The 2007–2013 Financial Perspective: Domination of National Interests

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ABSTRACT

This article confirms the validity of the hypothesis that national interests were the driving force behind the process and outcome of negotiations for the EU’s next financial perspective for 2007–2013. The hypothesis is tested by comparing hypothetical coalitions based on quantified national interests (partial net budgetary balances) and the actual (documented) coalitions. Based on these results, the article also discusses implications of the “net balances problem” for the 2008/09 EU budget review.

JEL: F3, F5, H77

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1 Introduction

Financial perspectives negotiations have played a central role in the evolution of the EU budget since 1988. They determine the content and expenditure ceilings of EU budget headings for a medium-term (currently 7-year) period and pave the way for changes in financing of the budget (Mrak and Rant, 2004). Negotiations start with an initial Commission proposal. This proposal is in turn submitted to the Council, which can alter and revise it. Following agreement in the Council, the financial perspective is formally adopted by the European Parliament in what is known as the inter-institutional agreement (Enderlein et al., 2005). Changes to the initial Commission proposal are most likely to occur in the Council, in which EU member states negotiate their contributions to and receipts from the EU budget often demanding a “juste retour” (Begg, 2005). The Council thus de facto holds the upper hand in EU budgetary matters, even though budgetary authority is formally split between the Council and the Parliament.

In the latest round of financial perspective negotiations, concluded in mid 2006, the EU and its member states determined the medium-term budgetary framework of the Union for the period 2007–2013, referred hereafter as the new financial perspective (NFP). Although the final outcome of the NFP negotiations is well known to the general public, this cannot be said for the negotiating process as such. Many member states were very explicit in their demands that the EU budget needs to be reformed through the NFP negotiations, yet their outcome brought little or no reform at all. The question is why? The intuitive and widely held hypothesis is that national interests have dominated over broader community interests and prevented any serious reform of the EU budget. This article addresses the validity of this hypothesis with a combination of empirical and qualitative analysis. Its main objectives are, first, to determine whether national interests have prevailed as the main incentive behind coalition formation in the NFP negotiations and, second, to shed some light on the factors
contributing to the “juste retour” problem as well as possible solutions in the context of the 2008/09 budget review.

Non-cooperative coalition theory (NCT) provides a theoretical background to multilateral negotiations like the NFP negotiations, in which several competing coalitions may form (Carraro and Marchiori, 2002; Carraro et al., 2005). In equilibrium, coalitions should be internally and externally stable, meaning that no coalition member has an incentive to leave its coalition to become an outsider, and that no outsider has an incentive to join a coalition (Barrett, 1994, 1997; Carraro and Siniscalco, 1993; Hoel, 1992; Hoel and Schneider, 1997; Rubio and Ulph, 2001). The final outcome is endogenously determined by the coalition structure that forms in the process of negotiations. Incentives that drive coalition formation thus provide an important rationale for the final outcome of negotiations. This theoretical prediction is of particular interest in the case of the NFP negotiations: if it can be proved that national interests were the driving force behind coalition formation, NCT would lead us to conclude that national interests played an important role in the final outcome of the NFP negotiations.

The methodology applied in this article involves a comparison of hypothetical coalitions based on estimated partial net budgetary balances, which act as a proxy for member states’ national interests, and coalitions that have actually formed in the Council through the course of the NFP negotiations. Hypothetical coalitions are derived by running hierarchical cluster analysis on the partial net balances. If the hypothetical and actual coalitions of EU member states coincide, this would be a strong argument in favor of the conclusion that the final outcome of the NFP negotiations was primarily a compromise based on national interests.

The rest of the article is organized as follows. Chapter two provides a brief description of the starting point of the NFP negotiations (the Commission proposal) and their final outcome (the inter-institutional agreement). Chapter three describes the methodology and data used to analyze coalitions of member states in the NFP negotiations. Chapter four presents the main results by
comparing hypothetical coalitions (based on cluster analysis) to the actual ones. Chapter five builds upon the results to discuss contributing factors and possible solutions to the net balances problem in the context of the 2008/09 budget review. The concluding chapter six summarizes the main findings of the article.

2 The 2007–2013 financial perspective

The February 2004 proposal of the European Commission (EC, 2004) was the starting point for launching the formal NFP negotiations. The proposal took into account the commitments already accepted by the member states, including full financial inclusion of the ten new member states by 2013 and of Bulgaria and Romania by 2016, significant financial support for the Lisbon Strategy as suggested by the Sapir report (Sapir et al., 2003), and adherence to the October 2002 Common Agricultural Policy (CAP) agreement (CEU, 2002). The Commission’s proposal, however, exceeded the budget restrictions requested by six major net contributors to the EU budget in their letter of December 2003. The Commission’s argument was that policy challenges faced by the EU over the 2007-2013 period cannot be financed with the relative expenditure level fixed at 1.00% of EU GNI. The Commission thus proposed an increase of the relative level to 1.14% of EU GNI from 1.08% in financial perspective 2000-2006.

4 The six net contributors that signed the letter were: Germany, France, the UK, the Netherlands, Austria and Sweden.

5 Key issues in the run-up to the Commission’s proposal are explained in detail in Appendix 1.
After nearly two years of the NFP negotiations, a compromise in the Council was reached under the UK presidency in December 2005 (CEU, 2005). The inter-institutional agreement was adopted in June 2006, with only minor changes to the earlier Council agreement (EP et al., 2006). When comparing the final inter-institutional agreement from June 2006 with the Commission’s initial proposal from February 2004, two conclusions emerge (see Table 1 for details):

First, the volume of expenditure has been reduced. The Commission’s proposal amounted to EUR 1,025 bn in commitments or EUR 929 bn in payments over the 7-year period, whereas the inter-institutional agreement was reached at the level of EUR 864 bn in commitments or EUR 821 bn in payments. Expressed as a percentage of GNI, expenditures (payments) have been scaled down to 1.00% of EU GNI, exactly the figure demanded by the six net contributors.

Second, in contrast to the Commission’s proposal, the structure of expenditures in the inter-institutional agreement leaned towards the common agricultural policy (heading 2) and cohesion policy (subheading 1B), and away from competitiveness (subheading 1A), other internal policies (heading 3), and external policies (heading 4). Hence, in spite of a general awareness among the member states about the need to reform the expenditure side of the EU budget, the outcome of the NFP negotiations in terms of expenditure structure more or less preserved the status quo.

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6 The distinction between commitments (entitlements) and payments (cash flows) in the EU budget is due to the multi-annual nature of some EU budget programs (EC, 2002).
Table 1: Expenditures in the new financial perspective

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>EUR (billions)</td>
<td>% of total</td>
<td>EUR (billions)</td>
</tr>
<tr>
<td>1 Sustainable growth</td>
<td>464.6</td>
<td>45%</td>
</tr>
<tr>
<td>1 A Competitiveness</td>
<td>121.7</td>
<td>12%</td>
</tr>
<tr>
<td>1 B Cohesion</td>
<td>342.9</td>
<td>33%</td>
</tr>
<tr>
<td>2 Natural resources</td>
<td>400.3</td>
<td>39%</td>
</tr>
<tr>
<td>CAP (1st pillar)</td>
<td>301.1</td>
<td>29%</td>
</tr>
<tr>
<td>CAP (2nd pillar)</td>
<td>88.8</td>
<td>9%</td>
</tr>
<tr>
<td>Fisheries + Environment</td>
<td>10.4</td>
<td>1%</td>
</tr>
<tr>
<td>3 FSJ (3 A) and Citizenship (3 B)</td>
<td>14.7</td>
<td>1%</td>
</tr>
<tr>
<td>4 EU as a Global Partner</td>
<td>88.1</td>
<td>9%</td>
</tr>
<tr>
<td>5 Administration</td>
<td>57.7</td>
<td>6%</td>
</tr>
<tr>
<td>6 Compensation</td>
<td>0.0</td>
<td>0%</td>
</tr>
<tr>
<td>Total</td>
<td>1,025.4</td>
<td>100%</td>
</tr>
</tbody>
</table>

Source: EC (2004), EC (2005b), EP et al. (2006) and authors’ calculations

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7 Part of the reduction in heading 4 is of accounting nature: the inter-institutional agreement excluded the European Development Fund (EUR 21.9 bn) from heading 4, which therefore remains outside of the budget in the 2007-2013 period (EC, 2005a). This fund was incorporated in the budget in the Commission’s proposal. Even if it is discounted from the Commission’s proposal, the percentage reduction in heading 4 still amounts to 25%.
3 Methodology and data for determining hypothetical coalitions

Hypothetical coalitions in the NFP negotiations are determined using cluster analysis, which groups statistical units (in this case, EU member states) into clusters based on their similarity according to chosen variables (in this case, “national interests” in negotiations). The analysis of hypothetical coalitions proceeds in two steps. In the first step, partial net budgetary balances of EU member states in the 2007-2013 period are defined to act as proxies for national interests. They are calculated from the member states’ estimated total net budgetary balances. In the second step, the hypothetical coalition structure of EU member states is obtained by running cluster analysis on their estimated partial net balances.

3.1 The concept of net budgetary balances

The net budgetary balance of a member state vis-à-vis the EU budget in a given year is equal to the difference between the member state’s receipts from and contributions to the EU budget in that particular year. This simple accounting definition includes cash inflows to the member state’s budget as well as cash inflows to final beneficiaries in the member state, which do not show up in the national budget. At the same time, it takes into account all cash outflows from the member state’s budget to the EU budget. At the EU level, net budgetary balances sum up to a negative number. This mostly reflects the fact that part of the funds from the EU budget flow to countries outside the Union (external policies) but are financed by member states.

3.2 Estimating total and partial net budgetary balances
During financial perspective negotiations, member states eventually have to take sides on individual issues that are on the agenda. In the NFP negotiations, the main issues on the agenda were the CAP, the cohesion policy, and the competitiveness policy (i.e., the Lisbon strategy objectives) in case of expenditures and the UK rebate in case of own resources. We consider projected net budgetary balances from the EU budget in the period 2007–2013 as the member states' only decision-making criterion about individual issues and maximization of their respective net balances as their dominant strategy. This is without a doubt a simplification of member states’ behavior. Nonetheless, net balances are the most immediately visible result of negotiations, since they are easy to explain to the public and carry implications for national fiscal policies.

In order to estimate the importance of individual issues for the net budgetary balances of individual member states, we quantify average annual total and partial net budgetary balances (hereinafter, total NBBs and partial NBBs) for each member state in the period 2007–2013.

*The total NBB* of a member state *i* can be expressed as:

\[ NBB_i = E_i - C_i + R_i \]  

(3.1)

in which:

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8 Other considerations driving member states' behavior in addition to net balances may include solidarity and support of European integration, as well as secondary benefits due to cross-border externalities and spill-over effects.
\( E_i \) is the total allocated expenditure to member state \( i \) from the EU budget, expressed in payments,
\( C_i \) is the total contributions of member state \( i \) to the EU budget, which consist of contributions based on traditional own resources, the VAT source, and the GNI source,
\( R_i \) is the net receipts of member state \( i \) from the UK rebate.

Our approach for estimating the individual elements of (3.1) replicates the methodology described by the European Commission in several technical documents (\textit{fiches}) during the NFP negotiations. This methodology is best summarized in EC (2005c).

\textit{Partial NBBs} are calculated by decomposing the total NBB of each member state into expected net cash flows from individual issues that were on the NFP negotiations’ agenda. We define the \textit{partial net budgetary balance} of member state \( i \) for issue \( j \) as:

\[
NBB_{i,j} = \left( \frac{E_{i,j}}{E_{EU,j}} - \frac{C_i}{C_{EU}} \right) \times E_{EU,j} \tag{3.2}
\]

in which:

\( E_{i,j} \) is the total expenditure allocated to member state \( i \) under issue \( j \),
\( E_{EU,j} \) is the total expenditure under issue \( j \) at the EU level,
\( C_i \) is the total (TOR, VAT, and GNI) contributions of member state \( i \) to the EU budget,
\( C_{EU} \) is the total (TOR, VAT, and GNI) contributions of all member states.
In (3.2), the expression \( \frac{E_{i,j}}{E_{EU,j}} \times E_{EU,j} = E_{i,j} \) denotes member state \( i \) receipts from issue \( j \), whereas the expression \( \frac{C_i}{C_{EU}} \times E_{EU,j} \) can be interpreted as the contribution of member state \( i \) to the financing of issue \( j \), under the assumption that total expenditure and total contributions at the EU level are equal \( (E_{EU} = \sum_j E_{EU,j} = C_{EU}) \).\(^9\) In this case, (3.2) calculates the expected net cash flows from individual issues on the NFP negotiations’ agenda. The partial NBBs of each individual member state, including the UK rebate, which is a special case of partial NBB, sum up to that member state’s total NBB, whereas the sum of partial NBBs for a particular issue across member states equals either zero or the negative of non-allocated expenditure under that issue.\(^10\) The latter result simply reflects the fact that a non-allocated expenditure represents a net burden for all member states.

Based on the discussion above, partial NBBs of EU member states have two interesting properties that make them attractive as a measure of an individual member state’s national interest in the underlying NFP issue:

- First, for an individual member state, a partial NBB measures the net contribution of the underlying NFP issue to the total NBB of that member state, expressed in EUR. Positive partial NBBs improve, whereas negative partial NBBs deteriorate a member state’s total NBB.

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\(^9\) This assumption is valid because of the balanced budget principle (EC, 2002).

\(^10\) Formal proofs are presented in Appendix 2.
Second, for individual issue, partial NBBs measure the net redistribution of funds across member states, expressed in EUR. Member states with positive partial NBBs are net recipients, whereas member states with negative partial NBBs are net contributors under a particular issue.

3.3 Methodological issues in cluster analysis

Cluster analysis forms new clusters or assigns cases to existing clusters based on distance as a measure of (dis)similarity between statistical units according to the clustering variables. Because of this, its results are very sensitive to the scale of the clustering variables. In the case of the NFP negotiations, the scale of partial NBBs can be expressed either in absolute terms (in EUR) or in relative terms (as a ratio). In reality, when member states decide which coalition to join, they do not compare expected net gains expressed in absolute terms because these to a large extent depend on the size of the country. Instead, they compare net gains, expressed in relative terms, which correct for size differences between member states. The same logic was followed in the cluster analysis, in which relative partial NBBs were defined based on the following formula:

\[
NBB_{i,j}^* = \frac{NBB_{i,j}}{\sum_{j=1}^{N} |NBB_{i,j}|}, \quad \text{in which } \sum_{j=1}^{N} |NBB_{i,j}^*| = 1 \quad (3.3)
\]

From (3.3), \( NBB_{i,j}^* \) can be interpreted as a relative contribution of partial NBB under issue \( j \) to the total NBB of member state \( i \). Conceptually, this relative contribution is similar to the notion of the share of a partial NBB in the total NBB of a country; however, we avoid using the word share because shares cannot be negative, whereas the definition in (3.3) implies both positive and negative values. Nevertheless, \( NBB_{i,j}^* \) are directly comparable between member states in the same way as shares. Hierarchical clustering is performed based on the
estimates of $NBB^*_{i,j}$ from (3.3), using squared Euclidean distance as the measure of (dis)similarity and Ward’s method, which tries to maximize within cluster homogeneity, as the algorithm for cluster formation.

### 3.4 Data

The level of expenditure for individual NFP headings is based on the data from the 2007–2013 inter-institutional agreement (EP et al., 2006; EC, 2006). In order to determine member state allocations for all expenditure headings, except for cohesion policy, member states’ observed shares based on EU financial reports and, in certain cases (most notably the CAP), agreed future financial commitments have been used. All of the documents required to calculate these shares are publicly available from the Commission’s websites. In the case of cohesion policy allocations, the bottom-up method summarized in EC (2005c) and CEU (2005) has been reproduced using publicly available Eurostat data.\(^{11}\)

The estimated net budgetary balances also take into account cash flows from the unspent commitments of the 2000-2006 financial perspective, using data from financial reports on the implemented EU budgets, the Copenhagen negotiations package (for new member states), and the 2000–2006 inter-institutional agreement.

In the case of member state contributions, TOR and VAT resources have been estimated based on data from the adopted EU budgets and, in the case of the

\(^{11}\) Details about this method are provided in Appendix 3.
VAT source only, GNI growth rates. In order to estimate the GNI figures up to 2013 required to calculate member states’ GNI and VAT contributions, growth rate forecasts by DG ECFIN up to 2006 (autumn 2005 report) and Commission growth rate assumptions beyond 2006 (2.2% for the EU-15, 4.1% for the EU-10, and 5.6% for the EU-2) have been used.

4 Results and analysis of coalitions

4.1 Estimates of total and partial net budgetary balances

The results of decomposition of net budgetary balances into partial net balances under the 2007-2013 inter-institutional agreement are presented in Table 2. The figures in columns A, B, and C are partial NBBs for the major spending items of the EU budget: the CAP, cohesion policy, and other. “Other” basically lumps together all other types of expenditure apart from CAP and cohesion; that is, expenditure under the competitiveness policy (the Lisbon strategy) and other internal policies (Freedom, Security, Justice, and Citizenship), expenditure under external policies, and administrative expenditure. A more detailed decomposition of “other” is given in Appendix 4. Column D contains partial NBBs for the UK rebate. The last column, E, contains total NBBs.
Table 2: Average annual partial and total NBBs in the 2007-2013 period based on the inter-institutional agreement (2004 prices)

<table>
<thead>
<tr>
<th></th>
<th>CAP Partial NBB</th>
<th>Cohesion Partial NBB</th>
<th>Other Partial NBB</th>
<th>UK rebate Partial NBB</th>
<th>Total NBB</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(A)</td>
<td>(B)</td>
<td>(C)</td>
<td>(D)</td>
<td>(E)</td>
</tr>
<tr>
<td>BE</td>
<td>EUR (mil.)</td>
<td>%</td>
<td>EUR (mil.)</td>
<td>%</td>
<td>EUR (mil.)</td>
</tr>
<tr>
<td>DK</td>
<td>305 0.14%</td>
<td>-675 -0.31%</td>
<td>-216 -0.10%</td>
<td>-176 -0.08%</td>
<td>-763 -0.35%</td>
</tr>
<tr>
<td>DE</td>
<td>-3,623 -0.15%</td>
<td>-4,764 -0.20%</td>
<td>-3,090 -0.13%</td>
<td>-339 -0.01%</td>
<td>-11,816 -0.49%</td>
</tr>
<tr>
<td>EL</td>
<td>EUR (mil.)</td>
<td>%</td>
<td>EUR (mil.)</td>
<td>%</td>
<td>EUR (mil.)</td>
</tr>
<tr>
<td>FR</td>
<td>1,427 0.08%</td>
<td>-4,455 -0.24%</td>
<td>-2,110 -0.11%</td>
<td>-1,478 -0.08%</td>
<td>-6,617 -0.36%</td>
</tr>
<tr>
<td>IE</td>
<td>1,170 0.80%</td>
<td>-243 -0.17%</td>
<td>-146 -0.10%</td>
<td>-117 -0.08%</td>
<td>663 0.45%</td>
</tr>
<tr>
<td>IT</td>
<td>-2,184 -0.15%</td>
<td>-1,297 -0.09%</td>
<td>-1,640 -0.11%</td>
<td>-1,204 -0.08%</td>
<td>-6,324 -0.42%</td>
</tr>
<tr>
<td>LU</td>
<td>-73 0.00%</td>
<td>-71 -0.30%</td>
<td>-250 -0.10%</td>
<td>-250 -0.10%</td>
<td>-2,500 -0.46%</td>
</tr>
<tr>
<td>NL</td>
<td>-513 0.08%</td>
<td>-1,330 -0.25%</td>
<td>-466 -0.09%</td>
<td>-72 -0.01%</td>
<td>-3,820 -0.46%</td>
</tr>
<tr>
<td>AT</td>
<td>1,710 0.08%</td>
<td>-243 -0.25%</td>
<td>-146 -0.10%</td>
<td>-117 -0.08%</td>
<td>663 0.45%</td>
</tr>
<tr>
<td>PT</td>
<td>316 0.21%</td>
<td>-2,197 -0.14%</td>
<td>-93 -0.06%</td>
<td>-118 -0.08%</td>
<td>2,302 1.56%</td>
</tr>
<tr>
<td>SE</td>
<td>-425 -0.13%</td>
<td>-736 -0.23%</td>
<td>-284 -0.19%</td>
<td>-2,400 -0.46%</td>
<td></td>
</tr>
<tr>
<td>UK</td>
<td>-4,941 -0.24%</td>
<td>-5,315 -0.27%</td>
<td>-2,894 -0.14%</td>
<td>5,425 0.27%</td>
<td>-7,724 -0.39%</td>
</tr>
<tr>
<td>BG</td>
<td>639 2.42%</td>
<td>488 1.85%</td>
<td>181 1.68%</td>
<td>-20 -0.08%</td>
<td>1,287 4.87%</td>
</tr>
<tr>
<td>CY</td>
<td>72 0.08%</td>
<td>-22 -0.15%</td>
<td>-12 -0.08%</td>
<td>-32 -0.15%</td>
<td>-12 -0.08%</td>
</tr>
<tr>
<td>CZ</td>
<td>544 0.53%</td>
<td>-219 2.10%</td>
<td>-105 -0.10%</td>
<td>-81 -0.08%</td>
<td>2,527 2.45%</td>
</tr>
<tr>
<td>EE</td>
<td>128 1.18%</td>
<td>-278 2.55%</td>
<td>-2 -0.02%</td>
<td>-9 -0.08%</td>
<td>395 3.63%</td>
</tr>
<tr>
<td>HU</td>
<td>919 0.96%</td>
<td>-2,047 2.14%</td>
<td>-108 -0.11%</td>
<td>-75 -0.08%</td>
<td>2,782 2.91%</td>
</tr>
<tr>
<td>LT</td>
<td>382 1.67%</td>
<td>569 2.48%</td>
<td>8 0.03%</td>
<td>-18 -0.08%</td>
<td>941 4.11%</td>
</tr>
<tr>
<td>LV</td>
<td>189 1.30%</td>
<td>385 2.66%</td>
<td>2 0.01%</td>
<td>-11 -0.08%</td>
<td>565 3.90%</td>
</tr>
<tr>
<td>MT</td>
<td>-8 -0.17%</td>
<td>-6 1.08%</td>
<td>-2 -0.12%</td>
<td>-4 -0.08%</td>
<td>37 0.72%</td>
</tr>
<tr>
<td>PL</td>
<td>2,649 1.09%</td>
<td>5,812 2.39%</td>
<td>-103 -0.04%</td>
<td>-191 -0.08%</td>
<td>8,167 3.36%</td>
</tr>
<tr>
<td>RO</td>
<td>1,530 2.00%</td>
<td>1,337 1.75%</td>
<td>380 0.50%</td>
<td>-59 -0.08%</td>
<td>3,188 4.17%</td>
</tr>
<tr>
<td>SI</td>
<td>88 0.27%</td>
<td>-280 0.87%</td>
<td>-29 -0.09%</td>
<td>-25 -0.08%</td>
<td>314 0.97%</td>
</tr>
<tr>
<td>SK</td>
<td>323 0.77%</td>
<td>-903 2.15%</td>
<td>-30 -0.07%</td>
<td>-33 -0.08%</td>
<td>1,163 2.76%</td>
</tr>
<tr>
<td>EU-27</td>
<td>0 0.00%</td>
<td>0 0.00%</td>
<td>-7,098 -0.01%</td>
<td>0 0.00%</td>
<td>-7,098 -0.01%</td>
</tr>
</tbody>
</table>

Source: Authors’ calculations
Based on the partial and total NBBs presented in Table 2, EU member states can be classified into two large groups: net contributors (with negative total NBBs) and net recipients (with positive total NBBs). Among net contributors, several member states have negative partial NBBs for all major issues on the NFP negotiations’ agenda. Among the member states with significantly positive total NBBs, most countries are net recipients due primarily to the cohesion policy and/or to the CAP.

There are at least three outliers that do not fit into this schematic classification of the EU member states according to their partial NBBs; as the hosts of most EU institutions, Belgium and Luxembourg receive most of the administrative expenditure under “other” and the UK is an outlier due to its rebate.

As far as the UK is concerned, Table 2 also shows that, without its rebate, this country would replace Germany as the largest net contributor to the EU budget in 2007–2013. The rebate improves the UK’s net budgetary balance in NFP by 41%. The largest financer of the rebate is France and, if it had been abolished, France’s net budgetary balance would have improved by 22%. The rebate thus manages to keep total NBBs of France and the UK, countries of equal size and roughly equal level of development, in parity. Without the rebate, the situation would have been significantly different. France’s average annual net contribution to the EU budget in NFP would have amounted to EUR 5.1 billion, while the

\[\text{\underline{12}}\] This can be seen by subtracting the UK rebate from the UK’s overall net budgetary balance and the German contribution to the financing of the rebate from the German overall net budgetary balance.
UK’s would have been EUR 13.1 billion. This comparison explains why the UK has been forcefully defending its rebate for the past 20 years. Furthermore, partial NBBs reveal a tight balance between the national interests of France (CAP) and the UK (rebate). France’s net contributions to the financing of the UK rebate virtually cancel out its net gains under the CAP. For the UK, on the other hand, the rebate approximately covers its net loss under the CAP. 13

4.2 Hypothetical coalitions in the NFP negotiations based on cluster analysis

Relative partial NBBs, calculated according to expression (3.3), are the basis for running the cluster analysis. These are graphically presented in Figure 1. Member states are plotted on the horizontal axis, and the relative contributions of their partial NBBs to total NBBs are plotted on the vertical axis. The absolute height of bars equals 100% for each EU member state. The positive part of each bar corresponds to those issues on the NFP agenda that bring relative net gains to member states, and the negative part of each bar corresponds to the issues on the NFP agenda for which member states incur relative net losses. Member states are ordered from the largest relative net recipients (left side of the graph) to the largest relative net contributors (right side of the graph). The order of the last five net contributors (DE, NL, SE, AT, IT) is somewhat arbitrary, since their

13 This raises a puzzling question why haven’t both countries so far been able to reach an agreement on mutual reduction in CAP spending and the UK rebate. It would seem that both of them have something to gain from the status quo. In France, this »gain« may be sustained inexpensive support for an important political interest group (the farmers), while in the UK, the »gain« may be sustained sense of independence from EU budget policies.
relative partial NBBs, calculated according to (3.3), all sum up to -100%. The relative importance of various net gains and net losses can be compared directly between different EU member states.

**Figure 1: Relative partial NBBs**

![Figure 1: Relative partial NBBs](image)

Source: Authors’ calculations based on Table 2

From Figure 1, it can be seen that the cohesion policy plays a major role in determining total NBBs of most EU member states. In the case of net recipients, its impact is mostly positive, and for net contributors, its impact is mostly negative. The CAP also has a strong impact on total NBBs with some notable net beneficiaries from the CAP among net contributors (Denmark, France, and Finland). The positive CAP net balances of France and Denmark are due to their high entitlements under the first pillar of the CAP (they both have a negative partial net balance for rural development) while the positive CAP net balance of Finland is due to the second pillar (Finland has a negative partial net balance for the first pillar). Ireland is an interesting outlier among net recipients due to the large and positive impact of net gains under the CAP on its total NBB, which are
due to positive partial net balances for both policy pillars. Other outliers (Luxembourg, Belgium, and the UK) are also clearly visible.

The relative partial NBBs presented above were inputted into a hierarchical clustering procedure. The results of this procedure are graphically summarized in the dendrogram in Figure 2. They provide an insight into hypothetical coalitions that might be expected to form based on national interests in the NFP negotiations. In the dendrogram, member states are plotted on the horizontal axis and the distances between them, which reflect (dis)similarities of their partial NBBs, are plotted on the vertical axis. Connectors between member states correspond to the formation of clusters. If the distance between cluster members is small (i.e., connections low on the vertical axis), the corresponding cluster is homogeneous, whereas if the distance between cluster members is large (i.e., connections high on the vertical axis), the corresponding cluster is heterogeneous.

**Figure 2: Dendrogram**

![Dendrogram](image)

Ward's linkage hierarchical cluster analysis
Clustering variables CAP* Cohesion* Other* Rebate*

Source: based on authors’ calculations
The dendrogram shows that based on relative partial NBBs for CAP*, Cohesion*, Other*, and the UK rebate* at least two very distinctive clusters can be visually identified. The first cluster is a hypothetical coalition of new member states, less developed Mediterranean countries (Greece, Portugal, and Spain) and Ireland, and the second cluster is a hypothetical coalition of the remaining old member states.\textsuperscript{14} Within this second coalition, Luxembourg and Belgium are outliers and closely related to each other. At a smaller distance level, four out of six member states that signed the letter demanding a 1% budget (DE, AT, NL, SE) seem to be very closely related, whereas the other two countries (UK and FR) seem to be somewhat distanced from this core group and less related to each other. A conclusion can be made based on the simple visual inspection of the dendrogram that solutions of two to three clusters seem to yield well-separated clusters that are internally sufficiently homogeneous.

In order to analytically confirm which cluster solutions (i.e., how many clusters) make the most sense for further analysis, the internal homogeneity of clusters is quantified by calculating R-squared as the ratio of between-groups to total sum of squares, pooled across all variables in the cluster analysis. The results are presented in Table 3.

\textsuperscript{14} With the exception is Cyprus, which is the only new member state with a negative total NBB.
Table 3: Homogeneity of clusters

<table>
<thead>
<tr>
<th>Number of clusters</th>
<th>Pooled sum of squares across all clustering variables</th>
<th>Homogeneity of clusters</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Within groups</td>
<td>Between groups</td>
</tr>
<tr>
<td>10</td>
<td>0.27</td>
<td>10.83</td>
</tr>
<tr>
<td>9</td>
<td>0.36</td>
<td>10.74</td>
</tr>
<tr>
<td>8</td>
<td>0.50</td>
<td>10.61</td>
</tr>
<tr>
<td>7</td>
<td>0.65</td>
<td>10.46</td>
</tr>
<tr>
<td>6</td>
<td>0.90</td>
<td>10.20</td>
</tr>
<tr>
<td>5</td>
<td>1.26</td>
<td>9.85</td>
</tr>
<tr>
<td>4</td>
<td>1.68</td>
<td>9.42</td>
</tr>
<tr>
<td>3</td>
<td>2.45</td>
<td>8.66</td>
</tr>
<tr>
<td>2</td>
<td>4.23</td>
<td>6.87</td>
</tr>
</tbody>
</table>

Source: Authors’ calculations

The range for R-squared is between 0 and 1. If R-squared equals 1, clusters are perfectly homogeneous (i.e., members in each cluster perfectly coincide according to the clustering variables). If R-squared equals 0, clusters are perfectly heterogeneous and cannot be separated from each other. A drop in R-squared in the process of cluster formation can therefore be interpreted as a loss of homogeneity within clusters.

There is no clear-cut rule as to which cluster solution is the most appropriate. It can be argued, however, that those cluster solutions make sense for the analysis in which the drop of homogeneity within clusters is significant as clustering proceeds to higher levels – that is, as the number of clusters decreases. From Table 3, it can be observed that a 10-cluster solution has an almost perfectly homogeneous structure within clusters. This is not surprising because there are only 27 EU member states. The loss of homogeneity is not too severe for solutions down to 3 clusters. The 3-cluster solution, however, represents a structural break (a decrease in homogeneity by 6.9 percentage points). An even larger break can
be observed with the 2-cluster solution (a decrease in homogeneity by 16.1 percentage points). The analysis of homogeneity within clusters thus confirms the preliminary conclusion that 3- and 2-cluster solutions make the most sense for analysis of hypothetical coalitions in the NFP negotiations.

In the last stage of the cluster analysis, characteristics of the 2- and 3-cluster solutions are analyzed according to the four clustering variables (relative partial NBBs): CAP*, Cohesion*, Other*, and Rebate*. For this purpose, cluster centers, which are basically unweighted averages of the clustering variables in individual clusters, are presented in Table 4. A number in the table for a particular cluster and a particular clustering variable, say CAP* in cluster 1 under a 2-cluster solution, can be interpreted as an average relative contribution of the clustering variable (CAP*) to total NBBs of all member states that belong to this cluster.

A 2-cluster solution includes 12 EU member states in the first cluster and 15 EU member states in the second cluster.

Member states in the first cluster have on average negative partial NBBs for all major issues on the NFP agenda, which also implies a negative average total NBB. This hypothetical coalition of “net contributors” corresponds to the left side group of member states in the dendrogram (Figure 2). On average, the cohesion policy has the most negative impact among all NFP issues on total NBBs of this group. It is thus rational to expect that the main objective of net contributors in

\[\text{(3.3)}\]

\[\text{An asterisk denotes that clustering variables are expressed in relative terms according to the formula \( (3.3) \).} \]
the NFP negotiations would be the overall reduction of the EU budget expenditure, and within this objective in particular the reduction of expenditure for the cohesion policy.

Table 4: Cluster centers for 2- and 3-cluster solutions

<table>
<thead>
<tr>
<th></th>
<th>2-cluster solution</th>
<th>3-cluster solution</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Cluster 1</td>
<td>Cluster 2</td>
</tr>
<tr>
<td>CAP*</td>
<td>−0.124</td>
<td>0.292</td>
</tr>
<tr>
<td>Cohesion*</td>
<td>−0.351</td>
<td>0.574</td>
</tr>
<tr>
<td>Other*</td>
<td>−0.066</td>
<td>−0.025</td>
</tr>
<tr>
<td>Rebate*</td>
<td>−0.068</td>
<td>−0.040</td>
</tr>
<tr>
<td>Member states</td>
<td>BE, LU, DK, FR, FI, DE, NL, SE, AT, UK, IT, CY</td>
<td>EL, HU, SK, EE, PL, LV, SI, LT, ES, PT, CZ, MT, IE, BG, RO</td>
</tr>
</tbody>
</table>

Source: Authors’ calculations

Member states in the second cluster have on average positive partial NBBs for CAP* and Cohesion* and negative partial NBBs for Other* and Rebate*. Due to the large and positive impact of CAP* and Cohesion* on total NBBs in this cluster, it is reasonable to expect the total NBBs to be positive as well. This hypothetical coalition of net recipients corresponds to the right side group of member states in the dendrogram (Figure 2). According to their characteristics, their main objective in the NFP negotiations should be a high level of expenditure for the cohesion policy and also the CAP.

The benefit of a 3-cluster solution is that it singles out Belgium and Luxembourg as outliers due to large receipts of administrative expenditure. This can be seen from the highly positive relative net contribution of Other* in cluster 1, which contains both countries. The outcome for the hypothetical coalition of net
contributors (cluster 2) is that Other* turns negative and in fact constitutes the second largest relative net loss, right behind cohesion policy. This implies that net contributors would rather sacrifice the cohesion policy and other issues (which include funds for the Lisbon strategy) than the CAP from the point of view of their national interest as defined by net budgetary balances. Cluster 3 contains net recipients and is exactly the same as in the 2-cluster solution.

Based on the cluster analysis presented above, it is reasonable to expect that the main issue in the NFP negotiations would be a confrontation between net contributors and net recipients over the issue of cohesion policy. Because both coalitions have opposite interests with respect to this issue, it is unlikely that major changes in the cohesion policy expenditure can be expected as the final outcome. Solidarity, particularly towards less developed new member states, may help net contributors and net recipients to reconcile their differences with respect to cohesion policy.

With respect to the CAP, the cluster analysis shows that interests of net contributors and net recipients are not so different. On average, both coalitions should be in favor of CAP expenditure in NFP, although their reasons are somewhat different. For net contributors, the CAP has the least negative relative impact on their total NBBs among all major expenditure issues, whereas for net recipients the CAP has a significant positive relative impact on their total NBBs.

The analysis of partial NBBs also suggests that the attitude to other issues should be mostly negative in the group of net contributors, whereas for the group of net recipients other issues should not be of vital importance due to their predominant interest in the cohesion policy and the CAP. Because net contributors’ main objective is supposed to be a lower level of expenditure in the EU budget and because it is unlikely that they can achieve this objective by significantly reducing cohesion expenditure, other issues, including the competitiveness policy (Lisbon strategy), seem to be the prime candidates for budget reductions.
4.3 Actual coalitions in the NFP negotiations

Actual (formally documented) coalitions in the recent NFP negotiations correspond very well to the hypothetical ones discussed above. The NFP negotiations in fact largely concentrated on discussions between net contributors (mostly old member states) and net recipients (mostly new member states) over the cohesion policy issue.

Among net contributors, a formal coalition of the six net contributors that requested a reduction in NFP expenditure to at most 1.00% of EU GNI has already been mentioned. Together with other net contributors, this coalition managed to achieve its objective by the end of the negotiations. Deviations of France and the UK from the rest of this group, which were noted in the dendrogram, also proved to be the case in reality, because both countries clearly showed preferences for some other issues on the negotiations’ agenda, in addition to the lowering of the overall level of the EU budget expenditure. For France, keeping the agriculture agreement from October 2002 was its top priority in the NFP negotiations, whereas for the UK the key concern in the negotiations was to keep the UK rebate as intact as possible. France succeeded in introducing its preferences for the CAP into the December 2003 letter of the six largest net contributors, while the UK defended the rebate by using its veto power and blocked a possible early agreement in the Council in June 2005. With the Council agreement reached in December 2005, both countries more or less achieved their strategic objectives in the NFP negotiations. Total NBBs of the remaining four countries in the coalition of the six net contributors were improved by granting them discounts in contributions to the EU budget and by reducing the overall level of the EU budget expenditure.

Among net recipients, a wide coalition named the “friends of the cohesion policy” was formed, with the objective of defending the cohesion policy envelope outlined in the Commission’s proposal. This coalition initially included the ten new member states and three of the old cohesion countries (Portugal, Greece, and
Spain). It was later also joined by Belgium, Ireland, Finland and Italy as observers. “Friends of the cohesion policy” coalition represented a kind of a counterweight to the coalition of the six net contributors and was also rather successful in the NFP negotiations because it succeeded in limiting the reduction of funds for cohesion policy. Whereas resources for this policy were reduced by 10% compared to the Commission's proposal, the overall EU budget expenditure was cut for 16% (see Table 1).

In contrast to cohesion policy, support for agriculture was dispersed both among the old and the new member states. In spite of some initiatives to reduce the CAP expenditures in the budget, the October 2002 agreement about the first pillar of the CAP (price and income subsidies) remained almost intact during the negotiations. The only reduction in the first pillar of the CAP was to include Bulgaria and Romania under the agreed ceiling. Most of reductions in agricultural funds were actually concentrated on the second pillar of the CAP (rural development).

At this point it is worth explaining some discrepancies between the actual coalitions and the ones predicted by the partial net balances. Based on their partial net balances, Italy, Denmark and Finland should have been in the coalition of net contributors when in fact they did not sign the letter of six.

Italy was not involved at all in the drafting of the letter since the idea for budget restriction surfaced in a semi-formal coordination of net contributors, known as the Noordwyk group, which in addition to the signatories of the letter of six also includes Denmark and Finland. Instead, Italy may have allied itself with the “friends of the cohesion policy” because it overestimated its own benefits from cohesion policy. The country is too developed to be eligible for cohesion fund support, however, there are significant interregional differences (underdeveloped south). Since most southern regions are eligible to receive convergence support in the 2007-2013 period, local pressures to keep the level of aid high may have lead to opposition to budget cuts in subheading 1b, Cohesion. Another reason for
Italy’s opposition to a 1% budget may also be its support of Trans-European Networks, which are included under subheading 1a, Competitiveness.

Finland and Denmark, while being members of the Noordwyk group, chose not to sign the letter of six. Finland’s main concern was that the letter of six only included safeguards for the first pillar of the CAP, while the country is a substantial recipient under the second pillar (rural development). The restrictive nature of the letter (1.00% of GNI) suggested that budget cuts would have to be made in all other headings apart from the first pillar of the CAP. Thus, the second pillar would not be spared. Finland subsequently called for the adoption of the NFP at the level of 1.10% of EU GNI. On the other hand, Denmark’s reservations might be related to its support of R&D expenditure and hence opposition to excessive budget cuts in subheading 1a, Competitiveness.

There were no explicit or implicit coalitions for other budget issues (i.e., the Lisbon strategy, or external and internal policies). Due to the lack of support, they were to a large extent sacrificed in order to reach a final balance between the net contributors and the cohesion countries. Large reductions in other issues in the inter-institutional agreement relative to the Commission proposal can be seen in Table 1. The table shows that competitiveness policy (i.e., the Lisbon strategy) was the main victim of the NFP negotiations. The volume of funds for this expenditure item was reduced by 39%. Why has the Lisbon strategy de-facto been treated as a reserve item in the NFP negotiations, even though it has been consensually identified as the key challenge of the EU in the NFP negotiations? The reason seems to be that all member states, following total NBBs as their strategic national objective in the NFP negotiations, had at least one issue in the negotiations that was more important for them than the Lisbon strategy. For the six largest net contributors, this was to reduce the overall level of the EU budget expenditure, and for the “friends of the cohesion policy” this was to keep the level of cohesion policy expenditures as high as possible.
Because the interplay of coalitions in the course of the NFP negotiations basically acted against any serious reform of the EU budget, EU member states have introduced a “revision clause” into the final NFP agreement. This clause basically says that the European Commission should prepare a general review of all expenditures and revenues of EU items by 2008/2009 in order to initiate discussion among the member states about the overall reform of the EU budget to be ready for implementation in the post-2013 period.

5 Implications of the “juste retour” problem for the 2008/09 EU budget review

5.1 Factors contributing to perpetuation of the “juste retour” problem

Our analysis has shown that member states’ behavior in the NFP negotiations can be linked to their net budgetary balances. Addressing this issue may be therefore important for the success of any future reform of the EU budget. But finding a solution requires first an understanding of why EU member states care so deeply about the net balances issue. There are several potential contributing factors.

First, the division of powers between the EU vs. national government level is conducive to national interests. The EU Council de facto has the largest influence on the outcome of the financial perspective negotiations, while the impact of institutions which represent the EU level (the Commission and the Parliament) is limited to making the initial proposal and marginal final corrections.

Second, redistribution across member states is a highly visible domestic political issue. Voters in net recipient countries on average experience net benefits (in terms of provided public goods and income subsidies), while voters in net contributing countries on average incur net costs (in terms of higher taxes). This
induces member states’ politicians to focus excessively on net balances in order to gain domestic political advantage.

Third, *solidarity between EU member states has limits*. These limits were clearly visible in the NFP negotiations as the degree of redistribution towards less developed member states was curtailed by lengthy phasing in periods (in case of the CAP for the new member states) as well as by ceilings on maximum allowable allocations of funds (in case of the cohesion policy). The NFP negotiations also revealed clear discontent about “solidarity” towards and between more developed member states.

Fourth, *the choice of expenditure instruments of the EU budget importantly contributes to the “juste retour” debate*. Even if member states agree that some degree of redistribution is required in order to promote cohesiveness of the Union, the expenditure instruments used to deliver it may be inappropriate. According to our calculations, almost 50% of structural and cohesion funds and as much as 80% of agricultural funds in the 2007-2013 period are still allocated to relatively well developed old member states. The expenditure side, combined with a relatively proportional system of own resources imply that a sizable portion of the EU budget has nothing to do with redistribution from more to less developed member states but is rather involved in redistributing funds between and even within more developed member states. Because of these horizontal inequalities,¹⁶ less fortunate member states are particularly sensitive to the issue of net balances.

¹⁶ In a strict sense, horizontal equity translated to EU budget terms would mean that member states on the same (per capita) level of prosperity should have the same (per capita) net budgetary balance.
Finally, the UK rebate has perpetuated and perfected the calculation of net budgetary balances since its introduction in 1984. Initially, the UK’s demand for a rebate could be viewed as an attempt to restore horizontal equity, however, due to changing circumstances, the rebate has itself become a source of new deviations from fairness. This has lead to increasingly complex calculation of the rebate as well as additional rebates on its financing and ad-hoc reductions in EU budget contributions for Germany, the Netherlands, Sweden and Austria. These recent modifications only increase the complexity of the own resources system and exacerbate the net balances problem.

5.2 Possible exit strategies from the “juste retour” problem

Moving forward, the main question for the 2008/09 budget review and the EU public finances beyond 2013 is how to unlock common interests for European public goods in the current interplay of national interests? There may be two complementary answers to this problem.

The first answer is strong external pressure. If global issues become part of national agendas, they can force politicians into cross-border cooperation. Such pressures can be felt in case of energy and food safety, issues relating to the climate change, security and competitiveness. Recently, we have also seen significant EU cooperation in facing the global financial crisis and recession.

17 European public goods in the context of the EU budget review are discussed by several authors. See for example Heinemann (2006), Begg (2008) or Wostner (2008).
None of these issues can be resolved by the EU budget alone. Nevertheless, some of the solutions may come in the form of “European public goods”, which could be financed through the EU budget. This would effectively diffuse some of the heated “juste retour” debate.

The second answer is to directly address the main factors that perpetuate the issue of net balances. Institutional solution calls for increasing the bargaining powers of the EU Commission and the Parliament in financial perspective negotiations. The Lisbon Treaty and the problems surrounding its ratification suggest that major institutional shifts are unrealistic in the foreseeable future. This implies that the only true alternatives for dealing with the problem of “juste retour” are either a change in the concept of net balances or a reform of redistributive instruments of the budget, both of which would have to be combined with a dissolution of the existing partial corrections in the own resources system, including the UK rebate. In this respect, several interesting proposals have been offered so far.

One solution is to modify the calculation of net balances so as to take into account a broader concept of costs and benefits apart from pure budget receipts and contributions (Sapir, 2003). Such a concept is justifiable on the grounds of secondary effects (externalities) that EU budget flows create.

A second possibility is to predetermine “fair” net balances of all member states vis-à-vis the EU budget according to a concise but negotiable horizontal equity rule in advance of any agreement on the content of the budget. “Provisional” net balances stemming from the deal on EU spending policies and own resources could then be complemented by a mechanism of fiscal transfers that would bring the “provisional” net balances to their predetermined “fair” level (de la Fuente and Domenech, 2001, de la Fuente et al., 2008). Incentives for proper absorption of EU funds would have to be taken into account under such proposal. If strict adherence to a horizontal equity rule proves damaging for political acceptance of such a proposal, the rule could be relaxed along at least two dimensions: either by
introducing long enough phasing in periods or by allowing for deviations of predetermined net balances from the horizontal equity rule based on political agreement between the member states (Wostner, 2008). Under any of these proposals decisions about the desired degree of redistribution would be separated from decisions about the content of EU policies, which could prove conducive to a more conceptual approach to the EU budget, one based on coalitions for common, EU interests.

A third possibility would be to functionally split EU budget policies into two baskets, according to both main public finance functions that it performs (redistributive and allocative). The present concept of net balances would then be limited to the redistributive basket, while the allocative basket would be set free of the “juste retour” debate and allowed in time to outgrow the redistributive part, depending on the established needs for European public goods (Heinemann, 2006). The redistributive basket could also be combined with the de la Fuente and Domenech’s (2001) horizontal equity rule or any other proposal aiming at predetermining the member states’ net balances (Wostner, 2008). The most difficult challenge of such a proposal would obviously be to determine, which expenditure items are allocative and which redistributive.

Finally, there is always the possibility of taking the need for horizontal equity into account in reforming the current EU budget policies (particularly cohesion policy and the common agricultural policy). Considerations that reduce horizontal redistribution (between equally developed member states) while preserving vertical redistribution (between member states at different levels of development) go some length towards this goal. If the EU budget review adopts this path, additional correction mechanisms may actually not be needed.
6 Conclusion

The outcome of negotiations about the EU’s medium-term financial perspective for the period 2007–2013 does not promise any fundamental changes in the EU budget for another seven years, despite vitally needed reforms. Non-cooperative coalition theory predicts that the outcome of multilateral negotiations such as those for the NFP will depend on the prevailing coalition structure and hence on the incentives that drive coalition formation. This article has tried to formally validate the intuitive and widely held hypothesis that national interests are the driving force behind coalition formation and outcomes of financial perspective negotiations using the case of the NFP negotiations. The article has also discussed the net balances problem in the context of the 2008/09 EU budget review.

The results of the analysis show that hypothetical coalitions of member states in the NFP negotiations based on quantified national interests (partial net budgetary balances) correspond well to the actual coalitions that have been formed during the NFP negotiations. This confirms the starting hypothesis of the article that national interests had a strong influence both on coalition formation as well as on the outcome of the NFP negotiations.

The main issue in the NFP negotiations was a confrontation between net contributors and net recipients over the cohesion policy issue. Because strong and opposing coalitions prevented a major reduction of cohesion policy expenditure, and taking into account that October 2002 CAP agreement remained almost unchanged, other expenditure items, especially those aimed at implementing the Lisbon strategy, became the prime instrument for reducing the overall level of the EU budget expenditure. The analysis shows that the lack of strong underlying national interests can be an important explanation for poor performance of the Lisbon strategy objectives in the NFP negotiations.
Factors that contribute to persistent focus of EU member states on net budgetary balances include the dominant role of the EU Council in financial perspective negotiations, national political considerations, limitations of pan-European solidarity, inappropriate expenditure structure resulting in horizontal inequalities and complex and partial correction mechanisms.

In addition to strong external pressure, possible solutions to the net balances problem include broadening the concept of net balances to include secondary effects of the EU budget, predetermining member states’ net balances in advance of negotiations on EU policies, separating allocative and redistributive elements of the budget and reforming redistributive EU policies to bring them closer in line with the concept of horizontal equity.

7 References


Appendix 1: Main issues in the run-up to the NFP negotiations

Several issues have influenced the substance of the initial Commission proposal for the NFP, presented in February 2004, and determined the agenda of the NFP negotiations that were carried out in the following two years.

The first and financially most substantial issue was to pay the price of the 2004 enlargement. The compromise in financial perspective 2000-2006, was to make new member states pay their full share of contributions to the EU budget starting with their accession, but to phase them in gradually for the most sensitive items on the expenditure side; namely, direct payments under the common agricultural policy and allocations under the cohesion policy (Rollo, 2003). Because these two items represent approximately 65% of the entire EU budget expenditure, old member states have in effect postponed the full budgetary impact of the 2004 enlargement to the period beyond 2006. The issue thus reappeared in the NFP negotiations.

Additionally, in March 2000 the Lisbon strategy was adopted (CEU, 2000). In March 2002 the Barcelona European Council set operational targets for this strategy, among other things an increase in research and development (R&D) spending to 3% of EU GNI by 2010, of which 1/3 should come from the public and 2/3 from the private sector (CEU, 2002a). The EU budget was seen as a potentially important catalyst for meeting these targets.

On the other hand, in October 2002 the Brussels European Council agreed to essentially “freeze” agricultural subsidies until 2013 (CEU, 2002b). According to this agreement, market measures (i.e., price and export subsidies) and direct payments (i.e., income subsidies), which constitute the first pillar of the common agricultural policy (CAP), were set to increase nominally by 1% per year in the period 2007–2013 relative to their 2006 level (Mayhew, 2003). Because the first
pillar of the CAP accounted for almost 40% of EU budget spending in 2006, the agreement significantly limited prospects for any serious restructuring of the EU budget, unless new priorities would either crowd out the remaining expenditure headings, come on top of the existing level of expenditure, or the CAP agreement was reopened.

Finally, in December 2003, six major net contributors\textsuperscript{18} to the EU budget expressed their concerns about the overall level of expenditure in the NFP in a letter written to the President of the European Commission. This letter stated, first, that the EU budget expenditure in the NFP should not exceed 1.00% of EU GNI and, second, that the conclusions of the Brussels European Council in October 2002 with respect to agriculture should be respected.

The above issues were also reflected in an independent report about the challenges faced by the EU, prepared by an expert group chaired by Andre Sapir (Sapir et al., 2003). Among its recommendations, the report proposed, first, a significant reform of the CAP, which would partially renationalize CAP subsidies and substantially reduce CAP spending from the EU budget; second, a significant increase in growth-oriented expenditure, particularly R&D, from the EU budget; and, third, a refocusing of the cohesion policy on bridging the development gap between the old and new member states.

\textsuperscript{18} Germany, France, the UK, the Netherlands, Austria, and Sweden
Appendix 2: Properties of partial net budgetary balances

In order to derive both properties of partial net budgetary balances, we first define total contributions to the EU budget and total expenditure of the EU budget and assume a balanced budget.

1. Total contributions to the EU budget

\[
C_{EU} = \sum_{i=1}^{27} C_i
\]  \hspace{1cm} (A1.1)

in which:

- \( C_{EU} \) are total contributions to the EU budget at the EU level (based on TOR, VAT, and GNI sources),
- \( C_i \) are total contributions of member state \( i \) to the EU budget (based on TOR, VAT, and GNI sources),
2. Total expenditure of the EU budget

Taking into account that total expenditure at the EU level (both allocated and non-allocated) is composed of $j$ types of transfers (issues under negotiation),\(^{19}\) we can write:

$$E_{EU} = \sum_{j=1}^{N} E_{EU,j} = 27 \sum_{i=1}^{N} E_{i,j} + \sum_{j=1}^{N} NAE_{EU,j} \quad (A1.2)$$

in which:
- $E_{EU}$ is total expenditure for all types of transfers at the EU level,
- $E_{EU,j}$ is total expenditure for $j$ type of transfers at the EU level,
- $E_{i,j}$ is total expenditure for all types of transfers at the EU level,
- $NAE_{EU,j}$ is non-allocated expenditure for $j$ type of transfers at the EU level.

3. Budget balance

$$C_{EU} = E_{EU} \quad (A1.3)$$

Taking into account A1.1 – A1.3, partial net budgetary balances have two interesting properties.

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\(^{19}\) In this article, the total net budgetary balance of a country is decomposed into four partial net budgetary balances: (i) CAP, (ii) cohesion policy, (iii) all other types of transfers, and (iv) UK rebate.
Corollary 1: The sum of partial net budgetary balances of member state \( i \) under all types of transfers and the UK rebate equals the overall net budgetary balance of member state \( i \).

**Proof:**

\[
NBB_i = \sum_{j=1}^{N} NBB_{i,j} + R_i
\]  
(A1.4)

Substitute (3.2) and (A1.2) into (A1.4) and rearrange:

\[
NBB_i = \sum_{j=1}^{N} E_{i,j} - \frac{C_i}{C_{EU}} \times \sum_{j=1}^{N} E_{EU,j} + R_i
\]  
(A1.5)

\[
NBB_i = E_i - \frac{C_i}{C_{EU}} \times E_{EU} + R_i
\]  
(A1.6)

By taking into account (A1.3), (A1.6) reduces to (3.1).

Corollary 2: The sum of partial net budgetary balances for all EU member states under \( j \) type of transfers equals zero in cases when \( NAE_j = 0 \), and equals \(-NAE_j\) in cases when \( NAE_j \neq 0 \).

**Proof:**

\[
\sum_{i=1}^{27} NBB_{i,j} = \sum_{i=1}^{27} \frac{E_{i,j}}{E_{EU,j}} \left(\frac{C_i}{C_{EU}} - 1\right) \times E_{EU,j}
\]  
(A1.7)

\[
\sum_{i=1}^{27} NBB_{i,j} = \left(\sum_{i=1}^{27} \frac{E_{i,j}}{E_{EU,j}} - \sum_{i=1}^{27} \frac{C_i}{C_{EU}}\right) \times E_{EU,j}
\]  
(A1.8)

If \( NAE_j = 0 \), then from (A1.2):
\[ \sum_{i=1}^{27} E_{i,j} = E_{EU,j} \quad (A1.9) \]

Substituting (A1.1) and (A1.9) into (A1.8), we get:

\[ \sum_{i=1}^{27} NBB_{i,j} = \left( \frac{E_{EU,j}}{E_{EU,j}} - \frac{C_{EU}}{C_{EU}} \right) \times E_{EU,j} = 0 \quad (A1.10) \]

If \( NAE_j \neq 0 \), then from (A1.2):

\[ \sum_{i=1}^{27} E_{i,j} = E_{EU,j} - NAE_j \quad (A1.11) \]

Substituting (A1.1) and (A1.11) into (A1.10), we get:

\[ \sum_{i=1}^{27} NBB_{i,j} = \left( \frac{E_{EU,j}}{E_{EU,j}} - \frac{C_{EU}}{C_{EU}} - \frac{NAE_j}{E_{EU,j}} \right) \times E_{EU,j} = -NAE_j \quad (A1.12) \]
Appendix 3: Calculation method for allocation of cohesion policy expenditure among EU member states

Member state allocations under the cohesion policy are determined according to the rules set out in the compromise proposal of the UK presidency (CEU, 2005) and also summarized in EC (2005c). These rules essentially determine cohesion policy envelopes for individual member states in three consecutive steps.

The first step determines eligibility of geographical areas in the EU for convergence, competitiveness and territorial cooperation objectives of the cohesion policy. NUTS-2 regions with per capita (PPP adjusted) GDP of less than 75% of the EU-25 average in the 2000-2002 period, as well as member states with per capita (PPP adjusted) GNI of less than 90% of the EU-25 average in the 2001-2003 period are eligible under the “convergence” objective. The remaining NUTS-2 regions are eligible under the “competitiveness” objective. NUTS-3 regions alongside member states’ borders, as well as the entire area of the Community are eligible under the “European Territorial Cooperation” objective. There also exceptional phasing-in and phasing-out NUTS-2 regions which fall between the “convergence” and “competitiveness” objectives.

The second step calculates the initial cohesion policy envelopes for each member state under each of the three objectives. In case of the “convergence” objective, per capita allocations for any eligible region are determined as a fixed percentage of the “regional development gap”, measured by the difference between the EU-25 and regional per capita (PPP adjusted) GDP in the 2000-2002 period. The fixed percentage applied to the “regional development gap” is based on national prosperity and ranges from 2.67% to 4.25%. In case of the cohesion fund, allocation shares for any eligible member state are based on the average of population and surface area shares of that member state among all eligible member states, corrected by a factor that reflects national prosperity. These shares are applied to the total cohesion fund envelope, which equals to 44.7 EUR
times the population of all eligible member states (roughly 125 million). Allocation shares for the “competitiveness” objective are based on the combined member states shares in former objectives 2 and 3 of the 2000-2006 financial perspective. These shares come close to the actual “competitiveness” objective shares, since they are based on a similar set of indicators (mostly population and employment) and weights. They are used since data required to calculate original “competitiveness” shares was not readily available at the time of the negotiations. Allocation shares for the “European Territorial Cooperation” objective are based on eligible population.

The third step involves capping of cohesion policy allocations for any single member state and some additional operations. The cap is applied when the overall cohesion policy envelope for any member state, which equals to the sum of the member state’s allocations under each of the three objectives of cohesion policy, exceeds the maximum allowable amount for that member state. Maximum allocations are expressed in relative terms (percent of GNI) and are individualized for member states according to their levels of prosperity. Member states with the lowest per capita income levels can receive cohesion policy allocations of up to 3.7893% of their GNI. This ceiling is then progressively reduced for more developed member states and reaches 2.7% of GNI for member states at the average EU-25 level of prosperity. In practice, however, only the least developed member states actually face reductions in their initial cohesion policy envelopes for the 2007-2013 period due to application of the cap. After capping, some of the funds are transferred from subheading 1b (cohesion) to heading 2 (natural resources) in order to cover for commitments of the new European rural development fund, which used to be included under cohesion policy in the 2000-2006 period. Finally, the share of cohesion fund in the total cohesion policy envelopes of new member states is increased to 1/3 and the share of the structural funds correspondingly reduced to 2/3, in order to reflect significant infrastructural investment needs of these economies.
In addition to the rules described above, there are also formulas that determine allocations under the “phasing-in” and “phasing-out” regimes and several ad-hoc arrangements for individual regions and member states that come on top of the rule-based calculations. All of this together determines the ultimate cohesion policy allocations to individual member states that enter into calculations of net budgetary balances.
Appendix 4: Detailed decomposition of “Other” partial net budgetary balances based on the inter-institutional agreement 2007–2013

Annual averages and 2004 prices

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<tr>
<th></th>
<th>Internal policies</th>
<th>External policies</th>
<th>Administration</th>
<th>Compensations</th>
<th>Total “Other”</th>
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<td>% GNI</td>
<td>EUR (mil.)</td>
<td>% GNI</td>
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Source: Authors’ calculations