THE BUDGET OF THE EUROPEAN UNION:
NEED FOR A REFORM

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MÜGE HAYRİYE GÜVENÇ

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Prof. Dr. Sencer Ayata
Director

I certify that this thesis satisfies all the requirements as a thesis for the degree of Master of Science.

Assist. Prof. Dr. Galip Yalman
Head of Department

This is to certify that we have read this thesis and that in our opinion it is fully adequate, in scope and quality, as a thesis for the degree of Master of Science.

Assist. Prof. Dr. Elif Akbostancı Özkazanç
Supervisor

Examining Committee Members

Prof. Dr. Halis Akder

Assist. Prof. Dr. Elif Akbostancı Özkazanç

Assist. Prof. Dr. Galip Yalman

I hereby declare that all information in this document has been obtained and presented in accordance with academic rules and ethical conduct. I also declare that, as required by these rules and conduct, I have fully cited and referenced all material and results that are not original to this work.

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Signature :

ABSTRACT

THE BUDGET OF THE EUROPEAN UNION:
NEED FOR A REFORM

Güvenç, Müge Hayriye
M.S., Department of European Studies
Supervisor : Assist. Prof. Dr. Elif Akbostancı Özkazanç

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This thesis assesses the underlying political and financial reasons of the recent budgetary crisis of the European Union. It aims to discuss the possible reform alternatives for the European Union budget in order to improve it to better serve for the objectives of the enlarged Union and to enable the Member States to share the budget burden more fairly. To this purpose, the thesis first analyzes the budget of the European Union in terms of its aims, evolution and structure of revenue and expenditure items and than presents a general overview of the shortcomings of the present own resources system. In general, the thesis discusses possible reform areas, in which the reform process could take place. The thesis also shows how the Union overcame the policy challenges, and particularly the budgetary implications brought out with the inclusion of Central and Eastern European countries and how its financial perspectives covering the 2000-06 and 2007-2013 periods were finalized.

Keywords: The EU Budget, Budgetary Implications of Eastern Enlargement, EU Budget Reform

ÖZ

AVRUPA BİRLİĞİ BÜTÇESİ:
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Bu çalışmada, Avrupa Birliği'nde yaşanan son bütçe krizinin siyasi ve mali nedenleri incelenmiştir. Birlik bütçesinin genişleyen Birliğin değişen amaçlarının başarılmasına ve Üye Devletlerin bütçe katkılarının daha adil bir yapıya kavuşturulmasına yönelik olası reform seçenekleri tartışılmıştır. Bu amaçla ilk olarak Birlik bütçesinin amaçları, gelişimi ve gelir gider kalemlerini incelenmiş ve daha sonra mevcut Öz Kaynaklar Sistemi'nin aksayan yönlerinin genel bir analizi yapılmıştır. Çalışmada genel olarak bütçe reformunun hangi alanlarda yapılabileceği konusuna yoğunlaşılmıştır. Diğer taraftan, Merkezi ve Doğu Avrupa ülkelerinin Birliğe üyeliğinin bütçesel etkileri ve bu çerçevede Birliğin 2000-2006 yılları ile 2007-2013 yıllarını kapsayan mali perspektiflerinin nasıl sonuçlandığı incelenen diğer konular arasındadır.

Anahtar Kelimeler: AB Bütçesi, Doğu Bütünleşmesinin Bütçesel Etkileri, AB Bütçe Reformu

To My Family

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TABLE OF CONTENTS

PLAGIARISM…………………………………………………………………..iii

ABSTRACT……………………………………………………………………iv

ÖZ………………………………………………………………………………v

DEDICATION…………………………………………………………………vi

ACKNOWLEDGMENTS……………………………………………………..vii

TABLE OF CONTENTS……………………………………………………..viii

LIST OF TABLES…………………………………………………………..xi

LIST OF FIGURES……………………………………………………………xii

CHAPTER

1. INTRODUCTION 1

2. DRIVES FOR A BUDGETARY REFORM IN THE EUROPEAN UNION 6

2.1 The Net Contributors' Problem 9

2.2 The UK Budget Rebate 14

2.3 The Stability and Growth Pact 18

2.4 Lisbon Strategy 21

2.5 Eastern Enlargement of the EU 25

2.6 Conclusion 29

3. GENERAL BUDGET OF THE EUROPEAN UNION 31

3.1 The Budget Principles 32

3.2 The Multiannual Financial Framework (MFF) and interinstitutional Agreement (IIA) 36

3.3 The Annual Budget Procedure 38

3.4 The Structure of the Budget 42

3.4.1 The Union's Revenue - the Own Resources System 42

3.4.2 The Union's Expenditure 47

3.5 The Budget Control 52

3.6 Economic Policy Functions of the EU Budget 53
3.7 Conclusion 58
4. HISTORICAL EVOLUTION OF THE EU BUDGET..................................... 61
4.1 Formative Period (1952-1969) 64
4.2 The Crisis in the Community's Finances (1970-1988)......................... 65
4.3 Delors I Package (1988-1992) 68
4.4 Delors II Package (1993-1999) 73
4.5 Conclusion 79
5. POLICY CHALLENGES AND BUDGETARY IMPACTS OF EASTERN ENLARGEMENT OF THE EU 81
5.1 Agenda 2000 and the Berlin Financial Framework 83
5.1.1 The Commission's Proposals 83
5.1.2 Berlin European Council 88
5.2 The Commission's Information Note and the Brussels European Council 93
5.2.1 The Commission's Information Note 93
5.2.2 The Brussels European Council and the EU Common Position on Financial and Budgetary Provisions 96
5.3 The Copenhagen European Council 97
5.4 Conclusion 101
6. BUDGETARY CHALLENGES OF THE ENLARGED UNION: THE NEED FOR A REFORM 104
6.1 The 2007-2013 Financial Perspective 106
6.1.1 Negotiations for the 2007-2013 Financial Framework 108
6.1.2 Evaluation of the 2007-2013 Financial Framework 110
6.2 Options for a Reform in the EU Budget 112
6.2.1 Reforms on the Revenue Side 112
6.2.1.1 Shortcomings of the current own resources system and related reform proposals 112
6.2.2 Reforms on the Expenditure Side 118

6.2.2.1 Shortcomings of the current own resources system and related reform proposals 118
6.3 CONCLUSION 125
7. CONCLUSION 130
BIBLIOGRAPHY 136

LIST OF TABLES

Table 2.1 Composition of EU Own Resources, 1995-2006…………………….12

Table 2.2 EU-15 Net Balances 1993-2006……………………………..…….13

Table 2.3 GNI Per Capita for EU-15 Selected Members…………………......17

Table 3.1 Timetable According to the Treaty……………………………....41

Table 3.2 Ceilings, Budget, Outturn……………………………………….46

Table 4.1 Delors I Financial Framework 1988-1992………………………...70

Table 4.2 Delors II Financial Framework 1993-9 (EU-12)…………………..75

Table 4.3 Structure of Expenditure of the EU Budget...................................…78

Table 5.1 Financial Framework for 2000-2006 (EU-21)……………………..90

Table 5.2 Distribution of Expenditures in the Enlarged Union……………....92

Table 5.3 Financial Framework for 2000-2006 (EU-25)……………………100

Table 6.1 Comparison of the Financial Frameworks Over Time……………111

Table 6.2 GNI Per Capita Contributions……………………………………117

LIST OF FIGURES

Figure 3.1 2006 Budget- Global Headings……………………………………….48

Figure 3.2 Evolution of EU Budget………………………………………………51

CHAPTER I

INTRODUCTION

The budget of the European Union (EU) has been substantially important throughout the European integration process. There are many factors that make the EU budget so important for various EU actors, such as the institutions of the Union, the politicians shaping the political route of the EU and the Member States. First, the budget has played a crucial role in furthering market integration through the policies it has financed. Whenever the EU actors attempted to speed up the process of European integration, the size and shape of the budget have been modified to accompany these attempts. The linkage between the budget and the European integration process can be easily observed by assessing the history of the European Union. Particularly, the Delors I Package, establishing the first financial framework for the Community, was justified with Single European Act. The launch of Economic and Monetary Union was accompanied with the Delors II Package and similarly third financial framework was linked to the Eastern enlargement of the Union.

Second, the amount of financial resources allocated to the EU budget is highly crucial for the Member States for a variety of reasons. With the introduction of the Community's Own Resources in 1970s, the Community gained financial independence and took a different form from international organizations. As the Union has grown over the years, both in terms of Member States it involves, and the number of policy areas it intervenes, the size of its budget has also increased substantially. At the current state of play, the EU expenditure is limited to 1,24 of total EU GNI[1]. Hence, the size of the EU budget is regarded very small since it remains small in relation to the Union's GNI and to the level of public expenditure in the Member States. "However, although the budget has little macroeconomic

[1] According to the provisions of the current Own Resources Decision (2000/597/EC, Euratom), the Gross National Income (GNI) replaced the conceptually identical Gross National Product (GNP) in the own resources area as from 2002.

significance for the Union as a whole, it is very important for those of the Member States that receive extensive transfers from the structural funds" (Laffan and Shackleton 2000, 213). Moreover, the amount of financial resources allocated to the EU budget is a highly debated issue for the Member States that have become net contributors to the EU budget throughout the years.

The third and the most important reason making the EU budget highly important is the fact that in general, the EU budget, like national budgets, tells us a lot about the type of governance prevailing in the EU. The structure of its revenue and expenditure items shed light on the priorities and conflicts embedded in various processes of the Union. Moreover, "analysis of budgetary politics casts light on the relationship between political and economic integration" (Laffan and Shackleton 2000, 212). Because, the adoption and implementation of policies necessary for market integration are highly dependent on the availability of financial resources. In this respect, one can assume the budget of the EU as the main tool for analysing the implications of the deepening and widening efforts of the Union as they have been all reflected in the structure of budgetary procedure and allocation of financial resources. The structure of the Own Resources System reflects the kind of the relationship between the European citizens, the Member States and the institutions since it establishes a direct link between the EU citizens and the Union. In particular, the existence of own resources of the Union represents the commitment of Union resources for the provision of Union public goods meaning that the EU money is used to serve for the European people.

It's obvious that a well functioning EU budget is a *sine qua non* for the success of the ongoing process of the European integration. Only if the EU budget has been endowed with sufficient financial resources and structured with adequate processes, the EU policies considered necessary for economic and political integration can be maintained and implemented. Without the support of the financial resources provided by the EU budget, neither the EU institutions nor any of the EU policies would have any meaning. Therefore it is critically important to detect both internal and external

defects, which give rise to the malfunctioning of the EU budget and to eliminate them in order to allow it to better serve for the needs of the European integration process.

Recently, the Union has been suppressed by a fundamental budgetary crisis. At the European Council Meeting of 17 June 2005, the Member States failed to reach an agreement on the Financial Framework of the Union for the period 2007-2013. The failure of the European Council to agree on the financial framework generated massively negative media coverage and brought the historically rooted budgetary problems at the top of the agenda. Even more important, it coincided with the constitutional crisis of the Union, resulting from the rejection of the European Constitution in both France and Netherlands.

In light of these developments, the thesis assesses the underlying political and financial reasons of the recent budgetary crisis of the European Union. It aims to discuss the possible reform alternatives for the EU budget in order to improve it to better serve for the objectives of the enlarged Union and to enable the Member States to share the budgetary expenditures more fairly. To this purpose, the next chapter of the thesis is devoted to the explanation and clarification of the factors that create substantial pressure for a budgetary reform in the EU. These factors can be summarized as the provisions of Stability and Growth Pact, the emergence of a net contributors' problem, the ongoing UK budget rebate, the eastern enlargement of the EU, and the goals of Lisbon Strategy. Third chapter is complementary to the second chapter since it gives a comprehensive overview of the EU budget including the budgetary principles, the budget structure, namely, the revenue and expenditure items, the budgetary procedure and the budget control. The fourth chapter gives the historical evolution of the EU budget. To this purpose, the reform packages that the EU budget underwent from the very beginning are analyzed. At the same time, the implications of the successive enlargements of the Union, particularly the first enlargement of the Union to include the UK, Ireland and Denmark the second enlargement to include Greece, Spain and Portugal and lastly the third enlargement

to include Sweden, Austria and Finland, on the EU budget are determined. The fifth chapter, on the other hand is devoted to the comprehensive analysis of the third financial framework of the Union for the period 2000-2006, which was initiated with the Agenda 2000 proposals and ended up with the Copenhagen European Council Conclusions in December 2002. In this regard, the background of the fierce budget negotiations and the political economy behind them are analyzed in a detailed manner. The analysis shows to what extent net contributions to the EU budget and dominance of national interests of the Member States distorted the negotiations and caused the Union to end up the process with slight changes in its principle policies contrary to the initial radical reform aims. The analysis also shows to what extent the third financial framework differed from previous financial frameworks in terms of treatment towards the candidate countries.

The sixth chapter presents a general overview of the shortcomings of the present own resources system and discusses possible reform options. In general, the arguments in this chapter evolve around the policy areas, in which this reform process could take place. To this purpose, all recent debates about a reform on the EU budget are included and assessed. In this regard, the thesis has the advantage of providing the reader with several different views. The thesis compares these views according to their relevance and feasibility in the short and medium term. Clearly the problem concerning budget is acute and it needs to be solved in a very limited period of time. The solutions that can be reached in the longer term will not be relevant since they will not lead to the best feasible result in the short term.

The thesis also shows how the Union overcame the policy challenges, and particularly the budgetary implications brought out with the inclusion of Central and Eastern European countries. In this regard, the thesis analyses how the Union's financial perspectives covering the 2000-06 and 2007-2013 periods were finalized. Since the current literature is full of possible reform scenarios for the Eastern enlargement of the EU and only a few of them have focused on the actual developments, the thesis contributes by explaining the recent developments in a more

comprehensive manner. In order to show how the Union has coped with the budgetary impacts and policy challenges of the Eastern enlargement, the thesis focuses on the Union's common positions in terms of the expenditure items such as the European Agricultural Guarantee Fund and Structural Funds during the accession negotiations since more than the half of the EU budget is spent on these policy areas.

As it has always been the case in the history of European integration, the Union's financial system is strictly connected with the political model of the European Union. The direction of the European integration, either to be federal or intergovernmental has always determined the context of budgetary politics and gave the final shape to the budget. Clearly, the structure of the EU budget and the budgetary negotiations among Member States are the reflections of European policies. Unless an agreement is reached on the European policies and the priorities for the Union are clearly set, it is not possible to establish a proper financial structure for the Union in order to make it better serve for the needs of increasing number of countries.

CHAPTER II

DRIVES FOR A BUDGETARY REFORM IN THE EUROPEAN UNION

The budget of the European Union has been substantially important throughout the European integration process and it still continues to preserve its importance. There are many factors that make the EU budget so important for both EU actors, namely, the institutions of the Union and the politicians shaping the political route of the EU, and the Member States. First, the budget has played a crucial role in furthering market integration and deepening the institutional setting of the EU through the policies it has financed. Whenever the EU actors attempted to speed up the process of European integration and to support the forthcoming enlargement waves, the size and shape of the budget were modified to accompany these attempts. For instance, the launch of Single European Act was accompanied by two sets of proposals, commonly known as the 'Delors I Package', on budgetary reform: *Making a Success of the Single Act*; and *Report on Financing of the Community Budget*. Single European Act was mainly a major revision of the Treaty of Rome that underpinned the completion of single market program in 1992. In the 1980s, the Community was experiencing very serious problems. The decision making process of the Community was slowed down due to the conflicts among the Community institutions. The adoption of the unanimous voting rule for various policy areas resulted in the aggregation of many vital Commission proposals in the Council. In addition to the existing problems peculiar to the structure of the Community institutions and the relations between themselves, the inclusion of relatively poor Member States, namely Greece, Spain and Portugal, increased the regional disparities within the Community and added up to the blockage of the process of European integration. The economies of these countries were not ready for the adoption of single market rules and they had to be supported financially in order to catch up with the incumbent Member States. There was a substantial need for a strategy on achieving an economic and social cohesion within the Community. As a consequence of these

problems, the Community actors decided to relaunch the integration process by putting a linkage between the internal market process and budgetary issues. The political link between the market integration efforts and the structure of the budget has been repeated in February 1992, when the Maastricht Treaty was signed and it was followed by a document *From the Single Act to Maastricht and Beyond: The Means to Match our Ambitions*. It will not be wrong to say that the inclusion of the Central and Eastern European Countries (CEECs) was also tried to be managed within the scope of Agenda 2000, which defined the main framework of the third financial perspective of the Union.

The second reason lying behind the importance of the EU budget stems from the fact that the amount of financial resources allocated to the EU budget is notable. As the EU has grown over the years, both in terms of Member States it involves, and the number of policy areas it intervenes, the size of its budget has also increased substantially. Furthermore, the introduction of the Community's Own Resources (ORs) in 1970s gave financial independence to the Community and distinguished the Community from international organizations. The establishment of the own resources was important in giving the Community a substantial amount of financial autonomy because the Community was rescued from being solely financed by the national contributions of the Member States. The political agenda of the Community would no longer be on the hands of the Member States that always look for ways to realize their national interests at the European level. Since the bulk of money channeled to the EU budget has been increasing and the Member States has been exerting less control over their allocation, the EU budget began to attract more attention of the EU actors as well as of the public and has become the top of the agenda. On the other hand, it is commonly known that the size of the EU budget is very small since it remains small in relation to Community gross national income and to the level of public expenditure in the Member States. "However, although the budget has little macroeconomic significance for the Union as a whole, it is very important for those of the Member States that receive extensive transfers from the structural funds" (Laffan and Shackleton 2000, 213).

The third and the most important reason making the EU budget highly important is the fact that in general, the EU budget, like national budgets, tells us a lot about the type of governance prevailing in the EU. The structure of its revenue and expenditure items shed light on the priorities and conflicts embedded in various processes of the EU. Moreover, "analysis of budgetary politics casts light on the relationship between political and economic integration" (Laffan and Shackleton 2000, 212). Because, the adoption and implementation of policies necessary for market integration and thus for the future of the Union are highly dependent on the availability of financial resources. In this respect, one can assume the budget of the EU as the main tool for analyzing the implications of the deepening and widening efforts of the Union as they have been all reflected in the structure of budgetary procedure and allocation of financial resources. From other point of view, it can be said that the structure of the Own Resources system reflects what kind of a relationship exists between the EU's citizens, its Member States and its institutions since it establishes a direct link between the EU citizens and the Union. In particular, the existence of own resources of the Union represents the commitment of Union resources for the provision of Union public goods meaning that the EU money is used to serve for the European people. Therefore, in line with the general view regarding the importance of the Union's own resources, it is sure that as well as the current application, the prospective structure of the Own Resources system will likely determine the future construction of the European integration process. Moreover, according to many EU actors and institutions, what kind of political entity either federal or intergovernmental that the EU will become in the future depends upon the future design of the ORs system. "Both the history and the relevant literature prove that the shape of the EC's revenue system is strictly connected with a political model of the European Community" (Cieslukowski 2005, 6).

Certainly, the EU budget as an important element of the EU system is not free of problems. A number of factors, both internal and external to the EU, hinder the success of the overall EU budget. It is sure that everyone may have a different opinion about the context of these factors. However, in this thesis we will try to focus on the most important and obvious ones for us. These factors can simply be listed as;

the formation of a "net contributors' club" (Laffan and Shackleton 2000, 224), the ongoing UK budget rebate, the pressure imposed by the implementation of Stability and Growth Pact (SGP)[2], the inclusion of CEECs and the prospective enlargements in the future, the context and requirements of the Lisbon Strategy and some defects peculiar to the adoption and implementation of the EU budget. These factors, in time, helped the EU budget become one of the highly debated issues within the process of European integration. Though they are very different from each other in terms of their dimensions and seem to be unconnected, they serve for the same purpose, and help the acceleration of the budgetary problem. For the time being, it is inevitable to launch a budgetary reform in the EU budget. The current structure of the Own Resources system and the budgetary decision making processes prove to be insufficient.

In this chapter, the primary aim is to define the probable reasons of the current budgetary dilemma and to set their relationship with the incremental evolution of the budgetary crisis. In this respect, the chapter draws a comprehensive picture of how these developments, namely, the net contributors problem, the UK budget rebate, the introduction of SGP, the Eastern enlargement of the EU, and the challenge of increasing international competition and the EU's response to this threat through the launch of Lisbon Strategy, acted individually as the agents of a budgetary reform in the EU.

2.1 The Net Contributors' Problem

According to Laffan (2001), the financial basis of the Community can be traced back to the European Coal and Steel Community (ECSC) in 1952. In line with the provisions of the Paris Treaty (1951) establishing the ECSC, the Community expenditures were financed through the taxes raised by the High Authority (later the Commission) until the signing of the Treaty of Rome (1957). These taxes were

[2] The existence of the political and economic pressure imposed on the EU budget by the implementation of the Stability and Growth Pact is cited by Professor Jim Rollo in his article titled *Agriculture, the Structural Funds and the Budget after Enlargement* and published in August 2003.

simply the levies imposed on the coal and steel industries. “The Treaty of Rome, establishing the European Economic Community (EEC), marked another stage in the formation of the financial resources of the Community, since it made a provision for two financial instruments: the European Social Fund (ESF) and the European Investment Bank (EIB)” (Laffan 2001, 196). However, these financial instruments proved to be insufficient to finance the increasing needs of the Community. The introduction of the Common Agricultural Policy (CAP) in the 1960s, and respective increases in revenue needs made the Member States recognize the need for own financing of the Community. As a consequence, in the Luxembourg Treaty (1970), the Member States agreed upon the Own Resources Decision, which introduced a new revenue base for the budget. The new revenue base, called as the Own Resources of the Community, consisted of three main revenue items; custom duties on all imports into the Union, agricultural levies on agricultural imports into the Union and up to 1 per cent of the value added tax (VAT) collected in the Member States.

The creation of the own resources of the Community was a turning point for the Commission for many reasons. It was the first concrete attempt on the way of giving the Community financial independence from its Member States. By this way, the Community would enjoy the opportunity of supporting the policies necessary for the market integration and financing European public needs. However, the own resources of the Community have proved to be a problematic issue since the beginning due to the fact that unlike the nation states, the EU has not had a central tax administration responsible for tax-raising and managing activities across the Union. The Union has only been granted powers to harmonize or coordinate different national taxation systems (especially consumption tax rates) in order to reduce tax competition and to receive some amount of VAT receipts of the Member States according to the provisions of the Own Resources Decision. In this respect, as the Member States collected the mentioned duties and taxes and paid them out from their national treasuries, they began to regard them as national contributions.

In addition, despite their brilliant advent, they soon became inadequate in financing the increasing levels of Community expenditure. The financial capacity of the Community was compelled by inclusion of new and poorer Member States and increasing number of policy areas that the Community needed to intervene in order to support market integration. Besides, the customs duties and tariff revenues that stemmed out from the implementation of the Common Trade Policy of the Community have been decreasing as a result of the General Agreement on Trade and Tariffs (GATT) and World Trade Organization (WTO) decisions. Above all and most important, “the VAT has been inherently regressive because the proportion of consumption to GDP is higher in poorer countries, which makes the VAT base a relatively higher proportion of GDP for these countries. High saving, net-exporting countries, by contrast, have a relatively lower VAT base” (Neal and Barbezat 1998, 91). Due to this fact, Neal and Barbezat consider the VAT based resource as creating inequity among Member States. From a general point of view, the current revenue base was not sufficient and also not fair enough in the financing of increasing levels of Community expenditures. Obviously, the financial basis of the Community budget was weakened due to the internal and external developments. As a reaction, the Commission introduced a GNP based resource in 1988 as part of the Delors I Package in order to balance the Community’s expenditures with its revenues. The net contributors’ problem simply stemmed out at this stage because GNP based resource had a national contribution character rather than an own resource.

As the money coming from the VAT based resource and customs duties have melted, the GNP based resource began to be used in substantial amounts in order to finance the gap between the Community expenditures and revenues. As it can be seen from Table 2.1, the GNI resource has come to present three-quarters of total revenues by 2006.

Table 2.1 The Composition of EU own resources, 1995-2006 (in per cent of total own resources; cash basis)

Percentage share of revenues:	1995	2000	2006
Traditional	16.7	16.5	12.7
VAT	45.0	38	14.2
GNP/GNI	25.9	40.5	72.0
Total own resources (€ billion)	81.2	92.7	107.1

Source: European Commission.

Since, the GNI resource is obtained by the application of a rate – to be determined pursuant to the budgetary procedure in the light of the total other revenue – to the sum of all the Member States' GNIs (Article 2(1)(d) of Council Decision 2000/597/EC, Euratom), the highest per capita GNI countries have been the primary contributors of the EU budget. In the successive years, this feature of the GNI source resulted in the domination of the Member States making the highest contribution to the EU budget in the budgetary process. By the introduction of the GNP factor, "the contributions of the Member States took on the character of membership fees" (Palankai 2003, 295). The financial autonomy of the Union was curbed and the allocation of Union funds was politicized. The budgetary politics tended to dominate the overall policy agenda as the Member States involved in budgetary negotiations in order to maximize their national benefits. According to Laffan and Shackleton (2000), the majority of states were in position of a net beneficiary from the budget by the 1990s. However, as the Union underwent successive enlargement waves to include poorer countries such as Ireland, Spain and Greece, an increasing number of Member States found themselves transformed from a net beneficiary to a net contributor. The 1995 enlargement added Sweden, Finland and Austria to the growing net contributors' club, and helped the aggravation of the issue. This transformation process can be easily seen in the Table 2.2 since it shows the changing net balance positions of the Member States between the years 1993 and 2004.

On the other side of the coin, there stand the countries that are receiving significant amounts of financial resources via the structural funds. These countries are

substantially benefiting from these funds and normally they do not want to lose their advantageous position. In light of these developments, it is not wrong to define the current budgetary politics as divided into two camps and dominated by the struggle between these two sides; one camp consists of the countries financing the EU budget through their national contributions and looking for ways to change this position and the other camp consists of the countries highly benefiting from these funds and trying to maintain the status quo. This division between the Member States also constitutes the basis of the main coalitions in the European Council.

Table 2.2 EU-15 Net Balances 1993-2004 (averages over stated periods as a percentage of GDP/GNI)

Country	1993-96	1996-99	2000-04
Belgium	0.03	-0.17	-0.19
Denmark	0.31	0.05	-0.05
Germany	-0.65	-0.55	-0.34
Greece	4.50	3.92	2.95
Spain	1.13	1.28	1.16
France	-0.14	-0.11	-0.11
Ireland	5.40	4.06	1.46
Italy	-0.18	-0.15	-0.09
Luxembourg	-0.54	-0.47	-0.38
The Netherlands	-0.25	-0.49	-0.47
Austria	-0.35	-0.36	-0.16
Portugal	3.17	3.09	2.07
Finland	-0.06	-0.09	0.03
Sweden	-0.41	-0.48	-0.38
UK	-0.13	-0.19	-0.04
UK Standard deviation	1.94	1.66	1.04

Source: European Commission.

The net contributors' problem is now one of the biggest problems regarding the budgetary politics since it hinders the adoption of effective budgetary decisions targeted at the realization of common EU policies and goals and brings the national interests of the Member States to the top of the budgetary politics. "The increasing dependence of the EU budget on inter-governmental transfers from national treasuries, accounting for almost 90% of EU total revenue in later years, encourages Member States to seek to maximize ill-defined concepts of national benefit from the EU budget" (Commission, 2004d).

It is clear that the current rules of the European budgetary system aggravate the net contributors' problem rather than eliminating it. The temporary solutions cannot replace a structural budgetary reform; they will only postpone its adoption. Therefore, only way to eliminate this problem is to make a radical reform in the revenue base of the EU budget. The prospective budgetary reform should be capable of underpinning the defects of the current budgetary structure in terms of the GNI based source, and introduce a new system that will limit the dominance of the Member States over the budgetary politics. The EU money should be used for the peoples of Europe as it was intended in the very beginning with the creation of own resources. The EU money should be allocated to the policy areas that will make a substantial contribution to the European integration process. The allocation of funds should be determined in line with the common policy goals, not just with the national interests of the Member States.

2.2 The UK Budget Rebate

In the Luxembourg Treaty of 1970, the six Member States of the Community agreed to fix the rules governing the financial resources of the Community. According to the agreement, revenue collected within the scope of Own Resources Decision would be automatically used in order to support the CAP. As a result, approximately 70 per cent of the EU expenditure was allocated to the financing of the CAP. By this way, "the rules of the game were fixed to the advantage of incumbents, above all France, making confrontation with the UK more or less inevitable" (Laffan and Shackleton 2000, 217). In fact, "with the creation of the CAP in 1962, France extended to Europe the traditional French policies of subsidizing farmers and protecting them from foreign competition by means of quotas and high external tariffs" (Ambler and Reichert 2001, 45). The effect of these policies and the shape of the Luxembourg bargain has been a massive redistribution of income from European consumers to the farmers. "Within Europe, high tariffs and price supports have produced another important redistribution of income from countries with relatively small farm sectors, such as Britain, to those in which agriculture historically has been most important,

such as France" (Ambler and Reichert 2001, 45). In order to protect the high-cost producers in European agriculture, the CAP required the imposition of a common external tariff, which would constitute one of the revenue items of the current Own Resources of the Community. As Neal and Barbezat state, this requirement of the CAP forced Britain to pay more than world prices since it was a major importer of food. Besides, because of its small agricultural sector, Britain was unable to benefit from the large agricultural funds given under the framework of CAP.

In addition to the problems concerning the application of the CAP, the VAT based resource soon proved to be problematic for Britain. The Member States' contributions in terms of VAT based resource were determined by the adoption of a harmonized VAT base. The harmonized VAT base was calculated not by considering the actual VAT receipts; instead it was calculated by fictional taxation of a given range of goods and services at standard rates. "Because the UK exempted from VAT a large range of goods, especially food and medicines, its financial contributions to the EU were large relative to its actual tax collections" (Neal and Barbezat 1998, 93).

In these circumstances, the UK was disadvantageous in terms of both revenue and expenditure sides when it became a member of the Community. "Furthermore, it should be recalled that during the first years after its accession, the UK was one of the least prosperous Member States with a GDP per capita well below the EU average. This tended to exacerbate the problem of the UK's negative budgetary balance" (Commission 2004d). It took only a couple of years for the British politics to realize the disadvantages stemming from the EU budget procedure. As a result, after its inclusion, "the British Treasury prepared a cost-benefit analysis of the EC membership, which revealed that although Britain contributed one-fifth of the EC's tax revenues, it received only a tenth of the EC's agricultural expenditures- no small matter since they accounted for nearly two thirds of the total EC budget" (Rasmussen 2001, 162). In addition, according to the official data of the Commission, the UK became the second largest contributor to the EU budget after Germany though it ranked the seventh among the Member States in GDP per capita. These

developments gradually culminated in the evolution of a stalemate, the so-called ‘I want my money back’.

As Rasmussen (2001) states, Margaret Thatcher brought the issue to the centre of the political agenda at the Dublin Summit in November 1979, and she tried to look for ways in order to get the Britain’s money back during the first several years of her Presidency. The other EU members were acting unwillingly to change the current situation. However, the resistance of Thatcher strengthened in time and paved the way for fierce negotiations over the other policy areas, even threatened the ongoing process of European integration. In fact, the Member States had only a few alternatives since they cannot change the rules of the CAP. The Britain’s position could be better off through financing more UK projects by the structural funds. However, this was not the outcome that Thatcher was striving for. As Rasmussen (2001) highlights, she was struggling to get a refund of approximately 70 per cent.

After several summits passed without achieving a common agreement on the UK rebate, the Member States of the Union finally agreed at the Fontainebleau European Council (1984), during the French Presidency. According to the conclusions of the Summit, the UK got a rebate, in which it would receive back 66 per cent of the difference between its share in revenues and share in allocated expenditure. In general, according to many EU actors, the French President, François Mitterrand, and the German Chancellor, Helmut Kohl, acted as real conciliators in the solution of the problem. According to Rasmussen (2001), after five years of struggle, Thatcher won almost what she was striving for and Germany in its attempts to solve the issue, endured even more cost than Britain since Germany’s contributions to the EU budget increased after the agreement.

However, contrary to the expectations, the rebate ameliorated the financial crisis of the Union, instead of solving it. Though the financial situation of the UK has improved throughout the recent years and it has become one of the most prosperous Member States, it still continues getting her money back from the EU budget. This

fact is even more visible in the following Table 2.3. "In 2003, GNI per capita of all net contributors to the EU budget, expressed in purchasing power standards (PPS), ranges between 97% and 111% of the EU-15 average. At 111.2%, the UK's relative prosperity is at the top of the range. This is in sharp contrast with the situation in 1984, when the UK was the least prosperous of the net contributors and only Greece and Ireland had a lower GNI per capita than the UK" (Commission 2004d).

Table 2.3 GNI per capita for EU-15 selected members (in PPS)

(EU-15 average = 100)

	1984	2003
United Kingdom	90.6	111.2
Denmark	104.0	111.1
Austria	-	109.8
Netherlands	95.0	106.6
Sweden	-	104.6
France	104.0	104.2
Germany	109.6	98.6
Italy	92.9	97.3

Source: European Commission

At the current financing situation, the UK does not participate in the financing of its own rebate. It is financed by the other twenty Member States according to their share in EU GNI. In particular, the shares of four net financiers, namely, Germany, Netherlands, Austria and Sweden, have been reduced by 75 per cent in line with the conclusions of the Berlin European Council in order to alleviate their budgetary imbalances. However, this is only a temporary solution to the problem. The UK has enjoyed a rebate on its annual contributions to the EU budget that has amounted to a yearly average of 5.3 billion Euro in the period 2001-2004. The remaining Member States are no longer willing to finance the UK budget rebate and their attempts are visible in every budgetary negotiation. Moreover, since the UK rebate is included in the Own Resources Decision, the UK has a very strong position in terms of setting the rules of the game. Therefore, the Own Resources System should be assessed and the current UK correction should be replaced by a more fair mechanism which would ensure fair burden-sharing among Member States.

2.3 The Stability and Growth Pact

The Single European Act (1987) aimed at the complete unification of the EU market by 1992 and it specified that economic and monetary union was an objective of the Community. "Clearly, with a free market for goods and services, the members could not at the same time have (a) stable exchange rates, (b) integrated capital markets, and (c) an independent monetary policy" (Hitiris 2003, 144). The Member States had to engage in more intensive and effective economic policy coordination as they began to involve more and more into intra trade and became more economically interdependent on each other. Moreover, further integration could lead to destabilization unless the Member States use a common currency. It was obvious that monetary union was a prerequisite for the sanity of the Community. In this sense, "Delors Report linked the completion of the single market to a single currency, with the coordination of all macroeconomic policies and the endorsement of 'binding rules for budgetary policies'" (Hitiris 2003, 144). It is sure that the Delors Report entirely met the requirements of the Community at that time and in line with the provisions of it, the Community signed the Maastricht Treaty in 1992. In fact, "Maastricht Treaty retained the institutional set up originally proposed by the Delors Committee and stated that Economic and Monetary Union (EMU) was to be achieved in three stages" (Altomonte and Nava 2005, 110). The main aim here is to analyze the convergence criteria set by the Maastricht Treaty rather than to explain the three stages of the monetary union.

Maastricht Treaty laid the foundations of the EMU by defining the three stages, which would end up with the adoption of a single currency within the monetary union. However, it also defined four convergence criteria (price stability, government finances, exchange rates and long-term interest rates) and obliged the Member States who want to participate in EMU to meet these criteria. The convergence criteria, which are presented in Article 121(1) of the Treaty Establishing the European Community, can be explained as follows:

1. “Price stability: In practice, the inflation rate of a given Member State must not exceed by more than 1.5 percentage points that of the three best-performing Member States in terms of price stability during the year preceding the examination of the situation in that Member State.

2. Government finances: The Treaty stipulates the sustainability of the government financial position and examines compliance with budgetary discipline on the basis of the following two criteria:

- The annual government deficit: the ratio of the annual government deficit to gross domestic product (GDP) must not exceed 3% at the end of the preceding financial year. If this is not the case, the ratio must have declined substantially and continuously and reached a level close to 3% or, alternatively, must remain close to 3% while representing only an exceptional and temporary excess,
- Government debt: the ratio of gross government debt to GDP must not exceed 60% at the end of the preceding financial year. If this is not the case, the ratio must have sufficiently diminished and must be approaching 60% at a satisfactory pace.

3. Exchange Rates: The Member State must have participated in the exchange-rate mechanism of the European monetary system without any break during the two years preceding the examination of the situation and without severe tensions. In addition, it must not have devalued its on its own initiative during the same period.

4. Long-term interest rates: In practice, the nominal long-term interest rate must not exceed by more than 2 percentage points that of, at most, the three best-performing Member States in terms of price stability”[3].

It is obvious that the convergence criteria is stability oriented and focuses on macro stability. According to Altomonte and Nava (2005), a careful analysis of these four convergence criteria takes us to a common outcome; at the core of the EMU lay two crucial requirements: First, the Member States should achieve a budgetary discipline and maintain it over time. Second, they should achieve a strong coordination among

[3] SCADPlus: Introducing the Euro:convergence criteria, http://europa.eu/scadplus/leg/en/lvb/l25014.htm

their macroeconomic policies. According to the provisions of the Maastricht Treaty, European Central Bank (ECB) is responsible for the operation of monetary policy in the Euro zone whereas the Member States remain responsible for setting their fiscal policies. In addition, the primary aim of the ECB is to achieve and maintain price stability. However, from a macroeconomic view, fiscal stability is a necessary condition for price stability. Therefore, in order to ensure price stability, the Member States have to achieve sufficient degree of fiscal stability. In other words, they have to balance their public finances in the medium term. Consistently with our analysis, the two items of the convergence criteria; a government deficit below 3 per cent of the GDP and a government debt ratio below 60 per cent of GDP, require the avoidance of excessive government deficits. To this purpose, the Article 104 of the Treaty gives a comprehensive definition on the application of excessive deficit procedure, through which Member States commit themselves to keeping their public finances under control.

"However, on the eve of the introduction of the single currency, the excessive deficit procedure was deemed not completely adequate to guarantee the fiscal discipline of Member States, especially in light of the dreadful records of public deficits and debt achieved in the past by some Member States" (Altomonte and Nava 2005, 133). Thus in order to clarify and strengthen the application of the excessive deficit procedure, the Union agreed upon the Stability and Growth Pact in 1997. In particular, the adoption of the SGP can be considered as the completion of the phase opened with the introduction of excessive deficit procedure. Under the SGP, each country in the Euro area was obliged to submit a stability program, while the others were obliged to submit convergence programs. In order to ensure fiscal discipline imposed by excessive deficit procedure, these programs would give the medium term targets for the budget balance and debt. In the broader context, the members of the EMU were obliged to keep their budgets in balance or in surplus in the medium-term and ensure the budget deficits not to exceed 3% of their GDPs. The SGP was revised in early 2005 and according to Altomonte and Nava (2005), its provisions have been loosened to some extent. However, it can be said that it still aims at strengthening the budgetary surveillance of the Member States' budgetary positions and eliminating

their budget deficits in the medium term. Because, the countries are obliged to set country specific medium term objectives of budgetary positions 'close to balance or in surplus' in their stability or convergence programs according to the provisions of SGP.

The provisions of SGP are important for the argument due to the fact that its introduction as part of the monetary union put the Member States under great pressure in terms of their fiscal policies. Although, the Member States are left responsible for their fiscal policies, they have to act within the framework of SGP. As the provisions of the Pact obliged the members of the EMU to keep their budgets in balance or in surplus in the medium-term and the budget deficits not exceed 3% of their national GDPs, they have increased the pressure over the public finances of the Member States. Even the EU's most prosperous Member States, particularly France and Germany, have began experiencing serious problems to fulfill the criteria. Due to the fact that Member States use their budgets as a macroeconomic policy instrument, they cannot help to eliminate the structural budget deficits. As a result, the Member States look for ways of creating additional revenue or cutting expenditure wherever they could. In this context, Rollo (2003) argues that the EU budget is seen as politically a free hit when it comes to reducing deficits. This perception is clearly reflected in the budgetary politics. From a more general viewpoint, the additional pressure created with the introduction of SGP as the complementary part of excessive deficit procedure can be considered as directly contributing to the acceleration of the net contributors' problem. Since Member States are tightened with the requirements of the excessive deficit procedure and SGP, they give their full attention to the EU budget and try to break the budget procedure as much as possible.

2.4 Lisbon Strategy

Lisbon Strategy can be described as the Union's most concrete effort to catch up in GDP per capita terms with more internationally competitive countries such as the United States (US) and Japan. The Union's low economic performance, in particular,

a sluggish economic growth with high inflation and low employment rates, and low level of international competitiveness since the early 1990s are the main reasons for the creation of such a comprehensive strategy. “Since 1995, the growth rate for the EU-15 has averaged 2.2% compared to a global average of 3.6% and 3.2% for the US” (Commission 2004b). The evidence suggests that Europe’s economic performance has been poor in relative terms and unless action is taken, the European economy will continue to decline. In general, what makes the Lisbon Strategy central to our argument about a potential budget reform is the close link between its targets and the expenditure structure of the EU budget.

There were in fact many reasons behind this low economic performance. Low contribution of employment to growth in Europe was one of them. “Traditionally the European labour market institutions have been characterized by a certain degree of rigidity, with though laws and rules disciplining the hiring and firing of people, a phenomenon known in the economic literature as Eurosclerosis” (Altomonte and Nava 2005, 165). As a result, wage levels were higher and downwardly rigid across Europe and this was directly contributing to the Europe’s low international competitiveness because it simply resulted in higher prices compared to the rest of the world. In addition, welfare state systems of some European countries have been notably requiring high levels of expenditure in order to finance redistributive policies. Since labour productivity has been low and financing such costly social models has been difficult, new ways were to be found in order to achieve higher rates of growth. Therefore, it was necessary to undertake major reforms in order to narrow the gap between Europe and internationally competitive countries.

The realization of the EU Member States the extent of economic performance gap between the US and some other Asian countries forced them to elaborate on the issue and look for ways of recovery. This elaboration process ended up with the introduction of Lisbon Strategy. It is in fact the result of a long decision-making process, initiated by the heads of state and governments meetings in Lisbon in March 2000 and continued in the four successive European councils.

The main aim of the Lisbon Strategy is to improve the EU's economic performance by achieving higher levels of sustainable growth in a stable macroeconomic framework and in a climate of social cohesion. The European leaders declared a new strategic goal for the next decade and committed the EU to become by 2010 the most dynamic and competitive knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion, and respect for the environment. According to many EU actors, the Lisbon Strategy was a comprehensive but interdependent series of reforms. Member States have to act in concert in order to increase the living standards, accelerate employment and productivity growth via a wide range of reform policies.

Consistently with these interconnected targets, the Lisbon Strategy requires urgent action across five policy areas; the *knowledge society* through the realization of more R&D studies and use of information and communication technologies (ICTs) across Europe, *completion of the internal market* for the free movement of goods and capital, and urgent action to create a single market for services, *creating a business climate* supportive to businesses including new enterprises, *modernizing the European social model through* investing in people by developing strategies for lifelong learning, vocational trainings and active ageing strategies and lastly, *achieving environmental sustainability* during the realization of these four policies (Commission 2004c).

To this extent, the Lisbon Strategy seems to be perfectly consistent with the previously identified need for the EU to promote a wide range of reforms in order to increase the overall productivity of the Union. However, as Gros and Micossi (2005) state, one of the weakest features of the Lisbon Strategy is its interconnectedness with the EU budget. Since the EU budget has been heavily financing the agriculture, "a declining sector with little prospects of employment and growth" (Gros and Micossi 2005, 1) it does not reflect the common European policy goals set out clearly in the Lisbon Strategy. Agriculture still dominates the budget expenditures with 40 per cent share while funds for the promotion of R&D studies, information and

communication strategies, education and etc. constitute only one third of the total.

Not surprisingly, looking back to the Member States' performances in the last five years is enough to make us disappointed with the implementation of Lisbon goals. Since the Lisbon targets are very difficult to attain by the individual efforts of Member States, the majority of them failed to achieve the expected results. According to the report (Commission 2004c) prepared by the High Level Group chaired by Wim Kok and published in November 2004, the overall performance of the European economy has been disappointing over the last four years. The economic growth in Europe has been weaker than in the US and Asia over the last two years, because of continuing structural weaknesses and because the rate of growth of public and private demand has been low. The report continues by stating that the disappointing outcome is also due to an overloaded agenda, poor coordination and conflicting priorities. Above all, it is because of the lack of determined political action across the Union.

The limited success of the incumbent Member States and the challenge of enlargement (Lisbon targets had to be reformed in order to include the new Member States) raised the concerns about the Lisbon Strategy and culminated in a mid-term review on 2 February 2005. According to the authorities, EU-27 is more likely to be compelled by the Lisbon targets than the EU-15 since the enlargement brings lower GDP countries and additional unemployed people into the Union. However, despite being aware of the challenges, the Commission linked the relaunch of the Lisbon Strategy with the CAP measures by making the same mistake. It stated that 'strong economic performance' will go hand-in-hand with 'the sustainable use of natural resources'. And once again, by exaggerating the agriculture's contribution to the EU's prosperity, it put the agriculture at the center of other policies.

Despite its very biased perception about the significance of agriculture in the lives of European citizens, the Commission also emphasized the need for improvement in connection between the EU budget and Lisbon targets in the mid-term review. To

improve Lisbon governance, the Commission called for a better link with the other EU policies, in particular the EU budget. In this respect, the EU felt for the first time the need to bring the EU budget in line with the Lisbon Strategy. This emphasis becomes quite crucial when the Union's suffrage from the issue in the last five years is taken into consideration. However, the last financial perspective covering the period of 2007-2013 did not take this issue considerably and the last financial framework was concluded with the dominance of agriculture expenditure over other expenditure items once again. Though the current situation is in favor of agriculture, this has to be changed and common European targets identified more clearly within the framework of Lisbon Strategy should be given more importance. The EU budget items should be restructured and the size of the budget should be expanded to enable more spending for research and innovation, which is the main driver for gaining a competitive edge internationally.

2.5 Eastern Enlargement of the EU

On 1 May 2004, the European Union experienced its biggest enlargement process in its history. The 2004 enlargement, which brought in eight countries from Central and Eastern Europe and the Mediterranean islands of Malta and Cyprus, raised the population of whole EU states by almost 75 million and made the EU a political and economic area with more than 450 million citizens. In addition, Romania and Bulgaria, which are even poorer in economic terms than the last ten countries, became the full members of the Union as of January 2007. Clearly, such a big integration is not free of costs. Enlargement has the potential to bring major economic and political opportunities for the Union while it constitutes a major challenge at the same time for the EU's substantial number of policies. Because of its bigger size, this enlargement differed from the previous enlargements of the EU and it raised extra questions for people on both sides. People have been concerned about the impact of the enlargement on their lives due to the fact that the average income levels of the ten new comers have been well below the present Member States. The differences in average income levels and living standards between the new comers

and present Member States could simply pave the way for significant number of problems. As already discussed the importance of the EU budget in reflecting the political governance prevailing in the EU and showing the implications of deepening and widening efforts, it is not surprising to clearly see the problems arising from the eastern enlargement in the budget negotiations.

The inclusion of the Central and Eastern European countries coincided with a time, in which budget deficits of the old Member States (EU-15) were high and the convergence countries were preparing to enter the third stage of EMU. As a consequence, it added up to the existing pressure stemming from fiscal discipline required for the membership to the monetary union. The extension of the EU to include the CEECs meant larger net budgetary contributions for the EU-15. As the candidate countries' per capita GDPs were lower and they were much more agricultural than the EU-15, they expected to receive major financial transfers from the EU budget under the current policies. However, "the present net contributors to the EU budget were not prepared to accept the sole financing of this transfer through higher contributions to the budget" (Weise 2002, 3). In addition, the Member States that have been highly benefiting from the financial transfers of the EU, did not want to lose their advantageous position. The inclusion of the economically backward countries would draw down the average per capita GDP level across the Union and those countries which were before entitled to major financial transfers would lose their eligibility as their per capita GDP would be higher than the new average levels. Thus they wanted to hold on to their current financial transfers as much as possible.

As a result, the budget of the European Union, particularly its size, its sources of revenue, and the areas of expenditure, has become one of the highly debated issues in the recent years. Given the limited size of the EU budget and the reluctance of the present Member States to increase its size, the inclusion of these countries brought out the need for a redesign of the current EU policies and financial transfers. In this respect, the European Commission published its document Agenda 2000 in 1997 in order to underpin the issue of prospective financial challenges arising from the

inclusion of Central and Eastern European countries and to show that the pre-accession and accession appropriations for the candidate countries could be managed in the new 2000-2006 budgetary framework. In the Agenda 2000, the EU-15 Member States agreed to retain the present own resources ceiling and they accepted that the additional financial burden of enlargement could be sustained without changing the present ceiling on the own resources. In fact, the Agenda 2000 proposals were notably different from the previous proposals of the Commission. "In contrast to its more radical proposals in 1987 and 1991, the Commission adopted a cautious strategy of incremental adjustment, rather than a bid for greatly increased resources and new sources of funding" (Laffan and Shackleton 2000, 230). "The net contributors to the EU budget argued that the underdeveloped market structure of the central and eastern candidates would not be able to absorb moderate funds productively (no more than 4 per cent of their own) or to match structural funding by an equal domestic expenditure contribution, in accordance with current EU rules." (Hitiris 2003, 216). Therefore, they saw no reason to expand the current budgetary expenditure.

The Agenda 2000 proposals constituted the core of the discourses during the Berlin European Council in March 1999 and the financial perspective covering the period of 2000-2006 was considerably restructured in line with the content of Agenda 2000. The Council decided to hold the present own resources ceiling at 1.24 of the Union's GNI. However "as the economic downturn intensified, the Member States were under considerable pressure to restrict the cost of the enlargement to a minimum" (Mayhew 2004, 152). And as a consequence, in the Copenhagen European Council (December 2002), they foresaw a substantial change in form of enlargement assumed in Berlin outcome and they agreed on a further decrease in the amount of funds.

According to Giuriato (2002), by doing this, they paved the way for a prospective difference in treatment between the EU-15 and the new Member States. Though "in the past, the lower GDP-level countries that joined the EU (such as Greece, Spain and Portugal) benefited from the high budgetary expenditure of the CAP and the

Structural Funds, and the Cohesion Fund specially designed for them" (Hitiris 2003, 216), the new Member States were left with less resources in order to implement the institutional and economic reforms necessary for complete integration into the European single market. Clearly, the consequences of such an enlargement could only be managed within the present budgetary ceiling by making a reduction in agricultural spending and further concentration of the structural funds. Due to this fact, the Union tried to cope with such a comprehensive enlargement through making some reforms in its two policy areas, namely, Regional Policy and CAP. In the framework of regional policy, the number of eligibility criteria was reduced from seven to three and they agreed to concentrate the Structural Funds on the most needy areas while limiting the maximum level of Structural Fund transfers with 4 per cent of national GDP. On the other hand, in order to prevent the new Member States from receiving high level of direct income payments under the current rules of the CAP, the present Member States proposed some transitional arrangements for the new Member States and agreed on a transnational period for the farmers of these countries.

Though, the new Member States were to contribute fully to the EU budget from the first day of their accession, they would not fully benefit from the financial transfers under the current budget procedure. "By the end even the new Member States realized that there was no hope of changing the financial framework and they concentrated instead on ensuring that the resources it contained for enlargement were utilized fully" (Mayhew 2004, 147).

Even more dangerously, the financial perspective of 2007-2013 has been decided consistently with these past developments. As the new Member States are now fully integrated into the institutional structure of the EU, the task of converging them towards the average EU standard of living has become more significant. However, the present budgetary procedure and budget structure do not allow these countries to successfully implement their reforms via the financial transfers provided by the Union. "In political terms, the existing Member States do not want the new Member

States to start strategic voting, as this might challenge, even destabilize, the coalitions that have already formed around certain issues such as the CAP within the European council members" (Crowley and Rowley 2006, 45).

2.6 Conclusion

This chapter is devoted to the explanation and clarification of the factors that create substantial pressure for a budgetary reform in the EU. These factors can be summarized as the provisions of SGP, the emergence of a net contributors' club, the ongoing UK budget rebate, the eastern enlargement of the EU, and the goals of Lisbon Strategy. Though these factors seem to be unconnected with each other, they are in fact closely interrelated with one another and contribute to the acceleration of each other. The introduction of SGP and its emphasis on strong budgetary surveillance on the Member States' national budgets and fiscal policies culminated in the Member States' tendency to view their contributions to the EU budget as an area to cut down their national expenditures. The UK budget rebate and the emergence of a net contributors club helped the existing tension deepen. Furthermore, the eastern enlargement of the EU to include economically backward countries accelerated the concerns of the Member States and brought even more tension. On the other hand, the increasing international competition and the EU's inability to cope with it brought out the need for a redesign of the current EU policies, and culminated in the establishment of the Lisbon Strategy goals whose attainment require substantial levels of EU money.

At the European Council Meeting of 17 June 2005, the issue of net contributions became more and more acute. The Member States could not agree on the Financial Perspective for the period 2007-2013 due to the provisions, which foreseen the continuation of UK budget rebate. Because, according to the Commission calculations, the enlargement would have increased the UK correction by more than 50 per cent compared to the average over the last years to reach an estimated 7.1 billion Euro if the current mechanism remained unchanged (Commission 2004d).

Even more dangerously, if the current system had remained unchanged, the correction would have increased 3 times more rapidly than EU expenditure. Finally, at the European Council of 16 December 2005, the heads of governments of the Member States agreed on a financial perspective for 2007-2013 and opened the way for negotiations with the European Parliament. Particularly, the agreement could only be reached on the basis of the adjustment of the UK correction to take account of enlargement, the introduction of temporary measures to reduce the contributions of the net contributing Member States, namely, Austria, Germany, the Netherlands and Sweden, and a future general review foreseen in 2008-2009, concerning both expenditure and the own resources system.

Though, the budgetary crisis seems to calm down for now, the issues lying in its roots have not been eliminated and would be probably revived in a few years time. Therefore, the current structure of the EU budget should be definitely redesigned in order to solve the existing issues and to meet the increasing needs of an enlarged Union.

In general, the factors that are analyzed in this chapter are not related to the budgetary procedure but they impose an external pressure over the budgetary politics. Therefore, the main aim in the next chapter is to give a comprehensive overview of the structure of the EU budget and the budgetary procedure in the EU while detecting the problems peculiar to its operational characteristics. Clearly, at the end of the third chapter, it is likely to have a general opinion about almost all factors related to the budget crisis.

CHAPTER III

GENERAL BUDGET OF THE EUROPEAN UNION

The general budget of the EU is the instrument in which the forecasts and authorizations relating to all revenue and expenditure considered necessary for the Community are shown. It simply records the guarantee for the borrowing-lending operations and payments to the guarantee fund for external relations. The financial provisions related to the adoption, implementation and control of the EU budget are laid down in the Articles 268 to 280 of the Treaty Establishing the European Community (TEC). According to the Treaty, the EU budget involves expenditure related to the first, second and third pillars of the Community[4]. However, the European Development Fund (EDF), the European Globalization Adjustment Fund and the expenditures related to 28 Community Agencies are not included in the EU budget.

The Own Resources ceiling, forming the maximum amount of revenue level assigned to the EU budget, is currently set to 1.24 percent of the EU GNI. This makes the EU budget small in size when compared to the national budgets of its Member States. When the facts that the actual level of expenditure has always stayed below the ceiling in the previous financial years and "most of the policy areas that make the bulk of public expenditure – defense, education, health, social welfare and so on – remain primarily the responsibility of Member States" (Nugent 2003, 366), are taken into consideration, it becomes even more clear that the EU budget has a very modest intervention area.

[4] The Treaty Establishing the European Union, Maastricht Treaty (1992), divided the EU policies into three main areas, the so called pillars. The first pillar, namely the Community pillar, contains matters pertaining to the Single Market and four freedoms, that is, free movement of persons, goods, services and capital across borders as well as the matters related to agriculture, environment, competitiveness, etc. The second pillar consists of the Common Foreign and Security Policy (CFSP). The third pillar comprises Police Judicial Cooperation in Criminal Matters (PJCC).

In spite of its small size, however, the EU budget is quite crucial in political terms for the Member States and not surprisingly, this political importance is reflected in its cumbersome budgetary procedure.

This chapter of the thesis is devoted to giving a comprehensive overview of the EU budget and explaining it in all its aspects. The analysis begins with the budgetary principles and continues with the budget structure, namely, the revenue and expenditure items, the budgetary procedure and the budget control. At the end of the chapter, the EU budget is evaluated in terms of its economic policy functions. Clearly, the evaluation of the economic policy functions of the EU budget makes the insufficiency of the current budget structure much more clear.

3.1 The Budget Principles

According to the Council Regulation (EC, Euratom) No 1605/2002[5], the establishment and implementation of the budget should respect the four fundamental principles of budgetary law (unity, universality, specification and annuality), and the principles of budget accuracy, equilibrium, unit of account, sound financial management and transparency. Each legislative act implementing the budget has to comply with these eight budgetary principles, which are defined below;

The principle of unity and budget accuracy: means all revenue and expenditure items pertaining to the Union are entered in a single, unified budget.

The principle of annuality: According to the principle of annuality, budget appropriations should be related to a specific financial year. The appropriations entered into the budget should run from January 1 until December 31. However, considering the fact that the Community budget needs to engage in multiannual operations, it is decided that the commitments must cover a larger period than one year. As a consequence, differentiated and non-differentiated appropriations are

[5] Council Regulation (EC, Euratom) No 1605/2002 of 25 June 2002 on the Financial Regulation applicable to the general budget of the European Communities.

established and differentiated appropriations are divided into two main items, which are commitment appropriations and payment appropriations. In non-differentiated appropriations, commitment and payment are the same while they are separate in differentiated appropriations. Commitment appropriations cover the total cost of legal obligations in the financial year, which comprises operations to be implemented over a period of more than one financial year. On the other hand, payment appropriations cover the expenditure arising either from current or from previous years' commitments. "The distinction between commitment appropriations and payment appropriations is especially important in areas like the structural funds, where the implementation of programs may lead to a slow build-up of payments overtime, so that a chronic imbalance between commitments and payments may occur" (Mayhew 2003, 6).

The principle of universality: The principle of universality states that budget revenues should be assigned to the entire budget, not to particular expenditures.

The principle of specification: Although budget revenues cannot be assigned to particular expenditures, appropriations are earmarked by the Budgetary Authority for specific purposes, by title and chapter. Transfer of appropriations between titles and chapters are subject to the Budgetary Authority's approval.

The principle of unit of account: All expenditure and revenue accounts entered in the budget must be drawn up in Euro. The unit of account of the EU budget has been the Euro since 1999.

The principle of sound financial management: All transactions related to the budget should be performed in compliance with the principles of economy, efficiency and effectiveness. The objectives to be set for activities covered by the budget should be specific, measurable, achievable, relevant and timely. In addition, the institutions should carry out ex ante & ex post evaluations for significant activities and programmes and should disseminate the results.

The principle of transparency: According to the principle, the information related to the implementation of the budget and accounts should be improved. In line with this requirement, the president of the European Parliament has the obligation to make the budget published in the Official Journal of the European Communities within two months following its adoption. The Commission shall publish a summary of the budget figures within one month of its adoption on the Union's web site. In addition, consolidated financial statements and financial management reports of institutions shall be published in the Official Journal.

The principle of equilibrium: According to the Article 268 of TEC, the revenue and expenditure shown in the budget should be in balance. Consistently with this provision of the TEC, the principle requires total amount of revenue appropriations shown in the budget to be equal to the total amount of payment appropriations. In other words, the EU, unlike its Member States, is not allowed to borrow to cover its general operational expenditures. Any surplus or deficit occurred during the financial year is corrected by a decrease or increase of the Member States' contributions. Moreover, the balance, negative or positive, is to be budgeted as expenditure or revenue in the following year.

In general, the effectiveness of the principle of equilibrium is highly debated and it needs to be reassessed. On the one hand, the rule ensures the budgetary discipline and keeps the volume of expenditure under control. According to Ackrill (2000), the balanced budget rule is crucial since it has acted as a driving force for agricultural policy reforms through the 1980s and 1990s as well as it has been central to EU reforms aimed at improving the financial management of the budget. In addition, he specifies the principle as a factor further ensuring the political accountability of the Union. "The EU budget is further away from voters and the balanced budget rule is thus a means by which voters can be reassured that expenditures will not be allowed to rise without limit or effective control" (Ackrill 2000, 5). In this framework, the application of the principle is entirely appropriate for the specific case of the EU budget.

On the other hand, since it puts a constraint on the expenditures, it results in a substantial amount of inflexibility within the budget. In particular, the budget loses its ability to compensate the unanticipated changes in expenditures and revenues. Moreover, the principle has two general outcomes: the first, the budget loses its notion as a fiscal policy instrument and the second; the implication of Keynesian policies becomes impossible. A critical number of scholars studying on the issue such as Laffan (2001), Palankai (2003), and Harrop (2000) cite this aspect of the EU budget. From a general point of view, since the EU budget is not allowed to run a deficit in recession years and surplus in boom years, it cannot be used as an effective policy instrument to point out the macroeconomic problems such as inflation or unemployment. Once it is recognized that many public budgets engage in operations in order to sustain macroeconomic stability, an important difference between the EU budget and many national budgets become clear. In this framework, one can think of the EU budget as a supranational fund created to collect money and channel them to the financing of the common EU policies and institutions, nothing more.

Contrary to this view, Ackrill (2000) emphasizes the appropriateness of the principle once again. As it is explained in detail in the coming sections, the Union's expenditure is classified as compulsory and non-compulsory expenditure. The compulsory expenditure mainly consists of agricultural spending whereas the non-compulsory expenditure comprises Structural Funds thus regional spending. Ackrill (2000) argues that since the regional spending is classified under non-compulsory expenditure and its growth is inherently limited and subject to maximum rate of increase, its share in the budget is determined by policy process rather than external economic spending. Consistently with this, the agricultural spending is determined by several factors but not particularly the economic cycles or shocks to economies. Therefore, according to Ackrill (2000), the principle expenditures undertaken by the EU budget are not subject to the same fluctuations as stabilization and thus the principle of equilibrium is appropriate for the EU budget.

3.2 The Multiannual Financial Framework (MFF) and Interinstitutional Agreement (IIA)

In the EU, the budgetary priorities are determined by interinstitutional agreements. In particular, the European Parliament, the Council and the Commission come together and agree in advance on the main budgetary priorities for the following period. In line with the interinstitutional agreement, they establish a framework for the Union's expenditure in the shape of a financial perspective.

In general, the EU budget is subject to an annual adoption procedure, which is analysed in detail in the coming section. However, the maximum levels of expenditure and revenue assigned to the Union are set before the adoption of annual budget when the Union prepares the Multiannual Budgetary Framework, which indicates the EU budgetary guidelines for both revenues and expenditure over a seven-year period. Financial Perspectives and Own Resources Decision together form the basis of the MFF. The Financial Perspective shows the maximum amount and content of prospective Union expenditure whereas the Own Resources Decision sets the limits for the Union's maximum revenue.

Both the Financial Perspective and Own Resources Decision are agreed unanimously in the Council after consulting the European Parliament. In other words, all the Member States should agree before reaching a common decision. This agreement is usually reached after long hours of discussions in the Council and the outcome is mostly a compromise. In this process, the European Parliament acts as an advisory body. It does not have autonomy to intervene in the process and say the final word. Moreover, since the Council consists of the representatives of the Member States; the decisions taken here have an intergovernmental character in nature. Therefore, unlike the common EU interests, only the decisions that satisfy the national interests of the Member States are likely to be taken. Clearly, the unanimous voting of the Financial Perspective and Own Resources Decision in the Council and the European Parliament's limited role within this process hinder the democratic character of the Union and make the EU budget a centre of national bargains.

As already discussed, the Union's budget should be in balance. Therefore, the maximum expenditure level defined in the Financial Perspective should be determined in accordance with the maximum revenue level declared in the Own Resources Decision and moreover, it should be lower than the latter in pragmatic terms. The Own Resources Decision is explained in the budget structure section. Here the focus is on the nature of financial perspectives.

The financial perspectives are prepared in accordance with the rules laid down in the interinstitutional agreement. The IIA contains the table of financial perspective in its Annex I. This table defines maximum amounts (ceilings) for broad categories of expenditure. The first IIA was concluded in 1988 for the application of the 1988-1992 financial perspective. Since then the financial perspective has been updated. The Interinstitutional Agreement of 6 May 1999 between the European Parliament, the Council and the Commission on the Budgetary Discipline and Improvement of the Budgetary Procedure laid down the financial perspective for the period 2000-06. Similarly, the Union's last Interinstritutional Agreement[6] lays down the financial perspective for the period 2007-2013.

The purpose of the financial perspective is to ensure budgetary discipline while keeping the total increase in expenditure under control and ensuring the smooth running of the annual budgetary procedure. To this purpose, it imposes a dual ceiling on expenditure; one for the total expenditure and one for each category of expenditure.

Each year the Commission makes a technical adjustment to the financial perspective for the coming year so that the budget figures are updated according to the developments. As the financial perspective is drawn up at current prices, it has to be adjusted each year to take account of inflation. On the other hand, since the ceiling

[6] The Council, European Parliament and the Commission reached to a compromise on the Interinstitutional Agreement, which contains the Financial Perspective for the period 2007-2013 on 4 April 2006. And it was adopted by the European Parliament on 17 May 2006 following the official signature by the three institutions.

on the own resources is expressed as a percentage of Union's GNI, the translation of this ceiling to an absolute figure requires the most recent data on the Union's GNI.

In sum, it can be said that the Multiannual Financial Framework has been successful in many aspects. First, it has ensured a smooth conduct of budgetary procedure. Second, it has controlled the growth of Union's expenditure. And last, it has been successful in resolving the conflicts between the three main institutions, the Commission, the European Parliament and the Council. In fact, the 1990s and 2000s saw peaceful budgetary procedures compared to the 1980s. As a result, each budget was adopted in time. Consistently with its success, the MFF was intended to be institutionalised in the draft Constitution as the 'Multiannual Financial Framework'. Unfortunately, the Constitution was not approved, and the efforts to institutionalise the MFF have been postponed at least for the being.

3.3 The Annual Budget Procedure

The EU budget is subject to an annual adoption procedure. The financial perspectives provide the general framework for this annual budgetary cycle since it sets the maximum amount and composition of prospective Union expenditure. Therefore, the annual budget of the Union is prepared respecting the expenditure limits determined in the financial perspective. In the budgetary procedure, the Council and the European Parliament act as the Budgetary Authority. Furthermore, the Commission plays an important role since it prepares and proposes the preliminary draft budget (PDB) to the two arms of budgetary authority each year. "Under the Treaty, the Council and the European Parliament have joint responsibility for deciding the Community budget on the basis of proposals from the Commission" (Hitiris 2003, 90).

In general, the Union's expenditure is categorized into two parts; Compulsory Expenditure (CE) and Non-compulsory Expenditure (NCE). The Compulsory expenditure refers to the expenditure directly arising from the Treaties whereas Non-compulsory Expenditure is regarded as not originating directly from the Treaties.

The expenditure related to the guarantee section of the CAP and pensions for EU employees are accepted as the CE and all the remaining expenditures are considered as NCE. The Council has the final say over CE while the Parliament is the last authority for the NCE. Indeed, the distinction between CE and NCE determines the division of power over the budget between the Parliament and the Council. According to Altomonte and Nava (2005), this division of power between the institutions has a rationale since the expenditure originating directly from the provisions of the Treaty has already received parliamentary approval, at the national level, when the same treaty was ratified in the national parliaments.

"For compulsory expenditures, the essence is that once the policies and policy goals have been determined within the Treaty, the EU is then obliged to spend as much as is necessary to fulfill those goals" (Ackrill 2000, 2). However, when it comes to non-compulsory expenditures, the total expenditure level is limited and subject to a maximum rate of increase each year. The importance of this division between the Union's expenditures and the relative authority separation between the Parliament and the Council is clearly seen in the annual budgetary procedure during the operation of double reading mechanism.

The precise rules governing the timetable and procedures related to the drawing up and approval of the annual EU budget is laid down in Article 272 of the TEC. In pragmatic terms, the first phase in the annual budget procedure for a typical year N begins with the arrival to the Commission of the expenditure estimates submitted by five Union institutions, namely, the Council, the Commission, the Parliament, the Court of Justice and the Economic and Social Committee. In light of these estimations of each institution, the Budget Commissioner and the Directorate General for Budget (DG Budget) of the Commission prepares the PDB for the year N. During the preparation of the PDB, "the Budget Commissioner and officials from the Budget DG hold many meetings, both formal and informal, to enable the interested parties to have their say" (Nugent 2003, 375). Even more importantly, before taking a final decision on the PDB, they take into consideration the political priorities defined by the three institutions, namely, the Council, the European

Parliament and the Commission, in the trialouge meeting, which is held at the end of March in order to discuss the possible priorities for the budget of that year. Once all the Commissioners in the Commission agree on the PDB, it becomes the official PDB and is sent to the Council by 15 June of the year N-1.

Most of the detailed examination of the PDB is undertaken by the Budget Committee of the Council. The Budget Committee, a working group of national officials, examines every aspect of the PDB, chapter by chapter, line by line. Acting by a qualified majority, it agrees on the Draft Budget and forwards it to the other arm of the Budgetary Authority, in other words to the Parliament, for a first reading by mid July of the year N-1. "The Parliament's Budget Committee is the nerve-centre for the management of the budgetary process in the European Parliament" (Laffan 2001, 205). In its first meeting, the Budget Committee of the Parliament can amend the non-compulsory expenditure while it can only propose modifications to the compulsory expenditure. On the other hand, the Parliament has also the right to reject the budget in its entirety. After the relevant departments of the Parliament examine the draft budget in detail; the draft budget is returned to the Council for a second reading (late October). "Before the Council responds to the Parliament's amendments and modifications, a conciliation committee is held between the two arms of the Budgetary Authority so that the Parliament and the Council can establish what the outstanding issues are" (Laffan 2001, 205). After the Council discusses and agrees on the proposed amendments and modifications, the budget is sent back to the Parliament for its second reading by mid November. At the end of December, when the procedure laid down the Treaty is completed, the President of the European Parliament declares that it has adopted the budget.

The timetable for the budgetary procedure specified in the Treaty is illustrated below.

Table 3.1 The Timetable According to the Treaty

Expenditure estimations of all Institutions	1 July
Preliminary Draft Budget (Commission to Council)	1 September
Draft Budget (Council to the European Parliament)	5 October
Draft Budget amended / modified (European Parliament to Council)	19 November (+ 15 days)
Draft Budget (Council to European Parliament)	4 December (+ 15 days)
Adoption	19 December (+ 15 days)

As indicated previously, the Parliament has also the right to reject the budget in its entirety by a majority of its members (367/732) and two thirds of the votes cast and ask for a new draft to be submitted to it (TEC Art. 272 (8)). In this case, the Commission presents 'new proposals' to amend the Council's second reading so that both arms of the Budgetary Authority can agree in a 'third meeting'. If the Parliament does reject the new proposals once again, then the provisional twelfth arrangements are put into force in order to ensure the continuity of public service and the Union operates on the basis of month-to-month financing. In particular, a sum equivalent to not more than one twelfth of the budget appropriations for the preceding financial year is spent each month (TEC, Art. 273).

The Commission is responsible for the execution of the budget adopted by the Budgetary Authority. Although, the majority of expenditure is managed by national authorities of the Member States, the Commission has overall responsibility for the implementation of the budget within the limits of appropriations due to the principles of sound financial management (TEC, Art. 274). Apart from these responsibilities, the Commission assists at all meetings, defends the PDB and comments on the amendments throughout the annual budgetary procedure. It can also propose amendments to the adopted budget via the Preliminary Draft Amending Budget (PDAB), if there are unavoidable, exceptional and unforeseen circumstances. The

PDBA should be submitted to the Council before 1st September and treated by the Council and the European Parliament within the deadlines foreseen by Art. 272 of the TEC. In other words, the PDAB follows the same procedure as PDB.

In sum, the annual budget procedure of the Union can be expressed as successful since it operates according to a clear timetable. In addition, there is a clear sharing of competences between the budget authorities. The division between the Union's expenditures as compulsive and non-compulsive expenditures is the most obvious sign of this practice. However, it is difficult to say that there exists a power balance between the institutions. The Commission is important only to the extent that it prepares the PDB and submits it to the two arms of budgetary authority. After all, it acts only as a consultative body and fulfils an essentially servicing capacity. On the other hand, the facts that the Council has the right of final say on the compulsory expenditure, and the compulsory expenditure dominates over the majority of the Union's overall expenditure put the Council above to the Parliament and thus hinders the democratic character of the budgetary process since the Parliament is the only body that represents the interests of the European citizens. In this respect, unless "by significantly increasing the proportion of the budget over which the European Parliament has most control - non-compulsory expenditure; and by giving the Parliament some control over compulsory expenditure" (Nugent 2003, 382), the Union could not improve the legal base of the budgetary process in terms of democratic legitimacy.

3.4 The Structure of the Budget

3.4.1 The Union's Revenue - the Own Resources System

The budget of the European Union shall, without prejudice to other revenue, be financed wholly from the Communities' own resources[7]. The European Communities' own resources may be defined as revenue allocated once and for all to

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[7] The provision is enshrined in both the Article 269 of Treaty Establishing the European Community and in the Article 1 of the Council Decision of 29 September 2000 on the System of European Communities' own resources.

the Communities in order to finance its budget and accruing to it automatically without the need for any subsequent decision by the national authorities. The Communities' own resources are established, collected, paid and controlled according to the rules of the own resources system. At present, the Communities' own resources system is based upon Council Decision No 2000/597/EC, Euratom and its two implementing Regulations: Council Regulation (EC, Euratom) No 1150/2000 and Council Regulation (EEC, Euratom) No 1553/89.

The own resources of the EU budget consist of:

- Traditional Own Resources (TOR), i.e. customs duties, agricultural duties and sugar levies, are defined in Article 2(1)(a) and (b) of the Own Resources Decision. In general, TORs are considered as pure Community revenue since they are directly resulting from the application of Community legislation. In this respect, customs duties result from the application of the Union's customs legislation as well as agricultural duties are collected on imports from third countries according to the provisions of the CAP. Sugar levies, on the other hand, are imposed on producers in the sugar sector and are used to cover Union's expenditure in that sector. However, the Member States are responsible for the collection of these resources as provided for in Article 8 of the Decision and they retain 25 % of these resources as a compensation for the costs of collecting them.

The Member States establish, account for, recover and make available TOR to the Commission in accordance with the more detailed rules laid down in regulation (EC, Euratom) No 1150/2000, which implements the Own Resources Decision. Traditional own resources are made available to the Commission, on a monthly basis. The Member States credits the amount to the account opened in the Treasury or the body it has appointed in the name of the Commission.

- VAT based resource is defined in Article 2(1)(c) of the Own Resources Decision. It derives from the application of a uniform rate valid for all Member States to their harmonized VAT assessment bases determined according to the Community rules.

However, the VAT assessment base of a Member State cannot exceed 50 per cent of that Member State's GNI. In other words, it is capped at 50% of GNI. Furthermore, the maximum rate applied to the harmonized VAT assessment base is set at 0.50% of the capped VAT assessment bases.

The harmonized VAT resources base is calculated by the Member States in accordance with Directive 77/388/EEC (the sixth VAT Directive) and Regulation (EEC, Euratom) 1553/89, which defines detailed provisions for the calculation of the base. During this process, the Commission carries out controls, together with the relevant authorities in the Member States, to ensure that the VAT resources base has been determined in a correct way.

- GNI based resource is used to provide the revenue needed to cover expenditure when all other sources of financing have been exhausted. It is calculated by applying a uniform rate to the sum of all Member States' GNI (Art. 2(1)(d) of Council Decision 2000/597/EC, Euratom).

The GNI of each Member State is determined according to Community rules. In the first step, at national level, the Member States calculate their GNIs in accordance with the provisions of the European System of Integrated Economic Accounts (ESA 95)[8], while remaining in the context of their national accounting procedures. In the second step, at Union level, the Commission applies uniform control procedures to guarantee that the data submitted by the Member States are reliable and comparable.

According to the budget figures realized in 2005, the VAT based resource is calculated as 16.02 billion Euro (14.9%) while the GNI based resource is calculated as 70.86 billion Euro (66.1%) in the EU budget. As it can be easily seen in 2005 budget figures, the GNI based resource has come to play a growing and decisive role in the funding of the EU budget. The Member States pay one twelfth of the VAT and GNI based resources contained in the approved annual budget, or approved

[8] ESA 95 GNI replaced ESA 79 GNP in the area of own resources as from the entry into force in 2002 of the current Own Resources Decision 2000/597/EC, Euratom.

Amending Budget to the Commission on the first working day of each month via crediting the amount to the account in the name of the Commission (Art. 6(3)(c) of Regulation (EC, Euratom) No 1150/2000).

At the Union level, GNI based resource is regarded as the best indicator of a Member State's ability to contribute. From one point of view, this claim is prudent. Because, "since the contributive capacity is measured by the Member States' GNI shares in the EU GNI, and since the GNI resource is more and more dominant resource in the EU budget, there emerges a practically perfect proportionality of budget contributions to contributive capacity" (Altomonte and Nava 2005, 229).

Along with the definition of the Union's own resources, the Own Resources Decision also lays down the precise rules related to the UK budget rebate. In this respect, it involves the correction mechanism applied to reduce the budgetary imbalance of the UK by a reduction in its VAT and GNI based contributions to the budget. In particular, the UK is granted the right to receive back the amount calculated by multiplying the difference between its percentage share in the sum of VAT assessment bases and its percentage share in total allocated expenditure with 0,66 (Art. 4 of Council Decision 2000/597/EC, Euratom). According to the provisions of the same Decision, the cost of correction is borne by the other Member States in relation to their share of Union GNI whereas the financing share of Austria, Germany, the Netherlands and Sweden is restricted to one forth of their normal share. As laid down in the Own Resources Decision, the UK disburses an amount far below from its GNI share and respectively this practice increases the contributions of the other Member States to a level higher then their GNI shares. In this respect, Altomonte and Nava (2005) argue that the presence of the rebate completely refutes the GNI based resource being the best indicator of a Member State's ability to contribute and makes the Member States' contributions deviate from being perfectly proportional with GNI. This view is also supported by the Commission in its report (Commission 2004d). According to the report, the UK correction constitutes one important exception to the ability to pay principle and it distorts equity indirectly

since the financing of the correction by the other Member States is not proportional to GNI.
In general, the UK budget rebate pertaining to a particular budget year N is calculated at least three times. The preliminary calculation takes place during the process of PDB while the temporary and complementary calculations take place during the process of PDAB.

In the budgetary procedure, there are four different maximum expenditure ceilings. The first one of these is the own resources ceiling. The Own Resources Decision defined the current own resources ceiling for the payment appropriations of the EU budget as fixed at 1.24% of the Union's GNI while own resources ceiling for the commitment appropriations as fixed at 1.31% of the Union's GNI (Art. 3 of Council Decision 2000/597/EC, Euratom). The second one is the financial framework ceiling. In times when the Union has defined a maximum ceiling of expenditure in the financial framework, there is nothing to do with the own resources ceiling. However, if the Union has not defined a maximum ceiling of expenditure in the financial framework, then the own resources ceiling becomes important. In general, the own resources ceiling is definitive since it clarifies the Member States' maximum amount of contribution to the EU budget. The third ceiling is determined in the annual budget procedure. And the last is the ceiling of the realized expenditure, called as the outturn. Each one of these ceilings should be lower than the previous one. The hierarchy between these ceilings can be seen in Table 3.2.

Table 3.2 Ceilings, budget, outturn (in % of EU GNI)

4 Levels	Payment Appropriations		Commitment Appropriations	
	2006	2013	2006	2013
Own Resources Ceiling	1.24	1.24	1.31	1.31
Financial Framework Ceiling	1.08	0.94	1.12	1.31
Budget	1.01	-	1.09	-
Outturn (2004)	0.97	-	1.05	-

Source: European Commission.

Apart from these revenues, the budgetary surplus of the previous year, fines and other sanctions imposed by the Commission and taxes levied on EU civil servants' wages and pensions constitute other revenues of the EU budget.

3.4.2 The Union's Expenditure

The Union's resources are allocated in a way that is coherent with the political priorities defined in the Multiannual Financial Framework. Consistently, the Union's broad categories of expenditure are defined and constrained by the limits laid down in the financial perspective, which forms part of the Interinstitutional Agreement. In general, the Union's money is spent in order to finance the Union's policies, which have been particularly centered on the agriculture sector, on cohesion, on the creation of an integrated internal market and on the achievement of macroeconomic stability, and administrative expenditures. For example, in the third Financial Framework (1999) of the Union, there were eight main expenditure headings, which were;

Heading 1: Agriculture
Heading 2: Structural Operations
Heading 3: Internal Policies
Heading 4: External Action
Heading 5: Administration
Heading 6: Reserves
Heading 7: Pre-accession Strategy
Heading 8: Compensations

As we can see from Figure 3.1, which provides an outline of main categories and volumes of expenditure in the 2006 budget, EU expenditure falls under eight main headings:

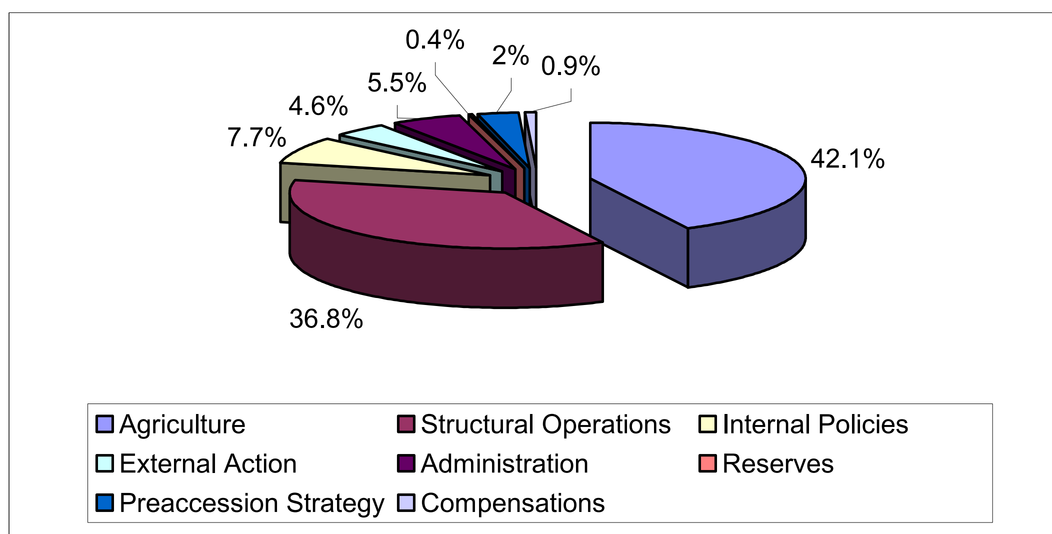

Figure 3.1 2006 Budget – Global Headings (in commitment appropriations)

In general, the expenditure under the Agriculture heading was devoted to the financing of the CAP and rural development policies. Structural Operations covered the Structural Funds[9] and the Cohesion Fund. Internal Policies contained expenditures for the financing of trans-European networks, research and innovation, education, training, energy and measures in support of small and medium-sized enterprises. Under the External Action heading, the Union financed mostly development and humanitarian aid to associate and other countries such as Mediterranean, Middle Eastern, Balkan countries. Administration heading covered the expenditure of the Union's institutions. Reserves heading of the Financial Perspective of the Union aimed at achieving flexibility in the management of the Union's finances. They were simply the monetary reserve[10], the loan guarantee reserve for non-member countries and the emergency aid reserve[11]. The pre-accession aid aimed to finance the agriculture, structural instruments and the PHARE programme for applicant countries in order to support them, while they are

[9] The Structural Funds are composed of three funds: the guidance section of the European Agricultural Guidance and Guarantee Fund, the European Social Fund (ESF) and the European Regional Development Fund (ERDF).
[10] To cover the impact of unforeseen movements in the euro/dollar parity on agricultural expenditure, abolished in 2003.
[11] To meet specific and unforeseen aid requirements of non-member countries.

transforming to be a member of the EU. Lastly, the Compensations heading covered the transitional budgetary compensations for the ten new Member States.

On the other hand, throughout the preparation process of the Financial Perspective covering the period 2007-2013, particularly, three main priorities were set for the enlarged Union. These priorities were namely sustainable development, European citizenship and the EU as a global partner[12]. In line with these priorities, the Union decided on the composition and amount of the main expenditure headings for the period 2007-2013. In this respect, the last Financial Framework was concluded consisting of six main expenditure headings. The broad categories of expenditure envisaged in the fourth financial framework for the Union are;

Heading 1: Sustainable Growth (43.3%)

- Heading 1a: Competitiveness for Growth and Employment (7.4%)
- Heading 1b: Cohesion for Growth and Employment (35.9%)

Heading 2: Preservation and Management of Natural Resources (44.4%)

Heading 3: Citizenship, Freedom, Security and Justice (1.0%)

- Heading 3a: Freedom, Security and Justice (0.5%)
- Heading 3b: Citizenship (0.5%)

Heading 4: The EU as a Global Partner (5.4%)

Heading 5: Administration (5.5%)

Heading 6: Compensation (0.4%)

In the last Financial Framework of the Union, Heading 1a has a substantial importance since it encompasses expenditure for research and innovation; education and training; security and environmental sustainability of EU Networks; support for an integrated single market and implementation of the social policy agenda, which are all defined as areas to be considerably supported and improved within the framework of Lisbon Strategy.

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[12] "Building Our Common Future: Policy Challenges and Budgetary Means of the Enlarged Union 2007-2013" Communication from the Commission to the Council and the European Parliament", Brussels, 26.2.2004.

In general, the new Financial Framework is commonly said to be more flexible compared to the previous one since it consists of six expenditure headings instead of eight. In addition, agriculture is grouped together with fisheries and environment under the Heading 2 and the main expenditure items of the Common Agricultural Policy, particularly market related expenditure and direct income payments to farmers are managed under this Heading. This is supposed to bring more efficiency in the allocation of funds. However, the financial package foresees no strategic change in order to adequately underpin the existing problematic issues, such as the UK rebate, the increasing needs of the Union because of the last enlargement and etc.

According to the final agreement on 2007-2013 Financial Perspective, the commitment appropriations of the budget are fixed at 864 316 million Euro, which accounts for 1.05% of EU-27 GNI and payment appropriations are fixed at 820 780 million Euro, which accounts for 1 % of EU GNI. Similarly, a 0.9% real annual growth is foreseen in commitment appropriations over the period 2007-2013 whereas this amount is 0.4% for the payment appropriations. Moreover, the growth of overall EU spending will be lower than EU-27 GNI growth, which is estimated at 2.3% (annual average) over the period 2007-2013 (European Commission). Since the payments appropriations are fixed at 1 % of overall EU GNI and the size of the budget remained relatively small, "there will be little room for the shift of resources in favor of research, education and institution building, badly needed to revamp growth, and the new requirements for foreign policy, defense and internal security" (Gros and Micossi 2005, 1).

In addition, a variety of instruments remained outside the EU budget. These are flexibility instrument, EU Solidarity Fund, Emergency Aid Reserve, European Globalization Adjustment Fund and European Development Fund. In sum, it can be said that the Multiannual Financial Framework is not fully satisfactory for the Union's objectives as a whole. It can be viewed as satisfactory only for some Member States that managed to maximize or remain unchanged their national interests at the end of the process.

As previously indicated, there exist many expenditure headings within the framework of EU budget. However, unfortunately, the main area of Union spending has always been the agriculture, particularly the guarantee portion of the European Agricultural Guidance and Guarantee Fund, the financial instrument of the CAP. The dominance of the agricultural expenditure over the other budget headings can be easily seen in Figure 3.2. Indeed, the agricultural expenditure has outweighed the other expenditures since the very beginning. On the other hand, the Structural Operations of the Union have always received fewer resources than the Union has needed in real. Throughout the reforms both on the budgetary side and CAP, the Union tried to lower the proportion of the agricultural spending in the overall EU expenditure. As a result, the Union managed at least a partial shift in its pattern of expenditure and increased the amount of resources allocated to the structural operations.

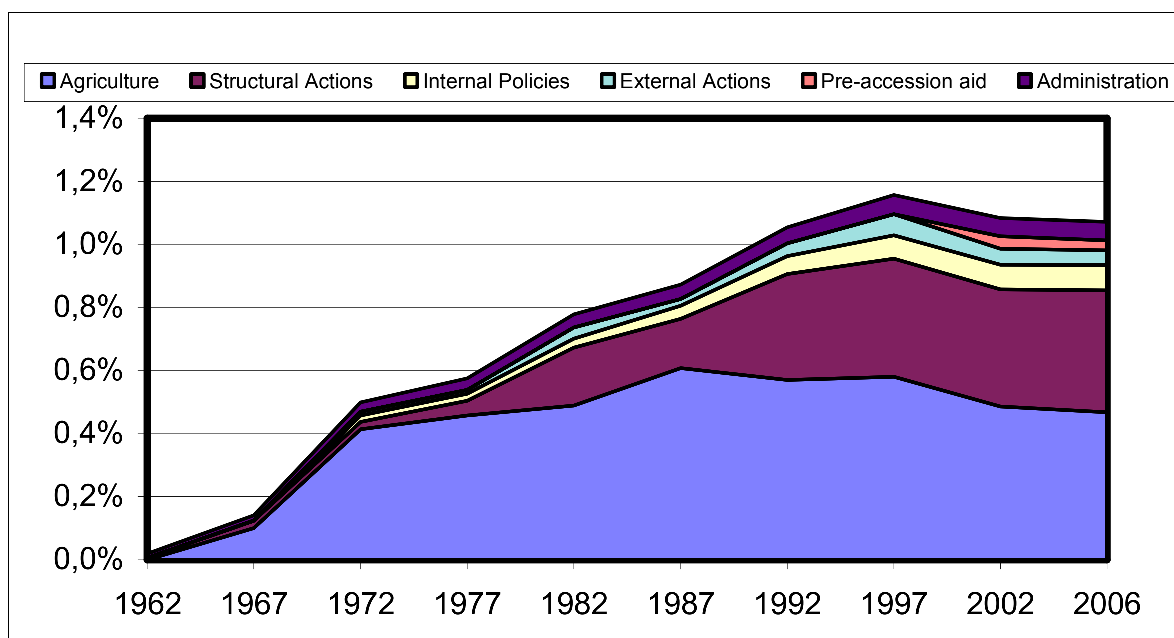

Figure 3.2 Evolution of the EU Budget (in % of GDP)

Source: European Commission

However, as it can be clearly seen both in the 2006 budget and 2007-2013 Financial Framework figures, the agricultural expenditure still continues to dominate over

other headings. In the last Financial Framework, the share of Heading 2 Preservation and Management of Natural Resources, which is 44.4 per cent is considered as almost the same with the share of Heading 1 Sustainable Growth, which is 43.3 per cent. This can be considered as an improvement when the previous dominance of the agricultural expenditure is taken into consideration. To this extent, there is nothing critical about the pattern of expenditure in the last Financial Framework. The argument arises from the fact that the Heading 1 is divided into two subheadings and Heading 1a, directly related to the attainment of Lisbon Strategy goals thus achieving competitiveness, received only 7 per cent from the EU budget. Therefore, the majority of the funds under Heading 1a are allocated to the Structural Fund actions comprising achieving convergence across the Union rather than achieving Lisbon Strategy goals. When the second Heading is divided, it is seen that the majority of funds are allocated to the main expenditure items of Common Agricultural Policy, market related expenditure and direct aids to farmers with 75.9%. Clearly, the dominance of agricultural expenditure is still the reality of the Union and the structure of the expenditure items still unfits the present requirements of the Union. Though the Union has to cope with the challenge of increasing international competition via the attainment of Lisbon goals and to this purpose, tried to make a connection between the budget and the mentioned goals under the Heading 1a - Competitiveness for Growth and Employment - in the Financial Framework for 2007-2013, the majority of the funds seem to be allocated to agriculture rather than to more acute policies such as neighbourhood policy, migration and security, internal market, prevention of climate change and energy safety and renewable energy resources.

3.5 The Budget Control

In general, the Community and the Member States should encounter fraud and other illegal activities affecting the financial interests of the Community through measures to be taken in accordance with Article 280 of the TEC. In this respect, the internal control of the EU budget is carried out by the related departments of the Commission. DG Financial Control is particularly the main department responsible

for the internal audit. On the other hand, the external control of the EU budget is given to a separate institution in order to enhance the accountability of the budgetary process. In this respect, "the technical control of budgetary execution is the responsibility of the European Court of Auditors" (Altomonte and Nava 2005, 204). The Commission submits annually to the Council and the European Parliament the accounts of the preceding financial year relating to the implementation of the budget (Art. 276 of TEC). In addition, the European Court of Auditors prepares an annual report, which contains detailed analysis of all areas of EU expenditure each year. In its report, the Court draws attention to the problematic areas concerning the execution of the budget. The Commission, on the other hand, is given the right to respond to the observations made by the Court. The report then is presented to the European Parliament together with the Court's suggestion on whether to grant political clearing or not to the Commission for the budgetary execution. The European Parliament examines the accounts submitted by the Commission together with the Court's report.

The European Parliament's role at this stage is quite crucial since it takes the political responsibility to guarantee to the EU citizens that the EU budget has been correctly executed within the framework agreed during the adoption process. By taking into account the issues outlined in the annual report of the Court of Auditors, the Parliament can give political clearing to the Commission by a qualified majority of its members, then the execution of the previous year's budget is approved. If the Parliament adopts discharge by an overqualified majority[13] of its members, this paves the way for the dismissal of the Commission[14].

3.6 Economic Policy Functions of the EU Budget

The budget is the skeleton of the state (Schumpeter 1991, 100) and it gives considerable information about the type of governance prevailing in the state.

[13] Qualified majority requires 50 % + 1 of the Parliament's members whereas overqualified majority requires 66 % + 1 of the Parliament's members.

[14] In March 1999, the European Parliament did not give political clearing for the execution of the previous year's budget. The Parliament's votes on the poor financial management of the Union's resources resulted in the resign of the entire Commission presided over by Jacques Santer.

Similarly, the budget of the EU and particularly, the structure of its revenue and expenditure items shed light on the priorities and conflicts embedded in various processes of the EU.

From a macroeconomic perspective, the public budgets perform three main functions. First, the public budgets fulfill the *allocation function* since they provide the social and public goods that are not usually provided by the market system. These public and social goods can range from infrastructure such as roads, bridges to education, defense and health systems. Second, the public budgets perform the *income distribution and redistribution activities* within the society through the operation of tax and welfare systems. Lastly, the public budgets play a crucial role in economic stabilization since they are used as fiscal policy instruments in order to ensure macroeconomic stability.

Consistently with the functions performed by public budgets, "the MacDougall Report published in April 1977 formulated the basic principles to be followed in the Community budget. According to the Report, the Community budget must also fulfil the main stabilization, allocation and redistribution functions of macroeconomic policy" (Palankai 2003, 298). The evaluation of the EU budget in terms of these three functions gives us considerable insight about the effectiveness of the EU budget throughout the years and shows us the extent it has adhered to the principles laid down in the MacDougall Report.

Allocation function: The Union has taken substantial steps on the way of creating a European common area of security and justice, which constitute an important part of the public goods. The Union also supported the development of infrastructure throughout Europe by means of Structural and Cohesion Funds. Though the infrastructure projects financed via the Structural Funds have been mainly aimed at furthering market integration, in the end they all culminated in the provision of some main public goods and improved the allocation function of the EU budget. To this extent, many scholars evaluate the EU budget as performing the allocation function.

However, on the other hand, there is neither a common EU education policy nor a standard health system across the Union. Besides, the Member States show no willingness regarding the issue. This is simply a matter of transferring national sovereignty. The Union policies and its actions have not penetrated yet in the public spheres of the Member States. In this respect, according to Palankai (2003), national budgets of the EU Member States have mainly retained their exclusive role related to the general provision of public goods and services and no significant changes can be expected in the near future.

Distributive/redistributive function: In general, taxation and compensation activities are considered as the main instruments of distribution/redistribution in a country. In case of the EU, the taxation and compensation activities still remain under the national sovereignty of the Member States. The Union has created various standards to be implemented in the Member States. However, the Member States are left free regarding the entire application. It is obvious that the Union does not directly tax and collect social security premiums in order to transfer them to less prosperous European citizens. In addition, according to Gramlich and Wood (2000), the primary goal of the Structural Funds and the Cohesion Fund is not redistribution and their small size prevents them from doing much to address economic inequalities within or across countries.

The EU has no central tax administration. It has been granted powers for receiving some part of the VAT statistically estimated by its Member States in accordance with the provisions of Own Resources Decision. As already indicated, the rules governing the calculation of VAT in each Member State are almost the same and the VAT tax systems have been harmonized, only tax rates differ to some extent. However, "it must be stressed that the rules defining tax burden in aid of the EU budget are completely different from the ones defining tax burden of the Member States' budgets" (Cieslukowski 2005, 8). Therefore, the rest of tax revenues to the national budgets are allocated according to the national preferences of the Member States. Furthermore, there does not exist a standard type of welfare system across the

Member States. For instance, there is no standard unemployment scheme across the Union that is financed wholly by the Union. As a result, the structure and coverage of the welfare systems vary across the Member States.

However, the Union has achieved considerable amount of redistribution across the Member States via the help of Structural Funds and of the support systems under the CAP (whether price support or direct income support). The Structural Funds and particularly the Cohesion Fund have been mainly channeled to the poorer Member States. The Union's financial resources have been allocated to big sized infrastructure projects, which cannot be financed by the individual efforts of the recipient Member States. Though the size of the EU budget is small and the funds allocated to the countries are inconsiderable, the effects of the Structural Funds and the agricultural support are particularly visible in countries whose GDP per capita levels lack behind the most prosperous Member States. Furthermore, the agricultural funds have substantially helped the modernization of agriculture sector, which was very weak in the beginning. As indicated previously, the creation of the CAP in 1962 paved the way for subsidizing farmers and protecting them from foreign competition by means of quotas and high external tariffs. There has been a massive redistribution of income from European consumers to the farmers and by this way the living standards of the farmers have significantly improved. Moreover, "within Europe, high tariffs and price supports have produced another important redistribution of income from countries with relatively small farm sectors, such as Britain, to those in which agriculture historically has been most important, such as France" (Ambler and Reichert 2001, 45).

In this framework, it is generally agreed that the EU budget fulfills the redistributive function of public budgets in a limited way[15]. However, the efficiency of the recent implementations is highly debated. It should be questioned whether the Union still needs to support agriculture. Altomonte and Nava (2005) state that the Structural Funds are correctly distributed across Member States, that is, according to an inverse

[15] Palankai (2003), Ackrill (2000) and Laffan (2001) considers EU budget as partially performing redistributive function via the use of Structural and Cohesion Fund and agricultural spending.

correlation with income. However, this is not the case for the entire EU budget. This simply results from the fact that though the cohesion and structural funds are mostly allocated to poorer countries, other funds particularly the CAP bias this distribution. Moreover, when the amount of Structural Funds allocated to the Central and Eastern European countries including Romania and Bulgaria in the previous and last financial perspectives are carefully evaluated and compared with the amounts allocated to the past candidate countries, it is likely to observe a serious deviation in the Union's redistributive capacity.

Stabilisation function: The EU budget was planned to finance only the administrative and organizational tasks in its early years. Clearly, as the Union has substantially grown in size both in terms of the number of Member States it involves and the number of policy areas it intervenes, the size of its budget has also grown. However, when we consider the fact that the payment appropriations assigned to the Union are fixed at 1% of total EU GNI in the last financial framework for period 2007-2013, the size of the EU budget still seems to be small in size when compared to the public budgets of the Member States. In addition, the adoption of the principle of equilibrium within the budgetary procedure does not allow the EU to carry budget deficits across financial years. In this respect, the budget loses its notion as a fiscal policy instrument since it is not allowed to run a deficit in recession years and surplus in boom years. Both the small size of the EU budget and the principle of equilibrium, as a result, prevent the EU budget from being an effective tool in terms of ensuring macroeconomic stability[16]. In fact, "an important difference is that national budgets are functional budgets, whereas that of the EU is an accounting type of budget. The budget itself is concerned mainly to raise revenues to balance its financial expenditures; it is not engaged in macroeconomic Keynesian stabilisation policies as running budgetary deficits to stimulate demand in order to reduce persistently high levels of unemployment" (Harrop 2000, 243).

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[16] Palankai (2003), Ackrill (2000), Laffan (2001), Harrop (2000) and Begg (2005) are some of the economists advocating that the EU budget does not perform economic stabilisation activities.

It is in fact a highly debated issue that the EU budget should perform the stabilization function. As already known, the Member States in the Euro zone adopts a common Monetary Policy within the framework of EMU. However, the Member States are free to implement their own fiscal policies in line with the requirements of Stability and Growth Pact. Clearly, they significantly coordinate their fiscal policies in order to reduce externalities. The Member States individually engage in macroeconomic stabilisation activities and carry the burden of financial costs of their intervention activities. Since the Union does not implement a common fiscal policy across the Union, it is practically irrelevant for the EU budget to perform stabilisation function on the current conditions.

In sum, it can be said that national budgets remain central to the allocation and distribution activities across the Union and the EU budget has respectively a very limited role. In this respect, Ackrill (2000) argues that the EU budget can be compared directly to sub-national budgets due to the fact that it undertakes distribution and allocation functions, but not have a role in economic stabilization. However, it is significant for the EU budget to perform redistributive activities in a more efficient and effective manner. In this respect, the prospective changes should focus on this issue and the Union budget should be directed towards achieving substantial redistribution via the help of its financial transfers.

3.7 Conclusion

It is clear that though the EU budget fulfilled a number of critical duties on the way of maintaining and deepening the integration process, there still exist many defects peculiar to its nature. The unanimity requirement in the Council to agree on the Multiannual Financial Perspective and the European Parliament’s limited role within this process hinder the democratic character of the Union and make the EU budget a centre of national bargains. In this respect, “unanimity for multi-annual spending decisions at the EU level is seen as the major obstacle to arriving at a genuine debate on the value added of the EU budget” (Altomonte and Nava 2005, 206).

On the other hand, the substantial rise in share of GNI resource within the overall budget revenues represents a trade-off between financial autonomy and financial sufficiency of the Union. The Commission has always advocated a larger and more supranational EU. To this purpose, it has always tried to extend the common policy areas as well as it struggled for a larger and more autonomous EU budget with more financial resources. However, the power imbalance between the Union's institutions, which is in favour of the Council and Council's institutional structure as being consisting of representatives of the Member States have transformed the EU budget into an expression of national interests of the Member States. The European Parliament, though it is the sole institution reflecting the European citizens' will, is only given limited powers in terms of decision making procedures related to the budget. Thus the Commission's efforts on the way of achieving a more supranational EU and relatively a larger EU budget were proved to be useless. On the current conditions, it is even more difficult for the Commission to improve the institutional setting of the Union as the Union is well underway of a mid-life crisis. The non-approval of the Constitution in France in May 2005 and then in the Netherlands pushed the EU to an unclear future. It's generally believed that the Union has gone too fast in the past and it has become impossible to absorb the rapid changes including the previous enlargement waves and the deepening efforts. Therefore, the Union should first tackle with the issue of Constitution and make it clear what kind of a political entity the Union is going to be in the future. Clearly, the future of the Constitution and the reform of the EU budget are directly linked to each other. Unless the future of the EU is decided, the Commission cannot take steps concerning the institutional structure of the Union. At least, the present Commission does not seem to be eager to deal with the issue and it tends to leave it to the next Commission in 2009.

In addition, the ongoing UK rebate and its inclusion in the Own Resources Decision seem to be one of the highly debated issues in the budgetary politics. At the same time, the Union still continues to support agriculture, a declining sector, and as a result, agricultural expenditures still seem to dominate over the other expenditures considered vital for the future of the Union. The dominance of agriculture over other

budget headings and comparatively small amount of financial resources allocated to CEECs result in a substantial loss in the redistributive performance of the budget. Though the financial resources are transferred from one side to another, the final beneficiaries are not the desired and rational ones.

Obviously, the continuation of the UK rebate and the dominance of agricultural expenditure in the EU budget reflect the ongoing struggle between France and the United Kingdom in budgetary politics. The fierce struggle between two countries is likely to continue unless both of them give up some part of their receipts from the EU budget. This mutual sacrifice implies two-sided reform in the budget, both on the expenditure side, which mainly consists of agriculture and the revenue side, which governs the rules concerning the UK rebate. It is sure that the final outcome is substantially dependent on the political will of the countries thus the extent to which the other gives up.

Furthermore, the adoption of principle of equilibrium in the financing prevents EU budget from being flexible across various expenditure headings and puts a strong constraint on the budget. In light of these drawbacks, it is clear that the EU budget should undergo throughout radical changes in order to have healthy budgetary governance and to realize the common policy goals of the enlarged Union. In this respect, both the structure of the EU budget, its size as well as the characteristics of its revenue and expenditure items, and the decision-making procedure should be reformed. Clearly, the political will of the Member States is quite crucial in terms of transforming the EU budget into a vehicle, which will effectively realize the common EU goals.

CHAPTER IV

HISTORICAL EVOLUTION OF THE EU BUDGET

The history of the EU can be considered as the history of the EU budget or vice versa. When the historical formation of the EU budget is carefully evaluated, it is possible to see a close connection between the evolutionary process of the common EU policies and the size and constitution of the budget. In addition, since the fact that the EU budget has always taken its final shape in accordance with the developments in the Community's common policies, particularly the Common Agricultural Policy is taken into consideration, it would not be wrong to regard the EU budget as of the same age with the Community's common policies. Whenever a new common policy has been introduced within the process of European integration, the size of the budget has increased respectively. This view is reinforced with the consideration of the fact that the establishment of the CAP in 1962 was entirely interconnected with the establishment of the Community's own resources in 1971 in order to increase the financial resources of the Community.

Moreover, the introduction of a new policy area, whether common or not, which falls fully or partially under the competency of the Community, brings out the need for the inclusion of separate expenditure items in the budget. In the 1970s, the inclusion of relatively poorer Member States, namely Ireland and the UK, into the Community highlighted the issue of increasing regional disparities within the territories of the Community. In order to reduce these regional discrepancies by simply financing the investment projects in the lower income regions of the Community, the Community established a financial instrument, namely the European Regional Development Fund (ERDF) in 1975. Well before the launch of the ERDF, the Community had decided to eliminate the defects within the labour market. As a consequence, the Community established the European Social Fund (ESF) with the aim to support training, retraining and mobility of the labour within the labour market. Moreover, the

Mediterranean enlargement in order to include economically backward countries, namely Spain, Portugal and Greece in the 1980s, brought out the need for more financial resources to be allocated to these regions. The per capita incomes of the countries were far below the Community average and their economies were not well developed enough to compete with the competitive forces existing in the EU economy. Therefore, they had to be substantially supported with the Community resources in order to catch up with the Community average. Consistently with this need, the Union created Cohesion Fund in 1992 in order to provide additional finance to the investment projects in infrastructure and transportation in these countries.

The respective introduction of new structural funds within the framework of European Regional Policy and the establishment of the Cohesion Fund in the following years forced the Community to increase the financial resources and particularly financial autonomy of the Community. The increasing amount of financial transfers going out to the backward regions[17] under the name of structural funds and to the Member States that were agrarian[18] under the name of CAP were all to be financed by these newly created budget items. Thus the CAP and Structural Funds became the two main areas that the Community's financial resources drained to. From the end of 1970s until today, it is possible to witness the continuing struggle between these two budget items.

As previously indicated, the history of the EU can be considered as the history of the EU budget or vice versa. Indeed, the integration views that have been dominant throughout the process of European integration have considerably affected the evolution of the EU budget. The European integration project in the early years of 1970s was mainly structured in line with the interests of federalists. The federal thought, which insisted on more supranational Community structuring, emphasized on giving financial autonomy to the Community and thus allocating more resources

[17] Ireland, Spain, Portugal and Greece were the main beneficiaries of the Structural Funds and the Cohesion Fund.
[18] France was substantially benefiting from the agricultural funds.

for the implementation of Community policies. The financial autonomy need of the Community was met by the establishment of Own Resources System. Similarly, the time period between the Community's early years and today witnessed this pattern of relationship between the dominant political priorities and the shape and share of the Own Resources in the EU budget.

In spite of its small size and respectively very modest intervention capability, the EU budget is politically important for the Member States. The creation of the Community's own resources in 1971 and the gradual increase in the level of Community expenditure in the successive years, caused the Member States become more concerned about where, for what, and how the EU money is spent. Thus they began to engage in budgetary politics. Regarding the issue, Laffan and Shackleton (2000) state that in addition to the increasing budgetary negotiations among the Member States, the two institutions of the Community, European Parliament and the Council, began to struggle with each other. From 1975 onwards, the European Parliament was only given budgetary powers to a modest extent, but no real legislative powers at all. It therefore used the budget as a tool to assert its limited powers. According to the Commission, this view clashed with the Council's, who was the sole legislative body at that time. As a consequence, many incidents occurred in 1980s. The European Parliament occasionally rejected the draft budgets for 1980, 1985, 1986 and 1988 and so that provisional-twelfth arrangements had to be applied for periods of five to six months as well as several actions were brought before the Court of Justice.

However, by looking at the general picture, "we shall also discover that there was a move from a highly conflictual budgetary process towards a more institutionalized pattern of budgetary making" (Laffan 2001, 195). The main reason for this modest change in the pattern of institutional relationships in terms of budgetary politics is mainly the introduction of multiannual financial frameworks agreed among the European Parliament, the Council and the Commission. With the launch of multiannual financial frameworks, the three institutions playing several roles

throughout the budgetary process have found the opportunity to come together and negotiate all their priorities before the approval of the overall Community budget. In this regard, the multiannual financial frameworks and the consequent interinstitutional agreements have served as a crucial arena to discuss and compromise. Therefore, the conflicts and aggravations between the institutions have not been carried to the budgetary negotiations at the Council to some extent.

In this chapter, the primary aim is to give the historical evolution of the EU budget. To this purpose, the reform packages that the EU budget underwent from the very beginning are analysed. At the same time, the implications of the previous enlargements on the EU budget are determined. This analysis will simply set the basis of the claim concerning the Eastern enlargement of the EU to be substantially different from the previous ones in terms of budgetary matters. In this framework, the history of the EU budget until the year 1999 is divided into four parts in order to make the analysis more profound and simple to determine the significant changes for the purposes of the study. The third Financial Perspective of the Union for the period 2000-06, in which all the budgetary implications of the Eastern enlargement could be seen, is not included in this chapter since it is analyzed in the successive chapter in a more comprehensive manner.

4.1 Formative Period (1952-1969)

Dividing the history of the EU budget into several parts is a difficult issue since the events substantially affected the other developments after them and they all acted within the framework of a chain reaction. The periods used as the basis of the analysis in this chapter are also inseparable within themselves and one period cannot be separated from the other periods as well as they cannot be thought individually. However, to make the analysis simpler and more profound, it is necessary to emphasize on small time periods and then compare the developments occurred during them. To this extent, the divisions between periods are made according to the context of budgetary politics.

In the first period between 1952 and 1969, which is also inseparable from the successive periods of 1970s and 1980s, the foundations of the Union's budget and so finances were established. The Community budget did not deal with substantial problems and witness intense budgetary conflicts throughout this period. It was a time for peace since the Community was newly born and its financial needs were relatively small.

As Laffan (2001) states the evolution of the financial resources of the EU budget can be traced back to the early years of European Coal and Steel Community (ECSC) in 1952. In line with the provisions of the Paris Treaty (1951) establishing the ECSC, the six Member States agreed to finance the Community expenditures through the taxes raised by the High Authority (later the Commission) until the signing of the Treaty of Rome (1957). These taxes were simply the levies imposed on the coal and steel industries. "The Treaty of Rome, establishing the European Economic Community (EEC), marked another stage in the formation of the financial resources of the Community, since it made a provision for two financial instruments: the European Social Fund and the European Investment Bank (EIB)" (Laffan 2001, 196). The main aim of ESF was to support labour market related measures in order to ensure the smooth functioning of the labour market and thus mobility of labour within the common market. On the other hand, the financial resources allocated via the EIB were targeted to finance the investment projects in the economically backward Member States in order to help them better integrate into the common market. However, these financial instruments proved to be insufficient to finance the increasing needs of the Community in time.

4.2 The Crisis in the Community's Finances (1970-1988)

The introduction of the European Agricultural Guidance and Guarantee Fund (EAGGF) in 1962 was a turning point for the Member States as they confronted with respective increases in revenue needs and the need for own financing of the Community. As a consequence, in the Luxembourg Treaty (1970), which is also

known as the Budget Treaty, the Member States agreed upon a new revenue base for the budget, which were enshrined in the Own Resources Decision.

According to provisions of the Luxembourg Treaty, the new revenue items of the Community budget were three consisting of;

- customs duties on all imports into the Union,
- agricultural levies on agricultural imports into the Union,
- up to 1 per cent of the value added tax collected in the Member States.

The provisions of the Luxembourg Treaty also included the introduction of a distinction between the compulsory and non-compulsory expenditures, where the European Parliament was only given moderate say on non-compulsory expenditures and excluded from deciding on the volume and content of compulsory expenditures on the other hand. The European Parliament was also given some power to adopt the annual budget; however, the budget discharge was to be carried by the joint decision of the Council and Parliament.

Though the own resources were consisting of three revenue items, only two of them were initiated to fully function. It was substantially difficult to establish a common VAT system across the Member States and to determine a common base for VAT assessment. These difficulties resulted in the postponement of the introduction of VAT based resource until 1979.

As already discussed in the previous chapters, the creation of own resources of the Community was a turning point for the Commission for many reasons. It was the first concrete attempt on the way of giving the Community financial independence from its Member States since the Community did not have its own resources at first; rather, it relied on national contributions to match its expenditures. By this way, the Community and in particular the Commission, the body continuously striving for a more supranational Community since the beginning, would enjoy the opportunity of supporting the common Community policies necessary for the market integration and financing European public needs.

According to Laffan and Shackleton (2000), the creation of new revenue items can also be considered as a reaction and measure taken before the coming enlargement to include Ireland, the UK and Denmark. In general, the founder Member States were aware of the fact that the first enlargement of the Community was prone to many budgetary conflicts and that they had to prepare the Community finances in order to lessen these prospective conflicts in advance. To this purpose, they met at the European Summit of Hague in December 1969 prior to the Luxembourg Treaty and fixed the rules before the advent of UK and Ireland. In fact, own resources were created in order to meet the expectations of the existing Member States, not the prospective comers. In addition, the financial resources were automatically canalized to the financing of the CAP, again serving for the needs of the existing Member States. The French government was the sole victor since it was assigned to a major part of the agricultural funds. And the loser was surely the UK, since it would receive considerably less from the CAP and was expected to contribute more under the revenue rules of the own resources. However, the UK was so volunteered to play the game according to the rules set by the existing Member States that it began to struggle for its own interests from the year of its inclusion onwards. Its gradual dissatisfaction culminated in the temporary solution for its budgetary imbalance at the Fontainebleau European Council in 1984, whereby it achieved to get a correction mechanism, commonly known as the UK rebate[19].

The Luxembourg Treaty was followed by Brussels Treaty in 1975. The Brussels Treaty can be considered as a success for the European Parliament to the extent that the Parliament was granted budgetary powers. According to the provisions of the Treaty, co-decision procedure was made the norm for the adoption of the annual budget and the competences of the institutions over the compulsory and non-compulsory expenditures were redetermined. The Parliament gained the power to say the last word on compulsory expenditure as well as it was given the right to reject and approve the annual budget and to grant discharge. In addition, the Court of

[19] As indicated in a detailed manner in the second chapter, at the Fontainebleau European Council (1984) the Member States agreed on a correction mechanism for the UK, in which it would receive back 66 per cent of the difference between its share in revenues and share in allocated expenditure.

Auditors was established by the 1975 Brussels Treaty in order to ensure budget control. To this extent, the decision-making powers on budgetary matters were shared between the Council and the Parliament. In the following years, it became likely to witness the Parliament's efforts to influence the budgetary process vis-à-vis the Council.

4.3 Delors I Package (1988-1992)

Despite their brilliant advent, the own resources of the Community soon became inadequate in financing the increasing levels of Community expenditure. The financial capacity of the Community was compelled by inclusion of new and poorer Member States in the Mediterranean enlargements[20] of 1981 and 1986 and increasing number of policy areas that the Community needed to intervene in order to support market integration. Cohesion became the largest obstacle blocking implementation of the single market program in 1987 as the poorer Member States had to be provided with greater resources under the European regional and social policy in return for market liberalisation.

On the other hand, the VAT based resource was regressive in its nature because the proportion of consumption to GDP was higher in poorer countries, which made the VAT base a relatively higher proportion of GDP for these countries. On the other hand, as Neal and Barbezat (1998) state high saving, net-exporting countries benefited a relatively lower VAT base. In this respect, the VAT based resource was creating inequity among Member States. Moreover, traditional own resources, which represented the only truly fiscal own resources of the Community have been decreasing as a result of the GATT and WTO decisions. "The proportion of customs and agricultural duties in income fell from about 50 % in 1980 to less than 34 % in 1987, while the proportion of VAT contributions rose from 42% to 66 %" (Palankai 2003, 304). In these circumstances, the current revenue base was not sufficient and fair enough to finance the increasing Community expenditures.

[20] Greece joined the Community in 1981 while Spain and Portugal became members of the Community in 1986.

As a reaction, the Commission led by Jacques Delors introduced a GNP based resource in 1988 as part of the Delors I Package in order to balance the Community's expenditures with its revenues. In general terms, as Dinan (1999) states, the Single European Act was an attempt to revitalize the European integration process through making changes on the current institutional and policy structures and extending the competences of the Community to cover some additional policy areas such as competition, research and development, consumer affairs and monetary policy. Consistently with this aim and to back up the policy changes, the EU budget had to be also restructured and endowed with necessary resources. In this framework, the launch of Single European Act was accompanied by two sets of proposals, commonly known as the 'Delors I Package', *Making a Success of the Single Act* and *Report on Financing of the Community Budget*. The Commission president, Jacques Delors, was a supranationalist, always striving for stronger Community institutions and policies. He is generally credited with the Community's metamorphosis (Dinan 1999, 103). He was the one to struggle and proceed with the single market program as well as to launch the EMU to capitalize on the single market's success. His personal objectives in terms of Community politics were all reflected in the EU budget and constituted the core of the EU finances in the late 1980s and early 1990s.

One of the most significant novelties of the Delors I Package was the introduction of the first Financial Framework for the period 1988-92, which can be seen in Table 4.1. Accordingly, the Package was accompanied by the first Interinstitutional Agreement between the Commission, Parliament and the Council.

Table 4.1 Delors I Financial Framework, 1988-1992 (million ECU at 1988 prices)

Appropriations for Commitments	**1998**	**1989**	**1990**	**1991**	**1992**
1. EAGGF Guarantee Section	27 500	27 700	28 700	29 000	29 600
2. Structural Funds	7 790	9 200	10 600	12 100	13 450
3. Policies with multi-annual allocations	1 210	1 650	1 900	2 150	2 400
4. Other Policies	2 103	2 385	2 500	2 700	2 800
5. Repayments and Administration	5 700	4 950	4 500	4 000	3 550
6. Monetary Reserve	1 000	1 000	1 000	1 000	1 000
Total	***45 303***	***46 885***	***48 900***	***50 950***	***52 800***
of which:					
- compulsory expenditure	33 698	32 607	32 810	32 980	33 400
- non-compulsory expenditure	11 605	14 278	16 090	17 970	19 400
Appropriation for Payments	***43 779***	***45 300***	***46 900***	***48 600***	***50 100***
of which:					
- compulsory expenditure	33 640	32 604	32 740	32 910	33 110
- non-compulsory expenditure	10 139	12 696	14 160	15 690	16 990
Appropriations for Payments	1.12	1.14	1.15	1.16	1.17
Own Resources ceiling as % of GNP	1.15	1.17	1.18	1.19	1.20

Source: Interinstitutional Agreement (OJ C 331, 7.12.1993).

In general, the main elements of the Delors I Package were;

- In addition to the three own resources established in 1970, the GNP based resource was included to the own resources of the Community.
- By the introduction of the fourth resource, there occured a sizeable increase in the overall financial resources available to the Community. With the Delors I Financial Framework, the maximum ceiling of the budget was increased to 1.2 per cent of the EU GNP. On the revenue side, the Package created a ceiling of 1.3 per cent of EU GNP for commitment appropriations and 1.2 per cent for payment appropriations.
- An agricultural guideline was introduced in order to ensure budgetary discipline in the agricultural expenditure. The Council laid down the principle of containment of agricultural expenditure whereby the annual rate of growth in agricultural expenditure must not exceed 74 % of the annual rate of growth of Community GNP. The 1988 agricultural expenditure figure was taken as the basis of the calculation in later years. In fact, this was the first Community attempt to control the increases in agricultural expenditure, which already reached enormous levels and constituted 80 per cent of the overall budgetary expenditure in 1979.
- The UK rebate was decided to be continued.
- The amount of structural resources allocated to the less prosperous areas of the Community was doubled for the period 1988-92. "The Council decided that the growth of the Structural Funds should be guaranteed in the medium term: the commitment appropriations in 1993 would be twice as high in real terms as in 1987" (Commission 2002a). For the purposes of rationalisation, the Council also decided that the Community funds would be targeted according to the following five general objectives:
    1. "objective 1: promoting development and structural adjustment in less-developed regions (ERDF, ESF and EAGGF Guidance Section)
    2. objective 2: converting the regions, frontier regions or parts of regions (including employment areas and urban communities) seriously affected by industrial decline (ERDF and ESF)
    3. objective 3: combating long term unemployment (ESF)
    4. objective 4: facilitating the occupational integration of young people (ESF)

5. objectives 5a and 5b: with a view to reform of the common agricultural policy, speeding up the adjustment of agricultural structures and promoting the development of rural areas (objective 5a EAGGF Guidance Section; objective 5b EAGGF Guidance Section, ESF and ERDF)" (Commission 2002a).

"By increasing the structural funds the 1988 reform strengthened the redistributive functions and cohesive effect of the budget" (Palankai 2003, 305). The less prosperous countries, namely Greece, Ireland, Portugal and Spain, benefited more since "they linked the completion of the internal market to an increase in structural funds, designed to reinforce economic and social cohesion" (Laffan and Shackleton 2000, 220). In general, nearly 65 % of all structural funds was planned to be allocated to the implementation of the first objective. After a number of assessments, seven Member States were qualified as eligible to get funding under objective 1. Moreover, all regions of Greece, Ireland and Portugal were defined as eligible to get the necessary funding.

Also the UK was advantageous as it managed to maintain its rebate without any changes. Though an agricultural guideline was established, a radical reform on the CAP was not yet on the way; therefore France as the gatekeeper of the agricultural funds was still advantageous.

On the other hand, the attempts to keep the agricultural expenditure under control with the introduction of the agricultural guideline served for the benefit of the other Community policies and signaled the move away from agricultural expenditure towards other policy fields. As well as doubling the funds allocated to structural funds, the Delors I Package also doubled the resources allocated to the internal policies such as education and training, research and so on. After that time, the share of structural funds in the budget has began to increase while the share of agricultural expenditure slightly decreased. "In 1988, CAP amounted to 60 per cent, structural expenditure to 17 per cent and research to 2.5 per cent of the EU budget, while in

1992 the same percentages were respectively 56 per cent, 25 per cent and 4.5 per cent" (Altomonte and Nava 2005, 210).

During the negotiations in order to reach an agreement on the Delors I Package, there were tense arguments on the overall size of the budget, the commitment of resources to economically backward regions and the need to discipline and streamline the CAP expenditure. The battle was multisided but indeed always between various coalitions formed in the Council. The main net contributing Member States to the budget were struggling for a smaller EU budget whereas the poorer countries receiving financial resources under the structural funds and other Community policies were endeavoring for a larger EU budget. On the other hand, the Member States benefiting most from agricultural funds, particularly France was trying to keep the CAP untouched while the countries paying the bills of the CAP, was forcing for a reform on it. However, despite the diverse desires of these extremes, the outcome was always a compromise and did not serve the entire desires of any individual state. From this point of view, the Delors I Package can also be considered as a compromise. However, according to Laffan and Shackleton (2000), it was the most successful compromise reached in favor of the Community. No other deal in terms of budgetary decisions became as successful as the Delors I deal. In this respect, "the Delors I Package was a major negotiating success for Jacques Delors and the Commission: the Commission claimed with some justification that they got 90 per cent of what they wanted" (Laffan and Shackleton 2000, 220).

4.4 Delors II Package (1993-1999)

After the first financial framework of the Community for the period 1988-92 expired, there came the urgent need to formulate another financial framework. The Community expenditures were continuously increasing as the Community engaged in new enlargement waves and new policy areas. "In particular, there was a need to take account of the financial impact of the reform of the common agricultural policy which started in 1992; to take stock of the reform of the Structural Funds and to adopt a new regulation, since the framework established in 1988 would be expiring

at the end of 1993; and to guarantee the development of policies needed for the internal market to run smoothly and to provide the Community with sufficient resources to meet its new international responsibilities" (Commission 2002a).

The second financial framework of the Community was agreed on the same pattern of the first one. Similar to the political link established between the Single European Act and the first budgetary reform, the second budgetary reform was also linked to the Treaty of Maastricht (TEU). "The Commission launched its Delors II proposals in the European Parliament in February 1992, just five days after the TEU was formally signed, with its document *From the Single Act to Maastricht and Beyond: The Means to Match our Ambitions* " (Laffan and Shackleton 2000, 222). The final structure of the 1993-1999 Financial Framework is illustrated in Table 4.2.

The negotiations to reach an agreement on the new medium term financial framework for the period 1993-1999 were mainly tenser than the negotiations on the previous financial framework since this time there were more Member States divided by fierce arguments. The two main issues were simply the amount of money allocated to the poorer Member States and the content of competitive measures designed to rescue the Western European economy from a general recession (Commission 2002a).

Table 4.2 Delors II Financial Framework, 1993-9 (EUR 12), (million ECU at 1992 prices)

Appropriations for Commitments	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**
1. CAP	35 230	35 095	35 722	36 364	37 023	37 697	39 389
2. Structural Funds	21 277	21 885	23 480	24 990	26 526	28 240	30 000
Structural Fund	19 777	20 135	21 480	22 740	24 026	25 690	27 400
Cohesion Fund	1 500	1 750	2 000	2 250	2 500	2 550	2 600
3. Internal Policies	3 940	4 084	4 323	4 520	4 710	4 910	5 100
4. External Action	3 950	4 000	4 280	4 560	4 830	5 180	5 600
5. Administration	3 280	3 380	3 580	3 690	3 800	3 850	3 900
6. Reserve	1 500	1 500	1 100	1 100	1 100	1 100	1 100
Monetary Reserve	1 000	1 000	500	500	500	500	500
External Action:							
Loan guarantees	300	300	300	300	300	300	300
Emergency Aid	200	200	300	300	300	300	300
Commitment Appropriations, total	***69 177***	***69 944***	***72 485***	***75 224***	***77 789***	***80 977***	***84 089***
Payment Appropriations, total	***65 908***	***67 036***	***69 150***	***71 290***	***74 491***	***77 249***	***80 114***
Appropriations for Payments as % of GNP	1.2	1.19	1.20	1.21	1.23	1.25	1.26
Own Resources Ceiling % of GNP	1.2	1.20	1.21	1.22	1.24	1.26	1.27

Source: Interinstitutional Agreement (OJ L 185, 15.7.1998).

The main elements agreed on the Delors II Package were;

- The maximum ceiling of the EU budget was raised from 1.2 per cent to 1.27 per cent of the EU GNP; however this budget ceiling was significantly lower than the 1.37 per cent originally proposed by Delors Commission.
- It was agreed to increase the share of the GNP resource in the budget while the existing 1.4% maximum rate applicable to the uniform VAT base was to be retained until 1995, but would be reduced from 1.4% to 1% in equal steps over the period 1995-99. This was mainly the concrete step of the desire of correcting certain regressive aspects of the existing system, particularly the VAT based resource.
- "The total amount of expenditure earmarked for economic and social cohesion increased by 75% from just over ECU 17 billion in 1992 to ECU 30 billion in 1999" (Commission 2002a).
- The Cohesion Fund, a new instrument, was introduced to finance infrastructure, transport and environment projects in countries with a per capita GNP below 90% of the Community average (Greece, Spain, Portugal and Ireland) in order to support their efforts towards economic convergence in the context of EMU.
- The increase in amounts available for internal policies was fixed at 30% over seven years. Actually this increase was less than the Commission and the European Parliament would have wished since the Member States were unwilling to see a substantial increase in expenditures related to the areas such as research and expenditure, trans-European networks, education, industry, culture and etc.
- The procedure concerning the agricultural guideline was left unchanged. Moreover, the agricultural guideline was raised by 74% of the percentage increase in GNP generated by enlargement (Commission 2002a).
- a new expenditure heading for external actions was included in the financial framework as well as two new reserves were established. The monetary reserve was established within the framework of the Delors I Package in order to contend with developments caused by significant and unforeseen movements in the dollar/ecu market rate. In addition to this, the Union agreed to establish an emergency aid reserve for non-member countries and a loan guarantees reserve to cover possible

calls on the guarantee granted by the Community for loans to non-member countries. By this way, the Member States recognize the fact that Cold War division was finished and there came the time for the EU to enhance its role in the relations with Eastern Europe.
- The mechanism for correcting budget imbalances of the UK was decided to be retained.

“The Delors II Package was the budgetary response to two major political events: the desire of the existing EU countries to achieve in the medium term the Economic and Monetary Union, and the desire of the Eastern European countries to undertake the necessary reforms of their economy and their political systems so as to be able, in the medium term, to join the EU” (Altomonte and Nava 2005, 210). In this framework, the second financial framework of the EU included a pre-enlargement expenditure mainly directed at improving the administrative capacity of the candidate countries and facilitating their alignment with the *acquis communautaire* under the external action heading.

On the other hand, a new procedure for interinstitutional collaboration in budgetary matters was introduced. This new procedure initiated the exchange of views on budget priorities and conciliation on compulsory expenditure. By this way, as stated in the Commission report (2002a), the European Parliament gained the right to initiate a dialogue with the Council on the amount of compulsory expenditure to be entered in the budget, even though the Council had the ‘last word’ on the matter.

The second financial framework of the Union coincided with the enlargement negotiations with Norway, Austria, Finland and Sweden. As it has been always the same, the budget became a decisive factor in concluding the accession negotiations. “In view of their relative prosperity, the applicant countries would contribute more to the Community budget than they might expect to receive by way of expenditure” (Commission 2002a). In fact, the accession countries had worries regarding the contribution to the Union budget and they requested to obtain a gradual ‘phasing-in’

of the own resources system. However, for the part of the Union, the implementation of a transitional period for these countries was only applicable in case of a loss of income. In any event, it was important for the Union not to find itself in a more difficult financial situation than previously after the enlargement was concluded.

At the end of the negotiations, the accession countries accepted to contribute fully to the own resources of the Union from the first day of their accession. In turn, the Union agreed to pay them budgetary compensations, commonly known as the ‘agri-budgetary’ package. The Union also created new channels within the scope of the Structural Funds, through which the accession countries could benefit in order to decrease their regional disparities. In this framework, a new objective was introduced in addition to the previous five objectives of the regional policy of the Union. The new objective was targeted to the regions with a population density not exceeding eight inhabitants per km^2. In particular, the main aim was to cover sparsely populated Nordic areas through the transfer of ERDF, ESF, EAGGF Guidance Section funds.

In general, as it can be seen in Table 4.3, the expenditure on CAP continued its decreasing trend and by 1999, the expenditure on CAP dropped to 46 per cent of the EU budget whereas the structural expenditure rose to 36 per cent, internal policy to 6 per cent and external expenditure to 4 per cent.

Table 4.3 The Structure of expenditures of the EU budget (as %)

Year	CAP	Structural Operations	Internal Policies	External Policies	Admini-stration	Reserves	Preacces-sion Aid
1970	92	5			3		
1980	69	16	2	3	5	5	
1985	70	14	3	4	5	4	
1990	58	24	5	3	5	5	
1995	50	31	6	5	5	3	
2000	46	36	6	4	5	1	2

Sources: European Economy and Bulletin of European Union. General Budget of the European Community, General Budget of the EU, Court of Auditors

4.5 Conclusion

In the early years of the Community, the agricultural policy was by far the dominant Community policy since it was supported by one of the ambitious founding countries, France. This political dominance culminated in the budgetary allocations in favor of the CAP expenditure.

However, throughout the years, this pattern of expenditure began to change and the budgetary politics shifted towards ensuring more solidarity and cohesion rather than supporting agriculture. With the inclusion of relatively poorer countries, diminishing regional disparities across the EU Member States became an urgent need and the EU responded to this need by increasing the share of structural funds in the overall EU budget, which in turn resulted in lower share of the CAP expenditure. Clearly, this shift improved the redistributive function of the EU budget as it channels resources from the rich to the poor. While Germany became the largest net contributor to the EU budget followed by Austria, Netherlands and Sweden, cohesion countries, Greece, Ireland, Spain and Portugal became the main beneficiaries.

The efforts to control the rise in the agricultural expenditure became the most controversial subject in the budgetary politics during these years. In general, there were two choices in front of the Member States; either to make a radical reform in the CAP by reducing the price supports and making the CAP re-nationalized thus reducing the burden of agricultural expenditure on the EU budget or to postpone its reform to prevent a train crash, all the effects of which would be felt in every EU policy. Except the 1992 MacSharry reforms in the CAP, which brought moderate cuts in the agricultural support prices and compensation of these price cuts partially by direct payments to farmers, the Member States remained reluctant to both make a fundamental reform in the CAP, towards totally eliminating the price supports, and to abolish the UK rebate, an item gradually becoming a major source of trouble. Thus instead of introducing reforms in the so-called trouble areas of expenditure, they preferred to preserve the status quo.

In the light of two budgetary reforms studied in this chapter, it becomes easier to observe the tendency of EU politics to support the new entrants with more financial resources. The first enlargement to include Ireland, the UK and Denmark was preceded by the establishment of "own resources", which effectively provided additional resources. Similarly, the budget was expanded after the Mediterranean enlargements of the 1980s. Besides the increase in the overall size of the budget, the new entrants were supported with additional financial instruments such as the Cohesion Fund and other Community programmes. In this respect, the Eftan enlargement of the Union in January 1995 to include Austria, Finland and Sweden was slightly different since the three new entrants were more affluent and all potential net contributors to the EU budget.

It is obvious that the EU responded to both internal and external developments throughout these years by making substantial changes in its policies and respectively in the structure of its budget. The size of the budget increased while its content changed at the same time. It became more redistribution oriented with the increases in the shares of structural funds. Though fierce negotiations were witnessed over the budgetary politics, the Member States in the end agreed to endow the EU budget with additional resources. This is critical since the third financial framework of the Union for the period 2000-06 points out a radical change in the views of the Member States. From many aspects, the Agenda 2000 proposals formed the basis of the third financial framework and similarly the Berlin Presidency conclusions indicate a break point in terms of budgetary concessions given in the previous enlargements. In this respect, the following chapter is devoted to demonstrating this shift in pattern in the budgetary deals.

CHAPTER V

POLICY CHALLENGES AND BUDGETARY IMPACTS OF EASTERN ENLARGEMENT OF THE EU

The last enlargement of the EU to include the Central and Eastern European countries is considered to be substantially different from the previous enlargements since it has not been accompanied by an expansion of EU budgetary resources as it was the case in previous enlargements despite the large number of countries waiting for accession. It was obvious from the very beginning that the accession of a large number of poorer countries, which were mainly agrarian and with great regional disparities would pose a major challenge to both sides.

Agriculture had a high importance for the economies of the CEECs since it constituted nearly 7% of GDP compared to 1.7% in the EU-15. However, low labour productivity of the sector and the unfavorable farm structure in the candidate countries, in particular the large number of small farms and the existence of durable semi-subsistence farming were the potential problems in terms of the CAP. The ten CEECs would increase the number of farmers by 120% and add to the area under cultivation by 42% (Swinnen 2002). Therefore, it was very likely that the enlargement would substantially increase the cost of the CAP, which already accounted for 45% of the total EU budget. Above all, the candidate countries had very low GDPs compared to the EU-15. Both before and after their accession, they would have to make a considerable investment in transport and infrastructure in order to reduce regional discrepancies and to catch up with the EU-15. In addition, they would have to establish the necessary institutional structure in order to effectively implement the *acquis communautaire* after their accession. Considering their relatively low per capita GDPs, it was clear that the financing of these huge investment projects in the candidate countries could only be financed via the Structural Funds of the Union.

On the other hand, the existing Member States were pressed by the fiscal constraints emerged from the implementation of Stability and Growth Pact as they were preparing to enter the third stage of the monetary union. The fiscal constraint upon the national state budgets combined with the ongoing economic downturn across the Union. Certainly, the inclusion of economically backward countries would compel the existing Member States to make larger financial transfers to the Union budget. However, they were all reluctant to finance additional budgetary contributions caused by the enlargement. In this framework, when Eastern enlargement became a likely prospect for the Union in the early 1990s, the EU-15 began to express their concerns about the enlargement and identified the CAP and the Structural Funds as the most problematic policy areas. According to Laffan (2001), there were two choices in front of the Union: it would either give up the enlargement process or it would change the rules governing the CAP and Structural Funds.

However, the enlargement was the reality of the Union and it was too late and risky to make a backward move. Since this was the case, the negotiations of the third financial framework of the Union for the period 2000-06 were conducted under the shadow of the forthcoming enlargement. Prior to the beginning of the budgetary negotiations, the Madrid European Council (1995) asked the European Commission to prepare a report concerning the impacts of the enlargement, particularly in terms of the Structural Funds and the CAP. The Council also called on the Commission to present a report on the future financial framework of the Union for the period 2000-06. In response, the Commission produced its Agenda 2000 document in July 1997. The Agenda 2000 was followed by a series of proposals for the reform of a number of Community policies. "The proposals of the Commission were wide-ranging and aimed, at least officially, at helping the Union to prepare for enlargement and to improve its negotiating position in the WTO talks" (Ferrer and Emerson 2000, 1). The most important proposals were on the agriculture, Structural and Cohesion Funds.

The primary aim of this chapter is to make a comprehensive analysis of the third

financial framework of the Union, which was initiated with the Agenda 2000 proposals and ended up with the Copenhagen European Council Conclusions in December 2002. In this regard, the background of the fierce budget negotiations and the political economy behind them are to be analyzed in a detailed manner. The analysis shows to what extent net contributions to the EU budget and dominance of national interests of the Member States distorted the negotiations and caused the Union to end up the process with slight changes in its principle policies contrary to the initial radical reform aims. The analysis also shows to what extent the third financial framework differed from previous financial frameworks in terms of treatment towards the candidate countries.

5.1 Agenda 2000 and the Berlin Financial Framework

The Agenda 2000 negotiations were even tenser than the negotiations of the previous budgetary deals. As well as establishing the new financial framework of the Union, decisions had to be taken on the reform of the CAP and Structural Funds in order to get prepared for the Eastern enlargement. At the time of the 1992 negotiations before the establishment of the second financial framework of the Union, the CAP was initially reformed in the context of the MacSharry reforms. In fact, the Agenda 2000 proposals aimed to continue the MacSharry reforms initiated in 1992. In terms of Structural Funds, the chief concern was about the size of allocations after enlargement. Thus the Commission's proposals concentrated on the issue of allocation criteria.

5.1.1 The Commission's Proposals

The Santer Commission, in its document for the 2000-2006 financial framework, proposed three substantial reforms: a CAP reform introducing co-financing of agricultural expenditures by the national budgets; a substantial simplification and concentration of the structural expenditures in the poorest areas of the EU; and a strengthening of the pre-accession strategy for the forthcoming enlargement, which

was supposed to take place in 2002 and to be limited to six countries (Estonia, Poland, Czech Republic, Hungary, Slovenia and Cyprus).

The Commission's original proposals foresaw no change in the existing own resources ceiling of the Union and decided to maintain it at 1.27% of Union GNP. According to the estimations of the Commission, the reform of the CAP and Structural Funds, the continuation of the other internal policies and external action and most importantly the cost of enlargement could be financed under the existing own resources ceiling. Obviously, what made the majority of Member States so concerned about the forthcoming enlargement was the worsening of the balances of the net contributors. In this regard, from the beginning of the negotiations, four net contributors, namely Austria, Germany, the Netherlands and Sweden, began discussing their budgetary burden. At the end, the German Presidency presented a number of measures to reduce the EU budget burden. At the heart of these measures, there were the introduction of a correction mechanism for 'excessive net contributions' for Member States; changing the own resources system by scrapping the VAT resource and only keeping the traditional own resources and GNI based resource; renegotiating the budget rebate of the UK; co-financing of the direct payments to farmers; phasing out Cohesion Funds for the Member States, which have entered the single currency; reducing or limiting the Structural Fund expenditures and introducing a ceiling to agricultural spending to an annual average equal to the expenditure for 1999 (40.5 billion Euro) for the period 2000 to 2006 (Ferrer and Emerson 2000).

The proposed correction mechanism was similar to the UK budget rebate since it would enable Member States, which exceeded in their net contribution to the EU budget 0.3 per cent or 0.4 per cent of GNP, to receive a rebate of 66 per cent of the sum over this level.

The German Presidency proposals required all Member States to sacrifice to some extent for the sake of the sustainability of the Union's expenditures. However, the

proposals received tough reactions from the other Member States. France as the main beneficiary of the agricultural funds, cohesion countries consisting of Spain, Portugal, Greece and Ireland as the main recipients of the Cohesion Fund and Structural Funds, Italy as the beneficiary of the current VAT system and the UK as the guard of its rebate opposed fiercely to the proposals.

On the side of the agricultural reform, the basic aim was to improve the competitiveness of the Union's agriculture on domestic and world markets by eliminating or reducing the gap between internal and world prices. To this purpose, the Commission proposed substantial price cuts for key products such as arable crops (down by 20% from 2000/01 marketing year onwards), beef (down by 30% over three years) and milk (down by 15% over four years). The proposals envisaged to compensate these price cuts with increased direct payments to farmers. This would allow the EU to go into the next round of WTO negotiations with more powerful stance and to defend the European model of agriculture (Pezaros 1999). In addition, the introduction of co-financing included in the German Presidency proposals would replace partially the direct payments to farmers from the Union budget with direct payments from national budgets. This would surely reduce the burden on the EU budget since some part of agricultural expenditure was to be financed now by national budgets of the Member States. On the other hand, this would as a result cause Member States to spend more from their national budgets to finance their agricultural sectors. In particular, France, having a relatively large agricultural sector compared to the other Member States was obviously the first to be substantially affected by this change in policy. In this regard, the proposals were unacceptable for France even at the beginning.

On the side of the enlargement, the Agenda 2000 proposals assumed that 6 countries, the Luxembourg Group consisting of Poland, Hungary, the Czech Republic, Cyprus, Estonia and Slovenia would join the Union in 2002. "In Agenda 2000 the Commission took a decision with respect to enlargement which was to plague relations and the accession negotiations up to the very end" (Mayhew 2004, 144).

“The Commission proposed that no direct compensatory aid should be granted to farmers in these countries, as accession should not, in principle, result in a lowering of internal agricultural prices for them” (Commission 2002a). From the Commission’s point of view, the proposal had a rationale since the direct aids were introduced in 1992 as part of the MacSharry reform, in order to compensate certain price cuts in the agricultural sectors of the Member States. In this respect and given the fact that the prices in the candidate countries would not be reduced after their accession, they would not suffer from any price cut. On the contrary, their domestic prices would substantially increase in order to catch up with the EU-15 average. However, as Ferrer and Emerson (2000) state, although there was some logic in the argument about not paying the CEECs direct payments after their accession, it was far from satisfactory. There were a number of reasons. First, a new farmer in the EU would be eligible to receive the payments though he/she was not affected by the price reductions at the time of the MacSharry reforms. The farmers of Eastern Germany, Austria, Sweden and Finland were the most visible evident of this occasion due to the fact that they were all entitled to the payments after their accession to the Union. “Second, excluding the CEEC farmers from the direct payments would entail an automatic increase in the regressivity of the policy, i.e. the direct payments will be going to the richer western farmers” (Ferrer and Emerson 2000, 19). In this respect, there would be the danger of a certain competitive distortion in the internal market (Mayhew 2004).

“It is true that the Commission proposed some additional funds for rural development in the new Member States, but this brought expenditure on the CAP in the new Member States to only just under 2 billion Euro in 2002 rising to almost 4 billion Euro in 2006 compared to annual expenditure in the old Member States of above 40 billion Euro” (Mayhew 2004, 145). On the other hand, the Commission proposed to double the pre-accession aid for CEECs in order to prepare them for accession. In this framework, the funds under PHARE would be increased and would focus on support for the development of administrative capacity and on the investment necessary to align with the *acquis communautaire*. In addition, new

instruments, Special Accession Programme for Agriculture and Rural Development (SAPARD) and Pre-accession Structural Instrument (ISPA), would be introduced whereby SAPARD would serve to modernize the agri-food chain and rural development projects in the CEECs while ISPA would contribute to financing projects on transport and the environment.

On the side of the reform of Structural Funds, the Commission proposed to maintain the size of the Structural Funds and the Cohesion Fund at its level 0.46% of GNP reached in 1999. Therefore, the additional Structural Fund expenditures for the CEECs would be managed under this level of expenditure. Clearly, this would mean reduced allocations for CEECs and changing the rules governing the structural operations. The Commission assumed a three-fold approach. First of all, the seven eligibility criteria of the Structural Funds were proposed to be reduced from seven to three:

- objective 1 (cohesion) for the least well-off regions (per capita GDP less than 75% of the Community average),
- "objective 2 (competitiveness) to cover areas undergoing change (in industry, services or fisheries), rural areas in decline and urban areas in difficulty" (Commission 2002a),
- objective 3 (employment) to support the adaptation and modernization of education, training and employment systems.

Second, the Commission proposal envisaged increased geographical concentration, by focusing on most needy regions and gradually phasing out areas which would be no longer eligible. Third, the Commission proposal required the simplification of the management rules related to the Structural Funds.

What made the Commission proposals concerning the Structural Funds unacceptable for the CEECs was the fact that the Commission proposed to limit the maximum level of transfers from Structural Funds to Member States at 4% of national GDP. "The limitation on the level of transfers looked reasonable, partly because a transfer

of more than 4% of GDP had never been exceeded in the history of the funds and partly because very large transfers are difficult to manage in the context of a stability oriented macro-economic policy" (Mayhew 2004, 145). However, given the fact that the CEECs had even lower per capita income than the other Cohesion countries, namely Greece, Ireland and etc., and they would likely to have lower absorption rate of EU funds[21] in the first years of their accession, they would have to make significant levels of financial transfers from their state budgets in order to finance investment projects necessary to catch up with the EU-15 average. It was certain that the additional financial transfers were going to be a significant burden for the state budgets of the new Member States.

On the own resources side of the budget, the CEECs were obliged to contribute fully to the own resources of the Union after the first day of their accession. The Commission was determined not to give any concessions on this subject.

5.1.2 Berlin European Council

During the negotiations at the Berlin European Council in March 1999, the Member States concentrated on the issues of stabilization of Union's general expenditure and resolving the issue of budgetary imbalances rather than on the effectiveness of the proposed reforms. At the end, the Council agreed on the Financial Framework of the Union for the period 2000-06 and it was included in the Interinstitutional Agreement of 6 May 1999 between the European Parliament, the Council and the Commission on budgetary discipline and improvement of the budgetary procedure.

As it can be seen in the Table 5.1, which illustrates the Financial Framework for the Union for the period 2000-2006, Berlin European Council agreed to fix the own

[21] It would be considerably difficult for the new Member States to draw down structural fund commitments from the EU budget in the first years of membership due to the complexity of the rules governing the Structural Funds and the inadequacy of their current administrative capacities. "Meeting the rules for the adoption of structural fund programmes is an extremely complex task, involving a mobilization of central and regional administrations within the country and extensive negotiations and coordination with the European Commission" (Mayhew 2003). Therefore, the amount of financial transfers from the Union would be much lower than expected and as a result, the new Member States would have to spend more from their national funds.

resources ceiling of the Union at 1.27 % of GDP until 2006. In spite of the reforms in the principle policies of the Union and the increased number of Member States from 2002 onwards, not only the Commission but also the Head of States met at Berlin Council considered necessary to increase the present own resources ceiling of the Union. Therefore, as Palankai (2003) states any increase in income and expenditure could only come from economic growth. They all assumed that the forthcoming enlargement and thus the additional financial burden could be managed within the present own resources ceiling of the Union. According to Giuriato (2002), this attitude clearly provided a difference in treatment between the present EU Member States and the Central and Eastern European Countries.

The CAP reform was blocked considerably by French insistence in the last minute and only partially undertaken. The fundamental element of the reform, co-financing of the agricultural expenditure did not get the Council's approval. Moreover, the Member States failed to agree on the extent of price cuts proposed by the Commission. At the end, the final compromise included the reduction in arable crop prices in two stages by 15% (instead of original cut of 20%), in beef sector by 20% (instead of 30%) and postponement of milk reforms until 2005. Pezaros (1999) argues that as Member States engaged in long bargaining on the agricultural reform proposals, the final compromise concentrated on making savings rather than reaching the targets of the reform. Most efforts focused on ways for reducing total amount of spending rather than eliminating market-distorting support measures or direct payments provided to farmers in order to protect their incomes. As a result, as it can be seen in Table 5.1, the CAP agreed at Berlin European Council continued to be the largest single item of the budget as well as it cost 2.7 billion EUR less than it was assumed in Agenda 2000. Ferrer and Emerson (2000) state that the reduction in expenditures was fictitious rather than real since the new 'reformed' CAP was less expensive just because of the reduction and postponement of Agenda reforms.

Table 5.1 Financial Framework for 2000-2006, EU-21 (million EUR at 1999 prices)

Appropriations for Commitments	2000	2001	2002	2003	2004	2005	2006
1. Agriculture	**40 920**	**42 800**	**43 900**	**43 770**	**42 760**	**41 930**	**41 660**
CAP (excluding rural development)	36 620	38 480	39 570	39 430	38 410	37 570	37 290
Rural Development	4 300	4 320	4 330	4 340	4 350	4 360	4 370
2. Structural Operations	**32 045**	**31 455**	**30 865**	**30 285**	**29 595**	**29 595**	**29 170**
Structural Funds	29 430	28 840	28 250	27 670	27 080	27 080	26 660
Cohesion Fund	2 615	2 615	2 615	2 615	2 515	2 515	2 510
3. Internal Policies	**5 930**	**6 040**	**6 150**	**6 260**	**6 370**	**6 480**	**6 600**
4. External Action	**4 550**	**4 560**	**4 570**	**4 580**	**4 590**	**4 600**	**4 610**
5. Administration	**4 560**	**4 600**	**4 700**	**4 800**	**4 900**	**5 000**	**5 100**
6. Reserves	**900**	**900**	**650**	**400**	**400**	**400**	**400**
Monetary Reserve	500	500	250				
Emergency Aid Reserve	200	200	200	200	200	200	200
Guarantee Reserve	200	200	200	200	200	200	200
7. Pre-accession aid	**3 120**	**3 120**	**3 120**	**3 120**	**3 120**	**3 120**	**3 120**
Agriculture	520	520	520	520	520	520	520
Pre-acc. structural instrument	1 040	1 040	1 040	1 040	1 040	1 040	1 040
PHARE	1 560	1 560	1 560	1 560	1 560	1 560	1 560
8. Enlargement			**6 450**	**9 030**	**11 610**	**14 200**	**16 780**
Agriculture			1 600	2 030	2 450	2 930	3 400
Structural operations			3 750	5 830	7 920	10 000	12 080
Internal Policies			730	760	790	820	850
Administration			370	410	450	450	450
Total App. For Commitments	**92 025**	**93 475**	**100 405**	**102 245**	**103 345**	**105 325**	**107 440**
Total App. For Payments	**89 600**	**91 110**	**98 360**	**101 590**	**100 800**	**101 600**	**103 840**
of which: enlargement			***4 140***	***6 710***	***8 890***	***11 440***	***14 220***
App. For Payments as % of GNP	**1.13**	**1.12**	**1.14**	**1.15**	**1.11**	**1.09**	**1.09**
Own Resources Ceiling	**1.27**	**1.27**	**1.27**	**1.27**	**1.27**	**1.27**	**1.27**

Source: EU Interinstitutional Agreement, May 1999.

As Table 5.1 illustrates, Structural Funds together with the Cohesion Fund on the other hand constituted the second largest share after agriculture in the budget. Structural Fund reforms agreed at Berlin European Council were in line with the Commission's proposals. In this framework, the number of eligibility criteria was reduced from seven to three, the funds were concentrated to the most needy regions and the rules were simplified.

Berlin European Council maintained the same assumptions about the date of accession and the number of countries involved but it reduced the overall level of budgetary financing for the enlarged Union (Mayhew 2004). The Council reaffirmed that the CEECs would not receive direct income supports after their accession up to 2006. Thus it paved the way for a competitive difference between EU-15 and CEECs. In terms of Structural Funds allocations, the Council decided to limit the maximum amount of Structural Funds allocated to a Member State at 4% of national GDP. In general, the Berlin European Council maintained the main elements with respect to the financing of enlargement (Mayhew 2004) and did not change amounts committed for enlargement. However, Giuriato (2002) states that it introduced important adjustments with respect to the position of the enlargement expenditures in the budgetary framework. In Agenda 2000, the Commission did not create specific headings for the CEECs and the additional expenditures caused by enlargement were included under the existing headings. The incumbent Member States foresaw in this the risk that the appropriations available for the EU-15 could be used for the CEECs unless they were classified under a different heading. To this purpose, "the Cardiff European Council (June 1998) decided the introduction of a double programming, one for the EU-15 and one for the enlarged Union, and the creation of two new headings, for pre-accession aid and for the enlargement expenditures" (Giuriato 2002, 12). Therefore, the expenditure for enlargement was 'ringfenced'. "This implied that expenditure on accession could not be increased by transferring funds from other headings and that any surplus funds from enlargement could not be used for other purposes" (Mayhew 2004, 146).

The Berlin European Council maintained the level of pre-accession aid proposed by the Commission. Therefore, the CEECs would receive 3 120 million Euro annually during the whole period between 2000-2006. These funds would be channeled through the PHARE, ISPA and SAPARD.

Own resources system was modified to some extent in order to correct 'excessive' net contributions. In this framework, the European Council decided to lower the maximum VAT call rate to 0.75% in 2002 and to 0.5% in 2004. The percentage of traditional own resources that the Member States retain to cover collection costs was increased from 10 to 25%. The UK rebate remained almost untouched only with some small adjustments to offset for instance the benefit that would arise upon enlargement (Commission 2002a) and the financing share of Austria, Germany, the Netherlands and Sweden was restricted to one forth of their normal share. Finally, the CEECs were expected to contribute fully to the own resources of the Union from the first day of their accession.
As it can be seen in Table 5.2, the Berlin Financial Framework mainly implied a differential treatment for the CEECs. In the enlarged Union, the Luxembourg Group countries would only receive 8.25% of the total funds available over the seven year. Moreover, the second wave countries would receive decreasing amount of funds under the pre-accession aid between 2002 and 2006.

Table 5.2 Distribution of the expenditures in the enlarged Union
(shares of the enlarged EU budget – commitment appropriations)

	2000	2001	2002	2003	2004	2005	2006	Total
EU 15	96.61	96.66	90.47	88.12	85.75	83.56	81.48	88.65
Pre-accession	3.39	3.34	3.11	3.05	3.02	2.96	2.90	3.10
Accession	-	-	6.42	8.83	11.23	13.48	15.62	8.25
Total	100	100	100	100	100	100	100	100

Source : elaboration on IIA (1999)

According to Giuriato (2002), the gap between the CEECs and the EU-15 was even deeper with reference to some expenditure chapters. For instance, in the agricultural sector, the first and second wave countries' shares in the EU agricultural policy were

respectively 3.9% and 1.16%. In terms of structural operations, more than 80% of the total financing was reserved to the EU-15.

In practice, limiting the maximum amount of Structural Funds allocated to a Member State at 4% of national GDP implied a considerable distortion of equity in the distribution of Structural Funds. The rule would certainly undermine the principle of equal footing of the EU Member States since high per capita income countries would receive more than low capita income countries. The ceiling would also discriminate among the CEECs where wealthy CEECs would be assigned to more funds than the poorer ones.

In general, the Berlin European Council conclusions were a major source of disappointment from the perspective of the Commission. The Commission, in its initial proposals, intended to initiate radical reforms in the Union's principle policies, particularly the most expensive ones. The Commission wanted to continue the MacSharry reform, which was successfully launched and implemented in the agricultural sector. In addition, it concentrated on the Structural Funds in order to make another major reform. However, despite the expectations, the outcome substantially differed from what was intended in the beginning. The reform proposals of the Commission were partially curbed and partially postponed by the Berlin European Council and the outcome took the form of a slight change in the policies.

5.2 The Commission's Information Note and the Brussels European Council

5.2.1 The Commission's Information Note[22]

In the framework of accession negotiations, the negotiation chapters on agriculture and structural policies are directly related to the chapter on financial and budgetary provisions since they have important budgetary implications. In order to allow the

[22] The European Commission's Information Note: Common Financial Framework 2004-2006 for the Accession Negotiations and its accompanying issues paper Enlargement and Agriculture: Successfully integrating the new Member States in to the CAP were published in 30.01.2002 in order to provide a road map for the Union in the accession negotiations.

Council to assess financial issues related to the enlargement in a common framework, the Commission prepared an information note, in which it set out the general approach it intended to take in the draft common positions in the fields of agriculture, structural actions and the budget. In fact, the Commission's information note proposed significant changes in the negotiating position of the Union while at the same time fully respected the financial framework for enlargement as decided in Berlin.

The Berlin framework envisaged the inclusion of six countries in 2002. In the information note, the Commission changed its previous assumptions related to the number of countries expected to join the Union and the date of accession and adopted a new scenario which foresaw the accession of ten countries in January 1st 2004. Since enlargement would not take place until 2004 and would now include ten countries instead of six, the Berlin financial framework had to be adjusted. In the information note, the following issues are addressed:

In terms of agricultural policy, the Commission considered that immediate full integration into the system of direct payments would only serve to freeze existing structures and hamper modernization in the new Member States (Commission 2002c). To this purpose, it proposed gradual introduction of direct payments over a transitional period of ten years into two steps. "In the first step, direct payments would be introduced in the new Member States equivalent to a level of 25% in 2004, 30% in 2005 and 35% in 2006 of the present system[23]. In the second step after 2006, direct payments would be organized in such a way as to ensure that the new Member States reach in 2013 the support level then applicable" (Commission 2002b). According to the proposal, this aid could also be topped up with national funds. In other words, the new Member States were given the option of complementing direct

[23] As the first reimbursement from the EU budget for the direct payments would only occur in 2005, no direct payments had to be budgeted in the budget for 2004. The amounts would be 1173 million Euro for 2005 and 1428 million Euro for 2006.

aid up to the level applicable prior to accession provided that the total support does not exceed the level of direct payments in the existing EU Member States[24].
Furthermore, for the programming period 2004 to 2006, the Commission intended to adapt the rural development policy in order to better meet the needs of the new Member States. In this respect, the Commission proposed to increase the Union's co-financing rate up to 80% for the rural development measures financed by the EAGGF "Guarantee Section" and to extend the use of differentiated appropriations in order to allow slower absorption in the new Member States.

In terms of structural actions, the Commission proposed to increase Cohesion Fund expenditure in the new Member States to a third of total structural spending in order to facilitate the absorption of structural funds. Therefore, "the burden for the national budgets of the new Member States would be slightly lighter, as the co-financing rate in the Cohesion Fund (maximum 85%) can be higher than in the structural funds for Objective one regions (Maximum 80% for Objective one regions located in a Member State covered by the Cohesion Fund)" (Commission 2002b).

In terms of internal policies, the Commission considered necessary to foresee adjustments for nuclear safety and for the continuation, during the period 2004-2006, of certain institution building actions covered by the pre-accession strategy but which are not eligible under the existing Community programmes or structural fund actions[25]. In this respect, the Commission proposed to allocate some additional 20 million Euro for each of the years 2004, 2005 and 2006 for decommissioning of the Bohunice nuclear power plant in Slovakia. Similarly, additional funds would be allocated for the decommissioning of Ignalina nuclear power plant in Lithuania. The Commission also proposed to finance development in the northern part of Cyprus and allocated specific financial resources for this purpose for the period 2004-2006.

[24] Such national top-ups would be approved by the Commission before adoption.
[25] In order to maintain a high level of nuclear safety in the Union, a number of candidate countries decided to decommission several nuclear power plants, which were internationally considered not to be upgradeable at reasonable costs. In the pre-accession period, the Union agreed to support the decommissioning efforts in the candidate countries through PHARE. However, as the date of inclusion to the Union was postponed to a later date, there emerged the need to further finance the funding of decommissioning activities, which correspond to the continuation of the pre-accession expenditure planned under PHARE under present Community programmes or structural fund actions.

In terms of the transitional arrangements for budgetary compensation, the Commission insisted on the full payment of contributions to own resources from the first day of accession. However, it also saw in this the danger of several candidate countries becoming net contributors to the EU budget in the first years of membership. "The insistence of the Union on the payment of full contributions to own resources from the first day of accession combined with the expected slow absorption of structural funds and the refusal of the Union to pay direct income subsidies to farmers meant that in some cases the net contribution of the new Member States would have been very significant" (Mayhew 2004, 150). As a result, The Commission agreed that no new Member State should find itself in a net budgetary position which is worse than the year before enlargement (Commission 2002b) and to this purpose, proposed the creation of a reserve in the amended financial framework for 2004-2006, which would be used in order to grant lump-sum budgetary transfers to the new Member States in a position of becoming net contributor to the EU budget. The reserve could amount around 800 million Euro annually. The Commission also required that the annual payment for budgetary compensation would stay within the overall limits foreseen in Berlin Financial Framework.

5.2.2 The Brussels European Council and the EU Common Position on Financial and Budgetary Provisions

The January proposals of the Commission were taken into consideration during the European Council meeting in Brussels on 24-25 October 2002. Not surprisingly, the present Member States showed a great unwillingness to pay any level of direct income aids to the farmers in the new Member States. "The debate went beyond the question of enlargement to that of the future of the CAP, with the net contributors to the EU budget on one side, against the countries which receive large agricultural subsidies from Brussels, notably France and Ireland" (Mayhew 2004, 151). As Mayhew (2004) states, the countries that were in favour of enlargement until that time, namely Germany, Sweden, the Netherlands and the UK were against paying

direct income subsidies to the new Member States because this would slow down the reform on the CAP and reinforce its current implementation. On the other hand, the countries that were less positive about enlargement, namely France and Ireland were now more willing to see the new Member Countries in the Union receiving some level of direct income subsidies. Cleary, they saw in this the possibility of continuation of the income subsidies in the longer term.

At the end, the Brussels European Council adopted the Commission's proposal on direct income subsidies. It also decided to limit the level of agricultural expenditure in the period 2007-2013 by 1% increase per year in nominal terms over the level reached in 2006. The position of the Union on financial and budgetary provisions was approved on November 8th 2002 and the candidate countries were left with only one month to negotiate both the financial chapter and the finish the agricultural sector (Mayhew 2004).

5.3 The Copenhagen European Council

On 13 December 2002, Heads of State and Government from the EU and ten candidate countries reached agreement on a formula for enlarging the EU to include ten new Member States as from 2004. According to the Council Conclusions, Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Slovak Republic and Slovenia would join the EU on 1 May 2004.

Two weeks prior to the Council, the Danish Presidency of the Union presented its own financial package related to the enlargement. In the package, the Presidency proposed to change the date of accession as May 2004. "This would change very little in terms of receipts from the EU but would save the new Member States four months of contributions to own resources and therefore remove any remaining doubts about the budgetary balance being positive in the first year of membership" (Mayhew 2004, 152). In addition, the Presidency proposed the introduction of a 'Schengen facility', a direct subsidy to the budgets of the candidates through which

the new Member States would be financially supported in order to strengthen the new external borders of the Union. Apart from these, the package included proposals related to amounts of financial transfers for the decommissioning activities in the new Member States and the possibility of topping up direct income subsidies using funds reserved for rural development.

The negotiations took place at the Copenhagen European Council were mainly between the Polish delegation and the Union and they were considerably tough for both sides. Poland was the largest candidate country thus it took the lead since it had more to lose. In the end, significant changes were made within the Danish package and the candidate countries accepted the outcome.

As regards agriculture, the Summit agreed an enhanced rural development strategy for the new Member States. The amount available for the ten candidate countries is fixed at 5.1 billion Euro for 2004-2006. From the first day of accession, a wide range of rural development measures would be co-financed at a maximum rate of 80% by the EU. Furthermore, direct payments for the new Member States would be phased in over 10 years. The starting level for 2004 is set at 25% of the full EU rate, rising to 30% in 2005 and 35% in 2006. After 2006, direct payments would be increased by percentage steps in such a way as to ensure that the new Member States in 2013 reach the CAP support level then applicable. According to the Council Conclusions, these direct payments available from the EU could be topped up by 30%, financed in part by the candidate countries' rural development funds and in part by national funds, i.e. up to 55% in 2004, 60% in 2005 and 65% in 2006[26]. From 2007, the new Member States are left free to continue to top up EU direct payments by up to 30% above the applicable phasing-in level in the relevant year, but financed entirely by national funds. Apart from these, the Schengen facility is agreed to amount almost 750 million Euro over the three years and the transitional arrangements for budgetary compensation which were previously agreed to amount around 800 million Euro annually are increased to almost 1.1 billion Euro for 2004-2006. However, since the

[26] The Summit introduced special provisions for topping up direct income subsidies in Cyprus and Slovenia.

new Member States gained additional four months during which they would not make any contributions to the EU budget, the previous Commission proposal to introduce a reserve for lump-sum budgetary transfers was left aside.

Overall, as Mayhew (2004) states the Copenhagen financial package was modest in relation to Berlin Financial Framework and even modest in relation to the Commission's proposal in January 2002. The new Financial Framework for the EU-25 was then adopted as illustrated in the Table 5.3.

When a careful comparison is made between the two financial frameworks agreed in Berlin European Council in 1999 and the Copenhagen European Council in 2002, it can be easily seen that there is no change in the overall own resources ceiling and there are only slight changes in the total amount of commitment appropriations and payment appropriations. It is even observable that the figures related to appropriations laid down in the Berlin Financial Framework were more generous than the figures agreed in the Copenhagen Financial Framework.

Table 5.3 Financial Framework for 2000-2006 EU-25 (million EUR at 1999 prices)

Appropriations for Commitments	2000	2001	2002	2003	2004	2005	2006
1. Agriculture	**40 920**	**42 800**	**43 900**	**43 770**	**44 657**	**44 657**	**45 807**
CAP	36 620	38 480	39 570	39 430	38 737	39 602	39 612
Rural Development	4 300	4 320	4 330	4 340	5 920	6 075	6 195
2. Structural Operations	**32 045**	**31 455**	**30 865**	**30 285**	**35 665**	**36 502**	**37 940**
Structural Funds	29 430	28 840	28 250	27 670	30 533	31 835	32 608
Cohesion Fund	2 615	2 615	2 615	2 615	5 132	4 667	5 332
3. Internal Policies	**5 930**	**6 040**	**6 150**	**6 260**	**7 877**	**8 098**	**8 212**
4. External Policies	**4 550**	**4 560**	**4 570**	**4 580**	**4 590**	**4 600**	**4 610**
5. Administration	**4 560**	**4 600**	**4 700**	**4 800**	**5 403**	**5 558**	**5 712**
6. Reserves	**900**	**900**	**650**	**400**	**400**	**400**	**400**
Monetary Reserve	500	500	250				
Emergency Aid Reserve	200	200	200	200	200	200	200
Guarantee Reserve	200	200	200	200	200	200	200
7. Pre-accession strategy	**3 120**	**3 120**	**3 120**	**3 120**	**3 120**	**3 120**	**3 120**
Agriculture	520	520	520	520			
Pre-accession structural instrument	1 040	1 040	1 040	1 040			
PHARE	1 560	1 560	1 560	1 560			
8. Compensations					**1 273**	**1 173**	**940**
Total App. For Commitments	**91 995**	**93 385**	**100 255**	**102 035**	**102 985**	**105 128**	**106 741**
Total App. For Payments	**89 590**	**91 070**	**98 270**	**101 450**	**100 800**	**101 600**	**103 840**
App. For Payments as % of GNI	**1.07**	**1.08**	**1.11**	**1.10**	**1.08**	**1.06**	**1.0**
Own Resources Ceiling as % of GNI	**1.24**	**1.24**	**1.24**	**1.24**	**1.24**	**1.24**	**1.24**

Source: OJ L 147, 14.7.2003.

5.4 Conclusion

This chapter is devoted to the comprehensive analysis of the third financial framework of the Union, which was initiated with the Agenda 2000 proposals and ended up with the Conclusions of the Copenhagen European Council in 2002. In its Agenda 2000 proposals, the Commission's primary aim was to convince the EU-15 that the Eastern Enlargement of the EU could be financed without changing the present own resources ceiling of the Union budget and thus the enlargement would bring no additional costs for the present Member States. In this respect, it was clear even at the very beginning that the Eastern enlargement of the EU was going to be substantially different from the previous enlargements since it was not accompanied by an expansion of EU budgetary resources.

The enlargement placed particularly large potential demands upon the budget because of three characteristics of the CEECs: low income levels, the large size of their populations and the importance of agriculture in these countries. The cost of enlargement combined with the EU-15's existing financial and economic problems. As the economic downturn intensified across the EU and some of the Member States were under great pressure caused by the process of budgetary consolidation required to meet the Maastricht convergence criteria, together with the budgetary constraint provided by the Stability and Growth Pact, the present Member States showed no willingness to finance the cost of enlargement. In particular, the net contributors to the EU budget, Germany, the Netherlands, Austria and Sweden called for reductions in their net contribution to the EU budget. In addition, Spain, Portugal and Greece were particularly concerned with reductions in their structural fund receipts.

In general, the Berlin European Council conclusions were a major source of disappointment for both the Commission and the candidate countries. It was a source of disappointment for the Commission because, though the Commission, in its Agenda 2000 proposals, intended to initiate radical reforms in the Union's principle policies, the Structural Funds and the agricultural policy which were particularly the

most expensive ones, the Council Conclusions considerably curbed them and they turned out to be slight changes. The reform proposals were mainly aimed at decreasing the cost of agriculture by introducing national co-financing and making the effective use of structural funds by allocating them to the most needy regions. However, the initial proposals of the Commission were substantially changed during the negotiations of Berlin European Council and reform proposals concerning the CAP were postponed to a later date. The Conclusions also disappointed the candidate countries since it paved the way for dual treatment for them by not introducing direct income subsidies in the candidate countries and by imposing new rules for the governance of the structural funds. Since they were obliged to fully contribute to the own resources of the Union, they were given no room in order to negotiate for the revenue side of the budget. In fact, the candidate countries were left with only modest financial resources in order to catch up with EU 15 in terms of raising the economic growth rate and improving living standards as well as establishing the necessary administrative capacity in order to implement the *acquis communautaire.*

The Copenhagen European Council changed some rules of the game in favour of the candidate countries without touching the overall ceiling of the own resources. In this regard, the Union agreed to give some level of the direct income subsidies to the candidate countries together with some improved conditions in terms of rural development measures. However, the different treatment towards the new Member States prevailing during the accession negotiations was still easy to observe.

In its third financial framework for the period 2000-2006, the Union continued to allocate a large share of its budget resources to agriculture. By not agreeing on the Commission's initial reform proposals which aimed to introduce co-financing of agricultural spending and to reduce the burden of agriculture on the EU budget and by extending the direct income subsidies to the farmers in the new Member States, the Union made it more difficult to change the current pattern of CAP expenditure in the future. In fact, as Grybauskaite (2007) states it has become more difficult to negotiate a reform on the CAP now since the new Member States would be entitled

to 100% of direct income subsidies as from 2014 and thus struggle not to lose their financial transfers. Therefore, in the longer term this problem has the potential of becoming even more acute.

CHAPTER VI

BUDGETARY CHALLENGES OF THE ENLARGED UNION: THE NEED FOR A REFORM

In June 2005, the European Council failed to reach an agreement on the new Financial Framework of the Union for the period 2007-2013. The failure of the European Council to agree on the financial framework generated massively negative media coverage and brought the historically rooted budgetary problems at the top of the agenda once again. Even more important, it coincided with the constitutional crisis of the Union, resulting from the rejection of the European Constitution in both France and Netherlands. Clearly, the structure of the EU budget and the budgetary negotiations among Member States are the reflections of European policies (Grybauskaite 2007). Unless an agreement is reached on the European policies and the priorities for the Union are clearly set, it is not possible to establish a proper financial structure for the Union in order to make it better serve for the needs of increasing number of countries. This widely explains what happened during the negotiations for the preparation of the last financial framework and the referenda crisis.

As Gros and Micossi (2006) state, the European Union has been recently experiencing serious problems in a variety of areas ranging from economics to social life: persistent slow growth and high levels of unemployment, social and economic strains related to the globalization, distrust of European citizens to the European institutions and uncommitment to the European integration project, widespread fears of integration, further enlargement and immigration from new Member States, and even spreading over to the EU level of domestic political weakness in key countries. Gros and Micossi (2006) argue that European project is unable to re-connect to European citizens. The ambiguity and opacity of policies and goals in the areas that matter most to public opinion distorted the already weak commitment of the

European citizens to the European integration and enlargement. “In order to rebuild consensus, three critical areas stand out in need of clarification and fresh initiative: the common framework for policy coordination, the budget and the democratic deficit in the European institutions” (Gros and Micossi 2006, 2). This is because the approval of the Constitutional Treaty is so important for the revival of the European integration project[27]. As long as the Union does not address the economic and social problems prevailing across the Union, the political support for the European integration project will continue to decline as it was best illustrated in the failed referenda on the Constitutional Treaty in France and the Netherlands.

Once the future of the Union is ensured with the clarification of political priorities and the decision making process of the Union is radically changed, the reform process of the EU budget can take place in order to reflect the new policy priorities (Grybauskaite 2007). Along this way, the approval of the Constitutional Treaty acts as a milestone. Since the rejection of the Constitutional Treaty by the citizens of founding members of the EU is a major signal that European citizens feel alienated from the developments in the EU, taking a political step to reform the resource and expenditure structures of the EU budget could be a good place to begin in order to send a signal to the European citizens that the EU is capable of taking the necessary steps to address the challenges ahead (Kernohan, Ferrer and Schneider 2005).

As Begg and Heinemann (2006) state, the fact that the current system of own resources does not provide the enlarged Union with sufficient and coherent financial resources for implementing its political choices has been widely recognized by most of the Member States and the European institutions. However, the negotiations for the new Financial Framework have shown that the Member States remained reluctant and seemed to be unready to take the political decision to change the current system.

[27] The current situation of the Union is very similar to the 1980s. Just as the Single European Act (1986) was crucial for the revival of the European integration project, which was substantially exhausted from economic downturns and inclusion of poorer Member States, the Constitution is now an important instrument to reinforce the deepening efforts of the Union and to give it dynamism. To this extent, the approval of the Constitution is likely to give an end to the current crisis in the Union.

The Member States could not reach an agreement on the reform proposals for the common agricultural policy and the structural funds during the negotiations for the third financial framework of the Union for 2000-2006. Similarly, they did not take the initiative to change the pattern of expenditure in the EU budget during the negotiations for the last financial framework. Furthermore, they introduced more complex and unfair mechanisms and added to the complexity and inefficiency of the present system.

In light of these arguments, the primary aim of this chapter is to make a general overview of the shortcomings of the present own resources system and to discuss possible reform options. To this purpose, initially the final financial framework of the Union for 2007-2013 is analyzed by focusing on its novelties brought to the own resources system. In this regard, the background of the budget negotiations and the political economy behind them are to be analyzed briefly. The analysis shows to what extent net contributions to the EU budget and dominance of national interests of the Member States distorted the negotiations and caused the Union to conclude its final financial framework with fundamental deviations from its policy objectives once again. Secondly, the shortcomings of the present system are addressed and finally the possible reform options are elaborated.

6.1 The 2007-2013 Financial Perspective

According to Barbier (2006), two factors influenced the thinking behind the 2007-2013 Financial Framework: first, the Sapir Report[28] drawn up by a group of experts at the request of Romano Prodi, President of the European Commission and secondly, the letter sent by the six main net contributors to the EU budget, namely Germany, France, the UK, the Netherlands, Austria and Sweden.

Negotiations for the preparation of the forth financial framework of the Union started in December 2003 when the six biggest net contributors sent a letter to the

[28] Sapir, A. et al. (2004), "An Agenda for a Growing Europe: making the EU economic system deliver", the Sapir Report, Oxford, Oxford University Press.

Commission and requested the future financial framework not to be higher than 1% of average EU GNI. Whereas the initial letter did not specify if 1% referred to commitment or payment appropriations, it meant a serious strain on the finances of the Union. In fact, a ceiling of 1% implied a substantial cut in the current budget when the arrival of ten new Member States in May 2004 and the likely accession of Bulgaria and Romania in the beginning of 2007 were taken into consideration. Clearly, this cut would be reflected most in the Union's policies such as competitiveness, security and citizenship and external dimension and funds going to the new Member States.

On the other hand, the recommendations of Sapir report relating to the EU budget acted as a powerful stimulus in the outgoing budget negotiations. In particular, the report defined the EU budget as an historical relic and continued by claiming that if the Union is determined to achieve growth and solidarity in an enlarged Europe, the EU budget should move away from the present inertia and be radically structured to support the growth agenda proposed by the report in line with the Lisbon objectives. In this regard, "the budget should be organized into three funds: 1) a fund to promote growth through expenditure for R&D, education and training and infrastructure 2) a convergence fund to help low income countries catch up 3) a fund to support economic restructuring" (Altomonte and Nava 2005, 216). The report implied that if the size of the budget would not be changed, then the EU should reduce the portion of the budget it spends on agricultural support to just 15%, compared with around 40% now (Sapir et al. 2004).

However, the Commission under Prodi prepared much more conservative proposals than Sapir's suggestions for 2007-2013 Financial Framework and ignored the advice of the report prepared by its own expert group (Peet 2005). The Commissioners accepted without question the October 2002 Chirac-Schröder deal to maintain spending on the CAP and they allocated over half of structural fund spending to the EU-15 rather than the new members (Peet 2005). By way of a response to the demands of the six net contributors, the Commission suggested introducing a

generalized correction mechanism (GCM) similar to the UK correction[29] (Barbier 2006).

6.1.1 Negotiations for the 2007-2013 Financial Framework

There were a number of challenges in front of the Commission both in terms of substance and finance as well as there stood the legacy of previously accepted commitments in the run up to the negotiations[30]. According to Mrak (2007), the Commission responded to these areas by proposing an own resources ceiling of 1.14%, complete phasing-in of new Member States for agriculture, increasing the resources for Lisbon objectives and introducing new activities in areas of freedom, security and justice.

Similar to the previous negotiations in the Council over budgetary politics, the Member States established coalitions among themselves in order to get as much as possible from the deal[31]. During the negotiations, France demanded that the British rebate to be abolished while the UK wanted the review of CAP funding to begin in

[29] In July 2004, the Commission published its Report on the operation of the own resources system, which encompasses a proposal for a new Council Decision on own resources together with a proposal for a Regulation on the implementing measures for the correction of budgetary imbalances. In the report, the Commission proposed a generalized correction mechanism as a short term adjustment in order to address the UK rebate. The report stated that due to the specific correction mechanism in its favour, the UK has contributed clearly less than the other Member States in relation to its GNI. Furthermore, since the UK correction is born by the other twenty Member States, they pay relatively more and the UK correction in this way has distorted equity indirectly. In this regard, the Commission argued in favour of replacing the current system with a generalized correction mechanism. The main characteristics of the GCM applicable to any Member State were:
- Starting if net contribution of any Member State exceed 0,35% of its GNI,
- Refunding of contributions above this at a rate of 66%,
- limiting the total refund volume to a maximum of 7,5 billion Euro in a year, which will be financed by all Member States according to their relative share of GNI.

[30] According to Mrak (2007), these were mainly the economic growth and jobs, economic and social cohesion after enlargement, continuation of CAP reforms, common security and defense policy and Europe as a global player together with the question of determining overall level of expenditures and structure of funding sources, including correction mechanism for net contributors.

[31] Group of six net payers to the budget, group of old Member States with positions closer to the Commission's proposal, group of old cohesion countries facing pressure on cohesion funds and group of new Member States putting cohesion as its top priority (Mrak 2007).

2009 contrary to the 2002 agreement on CAP reform[32]. As Barbier (2006) states, two net contributors, the Netherlands and Sweden, backed the UK, as did Spain, thereby causing deadlock. On the other hand, some countries led by France, opposed any fundamental reform of the CAP and insisted that the EU should not touch the 2002 deal that fixed CAP spending on direct payments until 2013. According to Begg and Heinemann (2006), the new Member States fought hard for additional money from the EU's regional aid budget against the resistance of those countries that currently benefit most from the EU's structural and cohesion funds, namely Spain, Portugal and Greece. In fact, the UK presidency's initial proposals were aimed at the preservation of its rebate. Surely this would be done to the detriment of the financial transfers to the new Member States under structural funds. The negotiations mainly took place between two countries, France and the UK. Both of them were ambitious in order not to give concessions over their interests, the CAP for France and the rebate for the UK. Peet (2005) states that any CAP review which would take place in 2008 would substantially reduce farm spending before the end of the next budget in 2013 and such CAP reforms would automatically reduce the British rebate.

After months of fierce negotiations, the agreement on the Financial Framework of the Union for 2007-2013 was reached on 16 December 2005 at the end of UK Presidency. In accordance with the conclusions of the Brussels European Council at 14-15 December 2005 and according to the Interinstitutional Agreement of 17 May 2006, the Commission has been invited to undertake a comprehensive review of EU revenue and expenditure including the Common Agricultural Policy and the UK rebate and to report in 2008/2009. In other words, France conceded that the CAP should be included in 2008-2009 spending review. Britain agreed to limit the size of its rebate with enlargement[33] and open the issue to further debate in the forthcoming

[32] The European Council decision in October 2002 allowed CAP spending to rise 1 per cent a year in nominal terms, implying a small fall in real terms. Proponents of CAP reform say that the deal sets an upper limit for CAP spending but does not guarantee fixed amounts (Peet 2005).

[33] The UK agreed that the expenditure for enlargement would not be included in the calculation of its rebate. By this way, the UK would contribute to the financing of new Member States as from 2007. According to Begg and Heinemann (2006), the UK only agreed to cut the rebate to pay for the UK's fair share of the costs of enlargement and although aid for the new members will in future be taken out of the equation when the rebate is calculated, the rebate will continue to rise in cash terms during 2007-2013.

review. The Member States did not adopt the proposals of the Commission on introducing a GCM. In fact, the report was considered successful as it directly addressed the deficits of the current system and at least proposed ways for recovery. However, as Begg (2005) argues, the proposed solution though appearing to be politically astute, did not deal with the underlying problem, the UK rebate and thus could not get the approval of the Member States. In addition, the UK managed to get a deal on the Financial Framework, which would largely fix EU spending for the period 2007 to 2013. The own resources ceiling for the budget is set again at 1,24% of Union GNI. The rate of call of the VAT resource is reduced to 0,3%. In terms of VAT call rate, three net contributors have gained temporary relief: the rate is set 0,225% for Austria, 0,15% for Germany and 0,1% for the Netherlands and Sweden. The new regulations brought to the own resources system are decided to be set down in a new Council decision on the own resources.

6.1.2 Evaluation of the 2007-2013 Financial Framework

Clearly, as Mrak (2007) argues, the process was strongly dominated by national priorities and therefore by net positions of Member States. In terms of expenditure side, the structure and content of the last financial framework of the Union has not changed substantially from the Agenda 2000. In this respect, according to Mrak (2007), the main victim of the negotiations has been the Lisbon strategy. The new budget has strongly implied the mismatch between the policy priorities and the allocation of spending. Begg and Heinemann (2006) argue that the new EU budget has little relevance for the Union's agreed policy priorities, most notably economic growth and employment; fighting cross border crime and terrorism; a stable EU neighbourhood and a stronger role for the EU in the wider world. Though the Member States collectively want a budget aimed at addressing certain policy objectives such as fostering EU-wide R&D, ensuring environmental sustainability and etc. as laid down in the Lisbon strategy, they care about their individual net contributions to the budget when the time comes to make a deal (Begg and Heinemann 2006). This is exactly what happened during the preparation process of the Financial Framework for 2007-2013. As a result, approximately 70 per cent of

total EU spending has been allocated to CAP and structural funds over the next seven year budget period. The comparison of the financial frameworks over time is illustrated in Table 6.1.

Table 6.1 Comparison of the Financial Frameworks over time

	Delors I (1992)	Delors II (1999)	Agenda 2000 (2006)	Last FF (2013)
CAP	56%	47%	43%	40.3%
Structural Expenditure	25%	36%	36%	35.7%
Internal Policy	4.5%	6%	8%	11.8%
External Expenditure	3.7%	7%	5%	6.3%

Source: Elaboration on Financial Frameworks

In terms of revenue side, the agreement has not introduced substantive changes from the Agenda 2000. Dominance of GNI resource in the budget still continues. Instead of totally abolishing the UK rebate, the Member States agreed to reduce UK rebate only temporarily. In addition, no general correction mechanism has been introduced. Moreover, the Member States agreed to give three net contributors to the budget a temporary relief on VAT call rates. This clearly added to the existing complexity of the system.

On the other hand, the Council decision concerning the adoption of a mid term review of the all aspects of the EU budget in 2008-2009 can be considered as a valuable opportunity to reestablish a fair system of own resources while at the same time to endow the EU budget with sufficient resources necessary to meet the needs of the enlarged Union. In accordance with the decision, the Commission would publish in 2009 a White Paper on modernizing budget expenditure and revenue. According to Grybauskaite[34] (2006), the document to be presented in 2008 or 2009 would contain three options and the most ambitious option would involve a deletion of rebates on rebates and exceptions on exceptions.

[34] Graybauskaite, Dalia, "Budget plans must wait for treaty deal", European Voice Article, 7-13 December 2006.

6.2 Options for a Reform in the EU Budget

The current own resources system has evolved as a result of successive modifications of the original system introduced in 1970 with Luxembourg Treaty and took its final shape in line with the decisions of the Berlin European Council in 1999. In practice, the Commission (2004d) considers the current financing system has provided the EU with stable and sufficient revenue until so far. At least, the finances of the Union are under control and the Union continues transferring financial resources to its main policy areas. However, in reality the present financial system has profound shortcomings as they are comprehensively explained in the previous chapters.

The European Council agreement on the new Financial Framework 2007-2013 made at the Brussels European Summit of 14-15 December 2005 contributed to the failure of the current system due to the fact that the financial package agreed consisted of numerous exceptions on the revenue side and compensation gifts to certain Member States on the expenditure side and ignored important Community activities and ambitious goals as regards Lisbon objectives or Trans-European Networks (Parliament 2007). In this regard, considering the current state of play over the budgetary politics, it becomes urgent to conduct a reform on both the expenditure side and the revenue side of the EU budget[35].

6.2.1 Reforms on the Revenue Side

6.2.1.1 Shortcomings of the current own resources system and related reform proposals

[35] The UK rebate is one of the most highly debated issues on the revenue side of the budget whereas the dominance of agricultural expenditure in the EU budget constitutes one of the biggest problems on the expenditure side. Due to this fact, the budgetary negotiations witnessed fierce negotiations between France and the UK. The UK is ambitious not to give up from its rebate until France sacrifices to some extent from its agricultural funds by letting a substantial reform on the CAP. Therefore, in the current situation, it is possible to undertake a budgetary reform as long as it is two sided. Lamassoure report (2007) also emphasizes the political link between a reform of revenue and a review of expenditure.

Dominance of national contributions in the budget and insufficient financial resources in order to meet the needs of an enlarged Union: Today, the major part of EU revenue is mainly based on national contributions since approximately 70% of the Union's revenue comes directly from the national budgets of the Member States through the GNI resource. In particular, most European citizens do not know how much they pay to the EU budget and what for they pay it. This considerably undermines the visibility of the current system (Commission 2004d). The traditional own resources (TOR) are the only direct link between the EU budget and the European citizens since they directly stem from the common policies of the Union. However, TOR only represents a very small part of total own resources in the current system, i.e. approximately 11.4 per cent in 2005. On the other hand, the overwhelming resource in the budget, the GNI resource is perceived to be less visible for citizens (Parliament 2007). Decreasing share of TOR in the budget and the consequent lack of a direct and visible link to the EU citizens also result in reduced accountability of the European Parliament (Commission 2004d).

Conclusions of the Berlin European Council (1999) and the Brussels European Council (2005) reinforced the dominance of GNI resource since they both introduced changes which pave the way for further declining trend of traditional and VAT based own resources and corresponding increase in the relative share of GNI based contributions. Actually, this trend has gradually resulted in the evolution of the net contributors' problem, which in turn hampered the financial autonomy of the Union.

The Lamassoure report (2007) draws attention to this issue and states that the current system of own resources mainly based on Member States' contributions is both unfair to the general public and anti-democratic, and does not help to highlight the commitment to European integration. According to the report, the dominance of national contributions in the financing of the EU budget is perceived as creating an additional burden on national budgets and increases the unwillingness of the Member States to pay for the common EU policies that have the potential to create additional value for the European citizens. The Member States are in a tendency to finance only

the policies in which they have an interest. Besides, the Union is unable to create sufficient financial resources in order to finance its policies thus lacking financial autonomy.

The Commission tried to address the problem arising from the insufficiency of the revenue base of the own resources system with its report on the operation of own resources published in 2004. In the report, in order to establish a direct link between the financing of the budget and European citizens and to eliminate dependence on transfers from national budgets, the Commission argued in favour of introducing a genuine fiscal own resource as from 2014 (Commission 2004d). In this regard, the new tax-based own resource would be introduced progressively as a replacement to the current VAT resource and would help gradually reducing the share of GNI resource in the budget. The Commission was aware of the fact that at the current stage of EU integration a fully tax-based system would not be realistic since none of the Member States were ready and thus it did not propose (Parliament 2007). The new fiscal resource would be neutral in terms of the level of EU funding as it would replace existing resources.

In the report, the Commission proposed three main options in order to improve the functioning of the EU financing system over the long term:

- *an own resources system with fiscal resources related to energy consumption*: the Commission proposed the creation of an EU levy limited to the tax base related to motor fuel used for road transport[36], which could be complemented by an EU levy on aviation fuel or the related emissions[37].

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[36] Leaded and unleaded petrol, diesel, LPG and natural gas used for transport.

[37] The Commission used the argument that since the European air transport system is highly integrated and aviation emissions transcend national borders, taxing such emissions at the EU level could be considerably beneficial in order to internalize the external socio-economic costs of climate change and other environmental effects caused by aviation into the price of air travel. The current exemption of aviation fuel (kerosene) from taxation for cross-border flights makes the option further available for the European use.

- *an own resources system with a fiscal VAT resource*: the Commission stated that "due to its direct link with daily consumption, and contrary to the current 'statistical' VAT resource, the application of an EU rate to national VAT bases would create a clear direct link between the financing of the EU budget and the citizen and increase awareness of the costs of the Union" (Commission 2004d). To this purpose, it proposed the introduction of a EU rate of 1% to cover about half of the financing needs of the EU budget.

- *an own resources system with a fiscal resource based on corporate income*: the Commission argued that the existence of 25 separate national tax systems and the multiplicity of tax laws, conventions and practices across the Union represents a barrier to cross border economic activity (Commission 2004d). In this regard, it proposed to define a common (consolidated) tax base in the field of corporate incomes first and then to adopt a minimum tax rate to the harmonized tax base. The harmonization of corporate taxes would contribute to the proper functioning of the internal market as well as it would constitute the basis of a revenue for the EU budget.

However, current state of play in the budgetary politics shows that even the Commission is skeptical about its own proposals, in particular related to the creation of a European tax to provide funds for the EU budget. According to Grybauskaite (2006), in the European politics, there is a problem with the idea of a tax because citizens think that it will be an additional burden on them. Moreover, national governments do not want to lose control over how much money the EU budget received.

In fact, a major number of economists and politicians have advocated an 'EU tax'. The Austrian government can be considered as one of them since it has suggested that the EU should use the 2008-2009 budget review to discuss an EU wide tax on short term cross- border financial investments as well as on air and sea travel (Begg and Heinemann 2006). However, the idea on taxation of financial flows has been

dismissed immediately as considered impractical by most experts. According to Begg and Heinemann (2006), the idea about the introduction of an EU-wide tax on energy consumption or financial investments has lost further support since the UK, which hosts Europe's biggest financial centre, in addition to some of the continent's busiest ports and airports does not like the idea.

On the other hand, some economists such as Mayhew (2007) and Lamassoure (2007) advocate improving the current financing system by a GNI based system. In this system, the VAT resource would be abolished and the revenue of the Union will totally come from the Member States' contributions on the basis of their GNIs and the existing traditional own resources of the Union[38]. By this way, the Member States would have a clear idea about the size of their contributions to the EU budget. Hence, the new system would be more transparent. At least, the contributions based on each country's GNI is likely to bring more equity to the present own resources system. According to Lamassoure (2007), this system would have the advantage of being simple and transparent and of constituting a possible step towards the establishment of a genuine own resources system for the Union[39].

The UK rebate: The UK rebate, on the other hand, is another problematic issue on the revenue side of the budget. The UK rebate mechanism and the complex formula used in its calculation makes the current system excessively complex and nontransparent. Besides, the UK correction constitutes one important exception to the ability to pay principle and it distorts equity indirectly since the financing of the correction by the other Member States is not proportional to their GNI[40].

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[38] The Parliament is also in favour of replacing the current financing system of the EU, while leaving in place traditional own resources, by a GNI system, taking the GNI shares as the basis for the Member States' contributions towards the Union's own resources and abolishing the VAT resource in its current form (Lamassure 2007).

[39] The Lamassure report argues in favour of a two-phase reform. The first, transitional phase would lead to the improvement of the current financing system by replacing it with a GNI based system. The second phase of the reform would be aimed at creating a genuine own resource for the EU, starting in 2014.

[40] As laid down in the Own Resources Decision, the UK disburses an amount far below from its GNI share and respectively this practice increases the contributions of the other Member States to a level higher then their GNI shares. In this respect, Altomonte and Nava (2005) argue that the presence of the rebate completely refutes the GNI based resource being the best indicator of a Member State's

The changes in the degree of prosperity enjoyed by EU net contributors since 1984 are outlined in the following Table 6.2. As it can be clearly seen in the table, with a sharp contrast to the situation in 1984, the UK's relative prosperity is at the top of the range with 111.2 per cent of GNI per capita expressed in purchasing power standards (PPS). However, the UK still continues to receive its money back from the budget on the basis of its rebate. This implies that the UK is contributing relatively less compared to the other Member States, which makes the current system unfair.

Table 6.2 GNI per capita of net contributors (in PPS) (EU-15 average=100)

	1984	2003
United Kingdom	90.6	111.2
Denmark	104.0	111.1
Austria	----	109.8
Netherlands	95	106.6
Sweden	----	104.6
France	104.0	104.2
Germany	109.6	98.6
Italy	92.9	97.3

Source: European Commission

Unfortunately, the 2005 Brussels European Council made the current system even more complex instead of creating a simpler and more transparent system by not abolishing the UK rebate and by adding further derogations and corrections benefiting other Member States[41] (Parliament 2007).

The Commission Report on the Operation of the Own Resources System tried to improve the current system via the generalized correction mechanism (GCM) throughout the 2007-2013 period[42]. In fact, the Commission proposal had the

ability to contribute and makes the Member States' contributions deviate from being perfectly proportional with GNI. This view is also supported by the Commission in its report Commission 2004d.

[41] Particularly, the adoption of different VAT call rates to three net contributing Member States, Germany, Austria, and the Netherlands in the financing of the UK rebate.

[42] GCM is explained in a detailed manner in the footnote 29.

potential to make the system more transparent by at least abolishing the UK rebate and the related exemptions to other Member States and would give all the Member States an equal footing in order to negotiate their net contributions to the budget. It was a demonstration of the Commission's good intentions towards solving the issue. However, according to Begg (2005), it was far from dealing with the problem. Furthermore, "generalizing the rebate even when accompanying it by a ceiling for the net budgetary balances would be a double mistake since it would only strengthen the anti-communitarian character of the system" (Parliament 2007, 11). In this respect, the best solution is the abolition of the UK rebate with its all aspects once and for all. However, when the fact that the UK is eager to negotiate for its rebate until the very end is taken into consideration, the abolition of the current correction mechanism becomes only possible with a parallel reform in the pattern of expenditure.

6.2.2 Reforms on the Expenditure Side

6.2.2.1 Shortcomings of the current own resources system and related reform proposals

The mismatch between the allocation of expenditure in the EU budget and the policy priorities of the Union: In general, the allocation of expenditure in the budget does not reflect the priorities of the Union. Though the Union strongly sets its commitment to the attainment the Lisbon strategy goals, there is a mismatch between the policy priorities of the Union and allocation of the expenditure. This can be explained in three parts. First, today the agricultural expenditure still continues to dominate over other expenditure headings in the budget. In the last Financial Framework, the share of Heading 2 Preservation and Management of Natural Resources is set at 44.4 per cent, 75.9 per cent of which will be allocated to the main expenditure items of Common Agricultural Policy, market related expenditure and direct aids to farmers. Secondly, if the Union's objective is to achieve cohesion among the Member States, than it has to improve the redistributive aspect of its

funds. In general, there exists a biased direction in the allocation of the structural funds. The evidence suggests that majority of the Union's structural funds are allocated to already prosperous Member States and to privileged regions[43] within the Member States instead of new Member States, which are much poorer[44]. Furthermore, some part of the structural funds is often used to revitalize outdated industries[45] that will never give the Union a competitive edge.

Thirdly, Heading 1a Competitiveness for Growth and Employment, which is directly related to the attainment of Lisbon Strategy goals thus achieving competitiveness, received only 7 per cent from the EU budget in the last Financial Framework. It is obvious that the current Financial Framework does not contain meaningful movement in the right direction (Gros and Micossi 2006).

At the moment, the key dilemma in front of the Union is deciding on the main objective of the EU budget. The EU actors should clarify whether the EU budget should primarily achieve commonly agreed EU policies or redistribute resources among individual Member States. So far, the EU budget served for the realization of the second objective[46]. Key policies of the Union, i.e. CAP and structural funds have served to a large extent for redistribution purposes until so far and helped achieving acceptable net budgetary positions.

If the Union is serious to achieve sustainable economic growth with more and better jobs and greater social cohesion, then the EU actors should undertake a major reform which will shift the Union's resources in favour of research, education, and institution building or the new requirements in foreign policy, defense and internal security (Gros and Micossi 2006). "In particular, the Union's resources should be

[43] In particular, Bavaria and Madeira still benefit from the Union's structural funds though they are situated within one of the most prosperous Member States of the Union.
[44] The dual treatment towards the new Member States in terms of the allocation of structural and agricultural funds is comprehensively explained in the previous chapter.
[45] Sapir, et al. (2004).
[46] This tendency has been still prevailing in the last financial framework of the Union. The common agricultural policy (almost 680 billion Euro) and the structural and cohesion policy (308 billion Euro) together make up %70 of the budgetary outline 2007-2013. The bulk of EU public expenditure hence goes into redistribution (Dullien and Schwarzer 2007).

used to reach four mutually reinforcing objectives: (a) promoting the competitiveness of enterprises in a fully integrated single market, (b) strengthening the European effort in research and technological development, (c) connecting Europe through EU networks, and (d) improving the quality of education and training" (Altomonte and Nava 2005, 315). Even the efforts aimed at the prevention of climate change, ensuring energy safety and renewable energy resources are likely to add a value to the current pattern of EU spending. An EU budget representing the common EU interests rather than the interests of individual Member States can help change the citizens' attitude towards the EU.

In fact, the argument about the fact that the European citizens do not know where the resources of Union budget are allocated may not be that correct[47]. In particular, the UK taxpayers seem to be aware of the fact that they pay subsidies that are going to prosperous Member States, particularly to France and Poland under the CAP, the taxpayers in the Netherlands and Austria seem to know that they are paying the financial transfers going to the new Member States under Structural Funds and France taxpayers seem to know that they are paying the UK rebate. It is possible to extend the argument and give more examples. The referenda failures in the Netherlands and France signal the European citizens' distrust towards the Union.

The Globalisation Adjustment Fund[48] can be used as an effective tool in order to establish a link between the Union and the European citizens. Since the Fund is planned to provide extra assistance to the workers suffered from globalization, it has the potential to make the Union closer to the people. The Union by supporting

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[47] This observation is based on the interviews, which I conducted during the research visits to London and Brussels in March 2007 within the framework of a Jean Monnet Project titled "The EU Enlargement Process and Europeanization: Comparative Perspectives From the Views of Young Researchers".

[48] The Member States agreed on the establishment of the Globalization Adjustment Fund at the Brussels European Council of December 2005. Though the Fund is not included in the Financial Framework, an annual amount of 500 million Euro will be allocated over the seven year period. The Fund will be a crisis mechanism designed to compensate for economic and social shocks resulting from globalization. The Fund will finance training and redeployment or reintegration of workers into the labour market, i.e. the costs of activities serving to find a new job. It will not be triggered until a set proportion of workers in the sector and region concerned as suffered from redundancy. The Fund will be used on a joint decision taken by the Parliament and the Council.

workers who lose their jobs due to major changes in the structure of world trade, can make the European citizens aware of at least that the Union works for them.

The issue of cohesion: There is widespread support for maintaining cohesion spending in the enlarged Union. As already discussed in the previous chapter, the 2004 enlargement represents an enormous challenge for the internal cohesion of the Union. “In particular, with the new Member States, the surface area of the Union has increased by 34 per cent, the population by 28 per cent but the GDP only by 5 per cent. Hence, by 1 May 2004, the average EU per capita GDP had decreased by 18 per cent, falling from 22 603 Euro to 19 661 Euro (if Romania and Bulgaria are included, this figure drops to 18 530 Euro)” (Altomonte and Nava 2005, 310). Consistently with these findings, according to the Commission’s third report on economic and social cohesion[49], the level of GDP per inhabitant, measured at purchasing power parity, ranged from 41% of the EU average in Latvia to 215% in Luxembourg. What is more striking that all the new Member States including Bulgaria and Romania have GDP per capita levels less than 75% of the average. Clearly, the regions of the new Member States are eligible to receive the Union’s Structural Funds under the current assessment criteria.

The Financial Framework for the period 2007-2013 has committed approximately 36 per cent of the Union funds to ensure cohesion under the Heading 1b: Cohesion for Growth and Employment. Although the share of Regional Policy in the EU budget has not changed substantially from the Agenda 2000 Financial Framework, the new package has provided relatively more funds with a more simplified and transparent priority framework[50] (Altomonte and Nava 2005).

[49] The Commission’s third progress report on cohesion: Towards a new partnership for growth, jobs and cohesion published in 2005 makes a comprehensive analysis of the economic and social disparities in the enlarged EU. The report clearly sets the disparity levels across the regions and illustrates the regional gaps widened with enlargement.

[50] Berlin European Council (1999) adopted three eligibility criteria, namely cohesion, competitiveness and employment for the allocation of Structural Funds. However, the Brussels European Council in December 2005 envisaged a different procedure in the allocation of Union’s Structural Funds, replacing three previous objectives. At the current state of play, the structural funds are channeled in line with three priorities. The Funds under priority 1, convergence are directed to the less developed Member States and regions thus replacing Objective 1. The Former Objective 2 and Objective 3 are replaced by priority 2 aimed at fostering regional competitiveness and employment. Finally, some of

Since growth is the greatest European priority, which should not be achieved at the expense of stability and cohesion, the EU should continue to support lagging regions. The Cohesion spending in the budget should remain at least at the same volume but should be properly distributed across Member States in a way that will benefit the poorer Member States.

CAP spending: In general, the EU's common agricultural policy is perceived to be inefficient and costly despite the past reforms. "It distorts the EU single market; it fails to increase the efficiency of European farming; and it principally benefits the biggest farms in the richest EU countries" (Thurston 2005, 1). On the other hand, the EU, particularly some Member States insist that CAP is needed to guarantee food security and help EU farmers. However, this reason does not totally justify such a great volume of expenditure in the EU budget in favour of agriculture. According to Gros and Micossi (2006), agriculture is a declining sector not helping the EU to become more competitive and to achieve sustainable growth. Thus its share in the budget should be reduced to more tolerable levels for all the Member States.

Until now, the Union has failed to undertake a substantial reform on the CAP. "There are three reasons why the CAP has proved so difficult to reform: the delicate balance of power between EU Member States; the rules for taking decisions on agriculture; and the entrenched nature of the farm lobby" (Thurston 2005, 5). France, as the gatekeeper of the CAP has always resisted to reform requests in the agricultural spending[51]. The inclusion of agrarian Member States in May 2004 brought into the Union more countries that will fight against such reform proposals. In fact, it has become now more difficult to negotiate a reform on the CAP since the new Member

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the current Community initiatives will be incorporated in a new priority aimed at European territorial cooperation. In addition, the Brussels European Council relaxed the deadlines for disbursing resources coming from the structural funds by replacing the N+2 rule with N+3 for the release of funds. For the years 2007-2010, the Member States with average per capita GDP less than 85% of the EU-25 average during the period 2001-2003 can use the Structural Fund appropriations within three years.

[51] France leads the CAP defenders, including Spain, Portugal, Ireland, Austria, Greece and Belgium. On the other hand, the UK, Sweden, Denmark and, at times, Italy, the Netherlands and Germany want a major reform in the CAP.

States would be entitled to 100% of direct income subsidies as from 2014 and thus struggle not to lose their financial transfers (Grybauskaite 2007).

Some advocates of CAP reform argue for the re-nationalization of the CAP. It is logical to allow countries to supplement EU farm payments through co-financing from national budgets[52]. By this way, the agricultural burden on the EU budget can be reduced to some extent. However, there also stands the danger of creating inequality among the Member States. Re-nationalization of the CAP will likely to create distortion in the EU since more prosperous Member States could afford it whereas the poorer ones cannot (Mayhew 2007). This danger can be eliminated by limiting the net recipients of CAP funding from Brussels only to countries with a per capita GDP below the EU average (Thurston 2005, 5). In fact, until so far, the World Trade Organization negotiations have been the real source of pressure of reform in the CAP rather than the budget (Kernohan, Ferrer and Schneider 2005). Unless the two biggest sides of contention, namely France and the UK come together to negotiate the CAP and the UK rebate, there does not seem a rational solution for the Union in the long run.

Decision making procedure: The unanimous voting of the Financial Perspective and Own Resources Decision in the Council and the European Parliament's limited role within this process is another factor undermining the democratic character of the current system and making the EU budget a centre of national bargains. In addition, the division in the Union's expenditures as compulsory and non-compulsory constitutes a main source of tension between the European Parliament and the Council. Since the Council has the final say on the compulsory expenditure and the compulsory expenditure dominates over the majority of the Union's overall expenditure, Council decisions become relatively more important than the decisions of the Parliament and leave the final shape of the decisions related to the most important policy areas of the Union to the political will of the Member States. Therefore, decision making procedure over budgetary issues should be reformed to

[52] According to Thurston (2005), co-financing should be voluntary and the EU should initially set strict upper limits. The limits can be raised over time, as EU funding is reduced.

give the Parliament more authority. "Clearly, the Union will not have a proper budget until both the multiannual financial frameworks and the yearly budget will be truly co-decided by Council and Parliament, based on a (non-binding) Commission proposal" (Gros and Micossi 2006, 10). However, Gros and Micossi (2006) also argue that this decision making power should not be extended so far as to override the decision on total resources ceiling, since the Parliament is likely to have a bias in favour of more spending at the European level. Certainly, there are a number of areas, in which more spending at the EU level does not guarantee the best solution to achieve the most desirable outcome. Therefore, "one solution might be to leave the last word on total resources to the Council, but let the European Parliament determine their allocation across categories of spending" (Gros and Micossi 2006, 10).

The size of the budget: The allocation of EU financial resources is closely related to the question of determining an actual size for the budget. Until so far, identifying the proper size for the EU budget in order to finance the needs of the Union has been one of the biggest controversial subjects in the budgetary politics. For the last three financial frameworks, the Union's total level of expenditure has been limited to 1.24 per cent of total EU GNI. In this regard, any increase in income and expenditure could only come from economic growth (Palankai 2003). Actually, "the right size of the budget depends on what the money is being spent on" (Begg and Heinemann 2006, 3). One of the conclusions of the Sapir report (2004) was that it was not the size of the budget that was the problem, but its bias towards farm spending and to regional aid that was too often used to revitalize outdated industries. In many cases, the Commission found it easy to increase the size of the budget. By this way, the national interests of the Member States would be optimized meanwhile the growth oriented policies would be financed with additional money. Not surprisingly, this was unacceptable for the net contributing Member States to the EU budget since it would make an additional burden on their state budgets.

Obviously, determining the volume of EU budget is closely related to identifying the EU expenditure objectives. If EU policies are taken as the main objective, then the

total volume should be a result of jointly identified priorities. If, however, redistribution is taken as the main priority, then decision about the volume is closely interrelated with the net balance acceptance issue. Ultimately, increasing the size of the EU budget is not a solution unless the resources are redirected towards more efficient policy areas.

6.3 Conclusion

The referenda failures in the founding Member States of the Union are important to the extent that they represent the current mistrust of the European citizens to the present political and institutional structures of the Union. Recent economic and social problems such as slow growth rates and high levels of unemployment, social and economic strains related to the globalization, widespread fears of integration, further enlargement and immigration from new Member States and the Union itself as being an elite driven process have resulted in a distrust of European citizens to the European institutions. They are not committed to the European integration project. The European citizens feel alienated from the developments in the EU. The Union, on the other hand, can convince the European citizens that the EU is willing and capable of taking necessary steps to address the current economic and social problems. In this regard, reforming the structure of its budget in order to serve for the common EU interests can be a good start. At the current state of play, the EU budget lacks a European perspective. The budgetary politics have been dominated so long by the net balances concerns of the Member States. As a result, the EU budget has been outdated and cannot meet the challenges of the changing world.

If the Union is serious to achieve sustainable economic growth with more and better jobs and greater social cohesion and become more competitive as laid down in the Lisbon strategy, it should look for ways to make a direct link between the Lisbon strategy goals and the budget. The Lisbon strategy objectives should be supported by the financial resources of the Union at a greater extent. The cohesion spending should be maintained, if not increased, at least at the current level in order to reduce

the widened regional gaps among the Member States. As previously indicated, the most recent enlargements represent an enormous challenge for the internal cohesion of the Union. Therefore, the Structural Funds should be targeted to the poorer Member States rather than the wealthy ones. Since growth is the greatest European priority, which should not be achieved at the expense of stability and cohesion, the EU should continue to support lagging regions. The CAP spending, on the other hand, should be reduced to moderate levels, in which food security across the Union is ensured and the farmers are not left worse. The governments of the Member States and particularly the European citizens are more likely to tolerate increases in the size of the EU budget as long as the policies that serve for the common EU interests are financed. The Union funds directed at achieving solidarity and cohesion, implementation of Lisbon strategy goals as well as prevention of climate change and ensuring energy safety can get more support from the European public. Recent Eurobarometer research results also show that European public opinion also remains very positive on issues relating to the European Security and Defense policy with an average of 75 per cent and to a common foreign policy with an average of 68 per cent[53].

At present, there are a number of core issues waiting for a solution: deciding on the main objective of the EU budget, determining the proper volume of EU budget expenditure, achieving a better balance between the Parliament and the Council in the budgetary procedure, determining how to finance the EU budget and etc. First of all, the EU actors should clarify whether the EU budget should primarily achieve commonly agreed EU policies or redistribute resources among individual Member States according to their net balance concerns. In fact, financing the commonly agreed EU policies and redistributing resources among the Member States are not always mutually exclusive goals. However, it seems that the national bargaining over budgetary allocations has resulted in a conflict between these two goals until now. It is clear that the current allocation of resources within the EU can be improved if only the Union establishes a balance between the redistributive and allocative functions of

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[53] Eurobarometer 66, Public Opinion in the European Union, December 2006. First results, field work September-October 2006.

the EU budget. Therefore, the Union budget should be targeted at redistributing money from the prosperous countries to the poorer ones while at the same time financing the policies that serve the common EU interests. In addition, the redistributive function of the Union budget should be improved in terms of the allocation criteria and governance of the Structural Funds.

Secondly, the EU actors should decide on the ways to finance the increasing levels of Union expenditure in the long run. At the current stage of European integration, creating an EU wide tax does not seem to be the solution applicable in the near future. Neither the governments of the Member States nor the European citizens feel ready for such a tax. The GNI based contributions of the Member States, on the other hand, seem more rational. In the long run, the Union should focus on introducing a new financing model based on each country's GNI. The VAT resource should be abolished along with the UK rebate and the revenue of the Union should totally come from the Member States' contributions on the basis of their GNIs and the existing traditional own resources of the Union. By these changes, the new system would be more transparent. The Member States would have a clear idea about the size of their contributions to the EU budget. At least, the contributions based on each country's GNI is likely to bring more equity to the present own resources system. Certainly, the UK rebate and the reform of the CAP are highly political issues whose solution depends on each other. The UK rebate is not likely to be totally eliminated without a radical reform on the CAP. In fact, the conflict between the biggest two Member States of the Union, France and the UK, and their supporters is likely to reflect the ongoing political balances within the European Union. The rational solution of these two issues will make the burden sharing of the EU budget more equal and acceptable to the other Member States.

Even under the new financing model, the Member States will struggle in order to maximize their national interests. They will regard the national contributions based on GNI in the financing of the EU budget as creating an additional burden on their national budgets just as today. However, if the Union budget gets a European

perspective at the same time and finances the policies that will boost the growth of EU economy, the governments of the Member States would know at least where the EU money goes, and the European citizens would be more confident that the Union is taking necessary steps to address the current economic and social problems.

On the other hand, the decision-making procedure over budgetary issues should be reformed to give the Parliament more authority. The unanimous voting of the Financial Perspective and Own Resources Decision in the Council and the European Parliament's limited role within this process undermines the democratic character of the current system and makes the EU budget a centre of national bargains. In this respect, both the multiannual financial frameworks and the yearly budget should be co-decided by the Council and Parliament based on a Commission proposal.

Last but not least, the allocation of EU financial resources is closely related to the question of determining an actual size for the budget. The decision to determine a proper size for the EU budget in order to finance the needs of the enlarged Union mainly depends on identifying the EU expenditure objectives. Once the sort of the policies that should be financed by the Union budget are decided, then the total volume can be identified in order to reflect jointly identified priorities.

The decision taken at the Brussels European Council in December 2005 on making a review of all aspects of EU revenue including the UK rebate and all aspects of EU expenditure including the Common Agricultural Policy in 2008/2009 is a good opportunity in terms of a budget reform. By the help of the review, the Union can manage to make a major reform on the revenue and expenditure structures of the EU budget. In this review process, the Commission should choose carefully the element that codifies the reform package. Similar to the previous linkages between the budgetary reforms and the deepening efforts of the Union, i.e. 2nd Delors Package was justified with EMU, 3rd Financial Framework was justified with Eastern enlargement, the Commission should find a political unifying factor that will constitute a direct link between the Union and the citizens. The most concrete

deepening efforts of the Union, namely the introduction of the Constitutional Treaty for the European Union can be backed up with a relatively well-designed budgetary reform. In more general terms, the present financial, institutional and social crisis of the Union can be addressed through the establishment of a direct link between a budgetary reform and European integration process.

Clearly, in order to cope with the referenda failures in the founding Member States of the Union, the budget reform should be carefully integrated to the other reform areas in the EU. Indeed, the budgetary reform might be used as a beginning to initiate the reforms in other areas. As it has always been the case in the history of European integration, the Union's financial system is strictly connected with the political model of the European Union. The direction of the European integration, either to be federal or intergovernmental has always determined the context of budgetary politics and gave the final shape to the budget. In this respect, the approval of the Constitutional Treaty of the Union is substantially important for the adoption of the budgetary reform. Since the rejection of the Constitutional Treaty by the citizens of founding members of the EU is a major signal that European citizens feel alienated from the developments in the EU, taking a political step to reform the resource and expenditure structures of the EU budget could be a good place to begin in order to send a signal to the European citizens that the EU is capable of taking the necessary steps to address the challenges ahead. It is clear that once the future of the Union is ensured with the clarification of political priorities and the decision making process of the Union is radically changed, the reform process of the EU budget can take place in order to reflect the new policy priorities.

CHAPTER VII

CONCLUSION

On 1 May 2004, the European Union experienced its biggest enlargement process in its history. The Eastern enlargement, which brought in eight countries from Central and Eastern Europe and the Mediterranean islands of Malta and Cyprus, raised the population of whole EU states by almost 75 million and made the EU a political and economic area with more than 450 million citizens. In addition, Romania and Bulgaria, which are even poorer in economic terms than the last ten countries, became the full members of the Union as of January 2007. Clearly, such a big integration is not free of costs. It was obvious from the very beginning that the accession of a large number of poorer countries, which were mainly agrarian and with great regional disparities would pose a major challenge to both sides.

The inclusion of the Central and Eastern European countries to the Union placed particularly large potential demands upon the budget because of three characteristics of the CEECs: low income levels, large size of their populations and the importance of agriculture in these countries. It constituted a major challenge for the Union's substantial number of policies, particularly for the Structural Funds and the Common Agricultural Policy. Moreover, the cost of enlargement combined with the EU-15's existing financial and economic problems. As the economic downturn intensified across the Union and some of the Member States were under great pressure caused by the process of budgetary consolidation required to meet the Maastricht convergence criteria, together with the budgetary constraint provided by the Stability and Growth Pact, the present Member States showed no willingness to finance the cost of enlargement. In particular, the four biggest net contributors to the EU budget, Germany, the Netherlands, Austria and Sweden called for reductions in their net contribution to the EU budget while Cohesion countries namely, Spain, Portugal and Greece were particularly concerned with reductions in their structural fund receipts.

As a result, the budget of the European Union, particularly its size, its sources of revenue, and the areas of expenditure, has become one of the highly debated issues. Given the limited size of the EU budget and the reluctance of the present Member States to increase its size, the inclusion of these countries brought out the need for a redesign of the current EU policies and financial transfers. In this respect, the European Commission published its document Agenda 2000 in 1997 in order to underpin the issue of prospective financial challenges arising from the Eastern enlargement. The Agenda 2000 was followed by a series of proposals for the reform of a number of Community policies, particularly the Structural Funds and the CAP. In its Agenda 2000 proposals, the Commission's primary aim was to convince the EU-15 that the Eastern enlargement could be financed without changing the present own resources ceiling of the budget and thus the enlargement would bring no additional costs for the present Member States. In this respect, it was clear even at the very beginning that the last enlargement of the EU to include the CEECs was going to be substantially different from the previous enlargements since it has not been accompanied by an expansion of budgetary resources, as it was the case in previous enlargements despite the large number of countries waiting for accession.

The Agenda 2000 proposals constituted the core of the discourses during the Berlin European Council in March 1999. In general, the Berlin European Council conclusions were a major source of disappointment for both the Commission and the candidate countries. It was a source of disappointment for the Commission because the Commission, in its Agenda 2000 proposals, intended to initiate radical reforms in the Union's principle policies, the Structural Funds and the agricultural policy, which were particularly the most expensive ones. The reform proposals were mainly aimed at decreasing the cost of agriculture by introducing national co-financing and making the effective use of structural funds by allocating them to the most needy regions. However, the initial proposals of the Commission were substantially changed during the negotiations of Berlin European Council and reform proposals concerning the CAP were postponed to a later date. The conclusions also disappointed the candidate

countries since it paved the way for dual treatment for them by not introducing direct income subsidies in the candidate countries and by imposing new rules for the governance of the structural funds. Since they were obliged to fully contribute to the own resources of the Union, they were given no room in order to negotiate for the revenue side of the budget. In fact, the candidate countries were left with only modest financial resources in order to catch up with EU 15 in terms of raising the economic growth rate and improving living standards as well as establishing the necessary administrative capacity in order to implement the *acquis communautaire.*

The Copenhagen European Council in December 2002 changed some rules of the game in favour of the candidate countries without touching the overall ceiling of the own resources. In this regard, the Union agreed to give some level of the direct income subsidies to the candidate countries together with some improved conditions in terms of rural development measures. However, the different treatment towards the new Member States prevailing during the accession negotiations was still easy to observe.

At the European Council Meeting of 17 June 2005, the Member States failed to reach an agreement on the new Financial Framework of the Union for the period 2007-2013. Most of the Member States have widely recognized that the current system of own resources does not provide the enlarged Union with sufficient and coherent financial resources for implementing its political choices, particularly indicated in Lisbon Strategy. However, they remained reluctant to take the political decision to change the current budgetary system. Not surprisingly, the failure of the European Council to agree on the financial framework generated massively negative media coverage and brought the historically rooted budgetary problems at the top of the agenda once again. Even more important, it coincided with the constitutional crisis of the Union, resulting from the rejection of the European Constitution in both France and Netherlands. The referenda failures in the founding Member States of the Union are important to the extent that they represent the current mistrust of the European citizens to the present political and institutional structures of the Union.

In fact, in addition to the budgetary crisis, the European Union recently experiencing serious economic and social problems such as slow growth rates and high levels of unemployment, social and economic strains related to globalization, widespread fears of integration, further enlargement and immigration from new Member States and the Union itself as being an elite driven process. As Gros and Micossi (2006) state, the European citizens are not committed to the European integration project. They feel alienated from the developments in the EU. The Union, on the other hand, can convince the European citizens that the EU is willing and capable of taking necessary steps to address the current economic and social problems. In this regard, reforming the structure of its budget in order to serve for the common EU interests can be a good start. The EU budget can get a European perspective contrary to the long lasting prevalence of the situation in which the net balances concerns of the Member States have dominated the budgetary politics.

The agreement on the new Financial Framework 2007-2013 made at the Brussels European Summit of 14-15 December 2005 contributed to the failure of the current budgetary system due to the fact that the financial package agreed consisted of numerous exceptions on the revenue side and compensation gifts to certain Member States on the expenditure side. In general, the allocation of expenditure in the budget does not reflect the priorities of the Union. Though the Union strongly sets its commitment to the attainment of the Lisbon strategy goals, there is a mismatch between the policy priorities of the Union and allocation of the expenditure. If the Union is serious to achieve sustainable economic growth with more and better jobs and greater social cohesion, then the EU actors should undertake a major reform which will shift the Union's resources in favour of research, education, and institution building or the new requirements in foreign policy, defense, internal security and energy safety.

In its last financial framework for the period 2007-2013, the Union continued to allocate a large share of its budget resources to agriculture. Despite the recent CAP reforms, the Union failed to reduce the burden of agriculture on the EU budget. The

extension of direct income subsidies to the farmers in the new Member States made more difficult to change the current pattern of CAP expenditure in the future. In fact, it has become more difficult to negotiate a reform on the CAP now since the new Member States would be entitled to 100% of direct income subsidies as from 2014 and thus struggle not to lose their financial transfers. Therefore, in the longer term this problem has the potential of becoming even more acute.

At present, there are a number of core issues waiting for a solution: deciding on the main objective of the EU budget, determining the proper volume of EU budget expenditure, achieving a better balance between the Parliament and the Council in the budgetary procedure, determining how to finance the EU budget, and etc. Considering the current state of play over the budgetary politics, it is urgent to conduct a reform on both the expenditure side and the revenue side of the EU budget.

The decision taken at the Brussels European Council in December 2005 on making a review of all aspects of EU revenue including the UK rebate and all aspects of EU expenditure including the Common Agricultural Policy in 2008/2009 is a good opportunity in terms of a budget reform. By the help of the review, the Union can manage to make a major reform on the revenue and expenditure structures of the EU budget. The Commission can also use this review process to establish a linkage between the budgetary reform and the deepening efforts of the Union. Obviously, the most concrete deepening effort of the Union, namely the approval of the Constitutional Treaty can be backed up with a relatively well-designed budgetary reform. In more general terms, the present financial, institutional and social crisis of the Union can be addressed through the establishment of a direct link between a budgetary reform and European integration process.

In order to cope with the referenda failures in the founding Member States of the Union, the budget reform should be carefully integrated to the other reform areas in the EU. As it has always been the case in the history of European integration, the Union’s financial system is strictly connected with the political model of the

European Union. The direction of the European integration, either to be federal or intergovernmental has always determined the context of budgetary politics and gave the final shape to the budget. It is clear that once the future of the Union is ensured with the clarification of political priorities and the decision making process of the Union is radically changed, the reform process of the EU budget can take place in order to reflect the new policy priorities.

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