

## **EPCS 2008**

### **Refocusing the EU budget – an institutional view**

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#### **Abstract:**

There is little disagreement that the EU budget should be refocused. Redistributive agricultural and structural spending should be reduced in favor of more public good spending as the Boege and Sapir reports demand. We use a public choice analysis to show how the actual budgetary rules led to deadlock, which makes a refocusing of the budget very unlikely. We demonstrate how Member States became net payers and net receivers, and why the underlying coalitions were fairly stable and will remain so under the Treaty of Lisbon. We propose an additional budget voted by veto to overcome the deadlock.

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I	Introduction .....	2
II	The EU budget development and its discussion in the literature .....	3
III	An integrated institutional approach .....	5
III.1	General approach.....	5
III.2	Application of the general approach to the EU budget .....	6
III.3	The evolution of redistribution through the budget .....	7
III.3.1	The Emergence of the European Economic Community in the Treaty of Rome (1957) at the Contractual Stage .....	7
III.3.2	Post-Contractual Stage I: France and the Financing of CAP 1958 – 1970 .....	8
III.3.3	Post-Contractual Stage II: Integration of United Kingdom/Denmark/Ireland and Spain/Portugal/Greece 1971 – 1986 .....	10
III.3.4	Post-Contractual Stage III: The Budget under Qualified Majority/Unanimity Rule 1987-2003 .....	13
III.3.5	Post-Contractual Stage IV 2004 to 2009: The Treaty of Nice .....	17
III.3.6	The Impact of the Treaty of Lisbon: 2009 and beyond.....	18
IV	Opening out the budget deadlock.....	19
IV.1	General conditions for a consensual way out of deadlock.....	19
IV.2	Applications of the general conditions.....	20
IV.2.1	Unanimity Rule .....	20
IV.2.2	Voting by Veto .....	21
IV.3	Implementation of Voting by Veto in the Treaty .....	22
V	Conclusions .....	22
VI	Bibliography.....	24

## I Introduction

Spending of the EU budget is dominated by redistribution, mostly based on agricultural and structural programs. Large sums of money are transferred from the Member States to Brussels and back to the Member States. Only little (about 14.5 percent of the budget) is spent for union wide public goods.<sup>2</sup> Furthermore detailed analyses show that many redistributive programs lead to perverted redistributive effects, favoring regions with large and rich agricultural producers (see e.g. Shucksmith et al. (2005)). Many economists therefore believe that redistribution is excessive and inefficient, while the provision of union wide public goods is too small. Therefore economists widely agree that a reallocation of the budget would generate welfare gains.<sup>3</sup>

Within the ongoing enlargement of the European Union the inefficient budget spending came increasingly into the focus of policy-makers. Most important in the discussion among policy-makers are currently two political proposals for a budget reform: the “Sapir Report” (initiated by the European Commission) and the “Boege Report” (initiated by the European Parliament).<sup>4</sup> Both reports agree that a shift of spending from redistributive agricultural programs to public good provision would be welfare-enhancing. The Sapir Report demands

<sup>2</sup> Expenditures for research, external activities and administration (in relation to total expenditures) are regarded as contributions to union wide public goods, while Member State specific expenditures have been defined as non-union wide. For the data see: European Commission (2006), EU Budget 2005, p 13.

<sup>3</sup> One example is Tabellini’s call for “more central provision of public goods in the areas of defence, foreign policy, and of aspects of internal security, border patrols, immigration policy. The abolition of borders between EU countries carries with it the need to centralize aspects of law enforcement against organized crime.” (Tabellini, 2002, pp. 17ff.)

<sup>4</sup> See Aghion et al. (2004) for the Sapir Report and European Parliament (2005) for the Boege report.

that 45 percent of total spending should in the future be used for public good provision (especially in infrastructure and research), 35 percent for “industrial convergence” and only 20 percent for restructuring programs including agriculture. The Boege Report focuses more on changes on the revenue side. The most important demand is that the Member States shall co-finance 25 percent of all agricultural spending of the EU. If total spending of the EU remains stable, this should increase the room for EU spending on public goods. Furthermore the incentives of Member States’ governments to call for EU spending are hoped to be moderated by the co-financing regulation.

It is striking that the most important reform proposals initiated by the institutions of the European Union do argue with the general importance of incentive effects (as e.g. in case of the instrument of co-financing demanded by the Boege Report), but fail to acknowledge that reforms have only a chance to be implemented if they are in line with the Member States’ interests given the status quo. In our view it is generally far from sufficient to ask: How should the budget look like? Instead we think that we need to ask: How did we end up in a situation, where large parts of the budget are devoted to inefficient agricultural programs? Why is there so much redistribution? Why does the European Union (as an institution that has been founded to promote free exchange in a common market) spend most of its budget on redistribution? And why is redistribution so persistent? Why are some Member States consistent net payers and others consistent net receivers? We believe that all these questions cannot be answered by a cost benefit analysis of the traditional public finance type. It requires a rigorously positive analysis of the incentives, costs and constraints of political decision makers. And only such an analysis can help us to develop ways out of the current situation towards a more efficient and public good oriented budget given the enlargement of the EU. In our view this is the only suitable approach to avoid that progress with respect to the EU budget is limited to normative reform proposals without any chances to be implemented.

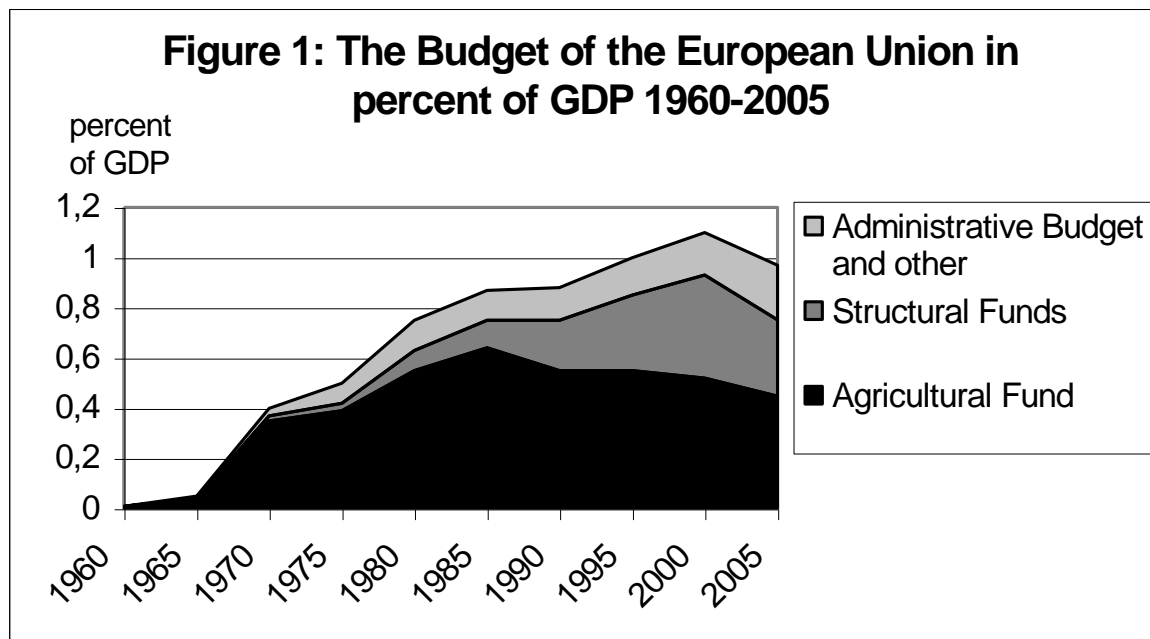
We offer such an approach here based on the theory of incomplete contracts. We analyze the development of the EU Budget since 1957 and show that not only voting rules as established in the EU treaties but as well the threat of exit played an important role in the development of EU spending. We argue that two different historically formed coalitions now have an incentive to veto changes on the financing and the expenditure side, which leads to budget deadlock and prohibits a change towards more public good provision. Based on our analysis we see the introduction of a separate budget for public goods with separate decision rules to be a viable alternative to overcome the current budget deadlock.

The paper proceeds as follows. Part II demonstrates the development of the EU budget, discusses approaches in the literature on the EU budget and establishes the need for an integrated institutional approach. To pursue a positive analysis of the incentives, costs and constraints of political decision making within the EU we develop an integrated approach, which takes the financing and the spending side into account (part III). We apply this approach to the historical development of the EU budget and show how a budget deadlock developed. Based on our historical analysis we analyze the changes resulting from EU enlargement. Finally we discuss institutional reforms, which would allow for ways out of the deadlock towards a more efficient budget (part IV). The last part concludes.

## **II The EU budget development and its discussion in the literature**

The European Economic Community started in the early years with a very small budget of around €80m, which increased strongly only after 1965 and reached a total of €121bn in 2006 – an absolute increase by a factor of 1500. After a slight reduction of spending within the last

years, the budget costs currently equal about 1 percent of EU GDP (see figure 1). While this seems to be only a small public budget we need to note that the EU budget is levied additionally to the national public budget.



Source: From data of the European Commission

In the *literature* we can distinguish three approaches to the budgetary process in the European Union.

Normative approaches are mainly concerned with four questions: How large should the budget be? How should the budget be financed? How should the budget be spent? And: Which decision making rules are “fair” to decide on the budget. Examples are the mentioned Sapir and the Boege Report as well as discussions about the advantages of an “EU tax”. A very comprehensive analysis of this kind, which includes polit-economic aspects as well and is focused on the revenue side of the budget, can be found in Heinemann et al. (2007).

A second group are descriptive approaches, which discuss the design of the budgetary rules and the decisions which have been taken. Examples are Messal (1989, 1991), Messal and Klein (1993), Peffekoven (1994), Strasser (1991) EU Commission (1995) and Lienemeyer (2002). Though this literature only describes what happened, not why it happened, it is very valuable for us, as it serves as a “data base” for our analysis.

A third group are positive approaches, which try to explain the development of the EU budget based on voting power given the decision rules laid out in the Treaty. Most of these approaches focus on the development of net payments. They argue that “power politics dictate the EU’s budget” (Baldwin et al., 1997, p. 157).

In our view only a positive analysis allows us to understand the development of the EU budget and to derive proposals for an institutional reform. While we generally share the belief of other approaches in the positive literature that power is important with respect to the EU budget, we nonetheless disagree with these approaches in three important points: First we argue that the historical development of the EU since the Treaty of Rome is crucial to understand the current budget incidence. Second we want to show that voting power alone is

not sufficient to explain the development of the budget and the budget incidence, but that credible exit threats play an important role as well. Third we argue that we explicitly need to study simultaneously the revenue and the expenditure side and not only the resulting net payments.<sup>5</sup> Therefore we want to propose a different approach based on the theory of incomplete contracts, which integrates these three criticisms in the existing positive literature.

### III An integrated institutional approach

How can we explain the development of the EU budget since the founding of the EU? What is the influence of the historical development on the current situation? What do we expect for the future development of the EU budget given its history? We propose to study the development of the EU budget based on a theory of incomplete contracts which is applied to a Union of states and takes exit threats into account. We will first describe our general approach and then apply the approach to the budget development of the EU from 1957 on.

#### III.1 General approach

To study the development of the EU budget the *theory of incomplete contracts* as developed for constitutions by Buchanan (1975), Brennan and Buchanan (1985) and others is predestined. It discusses the design of rules at the contractual level which will be executed later on the post-contractual level. Although decisions at the contractual level may be unanimous, their later execution may cause problems. Based on the theory of incomplete contracts we shall distinguish two alternatives:

- I. Some decisions made on the *contractual level* do not require further discussion or clarification on the post-contractual level, as the rights and duties of the parties have been reasonably well specified. The contract has simply to be executed. Possible misinterpretations of the terms of contract, which may emerge later on, are not reconsidered in the political process, but by courts. This holds in particular for contractual redistribution, i.e. redistribution as pre-designed in the contract, which can take place according to the agreed upon rules.
- II. It has to be anticipated on the contractual level, however, that some contractual provisions are incomplete and that new issues will emerge in the *post-contractual stage*. Within the contract it therefore has to be agreed on decision rules for issues not explicitly regulated on the contractual level. The application and the enforcement of these decision rules are often not called into question. It is simply assumed that the decisions according to these rules will be binding because the rules themselves have been agreed upon unanimously.

If the decision rules at the post-contractual level are just applied (e.g. to the budget process), then we could just focus on a positive analysis of voting power resulting from the agreed upon decision rules.

But in case of the EU we argue that we have to expand the general approach. In contrast to the case of a national state, where the individual citizens have only very limited influence, the Member States might threaten to harm the Union by terminating their contractual ties with the EU. Such a threatening has to be expected especially in case of the rules to settle post-contractual issues, which will, in general, not generate unanimously accepted outcomes.

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<sup>5</sup> Vaubel (2001, p. 36) has mentioned the problem of the different types of rules and coalitions, one on the expenditure and one on the revenue side, without, however, deepening his observation.

There will be Member States, who win and some who lose. The latter may reject the outcomes if they have the power to threaten to terminate the contract. If their threat is credible and has important negative consequences for the Union, special concessions for these Member States have to be expected. However the argument cannot only be applied to Member States with exit threats but as well for non-entry threats of Member States.

But what determines credibility of an exit or a non-entry threat? For the case of an exit threat we argue that the credibility will be strong in the early stages of a contractual arrangement, as long as the ties of cooperation which evolve under the roof of the contract are still loose. Therefore there is not much to lose by terminating membership. One important example for these ties is the integration of markets within a union. Through time, however, these ties will become more intense, the costs of exit will rise, which makes the threat of exit less credible, and the importance of the application of the constitutional rules to post-contractual decisions will increase more and more. A credible exit threat will lead to large concessions especially if important negative consequences for the other members of the Union are likely. This is the case if the threat comes from large and important Member States or a coalition of smaller Member States without whom the Union cannot be maintained. For non-entry threats the importance of a state for the further development of the EU is decisive.

**III.2 Application of the general approach to the EU budget**

What do we find if we apply the general approach of incomplete constitutional contracts including exit threats on the development of the EU budget process? We argue that we need to distinguish four different stages within the process (see figure 1).

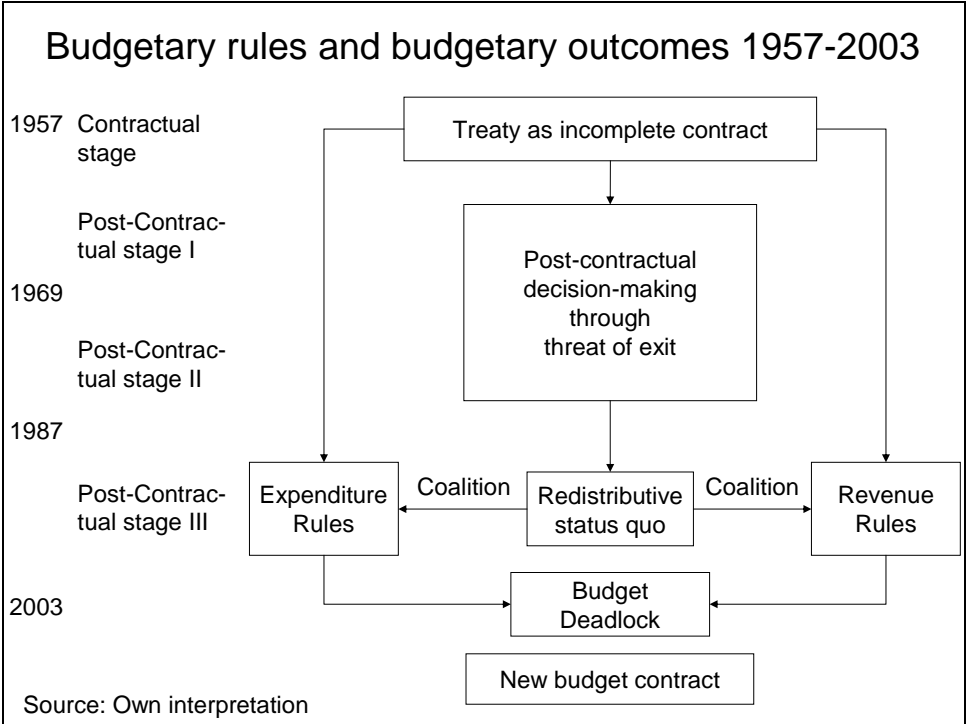


Figure 2: Budgetary rules and budgetary outcomes 1957-2000

We start with the contractual stage. In the Treaty of Rome of 1957 we can find contractual rules of redistribution of type I, which are applied without further decisions at the post-

contractual level, and rules of type II, which require redistributive decisions at the post-contractual level. Had the Treaty been designed as a fully complete contract, post-contractual redistribution would not be an issue. But the Treaty of Rome was typically an incomplete contract. Therefore post-contractual decisions on redistribution had to be expected.

In the post-contractual stages I (from 1958 to 1970) and II (from 1971 to 1986)<sup>6</sup>, redistribution did, however, not only take place according to the rules agreed upon the Treaty, but also through threat. Member state governments which had alternative policy options and who were able to harm the other Member States by terminating their membership used their threatening power to enforce their distributive goals in the budget.

With progressing co-operation in the Common Market, however, threats became increasingly less credible in the post-contractual stage III. As interfirm ties have been established it has become obvious that the loss from terminating membership would be large. Therefore threat as an instrument of influencing the budget was increasingly substituted by the formal rules of the Treaty. These rules, however, are far from perfect. They separate the expenditure side of the budget from the revenue side. Based on the status quo which resulted from the developments in the post-contractual stages I and II the formal rules of the treaty generate opposing coalitions, on either side of the budget. The expenditure side is dominated by net receivers, the revenue side by net payers, and both groups exert veto power. The result is that of a budget deadlock dominated by redistribution with fixed allocation of benefits and burdens per Member State.

### III.3 The evolution of redistribution through the budget

According to our presuppositions in the previous section and our general discussion of the theory of incomplete contracts we are now able to analyze the evolution of the EU budget in the four different periods (see figure 2) in more detail

#### III.3.1 The Emergence of the European Economic Community in the Treaty of Rome (1957) at the Contractual Stage

The original purpose of the Union as laid down in the Treaty of 1957 was the establishment of a Common Market and not that of a system of redistribution among Member States. In article 2 of the Treaty, redistribution is not even mentioned:

”The Community shall establish a common market and promote by progressive approximation of economic policies throughout the Community a harmonious development of economic activities, a continuous and balanced expansion, a growing stability, the raising of the standard of living and closer relations among Member States.” (art. 2, 1957)<sup>7</sup>

Redistributive elements show up only in later articles. art. 40 § 4 of the Treaty of 1957 mentions the establishment of „agricultural guiding and guarantee funds” and art. 123 the establishment of an ”European Social Fund”.

How can we explain the establishment of the agricultural and the social fund? To establish the European Economic Community all six founding Member States Belgium, Germany, France,

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<sup>6</sup> The developments on the different stages will be discussed in detail in the following parts.

<sup>7</sup> The original text of the Treaty of Rome is in German, French, Italian and Dutch. Translation by the authors.

Italy, Luxembourg and the Netherlands had to agree on the Treaty of 1957. While it was to be expected that export oriented Member States such as Germany would gain from free trade in the Common Market, such gains were much less certain for the more domestically oriented economies such as Italy and France. Their governments feared that the rents of integration would be shifted out of their countries. Therefore they aimed at institutionalized claims on the rents which ought to be guaranteed through the Community budget. The Italian workers should be helped by the Social Fund to overcome their structural problems when transforming from an agrarian to an industrialized economy, and the French farmers should be subsidized through the agricultural guiding and guarantee funds. Note that market intervention through funds was a rational way for the Italian and French governments to preserve a claim on the rents of integration. Only through funds could they rely to obtain the desired share of the Common Market benefits. The higher the growth of intra-community trade of manufactured goods, the larger is the structural divergence to less adaptable markets such as labor and agriculture and the larger are therefore the budgetary transfers required to compensate the losers. Lump sum payments, in contrast to funds, had to be negotiated anew in every year and were therefore not as reliable as funds.<sup>8</sup>

As funds were part of the Treaty, they were not unilaterally terminable and could only be removed by a unanimous decision. They became part of the *acquis communautaire*. Given that there is always at least one loser when a fund is abolished, it is difficult to see how unanimity could be achieved without replacing the fund by some other form of compensation, i.e. by perpetuating it. Therefore a persistent element of redistribution has been built in the European Economic Community since its beginning.

Critiques that funds are inefficient and should be abolished are, based on this background, ill founded. It should rather be asked what alternative arrangements would have been at the disposal of the French and Italian governments in 1957 to secure the rents of the Common Market permanently. It would soon become clear that only arrangements which are framed in the constitutional Treaty were safe.

### III.3.2 Post-Contractual Stage I: France and the Financing of CAP 1958 – 1970

After the establishment of the treaty in 1957 the post-constitutional stage I started and the post-constitutional rules of the Treaty were applied.

From the beginning the EU budget was split in three separate branches: the administrative budget (covering the administrative expenditures of the Commission, the Council and the European Court of Justice) the agricultural budget (representing the subsidies to farmers through the guiding and guarantee funds) and the social budget (for training and reintegrating workers subject to structural change).

**Table 1: Contribution shares to the Administrative Expenditures and the Social Fund (1957-1970) in percent**

Member State	Administrative Expenditures	Social Fund
Belgium	7,9	8,8
Germany	28,0	32,0
France	28,0	32,0

<sup>8</sup> An early emphasis of the compensation function of the EU budget has been given by Folkers (1995).

Italy	28,0	20,0
Luxembourg	0,2	0,2
Netherlands	7,9	7,0

Source: Treaty 1957 art. 200, see also Peffekoven (1994, p. 44)

The administrative budget and the social budget were financed by fixed share contributions as laid down in art. 200 of the Treaty of 1957 (see table 1). To the administrative budget, the three large countries, Germany, France and Italy e.g. had to contribute 28 percent each. To the Social Fund, France and Germany contributed 32 percent each while Italy contributed 20 percent. Changes were subject to unanimity. In the case of the social budget, regulations pertained also on the expenditure side. Subsidies were granted on a matching basis of 50 percent. The rules of the agricultural fund, in contrast, were quite different. First, the extent of the agricultural market was defined openly in art. 38 § 3 of the Treaty of 1957. It was not exactly defined how many or which products had to be subsumed in the agricultural fund. Second, neither the system of price guarantees nor that of structural aid to farmers has provided for national co-financing. Third, the contribution shares, which each Member State had to pay to the agricultural fund, were not fixed in the Treaty. They were negotiated periodically in the Council. Table 2 illustrates how much bargaining must have taken place in the process of agricultural budget determination since the common agricultural fund became effective in 1962. Five different distributions of country contribution shares had been recorded only in between 1962 and 1970. Moreover, these shares were only the general yardsticks on which further increments or decrements have been negotiated from year to year.

**Table 2: Contribution Shares to the Agricultural Fund 1962-1970**

Member State	7/1962 6/1965 <sup>a</sup>	1965/66	1966/67	7/1967- 12/1969 <sup>b</sup>	1970
Belgium	7,90	7,95	7,95	8,10	8,25
Germany	28,0	31,67	30,83	31,20	31,70
France	28,0	32,58	29,26	32,00	28,00
Italy	28,0	18,00	22,00	20,30	21,50
Luxembourg	0,20	0,22	0,22	0,20	0,20
Netherlands	7,90	9,58	9,74	10,35	10,35

<sup>a</sup>Fixed shares only. Variable supplementary shares (according to a Member State's net imports of particular farm products) are not included.

<sup>b</sup>Only for guiding expenditures; for guaranty contributions only if not covered by custom revenues (of which 90 percent were transferred to the Community)

Of the three budgets we would expect that the agricultural budget is most vulnerable to the attempts of countries to increase their national benefits. This results from two reasons: First, national redistribution via the administrative budget is hard to achieve as the administration had to be mainly at one place, at the capital of the Community. Second, the constitutional contract was (applying the theory of incomplete contracts) less complete regarding the agricultural fund than the social fund. The extent of the agricultural market was defined more openly, there was no co-financing and the contribution shares were frequently renegotiated.

What were the consequences of these different regulations in the Treaty? As far as the budget is concerned, responsibility rested mainly with the Council which had to apply qualified majority rule according to art. 148 § 2 of the Treaty of 1957. Therefore we would expect based on the Treaty that Member State governments were anxious to form qualified majorities in order to increase their net transfers from agricultural policies while reducing their contribution shares. But an historical analysis shows that this was done mainly not by

coalition building, but by the threat of exit, which dominated changes in the agricultural budget.

In these early years the stakes of the Member States in the Community were still small. Private enterprise contractual ties were not yet so developed. Therefore, an exit threat was credible and potentially harmful when made by a larger Member State, which was important for the future development of the Community. Given the vagueness of the contractual rules, the French government wanted to extend the agricultural fund in a way that was disapproved by the other Member State governments. The French intentions were outvoted by the Council in fall 1965. But given that the Community was so young and the stakes in it were still small, the French government, under President de Gaulle, had the option to exit and thereby to jeopardize the Community's future substantially. The French government decided to threaten the Community and chose to boycott all further meetings of the Council in fall 1965. Resulting from this pressure the unanimity rule was formally resumed in the so-called Luxembourg compromise of January 29, 1966 and the expansion of the agricultural fund was pushed through by the French government by its exit threat. This led to a steep increase of agricultural spending after 1965 (see figure 1) and a strong increase in redistribution via the agricultural budget.

What we can learn here is that the credible exit threat led to a crowding out of the constitutionally adopted qualified majority rule by the unanimity rule and the implementation of the redistributive preferences of a minority. Furthermore the examples of the Social Fund and the Agricultural Fund show the relevance of strict versus weak contractual budget rules. In the case of the Social Fund, post-contractual collective decision making has been avoided because co-payments have already delineated its size in the Treaty. In the case of the Agricultural Fund, however, collective decision making has been shifted from the contractual to the post-contractual stage where collective decisions were taken under the French government's threat to leave the Community and to jeopardize its further existence. Together, we can understand why the agricultural budget developed so differently from the social budget from 1957 to 1970 and why its rules were capable of bringing the Community in its first deep crisis.

### III.3.3 Post-Contractual Stage II: Integration of United Kingdom/Denmark/Ireland and Spain/Portugal/Greece 1971 – 1986

Two important changes in the budget process took place in 1970. A unitary budget was introduced and **second the role of the European Parliament in the budget process was strengthened.**

The tripartite budget – with earmarked contributions to agricultural, social and administrative spending – was given up in favor of a unitary budget within the decision on Community's own resources of 1970.<sup>9</sup> The unitary budget was financed initially by two sources of revenues: revenues of customs and other levies and a contribution by Member States calculated on their respective standardized VAT base. Later on, these two resources have become known under the names of "traditional own resources" and "VAT own resources". Formally the decision on the Community's own resources had a constitutional quality as it remained valid until it is

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<sup>9</sup> Decision 70/243 of the Council from April 21<sup>st</sup>, 1970 on the substitution of financial contributions of Member States by the Community's own resources.

replaced by a new decision on the Community's own resources. Thus, the status quo could only be changed by unanimity (Lienemeyer 2002, pp. 205-214).<sup>10</sup>

By the introduction of a unitary budget in 1970 the Member States gave up the possibility to directly control the spending for the different funds. How can we explain this voluntary reduction of control possibilities from a public choice perspective?<sup>11</sup> In our view four arguments were decisive: First the planned enlargement of the Union by the UK, Denmark, Ireland and the introduction of an additional fund for structural measures made the expected bargaining costs for four different budgets with nine Member States prohibitively high. Second the experience within the agricultural fund showed that the high bargaining costs nevertheless resulted in relatively little change in the national contribution shares given France's threat position resulting in a budget expansion more or less proportional to GDP. This experience might have increased the willingness of the Member States to fix the shares on the revenue side and concentrate bargaining on the expenditure side. Third the unanimity requirement for changes in the revenue system gave effectively every Member State a veto-right, which could be used to prohibit changes in the revenue structure or even to exert pressure on expenditure decisions. Finally the Commission with its monopoly as an agenda setter had the power to choose a proposal that was not against its interests. The Commission preferred a unitary budget over a tri- or four-partite budget because the influence of the Commission as the agenda setter was stronger in a unitary budget, as it allowed for much more discretion in shifting funds in between programs.

While the budget process had been an exclusive matter of the Council so far, the European Parliament received competences with respect to the spending of the budget in 1970.<sup>12</sup> Most importantly the Parliament got the "last say" with respect to the non-obligatory expenditures (especially for structural funds, administrative matters and research).<sup>13</sup> However in the period from 1971-1986 this change in the budget process had only minor consequences for the budget incidence. Non-obligatory expenditures for structural funds and research (the two fields where Member States could try to increase their revenues from the EU budget) accounted for only 5.1 percent of the whole budget in 1970.<sup>14</sup> Although this share increased to 15.8 percent in 1985 it was still too limited to affect the net payment positions substantially.<sup>15</sup> Therefore we neglect the influence of the Parliament in the period from 1970 to 1986 for our analysis here.

However the changes in the budget procedure and the introduction of an unitary budget and unanimity requirements on the revenue side did not lead to a reduced importance of threats of exit in the history of the Community from 1971 to 1986. Now, the question was about the UK rebate on the contributions to the budget.

When the United Kingdom joined the Union in 1973, it was supposed to accept the system of the Community's own resources of 1970 as an *acquis communautaire*. It had not only to waive all its customs revenues to the Community, but also to contribute to the VAT own

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<sup>10</sup> We shall return to the consequences of this rule in subsection IV.

<sup>11</sup> Unfortunately the positive literature studying this change is only very limited. Here a detailed study would be worthwhile.

<sup>12</sup> The European Parliament received furthermore the right to finally turn down the whole budget with a majority of 2/3 of the vote cast in 1975.

<sup>13</sup> With 60 percent of the vote cast (and 50 percent of its members) the Parliament became able to finalize changes of the budget with respect to the non-obligatory expenditures.

<sup>14</sup> Altogether non-obligatory expenditures accounted for 8.1% of all expenditures.

<sup>15</sup> Furthermore majority coalitions in the Parliament were not able to expand the size of the total budget for non-obligatory expenditures, as this was determined by the difference in between revenues and the obligatory expenditures, which were both decided in the Council.

resources. Given that British agricultural imports were large and own (subsidized) agricultural production relatively small (compared to those of other Member States) the overall balance resulted in a large net transfer in favor of the Community which was unacceptable for the British tax payers and their government (see table 3). Under the threat that the British citizens would vote against EC membership and the United Kingdom would leave the Community, the Council granted several yearly rebates and repayments up to 1984 when a permanent rebate was conceded in the own resources decision of the Council and the Member States.<sup>16</sup> Here again threat of exit led to direct effects on the budget.

**Table 3: Net Receipts from the EU Budget 1981 – 1984 in million ECU**

Member State	1981	1982	1983	1984	Σ 1981-84
Belgium	320	310	210	330	1170
Denmark	280	280	330	500	1390
Germany	-1770	-2320	-2300	-2950	-9340
Greece	160	690	940	990	2780
France	540	0	10	330	220
Ireland	590	740	770	920	3020
Italy	780	1520	1320	1710	5330
Luxembourg	270	250	270	280	1070
Netherlands	220	350	370	510	1450
United Kingdom	-1380	-1820	-1910	-1950	-7060

Source: Messal (1991, p. 113) and own calculations

Threat rather than formal decision making rules also determined the concessions made to the coalition of the *Spanish, Portuguese and Greek* governments at the time of their accession in 1984/85 and even more later on when the Single Market was at stake in 1986. In the early eighties, it was not implausible to assume that these nations might fall back into popular socialism or communism. Hence, their alternatives outside had to be estimated as relatively tempting compared to membership. The EC Member States, on the other hand, might have felt uneasy with communist neighbors in the East as well as in the South. Therefore, one can understand that they were willing to pay a price for the accession and adherence of these countries.<sup>17</sup> This price was paid especially by spending through the structural fund, which has doubled in the eighties (see figure 1).

*To sum up:* The concessions made to France and to Spain/Portugal/Greece on the expenditure side and to the United Kingdom on the revenue side make clear that it were often not so much the formal decision rules of the Treaty, but rather governments' capacity to credibly threaten to harm the Community by terminating membership that was decisive. Not all Member States, however, were able to exert such threats.

Germany as a large Member State had no credible alternative to its membership in the Community. Though its net payments were at least as large as those which the United Kingdom was expected to make (see table 3), it was unable to exert threat. For nobody seriously thought that Germany was able to leave the Community. Geographically enclosed between France and the COMECON it had nowhere to go. It turned out that the German

<sup>16</sup> It has to be added that the establishment of the structural funds had also the specific purpose to increase British receipts in order to reduce the British net payer position.

<sup>17</sup> For Greece, it was the problem of adherence as it entered in 1981 already.

government had even to contribute to filling the gap resulting from the British rebate which further increased its net payer position.

### III.3.4 Post-Contractual Stage III: The Budget under Qualified Majority/Unanimity Rule 1987-2003

In the following years, the power of governments to enforce budget decisions by threat of exit<sup>18</sup> decreased continuously. Member States grew closer together. Firms made cross border investments. A network of market ties emerged making threats of exit increasingly less convincing.<sup>19</sup> Sweden, Finland and Austria became members of the Union in 1995 but as their outside options were very limited, they were not able to negotiate special concessions.

As it has become evident that Member States would firmly adhere to the Community, it became possible to depart from the Luxembourg Compromise of 1966 and to return gradually to the collective decision rules of art. 148 § 2 of the Treaty of Rome (1957). A first step was the Single European Act of 1987 where qualified majority rule was extended to the issues of the Single Market. A second step was the compromise of Ioannina of 1994 where qualified majority was maintained (even with Austria, Finland and Sweden as new members), but the minority required for blocking an issue (temporarily) was set at 23 votes (26 percent) instead of 26 votes (29 percent) out of 87 votes. The actual endpoint of this development is the Treaty of Amsterdam in effect since 1999, which allows qualified majorities for Council decisions in important parts of budget policy.

What would we expect based on the change of the collective decision rules? Generally theories of decision making would predict that the application of qualified majorities instead of unanimity increases the likelihood of changes in the EU budget and the net payment positions of different countries as the number of possible winning coalitions increases. But what do we observe? We have calculated the average net payments per head for the period from 1995 to 1999 (when unanimity requirements were in place with respect to almost all expenditure and revenue decisions) and the period from 2000 to 2003 (when qualified majority was in place for important expenditure decisions and unanimity continued to be applied for revenue decisions). We have decided to start the second period in 2000 although qualified majority was in place since 1999 to account for the slack in policy-making.<sup>20</sup> Furthermore the two periods should be especially suitable for a comparison because of the stability of membership (EU 15).

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<sup>18</sup> Or: threat of non-entry in the case of Spain.

<sup>19</sup> Vaubel (2001, pp. 108-115) argues that EU politicians and public officials often form a sort of inner circle of friendship, artificial harmony and logrolling at the costs of the public at large. Therefore one can expect that the inner ties promote coherence too.

<sup>20</sup> However the results change only marginally if we analyze the periods 1995-1998 and 1999-2003 instead.

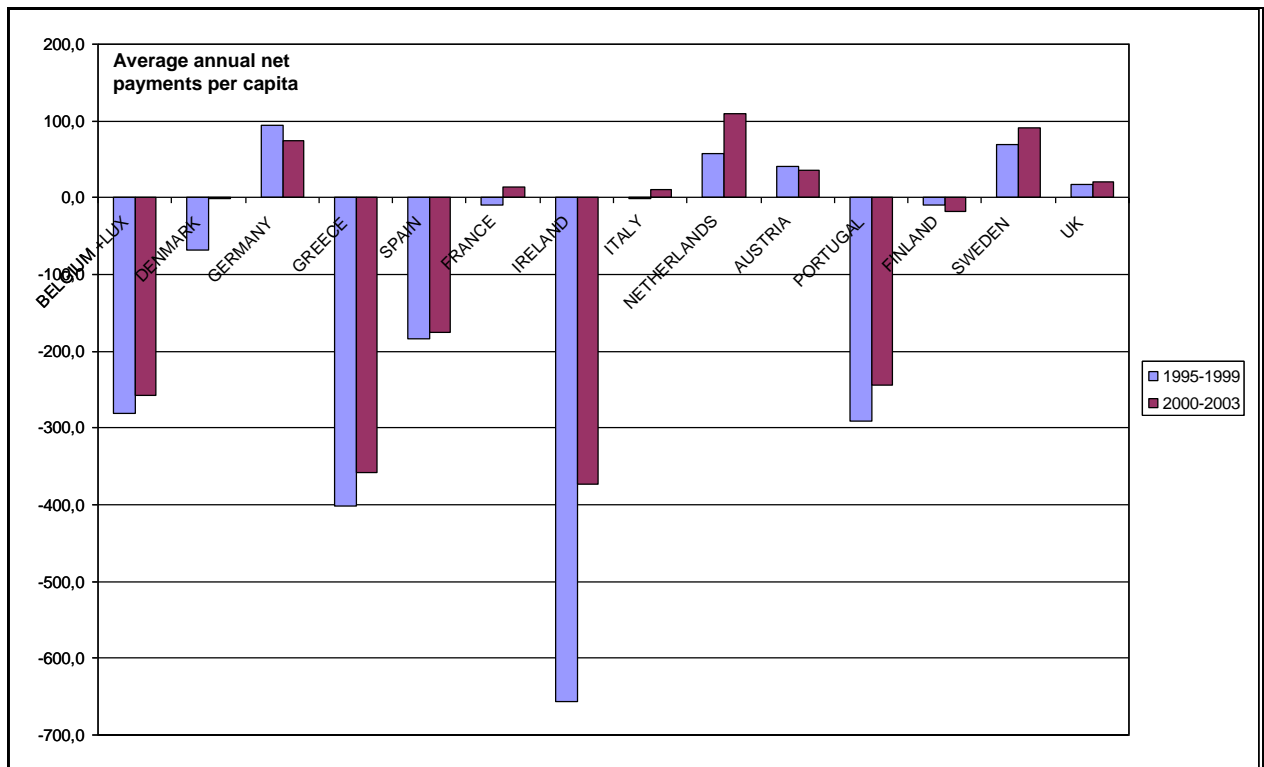


Figure 3: Average annual net payments per head before (1995-1999) and after (2000-2003) the Treaty of Amsterdam in Euro per capita

Figure 3 shows the average annual net payment positions per head in the periods analyzed. In the period from 1995 to 1999 we observe seven net receiver states. Ireland, Greece, Portugal, and Spain receive large net payments per head, while Denmark, Belgium and Finland receive moderate net payments. Net payers are Germany, Sweden, the Netherlands, Austria, Luxemburg and the UK. France and Italy are break-even states. They are formally net receivers, but the received payments are so small that we treat them as break-even states. If we compare these net payment positions with the average positions per head in the period of 2000-2003, we find a striking stability. France and Italy continue to be break-even states and continue to show a net payment of close to zero. Of all other Member States of the EU 15 none changes from a net recipient to a net payer or vice versa. And even the extents of average payments per head of the Member States do barely change. Only Denmark, which had been a net receiver in 1995-1999, became a break-even state.

How can we explain this result? In our view we need to start with the status quo before 1999. Based on exit threats combined with other effects as for example the relative importance of the agricultural sector a group of net receivers came out of the budget process since 1957, while other states (especially those without credible exit options) became net payers. Thereby we ended up in a situation of seven net receivers (Ireland, Greece, Portugal, Spain, Denmark, Belgium and Finland), six net payers (Germany, Sweden, the Netherlands, Austria, Luxemburg and the UK) and two break-even states (France and Italy). If we analyze voting power of the groups of net receivers and net payers we find (see table 4) that net receivers had a comfortable blocking minority of 32 out of 87 votes in the Council in 1999, strong enough to maintain the status quo of the allocation of Union's budgetary resources on agriculture and structural funds. The net payers are in a minority position too. They achieve 35 votes only. Two Member States, France and Italy, break even with 10 votes each. Even an attempt by net receivers or net payers to attract the votes of the break even states would not have changed the

outcome. Such coalitions would fall short of qualified majority with 62 votes. Our results do not change if we treat Denmark, which accounts for 3 votes, not as a net receiver but as well as a break-even state.<sup>21</sup> Similarly a proposal to reallocate some of the redistributive funds to provide public goods is unlikely to be accepted by the blocking minority of actual net receivers. For the costs of reduced transfers are very likely to be borne by them while the benefits accrue typically to all Member States.<sup>22</sup>

Table 4: Votes of net receiver states, net payer states and break even states under the rules of the Treaty of Amsterdam 1997 – 2003, EU 15

<b>Groups of Member States</b>	<b>Number of votes</b>	<b>Total votes</b>	<b>Blocking minority</b>	<b>Qualified majority</b>
Net receiver states	<b>32</b>	<b>87</b>	<b>25</b>	<b>62</b>
Net payer states	<b>35</b>	<b>87</b>	<b>25</b>	<b>62</b>
Break even states	<b>20</b>	<b>87</b>	<b>25</b>	<b>62</b>

Source: Own calculation.

If we move from the expenditure side to the *revenue side* the principle of a status quo oriented unanimity has been maintained since the first decision on own resources of 1970.<sup>23</sup> Hence an existing decision can be replaced only by a new unanimous decision.<sup>24</sup> This principle has important consequences for the net budget incidence. When the incidence of expenditures drifts away from the incidence of revenues (for the reasons given above) and net payers' positions are built up, then there is no way for the net payers to get rid of their burden. They will neither be able to reduce the general contribution rates nor to shift their own burden on the shoulders of the net receivers. Both attempts will fail to be accepted by the latter. There is only one way for the net payers to protect their interests: to veto proposals coming from the net receivers to further increase their contributions to the Union's own resources. Such a veto is indeed the only way for net payers to protect themselves against ever growing demands of net receivers. Any promises to net payers that higher contributions which they would make would be used for providing union wide public goods (or would be acknowledged as an advance in later negotiations)<sup>25</sup> should not be taken seriously. For under general fund financing it is upon net receivers to channel these funds towards themselves.

But what about the European Parliament in this period? Did we observe coalitions differing from those dominant in the Council trying to increase their net-payer positions based on the non-obligatory, in particular structural expenditures now belonging to the Parliament's

<sup>21</sup> Denmark is a special case here. It has been a net receiver state in the period from 1995-1999 and a break-even state in the period from 2000-2003. If we analyze the whole period from 1995-2003 Denmark is a net receiver state. Therefore we have decided to treat Denmark in the following calculations as net receiver state. However, even a classification as break-even state would not affect the validity of our general argument.

<sup>22</sup> A critical review of the assumptions made: First of all, one may object that it is a simplification to focus on the Council as a decision maker. Indeed, there are further players such as the Commission which has to make mid-term projections and which has to prepare the yearly budget. Moreover, negotiations take place between the Commission and the Council. But within the Council ministers have to fight fiercely for their national interests as contributors and receivers of funds. The better they fight, the larger is the support they will receive from their voters at home. And after all, they have to survive in national elections.

<sup>23</sup> 70/243/EGKS, EWG, Euratom, Abl., Nr. L 94 (1970), p. 19.

<sup>24</sup> Strictly speaking: The decision on European Communities' own resources is open-ended and therefore has to be ended unanimously which will not be done before a new own resources decision has been agreed. See: art. 269 [ex 201] of the Treaty and Council Decision on the system of the European Communities' own resources (2000/597/EC, Euratom).

<sup>25</sup> For example extra payments which chancellor Merkel assigned to Poland in the financial perspective 2005 did not affect Poland's position in the Treaty negotiations of 2007.

competences? A first glance seems to confirm this hypothesis as these expenditures increased after about 1990 (from 15.8 percent of the budget in 1985 to 39.7 percent in 2000; see figure 1). A closer look, however, reveals that in fact little change took place. The trends in figure 1 disguise that mostly a substitution took place from means for price support to means for structural support in agriculture, institutionally from the price guarantee section of CAP to the structural guidance section of CAP which belongs to the structural funds. As a large part of the other structural funds went to backward industrial and hence often agricultural regions as well, apparently the same group of net receiver Member States has benefited as before. This is not astonishing as net receiver states and break-even states encompassed nearly 60 percent of the seats in the European Parliament of EU-15 (and actually nearly 70 percent of EU-27). And the net payer states were not able to bribe enough net receiver and break-even states in order to form a qualified counter coalition to reallocate the Union's expenditures to their countries. Therefore it seems legitimate to largely abstract from the European Parliament as a decision maker in budgetary matters in this period.

*To summarize:* The historical development of decision making on the EU budget has resulted in a *re-distributive deadlock*. Net receivers use their blocking power to object any reallocation of resources away from their narrow individual interests, and net payers, anticipating net receivers' power to attract the additional resources to themselves, will veto any increase in their financial burden. But net payers cannot enforce a decrease of their burden; for that would be objected by net receivers under unanimity rule. Therefore the status quo is a stable equilibrium. Preserving the status quo means that the net budget incidence as it came out of the power play in the post-contractual stages I and II will be preserved. The claims by the Boege and Sapir Reports that more public goods should be provided will remain politically unnoticed.

It is important so see the effect of the *status quo related unanimity rule* for decisions on Union's own resources. Had the net payers the possibility to unilaterally terminate an existing own resources decision, e.g. after the usual six year duration of a financial framework, all Member State governments would be under pressure to discuss budget revenues and expenditures de novo and as a whole. The separation of revenues from expenditures would be abolished, and substantial reforms might become possible. Though such a reform might be desirable, it is irrelevant for our discussion; for no unanimity would be found to support it. Therefore it is unlikely that the EU budget process can be reformed within its own rules like "Munchhausen pulling himself out of the swamp by his own hair".

*An example* may illustrate how sensitively governments often react to proposals to change the distribution of the burden. When, in anticipation of the Berlin summit of 1999, the German government made some exploratory calculations on the possibility of obtaining an UK type rebate on its contributions, the Spanish government promptly reacted by submitting a counter-proposal requiring that Member States' contribution rates should rise progressively with respect to GNP with the obvious effect that the German government should pay more instead of less to Union's own resources.<sup>26</sup> The Spanish proposal was not even mentioned at the summit, but it had the effect of taking the German proposal off the agenda, and the status quo was maintained.

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<sup>26</sup> See H. Bündler, Die mühsame Suche nach dem richtigen Reformmodell, *Franfurter Allgemeine Zeitung* Nr. 193, 21 August 1998, p. 12.

If these deliberations are correct, the likely result is effectively one of non-decision making. Based on this budget deadlock, union wide public goods are unlikely to be provided in a larger amount, as those who benefit from redistribution in the status quo have to give up their privileges to finance these public goods and those who pay for the budget are reluctant to pay more money because they cannot earmark their contributions for the provision of public goods. The budget is likely to grow in line with the built-in rules. These rules are defined by the ceiling of 1.24 percent of Union's Gross National Income (GNI) as assessed in the own resources decision of 2000. The ceiling has been renewed in 2005 and it will remain at this level until 2013. Some readers may not be too unhappy with the deadlock because it guarantees a sort of "second best": As long as it is apparently not feasible to provide (more) union wide public goods, they may say, it is fortunate that the budget has a built-in stabilizer holding further growth down at the rate of growth of Union GNP.

### III.3.5 Post-Contractual Stage IV 2004 to 2009: The Treaty of Nice

In 2004 an enlargement of the European Union from 15 to 25 Member States took place and from 2007 on Romania and Bulgaria became the 26<sup>th</sup> and the 27<sup>th</sup> member. How does the enlargement affect the budgetary process?

So far we dispose only of very limited data of the impact of enlargement of the European Union on the budget incidence. With respect to the future development we believe that the mechanisms of exit threat of the post-contractual stages I and II will not re-emerge. The Union has become large enough to bear the exit of some of the new accession states. Therefore accession states lack a threat potential comparable to that of France in the sixties or the UK and Spain in the seventies and eighties.<sup>27</sup>

Table 5 shows net receivers, net payers and break-even states under the rules of the Treaty of Nice, now including the accession states which have been added all together to the net receiver states.<sup>28</sup> Obviously, net receiver states will not only keep, but even increase their blocking minority. This may hold even if some of the accession states and of the break-even states may become net payer states as a consequence of accession.<sup>29</sup> But net receivers (traditional and new) will not attract as many votes as to achieve a qualified majority. They will, however, be able to block policies reducing transfers to them. Net payers (even when augmented by some successful accession states) will remain weak. They have just enough votes to form a blocking minority, but are far off a qualified majority even in a coalition with the break-even states. Therefore the net receivers will be able to maintain the size of the agricultural and of the structural funds and to suppress public good programs. On the other hand net payers can use their voting power to block further expansion of the budget. All in all, therefore, little change has to be expected. Only the strain on the resources of the budget is likely to increase.

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<sup>27</sup> A good sign of this development is that the right of exit is integrated in the Treaty of Lisbon (see art. 49a).

<sup>28</sup> We continue to treat Denmark as a net receiver state.

<sup>29</sup> Malta, Slovenia, Czech Republic and Cyprus will receive an extra payment avoiding that they are pushed into a net payer position.

Table 5: Votes of net receiver states, net payer states and break even states under the rules of the Treaty of Nice 2004 – 2013 EU 27

<b>Groups of Member States</b>	<b>Number of votes</b>	<b>Total votes</b>	<b>Blocking minority</b>	<b>Qualified majority</b>
Net receiver states (old and new)	192	345	91	255
Net payer states	95	345	91	255
Break even states	58	345	91	255

Source: Own calculation.

### III.3.6 The Impact of the Treaty of Lisbon: 2009 and beyond

The Treaty of Lisbon, which is planned to come into effect in 2009, includes two important changes: First new decision rules in the Council are to be implemented and second the role play of the Council and the European Parliament in the budget process is changed.

With respect to the decision rules in the Council, the Treaty of Lisbon foresees new rules starting in 2014 (2017 in exceptional cases) requiring a double majority of 55 percent of the states (i.e. 15 states for approval) which have to represent at least 65 percent of the total EU population.<sup>30</sup> Furthermore four Member States are sufficient to form a blocking minority.

Based on these new rules the existing coalition of net receiver states will easily be able to maintain their blocking minority as they outnumber the other two groups. But they will not be able to meet the population criterion even in a coalition with the break-even states which would in case allow them to attract even more resources from the agricultural and structural funds. The coalition of net payers will fail on both; state votes and population even in a coalition with the break even states. But they can block expenditure decisions and, as a last resort, an increase of Union's total amount of own resources at their costs due to the unanimity requirement of art. 269 EC.

Table 6: Votes of net receiver states, net payer states and break even states under the Lisbon Treaty (EU 27)

<b>Groups of Member States</b>	<b>Number of votes</b>	<b>Total votes</b>	<b>Blocking minority</b>	<b>65% of the population</b>
Net receiver states	19	27	4	190,9 < 321,5
Net payer states	6	27	4	175,9 < 321,5
Break even states	2	27	4	117,4 < 321,5

Source: Own calculation.

With respect to the European Parliament the situation is more complex. **We remember from the previous section that following 272 EC that the European Parliament has currently the last word in non-obligatory expenditures (especially structural fund money and administrative expenditures) and can turn down the budget as a whole.** Based on art. 314 of the Treaty of

<sup>30</sup> The transitory regulations of the treaty of Lisbon (art. 3 § 3) foresee that - on demand of any member of the Council - a population criterium of 62% can be applied already from 2009 on. However this has no influence on the majority coalitions discussed here.

Lisbon TFEU the whole budget will be decided by the Council and the Parliament on equal footing. Many comments see the position of the Parliament to be reinforced compared to the status quo. However this is not the case. The constitutional draft of 2003 had originally foreseen that the Parliament can enforce its view in case of disagreement on any part of the budget.<sup>31</sup> The intergovernmental conference of 2004, however, decided that in case of disagreement in the Conciliation Committee the Commission has to write a new budget draft and the process starts anew.<sup>32</sup> Compared to art. 272 EC the position of the European Parliament is therefore clearly weakened. Under the present regulation of 272 EC the Parliament has the last word for all non-obligatory expenditures, while the Parliament will have to compromise on all expenditures with the Council in the Conciliation Committee under art. 314 of the Treaty of Lisbon TFEU.

Taken together we therefore expect that the Council which is dominated by net payer states will reinforce its dominant position in the budgetary process. Little or no change has to be expected in the revenue or expenditure structure from Lisbon and its reforms of the decision rules and the budget process. And we see little chances for an increase in the provision of union wide public goods.

## IV Opening out the budget deadlock

### IV.1 General conditions for a consensual way out of deadlock

Based on the Treaty of Lisbon we have to expect that the unanimity rule on the revenue side and the qualified majority rule on the expenditure side will be maintained. Even based on the new vote distribution (in effect from 2014 on) no group of net payers or net receivers has a large enough majority to change expenditure policy. Hence there will be neither a substantial provision of public goods nor a budget explosion.

How could we break up this deadlock with the goal of an increased provision of public goods? In order to be able to discuss various reform proposals in a realistic framework, we want first to establish three conditions which, in our eyes, are necessary prerequisites for any consensual agreement of Member States on the budgetary issue:

- a. *Separation*: collective decision making on public goods cannot take place within the existing budgetary rules. Net receivers would channel the means into redistribution and, in anticipation of net receivers' behavior; net payers would refuse to contribute. Therefore, a new, separate budget: "*The public good budget*" has to be introduced.<sup>33</sup> But the old budget "*The general budget*" has not to be given up in order to avoid that there are losers.<sup>34</sup>

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<sup>31</sup> "[T]he Parliament may ... acting by a majority of its component members and three fifths of the votes cast, confirm its amendments." art. III-310 § 8 of the constitutional draft of 2003.

<sup>32</sup> A majority decision of the Parliament (as in art. III-310 § 8, 2003) can (following art. 314 Treaty of Lisbon TFEU) only take place in the very unlikely case that the representatives of the Council (in corpore) first come to an agreement with the representatives of the Parliament in the Conciliation Committee and then come to the conclusion that they disagree formally in the Council.

<sup>33</sup> We acknowledge that new rules are required. But we doubt that these rules can be adopted without an integration of the status quo. Insofar our proposal differs from those e.g. by Buchanan and Lee (1994).

<sup>34</sup> Some may object that the principle of the unity of the budget is violated. But it has to be remembered that the Union never had a fully integrated budget. The budget of the European Community of Coal and Steel (during its existence) as well as the budget on loans and credits has always been separated from the general budget (see Strasser 1991, pp. 46-49). Furthermore the existence of separately financed "public good budgets" in other international organizations (as for example in the OECD) prove the feasibility of such an approach (see e.g. Heinemann et al. 2007, pp. 76 ff).

- b. *Veto*: the new budget procedure must be designed in a way that no party risks ending up in net payer position or aggravating its existing net payer position. Thus some veto-element must be part of the new solution.
- c. *Contributions*: since willingness to pay for public goods depends on a number of factors such as the characteristics of the good, individual preferences, income, price etc., the rules of financing should be flexible. They should take the form of individual contributions rather than general rate based payments.

All in all, we are searching for a pareto-superior procedure.<sup>35</sup> Leaving inefficiencies of the existing system aside, we want to find a procedure that opens opportunities for the provision of public goods available in the Union on a consensual basis. Insofar, our proposal is purely positive. It can be taken up by any party that wants to gain votes. It differs from normative proposals targeted to a change of the existing rules implying winners and losers and hence opposition.

## IV.2 Applications of the general conditions

Only a few rules can meet these three established criteria. Many collective decision rules have been proposed which exhibit fine properties like fairness or equal voting weight etc. But when starting from the status quo they fail to be accepted because some participants are made worse off. Consider e.g. the square root rule, i.e. the so called Yagellonian Compromise, which was proposed by the Polish government to the 2007 EU summit on the new Constitutional Treaty. Following this rule, a proposal is accepted by the Council if it reaches at least  $\frac{1}{2}(\sqrt{\Sigma \text{inhabitants}} + \Sigma \sqrt{\text{inhabitants}})$  which guarantees that each citizen has the same voting weight in the Council independent of the population size of her or his country. Though this proposal has been praised by game theorists and mathematicians, it is clear that it cannot be smoothly linked to the status quo. Inhabitants of large net payer countries are made worse off. They might propose alternatively not to count individuals in the square roots, but to count the amount of a country's contribution in euro etc. giving a larger weight to large states etc. etc. None of these proposals can be accepted unanimously.

Therefore we see only two alternatives to enable the increased provision of public goods: unanimity rule and voting by veto. We will discuss the two in the following.

### IV.2.1 Unanimity Rule

The application of the unanimity rule, as proposed by Knut Wicksell (1896), for a new and separate budget satisfies the conditions established above. All voters have a veto right and so no participant will end up in a position of being exploited. Moreover no vote weighting is necessary as under the actual qualified majority rule. For each decision maker pays according to his willingness to pay resulting from negotiations. A major disadvantage is, however, that vetoes have no price to the voters who can just say no and expect that someone else will take the burden of creating a new proposal. Therefore Wicksellian unanimity is an unwieldy

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<sup>35</sup> A current proposal of Friedrich Heinemann et al. (2007) on the reform of the revenue system takes a similar path (Heinemann et al. 2007). Heinemann et al. argue in favor of a separation of the budget into expenditures, which do not have clear or politically sensitive redistributive effects and expenditures, which have critical redistributive effects (as especially spending within the CAP and the structural fund). The two budgets shall be financed by different means and a general correction mechanism shall replace individually determined rebates (as e.g. the UK rebate). However this proposal differs from our approach in fundamental points. Most importantly our approach does not attempt to split expenditures of the current budget, but to introduce a completely new budget. Furthermore we focus not so much on the financing side of the budget but on the more important expenditure side. While we agree that the approach of Heinemann et al. is superior to most existing normative reform proposals by integrating polit-economic arguments, we are less optimistic with respect to the chances of breaking the current budget-deadlock via new revenue rules.

process not suitable for the European Parliament. Even in the Council with its 27 Members, unanimity seems to be practicable only when restricted to fundamental decisions and not to budget measures. It may, however, be useful for financing projects in the field of EU enhanced co-operation. In this case participants of such projects would not be forced to go through the ordinary EU budget.

#### IV.2.2 Voting by Veto

A second and less well-known alternative, which satisfies the three general conditions is “voting by veto” as developed by Dennis Mueller (Mueller, 1989/2003). Under this procedure each of  $N$  participants submits a proposal on the size and the cost sharing of a project. The status quo is added as a further proposal. Each participant has the right to eliminate – to veto – one proposal. Therefore she has an opportunity to compare and to evaluate the relative advantages of different proposals and veto the worst. Participation in voting by veto differs from unanimity rule in that a veto has a cost. For only those who make a proposal have the right to veto. So a participant has to prove her cooperative attitude. In that voting by veto is much better than unanimity rule. Who may exert her veto right first, second etc. is determined by lottery. Eventually, one proposal remains as the proposal which has not been vetoed and which is therefore acceptable by all participants.

Under voting by veto each participant has an incentive to take account of other participants’ preferences when making a proposal in order to avoid its elimination. Since many alternatives are proposed and subject to a veto, there is intense search process which leads to better solutions. Every participant can protect herself from being exploited by vetoing the least desired proposal. So do all other persons, and the resulting proposal will be fair and efficient.<sup>36</sup>

A further advantage of voting by veto is that it is not vulnerable to cycling because the procedure has a finite number of steps. For a given set of rankings and sequence of veto-voting, it produces a unique outcome (Mueller 1984). It is true that it may yield a different winner for the same set of rankings under a different order of veto-voting. But it has to be considered that the procedure produces incentives to select proposals with respect to other voters’ preferences, i.e. proposals benefiting not only the particular, but all voters.

Among the *possible disadvantages*, four are worth to be discussed:

First: the procedure is often said to be unfair because it does not differentiate between large and small Member States. All have the same voting power. Such an argument is, however, misleading as the same would hold under unanimity rule. And even with the qualified majority rule a group of small Member States can hold a veto position. The advantage of the voting by veto-concept is its inherent reciprocity. Any small Member State is well advised submitting proposals which take into account the interests of large Member States, because otherwise such proposals will be automatically vetoed by one of the large Member States. The voting by veto-concept thus does not provide undue influence of small Member States but rather mitigates the power of large and small Member States reciprocally.

Second: voting by veto is sometimes said to be complicated. This is, however not the case. The only additional work which is required compared to usual voting is that each voter establishes a ranking of the alternatives turned in. The elimination procedure will be made by a computer which will deliver the result within a minute.

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<sup>36</sup> See Mueller (1989, pp. 139-145) as well as Mueller 1984.

Third, the number of participants may be relevant for the outcome. If the number of participants is small, participants may behave strategically, if it is large, an individual may lack of the incentive to participate actively in the voting process. These are two well known characteristics of all voting systems and cannot be easily avoided. In so far voting by veto is not different. But it has to be considered that voting by veto is applied at a specific institution: the Council which is neither very small nor very large. It will have 27 members or 28 if Turkey joins the EU. Compared to competition policy, a market with that many suppliers would be regarded as fairly competitive. Therefore neither the problem of too few or too many is likely to be prevalent.

Fourth, voting by veto has been criticized for being vulnerable for strategic behaviour in a cartel. One can think of a sufficient number of participants agreeing to submit identical proposals designating one participant as the only payer and the number of vetoes by the latter being not large enough to cancel out the former. As, however, the cartelists have to share their prey, some may feel to be treated unjustly and enter a cartel with the victim. The battle between the cartelists of either side tends towards simple majority voting with instability and cycling. Given this perspective all participants may prefer to vote their vetoes sincerely as this behaviour generates the highest pay-off and stable outcomes.

### IV.3 Implementation of Voting by Veto in the Treaty

Voting by veto would not only satisfy the established three general conditions but could as well be easily implemented. Most importantly the title on financial provisions in the Treaty should be expanded: The following wording is being proposed as a third paragraph of art. 269 EC :

*"Additional to the general budget under the provisions of the preceding paragraphs of this article there will be a second budget on expenditures for public goods to be provided by the European Union. For this budget the following procedural rules are binding: Each year every Member State has to submit to the Council a draft law for a regulation for the raising of revenues and the regulation of expenditures for the Union's public goods budget according to the regulations issued by the Commission.<sup>37</sup> One draft law is last year's public goods budget. Member States have to exercise sequentially their right to eliminate one draft law each. Which Member State votes first, second and so on is determined by lot. The process stops when there is only one draft law left. This draft law which is not vetoed shall be adopted and put into effect by the Council."*

## V Conclusions

There is wide agreement that an increased spending on public and other joint goods on the EU level would generate welfare gains. But how could such an increased spending be achieved?

In this paper we demonstrated that we are in a situation of a persistent budget deadlock on the expenditure as well as on the revenue side in the European Union. It is not that some Member States are accidentally winners and some are losers in the budgetary process, but that the rules persistently favor some at the costs of others so that there is little change between the two groups. Whether a Member State is on the winning or the losing side depends a lot on its initial ability or inability, in the early years of European Economic Community, to exert threat

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<sup>37</sup> The Commission may require to split the public good budget in order to apply voting by veto on different public goods.

in order to influence the emerging division between those who receive and those who pay. Unanimity or close to unanimity rules had the effect that changes of this status quo were difficult to achieve as the veto power of potential losers was strong. Stable coalitions dominated either side and are likely to block any substantial changes in the enlarged EU.

These findings lead to a pessimistic evaluation of normative approaches, which propose to change the financing of the EU budget e.g. by the introduction of an EU tax or co-financing of agricultural spending (as demanded in the Boege Report) as well as of proposals to reallocate spending more towards more public goods (as demanded e.g. by the Sapir Report). We are not aware of a normative proposal, which could seriously be expected to break up the existing deadlock on the revenue or on the expenditure side.

We do not add one more proposal on what should be done in the EU. We rather say: If the present situation is inefficient in that subsidies are too large and the amount of public goods is too small, then we must focus on institutional improvements to realize these possible efficiency gains. In our view such institutional improvements must satisfy three conditions: First a new budget earmarked for public good provision needs to be implemented. Second the decision rules on this new budget need to include a veto right for each Member State. And finally the Member States' payments should take the form of individual contributions instead of general rate-based payments. For decisions among only a few Member States in the field of enhanced co-operation we may use unanimity rule outside the ordinary budget. We argue, however that for larger projects the most efficient decision rule for public goods is an additional public-good budget voted by veto. Voting by veto is easy to implement, reveals efficiency enhancing public goods and leaves decision making in the ordinary EU budget and thereby the status quo untouched. Furthermore the included veto-rights avoid the exploitation of Member States.

In our view, the introduction of a separate public-good budget with voting by veto as decision-rule is therefore the most promising way out of the budget deadlock of the EU.

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