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## Summary

This article focuses on budgetary and re-distributive modes in the EU. Starting from theoretical and conceptional considerations, the paper identifies the main areas of redistributive effects of the EU budget and examines their emergence and evolution. Also reflecting lessons that can be drawn from experience, the author presents results of empirical analysis and the impact of the EU enlargements on budgetary redistribution. Finally, the author reveals that the EU budget has to be regarded as redistributive from both the revenue and expenditure side.

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## I. Introduction

In the academic literature the most typical way to conceptualize fiscal transfers in the EU is to see these flows of public money as a kind of fiscal federalism which is motivated by economic needs. According to this view, the EU would act as a benevolent policy-maker, which takes money from the rich member states and redistributes it to the economically less prosperous regions and countries in the interest of the common good. This is the publicly stated reason for unequal net fiscal flows within the EU.

Redistribution is, anyway, an important political and economic issue in the process of European integration. This question refers to the ability of federal or national systems to implement re-distributive transfers between their members. At EU level the redistribution is understood as the process in which money is transferred from one of the member states to another one through the EU budget. This whole complex issue has received a special attention by the European Commission since nominal convergence imposed by the Maastricht Treaty was aimed to promote and to enhance real convergence among member states in the long run.

## II. Some conceptions and theoretical issues

The EU member states can have several reasons to justify the existence of redistribution policies. In particular, as stated in different treaties, the European Community shall aim at reducing disparities between the levels of economic development of member states and the backwardness of the least favoured regions.

However, it can be argued that these policies do not aim to support a continuous and constant transfer from richer to poorer member states, but to establish appropriate conditions in which a backward economy can catch up with the leading ones more quickly than in the absence of such policies. In the long run, the financial assistance to a given member state or region vanishes as disparities with the rest of the Union disappear. In other words, one can say that redistribution policies aspire to speed up the convergence process of poorer countries or regions to the average Community level.

The analyses of the re-distributive effects of the EU general budget is particularly important because redistribution policies are nowadays of greater importance in the EU budget due to the Eastern enlargement than they were decades ago, at the early phases of the European integration process. In fact, when the Maastricht Treaty was signed it was also decided to reduce some of the existing economic disparities that could be deepened by EMU and could endanger the well functioning of the common monetary policy.

Redistribution policies imply transferring income among member states to alleviate persistent differences in per capita income levels and, as growth models can show, these policies can increase the speed of convergence of beneficiary countries to common steady states. However, the small size of the EU budget limits the magnitude of these effects. In any case, it must be understood that these policies do not account for all the gains EU countries derive from the EU.

The expenditure policies of the member states have stabilisation and redistributive elements. In economic policy analysis, in most cases analysts do not make very clear distinction between the process of economic stabilisation policies and redistribution policies. Some other authors<sup>1</sup> pointed out, however, the convenience of analysing them separately. Stabilisation

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<sup>1</sup> von Hagen (1992) or Bayoumi and Masson (1995)

policies are often justified by the existence of transitory or cyclical deviations from trend output that may be mitigated by the redistribution of income from regions or countries having a temporary expansion to those experiencing a transitory recession. Contrary to the stabilisation policies, redistribution policies imply transferring income among members to alleviate persistent differences in per capita income levels and implementing policies that stimulate long-run growth in poorer countries or regions to reduce economic inequalities. The treaties of the EU contain both stabilisation policy and redistribution policy.

In the course of the last decades, redistribution policies have got increasing importance in the EU budget, as economic and social cohesion has become one of the most important pillars of the EU. Economic and political considerations and priorities were giving rise to policies aimed at the reduction of regional disparities, at the support of regions affected by economic changes and at the development of human resources throughout the EU. These objectives have not only implied a firm political will by the Commission, but they have also been reflected in the treaties signed by member countries. Thus, Article 158 of the Treaty Establishing the European Community declares that "[i]n order to promote its overall harmonious development, the Community shall develop and pursue its actions leading to the strengthening of its economic and social cohesion. In particular, the Community shall aim at reducing disparities between the levels of development of the various regions and the backwardness of the least favoured regions or islands, including rural areas."

Or, Article 2 of the Treaty of the European Union states that "the Community shall have as its tasks, by establishing a common market and an economic and monetary union and by implementing common policies,... to promote throughout the Community a harmonious, balanced and sustainable development of economic activities, a high level of employment and of social protection, ... convergence of economic performance, ... and social cohesion and solidarity among Member States".

In 1992, when the Maastricht Treaty laid down the basis for establishing the EMU by 1999, it was also decided to reduce some of the existing economic disparities among future members that could endanger this ambitious project, and also to address the risk that EMU could deepen regional disparities. Additionally, both the Treaty's requirement as well as the Stability and Growth Pact<sup>2</sup> limit budget deficits<sup>3</sup>, also they constrain the possibilities of poorer states of increasing their investments to catch up with their richer partners. In response to these questions, the Maastricht Treaty established a new Cohesion Fund to channel financial assistance to the four poorest states<sup>4</sup>. The Eastern enlargement of the EU has resulted in that the gap between the more developed and the least developed member states further and substantially increased. To reduce this gap there are not only interests to maintain but to increase even further in the future the weight that cohesion and structural policies have in the European project.

### **III. The main areas of the redistribution effects of the EU budget**

Among the main characteristics of the EU budget there are some, which are important from the point of view of redistribution.

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<sup>2</sup> SGP was signed in Dublin in 1996

<sup>3</sup> by a maximum of 3 percent of gross domestic product (GDP)

<sup>4</sup> The poorer member states are, which had a per capita GDP below the 90 percent of the Union's average in PPP terms.

Firstly, most of the EU expenditure is not explicitly intended to be redistributive. For example, the main goal of the R&D (research) spending is to improve the level of scientific research general in the EU member states, and to subsequently strengthen the competitiveness of European economies in the global competition, and not to allocate funds to support research works in the poorer member states. Only in the case of structural policy the redistribution among member states and their regions is an explicit goal.

Secondly, some funds are intended to be redistributive, not between member states, but between social groups. The best example would be the CAP payments. They are clearly redistributive in nature, but their goal is to redistribute wealth from taxpayers and consumers to one specific social group, the agricultural producers.

However, an important question should be also raised whether the intended main objective of specific EU funds is to redistribute between member states or not, and whether they have such redistributive effects in practice or not. States with efficient farm production will inevitably benefit from CAP payments more than states in which agriculture is less efficient, and the question is whether this outcome was the intended goal of the EU's policy-makers, or not. Therefore, analysis of the actual redistributive effects of all EU programmes is justified, regardless of what the declared goals of the programme are.

On the expenditure side of the EU budget, the following components have the largest redistribution impacts: common agricultural policy (CAP), structural operations, internal policies, external policies and administration costs.

- The largest component of EU spending is the common agricultural policy (CAP). Almost 40 % of EU spending is used to cover the costs of the CAP. Traditionally, the share of CAP payments was even higher, for example 75 % in 1972. Yet, it is only the budget share of the CAP that has declined. In absolute terms, CAP payments have risen over the years. The main reason for the decline of the share of the CAP in the budget has been the fast growth of spending on structural policy.
- The next largest component of the spending is the Structural funds aiming at improving economic and social cohesion in the EU, i.e. to promote growth in economically less developed member states and their regions. The share of structural expenditures was less than 5 per cent of the total budget in 1975 but currently, approximately one-third of the budget is allocated to this purpose.
- The third largest component (7 per cent) of the expenditure side of the EU budget consists of funds allocated to internal policies. This category covers various policies such as research and development, education, culture, trans-European networks, energy and environment.
- External action spending is mostly directed outside of the EU. This comprises spending on development and humanitarian aid and financing the economic transformation of the EU's neighbour states (e.g. in the Mediterranean region and in the East). Pre-accession aid is paid to future member states to prepare their economic, legal and political institutions for joining the Union.
- Finally, 5 per cent of the expenditure is used to finance EU administration in Brussels and other locations.

While the expenditure side of the EU budget can be disaggregated into thousands of spending categories, the revenue side of the budget is fairly simple. There are basically only four different sources of money.

- The two oldest form of EU financing, often referred to as the traditional own resources, are based on customs and agricultural duties which are paid directly to the Union budget.
- A little over one-third of the budget is covered by value added tax (VAT) payments, which means that member states pay a share of their VAT revenue to the Union.
- The largest component of the revenue side is known as the fourth resource. This is a payment based on the member states' national products (GNI), i.e. rich countries pay more than poorer countries.

#### **IV. Emergence and Evolution Budgetary / Redistributive Mode**

The EU common budget like any national budget has redistributive function, which is to serve common policy aims of the member states. One of the most important issues of the redistributive effects of the EU budget is how to set member states' fiscal balances in a manner that is consistent with equity criterion without sacrificing other economic policy goals.

Statistical and econometric analyses based on the relationship between per capita net budget balances (difference between transfers from and contribution to EU budget) and relative net GNP per capita across the EU member states have indicated that the net effect of the EU budget is redistributive. It means that on the one hand the net balances are on average positive in the case of the less developed or poorer member states and negative in the case of the more developed or richer countries on the other. In practical terms it indicates that for a typical citizen of a more developed or richer than the average EU member state, the net effect of the EU budget is equivalent to a flat tax of between 5 to 6 % levied on the difference between his or her gross income and the EU average. In the case of the citizens of the less developed or poorer member states the net effect of the EU budget is a transfer or subsidy of the same magnitude.

These figures of flat tax on the one and subsidy to the other EU citizen are relatively very small compared with the degree of regional redistribution within any member state. The redistribution within a country is attained through the national budget and fiscal system and its size typically lies around 30% in the EU member states. Comparing the volume of EU budget expenditure, which is only around 1 % of GNP to the figures of national budget expenditures ranging between 30 to 55 % of GNP it can be stated that the EU budget is a rather effective economic policy instrument for redistribution among the member states. It has various reasons.

Statistical time series show that the net expenditures of the EU budget have been distributed rather unevenly across the member states. A significant part (around 60 %) of the variation is related to the per capita GDP levels that is the poorer a member state is the larger the support given from the budget. Substantial deviations, however, indicate that member states having similar income levels are often treated differently. It means that there are member states which receive support from the EU budget meanwhile there are other member states of the same development category, which do not. The first experiences of the new member states underpin this fact, however thorough analyses cannot yet be done because of various reasons (lack of sufficient data, or the already existing time series are too short and the new member states joined the EU at the end of the out-going financial framework and a well founded evaluation is almost impossible, etc.).

Regarding the main features of the evolution of the budgetary situation in a longer term some points can be mentioned. In qualitative terms there have not been many changes. The most important modification has been the rather dynamic increase in the redistributive impact of

the EU budget since the mid-1980s. This increase was more dynamic during the first 7 to 8 years than thereafter. The econometric analyses have shown that the arbitrary elements of the budget allocation increased until 1993 and have since decreased.

The redistributive effects of the EU budget derive from both its expenditure and revenue sides. Regarding the evolution of the budget, the expenditures have become increasingly progressive with the growth of structural spending. This expenditure item has heavily concentrated on the less developed member states and turned to be the most redistributive of all budget items. The functioning of the FEOGA of the CAP has got also redistributive effects but only because the weight of agriculture employment is substantially larger in the less developed member states than in the more developed ones. Payments per farmer, however, vary substantially across countries and disfavour the less developed member states. As far as the revenue side of the budget is concerned, the contributions of the member states are approximately proportional to their incomes but the shares of sources of revenue are very disproportionate particularly in the case of VAT and tariffs revenues.

The overall redistributive impact of the fiscal flows across the member states is significant, given the relatively small size of the budget and they are brought about mainly by the structural and cohesion policy expenditures. The degree of redistribution increased substantially for the previous decades but was stagnating during the last decade. The distribution of net contributions across member states shows large and continual deviations from the longer term average pattern. The key question is what is considered as a fair allocation of fiscal costs and benefits. The existence of large surpluses and deficits is serious matter for concern and roots of recurrent dispute on the budget. The Commission's view is certainly correct when it argues that in spite of the fact that the fiscal balances are the most visible and quantifiable factors, they can capture only a part of the costs and benefits of EU membership. As a consequence of it, public and government views on the general fairness of the budgetary system are likely to depend on the extent to which the redistribution is perceived to be reasonable and unbiased.

## **V. The feasibility of new governance in budgetary policy**

An important issue is how the implementation of new mode of governance in the budgetary field can ensure that the budgetary and redistribution policy could obtain even wider public and government support within the EU.

If the EU budget is an implementation instrument of common policy goals and policies then how can the Community bring the budget closer to the peoples of its member states it is intended to serve? Bridging the gap between the Commission and member states' governments on the one hand and governments and peoples would pose fresh challenges to the budgetary and redistributive process and policy. The Community needs to move beyond a mechanical conceptualisation and governance to one that recognises the relationship between policy, planning and implementation within a realistic functional framework. The Community needs to avoid the alienation that can develop with the growing gap between the EU and the peoples of its member states it serves. Two ways to bridge this gap is to strengthen the relationship and two-way communication with civil society and to develop processes that will enable political structures to directly, and strategically contribute to the development of the EU budget.

It is a platitude or common knowledge that rhetoric cannot and should not replace reform because the outcome will be disappointing. The outcome of the redistribution at EU level should be changed and improved. New decision-making processes must be institutionalised to ensure such engagements achieve their goals. This endeavour is already reflected in certain common policy areas, which calls for fresh forms of inclusion, consultation and mobilisation which

could effectively inform and influence institutions and policies including the budget which concretizes policy for planned implementation.

The implementation and consolidation of the new mode of governance require the transformation of institutions of governance to ensure that it is capable of facilitating the pursuit of the new goals. This is also translated into good governance through the policy and process of deepening participatory democracy. Principles of transparency, accountability and responsiveness have driven a number of policy changes in institutional design and the development of enabling structures for good governance. Good governance requires the involvement of civil society including labour and business as well as other social partners in the decision-making.

Various political space and participation of member states' governments in the preparation of EU budget are the main characteristics of the present situation. How can those challenges be addressed which are arising from a non-homogeneous civil society which exists in the member states in a way that substantial part of their views is not distorted and/or diluted? It is an often mentioned point that where people are not involved in decisions that affect their lives, social policies and political interventions are less likely to succeed. Participatory democracy should therefore complement and enhance representative democracy. The question is how this should be addressed in details in the case of the EU budget. In the context of new mode of governance and participatory democracy, political space creates a natural opportunity for greater participation in the preparation process of the budget. It is not necessarily optimal if technocrats only draft the budget without being influenced by a political policy process. A further related question is how the capacity of all legislatures can be strengthened to examine and assess the allocation of resources to achieve the stated targeted results?

EU budgetary policy must support the development of the member states and the implementation of the common policy goals of the EU member states. The direct goals of the budgetary policy like in the case of all community policies must be subject to regular review in terms of its impact on the overall objectives of the community policies. It is often impossible for the public to appreciate the purpose of expenditure and the achievements of the objectives.

The reforms of the EU budget over the last decades have often striven to ensure greater political intervention of member countries' governments. Thus, the question is how the public can effectively participate in the preparation of the budget in terms of determining policy priorities for implementation and alerting to new developments, which can be incorporated into the budget. Related issues are first, how public awareness and understanding can be increased of both the current and long-term implications of the budgetary situation and second, how enhanced opportunities for public input can be created to budgetary and redistributive decisions.

The question of the appropriate level of centralization and decentralisation of budgetary policy can be also addressed. The main points are the assignment of competency to tax, spending and regulatory responsibility to the various spheres of governance and the interface with the private sector and civil society. This framework should assign responsibility to that sphere of governance at which the delivery is optimal. It is obvious that the decentralization of the budgetary policy of the EU is not necessarily always better than centralization. A further centralisation of certain elements of budgetary and redistributive policies in the EU would be indeed preferable. The likely optimal solution is that centralisation and decentralisation processes should take place at the same time but in different areas.

Sub-community governance levels often pursue "self-interest" policies and strategies seeking a "free-ride" with no accountability that undermines community unity. The principle of co-operative governance containing elements of centralisation is an essential catalyst to overcome

ing this problem. This principle and collective principle act as a countervailing weight to the "beggar-thy-neighbour" policies. The accessibility of information, which is related to the third important principle, that is the principle of transparency, is not only necessary but also an essential requirement for effective oversight by the legislatures. If social and economic partners, civil society and labour are to effectively contribute to the development of the policy priorities in the budget then access to relevant information is an imperative.

What is needed is to facilitate fiscal harmonization and stabilization and stability checks. The advantages of a community level budget should be successfully merged with the advantages of fiscal decentralization in an effective intergovernmental fiscal system. It has to be kept in mind that one of the effects of globalization is the increasing impacts on the designs of fiscal systems in a globalised world economy. These impacts can prevail more vigorously in the integrated European economies.

Any budgetary system of good governance requires not only political will but well-functioning common or at least harmonised accounting and financial management and tax systems and also adequate information systems. Regular reviewing of EU budget policy priorities and ensuring an engagement with lower levels should be the main features of a political policy dialogue and not a one way street of instruction. It implies a change in the instruments of budgetary management but also a change in the style and mode of governance. The changes should lead to larger budget integrity, greater transparency and increasing accessibility. Changes in managing the budget should concern the rules of procedure and position that are introduced to transform the behaviour of those involved as well as the redistributive function of expenditure.

The needs to change are set off by various issues, problems and questions. What should be the EU's spending priorities and how much should it be spending in total? How might the main current areas of spending be reformed? The EU's latest enlargement has brought these matters to a head, but arguably a serious debate about the EU budget is long overdue. The fact that this discussion is taking place after the entry of ten new member states rather than before is only likely to increase the problems of reaching agreement.

The practice shows that the main objective of EU spending is to achieve acceptable net balances rather than agreed policy objectives. The larger net contributors, which belong to the group of more developed member states, press hard for a reduction of their net contribution, while the less developed member states argue that their positive net balances should be preserved on equity grounds. Disparate national interests are also clearly evident in the opinions on the proposals for the restructuring of farm and structural programmes and British rebate. Besides these conflicts between national interests, one of the most critical obstacles to a budget consensus is the absence of a shared and operational equity criterion for the redistribution of net budget contributions.

## **VI. Lessons drawn from experience**

On the basis of experience of the current budget system and several theoretical arguments there are some crucial issues and points, which should be taken into consideration when a new mode of governance is designed and evaluated for the redistributive or budgetary mode of governance:

- Net EU budget contribution (balances) should be linked to income per capita through simple rules that reflect an evolving consensus on the desirable degree of redistribution and treats member states with similar income levels in a similar way.

- The budget items should be evaluated in terms of the policy goals and not their redistributive effects. But taking into account the principle of cohesion, the overall distribution of net benefits should be inversely related to income levels.
- The new mode of governance of the budget should provide a transparent way of implementing the principle of cohesion without sacrificing other policy objectives. It should reduce the scope for real and perceived inequalities in the redistribution of budget resources. The system should be based on such operational principles that the member states (government and its social partners) need to negotiate over a single, easily understandable and interpretable parameter and not over a list of specific items that may lead to obviously arbitrary distribution.
- New procedures should be introduced which can change the incentives faced by member states governments. The changes should include that the overall spending targets for each programme, which are now largely set in advance, should be loosened up. The importance of horizontal programmes should be increased because their impact on member states' net balances cannot be measured exactly in advance.
- The new mode of governance of the budget should increase the role of the social partners in the member states and reduce that of the national governments in the decision making process and the implementation process of the budget by different means. An additional important issue is the decoupling of national contribution to the EU budget from the national budgets (e.g. direct European taxes).

The EU failed to achieve a reform of the budget system during the negotiations over the Financial Perspective for the period 2007-2013 but there will be a possibility to do it in 2008-2009 when the budget policies will be reviewed. The EU should go the whole way and introduce a transparent redistributive system that is not linked to EU policies. Its main objective should be a simple one, namely to achieve a fair and politically acceptable financial burden sharing and redistribution of financial benefits and contribution. The principle of new mode of governance can provide substantial guideline to achieve this end.

## **VII. Some analytical approaches**

Different types of empirical analysis of redistribution effects emanating from EU's budget policy can be made. In order to analyze these effects, complete information about the geographic distribution of European revenues and the allocation of operating expenditure among EU member states are needed. Although the basic statistical information is generally available at national level some qualifications which condition the analysis should be made. As the European Commission (1998) has pointed out that the fiscal balance of each country does not account for all the economic benefits that they derive from the EU due, at least, to three main reasons.

- there are some important indirect gains which are not taken into account when comparing fiscal balances between countries, such as spillover effects stemming from, for example, the development of European transport networks.
- there are some difficulties in determining the nationality of the final beneficiaries of the different expenditures of the EU budget.
- the EU funds are heterogeneous across countries and direct comparisons between diverse categories of these expenditures are not easy.

## VII.1 Redistribution effect on the basis of the relationship between income and fiscal flows

One of the statistical calculations was done by R.Domenech et al<sup>5</sup>. Using EU budget data on a cash basis from 1986 to 1998, the main result which could be obtained is that the EU budget had a re-distributive character, though only on its expenditure side<sup>6</sup>. Among the expenditure categories, which were taken into consideration, the most re-distributive one was the regional fund, followed by the social fund and by the guarantee section of the EAGGF. All of them became increasingly re-distributive in the course of the time. These findings of statistical calculations did not basically alter when the regressions were run on the basis of PPPs. Nonetheless, they were different when some countries were excluded from the sample<sup>7</sup>.

The re-distributive character was different as far as total budgetary revenues were concerned. In contrast with the results for the US, in the case of the EU-15 these calculations showed relative proportionality with income. Surprisingly, the only exception seemed to be the GNP resource, which apparently showed a re-distributive effect in the early 1990s, but at the end of the period it had an elasticity equal to one.

If the net financial balances were considered, these calculations showed that the EU budget had a surprisingly strong re-distributive effect on the income of the member states. This outcome is, however, a necessary condition to speed up the convergence process among the member states.

The results of this analysis and calculations showed that the EU budget redistributed 5 % of any difference between richer and poorer member states. Although this number was well below the estimates for the US (federal taxes and transfers redistribute approximately a 20 %), it was important to notice that this redistributive effect was achieved with budget resources that represented less than 1.27 % of the European GNP.

An important finding of these statistical calculations was that not all EU member states were treated alike. The study identified three different groups of member states. First, those countries that benefited more than it would have corresponded to their per capita income level. Second, those countries whose per capita financial balances were in line with their per capita income levels. It was interesting to see that, in this group there were countries which questioned the then system of distribution policies implied by the EU budget. The third group comprised those countries which get a poorer treatment.

The authors have also emphasised that there are several natural extensions to the findings of their paper. First, although they have analyzed the redistributive effects of EU budget at national level, most fiscal policies in the expenditure side are determined by principles of regional cohesion and solidarity. Certainly, some revenues cannot be easily redistributed at regional level and, therefore, this kind of analysis would be only partial. A second possible extension is related to the analysis of level and growth effects for the EU as a whole of these redistributive policies. Their model could be easily modified to consider some kind of spillover effects across countries which can not only affect the convergence paths but also the steady

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<sup>5</sup> R. Domenech, A. Maudes and J.Varela (?) mimeo.

<sup>6</sup> For instance, according to their calculations the elasticity of total per capita expenditure in current Euros with respect to per capita income was less than one with a point estimate of -0.23 for the EU15, although not statistically different from zero.

<sup>7</sup> For example, excluding Ireland greatly reduced the redistributive power of the expenditures, since all the elasticity indicators of the four expenditure categories increased. Likewise, if Luxembourg was excluded from the sample, the common agricultural policy became regressive.

state levels of European countries. Thus, at the empirical level, instead of looking for the winners and the losers of these policies, it is also relevant to study if redistribution has also positive effects upon countries that are net contributors to the EU budget.

## VII.2 Representation and fiscal redistribution

The theoretical starting point of this analytical approach is that fiscal transfers are indeed a function of economic wealth, i.e. the poorer the country is, the more it benefits from the EU budget. However, there are sometimes major deviations from this basic rule. It means that some countries clearly benefit more from fiscal transfers than their levels of economic affluence would justify.

As several cases have shown, EU member states with smaller populations have often relatively more influence on the EU's decision-making process than larger member states<sup>8</sup>. Smaller countries are particularly overrepresented in the Council of the EU (Council of the Ministers) measured on the basis vote per million citizens. Of course, one would, then, raise the following question; what would prevent these smaller member states from using their overrepresentation to receive 'extra' benefits from the EU decision making process?

Small over-represented member states may be very attractive targets of vote buying bids. 'Since they are in effect endowed with more votes per capita than larger states, they can offer a good value — more votes can be purchased in exchange for fewer benefits'<sup>9</sup>. This reasoning leads to the hypothesis that small member states can benefit more from the EU's fiscal transfers than larger member states. This reasoning can also explain the observed fact that smaller member states vote against the majority in the Council significantly more rarely than the large countries.<sup>10</sup>

One way to proceed during a vote buying bid is to offer either some concession in some other decision, which may or may not be related to the proposal on the table. These concessions can be material or non-material in nature, i.e. they may involve regulatory changes, or changes to give more EU subsidies to these countries. Now, which of the two states is cheaper to 'buy' to support the proposal? To a small member states or a big member states? It is obvious that the costs of persuading a small member state can be significantly lower than to persuade a big one to support the proposal.

The multi-annual (7 years) financial framework, which is the basis of the annual budgetary decisions, has to be endorsed by the European Council according to the unanimity rule. Whereas, the bulk of the decisions on the details are taken in the Council on the basis of the qualified majority voting rule. However, the logic of over-representation applies to unanimous decision-making as well. In fact, when consensus is required for the approval of a proposal, smaller member states are even more over-represented than in the case with qualified majority voting. When decisions are taken unanimously each member state has equal voting power. Thus, the differences in voting power per capita are even more pronounced.

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<sup>8</sup> Studies from the USA have shown that the unequal distribution of seats in the Senate has led to similar consequences: small states are favoured in the distribution of federal funds (Atlas *et al.* 1995; Lee 1998).

<sup>9</sup> Rodden (2002) p.159

<sup>10</sup> Mattila and Lane (2001).

## VIII. Some results of empirical analysis

There are various forms and ways of redistribution among the member states. The beneficiaries of the EU budget are member states, which receive more funds to allocate nationally than they pay into the EU budget. The net contributor member states are, which pay more into the EU budget than they receive from it. The EU budget can be re-distributive both from its revenue and from its expenditure sides. It means that the revenue side of the budget is re-distributive if all member states receive equal amounts in terms of per capita from the EU budget, but their contributions to the budget depends e.g. on their relative wealth or levels of development. Contrary to this case, if the member states contribute equal amounts to the EU budget but some of them receive relatively more than the others, the expenditure side of the budget is re-distributive. Thus, it is necessary to analyse both the expenditure and revenue sides of the EU budget so that a rather objective evaluation could be made.

In this context, budgetary balance is defined simply as the difference between national contributions to the EU budget and the nationally allocated EU expenditure. It is important to remember that not all EU expenditure is divided between member states. For example, expenditure assigned to humanitarian aid to developing countries, pre-accession aid to future member states and administrative costs cannot be seen as apportioned to member states. However, as could be seen from the statistical data<sup>11</sup>, these nationally non-allocable expenditures amount to only a relatively small part of the total budget.

The empirical analysis includes the relationship between member states' wealth and their fiscal balance *vis-à-vis* the EU budget. A simple bi-variate analysis of member states' relative prosperity and their net fiscal position is performed in Figure 1. This figure shows the connection between the prosperity of an EU member state in terms of GDP (x-axis) and the number of net transfers it receives annually measured in per capita terms (y-axis). Ireland was by far the greatest net recipient country. On average, each Irish citizen received annually almost 550 euros during the period 1995—2002. Greece, Portugal and Spain follow Ireland on the list of the EU's greatest net recipients. The two countries that were the greatest net contributors to the EU budget were Luxembourg (165 euros per capita annually) and Germany (105 euros).

A regression line in Figure 1 describes the overall level of redistribution in the EU-15. The negative slope of the line reflects the redistributive nature of fiscal transfers: poorer member states receive more transfers than wealthier states. It can be interpreted<sup>12</sup> that this line 'reflects the consensus on the desirable degree of redistribution implicit in the *status quo*'. This regression line in Figure 1 can also be used to assess the fairness of current fiscal transfers. Deviations from the line indicate that some member states benefit more from the EU budget than their relative wealth would lead one to expect, while other countries are contributing to the EU budget more than they should. The redistribution levels implied by the regression line can be called as 'fair'. Thus, the states that are above the line received too much EU expenditure, or they contributed too little to the budget, and, conversely, the states under the line contributed too much or received too little.

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<sup>11</sup> The net beneficiary and contributor data used in this analysis come from Commission reports that analyse the fiscal flows between the EU and its member states (European Commission 2002a, 2003). These reports include statistical annexes which show member states' annual budgetary balances, and the main components of the EU budget that contribute to these balances. The rest of the data used in the analysis (relative gross domestic product (GDP) per capita and population figures) is from Eurostat's (2002, 2003) statistical yearbooks. The time frame of the empirical analysis is an eight-year period 1995—2002.

<sup>12</sup> de la Fuente and Doménech (2001) p.308

The next step of the analysis is the demonstration of the deviation of actual net transfers of each member state from the so-called ‘fair’ level (Table 2). The levels of current net transfers are measured in per capita figures. The last column of the table also shows the ‘fair’ level of net transfers calculated from the regression line in Figure 1. As it can be seen in Figure 1, most member states are located rather close to the line, indicating that their net fiscal balance is approximately the same as it would be under the ‘fair’ redistribution. There are some notable exceptions, however; in particular, Ireland and Luxembourg. On average, each Irish citizen benefited from EU transfers in the 1995—2002 period annually by 546 euros, yet given the level of per capita GDP each Irish citizen should have been contributing 67 euros to the EU budget. During the same period, Luxembourg was a net contributor to the budget, but because Luxembourg is by far the richest EU country in terms of GDP, it should have been paying much more. Also Denmark, the second wealthiest country in the EU, is a net recipient when it should be a net contributor. Sweden and Germany are the two countries that are contributing too much money to the budget.

The results of the regression analyses made by Mattila showed that the EU budget was clearly redistributive on its revenue side. The positive sign on the GDP variable indicates that the wealthier the member state, the more it contributes to the EU budget. In general terms, it seems that poorer member states contribute less and benefit more from EU fiscal flows. Consequently, it is no surprise that the net contributions are also redistributive.

The variable measuring the over- or under-representation of member states as regards Council voting power is statistically significant when looking at EU spending and net contributions. This finding supports the hypothesis, derived from the vote trading theory, according to which smaller countries can use their over-representation to their advantage when spending decisions are being made in the Council meetings. When controlled for their level of economic development, smaller member states receive a larger share of the expenditure than bigger member states. In practice this means that the distribution of power within the Council can explain the deviations from the line of ‘fair’ redistribution in Figure 1, meaning that small member states are more likely to be located above the line, and large member states are more likely to be under it.

The analysis can be continued in such direction, which takes into consideration the various components of the expenditure side of the EU budget. To this end the components of EU expenditure have to be analysed in more details. The expenditure items are divided into three subcategories: CAP payments, structural operations, and spending on internal policies. The results showed that it was the structural operations only that are clearly redistributive. Spending on the CAP does not depend on recipient countries’ level of economic affluence when Luxembourg is excluded from the analysis. When all member states are included CAP spending is redistributive: poorer countries receive somewhat more CAP subsidies than wealthier countries.

According to this analysis internal policies seem to favour, in contrast to the CAP, rich countries, although this effect is visible only when Luxembourg is dropped from the regression analysis. The wealthier a member state is, the more it benefits from this expenditure item of the EU budget. Due to the fact that internal policies constitute only a relatively small share of EU expenditure only when contrasted to structural operations, this ‘regressive’ nature of expenditures to internal policies is not enough to override the ‘progressive’ effects of structural expenditures in the total budget.

Smaller countries seemed to be able to use their disproportionate influence when decisions on spending in all the three categories are made. The overall conclusion of these results was that

the contribution side of the EU budget was undoubtedly redistributive favouring poorer member states. Whereas, looking at the expenditure side of the EU budget, the picture is more mixed and complex. The distribution of EU expenditures can be explained by recipient countries' economic situations and their over- or under-representation in the Council. This is particularly discernible in the distribution of CAP subsidies and spending on internal policies. In the case of these two budgetary items the Council voting power seemed to be a more important factor or a better predictor of distribution outcomes than the level of economic affluence.

## **IX. Impacts of the EU enlargements**

It is an important question to analyse how much the enlargements of the EU influenced the budgetary redistribution. The issue is in which way the pattern of redistribution prevailed in the pre-enlargement period of the EU of fifteen member states was changed when the number of member states was increased to 25 in 2004 and to 27 in 2007. The starting premise was the known fact that poor member states received more benefits from the EU of 15 member states than rich member states. However, when controlled for their economic affluence, some member states have clearly benefited more from the EU's fiscal transfers than others. One reason for these 'deviations' was hypothesized to be the unequal amount of relative influence of member states as regards EU decision-making. The results from the empirical analyses showed that the system of redistribution was based partially on economic needs and partially on 'power politics', in which smaller member states were able to use the disproportional allocation of Council votes to their advantage. All other things being equal, small member states, such as Denmark, Ireland and Luxembourg, have received significantly more net transfers from the EU budget than their levels of economic prosperity would have justified.

The impacts of the enlargements in 2004 and then in 2007 opened up possibilities for changes and prevalence of previous trends. New rules of decision-making for the post-enlargement EU were agreed upon in the Nice Treaty in 2000. One of the most important changes concerned the distribution of votes in the Council. The decision was that following the enlargement, the weighted votes should be distributed more equally in proportion to each member state's population than they had been in the EU of fifteen member states. Nevertheless, even after these changes, smaller member states have relatively more votes than larger states. It is an important factor that, most of the new member states in the enlarged EU are both small and relatively poor, which placed them in a relatively good position to succeed in their demands for more fiscal transfers and to influence the budgetary redistributive system and decision making process.

## **X. Conclusion**

The results of the various analyses showed that the EU budget has been redistributive from both the revenue and expenditure side; in other words, poor member states pay a smaller share of the revenues and receive a larger share of the expenditures than richer EU member states. Looking at the expenditure side of the EU budget, a more detailed analysis could show that the structural funds only were significantly redistributive. Expenditures on internal policy programmes seemed to be different as richer the member state benefited them more. The vote trading theory surmised that member states endowed with more per capita influence in EU decision-making could use their overrepresentation to their advantage when budget decisions were made. This effect could not be detected on the revenue side of the budget. Overrepresented member states are not able to use their 'extra' voting power to reduce their share in the contribution to the EU budget.

An important issue is how the implementation of new mode of governance in the budgetary field can ensure that the budgetary and redistribution policy could obtain even wider public and government support within the EU. On the basis of experience of the current budget system and several theoretical arguments there are some crucial issues and points, which should be taken into consideration when a new mode of governance is designed and evaluated for the redistributive or budgetary mode of governance. This finding is likely to be related to the facts that the EU budget is, from certain points relatively uncomplicated and very complicated from other aspects. When the rules are transparent and rather simple it is more difficult to treat member states unequally.

## XI. Annex: Tables and Figures

**Table 1: OVERVIEW OF THE NEW FINANCIAL FRAMEWORK 2007-2013**

In million EUR at 2004 prices

COMMITMENT APPROPRIATIONS	2006 (a)	2007	2008	2009	2010	2011	2012	2013	
<b>1. Sustainable growth</b>	47.582	59.675	62.795	65.800	68.235	70.660	73.715	76.785	
<b>1a. Competitiveness for growth and employment</b>	8.791	12.105	14.390	16.680	18.965	21.250	23.540	25.825	
<b>1b. Cohesion for growth and employment (b)</b>	38.791	47.570	48.405	49.120	49.270	49.410	50.175	50.960	
<b>2. Sustainable management and protection of natural resources</b>	56.015	57.180	57.900	58.115	57.980	57.850	57.825	57.805	
<b>of which: Agriculture - Market related expenditure and direct payments</b>	43.735	43.500	43.673	43.354	43.034	42.714	42.506	42.293	
<b>3. Citizenship, freedom, security and justice</b>	1.381	1.630	2.015	2.330	2.645	2.970	3.295	3.620	
<b>4. The EU as a global partner (c)</b>	11.232	11.400	12.175	12.945	13.720	14.495	15.115	15.740	
<b>5. Administration (d)</b>	3.436	3.675	3.815	3.950	4.090	4.225	4.365	4.500	
<b>Compensations</b>	1.041								
<b>Total appropriations for commitments</b>	120.688	133.560	138.700	143.140	146.670	150.200	154.315	158.450	
<b>Total appropriations for payments (b)(c)</b>	<b>114.740</b>	<b>124.600</b>	<b>136.500</b>	<b>127.700</b>	<b>126.000</b>	<b>132.400</b>	<b>138.400</b>	<b>143.100</b>	<b>average</b>
<b>Appropriations for payments as a % of GNI</b>	1,09%	1,15%	1,23%	1,12%	1,08%	1,11%	1,14%	1,15%	1,14%
<b>Margin available Own resources ceiling as a % of GNI</b>	0,15%	0,09%	0,01%	0,12%	0,16%	0,13%	0,10%	0,09%	0,10%
	1,24%	1,24%	1,24%	1,24%	1,24%	1,24%	1,24%	1,24%	1,24%

(a) 2006 expenditure under the current financial perspective has been broken down according to the proposed new nomenclature for reference and to facilitate comparisons.

(b) Includes expenditure for the Solidarity Fund (€1 billion in 2004 at current prices) as from 2006. However, corresponding payments are calculated only as from 2007.

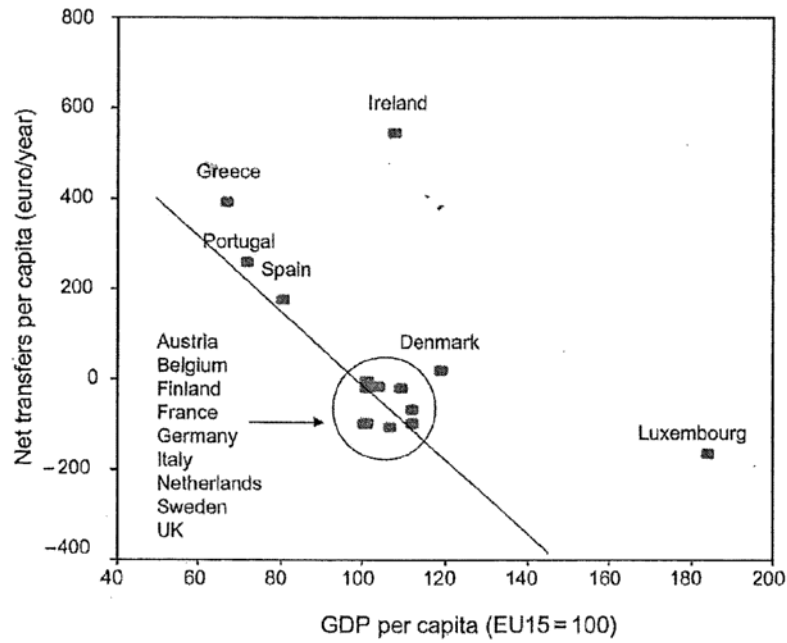
(c) The integration of EDF in the EU budget is assumed to take effect in 2008. Commitments for 2006 and 2007 are included only for comparison purposes. Payments on commitments before 2008 are not taken into account in the payment figures.

(d) Includes administrative expenditure for institutions other than the Commission, pensions and European schools. Commission administrative expenditure is integrated in the first four expenditure headings.

**Table 2: GDP per capita and average annual net transfers in the EU, 1995—2002**

<b>Country</b>	<b>GDP per capita (EU15 100)</b>	<b>Net transfers (euros/capita)</b>	<b>‘Fair’ net transfers (euros/ capita)</b>
<b>Greece</b>	67.2	391	288
<b>Portugal</b>	71.9	258	47
<b>Spain</b>	80.7	177	169
<b>UK</b>	100.4	—31	—3
<b>France</b>	100.9	—19	—8
<b>Finland</b>	101.1	—3	—9
<b>Sweden</b>	101.3	—96	—11
<b>Italy</b>	103.8	—17	—33
<b>Germany</b>	106.5	—105	—57
<b>Ireland</b>	107.7	546	—67
<b>Belgium</b>	109.1	—21	—80
<b>Austria</b>	111.9	—67	—104
<b>Netherlands</b>	112.3	—97	—108
<b>Denmark</b>	119.2	21	—168
<b>Luxembourg</b>	183.9	—165	—736

**Figure 1: Average annual net transfers in the EU and relative per capita GDP, 1995— 2002**



Source: de la Fuente and Domenich

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