New demands for EU spending: justifiable or fanciful?

Iain Begg, European Institute, LSE[1]

Abstract

The aim of this paper is to examine how expenditure from the EU budget on new classes of public goods could help to address major demands on policy after the end of the 2007-13 Multi-annual Financial Framework, formally agreed in 2006. It starts by discussing principles for preferring the EU level and their limitations as a guide to decision-making, an exercise that builds partly on insights from first- and second-generation fiscal federalism, but also brings in political economy considerations. The paper then looks specifically at two areas of economic governance in which it is frequently claimed that the current low level of EU spending is simply not commensurate with the aims the Union has set itself and has embodied in its principal co-ordination processes. These are how to secure a transition to a low carbon economy (part of both the Sustainable Development Strategy and the evolving Energy Policy for Europe) and how to underpin efforts to boost productivity growth as part of the Lisbon strategy. The main message from the paper is that although the EU budget could, and probably should, be orientated more towards these aims as part of a more coherent approach to economic governance, hard choices will be needed in deploying what is certain to remain a limited policy instrument.

1 Introduction

There is widespread agreement that the EU budget is out-of-date, ill-suited to the emerging demands on the EU and, worse, trapped by path dependencies that severely circumscribe the options for change. In the words of Italian economists Buti and Nava (2003: 1) it is 'a historical relic'. As any Italian knows well, however, relics can endure for centuries with subsequent generations ready to cherish and adapt them, rather than knocking them down and starting again. The shortcomings in the budget have been extensively rehearsed and it can sometimes appear as though there are, indeed, features that are preserved for purely historical reasons, rather than because they meet the needs of the present (see, among many others: Le Cacheux, 2005 and 2008; Begg, 2005 and 2007). Equally, the EU budget has to contend with an environment in which there is no easy answer to the question 'what is the EU for?', and in

[1] I am grateful to the Swedish Institute for European Policy Studies (SIEPS) and to the Foreign and Commonwealth Office for financial support for the projects on which this paper is based.

the absence of an unambiguous vision of what the *finalité politique* of the Union is likely to be, it should not be surprising that it is hard to find an agreed direction for reform of the budget, let alone to discern a *finalité budgetaire*.

The aspects most criticised include the continuing prominence of the Common Agriculture Policy (CAP) in expenditure, the increasing opacity of (and dubious rationale for) 'corrections' that diminish the net contributions of certain Member States, a lack of flexibility (especially in responding to new challenges), and other flaws in governance including the legitimacy of the processes of decision-making. More generally, what is absent from the debate on the EU budget is a convincing sense of where the EU level should fit into a system of multi-level public finances. At 1% of EU GNI, the EU level's spending is only a small proportion of aggregate public spending in the union which is around 40% of GNI, Thus, despite being a large figure (currently around €130 billion, larger than the GNI of a number of the smaller Member States), it is just 2.5% of public spending. As Jonas Eriksson pointed out in a recent SIEPS paper (Begg, Sapir and Eriksson, 2008: 9) 'to say that its economic impact is significant would be a serious exaggeration'.

In typical federal systems, the highest level of government will be responsible for a sizeable proportion of public expenditure and taxation. Thus, in the US, it is in excess of 20% of GNI[2] and the proportions in other major federations are of similar orders of magnitude. Figure 1 shows the broad breakdown in a range of countries between central and sub-national government in both revenue and expenditure. Although the chart shows that federal countries such as Canada, Australia and the US tend to assign more public finance functions to lower tiers of government, it also demonstrates that sizeable delegation also happens in unitary states. Moreover, other work by the OECD (notably through its *Network on Fiscal Relations across Levels of Government* and the publications flowing from the network's activities) suggests that there is something of a global trend towards decentralisation.

Perhaps more importantly, the federal level of government plays a pivotal role in systems of public finance, with fairly well defined hierarchies of administration. These roles have been extensively theorised and analysed in the literatures on fiscal federalism and multi-level governance. In practice, the central government in unitary states also fulfils similar functions, so that although the term 'federal' is often used in the academic literature, the relevant distinction is between central and sub-national government. The question that then arises, and which this paper addresses, is whether this literature can inform the debate on reform of the EU budget. Fiscal federalism is about more than tax and spending arrangements and, thus,

---

[2] According to a Citizens' Guide produced by the US *Government Accountability Office*

something of a misnomer, to the extent that it 'is concerned with the division of policy responsibilities among different levels of government and with the fiscal interactions among these governments' (Wildasin, 2008).

1.1 The 2008/9 review of the budget

Considerable effort has been expended on trying to define how the EU budget should be reformed, and the slow-burning 2008/9 review has provided an opportunity to approach the issue from first principles. For the Commission (2007), the starting-point should be policies, and the consultation paper published to launch the review sets out a range of areas in which EU spending could be expected to support the achievement of policy objectives. Others have argued that EU spending should be subject to the rigorous application of the principle of subsidiarity, implying that it should occur only when there is a demonstrable benefit from assigning the spending to the supranational level. In fact, the UK government contribution to the consultation proposes that EU spending can be justified only when three tests have been passed: demonstrable added value from spending at EU level; ensuring that the outlays are proportionate to the task; and that the EU spends the money effectively (HM Treasury, 2008).

The 2008/9 budget review - still, at the time of writing, too low on the 'to-do' list of the European institutions to be completed - might have been, and could still be, a once-in-a-generation opportunity to reform the budget in line with the priorities of today and tomorrow, rather than yesterday. As such, it might be expected to take more account of underlying economic and political theories. But it has, so far, been over-shadowed by other political priorities. Initially, the Irish referendum on the Lisbon Treaty inhibited any debate on the budget because of the perceived risk that an injudicious statement from 'Brussels' would be seized on by the 'no' campaign, and even in the aftermath of the negative result, there have been few leading politicians willing to adopt firm positions while a solution to the ratification was sought. Subsequently, the economic crisis has, not unreasonably, been the principal pre-occupation of the EU's leaders.

The upshot is that the review is running out of political time and space, bearing in mind that the five year mandates of the current Commission and Parliament expire in 2009. As a result, the original approach to the review, which was to concentrate on principles and policies rather than on money, is likely to be overtaken by the early skirmishes on the next Multi-annual Financial Framework (MFF) that will be needed once the present one covering 2007-13 ends. This would be unfortunate and it is to be hoped that it will still be able to draw on underlying principles rather than being caught in the customary dogfight over money (and money back).

1.2 Aims and outline of the paper

This paper focuses on the sorts of shifts in the pattern of expenditure inside the EU budget that can be justified, taking into account such concerns as subsidiarity, added value and proportionality, and on whether public expenditure at the EU level in these areas can be effective. A related issue is how extensive the overall spending envelope for these purposes should be and the implications for the structure of EU financing, especially the balance between direct spending and loan finance through bodies such as the European Investment Bank. The second section of the paper looks afresh at the principles for assigning policy to the EU level, drawing especially on fiscal federalism and multi-level governance. The subsequent two sections assess the potential for using the EU budget, first, to bolster productivity and, second, as an instrument for supporting a transition to a low carbon economy. A concluding section recalls the well-known realities of budget negotiation in the EU, highlighting some of the decision-making dilemmas that arise, and suggests a way forward.

2 Conceptual models for a supranational budget

According to Riker (1964: 101), the essence of federalism is that each level of government has 'some activities on which it makes final decisions'. This characterisation raises the perennial question of whether the EU can be regarded as a level of government equivalent to the standard models as found in the US, Germany and other well-established federal nation-states, but also suggests a means of portraying EU finances. While it is self-evident that the EU is a long way from being a federal system and the 'f'-word remains taboo for many Member States, it is nevertheless worth looking at the extent to which it has federal characteristics.

There is an extensive and well-developed literature on the merits of federal systems in delivering public goods (for a recent overview, see Inman, 2007) that has resonance for the EU, Indeed, James Madison, in Federalist Paper No. 46, eloquently debunks the idea that the states have to fear a more powerful centre: 'the powers proposed to be lodged in the federal government are as little formidable to those reserved to the individual States, as they are indispensably necessary to accomplish the purposes of the Union'.

For Rodden (2006a: 5) 'the promise of federalism is a straightforward proposition that has shown up time and again in political and economic theory from Montesquieu to James Madison to Richard Musgrave: In heterogeneous societies, government policy is most likely to be aligned with the preferences of citizens in the presence of multiple layers of government, each charged with different responsibilities. Higher-level governments can provide federation-wide collective goods like common defense and free trade, while lower-level governments can provide goods like trash collection and religious education that will be consumed locally. If each layer of government stays within its bounds and respects the authority of the other, citizens can hold each layer of government separately accountable for its activities'. He also notes that it necessarily means a weaker centre, something that manifestly applies in the EU. But on another criterion, namely the probability that the centre will bail out the sub-national level, the EU doubly fulfils Rodden's ideal. Not only does it have no capacity as a fiscal authority to do so, but the monetisation of Member State debt by the European Central Bank is explicitly forbidden in the Treaty.

2.1 Fiscal federalism as a guide

Fiscal federalism, especially, might be expected to offer insights into how the EU budget should evolve and ought to be pivotal in theorising and understanding the public finances of a multi-level governance system such as the EU. Wildasin (2008) states, perhaps stretching the point, that the EU 'can be viewed as an emerging federation in which EU-level political and fiscal institutions are gradually developing'. He also reiterates the division of labour suggested by what he calls a 'broad normative consensus' that the highest level of government (a status he argues *could* be conferred on the EU) should normally be responsible for stabilisation policy and for distributive policies, whereas allocative policies should be situated at the level of government 'whose jurisdictional boundaries are co-terminous with the geographical scope of the regions affected by these policies'.

Other prominent scholars have also noted the EU's gradual evolution in a federal direction: for example, Inman (2007: 523) states that the EU 'is now moving albeit slowly, towards a more integrated political union founded upon federal principles of governance'. Although it might be argued that the mood in recent years has swung markedly against political union on federal lines, the budget is one of the most visible manifestation of the EU as an inter-governmental phenomenon. An earlier paper by Gramlich and Wood (2000) argued that although some aspects of fiscal federalism can readily be discerned in the EU's development, the unique nature of the EU's development calls for fresh approaches that more convincingly capture the fiscal arrangements of the Union. It is this *sui generis* character of the EU that makes it so difficult to apply the more standard precepts of fiscal federalism.

What fiscal federalism addresses has been set out by Bird (2003) who argues that it comprises the following:

- Expenditure assignment: who should implement which spending programmes
- Revenue assignment: who should levy which taxes
- How to mitigate vertical imbalances between the revenues and expenditure of sub-national government

- Whether and how to offset horizontal imbalances between needs and capacities of units at the same level
- Who determines the capacity to borrow and according to what rules
- The nature of the underlying political and institutional system and its ability to settle differences.

Bird argues that efficient governance is achieved by applying the 'matching principle', under which 'benefit areas' are matched by 'financing areas'. In so doing, he reaffirms the well-established principles of Oates (1972 and 1999) who pioneered work on fiscal federalism and continues to be a leading contributor. Bird also asserts that the aim should be to decentralise as far as possible, a principle he equates with subsidiarity as used in the EU.

However, even the briefest inspection of how public finances in the EU are arranged reveals that there is scarcely any resemblance between the public finance model of the EU and that of any of the US, Switzerland, Canada or Germany, four countries which have featured especially prominently in the academic literature on fiscal federalism. Hence, an uncomfortable conclusion from most attempts to apply insights from such theories is that the very particular circumstances of the EU do not fit well with standard approaches. As Vito Tanzi argues in a recent key-note paper presented to a major conference on fiscal federalism, the theory has two substantial shortcomings (Tanzi, 2007). First, it does not offer a convincing template for analysing delegation upwards to supranational institutions, despite the fact that such institutions are playing an increasingly influential role in economic governance. As he puts it, 'We have been spending too much time looking down from the central government's layer. It is time to look up from that layer'. The EU has by far the greatest reach of these institutions and, although much of its activity is regulatory, could reasonably be expected to have expenditure functions that extend well beyond what it currently does. Second, Tanzi stresses that the relationships between tiers of government typically reflect historical developments and compromises, much more than design based on principles rooted in theoretical approaches such as fiscal federalism. Nevertheless, the political or institutional logic that gave rise to the existing frameworks can become ill-adapted to new circumstances. He therefore criticises the notion that there is an optimal fiscal arrangement that can be embodied in a constitutional settlement.

In addition, much of the attention in the standard fiscal federalism models concerns how a substantial and powerful central government mediates between multiple sub-national units. This, plainly, is not a convincing description of the inter-governmental relations in the EU where the small scale of the supranational tier and its highly skewed functions bear little resemblance to the theoretical model of a central government. In the EU, it is the budget of the single supranational authority which is the outcome of the wrangling between powerful central governments. In the standard model, the issues of vertical and horizontal equalisation loom large, and there are heated debates about the most suitable forms of inter-governmental grants yet, in the EU setting, the most contentious issues concern Member State net balances and whether or not the EU level should have any autonomy in its revenue raising.

Second-generation fiscal federalism

More recent work has shifted somewhat from the normative preoccupations of FGFF to explore in a positive manner the incentives facing government at different levels. In much of what has been dubbed 'second generation fiscal federalism' (SGFF), the academic literature suggests that careful analysis of incentives and of the inter-play between market forces and the public sector is needed in allocating expenditure functions (see: Oates, 2005; Weingast, 2006). Weingast (2006), citing a number of other studies, argues that a key innovation in SGFF is to focus on the growth-enhancing effects of the model of fiscal decentralisation, rather than the equity effects emphasised in FGFF. Could it be that the EU budget is too little orientated towards growth (which would arguably boost the EU's coffers) because financing by inter-governmental transfers diminishes incentives to promote public goods and increases incentives to engage in side-payments?

Common-pool problems are emphasised in SGFF – see also Osterloh et al. (2007). They arise where the incentive facing a decision-maker is how to secure (whether for constituents or for interests the decision-maker wants to favour) a disproportionate share of the public goods produced by a higher level of government. With a common pool, an absence of fiscal equivalence may lead to under-provision of public goods if the tax-payers are few and well-organised to sow division among many beneficiaries. If the Member States are regarded as the taxpayers, the EU could be said to conform to this model. By contrast, the common-pool problem when there are many tax-payers and few beneficiaries is that the latter, if well-organised, can extract more than their fare share, the more so if they are the decision-makers.

The constitutional or institutional design will then be influential. Thus, in the EU, the unanimity that applies to the budget can accentuate common pool problems, especially for veto players (for example, small Member States) that can exercise greater power than if they had to compete for resources on the basis of population or economic weight. Side-payments (or, more pejoratively, resort to 'pork barrel' payments, as so often seen in US budgetary settlements) are then needed to make agreement possible. If decision-makers, in addition, are beholden to specific constituencies for votes or influence, then they can make common cause to capture budgets. It does not take 20-20 vision to see the CAP through this lens. SGFF again, sees fiscal equivalence as the solution.

Soft budget constraints are also a form of common pool problem because they facilitate shifting of the costs of obtaining public goods and services. However, the main sense in which this phenomenon manifests itself in the EU, is that its substantial regulatory output and, latterly, different forms of policy co-ordination lead to obligations that the Member States or sub-national governments have to finance. A possible deduction here is that the EU will tend to be too active because it knows that it will not have to fund the resulting expenditure. This suggests something of a paradox that having too small a budget at EU level leads to higher aggregate public expenditure. In some federal settings, according to Weingast (2006), central governments exhibit predatory behaviour that expropriates the benefits of decentralisation. There is no immediately obvious way in which this applies to the EU, but it may be a feature that deserves further investigation.

Weingast (2006), in his summary of the differences between FGFF and SGFF stresses that they are complementary rather than alternatives. But he also emphasises the importance of revenue raising by sub-national government and, as a second stage, of ensuring that the government in question has to find most of the marginal costs of new spending. Generally, the challenge for reform of the EU budget is to ascertain to what degree the notion of market enhancing expenditure central to SGFF is not only influential, but also relevant in a small budget which has to reconcile so many conflicting political aims (Enderlein, 2007).

2.2 Implications for the EU budget

There are both conceptual and empirical issues – and, inevitably, disagreements – about how to frame the EU budget in the light of the theoretical models and their implications for good policy design. The differing views on federalism make it almost impossible to derive uncontested theoretical propositions that can guide the EU budget. As Rodden (2006b: 2) bluntly puts it, 'the prevailing view of federalism as a clean division of sovereignty between higher and lower-level governments is giving way to a notion that authority over taxation, expenditures, borrowing, and policy decisions is inherently murky, contested, and frequently renegotiated between governments, with federal constitutions analogized to the "incomplete contracts" of industrial organization theory'. For this reason, it may be over-optimistic to expect that a convincing design for the EU budget can be elaborated from first principles.

Much of the literature on fiscal federalism and multi-level governance assumes a clear hierarchy of government, let alone governance. It follows that attempting to apply the insights and tools derived from this literature to the political and economic choices around the EU budget is not easy. Yet, in some areas, lessons can be drawn, not least in assigning responsibilities for public expenditure and inter-governmental transfers among tiers of government in a manner consistent with the principle of subsidiarity. The challenge in the highly politicised context of the EU is to establish in what circumstances (bearing in mind the small size of the budget) the principle can be convincingly applied. Instead, the question becomes one of trying to work out to what degree the underlying principles can inform the choices about what expenditure should be undertaken by the EU level and how it should be financed.

A key issue to resolve is, thus, whether the conventional interpretations of allocation and distribution, if not stabilisation, can so readily be applied to the EU. Distribution in EU terms is not, in the first instance, inter-personal – the essence of the approach adopted in fiscal federalism – but among Member States. Indeed, there is no presumption that cohesion policy will benefit households in the lowest deciles of the income distribution; instead, its primary effect in the lexicon of the fiscal federalism model is to act as a form of fiscal equalisation, albeit one that straddles allocative and distributive aims.

These insights must colour how EU expenditure, as an instrument of economic governance, is understood and applied. One reading is that most of today's EU budget is distributive (namely the CAP and cohesion) and that true European public goods are a minor share. Others contend that objectives such as food security or the spreading of economic development have public good attributes and thus that it is an exaggeration to classify these policies in their entirety as distributive.

There is now something of a consensus that the EU is not on course to become a United States of Europe, and thus the federal level of a multi-level governance system. Granted, it has acquired and continues to accumulate considerable regulatory powers, consistent with Majone's (1996) notion of the regulatory state. Granted, too, there is a demand to rethink the expenditure competences that the EU is assigned. But all of this is within the rather limited sphere of an EU level subject to much more restrictive constitutional limits on its ambitions than apply to federal nation states. Consequently, Tanzi (2007) is surely correct to argue that the emergence of the supranational level as a significant, but often narrow policy actor represents a qualitatively new phenomenon that fiscal federalism struggles to accommodate. In practice, the allocative function of the EU budget is primarily about the case for EU level public goods, but is adjusted to allow for transfers between Member States, a function that is very different from the inter-personal redistribution that features in fiscal federalism.

2.3 Subsidiarity applied: the Ecorys report

The most extensive recent study of the expenditure side of the budget has been done by Ecorys, CPB and IFO (2008) – hereafter, the Ecorys report. It looks at the rationale for the existing and prospective future EU spending from the perspective of public finance theory and the principle of subsidiarity and, not surprisingly, concludes that were these principles to be applied rigorously, substantial changes in the structure of spending would be justified.

Throughout, in the study, the broad approach taken is to find reasons *not* to assign public spending competence to the EU level.

The study builds on the straightforward subsidiarity test developed by Ederveen et al. (2008) which poses the question hierarchically:

1. Is action at the EU level necessary to achieve the stated aims?
2. Can it be achieved by co-ordination of national efforts?
3. Even if EU level expenditure is justified, how much is needed to ensure a proportionate response?

But the two questions that then arise are, first, how to justify change and, second, how to refocus EU spending. Concepts such as subsidiarity and proportionality, or the assertion that EU spending must be confined to policies for which there is a demonstrable added value, can sound too abstract to be operational. Even if they deserve to be more prominent in shaping the EU budget, there are tough obstacles to applying them. The status quo is powerful and the lobbies that underpin the continuation of policies such as the CAP are highly effective. In addition, the EU budget manifestly still has a role to pay in smoothing the (bumpy) road towards European integration by transferring resources between Member States as part of grand bargains. These may be parcelled up inside policies that have worthy objectives (cohesion as a public good), but are inevitably susceptible to the pork-barrel politics of *juste retour* thinking. A further constraint is the size of the budget because, so long as the budget is set at about 1% of GNI, entire categories of public spending are effectively excluded from consideration, irrespective of political or efficiency arguments for shifting them upwards. Typically, federal budgets account for 10% or more of GNI and even the much smaller 'federal-light' budget of 5%-7% discussed in the MacDougall report looks like fantasy.

Even if a moderate increase to 1.3% or 1.5% of GNI is contemplated, there is no easy way to use theoretical models to arrive at an objective list of what should be in the EU budget rather than at other levels of government. The Ecorys report made a rigorous effort to apply its extended subsidiarity test and reaches plausible conclusions about the relative merits of assigning different classes of public spending to the supranational level. It proposes three 'packages' as underlying narratives for a reformed EU budget:

- Climate change and energy
- Knowledge and innovation
- Common security and foreign affairs

Each has its merits, but the key point is that they are alternatives, and choosing one rules out the others. The remainder of this paper looks at how a future EU budget might concentrate on a narrow, but politically salient and economically rational set of tasks. Two that stand out are dealing with climate change and responding to the competitive challenges associated with globalisation – even as the model itself comes under stress as a result of the economic downturn. But the EU could equally find a resonance in enhancing its role in external action, security matters and common foreign policy. Adding the budgetary costs of all these areas together, and taking into account the need for some inherited elements of spending to continue, would greatly overload the EU budget, especially if it is to remain at around 1% of EU GDP, which emphasises the hard choices that will be required. The next two sections look at competitiveness and climate change in more detail.

3 Competitiveness and productivity

For the Commission it is, arguably, the Lisbon strategy which has been its core 'project' since 2005. The strategy is, first and foremost, about structural reform of the EU economy and the principal aims include shifting the EU towards knowledge intensive activities, boosting the employment rate, better regulation and, generally, the enhancement of market disciplines. Although the merits of a market-dominated approach to supply-side policies has been questioned as a result of the perceived impact of market failures in the 2008/9 downturn, the broad thrust of policy is not likely to change greatly in the coming years. The weaknesses on the supply-side of the EU economy have been documented and analysed extensively in numerous reports by the OECD, the European Commission and other bodies, and there is no need to go over all the familiar ground on the diagnoses of what needed to be done. Instead, the principal challenge is to translate diagnosis and strategising into effective implementation. In this regard, primary governance imperatives are how to relate the Lisbon strategy to other major policy initiatives, given that it was, especially in its first five years devoid of real policy instruments, including a meaningful budget.

Various contributions, of which the Sapir report (2004) was perhaps the most prominent, had sought to emphasise the importance of re-orientating the budget much more towards growth promoting policies, and much of the subsequent political spin has been devoted to showing that the 2007-13 MFF was, indeed, a budget for 'growth and jobs'. Certainly, the budget was presented in a new way to highlight growth and competitiveness and the fact that in 2008, for the first time, expenditure on competitiveness aims exceeded CAP spending was presented as compelling evidence of the shift. However, the latter claim is only justifiable if the whole of the cohesion budget is deemed to be in support of competitiveness.

Certainly, the current round of cohesion policy includes an obligation 60%[3] of spending has to be on projects that support the aims of the Lisbon strategy. Yet it is remarkable that over the entire span from 1988 - when the budget underwent major reform - to the projected figures for 2013, some three-quarters of EU spending has consistently gone to the CAP (including the so-called second pillar which supports rural development as opposed to direct payments to farmers) and cohesion.

What, then, might a future budget contain that can contribute to competitiveness objectives? Perhaps surprisingly, the Ecorys report is rather ambivalent about the case for more EU spending in these areas. However, it is partly a matter of definition. In the study, the headings of expenditure under discussion cover several relatively small budget lines that bear on competitiveness (the internal market, taxation and customs, external trade, and the competitiveness and innovation policies overseen by DG Enterprise), but not R&D which is, in fact, the largest element of line 1a (Competitiveness for growth and employment, i.e. the non-cohesion elements) in the current budget. The report does, by contrast, emphasise the

Internal market spending (0.05% of the budget today) is predominantly administrative and analytic, and there is little scope for public investment in this area. Similarly low amounts are spent on taxation and customs, competition policy, and on external trade policy, in all of which the main tasks are, again, administrative. It could be argued that trade promotion might be an area that could benefit from collective action, but there are evident national sensitivities to take into account. The competitiveness and innovation policies do embrace a number of spending programmes, as well as administrative expenditure and are much the biggest of the five categories discussed. However, it is important to note that the programmes in question are principally about diffusion – especially to SMEs – rather than the knowledge creation implicit in R&D programmes funded elsewhere in the EU budget. This leads the authors of the Ecorys report to argue that there is not a strong case for boosting EU spending in this area, notably because the risks are slender of spillover effects inducing Member States or localities to under-invest in such policies.

These arguments have some force, but are also open to criticism. Cross-border co-operation between SMEs can be an important channel for diffusing innovation, suggesting a case for the EU level to provide resources to achieve it. Similarly, in an increasingly globalised knowledge market, mechanisms funded at EU level for linking companies and research

---

[3] Strictly, the obligation is limited to the EU-15 countries, but it has become a de facto norm for the other Member States which receive the bulk of cohesion transfers.

institutes, could be helpful. In both cases, what the EU level is best equipped to do is to develop programmes that open doors.

4 Responding to climate change

There is a budding consensus that climate change concerns mean that a business-as-usual (BAU) scenario for the character of EU growth is no longer tenable and that economic governance will, henceforth, have to be much more concerned with the quality of growth and not just with expansion *per se*. Indeed, there are already strong indications that one of the consequences of the 2008/9 economic downturn will be a recasting of the capitalist model towards the 'green' economy. For these reasons, a post-2010 framework for economic governance is likely to have to place policies to curb carbon emissions more firmly at the centre of policy-making and will need to be coherent across policy areas.

The Stern Review (2007) has been very influential in translating the scientific debate into economic analysis. The Review, together with subsequent work by Stern (2008), also highlights the long timescales needed for action and thus the imperative of acting now, rather than waiting for the effects of climate change to show themselves. It will have to involve a profound change in the relationship between energy use and GDP, implying sharp reductions in the energy intensity of GDP and in the carbon intensity of energy. The scientific analysis suggests that to limit global temperatures to an increase of no more than 2º Celsius, the concentration of carbon in the atmosphere has to be capped at 500 parts per million or lower. Global emissions would need to fall progressively to reach 50% of current levels by 2050 just to stabilise the amount of carbon in the atmosphere, while lowering them would be even more demanding.

But the opportunities it will afford also have to be stressed, notably the prospect of the creation of a substantial number of 'green' jobs and the emergence of new sectors of activity. EU policies will have a central role in a comprehensive approach, going well beyond the Energy Policy for Europe with its '20-20-20' approach. Thus, in the evolution of the Lisbon strategy after 2010, low-carbon objectives can be expected to feature much more prominently than hitherto, while cohesion policy will be under pressure to go much further than it has already in supporting initiatives to counter climate change. If such a qualitative change occurs, it is bound to have ramifications for the budget which will need to play its part in promoting the desired changes.

4.1 Why the EU budget?

The magnitude of the changes required points to the need for a novel approach to governance, including re-thinking whether EU expenditure can play a pivotal or catalytic role. Equally, funding elements of a carbon abatement strategy at the EU level requires a robust economic justification, and will have to complement what is done at other levels of government and by private agents.

Many of the standard economic arguments for assigning spending competences to the EU level are especially apposite for countering climate change. One is that if a single Member State is unable to appropriate the full benefits from investment in public goods it will invest less than is socially optimal; another is that there may be economies of scale from investment at a more aggregated level.

In standard welfare analysis a pure public good is one which can be shared completely and is thus *non-rivalrous* in the sense that the benefits of the good obtained by one individual (or, perhaps more tellingly in the EU context, one Member State) do not detract from the benefits accruing to others. By the same token, no individual can be left out, so that pure public goods are also *non-excludable*, with benefits flowing to all citizens, irrespective of circumstances. Prevention of climate change fits this characterisation closely.

Treating carbon abatement as a public good in this way has a number of policy implications. First, there has to be agreement on what constitutes a public good, although it can be argued that dealing with climate change will confer benefits on all parties and leave no-one out. Much of the carbon reduction agenda is, *par excellence*, about 'commons' that affect people across the globe: a tonne of carbon emitted into the atmosphere has exactly the same effect wherever it originates.

Second, the corollary of carbon abatement being non-excludable is that individuals (or countries) then have no incentive to pay, as they can free-ride. Third, there is a delicate balance to be struck or a need for multi-lateral co-operation if a revolt by tax-payers in countries which do act, or are under pressure to act, is to be avoided, leading to systematic under-spending on the public good.

4.2 How much money and on what?

There are many initiatives to abate carbon emission for which a plausible case for EU budgetary support can be made on the basis of analytic criteria. In principle, different categories of spending could be ranked according to their 'scores' on a range of relevant criteria, such as the scope for added value from EU level spending, the cost effectiveness in terms of volume of carbon abated and the aggregate impact. Such an exercise would be useful, but would be expected to identify more projects than could be supported by a limited budget. Hence it is inevitable that decisions on which to assign to the EU budget will reflect political judgements as well as purely analytic considerations.

It is important to note that the EU budget already funds policies that contribute to carbon mitigation, although it is not easy way to work out how much is being spent at present. The main budgetary headings under which there are outlays that do so are cohesion, rural development, energy, transport, research and external action. Totting up the various programmes, the current annual level of such spending is estimated to be in the range €4-10 billion out of a total budget of €129 billion. The explanation for the range is that certain large items of EU expenditure contribute only indirectly to carbon abatement (notably support for rail building). It is also noteworthy that the European Investment Bank (EIB) lends substantial amounts for rail infrastructure.

Actions to support lower carbon emissions can be on both the demand side and the supply-side of the economy; and some will have short-term benefits, while the pay-off from others will take much longer. The trouble, though is that once the easy options are exhausted, more controversial changes will be needed if the EU is to make progress towards an aggregate as high as 80% cuts and difficult compromises will have to be brokered. Given that there is, as yet, no credible alternative to oil-based fuels for transport, other sectors such as electricity generation may have to become effectively zero-carbon within two or three decades, and there is a compelling case for the EU budget to support this transition.

Technological developments will obviously loom large in any transition to a low carbon economy, but it is important to distinguish between different forms of such investment. Major impacts in the coming decade will, principally, stem from improving and diffusing existing technologies, but there will be a parallel need to boost investment on known, but as yet uncommercial technologies that offer scope for more bigger cuts in carbon emissions over a longer time horizon. In addition, there will have to be resources to develop the breakthrough technologies that will provide much longer term solutions.

Even timely carbon abatement projects will not deliver results quickly, so that there is a high probability that temperatures will rise over the next two decades. If so, there are likely to be calls for public funding to underpin adaptation to effects such as rising sea levels. Care is, however, needed to avoid an adaptation strategy diminishing commitments to dealing with the underlying problem of rising atmospheric carbon concentrations.

Nevertheless, there could be a rationale for EU funding for adaptation policies on much the same logic as for cohesion policy. Differences in fiscal capacity or in the incidence of carbon reduction policies, contingent on the scale of the transformation that is needed in a national or regional economy, could justify such outlays.

Although it elicits opposition from some environmental interests, a key technology will be carbon capture and sequestration (CCS), a process which will allow for increased use of coal, an abundant and widely distributed primary source of energy that is especially suited to electricity generation, but with much lower emissions (see Ansolabehere, S. et al., 2007). EU funding for full-scale demonstration projects has been strongly advocated and the urgency of moving quickly has been highlighted (Egenhofer, 2008).

Many other projects for technological advances, from the grand in scale to the minor, are also worth pursuing, so that criteria for allocating resources are required. In general, the approach should be to select projects for funding on the basis of excellence rather than picking winners. In addition, it should be stressed that it is not only 'big' science and engineering that are relevant, but also smaller projects and what might be described as social technologies that stimulate energy saving. The adoption of eco-driving techniques, for example, can lower petrol consumption by at least 10%

4.3 Concentrating efforts: the hard choices

Potentially contradictory criteria bear on where to concentrate inevitably scarce EU resources. A value for money test would call for ranking policies according to the public expenditure needed per tonne of CO_2 abated. But such costs vary over time, whether because of scale or learning effects, or because of technological change. It is also important not to overlook the potential volume of carbon reduction that can be achieved in different ways and thus not to pin too many hopes on cheap options with limited scope.

In addition, many of the more difficult options will proceed in stages. CCS, for example, can be expected to go from very costly piloting and developmental stages, through full-scale demonstration to lower cost roll-out. It is also important to allow for underlying regulatory changes that may make CCS commercially attractive if an effective carbon price at a high enough rate is achieved, whereas in present circumstances investment in CCS will be limited without public sector support. An important start has been made with the decision of the December 2008 European Council to hypothecate some of the revenue from the EU's Emissions Trading System to part fund up to 12 demonstration plants, but there are further stages to the full-scale operation of CCS that may also warrant public funding, notably to finance the necessary pipeline infrastructure.

Political sensitivities are bound to arise for some potential EU spending. Highly cost-effective results in terms of lowering emissions may be attainable from EU spending outside the EU, but would face internal objections that spending should be 'at home'. A more subtle (but still telling, given the EU's aspirations to exercise normative power) objection is that it might also create the impression that the EU was balking at taking the lead in curbing its own emissions, reducing pressure on others to follow.

There are further political sensitivities around the overall annual spending that could be envisaged for carbon abatement, especially the fact that the EU budget today is around 1% of EU, which means that if more spending is to go on a strategy to counter climate change, either the overall budget would have to be increased or other policies would have to be squeezed. Taking the lower bound of €4 billion of current EU outlays on policies that reduce carbon emissions as a starting point and three target levels for future spending of €15, €30 and €50 billion as the bases for scenarios, the consequences for other spending vary substantially. With the current total of €129 billion, reaching €15 billion on carbon abatement policies would mean cutting other policies by 11%, while €50 billion would mean slashing other policies by 46% - equivalent to the entire CAP and rural development budget. There is, however, a margin between the present level of the budget and the 'own resources ceiling' (set at 1.31% of EU GNI for commitments) which gives room for an additional €35 billion annually at 2008 prices. In other words, sizeable outlays on climate changes while likely to attract opposition, are not beyond the pale.

Nevertheless, a compelling case for the EU budget to support certain classes of expenditure on climate change can be constructed. For example, the Ecorys report identifies among the strong contenders for increased EU level spending several which relate to climate change, including transport and energy (for which the report finds a case for a switch from national budgets to the EU budget, albeit without necessarily spending more in aggregate) and environmental policies (where the report advocates an overall increase in spending). Broadly similar conclusions are reached in a paper by Adelle et al. (2008) who also call explicitly for EU funding of CCS demonstration plants, while Behrens et al. (2008) are convinced that the EU budget should have a leading role in funding policies aimed at countering climate change.

In selecting a portfolio of carbon-reduction projects to be supported from the EU budget, the EU has to balance the short-term and the long-term, the certain and the more speculative or experimental, internal measures and support for action elsewhere in the world, mitigation and adaptation, and the modalities of implementing policies (especially the degree to which they should be embedded in existing expenditure programmes). Some of these will require the creation of new funding mechanisms, while others are capable of being incorporated within existing procedures or expenditure programmes, such as cohesion policy.

5 Conclusions

Theories rooted in fiscal federalism only offer indirect help in determining what should be in the EU budget, for the simple reason that too many of the foundations of these theories just do not apply in the EU. Yet despite the absence of a convincing theoretical framework, a number of principles can be put forward in determining when and how EU money is justified for competitiveness or climate change purposes. First, there has to be a demonstrable added value from spending at EU level. Simply put: if one euro spent at EU level achieves more, on average, than one euro spent at Member State level, there is added value.

Second, a European strategy should be focused on public goods with EU-wide benefits and the emphasis should be on obtaining the best returns from such investment in public goods, irrespective of where they are located in the Union. Attempts to spread spending among Member States so as to spread the apparent benefits or to meet targets for net accounting balances (*juste retour* or 'my money back') will risk blurring their purpose. That said, it is undeniable that no policy is ever entirely spatially neutral.

Third, two sorts of co-financing should be contemplated: by Member States and by creating new loan funds that private agents can access (for example from the European Investment Bank, a potentially significant source of funding for such long-term purposes).

Fourth, while proportionality (spending should only be as much as is needed to achieve the agreed aims) is a sound principle, timing will be critical. Many Lisbon-related aims will require early actions at EU level, for example to overcome immediate bottlenecks in networks or to put in place the bases for longer-term knowledge enhancement. Similarly, a transition to a low carbon economy will require the definition of a trajectory for change, with milestones of increasing ambition, so that proportionality may need to be defined as a moving target.

Fifth, there is some attraction, not least from a political economy perspective, in embedding competitiveness or carbon abatement strategies at least partly within existing expenditure programmes, especially cohesion budgets, even though there is a risk of overloading the latter. Sixth, recognising that business values certainty in the interests of long-term planning, the potential contribution of EU spending in establishing a stable framework for carbon abatement is also worth stressing.

Finally, supply-side policies are not just about fixed investment, hard science or engineering, but also about the socio-economic context, including the likely impact of structural change on employment patterns or of carbon pricing on fuel poverty. These sorts of changes will have ramifications for social justice, both within the EU and for other parts of the world, so that EU funding to deal with the distributive consequences may well be justified.

The timing of a scaling-up of responses to the challenges of smoothing supply-side changes in the aftermath of the economic downturn or of accelerating carbon-related initiatives also has to be considered. Given that a review of the EU budget is in progress and that some Member States are open to moderate changes in the composition of EU spending over the remainder of the current Multi-annual Financial Framework, the scope for moderate changes in the 2010-13 period should not be overlooked. Following the precedent of funding being switched to the *Galileo* project and the €5 billion energy related package grudgingly agreed at the spring 2009 European Council, it is conceivable that further small amounts could be shifted towards specific projects linked to carbon reduction. If so, a strong contender would be immediate EU funding for construction of CCS demonstration plants.

5.1 Bringing Lisbon and low carbon objectives together

Analytic principles suggest that forestalling climate change is a compelling example of a public good at the European (and, indeed, global) level, and thus of the sort of expenditure that should be more prominent in the EU budget than the some of the public goods currently funded, as well as the distributive policies that currently dominate the budget. In addition, the EU budget has the potential to be pivotal in financing those public goods which risk being under-provided by other levels of government because of political economy considerations.

Beyond 2013, and assuming further 5 or 7 year MFFs, a key issue is whether 'low-carbon' becomes the underlying narrative for both a future Lisbon strategy and the EU budget, or what will be needed to make it so. Packages cannot realistically be constructed so far in advance of the start of negotiations about money, not least because it will be difficult to escape the need for some geographical balance, but the content would be expected to include support for:

- Technological advances, aimed at boosting energy efficiency, the development of low-carbon means of generating electricity from coal and hydrocarbons, and boosting alternative energy sources. Such advances can also help to underpin EU strengths in the 'green' economy sectors that may well be where substantial market potential lies.
- Investment in new infrastructure needed to distribute alternative forms of energy or to facilitate greatly reduced emissions of carbon. Again, there is a potential competitive dividend here if the result is to enhance energy productivity in such a way as to reduce the cost to businesses of energy use.
- Initiatives to promote lower carbon use, through education, exhortation and novel approaches to regulation, but also through eye-catching measures that can help to consolidate reduction of carbon usage as a routine practice.
- Spending outside the EU to assist countries constrained by limited fiscal capacity to implement low carbon strategies.
- Dealing with the consequences of structural change and climate change, as well as the impact of a carbon mitigation policies by funding projects or compensation programmes that offset the more extreme negative effects, paying attention to both potential social and regional divergences in the impact.

Whatever, the EU decides to do, it will be part of a budgetary package and thus subject to the horse-trading that invariably accompanies EU negotiations. Devising spending packages that respect these principles will be far from easy, yet it should also be recognised that there are different configurations of spending that can deliver similar results, leaving ample scope for the kind of deals at which the EU excels. In particular, there will be some elements in any package that appeal to certain Member States more than others, whether because of political preferences or because there is the prospect (or, at least, the perception) of net economic gains. If only for this reason, some effort will be needed to sweeten the pill for the countries that risk losing some of their current receipts from the budget.

References

Adelle, C., Pallemaerts, M. and Baldock, D. (2008) *Turning the EU budget into an instrument to support the fight against climate change* Stockholm: SIEPS

Ansolabehere, S. et al. (2007) *The Future of Coal: Options for a Carbon Constrained World* Cambridge, Mass.: MIT

Begg I. (2005) *Funding the European Union* London: The Federal Trust

Begg, I. (2007) 'Rethinking the EU's Finances: the 2008/9 budget review' in Ludlow, P. ed. *Setting EU Priorities 2007* Ponte de Lima: European Strategy Forum

Begg, I., Sapir, A. and Eriksson, J. (2008) *The Purse of the European Union: Setting Priorities for the Future*, Occasional Paper No. 2008: 1op, Stockholm: SIEPS

Behrens, A., Nunez-Ferrer, J. and Egenhofer, C. (2008) 'Financial impacts of climate change: implications for the EU budget' *CEPS Working Document* No. 300, Brussels: CEPS

Bird, R.M. (2000) 'Intergovernmental fiscal relations: universal principles, local applications' Georgia State University International Studies Program Working Paper no. #00/2

Commission (2008) 'Consultation report. Reforming the budget, changing Europe: short summary of contributions' Working document SEC(2008) 2739, Brussels, 3.11.2008

Ecorys, CPB and IFO (2008) *A study on EU spending*, for DG Budget, European Commission http://ec.europa.eu/budget/reform/conference/documents_en.htm

Egenhofer, C. (2008) 'The demonstration phase for carbon capture and storage: the case for public support' *CEPS Policy Brief* No. 174, Brussels: CEPS

Enderlein, H. (2007) 'Three worlds of fiscal federalism: solving the trilemma of multi-level fiscal frameworks in industrialized countries' Working Paper, Hertie School of Governance

Gramlich, E.M. and Wood, P.R. (2000) 'Fiscal federalism and European integration: implicationsfor fiscal and monetary policies' *Board of Governors of the Federal Reserve System International Finance Discussion Papers* No. 694

HM Treasury (2008) *Global Europe: Vision for a 21st Century Budget*, Norwich: HMSO

Inman, R.P. (2007) ‘Federalism’s values and the value of federalism’ *CESifo Economic Studies* 53, 522-60

Iozzo, A., Micossi, S. and Salvemini, M.T. (2008) ‘A new budget for the European Union’ *CEPS Policy Brief* No. 159, Brussels: CEPS

IPCC (2007) *Climate Change 2007: Fourth Assessment Report*, Cambridge: Cambridge University Press

Le Cacheux, J. (2005) ‘European budget: the poisonous budget rebate debate’, *Notre Europe Study* no. 47, www.notre-europe.eu, June.

Le Cacheux, J.(2008) ‘Funding the European budget with a genuine own resource. The case for a European tax’, *Notre Europe Study*, www.notre-europe.eu

Majone, G. (1996) *Regulating Europe* London: Routledge

Oates, W.E. (1972) *Fiscal Federalism*, New York, NY., Harcourt Brace Jovanovich

Oates, W.E. (1999) ’An Essay on Fiscal Federalism’, *Journal of Economic Literature*, vol. 37

Oates, W.E. (2005) ‘Towards a second-generation theory of fiscal federalism’ *International Tax and Public Finance* 12, 349-73

Osterloh, S. Mohl, P. and Heinemann, F., (2007) ‘EU budget reform options and the common pool problem’ Mannheim: ZEW

Riker, W.H. (1964) *Federalism: Origin, Operation, Significance*, Boston: Little

Rodden, J. (2006a) *Hamilton’s Paradox: The promise and peril of Fiscal Federalism*, Cambridge: Cambridge University Press

Rodden, J. (2006b) ‘The political economy of federalism’ in Weingast, B/R. and Wittman, D., eds., *Oxford Handbook of Political Economy*, Oxford: Oxford University Press

Sapir, A. et al. (2004) *An agenda for a growing Europe: the Sapir report* Oxford: OUP

Stern, N. (2007) *The Economics of Climate Change: Stern Review*, Cambridge: Cambridge University Press

Stern, N. (2008) ‘Key elements of a global deal on climate change’, Working Paper, LSE

Tanzi, V. (2007) ‘The future of fiscal federalism’ paper presented to the conference on *New perspectives on fiscal federalism: intergovernmental relation, competition and accountability*, Berlin, 18-20 October 2007

Weingast, B.R. (2006) ‘Second-generation fiscal federalism: implications for decentralized democratic governance and economic development’ Available at SSRN: http://ssrn.com/abstract=1153440

Wildasin, D.E. (2008) ‘Fiscal federalism’ in Durlauf, S.N. and Blume, L.E. *The New Palgrave Dictionary of Economics Online*, Palgrave Macmillan DOI:10.1057/9780230226203.0579