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Chapter 2

European Union Finances

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1. Introduction

An early exercise in economic integration in Europe was the Benelux Economic Union dating from 1944, when the Belgian, Dutch and Luxembourg governments in exile concluded a treaty to establish a customs union. Less than a decade later, another exercise in economic integration was initiated in the form of the European Coal and Steel Community (ECSC). This is one of the three predecessors of the European Union[1] (EU). It was founded in 1951 and based on a common market, common goals and common institutions. The second predecessor of the EU is the European Atomic Energy Community (Euratom), founded in 1957. And the third predecessor is the European Economic Community (EEC), also founded in 1957 (often referred to as the Common Market).

The EEC is often considered to be the very beginning of the EU, but this seems unwarranted given that there are three predecessors. Apart from the fact that the ECSC was the first predecessor to be founded, there are at least three reasons for considering the ECSC to be the most important of the three predecessors:

(1) The ECSC was a major and successful exercise in economic integration as part of the post-war drive for closer unity in Europe.

(2) It set up a series of institutions that, in modified form, continued to exist.[2]

(3) Underlying the drive for closer economic ties has been the parallel desire for political union.

In fact, the ECSC was an economic response to a political problem. Germany, which had triggered world wars twice in the twentieth century, was the crucial problem. The

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[1] I will use the term EU throughout the chapter, thus also before the EU was established and European Economic Community (EEC) was the proper term.

[2] Examples are the European Commission (which has the High Authority of the ECSC as its predecessor), the Council of the EU (with the Council of Ministers as its predecessor), the European Court of Justice, the European Parliament (which has the Common Assembly as its predecessor), and the Economic and Social Committee (with the Consultative Committee as its predecessor).

question was whether it should be allowed to revive in sectors such as steel and coal that are key to war efforts. By including Germany in the ECSC, it could be contained in Europe and the ECSC members (including Germany) would become interdependent in these key industries. The external threat to European democracies during the Cold War era ensured some internal coherence. Western European countries had in common the need to fight communism. Thus, anti-communism was a valuable adhesive factor. The collapse of communism changed this situation profoundly. Rather than being allied by a negative force – an external threat – European countries were now driven by positive factors leading to coherence and alliance (Van der Hoek, 1998).

The founding fathers of the supranational Europe believed that once European integration had begun (in the field of coal and steel), internal dynamics would push integration to comprise more and more fields, which would inevitably result in monetary and political union. However, this automatic integration mechanism worked out only partially. Economic integration allows, at least in principle, for quantification of the interests of the partners involved, and a difficult process of negotiations and exchange has led to results.

In the 1990s, the EU stimulated the process of European unification in several ways. It responded quickly to the collapse of communism in Central and Eastern Europe marked by the fall of the Berlin Wall in November 1989 and the collapse of the Soviet Union in August/September 1991. As early as December 1991, the EU signed Association Agreements with Poland and Hungary. These agreements formed the legal basis for bilateral relations between the EU and the associated countries. The Europe Agreements, as these agreements were called, offered trade concessions and other benefits normally associated with full membership of the EU. The aim of the agreements was to establish a free-trade area between the EU and the associated countries and, ultimately, to enlarge what was then still the EEC with new members in Central and Eastern Europe. In the next phase, Europe Agreements were also concluded with Bulgaria, the Czech Republic, Romania and Slovakia (1993); Estonia, Latvia and Lithuania (1995); and Slovenia (1996). The process was concluded by the accession of eight new Member States in Central and Eastern Europe in 2004,[3] followed by the accession of Bulgaria and Romania in 2007.

[3] At the same time two mini-states in the Mediterranean (Cyprus and Malta) joined the EU.

The EU also further developed its institutional settings, including the division of budgetary powers, which is quite complicated. The European Commission, the European Parliament and the Council of the EU have different roles and powers in deciding the budget. In its role of proposer, the Commission submits the preliminary draft budget to the Council of the EU. Next, Council and Parliament must work on the basis of this proposal. The Council has the final word on compulsory spending, which covers all expenditure resulting from international agreements and the EU treaties. From 1975, however, the Parliament has the final word on non-compulsory expenditure, which is classified as all other spending. The budget is subject to approval by the European Parliament, and its president signs the budget into law.

In particular after 1979, when the European Parliament's legitimacy was boosted by direct elections, the European Parliament has struggled for more powers. Step by step it has increased its competences, thereby gaining power and importance. The budgetary procedure allows it to propose modifications and amendments to the European Commission's initial proposals and to the positions taken by the Member States in the Council of the EU. In the past, the European Parliament has voted to reject the budget when its wishes had not been adequately respected. Monitoring of expenditure is the continuous work of the Parliament's Committee on Budgetary Control, which is supposed to seek to make sure that funds are spent for the purposes agreed and to improve the prevention and detection of fraud. The European Parliament makes an annual assessment of the Commission's management of the budget before approving the accounts and granting it a discharge on the basis of the Annual Report of the Court of Auditors.

In terms of the budget the EU has always been focused strongly on the Common Agricultural Policy (CAP). The CAP is clearly a supranational policy, but other policies were essentially intergovernmental in nature and reflected the reluctance of Member States, particularly of France and the UK, to allow Rome Treaty supranational powers to spread to other issues. Only in recent years the share of agricultural spending in the EU's budget has substantially declined and the relevance of other policies has increased in terms of their shares in the budget.

The rest of this chapter deals with the EU's budget in more detail. Section 1 considers the budget from the perspective of the branches of government. Section 3 analyses the revenue side and section 4 the expenditure side of the budget. Section 5 considers the problem of the budgetary balances. Finally, section 6 presents a summary.

2. The EU Budget[4]

Traditionally, three branches of government are distinguished in a mixed economic system:

(1) *Allocation branch*

This branch pertains to the influence of government on the use of the factors of production. The market is unable to provide for certain goods and services, in particular public goods. This is called market failure. Another possibility is that the market does work, but not very efficiently, for example due to externalities, monopolies, etc. In these instances, which are called market imperfections, government intervention may lead to a more efficient market outcome, in particular if the government is able to abolish externalities or monopolies or to regulate them effectively.

(2) *Distribution branch*

This branch pertains to the government's influence on the size distribution of real incomes. In the nineteenth century, the prevailing view in Europe was that governments should leave the income distribution as it resulted from the production process. Governments were focused on distribution-neutral taxation. But in particular after World War II, European governments assumed responsibility for the size distribution of incomes.

(3) *Stabilization branch*

Since Keynes we know that government, at least in theory, can bring about a macro-economic equilibrium. In the Keynesian view, public expenditures and revenues are considered instruments of macro-economic policy. Key to this branch is the circular flow effect – that is, the government's influence on aggregate supply and demand.

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[4] The European Commission held a conference on budget reform in April 2008. The conference papers and presentation have been published on the web <http://ec.europa.eu/dgs/policy_advisers/discussions_papers_en.htm>.

Although all three branches apply to each of the EU Member States, only two branches apply to the EU: the allocation and the distribution branches. The allocation branch is particularly applicable in the case of externalities, monopolies and public goods that the EU could deal with more efficiently than individual Member States. Concrete examples are cross-border pollution and cross-border crimes, monopolies of multinational enterprises (e.g., Microsoft) and peacekeeping operations.

The distribution function also applies to the EU although to a more limited extent relative to individual Member States.[5] While Member States assume responsibility for the primary, secondary and tertiary income distribution, the EU aims at convergence between regions by spending structural funds. Inghelram (2007) argues that the redistributive function is associated with the EU's convergence objective. Gros (2008) states that there are 'two principal justifications for EU spending: re-distribution and providing European-wide public goods'. Feld (2005) observes that empirical evidence of the EU's distributive impact is diverse. However, he concludes that the structural funds do not achieve income convergence between regions, but rather redistribute income from the rich to the poor EU Member States, although rich countries still receive funds for their poor regions.

The stabilization branch does not apply to the EU for two reasons: an institutional and a practical one. The institutional reason is that the EU is legally obliged to balance its budget. Article 268 of the Treaty contains the following statement: 'The revenue and expenditure shown in the budget shall be in balance.'[6] Consequently, the EU cannot run a budget deficit. The practical reason is that the EU budget has always been small relative to the EU's Gross National Income (GNI). The EU's actual budget size amounts to approximately 1% of EU GNI.[7] The payment appropriations in the 2008 budget amount in absolute terms to EUR 120 billion. This compares to a 2008 budget of EUR 209 billion of the central government of the Netherlands alone. Thus, the mere size of the EU budget

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[5] Feld (2005) argues that the EU has no role in income redistribution on the basis of political economy arguments, although the EU assumes responsibility in practice.

[6] <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2006:321E:0001:0331:EN:PDF>.

7 See <http://ec.europa.eu/budget/reform/issues/article_5957_en.htm>.

makes it impossible for the EU to fulfil the stabilization function through the EU budget.[8] Rather, it should be done through the national fiscal systems of the Member States. The EU can only play a role in fulfilling the stabilization function by policy coordination. In fact, this is what the EU does, in particular in the framework of the Stability and Growth Pact. 'There is a broad agreement that common supranational fiscal rules are necessary to address the risk of spillovers from domestic fiscal policies. A framework to coordinate fiscal policies is thus seen as instrumental' (Jonung, Larch and Fischer, 2008).

3. Revenues

Until 1971, the EU was entirely financed from financial contributions by the Member States. The first own resources were introduced in the period 1971–1975 mainly in the form of customs and agricultural duties collected under the rules of the customs union. These revenues are own resources because they are allocated irrevocably to the EU without the need for any subsequent decision by the Member States' governments. Many proposals have been put forward to introduce an EU tax in one form or another, such as an energy consumption tax and a tax on internationally mobile activities. However, none of these proposals has ever been adopted. Thus, there is no EU tax imposed directly by the EU, which reflects the fact that taxation is in the heart of Member States' national sovereignty (Van der Hoek, 2003).

Currently, the EU budget is financed from the following three own sources of revenue (for 2007, the shares in total revenues):

Traditional own resources	15%
Value Added Tax (VAT) based resource	15%
GNI-based resource	69%

The traditional own resources were introduced in the period 1971–1975 and consist mainly of customs and agricultural duties. [9] Revenues from the traditional own resources increased until 1978, declined in the period 1978–1983, increased somewhat again in the

[8] Von Hagen & Hammond (1998) refer to the MacDougal Report from 1977, which estimates that an EU budget of at least 7% of EU GDP is necessary to pursue a stabilization policy effectively. This is seven times larger than the current size.

[9] Member countries can retain 25% of all duties as a compensation for their collection costs. This represents a net decrease of the financial contributions to the EU budget of Member States collecting a large share of customs duties at important EU entry points because the actual collection costs are significantly lower than 25%.

period 1983–1993 and decreased continuously after 1993.[10] Revenues from the VAT-based resource started to flow in 1979 and soon became the EU's primary source of revenue. However, its significance started to decline in the late 1980s. The VAT-based own resource is not a straightforward fiscal resource representing a certain percentage of VAT collected in each Member State. Rather, it is a contribution from Member States that is calculated on the basis of a harmonized VAT assessment base and a uniform rate. The GNI-based resource was introduced in 1988 and became rapidly the EU's primary source of revenue.

The traditional own resources are nowadays the relatively smallest revenue category. The reason is that customs duties decreased as a result of continued trade liberalization, while the EU budget continued to increase. Although the VAT-based own resource was already introduced in 1970, it did not yield revenues until 1979, when a harmonized calculation base was agreed upon. The introduction of this resource mirrored the wish that richer countries would pay more into the EU budget. However, the VAT-based resource's significance was reduced later on through a reduction of the percentage of the VAT base paid and a capping of the VAT base (currently, 50% of GNI). The introduction of the third (GNI-based) resource[11] was intended to complement the existing own resources. However, due to the reduced yield of the traditional own resources and the diminished significance of the VAT-based resource, the GNI-based resource has become the EU's single most important own resource. Obviously, the revenue structure changed profoundly in the course of time.

The GNI-based resource will gain somewhat more in importance until 2013 at the expense of the traditional own resources and in particular of the VAT-based resource. However, the financial perspectives 2007–2013 do not foresee a major further change in the revenue structure.[12] Interestingly, the current revenue structure resembles the EU's financing method as it existed before the own resources were introduced. Until 1971, the

[10] See for the development of the shares of the own resources in the period 1958–2008: <http://ec.europa.eu/budget/reform/history/history1957_en.htm>.

[11] The GNI resource is sometimes referred to as the fourth resource because after the introduction of the VAT-based resource the own resources were divided into three categories. This was due to the fact that the traditional own resources were divided into two distinct categories: agricultural levies and customs duties. However, this distinction is now obsolete.

[12] See for the revenue structure in the period 1988–2013:. <http://ec.europa.eu/budget/reform/issues/article_5957_en.htm>

EU was entirely financed from financial contributions from the Member States, while there is hardly a difference between these contributions and the GNI-based own resource.

4. Expenditure

The first EU budget was adopted for 1958 and covered only administrative expenditure.[13] The European Agricultural Guidance and Guarantee Fund (EAGGF) was launched in 1962, and agricultural expenditure soon made up the majority of the budget. Although existing policies were strengthened – in particular the European Social Fund and the European Regional Development Fund – and new policies were implemented – such as the common fisheries policy, the first research framework program and the integrated Mediterranean programs – the share of agricultural spending in the budget continued to grow until the late 1980s. From the early 1990s, a larger share of the budget was allocated to cohesion policies, while the Maastricht Treaty (1992) introduced a range of new policy areas including common foreign and security policy and justice and home affairs. The share of agricultural expenditure slowly diminished from the early 1990s.

There has been a marked development in the shares of the most important policies in the budget in the period 1988–2013.[14] The share of the CAP will have nearly halved in 2013 relative to its share in 1988. The share of the Cohesion policy will have almost doubled in 2013 relative to its share in 1988. And the share of other policies will have more than tripled in 2013 relative to their share in 1988. Thus, in a quarter of a century the expenditure structure will have changed profoundly.

As mentioned in section 1, the European Commission, the European Parliament and the Council of the EU play a role in the budgetary process. Through an interinstitutional agreement, they agree in advance on the main budgetary priorities for a period covering a number of years, thereby establishing a framework for expenditure in the form of a financial perspective. The first interinstitutional agreement was concluded in 1988 for the application of the 1988–1992 financial perspective. Since then, the financial perspectives have been updated in 1992 for the period 1993–1999, in 1999 for the period 2000–2006 and in 2006 for the period 2007–2013. The financial framework may be revised in

[13] See for the development of expenditure over the period 1958–2008: <http://ec.europa.eu/budget/reform/history/history2007_en.htm>.

[14] See for the data: <http://ec.europa.eu/budget/reform/issues/article_5957_en.htm>.

response to any initially unforeseen circumstances. Each year the Commission makes technical adjustments to the financial framework. First, it recalculates the financial framework using the prices of the following financial year and total credit amounts on the basis of a fixed deflator (of 2% a year). Second, it calculates the margin available under the own resources ceiling. Obviously, the total appropriations remain well below the ceiling of 1.24% of GNI.

The budget consists of two parts: commitment appropriations and payment appropriations. The former are the amounts authorized that can be reserved in a given year for programs or projects (budgetary commitment). Appropriations for payments are the amounts authorized for actual money that can be used in a given year to honour obligations stemming from a budgetary commitment. The level of commitments determines the payment level for the upcoming years, which to a certain extent will mechanically reflect the impact of legal obligations entered into during previous years. The level of payments represents the actual cash outlay during a budgetary year and, therefore, the amounts that need to be financed by own resources. Generally, payments tend to be somewhat lower than commitments.

Table 2.1. Overview of the Financial Perspective 2007–2013 (in 2004 Prices, Billion Euros)

Commitments Appropriations	2007	2008	2009	2010	2011	2012	2013	2007–2013
1. Sustainable growth	51.3	52.9	54.1	54.9	55.4	56.8	58.3	383.6
2. Preservation and management of natural resources	53.5	54.3	53.7	53.0	52.4	51.8	51.2	369.8
3. Citizenship, freedom, security and justice	1.2	1.3	1.4	1.5	1.6	1.8	2.0	10.8
4. EU as a global player	6.2	6.5	6.7	7.0	7.3	7.7	8.0	49.5
5. Administration	6.6	6.8	7.0	7.1	7.3	7.4	7.6	49.8
6. Compensations	0.4	0.2	0.2					0.8
Total	119.2	122.0	123.0	123.5	124.0	125.5	127.0	864.3
As a percentage of GNI	1.10	1.08	1.07	1.04	1.03	1.02	1.01	1.05
Appropriations for	115.1	119.8	112.2	118.5	116.2	119.7	119.2	820.7

payments								
As a percentage of GNI	1.06	1.06	0.97	1.00	0.97	0.97	0.94	1.00

Source: European Commission [http://europa.eu/scadplus/leg/en/lvb/l34020.htm].

Table 2.1 shows how the financial perspective for the period 2007–2013 is categorized in six main headings. The first heading ('sustainable growth') consists of two subcategories: 'competitiveness for growth and employment' (covering activities that aim to strengthen the EU's growth potential, such as research, education and Trans-European networks) and 'cohesion for growth and employment' (aiming to improve growth and prosperity throughout the EU). The second heading ('preservation and management of natural resources') puts together a comprehensive approach to the EU's natural resources, including agriculture (market expenditure and direct allocations), rural development, fishing and the environment. The third heading ('citizenship, freedom, security and justice') consists of two subheadings: 'freedom, security and justice' (including activities with a view to strengthening fundamental rights, stepping up the fight against terrorism and organized crime, and addressing the issues of immigration and judicial cooperation) and 'citizenship' (covering activities promoting European culture, protecting public health and fostering solidarity within the EU). The fourth heading ('EU as a global player') covers activities outside of the EU's borders, including enlargement, bilateral relations, regional-level relations with its neighbours, humanitarian aid and development aid.

The actual budget figures are higher as a result of adjustments for inflation. Table 2.2 shows the actual amounts of the 2008 budget as adopted by the European Parliament. For the first time ever, the largest share of the EU budget – 45% – has been allocated to economic growth and greater cohesion in the EU-27. The total budget amounts to EUR 129.1 billion in commitment appropriations, which corresponds to 1.03% of the EU GNI. The payment appropriations amount to EUR 120.3 billion, which corresponds to 0.96% of EU GNI.

Table 2.2. Commitment Appropriations EU Budget 2008 (Billion Euros)

1. Sustainable growth	58.0
2. Preservation and management of natural resources	55.0

3. Citizenship, freedom, security and justice	1.3
4. EU as a global player	7.3
5. Administration	7.3
6. Compensations to new EU countries	0.2
Total	129.1

Source: European Commission <http://ec.europa.eu/budget/budget_detail/current_year_en.htm>.

5. Budgetary Balances

The budgetary (or net) balance is the difference between what a country receives from and pays into the EU budget. There are different methods of calculating net balances. In its annual report on allocated expenditure, the Commission uses a method based on the same principles as the calculation of the correction of net imbalances granted to the United Kingdom (the UK rebate). The Dutch government uses another method – the so-called accounting method – that leads to a more unfavourable result for the Netherlands than the Commission's method. According to both methods, the Netherlands has the biggest budgetary balance as a percentage of GNI and is the relatively biggest net contributor to the EU budget. Thus, the different result does not pertain to the ranking order, but rather to the size of the net balance. It is bigger according to the Dutch government (0.77% of GNI in 2007) than according to the Commission (0.50% of GNI in 2007).[15][k1]

Figure 2.1 shows the estimated average net budgetary balances for the Member States in the period 2008–2013 on the basis of the European Commission definition. Interestingly, the Dutch debate about the budgetary balance did not start until the early 1990s. It seems obvious that this has to do with the fact that the Netherlands enjoyed a positive net balance until the early 1990s. Only after it turned negative did Dutch politicians start to discuss the budgetary balance.

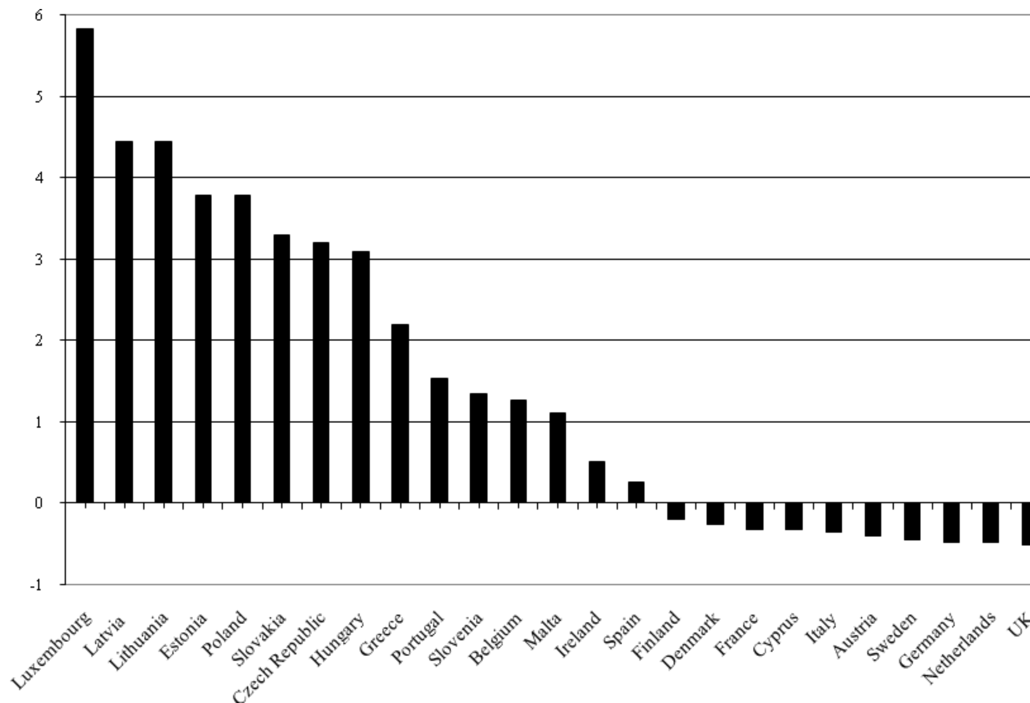
The 1984 Fontainebleau agreement determines that any Member State sustaining a budgetary burden, which is excessive in relation to its relative prosperity, may benefit from a correction at the appropriate time. This agreement solved the long-running British problem of what was considered the excessive British contribution to the budget. Basically, the UK received a (permanent) rebate. Later on, 'rebates on the rebate' to the

[15] *Source*: Parliamentary Papers (2009), p. 37.

traditionally largest net contributors to the EU budget have been agreed upon. As a result, Austria, Germany, the Netherlands and Sweden pay only 25% of their normal financing share of the UK rebate.

All these corrections have considerably reduced the simplicity and transparency of the EU's funding system. It seems questionable whether the various correction mechanisms are justified. Moreover, constructing estimates of budgetary balances is merely an accounting exercise of the purely financial costs and benefits that each Member State derives from the EU budget without giving any indication of the other benefits gained from EU policies such as those related to the internal market and economic integration, political stability and security.

Figure 2.1. Estimated Net Budgetary Balances (Average 2008–2013) in % of GNI[16]



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Source: Schneider (2007).

The problem of budgetary balances has been a serious obstacle to substantive budget reform. Recently, De La Fuente et al. (2008) put forward a proposal to introduce a system of compensatory transfers that will make the net balances of EU Member States inversely proportional to their relative income levels and the adoption of a multi-stage budget-setting procedure consistent with it. This would decouple the desired level of redistribution from the rest of the budget negotiation. As a result, it should be easier for Member State governments to discuss core EU revenue and expenditure policies on their own merits rather than in terms of their impact on national fiscal balances.

6. Summary

Traditionally, three branches of government are distinguished in public finance: the allocation branch, the distribution branch and the stabilization branch. Although the first

[16] The calculations were made before Bulgaria's and Romania's accession. Therefore, these countries have not been included in Figure 1. The original calculations are from the European Commission (2005).

two branches apply to the EU budget, the third does not for two reasons. First, the EU is legally obliged to balance its budget. Second, the EU budget accounts for only 1% of the EU GNI. The EU can only play a role in fulfilling the stabilization function by policy coordination as it does in the framework of the Stability and Growth Pact.

The EU's revenue system has developed from national contributions (until 1971) to a system of own resources. The traditional own resources (in the form of customs and agricultural duties) were introduced in the early 1970s. The VAT-based own resource was introduced in 1970, although it did not yield revenues until 1979. In 1988, a GNI-based own resource was introduced. The GNI-based own resource is now the EU's primary source of revenue. Therefore, the current revenue structure resembles the EU's financing method as it existed before the own resources were introduced as there is hardly any difference between the national contributions from before 1971 and the GNI-based own resource.

The share of agricultural spending in the EU budget continued to grow until the late 1980s, when it amounted to approximately two-thirds. However, the share of the CAP has gradually declined due to the implementation of other policies and is expected to amount to approximately one-third by 2013. The EU has agreed on a ceiling of 1.24% of EU GNI for the expenditure.

The problem of budgetary balances has led to the introduction of a number of corrections in the EU budget, which have considerably reduced the simplicity and transparency of the EU's funding system. Moreover, it seems questionable whether these correction mechanisms are still justified. In addition, the problem of budgetary balances has proved to be a serious obstacle to substantive budget reform.

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