THE EU BUDGET DISPUTE – A BLESSING IN DISGUISE?

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Abstract

This paper analyses the European budget and the position of the ten new member states. We argue that the EU budget should be reconsidered, as the Union has expanded to 27 member states and has become more heterogeneous. The budget priorities must be re-oriented towards potentially productive spending programmes. A simple economic growth model illustrates that the current EU budget setting is, at best, neutral with respect to the EU-wide long-term growth potential and may actually hamper growth in the majority of the EU countries if the distortionary nature of taxation is taken into account.

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1. Introduction

The European Union went through a difficult time in 2005. First, voters in France and the Netherlands rejected the Constitutional Treaty, throwing the institutional architecture of the EU into doubt. Then, in June 2005, the EU summit failed to approve the new budget outlook for 2007–2013 proposed by the European Commission. After frantic negotiations and concessions from Germany, Britain and the new member states the outlook was approved in December 2005 and a review of the budget was promised in 2008–2009.

The European Union budget is tiny – about 1% of the Union's GNI – compared to national public budgets, which typically consume more than 40% of the country's GNI. Still, even this small budget is a legitimate concern for policy makers and analysts, as it represents about €120–150bn annually, and for poorer countries transfers from the budget may reach as much as 4% of their GDP, i.e. significant amount, especially given their frail budgetary position.[1]

The budgetary discussion has been difficult, which is not that surprising given the long list of contentious issues that emerged during the preliminary discussions. The European Union has to accommodate ten new member countries that joined the EU in 2004 together with Bulgaria and Romania that joined the EU in 2007. As all these countries tend to be poorer than the existing members (with few exceptions) and tend to have larger agricultural sectors, the new EU make-up thus has serious budgetary consequences. At the same time, the EU is grappling with its ambitious "Lisbon agenda", which was launched in 2000 with the goal of creating "the most competitive economy" by 2010. Although the project is in doubt, the EU's budget for 2007–2013 is expected to accommodate some aspects of the Lisbon agenda. These two developments put two largest EU budgetary programmes in the spotlight: the Common Agricultural Policy (CAP) and the Structural Funds (SF), which together consume 80% of the EU budget. To complicate matters further, the United Kingdom's rebate, applied since 1984, has come under attack, with some countries arguing for it to be replaced by a more general compensation scheme.

However, the EU budget is subject to inter-governmental negotiations, and often bargains, so it is more a reflection of political preferences and historical compromises than a welfare-maximising instrument. But the enlargement of the EU and the aforementioned factors have made this budgetary round much more fragile and potentially volatile. There are more numerous and more heterogeneous players in the game and equilibrium is harder to find. Indeed, as the collapse of the EU constitution in May 2005, when France and the Netherlands failed to approve the document in a referendum, illustrates, the EU is at a crossroads. The "ever closer Union" principle embedded in the original EU project is under threat and a reverse motion is a real possibility for the first time in the EU's history. In this context, the EU budget gains greater importance than its financial whereabouts would suggest. It is a battlefield for the future of the EU, so its fate is of crucial importance, not least for the new member states that have just joined the Union.

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[1] See Schneider and Zapal (2006) on this.

In this paper, we aim to provide a comprehensive discussion of the EU budget's outlook and an analysis of its efficiency in achieving the goals set by national and Union authorities. The paper is organised as follows. After this introduction, we discuss the EU budget for the period 2000–2006, with a special focus on the 2004 enlargement in the second chapter. In the third chapter, we analyse the budgetary data from 2004 – the first year in which the new member states contributed to the budget and drew resources from it. We show that the new members were unable to qualify for all the allocated funds, especially in agriculture and the structural funds.

The fourth chapter is devoted to the EU's budgetary proposal for the 2007–2013 financial framework. We analyse to what extent the proposed reshuffling of the EU budgetary priorities reflects economic reasons and to what extent it may be supportive of the Lisbon agenda goals. We also briefly discuss the European Commission's proposals to reform the British rebate instituted in the 1980s. We illustrate how the perspective was changed in late 2005 to accommodate member states' concerns and we show that the subsequent cuts were disproportionately concentrated in structural operations while agricultural subsidies were left largely intact.

The fifth chapter employs a simple growth model to determine the likely effects of the EU budget on the economic growth and performance of the EU member states. We find that, once the distortionary nature of taxation is taken into account, the EU budget increases growth in ten EU-25 member countries and has an insignificant or mildly negative impact on the remaining fifteen. If we take the EU-25 as a single entity, the EU budget most probably has a negligible effect. The new member states are, however, more likely to get a positive stimulus from investment in physical and human capital.

The sixth chapter is devoted to a brief analysis of the new financial framework's impact on new member states' budgets and we find that the new framework for 2007–2013 maintains their inferior position vis-à-vis the old member countries. We also suggest a re-shaping of the EU budget to reflect the new set-up of the Union, which now consists of 27 widely income-different countries. In accordance with other analyses, we argue that the enlarged Union cannot continue to support the excessively expensive agricultural policy, which brings no tangible economic benefits. Also, slashing agricultural expenditure would allow the EU budget to concentrate on programmes with Union-wide effects. The last chapter concludes the paper and offers some tentative recommendations.

2. Financial Perspective for 2000–2006

The European Budget has been a contentious issue for the member states since its conception in 1952 (as a small budget of the European Coal and Steel Community, as it was then). Regardless of the EU's cherished community spirit, most countries have treated the budget as a battle for funds among countries. The main preoccupation of many was to "get my money back", as succinctly put by the British Prime Minister Margaret Thatcher in 1978. The result is not a budget concentrated on programmes better executed at Union level, but rather a hotchpotch of programmes structured so as to compensate countries that dislike or fear certain EU policies. Thus, the budget reflects more historical than economical forces and, from this perspective, could

be considered a "historical relic".[2] In this chapter, we will discuss the main pillars of the EU budget and their efficiency.

Common Agricultural Policy

The Common Agricultural Policy (CAP) accounted for 44% of the EU's budget in 2004, while the agricultural sector created less than 4% of EU-25 GDP. The CAP was established by the Treaty of Rome in 1957, where its basic objectives were outlined. These have hardly changed since. The official objectives are to "assure the availability of supplies at reasonable prices for consumers"; to "ensure a fair standard of living for farmers"; to "increase agricultural productivity"; and to "stabilise agricultural markets". The more earthy motivation was to compensate France for opening its markets to German (and Belgian and Dutch) industrial firms. The CAP's lasting status is reflected in the fact that it is excluded from discussion in the European Parliament, which is supposed to control the EU's budget.

The scheme used to consume as much as 60% of the EU budget. In 2004, the CAP accounted for €43bn, plus a further €6.5bn was spent on rural development projects, often interconnected with the CAP[3]. The biggest recipient of CAP expenditures has traditionally been France, accounting for 20–25% of the total.[4] The biggest beneficiary per head, however, is Ireland, which receives almost €500 per head, followed by Greece with €250 per head.

The CAP has been "reformed" many times. The last reform package dates from 2003. The CAP has shifted from production support towards direct support to farmers, i.e. income support for a specific group. By doing so, the CAP has lost its EU-wide aspects and has developed into just another redistributive mechanism. As such it should be delegated back to the national level, as the EU is not involved in redistributive policies within countries.

Moreover, the CAP fails in its official stated goals of delivering goods at "reasonable" prices and "stabilising agricultural markets". Due to high guaranteed prices and trade restrictions, European consumers pay more for agriculture than they would in the absence of the CAP. The agricultural sector is increasing its productivity, albeit slowly, and farmers enjoy a "reasonable standard of living", but the whole sector is far from stable and the stability it benefits from is compensated by constant turmoil in world agricultural markets and tensions between the EU and its trading partners, which blame it, correctly, for unfair practices in subsidising its agricultural exports. The CAP has succeeded in placating potentially rebellious farmers in several EU member states, but it has, at the same time, made the agricultural lobby formidably powerful and determined to maintain the status quo.

A good illustration of the agricultural lobby's power is the 2003 reform, which actually increased the costs of the CAP, as additional payments to milk producers were introduced (at a cost of €1.4bn in 2005). Moreover, modified crop payments for rice increased the costs of the CAP by

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[2] This term was first used by the Sapir report, 2003.

[3] The measures for the development of rural areas are: payments for agro-environmental measures, support for farming in handicapped areas, payments for measures aimed at early retirement, assisting investments in rural facilities and food processing facilities, funds aimed at education and training, support to improve forestry management, renovating and development of villages and support for the diversification of farmer's incomes in rural areas (European Commission (2004a).

[4] The French relationship to the CAP was summarised in an observation by Jorge Nunez Ferrer of the CEPS that "the CAP is the French rebate" – see House of Lords, p. 58.

€300m in 2005. A few other programmes ("specific quality premium for durum wheat" and "payments for nuts" – apparently fruit) increased the costs by a further €640m). Thus, the "reform", which also included some cuts, led to an increase of €1.3bn in the CAP budget.[5] The budget increased by 8.3% to €51bn for 2005. Also, the very fact that agricultural subsidies were cut the least in the final negotiations on the 2007–2013 perspective show the exclusive position of this spending programme in the EU budget – see chapter IV for details.

It is interesting to note that only €0.65bn (or 1.5%) of the total agriculture budget went to the ten new member states in 2004. Interestingly, these countries were "allowed" to top up the EU's payments to their farmers.[6] This decision in fact represents "re-nationalisation" of agricultural policy, but went unnoticed in countries that strongly oppose any cuts in the EU agriculture budget. Why, then, couldn't the CAP be scaled back in the old EU member countries and they be given the same "right" to increase subsidies from their national budgets, as the new EU-10 nations do? Such re-nationalisation would reveal national preferences for spending on agricultural support. While some countries may prefer even higher subsidies than the current CAP provides, others may opt for much reduced support.

The development to date begs the question whether the CAP can be reformed at all. The European Council fixed the CAP expenditures for 2007–2013 in autumn 2002, after brisk agreement was reached between France and Germany, thus pre-empting any discussion of the CAP within the 2007–2013 financial framework formal discussions. This rather exceptional decision was apparently guided by the two countries' wish to avoid an agricultural policy discussion in an enlarged Union, where some members might have questioned the CAP's logic. The move constitutes a flagrant breach of the budgetary process and should be prevented in future.[7]

The 2002 deal, however, may be circumvented by treating the deal as a ceiling, not as spending targets, i.e. as the Financial Perspective is always treated. Here, the Constitutional Treaty is crucial, as it would scrap the differences between "compulsory spending", i.e. the CAP, and the rest. Thus, the European Parliament would begin to influence the CAP spending policies and it might not feel constrained by the Franco-German deal of 2002.[8]

Structural funds

The second most important EU budgetary programme is the so-called "structural measures", implemented through four structural funds and the Cohesion Fund. In 2004, these funds accounted for 35% of the EU budget. There are four structural funds (the European Regional Development Fund – ERDF, the European Social Fund – ESF, the European Agricultural Guidance and Guarantee Fund – EAGGF, and the Financial Instrument for Fisheries Guidance – FIFG).

The structural funds are distributed among the EU member states according to three "objectives":

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[5] European Commission: Budget 2005, p. 28.

[6] The new member states joined on May 1, hence they were eligible for two thirds of the annual funds. Their compensations, though, were capped at 25% of the direct aid of the EU-15 members in 2004, and they will be eligible for 30% in 2005 and 35% in 2006. The direct aid payments will increase progressively towards the full aid levels already applicable in the other 15 member states.

[7] Some argue that even the 7-year horizon for the financial framework is too long, as it is longer than the European Commission and European Parliament tenure. See House of Lords (2005).

[8] The French decision from May 2005 to block the new Constitutional Treaty may thus block the European Parliament's intervention in the CAP.

Objective 1: Eligible areas are those that have less than 75% of EU average per capita GDP. Such areas are eligible for financial aid for improving infrastructure, employment and the development of the industrial sector. The Objective 1 regions received 64% of the total budget allocated for the structural policy.

Objective 2: Eligible areas are those with economic and social difficulties, such as restructuring, negative economic growth and high unemployment. In 2004, 10% of the structural funding was spent on this objective.

Objective 3: Aimed at the modernisation of education systems and the creation of employment, this Objective covers those areas not included in Objective 1. Within Objective 3, 11% of all the structural funds were spent in 2004.

Lastly, the *Cohesion Fund*, created by the Maastricht Treaty in 1994 and designed for countries whose per capita GDP is below 90% of the Community average, spends 14% of the total structural budget. The member states qualifying for the money are Spain, Portugal, Ireland and Greece[9] as well as all the new EU members. The money is spent on environmental and transport network projects.[10]

The biggest recipients of the structural funds and Cohesion Fund are Greece and Portugal with spending of €2,200 per head, followed by Spain and Ireland with spending above €1,000 per head. The highest contribution measured as a percentage of GDP was received by Portugal in 1993, when the structural funds invested 3.5% of GDP in Portugal. The rest of the EU-15 countries receive much smaller transfers through the structural funds. The 2004 enlargement, however, destabilised the structural funds. 92% of the new member states' populations live in regions with income below 75% of the EU-25 average.[11] If, as expected, Romania and Bulgaria become EU members in 2007, this number will increase further.

Due to the enlargement, several regions that were eligible for "Objective 1" in the previous financial framework have lost this status. This effect would entail 18 regions with 17 million inhabitants – all the Eastern German *Länder*, parts of Wales and Scotland in the UK, and parts of Spain, Greece and Portugal.[12] The European Commission suggests creating a new facility for these "statistical effect" regions providing them with transitional access to the structural funds. Also due to this measure, 52% of the spending would continue to be spent in the EU-15 countries during the new financial perspective period 2007–2013. The ten new members would be eligible for 42%, the remaining 6% being allocated to Bulgaria and Romania.

The European Commission suggests expanding the structural funds to so-called "phasing-out" regions which lost their eligibility due to the "statistical effect". Moreover, eligible regions which do not fulfil the convergence criteria even without the statistical effects of the enlargement would

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[9] Towards the end of 2003, the EU reviewed the eligibility of these countries by checking their economic and social progress and decided that they were still eligible for developmental funds; see the discussion of the "statistical regions" below.

[10] During the 2005 British presidency, an idea of a "Globalisation Fund" was floated. The fund was supposed to compensate workers in firms affected by globalisation and lower tariff barriers. The idea, though, did not gain much support.

[11] Only Prague, Bratislava and Cyprus do not qualify for Objective 1 status.

[12] See Federal Office for Building and Regional Planning, Berlin, September 2004.

now be classified as "phasing-in" regions. These "phasing-in" regions would be eligible under the new arrangement, as the EC wants to transform existing Objective 2 instruments into general support for regional development – for details see chapter III. Also, the 2007–2013 budget cuts the mandatory co-financing share from 25% to 15% of total costs.

New Member States

Eight Central and Eastern European countries and two Mediterranean islands became member states (NMSs) of the European Union in May 2004, followed by Bulgaria and Romania in January 2007.[13] In budgetary terms, their membership was accommodated by the Copenhagen European Council in 2002. The NMSs were given total commitments of €41bn and they are expected to contribute €15bn to the budget. The most contentious issue was the expansion of the CAP to the NMSs, which resulted in the compromise described above – see footnote 6.

Prior to their entry to the EU, there were many estimates as to the budgetary impact of the NMSs' membership. Some studies, most notably Kopits and Szekely (2002) took a very pessimistic view, estimating that EU membership would worsen the budgetary balance in the NMSs by as much as 4.75% of GDP for the Czech Republic, 4% for Estonia and Hungary, and 3% for Poland and Slovenia. As noted in Hallet (2004), their estimates were based on the assumption that all co-financing of the EU structural funds' spending will be new spending by national governments.

Hallet (2004) reached less negative results for the Polish budget. He estimated that the fiscal balance may worsen by approximately 1% of GDP as a result of EU membership, arguing that a substantial part of the EU payments will not benefit the government budget but will go straight to the final recipients, often private (farmers) or independent from the government (universities).

Other estimates were more cautious. Backé (2002) estimated the net effect of EU membership on the net fiscal balance "over the medium term" as neutral. Besides being less aggressive on co-financing, he also assumed lower administration costs and quantified the "positive growth effect" of EU membership, which should improve the budgets of the NMSs by 0.5–1.0% of GDP.

Even more optimistic are Hallet and Keereman (2005) who argue that the NMSs will gain from membership, partly due to the negotiated "compensation scheme", which directs €1–1.4bn to the NMSs in the 2004–2006 period. He estimates that the NMSs will gain, on average, 0.9% of GDP in 2004, 1.5% of GDP in 2005 and 1.6% of GDP in 2006. The biggest net receiver is Lithuania, which may receive 2–2.5% of GDP in net transfers in 2006.[14] Latvia is scheduled to receive a net 2% of GDP in 2006. The lowest net gains are expected in Cyprus, Slovenia, Hungary and the Czech Republic (around 0.5% of their GDPs). These estimates are supported by our analysis of the 2004 data – see chapter III.

The crucial point in Hallet's analysis is the interpretation of the co-financing requirements and the so-called "additionality" of the EU budget payments. Using European Commission documents, Hallet argues that additionality requires only limited additional spending from the NMSs' budgets, ranging from 0.1% of GDP for Cyprus to 1% of GDP for Latvia in 2006. The average

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[13] As there is not sufficientr data available for Bulharka and Romania, this texts concerns only the 2004 enlargement.

[14] A part of this reflects the EU's specific allowance for decommissioning of the Ignalia nuclear plant.

co-financing requirement is only 0.5% of GDP in both 2005 and 2006. These low requirements (compared to Kopits and Szekely) are based on the European Commission interpretation that the additional requirement relates only to EU funding, not to national co-funding. Thus, the NMSs are free to reallocate their spending towards projects not financed by the EU structural funds and this reallocation may be at the expense of potentially EU-financed programmes. Given, however, that most NMSs already spend more than 3% of their GDP on capital formation that is eligible for structural fund and Cohesion Fund financing, it should be fairly easy for the NMSs to satisfy the additionality requirement.

It should be stressed that these estimates typically do not quantify the benefits that the NMSs and their budgets may gain from EU membership. It is fair to expect that membership will have a positive sustained impact on growth and employment in the longer run – see chapter IV. This, in turn, will be reflected in an endogenous windfall gain in income tax revenue and a decline in social transfers.

3. The New Member States and the Budget in 2004

The first year the new member states spent in the EU – i.e. the incomplete 2004, as they joined the EU on 1 May – presents an opportunity to analyse the real impact of the EU budget on these countries. For this purpose, we compare "appropriations for payments" as approved at the EU's Copenhagen summit in 2002 with the actual 2004 data as reported in European Commission (2005). The Copenhagen framework was itself a restrictive version of the so-called Berlin Financial Framework of 1999. The European Union planned in 1999 to spend €12bn on the new member states in 2004 and to increase this payment to €14bn in 2005 and eventually to €17bn in 2006 (all at 1999 prices). These "commitments", reaching €43bn, were cut by some 4% in Copenhagen. The EU planned to spend 60–65% of this money on the structural funds and "only" €9.5bn was planned for the agricultural sector.

However, both the national authorities and EU officials have found it difficult to abide by this plan. The available data show the sums that were appropriated in the EU budget for the new member states. The actual spending will not be known until the end of 2007, when the transfers must be cleared and approved by the European Commission. Therefore, the data in the following table do not show the final spending, but the maximum amounts that these countries can qualify for. Even then, most countries diverged from what the EU budget had envisaged.

Table 1: EU Budget 2004 Spending in the New Member States: Plan versus Reality (EUR millions)

Area	Agriculture	Structural Operations	Internal Policies	Pre-Accession and Compensation	TOTAL
Cyprus:					
Perspective	12.4	6.0	5.7	107.6	131.7
Budget	7.5	5.3	11.1	107.0	130.9
Czech Republic:					
Perspective	100.0	168.5	51.0	481.0	800.5
Budget	90.8	161.7	26.9	514.2	793.6
Estonia:					
Perspective	28.8	39.2	30.7	82.8	181.5
Budget	15.6	37.5	34.5	108.1	195.7
Lithuania:					
Perspective	72.8	93.6	94.5	161.8	422.7
Budget	49.5	94.4	114.0	221.5	479.4
Latvia:					
Perspective	42.1	66.2	37.2	118.5	264.0
Budget	32.8	64.9	37.1	125.8	260.6
Hungary:					
Perspective	124.7	209.2	100.3	390.3	824.5
Budget	60.7	203.1	92.2	344.7	700.7
Malta:					
Perspective	3.4	6.6	2.4	57.0	69.4
Budget	2.7	6.4	4.3	56.4	69.8
Poland:					
Perspective	425.7	859.0	154.0	1412.8	2851.5
Budget	297.4	843.5	176.6	1379.6	2697.1
Slovakia:					
Perspective	57.2	118.2	39.8	183.2	398.4
Budget	41.1	116.1	34.2	188.3	379.7
Slovenia:					
Perspective	43.4	27.0	49.7	145.9	266.0
Budget	49.4	24.4	57.9	148.2	279.9
Total EU-10					
Perspective	**910.5**	**1593.5**	**565.3**	**3140.9**	**6210.2**
Budget	**647.5**	**1557.3**	**588.8**	**3202.9**	**5996.5**

Source: European Commission (2005) and author's calculations.

As Table 1 illustrates, the total expected budget for 2004 was not fulfilled, as the new member states qualified for less than €6bn, while the appropriations were €6.2bn. The biggest "underachiever" was Hungary, which qualified for only €700m instead of the expected €825m (85%). In absolute terms, Poland lost some €154m. On the other hand, Lithuania could, if all programmes get approval, spend almost €480m, some €57m or 13% more than it was supposed to. The Czech Republic, Cyprus, Latvia and Malta all came very close to the originally planned sums. The following figure illustrates the individual countries' standings vis-à-vis the Copenhagen plan.

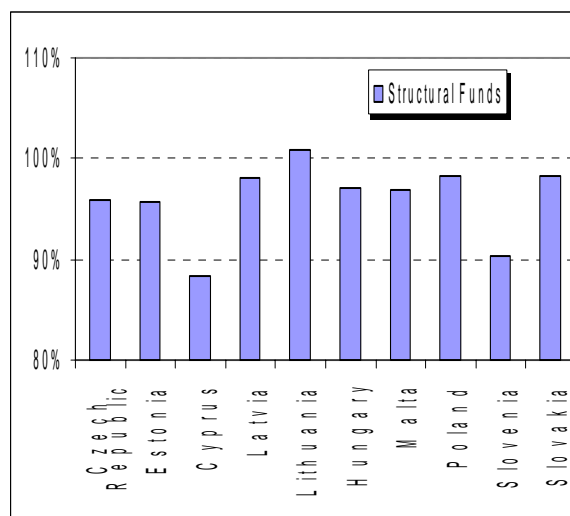*Figure 1: Budget Transfers from EU Budget as Percentage of Copenhagen Plan*
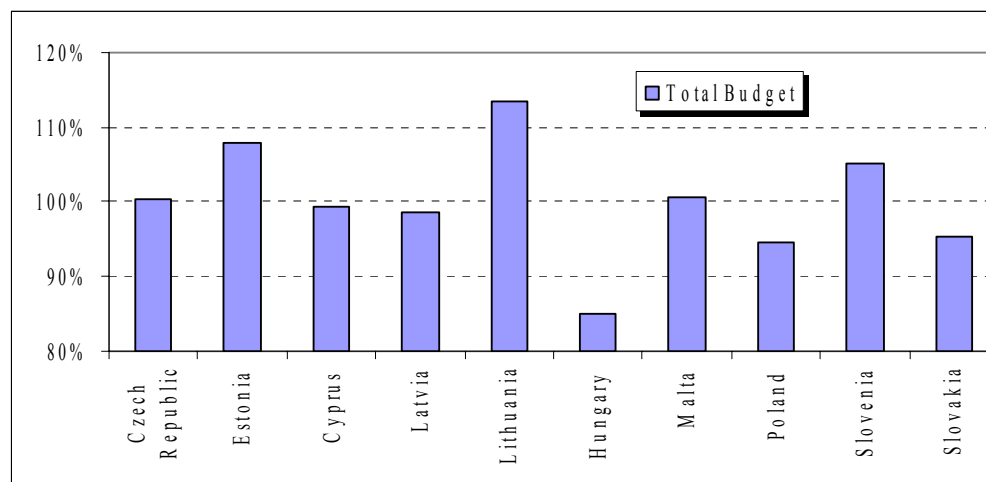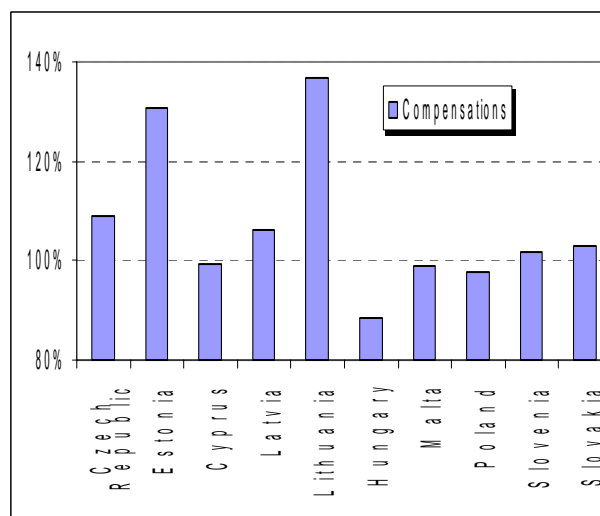

Source: Author.

Looking at the structure of the transfers, the new member states received two basic categories of budgetary transfers from the EU budget in 2004. Roughly one half of the total transfers – €2.7bn, i.e. 48% of the total – financed structural operations, agricultural transfers and internal policies (such as research and development, consumer protection, etc.). Although the economic ratios for these policies vary widely, they are all a constant fixture in the EU budget and will continue, perhaps in some disguise, in the next budgetary period 2007–2013 – see chapter IV for a discussion. The remaining €3.2bn was transferred to the new members through two specific instruments – Pre-Accession Aid and Compensation for New Member States. These programmes either have been phased out already, or will diminish quickly (compensation is to fall from €1.2bn in 2004 to €900m in 2006).

Therefore, one may argue that the former group of budgetary transfers is more important, as it better reflects the country's ability to draw money through regular processes and this ability will be crucial if the country is to improve its budgetary position vis-à-vis the EU budget. The following two figures thus show the "success rate" of the new member countries in the two expenditure categories. It is interesting that only Lithuania was able to fill its "quota" of the "structural funds". Other countries typically qualified for 95% of the allocated sum; only Slovenia and Cyprus managed just 90% of the allocated resources. As far as compensation is concerned, only Poland and Hungary did not qualify for the whole amount. Lithuania, on the other hand, may receive €60m more than was planned – a hefty bonus of 37%.

Figure 2a: "Structural" Transfers from EU Budget as Percentage of Copenhagen Plan   *Figure 2b: "Compensation" Transfers from EU Budget as Percentage of Copenhagen Plan*

Source: Author.

Last but not least, we look at the spending items on which the EU budget money was used. As we show in chapter V, not all expenditures support economic growth. Some expenditure may, in fact, undermine long-term growth by, for example, encouraging interest groups to capture part of government spending. Therefore, we divide expenditures into two categories: productive and unproductive. While the division is arbitrary, we believe it captures the most important features of spending. Kneller, Bleany and Gemmel (1999) made a similar distinction in their paper, where they classified expenditures with a "substantial capital content" as productive.[15] Ederveen et al. (2002) argue that EU budget transfers may play another role than promoting economic efficiency (enhancing cultural or environmental values, for example), but this view has an obvious deficiency in its vagueness.

Therefore, we classify the following spending programmes as "productive": all structural operations, i.e. including the Cohesion Fund, which may be questionable. The Cohesion Fund plays a significant role in the three Mediterranean countries: Spain, Portugal and Greece, where the Cohesion Fund accounted for 0.2–0.25% of GDP in 2004. Furthermore, from among the Internal Policies, we classify spending on training and research and development as "productive".

Among the 25 EU members, Portugal seems to be the record breaker, as it spends 80% of EU budget transfers on "productive" programmes. Among the "old" EU-15, Luxembourg receives only 5% of total transfers in productive ways. However, Luxembourg is very special, as a full 90% of its transfers come in administrative expenses. Among the more typical members, Austria and Belgium receive only about 20% of transfers in the productive category – see table 2.

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[15] They classified spending on public services, defence, education, health, housing and transport as productive. The paper, though, concentrated on national budgets within the OECD countries.

***Table 2: Spending from the EU Budget, selected categories (% of GNI)***

	Agriculture	Structural Funds	Internal Policies	TOTAL	Total Productive
Belgium	0.38%	0.12%	0.26%	**1.72%**	0.31%
Czech Republic	0.11%	0.20%	0.04%	**1.01%**	0.22%
Denmark	0.62%	0.10%	0.07%	**0.81%**	0.15%
Germany	0.29%	0.21%	0.04%	**0.55%**	0.25%
Estonia	0.20%	0.46%	0.43%	**2.51%**	0.56%
Greece	1.70%	1.72%	0.11%	**3.54%**	1.81%
Spain	0.81%	1.22%	0.03%	**2.07%**	1.25%
France	0.57%	0.15%	0.05%	**0.79%**	0.19%
Ireland	1.51%	0.68%	0.07%	**2.29%**	0.73%
Italy	0.38%	0.34%	0.06%	**0.79%**	0.38%
Cyprus	0.06%	0.04%	0.10%	**1.22%**	0.12%
Latvia	0.30%	0.60%	0.34%	**2.46%**	0.68%
Lithuania	0.28%	0.54%	0.66%	**2.79%**	0.60%
Luxembourg	0.17%	0.13%	0.31%	**4.79%**	0.26%
Hungary	0.08%	0.27%	0.12%	**0.95%**	0.31%
Malta	0.06%	0.15%	0.09%	**1.77%**	0.23%
Netherlands	0.29%	0.08%	0.09%	**0.47%**	0.15%
Austria	0.49%	0.14%	0.06%	**0.70%**	0.18%
Poland	0.16%	0.44%	0.09%	**1.42%**	0.48%
Portugal	0.63%	2.63%	0.07%	**3.34%**	2.68%
Slovenia	0.19%	0.09%	0.22%	**1.08%**	0.14%
Slovakia	0.12%	0.35%	0.09%	**1.15%**	0.38%
Finland	0.59%	0.24%	0.06%	**0.91%**	0.30%
Sweden	0.31%	0.15%	0.05%	**0.52%**	0.20%
UK	0.24%	0.13%	0.03%	**0.41%**	0.16%
EU	0.42%	0.34%	0.05%	**0.89%**	**0.38%**

Source: Allocation of EU Expenditure by Member State, European Commission (2005).

The share of productive investment differs widely among the new member states. The highest share – one third – is recorded for Poland, Slovakia and Hungary. On the other hand, Cyprus, Malta and Slovenia spend only about 10% of total EU budget transfers on "productive" investments. On average, the new member states tend to spend less on productive investments – only 23% of total EU budget transfers – than the "old" members.

We may thus conclude that the new member states failed to use the EU budget appropriations fully, but the result is not homogeneous for all countries. Estonia and Lithuania received the most, mainly due to their success in attracting "compensation" payments from the EU budget. On the other hand, Hungary and Poland fared the worst, mostly due to their mediocre record in receiving "compensation payments". The new member states underperformed the old members also in the productive investment ratio, as most of the transfers were geared either towards agricultural subsidies or towards unspecified "compensation" schemes.

***Figure 3: Share of Productive Transfers from EU Budget in New Member States (and
Portugal)***
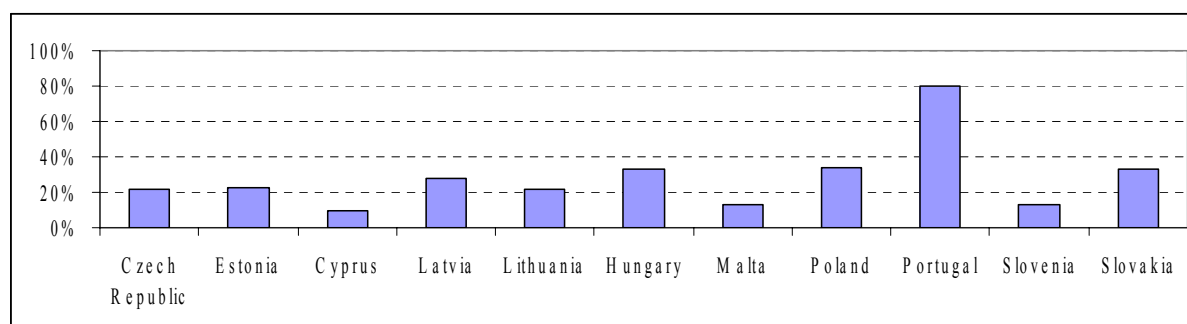
Source: Author.

4. The New Financial Perspective for 2007–2013

Although the last financial perspective has still not run its course, the negotiations for the next
perspective for 2007–2013 have begun in earnest. The European Commission announced its
proposal, which met with resistance from some EU countries and was rejected by the EU summit
in Luxembourg in June 2005. The negotiations have been complicated by the recent enlargement,
which has increased the number of countries and also the number of compromises and potential
horse-trading required to reach a deal. The main contentious issues have been the size of the
budget (1% or 1.24% of EU GDP), the restructuring of the budget so as to give more support to
the EU's main economic policy package – the Lisbon agenda, the treatment of the new member
states, and the future of the United Kingdom rebate. In December 2005, an amended financial
perspective was approved by the European Council, which fixed total spending (commitments) in
2007–2013 at €862bn (1.045% of EU GDP). The deal cuts €160bn from the original Commission
proposal, with the cuts (ironically) concentrated in the first heading of the budget, i.e. the
"sustainable growth" chapter (where a massive €90bn was shaved from the EC's budget
proposal). We will discuss these issues in this chapter.

The size of the budget

As we noted in the previous chapter, the EU budget accounts for a small share of public
expenditures across the EU. While average public expenditures in the EU were 48% of GDP in
2003[16], the EU's central budget hovers around 1% of total EU GDP.[17] Indeed, it fell from 1.05%
of GDP in 1992 to 0.98% in 2003. Nevertheless, the budget is criticised as "a historical relic …
inconsistent with the present and future state of EU integration" – see the Sapir report, p. 162. The
criticism, briefly sketched in the previous chapter, stems from the very nature of the EU budget,
which has not been built as a tool to improve the EU's competitiveness or to increase its growth
through spending on EU-wide public goods. The budget has been used rather as a political tool for

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[16] See European Commission (2004b).

[17] Indeed, the Sapir report argues that the national budgets, which account for 97.5% of public spending within
the EU, need reform as urgently as the EU budget.

compensating countries that were either damaged by certain EU policies or feared that they may be damaged.

The Sapir report goes on to argue that the EU budget is a means of redistributing funds from one group of citizens to another. As such, it often degenerates to a zero-sum game in which individual countries compete to divert as much of the budget as possible to their own benefit, disregarding the EU-wide benefits. This is confirmed by our growth analysis in chapter V below, which shows a negligible impact of the EU budget on EU-wide economic growth.

In December 2003, a group of six net contributors to the EU budget (Austria, France, Germany, the Netherlands, Sweden and the UK) attacked the EC's initial proposal and called for a ceiling of 1% of GNI over the whole 2007–2013 period. The European Commission's spring 2005 proposal ignored this requirement. Its official proposal – see European Commission (2004) – envisaged appropriations for commitments at 1.24% of GNI throughout the 2007–2013 period. The EC wanted the payments to rise gradually from 1.09% of GNI in 2006 to 1.15% in 2007 and 1.23% in 2008. Only then should the payments fall again – to 1.15% of GNI in 2013. The Commission defended its position in a short memo in May 2005: "Why 1% is not enough", in which the EC outlined the inconsistency in the position of the "Six". While France is adamantly against any change in agricultural expenditure, the UK refuses even to contemplate changing its rebate. Thus, while both countries may be urging for budgetary constraint, they are opposed to the most appealing cuts in EU budget expenditures.[18]

The structure of the framework 2007–2013

The financial framework proposal submitted by the European Commission to the June 2005 Luxembourg summit was rejected at the summit. The falling-out was apparently driven by a long-standing British–French conflict over the two most contentious EU budget items: the CAP and the UK rebate. Nevertheless, these feuds were present during the previous budget negotiations and eventually gave way to a compromise. Indeed, the December 2005 summit reached a compromise whereby the EU budget was set at 1.045% of the EU's GNI level. The financial perspective was then little changed in a deal made between the European Parliament, Commission and Council in June 2006. The winners of the negotiations were France and the CAP. While the "competitiveness" budget was cut by a massive €59bn (over the 2007–2013 period) and the cohesion funds by a further €30bn, agricultural spending barely budged, falling by €8bn – see table 3 below.

The Commission nevertheless managed to defend its reshuffling of the EU budget, or rather of its headings, which was inspired by the Lisbon agenda's ambitious goal of creating "the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion" by 2010.[19] While the Lisbon agenda has been quietly buried, the EU budget proposal does take inspiration from it and from subsequent reports looking at the reasons why the Lisbon agenda is faltering. The most

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[18] Probably as a face-saving gesture, the EC proposed to cut about €50bn from the accumulated budget in 2007–2013, i.e. about 5% of the budget – see Financial Times, May 19, 2005. As it happens, the cuts should be concentrated in research and development, the very area that the EC was promoting as the flagship of its 2007–2013 budget proposal.

[19] See Presidency Conclusions: Lisbon European Council, March 2000.

prominent of these reports, the "Sapir" report, proposed that the budget should be radically reorganised into three funds: for growth, for convergence and for restructuring. This should, according to the report, allow the budget to play a more transparent role.

The Commission was clearly inspired by the Sapir report, but it was also bound by the existing policies and their budgetary consequences. Thus, the Commission in its proposal outlined three main "policy objectives" for the budget:

- Sustainable development which encompasses:
  o Competitiveness for growth and employment,
  o Cohesion for growth and employment, and
  o Preservation and management of natural resources.
- European citizenship consisting of:
  o Freedom, security and justice and
  o Access to basic public goods
- The EU as a global partner – promoting its core values.

The re-juggled budget abolished the current structural funds and merged them into the sustainable development objective. The current CAP has been moved to "natural resources management". The Commission's original proposal envisaged agricultural spending falling from 42% of the EU budget in 2004 to 26% in 2013. However, the amended budget proposal envisages the share of agriculture being 34% in 2013. Moreover, further funds will be allocated to agriculture through the rural development facility.

Table 3: Financial Framework for 2007–2013, versions from June and December 2005 (2005 prices, EUR millions)

	Version	2007	2008	2009	2010	2011	2012	2013	Total/ Average
1. Sustainable Growth	June 2005	58,735	61,875	64,895	67,350	67,795	72,865	75,950	471,465
	Dec 2005	51,090	52,148	53,330	54,001	54,945	56,384	57,841	379,739
	June 2006	51,267	52,415	53,616	54,294	55,368	56,876	58,303	382,139
1a Comp. for Growth and Employ-ment	June 2005	12,105	14,390	16,680	18,965	21,250	23,540	25,825	132,755
	Dec 2005	8,250	8,860	9,510	10,200	10,950	11,750	12,600	72,120
	June 2006	8,404	9,097	9,754	10,434	11,295	12,153	12,961	74,098
1b Cohesion for Growth and Employ.	June 2005	46,630	47,485	48,215	48,385	48,545	49,325	50,125	338,710
	Dec 2005	42,840	43,288	43,820	43,801	43,995	44,634	45,241	307,619
	June 2006	42,863	43,318	43,862	43,860	44,073	44,723	45,342	308,041
2. Preserv. and Mngt of Natural Res.	June 2005	57,180	57,900	58,115	57,980	57,850	57,825	57,805	404,655
	Dec 2005	54,972	54,308	53,652	53,021	52,386	51,761	51,145	371,244
	June 2006	54,985	54,322	53,666	53,035	52,400	51,775	51,161	371,344

Of which: Agriculture	June 2005	43,500	43,673	43,354	43,034	42,714	42,506	42,293	301,074
	Dec 2005	43,120	42,697	42,279	41,864	41,453	41,047	40,645	293,105
	June 2006	43,120	42,697	42,279	41,864	41,453	41,047	40,645	293,105
3. Citizenship	June 2005	2,570	2,935	3,235	3,530	3,835	4,145	4,455	24,705
	Dec 2005	1,120	1,210	1,310	1,430	1,570	1,720	1,910	10,270
	June 2006	1,199	1,258	1,380	1,503	1,645	1,797	1,988	10,770
4. Global player	June 2005	11,280	12,115	12,885	13,720	14,495	15,115	15,740	95,350
	Dec 2005	6,280	6,550	6,830	7,120	7,420	7,740	8,070	50,010
	June 2006	6,199	6,469	6,739	7,009	7,339	7,679	8,029	49,463
5. Admini-stration	June 2005	3,675	3,815	3,950	4,090	4,225	4,365	4,500	28,620
	Dec 2005	6,720	6,900	7,050	7,180	7,320	7,450	7,680	50,300
	June 2006	6,633	6,818	6,973	7,111	7,255	7,400	7,610	48,800
6. Compen-sation	June 2005	0,120	0,060	0,060	0	0	0	0	0,240
	Dec 2005	0,419	0,191	0,190	0	0	0	0	0,800
	June 2006	0,419	0,191	0,190	0	0	0	0	0,800
TOTAL Commit-ments	June 2005	133,560	138,700	143,140	146,670	150,200	154,315	158,450	1,025,035
	Dec 2005	120,601	121,307	122,362	122,752	123,641	125,055	126,646	862,363
	June 2006	120,702	121,473	122,564	122,952	124,007	125,527	127,091	864,316
TOTAL in % of GNI	June 2005	1,15%	1,23%	1,12%	1,08%	1,11%	1,14%	1,15%	1,15%
	Dec 2005	1,10%	1,08%	1,06%	1,04%	1,03%	1,02%	1,00%	1,05%
	June 2006	1,10%	1,08%	1,07%	1,04%	1,03%	1,02%	1,01%	1,05%
TOTAL Payments	June 2005	124,600	136,500	127,700	126,000	132,400	138,400	143,100	928,700
	Dec 2005	116,650	119,535	111,830	118,080	115,595	119,070	118,620	819,380
	June 2006	116,650	119,620	111,990	118,280	115,860	119,410	118,970	820,780
TOTAL in % of GNI	June 2005	1.07%	1.21%	1.00%	0.93%	0.98%	1.02%	1.04%	1.04%
	Dec 2005	1.06%	1.06%	0.97%	1.00%	0.96%	0.97%	0.94%	0.99%
	June 2006	1.06%	1.06%	0.97%	1.00%	0.96%	0.97%	0.94%	1.00%

Source: Towards a New Financial Perspective 2007–2013, European Commission, June 2005,

Council of the European Union, document 15915/05, December 2005,

Interinstitutional Agreement between the EP, the Council and the Commission on budgetary discipline and sound fiscal management 2006/C139/01, 23 June 2006 (available at: http://ec.europa.eu/budget/prior_future/next_fin_framework_en.htm).

A. Competitiveness for growth and employment

This first objective is inspired by the Sapir report and aims at promoting economic growth. This being Europe, though, growth is couched with cohesion considerations and the result is a mixture of hardly compatible policies.

The Commission argues that the main objectives within this objective (sic) are: a) promoting competitiveness in fully integrated internal markets, b) strengthening European

research and technological development, c) connecting the EU through networks, d) improving the quality of education and training, and e) helping European society to manage change with social policy. While these are rather vague principles, two aspects stand out. First, the Commission advocates full integration of EU markets, i.e. including the so-far fragmented service sector. Second, the Commission supports the Lisbon agenda's goal of 3% of GDP expenditure on research and development by boosting its expenditure on this agenda.[20] However, the December 2005 negotiations cut an awesome €90bn from this objective, the greatest cut among all the objectives in absolute terms.

Two reservations vis-à-vis the EU increasing its role in financing research may arise. First, it is far from clear that the EU budget is more efficient than national budgets in financing R&D. The Commission proposes to increase its R&D expenditure significantly but does not provide much on its implementation strategy. The social policy agenda is even more contentious. The Commission claims that its spending may reduce health and safety risks, increase the number of EU citizens benefiting from social security coordination, increase the number of employed people and promote social dialogue. Whether €13bn is good value for money remains an open question.

B. Cohesion for growth and employment

The Commission proposal brings one fundamental change from the previous financial framework: the cohesion policy changes from being a time-limited and geographically focused policy to a permanent policy pursuing "balanced territorial development". This was strongly opposed by the new member states, but also by the UK and Sweden, who argued that cohesion funds should be allocated exclusively to the poorest member states and should not be allocated on a regional level (NUTS2).

The Commission nevertheless proposed and defended three main objectives within this objective: a) convergence with a focus on the less developed member states and regions, including "statistical effect regions", b) regional competitiveness and employment, and c) European territorial cooperation.

Taken together, the Cohesion policy accounts for €308bn in the 2007–2013 period, i.e. 36% of the total budget. The largest part would go to the convergence objective, to which all regions with income below 75% of the EU average, "statistical effect regions" and countries with income below 90% of the EU average would be entitled. This generous interpretation of the convergence needs is driven by the Commission's desire to guarantee approval from countries that benefited from the structural funds in the "old" EU-15 and now risk losing this entitlement. Further, in the second objective – regional competitiveness – the Commission wants all regions within the EU to become eligible, including the richest ones. The last objective – territorial cooperation – would consume only 4% of this objective's budget, i.e. €14bn. As a gesture towards the new member states, the Commission would cut the co-financing requirement – which is very sensitive for the new member states – from 25% to 15%, i.e. making projects more affordable for these countries. At the same time, this cut weakens the in-built disciplinary effects of co-financing.

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[20] It is thus surprising to see the EC proposing to cut about €50bn from research and development spending, as noted above.

The structural funds have been traditionally fought over along national lines, as no country wants to lose its entitlements. As indicated above, the recent enlargement has made the competition for funds much fiercer and some "old members" have utilised their incumbent position. Indeed, the Commission estimates that about 50% of the total funding will go to the EU-15 in the 2007–2013 period, the remaining half being directed at the ten new members from 2004 and Bulgaria and Romania.

C. Preservation and management of natural resources

This is the second largest spending programme in the new financial perspective, accounting for almost 40% of the total budget, i.e. €404bn. It gets only limited exposure in the Commission budget proposal, as it is based on a pre-emptive agreement of the European Council in 2002. The budget proposal does not provide any details as to how the CAP expenditures will be split between production-related payments and direct income subsidies.

Four fifths of this objective is earmarked for CAP expenditures, 20% goes to rural development programmes and the remaining funds are allocated for fishery and, finally, environment purposes.[21]

The biggest item, CAP payments, is expected to grow by 1% annually in nominal terms, thus precipitating a slow decline in these payments in real terms and also as a share of the EU budget. However, the CAP continues to fail the test of efficiency. The EU budget is supporting a declining and economically hardly significant sector with no evident EU-wide economies of scale.[22] Given the widely different preferences for agricultural sector support among member countries, re-allocation of the CAP to the national level would certainly be welfare improving. As the CAP gives more importance to direct income support, this heterogeneity becomes ever more visible. Subsidising farmers across the EU with the same income subsidy evidently does not make sense, as evidenced by the current lowered level of subsidies to the new member states

D. European citizenship

This is the smallest objective in budgetary terms, accounting for €10bn, or a mere 1% of the total budget. Moreover, during the final negotiations in December 2005, this objective's budget was cut by more than 50% (from the originally envisaged €24bn). Besides internal security policies (border protection, common asylum and immigration policy) the objective also contains the cryptic "access to basic goods and services" (accounting for 20% of this objective's budget). This represents an extension of the EU's policies, as currently no goods and services are provided by the EU. The budget waxes on about vague policies to "reinforce safety and security standards to achieve clean energy and transport systems", or ensuring "safety of goods" but provides little guidance on how the money would actually be spent and why this should be an EU policy at all.

E. The EU as a global partner

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[21] Most environmental programmes are to be financed from the cohesion policy or external relations objective.

[22] The CAP is also the main reason for the UK rebate. As the rebate becomes more and more challenged, it exposes the skewed nature of the CAP as well.

The last objective accounts for €50bn over the 2007–2013 period, or 5% of the total budget. It is aimed at increasing the EU's role as a major global player. The Commission proposes to spend roughly half of this heading's budget on the EU's neighbourhood policy, which encompasses such differentiated regions as Russia, the Balkans, the Mediterranean and the Persian Gulf. The remaining half is to be spent on "sustainable development", mainly cooperation with developing countries focused on eradication of poverty via the Millennium Development Goals. As world development remains high on the agenda of the EU governments and the common EU activities are regarded positively both by the public and by politicians, there is little resistance to this last objective. However, quantification of the benefits that this objective yields is impossible.

Own resources and EU tax

The new financial perspective for 2007–2013 also presents an opportunity to analyse the revenue side of the EU budget. The Commission argues that one way to increase the transparency of the EU budget is to introduce a visible tax resource payable by EU subjects. The Commission names three possibilities: corporate tax, VAT tax and energy tax. Each of these three taxes would have different country-specific effects and would face stiff opposition from countries in danger of losing more than proportionally from its introduction.

A new "EU tax" would shift the system from relying mainly on government contributions (through the now dominant GNI-based resource) to financing by citizens and/or firms within the EU. While this shift might be preferred from the point of view of administrative transparency and might be also more convenient for the Commission, it is not evident that it would be more "fair" or "transparent" to European taxpayers and it would certainly not increase the EU's popularity. Thus, the proposal will not come to any practical use any time soon, as the Commission itself acknowledges.[23]

UK Rebate

The last, but perhaps most flammable, issue introduced in the Commission's new financial perspective proposal, is the future of the UK rebate. The rebate, introduced in 1984, "corrects" the UK's excessive net contribution to the EU budget caused by low transfers to the British agricultural sector. Without the rebate, the UK would be the biggest net contributor to the EU budget in absolute terms. The rebate in 2003 totalled almost €5bn. As the rebate costs have increased, four net contributors to the EU budget (Austria, Germany, the Netherlands and Sweden) have paid only 25% of their ex-ante share of the UK rebate since 2002; the remaining share of the cost of the UK rebate is financed by other member states, mainly France, Italy and Spain.

The Commission proposed to introduce a "generalised correction mechanism" that would compensate countries whose net contributions exceed a certain threshold as a percentage of GNI. Above the threshold, the country would pay contributions to the EU budget at a reduced rate. The Commission claimed that this would both correct the budgetary burden for net payers and maintain solidarity within the EU. As an illustrative example, the Commission estimated the budgetary impact of the generalised correction mechanism with the threshold for net contributions at 0.35% of GNI and then a rebate of 66% on contributions above the threshold. Moreover, the net

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[23] See European Commission (2004a), page 37.

contributions would be capped at €7.5bn for each country. Evidently, the cap expressed in absolute terms favours large countries, and as table 4 suggests, the Netherlands, Germany, Italy and Sweden would benefit most from the change.

Table 4: Estimated Net Budgetary Balances, Average 2008–2013 (% of GNI)

	No correction	UK rebate	EC proposal
Luxembourg	5.89%	5.80%	5.83%
Latvia	4.51%	4.40%	4.45%
Lithuania	4.50%	4.41%	4.44%
Estonia	3.85%	3.76%	3.79%
Poland	3.85%	3.76%	3.79%
Slovakia	3.36%	3.27%	3.30%
Czech Republic	3.26%	3.17%	3.20%
Hungary	3.15%	3.06%	3.09%
Greece	2.25%	2.16%	2.19%
Portugal	1.60%	1.50%	1.54%
Slovenia	1.40%	1.31%	1.34%
Belgium	1.32%	1.21%	1.27%
Malta	1.16%	1.06%	1.10%
Ireland	0.56%	0.47%	0.51%
Spain	0.32%	0.23%	0.26%
Finland	-0.14%	-0.25%	-0.20%
Denmark	-0.20%	-0.31%	-0.26%
France	-0.27%	-0.37%	-0.33%
Cyprus	-0.28%	-0.37%	-0.33%
Italy	-0.29%	-0.41%	-0.35%
Austria	-0.37%	-0.38%	-0.41%
Sweden	-0.47%	-0.50%	-0.45%
Germany	-0.52%	-0.54%	-0.48%
Netherlands	-0.55%	-0.56%	-0.48%
UK	-0.62%	-0.25%	-0.51%

Source: European Commission (2004d).

In December 2005, the UK proposed to cut its rebate by €10bn (about 20% of the total) as a way to "pay" for the enlargement. While this allowed the 2007–2013 budget to get through, the discussion of a more stable budgetary correction mechanism was shelved.

5. The EU Budget and Potencial Economic Growth

In this chapter we will discuss the impact of the EU budget on the potential growth performance of the European countries. For that purpose, we will use a simple overlapping generations growth model, applied by Tanzi and Chalk in Buti et al. (2002) and inspired by Barro (1991) and Mendoza (1997). We will then apply the model results to the EU budget data to assess the budget's contribution to economic growth in individual countries and in the whole EU. We should stress that this exercise ignores the short-term demand effects of EU budget transfers, no matter how strong they might be. While we follow a rather standard classification (see, for example, Kneller, Bleany and Gemmel, 1999), our analysis makes an unavoidably normative decision as to which expenditures (may) contribute to economic growth. Finally, we concentrate on long-term effects, as they will shape each country's performance for years to come. Also, our analysis treats

transfers from national budgets to the EU budget as "new" spending that requires increased taxes. As governments successfully reclaim most of this money, they may not see it necessarily as a new spending programme.

While the Tanzi and Chalk model is very simple, its conclusions were supported by a more sophisticated analysis by Ederveen, de Groot and Nahuis (2002), who empirically explored the effectiveness of the European budget using a panel data analysis for 13 countries in the European Union. They show that the structural funds are weakly effective for countries with the proper institutional framework. The latter result is obtained for a wide range of conditioning variables, such as openness, institutional quality, corruption and indicators for good governance. Where institutions are underdeveloped, the structural funds either do not influence economic growth or may even hamper it (see Ederveen et al., 2002, for a discussion). Our model complements previous models by adding the (negative) impact of taxes used for raising necessary funds.

The model

The model uses a classical production function with capital and labour, where capital comes in two forms: private K_t and public $K_{G,t}$. The production function has constant returns to scale with respect to the stock of public and private capital, but increasing returns to scale overall.

$$Y_t = K_{G,t}^{1-\alpha} K_t^{\alpha} L_t^{\beta} \quad where \, \alpha + \beta = 1 \tag{1}$$

Households maximise their lifetime utility and every worker supplies one unit of labour every period. In order to make model as simple as possible, we assume that the labour supply does not depend on taxes and that the saving rate is not influenced by the interest rate.

Consumption in the future depends on savings Z_t and the rate of return R_t. Optimal savings Z_t finance both private and public investment in the next period.

$$z_t = \frac{\xi}{\xi + 1} w_t(1 - t) = sw_t(1 - t) \tag{3}$$

The government finances its budget by levying a uniform tax rate t on all income from capital and labour. It then spends the entire budget on new capital G_t and on servicing debt B_t:

$$B_{t+1} = R_t B_t + G_t - t(w_t L_t + R_t K_t + R_t B_t) \tag{4}$$

$$K_{G,t+1} = (1 - \delta_G)K_{G,t} + G_t - K_{G,t}$$

where δ_G is the depreciation rate for public capital (we assume a zero depreciation rate for private capital K_t).

Firms maximise profit:

$$\max_{Kt, Lt} \, K_{G,t}^{1-\alpha} K_t^{\alpha} L_t^{\beta} - w_t L_t - r_t K_t \tag{5}$$

Capital and labour are paid according to their marginal productivity:

$$R_t = 1 + \alpha\, \frac{Y_t}{K_t}; \quad w_t = \beta\, \frac{Y_t}{L_t} \tag{6}$$

As we assume perfect capital markets, in every period savings equal investment:

$$z_t L_t = s(1-t)\beta Y_t = B_{t+1} + K_{t+1} \tag{7}$$

And private capital grows with total savings and falls with increasing government debt B_t and increasing taxes. So we may formulate a "crowding-out equation" (8):

$$K_{t+1} = s(1-t)\beta Y_t - B_{t+1} \tag{8}$$

Finally, we derive the growth equation. Growth could be disaggregated into the three factors' contributions:

$$\frac{Y_{t+1}}{Y_t} = \left(\frac{K_{G,t+1}}{Y_t}\right)^{1-\alpha} \left(\frac{K_{t+1}}{Y_t}\right)^{\alpha} L_{t+1}^{\beta}; \quad where\ L_t = 1 \tag{9}$$

Substituting for private and public capital from equations (4) and (8) allows us to express the growth as a function of public capital $K_{G,t.}$, the tax rate t and the relative debt level B_t:

$$\frac{Y_{t+1}}{Y_t} = \left(\frac{G - \delta_G K_{G,t}}{Y_t}\right)^{1-\alpha} \left(s(1-t)\beta - \frac{B_{t+1}}{Y_t}\right)^{\alpha} L_{t+1}^{\beta} \tag{10}$$

Equation (10) allows us to disentangle the effects of government fiscal policy on economic growth. While increasing public capital $K_{G,t}$ increases economic growth, its financing growth decreases, either through the tax effect or through the debt effect. The debt effect is straightforward: the higher the debt B, the lower the growth. The tax effect has two channels: first, taxes lower growth. But at the same time, the higher taxes allow a decrease in debt, i.e. they may encourage growth. However, the former tax effect is of a stronger magnitude and dominates the effect of (possibly) lower debt. The total effect of government policy depends on parameters α and β.

The growth effect

The Tanzi and Chalk model can be estimated and these estimates may be used in calculations of the total potential growth effect. Tanzi and Chalk estimated that debt lowers growth by a factor of 0.02, direct taxes lower growth by a factor of 0.08 and public investment boosts growth by a factor of 0.25. Nevertheless, these elasticities at least provide us with some crude estimates of the EU budget's effect on the EU-wide economy. Kneller, Bleany and Gemmel (1999) estimated that "distortionary taxes"[24] cut growth by a factor of 0.44, while non-distortionary taxes[25] made no impact. According to Kneller et al., productive investment increases growth by a factor of 0.27 i.e. very similarly as in the Tanzi-Chalk specification.

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[24] Defined in their paper as taxes on income and profit, social security contributions, and taxes on property.

[25] All taxes on domestic goods and services.

To assess the growth impact of the EU budget we used the European Commission analysis of allocation of expenditures and revenues by member state (European Commission, 2005). This allows us to distribute among all 25 EU member states. The following table summarises the payments of individual countries to the EU budget.

The most important is the TOTAL column, which shows the total contributions of individual countries from various distorting tax sources. The table illustrates that the highest share of national income (and thus the highest distortion) is borne by Belgium, which pays 1.34% of its GNI to the budget. The lowest burden falls on the UK, due to its rebate. The ten new member states of the EU were members for only 8 months, so their contributions are proportionally lower. Three out of the four countries that are almost completely excluded from UK rebate financing – Germany, Austria and Sweden – fare relatively well, too.[26]

Table 5: Distribution of Resource Payments by Member States in 2004 (% of GNI)

	TRADITIONAL OWN RESOURCES	VAT BASED OWN RESOURCES	GNI BASED OWN RESOURCES	UK REBATE	TOTAL
Belgium	0.44%	0.12%	0.69%	0.09%	**1.34%**
Czech Republic	0.07%	0.10%	0.46%	0.06%	**0.69%**
Denmark	0.13%	0.11%	0.68%	0.08%	**1.00%**
Germany	0.11%	0.12%	0.68%	0.02%	**0.93%**
Estonia	0.09%	0.09%	0.44%	0.06%	**0.68%**
Greece	0.12%	0.15%	0.70%	0.09%	**1.06%**
Spain	0.12%	0.15%	0.70%	0.09%	**1.06%**
France	0.07%	0.14%	0.68%	0.09%	**0.98%**
Ireland	0.10%	0.15%	0.68%	0.09%	**1.02%**
Italy	0.09%	0.15%	0.69%	0.09%	**1.02%**
Cyprus	0.16%	0.10%	0.47%	0.06%	**0.79%**
Latvia	0.07%	0.08%	0.41%	0.06%	**0.62%**
Lithuania	0.08%	0.09%	0.45%	0.06%	**0.68%**
Luxembourg	0.06%	0.16%	0.72%	0.09%	**1.03%**
Hungary	0.07%	0.10%	0.47%	0.06%	**0.70%**
Malta	0.12%	0.10%	0.47%	0.06%	**0.75%**
Netherlands	0.30%	0.14%	0.69%	0.01%	**1.14%**
Austria	0.08%	0.11%	0.70%	0.01%	**0.90%**
Poland	0.06%	0.10%	0.68%	0.09%	**0.93%**
Portugal	0.09%	0.14%	0.69%	0.09%	**1.01%**
Slovenia	0.05%	0.10%	0.45%	0.06%	**0.66%**
Slovakia	0.06%	0.09%	0.46%	0.06%	**0.67%**
Finland	0.06%	0.14%	0.68%	0.09%	**0.97%**
Sweden	0.11%	0.13%	0.70%	0.01%	**0.95%**
UK	0.13%	0.15%	0.69%	-0.30%	**0.67%**
EU	**0.12%**	**0.14%**	**0.68%**	**0.00%**	**0.94%**

Source: European Commission (2005).

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[26] The fourth – the Netherlands – has its contributions boosted by the high customs duties that are collected in its ports, even though the costs are borne by customers, mostly in Germany.

The following table 6 shows the allocation of expenditures by member state for various expenditure categories. In order to assess their impact on economic growth, we have to disentangle these categories into those that can be attributed to capital accumulation – productive investment – and those that serve other purposes, mostly redistributive. As argued above, we classified structural operations, spending on training and spending on research and development as "productive". While education and training clearly do not contribute to physical capital, it can be argued that they increase human capital and thus increase economic growth.[27]

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[27] See also chapter III for a detailed discussion.

Table 6: Allocation of Expenditure by Sector and by Member State in 2004 (% of GNI)

	AGRICULTURE						STRUCTURAL OPERATIONS				INTERNAL POLICIES						
	Direct Aid	Export Refunds	Storage	Rural Develop.	Other	*Total Agric.*	Structural Funds	Other Structural	Cohesion Funds	*Total Structural*	Training, culture	Energy, environ.	Consumer protection	R&D	Other	*Total Internal*	**TC**
Belgium	0,14%	0,17%	0,01%	0,02%	0,04%	*0,38%*	0,12%	0,00%	0,00%	*0,12%*	0,04%	0,01%	0,04%	0,15%	0,02%	*0,26%*	
Czech	0,00%	0,00%	0,00%	0,11%	0,00%	*0,11%*	0,20%	0,00%	0,00%	*0,20%*	0,01%	0,00%	0,00%	0,01%	0,02%	*0,04%*	
Denmark	0,44%	0,13%	0,00%	0,02%	0,03%	*0,62%*	0,10%	0,00%	0,00%	*0,10%*	0,01%	0,02%	0,00%	0,04%	0,00%	*0,07%*	
Germany	0,21%	0,02%	0,01%	0,04%	0,01%	*0,29%*	0,21%	0,00%	0,00%	*0,21%*	0,01%	0,00%	0,00%	0,03%	0,00%	*0,04%*	
Estonia	0,00%	0,01%	0,00%	0,19%	0,00%	*0,20%*	0,46%	0,00%	0,00%	*0,46%*	0,06%	0,01%	0,32%	0,04%	0,00%	*0,43%*	
Greece	1,15%	0,01%	0,01%	0,08%	0,45%	*1,70%*	1,51%	0,00%	0,21%	*1,72%*	0,03%	0,00%	0,01%	0,06%	0,01%	*0,11%*	
Spain	0,55%	0,02%	0,01%	0,07%	0,16%	*0,81%*	0,97%	0,00%	0,25%	*1,22%*	0,01%	0,00%	0,00%	0,02%	0,00%	*0,03%*	
France	0,44%	0,03%	0,00%	0,05%	0,05%	*0,57%*	0,15%	0,00%	0,00%	*0,15%*	0,01%	0,00%	0,01%	0,03%	0,00%	*0,05%*	
Ireland	0,90%	0,18%	0,03%	0,29%	0,11%	*1,51%*	0,66%	0,00%	0,02%	*0,68%*	0,03%	0,00%	0,01%	0,02%	0,01%	*0,07%*	
Italy	0,27%	0,01%	0,01%	0,05%	0,04%	*0,38%*	0,34%	0,00%	0,00%	*0,34%*	0,01%	0,00%	0,01%	0,03%	0,01%	*0,06%*	
Cyprus	0,00%	0,00%	0,00%	0,06%	0,00%	*0,06%*	0,04%	0,00%	0,00%	*0,04%*	0,04%	0,01%	0,01%	0,04%	0,00%	*0,10%*	
Latvia	0,00%	0,00%	0,00%	0,30%	0,00%	*0,30%*	0,60%	0,00%	0,00%	*0,60%*	0,05%	0,01%	0,25%	0,03%	0,00%	*0,34%*	
Lithuania	0,00%	0,00%	0,00%	0,28%	0,00%	*0,28%*	0,52%	0,00%	0,02%	*0,54%*	0,05%	0,27%	0,29%	0,01%	0,04%	*0,66%*	
Lux	0,10%	0,00%	0,00%	0,07%	0,00%	*0,17%*	0,13%	0,00%	0,00%	*0,13%*	0,06%	0,02%	0,15%	0,07%	0,01%	*0,31%*	
Hungary	0,00%	0,00%	0,00%	0,08%	0,00%	*0,08%*	0,27%	0,00%	0,00%	*0,27%*	0,02%	0,00%	0,08%	0,02%	0,00%	*0,12%*	
Malta	0,00%	0,00%	0,00%	0,06%	0,00%	*0,06%*	0,15%	0,00%	0,00%	*0,15%*	0,06%	0,00%	0,01%	0,02%	0,00%	*0,09%*	
Netherl.	0,09%	0,11%	0,00%	0,01%	0,08%	*0,29%*	0,08%	0,00%	0,00%	*0,08%*	0,01%	0,00%	0,01%	0,06%	0,01%	*0,09%*	
Austria	0,26%	0,02%	0,00%	0,20%	0,01%	*0,49%*	0,14%	0,00%	0,00%	*0,14%*	0,01%	0,00%	0,01%	0,03%	0,01%	*0,06%*	
Poland	0,00%	0,01%	-0,01%	0,15%	0,01%	*0,16%*	0,44%	0,00%	0,00%	*0,44%*	0,02%	0,00%	0,05%	0,02%	0,00%	*0,09%*	
Portugal	0,36%	0,02%	0,00%	0,15%	0,10%	*0,63%*	2,39%	0,00%	0,24%	*2,63%*	0,02%	0,00%	0,01%	0,03%	0,01%	*0,07%*	
Slovenia	0,00%	0,00%	0,00%	0,19%	0,00%	*0,19%*	0,09%	0,00%	0,00%	*0,09%*	0,02%	0,00%	0,17%	0,03%	0,00%	*0,22%*	
Slovakia	0,00%	0,00%	0,00%	0,12%	0,00%	*0,12%*	0,35%	0,00%	0,00%	*0,35%*	0,02%	0,01%	0,05%	0,01%	0,00%	*0,09%*	
Finland	0,30%	0,06%	0,00%	0,22%	0,01%	*0,59%*	0,24%	0,00%	0,00%	*0,24%*	0,01%	0,00%	0,00%	0,05%	0,00%	*0,06%*	
Sweden	0,22%	0,02%	0,00%	0,06%	0,01%	*0,31%*	0,15%	0,00%	0,00%	*0,15%*	0,01%	0,00%	0,00%	0,04%	0,00%	*0,05%*	
UK	0,19%	0,02%	0,00%	0,01%	0,02%	*0,24%*	0,13%	0,00%	0,00%	*0,13%*	0,00%	0,00%	0,00%	0,03%	0,00%	*0,03%*	
EU	**0,29%**	**0,03%**	**0,00%**	**0,05%**	**0,05%**	*0,42%*	**0,31%**	**0,00%**	**0,03%**	*0,34%*	**0,01%**	**0,00%**	**0,01%**	**0,03%**	**0,00%**	*0,05%*	

Source: European Commission (2005) and author's calculations.

The country that receives most of this "productive" investment in 2004 is Portugal (2.7% of its GNI), followed by Greece (1.8% of GDI) and Spain (1.3% of GNI). The three Baltic countries benefited most from among the new EU-10, but they still received only 0.5–0.6% of their GNI in productive investment. Other countries receive less than 1% of GNI, the lowest beneficiaries being Denmark, the Netherlands, Cyprus, Slovenia and the UK, which all receive only 0.1–0.2% of GNI in productive investment from the EU budget.

We finally combine these two inputs – taxes paid and capital investments received – to calculate the total effect of the EU budget on economic growth in the EU-25. The results are summarised in figure 4. Five countries of the old EU-15 are estimated to gain a positive growth impulse from the EU budget: Portugal, Greece, Spain, Italy and Ireland. The remaining ten countries suffer a negative effect, ranging from a negligible number in Finland to a -0.06% effect for the Netherlands. Among the new EU-10, the three Baltic countries get a 0.1% boost due to EU budget transfers. Poland, Slovakia, Hungary, the Czech Republic and Malta are in the neutral region: their performance is unchanged after the transfers. Slovenia and Cyprus may suffer a (very limited) setback to their growth rate.

Figure 4: Growth Effect of the EU Budget 2004 (% of GNI)
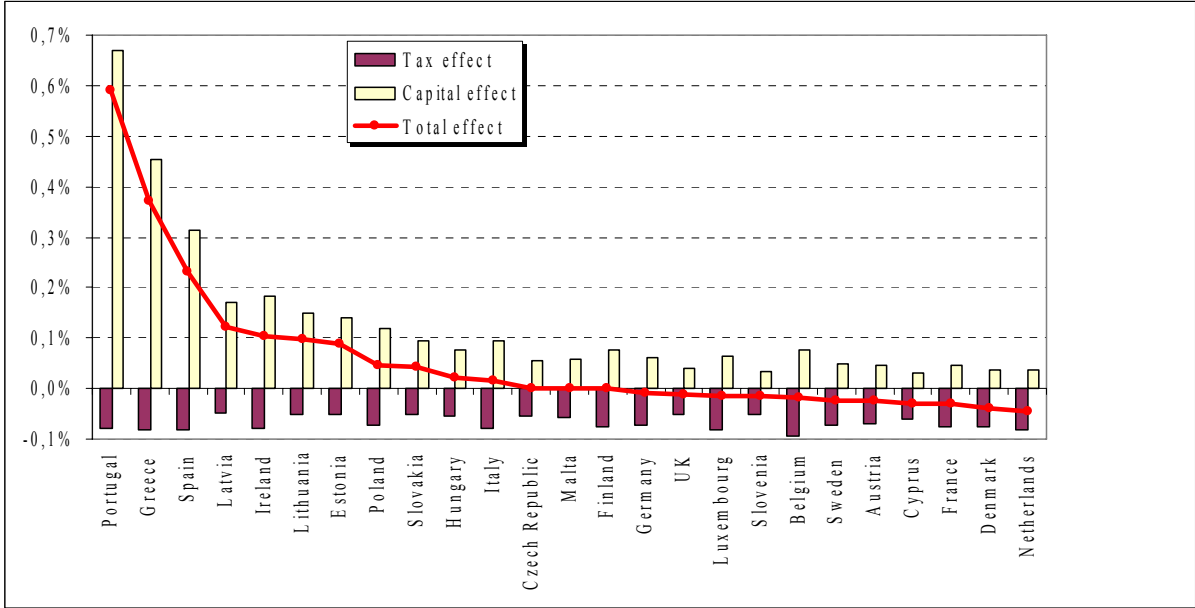
Source: Author's calculations.

It should be repeated here that these effects account for only the direct budgetary effects of the European Union. We do not take into account effects of higher competition from within the single market, neither do we account for macroeconomic policies on the EU level. On the other hand, our results should not be dismissed out of hand. The annual boost of 0.6% for the Portuguese economy adds 6% to the economy over a decade, a sizeable effect. Other "southern" countries – Greece and Spain and to an extent also Italy – also received a boost.

However, if we take the European Union as a single entity, its growth potential is unaffected by its budget. The EU-25 countries paid in 2004 on average (GNI weighted) 0.9% of GNI in taxes to the budget. They received, on the other hand, 0.89% of GNI from the EU budget, but only 0.38% could have been classified as "productive investment" contributing to higher competitiveness of the EU economy (with all the caveats applied above). Thus, taken together, the EU budget may spur the EU's growth by a statistically insignificant 0.023% a year. It is fair to argue that such a miniscule effect is negligible and that there is probably no EU-wide economic effect from the EU budget.

One remark is due, however, in this context. If we applied the same methodology to any national budget of an EU member country, the effect would be much worse, as all countries devote a major part of their budgets to redistributive programmes that would not qualify as "productive" in the Tanzi and Chalk methodology.

6. The New Member States' Position

This chapter deals with the potential impact of the new financial perspective for the period 2007–2013 on the new member states (NMSs), and specifically on the Czech Republic. The NMSs are all certain to remain net beneficiaries of the budget, but they will have to compete for funds not only with the current objective 1 countries (Portugal, Greece, Spain), but with many other "phase-in" and "phase-out" regions. As table 6 above shows, the biggest beneficiaries will be the three Baltic countries and Poland, which are expected to receive net transfers of around 4% GNI annually. Hungary, Slovakia and the Czech Republic should benefit to the tune of 3% GNI annually, while Slovenia will receive the lowest transfers (between 1% and 2% of GNI).

The crucial factor, however, is how the member countries use the funds transferred from the EU budget, i.e. whether they use them for "productive investment" in line with Tanzi and Chalk or whether they waste them by financing purely redistributive programmes. The old member countries differ to a large extent in their ability to channel EU funds towards more productive investment. By definition, countries receiving structural funds should enjoy higher productivity effects. Indeed, 80% of EU funds spent in Portugal can be classified as "productive". This share, though, falls to 60% for Spain and even to 42% in another big recipient – Greece. As we illustrated, the new member states do not reach this high productivity level, as most of their transfers are "compensation" payments geared towards general budgets. Figure 5 shows that the new member states receive the bulk of their budgets from the compensation programmes.

Figure 5: Share of Productive Investment (% of total spending)

A bar chart titled with percentage axis from 0% to 100%, showing stacked bars for: Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Portugal, Slovenia, Slovakia.
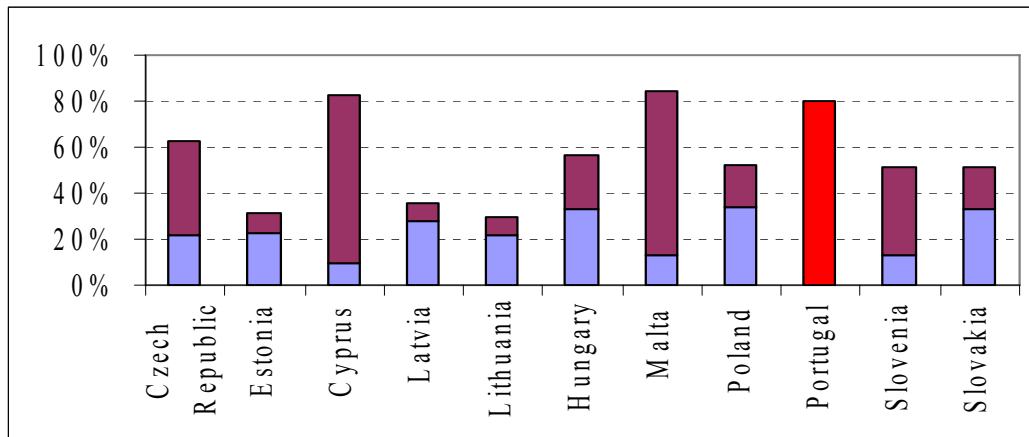
Source: Author's calculations.

If we make a "reasonable" assumption that the NMSs, in the medium term, will not be as efficient as Portugal but they will increase their share of productive investment to some 50% of total EU transfers, they may expect a boost to their growth rate of some 0.5% for the Baltic countries and Poland, 0.4% for the three central European countries (Hungary, Slovakia and the Czech Republic) and 0.3% for Slovenia.

The impact of European Union membership is not, however, limited to budgetary transfers. Especially for the new members, EU membership is supposed to accelerate their convergence to the higher income countries. As our estimates in the previous chapter suggest, EU membership (and the capital investment it brings) may increase a country's growth rate. In this respect, it matters more whether the EU will complete the single market, improve its macroeconomic framework and boost investment in human capital than whether the new financial perspective will direct more or less capital investment to the NMSs.

Nevertheless, the budget may support the NMSs' convergence. In this respect, the new financial framework for 2007–2013 may play an important role in redirecting funds from non-productive programmes, such as the CAP, to more pro-growth agenda. The Commission set a very ambitious goal of increasing investment in research and development, which should reach €80bn over seven years. For this investment to be successful, however, a functioning system of EU-wide coordination must be set up in order to select the best projects and avoid duplications.

The new member states face a challenging dilemma in this respect. As they are to gain most from the EU acceleration, they should be supporting the reallocation of funds to research and development. Also, their agricultural lobbies are less organised and less "corrupted" by the CAP, so elimination of some CAP subsidies would face less strong opposition. Thus, the NMSs should join countries such as the UK and the Netherlands and accelerate the CAP reduction in order to make room for more productive investment.

On the other hand, the NMSs would most probably benefit less than proportionally from a reallocation. Their research and development capacities do not guarantee that they would qualify

for a proportional part of the funds spent. Moreover, the NMSs tend to have proportionally larger agricultural sectors, so they stand to gain more from the (unreformed) CAP, once its most striking bias is eliminated. Thus, from this point of view, short-term budgetary logic should lead the NMSs to support France and the EU's "Mediterranean wing".

The NMSs' position on the UK rebate is much more straightforward: they stand to gain from the elimination of the UK rebate, even if it is substituted by the Commission's proposal of a generalised correction mechanism – see table 5. Thus, if the EU leaders opted for a grand "zero", i.e. joint elimination of the rebate and substantial reduction in CAP spending, the new member states should celebrate.

The NMSs may protest against a more generous interpretation of the qualifying conditions for the new structural objectives. In fact, however, the NMSs stand to lose only marginally there. "Statistical effect regions" will qualify for only €22bn over the whole financial perspective, 2% of the entire budget.

7. Conclusion

The European Union finds itself in a fascinating period. The great push for more integration and enlargement in the 1990s has led to some fatigue within the EU. At the same time, the EU is underperforming in economic terms not only against the USA, but more importantly against the expectations of its own citizens. As a reaction, the EU has set out to streamline its governance and to re-focus towards growth-friendly activities. The Union's financial framework for the 2007–2013 period reflects these conflicts. On the one hand, all the member countries are obsessed with limiting their net contributions to the budget. On the other hand, no country seems to be prepared to give up its own pet projects on the spending agenda. Add to this ten newcomers trying to muscle their way to funds from the EU and the mixture becomes very combustible.

Nevertheless, even in this flux, the EU authorities and their masters in the national governments should seek an economically efficient framework for the new financial perspective spanning the period 2007–2013. Both the European Commission proposal and the Lisbon agenda provide some useful guiding principles. First, the EU budget should limit its non-productive spending, mostly on the Common Agricultural Policy. The CAP has been nudged towards yet another redistributive policy that is better run at the national level. For example, the 2004–2006 co-financing of EU budget transfers to farmers in the new member states represents a first attempt at introducing a national co-financing mechanism into the CAP and should be extended.

Second, the European budget may increase its convergence role by concentrating more on poor member states. In this respect, the dilution of the structural funds' focus on poor member states, as envisaged in the new financial perspective, is counterproductive. The EU should consider moving towards a more generalised model whereby richer countries would support poorer ones through a system of redistributive grants among countries. Such a generalised system would end the current anomaly where the two richest member states – Luxembourg and Ireland – are also the biggest net recipients of EU funds.

Last, but perhaps not least, the EU may play useful catalytic role in financing some areas with potential economies of scale or high public good or externality effects. These may include research and development (including international training and education, where Erasmus is planned to take 40% of the education budget, i.e. €14bn) and infrastructure programmes.

The Sapir report (2003) similarly argues that the budget should shift from agriculture to promoting economic growth by spending on research and development and education. The new member states may play a useful role in the EU budget negotiations if they help to bring about a substantial change in the budget. The EU budget as it is now represents a neutral factor for most countries and it will accelerate the new member states' economies only marginally. Given the attention, effort and time given to the budget, it is not good value for their money.

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