

POLICY ANALYSIS

Fighting over Peanuts? The European Union Budget

- Top of the agenda at the European Union (EU) summit on 15/16 December 2005 is the budget for 2007-13. The original proposal from the European Commission was for a budget of one trillion euros or 1.21% of EU gross national income (GNI). The proposal at the end of the Luxembourg presidency, rejected at the summit in June 2005, was for 871 billion euros (1.06% of EU GNI). Six months, and much discussion later, the UK's proposal is for 847 billion euros (1.03% of EU GNI).
- Any changes to the overall size and composition of the budget as a result of the summit are likely to be marginal. The current UK proposal includes cuts in development aid to new member states, cuts in rural aid to old member states, a major review of all spending in 2008 and a small reduction in the UK's rebate.
- Of the current EU budget, approximately 45% goes on the Common Agricultural Policy (CAP), 35% on structural funds (the EU's supra-national regional policy) and 7% each on aid, administration and a diverse range of other policies.
- The CAP has several negative effects. These include artificially inflating food prices in the EU, which is bad for consumers, particularly poorer ones; driving down the world price of food, which is bad for countries that produce food, many of which are poor and middle-income countries; and encouraging overproduction and specialisation by farmers, both of which may be bad for the environment.
- Major reform of the CAP would use the principle of subsidiarity to repatriate the CAP to national level where it clearly belongs.
- There are two main problems with the EU's structural funds. First, the allocation of expenditure is highly political and as a result not well targeted on the poorest regions in the poorest countries. Second, the expenditure itself has not been very effective: no Objective 1 region (those targeted by the funds) has moved out of the category.

- Major reform of the structural funds would remove the redistributive element that gives funding to richer countries and focus all expenditure on the poorest regions in the expanded EU. This would also involve cuts for regions that were Objective 1 in the old EU15, but are now above average income in the EU25. The current proposals would continue to fund these regions despite the entry of much poorer regions.
- EU spending on administration includes the costs of running the institutions supporting the single market, which deliver large economic gains to the EU as a whole. Thus, a tiny proportion of the budget is leveraged into much larger gains.

Introduction

‘If we cannot get a large deal, which alters fundamentally the way the budget is spent, then... we will have to have a smaller EU budget.’

Tony Blair, 1 December 2005, Kiev.

The argument over the UK’s rebate has created much heat on how European Union (EU) spending should be financed. But it has shed little light on the fundamental questions of the appropriate size and composition of the EU budget. What should be the EU’s spending priorities and how much should it be spending in total? This analysis lays out the main current areas of spending and how they might be reformed.

The EU’s latest enlargement has brought these matters to a head, but arguably a serious debate about the EU budget is long overdue. The fact that this discussion is taking place after the entry of ten new member states rather than before is only likely to increase the problems of reaching agreement. This is particularly true because the fiasco over the constitution means the EU has failed to resolve the one thing on which the constitution should have been focused – the way in which decisions are reached within the EU.

The Common Agricultural Policy

The Treaty of Rome (1957) spelled out the objectives of the CAP, which now takes up roughly 45% of the EU budget: increased productivity, a fair standard of living for the agricultural community, market stabilisation, ensuring the availability of supplies and ensuring that supplies reach consumers at reasonable prices. While it has succeeded in achieving its aim of self-sufficiency, the associated costs go far beyond the budgetary costs that have been highlighted in the recent debate.

The CAP has used an array of instruments to try to reach these objectives. Taking all these instruments together, the OECD estimates that between 2002 and 2004, producer support accounted for, on average, 34% of farm receipts in the EU.¹

There are two main types of support: market-based support and direct support. Around 65% of EU support is market-based while direct payments to farmers account for another 30%.² These direct payments are often based on historical entitlement.

The distribution of support is very unequal. Market support obviously tends to favour large farmers who sell the most. Direct support need not benefit large farmers more, but in the EU it does. This is because direct support has been implemented incrementally and the levels have usually been decided on so as to compensate farmers for whatever level of market support was disappearing.

As market support benefits larger farmers, this use of historical payment entitlements to calculate continuing direct support means that it is very unfairly distributed too. To give just one example, in 2002, farms of 0-1.25 hectares accounted for 50% of farms in the EU, but received only 4.3% of direct payments. Farms of 20 hectares or above accounted for 5% of

¹ See OECD (2005), ‘Agricultural Policies in OECD Countries: Monitoring and Evaluation 2005’. Highlights are available from <http://www.oecd.org/dataoecd/33/27/35016763.pdf>

² OECD (2005): Figure 1.5 .

the EU's farms and received 50% of direct payments.³ The benefits from both direct and market support are very unequally distributed.

Both types of support distort the agricultural market although market support is more distortionary than direct support. In 2003, the EU agreed reforms to the CAP that would involve less market support and more direct payments under something called the single payment scheme.

The extent to which direct support distorts the market depends on whether or not it is fully or only partially 'decoupled'. Direct support is partially decoupled when the direct payment is independent of the amount produced but still requires the farmer to grow the same crop on the land as was grown prior to the move to direct payment. For example, if the payment is based on the fact that historically the farmer grew wheat, they must still grow wheat to get the payment.

Under full decoupling, farmers can, roughly speaking, do whatever they like with the land and still get the payments. The degree to which payments are partially or fully decoupled depends on both the crop and the country. For example, under the single payment scheme, Germany, Ireland, Italy, Luxembourg and the UK chose to maximise, while France chose to minimise, the extent of decoupling allowed under the reform.

The current situation

- Significant amounts of market support will remain even under the reformed CAP. EU prices for major products, such as wheat, will still be kept above world prices and export subsidies used to offload excess production on world markets.
- The EU will see growing use of direct support although much of this direct support will still be distortionary because it will only be partially decoupled.
- Some sectors that are of most concern to developing countries, in particular sugar and cotton, still remain very heavily distorted.

The negative impact of the CAP

- The CAP makes EU food prices artificially high. This is bad for consumers. It is particularly bad for poor consumers who spend a higher proportion of their income on food. In other words, the impact is regressive.
- High food prices encourage overproduction by EU farmers and also divert farmers' energies from other activities (such as tourism). Higher prices for farm outputs raise the costs of inputs. In particular, the prices of land and of patented/branded chemical fertilisers and pesticides are higher as a result of the CAP. Research suggests that these input providers might actually gain more than twice as much as farmers from price support.⁴

³ Source: Table 3.6.1.10 in 'Agriculture in the EU – Statistics and Economic Information', European Commission (2002), reproduced in Baldwin and Wyplosz (2004), *The Economics of European Integration*.

⁴ See Mahé and [Ortalo-Magné](#) (1999), 'Five Proposals for a European Model of the Countryside, *Economic Policy*.

- On world markets, the combination of lower demand from EU consumers and higher supply from EU farmers drives down the world price of food. This is bad for countries that produce food, many of which are poor and middle-income countries. It may help some very poor countries that are reliant on food imports. But the overall impact on these food-importing countries may still be negative when taking account of the knock-on effects from EU agricultural policies that distort sectors in which these poor countries are exporters.
- Overproduction on a given amount of land requires higher inputs of chemical fertilisers and pesticides. This intensification may be bad for the environment. For animal production, intensification implies farming techniques that run counter to current demands for better animal welfare.
- High stable prices encourage farmers to specialise because they do not need the insurance that is provided by a diversified farm producing lots of different goods. This specialisation means less diverse local eco-systems, which may be bad for the environment.
- These negative effects on the environment reduce the ‘public good’ aspect of the countryside that comes from its use for recreation by non-rural households. This is ironic, because this public good aspect remains a key reason why some form of agricultural subsidies may be justified.
- ‘Public good’ aspects also matter in the fact that the CAP’s focus on farmers ignores other elements of the rural economy. These other elements may be more important than farming and yet may be negatively affected by policies developed with only farmers in mind. (The UK’s recent experience with foot and mouth disease shows just how important these considerations can be.)

A ‘large deal’ on the CAP

There are many proposals floating around for further reform of the CAP. But it should be clear by now that a ‘large deal’ on the EU budget would involve a fundamental reform of the CAP. A ‘very large deal’ would preferably use the principle of subsidiarity to repatriate the CAP to national level where it clearly belongs.

Repatriating CAP to the national level would have several benefits:

- First, different countries have very different views on what form agricultural policy should take. At the moment, everyone is forced to compromise.
- Second, from an economist’s perspective, the overall level of distortion is likely to be lower with the CAP repatriated.
- Third, the resulting budget would be considerably smaller and the justification for the UK’s rebate considerably reduced.
- Fourth, the CAP is highly redistributive across EU countries and it is the redistributive elements of the EU budget that are the most controversial.

Structural funds

Like the CAP, the EU's structural funds form a large budget item – 35% of the total – with a significant redistributive element. There are a number of components to the structural funds, all of them essentially aimed at dealing with the fact that EU economic activity is highly concentrated geographically at the national level as well as within nations. In other words, some countries and regions are much richer than others.

The EU identifies poor regions according to different objectives. By far the most important of these is Objective 1. To be Objective 1, a region must have GDP per capita that is 75% or less of the EU average. These regions then get the lion's share of structural fund expenditure – planned at around 80% in the proposals for 2007-2013.⁵

The main problem with the current structural funds is that they have not done a very good job. To give just one example, no Objective 1 region has, as yet, moved out of the Objective 1 category (other than as a result of boundary changes). There appear to be two main problems. First, the allocation of expenditure is highly political and as a result not well targeted. Second, the expenditure itself has not been very effective.

The allocation of structural fund spending

The structural funds are a supra-national regional policy. Setting aside the pros and cons of a national regional policy, the economic argument for an EU-wide policy is one of targeting. It should allow member states to target the most disadvantaged regions in the Union.

Rather surprisingly, in the 2000-06 spending period, less than 50% of EU structural funding went to the four poorest nations – the 'cohesion four' of Greece, Ireland, Portugal and Spain. Germany got 15%, the UK 9% and France 8%.⁶

Of course these nations have problem regions, but the financial targeting argument should see resources flowing to the poorest regions in the poorest countries with richer nations left to deal with their own regional problems. This does not happen because structural fund expenditures are highly political and used as a redistributive element in the EU budget.

Types of structural fund spending

There are three main types of structural fund expenditure in Objective 1 regions. Aid for production sectors accounts for around 40%, infrastructure accounts for around 30%, with human resources taking the other 30%.

Evidence is beginning to emerge that the first two of these do very little for regional disparities. Production support is often targeted at the wrong things: either propping up declining industries or attracting high technology activities that do little to help local residents.⁷

Infrastructure investment may be vital for the completion of the single market but it has had little effect on regional disparities (as is so often the case when trying to tackle two objectives

⁵ See proposals for the new structural funds regulations for the period 2007-13: http://europa.eu.int/comm/regional_policy/sources/docoffic/official/regulation/newregl0713_en.htm

⁶ See Baldwin and Wyplosz (2004) *The Economics of European Integration*, Table 9.3.

⁷ See Midelfart and Overman (2002), 'Delocation and European Integration: Is structural spending justified?' *Economic Policy*.

with one instrument).⁸ Investment in human resources does appear to have some impact, but its share in expenditure has traditionally been low and has only risen in recent years.

A 'large deal' on structural funds

Major budgetary reform of the structural funds would remove the redistributive element that gives funding to richer countries and focus all expenditure on the poorest regions in the expanded EU. This would also involve cuts for regions that were Objective 1 in the old EU15, but are now above average income in the EU25 (because the EU average income has fallen).

The current budget proposals would continue to fund these regions despite the entry of much poorer regions in the new member states. A 'very large deal' on this might see the budget slashed and all expenditure becoming project-based with decisions according to economic and social evaluations only.⁹

EU spending beyond agriculture and regional policy

Roughly 7% of the EU budget goes on development aid to poor countries. Another 7% goes on administration. And 7% goes on a range of policies falling under such headings as audiovisual technology, consumers rights, culture, energy, enterprise, environment, foreign and security policy, fraud, human rights, information society, institutional affairs, public health, research and innovation, taxation and transport.

EU spending on administration includes the costs of running the European Commission, the European Parliament, the European Court of Justice and all the other European institutions. It is these institutions that support the running of the single market.

Most economists think that the single market delivers reasonably large economic gains to the EU as a whole: estimates range from 4% to 12% of EU GDP. Thus, a tiny proportion of the budget is leveraged into much larger gains.

Of course, as with any bureaucracy, there is waste that could and should be targeted. But the (at times obsessive) focus on the Brussels bureaucracy targets the one component of the EU that fairly certainly delivers considerable economic benefits to member states and which in any case constitutes a tiny fraction of the budget.

How should EU spending be financed?

The EU budget contributions are calculated on the basis of GNP (80%) and VAT receipts (20%) with tiny components based on customs and agricultural duties. A large deal on the EU budget, which removed many of the redistributive elements, would mean that the current formula produced net contributions roughly in proportion to GDP, presumably removing the need for the UK rebate.

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⁸ Rodriguez Pose and Fratesi (2004), 'Between Development and Social Policies: The impact of European structural funds in Objective 1 regions', *Regional Studies*.

⁹ Richard Baldwin at HEI in Geneva has recently put forward this argument. See: <http://hei.unige.ch/~baldwin>