2009:1

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Fiscal Federalism, Subsidiarity and the EU Budget Review

Sieps
Swedish Institute for European Policy Studies

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– SIEPS 2009:1 –

Report No. 1
April/2009

Publisher: Swedish Institute for European Policy Studies

The report is available at
www.sieps.se

Cover: Svensk Information AB

Print: EO Grafiska AB

Stockholm, April 2009

ISSN 1651-8942
ISBN 978-91-86107-07-9

PREFACE

'What should the EU spend its money on?' is a recurrent and still highly topical question. Many distinguished researchers have attempted to find answers, or even indications, in economic and political theories. Despite repeated attempts to reform the budget, since it was last substantially recast 20 years ago, the EU budget has, in most respects, hardly evolved. Indeed, the budget today is far from the blueprint set out in the MacDougall report, published some 32 years ago, that proposed a structure for public finances based on federal principles. The EU budget has been labelled a 'historical relic', shaped by grand bargains that on the one hand have allowed the integration process to move forward, but on the other hand have made it ill-suited to address future challenges.

Against the backdrop of the ongoing attempt to reform the budget, decided by the European Council in December 2005 and officially launched by the European Commission in September 2007, Professor Iain Begg revisits the academic literature and analyses to what extent theory can inform the discussion on budget reform. The answer may seem disheartening, in so far as the exploration reveals that theory does not provide a conclusive roadmap for reform. However, his analysis makes it very clear that Europe is facing hard political choices that must be based on a serious discussion of what we want the EU to be and do.

Anna Stellinger
Director, SIEPS

The Swedish Institute for European Policy Studies, SIEPS, conducts and promotes research and analysis of European policy issues. The results are presented in reports and at seminars. SIEPS strives to act as a link between the academic world and policy-makers at various levels.

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ACKNOWLEDGEMENTS

The author is grateful to SIEPS for supporting this project, and to Jonas Eriksson, Anna Michalski, Anna Stellinger and two anonymous referees for sound advice on improving earlier drafts.

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SUMMARY

1. There is widespread agreement that the EU budget is out-of-date, ill-suited to the emerging demands on the EU and, worse, trapped by path dependencies that severely circumscribe the options for change. Its role in economic governance is unsatisfactory and bears little resemblance to that of central government in nation-states, whether federal or unitary, a state of affairs that reflects the continuing ambivalence about 'what the EU is for'.
2. In even the most decentralised of federal systems, the central government is responsible for a sizeable proportion of public expenditure and taxation, and has a pivotal role in the administration of public finances. These functions of central government have been extensively theorised and analysed in the academic literatures on fiscal federalism and multi-level governance and it might therefore be expected that they could be helpful in reforming the EU budget. Indeed, the 1977 MacDougall report provided a blueprint for an EU budget with such a federal structure, based on the theories.
3. In practice, however, the subsequent development of the budget – last substantially re-shaped in 1988 – has been limited. It has remained at around 1% of EU GNI, continues to spend the bulk of its resources on just two main policies (agriculture and cohesion), and is financed predominantly by direct contributions from the Member States rather than authentic own resources.
4. With a major review of the budget in progress and announced as being bound by no taboos, it is timely to revisit the theoretical principles behind it and to consider whether they offer any insights into how reform should proceed. This paper reviews the messages from this academic literature and confronts them with the realities of the EU in an attempt to shed light on possible reform trajectories.
5. Different disciplinary standpoints lead to different views on how to analyse the EU budget. The political science literature on multi-level governance has been predominantly concerned with issues of legitimacy of the EU level as a budgetary authority, whereas economic analysis rooted in variants of fiscal federalism has looked mainly at the economic efficiency and distributive consequences of different possible mixes of competencies.
6. Fiscal federalism concerns the division of labour between tiers of government in policy-making, instead of being confined to fiscal arrangements in federations. Earlier contributions (first-generation

fiscal federalism) focused on the normative case for assigning responsibilities to different tiers of government and for shaping the inter-actions between levels of government. What has become known as second-generation fiscal federalism complements the earlier work by looking at the incentives facing policy-makers, how to prevent government failures, and exploring the institutional structures that offer the best prospects for efficient and effective government.

7. Several key propositions emerge. First, all the theoretical models presume a strong central government that has to mediate between a plethora of sub-national governments. The theory suggests that stabilisation policy and re-distribution should largely be assigned to central government, whereas allocative policies should be pitched at the level of government that is best able to match the scope of the policy with the jurisdiction it covers. For allocation, the trade-off is between advantages of decentralisation in catering to the preferences for public goods of citizens in a particular territory against the possible advantages of centralising the provision of the public goods from economies of scale, the internalisation of externalities and other considerations.

8. Although fiscal federalism and related theories can offer some insights into whether a particular funding instrument should be 'owned' by a specified level of government, these insights do not, ultimately, translate into the factors that are upper-most for the EU. Similarly, even where there are obvious benefits from centralising spending at EU level, political sensitivities dictate that certain policies have to be reserved for the national level, with a logic of sovereignty to the fore. The upshot is that for many major policy areas, a supposedly objective approach to assigning expenditure to the EU level is simply not applicable. What can be observed about the EU is that it is given responsibility for producing different sorts of public goods (or for trying to curb public 'bads') that the Member States would not produce on their own.

9. In essence, the principle of subsidiarity, which asserts that a policy should be located at the lowest level of government at which it can be efficiently delivered, relies on much the same reasoning as fiscal federalism. In exploring how the EU budget might be reformed, a possible approach is to use a subsidiarity test to identify the policies that should be assigned to different levels of government.

10. Such an approach was adopted in a recently completed study by a consortium led by the Ecorys consultancy. It concluded, somewhat predictably, that agricultural spending should be returned to the Member State level, while there should be increased EU level spending on, notably, policies to counter climate change, on EU external action and on research and development. Perhaps surprisingly, the study does not find a persuasive case for increased EU spending on competitiveness-related policies or on internal security, even though these are two areas in which the EU has become a more prominent actor in recent years.

11. Arguably, the supranational level is qualitatively different from typical central governments. In this regard, the fact that the EU is set up as a union of citizens *and* of Member States is one of its most distinctive features. In particular, it implies that the accountability of the union is to Member States as much as to citizens. It also means that, in shaping the budget and in the political economy of decision-making on public finances, the Member States have a pivotal role. In addition, it is highly salient that migration – the basis for the notion of 'voting with your feet' that partly underpins the incentive properties of fiscal federalism – is a very weak mechanism in the EU.

12. Consequently, anyone looking to the economic and political theories to provide compelling guidance on how the EU budget should be reformed is going to be disappointed, because there is simply too big a gap between the political realities of the EU and the sort of fiscal constitution that would emerge if the models were even partly applied.

13. First, the size of the budget is a constraint because, so long as the budget is set at about 1% of GNI, entire categories of public spending are effectively excluded from consideration, irrespective of political or efficiency arguments for shifting them upwards. Typically, federal budgets account for 10% or more of GNI and even the much smaller 'federal-light' budget of 5%-7% discussed in the MacDougall report looks like fantasy.

14. Even if a moderate increase to 1.3% or 1.5% of GNI is contemplated, there is no easy way to use theoretical models to arrive at an objective list of what should be in the EU budget rather than at other levels of government. The Ecorys report made a rigorous effort to apply its extended subsidiarity test and reaches plausible conclusions about the relative merits of assigning different classes of public spending to the supranational level.

15. Yet it is dealing in shades of (dark) grey, rather than black and white, insofar as a credible case can be made for a variety of different 'packages' as the focus of the budget: the three discussed in the report are 'climate change', 'knowledge and innovation' and 'common security and foreign affairs'. Each has its merits, but the key point is that they are alternatives, and choosing one rules out the others.

16. In addition, the EU budget manifestly still has a role to play in smoothing the (bumpy) road towards European integration by transferring resources between Member States as part of grand bargains. These may be parcelled up inside policies that have worthy objectives (cohesion as a public good), but are inevitably susceptible to the pork-barrel politics of *juste retour* thinking. As the negotiation of the Obama fiscal package showed yet again, such side-payments are the price to be paid to attain wider objectives, and an implication is that a sizeable share of the budget will continue to be required for payments of this sort. This need not mean the CAP lasts forever, but it does mean – especially with so low proportion of GNI available for the budget – that the room for manoeuvre will remain limited in switching towards authentic EU public goods that tick the right boxes on objective tests.

17. In these circumstances, and to dispel counsels of despair, the challenge will be to put forward eye-catching proposals for EU spending that is legitimated by being associated with major EU initiatives. A concerted response to climate change is an obvious one, especially if it simultaneously addresses energy security. But others could be envisaged, so that what is needed is a debate on an underlying narrative for the budget. The eventual answer will not, however, be found in the theoretical literature, but will instead emanate from hard political choices about what we want the EU to be and do.

INTRODUCTION

There is widespread agreement that the EU budget is out-of-date, ill-suited to the emerging demands on the EU and, worse, trapped by path dependencies that severely circumscribe the options for change. In the words of Italian economists Buti and Nava (2003: 1) it is 'a historical relic'. As any Italian knows well, however, relics can endure for centuries with subsequent generations ready to cherish and adapt them, rather than knocking them down and starting again. The shortcomings in the budget have been extensively rehearsed and it can sometimes appear as though there are, indeed, features that are preserved for purely historical reasons, rather than because they meet the needs of the present (see, among many others: Le Cacheux, 2005 and 2007; Begg, 2005 and 2007; and the several contributions to the SIEPS project on budget reform[1]). Equally, the EU budget has to contend with an environment in which there is no easy answer to the question 'what is the EU for?', and in the absence of an unambiguous vision of what the *finalité politique* of the Union is likely to be, it should not be surprising that it is hard to find an agreed direction for reform of the budget, let alone to discern a *finalité budgetaire*.

The aspects most criticised include the continuing prominence of the Common Agriculture Policy (CAP) in expenditure, the increasing opacity of (and dubious rationale for) 'corrections' that diminish the net contributions of certain Member States, a lack of flexibility (especially in responding to new challenges), and other flaws in governance including the legitimacy of the processes of decision-making. More generally, what is absent from the debate on the EU budget is a convincing sense of where the EU level should fit into a system of multi-level public finances. At 1% of EU GNI, the EU level's spending is only a small proportion of aggregate public spending in the union which is around 40% of GNI, Thus, despite being a large figure (currently around €130 billion, larger than the GNI of a number of the smaller Member States), it is just 2.5% of public spending. As Jonas Eriksson pointed out in a recent SIEPS paper (Begg, Sapir and Eriksson, 2008: 9) 'to say that its economic impact is significant would be a serious exaggeration'.

In typical federal systems, the highest level of government will be responsible for a sizeable proportion of public expenditure and taxation. Thus, in the US, it is in excess of 20% of GNI[2] and the proportions in other major federations are of similar orders of magnitude. Figure 1 on page 13 shows

[1] Details at: http://www.sieps.se/
[2] According to a Citizens' Guide produced by the US *Government Accountability Office.*

the broad breakdown in a range of countries between central and sub-national government in both revenue and expenditure. Although the chart shows that federal countries such as Canada, Australia and the US tend to assign more public finance functions to lower tiers of government, it also demonstrates that sizeable delegation also happens in unitary states. Moreover, other work by the OECD (notably through its *Network on Fiscal Relations across Levels of Government* and the publications flowing from the network's activities) suggests that there is something of a global trend towards decentralisation.

Perhaps more importantly, the federal level of government plays a pivotal role in systems of public finance, with fairly well defined hierarchies of administration. These roles have been extensively theorised and analysed in the literatures on fiscal federalism and multi-level governance. In practice, the central government in unitary states also fulfil similar functions, so that although the term 'federal' is often used in the academic literature, the relevant distinction is between central and sub-national government. The question that then arises, and which this paper addresses, is whether this literature can inform the debate on reform of the EU budget. Fiscal federalism is about more than tax and spending arrangements and, thus, something of a misnomer, to the extent that it 'is concerned with the division of policy responsibilities among different levels of government and with the fiscal interactions among these governments' (Wildasin, 2008).

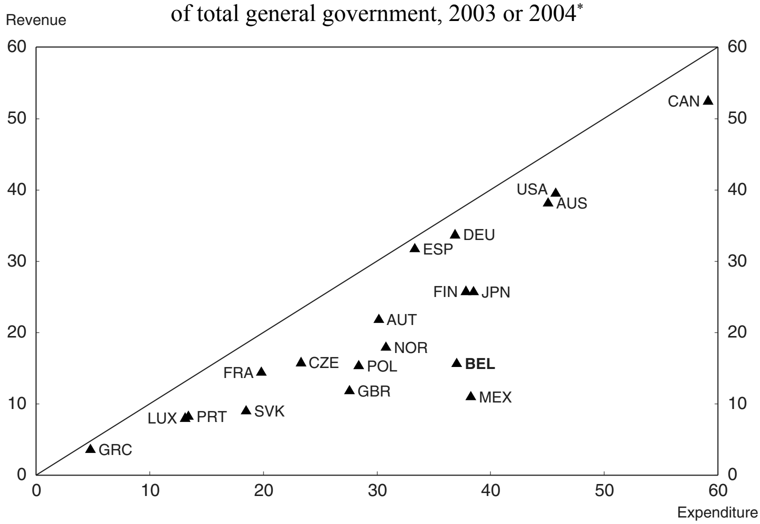
1.1 The 2008/9 review of the budget

Considerable effort has been expended on trying to define how the EU budget should be reformed, and the slow-burning 2008/9 review has provided an opportunity to approach the issue from first principles. For the Commission (2007), the starting-point should be policies, and the consultation paper published to launch the review sets out a range of areas in which EU spending could be expected to support the achievement of policy objectives. Others have argued that EU spending should be subject to the rigorous application of the principle of subsidiarity, implying that it should occur only when there is a demonstrable benefit from assigning the spending to the supranational level. In fact, the UK government contribution to the consultation proposes that EU spending can be justified only when three tests have been passed: demonstrable added value from spending at EU level; ensuring that the outlays are proportionate to the task; and that the EU spends the money effectively (HM Treasury, 2008).

The 2008/9 budget review might have been, and could still be, a once-in-a-generation opportunity to reform the budget in line with the priorities of

Figure 1 Comparisons of decentralisation in selected countries

Sub-national shares of revenue and expenditure in per cent of total general government, 2003 or 2004*



* 2002 for Mexico. Revenues include direct and indirect taxes as well as non-tax revenues received by regional and local governments. Transfers between government levels are netted out. For Australia the Goods and Services Tax (GST) is considered as a state tax. For Norway data exclude revenues from oil production.

Source: OECD Annual National Accounts Database, May 2006; Belgostat; Statistics Canada; Statistics Norway; US Bureau of Economic Analysis; Australian Bureau of Statistics (2006).

Source: OECD (2007)

today and tomorrow, rather than yesterday. As such, it would be expected to take more account of underlying economic and political theories. But it has, so far, been over-shadowed by other political priorities. Initially, the Irish referendum on the Lisbon Treaty inhibited any debate on the budget because of the perceived risk that an injudicious statement from 'Brussels' would be seized on by the 'no' campaign, and even in the aftermath of the negative result, there have been few leading politicians willing to adopt firm positions while a solution to the ratification was sought. Subsequently, the economic crisis has, not unreasonably, been the principal pre-occupation of the EU's leaders.

The upshot is that the review is running out of political time and space, bearing in mind that the five year mandates of the current Commission and Parliament expire in 2009. As a result, the original approach to the review, which was to concentrate on principles and policies rather than on money, is likely to be overtaken by the early skirmishes on the next Multi-annual Financial Framework (MFF) that will be needed once the present one covering 2007-13 ends. This would be unfortunate and it is to be hoped that it will still be able to draw on underlying principles rather than being caught in the customary dogfight over money (and money back).

1.2 Aims and outline of the paper

In thinking about the EU's 'fiscal constitution', what is needed is a conceptual basis for determining whether and how delegation of fiscal responsibility to the supranational level makes sense, and the aim of this paper is to contribute to the debate on these issues. While there is no ready parallel for the EU in any existing federal system, McKay (2001) suggests that at least in its degree of decentralisation Switzerland is the closest living relative. He also notes that there are certain aspects of fiscal arrangements in which the EU is more centralised than some existing federations, citing the rules on harmonisation of VAT rates or on curbs on excessive deficits.

Rodden (2006a), in a wide-ranging study, notes that one of the founding fathers of the US – Alexander Hamilton – had expressed doubts about denuding the centre of fiscal powers and leaving too much budgetary authority with the states. Modern day examples cited by Rodden testify to considerable fiscal indiscipline at sub-national level in a number of federal states that have, as a result, suffered from stabilisation difficulties. Part of Rodden's thesis is that the theoretical advantages of federated fiscal systems are often belied by the realities of implementation. In colourful terms reminiscent of Hamilton, Rodden (2006a: 4) observes that,

> at the beginning of the twenty-first century, decentralized federalism is to political economy what Prozac is to mental health. Use is on the rise and everyone is talking about it, but some tout its extraordinary benefits while others insist that it just as often makes things worse. It is increasingly clear that the treatment has vastly different effects on different subjects, but no one knows how, why, or under what conditions it succeeds or fails.

Yet there is little in the cases Rodden (2006a) cites that captures the likely circumstances of the EU or, for that matter, to sound alarms. To the extent that fiscal indiscipline afflicts the EU, it is not a problem caused by the EU level and is, instead, more about national resistance to the Stability and Growth Pact or infelicities in the nature of national systems. Indeed the focus of debate on budgetary matters in the EU has been much narrower, raising questions about what sort of fiscal authority it is or could be, given that it has, hitherto, exhibited few of the characteristics of a genuine federal budget.

Could it be different? In an era in which fiscal policy is being called upon to respond to economic crisis, the lack of any stabilisation capability at EU level can appear to be strange. At the same time, the inter-governmental relations in some existing federations are being challenged. The next section looks mainly at the key implications for multi-level budgeting from theoretical work. The third section tries to interpret the realities of the EU in the light of the theoretical model, while section 4 discusses the limitations of the theories. Section 5 considers the way forward, then concluding comments complete the paper.

2 INSIGHTS FROM THEORY

Various branches of public economics bear on relationships in the fiscal arena between different tiers of government. Using the Musgrave trilogy of stabilisation, distribution and allocation offers one route into the analysis of EU budgeting. Stabilisation is normally deemed to be an activity for the highest level of government and most multi-level systems are, indeed, structured to assign competence in this way, not least because of the imperatives of overall fiscal discipline which are far harder to achieve if multiple governments are entitled to borrow. Martinez-Vazquez et al. (2006) do, though, make the interesting observation that in some systems, certain of the tasks assigned to sub-national governments can more easily be varied to reduce or increase demand – speeding-up or slowing-down road maintenance for stabilisation reasons, for example, can be easier than altering the size of an army.

Distribution is also seen as an activity for the highest tier to prevent tax competition or a race to the bottom in which well-off jurisdictions have the incentive to cut welfare benefits. By contrast, allocation of resources is seen as the branch of public finance most suited to decentralisation because the allocations can then be tailored to reflect local preferences. Some public goods do, nevertheless, have wider reach than the locality and may, indeed, only make sense at a much more aggregated spatial level.

2.1 Federalism as a template

According to Riker (1964: 101), the essence of federalism is that each level of government has 'some activities on which it makes final decisions'. This characterisation raises the perennial question of whether the EU can be regarded as a level of government equivalent to the standard models as found in the US, Germany and other well-established federal nation-states, but also suggests a means of portraying EU finances. While it is self-evident that the EU is a long way from being a federal system and the 'f'-word remains taboo for many Member States, it is nevertheless worth looking at the extent to which it has federal characteristics. There is an extensive and well-developed literature on the merits of federal systems in delivering public goods (for a recent overview, see Inman, 2007).

In fact, the notion that federalism is about finding ways of providing public goods for an entire Union while continuing to provide constituent parts of the Union with enough scope for holding the government to account is prominent in the thinking of James Madison – see, for example, Federalist Papers No. 45 and 46. From the latter, this statement eloquently debunks the idea that the states have to fear a more powerful centre: 'the powers proposed to be lodged in the federal government are as little formidable to those reserved to the individual States, as they are indispensably necessary to accomplish the purposes of the Union'.

For Rodden (2006a: 5) 'the promise of federalism is a straightforward proposition that has shown up time and again in political and economic theory from Montesquieu to James Madison to Richard Musgrave: In heterogeneous societies, government policy is most likely to be aligned with the preferences of citizens in the presence of multiple layers of government, each charged with different responsibilities. Higher-level governments can provide federation-wide collective goods like common defense and free trade, while lower-level governments can provide goods like trash collection and religious education that will be consumed locally. If each layer of government stays within its bounds and respects the authority of the other, citizens can hold each layer of government separately accountable for its activities'. He also notes that it necessarily means a weaker centre, something that manifestly applies in the EU. But on another criterion, namely the probability that the centre will bail out the sub-national level, the EU doubly fulfils Rodden's ideal. Not only does it have no capacity as a fiscal authority to do so, but the monetisation of Member State debt by the European Central Bank is explicitly forbidden in the Treaty.

Federalism typically implies a balancing act in which the institutional framework is geared towards the simultaneous achievement of the advantages of large and small governmental units (Rodden, 2006b). Rodden notes that the early impetus towards federal solutions came from concern about, on the one hand, enough central powers to prevent despotism and, on the other, the need to avoid an accumulation of power at the centre that would over-ride the preferences of constituent parts. However, in other settings, the issue federalism tries to confront is the efficiency of policy and its distributive impacts. In Rodden's analysis, the economic approach pioneered by Oates (1972), which concentrates on optimal tax collection and provision of public goods, and the political science approach of scholars such as Riker (1964) may have left significant gaps in understanding. Certainly, in looking at the EU budget it is easy to find support for his view. A useful checklist for defining and comparing federal systems is offered by Weingast (2006) who sets out five attributes:

1. **Hierarchy** in which there are clearly delineated functions according to the level of government

2. **Sub-national autonomy** as demonstrated by the lower tiers having primary responsibility for deciding on the provision of public goods in their jurisdiction
3. **A common market** for goods, services and factors of production
4. **Hard budget constraints**
5. **Institutionalised political authority**, through which the formal autonomy of the sub-national tier is assured in practice.

Locating the EU within such a framework requires some subtlety. Plainly, a top-down model that has the supranational level at the pinnacle is not applicable, but lateral thinking might suggest that a purely vertical hierarchy does not properly capture the way functions are distributed. Instead, it could be argued that the EU level is a 'satellite' around the national level, with certain delegated functions. Seen in this way, the EU level has substantial autonomy in the provision of public goods in its sphere of influence, but faces differing constraints from the inter-governmental bargaining that goes on. The latter is especially true of the public expenditure of the EU level, whereas many of its regulatory activities are almost entirely autonomous.

Condition 3 is met in principle and is an enduring aim of policy, though often compromised in implementation and condition 4 is applied robustly – indeed, the hard budget constraint facing the EU manifests itself in multiple ways, including the own resources ceiling, the multi-annual financial framework and the annual budgetary procedure. It is, however, in the last criterion that it becomes much more difficult to characterise the EU as federal. The EU does have constitutional standing, fulfilling one element of the criterion, but is subject to various controls that diminish others. The European Parliament, for instance, has a somewhat ambivalent role in relation to the EU budget. It notionally shares responsibility with the Council in deciding on the budget, yet has always had to defer to the latter when the deal is done. The codification in the Lisbon Treaty of the MFF and of the inter-institutional agreement may change the game and tilt the balance of power in public finances a little towards the Parliament, but the EU is still a long way from a democratic process in which political parties put forward competing taxation and expenditure packages for the electorate to make a choice. Representation with taxation, in short, remains elusive.

A further complexity in inter-governmental relations is the inter-play between modes of governance, especially in the EU where economic policy co-ordination has, in recent years, assumed growing importance, while regulation has long been the primary mode of governance. This evolution has potential ramifications for the design of a fiscal constitution. Co-ordination of national policies, currently most wide-ranging in the Lisbon strategy, but likely to become more prominent in energy policy and in efforts to counter climate change, tends to imply that Member States assume the financial responsibility for the policies that are co-ordinated. Yet one of the many demands on the EU budget is to provide financial support for (so far) the Lisbon strategy and – in future, judging by the Commission (2007) consultation paper – for climate change policies. What makes sense in an academic analysis can easily look fanciful in real politics. A strong case for common defence, for example, could be constructed on added value grounds, as could a common border police force. The former appears to be beyond the pale politically, yet the latter has become credible as a result of the extension of Schengen to all but five of the EU-27 Member States.

Although recent political debate, culminating in the Lisbon Treaty, appears to have put an end to the ambition of some protagonists to construct a political union in Europe that would be federal in character, it has left open the question of what sort of body the EU may be in the end. This, in turn, means that it remains uncertain to what degree the EU can be portrayed either as a level of government, distinguishing it from international organisations with limited scope, or an agency with broad, but clearly prescribed aims that mean it lacks state-like attributes. In practice, the persuasive answer is that the EU is one of a kind (*sui generis*) in having a distinctive mix of these various characteristics. Nevertheless, and even taking into account the *sui generis* character of the EU, a conception of the EU as a component of a multi-level fiscal system, rather than a glorified agency may offer some insights. If, to begin with, a reasonably rigorous test of subsidiarity were to be applied to EU spending, it would be unlikely to yield anything resembling the current spending mix. Equally, it might well (if practice elsewhere is a valid guide), point to various areas of public spending that ought to be pushed upwards.

2.2 If not federalism, what about fiscal federalism?

Fiscal federalism, especially, might be expected to offer insights into how the EU budget should evolve and ought to be pivotal in theorising and understanding the public finances of a multi-level governance system such as the EU. Wildasin (2008) states, perhaps stretching the point, that the EU ‘can be viewed as an emerging federation in which EU-level political and fiscal institutions are gradually developing’. He also reiterates the division of labour suggested by what he calls a ‘broad normative consensus’ that the highest level of government (a status he argues *could* be conferred on the EU) should normally be responsible for stabilisation policy and for distributive policies, whereas allocative policies should be situated at the level of government 'whose jurisdictional boundaries are co-terminous with the geographical scope of the regions affected by these policies'.

Other prominent scholars have also noted the EU's gradual evolution in a federal direction: for example, Inman (2007: 523) states that the EU 'is now moving albeit slowly, towards a more integrated political union founded upon federal principles of governance'. Although it might be argued that the mood in recent years has swung markedly against political union on federal lines, the budget is one of the most visible manifestation of the EU as an inter-governmental phenomenon. An earlier paper by Gramlich and Wood (2000) argued that although some aspects of fiscal federalism can readily be discerned in the EU's development, the unique nature of the EU's development calls for fresh approaches that more convincingly capture the fiscal arrangements of the Union. It is this *sui generis* character of the EU that makes it so difficult to apply the more standard precepts of fiscal federalism.

What fiscal federalism addresses has been set out by Bird (2003) who argues that it comprises the following:

1. Expenditure assignment: who should implement which spending programmes
2. Revenue assignment: who should levy which taxes
3. How to mitigate vertical imbalances between the revenues and expenditure of sub-national government
4. Whether and how to offset horizontal imbalances between needs and capacities of units at the same level
5. Who determines the capacity to borrow and according to what rules
6. The nature of the underlying political and institutional system and its ability to settle differences.

Bird argues that efficient governance is achieved by applying the 'matching principle', under which 'benefit areas' are matched by 'financing areas'. In so doing, he reaffirms the well-established principles of Oates (1972 and 1999) who pioneered work on fiscal federalism and continues to be a leading contributor. Bird also asserts that the aim should be to decentralise as far as possible, a principle he equates with subsidiarity as used in the EU.

However, even the briefest inspection of how public finances in the EU are arranged reveals that there is scarcely any resemblance between the public finance model of the EU and that of any of the US, Switzerland, Canada or Germany, four countries which have featured especially prominently in the academic literature on fiscal federalism. Hence, an uncomfortable conclusion from most attempts to apply insights from such theories is that the very particular circumstances of the EU do not fit well with standard approaches. As Vito Tanzi argues in a recent key-note paper presented to a major conference on fiscal federalism, the theory has two substantial shortcomings (Tanzi, 2007). First, it does not offer a convincing template for analysing delegation upwards to supranational institutions, despite the fact that such institutions are playing an increasingly influential role in economic governance. As he puts it, 'We have been spending too much time looking down from the central government's layer. It is time to look up from that layer'. The EU has by far the greatest reach of these institutions and, although much of its activity is regulatory, could reasonably be expected to have expenditure functions that extend well beyond what it currently does. Second, Tanzi stresses that the relationships between tiers of government typically reflect historical developments and compromises, much more than design based on principles rooted in theoretical approaches such as fiscal federalism. Nevertheless, the political or institutional logic that gave rise to the existing frameworks can become ill-adapted to new circumstances. He therefore criticises the notion that there is an optimal fiscal arrangement that can be embodied in a constitutional settlement, and even where the inter-governmental fiscal relations are embodied in this way (as in Brazil or the US), he notes the increasing role of the constitutional court in resolving tensions.

In addition, much of the attention in the standard fiscal federalism models concerns how a substantial and powerful central government mediates between multiple sub-national units. This, plainly, is not a convincing description of the inter-governmental relations in the EU where the small scale of the supranational tier and its highly skewed functions bear little resemblance to the theoretical model of a central government. In the EU, it is the budget of the single supranational authority which is the outcome of the wrangling between powerful central governments. In the standard model, the issues of vertical and horizontal equalisation loom large, and there are heated debates about the most suitable forms of inter-governmental grants yet, in the EU setting, the most contentious issues concern Member State net balances and whether or not the EU level should have any autonomy in its revenue raising.

Despite these reservations, there are reasons not to throw out the baby with the bathwater. The potential application to the EU of many of the key elements of what is becoming known as 'first-generation fiscal federalism' (FGFF) are surveyed by Oates (2002) who makes the interesting observation that because fiscal federalism[3] starts from the proposition that there is a powerful central government, 'it doesn't seem to fit very well the cases of emerging "confederations" such as the European Union'. Yet he also states that 'using the fiscal federalism model to think about the European Union does, I think, provide some useful insights'. Oates recalls that many of the issues about European fiscal federalism were analysed in the MacDougall report (Commission, 1977), and bemoans the fact that few have really been resolved. He also observes that the EU is equipped neither to engage in macroeconomic stabilisation using fiscal instruments nor to be responsible for re-distribution, in contrast to the central governments in nation-states.

Building on these points, Box 1 on the next page summarises insights about what FGFF implies for the EU budget.

2.2.1 Second-generation fiscal federalism

More recent work has shifted somewhat from the normative preoccupations of FGFF to explore in a positive manner the incentives facing government at different levels. In much of what has been dubbed 'second generation fiscal federalism' (SGFF), the academic literature suggests that careful analysis of incentives and of the inter-play between market forces and the public sector is needed in allocating expenditure functions (see: Oates, 2005; Weingast, 2006). Weingast (2006), citing a number of other studies, argues that a key innovation in SGFF is to focus on the growth-enhancing effects of the model of fiscal decentralisation, rather than the equity effects emphasised in FGFF. Could it be that the EU budget is too little orientated towards growth (which would arguably boost the EU's coffers) because financing by inter-governmental transfers diminishes incentives to promote public goods and increases incentives to engage in side-payments?

Common-pool problems are emphasised in SGFF. They arise where the incentive facing a decision-maker is how to secure (whether for constituents or for interests the decision-maker wants to favour) a dispropor-

[3] In fact, Oates poses the rhetorical question of whether the term 'fiscal federalism' was unfortunate, insofar as what is analysed is the broader economics of multi-level government, although he notes that 'public-finance economists know what they mean by the term'.

Box 1 Lessons for the EU from first-generation fiscal federalism

The structure of government: FGFF, in the words of Oates (2002: 37), 'presumes a substantial and strong central government with monetary, fiscal, and regulatory powers', a description of a political and administrative configuration that manifestly does not fit the EU. Oates observes that the theory does not offer inviolable rules and policy assignments, but can nevertheless offer insights and guidance for the structure of the public sector.

Motivation of policy-makers: one of the key underlying assumptions of FGFF is that governments are benevolent and concerned with correcting market failures, and thus not afflicted by 'Leviathan' tendencies (as articulated by public choice theorists such as Brennan and Buchanan, 1980) that lead to government failure.

Assignment of functions: the standard model from FGFF has macroeconomic stabilisation and redistribution policy at the highest level, but emphasises decentralisation in allocative policies, especially where the consumption of the public goods is entirely or predominantly within clearly delineated territorial boundaries. This is the decentralization theorem propounded by Oates (1972) and concerns the incentives to align the provision of public goods with the preferences of the residents of a jurisdiction. In FGFF, the normative choice between central or local provision is essentially a trade-off between any benefits of centralisation, such as reaping economies of scale or internalising spillovers, and the advantages of decentralisation in identifying divergences in needs and accommodating diversity in preferences.

Tax assignment and hard budget constraints: if governments have to raise the money to finance any marginal increase in their expenditure, they will tend to be much more accountable to their constituencies. This principle, linked to fiscal equivalence (Olson, 1969), implies that all levels of government need to be able to raise revenue. The theory, consequently, argues for jurisdictions to have identifiable 'own' taxes. The assignment of particular taxes is then important in avoiding distortions and leads to analyses that match the scope of a tax with the scope of the public goods it funds. This result does not preclude inter-governmental grants, but pleads for them to be well thought-out by ensuring that decision-makers cannot use political pressure to pass costs on to other jurisdictions.

The role of tax-payer or benefit-claimant mobility in FGFF is substantial, although Oates (2005: 354) argues that it is not essential to the normative case for fiscal equivalence: 'the more homogeneous in their demands for local services are local jurisdictions and the greater the variation in these demands across jurisdictions, the larger are the potential welfare gains from decentralized finance…[it] strengthens the case for the decentralized provision of relevant services, but it is (in my view anyway) only part of the story'.

Sources: Oates (2002 and 2005); Weingast (2006) and Ecorys et al. (2008)

tionate share of the public goods produced by a higher level of government. With a common pool, an absence of fiscal equivalence may lead to under-provision of public goods if the tax-payers are few and well-organised to sow division among many beneficiaries. If the Member States are regarded as the taxpayers, the EU could be said to conform to this model. By contrast, the common-pool problem when there are many tax-payers and few beneficiaries is that the latter, if well-organised, can extract more than their fare share, the more so if they are the decision-makers.

The constitutional or institutional design will then be influential. Thus, in the EU, the unanimity that applies to the budget can accentuate common pool problems, especially for veto players (for example, small Member States) that can exercise greater power than if they had to compete for resources on the basis of population or economic weight. Side-payments (or, more pejoratively, resort to 'pork barrel' payments, as so often seen in US budgetary settlements) are then needed to make agreement possible. If decision-makers, in addition, are beholden to specific constituencies for votes or influence, then they can make common cause to capture budgets. It does not take 20-20 vision to see the CAP through this lens.[4] SGFF again, sees fiscal equivalence as the solution.

Soft budget constraints are also a form of common pool problem because they facilitate shifting of the costs of obtaining public goods and services. However, the main sense in which this phenomenon manifests itself in the EU, is that its substantial regulatory output and, latterly, different forms of policy co-ordination lead to obligations that the Member States or sub-national governments have to finance. A possible deduction here is that the EU will tend to be too active because it knows that it will not have to fund the resulting expenditure. This suggests something of a paradox that having too small a budget at EU level leads to higher aggregate public expenditure. In some federal settings, according to Weingast (2006), central governments exhibit predatory behaviour that expropriates the benefits of decentralisation. There is no immediately obvious way in which this applies to the EU, but it may be a feature that deserves further investigation.

Weingast (2006), in his summary of the differences between FGFF and SGFF stresses that they are complementary rather than alternatives. But he also emphasises the importance of revenue raising by sub-national government and, as a second stage, of ensuring that the government in question has to find most of the marginal costs of new spending. Generally, the challenge for reform of the EU budget is to ascertain to what degree the notion of market enhancing expenditure central to SGFF is not only influential, but also relevant in a small budget which has to reconcile so many conflicting political aims.

[4] Indeed, Lowi's (1979) 'iron triangle' provides a persuasive description of the common interest between farmers, the decision makers in the Council of Agriculture Ministers and the executive in DG AGRI, and how it helps to explain the longevity of the CAP despite the widespread criticism of it.

2.3 Multi-level governance

The institutional structure of the EU is often referred to as multi-level governance (MLG), although the expression can also be used more broadly in most other settings, including unitary or federal systems. A useful insight (based on concepts suggested by Marks and Hooghe, 2004) when looking at the EU budget may be to distinguish between what they call Type I multi-level governance (which is general and can be considered to approximate to federalism), and what they call Type II is much more ad hoc, with specific arrangements for specific policy areas. As a generalisation, the EU seems to tilt more towards Type II. A strong motivation for decentralisation is to spread the burden of governing increasingly complex economies, but it can also be argued that adding a further (supranational) level can also be a means of spreading the governance as well as focusing it better.

Indeed, it can be argued that in some cases the strength of support for a more traditional federal model is being questioned. In Belgium, for example, the push towards decentralisation is partly motivated by political demands for greater autonomy, but there is also an element of the richer regions seeking to curb net transfers mediated by central governments that emerge partly from pandering to interests at lower levels. For some regions, moreover, the EU level can be an ally against their own central government leading to a form of hollowing-out of the state.

The thrust of the bulk of previous work has been on the division of labour between central and sub-national government. In this respect, the new political economy literature surveyed by Rodden (2006b) has insights into why it may be better to retain tax raising and income distribution powers at decentralised levels. He cites the work of Boix (2003) who argues that decentralised decision-making can be useful in holding together federations where income disparities might lead to fears that the income of the richer would be expropriated. Here, there may be some resonance for how the EU functions, not least because of the comparative absence of solidarity for more than limited cross-border income transfers.

The EU budget also has to be seen in the light of the widespread trend – albeit one with diverse motivations (Ahmad and Searle, 2005) – towards decentralisation of fiscal competences. Decentralisation is widely supported, but is not a panacea and can have adverse effects, especially where systems have design shortcomings. A conclusion of the political economy literature surveyed by Ahmad et al. (2008) is that appropriate incentives for decentralisation will only be present when lower tier governments have the scope to raise revenue at the margin. Logically, the same conclusion should apply to the EU. This raises awkward questions about where the responsibilities should lie for different sorts of fiscal interventions.

In the design of any system of multi-level public finances, there will inevitably be tensions between competing goals, and any system will require Member States to trade-off certain goals for other. For some Member States, the over-riding priority is to constrain the size of the EU budget, such that even if it does have an uneven territorial incidence, the net cost will be small enough to be politically manageable. Mediation between goals is, according to Enderlein (2007), prone to mutual incompatibility. He suggests that there are three underlying goals of multi-level systems, only two of which can be realised simultaneously. They are:

- To apply the principle of fiscal equivalence that the jurisdiction should raise all, or most of, the money it spends;
- The principle of power sharing between the various levels in a federal system in which each level has a say in the fiscal arrangements; and
- The principle of equality in living conditions across lower level jurisdictions.

A more limited version of the third goal would be, as in the German *finanzausgleich* equalisation system, to ensure equality, or near equality, of public service provision, irrespective of ability to pay. Clearly, it is not just formally federalised entities which wrestle with these principles; indeed, the scale of transfers between richer and poorer jurisdictions in many unitary countries can reach very high proportions of the disposable income of the most supported regions.[5] However, the second principle (which Enderlein suggests might also be called 'representational equivalence') is generally more explicit in federal systems where states of a union may have powers deriving from their designation as a separate territorial entity, rather than their numerical weight in either population of GDP. Nevertheless, the term 'federal' may be somewhat misleading in analysing intergovernmental fiscal relations.

The choices made within this 'trilemma', as Enderlein calls it, translate into different models of inter-governmental relations, and he identifies the following three 'ideal-types' rooted indifferent configurations of the trilemma:

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[5] For example, the two Northernmost Swedish counties, Northern Ireland and parts of the Mezzogiorno in Italy receive net fiscal transfers amounting to around 30% of income from the rest of their respective countries, none of which is formally a federation (Begg, 2004). Manifestly, this dwarves the transfers via EU cohesion policy which are capped at 4% of recipient region GDP.

- Competitive federalism in which the goal of equality of living conditions is sacrificed, principally in order to achieve gains in economic efficiency
- Solidaristic federalism which gives greater weight to equality objectives, but at the expense of the equivalence principle
- A somewhat contradictory label of unitary fiscal federalism in which representational equivalence is foregone.

As so often, the distinctions between the three concern the incentives facing sub-national governments, but they also reflect features built into the institutional design. Competitive systems, for example, are intended to reward 'good' behaviour rather than to compensate bad policy. However, a solidaristic system will be unable to ensure fiscal equivalence. If central government is relatively unconstrained by having to obtain the assent or co-decision of sub-national governments, it can (at least if benevolent) determine transfers on the basis of need rather than bargaining power.

2.3.1 Subsidiarity and centralisation: principle and practice

Since the signing of the Maastricht Treaty, the idea of 'subsidiarity' has been prominent in shaping what the EU does (and does not, or should not, do). At its simplest, the principle of subsidiarity is straightforward: a policy should be assigned to lower levels of government, and thus closer to the citizens it affects, unless there are demonstrable benefits of conducting the policy at a higher level. This is not the same as saying that decentralisation should invariably be the aim, and critics of the EU who argue along such lines traduce the principle. But any attempt to apply subsidiarity consistently and rigorously inevitably comes up against a catalogue of objections, ranging from preservation of vital national interest to inertia in changing existing arrangements. In other words, there is a powerful political dimension to the assignment of policy competencies, reinforced by the ambiguity about the degree to which the EU can (or is permitted to) act as a tier of government.

A preference for decentralising public expenditure is assumed to be widespread and to reflect a wish to reflect local choices in expenditure decisions, thereby improving the effectiveness of policy. Brueckner (2007) suggests that a more nuanced analysis of decentralisation – one in which a distinction is drawn between the degree of autonomy of lower tiers in deciding on public goods and the extent to which they have own resources – can be illuminating. This analysis can offer some insights for analysing the EU.

Yet as Ehtisham et al. (2008) point out, efficiency in policy delivery is not always the prime concern, so much as a demand for autonomy in decision-making, even if there are costs in terms of efficiency foregone. The autonomy ceded by decentralisation is, however, only partial if the central government retains the power to decide how what devolved budgets are spent on or to impose conditions on the use of the funds. Here again, there are parallels with the EU system in which the supranational tier has its hands tied in what it does and – especially where the *juste retour* philosophy prevails – in where money is spent. For much of what it spends, the EU is little more than an agent for the Member States, rather than an autonomous tier of government. It is one of the many paradoxes that the EU budget is akin to that of a local council, yet it represents even greater centralisation in an era in which many developed countries have been introducing reforms aimed at decentralising.

2.3.2 Fairness and equalisation

There are two distinct meanings of the word 'juste' in French: one is a sense of fairness which would imply that a juste retour is not one that necessarily means money back; the second interpretation of 'juste' connotes exactness and can be taken to imply that there is a figure that has to be reached, fair or not. Fiscal federalism would be expected to have something to say about the approach to fairness among Member States. In FGFF models, the underpinnings for grants from central government to sub-national jurisdictions are imbalances in revenue raising capacity, spillovers between jurisdictions and administrative efficiency. Much of the EU debate, by contrast, stems from a club membership philosophy in which the Member States set great store by receiving enough back in the form of financial flows to justify gross payments. *Juste retour* in the sense of sufficient 'money back' in relation to the money contributed, in other words, rather than a wider conception of equity is central to the politics and decision-making around the EU budget.

The share of the sub-national level in the total public spending of OECD countries in 2001 was of the order of one-third, whereas sub-national revenue raising was 22%, albeit with substantial differences between countries. However, whether a nation is unitary or federal does not appear to result in systematic differences (Joumard and Kongsrud, 2003). Intergovernmental transfers finance a very high share of the expenditure of sub-national governments, reaching a third in OECD countries and 46% in the non-Nordic European countries.

Equalisation across sub-national jurisdictions is widely practiced, accounting for an average of 2.3% of GDP in OECD countries, and ranging between 0.5% and 3.8% (Blöchlicher et al., 2007). These outlays, not surprisingly, contribute to a substantial reduction in regional disparities, reducing gaps in fiscal capacity by two-thirds on average. The main reasons for equalisation schemes are to promote equity (either in the tax burden for a given level of public services or to ensure that central government funded public services are, at the margin, fairly allocated); to prevent externalities that distort the allocation of resources; or to provide insurance against asymmetric shocks (Blöchlicher et al., 2007). However, the study notes that equalisation can be problematic for a number of reasons, including negative effects on incentives for tax-raising, encouragement of rent-seeking and engendering instability in public finances.

Equalisation systems vary substantially in design and in implementation. Some are formula driven, while others are more discretionary. The channels for net transfers may be vertical (from the centre to the sub-national), horizontal (from richer to poorer states) or a combination of the two. In addition, systems may be explicit in their aims (typically through grants that are primarily aimed at boosting fiscal capacity) or the indirect consequence of other policies that allocate money according to the target of the policy (for example unemployment benefits or pensions) in ways that systematically equalise between regions – see, *inter alia*, Begg, 2004; Enderlein, 2007).

3 IMPLICATIONS FOR THE EU BUDGET

There are both conceptual and empirical issues – and, inevitably, disagreements – about how to frame the EU budget in the light of the theoretical models and their implications for good policy design. The differing views on federalism make it almost impossible to derive uncontested theoretical propositions that can guide the EU budget. As Rodden (2006b: 2) bluntly puts it, 'the prevailing view of federalism as a clean division of sovereignty between higher and lower-level governments is giving way to a notion that authority over taxation, expenditures, borrowing, and policy decisions is inherently murky, contested, and frequently renegotiated between governments, with federal constitutions analogized to the "incomplete contracts" of industrial organization theory'. For this reason, it may be over-optimistic to expect that a convincing design for the EU budget can be elaborated from first principles.

Much of the literature on fiscal federalism and multi-level governance assumes a clear hierarchy of government, let alone governance. It follows that attempting to apply the insights and tools derived from this literature to the political and economic choices around the EU budget is not easy. Yet, in some areas, lessons can be drawn, not least in assigning responsibilities for public expenditure and inter-governmental transfers among tiers of government in a manner consistent with the principle of subsidiarity. The challenge in the highly politicised context of the EU is to establish in what circumstances (bearing in mind the small size of the budget) the principle can be convincingly applied. Instead, the question becomes one of trying to work out to what degree the underlying principles can inform the choices about what expenditure should be undertaken by the EU level and how it should be financed.

A key issue to resolve is, thus, whether the conventional interpretations of allocation and distribution, if not stabilisation, can so readily be applied to the EU. Distribution in EU terms is not, in the first instance, inter-personal – the essence of the approach adopted in fiscal federalism – but among Member States. Indeed, there is no presumption that cohesion policy will benefit households in the lowest deciles of the income distribution; instead, its primary effect in the lexicon of the fiscal federalism model is to act as a form of fiscal equalisation, albeit one that straddles allocative and distributive aims. Similarly, it is only as a result of some effort having been made, in the 2003 reforms, to slant CAP payments towards lower income farmers (so-called degressivity) that there is a limited degree of inter-personal redistribution among a single sector of the population, rather than for the population as a whole. Even then, the large farmers and landowners remain the main beneficiaries of the CAP and a recent study by Bureau and Mahé (2008) concludes that 'the capping and modulation of payments has been proposed for a long time by the Commission but has yet to become reality, except for a limited modulation'.

Stabilisation policy within the EU is, as laid down by the Maastricht governance model, firmly reserved to the Member State as a policy function and it can also be argued that larger Member States do, indeed, have sufficient economic weight to fulfil this function. Bail-out of the EU level by the Member States is precluded by the balanced budget provision and (at least for the present) by the operation of the GNI resource as a balancing one. Nevertheless there are features of the political – as opposed to fiscal – organisation of the EU that have some resonance. Rodden (2006a: 10) asserts that 'if the center is merely a loose, logrolling coalition of regional interest groups, it has a hard time resisting bailout requests or firmly regulating the fiscal behavior of local governments. Furthermore, intergovernmental grants and loans from the center to the lower-level governments are likely to be highly politicized'. The bailout element does not apply, but veterans of EU budget negotiations may find the notion of politicised transfers more than a little familiar!

These insights must colour how EU expenditure, as an instrument of economic governance, is understood and applied. One reading is that most of today's EU budget is distributive (namely the CAP and cohesion) and that true European public goods are a minor share. Others contend that objectives such as food security or the spreading of economic development have public good attributes and thus that it is an exaggeration to classify these policies in their entirety as distributive. Yet an irony is that in the logic of fiscal federalism the EU level *should* be engaging in distribution, leaving the public goods to lower tiers of government, except where there is a persuasive case that they should be pushed upwards (that is, a subsidiarity test). There is, though, some opportunity for the lower levels to assist in either stabilisation or redistribution, despite the case against, but more as an agent in delivering programmes than a principal.

There is now something of a consensus that the EU is not on course to become a United States of Europe, and thus the federal level of a multi-level governance system. Granted, it has acquired and continues to accumulate considerable regulatory powers, consistent with Majone's (1996) notion of the regulatory state. Granted, too, there is a demand to rethink the expenditure competences that the EU is assigned. But all of this is within the rather limited sphere of an EU level subject to much more restrictive constitutional limits on its ambitions than apply to federal nation states.

Consequently, Tanzi (2007) is surely correct to argue that the emergence of the supranational level as a significant, but often narrow policy actor represents a qualitatively new phenomenon that fiscal federalism struggles to accommodate. In practice, the allocative function of the EU budget is primarily about the case for EU level public goods, but is adjusted to allow for transfers between Member States, a function that is very different from the inter-personal redistribution that features in fiscal federalism.

3.1 Subsidiarity applied: the Ecorys report

The most extensive recent study of the expenditure side of the budget has been done by Ecorys, CPB and IFO (2008) – hereafter, the Ecorys report. It looks at the rationale for the existing and prospective future EU spending from the perspective of public finance theory and the principle of subsidiarity and, not surprisingly, concludes that were these principles to be applied rigorously, substantial changes in the structure of spending would be justified. The study builds on the straightforward subsidiarity test developed by Ederveen et al. (2008) which poses the question hierarchically:

1. Is action at the EU level necessary to achieve the stated aims?
2. Can it be achieved by co-ordination of national efforts?
3. Even if EU level expenditure is justified, how much is needed to ensure a proportionate response?

The first question in the test asks whether there are sufficient benefits from centralisation of the policy area to offset the gains from decentralisation. For the EU, it then asks whether there is shared competence and if the answer to both questions is yes, poses the further question of whether voluntary co-operation between Member States can achieve the desired aims. If not there is a case for the supranational level to be responsible for the policy area. However, the Ederveen et al. approach then imposes a test of proportionality to ascertain how engaged the EU level should be in delivering the policy. The voluntary co-operation test will vary with the policy under consideration. In the terms used by Ederveen et al., it requires credibility which could also be interpreted as trust that partners will not renege. In turn, credibility depends on the incentives governments face, and the monitoring and sanctioning of any cheating.

Throughout, in the Ecorys study, the broad approach taken is to find reasons *not* to assign public spending competence to the EU level, either by demonstrating that the policy aims can be achieved without money being spent, or if money has to be spent, that the Member State level (or sub-national government) is appropriate.

3.1.1 Applications to different policy fields

Different factors come into play in thinking about whether particular arguments justify an EU level policy intervention. Thus, in considering whether there is a persuasive case for EU action to promote adaptation to climate change, conflicting considerations arise. The uneven incidence of impacts suggests that solidarity may justify outlays from the EU level. Yet, as the Ecorys report points out, the Member States have information advantages in dealing with the consequences of climate change, and there are risks that providing resources from the EU budget may be an incentive to Member States to free-ride by doing less to prevent the most adverse effects, in the knowledge that the EU will offer a bail-out.

In terms of broad areas of expenditure on structural policies of different sorts, the Ecorys report comes to fairly predictable conclusions about which policy areas should receive higher or lower EU expenditure in the future if economic efficiency criteria are strictly applied. Agriculture and rural development should fall dramatically and cohesion spending to a lesser extent, while there should be moderate increases in EU spending on: R&D; environmental policies; the maritime element of fisheries policy; network industries; and foreign aid and neighbourhood policy. Limited EU spending on defence is also advocated on these grounds.

In six other areas, the report suggests no change. They are: macroeconomic policy; social affairs and employment; education and culture; health and consumer policy; competitiveness and single market policies; and freedom, security and justice. The last two categories may strike some readers as surprising to the extent that these are areas in which the EU has 'majored' in recent years and are worth examining in greater detail.

Stabilisation is a function that the 2008/9 economic crisis has reminded us is a ought to be centre-stage, yet is conspicuous by its absence in the debate around the EU budget. The Ecorys report tries hard to find some connection between the EU budget and stabilisation policy, citing the guarantees offered to countries receiving loans for balance of payments support through the European Community Guarantee for Community loans. However, it does not find a convincing reason for stabilisation to be incorporated into the budget and concludes that, in any case, it is a non-issue because of the small size of the budget. The implication is that the burden of fiscal stabilisation will necessarily remain with Member States.

Competitiveness and the single market has, arguably, been the main thrust of Commission policy since 2005 and is, moreover, a policy area that has been highlighted in the presentation of the EU budget in recent years.

Indeed, the web-site of DG Budget makes great play of the fact that in 2008, for the first time, the EU budget will allocate more resources to competitiveness policies than to the CAP.[6] In the Ecorys study, however, the headings of expenditure under discussion cover several relatively small budget lines that bear on competitiveness (the internal market, taxation and customs, external trade, and the competitiveness and innovation policies overseen by DG Enterprise), but not R&D which is, in fact, currently the largest element of line 1a in the budget.

Internal market spending (0.05% of the budget today) is predominantly administrative and analytic, and there is little scope for public investment in this area. Similarly low amounts are spent on taxation and customs, competition policy, and on external trade policy, in all of which the main tasks are, again, administrative. It could be argued that trade promotion might be an area that could benefit from collective action, but there are evident national sensitivities to take into account. The competitiveness and innovation policies do embrace a number of spending programmes, as well as administrative expenditure and are much the biggest of the five categories discussed. However, it is important to note that the programmes in question are principally about diffusion – especially to SMEs – rather than the knowledge creation implicit in R&D programmes funded elsewhere in the EU budget. This leads the authors of the Ecorys report to argue that there is not a strong case for boosting EU spending in this area, notably because the risks are slender of spillover effects inducing Member States or localities to under-invest in such policies.

These arguments have some force, but are also open to criticism. Cross-border co-operation between SMEs can be an important channel for diffusing innovation, suggesting a case for the EU level to provide resources to achieve it. Similarly, in an increasingly globalised knowledge market, mechanisms funded at EU level for linking companies and research institutes, could be helpful. In both cases, what the EU level is best equipped to do is to develop programmes that open doors.

Standard normative arguments from fiscal federalism can readily be deployed to justify EU spending on environmental policy – and efforts to counter climate change in particular. For carbon mitigation, the opportunity for free-riding leading to under-investment is obvious. The incidence of

[6] This claim is open to dispute, because it is arrived at only by adding together cohesion spending (line 1b) and the policies under the heading of 'competitiveness for growth and employment' (line 1a).

adverse effects is also relevant, not least because governments have no incentive to deter economic agents from pollution in other countries.

Development assistance is an area in which a common budget at EU level makes sense on analytic grounds, both because it enables pooling of effort and to avoid free-riding. Yet it also raises an intriguing point which is where to draw the line between the EU level and the Member States, especially if some of the latter want to raise the percentage of GDP to a higher level than the EU norm. As the Ecorys report notes, assigning all of EU development aid to the EU budget would – if the 0.7% of GDP target is attained[7] – consume the lion's share of an EU budget that is set at 1% of GDP. The solution suggested is to fund a core amount through the EU budget, leaving Member States to top-up. One side-benefit of doing so would be to increase the diversity of aid channels, potentially affording more scope for policy learning and transfer.

It is interesting to recall that the MacDougall report (Commission, 1977: 14-15) called for more of the external spending on development assistance to be financed through the EU budget and foresaw the need for an increase in EU level spending on 'structural, cyclical, employment and regional policies', justifying these by the need 'to reduce inter-regional disparities in capital endowment and productivity'. Today, however, what the Ecorys report calls supra-European club goods are confined to a limited subset of beneficiaries, distinguishing them from multilateral actions. This is not necessarily an argument for centralisation as such, but it may help the EU in exercising leverage in negotiations. The EU as a whole benefits from stability of neighbours in political, economic and security terms, so that there is a public good element here, too.

Other issues discussed in the Ecorys report include:

- Other than supporting international trade negotiations related to agricultural products, there is very little reason for the EU budget to continue to support the CAP. Indeed, the conclusion drawn is that only path dependency can be adduced as an argument.
- The case for EU funding of cross-border network infrastructure is well-known and, as markets become more integrated, this argument becomes stronger. The Ecorys report notes, too, that there are incentives to over-charge foreigners who have no redress other than retaliation, which could lead to retaliatory action that pushes up costs.

[7] It is currently barely half the target.

To lessen the risk of common-pool problems, co-financing or user fees can be a mitigating strategy.

- Border control shows clear cross-border public good characteristics. Countries on the external border bear the costs, while those with no external borders (other than international airports) may free-ride.

3.2 The revenue side

On the financing side of the budget the choice is deceptively simple. The EU is, at present, funded principally by transfers from the Member States' general budgets. These *national contributions* (to use the jargon of EU finances) have a number of attractions that only have a limited connection to fiscal federalism theories. In particular, the current make-up of EU resources, dominated by the GNI resource which now accounts for some 70% of EU revenue, has the important property that the call on national funding fluctuates to reflect the expenditure from the EU budget. This 'residual' property of the GNI resource means that (subject to expenditure being below the own resources ceiling, which it has been consistently since the resource was introduced twenty years ago) unlike other governments, the EU does not face a financing constraint.[8] In this respect the revenue raising of the EU level is of a second-order of importance in budget negotiations, an attribute of the system that is very different from that of other governments which often have to struggle to find politically acceptable ways of raising revenue. Moreover, as the EU is required to balance its budget (Art. 268, TEC), a resource which adapts seamlessly in this way is doubly attractive.

Against this backdrop, it is almost ironic that one of the more powerful messages from fiscal federalism is that governments should raise what they spend, rather than relying on grants from other levels of government. Granted, the message relies on *top-down* analysis, not the *middle-up* (for want of a better expression) formula employed in the EU, but it is worth dwelling on why the fiscal equivalence approach struggles in the EU context. First, even though true own resources ought to be more congruent with theoretical analysis that emphasises the incentives facing government, they tend to be advocated in the EU for rather different reasons. According to the theory, developed from the pioneering contribution of Olson (1969), governments which do not have to raise all their revenue have incentives to seek ways of avoiding paying and of trying to extract more from the

[8] For an extended analysis, see the study done as an input to the 2008/9 Budget Review by Begg, Enderlein, Le Cacheux and Mrak (2008).

'common pool' of public goods and services. It is, in Olson's terminology, a problem of collective action.

Advocates of true own resources, often labelled a tax (or taxes) for Europe, cite a variety of arguments, most of which are political rather than analytic, although it is worth making the point that the Treaty states that the 'budget shall be financed wholly from own resources' (art 269, TEC). A simple definition of an own resource is a stream of revenue that is assigned unambiguously to a particular level of government. However, reality is never that neat and, according to Bird (2000), a genuine own resource has to be assessed on a number of further criteria. The first is which government has the power to assess the revenue source and thus determine the tax base. Second, 'ownership' will be reflected in the setting of the tax base, while a third criterion is which government collects the tax. Bird notes that some of the taxes often adjudged to be owned by a government only fulfil some of these criteria, casting doubt on who 'owns' it. Collection, for example, may often be centralised, yet the proceeds still accrue to sub-national tiers (Sweden, though, is a counter-example with major taxes on income collected locally but with a proportion spent by other levels of government).

An additional reason for looking at own resources, stressed in SGFF, is to favour fiscal equivalence because it permits better accountability of the tier of government to its tax-payers and militates in favour of market enhancing public goods. If taken to its logical conclusion, this reasoning would mean that the EU level ought to have more direct revenue raising power and not be reliant on transfers, and that it would be more likely to boost the share of public goods in the budget, rather than distributive outlays. This raises the question of whether the characterisation of EU revenues as inter-governmental grants is, in fact, accurate. In legal terms, the GNI and VAT resources are 'owned' by the EU level because they are formalised in successive own resources decisions (see House of Lords, 2007, for a robust statement of this standpoint). Yet they do not really fulfil the analytic ownership criteria.

Nor need the debate on own resources be confined to recognised taxes, introducing further complications that theory struggles to accommodate. The EU has a number of policy competencies that are actual or potential sources of revenues, such as the proceeds of auctioning emissions' trading permits, or central bank monetary income, notably from seigniorage. A conclusion of the recent study for the EU Commission (Begg et al., 2008) is that there are many viable revenue sources that could be used to fund the EU level, but that the choice between the various instruments depends largely on what properties decision-makers want the funding instrument to exhibit.

If what matters most is to assure the flow of revenue and to achieve a tolerable degree of fairness among Member States in gross payments, the present system based principally on GNI-related national contributions has much to commend it. If, by contrast, there are political aims such as enhancing the visibility and accountability of the EU's revenue raising or of using Pigouvian taxes to alter behaviour (for example, through a carbon tax), then a different mix of funding instruments would be warranted. Although fiscal federalism and related theories can offer some insights into whether a particular funding instruments should be 'owned' by a specified level of government, a conclusion of the study by Begg et al. (2008) is that these insights do not, ultimately, translate into the factors that are upper-most for the EU.

In assessing what sorts of funding instruments might be used for the EU budget, theory provides some guidance. Among different types of taxes, land is immobile and labour only marginally mobile – especially in an EU in which national social protection systems and other social policies deter economic migration. By contrast, corporate profits or investment income are more likely to move to seek the most favourable tax regimes, thereby introducing market distortions. These differences suggest that the EU should harmonise the latter, but allow Member States much more latitude over the former (Gramlich and Wood, 2000). Consumption taxes such as VAT are more contentious, as there are evident opportunities for cross-border shopping, though on a relatively limited scale. In any event, VAT is partially harmonised and – it should be recalled – has been one of the resources already used for the EU budget, albeit with adjustments. VAT is, in addition, regularly canvassed as a potential resource for funding the EU budget (for a recent re-statement of this view, see Iozzo, Micossi and Salvemini, 2008)

3.3 Corrections: showing the limits of theory?

The enormous attention devoted to *juste retour* is one of the striking characteristics of EU finances, yet can be hard to relate to theory. In other polities, the big debates surround the formulae used to distribute inter-governmental grants, the 'ownership' of taxes and the assignment of spending tasks. In addition, the extensive study of equalisation is, on the whole, an exercise driven by equity considerations that might be expected to bear on net balances. Yet, curiously, there is no obvious tradition in the various theories that gives much guidance on how corrections to accounting balances should function. The theory of clubs (see, for example, Casella and Frey, 2002) might offer some clues for understanding why club members seek certain levels of access to club goods, but even then it tends not to provide a model for how ‘my money back’ enters the equation. In international organisations, some members have used the threat (or, in some cases, the fact) of withholding subscriptions to influence the spending priorities of the organisation. But there is no obvious parallel for explicit corrections as used in the EU. Once again, the inference has to be that the issue is unique to the Union.

In practice, the net balance approach to EU budgeting echoes many of the disputes in the decentralisation debate about how to apportion central government revenues and spending. Advocates of tax competition – following the well-trodden path of Tiebout (1956) – would counter that such competition is beneficial because it pushes sub-national governments to be more efficient and responsive in the bundles of public goods they produce (for a survey, see Wilson, 1999), but there is also a risk (Ahmad et al., 2008) that local administrations will be more prone to capture or indeed outright corruption. It is a moot point whether the EU level is more or less open to this risk than Member States central governments.

In the EU budget, it has long been the case that the most fraught negotiations typically centre on how much each Member State’s net contribution or receipts should be. A curious tension then arises between policy driven spending programmes and accounting ratios that measure net positions. Political judgements of what is acceptable have, then, resulted in a proliferation of devices used to ‘correct’ national positions. Formally, the most significant of these are on the revenue side of the budget, although various expenditure decisions can only be fully rationalised as de factor corrections. Box 2 on the next page summarises the history of ‘corrections’ as used in EU finances.

Box 2 A rebate by any other name...

The original 'abatement' was granted to the UK in 1984 to offset the fact that the UK received only a comparatively low share of EU spending, resulting in an unreasonably high net contribution.

At the same time, Germany (as the only other substantial net contributor) was asked to pay only a part-share of its ex-ante contribution to the UK rebate, with other countries having to make up the shortfall pro rata.

In the 1999 budget settlement, three other Member States (Austria, the Netherlands and Sweden) were also given rebates on their contributions to the UK abatement.

Also in 1999, it was agreed that the 'fee' paid to Member States for collecting customs duties would be increased from 10% of the proceeds to 25%, a change that mainly benefited the Netherlands because of the disproportionate share of imports from the rest of the world entering the EU through Dutch ports (especially Rotterdam). The UK, however, undertook to forgo part of the windfall gain it would have received from this amendment.

Special payments under the Structural Funds were agreed for the Netherlands, Austria and Sweden with no more justification than, to cite the example of an allocation of €500 million to the Netherlands, a bland statement that this was 'to take account of the particular characteristics of labour market participation in the Netherlands'.

Further back-door rebates were included in the 2007-13 budget settlement, in addition to a new clutch of ad hoc spending commitments, through:

- Continuation of the rebate for the same four countries on the UK abatement.
- Reducing the call up rate on the VAT resource for the Netherlands and Sweden (cut to 0.10), Germany (down to 0.15) and Austria (set at 0.225), compared with a rate for all other Member States of 0.30.
- Reducing the call up rate on the 4th resource for the Netherlands by €605 million annually and for Sweden by €150 million over the period 2007-13 only.
- Bavaria, a prosperous region, is accorded an (unexplained) special payment of €75 million from the Structural Funds.

The upshot is a system now so full of special cases that it is increasingly bereft of underlying principles and lacking in transparency.

Source: Begg (2007)

4 THE LIMITS OF ANALYTIC WORK

The lack of a convincing answer to the question of 'what the EU is for' (Alesina, et al., 2002) is a fundamental obstacle to dispassionate academic assessment of what the EU budget should support, and is exacerbated by different disciplinary standpoints. As Figueira (2007) notes, the political science literature has been predominantly concerned with issues of legitimacy of the EU level as a budgetary authority, whereas economic analysis rooted in variants of fiscal federalism has looked mainly at the economic efficiency and distributive consequences of different possible mixes of competence. Yet both strands of thinking are manifestly influential. The trouble is that they tend to remain separate, making it difficult to identify why a particular element of spending should or should not be assigned to the EU level. Economic logic, for example, would tend to say that expenditure subject to very obvious economies of scale should gravitate to the highest level of government. Yet it is clear that political sensitivities dictate that certain policies have to be reserved for the national level.

Conversely, it can be argued that items could be included in the EU budget for legitimacy reasons, even when a credible economic logic is absent. The stickiness of the CAP, for instance, can be explained in terms of path dependency or even a political settlement, even though economic logic overwhelmingly rejects it. In a roundabout way, therefore, it can (almost) become possible to defend having the CAP in the EU budget, not because it makes analytic sense, so much as because it reflects a political choice.

The Ecorys report shows that it is possible, using a consistent framework, to appraise a range of policy areas and to identify those for which centralisation at the European level makes most sense. It would, in principle, also be possible to draw up a list of candidates for EU funding according to some form of subsidiarity index that took account of different criteria. Thus, EU spending on mitigation of climate change, given that there are clear externalities, evident economies of scope and that it chimes with EU policy priorities would be expected to score highly on such an index. By contrast, the EU's legitimacy in paying for social policy initiatives that favour certain interests are much more difficult to justify. Overlaying the analytic case are the various path dependencies and political constraints that make application of principles problematic.

Hence, a supposedly objective approach to assigning spending to the EU level will always have limitations for a number of disparate reasons. First, the size of the EU budget cannot be divorced from the composition of spending. In a true federal system, the division between central and decentralised tiers of government concerns large proportions of GDP. A simple 50:50 division of public spending between these two levels when the state accounts for some 40% of GDP means an order of magnitude for the federal level of 20%, twenty times the level of the EU budget. With this order of magnitude, substantial spending programmes can be assigned to the federal level – and be defended on analytic grounds. At 1% of GDP, however, the EU level can only be responsible for a highly selective 5% of what, elsewhere, are federal public spending functions, and the question that then arises is whether it is worth engaging in a complex analytic exercise, rather than simply deciding on specific tasks for the EU.

A second limitation on assigning policies to the EU is that even if analytically sound reasons are applied to select viable choices for EU spending, there are often political over-rides on the options. Defence or foreign representation, for instance, exhibit many characteristics that warrant delegation to higher levels of government. But both are policy areas that enable nation states to define what they stand for, as indeed are social policies that shape the distribution of well-being. The EU cannot expect to intrude in these areas just because economies of scale might make it more effective in delivering policy.

One way to reconcile the reality of what the EU does with the tenets of fiscal federalism may be to distinguish between the positions of governments in a geographical hierarchy and a hierarchy of governance functions they fulfil. In this regard, Tanzi (2007) makes the point that what is novel about the various supranational institutions is that they produce public goods of different sorts (or try to curb public 'bads') that would not be achieved if left to nation-states.

Even so, in any reform exercise, the direction of change is a key consideration. In the Ecorys report, it is suggested that the many political economy constraints on change can be taken into account by gradual shifts, but that the target should nevertheless be to move towards an economically efficient composition of spending. But political salience also implies a need to select a broad theme for the budget. Previous such themes have included the single market and monetary union (in the first two *Financial Perspectives* after 1988), enlargement (after 1999) and, less successfully, the Lisbon strategy (the current MFF). Although there are many directions a future EU budget could take and no reason to regard them as mutually exclusive, political factors suggest that a single focus may be desirable.

4.1 Where fiscal federalism is orthogonal to the EU budget

There are many tenets central to the economics and political science literature that either do not apply to the EU or, even if they might, are belied by the realities of what the EU is or is likely to become. In several respects, the different strands of theoretical work, especially fiscal federalism, focus on issues that are remote from those that feature most prominently in the wrangles over the EU budget, and rely on assumptions and insights that cannot readily be associated with it. As noted above, perhaps the key difference is that in discussing the EU, it is twenty-seven central governments dealing with a single supranational budget, whereas the usual fiscal decentralisation model is a powerful central government mediating between multiple actors and budgets at sub-national level. It is a moot point whether this is just a matter of which end of the telescope to look through or a fundamental obstacle to using the theories.

Even if that obstacle is overlooked, applying fiscal federalism and MLG theories to the EU budget is problematic for a range of reasons. First, the Treaty and the power balance between the institutions mean that the EU level has few of the competencies normally assigned to the highest level of government. Moreover, the legislative structure militates against a shift. Thus, although the European Parliament has gradually increased its power in successive Treaty reforms and will obtain further rights if the Lisbon Treaty is finally ratified, it remains the case that it is a legislature which, despite being directly elected by citizens, can be (as various commentators have observed) characterised as having 'representation without taxation'. By contrast the Council – representing the Member States – has long been the moving force in shaping what the EU can do overall, and certainly in the public finance arena. The EU's purpose, as stated in Art. 1 TEU, 'shall be to organise, in a manner demonstrating consistency and solidarity, relations between the Member States and between their peoples'. The fact that it is set up as a union of citizens *and* of Member States can, perhaps, be identified as one of the most distinctive features of the EU. In particular, it implies that the accountability of the union is to Member States as much as to citizens. It also means that, in shaping the budget and in the political economy of decision-making on public finances, the Member States have a pivotal role.

A second way in which the realities of the EU depart from much of the theory is, as Jonas Eriksson (Begg, Sapir and Eriksson, 2008: 11) puts it, 'that migration within the EU is fairly insignificant, implying that agents will neither respond to spending decisions in neighbouring Member States, nor will they choose to exit as a response to spending decisions in their own Member State'. This matters because the notion of 'voting with your feet' is one of the mainstays of many of the key propositions in fiscal federalism, above all in relation to redistributive policies. In fact, many of the constraints on budgetary actors within a multi-level system derive from concerns about how economic agents will respond. It can, however, be argued that although migration of persons is limited in the EU, flows of capital are subject to few obstacles.

Third, while it might be expected that a set of tasks for the EU level would be decided using objective criteria to determine whether these tasks warrant EU level spending, the actual budgeting process functions differently, relying above all on setting a spending limit. In much of the debate on the budget, a strong position adopted by economists is to distinguish more acutely between true public goods and distributive payments or, more scathingly, 'side-payments'.[9] There are also distinctive aspects of the EU that are striking as matters of practice, rather than principle, not least the small size of the budget. Resort to corrections is another.

Tax competition is an especially delicate matter for the EU. In the mainstream fiscal federalism literature, centralised taxation is advocated for a number of reasons, but with expenditure devolved to lower tiers of governance unless there are significant spillovers or opportunities for economies of scale. A key argument for centralised taxation is to limit tax competition that not only creates immediate distortions, but also risks cutting public expenditure below optimal levels because governments dare not levy taxes. In this vein, it is worth noting that the single market is manifestly a core part of the EU integration project, but one that is at risk of being compromised if governments engage in tax competition, certainly if the tax base is mobile across EU borders.

Debt, too, is a facet of EU public finances that sits uneasily with the theory. The EU is bound by Art. 268 (TEC) to balance its budget,[10] not just over the MFF, but annually. In practice this means that it often has to repay money to the Member States, a practice that has been interpreted further to mean that an anticipated surplus cannot easily be redirected for other purposes. This latter aspect of the EU finances has been repeatedly criticised in the European Parliament and is one of the reasons for doubts about the

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[9] For an exposition of the reasoning, see the contribution of Andre Sapir to Begg, Sapir and Eriksson (2008).

[10] In this regard, it has more in common with narrowly defined local government than the highest tier in a multi-level fiscal system.

rigidity of the MFF as a framework for budgeting. It certainly testifies to the limited autonomy of the EU level. However, a more analytic issue is that the absence of a borrowing capability at EU level itself limits the EU as a fiscal entity. To the extent that the EU is investing in long-lasting EU public goods, a 'normal' tenet of public finance would be to impose some of the cost of the investment on future generations through financing the investment by borrowing.

In short, the lessons from theory are by no means unambiguous. Here the distinction between first and second generation fiscal federalism is germane, but there are also political economy considerations and more overtly political analyses that have to be taken into account.

5 THE REFORM AGENDA

Although the Commission has tried hard to push for the review of the budget to look beyond the tired debates of recent MFF negotiations, there is as yet little sign that it is succeeding in engendering much fresh thinking. There are likely to be several elements to consider. A minimalist approach would be for the supranational level to assume the administrative costs of implementing regulation or co-ordination, although even for this task, EU experience make it clear that there can be a division of labour between policy formulation, implementation and enforcement. The 'federalisation' of EU competition policy in 2003 illustrates this point. At the other end of the spectrum, there could be expectations that the supranational budget will provide for investment in a substantial range of public goods needed to underpin either regulation or co-ordination, logically distinct from the direct provision of public goods.

Yet the scope for the EU level to act 'federally' is still an issue. Vivien Schmidt (2006), in assessing the EU as a tier of government, recalls Lincoln's famous dictum. She asserts that in the EU there is government for the people, but much less so of and by the people. She also proposes the term 'regional state' to capture the somewhat odd conjunction that characterises the EU of centralisation in significant policy areas and denial by the Member States of powers in others, and she compares it to pre civil war United States in its degree of institutional development. It may be that these ideas help to explain why the EU struggles to move forward in an area subject to so many sensitivities as public expenditure. It is also evident that calls for subsidiarity rooted in economic efficiency are very often going to be in conflict with what is politically expedient or acceptable. In short, political economy has to be brought into the reform debate.

5.1 The political economy of reform

In the literature about fiscal decentralisation, several political economy issues arise that, when the direction of inter-action is inverted from downwards to upwards, could offer some insights for the EU budget. Any decentralisation is effectively a contract 'between the political representatives of national and subnational governments. As in the case for all legal agreements that extend into the future, these contracts cannot specify and anticipate possible developments that may require rewriting of the original contract. For this reason, unless the occasional rewriting of the contracts is relatively simple and possible, a powerful referee to help settle future disputes is needed' (Ahmad et al., 2008: 13).

Some of the influences, such as lobbying can lead either towards or away from centralisation. Farmers have succeeded in promoting a centralised agricultural policy; for defence interests, by contrast, there are probably advantages (not least maintaining separate procurement budgets that provide steady markets) in keeping policy at national level despite the considerable scope for economies of scale of pooling of resources. Difficult issues also arise around pooling of research, with some Member States worrying that they would lose out in obtaining funding, even if pooled funds offer the prospect of better returns for the EU as a whole.

By contrast, national interests may result in an inefficient slowing of centralisation. For example, centralisation of tax collection may make sense either because of economies of scope from having a single authority, even if the proceeds are then redistributed. There are also, for some classes of tax, clear difficulties about the appropriation of revenues to lower tiers, and in nearly all federations the answer is found in central government collecting a much higher share of the revenue then distributing it to subnational government according to various keys.

Ederveen et al. (2008) discuss a number of possible political economy influences, several of which are, quite reasonably, shown to be inconclusive. Thus, while a strict subsidiarity test would assign responsibility for higher education to lower levels of government, they point out that competition between universities for EU funds may stimulate better performance and be less prone to capture by domestic interests. Another example is issue linkage where a deal on one area may be easier if there is a parallel deal on another, with explicit side payments as the limiting case. Indeed, a pure side-payment in the EU budget may be justifiable *only* because it permits the unblocking of another more significant policy area.

Imposing a hard budget constraint on lower levels is a prominent topic in the literature on fiscal federalism, especially in relation to emerging economies. Central government is able to impose fiscal discipline on lower tiers through well-designed transfers and by being strict on bailouts. But the supranational level in the EU is ill-equipped to do so and even the policy tool that has some relevance in this regard, the Stability and Growth Pact, is unrelated to the EU budget. For the EU level, a hard budget constraint is already a reality achieved partly through the own resources ceiling which imposes an upper limit on the amount of revenue that can be assigned to the EU budget. The constraint is reinforced by the strong focus on net balances which gives a sizeable minority of Member States a strong incentive to contain their net contributions by restricting the overall size of the budget. The upshot is the oddity that the actual budget has consistently been below the limit (currently 1.24% of GNI for payments). Indeed, it is projected to be just over 1% of GNI over the course of the Multi-annual Financial Framework for 2007-13, and to decline to reach 0.94% of GNI by 2013, at which point the actual spending will be just three quarters of the permitted ceiling.

In political economy terms it could be argued that the EU level ought to be better able to support large-scale projects that underpin economic growth, because it has less need to placate vested interests by favouring immediate distributive policies. Thus, although there is a presumption in the decentralisation literature that greater efficiency in public expenditure can follow from decentralisation, it is by no means certain. Subsidiarity is a useful principle, but only provided that it is properly applied, as opposed to being employed as a one-way drive towards decentralisation, given that the whole point is to pitch expenditure at the level at which the returns are greatest, even if there is a systematic preference for lower levels. Developments over time may have some relevance. The EU manifestly has to confront the diverse challenges of globalisation, some of which call for public goods at the European level. Increased international investment flows, whether within the 27 Member States or in exchanges with the rest of the world, result in new forms of cross-border externalities that may call for public spending.

6 CONCLUSIONS

It is verging on the banal to state that the *sui generis* character of the EU renders it difficult to place within the logic of economic theories such as fiscal federalism. Yet it is worth trying. Oates (2002: 42) observes that many of the issues under discussion today had already been reviewed in the MacDougall report (Commission, 1977), but as he puts it: these issues 'are by no means new ones; at the same time, they have not, in my view, really been resolved'. The EU level of governance is not the central government that, in the theories, has to do battle with, and mediate between, many sub-national governments. Rather, it is a form of government that lacks the authority or legitimacy to be at the pinnacle of policy-making. Yet it exercises power in ways that are distinctive and that challenge standard theoretical models.

The MacDougall report also set out far-reaching proposals for EU budgetary reform that, in many respects, represented how the EU would look if it followed the fiscal federalism model. The report advocated a budget of around 2% to 2.5% of GDP in a pre-federal EU, and rising to 5% to 7% in a more federal EU in which the central state remained relatively small and left social and welfare spending at the Member State level. Such a 'small-federal' budget would, plainly, still be far short of the 20% plus share of GDP of the federal government in mature federations. That even the lowest of these figures is double what the EU budget is today, despite the considerable advances in integration over the three decades since the report was published, testifies to the straitjacket within which the budget is contained. It also reveals how far the EU is from the ideal-type.

Some fiscal federalism principles, such as matching the scope of the public goods with the reach of the jurisdiction, may be just as valid for the EU as for any other governmental entity. Similarly, the logic of FGFF and, more so, SGFF is that there should be substantial revenue raising capacity at lower levels, principally as a means of ensuring that policy-makers face appropriate incentives, and there is no reason to suppose that the idea does not also apply to the EU level. Yet direct revenue-raising by the EU is highly contentious and is manifestly resisted by Member States loath to cede the 'power to tax'. In FGFF the broad presumption is that there are benevolent social planners as opposed to the more self-interested kind assumed in SGFF. Critics of the EU will, no doubt, be quick to argue that 'Brussels' is indeed a prime example of *Leviathan* and there have been occasions when grandiose spending projects have seemed to conform to this view. Equally, for the bulk of EU spending it is as often the EU level that struggles to mediate as an honest broker between Member States determined to secure an even more *juste* ‘retour’ at the expense of others.

Much of what the EU of today spends can be shown to be at odds with rather straightforward analysis of what a supranational entity, even one hemmed-in by the pretty onerous restrictions the Member States impose, *ought* to spend. The shopping-list is easily drawn-up and would be unlikely to surprise the unbiased observer; and for this purpose, the Ecorys study constitutes a viable starting-point. Some of the specific analysis and recommendations in the report might be disputed and different priorities might emerge, but most would not be contested. Equally, some incentive-related attributes highlighted in the literature do apply in the EU. For example, a feature of cohesion policy is that it requires recipient regions to raise sufficient revenue to co-finance the projects implemented, thereby conforming to good practice in such transfers.

But the two questions that then arise are, first, how to justify change and, second, how to refocus EU spending. Concepts such as subsidiarity and proportionality, or the assertion that EU spending must be confined to policies for which there is a demonstrable added value, can sound too abstract to be operational. Even if they deserve to be more prominent in shaping the EU budget, there are tough obstacles to applying them. The status quo is powerful and the lobbies that underpin the continuation of policies such as the CAP are highly effective. To put it another way, possible triggers for a comprehensive reform of the EU budget are not very visible.

In any assessment of the role of the EU budget in this regard, it is noteworthy that adjustment mechanisms that are powerful in the context of the nation-state are very limited in the EU. Thus, cross-border economic migration tends to be of an order of magnitude lower than intra-country migration. Institutionalised means of equalisation within Member States are very powerful, but the small EU budget necessarily limits the degree to which it can redistribute income. Moreover, there is an ambiguity about what is distributive and what is allocative in flows from the EU budget to Member States. Risk sharing is not something the EU can easily implement, if only because obtaining the assent of the Council, representing the Member States, requires unanimity, in contrast to the simple majority that would be needed if approval by the European Parliament were critical. What this leaves is a need for a focus on the sorts of public goods that make most sense at the EU level, but selectively. Theory can be helpful, but ultimately deciding what the EU should spend public money on is about hard choices and limited ambitions.

A binding constraint on reform is the size of the budget because, so long as the budget is set at about 1% of GNI, entire categories of public spending are effectively excluded from consideration, irrespective of political or efficiency arguments for shifting them upwards. Typically, federal budgets account for 10% or more of GNI and even the much smaller 'federal-light' budget of 5%-7% discussed in the MacDougall report looks like fantasy.

Even if a moderate increase to 1.3% or 1.5% of GNI is contemplated, there is no easy way to use theoretical models to arrive at an objective list of what should be in the EU budget rather than at other levels of government. The Ecorys report made a rigorous effort to apply its extended subsidiarity test and reaches plausible conclusions about the relative merits of assigning different classes of public spending to the supranational level. It proposes three 'packages' as underlying narratives for a reformed EU budget:

- Climate change and energy
- Knowledge and innovation
- Common security and foreign affairs

Each has its merits, but the key point is that they are alternatives, and choosing one rules out the others.

In addition, the EU budget manifestly still has a role to play in smoothing the (bumpy) road towards European integration by transferring resources between Member States as part of grand bargains. These may be parcelled up inside policies that have worthy objectives (cohesion as a public good), but are inevitably susceptible to the pork-barrel politics of *juste retour* thinking. As the negotiation of the Obama fiscal package showed yet again, such side-payments are the price to be paid to attain wider objectives, and an implication is that a sizeable share of the budget will continue to be required for payments of this sort. This need not mean the CAP lasts forever, but it does mean – especially with so low proportion of GNI available for the budget – that the room for manoeuvre will remain limited in switching towards authentic EU public goods that tick the right boxes on objective tests.

Despite this rather pessimistic conclusion and to dispel counsels of despair, the challenge will be to put forward eye-catching proposals for EU spending that is legitimated by being associated with major EU initiatives. A concerted response to climate change is an obvious one, especially if it simultaneously addresses energy security. But others could be envisaged so that what is needed is a debate on an underlying narrative for the budget.

The eventual answer will not, however, be found in the theoretical literature, but will instead emanate from hard political choices about what we want the EU to be and do.

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SAMMANFATTNING PÅ SVENSKA

Det råder stor enighet om att EU:s budget är omodern, dåligt anpassad för unionens framtida utmaningar och fångad i historiska låsningar som allvarligt begränsar alla möjligheter till reform. Budgetens funktion som ekonomiskt styrmedel skiljer sig på avgörande sätt från hur statsbudgeten normalt fungerar i nationalstater, vare sig det handlar om federala stater eller enhetsstater. Detta förhållande avspeglar i sig den ständiga ambivalensen om ”vad EU är till för”.

Även i de mest decentraliserade federala systemen är den centrala regeringen ansvarig för en stor del av de offentliga utgifterna och beskattningen och spelar en avgörande roll i de offentliga finanserna. Dessa funktioner har grundligt teoretiserats och analyserats i den akademiska litteraturen om fiskal federalism och flernivåstyrning. Det vore därför rimligt att förvänta sig att teorierna ska kunna användas i reformen av EU:s budget. Faktum är att den så kallade MacDougall-rapporten från 1977 tillhandahöll en planritning för en EU-budget med federal struktur baserat på dessa teorier.

I verkligheten har budgeten – som senast stöptes om på ett mer omfattande sätt 1988 – utvecklats litet. Den ligger fortfarande kvar vid cirka 1% av EU:s BNI; större delen av resurserna läggs på jordbruk och sammanhållning; och den finansieras huvudsakligen av direktbidrag från medlemsstaterna, snarare än av äkta egna medel.

I och med att det nu pågår en översyn av budgeten ”utan några förutfattade meningar”, är det lämpligt att återbesöka de bakomliggande teoretiska principerna och undersöka om de erbjuder några insikter i hur reformarbetet bör fortskrida. Rapporten granskar den akademiska litteraturen och konfronterar den med EU:s verklighet idag, i ett försök att staka ut möjliga reformvägar.

Olika disciplinens synsätt leder till olika sätt att analysera EU:s budget. Inom den statsvetenskapliga litteraturen om flernivåstyrning har man främst fokuserat på EU:s legitimitet som budgetmyndighet, medan den ekonomiska analysen, med utgångspunkt i olika varianter av fiskal federalism, framför allt har undersökt koncept som ekonomisk effektivitet och fördelningseffekter av hur kompetensen fördelas mellan olika nivåer i systemet – det vill säga lokal, regional, statlig eller överstatlig.

Fiskal federalism lägger fokus på arbetsfördelningen mellan olika styrningsnivåer när politiken skapas och begränsar sig inte till fiskala arrangemang i federationer. Tidiga bidrag i det som kallas den ”första generationen” av fiskal federalism fokuserade på det normativa fallet när ansvar fördelas mellan olika styrnivåer och hur interaktionen utformas mellan dessa nivåer. Andra generationen av fiskal federalism kompletterar de tidiga modellerna genom att granska de politiska aktörernas incitament; undersöka hur myndighetsmisslyckanden ska förhindras; och utforska de institutionella strukturer som leder till den mest effektiva och ändamålsenliga styrningen.

Flera nyckelförslag växer fram. Till att börja med utgår samtliga modeller från en stark central regering som måste medla mellan en mängd regionala och lokala myndigheter. Teorin föreslår att stabiliserings- och fördelningspolitik i huvudsak bör centraliseras, medan allokeringspolitiken bör ligga på den nivå som är bäst lämpad att anpassa politiken till den jurisdiktion politiken gäller. När det gäller allokering finns en kompromiss att ta hänsyn till mellan fördelar av decentralisering (att tillmötesgå lokala preferenser för offentliga varor), respektive fördelar av centralisering (om det råder stordriftsfördelar eller finns ett behov av att internalisera externa effekter).

Även om fiskal federalism och närliggande teorier delvis svarar på frågan om vilken nivå av systemet som bör ”äga” specifika offentliga utgifter, så räcker de inte till när det gäller Europeiska unionen. På samma sätt är det omöjligt att lyfta upp utgifter till EU-nivån eftersom det rör sig om politiskt känsliga frågor, där suveränitetens logik kräver att de ska hållas på nationell nivå – trots att det finns uppenbara centraliseringsfördelar. Ett objektivt försök att bestämma vilka utgifter som ska hanteras på EU-nivån är därmed inte möjlig på flera större politikområden. EU har tilldelats uppgiften att producera olika typer av offentliga varor (eller att hindra uppkomsten av negativa effekter) som medlemsstaterna inte själva skulle producera.

Subsidiaritetsprincipen, som innebär att politiken ska drivas på den lägsta möjliga effektiva nivån, vilar på i stort sett samma grunder som fiskal federalism. I frågan hur EU:s budget bör reformeras kan en möjlig väg vara att använda ett ”subsidiaritetstest” för att identifiera olika områden som ska tilldelas specifika nivåer i systemet. En sådan ansats används i en nyligen avslutad studie genomförd av ett konsortium under Ecorys ledning. I studien drar författarna den relativt uppenbara slutsatsen att jordbrukspolitiken ska återföras till medlemsstaterna, medan utgifter på EU-nivån ska satsas på att motverka klimatförändringar; stödja EU:s externa åtgärder; och främja forskning och utveckling. Studien finner däremot inget stöd för att öka EU:s utgifter på konkurrensrelaterade åtgärder eller på intern säkerhet, vilket är överraskande då det rör sig om två områden där EU på senare år har intagit en framträdande roll.

Den överstatliga nivån skiljer sig kvalitativt från den typiska centrala nivån i nationalstater. Det faktum att EU är en union av medborgare *och* medlemsstater innebär att utkrävandet av ansvar är lika mycket en fråga för medlemsstaterna som för medborgarna. Det betyder också att medlemsstaterna har en central roll i budgetens utformning och också, i termer av politisk ekonomi, beslutsfattandet kring de offentliga finanserna. Dessutom är det i sammanhanget intressant att migrationen inom unionen är förhållandevis liten, vilket innebär att medborgarna i EU inte kan sägas ”rösta med fötterna” – det vill säga flyttar till en annan medlemsstat om de är missnöjda med utgifterna i den egna medlemsstaten.

Det är därför något av en besvikelse att konstatera att de ekonomiska och politiska teorierna inte ger något svar på hur EU:s budget bör reformeras. Gapet är helt enkelt för stort mellan EU:s politiska verklighet och den fiskala konstitution som skulle utvecklas om modellerna (om så bara delvis) applicerades.

Till att börja med är budgetens ringa storlek en begränsning. Så länge budgeten ligger kvar vid 1% av EU:s BNI kommer stora områden av offentliga utgifter att vara uteslutna, oavsett om det finns politiska och effektivitetsargument för lyfta dem till EU-nivån. Federala budgetar representerar generellt 10% eller mer av BNI och även en mindre ”för-federal” budget på 5%-7%, som diskuterades i MacDougall-rapporten, framstår i sammanhanget som rena fantasier.

Även om en måttlig ökning till 1.3% eller 1.5% av BNI vore möjlig finns det inget enkelt sätt att använda teoretiska modeller för att på ett objektivt sätt ta fram en lista med utgifter som ska lyftas till EU-nivån. Ecorys-rapporten försökte att på ett noggrant sätt använda sig av ett utökat ”subsidiaritetstest” och kom fram till möjliga slutsatser om de relativa fördelarna av att förflytta olika områden av offentliga utgifter till den överstatliga nivån.

Det handlar dock om gråzoner snarare än en svart-vit verklighet, eftersom det är svårt att på ett trovärdigt sätt ta fram olika ”paket” av utgifter på vilka budgeten ska fokusera. De tre paket som diskuteras i Ecorys-rapporten är ”klimatförändringar”, ”kunskap och innovation” och ”gemensamma säkerhets- och utrikesfrågor”. Var och en har sina förtjänster, men poängen är att de är alternativ och att valet av ett alternativ utesluter ett annat.

Dessutom har EU:s budget en klar roll att spela när det gäller att jämna ut den (guppiga) vägen mot europeisk integration, genom att överföra resurser mellan medlemsstater för att nå större gemensamma mål. Detta kan göras inom olika områden som har sådana övergripande mål (till exempel sammanhållning som offentlig vara), men kommer oundvikligen att leda till krav på sidobetalningar, i sin tur en konsekvens av medlemsstaternas fokus på sina respektive nettopositioner i budgeten. Förhandlingarna kring Obamas utgiftspaket visade ännu en gång att sidobetalningar är ett pris som måste betalas för att uppnå högre mål och att en stor bit av kakan även i framtiden måste användas för den typen av betalningar. Det innebär inte att den gemensamma jordbrukspolitiken måste finnas kvar för evigt. Däremot betyder det – givet den ringa andel av BNI som görs tillgänglig för EU:s budget – att det finns ett begränsat utrymme för att kunna lägga mer resurser på offentliga varor som verkligen hör hemma på EU-nivån, vare sig det skulle innebära att man ”bockar av” de rätta rutorna i ett objektivt test.

Under dessa omständigheter – och detta är ingen omöjlig uppgift – är utmaningen att ta fram lättillgängliga förslag till utgifter i EU:s budget som är legitima eftersom de kopplas till stora EU-initiativ. Ett samlat projekt i klimatfrågan är ett exempel, i synnerhet om det också tar upp energisäkerheten, men det är inte det enda möjliga projektet. Vad som behövs är en debatt om vad EU är till för, vilket därmed också skulle definiera dess budget. Svaret på den frågan kommer inte att hittas i den teoretiska litteraturen. Det är, till syvende och sist, en fråga om att göra svåra politiska val.

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