 20th century, laid the analytical foundations on which these incentive mechanisms are based. They are to be found, for example, in the case of private sector players, in the "polluter pays" policy, and, within the public sector, in the proportional budget allocations to local authorities, e.g. infrastructure appropriations in France.
[13] For a critical reading of the Sapir Report and its proposals for an overhaul of EU budgetary expenditure, see Le Cacheux and Sterdyniak, 2003.
[14] Note that a proposal to abandon the unanimity rule in Community budgetary decisions was made by the European Commission and accepted by five of the six founder countries in 1965. It was the French government that opposed the motion with its notorious 'empty seat' policy when the French representatives refused to attend meetings of European institutions for six months. The crisis was finally resolved with the 'Luxembourg Compromise' under which it was decided that each member state could veto any proposal if it felt that its vital interests were threatened.
[15] And would do so to an even greater extent if the general adjustment system for net balances recommended by the European Commission – a systematic cap – were to be introduced. Under this, national governments would be encouraged to minimise Community expenditure booked on their soil in order to qualify for a maximum rebate.
[16] It was probably to prevent such bargaining that the Commission proposed a system for automatically capping national net balances. But as stated above, this system may have a perverse impact on expenditure choices because of the incentives involved.
[17] GDP and GNI often differ considerably in very open economies. The most striking examples within the EU are Luxembourg and Ireland the GDP per capita of which is much higher than the EU average, whereas the GNI per capita is close to the average. The gap in both cases is explained by revenues - mainly income from capital - paid to residents in the rest of the world.
[18] For a detailed analysis of these options, see European Parliament 2005. Whatever the circumstances, a European tax would not prevent member states which wished to do so from levying other taxes on the same tax base. This is quite common in existing federations, notably in the US where there is a federal and very often a state tax on corporate profits. see. Sterdyniak et al., 1991 ; McLure, SGES, 2005.