Global Counsel

The political small print in the EU budget

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Summary

- At face value, last week's collapsed budget negotiations in Brussels were a reminder that there is a good reason why the European Union only debates its long term budget once every seven years. Rather than have an argument every year, the EU has a big argument every seven.

- What happened in Brussels is as much about politics as money. The negotiations broke down over about €30bn in spending from a €1trn budget. The debate was and is about the political theatre of cutting, freezing, or raising EU spending at a time when all national governments are engaged in some form of austerity and many are undertaking sharp fiscal contractions.

- The EU budget testifies to the difficulty the EU has in expanding spending in areas that would actually deepen the European Single Market: cross-border infrastructure, joint research and development spending and provision of innovation subsidies. This budget will probably reverse some of the limited progress in this area.

- But the more important elements of this budget may be buried in the text, rather than the headline spending levels. The draft budget tabled in Brussels contains some interesting proposed changes in the way the EU raises and spends money that reflect a growing desire to give the European 'centre' more autonomous resources and more discretion to use them as an incentive to toe a European policy line. These ideas have been echoed by the European Commission's own blueprint for the governance of the Eurozone, published this week. This may be the real significance of this budget debate.

At face value, last week's collapsed negotiations in Brussels were a reminder that there is a good reason why the European Union only debates its long term budget once every seven years. Rather than have an argument every year, the EU has a big argument every seven. The seven year budget must be agreed by unanimity, which adds to the general air of political horsetrading. Last week's Summit was not particularly acrimonious or prolonged, at least not by the standards of past budget negotiations.

So why the failure to reach a deal? Berlin and London were pushing for a freeze in real terms spending at current levels, with some redistribution within the budget away from agriculture to areas such as research and development. The compromise proposal floated by Herman Van Rompuy at the start of last week's Summit would have frozen or cut Common Agricultural Policy spending, reduced spending slightly on development subsidy programmes and cut spending from the 'growth and competitiveness' funds that are targeted for science and cross border infrastructure.

During the Summit, Berlin was keen to defend the cohesion spending important to its key Polish ally (see GCI12/34 *Is Warsaw the new London for Berlin?*), but anxious not to move too far from London's tougher line on an overall real terms spending freeze. Keeping Paris happy was less of a priority (see GCI12/37 *<u>François Hollande after Six Months</u>*), and French President, François Hollande, refused to accept the farm subsidy cuts, even after Van Rompuy reduced them slightly in his second compromise text. The chances are that the parties will return to Brussels early next year and agree something close to the deal they left on the table last week.

What should we make of all this? For investors, €30bn spread over seven years is largely irrelevant, although cuts may ultimately impact a small number of individual projects in the cross-border infrastructure area. There will be small, scattered impacts across farm programmes, science funding and EU-subsidised development projects. But some of the more important elements of this budget may be buried in the text, rather than the headline spending levels. This Global Counsel Insight asks if there is deeper significance to this budget than the numbers.

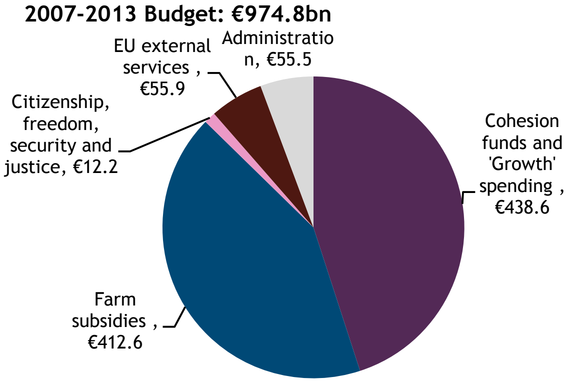
It's not (entirely) about the money

Needless to say, what happened in Brussels is as much about politics as money. The negotiations broke down over about €30bn in spending from a €1trn budget. The debate was, and is, about the political theatre of cutting, freezing, or raising EU spending at a time when all European national governments are engaged in some form of austerity. And deciding where any cuts should fall. The EU is not a federal government and its budget is basically a redistribution mechanism for EU states. The seven year, €1trn budget is around 1% of EU GDP. Most of that is redistributed back to the European Member States in the form of agricultural subsidies and what is called 'cohesion funding' – EU support for economic development projects in poorer EU states. 80% of the EU budget is actually 'spent' by national and regional governments.

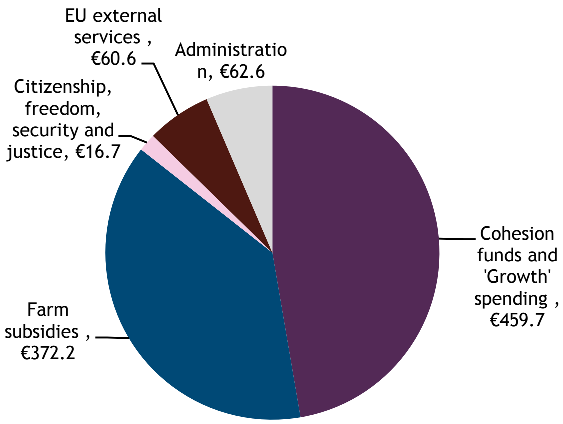
Moreover, although EU regulation has a deep reach in European life, there are actually only a very small number of areas where the EU has agreed to pool spending, and farm subsidy and development subsidy (whatever the euphemism in EU budget lines) are the two key areas. The maintenance of the central bureaucracy in Brussels and the EU's foreign service account for around 12% of its budget. The last two seven year budgets have not seriously challenged in any way this basic dominance of EU spending by transfers to poorer countries and farmers. This budget will be the same.

Politically, these are not distributions among regions of a single political state, but 'international' transfers from the taxpayers of one European state to those of another. Although Europeans like to invoke 'solidarity', the Eurozone crisis and its implicit demand that economically stronger European states support or even bail out weaker ones has made this question of fiscal transfers even more sensitive than usual. The politics of the budget are the politics of the EU in microcosm.

2007-2013 Budget: €974.8bn



Second Van Rompuy Draft Budget 22 November €971.8bn



Charts 1 and 2: The last EU Budget and the shape of the next one (2011 prices)

Source: European Commission, public sources

The political limits of economic integration

But they also reflect a wider issue for Europe. Europe has chosen to 'collectivise' a number of things within the EU. Above all, certain forms of subsidy, some aspects of its external relations, including trade policy, and the harmonisation of large chunks of its regulatory frameworks, most recently in financial markets. But almost all of the underlying market structures and almost all of the market supervision in the EU remain national, delivered by national governments to the tune of national politics.

This is the simple reason why so many of the EU's big economic and political 'projects' – the European Single Market and the Eurozone most obviously – have the unmistakable air of being half-finished. The politics of European integration have allowed unification to proceed to a certain point, but not further. This, of course, is the basic problem with the Eurozone: it is a monetary union without the traditional backstops of fiscal or political union.

The EU budget testifies to the difficulty the EU has in expanding spending in areas that would actually deepen the European single market: cross border infrastructure, joint research and development spending and provision of innovation subsidies. Because existing spending and the overall level of transfers to the EU are so politically sensitive, efforts to transfer money or increase spending in areas like infrastructure, science and technology and 'growth' policy have made only the most incremental progress over the last two decades. In this budget, they are likely to absorb most of the pressure for spending discipline.

There are a number of ironies thrown up by this. Britain, which is a staunch critic of agricultural subsidy spending in the EU actually has a disincentive to see it cut, because of the 'rebate' negotiated by Margaret Thatcher in the 1980s, that sees around £3bn returned to the UK each year from the farm subsidy pot because of its small number of subsidised farmers. Cut farm spending and you cut the UK rebate. So the UK ends up pushing for cuts that will inevitably come out of the marginal 'growth' spending on things like infrastructure that it likes to champion.

The political small print

Nevertheless a close reading of the Van Rompuy draft budget leaked during the Summit suggests some interesting shifts are taking place beyond the numbers that made the headlines last week. A couple of these are worth noting in particular because they are small but important attempts to address the bigger EU – or at least Eurozone - problem of a weak centre and a fragmented market.

First, both the Commission's early proposals and the Van Rompuy budget draft contain mechanisms making cohesion spending in the EU conditional on macroeconomic good behaviour. The budget proposes giving the Commission the power to declare an EU state in breach of EU rules on both fiscal discipline and the management of economic imbalances within the EU, and to cap its access to cohesion funds until it addresses the problem. This is a toehold at the EU level for the concept of budget autonomy – funds that are distributed to Member States at the discretion of the EU, rather than simply recycled back to Member States. This has the fingerprints of Berlin on it, and it is an important step.

Second, the Van Rompuy budget draft contains a commitment to the creation of a Financial Transaction Tax as part of the EU's 'own resources' – the sources of funding that go directly into the coffers of the European institutions, including tariffs collected at the EU borders and fines levied by the EU's competition authorities. The budget draft explicitly states that this proposal would be carried forward by the states of the Eurozone alone, as the UK in particular would be opposed. But here, in embryonic form, is a tax levied at the level of the Eurozone, to contribute to the governance of the Eurozone – and idea that Van Rompuy's team have been quietly consulting on for months.

These are hardly a revolution, but they are an interesting little eruption of centralised economic governance. The European Commission's own blueprint for EU economic governance published this week goes further, proposing the establishment of a separate fund for the Eurozone that would be used to provide incentives for structural reform. In the Commission plan, this would ultimately be the core of a separate Eurozone Treasury.

While it is tempting to look at the EU budget as simply another example of Europe's painful dysfunction, the budget debate actually tells us three important things about the EU. The first is something about the limits of political integration in Europe. The second is something about the limits of economic integration. In the same way that the politics of European integration are acting as a check on the kind of collective action that might resolve the Eurozone crisis, they are also acting as a check on the kinds of spending or investment that might genuinely deepen the single market.

But the third is that behind the absolute spending levels, this budget contains some interesting proposed changes in the way the EU raises and spends money that reflect a growing desire, at least in Brussels and Berlin, to give the European 'centre' more autonomous resources and more discretion to use resources as an incentive to toe the new European policy line. This may be the real significance of this budget.

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