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ANALYSIS

The European budget and the "fair return" principle: what is it about?

The notion of "fair return" has been present implicitly since the early days of European construction and has become more visible since the 1980s, occupying an important place in budgetary discussions at Community level. It is most often based on the calculation of the balance between expenditure from which member states benefit and their financial contributions to the Community budget.

With the "European financial framework" revision exercise starting next summer, it is worthwhile looking again at the exact scope of this notion which often gives rise to criticism in academic writing[1].

- Can we really define the "fair return rates" for each EU state and, if so, using what method?
- What is the scope of these "return rates"?

"Return rates" and the redistributive character of the Community budget

First of all, analysis of "return rates" occupies a central place in discussions of the Community budget because of the confederal nature of the EU[2] and the pre-eminent legitimacy of its member states. Though it expresses (in part) an evaluation of the "return on investment" for different Community expenses in comparison with their collective usefulness and EU needs, taking "return rates" into account also – and above all – expresses the member state's intention of controlling the total amounts of budgetary transfers towards the EU and between its member states, i.e. the degree of financial solidarity that the latter judge acceptable to agree to between one another.

An analysis linked to the redistributive character of the EU budget vis-à-vis European openness to trade

The place given to "return rates" in Community budget negotiations is all the greater since this budget has been set within a "redistribution" process that seeks to compensate those who may suffer from the effects of European openness to trade[3] (see Box 1).

Box 1

• The Common Agricultural Policy was set up in the 1960s on the basis of a Franco-German compromise built on the acknowledgement that since German industry would greatly benefit from the Common Market, it was legitimate for French agriculture to benefit from EEC membership as well[4].
• The setting up of European Social Funds was also decided upon when the Treaty of Rome was signed: its general aim was to compensate for competitive impact linked to the introduction of the Common Market and the particular objective of favouring the training and mobility of Italian workers.
• The Regional Policy developed rapidly after the United Kingdom joined (creation of the ERDF in 1974) to benefit a country that, at the time, was behind in development compared to the Community average and unlikely to benefit from the CAP.
• A prolongation of this policy is the "Structural Policy": the means made available for the latter were doubled when the Single Market was put on track (the "Delors 1 Package") and following the membership of Greece, Spain and Portugal[5].
• The resources allocated to this policy were then increased by 50% following the agreement relating to the transition to the Economic and Monetary Union ("Delors 2 Package"), which also led to the creation of the "Cohesion Fund" to facilitate the changeover to the euro[6].
• Lastly, and more symbolically, it is worth noting that the Structural Funds financed regions with "low population density"[7] following the membership of Sweden and Finland.

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[1] See, for example, Jacques Le Cacheux in "Budget européen: Le poison du juste retour" ("European budget: the poisonous budget rebate debate") – *Notre Europe* – June 2005.
[2] In fact, it may be observed that it is invoked in most unions of states (the United States and Canada, for example), and – moreover – within countries whose political organisation is based on strong regional autonomy (Spain, Italy).
[3] European openness to trade has made headway both in technical terms (the Treaty of Rome and the Single European Act, principally) and in geographical terms (the joining of new member countries).
[4] The Chirac-Schröder agreement of 2002 may be seen as a renewal of this founding agreement.
[5] It should be noted that Spain and Portugal did not take part in the negotiations that led to the signing of the Single Act in 1985, and one objective of doubling Structural Funds was also to make it more attractive in their eyes.
[6] The Cohesion Fund was set up to benefit Spain, Greece, Ireland and Portugal.

This redistributive logic has made possible significant financial transfers between EU states since the early days of European construction, and these transfers have escalated in the course of the last 20 years (Table 1). In other words, some states have benefited from net transfers while others – on the contrary – have been net contributors, accepting a negative return in the name of Community financial solidarity.

Table 1 – Cumulative net balances of the main contributors/beneficiaries of the EU budget (1986/2005)

In billions of euros	Germany	UK	France	Spain	Greece	Ireland
Total net balance	-175	-40	-30	+104	+56	+41
Average annual net balance	-8.76	-2	-1.5	+5.2	2.8	+2.1

Source: Nicolas-Jean Bréhon – "Policy Paper" of the Robert Schuman Foundation – March 2007

In this respect, the idea that the Community budget is a "historical relic"[8] should be seriously evaluated, taking an analysis of the present effects of European openness to trade as a standard of measurement: if the latter remain inegalitarian depending on states and regions[9], it would seem, on the whole, justified for the EU budget to continue to play a significant redistributive role.

Observers[10] have suggested giving full recognition to this redistributive logic, making the principle of transfers between states explicit and organising it more directly via intergovernmental cross-subsidies: in this way, the transfers would no longer result from the balance between contributions made by states to the Community budget and the expenditure received by them, and the latter expenditure could be defined and fixed on the basis of its common usefulness and according to its effectiveness.

An issue that has scarcely been put into perspective by the notable increase in non pre-allocated expenditure

The increase in non pre-allocated Community expenditure[11] is strengthening the redistributive logic between regions but not necessarily between states (see Box 2).

Box 2

- Economic legitimacy for allocated expenditure provided for by "Section 1a" of the financial framework which does not aim to compensate for the effects of European openness to trade but to respond to other economic challenges (growth, competitiveness) in sectors where European intervention gives rise to positive externalities or increasing returns to scale (R&D, education and transport, in particular).
- Social legitimacy for redistributive expenditure provided for by this "Section 1a" so long as it is not addressed to countries or regions but to people (the example of non pre-allocated European Social Fund expenditure and expenditure linked to the new Globalisation Adjustment Funds).
- "Civil" legitimacy for expenditure provided for by Section 3 (security, justice, citizenship, etc.) which concerns the management of non-market dimensions of the European free movement space.
- International legitimacy for external expenditure provided for by Section 4 (humanitarian aid, development aid, CFSP, etc.), which contributes to the EU's affirmative role on the world scene.

This non pre-allocated expenditure is meant to be scheduled and used according to its presumed effectiveness and not according to its redistributive scope between states. Also, its increasing role within the Community budget may contribute to toning down debates about "return rates" (which are given full voice in negotiations concerning redistributive expenditure, particularly for agriculture and cohesion).

However, with the noteworthy exception of external expenditure, most non pre-allocated expenditures can be "shared out" *ex post* according to which countries they are granted to (see Table 2) and this *ex post* distribution is often taken into account by EU member states during budgetary negotiations. Furthermore, for each expenditure concerned, a substantial increase is only possible if supported by European consensus concerning collective preferences and the needs of EU countries, a consensus of the same order as that established for the redistributive role of the EU budget with regard to European openness to trade.

Table 2 – Expenditure proportions in the 2007-2013 financial framework

	In total expenditure	*Of which, pre-allocated expenditure:*	*Of which, expenditure distributed only ex post:*
1a. Competitiveness for growth and employment	8.6%	13.9%*	84.8%**
1b. Cohesion for growth and employment	35.7%	100%	0%
2. Natural resources	42.9%	99.9%	0%***
3. Citizenship, freedom, security and justice	1.3%	0%	92%****
4. The EU as a global partner	5.7%	0%	0%
5. Administration	5.8%	0%	98%*****
Total	**100%**	**79.7%**	**13%**

Sources: European Commission. Calculations by the Centre d'analyse stratégique

* This mainly concerns expenditure relating to trans-European transport and energy networks. ** The non-distributed balance corresponds to expenditure pertaining to research, the Galileo programme and the programme to promote small and medium-sized businesses. *** The non-distributed balance corresponds to governance expenditure in the fields of fishery, the environment, international agreements, etc. **** The non-distributed balance corresponds mainly to certain expenses linked to migration flow and visas, fighting fraud, etc. ***** The non-distributed balance corresponds to expenditure on representation and official meetings. The vast majority of administrative expenses are distributed to the head offices of different EU institutions and agencies. Belgium and Luxembourg are by far the main beneficiaries.

[7] At the time, this was "Objective 6" of the Structural Funds.
[8] The expression was used by André Sapir in *An Agenda for a Growing Europe* – Report to the President of the European Commission – July 2003.
[9] This seems to be the case, according to the "Cohesion Reports" published by the European Commission.
[10] See Iain Begg and Friedrich Heinemann, "New Budget, Old Dilemmas" – *Briefing Note* from the Centre for European Reform – February 2006.
[11] While non pre-allocated expenditure represented an average of 84% and 82% of Community expenditure in the 1994-1999 and 2000-2006 periods, it only represents 79.7% for the 2007-2013 period (see Table 1).

The apparent return rate is based mainly on the calculation of "net budgetary balances" and, in fact, on the total amount of expenditure

The analysis of return rates is based on the "net budgetary balances", calculated using the difference between national payments to the EU and the Community expenditure benefiting each country. These balances reveal whether countries are "net contributors" to – or "net beneficiaries" of – the Community budget.

There was fairly lively debate concerning the equitable character of Community revenue in the 1980s. Today, it seems less intense, particularly because the creation of a "4th resource" based on the GDP of EU countries – which now represents more than 2/3 of Community revenue – has made it possible to establish Community budget financing on a contributory basis that is considered equitable by member states because it reflects their relative wealth. As a result, therefore, discussions between member states now focus more on the "expenditure" part of the Community budget. They concern, on the one hand, the definition of expenditure planned at the end of European budgetary negotiations – much of which is "pre-allocated" according to country, particularly with regard to the CAP and Structural Funds – and, on the other, the distribution of expenditure effectively carried out by the EU, most of which is shared out *a posteriori* according to the countries who have benefited from it on the basis of a yearly detailed account established by the European Commission[12].

This "net budgetary balance" approach is admittedly fragile and even questionable from a technical point of view, since the imputation of receipts and expenses on a national basis is, by its very nature, difficult: receipts provided by a state may, for example, be generated by foreign companies or nationals[13]; and Community expenditure "allocated" to one country may benefit another[14]. Despite these limitations, "return rates" remain a central political fact within the EU and must then be included in the analysis.

This approach – which sticks to an accounting analysis based solely on net budgetary balances and does not include all economic and political gains and losses linked to EU membership – is however partial and questionable from a political point of view.

How to evaluate the "fair" return rate?

If the European political framework remains unaltered, the assessment of "return rates" is likely to endure in discussions of the EU budget. It would seem worthwhile, therefore, to focus analysis on the evaluation of their more or less equitable character, which depends on both the calculation basis used and the measurement criteria selected.

The evaluation of the equitable character of "return rates" depends directly on the evaluation basis used

The evaluation of the equitable character of return rates can vary widely according to the calculation bases used which may be strictly financial, economic or diplomatic.

- **A strictly financial analysis** of net budgetary balances takes one back solely to the accounting difference between contributions paid to the EU and Community expenditure allocated per country. Such an analysis may lead to calls for strictly balanced accounts or limitations on the possible level of net contributions or benefits: in both cases, however, the other gains or losses linked to EU membership are overlooked: since it was established mainly to offset the inegalitarian effects of European openness to trade, the impact of this budget cannot be evaluated correctly unless we take into account all the costs and profits engendered by the latter.

- **An economic analysis** would include not only the net budgetary balance of EU countries but also all the gains and losses derived from membership of the Single Market. On this score, studies published by the European Commission[15] traditionally include the net budgetary balance of a country, its trade balance in relation to other EU countries, its situation in relation to investment flows from and to other EU countries, and other micro-economic factors (developments in prices and competition) and macro-economic factors (the impact on growth and employment). According to this analysis, a country will accept being a net contributor all the more readily if its EU membership brings significant total economic benefits, from a global viewpoint as with regard to net beneficiary states, and vice versa.

Table 3 – "Economic balance" items for a few member countries with regard to the EU

2004, in % of GDP	Germany	France	United Kingdom	Spain	Poland
Operational budget balance	-0.32%	-0.18%	-0.17%	1.01%	0.71%
Balance in relation to intra-European FDIs[16]	-0.69%	-0.97%	1.23%	-2.30%	4.47%
Trade balance in relation to the EU[17]	+4%	+0.22%	-2.96%	-0.54%	-0.49%

Sources: European Commission – Eurostat – OECD – Calculations by the Centre d'analyse stratégique

- **A more global political analysis** would consist in perceiving a country's net budgetary balance in relation to all the gains and losses (economic, social, diplomatic, etc.) derived from EU membership. It may, for example, be emphasised that the historically high level of Germany's net contribution to the EU budget is partly linked to its will to take maximum advantage of all the benefits of European construction, including the diplomatic benefits. It may also be considered that new member countries are often inclined to content themselves with a level of expenditure and net balance that is sometimes limited, but in addition to which come all the economic and political gains (security, stability, influence, etc.) generated by EU entry.

Whether "return rates" are equitable or not also varies according to the evaluation criteria selected

Being unable to rely on political or economic balances established in a clear and consensual manner, "return rate" analysis is today based on an evaluation of whether "net budgetary balances" are equitable or not. An appraisal of the debate shows that this evaluation can be carried out using three main criteria. It may indeed be considered that:

[12] See "Report on the Allocation of EU Expenditure by Member State in 2005" – European Commission 2006.
[13] E.g. French imports, the customs duties for which are paid in Rotterdam, or German tourists paying VAT in Marbella.
[14] E.g. financing student exchanges or financing the supply of "input" for companies.
[15] See, for example, "Steps Towards a Deeper Economic Integration: the Internal Market in the 21st Century" – European Commission – 2007.
[16] It would also be appropriate to include FDIs from non-European countries, the localisation of which is often linked to Single Market membership, as well as to portfolio investments.
[17] Please note that the figures cited here concern exchanges of goods and services.

- **A budget balance is equitable if it is balanced.** Margaret Thatcher's slogan, "I want my money back", illustrates such an approach, which would seem to contradict the principle of financial solidarity at work within the EU budget. Furthermore, it is worth noting that this approach is more likely to be put forward when the political climate between member states is in a deteriorated condition.

- **A budget balance is equitable if it is not excessive**: that is, if the financial contribution agreed to by a country in favour of the EC does not exceed certain limits. An analysis of the *ad hoc* corrective mechanisms that the United Kingdom and four EU countries (Germany, Austria, the Netherlands and Sweden) benefit from shows that EU states have, in the past, balked at seeing their net contribution approach or exceed the threshold of 0.5% of their GDP (the United Kingdom in the 1980s, Germany in the 1990s, the Netherlands today). It is significant that the European Commission[18] has taken note of these successive correction requests and proposed setting up a systematic "capping" mechanism to benefit member states whose net contribution exceeds 0.35% of their GDP: according to the Commission, this "generalised correction mechanism" could be established on the basis of the net budgetary balance of each member state and "triggered beyond a threshold, expressed as a percentage of each Member State's GNI" which expresses the maximum degree of financial solidarity acceptable between the member states, "representing a sort of basic *reasonable net contribution*."[19]

- **A budget balance is equitable if it conforms to the contributory capacities of the country concerned**, i.e. to its relative wealth in comparison with other EU countries. This option is in the formula accepted by the European Council in Fontainebleau, which decided on the principle of compensating the United Kingdom: in effect, its conclusions lay down that "any Member State sustaining a budgetary burden which is excessive in relation to its relative prosperity may benefit from a correction at the appropriate time"[20]. A more comprehensive application of this principle could lead to making the net balances of the different EU countries more directly proportional to their situation in terms of relative wealth measured by wealth per inhabitant[21]. On the basis of the 2005 data[22], such an analysis shows that the distribution of net budgetary balances conforms, overall, to the relative levels of wealth since all the countries that are net contributors have a higher relative level of wealth than the Community average, and all the countries that are net beneficiaries have a lower level – with the notable exception of Ireland[23]. Within the two categories, the European hierarchies in terms of net budgetary balances and relative levels of wealth are not strictly parallel: for example, countries like Austria, Denmark and the United Kingdom[24] could contribute more given their relative level of wealth, and Greece could receive fewer Community funds for the same reason. This observation might lead one to suggest that a minimum level of net contribution could also be defined for the richest EU countries to ensure that they show minimum Community financial solidarity[25].

Invoking the principle of "fair return" is not necessarily "poisonous"[26] to European budgetary discussions: "it all depends on the dose"[27] and on the way in which this notion is apprehended. As things stand, the affirmation of an evaluation of "fair return" established on a sufficiently broad politico-economic basis and founded on an assessment of the relative wealth of EU countries would be the most realistic, and the fairest, direction to take.

The greater or lesser role played by the notion of "fair return" in EU budget discussions will doubtless continue to depend closely on the Community's political climate[28]. It may also be put into perspective by the increasing number of Community expenditures based on non-redistributive legitimacies (e.g. external expenditure and R&D or transport expenditure).

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[18] See European Commission COM (2004) 101 final, "Building our common future: Financial and political outlook for the enlarged Union".
[19] In "Proposal for a Council Decision on the system of the European Communities' own resources" – COM (2004) 501 final
[20] This was precisely the case with the United Kingdom which, at the time, was one of the poorest countries in the EU in terms of wealth per inhabitant (it was 10th out of 12) but is, today, one of the richest.
[21] This is the method adopted in Germany to determine the amount of transfers between the different "Länder" (the "Finanzausgleigh" mechanism).
[22] See "Report on the Allocation of EU Expenditure by Member State in 2005" *op. cit.*
[23] Note that, if one takes into account the distribution of administrative expenditure, Belgium and Luxembourg become net beneficiaries (+0.83% and +3.09%), despite their level of relative prosperity.
[24] It is, furthermore, on this basis that the level of compensation granted to the United Kingdom was revised downwards in December 2005.
[25] See Jorge Nunez – "Reforming the Own Resources System: What for?" – *Notre Europe* conference, Brussels, 19 April 2007.
[26] The term used by Jacques Le Cacheux in "Budget européen: Le poison du juste retour" ("European budget: the poisonous budget rebate debate") – *op. cit.*
[27] In the words of Pasteur, also cited by Nicolas-Jean Bréhon, *op. cit.*
[28] In this respect, discussions of the 2007-2013 financial framework took place in a particularly negative climate marked, in particular, by European divisions over the war in Iraq and by the rejection of the Treaty establishing a Constitution for Europe by France and the Netherlands.