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Towards a European Budgetary System

Marco Buti and Mario Nava

ABSTRACT

The present EU budget is inconsistent with the current state and future prospects of European integration. Three failures are most evident: first, spending is heavily tilted towards the support of a declining sector, agriculture; second, it is almost impossible to reallocate spending across time and across policies; and third, its size is unrelated with the goals of the Union. Transforming the Community budget into a means through which the economic policy of the Union is consistently defined and put into practice requires correcting these failures. This can be done by moving towards a fully fledged "European Budgetary System" in which the EU and national budgets pursue, in a co-ordinated manner, commonly-agreed objectives set in the Broad Economic Policy Guidelines. On a multi-annual basis, the EU Financial Perspectives and the national Stability and Convergence Programmes would be set within an aggregate European Budgetary Programme. Annually, this should give rise to a EU Budget Law to be approved alongside national budget laws.

JEL Classification: E61, E62, H5, H6, H77
Keywords: European Union, Fiscal Policy, EU budget, Fiscal Federalism

1. INTRODUCTION[(*)]

As it stands today, the EU budget is an historical relic. Three failures are most evident. First, its spending composition is heavily tilted towards the support of a declining sector, agriculture; second, it is almost impossible to reallocate spending across time and across policies to reflect economic and political priorities; and third, its size bears no comparison to any of the budgets of EU countries and it is unrelated with the EU goals.

First, in terms of composition, the current EU budget still largely reflects a double deal: the EC-6's Common Market and the Single Act of 1985. The first deal entailed a large share of Community expenditure devoted to the Common Agricultural Policy (CAP) as a price to be paid for allowing Germany's industrial products to enter the French market. The second deal saw the rise of spending on cohesion and regional policies in the context of the Iberian enlargement as the price to be paid for compensating the possible losers of the 1992 Single Market project. Those two policies together represent some 85% of the EU budget. The remaining 15% is divided between third countries' policies (essentially development aid and growth-enhancing assistance), internal allocative policies (such as research, Trans-European networks, etc) and administrative expenditure. The EU does not finance a EU-wide welfare system and thus plays no role in explicit interpersonal redistribution. However, the CAP, which originally represented much of the allocative function of the EU budget, by moving away from price support towards direct aid, increasingly contributes interpersonal redistribution. Equally the EU budget has no role in macroeconomic stabilisation.

Second, the EU budget displays a degree of rigidity far exceeding that of national budgets both across time[1] and across budgetary headings. Both in the multi-annual programming and in the annual budgetary procedure, the transfer of money across budgetary headings is subject to cumbersome procedures, largely exceeding those at the national level.

Third, given its small size (1.05% of GDP in 2003), the EU budget has practically no macroeconomic relevance. National budgets, measured as the

(*) Group of Policy Advisors, European Commission. The views expressed in this article are those of the authors and should not be attributed to the European Commission. We would like to thank, without implicating, Alberto Alesina, Carlo Altomonte, Manfred Bergmann, Martin Hallett, Wilhelm Kohler, Alberto Majocchi, Mauro Maré, Alessandro Petretto, Riccardo Rovelli, Guido Tabellini, Rick van der Ploeg, and Helen Wallace for insightful comments. We thank also the participants at the seminars of the ECB, of IGIER, of the EUI, of the Universities of Bologna, Florence, Linz and Pavia to which earlier versions of this paper were presented. We are grateful to Kirsten Lemming-Christensen for excellent research assistance.

1 Article 269 TEC constraints the EU budget to equilibrium in each and every budgetary year.

average of public spending, amounted in 2002 to 48% of GDP in the euro area and 47% of GDP in the EU as a whole. The smallest national budget – that of Ireland – is almost 36% of GDP. Moreover, the maximum size (1.27% of EU GNP) of the EU budget is predetermined by a 1992 political agreement confirmed in 1999 and has no relation with goals and objectives of the EU.

While highlighting these three failures, we do not deny two positive features of the EU budget compared to national budgets, namely simplicity and transparency. Nevertheless it is increasingly evident that the current EU budget is inconsistent with the present state and future prospects of European integration. While its historical and political roots are deep, the EU budget does not stand up to economic and political scrutiny: no federation (mature or not) around the world has a budget whose dominant share is devoted to supporting a declining sector, does not provide public goods typically featuring large economies of scale, and does not supply any stabilisation in case of idiosyncratic disturbances.

Starting from this initial assessment, two alternative approaches are possible. Either, one considers that the current EU budget is a "political equilibrium" whereby money is transferred across countries according to the logic of the *juste retour*.[2] Hence, any adjustment to the Budget can only be at the margin. Or, as we do in this paper, one considers that the added value generated by EU expenditure should prime on the issue of "who pays what" and therefore even a radical change of the functions of the EU budget is possible (and indeed desirable).

How can the weaknesses of the present budgetary arrangements be tackled? We propose to establish a vertical coordination between national and EU budgets by moving towards a European Budgetary System in which both the national and the EU budget "play together". At present, there is no coordination between the EU and national budgets, either on the spending or on the revenue side. The issue of coordination between EU and national budgets is an area left largely unexplored by the economic literature.

The paper is organised as follows. Section 2, after a bird-eye view of the theory of multi-level finance, presents a conceptual framework for the vertical coordination between the EU and the national budgets. Section 3 identifies the areas where EU finances should be re-oriented. Section 4 deals with the issue of flexibility in the EU budget. The following two sections tackle the issue of coordination between the EU budget and the national budgets. Section 5 put forward the idea of a European Budgetary System, the main proposal of the paper. Section 6 spells out how it could work in practice. Section 7 concludes.

[2] In the EU jargon, the *juste retour* (or the net balance) approach is the issue of "who pays what". This approach epitomised by the famous Margaret Thatcher's sentence "I want my money back", consists in a rather crude calculation of the accounting difference between estimated payments from and expenditure to any given Member States of the EU. Economic added value generated by the EU expenditure, externalities of the EU expenditure and revenues (which by definition are very large), the economic significance and reliability of the accounting evidence are totally disregarded by the net balance approach.

2. RE-THINKING THE FUNCTIONS OF THE EU BUDGET

2.1 The old and new theory of multi-level public finance: a bird's-eye view

Thinking of the future EU budgetary system raises the issue of the allocation of competencies between the Community and the Member States. The classic theory of fiscal federalism and new political economy of multi-level government set a number of criteria for deciding how to allocate competencies between the central EU level and Member States.

Classic fiscal federalism emphasises the need to:

i. *Internalise externalities*: if the positive effects of programmes on economic actors other than those financing them are not internalised, free riding will lead to an under-supply of such programmes;
ii. *Avoid internalities*: prevent beneficiaries of spending programmes from shifting their financing onto agents (usually taxpayers in the same or in other jurisdictions) who do not benefit from those programmes;
iii. *Exploit economies of scale*: increase in efficiency of supply arising from declining costs of production;
iv. *Attain minimum size*: small countries or jurisdictions do not attain the critical mass to provide the minimum amount of certain types of public goods;
v. *Take into account heterogeneity of preferences*: when preferences between jurisdictions are heterogeneous, a decentralised provision of public goods is superior when compared with a uniform supply at the central level.

While fiscal federalism focuses on competencies, a parallel can be drawn between these and spending allocations.[3] The theory implies that the functions of two of the three of Musgraves' branches of government – that is income redistribution and cyclical stabilisation – should be carried out at a sufficiently high level of government. In the public finance area, the allocation function

[3] Clearly, the relation between competencies and spending is complex. Competencies allocated to the EU, disregarding whether exclusive or shared, may generate four types of spending: 1) only EU spending (e.g. CAP); 2) EU and national spending (e.g. Structural actions); 3) only national spending (e.g. environmental regulation); 4) no spending at all (e.g. competition policies).

deals with the provision of public goods either as pure public goods (non-rival and non-excludible), quasi-collective goods or merit goods (Moesen, 2002).

As shown by Alesina et al. (2001, 2003), there exists a trade off between the benefits of scale and the costs of heterogeneity: the EU should focus on policy areas where economies of scale and externalities are large, and delegate to national or lower-level governments the policy areas where heterogeneity of preferences is predominant relative to the benefits of scale.

Classic fiscal federalism is built on the assumption of a benevolent social planner. The new theory of fiscal federalism encompasses the political economy of the decision making process (see, e.g. Persson et al., 1996, Tabellini, 2003).

Three aspects are stressed. First, second-best considerations related to constraints in policy formation imply that the provision of a public good, at a level different from the optimal one, in the absence of such constraints, can still be welfare enhancing. Second, in order to foster political acceptability of provision of a certain programme, it is necessary to compensate the losers. For instance, "giving something to everybody" may be inefficient (by entailing "transfers churning"), but may enhance the political acceptability of redistribution.[4] Third, the fiscal federalism literature largely ignores decision-making costs (ex ante) and frustration costs (ex post) which are typical of large and heterogeneous groups.[5] The existence of such costs implies that the EU level should focus on medium-term or time-invariant priorities which do not require frequent re-negotiations (see section 5).

Fiscal federalism, however, even if supplemented with the new political economy approach, does not encompass the EU political dimension of subsidiarity and proportionality enshrined in Article 5 TEU[6]: unless there is a clear case for carrying out a project at EU level, subsidiarity considerations

[4] This applies also at the national level to the welfare state where the willingness of relatively well-off income earners to finance the social programmes has been eased by the fact that they themselves benefited from such programmes. See, Buti, Franco and Pench (1999).

[5] See Teutemann (1992). A possible political reaction could be the shift, in the case of certain public goods to clubs within the EU, making use of the "reinforced cooperation" procedure foreseen in the Nice Treaty.

[6] *"The Community shall act within the limits of the powers conferred upon it by this Treaty and of the objectives assigned to it therein. In areas which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity, only if and insofar as the objectives of the proposed action cannot be sufficiently achieved by the member States and can therefore, by reason of scale or effects of the proposed action, be better achieved by the Community. Any action by the Community shall not go beyond what is necessary to achieve the objectives of this Treaty."*

would plead in favour of financing the project at national level. The burden of proof should be with the higher level.

2.2 A conceptual framework for vertical co-ordination

At present, the EU and national budgets are almost completely separated. EU spending is practically fixed both in terms of size and composition, with its ceiling and structure set every seven years in the so-called Financial Perspectives. National budget priorities are set largely disregarding EU programmes, with the exceptions of agriculture and cohesion where EU intervention is sizeable. However, considerations on the relative effectiveness of EU and national spending are largely absent in determining how to carry out public policies. This is a source of inefficiency as it leads to lower-than-desirable provisions of public goods or higher-than-needed overall public spending.

For expository convenience, it is useful to think of any policy as a public good[7], Y, which is being produced through two inputs, national spending, G_N, and EU spending, G_{EU}[8]:
(1) $Y = f(G_N, G_{EU})$

G_N and G_{EU} are characterised by a specific productivity, α and β, respectively. α and β should be seen as technical coefficients, reflecting the first four criteria (i. to iv.) identified in the section above.
The overall public spending plays the role of budget constraint and is indicated by G:
(2) $G = G_N + G_{EU}$

However, in the case of some public goods (defence, redistribution) heterogeneity of preferences (criterion v. in the section above) may translate into a capping to the politically feasible amount of EU expenditure.
(3) $G_{EU} \leq \hat{G}$, where $\hat{G} \geq 0$.

This capping, which can be greater than or equal to zero depending on the heterogeneity of preferences, would introduce a kink in the linear formulation of equation (2), and would make the budget horizontal at the level of $G_{EU} = \hat{G}$.

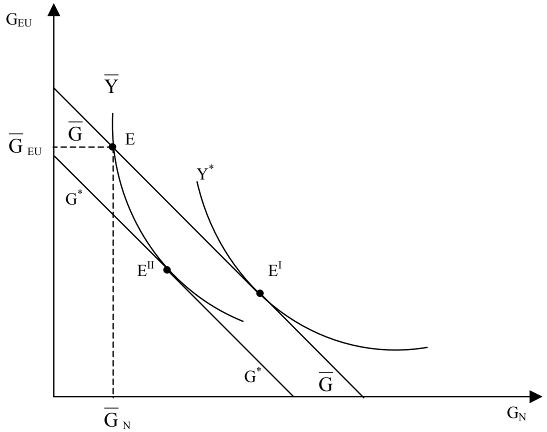
[7] This applies naturally to the allocation function of public spending, but also equity and stabilisation can be thought of as a public goods supplied by the national and the EU level. Clearly, in the case of equity, cross-country redistribution can only be carried out at supra-national level.

[8] For simplicity, in what follows G_N and G_{EU} are treated as a single value. However G_N should be thought of as a matrix (the spending items per line and the countries per column) and G_{EU} as a vector.

Figures 1, 2 and 3 give a graphical representation of the model. The existing distribution of spending between the national and the EU level (E in all figures) most likely reflects current political and institutional constraints. E is clearly a sub-optimal position. Under no-capping, an optimising benevolent policy maker, controlling both G_N and G_{EU} would, given the total amount of resources, choose the sharing of the production between national and EU level of expenditure that maximises the production of public goods, or, for a desired level of output, choose the optimal sharing of spending between the EU and the national level that allows to minimise G. The sharing will be determined by the form of the production function f(.), different productivity of the national and the EU expenditure and the form and the level of the budget constraint[9].

In Figure 1, we assume $\alpha>\beta$. An optimal allocation of spending between the EU and national budgets implies moving from E (reflecting the existing allocation between EU and national budgets) to either E^I (maximum Y) or E^{II} (minimum G).

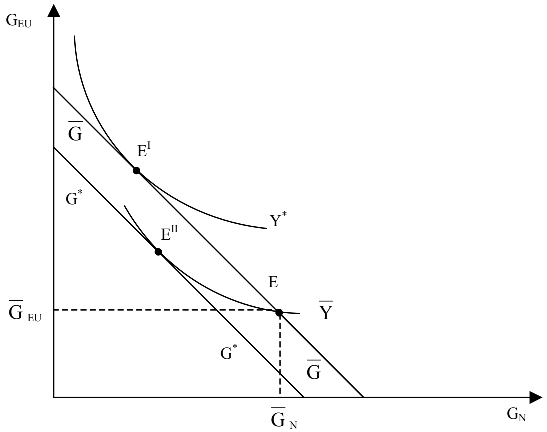
Figure 1: Higher productivity of national spending, $\alpha>\beta$



[9] Equation (2) implies a 45-degree budget constraint. However the expression could be generalised by attaching to G_N G_{EU} their specific "prices" which would capture the distortions due to taxation. Today, the EU Budget is mostly financed by national contributions, which are financed by national taxes: the financing of G_N and G_{EU} generates, therefore, the same distorsion. In the future, if the EU budget were to be financed by a particular subset of national taxes, the distorsions generated by the two sets of taxes (and hence the coefficients of G_N and G_{EU} in (2)) could be different, thereby changing the slope ot the budget constraint. While this would affect the location of the optimal point, the qualitative conclusions of our analysis do not change. We are indebted to Wilhelm Kohler for this intuition.

The opposite holds in Figure 2 where $\beta>\alpha$. Hence, Y would be maximised for a given level of total spending if much of the financing would take place at the Union level.[10]

Figure 2: Higher productivity of EU spending, $\beta>\alpha$



[10] While in Figures 1 and 2, we have an internal solution (i.e. a certain public good is produced optimally by a combination of EU and national spending), it cannot be excluded that efficiency is optimised by allocating spending on a certain public good totally at the EU or at the national level. This must be the case for a host of public services of purely national or local interest, see next section.

Figure 3: Constrained preference on EU spending, $\beta>\alpha$

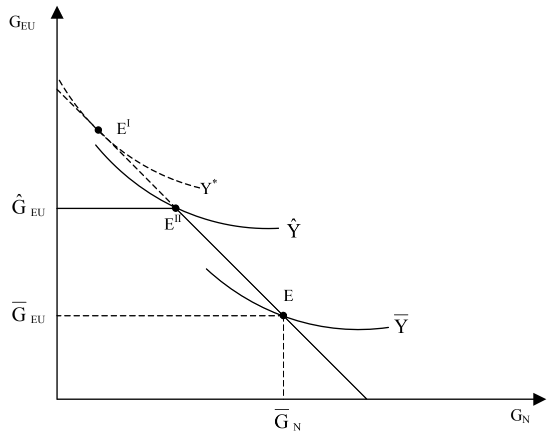


Figure 3 depicts the case where EU spending is more productive than national spending, but there is a ceiling on its amount (equation 3). It means that for a particular policy the feasible amount of G_{EU} is constrained by heterogeneity of preferences, and therefore trespassing that level of EU expenditure proves politically unfeasible. Therefore, as the figure shows, the unconstrained optimum (E^{I}) cannot achieved. Nonetheless, equilibrium E^{II} is still preferable to the initial distribution of spending between the two levels of government.

In the three figures, jumping directly from the current sharing of spending to the (unconstrained or constrained) optimal sharing may prove unfeasible. In particular, the decision-making process as well as rivalries between institutions and levels of governance may hinder reaching the first best solution. Nonetheless, a gradual move towards the optimal composition of spending would still improve efficiency.

In essence, in order to reform public spending in the EU economy, one has to pass a judgement on the desired level of output, Y*, on what type of production function is relevant for the production of any given public good[11], on

[11] For instance, a linear production function associated with a linear budget constraint will deliver only corner solutions: that is policies which ought to be run totally either at the national level or at the EU level depending on which level the productivity is the greatest. In Annex, we develop a simple model based on the linear setting where we analyse the problem

the relative value of α and β and on the possible political ceiling of EU spending, $\hat{G}$. As we will argue below, a EU budgetary system should complement such an assessment with an overall budget constraint, G*, thereby overcoming separate, and by definition sub-optimal, constraints on G_N and G_{EU}. This amounts to saying that the optimal amount of G_N and G_{EU} is endogenously determined and not set a priori.

3. WHAT SHOULD THE EU BUDGET DO?

3.1 Re-orienting EU spending

Even to the layman, it is apparent that the current EU budget hardly conforms to the normative implications of the theory of fiscal federalism, even taking into account the political economy constraints stressed by the most recent literature.

As we argued in the introduction, the EU has a small central budget which is neither adequate in terms of composition to the new stage of economic and political integration, nor sufficiently flexible to adapt to changing circumstances and political priorities. Clearly, path dependency matters: it would be politically ingenuous to attempt to redesign the EU budget from scratch. Nonetheless, the contradictions of the current budget and, more broadly, the public finance arrangements within the EU (Community and Member States' budgets) are becoming increasingly apparent as integration deepens amongst a subset of countries (those sharing monetary sovereignty) in a Union that, with enlargement, becomes more heterogeneous.

The discussion below is organised around the three Musgravian branches of government: allocation, redistribution and stabilisation.[12]

Allocation

New EU public goods. In the enlarged Europe, defence, internal security and external aid will have to be increasingly supplied at the central level. These are textbook examples of public goods to be provided centrally. Protection against organised crime and terrorism, border patrols, immigration policy, and aid to

of spending allocation between the national and the EU level and we also take into account institutional or political constraints

[12] The scope of the following discussion (and of the paper in general) is not to determine the values of α and β for any type of policy, but rather to show how competencies could be reorganised on the basis of the implicit values of α and β which have emerged from the most recent literature on fiscal federalism. Several of the issues discussed in this section were already dealt with at the beginning of the 1990s in the report *Stable Money, Sound Finances*, see European Commission (1993).

third countries are characterised by large economies of scale, strong externalities, relatively homogeneous preferences, the need to attain a minimum size and the risk of free riding. Moreover, as stressed by Tabellini (2003) and Berglöf *et al.* (2003), coordinating national policies is not enough as all these areas concern the executive power of governments and are executed by specific bureaucracies. Central provisioning will also strengthen the bargaining position of Europe on the world scene.

As to defence, several of the above criteria apply, but heterogeneity of preferences (e.g., political neutrality) persists. In the past, provisioning at the EU level has encountered political resistance, explained by the fact that centralised supply implies "delegation" from national to European policymaking bodies of the authority to decide over "sovereign-sensitive" goods (Persson et al., 1996). This has imposed a close to zero capping to the defence expenditure made at the EU level. To the extent that the EU moves towards political union, such reluctance should gradually be overcome. A solution could be to focus EU provisioning onto the relatively less controversial aspects of these policies (e.g. in defence, start with the Rapid Reaction Force) and dissociate direct participation from financing (all EU members would contribute to the financing via the EU budget, but the countries encountering political opposition would not be directly involved in execution).

<u>*Growth-enhancing expenditures*</u>. The EU liberalisation initiatives of the last decade have not translated into higher growth. The so-called Lisbon strategy, set out by the Lisbon European Council in Spring 2000, is set to transform the static efficiency gains of the Single Market into dynamic efficiency gains. Several of the components of the strategy do not have budgetary implications or, when they do, are to be carried out at the national level. Nonetheless, some growth-enhancing policies with large externalities could be carried out at the EU level. Examples of these are major R&D and innovation programmes and Trans-European Networks, especially along East-West axes.

<u>*Other internal policies*</u>. A larger heterogeneity of preferences in a wider Europe entails a strict application of the "subsidiarity test". Several existing spending programmes under the Internal Policies category do not pass this test. Future EU activities could focus on fostering citizens' Europe. Increased mobility across countries could be promoted by setting goals in education and language proficiency coupled with EU financing of minimum standards (von Hagen, 2002)[13].

[13] As pointed out by von Hagen (2002), increasing mobility could be also seen as a way of lessening the costs of EMU.

<u>*Common Agricultural Policy*</u>[14]. The reduction in agricultural spending is the *conditio sine qua non* to claim a stronger role of the EU budget in other, more suitable areas. The CAP hardly complies with any of the criteria identified in Section 2 and can actually be taken as an example of optimisation of internalities with perverse redistribution effects. The shift away from price support towards direct aid (supporting farmers' revenue) needs to continue. However, direct aids amount to interpersonal redistribution of a specific class of citizens (workers in the agricultural sector): there is no justification to carry out these kinds of transfers via the EU budget. The need to sharply reduce the share of the EU budget devoted to agriculture to make room for other priorities has long been recognised (e.g. Padoa-Schioppa, 1987). Boldness requires going beyond a very mild erosion of the CAP share in the budget – as decided in the Brussels European Council in October 2002 - and addressing head-on the issue of a radical reform of the CAP, including its partial re-nationalisation (at least of direct aids).

Redistribution

Fiscal federalism suggests that income redistribution should be carried out at a sufficiently high level of government. Income redistribution can be done both across individuals of a given country and across countries. So far, the bulk of EU involvement in redistribution has concentrated on income redistribution across countries. The interpersonal dimension, which is at the basis of the welfare state and the European Social Model has, up to now, remained within the remit of national governments. Interesting proposals for a direct EU involvement in interpersonal redistribution have been made. However, albeit the idea of a EU-wide minimum social safety net has its merits,[15] political and feasibility constraints will most likely limit the main goal of the EU redistribution to policies for regional or national convergence. This is consistent with the theory of fiscal federalism, with the heterogeneity of preferences towards redistribution and with the different information constraints faced by the EU and the national level. Indeed, "the Community […] is not well suited to executing distributive policies at the level of individual persons or small enterprises. Efficient income distribution requires detailed administration at the level of the individual, and coherence with features of income tax and social security systems, and the Community cannot assure this" (Padoa-Schioppa, 1987: 133).

[14] The nature of CAP as an allocative or redistributive policy is much disputed (see Nava 2000). As a redistributive policy, one of the many reasons why the CAP is widely criticised is due to the fact that its redistribution function depends more upon the work title (e.g. producer of a given product) and it is positively correlated with the potential income of the beneficiary.
[15] See, Bertola (1999), Bertola et al. (2000), and Boeri and Terrell (2002).

The current design and implementation of the EU cohesion policy is such EU transfers are very diffused across the EU territory. At present, all EU countries receive funds under the EU cohesion policy and only Luxembourg and Denmark (and Belgium and Netherlands from 2007) do not have at least one region assisted by the so-called Objective 1 intervention[16].

In order to make the EU cohesion policy more effective, we argue in favour of redesigning EU cohesion policy. Funds should focus on (a) fostering income convergence of poorer countries, and (b) reducing the social costs of factor reallocation. Hence, conceptually, one could therefore imagine that cohesion policy is implemented via two different funds, responding to the two needs of convergence and restructuring: "Convergence Aid" funds devoted to helping backward countries and regions to catch up with richer countries; and "Restructuring Aid" funds which are intended to facilitate the resource reallocation for those *entities* affected by shocks of exogenous nature (e.g. technological change, globalisation, enlargement).

Convergence Aid funds are intended as pure convergence policy in favour of less prosperous countries and should be used for two purposes: institution building and growth-enhancing expenditure (such as R&D, education and training, infrastructure, etc.). In order to be able to spend money, efficiently, for growth-enhancing expenditure, a country needs a very efficient legal and administrative system in place. Building legal and administrative capacity is a top priority in any cohesion strategy across the EU, because of the contribution to growth that a high quality administrative and legal system makes. Several empirical studies show a positive correlation between income convergence in Europe and standard indicators of quality of administration quality of administration.[17] Institution-building is particularly important for the new EU Member States.

Restructuring Aid funds should be available to those *entities*, in any country, affected by structural adjustment. Since resource reallocation affects people in different geographical locations and belonging to different industrial sectors, entities could be defined either as sectors or as territorial units or as the combination of both (given sectors in given places). Restructuring funds may

[16] Objective 1 regions are those where residents have a per-capita income of less than 75% of Community average. This is the result, *inter alia,* of the predominant regional focus of EU cohesion expenditure and of cohesion negotiations driven by net balance considerations. Net balance considerations find their natural humus in the EU cohesion policy, because the Council needs unanimity to agree on this policy, which gives to each and every country a *de facto* veto. National political constraints make that each country worries more about being able to flag "a negotiation success" than about being sure that funds are spent in those policies having a higher Community added value.

[17] See, e.g. Mairate and Hall (2000) and Hallet (2002).

also play a stabilisation role to the extent that since it is very likely that shocks are uncorrelated across countries, regions and sectors.

A new design for the EU cohesion policy would help addressing two directions for reform that are central to the ongoing debate on the future of EU cohesion policy: a) geographical focus, and b) earmarking of EU funds.

As for the first issue, several arguments have been put forward in the literature in favour of a shift from the current regional focus towards a country focus. First, efficiency may better be obtained by allocating money at country level and letting the country itself decide where to invest it, rather than the EU deciding which regions within a country deserve support (an argument paying respect to the subsidiarity principle). Second, the current regional focus may result in treating unequally, because of different regional imbalances, countries with otherwise similar levels of wealth (de la Fuente, 2001). Third, EU cohesion and structural policy is only a part (often, relatively small) of the regional (or sectoral) policy pursued at the national level using domestic funds. Fourth, enlargement will vastly increase national income disparities, but not regional income disparities. Furthermore in the process of national income convergence an increase of the regional income imbalances is inevitable: it could be accommodated, but not impeded. Leaving to the countries, rather than to the regions, the task of deciding how to use EU funds would ensure greater coherence of the EU and national intervention and it would avoid the perverse implication of subsidising those countries whose national regional policy are less effective. The on the ground management and use of the funds can obviously be made at the regional level.

The distinction between Convergence Aid and Restructuring Aid is important to assess the relevance of these arguments. A country focus appears preferable in the case of Convergence Aid. This would imply that countries (as opposed to regions) would decide on the use of funds. Assignment of funds could still take into account to any chosen degree regional imbalances within a country (by looking at both mean and dispersion of per-capita income). Instead, a regional or a sectoral focus still seems justified in the case of Restructuring Aid, except perhaps for small and very specialised countries.

As for the second issue, earmarking EU funds makes sense only if two conditions are simultaneously reunited: a) that "Brussels" can effectively assess the need and monitor the outcome of the EU funds' use; b) that their "specific use" is a central piece of a larger EU strategy. Building a high-quality legal and administrative system appears to meet those two conditions. Indeed, during the pre-accession period, the EU has gained considerable experience in monitoring the quality of the national administrations and it had set a number of tools (financial assistance, but also twinning programs between current and future EU Member States) to improve that quality.

To strengthen the contribution of the convergence funds to EU growth, the key principle of "conditionality" should be extended to both earmarked and non-earmarked funds. In particular one could make the disbursement, of a significant part of the money of the same or of the following financial period, dependent upon reaching an agreed performance in terms of results of the use of funds.[18] Conditionality has also an added benefit from a political economy viewpoint as imposing conditions on the use of resources may reassure countries which are net contributors to the EU budget. This argument may gain strength in an enlarged Europe.

Stabilisation

EMU raises the issue of cyclical stabilisation in the event of asymmetric shocks. Federations around the world typically have a large central budget and stabilisers, which automatically smooth idiosyncratic shocks. In principle, local budgets are subject to balance requirements and lending restriction while the federal budget is less so. The EU fiscal rules have an opposite logic. They imply that stabilisation is carried out at the national level: countries should bring their budgets "close to balance or in surplus" in normal times so as to have sufficient room for manoeuvre to absorb negative shocks without infringing the 3% of GDP deficit limit[19]. The Commission has recently stressed the importance to assess the medium term deficits targets in structural, rather than nominal terms (European Commission, 2002b). This is consistent with the absence of centralised stabilisation.

While shock-absorption via national budgets will remain the norm in EMU, there is the question of risk sharing in the event of large idiosyncratic shocks. In such a case, a response by the EU budget could be welfare-enhancing. As either the setting of EU automatic stabilisers[20] or the possibility for the EU budget to run deficits or surpluses appear politically unfeasible, two options remain: an insurance instrument triggered by asymmetric disturbances (Italianer and Vanheukelen, 1993) or the possibility of raising funds in the market by the EU (extra-budget) and transferring them to the Member country hit by the shock. The first option could be accommodated by creating a single, but

[18] This would improve over the current mechanism of the "performance reserve" which triggers a 4% increase of the funds in case of good performance.
[19] See, Brunila, Buti and Franco (2001).
[20] For instance, von Hagen (2002) has suggested that minimum unemployment benefits for a limited period (say six months) could be paid by the EU. An idea along similar lines was first put forward in the Marjolin report in the 1970s (European Commission, 1975).

"universal" reserve which could be used for stabilisation as well as other purposes. Such a reserve could be mobilised by the Commission via automatic rules, without passing through a cumbersome procedure, and possibly replenishing the reserve during the year by unused commitments[21] [22]. An argument in favour of the second option is the fact that large country-specific shocks are rare and thus such a facility would be seldom activated.

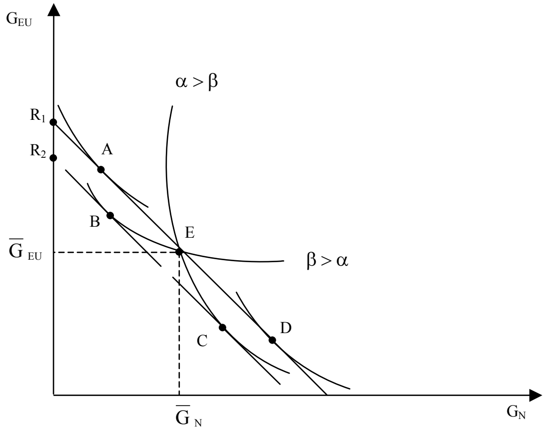
Summing up

The conceptual framework laid out in section 2 allows us to summarise the challenges faced in re-thinking the attribution of allocative tasks between the EU and the national budgets. The approach put forward amounts to "endogeneise" the size of the EU budget so as to allow, in the steady state, to minimise the total amount of public spending (national plus EU) for a given level of output.

Figure 4 illustrates the overall budget constraint (EU plus national spending) as the 45° straight line. The production schedules are the curves[23] going through EB in the case of higher efficiency of EU spending and the line going through EC in the case of higher efficiency of national spending.

[21] As a precedent, for the first time in August 2002, following the flooding in Central Europe (especially the Czech Republic and Germany), the resources for the emergency funds have been taken from the unused commitments for the structural policy.
[22] However, the literature has pointed out that, even leaving aside political and moral hazard constraints, constructing such an automatic mechanism is not easy. See, e.g. von Hagen and Hammond (1996).
[23] For those policies where optimal production takes place fully at the national level or at the EU level, the outcome would be either a move towards total re-nationalisation or a move towards total centralisation at the EU level.

Figure 4: From the current to the future apportioning of spending across government levels



According to the analysis in the previous section, the CAP should move from E towards C, implying a gradual re-nationalisation of agricultural policy, coupled with, in perspective, a lower support to the sector (shift to a lower level of Y). External aid, defence and internal security would be shifted along the EA line, representing a move from national to EU financing and, for some of the items, entailing also an overall rise in public spending. In line with the Lisbon strategy R&D, Trans-European Networks (TENs), European citizens' programmes (such as the Erasmus programme) and major innovation projects, would move from E towards B or A. Finally, most of the so-called "other internal policies" in the current EU budget covering a host of smaller programmes would probably have to shift from E to D or C.

Redistribution programs across countries are correctly undertaken at the EU level, that means along the Y-axis. Whether the "intensity" level should be at R_1 or R_2 is a political rather than a technical choice. As to stabilisation, no centralised tool has been designed at the EU level and political constraints make any change unlikely in the foreseeable future.

3.1 Re-orienting EU revenues

This paper deals mainly with the expenditure side of the EU budget. It pleads for a reassessment of the functions of the EU Budget according to the generated added value of the EU and National expenditure. In other words it looks at the

contribution of the EU expenditure to the EU aims rather than at the accounting logic of the *juste retour*.

Both the European Commission and the academia have indicated that the current system of financing the EU budget is imperfect in several respects, namely, with respect to transparency, accountability vis-à-vis the EU citizens and citizens' perception of the financial autonomy of the EU institutions from Member States.[24] By 2006, some 90%[25]. of the EU budget will be financed by national contributions linked to the GNP of any Member State and only the remaining 10% by direct levies on citizens. The GNP contribution, while having other positive facets, is at the root of the debate on the *juste retour:* this debate hampers a genuine discussion on the added value of any EU expenditure to emerge. Therefore, if the expenditure side of the EU budget should evolve accordingly to the principles outlined above, the revenue side should also evolve consistently with them. This means that, while preserving the principle of the budgetary equilibrium, those sources of funds having an obvious national identification (such as the GNP contributions) should be reduced in favour of new sources of funds having a natural EU base. Natural EU taxes are those sources of funds that have a clear rational to accrue to the EU budget because their existence depends on EU policies and that display a clear mismatch in the geographical pattern of tax collection and tax burden. That is the case, for example, with the profits of the ECB, which exist only because EMU exists and whose current national re-apportioning is, from an economic standpoint, debatable[26]. That is also the case for other taxes, such as savings taxes, corporate taxes, stock exchange taxes, environmental taxes etc. Each of these taxes is suitable to a different degree depending on the different level of harmonisation of the tax base. The size of the EU budget is so small that even a very partial accruing to the EU budget of one or more of the mentioned taxes would suffice to cover the financing needs. Further economic integration, in particular post-enlargement, is likely to only increase the number of natural EU taxes that could accrue (partially or totally) to the EU budget.

4. INCREASING THE FLEXIBILITY OF THE EU BUDGET

Looking at the EU budget in an historic perspective one observes, at the end of the 1980s, a change in the regularity of revenues and expenditure. Since 1988, the "budgetary peace" between the Commission, the Council and the European

[24] See European Commission (2002c), section 1.4., Goulard and Nava (2002) and Tabellini (2003).
[25] GNP contributions plus that part of the VAT contributions calculated via the GNP keys.
[26] Article 33 of the ECB's Statute provides for a transfer from the ECB to the national central banks using a key equal to the arithmetic average of population and GNP (Article 29 of the Statute). This is subject of much controversy, see H.W. Sinn and H. Feist (2001), J. Murray Brown (2001) and European Central Bank (2001).

Parliament, the three institutions involved in the EU budget procedure, increased markedly[27]. This improvement in stability has gone hand in hand, however, with a reduction in the flexibility of the EU budget and an increase of the complexity of the rules governing it.[28]

There is a clear and well-understood trade off between resources stability and financial peace, on the one hand, and margin of manoeuvre or flexibility, on the other hand. In 1988, with the adoption of the so-called Delors I package, which instituted the first Financial Perspectives (FP), a political choice had been made in favour of the former. The FP set every seven years the ceilings for all budgetary headings and for certain subheadings. Once the FP are set, Member States have historically displayed stiff reluctance to shift resources across years and headings. At present, moving unused resources, even within the annual budgetary procedure, from one to the other budgetary heading (or even sub-heading), is difficult if not impossible altogether.

In the medium to long run, both the EU budget and the national budgets have to respect similar constraints in terms of deficits. The EU budget is subject to the strict requirement of equilibrium laid down in Art. 269 TEC[29], while national budgets are subject to the medium term target of "close to balance or in surplus" of the Stability and Growth Pact. The difference between the two conditions boils down to the fact that the EU budget must always be balanced in each and every year, while national budgets have to be broadly balanced over the cycle thus allowing for deficits (up to 3% of the GDP) to appear in recession years and surpluses in boom years.

A political choice in favour of stability at the expense of flexibility is not dissimilar from the one characterising EMU. In the run up to and in the early years of EMU, the trade-off between stability and flexibility of national finances was firmly resolved in favour of the former. Recently, however the Commission has moved in the direction of taking account of flexibility (European Commission, 2002b) by accepting that countries with sound public finances (i.e. low stock of public debt, low implicit liabilities) could run small structural deficits without violating the requirements of the Pact. There is some ground to argue that a similar move should be undertaken in the EU finances.

[27] Since 1988 the EU budget has always been adopted on time and complaints to the Court of Justice by one or the other Institutions have nearly disappeared. In the period 1975-1988, preceding the FP, the adoption of the EU budget was delayed in 6 years out of 13 and the EU institutions complaint to the Court of Justice on 3 occasions.
[28] For a lucid overview of the issue of flexibility in the EU Budget, see Montagnon (2002).
[29] The European Convention seems oriented to respect both the spirit and the letter of this article (see Art. 39 of European Convention, 2002).

In sum, while the FP have helped ensure an orderly development of budgetary expenditure of the EU budget and guaranteed budgetary peace for the EU, it is increasingly evident that the current degree of flexibility is not compatible with the functions of a modern budget and does not permit the EU budget to react timely to changing circumstances. A higher flexibility is a pre-condition to move to a truly European Budgetary System, as proposed below.

5. DESIGNING A EUROPEAN BUDGETARY SYSTEM

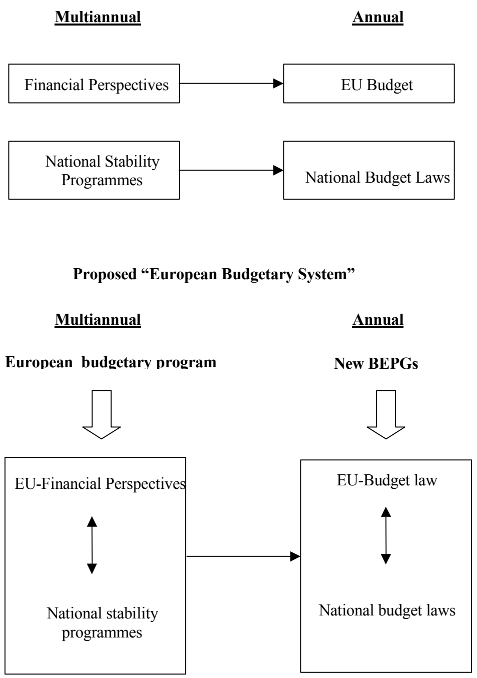
Rethinking the EU budgetary arrangements goes beyond rethinking at which level individual policies should be carried out and how to conduct an EU fiscal policy under the straitjacket of excessive rigidity and small and predetermined size. The basic tenet of this paper is that introducing vertical coordination between the EU and national budgets can help to address the fiscal failures identified above.

So far, the EU and national levels have remained separate. As exemplified in the top part of Figure 4, fiscal policy in the EU is the outcome of two non-coordinated sets of instruments: on the one hand the EU budget and on the other hand the national budgets of the 15 Member States[30].

[30] According to the Presidency Conclusions of the Copenhagen European Council, of December 2002, the EU members are set to become 25 from May 1st, 2004, and 27 from the year 2007.

Figure 5: Towards a European Budgetary System

Current Budgetary System



However, as the EU moves towards stronger fiscal policy co-ordination, such separation needs to be overcome. This has potentially profound implications for both the annual budget and the multi-annual FP.

The bottom part of Figure 4 shows how a coherent EU budgetary system, which puts the EU budget in line with the national budgets could be articulated. The EU budget is to be looked at as centralised (at EU level) fiscal policy subject to decentralised national constraints (EU budgetary resources are essentially Member States' contributions). National budgets are to be looked at as a decentralised system of fiscal policy subject to centralised EU constraints (the Stability and Growth Pact and the Broad Economic Policy Guidelines, BEPGs).

In a medium term framework (covering a time span of, say, five years), EU policy makers should elaborate an aggregate European Stability Programme which sets the spending priorities for the Union and the Member States[31]. It would also decide how to allocate spending on individual items between the EU and the Member States. The national Stability Programmes and a new EU-level Stability Programme – which would replace the current FP - would translate the common objectives into concrete medium term spending programmes. The provisions of the Stability and Growth Pact – namely the medium term target of "close to balance or in surplus" and the 3% of GDP deficit ceiling – will continue to apply to all EU countries.

The aggregate Stability Programme as well as its national and EU components would be rolled over and updated annually. This would mark a fundamental change compared to the existing situation where each national stability programme is decided on an individual basis and the FP are set every seven years and are fixed within such a period.

A similar process would take place on an annual basis. The EU budget and national budgets should form a coherent set, adhering to the strategic objectives of the BEPGs (see Table 1 on the links between the BEPGs and the EU budget). This should be included in the "New BEPGs", which should contain both recommendations for the EU level policies and, country tailored, recommendations on national priorities. As mentioned in section 2.1, given the relatively high decision-making costs (ex-ante) and frustration costs (ex-post), at the EU level, the annual process should mainly focus on fine tuning multi-annual priorities.

The upshot is that Member States and EU institutions would decide together how to translate their common policy priorities into global budgetary commitments and how these commitments are shared between the national and the EU levels. This implies building vertical links between the EU and the national budgets. Clearly, fiscal discipline will need to be upheld: the reconsideration of the distribution across jurisdictions should not imply an overall increase in spending. In the past, the stress on the contradiction between

[31] This paper focuses mainly on allocative policies. A proposal for a budgetary coordination mechanism putting the emphasis on stabilisation was submitted by the then French Finance Minister, Dominique Strauss-Khan, at the informal Ecofin Council in Dresden in April 1999. The French proposal stressed that the aggregate policy stance at the EMU level must be examined on the basis of an aggregate stability programme. The proposal pointed out that the objective to achieve an adequate policy stance for the EMU as a whole should be taken into account when examining the national stability programmes. For a discussion, see Buti et al. (2003). A similar proposal has been presented recently by the vice-president of the EU Convention, Giuliano Amato, see Amato (2002). On similar lines, see Collignon (2002) and Majocchi (2002).

(Maastricht-induced) national prudence and alleged EU "largesse" has underpinned the refusal to reconsider EU budgetary responsibilities. However, as we move towards a EU budgetary system, such reluctance should be overcome. Such reassessment would not necessarily imply a substantial rise in the EU budget. As we pointed out in section 3, a rise in spending in certain areas would go hand in hand with a reduction in others. What this new approach would bring is a better efficiency: to the extent that the existing distribution of spending between the national and the EU level is not optimal, the net effect would be a decrease in overall public expenditure.[32]

A couple of examples would help clarify this general statement. In September 2002 at the Johannesburg Summit on sustainable development, Heads of State and Government have agreed to pledge 0.7% of each country's GDP for development aid. The higher potential effectiveness of a centralised management of these resources calls for the assignment of such intervention prevalently at the EU level. The Lisbon growth strategy sets a target of investing 3% of EU GDP in R&D in order to foster competitiveness. Criteria of efficiency and effectiveness should be the base for the split between private and public spending, and, within the latter, between national level and the EU level. It makes sense, for instance, to carry out large research and innovation projects directly at the EU level.

The 2001 BEPGs showed an opening in this direction: "Just like the Member States, the Community should apply strict budgetary discipline. This must be applied to all categories of the Financial perspectives, while respecting the inter-institutional agreement on budget discipline *and the improvement of the budget procedure; a flexible allocation of Community resources should be exploited in order to enhance the economic impact of the EU Budget*".(emphasis added). The Commission Communication on economic policy coordination of February 2001 (European Commission, 2001) states that "the establishment of guidelines and priorities in the EU budget should be embedded in a global vision encompassing both the guidelines and priorities in the budgets of the Member States and the criteria established in the Broad Economic Policy Guidelines in order to enable Member States to take them into account in their budget laws".[33]

[32] We show in Annex, that, under certain circumstances, the current budgetary arrangements imply a higher overall spending and a lower supply of public goods than what would be implied by the optimal allocation of spending between the two levels of government.

[33] An even more ambitious objective would be to discuss, when establishing the priorities in the EU budget, also those policies, which have little financial impact for the EU budget, but a great financial impact on national budgets (ex. Community fiscal directives, environmental directives, etc). This would allow national policy-makers to take account of community inputs and embody them into their national policies. Von Hagen (2002) strongly supports the view of making "law making" compatible with "money spending" and more generally of assessing the financial impact, for the EU system, of "law making".

Table 1: The BEPGs and the EU budget

	Priority BEPG 2002	*Budget item (B-2002, adopted by the EP on 13/12/01)*
1	Accelerate reforms in the network industries	B2-7 (Transport) B5-7 (Trans-European Networks)
2	Promote the quality of public expenditure by redirecting funds towards physical capital	B2-1-0 (Structural Funds: Objective 1)
3	Enhance environmental sustainability	B4-3 (Environment) B6 (Research and technological Development)
4	Investments in human capital, R&D and ICT	B2-1-2 (Structural Funds: Objective 3) B6 (Research and technological Development)
5	Active labour market policies and lifelong learning	B2-1-2 (Structural Funds: Objective 3) B3-1 (Education, vocational training and youth) B3-4 (Social dimension and Employment) B5-3-2 (Internal Market: Promotion of growth and employment: measures to assist firms) B5-5 (Labour market and technological innovation);
6	Encourage entrepreneurship by improving access to finance especially for SMEs	B5-5 (Labour market and technological innovation)

6. A "EU BUDGET LAW"

Consistently with the European Stability Programme, the annual EU budget should become a true "EU Budget Law". In order to achieve this aim, the current budgetary procedure (budget proposal, approval and implementation) would have to be overhauled.[34] This would be possible only if a balance of "sticks and carrots" is found to avoid conflicts among the Commission, the Council and the European Parliament (the last two being the two arms of the EU "budgetary authority").

[34] The draft skeleton for the European Constitution (European convention 2002) has an article (Art. 40) specifically dealing with budgetary procedure for the EU budget adoption.

Table 2 spells out the differences between the current budgetary procedure and our proposal.

Phase 0: Multi-annual planning

Currently, the Council, acting on a proposal from the Commission and subject to the majority approval in the European Parliament, fixes the FP which are then enshrined in the Inter Institutional Agreement. The FP establish the maximum expenditure per annum, per budgetary heading and in certain cases per budgetary sub-heading (e.g. Cohesion and structural funds within the Structural action heading).

In its second Communication to the Convention (European Commission, 2002c), the Commission has proposed that FP are adopted in co-decision between the Council and the European Parliament and that "(t)he Convention will have to look into the question of associating the national parliaments in this decision". This goes in the direction we suggest. The multi-annual planning of the EU should be in tune with national planning. Instead of being fixed for seven years, the FP would be rolling and linked with the BEPGs within a European Stability Programme.

Phase 1: Budget proposal

Currently, this phase covers Internal (to the Commission) Budgetary Hearings. The Commission makes the arbitrages of the expenditure claims across its own departments while making sure that FP are respected. Before completing the draft budget the Council, Commission and Parliament hold a trilogue. By the end of April, the Commission submits the draft budget for the following year to the Budgetary Authority (Council and Parliament).

According to our proposal, the current budgetary hearings phase should be "de-technicised" and "opened to the outside". This phase could become a political phase in tune with the debate taking place at the national level.

Table 2: PROPOSAL VS. CURRENT SITUATION

	Phase 0: Once every 7 years	*Phase 1: 1 January to 30 April year T*	*Phase 2: 1 May to 31 December year T*	*Phase 3: Year T+1*
CURRENT PROCEDURE	The Council, acting on a Commission's proposal and subject to majority in the EP adopts the Financial Perspectives	*Commission Internal technical* hearings	First and Second reading of the Commission's Draft Budget by the EP and the Council. No role for the Commission as a College.	1) Commission executes Budget 2) Commission gives administrative report for year T-1 (*compte de gestion*) in April and political report Allocated expenditure report) in July. There is no institutional discussion on either. 3) Commission proposes to EP and Council the mobilisation of unused resources.
OUTPUT	Multi-annual planning	Commission's Budget proposal	Parliament Budget Adoption	Commission's implementation and reporting
NEW PROPOSAL	Co-decision between EP and Council for the adoption of the Financial Perspectives	1) Commission's presentation to the Jumbo Council 2) Commissioners' presentations to specialised Councils	I Reading: May-Sep: 1) Commission ensures consistency between EU and national budgets 2) Commission active in Council and EP Budget discussion II Reading: Oct-Dec: Council and EP Second reading	1) Commission and member States executes budget 2) Commission is charged with the March and September reporting for budget of year T-1 and year T. (in parallel with MS's reporting). 3) BEPG implementation report extended to the EU budget (policy-by-policy). 4) Commission responsible for mobilising a universal reserve and unused resources
OUTPUT	Multi-annual planning	Commission's Budget proposal	Parliament Budget Adoption	Commission's implementation and reporting

The Commission would present (end January/early February), at a Jumbo Council (Ecofin plus Budget Councils) and the European Parliament, its budgetary proposal for the following year and listen to national priorities and to the national intentions for the different policies[35]. Budgetary hearings cease to be only internal, but become external, and more political, in order to coordinate EU budget and national political priorities. Following the Jumbo Council, individual Commissioners would go to specialised Councils to present the Commission's budget proposals. Commissioners and national ministers would check the coherence of their strategies – in line with the BEPG – and undertake to modify the initial proposal to achieve an overall consistent policy.

The Commission remains the *last authority* in the drafting phase and, as such, must ensure consistency between EU budget and national budgets. The Council and the European Parliament, however, would get involved in a phase where their role is, so far, null.

Phase 2: Budget approval

Currently, the Council and European Parliament, in their capacity of budgetary authority, go through the first reading of the Budget (approximately by September) and the second reading (between September and December). The Parliament finally adopts the Budget in December. There is no formal role for the Commission during this phase.[36] This has facilitated the task of several lobbies attempting to influence the Parliament's *rapporteurs* to modify the appropriations of specific budget lines, with the result, in most cases, of increasing the proliferation of small programmes, entailing a misallocation of resources and reducing the overall coherence of the budget.

In our proposal, while the Council and the European Parliament would remain *the last authorities,* the Commission would play an active role, in particular making sure that, during the first and second readings, the consistency between the EU and the national budgets is maintained.

Phase 3: Budget implementation and reporting

At present article 274 lays down that "(t)he Commission executes the Budget under its own responsibility". This has been criticised namely because, in economic terms, it does not always seem justified and in political terms it seems at odds with subsidiarity. If convergence policy would be implemented via

[35] If the more ambitious approach mentioned in footnote 33 is chosen, the Commission may also be expected to discuss those regulatory policies that have an impact on national budgets.
[36] However, on average the changes with respect to the draft budget are minute (often less than 1% of the total budget, in 2003 0.32%).

(conditional) block grants rather than the current earmarked funds, this legal provision would need to be changed in favour of joint responsibility of the Commission and the member states in executing the budget. Currently, the Commission implements the budget, but has a limited autonomous political role to play, even in the event of re-allocation of the under-spending.

In our proposal, a parallel between the Commission and the EU Member States would need also to be established in terms of reporting. Currently Member States make their notifications known in March of each year (for the budget implementation of the previous year) and in September (for the budget implementation of the same year). A similar reporting should be established for the EU budget and an overall report should be sent to the Council and the European Parliament. Going beyond the purely financial dimension, the Implementation Report of the BEPG issued every February should be extended to the EU budget and policies. Finally, a critical issue is that of the mobilisation of unused resources, in co-ordination with programmes and priorities of Member States.

7. CONCLUSIONS

Due to its small size, historically-determined rather than priority-oriented composition and lack of flexibility, the EU budget plays a modest role in the economic policy of the EU and the euro area. This translates into the fact that, at the central level, the EU is left, *de facto*, without one of the most powerful instruments of economic governance, the budget. Some take the view that this is because the EU budget is bent to satisfy national requests and nothing should be substantially changed otherwise the whole “EU political equilibrium” would collapse. On the contrary, we have taken the “benevolent” view that one can improve upon the design and the structure of the EU budget.

The basic tenet of this paper is that, as the EU moves towards a higher level of integration, it needs a more consistent system of public finances which encompasses both national and EU budgets. We propose to move towards a truly European Budgetary System where EU and national budgetary processes are closely aligned and an effective vertical coordination occurs in areas of common intervention. Implementation of this proposal would not require any change in the provisions of the Stability and Growth Pact. “Endogenising” the amount of public spending carried out at the EU level would help reduce the political controversies surrounding the size of the EU budget.

The main objective of this proposal is to move towards EU’s economic governance where the community and national levels play together. The role of the EU budget would be valorised *in crescendo* with EU fiscal surveillance

which is currently being extended from “below the line” (budget balances) to “above the line” (single items of expenditure and revenues), with a growing emphasis on the quality of public finances (European Commission, 2000, 2002a).

It goes without saying that several aspects of the proposed system and its functioning need further reflection. For instance, it remains to be seen whether the aggregate stability programme and, *a fortiori*, the EU-level stability programme, should encompass non-euro area countries. Second, in order to make this proposal viable, one should study how to contain the transaction costs involved by the horizontal and vertical coordination processes. Third, in order to function effectively, the system would require some synchronisation of budgetary procedures at the different levels of government (including regional ones in some Member States). An interesting idea initially put forward by Jacques Delors (see Pisani-Ferry and Jacquet, 2001) is to separate the budgetary calendar between a first ‘EU semester’, in which EU priorities would be defined, and a ‘national semester’, in which such priorities are tailored to the national level. These and other issues deserve further scrutiny.

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ANNEX: THE DISTRIBUTION OF SPENDING BETWEEN NATIONAL AND EU BUDGET UNDER POLITICAL CONSTRAINTS: A SIMPLE MODEL

In the present circumstances, the decisions on how to allocate spending between national and EU budget are completely separated. Given the current institutional constraints, EU spending is practically fixed. At the national level, fiscal discipline and political economy constraints make it costly to depart from the existing level of public spending.

In order to model the financing of a desired level of public good or service, we assume a linear "production function":

(1) $Y = \alpha G_N + \beta G_{EU}$

Where G_N is national spending, G_{EU} is community spending and α and β are their respective productivity.

As pointed out in the text, such a production function gives rise to corner solutions: if spending can be freely allocated between the EU and the national level, the whole financing would take place either at EU level (if $\beta>\alpha$) or at the national level (if $\beta<\alpha$). We assume however that political or institutional constraints make it costly to move away from some EU and national spending levels (indicated below by $\overline{G}_N$ and $\overline{G}_{EU}$) which are dictated by political/institutional constraints.

In order to capture these constraints, we assume the following loss function:

(5) $L = (Y - Y^*)^2 + \theta(G_N - \overline{G}_N)^2 + \lambda(G_{EU} - \overline{G}_{EU})^2$

Where Y^* is the desired level of output.

Minimising (5) with respect to G_N and G_{EU} yields:

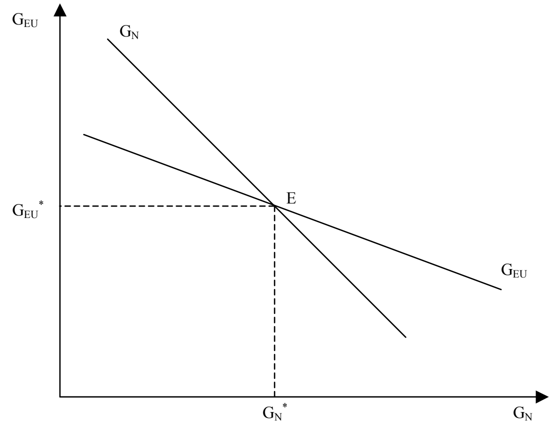
(6) $G_N^* = \dfrac{\theta(\beta^2 + \lambda)\overline{G}_N - \lambda\alpha\beta\overline{G}_{EU} + \lambda\alpha Y^*}{\lambda\alpha^2 + \theta(\beta^2 + \lambda)}$

(7) $G_{EU}^* = \dfrac{\lambda(\alpha^2 + \theta)\overline{G}_{EU} - \alpha\beta\theta\overline{G}_N + \beta\theta Y^*}{\lambda\alpha^2 + \theta(\beta^2 + \lambda)}$

The relationship between G_N and G_{EU} is represented in Figure A.1. A fall in $\overline{G}_N$, leads to a rise in G_{EU} and a higher Y^* implies a rise in both spending. A fall in λ leads to a rise in both G_{EU} and G_N.

As expected, a higher and more productive EU spending leads to a lower national spending[37].

Figure A1: EU and national spending under political constraints



One can take the current situation as implying very high values of λ, implying that $G_{EU} = \overline{G}_{EU}$.[38] If the EU moves to a truly "budgetary system", the constraints on G_N and G_{EU} will be lifted and the choice of financing will depend on the relative efficiency of each type of spending. Nevertheless, in the transition, the existing constraints may still play a role. The transition can be thought of as a gradual reduction in the value of λ and θ, with the former which is very high today, coming down at a higher pace, together with a departure from the initial objectives of G_{EU} and G_N.

For analytical convenience, it is useful to take as a benchmark the case in which the desired level of output is equal or higher than that produced by allocating the total desired level of spending to the most efficient level of government. Formally: $Y^* \geq \alpha\overline{G}$ if $\alpha>\beta$ or $Y^* \geq \beta\overline{G}$ if $\alpha<\beta$.

[37] However, the resulting level of output will correspond to the desired level only if $\overline{Y} = Y^*$, where $\overline{Y} = \alpha\overline{G}_N + \beta\overline{G}_{EU}$.

[38] If so, the level of national spending becomes: (8) $G_N^* = \dfrac{\alpha Y^* + \theta\overline{G}_N - \alpha\beta\overline{G}_{EU}}{\alpha^2 + \theta}$

Under such an assumption, and assuming that the current level of *Y* is lower than *Y**, it is easy to show that the current total level of spending is larger and the output is lower than the final equilibrium. Under $\alpha<\beta$ this occurs because, in order to shift Y towards Y*, G_N is set higher than $\overline{G}_N$ even though it is less productive than G_{EU}. On the contrary, $\alpha>\beta$, the desired increase in G_N is not compensated by a corresponding reduction in G_{EU}. As pictured in Figures A.2 and A.3 (under the case of $Y^*= \beta G_{EU}$ and $Y^*=\alpha G_N$, respectively), the offsetting reduction in the least productive spending only takes place over time as the constraints on λ and θ are reduced. In the final equilibrium, the desired level of output is wholly financed via the most efficient spending.

Figure A2: More efficient EU spending

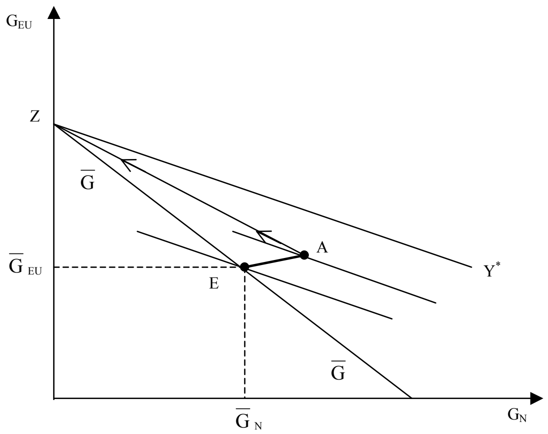
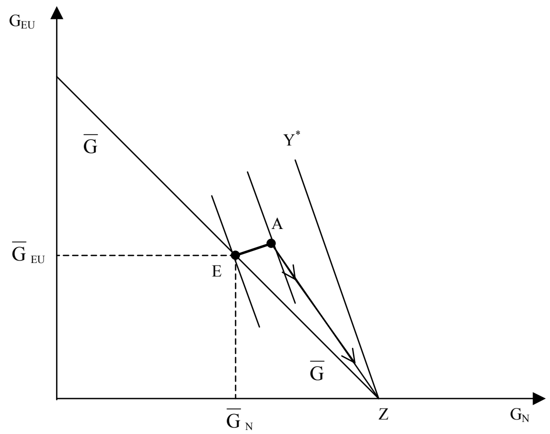


Figure A3: More efficient national spending



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