Working paper
R2007:015

EU budget and policy reforms to promote economic growth

Jorge Núñez Ferrer[*]

SWEDISH INSTITUTE FOR GROWTH POLICY STUDIES

[*] *Jorge Núñez Ferrer, CEPS (Centre for European Policy Studies)*

ITPS, Swedish Institute For Growth Policy Studies
Studentplan 3, SE-831 40 Östersund, Sweden
Telephone: +46 (0)63 16 66 00
Fax: +46 (0)63 16 66 01
E-mail info@itps.se
www.itps.se
ISSN 1652-0483
Arkitektkopia, Stockholm 2007

For further information, please contact Anders Östhol
Telephone +46 (0)8 456 67 44
E-mail anders.osthol@itps.se

Foreword

This report was prepared for the ITPS in connection to an assignment from the Ministry of Finance on future reforms of the EU budget. It addresses some of the key issues at stake when discussing possible reforms of the EU Budget before the upcoming review of the long-term budget 2008–2009. The purpose of the paper is to bring up a set of issues which is likely to come up on the agenda during the review, with particular focus on EU spending. A critical evaluation is carried out analyzing the impact EU policies may have on economic growth. Hopefully the report helps to bring up some essential issues that need to be raised in order make EU policies more growth-oriented.

Jorge Núñez Ferrer, an associate of the Brussels think tank CEPS (Centre for European Policy Studies) took on the challenge to write the report with great competence and enthusiasm. Anders Östhol of the Swedish Institute for Growth Policy Studies (ITPS) has managed the project. The views expressed by the author are his own and may not necessarily reflect the opinion of ITPS. The project will be concluded by the end of November.

Östersund, October 2007

Håkan Gadd
Head of department

Table of content

1 Introduction

In March 2000 European Union leaders committed to do all it would take to make the EU the "most dynamic and competitive knowledge economy-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion and respect for the environment." Such a high level declaration on such a highly ambitious goal requires a concerted approach and intensive measures by the Member States. These measures would also call for more substantial intervention at regulatory, policy and budget level within the EU.

However the EU has effectively failed to tackle the stated objectives and may even have distanced the Union from them. In 2004 the Kok Report unequivocally noted that the EU had not undertaken the necessary steps, and this remains the case today, just three years before 2010.

One possible cause for this failure has been the large number of objectives included in the declaration that are in many cases contradictory or at least difficult to achieve at the same time. What is more, the lack of clear direction and stepped actions, mid-term targets, evaluations and any mechanism to compel coordination have ensured that virtually nothing has been done to achieve the goals.

The European budget and its policies, which have suffered from a growing sclerosis due to inappropriate decision-making procedures, have naturally hardly been improved in line with these objectives. Not only is it not yet clear what exactly the EU should be doing in general, but even where agreements are in place for actions, Member States have not shown the political will to implement reforms. The Sapir Report, published in July 2003, refers to the EU budget as a "historic relic...inconsistent with the present and future state of EU integration" (p.162). It argues that the budget fails to focus on EU priorities as very little money is allocated to areas that might help deliver a much-needed boost to economic growth.

The EU budget and the policies financed by it cannot solve the EU's lack of competitiveness, but could help in areas where coordination can create economies of scale at EU level in e.g. transport, energy and research and development. Where the budget supports growth, it usually does so indirectly and accidentally. In the absence of substantial reform, existing policies have simply provided a kind of growth oriented impetus, introducing ill-defined Lisbon criteria to the CAP and Structural Funds, such as adding new economic diversification measures for rural development, or earmarking a share of the structural and cohesion funds to Lisbon oriented actions (which include motorways).

Political pressure is mounting for fundamental reform and a review of the budget and policies in 2009 may create the grounds for a radical overhaul.

Plenty has been written on the available options for reforming the EU budget and its individual policies, with most of the structures proposed far more in line with the needs of the EU. This paper will first outline the underlying principles which EU budget priorities should fulfil. It will then discuss whether the EU can or should play a role in promoting growth. This will be followed by an analysis of the present funding structure of the funds to determine if policies are in line with necessary criteria to be part of the EU budget and compatible with a growth orientation. The report will then conclude by presenting various options for reform

2 What should the budget finance?

Opinions differ as to what should be funded by the EU. Here academics, politicians, civil organisations and pressure groups often promote conflicting positions. While the budget may include both financial and political items, there is nonetheless the need to search for specific principles and rules on what a supranational instrument like the EU budget should finance. A number of problems with the present budget could have been avoided, if the policies had been structured around those principles.

Analysing the optimal distribution of tasks to different levels of governance can offer a powerful insight into which characteristics expenditure at EU level should fulfil. These are based on the Theory of Fiscal Federalism pioneered by Musgrave in 1959 in his 'Theory of Public Finance'. This analytical approach addresses the question which areas of public policies should or should not be undertaken at different levels of government.

Fiscal Federalism concentrates on the need to internalise externalities, avoid internalities, exploit economies of scale, attain a minimum scale, or take into account the heterogeneity of preferences.[1] Classical Fiscal Federalism seeks the optimal distribution of responsibilities, regardless of the institutional structures. As such it implicitly assumes the EU is just another level of governance, as legitimate to act in all public spheres as a national or regional power, i.e. the EU is regarded as being an optimal federal system.

Studies for the EU budget generally deviate from the formal classic Fiscal Federalism approach and include aspects of the political economy of the decision making process (see e.g. Persson et al., 1996; Tabellini, 2003; Gros and Micossi, 2005). Further EU limitations are discussed in the work by Nuti and Nava (2003) which includes decision-making costs or frustration costs which the EU suffers due to its heterogeneous structure, they include the internal process of decision making and monitoring of funds as an additional issue to take into account. This latter approach influenced the most notable result of EU budget Fiscal Federalism studies, the Sapir report (2003), which draws heavily on the insights of this theory to reach its conclusions.

These Fiscal Federalism analyses of the EU budget differ from classical theory, in that they all consider the EU as not simply another level of governance and that the EU budget is particularly restricted in size, the latter is especially the case with the most recent papers. Such analyses also need to decide what the main objectives of the EU budget should target, excluding some areas in which the EU may in theory be the best level of governance, but

---

[1] *Internalise externalities: this is to avoid free rider effects on public goods for positive externalities, or avoid the cost of negative effects falling on non beneficiaries, for example for environmental policies.*

ii. Avoid internalities: avoiding the imposition costs on a person in the long-run that are not taken into account when making decisions in the present.

iii. Exploit economies of scale: reducing costs and increase in efficiency by pooling together resources.

iv. Attain minimum size: Pooling resources allows countries which on their own cannot deliver a public good due to a lack of critical mass to manage to provide it.

v. Take into account heterogeneity of preferences: when preferences between jurisdictions are heterogeneous, a decentralised provision of public goods is superior when compared with a uniform supply at the central level.

would be unlikely to gain a mandate or have the resources to so act. For instance, the Sapir report concentrates on a growth approach and the budget structure it presents excludes areas of internal security, foreign policy and defence which others, such as Gross and Micossi (2005) include.

One common theme in all studies based on Fiscal Federalism is the specific guiding principle for the EU: that policies funded by the EU should target the European public good, for which there would be an under-provision (due to a market failure) and where EU intervention creates additional value added.

Figueira (2006) partially distances herself further from pure Fiscal Federalism and includes elements borrowed from public choice. She criticises the Fiscal Federalism analyses for ignoring the defined areas of action already enshrined in the European Union Treaty. Analyses based on Fiscal Federalism make their own interpretations of what the European Union should do. The Sapir report, for example, chooses to define a budget based on the growth objectives of the Lisbon agenda, but ignores other European Union objectives that may also require EU budgetary intervention. In Figueira's opinion, an analysis of the role of the budget should not decide on objectives and take into account those set by the treaties. Fiscal Federalism theories should then address skills breakdowns and the role of the budget in determining the necessary policies.

All Fiscal Federalism analyses, including Figueira's, look at the role of the budget relatively independently of the present budget, i.e. they apply zero-based budgeting. Minimal concessions are sometimes given to phase out the present budget, or limited space is given to the need of second-best approaches, where certain sub-optimal policy structures are permitted given the institutional constraints and the unavoidable need to accept certain policies to make others acceptable. Figueira adds those policies included in the Treaties. The instruments (budgetary or otherwise) used to achieve the objective should then be optimal.

There are also other zero-budgeting approaches, which concentrate on reforms of specific policies, such as the Common Agricultural Policy (CAP) or the Cohesion Policy. Those use a number of different angles for the policy proposals and elements of Fiscal Federalism are included, as well as other efficiency items, such as implementation costs. Often these policies do not question if the EU should intervene at all in this area, which Fiscal Federalism analyses do for the overall budget. Particularly interesting analyses in this direction can be found for the CAP, Tangermann (1991), Buckwell et al. (1997), Swinbank, A. and Tranter, R. (2004).

Analyses that assume that the present policies impose severe constraints on the future budget structure are generally not of academic origin, but produced by EU institutions and beneficiary groups. In general these concentrate on reforms based on adapting present policies to achieve new objectives and avoiding radical changes due to political decisions or constraints (See Ahner and Scheele, 2003; European Commission, 2004b). Academic analyses that look at the political and institutional limitations do not address the budget composition per se nor do they seek the optimal budget structure. They concentrate on the decision-making process and the forces which have formed the present budget. Game-theorists and political scientists are mainly involved in these approaches and may give indications of what the future budgets are likely to look like, but do not say what the budget should actually do (see Widgren, 2006). Even so, such analyses are important when discussing optimal budget structures, because the decision-making process will affect the probability of these ever being implemented.

All the above analyses and in particular those that analyse the whole budget present a list of principles and characteristics EU expenditures should possess. Any serious attempt to improve the present budget structure or present new proposals for the budget for best achieving common EU objectives (economic or political in nature) has to take into account certain crucial principles. With the EU consolidated as a single entity and economic challenges becoming the central preoccupation of the EU, optimisation and cost effectiveness are becoming necessary mantras.

2.1 Fundamental principles for policies funded by the EU budget

There are fundamental principles for EU policies in general to which *all* interventions by the EU budget should be subordinated. These are the principles of subsidiarity, additionality, proportionality and value for money. The first two are enshrined in the treaties and rules of the European Union. The latter two are based on the clear need to avoid waste in a budget with strong financial limitations. In addition, two guiding principles that should be followed are targeting EU public goods and creating European value added.

Subsidiarity

The Maastricht Treaty of 1992 has already clearly spelled out the first characteristics of any EU policy or budget item, it should be governed by the principle of subsidiary, i.e. the EU should only act when it is better suited to do so compared to lower levels of governance. The exact wording of the Treaty actually only imposes this rule for those areas in which the EU does not have exclusive expertise, to allow the Member States the freedom to confer on the EU expertise where this principle is violated, such as for agricultural policy.

Proportionality

Proportionality is a fundamental principle of European Union law. According to this principle, the EU may only act in direct proportion to what is required to achieve its objectives, and no further. This principle has governed the European Union since its inception in 1957 and is explicitly included in the proposed new Treaty establishing a constitution for Europe.

Additionality

This principle is restricted to the cohesion policy, but should apply throughout the budget. It states that EU financial intervention should not be a substitute for national funding which would have occurred in the absence of such intervention. EU funding should not in any event reduce aggregate national public spending through substitution.

Value for money

EU actions should be as cost-effective as possible and regularly reviewed.

2.1.2 Guiding principles for the EU budget

Two important principles are presented in Fiscal Federalism analyses. These should be aimed for, but are listed separately, to factor in the EU sometimes having to act in areas where these are not fully applicable. However, they should be *central to all policies aimed at fostering growth*.

Financing EU public goods

Analyses based on Fiscal Federalism argue that EU budget expenditure should be restricted exclusively to funding the European public good, which would be underprovided for if left to lower levels of governance.

Value Added

Actions financed through the EU budget should create a value added. In financial terms, this means that the post investment return in the recipient area should be higher than if investment had never been made. This criterion does not require the overall welfare return at EU level to be higher after a transfer. This may be desirable but difficult to quantify and sometimes not possible, but should apply at least for the recipient area. The principle of additionality should be adhered to strictly.

For some policies, the value added may also not be quantifiable in economic terms, but substantial and important in political terms. This has to be taken into account, but in the case of growth oriented policies, where effective economic returns are to be maximised, such political criteria should not be applied in principle.

EU budget expenditure should adhere to certain fundamental principles enshrined in the treaties or determined by rational analysis, those are:

- **Subsidiarity**
- **Proportionality**
- **Additionality**
- **Value for Money**

In addition, all policies and especially those aimed at fostering growth should:

- Be aimed at **the European public good**
- Create a **value added at European level**

3 What role for the budget to foster growth?

As the Kok Report clearly states, the EU budget cannot and should not be responsible for fostering economic growth in the EU. The Lisbon Agenda is in fact mainly a Member State initiative. Achieving its goals of growth and competitiveness relies mainly on structural reforms within Member States, such as labour market reforms or economic reforms which remain the responsibility of individual Member States. Most policies that are needed to achieve Lisbon do not require public expenditure at EU or national level at all. It is up to Member State governments to pursue structural reform in their employment and social policies.

Nevertheless, the EU budget can play an important role where the EU can pool its collective resources to create economies of scale. Investment in innovation and human capital to increase capacity depends on the EU as a whole. There is a place for collective action at the level of Research and Development, education and infrastructure programmes, which the principle of subsidiarity requires to be done at EU level. This is mostly regulatory work although financial intervention an be used as catalysts to ensure necessary actions are undertaken, even if the implementation itself and a substantial part of the funding are provided by national purses or the private sector.

It is also important to stress that the potential of EU interventions can only be fully realised if the internal market is completed, as the recent House of Lords report (2005) repeatedly stresses.

3.1 Determinants of Economic Growth and the budget

To understand what role the EU budget can have in promoting growth it is first necessary to determine in which areas it can play any positive role. To do so, one needs to abstract from the present budget and objectives a list of variables that determine economic growth performance in a country and the policies most effective in implementing them.

Figueira (2006) summarises the determinants of economic growth as: human capital; fertility rate; government consumption; rule of law; terms of trade; investment ratio; and initial GDP of the country. To foster growth at EU level, the policies that have a major impact on economic growth are: product market reforms (abolishing all barriers to trade within the EU and increasing competition within markets), capital market reforms (making EU capital markets more efficient, namely by fostering their integration across borders), policies for innovation (including research, education and policy on patents), labour market reforms and policies to improve infrastructure (mainly transport).

Figueira (ibid.) concludes that the policy areas with the greatest potential to foster growth in the EU are therefore: Industrial and competition policies (internal market integration and liberalisation), research policies, education policies, employment policy (labour market reform) and transport policy. Accordingly, to foster growth at EU level that the EU budget should include EU wide research and development programmes, education and Trans-European infrastructure.

This does not mean that the EU budget should only concentrate on the above, but that these should be well devised and well funded.

3.2 Requirements for the non-growth oriented policies

The EU has other laudable objectives in addition to growth; in fact the EU seeks to combine growth with sustainability and cohesion. The EU will therefore intervene in the areas of environment, cohesion, employment and even safety and security. However these budget items are required to minimise any negative growth effects, i.e. they should be efficient.

This list does not mention the CAP or rural development. These are policies aimed at cohesion, the environment and food safety and should simply be seen as part of the points listed above.

The main responsibility to foster growth in the European Union lies with the Member States and their domestic structural reforms. In addition, the EU should strive to complete the internal market.

The EU budget has nonetheless ***a role to play in encouraging growth in the EU where collective action indicates economies of scale*** (increased efficiency and reduced costs). The EU cannot and should not be the main financial tool, but should intervene as a catalyst for or run those projects where there is a European Public Good with Value Added.

Those pinpointed in the literature are:

- Research and Development
- Education
- Transport

For those policies where growth at EU level is not the main objective, efficiency and value for money are central criteria. They should minimise any negative impact on growth.

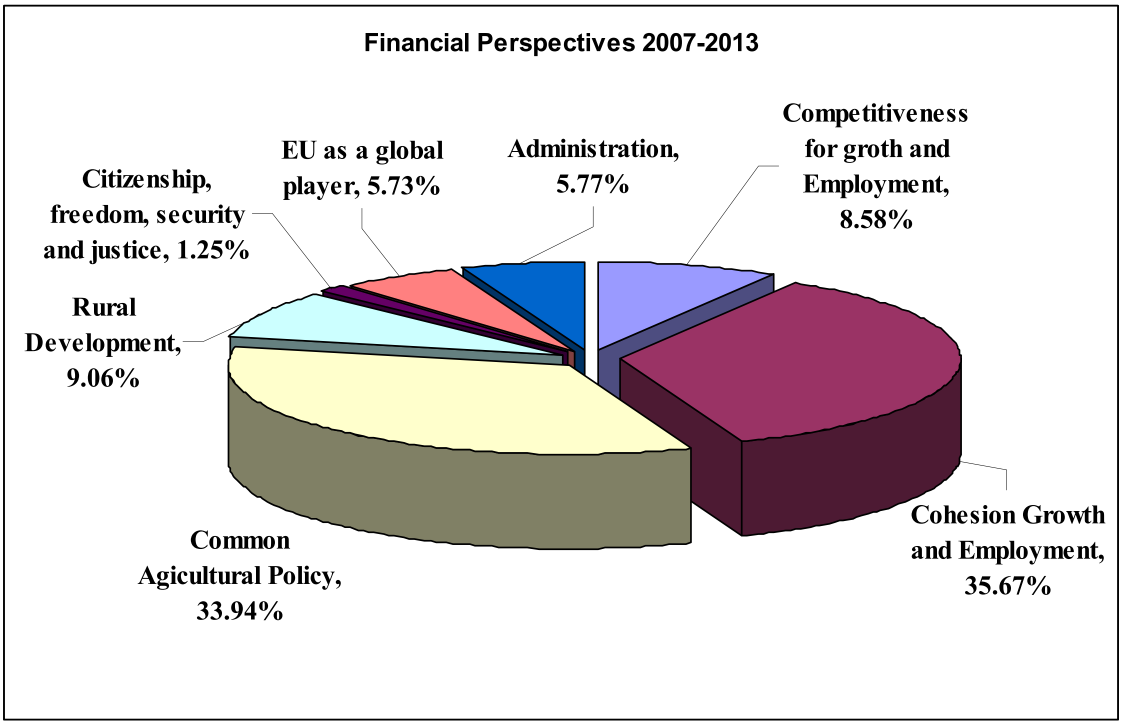
4 Quality and growth orientation of the present budget

The present budget is a result of political agreements to address problems identified by the governments of the Member States as needing attention at EU level. The main objectives of the budget until recently were not growth related. The two main policies of the Financial Perspectives, the Common Agricultural Policy and the Cohesion Policy (Structural and Cohesion Funds), originate from the decisions to increase production and revenues in the agricultural sector in the sixties and the need to support less developed regions in the eighties (Figure 4-1).

Both are redistributive policies. Regional and cohesion policies are growth orientated, but concentrate on the need to foster growth in regions that have fallen behind and closing income gaps between different parts of the EU. They are not oriented towards the overall growth of the EU. Only a very limited proportion of the remaining budget is targeted at EU wide growth oriented policies. These are the budgets for Trans-European networks (TENs), the funds for R&D and measures for education.

While the budget is not surprisingly quite inefficient in targeting European wide growth, a further problematic is that several policies within the budget are very sub-optimal in targeting their own objectives. Many actions are inefficient, excessively costly with a dubious value added, not only at EU level, but even for the areas targeted. Which means a high chunk of the budget has an adverse impact on growth needlessly.

Figure 4-1 EU budget composition.



4.1 What to do with the present budget?

Analyses based on Fiscal Federalism avoid addressing the present budget altogether and simply propose a budget structure in line with the best distribution of the responsibilities between the EU and its Member States. If one assumes that the overriding priority of the European Union is growth, the final budget would be similar to the one presented by Sapir (2003) or to a lesser extent Gross and Micossi (2005).

However, growth is not the only objective of the EU, and it is very unlikely that it ever will be the only objective. Thus the most important task in a budget review is to ask in which areas the EU should intervene, which of these areas should be European by nature and how can we ensure that the budget fosters growth and that other interventions assist or at least negative minimise growth implications. Accordingly, this report will take an approach more in line with Figueira's (2006) public choice approach.

4.2 What are EU objectives?

Figueira (ibid.) has used the declarations in the EU treaty (Title 1, article 2) to determine the objectives of the EU. From the wording, which is formulated in terms of overall goals, one can summarise the main objectives as:

- Economic Growth
- Sustainable Growth
- Convergence
- External Security
- Internal Security

The present EU budget is a result of the past interpretation of the way to achieve the stated objectives. The EU did not consider that growth oriented policies were the main domain of the budget. The budget concentrated on equity criteria, based on convergence ideas across regions and across sectors (the CAP). Growth was not considered until recently a domain for the budget, except in the area of convergence.

Similarly, sustainability was neglected and environmental policy underdeveloped, a policy which Fiscal Federalism considers in large part a collective good with important European wide externalities. External and internal security was also neglected and remains underdeveloped today.

The CAP should in theory follow additional objectives of the treaty specifically devised for the sector (Article 33 of the Treaty). Even accepting the special place of agriculture, its policies are highly inefficient in reaching the objectives set.

Further, while the CAP and Structural and Cohesion Funds formally address equity and convergence criteria, the reality is very different. The redistributive nature of the policy with names or regions attached to funds has induced Member States to determine the distribution of the funds based on 'pork barrel' politics. Member States compete for the funds and use the policies as a vehicle to maximise returns or minimise losses. The more the policies distance themselves from hard needs on the ground, the stronger the net balance arguments become. The latest negotiations on the Financial Perspective were described by some participants as a mathematical calculator competition.

There is a clear indication, that the present EU budget concentrates on a very narrow part of the main objectives and does so inefficiently (Table 4-1 presents a list of the present policies and the financial share of the main components).

Table 4-1 Expenditure headings and instruments of EU budget and fund share 2007.

EU Policy		**Share of budget**
Competitiveness	Education and training	0.7 %
	Research	4.4 %
	Competitiveness and innovation	0.3 %
	Energy and transport networks	0.8 %
	Social Policy Agenda	0.2 %
Cohesion	Convergence	27.9 %
	Regional competitiveness and employment	
	Territorial cooperation	7.1 %
		0.9 %
Preservation of natural resources	Agricultural expenditure and direct aids	33.8 %
	Rural Development	9.8 %
	Environment	0.2 %
Freedom Security and Justice	Security policy, migration policy	
	Health and consumer protection	0.5 %
	Rapid response	
Citizenship	Culture	0.5 %
	Media	
	Public health and consumer protection	
EU as a global partner	Pre accession instrument	1.0 %
	Neighbourhood policy	1.1 %
	Development cooperation	1.7 %
	Humanitarian aid	0.5 %
	Democracy and human rights	0.1 %
	Common foreign and security policy	0.2 %
	Stability instrument	0.1 %

Source: European Commission, 2007 budget figures.

For the past 30 years, the needs and demands for a policy shift towards a greater concentration on growth, sustainable growth, internal and external security have increased. The Lisbon Agenda for growth calls for a prioritisation of the first objectives, the Gothenburg declarations for a strengthening of sustainability. Calls for policies centred on security, such as a common immigration policy have also increased, and the EU is required to intervene more heavily in external aid and security operations. Most of the actions required need financial support, but EU budget reforms have fallen short of requirements and the financial allocations for several important priorities are almost symbolic. Decision making procedures, limitations in size of budget, and not least a lack of trust in the efficiency of the EU institutions in handling the funds, have hampered the prioritisation of four of the main objectives of the EU in the budget.

4.3 What to retain, what to add and what to discard of the present budget?

Given the change in the balance of objectives in the EU, how does the present budget score on the present main objectives and what is the level of growth orientation? Should the present budget be scrapped and replaced, or is it just a matter of reforms within budgetary headings?

As the EU has become a more solid entity with different challenges of an economic nature, the goals have shifted to economic objectives. For these, efficiency is of prime importance to reap the financial benefits. Other policies regardless of their growth orientation should be efficiently devised and cost effective. As mentioned in section 2 all EU policies should abide by certain principles.

The following analysis will concentrate on the performance of the policies in achieving their objectives and if they are in tune with the principles for a European budget policy. The analysis will be more detailed for the policies with a larger budget in particular, agricultural policy and the cohesion policy.

4.3.1 Preservation of natural resources

The title of this EU expenditure heading is very misleading, 76 percent is composed of direct support to farmers, 22 percent mainly to farm oriented investments and agri-environmental policies and barely anything for environmental investments. Given the enormous priority of the environment for the future, it is rather unfortunate to see it being given such little relevance. Due to the cross-border nature of pollution, environmental actions quintessentially need to be solved at multinational level. Simply admitting that convergence policies and R&D have some environmental aspects is clearly not sufficient.

The Common Agricultural Policy

The Common Agricultural Policy (until recently the largest item in the budget – 36 percent for 2006) is the policy facing the greatest criticism. At present, the few defenders of the present structure of the policy are mainly limited to the beneficiaries of the funds. Many of those sympathetic with a continuation of an agricultural policy consider the structure outdated and counterproductive. A considerable number of analysts and policymakers want the policy to disappear.

The CAP plays a pretty controversial role in the distribution of funds. The way it is designed benefits the countries with the highest yields of specific products, and within these countries the largest and often wealthiest producers, as it overwhelmingly consists of direct payments per ha of land linked to historical yields. The highest yields are generally concentrated to the most developed countries. Cattle are also highly subsidized, and concentrated in specific countries. The most supported product mix benefits Western continental Europe in particular (and Ireland, also a large beneficiary due to the large cattle herds). In terms of per hectare and farmer subsidies, countries such as Belgium, Denmark, France and Ireland are big beneficiaries, so much so that a prosperous country such as Denmark had been a net beneficiary of the budget till the year 2000 and Ireland is expected to remain so for the foreseeable future. The CAP strongly affects the distribution of the EU budget, and the policy is considered largely responsible for net balance disputes.

Calls to reform the CAP have resulted in a series of reforms, but the inability of decision-makers to tackle problems without taking net balances into account, has left the financial structure of the policy largely intact. Fresh attempts to make it more environmental and growth oriented through rural development policies have been very inefficient and plagued by distributional rigidities. The national/regional incidence of rural development funds is even indirectly linked to the average historical yields of 1989-1991.

The Treaty of the European Union lists general objectives for the Common Agricultural Policy which are: to increase productivity of the agricultural sector, to ensure a fair standard of living for farmers, to stabilise markets, to assure availability of supplies and to ensure prices are reasonable for consumers. Price support and direct payments (market support mechanisms) are the main vehicles to address these objectives.

From the very start the policy was ill conceived for two reasons. Firstly, it masqueraded as a rural policy, even though rural areas are not exclusively dedicated to farming. Secondly, it introduced one of the most distorting mechanisms possible to support the sector: price support. This policy immediately contradicted two of the objectives: the reasonable price objective and the stabilisation of markets (due to the adverse effects on other sectors and the world market). Due to the highly inefficient market support mechanisms, large deadweight costs arose, as a result the cost of the policy is in absolute terms roughly equal to the gross value added of the agricultural sector (see Wichern, 2004). The CAP was also designed without regard to environmental or adverse financial distribution effects. The impact of the policy prompted the shift to a rural development policy, a process only now starting to become important.

Table 4-2 CAP performance in achieving its objectives.

Objectives	**Quality of intervention, achievement of objective**
To increase agricultural productivity by promoting technical progress and by ensuring the rational development of agricultural production and the optimum utilisation of the factors of production, in particular labour	**Highly inefficient:** The CAP has been very successful in increasing production, not productivity. Costs of production increased, fuelled by subsidies and price support which have driven input costs higher. Transmission of support to farmers very low.
To ensure a fair standard of living for farmers	**Very inefficient:** Mainly market support policies, which are highly distorting and highly inefficient, with support largely accruing to farms that do not need income support. No means testing attached. The intended recipients most in need of support, small family farms, gain little benefit.
To stabilise markets	**Bad:** Depending on the term stabilisation. Prices to farmers in Europe were stabilised, distorting prices of other markets and destabilising world markets.
To assure availability of supply	**Excessive:** Availability of supply was soon assured and then exceeded, creating the infamous surpluses that needed dumping or destroying. The situation has improved, but there is still a level of distortion and world market dumping remains.
To ensure that supplies reach consumers at reasonable prices	**Fails:** Given the inefficiency of the policy in attaining its objectives, high prices for consumers were unreasonable.

In terms of the principles to be followed for items in the EU budget, the CAP is incompatible and also neither contributes to growth nor minimises its negative impact on growth.

Table 4-3 Score on principles of intervention for the CAP.

Compulsory	
Subsidiarity	**Fails:** Proponents of the policy consider that the policy fulfils this criterion because the CAP is necessary for the single market of agricultural products. There is however no reason for the EU to use EU funds to support agriculture. A single market can be guaranteed through regulations.
Proportionality	**Fails:** As the objectives of the policy are inefficiently targeted or missed, it fails to fulfil this criterion.
Additionality	**Does not apply:** Governments have pooled their resources. National financial allocations are not possible.
Value for money	**Fails:** The policy is highly inefficient and costly.
Highly recommended	
European public good	**Fails:** According to Fiscal Federalism there is hardly any reason under the present state of agriculture to consider support at EU level necessary.
European value added	**Fails:** The policy is not creating a value added in economic terms for Europe. At political level its contribution today can even be considered negative.
Compatibility with growth objective	
Growth compatible	**Fails:** Deadweight costs are excessive. Negative effects on growth not justifiable for the inefficiently targeted objectives.

The results indicate that the present Common Agricultural Policy, which concentrates on income support, should be abolished altogether. Some limited aspects could be retained, e.g. support for poor farmers (based on means testing and household income). Environmental support can be linked with regulatory systems and financial support under specific conditions and reflecting real costs of implementation.

The Rural Development Policy

As a response to the failings of the Common Agricultural Policy, there has been a shift towards the increasing importance of support for rural development, which can be categorised as being in line with the convergence policies and sustainable growth. The rural development policy has a large number of measures which can be subdivided as having three objectives: Restructuring the farm sector and improving its competitiveness, improving the environment and assist economic development of rural areas. The first objective absorbs the bulk of the funding, and the second and third dominated by farms and farming, which indicates that the rural development policy is mainly a farm policy, which goes against the recommendations of most academic research and work by the OECD (1996, 2001 and 2003). These clearly show that rural development is better achieved by holistic actions targeting all activities in the rural economy. Even in the most rural of all regions of the EU, employment in agriculture does not match employment in services and industry. The decline in rural areas is generally attributed by the aforementioned studies to the decline of infrastructure quality and services, not farming.

Table 4-4 Rural Development performance in achieving its objectives.

Objectives	Quality of intervention, achievement of objective
Improving the competitiveness of the agricultural and forestry sectors	**Mixed/inconclusive:** Evaluations are inconclusive on the impacts of the actions.
Improving the environment and the countryside	**Mixed/weak:** It is biased towards agri environmental measures which are often landscaping, rather than the environment. A number of actions fund activities which would otherwise be undertaken anyway. Support for Less Favoured Areas (LFAs) has been severely criticised by its aleatory distribution and the very little rationale in its implementation (see European Court of Auditors, 2003).
Improving the quality of life in rural areas and encouraging diversification	**Fails:** It is still centred on farming, while a successful rural development policy should target all sectors.

On the principles for intervention at EU level, Regional Development is an improvement on the CAP but still fails to meet the necessary criteria for EU intervention, as the table below presents. It needs additional reforms to become a well-targeted policy.

Table 4-5 Score on principles of intervention for the Rural Development Policy.

Compulsory	
Subsidiarity	**Pass but could improve:** As long as the policy targets intervention which are better performed at EU level. It is a distributive policy between regions.
Proportionality	**Fails:** The policy is not well devised to attain its targets of promoting rural economies. It is still highly skewed towards agriculture in its social and economic objectives. It is affected by political impositions unrelated to the objectives, in particular for the allocation of funds between regions.
Additionality	**Partially applies:** The rule of additionality applies in principle, but evaluations are still too weak to verify.
Value for money	**Fails:** Due to the inefficiencies in allocating the rural development funds and the farm bias in the objectives it does not fulfil this criterion. There is hardly any income criterion for support. Eligibility is based on how rural an area is, with rural here vaguely defined.
Highly recommended	
European public good	**Partial:** Strictly environmental actions and those measures aimed at income diversification may be considered a European public good. Questions remain on correct level of expertise in some areas.
European value added	**Partial:** Some aspects of the policy, especially in the environment, food safety and development fields may be considered as enhancing value added. But the policy needs to be better designed.
Compatibility with growth objective	
Growth compatible	**Partial:** The opportunity costs of the policy are not clear. Efficiency of the policy and evaluation quality needs improving.

The rural development policy could be continued as long as it becomes a rural dimension of what the Structural Funds do at larger scale at regional level. Many actions may even be better treated in other parts of the budget, rather than in ‘natural resources’. Eligibility criteria should be better defined.

Environmental policy

There has barely been an important EU environmental intervention of note, especially where funding is concerned. A big change is clearly needed under the headings of priorities and weighting of ‘natural resource’. Most of this budget is only tenuously linked to natural resources. On the principles for EU intervention a fully fledged environmental policy would score very well. At present, needs vastly exceed means, and therefore plenty of improvements are required.

Table 4-6 Score on principles of intervention for environmental actions.

Compulsory	
Subsidiarity	**Pass:** Pollution is often cross-border and thus naturally a supra-national issue.
Proportionality	**Fails:** The EU interventions and funding are not in line with the challenges ahead.
Additionality	**Pass:** The EU intervenes on issues which have to be solved in addition to national interventions.
Value for money	**It is under funded.** A stronger policy with more coordination between Member States would deliver more value added.
Highly recommended	
European public good	**Pass:** The environment is a global public good
European value added	**Pass:** Pooling resources increases efficiency.
Compatibility with growth objective	
Growth compatible	**Partial:** It can have important implications for growth, also positive. Potentially it could become important if it pools together the fragmented approach of Member States.

4.3.2 Cohesion Policy

The cohesion policy is composed of Structural Funds (Regional Development Funds ERDF and Social Funds ESF) aimed at regions with low GDP per capita (75 % of EU average) and Cohesion Funds for countries with a GDP under 90 percent of the EU average.

Should the EU be involved in regional policy? As far as interregional redistribution is concerned – the answer is yes. Solidarity aspects of the EU are better handled at EU level. The EU can play a role in fostering growth in its poorer regions. However, the cohesion policy has been questioned, and some analysts consider that many of its actions are not justified. Effectively, the growth rates of poorer members would have been achieved thanks to opportunities in the internal market, regardless of funding.

Regional and cohesion funds have suffered from the side-effects of the pork barrel approach to funding allocation. One of the most notable cases being the former objective 6, which then became part of objective 1, which allowed support for regions with low population density above a certain geographical latitude. This is often considered compensation to Sweden and Finland as they received lower CAP benefits. The two countries are no longer eligible for convergence funds today.

The Cohesion Fund is also considered to have come about due to pressure from Spain for compensation to offset adverse effect of the internal markets on Spain. This was intended to be solely for the period until the introduction of the single currency, but has lingered on for political reasons. This does not mean that cohesion funds are not useful, more that the decision to continue with them was not based on efficiency criteria.

Table 4-7 Cohesion Policy performance in achieving its objectives.

Objectives	Quality of intervention, achievement of objective
ERDF aims to reduce disparities between the levels of development	**Inconclusive:** Convergence between regions has not been achieved, but this is not a realisable objective, as poorer regions often lack the assets to match growth rates in richer regions. How the regions would have fared in the absence of the policy is what counts. Still dominated by distributional problems with the allocation of fund by country, which is dominated by politics.
ESF aims to improve productivity, employment rates, social inclusion and cohesion.	**Mixed/ weak:** It is unclear what the role of the EU should be. Often the measures have a weak impact and lack effectiveness due to national labour legislation rigidities.
Cohesion Fund assists eligible Member States to catch up with Europe's wealthier regions	**Positive/mixed:** Some countries have developed fast, others are lagging behind. The effectiveness depends on the coordination in the recipient country.

Research on the value added of the structural and cohesion funds is largely inconclusive. Some argue that the overall value added may be negative due to opportunity costs. There are indications, however, that the performance of the Structural Funds is closely related to the quality of programming, and it probably has had beneficial effects in countries like Spain and Ireland for this reason.

In theory, Structural and Cohesion Funds score well on the principles for EU intervention, but the problem with the policy lies in individual policy actions. An analysis and re-evaluation of the quality and appropriateness of certain eligible measures should be undertaken.

Last but not least, there is a need to review evaluation, auditing and control of fund allocation. The process of evaluating the funds should be handled by an independent agency. For auditing and control, there are clear issues with Member States on the separation of expertise. The EU institutions are responsible for the correct use of the funds, while Member States are responsible for implementing and auditing the policies.

Table 4-8 Score on principles for intervention for the cohesion policy.

Compulsory	
Subsidiarity	**Pass:** Programming and implementation of the funds are in the hands of the recipient countries and regions. However, in terms of evaluation, auditing and control, the roles of national administration and the EU should be reviewed.
Proportionality	**Weak:** The Structural Funds and cohesion funds need improving if they are to achieve their objectives. It is unclear if the policy can or should achieve the objective of reducing interregional disparities.
Additionality	**Pass:** It is a fundamental objective of the policy, and the evidence suggests this is being adhered to in principle.
Value for money	**Weak**: There are indications that the policies could be improved.
Highly recommended	
European public good	**Pass:** The development of poorer regions is in the interests of the EU
European value added	**Weak:** Intervention in the poorest countries and regions is generally considered vital. The value added of each € invested in the poorest region is considered to exceed the value in a richer region. However, the opportunity costs in wealthier but still eligible regions are questionable.
Compatibility with growth objective	
Growth compatible	**Yes:** if the policy is devised efficiently to minimise opportunity costs and maximise returns. It is largely an implementation issue.

According to the Sapir report (2003) and endorsed by some net contributors, there is a question mark surrounding the need to have regional policy intervention in wealthier countries with eligible regions, and whether the Member State should finance such development. This position has some rationale in terms of pure economics. Wealthier Member States not only have greater means for regional investment, they also generally have greater social support. What is more, net contributors can replace the EU funds to the region with the savings available by having to make smaller contributions to regional policy.

This argument, however, is generally rejected by the regions concerned, which do not see national government investment in the region as having the same intensity. Regions also appreciate the empowerment EU regional funds give them to define their own priorities. From a political point of view, there is also an important equity issue, namely does denying support to poorer regions in wealthier countries run counter to the principle of equal treatment of EU citizens, where citizens in a similar situation (in terms of GDP per capita in PPP) are treated differently because of where they live?

Even so, the merit of this last point is questionable, as similar GDP per capita in a region does not de facto mean a similar interpersonal situation. Regions with a similar GDP per capita in purchasing power parities do not necessarily have comparable infrastructures, social security provision or equivalent public services provision in their respective regions.

In any case, the introduction of national wealth as an addition to the regional GDP per capita criterion for eligibility would fundamentally change the nature of the policy. It would lose its European wide character. Any decision cannot be based on economic rationale alone and there are heavy political connotations attached.

4.3.3 Competitiveness Funds

The EU has introduced a number of aims to promote the competitiveness of Europe and its capacity to face the challenges ahead. The EU budget is expected to intervene in the most appropriate form, taking into account the subsidiarity principle and thus support actions that are better served at supranational level.

To date the EU budget concentrated its resources on cohesion and sector related problems. Successful ventures were assumed to be self-generating and self-sustaining. Investment for companies was limited mainly to cohesion regions and industries in decline (objective 2).

Recognising the need to foster competitiveness, the European Commission proposed for the next financial perspective to bring existing pilot programmes on research, support for start-ups and connectivity across Europe to the forefront of EU policy intervention, creating a large and distinct budget under the new heading Competitiveness and Employment. Policies equivalent to the present objective 2, plus R&D and European transport and energy corridors (TENs) are funded under this heading.

The new Financial Perspectives also reinforce actions which are deemed to be important for the future competitiveness of the EU. The competitiveness heading increases and expands EU interventions for the development of SMEs, education and lifelong learning programmes and the Trans-European networks.

While investment in Competitiveness is certainly a positive idea, the role of EU funding is not. The value added for the EU of these programmes is still under debate. The budgetary allocation of funds is limited, but the optimum level of funding is also very unclear.

Research and Development

Interventions for research and development are clearly in line with Fiscal Federalism and all the principles for EU interventions. The performance of R&D spending is mixed, also because of lack of funds. The policy has just started to become a serious budgetary item, even if still not fully developed. At this stage it is premature to judge the funds.

Table 4-8 Score on principles for intervention of research and development policy.

Compulsory	
Subsidiarity	**Pass:** There is a clear role for research funding at EU level.
Proportionality	**Unclear:** the optimal funding at EU level is unclear.
Additionality	**Pass**: It is officially so, but substitution effects should be assessed.
Value for money	**Pass:** R&D finance at EU level can *potentially* lead to important economies of scale.
Highly recommended	
European public good	**Pass**
European value added	**Pass**
Compatibility with growth objective	
Growth compatible	**Yes**

The important issue to answer is what the correct allocation of resources should be. It is a well-documented fact that the EU spends a smaller proportion of GDP on R&D than the US and Japan. Innovation is considered a key factor for economic growth and the future sustainability of the European economy. The European Commission has thus proposed a considerable increase in funds for research and investments leading to increased competitiveness. However, the share of *public funding* is already higher (Table 4-10) than in the US and Japan.

Table 4-9 Gross domestic expenditure percentage of GDP on R&D, 2003.

EU25	**US**	**Japan**	**China**
Expenditure as % of GDP			
1.93 %	2.59 %	3.15 %	1.31 %
Growth in GERD[2] (annual real growth 2000–2003)			
2.4 %	0.4 %	2.2 %	18.6 %
Proportion of public expenditure in GERD, 2002			
34 %	31 %	18 %	

Source: European Commission, key figures 2005

While no Member State argues that expenditure in R&D does not need to increase, the source and type of R&D investments are open to question. As public sector R&D investment in the EU is higher than in the US and Japan, is increasing R&D via the EU budget a sensible option? Given the size of private R&D investment in the US and Japan, the EU Member States should look hard at their national policies. Regulation, rigid labour markets, bureaucracy and unsuitable fiscal regimes may well be the reason for Europe's laggardness. Keeping the inefficiencies of the private sector and increasing public expenditures are unlikely to improve the situation.

The EU's approach to R&D may well be also ineffective and even counterproductive. Gros and Micossi (2005) are very critical on the strategy of R&D investment via the EU budget, considering it wasteful and politically influenced and they call for a substantial change in the rules.

Nonetheless, some actions have been positive. Since as early as 1994 the EU has been experimenting with different pilot projects – Regional Innovation Strategies and Regional Technology Transfer actions. In the Programming Period 2000–2006 these programmes were structured into a central strategic goal, which is to develop the European Research Area. The European Framework Programmes and pilot programmes for regional cooperation for innovation (such as the PAXIS programme) are becoming stronger by the year.

There is evidence that EU funding in R&D has been successful where critical mass and cross border benefits exist despite the figures representing less that 6 percent of total EU spending in R&D. It has enabled duplication and fragmented research to be avoided where coordination and economies of scale are important. While there is general agreement that the role of the EU budget could be stronger, there is no clear indication of what size and purpose this should have.

Generally speaking, funding directed towards R&D and to foster competitiveness should be allocated according to excellence. Countries or regions would not be able, as with agricultural, rural and structural funding, to obtain a predetermined budget allocation for their country. With today's discussions so concentrated on net balances, there has been little interest shown by Member States to support an increase in funding for this heading. There is a big risk that the pie will be divided on a political basis, undermining its effectiveness.

[2] *Gross Domestic Expenditure on R&D (GERD).*

Political allocation of funding or responsibilities could cause considerable damage and an unfortunate example of the consequences of this can be seen with the Airbus.

Trans-European Networks

Trans-European Networks are considered a fundamental ingredient for efficient developed markets. The objectives are reasonable in theory: to ensure that transport links enable efficient cross border trade and connectivity across countries for energy to create competition between suppliers, or for energy security. The fund assists these aims by financing transport and energy connectivity, but is this necessary?

TENs for transport are also financed by cohesion funds in countries with a GDP per capita less than 90 percent of the EU average, which means the budget falling under competitiveness Heading is for areas that do not benefit from cohesion funds. The benefits of funding transport links in wealthier Member States via this budget are questionable and raise additionality issues. The need for EU funds should be reassessed.

In the case of energy markets, these are dominated by national organisations, that have not made any investments in connectivity to other countries. There is no financial incentive for such energy suppliers that often have a monopoly or near monopoly on their domestic market to connect to foreign grids. The EU can open these markets by funding the requisite infrastructure for connectivity. For gas, the main argument is energy security. Special pipelines to enable a switch between suppliers could be built. There is indeed an argument in favour of EU action in both areas, but some more cost benefit analysis should be undertaken.

Table 4-10 Score on principles of intervention for Trans-European Networks.

Compulsory	
Subsidiarity	**Pass:** However, in transport for planning, not always for funding
Proportionality	**Unclear:** For transport in wealthier Member States.
Additionality	**Pass:** But may fail in wealthier Member States.
Value for money	**Pass:** There is plenty of scope to develop economies of scale, but a cost benefit analysis is required for energy security. What value would it offer?
Highly recommended	
European public good	**Pass**
European value added	**Pass**
Compatibility with growth objective	
Growth compatible	**Yes**

Intervention for SMEs

In theory the EU can play a role in assisting the development of SMEs when this is part of a European restructuring process. SME development is also quite dependent on national incentives and regulations.

Publicly funded SME development can often be a substitute for private financial sources. The latest comprehensive evaluation financed by the European Commission claims that the policy has had very strong value added, and that without such intervention 75 percent of the SMEs assisted would never have come into being (European Commission, 1999). A recently completed evaluation of some of the programmes for SMEs (Renda, Schrefler and van Dewal, 2006) concluded that these are acceptable as an EU policy although there is scope for improvement.

A comprehensive review of the schemes to support SMEs should be undertaken to ensure that the EU is not a substitute for national or private funding schemes. There is occasional puzzlement that EU SME schemes are not used in some regions because national schemes are easier to use. In such cases the EU schemes should simply not be available, and should be regulated by state aid rules. EU measures should not be a substitute for national aid or private financial institutions. Only in countries or regions with inadequate support provision should there be scope for EU intervention.

Table 4-11 Score on principles of intervention for SME assistance.

Compulsory	
Subsidiarity	**Pass**
Proportionality	**Unclear**
Additionality	**Unclear:** Depends on quality of implementation. There is a risk of being a substitute for private finance or other aids.
Value for money	**Unclear**
Highly recommended	
European public good	**Pass:** If well devised
European value added	**Pass:** If effective
Compatibility with growth objective	
Growth compatible	**Yes**

4.3.4 Internal Policies and External action

Security, external action and defence are important areas of intervention where the EU would be better placed to act. The funding allocations are far from adequate and policies too underdeveloped.

When it comes to external measures, the EU budget neither reflects the ambitions of the European Union abroad, nor provides the necessary means to meet present needs.

It is very much in the interests of the European Union to interface with its neighbours. Political stability and economic growth in neighbouring areas offer opportunities for the EU and are of crucial importance. Most of its neighbours view the European Union is as an ideal to aspire to. Membership of the European Union has been applied for, and countries have undertaken lengthy, difficult and costly reforms to gain trading access or to adopt the EU *acquis communautaire*, which is heavily charged with costly political and economic requirements.

EU influence in the neighbouring regions relies heavily on persuasion rather than power. Access to Europe's markets, the benefits of closer ties and ultimately membership have changed the political landscape of Eastern Europe at record speed. This is also largely due to the EU introducing conditionalities into its programmes (PHARE, TACIS, CARDS, etc.). EU influence even extends beyond the neighbouring countries, via its international aid programmes. However, despite the heavy reliance of the EU on support through association agreements, pre-accession programmes and aid to secure stability, influence and future trade partnerships), the EU external measures budget is still very limited. The economies of scale that could be achieved in external action at EU level are very important, while the EU cannot punch its full weight on the global security stage without pooling its resources.

The EU is also criticised for a lack of resources for managing external programmes. In fact, the EU relies heavily on external consultants with varying success. Paradoxically, however, Member States can refuse to agree to EU administration being increased in line with the responsibilities they themselves have invested in it.

In the case of internal security, Member States have been remarkably reluctant to expand EU involvement in this field. Gros and Micossi (2005) are surprised so little interest is being shown in an area where citizens clearly demand more coordinated action. The fact that this heading is so underfunded is in part due to political reluctance to shift resources from the CAP and Structural Funds to internal or external actions.

EU budget interventions in the new financial perspectives show that a ***considerable part of the funds are used for interventions not in line with the fundamental principles EU policies*** should possess ***and are incompatible with a growth orientation of the funds.***

The Common Agricultural Policy is a particularly strong case in point. In its present form, it not only fails to comply with the principles that EU policies should follow, it also has a very negative impact on the rationale of the EU budget.

Most ***CAP direct payment support should therefore be phased out***, leaving some scope to support farmers on low incomes, based on means testing of farm households.

The Cohesion policy and rural development policies do have a role to play in the EU budget, but the individual measures ***need revisiting***.

R&D has an important role to play at EU level but the optimum level of funding is unclear.

TENs are potentially important investments, but those for transport need reassessing.

Funding for external action and internal policies is extremely low and should increase in line with better policies ***given the economies of scale benefits.***

5 A strategy for a growth oriented reform

The budget structure is suboptimal. Much of the funding is allocated to inefficient policies that waste resources and therefore incompatible with a growth orientation for the EU, and the efficient use of public resources. Any policy, whether social, sector related or international should take into account the economic implications when being devised. Some policies may indeed be necessary, despite negative implications, but all policies should be optimised to comply with the principle of value for money.

Budgetary reform requires a definition of the fundamental characteristics EU budget policies should adhere to. This list of requirements should include: subsidiarity, proportionality, additionality and value for money. Such policies should also in principle be aimed at the European public good for which there is an underprovision due to market failure. Funding should be available for policies that create a value added for the European Union, directly or indirectly (by pooling resources, reducing costs and increasing economies of scale).

As such it is important that present policies and the measures financed by them, along with other future policies should be assessed in line with these criteria.

5.1 Budget priorities to specifically boost European growth

Analyses of how well the EU budget supports EU growth targets suggest it is far from perfect and can be counterproductive as a whole. Firstly, the budget does not offer a well-developed strategy for growth. What is lacking is clearly set out in the Sapir report.

A budget devised to intervene to promote growth should concentrate on R&D, education, training, infrastructure and restructuring aid. Convergence should concentrate the resources on poorer countries to assist them to increase their rate of growth and convergence. The main target should be institution building and human and physical capital. Restructuring aid is for temporary assistance for employment relocation assistance in case of shocks in particular.

According to Sapir convergence policy should concentrate solely on the poorest countries. Regions in wealthier Member States should not be targeted, as these countries can provide their own funding support. This reflects the view of Tarschys (2005), who felt that the social policies of the wealthier countries, meant interregional income disparities in wealthier Member States was considerably less than disparity in GDP. Such a decision would be largely political, but there is reason to consider further limiting the support to poorer regions in wealthier Member States and concentrate more to the poorest Member States.

The Sapir report presents a budget that is exclusively aimed at growth, and does not allocate funding to important areas for EU intervention in security, external action and the environment, where economies of scale in cooperative action would prompt economists to allocate such expertise to the European Union. These should be included.

5.1.1 Automatic stabilisers for the EU budget?

Some academics call for the EU budget to run an automatic stabiliser to cushion the impacts of asymmetric shocks to the economy. Countries which are members of the single currency area lost two important economic instruments to deal with financial or real shocks: exchange-rate policy and monetary policy. In addition the Stability and Growth Pact limits the ability of Member States to cushion economic crises.

Integration in the EU reduces some risks of asymmetric shocks to the economy but increases the risk of suffering from spill-over and overlaps of asymmetric shocks in other countries.

It is estimated that such a system would require substantial funds publications on this discuss ranges from 1 to 5 percent of EU GDP. In case of an asymmetric shock (production falling below a set trigger) support valued on the difference between the national and EU growth rate can be provided. The funds would be used immediately in special programmes devised for such shocks.

While useful, this system should only be created if the budget as a whole were modernised. It would also be reasonable to consider the funds as an "insurance policy" outside the EU budget.

5.2 Reinforcing growth orientation of other policies

In the case of policies that are not primarily directed at growth, their contribution, to growth, negative or positive, should be taken into account. As such the EU budget can fund a number of other objectives considered to fulfil the criteria presented in this paper. The requirements of value for money, subsidiarity, proportionality and additionality should already guarantee the policy will have a minimal adverse impact on growth. When coupled with financing of a European public good with value added at European level this should ensure that it creates a positive growth effect, at least when taking the place of less efficient national interventions.

It is clear from the analysis presented that the present CAP is incompatible with an efficient budget. A reform of the budget to reinforce growth orientation includes plans to phase out direct support to the farming sector. There may be limited scope for support for the poorest farmers.

The rural development policy, could, in principle, be considered in a similar fashion as the cohesion policy. But the present structure and eligibility criteria are suboptimal. The policy has to change further to become a fully-fledged instrument to encourage real economic growth in rural areas and the environment. The present policy is suboptimal and biased towards agriculture. The rural development policy should be an additional measure for larger regional plans and have better eligibility criteria. An optimal solution would be to separate the rural policy into its various components: Economic development of rural areas, environmental protection and food safety and quality. This would avoid the present mix-up with regard to the role of the funds.

Eligibility criteria should be clarified and reinforced while the three components could come under the respective headings dealing with convergence, the environment and consumer protection.

The expansion of the budget into other areas may also be important for growth, if the pooling of resources creates economies of scale and savings in areas such as defence or environmental protection. As such, a growth oriented budget would not be solely the domain of growth-enhancing activities.

5.3 Steps to achieve necessary reforms

Further analysis and the development of a budgetary structure based on the ideas set up in the previous two sections should be undertaken for the budget review. All polices and actions emanating from them should be tested for compliance with the main criteria. Of all the criteria, cost effectiveness and minimal distortion of the economy to achieve their goals should be the most basic principles.

Implementing the reforms will require not only a very strong political will, but also a very well defined timetable. A budget structure for the next Financial Perspectives should be established. It could include a phasing in during the next Financial Perspectives, especially to allow a shift in resources from direct support to agriculture, for example. The new structure and division of resources could be set for 2016, for example, allowing for a three year transition period if the present Financial Perspectives are not altered.

Such a timetable should facilitate negotiations, as it is easier to agree on a longer-term objective than an immediate reform.

Table 5-1 Example of a growth oriented budget with better and clearer headings:

Heading	Contents
1. Growth and competitiveness heading 25 % of funds	Investments in R&D, ICT, education and restructuring
2. Convergence 25 % of funds	Support for poorer regions and countries, the weighting of infrastructures should only be significant in poorest eligible regions. Funds for the wealthier of the eligible regions should be mainly for human capital and financially more limited.
3. Environment 20 % of funds	Protection of the environment Adaptation to climate change Investment in cleaner infrastructures and clean energy Includes agriculture and rural development measures for the environment.
4. Security and citizenship 10 % of funds	Present actions enhanced, should include food safety
5. External action 15 % of funds	Present actions enhanced
6. Administration 5 % of funds	

The size of the future budget should not be determined at his stage, even if specific ceilings or prioritisation of funds can be predetermined. Setting a ceiling in today’s climate before estimating a rational cost may be detrimental. However, the measures for headings 1,3,4,5 need substantial increases, with funds partially drawn from the agricultural policy and the cohesion policy.

All policies should maximise the positive growth impact or minimise any negative effect. Given the challenges ahead and the need to create economies of scale, the environmental heading should include an important component for adaptation to climate change and investment in clean technologies. The latter is today confusingly included in under the heading of competitiveness.

Increasing the growth orientation of the budget requires:

- ***Reinforce and improve policies aimed at R&D, education, transport and infrastructures***.
- Ensure that ***non-growth oriented policies target objectives European in nature***
- Ensure that ***the non growth oriented policies are cost efficient and not in conflict with EU growth performance***. Negative growth impacts should be minimised. This would require the CAP to be drastically reduced and reformed.
- ***Areas where the European Union could generate economies of scale should be reinforced***. These are e.g. funds for environment, internal security and defence

The analysis of the budget components, a new budgetary structure and a timetable to reach this structure should be agreed.

6 Conclusions

The EU budget's role in fostering growth is very limited; most actions have to be undertaken at national level in the form of structural and fiscal reforms. At EU level, the cornerstone for fostering growth is the full realisation of the internal market, which is not a financial issue. However, the EU budget can help in taking advantage of the political integration of the Member States to create efficiencies of scale in some areas, creating additional growth opportunities. So its actions should always add to growth, even if only by reducing costs and increasing efficiency of policies, compared to separate national actions.

To ensure that the budget becomes growth oriented it needs reforming; it is out of date, wasteful and largely incompatible with a growth orientation. EU budget priorities should adhere to certain fundamental principles enshrined in the treaties or determined by rational analysis, namely: subsidiarity, proportionality, additionality and value for money. In addition, all policies and specially those aimed at fostering growth should be aimed at the European public good and should create a value added at European level.

There is a role for the EU budget to intervene in growth oriented aspects where pooling of resources and coordination can create economies of scale. This is in the fields of R&D, education and transport. For R&D and education, the role is primarily to support cooperation and act as a catalyst for multinational cooperation, creating links and reducing duplication of research. This is a role which the subsidiarity principle or the theory of Fiscal Federalism would allocate to a higher level of governance.

A big unknown is the level of funding required to ensure the proportionality principle can be fulfilled. Especially in the case of R&D, the EU seems to have structural problems inhibiting investment in the private sector. Bolstering public funding without resolving this problem is very suboptimal. It is possible that pooling part of existing public spending into the EU budget would be enough, while improving the conditions for private R&D investments.

In the case of transport and energy, the EU can assist in developing cross-border infrastructures to improve Trans-European mobility and connectivity, reduce costs and improve internal market efficiency. Coordination is better served at EU level with funding in particular to support infrastructures in countries that would not be able to afford otherwise.

In addition to those growth oriented policies, Fiscal Federalism theory, in line with the subsidiarity principle, allocates some other policies at EU level. Having policies which are more efficient and cost effective when handled at supranational level is in line with a growth oriented budget, because efficient collective action reduces overall costs and with it, EU welfare. Further research needs to be performed on individual measures that the EU is already taking or measures that should be taken.

Of course, transferring policies to the EU budget that would in theory be better run at supranational level does not guarantee that this will be good for growth per se. A budget where funding is allocated geographically based on political criteria may not only be less optimal but may well be counterproductive. The opportunity costs of badly allocated supranational R&D investments, for example, may be higher than suboptimal use at national level. Whatever the budget structure, bad rules and bad implementation will nullify all or some of the benefits of scale and may even create large inefficiencies. Thus a review of the decision-making, implementation and control systems and the methods of exante and ex-post evaluation has to be undertaken. This would also be supported by a resources system which does not foster rent-seeking by Member States.

More work is needed for a successful review of the budget in line with growth objectives. Growth orientation of the budget is achieved not only by reinforcing competitiveness-oriented policies, but also by improving the efficiency of all actions. Further analysis is necessary to evaluate the quality of different policies and the actual measures these are composed of. Criteria for EU intervention should be based on clear principles for EU budget expenditures as presented in this paper. In addition, work on necessary changes to ensure optimal decision-making and implementation is imperative, the bad allocation of resources or implementation eliminates the potential benefits of supranational action.

References

Ahner, D. and Scheele M. (2000), *The Common Agricultural Policy: An overview from where we come, Where we are, Tasks ahead*, paper presented at the International Postgraduate Course on "European Agricultural Policy in Transformation", Wageningen University, 15 September 2000.

Buckwell, A. et al. (1997), *Towards a Common Agricultural and Rural Policy for Europe*, European Commission, DG ECOFIN, European Economy Reports and Studies, No.5: 1–97.

Buti, M. and Nava, M. (2003), *Towards a European Budgetary System*, European University Institute (EUI) Working Papers, RSC No. 2003/08.

European Commission (1999), *Thematic Evaluation of Structural Funds Impacts on SMEs*, European Commission, Brussels.

European Court of Auditors (2003), *Special Report No 4/2003 concerning rural development: support for less-favoured areas, together with the Commission's replies*, 2003/C 151/01, Luxembourg.

European Commission (2004), *Facing the challenge', Report from the High Level Group chaired by Wim Kok*, Brussels, 3 November 2004.

European Commission (2004b), *A new partnership for cohesion convergence competitiveness cooperation*, Third report on economic and social cohesion, European Commission, Brussels.

European Commission (2004c), *Financing the European Union: Commission's report on the operation of the own resources system*, COM (2004) 505 final, Volume I and II.

Figueira, F. (2006), "How to Reform the EU Budget? Going Beyond Fiscal Federalism", paper presented at the Jean Monnet Conference on Europe's Democratic Challenges – EU Solutions?, School of International Studies, University of Trento, Italy, 30 June – 1 July 2006, www.4.soc.unitn.it:8080/dsrs/eudemocracy/content/e1374/e1455/e1464/PaperFigueira.pdf

House of Lords (2005), *Future Financing of the European Union*, EU Committee, Sixth Report of Session 2004-05.

Renda, Schrefler and van Dewal, (2006), *Ex post evaluation of the MAP 2001-2005 Initiative and suggestions for the CIP 2007-2013*, Special CEPS Reports , CEPS, Brussels (www.ceps.be).

Sapir, A. (2003), *An Agenda for a Growing Europe, Making the EU Economic System Deliver, Report of an Independent High-Level Study Group established on the initiative of the President of the European Commission*, European Commission, Brussels.

Gross, D. and Micossi, S. (2005), *A Better Budget for the European Union – More Value for Money, More Money for Value*, Centre for European Policy Studies (CEPS) Policy Brief No. 66 (www.ceps.be).

Musgrave, R. (1959), *The Theory of Public Finance*, New York: McGraw Hill.

OECD (1996), *Territorial Indicators of Employment - Focusing on Rural Development*, OECD, Paris.

OECD (2001), *OECD Territorial Outlook- Territorial economy*, OECD, Paris

OECD (2003b, *The Future of Rural Policy - from Sectoral to Place Based Policies in Rural Areas*, OECD, Paris.

Persson, T., Roland, G. and Tabellini, G. (1996), *The Theory of Fiscal Federalism: What does it mean for Europe?* IGIER Working Paper No. 101 (www.igier.unibocconi.it).

Swinbank, A. and Tranter R. (2004), *A Bond Scheme for Common Agricultural Policy Reform*, CABI, August , 2004.

Tabellini, G. (2002), *The Assignment of Tasks in an Evolving European Union*, CEPS Policy Brief No. 10 (www.ceps.be).

Tangermann S., (1991), *A bond scheme for supporting farm incomes*. In Marsh J., Green B., Kearney B., Mahé L., Tangermann S., Tarditi S. The changing role of the Common Agriculture Policy : the future of farming in Europe. London: Belhaven Press.

Tarschys D. (2005), *The Enigma of European Added Value: Setting Priorities for the European Union*, Sieps 2005:4, Stockholm 2005.

Wichern, R. (2004), *Economics of the Common Agricultural Policy*, Directorate of Economic and Financial Affairs, Economic paper No 211, European Commission, Brussels.

Widgren, M. (2006), *Budget allocation in an expanding EU – A power politics view*, Swedish Institute for European Policy Studies.