Budgeting for Growth: A perspective on the long term budget of the EU

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Foreword

Multiple and complex issues are facing any long term reform of the EU budget. The present analysis is the first within an ongoing project at the ITPS. It has been developed in fruitful dialogue with Katarina Gralén of the Ministry of Finance. Christer Christensen and Olof Sandberg of the Ministry of Enterprise, Energy and Communication, Britt-Marie Tygård of the Ministry of Education and Research, and Erik Rudal of the Prime Minister´s Office have participated in a group which has discussed the topics at hand from various angels. Also Professor Daniel Tarschys of the University of Stockholm has contributed. Thanks to all for insightful and helpful comments. However, ITPS alone is carrying the responsibility for the content of the report. The project team has included, Håkan Gadd, Anders Östhol (project manager), Torbjörn Danell and Jorge Núñez Ferrer of the CEPS (Centre for European Policy Studies).

Östersund, May 2007

Sture Öberg
Director-General

Content

Summary

In this report, the multi-annual budget for the period 2007–2013 will be scrutinized in terms of what it may contribute to economic growth. In the study, the examination of the sources of growth is an attempt to look at and discuss the EU budget from a growth perspective. It gives us an opportunity to investigate different possibilities to boost economic growth and to provide a basis for the discussion about the review of the budget and its policies in 2009. For the past 30 years, the needs and the demands for a policy shift towards a greater concentration on growth, sustainable growth, internal and external security have increased. The Lisbon Agenda for growth calls for a prioritization of the first objectives, the Gothenburg declarations for a reinforcement of the sustainability. There is a clear indication that the present EU budget concentrates on a very narrow part of the main objectives and this inefficiently.

For the forthcoming overview of the EU budget the following points summarize some of the major observations we have made in this study with implications for a future reform. There is no uniform or simple interpretation of growth problems within the EU in relation to other areas. Many in this study point to the need for better and more effective priorities within the EU – strategic issues need to be emphasised once again with an increased focus on growth.

There are fundamental principles for EU policies in general to which *all* interventions by the EU budget should be subordinated. They are enshrined in the treaties and rules of the European Union. Other principles are based on the clear need to avoid waste in a budget with strong financial limitations. The principles are the subsidiarity, additionality, proportionality, value for money, EU public goods and creating European value added. The analysis concentrate on the performance of the policies in achieving their objectives and if they are in tune with the principles for a European budget policy.

The EU budget interventions in the new financial perspectives show that a considerable part of the funds are used for interventions not in line with the fundamental principles EU policies should posses and are incompatible with a growth orientation of the funds. The Common Agricultural Policy (CAP) is a particularly strong case. In its present form, it not only fails to comply with the principles that EU policies should follow, but it has also a very negative effect on the rationale of the EU budget. Most of the CAP direct payment support should thus be phased out, leaving some space to support farmers with low incomes, based on means testing of the farm households. The Cohesion policy and rural development policies do have a role to play in the EU budget, but the individual actions need revisiting. R&D has an important role at EU the level but the optimum level of funding is unclear. These are potentially important investments, but those for transport need reassessing.

The significance of regulations are most obvious in two fields; the completion of the internal market and competition policy. The primary gains of competition are well-known - open markets, undistorted competition which is assumed to lead to effective production and optimal prices. The EU budget’s role in fostering growth is very limited; most actions have to be undertaken at national level in the form of structural and fiscal reforms. At EU level, the cornerstone for fostering growth is the full realization of the internal market, which is not a financial issue.

There is a role for the EU budget to intervene in growth oriented aspects where pooling of resources and coordination can create economies of scale. This is in the fields of R&D, education, transport, infrastructure and environment.

1 Budgeting for growth

"Europe will soon catch up with America not because of a superior economy or technological base, but because it is coming together, amassing the impressive resources and intellectual capital already possessed by its constituent states." [1]

The European Union budget is not primarily associated with economic growth. On the contrary, it is understood more as a steering instrument for the allocation of resources and the distribution of expenditure and costs. The budget could be described as an institution in itself, a fairly slowly-changing and path-dependent institution, with its own history, reflecting a variety of inherited conflicts. Over the years, it has developed its own particular style of problem-solving, while aiming at reaching a consensus on a wide range of different issues. Its purpose is to achieve a balance between various interests and among other institutions and national governments.

Neither the expenditure side, nor the revenue side give any indication that economic growth is the ultimate objective of the European Union. Peace was one main objective in the early years of its 50 year history. Individual sectors of the economy received disproportionately high attention, such as the coal and steel sector which from 1952 accounted for the budget of the Economic Coal and Steel Community through a direct tax on each ton of steel produced. From the Treaty of Rome in 1957, national contributions by levies became the main revenue. It was not until 1970 a system for EU´s own resources were re-established. The agricultural sector has been heavily supported by subsidies through the budget in proportion to the size of this particular sector.

The promotion of integration itself stands out as the most persistent and overshadowing objective of the EU that makes sense. Stability, cohesion and convergence stand out as operational objectives. Only on rare occasions has centralising supra-national ambitions come to the forefront. At these times, sovereignty has been safeguarded by national states. Virtually all efforts of the EU have basically to be supported by the treaties signed by national governments. Whenever approaching anywhere near the formation of a political union it has unleashed concerns and fears that EU will turn into a super-state. The stalemate reached after the national referendums in France and the Netherlands over the constitution in 2005 did put an effective, but temporary, end to a major reform of EU institutions.

Nevertheless, in recent years, it has become common to argue for a kind of cautious gradualism supported by previous experiences of so-called functional integration. Most recently, the Lisbon process attempted to direct the policies of the EU towards economic growth by redesigning the policy framework. Various new names on expenditures have been adopted to signal change in favour of a more thorough modern growth perspective. This shift in outlook is inherent in the emphasis on both competitiveness and greater cohesion for growth and employment. Previously, the structural funds were more associated with redistribution and compensation to poorer regions within the union. In this regard, the Lisbon process symbolises a shift in perspective in the direction of more priority to economic growth at the expense of large amounts reserved for redistribution.

[1] Kupchan, C. A. *The End of the American Era: U.S Foreign Policy and the Geopolitics of the Twenty-first Century*, Alfred A. Knopf, New York, 2002

1.1 Purpose

In this report, the multi-annual budget for the period 2007–2013 will be scrutinized in terms of what it may contribute in terms of economic growth. As much as nine tenths of the budget comes from Member State contributions, agreed after lengthy negotiations, every seven years. The revised financial regulation was finally agreed by the European Parliament and the Member States on 29 November 2006 and adopted unanimously by the Council on 13 December last year. In February the annual budget 2007 was presented with adjusted figures for the same period (see Table 1 on p.33).

This is not the place to come to any definite conclusions based on solid evaluations which would be desirable. However, there is knowledge and experience available in various works on economic growth which helps us to put EU policies into a growth perspective. In this study, the examination of the sources of growth is an attempt to look at and analyse the EU budget. It gives us an opportunity to investigate different possibilities to boost economic growth.

1.2 Basic structure of the report

In the first section of this presentation, the aim is to bring some of these experiences from both theoretical overviews and empirical evidence to the forefront – basically the focus is on sources of growth. The assumption is that there is a fairly common pool of experience and knowledge available on the subject. Secondly, aware as we are of the certain circumstances under which the European Union operates, the aim is to examine more closely what opportunities the EU has to fulfil its seemingly high ambitions in fostering economic growth.

The examination reveals that there are many limitations which put restraints on the EU and its prospects to succeed in its ambitions. Furthermore, a critical discussion sums up this presentation with a focus on the possibilities to reform the budget in favour of more growth oriented policies. Budgetary restraints, general institutional design, aim of the budget and its current content are uncovered. Major reforms of the budget will have to wait until after 2013. However, the European Commission will present its view in 2008. We will not focus on the revenue side. Focus is predominantly on the expenditure side and to a degree on regulations.

In the section below, general growth theories and their implications are introduced. In this report, we investigate the sources of growth from a European view point without any reference to individual national standpoints or interests at stake. We attempt to present a meta-perspective of the EU budget which may bring us forward and eventually help us suggest which aspects will require more in-depth analyses. In the end guiding principles for policies financed by the EU budget are presented.

2 The sources of growth

The enlargement of the EU has now become a reality and now we face new possibilities, challenges and tensions throughout Europe. The EU budget's first priority is to strengthen the integration between Member States. About 80 percent of the budget resources concerns convergence aspects and around 15 percent of the budget is assigned more directly towards growth aspects (see Table 2 on p. 43). The structure of the EU budget reveals the low priority given to growth from a financial point of view within the EU. However, if we go back to the Lisbon strategy, one of the main objectives is to give considerable higher priority to growth within the EU in order to achieve improved productivity and the ability to compete with the rest of the world. Growth has a variety of sources. Below follows an outline of some of the sources that may be helpful in strengthening the European economy in the future.

2.1 European attitudes toward growth and the EU budget

One of the key recommendations from the Kok report is the following:

> *"The EU budget should as far as possible be reshaped to reflect the Lisbon priorities. Part of this reshaping should be an analysis of the possibilities to introduce budgetary incentives to encourage Member State achievement of Lisbon targets."*[2]

One of the key aspects for the Union and Member States is to implement the Lisbon strategy; Wim Kok underscores that countries should back up their words as far as possible with financial incentives. A large amount of money has already been allocated – directly or indirectly – to growth, employment and competitiveness. However, Kok claims that there still a lot of work to do in order to enhance further growth in the European economy.[3]

The construction of the knowledge society in Europe and the delivery of sustainable economic growth come with tough choices. In Gothenburg 2001, the European Council discussed "A Sustainable Europe for a better world: A European Strategy for Sustainable Development", proposed by the European Commission. It became a main step toward focusing on issues such as climate change.[4] Resources have to be refocused and structural change is never without its problems. Nevertheless, security is not achieved by resisting or delaying reform. Compared to the initiating of the Single Market 1992, the establishment of a single currency and the enlargement, the Lisbon strategy has not been a success. A lack of understanding of the Lisbon strategy and its importance to Europe's future has narrowed the co-operation between European institutions and Member States. Unfortunately, one of the reasons for this is that according to Kok's report, progress has been inadequate, largely due to lack of commitment and political will. The report states that there needs to be more coherence and consistency between Lisbon's means and ends together with a thorough overhaul and redesign of the processes for implementation and communication.[5]

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[2] Commission of the European Communities, *Facing the Challenge: The Lisbon Strategy for Growth and Employment,* Report from the High Level Group, Chaired by Wim Kok, November 2004, p. 42

[3] Ibid, p. 42

[4] Communication from the Commission, *A sustainable Europe for a Better World: A European Union Strategy for Sustainable Development*, Commissions proposal to the Gothenburg European Council, Brussels, 2001

[5] Ibid, p. 39

The Lisbon strategy for growth and employment is an equally important project. The European Commission and Member States, together with social partners and other stakeholders throughout Europe, must now show that they are committed to the Lisbon process and accept their responsibility in implementing the agreed reform programme.[6]

The progress of the Lisbon strategy has been weak because Member States have not found ways to be more consistent when it comes to sharing the same goals and developing policies which need to be mutually reinforcing and not pulling in opposite directions. From a European point of view, to achieve the aim of more growth and employment means ensuring that there is clear alignment between participants, policies and objectives. The Lisbon strategy is characterised by its many indicators, i.e. more than a hundred indicators have been associated with it. Too many indicators make this strategy ineffective and do not help the Member States to improve their record.[7] However, in this case, the main problem is probably not the large number of indicators. It is possible to have a large number of indicators as long as they are directed at or correspond with the goals.

If we study the implementation of the structural programme at regional level, it is clear that the regional players base their prioritised input areas on a reasonable foundation of knowledge concerning what needs to be done to safeguard the region's future requirements. The problem is that the strategy issues themselves are not given sufficient priority, i.e. how the whole question is underestimated and becomes an ineffective tool for achieving regional growth. Another problem is that the goals are not always clear and measurable. Several objectives may emerge in the same formulation and, in many cases, these have a visionary nature. As a consequence, regional players have difficulties in defining a clear hierarchy of goals showing a ranking of the different objectives. It may, for instance, be problematic to optimize a fixed objective without this being at the expense of another goal, e.g. a growth target in relation to an environmental goal.[8]

In 2004, the Member States were lagging behind in the implementation of directives and the lack of commitment was seen by the Kok report as a major problem. The open method of coordination had fallen short of expectations and the community method had not delivered what was expected. The governments have to show more commitment to implement the strategy on a national level. Much of the Lisbon strategy depends on the progress made in national capitals. There are no unique methods at a European level that can resolve the Member States' lack of commitment to the process.[9]

There are two dominating policies within the EU with a bearing on growth policy; the competition and the cohesion policy. Since the late 1980s, the Commission has been using competition policy as a tool for liberalising markets. The Commission increasingly questioned whether a legal monopoly is necessary to ensure public access, gradually forcing open monopoly markets. The social policy aims at building an active labour market policy and the convergence policy is designed to promote regional convergence by allocating development funding to countries and regions on a non-competitive basis.[10]

One of the major problems has since long been the vast resources earmarked for agricultural policy. From the end of the 1980s and onwards, the weight of agriculture in the

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[6] Ibid, p. 39
[7] Ibid, pp. 40-43
[8] ITPS A2007:003, *Förhandsbedömning av de operativa regionala strukturfondsprogrammen*, p. 97-98
[9] Commission of the European Communities, *Facing the Challenge: The Lisbon Strategy for Growth and Employment,* Report from the High Level Group, Chaired by Wim Kok, November 2004, p. 42 and p. 45
[10] Sapir A., *An Agenda for Growing Europe: Making the EU Economic System to Deliver*, Report 2003, p. 18

budget has been reduced by simultaneously expanding structural expenditure. Over a period of four years, farm support was reduced from 60 percent of the budget to 52 percent, while the share of the Structural Funds was raised from 17 percent to 27 percent. The budget for research was doubled in this time period, although it still only made up 4 percent of the total budget in 1992. The Delors-II financial package (1993–1999) changed the budget in the same direction. By 1999, the share of agriculture was down to 45 percent, while the structural policies represented 35 percent of the total budget.

The next budgetary package, Agenda 2000 (2000–2006), reflected the upcoming eastern enlargement. The financial difficulties became more problematic during this period because all new candidate countries have incomes per head below the EU average while at the same time their agricultural sector is much larger. In spite of the enlargement, agricultural expenditure did not increase its share in the total budget which was kept roughly at the same level as 1999. The economic situation at that time led to a tightened EU-budget. In 2004, new adjustments were made for integrating ten new members in the community.[11] The EU common budget is small and most of its expenditure is determined years in advance, and the resources are mainly a support for farmers and poorer regions. The next budget round during the next medium-term budget plan that will run from 2007 to 2013 inclusive is now under debate. In the near future, an overview (2008/2009) will be carried out and the EU faces difficult considerations and compromises in respect of agricultural issues and the UK budget rebate. In 2004, the number of EU members grew from 15 to 25 and the population of the EU did increase by some 70 million citizens. In the beginning of 2007 another enlargement added about 30 million more citizens. This has not affected the budget, it has only risen marginally.[12]

Any Member State would agree that the Union should only spend money if and when there is an added value in doing so at EU level. However, scholars reveal a wide range of variation as to what the added-value more precisely may boil down to. This being said it is little scholars has agreed on. Daniel Tarschys has studied the usefulness or 'value added' for different policy areas. Central issues touched on are as follows: What should we all pay for? What is the best use of the European Union’s scarce resources? How should tasks and expenditure be apportioned between the Union and its Member States?

The ‘Value Added’ issue is a question of making this far too inclusive and blunt tool into an effective instrument for carrying out centrally determined priorities and policy choices. Many people are persuasive about its good qualities in the long term and indeed most things will have a positive effect, in some way, in a knowledge-based economy. Too many measures are legitimated at present on the basis of a framework that is too broad and vague defined. This does not provide the necessary precision and is inadequate for the purpose of setting priorities within a budget which is after all limited in scope.[13] Tarschys is of the opinion that:

[11] Ibid, p. 19f
[12] Begg, I., The *EU-budget: Common Future or Stuck in the Past? Centre for European Reform*, briefing note, 2004, p. 1.
[13] Tarschys D., *The Enigma of European Added Value: Setting Priorities for the European Union*, SIEPS 2005:4

> *“We have to choose a fastidious approach to the idea of European added value, a strategy that is quality-conscious and exacting.”*[14]
>
> *”…suggesting that particular consideration should be given to investments in high-yielding cross-national public goods and to initiatives making significant contributions to the sense of solidarity and cohesion in Europe.*”[15]
>
> *“On the one hand, there is a need to take a good hard look at the economic elements involved. To qualify as yielding a high European added value on this count, an investment would have to offer credible promises of sound returns, benefiting at least two countries, preferably more, and in many cases the entire Union. The second part of the appraisal would aim at estimating the strength of various proposals with regard to their contribution to European cohesion, in the widest sense of that word. In many instances, the relevant value increment of proposed expenditure is its capacity to strengthen the attitudes and behaviour underpinnings of the European project.”*[16]

The problem, according to an acknowledged budget expert, is that all countries have their own views on what constitutes added value. When it comes to budget allocations, the overriding objective for most Member States is not to further the common good, but to ensure that the EU spends as much of ‘their’ money as possible on policies that benefit them.

Many Member States are in favour of spending more on boosting growth and competitiveness. It is widely acknowledged that the EU must help the poorer newcomers in Central and Eastern Europe to catch up with western income levels. There is a demand for the EU to take on the challenges of securing its external borders, policing immigration and using its weight in global affairs.[17]

However, it is considerably more difficult to see this common intention being fulfilled in practice. The Member States are currently far too focused on their own benefits and this creates incompatible demands between Member States. The current budget battles are well established. There is tension between the net contributors and the net recipients about the size of the overall budget. There is tension over who receives what from the budget. Economists have also challenged the composition of EU spending and there are disputes over how the EU should finance its budget, i.e. through its own taxes or transfers from Member States’ budgets.[18]

Iain Begg’s conclusion is that the Commission’s proposal offers little that is new or innovative; the expenditure items largely reflect the same view. However, it cannot be denied that there are positive changes and the allocation for policies to promote growth and competitiveness will double. Is this allocation enough? Iain Begg implies that the budget proposal that is now on the table will not prepare the EU for future challenges. It could turn out to be yet another missed opportunity.[19]

Sapir and his colleagues are also very critical of the EU budget. In the so-called Sapir report, it is argued that most of the expenditure should be geared towards the promotion of

[14] Ibid, pp. 95-97
[15] Ibid, p. 7
[16] Ibid pp. 95-98
[17] Ibid, p. 1
[18] Ibid, pp. 1-3
[19] Ibid, pp. 3-5

growth and competitiveness and away from a focus on farmers and redistribution to poorer regions. The problem according to the much quoted Sapir report is that all Member States want to promote growth and convergence without acknowledging what really has to been done. The EU budget currently does not clearly show how we can improve EU growth overall with a budget where three-quarters of the expenditure goes to farmers and regional policies and at the same time, where very little is spent on achieving its declared goal of becoming the world's most competitive knowledge-based economy by 2010. If the EU wants to stress further the importance of competitiveness and growth, the structure and allocation of EU budget resources has to change according to what is needed for growth in a knowledge-based economy. EU spending cannot solve the needs of the Member States by redistribution from rich to poor. It will only have a moderate effect on such a process and EU spending has no direct impact on the macro-economic stability of the Member States. The EU's priorities should undoubtedly better reflect the good intention to become more growth-oriented in terms of both outlook and impact.

2.2 Growth theory directions

Today, no unified theory exists to determine growth. Instead, there are several partial theories that discuss the role of various factors in determining economic growth. There are two major theories on growth: the neoclassical growth model[20] and the theory of endogenous growth[21] Differences between theories of growth depend on how they choose to weight a set of factors which are key determinants of economic growth. In neoclassical growth theory, much of the attention is on rates of savings/investments, while endogenous growth theory has a greater focus on other determinants of economic growth, such as human capital and innovation activities.

It is not just the economic factors which affect economic performance. High growth is also dependent on non-economic factors, i.e. institutional factors have been assigned a substantial role.[22] One may distinguish between "proximate" and "fundamental" sources of growth. Proximate sources of growth concern performance aspects which depend on the accumulation of capital, labour and technology. Fundamental sources of growth concern institutions, legal and political systems, demography, geographical and socio-cultural factors. New sets of data have been an important source for testing a set of determinants and their relevance for growth. It has enhanced the possibilities of obtaining confirmation, in another way than previously, of the significance of different sources of growth in the development of the economy[23]

2.2.1 Investments in capital and labour

Investments are an important determinant of economic growth. Numerous studies have investigated the correlation between economic growth and investments. However, the results are not as robust if we consider causality. Some researchers claim that investment drives growth, others state that it runs in the opposite or in both directions.[24]

[20] Solow, R. M., "A Contribution to the Theory of Economic Growth", *Quarterly Journal of Economics*, Feb., 1956, 70 (I), pp. 65-94
[21] Romer, P., "Increasing Returns and Long-run Growth", *Journal of Political Economy*, 1986, pp. 1002-1037
[22] North, D. C., *Institutions, Institutional Change and Economic Performance*, Cambridge University Press, Cambridge, 1990
[23] Artelaris P. & Arvanitidis P. & Petrakos G., *Theoretical and Methodological Study on Dynamic Growth. Regions and Factors Explaining their Growth Performance*, Dynreg, no.1, 2006, p. 3-4
[24] Ibid, p. 8-9

If we consider what is crucial, investment focus is shifted towards capital and labour. There are basic determinants of economic growth. Presently, these are focused on venture capital, and the successful development of a venture capital industry, which is essential for stimulating enterprises with potential for growth and high returns. Venture capital is focused on helping finance high-tech start-ups.[25] Europe has not found a plan that is adequately supportive of such enterprises. There are problems pointed out concerning early-stage financing. Another problem is that the profitability of such investments in Europe remains well below the level in the US. Venture capitalists, who finance innovative activities, are a group which responds to taxes. If taxed too heavily, they will not have sufficient incentives to put funds into risky ventures. Venture capitalists deal with small and medium-sized enterprises. They are less capital-intensive than larger companies and are looking for an environment with relatively simple corporate tax structures, with low rates of tax and broad tax bases. According to the Sapir report, there is still a large degree of heterogeneity in corporate tax systems within Europe. Taxes have been reduced. However, the system of taxes has to be simplified.[26]

Another source of growth is of course reflected in the labour market. Europe has not succeeded in terms of employment creation and this has been a major factor behind poor growth over the last three decades. One explanation to the weak labour market is the lack of labour market flexibility. This concerns different institutional arrangements and how Europe can change this arrangement to strengthen the labour market.[27] The increased need for flexibility in the employment market has also been examined in an ITPS study.[28]

To learn more about how public polices have to change to promote growth we have to identify the key determinants of economic growth and development. One way to do this is to identify key determinants: "the fraction of the variance of income across countries that is explained by variations in factor accumulation (labour, physical and human capital) accounts exclusively for around 40 percent (upper bound). Thus, the bulk of international income differences are due to variations in total factor productivity (TFP)." "It follows that a successful theory needs to explain why some countries catch up in terms of productivity (TFP) while others lag behind."[29] From this point of view, economic growth is mainly about promoting growth by means of catching up and closing the gaps in innovations and technology.[30]

2.2.2 Technology and human capital

A particular key determinant which often remains unexplored is technological progress which is regarded as exogenous to the economic system in question. This has led to exploration of an alternative explanation among researchers and has resulted in the introduction of new accumulation factors, such as innovation or knowledge creating self-sustained economic growth. Paul Romer analyses how external factors such as knowledge spill-over and learning by doing affects the technological process and long term growth. Robert Lucas puts emphasis on how growth is affected by human capital. This research has

[25] Sapir A., *An Agenda for Growing Europe. Making the EU Economic System to Deliver*, Report 2003, p. 38, and Baygan G. & Freudenberg M., *The Internationalization of Venture Capital Activity in OECD countries: Implications for Measurement and Policy*, STI working papers, no. 7, 2000

[26] Ibid, p. 37-39

[27] Ibid, p. 39-40

[28] Rauhut, D. & Falkenhall B. (red)., *Arbetsrätt, rörlighet och tillväxt*, ITPS A 2005:016

[29] Schiffbauer M., *Theoretical and Methodological Study on the role of Public Policies in Fostering Innovation and Growth,* Dynreg, no. 4, 2006, p. 5

[30] Ibid, pp. 5-7

resulted in identifying three significant sources of growth: new knowledge, innovation and public infrastructure. One of the consequences of this shift in focus in growth theory from a neoclassical approach in favour of endogenous growth theories has been a greater interest in policies and how policies may promote growth in the long run.[31]

If the intention is to strengthen self-sustained growth, stakeholders and researchers should give higher priority to determinants such as human capital, innovation, and research and development (R&D). These factors are crucial and complementary determinants behind economic growth figures. Many different variables have been used in order to measure the quality of human capital. However, the focus on education remains important. We may claim, based on the experience of a large number of studies, that an educated population is a key determinant of economic growth. Researchers have found that higher education has the largest effect on growth compared to both secondary and primary schooling.[32]

One of the most important determinants of growth along with education is innovation activity. Such activity is often measured by indexes such as R&D investment and successful patent applications. However, innovation is central to economic success and increasing productivity and growth. It is a way to introduce new technology and new products and processes into the market.[33] The key agent in such a process is the entrepreneur, who has the ability to reinforce new innovation and create new growth markets. Therefore, it is necessary to develop policies that stimulate entrepreneurial behaviour and entrepreneurship in Europe. Entrepreneurs not only create new businesses, their real impact is when their businesses grow.

We also have to consider that countries that are at different stages of economic development require different skills. The closer a country gets to the world's technological frontier, the greater the importance of higher (tertiary) education to promote R&D. However, if a country has not succeeded in reaching this level and is characterised by a large degree of imitation of foreign technologies, it does require more basic primary and secondary education. Researchers use this approach to explain productivity differences between the US and the EU. In the year 2000, only 24 percent of the EU population had completed degree-level education compared to 37 percent of the US population. Also the educational expenditure on tertiary education is much larger in the US than in the EU. Empirical evidence exists that shows that the lack of advanced tertiary education may explain growth differences among countries. This skill-specific education effect contributes to a productivity gap between the US and the EU.

One conclusion is that there are different institutional frameworks appropriate for different stages of economic development and that there is a positive correlation between the degree of product market competition and innovation, and growth. However, the relation is much stronger when companies are close to the world technology frontier.[34]

Results show that European countries have moved closer to the technology frontier. The technological revolutions in communication and information are significant for European growth. New institutional arrangements have to develop which can better promote necessary changes in economic institutions and organisations. From the Sapir report, the

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[31] Artelaris P. & Arvanitidis P. & Petrakos G., *Theoretical and Methodological Study on Dynamic Growth*: *Regions and Factors Explaining their Growth Performance,* Dynreg, no.1, 2006, p. 5f
[32] Ibid, pp. 9-10
[33] Ibid, p. 10
[34] Schiffbauer M., *Theoretical and Methodological Study on the role of Public Policies in Fostering Innovation and Growth,* Dynreg no. 4, 2006, pp. 10 and 25

conclusion is that the necessary adjustments of institutions have been delayed and have not up to now been implemented on a large scale in Europe, which accounts to a large extent for our growth deficit.[35] Europe is a region which is dependent on innovation (not imitation), the region is close to the technology frontier and its growth is mostly driven by innovation and therefore the ability of its enterprises and regions to adapt to technical progress. Through entrepreneurial activities and investments in R&D, new innovations can be developed. However, there are a few challenging key requirements for creating a more innovative environment in Europe. Above all, the institutional framework for research investment needs to be improved in the following aspects:

- A better system for the protection of intellectual property rights on innovations;
- A high productivity of R&D, which itself requires a better education and research subsidy system;
- Low interest rates as R&D investments are forward-looking; this in turn calls for a stable macro economy;
- Product market competition, low entry costs, and market openness to stimulate innovation by incumbents;
- Good access to risk capital by new start-up companies;
- More flexible labour market institutions, so that new innovators can quickly find workers that match their new technologies.[36]

Europe is by and large an innovation-driven economy and its future is becoming increasingly dependent on the quality of higher education. If we consider patents as a partial measure of R&D output, it can be stated that Europe's output is far from reaching the level of US.[37] However, one should be aware that the patent is, in many cases, too simple a measurement for tracing differences in technological systems. It is a measurement that does not in any way capture the outcome of an innovation system. In studies concerning different countries' innovation systems, researchers have now placed greater focus on how human resources are created by education, the employment market and 'learning by doing'. International organisations such as the OECD have not paid sufficient attention to how the knowledge-based economy is affected by the performance of national systems. The focus has remained on easy-to-measure indicators such as R&D and patents. Tacit, embodied and organisation-embedded knowledge are, according to Bengt-Åke Lundvall, the most important elements behind national competitiveness.[38]

2.2.3 Environment and growth

Europe is moving towards fulfilling sustainable growth. Therefore, the integration of environmental considerations into the strategy of growth is necessary in order to avoid damage. The Lisbon strategy reflects Europe's commitment to the environment and how it is a source of competitive advantage in global markets and increased competitiveness. The choices of policies are not easy because the balance between economic, social and environmental questions have to be considered. Earlier, we highlighted the importance of

[35] Sapir A., *An Agenda for Growing Europe: Making the EU Economic System to Deliver*, Report 2003, p. 29
[36] Ibid, p. 30
[37] Ibid, pp. 30-34
[38] Lundvall B-Å., *Innovation Systems between Policy and Research*, Innovation pressure Conference, 2006

innovation for growth, and one way that this can be achieved is by promoting eco-efficient innovations. At the forefront is the creation of innovations that lead to less resource-intensive products, less pollution and more efficiently managed resources. Europe has the opportunity to develop eco-efficient innovation within agriculture, healthcare, electronics, energy, transport and chemicals. However there are still several market barriers which hinder progress in this field.[39]

More needs to be learned about how to combine short-term and long-term objectives and how to balance environmental objectives with ambitions of growth and employment. A well-informed decision is when economic, social and environmental questions are considered in the context of the Lisbon strategy. The EU has ambitions to follow the same path as before and continue with its strategy to be the world leader in environmental matters, without ignoring the impact this will have on growth. It is always a risk that environmental considerations are not seen as important aspects in the future growth of countries. Europe needs to formulate growth policies that use the right assessment tools for making environmental strategic decisions in both the short and long term. Above all, Europe must pursue the long-term objective of increasing energy and resource efficiency. Increasing energy efficiency and further developing alternative energy sources will not only help to reduce oil-dependence but could also serve EU competitiveness by reducing the energy bill.[40] In this area, growth will not be achieved by further deregulation of the market. The Sapir report states the following:

> *"The above actions can be supported by the continued improvement of the environmental policy toolkit in order to promote better regulation. The new approach to environmental policy that the EU and Member States have adopted in recent years needs to be continued. Such an approach consists of setting long-term targets without prescribing the technological means to achieve these targets."*[41]

Currently, thorough research has not yet been carried out within the areas of environment and growth and more knowledge is needed. The relationship between the environment and economic development is complicated and it is difficult to obtain reliable data. Hence, research in this area has not yet reached a consensus on the relationship between growth and environment.[42] Environmental issues have acquired further topicality in connection with the latest climate report from the UN (2007).[43]

2.2.4 Institutions and growth

One major, multi-dimensional source of growth is the institutional framework. The term "institutions" refers to the formal rules, informal constraints and their enforcement characteristics that together shape human interaction.[44] There are five key institutions: property rights, regulatory institutions, institutions for macro-economic stabilisation, institutions for social insurance and institutions of conflict management. Institutions such as these may have a direct impact on economic growth; however they often affect other

[39] Ibid, p. 35f
[40] Ibid, p. 37f
[41] Ibid, p. 38
[42] Boschini A. & Eriksson R., *Den europeiska tillväxtdebatten*, SIEPS 2005:11, p. 36
[43] *Climate Change 2007: The Physical Science Basis. Summary for Policymakers*, Contribution of Working Group 1 to the Fourth Assessment Report of Intergovernmental Panel on Climate Change
[44] North, D. C., *Institutions, Institutional Change and Economic Performance*, Cambridge University Press, Cambridge, 1990

determinants of growth indirectly, i.e. investment, human or physical capital. Normally, institutions are effective in promoting growth when it reduces uncertainty. Transaction costs decrease and it is easier for a country to attract investment or human capital. The most commonly used measures of the quality of institutions are the rule of law and bureaucratic quality, government repudiation of contracts, risk of expropriation and corruption.[45] Researchers have recently measured the quality of the institutional framework based on a number of variables. The results show a positive relationship between economic growth and lower macro-economic volatility, security of contracts and intellectual property rights. All these studies have affirmed a strong correlation between institutions and economic performance.[46]

In addition, new research shows the importance of factors such as higher entry costs and a lower level of turnover for explaining the lower productivity in Europe compared to the US.[47] The difficulties lie in the fact that the EU consists of many different countries with shifting histories and different public authority cultures.

One of the problems is that administrative burdens are high in Europe and this decreases the industries' opportunities to profit and promote their innovations. In Europe, the innovative industries require quicker access to the market for improving their returns on their innovation. If we also consider the difficulties that some European countries have to catch up with the technology frontier of other countries, it has been found that the lower the entry barriers, the faster the process of catching up with best-practice technologies in manufacturing industries.[48] Hence, it is essential to create an institutional framework in all European countries that lowers the entry barriers for innovative markets.

Economists agree that institutions are an important factor for economic growth. However, there is far less coherence across the analyses. Despite this, there is a widely shared agreement that focusing on institutions deepens the analysis of growth and it has an effect on other key factors such as technological advancement, education, resource allocation and physical capital formation. They also agree that institutions influence the ways in which economic actors get things done. A transaction can be very costly and difficult if the institutional framework is not effective.[49]

2.2.5 Other sources of growth

The interest in new factors and their influence on growth is intensifying. Several social-cultural factors have been put under scrutiny, including ethnic composition and fragmentation, language, religion, beliefs, attitudes and conflicts. One problem is being able to judge the strength between these factors and growth. One example of the problems in predicting the outcome is the difficulty in estimating the impact of cultural diversity on growth. It can have a positive impact on business and cooperation but it can also create social conflict and uncertainty. However, at the moment there are researchers who believe that trusting economies are expected to have stronger incentives to innovate, to accumulate

[45] Artelaris P. & Arvanitidis P. & Petrakos G., *Theoretical and Methodological Study on Dynamic* Growth: Regions and Factors Explaining their Growth Performance, Dynreg no. 1, 2006, p. 14
[46] Ibid, p. 15
[47] Schiffbauer M., *Theoretical and Methodological Study on the role of Public Policies in Fostering Innovation and Growth*, Dynreg no. 4, 2006, p. 26
[48] Sapir A., *An Agenda for Growing Europe: Making the EU Economic System to Deliver*, Report 2003, p. 37
[49] Nelson R., *Technology Institutions, and Economic Growth*, London 2005, p. 152f

physical capital and to exhibit richer human resources. Hence, new indicators have been used to capture trust, civic standards and cultural attitudes which promote growth.[50]

Geographical influences are also a source of growth. These include natural resources, topography and climate. Geography has an effect in many areas such as transport costs, competitiveness and productivity. Researchers have also stressed the importance of the relationship between demographic trends and economic growth. Population growth, population density, migration and age distribution are the demographic variables which mostly affect economic growth.[51]

If we compare the EU with the US, demographic trends are more favourable in the US. However, this cannot be seen as the main explanation for the growth differential, but it is a more observable problem in Europe and affects the future labour market.[52] The Member States have to secure this shortage of labour in the future through non- EU immigration, which means that growth is dependent on successful inclusion of migrants and ethnic minorities in society, especially on the labour market.[53]

In the debate on growth from the1990s and beyond, demographic factors are increasingly discussed within Europe. The ageing population and the decrease in the ratio of the population of working age to total population are having a negative effect on production capacity and income tax revenues. This is also increasing the State's pension and healthcare expenditure.[54]

We may also mention economic policies, macro-economic conditions, government fiscal policy and financial systems. It seems that favourable macro-economic conditions are necessary but not sufficient for economic growth, especially as they reduce uncertainty. Inflation is one key determinant for creating economic stability and in the long term promotes growth. If we look closely into economic policies, they influence several aspects of an economy through investment in infrastructure, human capital, trade policies, improvement of political and legal institutions etc. Government fiscal policy influences the tax burden and budget deficits. An effective financial system is also significant for increasing economic performance. These macro-economic factors have a major impact on savings, private capital accumulation and investment. Finally, openness to trade is a major determinant of growth performance. Openness affects economic growth through technology transfer and diffusion of knowledge, increasing scale economies, exposure to competition, and exploitation of comparative advantage.[55]

How is trade central to European growth? It can be stated that the single market has led to an increase in trade of 40 percent within the EU between 1992 and 2002. There is no doubt about the positive relationship between growth and trade. Countries, which are characterised by free trade, have much larger GDP per capita than other countries. There are no

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[50] Artelaris P. & Arvanitidis P. & Petrakos G., *Theoretical and Methodological Study on Dynamic Growth: Regions and Factors Explaining their Growth Performance*, Dynreg, no. 1, 2006, p. 17; Putnam R., *Den fungerande demokratin: Medborgarandans rötter i Italien*, SNS, Stockholm, 1996

[51] Ibid. p. 18-19

[52] Sapir A., *An Agenda for Growing Europe. Making the EU Economic System to Deliver*, Report 2003, p. 26

[53] Commission of the European Communities, *Facing the Challenge: The Lisbon Strategy for Growth and Employment*, Report from the High Level Group, Chaired by Wim Kok, November 2004, p. 34

[54] Boschini A. & Eriksson R., *Den europeiska tillväxtdebatten*, SIEPS 2005:11, p. 36-37

[55] Artelaris P. & Arvanitidis P. & Petrakos G., *Theoretical and Methodological Study on Dynamic Growth: Regions and Factors Explaining their Growth Performance*, Dynreg, no. 1, 2006, pp. 11-13

mixed opinions among researchers about such a positive relationship. Trade is fundamental for a country's growth.[56]

2.2.6 Growth performance in Europe

The EU has achieved a great deal throughout the last decades, but in terms of macro-economic performance, figures have been disappointing both in absolute terms and with regard to the US. Despite far-reaching reforms, which have led to lower inflation, consolidation of public finances and the single market programme, growth has not been at a satisfactory level.[57] Oliver Blanchard has a more positive analysis of Europe's performance than for instance André Sapir. However, he confirms that unemployment is very high in many European countries and that Europe clearly suffers from inefficient regulation in financial, goods and labour markets. New reforms are taking place in Europe which causes political tensions. These tensions are not a reflection of immobility; they are a symptom of change. Blanchard analyses the differences in productivity between the EU and the US and finds that slower productivity growth in retail and wholesale trade are two of the main factors behind the difference between EU and US productivity growth in the late 1990s. To get an overview of these problems, we have to look closer at regulation and reforms in the product and financial markets. Much of the reform is continuing through the implementation of the competition policy. The question is how far deregulation has progressed throughout Europe.

The result of two studies shows that Europe remains more regulated than the US. But regulation has steadily decreased in Europe over time, especially during the 1990s. However, in some European countries, regulation has not led to an increase in the share of the most effective retail firms as it has in the US. It is important to take notice of the result of several studies which show how deregulation has had an influence on the level of productivity, the degree of competition and the behaviour of companies. The deregulation of the product and financial markets creates political tension and forces reforms in the labour market. This political instability can push policy reforms in the wrong direction, slowing down European growth performance. Oliver Blanchard concludes that we also have to consider the public sector. This remains ineffective in many countries. We should further highlight the quality of higher education, which is mediocre in many European countries.[58] As we mentioned earlier in this study, higher education is central to growth performance, especially for countries near to the technology frontier in their respective sectors.

2.2.7 Growth and inequality

The inequality within countries in the EU accounts for 90 percent of the total inequality. Hence, this inequality is more substantial than across countries. The total inequality within EU countries increased during the 1990s, which was a period of sluggish growth in Europe.

If we consider different periods, growth is an important factor in reducing inequalities within countries. If we compare inequalities across countries within the EU, the trend has been positive and inequalities have decreased steadily from the 1970s to 2000. A conclusion that can be drawn is that growth is an important aspect for reducing inequalities

[56] Boschini A. & Eriksson R., *Den europeiska tillväxtdebatten*, SIEPS 2005:11, p. 38f
[57] Sapir A., *An Agenda for Growing Europe: Making the EU Economic System to Deliver*, Report 2003, p. 25
[58] Blanchard O., "The Economic Future of Europe", *The Journal of Economic Perspectives*, no. 4, 2004, pp. 4-10, and p. 24

within countries. If we observe the reduction of inequalities across countries, it seems to largely depend on cohesion policy and implementation of the Single market.

Stimulation of growth within countries seems to be a major determinant in the reduction of inequalities both within and also across countries in the EU.[59] The aim of the structural funds is to reduce inequalities and stimulate growth within countries. For example, in Sweden, the structural fund's impact on a region's economic performance has been evaluated experiences limited effects.[60]

The Swedish regions welfare is at the average European level, if we do not include Stockholm. In Sweden, regional differences have grown. Sweden, France and Italy are countries which follow the same path, and regions within these countries are becoming more diverse. The structural funds are not all about re-distribution of resources to other regions, but more about supporting development where regions strengthen their own ability to use their own resources for creating more stable development on their own terms. Hence, the aim of the structural funds is not to reach a level where there are no regional differences. Instead, it is about supporting a region's own development on its own terms. If we consider all countries in the EU, the regional differences are very large. The regional differences in Sweden are small compared to other countries.[61] The results from the evaluation of structural funds in Sweden show no convergence between regions between 1990 and 1999. The differences are becoming larger over time and it is not easy in this case to see any redistribution effect from structural funds.[62]

2.3 Considerations for the future

Previous studies have shown that the policy measures of public authorities are significant instruments in stimulating growth and innovations. We cannot, however, start from the basis of any universal solution; rather there is a need to direct the focus towards a number of central growth areas. In order to achieve better results on the basis of a growth perspective, clearer priorities and guidance are required for where and how the investments shall be implemented. New knowledge on the development stages and specific conditions of countries are also required. The Member States of the EU possesses different prerequisites and there is, within the EU, an increased demand for shifting the investments towards measures that to a greater extent stimulate an innovation-driven growth.

There is support for the view that an improvement in physical and human capital benefits growth. However, variations in the growth rate cannot be explained by current measurable production factors. The big question is how much of the unexplained portion of the variation in growth rates can be ascribed to technological knowledge development or, for example, institutional quality which are also hard to measure. Regardless of the measurement difficulties, these factors are significant for growth. Quite a number of research reports indicate that institutions play an important role in national income development. The analysis of the causality is also problematic, with regard to many of these so-called growth sources. The causality is not unambiguous; rather it is frequently a

[59] Sapir A., *An Agenda for Growing Europe: Making the EU Economic System Deliver*, Report 2003, p. 63
[60] ITPS A2004:9, *Effektutvärdering av de geografiska målprogrammen inom EG:s strukturfonder*; ITPS A2007:003, *Förhandsbedömning av de operative regionala strukturfondsprogrammen;* NUTEK 2004:39, *EU:s strukturfonder – ett verktyg för regional utveckling*; NUTEK 2004:10, *Med näringslivet i fokus: Halvtidsutvärdering mål 2 västra*., NUTEK 2006:83, *Strukturfonder, entreprenörskap och företagandets villkor*
[61] NUTEK 2004:39, *EU:s strukturfonder – ett verktyg för regional utveckling*, pp. 17-19
[62] Ibid, p. 57, p. 71

question of a complex connection. This is to a high degree characteristic for a growth area such as the environment.[63]

One way of analysing the effects of growth at the EU level is to attempt to identify 'trade-offs' or so-called complementary factors that exist between for instance growth, stability and solidarity, economically and socially (cohesion). Another way of analysing the EU's development is to investigate how these positive trade-off effects can be further strengthened in future. How can we achieve higher growth within a broader EU? The stability that has been achieved within the EU at micro level has been a significant factor in creating better preconditions for more rapid growth in the future. There exists a complementary interaction between increased stability and growth. However, it is hard to estimate exactly how significant it has been for growth within the EU.

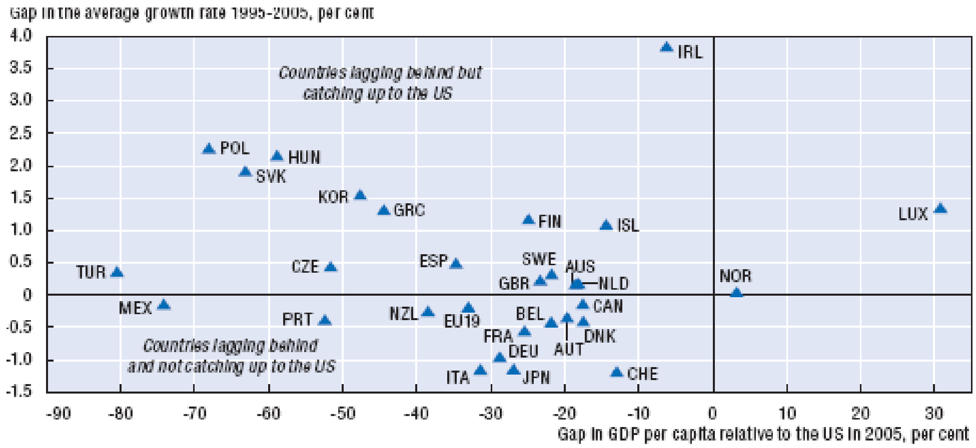
The focus is directed on another form of complementary interaction, i.e. between growth and cohesion. Here, there have been difficulties within the EU in creating a favourable trade-off. The growth that has arisen due to increased market liberalization, integration and agglomeration effects has been reduced with the aid of policy measures focused on redistributing resources within the EU. The starting point for economic and social cohesion has been what is perceived as socially acceptable at EU level. On the basis of the Sapir Report, it has been claimed that this complementary interaction has not functioned in all situations. Some of the policy measures carried out at EU level to strengthen the goal of cohesion have not been properly designed and have counteracted necessary regional specialisation. This has been negative for growth.

Up to a point, investments in infrastructure for instance, are effective in promoting growth. However, at some point returns are diminishing. In the new Member States of the EU after 2004 the regional disparities were in fact less than within the EU 15 area. Since joining the EU, these countries are likely to get larger regional disparities due to dynamic growth effects. In the present situation, public investments supported by the EU may add to concentration effects, whereas competition for production factors is getting stronger within countries and among regions. Dynamic economies other than the large countries within the EU are signified by the success on key variables such as greater productivity in R&D, rapid increase of foreign direct investments as a share of GDP and successful reforms of the financial system.[64]

Figures 1-2 below compare GDP data on a sample of countries in relation to the U.S. Both diagrams reveal that few countries may compare themselves with the US. On average GDP per capita is lower than in the U.S. Statistics are based on 19 countries in the period 1995-2005. However, measured by labour productivity, a few more countries actually exceed the US. The inclination in Europe to choose leisure time over working extra hours is part of the explanation behind the slightly improved performance.

[63] Boschini A. & Eriksson R., *Den europeiska tillväxtdebatten*, SIEPS 2005:11, p. 39
[64] Artis, M. Banerjee, A. Macelino, M., *The Central and Eastern European Countries and the European Union*, Cambridge University Press, Cambridge, 2006

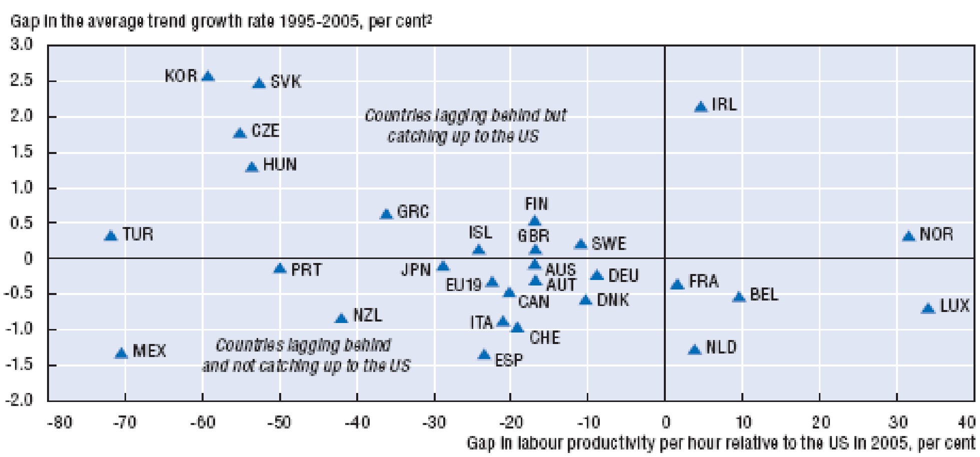
Figure 1 GDP per capita levels and growth rates: gap via-á-vis the United States



The average growth rate of GDP per capita is calculated on the basis of volumes data from national accounts sources. The level of GDP per capita is calculated on the basis of 2005 PPPs. In the case of Luxembourg, the population is augmented by the number of cross-border workers in order to take into account their contribution to GDP. Data for Greece do not take into account the 25 per cent upwards revision to the level of GDP announced in 2006.

Source: OECD, *Economic Policy Reforms: Going for Growth*, 2007, OECD, Paris, p. 4

Figure 2 Labour productivity levels and growth rates. Gap vis-à-vis the United States



1. The average trend growth rate of labour productivity, measured as GDP per hours worked, is calculated on the basis of volumes data. Data for Greece do not take into account the 25% upwards revision to the level of GDP announced in 2006.
2. 1998-2005 for the Czech Republic, 1995-2004 for Mexico and Turkey; Poland is not included in the EU19, due to missing hours data in 1995.

Source: OECD, *Economic Policy Reforms: Going for Growth*, 2007, Paris, OECD p. 19

The main explanation behind weak growth in Europe can be put down to problems on the supply side within the EU. There still remain obstacles that hinder integration with the EU's labour and financial markets. The Sapir Report highlights the fact that the institutional framework is not sufficiently developed to carry out the necessary structural reforms in order to create a competitive, dynamic and innovative European economy. This leads to the conclusion that Member States must prioritise higher growth targets, not only because they lead to higher incomes. A more competitive and dynamic economy is required to finance a higher level of cohesion within the EU.[65] The Sapir Report draws the following conclusion:

> *"While it would be important to redesign cohesion policies at both the EU and national levels to address better the adverse consequences of such policies for growth, and while some features of the current macroeconomic policy setting in EMU should be revised to favour growth while maintaining stability, these measures would achieve only limited results if not complemented by decisive microeconomic policies aimed at expanding the growth potential."*[66]

The question is how Member States within the EU succeed in implementing economic policy measures in future. This is regarded as a critical factor in getting the European economy to perform better. Economic governance is a question of emphasising the broad processes of policy creation on the part of public institutions and private players. These constitute a hub of agents that influence the institutional preconditions for economic success in Europe. The enlargement of Europe contributes with an increased heterogeneity and the issue that becomes increasingly topical is whether it is possible to create a unified system of rules and procedures under such preconditions.[67] The EU's institutions have many different roles and their relationship with Member States is complex. The principal tension existing between the EU and the Member States is largely due to the gap that exists between goals and resources. Another complexity with EU is the inter-governmental negotiations that are taking place at the stage in the European Council and which requires consensus. At any point a country may threaten to withdraw from an approaching agreement and thereby jeopardize the entire EU budget process.

The Single Market has proved to be more difficult to implement than expected. The Member States have ended up in different positions in relation to the Single Market. Successes have been hindered by the large variation in methods of procedure, regulations and preferences. There has also been prominent criticism against attempts carried out to create a more unified system of regulations within the EU. The social and cultural differences between Member States contribute to limiting the possibilities of carrying out certain economic policy measures. 'Subsidiarity' is a solution that is offered for finding a compromise (trade-off) between the needs of the Single Market and the heterogeneity of different Member States, i.e. their need for taking account of and adapting themselves to their preferences (to be discussed more thoroughly later). This means that no agreement exists as to how these common principles shall be achieved.[68]

The perspective of subsidiarity may offer a picture of how the current EU mix of different centralised and decentralised policies affect national economic revenues and costs. An example of this twin-track principle and of how the demand for centralisation or decentralisation may be modified is shown clearly within the field of European education. The clear link between education and long-term economic growth has meant increased demands on centralisation within the area of education. The open coordination method has, however, not been regarded as effective and has contributed to new demands being made for supranational initiatives in the area of education during the period 2007-2013.[69]

[65] Sapir A., *An Agenda for Growing Europe: Making the EU Economic System to Deliver*, Report 2003, pp. 69-73
[66] Ibid, p. 74
[67] Sapir A., *An Agenda for Growing Europe: Making the EU Economic System to Deliver*, Report 2003, p. 75
[68] Ibid, p. 80-81
[69] Pelkmans, J., *Testing for Subsidiarity*, BEEP briefing no. 13, 2006, p. 18

The Lisbon Strategy has meant that the EU has succeeded in identifying, but also agreeing on central growth targets that are widely shared by the EU countries. It has also meant that a large part of the policy responsibility for finding effective measures for growth remains with the Member States. The need that exists to decentralise or centralise the control of such a process is open to discussion. The Sapir Report investigates whether it is possible to maintain that any of the economic failures within the EU are due to the way that development has been led within the EU.[70]

In the next section we will look closer at how the EU budget functions and some problems associated with it when it comes to the fulfilment of all the expectations which are connected to boosting economic growth.

[70] Sapir A., *An Agenda for Growing Europe: Making the EU Economic System to Deliver*, Report 2003, p. 85

3 The EU budget 2007-2013

The long-term budget for the EU for the period 2007–2013 shall be seen against the background of the critique that was put forward before its implementation. The economic growth record was one major weakness which was pointed out. Three priorities were expressed explicitly by the EU Commission:

a) *Promote sustainable development*. This includes the internal market and political issues on different spheres (economy, social issues, and environmental issues) targeting competition, cohesion and natural resources.

b) *Link to the political concept of union citizenship*, which includes freedom, justice, security and basic access to collective goods.

c) *Cutting out a well defined role for the EU as a partner on the global arena*.[71]

Various targeted goals are addressed under the flag of sustainable development – mainly social and political goals. However, all in all if possibilities for evaluation are set up as a prerequisite, the wide ambitions are narrowed down considerably. After all, the share of the EU budget which directly relates to economic growth is small. After a period of time, the Lisbon process limited its scope to two fundamental goals – employment and growth. It seems clear that the Lisbon process is the most ambitious attempt to put forth a policy for European competitiveness so far.

How is all this related to national policies? It could be said that the connection is evident in that competitiveness internationally requires adjustments at national, regional and company level. An actual decentralisation was beginning with the drift toward more responsibility of the nation-states within the EU. The so-called open coordination method recognized that budget adjustments were made under different social regimes. The method is applicable to a range of policy-fields – social security (art. 136-137, art. 144), pension system reforms (art. 140), information society (indirectly) and research and development.[72]

Since 1992, the budget policy has been coordinated by the growth and stability pact (GSP); the labour market is coordinated by the so-called Luxembourg process. With Lisbon, social inclusion and employment issues were included in national action plans. An obvious weakness is the lack of connection to any major programme within the EU.[73] These elements form a platform for interstate coordination of policies without any transfer of powers to any supranational body for policy-making.

Growth policy is not particularly coherent within Sweden, so it is not so surprising after all that coordination internationally is quite a challenge. The Financial plan is not perceived as a steering document in the eyes of stakeholders within the government.[74] After all, the Ministry of Finance is the major ministry responsible for policies within the policy-network established around growth policies. Its focus is predominantly based on macro-economic strategies and labour market policy. In contrast, at the regional level, proximity and regional networks are pointed out as decisive factors for growth and competitiveness

[71] SCADPlus, *Towards a new financial framework 2007-2013*, http://europa.eu/scadplus/leg/en/lvb/l34004.htm
[72] Borrás, S. & Jacobsson, K., "The Open method of co-ordination and new governance patterns in the EU", *Journal of European Public Policy*, Vol. 11, No. 2, April 2004
[73] Commission of the European Communities, *Facing the Challenge: The Lisbon Strategy for Growth and Employment*, Report from the High Level Group, Chaired by Wim Kok, November 2004
[74] Pierre, J.," En samlad tillväxtpolitik?", *Tillväxtpolitisk utblick*, nr. 3, december 2004

which implies a somewhat different agenda. Despite this it is stressed that growth policy is a concern mainly for the states among some governments. The other ministry with a strong stake in growth policy is the Ministry of Enterprise, Energy and Communication. The ministry reform of 1999 paved the way for a broad Ministry which ideally would build a platform for a more coherent growth policy. In sum, the Ministry of Finance continues to have the most obvious coordinating function, while other areas are handled elsewhere – industrial policy, education policy, research policy, trade policy, infrastructure policy, labour market policies, and regional policy. A growth policy must at least comprise three ingredients – promotion of investments, new technology and education.[75]

3.1 Need for a modern budget

The concept of the modern budget is far from self-evident. A reasonable interpretation is that the future budget ought to be more growth-oriented, i.e., growth oriented in terms of investments and better in correspondence to economic growth and opportunities evaluation.

It is not a particularly daring proposition to assume that a modern budget will have to cut down on the ambitions within the frame of agricultural and EU structural policies. According to established theory, a budget should concentrate on expenditure where welfare gains may be achieved by centralising the financial powers.[76] Traditionally, three functions should be fulfilled in a conventional budget:

- Allocation of resources
- Redistribution of resources
- Macroeconomic stabilisation

It has to be said that the functions of the EU budget are very limited in comparison to national budgets. Financial policies are not in the domain of the EU; its stabilisation function is therefore extremely limited. As already noted redistribution does take place within the EU budget, most obviously within the agricultural and structural policy. Strong limitations are put on supra-national policies since individual governments are occupied with calculating their net contributions to the budget each year and naturally what they get back from it. The net contributory countries, including Sweden, have urged for a ceiling on the GDI contribution to the budget in order to put a limit at a maximum of 1 percent of GDI. In the current long-term budget for 2007–2013, the ceiling was finally fixed at 1.048 percent of GDI, after approval of the EU Parliament.

Only a limited share of the budget is obligatory and therefore excluded from the competence of the EU Parliament. In summary, the budget is constantly exposed to attempts to cut down on national contributions, at the same time as national governments are inclined to get the most back from the budget to finance adjustment and structural changes of their own economies. The situation leads to deadlocks in negotiations, openings for package deals and arguments.

There are a number of existing targets which may be evaluated: a) economic growth, labour productivity, employment, competence of the workforce, growth-oriented

[75] Lau, L. J., "The Sources of Long-Term Economic Growth: Observations from the Experience of Developed and Developing countries", Landau, R. Taylor, T. and Wright, G., *The Mosaic of Economic Growth*, Stanford University Press, Stanford, California, 1996
[76] Musgrave, R. M., *The Theory of Public Finance*, McGraw Hill, New York, 1959

investments, sustainable public finances.[77] If we stick to these quite narrow goals, it makes growth the primary objective. The lion's share of the convergence goals is not related to the agricultural policy, which in fact has drifted away from being a production subsidy to become a general support for rural development, increasingly with individuals as the beneficiaries.

The expenditures under objective 1a and 1b in the EU budget have a more obvious link to growth policy. Although redistribution as indicated above is a natural ingredient in a budget, it is not necessarily a part of growth policies, at least in a narrow sense. Under heading 1a, leeway is provided for EU efforts within sectors such as research, education and Trans European Networks (TEN).

However, it is evident that efforts made to speed up or soften the consequences of growth, also belong here. Therefore, goals under heading 1b are included in the growth policy perspective, on good grounds – cohesion and welfare are objectives which cannot be left out of the analysis.

Structural policy and promotion are adequate terms for describing these goals. An analysis of growth policy and structural funds within the same framework uncovers different regulation styles. Growth may be promoted both by de-regulation and re-regulation, whereas structural policies at least within the institutions of the EU without exception are associated with expenditures. At a national level, it is obvious that, for instance, competition policy which aims to establish fair competition requires regulations to deal with national monopolies and oligopoly behaviour that are natural ingredients in growth policy, but are not necessarily associated with any increases in expenditures.

Centraalplan bureau (CPB) in the Netherlands has concluded that an application more in favour of re-nationalisation may lead to a reduction of the budget by half.[78] For instance, as CAP has been disconnected from production and transformed to a question of rural development, there are opportunities to renationalise agricultural policy and large portions of the cohesion fund. Since there is no connection to the individual landowner's economy, this support may as well be brought into the realm of national policies it is argued.

The Sapir report has in the same vain branded the EU budget a historical relic. The report gave a rather harsh view on this point. For the purpose of simplification, the report proposed a reform towards fewer and more outspoken growth objectives. A particular fund for growth (including research), a convergence fund including expenditure for structural policy outlays with a focus on the Member States, and an objective to support businesses in their adjustment to global competition. Any particular compensation would be unnecessary beyond how other industries are treated.[79] This radical proposition would decrease the agricultural expenditures from 40 percent at present to about 15 percent of the total budget. The argument on regions follows along the same lines. Thus, it might be argued that wealthy countries possess sufficient resources to support their own lagging regions within the national policy-framework. However, within the frame of inter-governmental negotiations propositions arguing along these lines are highly unrealistic.

The general standpoint of the Swedish government seems to call for an effective and restrictive budget policy. Sweden wants to see modernisation of the contents of the EU

[77] Allianz Dresdner Economic Research, *European Growth and Jobs Monitor: Indicators for success in the Knowledge Economy*, The Lisbon Council & Allianz, http://www.lisboncouncil.net/media/europeangrowthjobsmonitor.pdf
[78] Gelauff, G. Stolwijk, H. and Veenendaal, P., *Europe´s financial perspectives in perspective*, CPB Discussion Paper 101, 2005
[79] Sapir, A. et al., *An Agenda for a Growing Europe: The Sapir Report*, Oxford University Press, Oxford, 2004

budget in the direction of a greater focus on growth-promoting measures such as R&D, increased efforts in the field of global partners, and also a decreased emphasis on the common agricultural policy.[80] The national budget reveals that the Swedish government sets off payments for the EU to the total amount of 28.066 million Swedish Kronor. The returning flow of resources amounted to 12.845 million (SEK) in the year 2006 and consists mainly of financing of agricultural subsidies, payment from the fisheries fund, regional policies, the social fund and financing of Trans European Networks (TEN).[81] The Swedish government has expressed concerns that the EU will have to concentrate its efforts on a limited number of issues of a genuinely trans-border nature in order to become more effective.[82]

3.2 The revenue side

The EU has had its own resources since 1970 enabling it to play a decisive role in European politics. Incomes are derived from customs duties, levies from agricultural products, and a set fee based on the value added tax (0.3 percent from 2007). In addition, a levy based on GNI amounts to slightly above one percent in each country constitutes a major share of the budget. The sugar levy on surplus production, charged at the EU external borders is also included in the EU budget.

The largest share of income is made up of the value added tax, around 70 percent of the revenues. The current trend reveals that the share of the GNI-based fee is increasing which is why several states wish to put a ceiling on it. Over the years, the significance of the value added tax has decreased. It has fallen as a share of total national revenues from tax from one percent down to 0.5 percent between 2002 and 2004.[83] The ceiling on outlays in the Member States is set to 1.24 percent of GNI within the entire EU area. A fixed maximum percentage on the net-receiving countries concerned is set at 4 percent of the GNI. Only 9 out of 25 Member States were net contributors to the budget in 2004, all the others were net receivers.

3.3 The expenditure side

With its origins in the treaty of Rome, article 40, the Agricultural Guidance and Guarantee Fund – later CAP (Common Agricultural Policy) was added to the budget and with that, redistribution of resources was added as one of the functions of the EU budget. Following up on the MacDougall report[84] in 1977, a second type of expenditure was added in the form of structural reforms in 1988 with the purpose of compensating regions lagging behind in economic development. The redistribution effect of CAP is strongly questioned due to its one-sided focus on agriculture without any regard to their overall economic situation. Eventually, CAP has come to abandon its previous links to production and has turned into a more or less individual income support without any closer link to individual needs.[85]

As a side-effect of enlargement of the number of Member States further expenditure has been added in order to compensate for the increased exposure to competition. However,

[80] Regeringskansliet, http://www.regeringen.se/sb/d/2582/a/12257
[81] EU-upplysningen, *EU:s budget 2006 och Sveriges avgift och återflöde*, 2006
[82] Regeringskansliet, http://www.regeringen.se/sb/d/8602/a/79107
[83] Widgrén, M., *Budget Allocation in an Expanding EU: A Power Politics View*, SIEPS 2006:11
[84] MacDougall, G., "Report of the Study Group on the Role of Public Finance in European Integration", *European Commission and Finance Series*, 2 vols., General Report, Brussels, 1977
[85] Widgrén, M., *Budget Allocation in an Expanding EU: A Power Politics View*, SIEPS 2006:11 p. 21

not more than 20 percent of the expenditure in the budget is general for the entire EU and is not country-specific.

3.3.1 Headings in the budget

In the budget, the objective **Competitiveness for growth and employment (heading 1a)** devote resources to growth related issues (see Table 1).

Table 1 EU Budget 2007–2013 (Euro, million, 2004 prices)

	2007	*2008*	*2009*	*2010*	*2011*	*2012*	*2013*
Commitment appropriations							
Sustainable development	**54 905**	**56 736**	**59 197**	**61 144**	**63 601**	**66 640**	**69 678**
1a Competitiveness for growth and employment	9 418	9 847	10 769	11 750	12 974	14 239	15 490
1b Cohesion for growth and employment	45 487	46 889	48 428	49 394	50 627	52 401	54 188
Conservation and management for natural resources	**58 351**	**58 800**	**59 252**	**59 726**	**60 191**	**60 663**	**61 142**
of which Agriculture - market and direct aid payments	45 759	46 217	46 679	47 146	47 617	48 093	48 574
Citizenship, freedom, security and justice	**1 273**	**1 362**	**1 523**	**1 693**	**1 889**	**2 105**	**2 376**
EU as a global partner (b)	**6 578**	**7 002**	**7 440**	**7 893**	**8 430**	**8 997**	**9 595**
Administration (c)	**7 039**	**7 380**	**7 699**	**8 008**	**8 334**	**8 670**	**9 095**
Compensation (d)	**445**	**207**	**210**	**0**	**0**	**0**	**0**
TOTAL:	**128 091**	**131 487**	**135 321**	**138 464**	**142 445**	**147 075**	**151 886**

Comment: Budget shares in figures based on the first budget (2007) within the current multi-annual budget. Note that the figures above slightly differ from the Inter-institutional Agreement and financial framework (2007-2013) from 17 May 2006.

Source: European Commission*, General Budget for the European Union for the Financial Year 2007: The Figures,* February 2007

What is noticeable is the ongoing re-orientation of the budget towards more growth policy visible in the money the EU devotes to research. The resources available for research by the end of the period, in 2013, are anticipated to be 75 percent higher than in 2006. The following aims are inherent in this shift in emphasis.[86]

- Promoting the competitiveness of companies within a fully-integrated single market, and particularly industrial competitiveness, entrepreneurship, the growth of small businesses, the innovative potential, innovation, investment in information technology for public services, eco-efficient technologies.
- Stepping up and improving European research and technological development in order to create a European research area and to achieve the target of bringing public investment in research up to at least 1 percent of GDP. Financial aid for independent researchers, partnerships, networking between laboratories and the coordination of programs and policies are all essential elements within the given priorities space and security.
- Connecting Europe through EU networks: the cost of congestion is put at 1 percent of GDP, and improved connections could potentially add 0.23 percent to GDP. A list of 26 priority projects has been compiled for the period up to 2020, at a cost of 220 billion euros. The levels of funding will reach its peak in the period 2007–2013.
- Improving the standard of education and training, with a particular emphasis on mobility: The aim is for 3 million university students to benefit from this up to 2010,

[86] SCADPlus, *Towards a new financial framework 2007-2013*, http://europa.eu/scadplus/leg/en/lvb/l34004.htm

for 150,000 vocational trainees to take part in mobility schemes each year by 2013, for 10 percent of the school population to be involved in mobility schemes over the course of the program and for 50,000 adults to take part in lifelong learning schemes.

- Achieving the social policy agenda: this agenda, an integral part of the Lisbon strategy, combines legislation, the open method of coordination and social dialogue.

Under this heading, we find most of the expenditure that is normally associated with growth policy. It is notable that from the outset of the new multi-annual budget in 2007, the increase in expenditure compared to 2006 is up about 19 percent, which indicates a change in emphasis. The means devoted to the Lisbon Agenda are included under this heading.

The second building block in the budget plan concerns **Cohesion for growth and employment (heading 1b)**. In order to better adjust to the new priorities, the following points have been established.

- Convergence: efforts must be concentrated on the least-developed Member States and regions.
- Regional competitiveness and employment: this objective mainly targets the Member States and regions not affected by convergence, given that there will continue to be significant needs.
- European territorial cooperation through cross-border programmes.

Reformulation of the target fulfilment within the cohesion policy directed towards state level instead of regional level would considerably divert focus from regions to national governments. Such a reform would most likely satisfy both net contributing countries as well as receiver countries because it gives them more control. The doubling of the budget for the structural funds in 1988 was a side-payment to Spain, Portugal, Ireland, and Greece in return for continued commitment to the internal market that was at the time due for completion in 1992. “In other words, the budget came first, then the policy followed”.[87] From this starting point, it is not surprising that there are severe difficulties in getting a reorientation of policies to become more in tune with economic growth policy objectives. Empirical evidence suggesting that the EU structural funds have on average accelerated economic convergence between regions remains weak.[88]

An attempt to evaluate how the agenda for the cohesion fund should change the opinions expressed in the new Member States in the EU from 2004 was addressed.[89] The results are very interesting. Conclusions points to a range of prioritized goals. The intention is to move further in the direction toward a knowledge-based economy. Cross-border cooperation is also given high priority among the new Member States. This concerns both integration of labour markets, cross-border infrastructure etc. The study found evidence that regional convergence was low on the agenda of the new Member States. The country studies found more support for horizontal growth-stimulating measures, for instance human capital, R&D, institution building and cross-border cooperation more in line with a modern budget.

[87] Hooghe, L. *Cohesion Policy and European Integration: Building Multi-Level Governance*, Oxford University Press, Oxford, 1996, p. 7

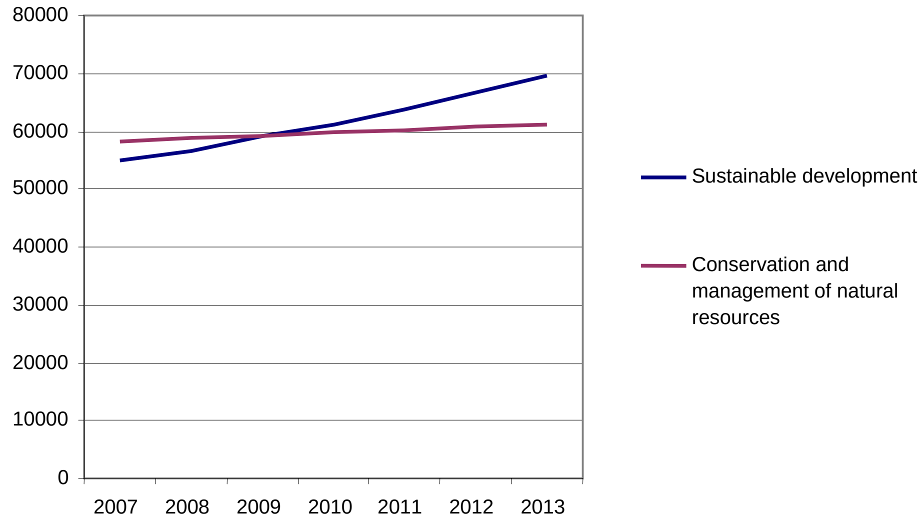
[88] Gros, D. and Micossi, S., *A Better Budget for the European Union: More Value for Money, More Money for Value*, CEPS Policy Brief, No. 66, February, 2005

[89] SIEPS, *From Policy Takers to Policy Makers: Adapting EU Cohesion Policy to the Needs of the New Member States,* SIEPS 2005:5

The second building block is entitled **Preservation and management of natural resources (heading 2).** Approximately 72 percent of the resources under this heading are earmarked for agricultural policy (CAP). In 2006, rural development policy was added and the new common fisheries policy (January 2003) for which the Commission proposes a simplification of the financial arrangements and structures. Environmental matters are also of great importance and the Commission suggests increasing funding in this area and is developing an instrument which would allow strict environmental measures to be taken.

Based on current preferences expressed in the EU budget, the CAP expenditure will decrease at a natural rate relatively to other main expenditures such as sustainable development (see Figure 4 below).

Figure 3 Expenditures on two different objectives in the EU budget 2007–2013 (million Euros at 2004 prices)



Comment: Sometime during 2009 objective 1 – sustainable development is scheduled to surpass objective 3 – Conservation and management of natural resources according to the Financial Perspective.

Source: European Commission*, General Budget for the European Union for the Financial Year 2007: The Figures,* February 2007

During the current multi-annual budget for the period 2007–2013, CAP is estimated to decrease from the present share of 45 percent down to approximately 37 percent.[90] Somehow, this development will be instrumental in achieving a more growth-oriented budget. Based on the budget outcome for 2007 the expenditures under this heading will be passed by sustainability heading somewhere during 2009 everything else being equal. However, the proposed budget for 2008 indicates that spending on growth and employment policies increases by plus 4.2 percent compared to 2007, to reach 44.2 percent of the budget, against 43.6 for the protection and management of natural resources,

[90] Pelkmans, J., *Testing for Subsidiarity*, BEEP briefing no. 13, College of Europe, Bruges, February, 2006, p. 24

including the Common Agricultural policy.[91] The occurrence of common expenditure within education and R&D is likely to benefit from a drift away from both CAP and the cohesion fund. The increased attention paid to education and R&D is favoured by the slow adjustment away from the expenditure linked to the expenditure on CAP and Cohesion for which relevance to economic growth is not always entirely clear.

The next heading is **Citizenship, freedom, security and justice (heading 3).** This heading proposes reinforcing the EU as an area of freedom, security and justice through a simplified structure based on three framework programmes ("Freedom of movement and solidarity in the area of external borders, asylum and immigration", "Security" and "Justice and fundamental rights") which would replace all the existing instruments. Management of the funds would be largely shared by the Member States. In the first framework programme, the Commission proposes the creation of an Agency for External Borders and expects Europol, Eurojust and the European Police College to become EU bodies.

This heading also proposes actions and programmes to ensure access to basic goods and services and to foster European culture and diversity, and the creation of solidarity and a rapid reaction instrument.

The European Union as a global partner (heading 4) The emphasis will be placed on the need for the EU to achieve a level of political influence commensurate with its economic influence, so that, in its region and beyond, the EU can be active not only in economic and political areas but also in areas such as promoting stability, conflict prevention and crisis management. As a partner in sustainable development, the EU sets out to fight poverty, pursue the millennium development goals set by the United Nations and promote common positions that will give coherence to multi-lateral negotiations. As a global player, it must work for effective multilateralism and contribute to security in the region. There must also be greater coherence in bilateral relations and international institutions by establishing a single policy framework.

For this heading, the Commission proposes a drastic simplification of instruments, based on coherence and the importance of the results in relation to the attribution of resources. In the new architecture proposed, three instruments directly support European external policies: the Pre-Accession Policy (IPA), the European Neighbourhood and Partnership Instrument and the Development Cooperation and Economic Cooperation Instrument, which will be the main means of cooperation with other non-EU countries not covered by the first two instruments.

With a view to responding to crises and to certain regional or international problems, the Commission proposes three further instruments: the Humanitarian Aid Instrument, the Macro-Financial Assistance Instrument (MFA) and the Instrument for Stability. The Instrument for Stability would also be used to address trans-border challenges such as the war against terror and trafficking, to promote nuclear safety, to provide electoral assistance and to develop the peace-keeping capacity.

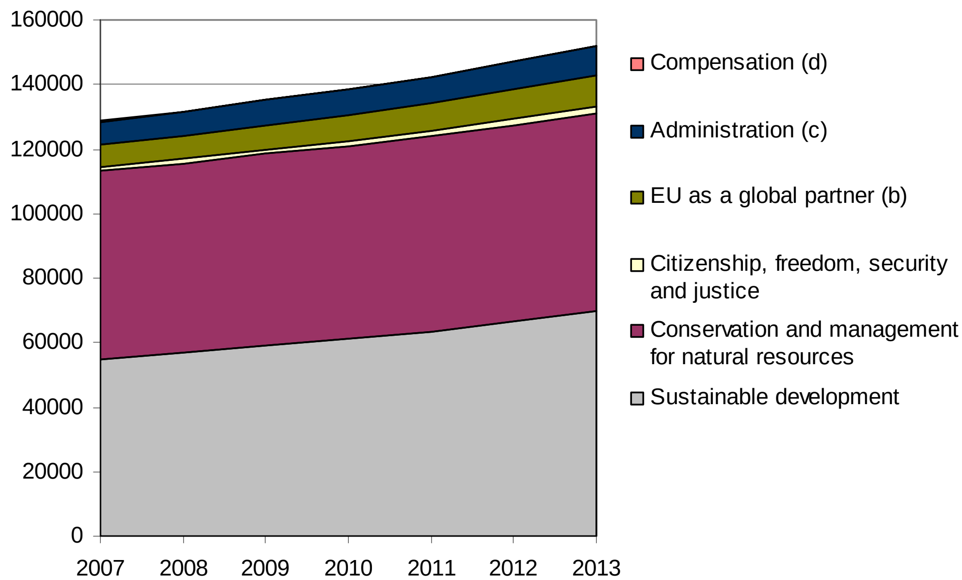
Administration (heading 5) sums up the administrative costs for the European institutions and its personnel.

[91] European Commission, *Proposed Budget 2008: Growth and employment at the heart of EU spending,* http://ec.europa.eu/budget/budget_detail/next_year_en.htm

Under the heading **Compensation (heading 6) resources** are earmarked for the enlargement. However, they will be phased out from the budget already within three years (see Table 1 above and Figure 5 below for an orientation on total budget shares).

Figure 5 confirms a very slowly changing budget because of its many inherent conservative elements. Mostly expenditures are best predicted by the share of the budget in the previous year. To depart from this pattern radical changes has been proposed by some scholars speaking in favour of a zero sum budgeting view at least on the long term budget.[92]

Figure 4 Shares of various expenditures in the EU Budget 2007–2013 (millions of Euros, in 2004 prices)



Comment: All objectives in the budget and their relative shares over time. The picture reflects that the EU budget is only slowly changing character.

Source: European Commission, *General Budget for the European Union for the Financial Year 2007: The Figures,* February 2007

[92] Tarschys, D., "Agenda 2014: A Zero-Base Approach", Unpublished paper presented at Notre Europe, Seminar, The EU Budget: What For?, 19 April, Brussels, 2007

4 Guiding principles for policies financed by the EU budget[⊗]

There are continuously stronger demands in place in order to judge if the EU level is appropriate for problem-solving. Guidance for how the EU policy may be motivated in the narrow sense is provided by three main criteria which are possible to evaluate.

- Effectiveness: some results may solely be achieved by efforts at EU level.
- Cost-efficiency: measures at EU level may prove more profitable
- Coordination: EU measures stimulate, complement and trigger coherent actions and policies

However, there are more fundamental principles for EU policies in general to which *all* interventions by the EU budget should be subordinated. These are the subsidiarity, additionality, proportionality and the value for money principles. The first two are enshrined in the treaties and rules of the European Union. The second two are based on the clear need to avoid waste in a budget with strong financial limitations. In addition, two guiding principles that should be followed are targeting EU public goods and creating European value added.

According to the literature, the EU budget expenditures should adhere to certain fundamental principles enshrined in the treaties or determined by rational analysis, those are:

- Subsidiarity
- Proportionality
- Additionality
- Value for Money

In addition, all policies and specially those aimed at fostering growth should:

- Be aimed at European public goods
- Should create a value added at European level

Subsidiarity

Though the distribution of competence between the EU-level and the Member States is a sensitive issue we cannot disregard the dividing line between these two tiers. The purpose of the usage of the principle of subsidiarity is devoted to solve the distribution of powers whenever competences are shared between the Member States and at EU level. According

[⊗] The analysis in Chapter 4 is mainly based on a draft report by Núñez Ferrer, J., “EU budget and policy reforms in order to promote economic growth”, Final Draft for submission, CEPS, 2 May 2007 (Unpublished paper prepared for the Swedish Institute for Growth Policy Studies – ITPS) to article 5 in the treaties (Amsterdam treaty), the Community may take initiatives under the subsidiarity principle only as far as sufficient measures cannot be afforded by the Member States and undertakings can be better handled by the Community because of the size of, or the scale of the effects. Normally, reasoning along these lines results in decentralisation, more often than not in favour of the transfer of responsibilities to the Member States.

The Maastricht Treaty of 1992 has already clearly spelled out the first characteristics of any EU policy or budget item, it should be ruled by the principle of subsidiary, i.e. the EU should only act when it is better suited to do so compared to lower levels of governance. The exact wording of it in the Treaty actually only imposes such rule for those areas in which the EU does not have exclusive competence, to allow the Member States the freedom to confer to the EU competences where this principle is violated, such as for agricultural policy.

Jacques Pelkmans has developed several criteria for testing the principle of subsidiarity in a functional manner. The major conclusion is that the concept which has support in the treaties may be used for both centralising and decentralising purposes. In areas of shared competences, the Community must demonstrate a need to act in common, as given by existence of either economy of scale or cross-border externalities. Secondly, any action must be proportional to the desired objective. The principle urges the EU to justify its quest for greater competence on a case-by-case basis so that only necessary to attain an objective should be carried out at "central" level.[93]

Basically, if cooperation cannot be achieved, or be credible, there is a case for centralisation. The subsidiarity test can derive assignments at EU level in five steps as follows:

1 Identify whether a measure falls within the area of shared competences (if it is exclusive to the Community, the test does not apply).

2 Apply the criteria by asking if there are scale effects speaking in favour of action and/or externalities further strengthening the arguments for action (art. 5 of the Amsterdam treaty). The occurrence of cross-border externalities is a major reason to act. For instance, this may appear if the positive effects resulting from the actions of region A are restrained by the positive effects that the action has on the policy objectives of region B. A negative externality occurs whenever a measure taken by region A is taking place at the expense of the welfare of region B.

3 The next step in the test is to verify if credible cooperation is feasible. If cooperation cannot be achieved either because it is impossible to monitor effectively at other levels or there is insufficient compliance with the objective there is a ground for the EU level to act.

4 If 1 and 2 are confirmed, and 3 denied, then the assignment is appropriate at EU level.

5 Finally, define to what extent (proportionality) implementation, monitoring and enforcement should be assigned at EU level, or, indeed, can be assigned to the Member States, perhaps in a common framework.[94]

[93] Pelkmans, J., *Testing for Subsidiarity*, BEEP briefing no. 13, College of Europe, Bruges, February, 2006
[94] Ibid, p. 8

Proportionality

The principle of proportionality is a fundamental principle of European Union law. According to this principle, the EU may only act to exactly the extent that is needed to achieve its objectives, and no further. Based on estimates of the appropriate size and scale the principle of proportionality works as a guideline for building in limitations of the commitment at EU level in order to live up to the spirit of the treaties (Title III, Article 9 (4). Auditing, review and evaluation should wherever possible be in proportion to the size of the programs.[95]

This principle has ruled the European Union since its inception in 1957 and is explicitly mentioned in the proposed new Treaty establishing a constitution for Europe.

Additionality

This principle is restricted to the cohesion policy, but should apply throughout the budget. It states that EU financial intervention should not substitute for national funding which would have occurred in the absence of the intervention. EU funding should in any case not reduce aggregate national public spending through substitution.

Value for money

EU actions should be devised to be the cost-effective and should be regularly evaluated.

4.2 Criteria for EU responsibility

Two important principles are presented in Fiscal Federalism studies. These should be aimed for, but are listed separately, accepting that the EU may be required to act in areas where these are not fully applicable. However, they should be *central to all policies aimed at fostering growth*.

Financing EU public goods

Studies based on Fiscal Federalism argue that the EU budget expenditure should be restricted exclusively to financing European Public goods, which would be underprovided if left to lower levels of governance.

Value Added

The actions financed through the EU budget should create a value added. In economic terms, this means that the economic return in the recipient area after an investment of the EU should be higher than without the investment. This criterion does not require the overall welfare return at EU level to be higher after a transfer. This may be desirable but difficult to quantify and sometimes not possible, but should apply at least for the recipient area. The principle of additionality should be adhered to strictly.

For some policies, the value added may also not be quantifiable in economic terms, but substantial and important in political terms. This has to be taken into account, but in the case of growth oriented policies, where effective economic returns are to be maximised, such political criteria should not be applied in principle.

[95] SIEPS, *From Policy Takers to Policy Makers: Adapting EU Cohesion Policy to the Needs of the New Member States,* SIEPS 2005:5

4.3 What are the objectives of EU?

Scholars applying a fiscal federalism perspective have been inclined to define there own criteria when discussing distribution of competence between the state- level and the EU-level. One of the scholars[96] dealing with the issue has used the declarations in the EU treaty (Title 1, article 2) to determine the objectives of the EU. From the text, which is formulated in overall goals, one can summarize the main objectives as:

- Economic Growth
- Sustainable Growth
- Convergence
- External Security
- Internal Security

The present EU budget is a result of the past interpretation of the way to reach the stated objectives. The EU did not consider that growth oriented policies were the main domain of the budget. The budget concentrated on equity criteria, based on convergence ideas across regions and across sectors (the CAP). Growth was not considered until recently a domain for the budget, except in the area of convergence.

Similarly, the aspect of sustainability was neglected and environmental policy is underdeveloped, a policy which Fiscal Federalism considers in large part a collective good with important European wide externalities. The external and internal security seems underdeveloped today.

The CAP should in theory follow additional objectives of the treaty specifically devised for the sector (Article 33 of the Treaty). Even accepting the special place of agriculture, its policies are highly inefficient in reaching the objectives set.

Furthermore, while formally the CAP and Structural and Cohesion Funds address equity and convergence criteria, reality differs significantly. The redistributive nature of the policy with names or regions attached to funds has induced the Member States to decide the distribution of the funds based on a ‘pork barrel’ game. Member States compete for the funds and use the policies as a vehicle to maximize returns or minimize losses. The more the policies distance themselves from hard needs on the ground, the stronger the net balance arguments become. The latest negotiations on the Financial Perspective were described by some participants as a mathematical calculator competition.

There is a clear indication that the present EU budget concentrates on a very narrow part of the main objectives and this inefficiently (Table 2 below presents a list of the present policies and the financial share of the main components).

[96] Figueira, F., “How to Reform the EU Budget?: Going Beyond Fiscal Federalism”, paper presented at the Jean Monnet Conference on “Europe’s Democratic Challenges – EU Solutions?”, School of International Studies, University of Trento, Italy, 30 June - 1 July 2006, www4.soc.unitn.it:8080/dsrs/eudemocracy/content/e1374/e1455/e1464/

Table 2 Expenditure headings and instruments of EU budget and fund share 2007

EU Policy		**Share of budget**
Competitiveness	• Education and training	0.71%
	• Research	4.35%
	• Competitiveness and innovation	0.32%
	• Energy and transport networks	0.79%
	• Social Policy Agenda	0.16%
Cohesion	• Convergence	27.91%
	• Regional competitiveness and employment	7.11%
	• Territorial cooperation	0.87%
Preservation of natural resources	• Agricultural expenditure and direct aids	33.75%
	• Rural Development	9.80%
	• Environment	0.16%
Freedom Security and Justice	• Security policy, migration policy • Health and consumer protection • Rapid response	0.47 %
Citizenship	• Culture • Media • Public health and consumer protection	0.47 %
EU as a global partner	• Pre-accession instrument	1.03%
	• Neighbourhood policy	1.11%
	• Development cooperation	1.74%
	• Humanitarian aid	0.55%
	• Democracy and human rights	0.08%
	• Common foreign and security policy	0.16%
	• Stability instrument	0.08%

Comment: Some items do not have a subdivision in the budget information and were aggregated. This is because in fact there is flexibility between the subheadings and because these are very small amounts. The sum of all will not add to 100 percent because administration and some reserves are not included. Nevertheless, the figures give an indication about the various weights attached to each instrument.

Source: Núñez Ferrer, J., "EU budget and policy reforms in order to promote economic growth", Final Draft for submission, CEPS, 2 May 2007 (Unpublished paper prepared for the Swedish Institute for Growth Policy Studies – ITPS) and European Commission*, General Budget for the European Union for the Financial Year 2007: The Figures,* February 2007

For the past 30 years, the needs and the demands for a policy shift towards a greater concentration on growth, sustainable growth, internal and external security have increased. The Lisbon Agenda for growth calls for a prioritization of the first objectives, the Gothenburg declarations for a reinforcement of the sustainability. Calls for policies centred on security, such as a common immigration policy have also increased, and the EU is required to intervene more heavily in external aid and security operations. Most of the actions required need a financial backing, but the EU budget reforms have fallen short of the requirements and the financial allocations for several important priorities are nearly symbolic. The decision making procedures, the limitations in the budget size, and not least a mistrust in the efficiency of the EU institutions in handling the funds, have hampered the prioritization of four of the main objectives of the EU in the budget.

4.4 What to retain, what to add and what to scrap of the present budget?

Given the change in the balance of objectives in the EU, how does the present budget score on the present main objectives and what is the level of growth orientation? Should the present budget be scrapped and replaced, or is it just a question of reforms within budgetary headings?

As the EU has become a more solid entity with different challenges of an economic nature, the goals have shifted to economic objectives. For those, efficiency is of prime importance to reap economic benefits. Other policies regardless of their growth orientation should be efficiently devised and cost effective by nature. As mentioned in section 4 all EU policies should abide by some principles.

The following analysis will concentrate on the performance of the policies in achieving their objectives and if they are in tune with the principles for a European budget policy. The analysis will be more detailed for the policies with a larger budget in particular, agricultural policy and the cohesion policy.

4.4.1 Preservation of natural resources

The title of this EU expenditure heading is highly misleading, 76 percent is composed of direct aids to farmers, 22 percent mainly to farm oriented investments and agri-environmental policies and a pittance to environmental investments. Given the enormous priority of the environment for the future, it is rather unfortunate to see it having such little relevance. Due to the cross-border nature of pollution, environmental actions are quintessentially to be solved at multinational level. Even admitting that convergence policies and R&D have some environmental aspects, it is clearly not sufficient.

4.4.2 The Common Agricultural Policy

The Common Agricultural Policy (until recently the largest item in the budget – 36 percent for 2006) is the policy facing the greatest criticisms. Presently the few defenders of the present structure of the policy are mainly limited to the beneficiaries of the funds. Many of those sympathetic with a continuation of an agricultural policy consider the structure outdated and counterproductive. A considerable number of analysts and policymakers want the policy to disappear.

The CAP does in fact play a rather controversial role in the distribution of funds. The way it is designed it benefits the countries with the highest yields on specific products, and within these countries the largest and often wealthiest producers, as it overwhelmingly consists of direct payments per ha of land linked to historical yields. The highest yields are generally concentrated in the most developed countries. Also cattle are highly supported, and concentrate in specific countries. The most supported product mix benefits Western continental Europe in particular (and Ireland, also a large beneficiary due to the large cattle herds). In terms of per hectare and farmer support, countries such as Belgium, Denmark, France or Ireland are high beneficiaries, so much so that a prosperous country such as Denmark has been a net beneficiary of the budget until the year 2000 and Ireland is expected to remain so for the foreseeable future. The CAP strongly affects the distribution of the EU budget, and the incidence of the policy is considered largely responsible for the net balance disputes.

Calls for reforming the CAP have induced a series of reforms, but the difficulty of the decision-makers to address the problems without taking net balances into account, has left the financial incidence of the policy largely intact. New attempts to make it more environmental and growth oriented through rural development policies have been very inefficient and plagued by distributional rigidities. The national/regional incidence of rural development funds is even indirectly linked to the average historical yields of 1989 to 1991.

The Treaty of the European Union lists general objectives for the Common Agricultural Policy which is: to increase productivity of the agricultural sector, to ensure a fair standard of living for farmers, to stabilise markets, to assure availability of supplies and to ensure prices are reasonable for consumers. Price support and direct payments (market support mechanisms) are the main vehicles to address these objectives.

From the outset the policy was ill-conceived due to two aspects. First, it was claimed to be a rural policy, ignoring that rural areas are not the exclusive domain of farmers. Second, it introduced one of the most distorting mechanisms possible to support the sector - price support. This policy obviously was contradicted two of the objectives, the reasonable price objective and the stabilization of markets (due to the adverse effects on other sectors and the world market). Due to the highly inefficient market support mechanisms large deadweight costs arose, as a result the cost of the policy is in absolute terms roughly equal to the gross value added of the agricultural sector.[97] CAP also was designed disregarding environmental and adverse financial distribution effects. The impact of the policy prompted a shift to rural development policy, a process only now starting to become important.

[97] Wichern, R., *Economics of the Common Agricultural Policy*, Directorate of Economics and Financial Affairs, Economic paper, no. 211, European Commission, Brussels, 2004

CAP performance in achieving its objectives

Objectives	**Quality of intervention, achievement of objective**
to increase agricultural productivity by promoting technical progress and by ensuring the rational development of agricultural production and the optimum utilisation of the factors of production, in particular labour	**Highly inefficient:** The CAP has been very successful in increasing production, not productivity. Costs of production increased, fuelled by subsidies and price support which have driven input costs higher. The transmission of support to farmers is low.
ensure a fair standard of living for farmers	**Very inefficient:** Mainly market support policies, which are highly distortive and highly inefficient, with support largely falling on farms which do not need income support. No means testing attached. Those most in need of support and which are intended recipients, small family farms, benefit little.
to stabilise markets	**Bad:** Depending on the term stabilisation. Prices to farmers in Europe where stabilised, distorting prices of other markets and destabilising world markets.
to assure the availability of supplies	**Excessive:** Availability of supplies was soon assured and then exceeded, creating the infamous surpluses that needed dumping or destroying. The situation has improved, but there is still a level of distortion and world market dumping remaining.
to ensure that supplies reach consumers at reasonable prices	**Fails:** Given the inefficiency of the policy in attaining its objectives, high prices for consumers were unreasonable.

From the point of view of principles to be followed for items in the EU budget, the CAP is incompatible and also does neither contribute to growth nor minimize its negative impacts on growth.

Score on principles of intervention for the CAP

Compulsory	
Subsidiarity	**Fails:** Proponents of the policy consider that the policy fulfils this criterion because the CAP is necessary for the single market of agricultural products. There is, however, no reason for the EU to be using EU funds to support agriculture. A single market can be guaranteed through regulations.
Proportionality	**Fails:** As the objectives of the policy are inefficiently targeted or missed it fails to fulfil this criterion.
Additionality	**Does not apply:** Governments have pooled their resources. National financial allocations are not possible.
Value for money	**Fails** The policy is highly inefficient and costly.
Highly recommended	
European public good	**Fails:** according to Fiscal Federalism there is hardly any reason under the present state of agriculture to consider support at EU level necessary.
European value added	**Fails:** The policy is not creating a value added in economic terms for Europe. At political level its contribution today can even be considered negative.
Compatibility with growth objective	
Growth compatible	**Fails:** deadweight costs are excessive. Negative effects on growth not justifiable for the inefficiently targeted objectives.

The results indicate that the present Common Agricultural Policy, which concentrates on income support, should be abolished altogether. Some limited parts could be retained, which is the support to poor farmers (based on means testing and household incomes). Environmental support may be linked with regulatory systems and financial support under specific conditions and reflecting real costs of implementation.

The Rural Development Policy

As a response to the failings of the Common Agricultural Policy, a shift has been taking place with the increase in importance of the support to rural development, which can be categorised as being in line with the convergence policies and sustainable growth. The rural development policy has a large number of measures which can be subdivided as having 3 objectives: Restructuring the farm sector and improving its competitiveness, improving the environment and assist the economic development of rural areas. The first objectives absorbs the largest part of the funds, the second and third are dominated by farms and farming activities, which indicates that the rural development policy is mainly a farm policy, which is against the recommendations of most academic research and work by the OECD.[98] These clearly show that rural development is better achieved by holistic

[98] OECD, *Territorial Indicators of Employment - Focusing on Rural Development*, OECD, Paris, 1996; OECD, *OECD Territorial Outlook- Territorial economy*, OECD, Paris, 2001; OECD, *The Future of Rural Policy - from Sectoral to Place Based Policies in Rural Areas*, OECD, Paris, 2003

actions targeting all activities in the rural economy. Even in the most rural of all regions of the EU, employment in agriculture does not match employment in services and industry. The decline in the rural areas is generally attributed by the aforementioned studies to the decline of infrastructure quality and services, not farming.

Rural Development performance in achieving its objectives

Objectives	**Quality of intervention, achievement of objective**
Improving the competitiveness of the agricultural and forestry sectors	**Mixed/ inconclusive:** Evaluations are inconclusive on the impacts of the actions.
Improving the environment and the countryside	**Mixed / weak:** It is biased towards agri-environmental measures which are often landscaping, rather than the environment. A number of actions finance activities which would otherwise be undertaken anyway. Support for Less Favoured Areas (LFAs) has been severely criticised by its aleatory distribution and the very little rationale in its implementation.[99]
Improving the quality of life in rural areas and encouraging diversification	**Fails:** It is still centred on farming, while a successful rural development policy should target all sectors.

On the principles for intervention at EU level, Rural Development is an improvement to the CAP but still fails to fulfil the necessary criteria for EU intervention, as the table below presents. It needs additional reforms to become a well target policy.

[99] European Court of Auditors, *Special Report* No 4/2003 concerning rural development: support for less-favoured areas, together with the Commission's replies, 2003/C 151/01, Luxembourg, 2003

Score on principles of intervention for the Rural Development policy

Compulsory	
Subsidiarity	**Pass but could improve:** As far as the policy targets interventions which are better performed at EU level. It is a distributive policy between regions.
Proportionality	**Fails:** The policy is not well devised to attain its targets to promote the economy in rural areas. It is still highly skewed towards agriculture in its social and economic objectives. It is affected by political impositions unrelated to the objectives, in particular for the allocation of funds between regions.
Additionality	**Partially applies:** The rule of additionality applies in principle, but evaluations are still weak to verify.
Value for money	**Fails:** Due to the inefficiencies in allocating the rural development funds and the farm bias in the objectives it does not fulfil this criterion. There is hardly any income criterion for support. Eligibility is based on rurality of areas, with rurality vaguely defined.
Highly recommended	
European public good	**Partial:** Strictly environmental actions and those measures aimed at income diversification may be considered a European public good. Questions remain on correct level of competence in some areas.
European value added	**Partial:** Some aspects of the policy, especially in the environmental, food safety and development fields may be considered as value added enhancing. But the policy needs to be better designed.
Compatibility with growth objective	
Growth compatible	**Partial:** The opportunity costs of the policy are not clear. Efficiency of the policy and evaluation quality needs improving.

The rural development policy could be continued as long as it becomes a rural dimension of what the structural funds do at larger scale at regional level. Many actions may even be better treated in other parts of the budget, rather than in ‘natural resources’. Eligibility criteria should be better defined.

Environmental policy

One can hardly speak of an important EU environmental intervention, especially as far as funding is concerned. There is clearly a strong change needed in the priorities and weights of the ‘natural resources’ heading. Most of the budget is only faintly linked to natural resources. On the principles for EU intervention a fully fledged environmental policy would score very well. At present, the needs are way above the means, thus a lot has to be improved.

Score on principles of intervention for environmental actions

Compulsory	
Subsidiarity	**Pass:** Pollution is often cross-border and thus naturally a supranational issue.
Proportionality	**Fails:** The EU interventions and funding are not in line with the challenges ahead.
Additionality	**Pass:** The EU intervenes on issues which have to be solved in addition to national interventions.
Value for money	**It is under funded**: A stronger policy with more coordination between Member States would create more value added.
Highly recommended	
European public good	**Pass:** The environment is a global public good
European value added	**Pass:** Pooling resources increases efficiency.
Compatibility with growth objective	
Growth compatible	**Partial:** It can have important implications for growth, also positive. Potentially it could become important if it pools together the fragmented approach of Member States.

4.4.3 The Cohesion Policy

The cohesion policy is composed of Structural Funds (Regional Development Funds ERDF and Social Funds ESF) aimed at regions with low GDP per capita (75 percent of EU average) and Cohesion Funds for countries with a GDP under 90 percent of the EU average.

Should the EU be involved in regional policy? As far as interregional redistribution is concerned, the answer is yes. Solidarity aspects of the EU are better handled at EU level. The EU can play a role in fostering growth of its poorer regions. However, the Cohesion policy has been put into question, and some analysts consider that many of its actions are not justified. The growth rates of the poorer members would thus have been achieved regardless of the funds due to the opportunities of the internal market.

Regional and cohesion funds have suffered from the side-effects of the pork barrel approach to funding allocation. One of the most notable cases being the former objective 6, which then became part of objective 1, which allowed support for regions with low population density in over a certain geographical latitude. This is often considered a compensation Sweden and Finland received for their lower CAP benefits. They are now no longer eligible for convergence funds.

The Cohesion Fund is also considered the result of pressure by Spain to be compensated for adverse effects of the internal market on Spain. They were conceived only for the period until the introduction of the single currency, but have lingered for political reasons. This does not mean that cohesion funds are not useful, but that the decision to continue them was not taken based on efficiency criteria.

Cohesion Policy performance in achieving its objectives

Objectives	**Quality of intervention, achievement of objective**
ERDF aims to reduce disparities between the levels of development	**Inconclusive:** Convergence between regions has not been achieved, but this is not a realisable objective, as poorer regions often lack the endowments to match growth rates in richer regions. The importance is how the regions would have feared in the absence of the policy. Still dominated by distributional problems with the allocation of fund by country, which is dominated by politics.
ESF aims at improving productivity, increasing job rate and social inclusion and cohesion.	**Mixed / weak:** It is unclear what the role of the EU should be. Often the impacts of measures are weak and ineffective due to national labour legislation rigidities.
Cohesion Fund assists the eligible Member States to catch up with Europe's wealthier regions	**Positive/ mixed:** Some countries have developed fast, others are lagging behind. The effectiveness depends on the coordination in the recipient country.

Research on the value added of the structural and cohesion funds is largely inconclusive. Some argue that the overall value added may be negative due to the opportunity costs. There are indications, however, that the performance of the structural funds is closely related to the quality of programming, and it probably has had positive effects in countries like Spain and Ireland for this reason.

Theoretically Structural and Cohesion Funds score well on the principles for EU intervention, but the problem of the policy lies in the individual policy actions. An analysis and re-evaluation of the quality and appropriateness of certain eligible measures should be undertaken.

Last but not least, there is a need to review evaluation, auditing and control of fund allocation. The process of evaluating the funds should be in the hands of an independent agency. For Auditing and control, there are clear issues on the separation of competences with the Member States. The EU institutions are responsible for the correct use of the funds, while the Member States hold the responsibility of implementing the policies and auditing them.

Score on principles for intervention for the cohesion policy

Compulsory	
Subsidiarity	**Pass:** Programming and implementation of the funds are in the hands of the recipient countries and regions. However, in the areas of evaluation, auditing and control, the roles of the national administrations and the EU should be reviewed.
Proportionality	**Weak:** The structural funds and cohesion funds need still to be improved to make them achieve their objectives. It is unclear if the policy can or should achieve the objective of reducing interregional disparities.
Additionality	**Pass:** It is a fundamental obligation for the policy, and evidence seems to indicate that it is adhered to in principle.
Value for money	**Weak:** There are indications that the policies could be improved.
Highly recommended	
European public good	**Pass:** The development of poorer regions is in the interest of the EU
European value added	**Weak:** The intervention in the poorest countries and regions is generally considered necessary. The value added of one € invested in the poorest region is considered to exceed the value in a richer region. However, the opportunity costs on wealthier but still eligible regions are questionable.
Compatibility with growth objective	
Growth compatible	**Yes:** if the policy is devised efficiently to minimise opportunity costs and maximise returns. It is largely an implementation issue.

According to the Sapir report and endorsed by some net contributors, there is a question about the need to have regional policy intervene in wealthier countries with eligible regions, leaving it to the member state to finance their development. This position has some rationale from a pure economic point of view. Wealthier Member States not only have more means to invest in their regions, but social support is generally higher. Additionally, net contributors can substitute the EU funds to the region with the money they save by having to contribute less to regional policy.

This argument, however, is generally rejected by the concerned regions, which do not see the national government investing in the region with an equivalent intensity. Regions also appreciate the empowerment EU regional funds gives them to define their own priorities. From a political point of view, there is also an important equity question, refusing poorer regions in wealthier countries support, runs counter to the principle of equal treatment between EU citizens, where citizens in a similar situation (in terms of GDP per capita in PPP) are treated differently because of their location.

Nevertheless, the merit of this last point is questionable, similar GDP per capita in a region does not de facto mean a similar interpersonal situation. Regions with a similar GDP per capita in purchasing power parities say nothing about the comparative state of infrastructures, social security intensity or public services provision in the regions.

In any case, the introduction of national wealth as an addition to the regional GDP per capita criterion for eligibility would fundamentally change the nature of the policy. It would loose its European wide character. The choice cannot be decided based on economic rationale alone and it has heavy political connotations.

4.4.4 Competitiveness Funds

The EU has introduced a number of aims to promote the competitiveness of Europe and its capacity to face the challenges ahead. The EU budget is expected to intervene in the most appropriate form, taking into account the subsidiarity principle and thus support those actions which are better served at supranational level.

Until now the EU budget concentrated its resources on cohesion and sectoral problems. Successful ventures were assumed to be self-generating and self-sustaining. Investment for companies was limited mainly to cohesion regions and industries in decline (Objective 2).

Recognising the need to foster competitiveness, the European Commission proposed for the next financial perspective to bring existing pilot programmes on research, support for start-ups and connectivity across Europe to the forefront of EU policy intervention, creating a large and distinct budget under the new heading Competitiveness and Employment. This heading provide finance for policies equivalent to the present objective 2, but also R&D and European transport and energy corridors (Trans European Networks).

The new Financial Perspectives also reinforces actions which are deemed to be important for the future competitiveness of the EU. The competitiveness heading increases and expands the EU’s interventions for the development of SMEs, programmes education and lifelong learning and the Trans-European networks.

While investment in Competitiveness is certainly a positive idea, the role of the EU funds is not. The value added for the EU of these programmes is still under debate. The budgetary allocation of funds is limited, but the optimum level of funding is also very unclear.

Research and Development

Interventions for research and development are clearly in line with Fiscal Federalism and all the principles for EU interventions. The performance of R&D spending is mixed, also because of lack of funds. The policy has just started to become a serious budgetary item, even if still not fully developed. At this stage it is premature to judge the funds.

Score on principles for intervention of research and development policy

Compulsory	
Subsidiarity	**Pass:** There is a clear role for research funding at EU level.
Proportionality	**Unclear:** the optimal funding at EU level is unclear.
Additionality	**Pass:** It is officially so, but substitution effects should be checked.
Value for money	**Pass:** R&D finance at EU level can *potentially* lead to important economies of scale.
Highly recommended	
European public good	**Pass**
European value added	**Pass**
Compatibility with growth objective	
Growth compatible	**Yes**

The important issue to answer is what the correct allocation of resources should be. It is a well documented fact that the EU spends less as a share in GDP on R&D than the US and Japan. Innovation is considered a key factor for economic growth and the future sustainability of the European economy. The European Commission has thus proposed a considerable increase in funds for research and investments leading to increased competitiveness. However, the share of *public funding* is already higher (Table 3) than in the US and Japan.

Table 3 Gross domestic expenditure in percentage of GDP on R&D, 2003

EU 25	US	Japan	China
Expenditures as % of GDP			
1.93%	2.59%	3.15%	1.31%
Growth in GERD[100] (annual real growth 2000-2003)			
2.4%	0.4%	2.2%	18.6%
Share of public expenditure in GERD, 2002			
34%	**31%**	**18%**	

Source: European Commission*, key figures*, 2005

While no Member State argues that expenditure in R&D does not need to increase, the source and type of R&D investments are issues of debate. As the public sector R&D investment in the EU is higher than in the US and Japan, is increasing R&D through the EU budget therefore sensible at all? Given the size of private R&D investment in the US and Japan, the EU Member States should look hard at their national policies. Regulation, rigid labour markets, bureaucracy and unsuitable fiscal regimes may well be the reason for Europe’s laggardness. Keeping the inefficiencies of the private sector and increasing public expenditures will unlikely improve the situation.

The EU’s approach to R&D may well also be ineffective and even counterproductive. Daniel Gros and Stefano Micossi[101] are very critical on the strategy of R&D investment through the EU budget, considering it wasteful and politically influenced and demand a substantial change in the rules.

Nevertheless, some actions have been positive. The EU has been experimenting with different pilot projects already since 1994, the Regional Innovation Strategies and Regional Technology Transfer actions. In the Programming Period 2000–2006 these programmes developed to form a central strategic goal, which is to develop the European Research Area. The European Framework Programmes and pilot programmes for regional cooperation for innovation (such as the PAXIS programme) have been becoming stronger year by year.

There is evidence that EU funding in R&D has been successful were critical mass and cross border benefits exist despite the sums representing less that 6 percent of total EU spending in R&D. It has allowed to avoid duplicated and fragmented research were coordination and economies of scale are important. While there is generally an agreement that the role of the EU budget could be stronger, there is no clear indication of the size it should have and for what it should be used.

[100] Gross Domestic Expenditure on R&D (GERD)
[101] Gros, D. and Micossi, S., *A Better Budget for the European Union: More Value for Money, More Money for Value*, CEPS Policy Brief, No. 66, February, 2005

Generally, funding directed to R&D and to foster competitiveness should be allocated according to excellence. Countries or regions would not be able, as is for agricultural, rural and structural funding, to capture a predetermined budget allocation for their country. With today's discussions so concentrated on net balances, the interest of Member States to support the increase in funding for this heading has been weak. There is a strong risk that the pie will be divided on a political basis, undermining its effectiveness. Political allocation of funding or responsibilities could cause considerable damage and an unfortunate example of the consequences exists for Airbus.

Trans European Networks

Trans European Networks (TENs) are considered a fundamental ingredient for efficient developed markets. The objectives are reasonable as ideas: ensure that transport connections allow cross border trade efficiently and ensure connectivity across countries for energy to create competition between providers, or for energy security. The fund assists in their creation by financing transport and energy connectivity, but is this necessary?

TEN for transport are financed also by the cohesion funds in countries with a GDP per capita under 90 percent of the EU average, thus the budget of in the competitiveness Heading is for those not benefiting from cohesion funds. The benefit of funding transport connections in wealthier Member States through the budget is questionable and the additionality criteria hardly satisfied. The need of EU funds should be reassessed.

For energy markets, it is true that it is dominated by national players, and that these have not invested in connectivity to other countries. There is no economic incentive for the energy suppliers which often have monopoly or near monopoly in their country to connect to foreign grids. The EU can open these markets by financing the needed infrastructure for connectivity. For gas, the main argument is energy security. Special pipelines ready to shift suppliers could be built. There is indeed an argument in favour of EU action in both areas, but some more cost benefit analysis should be undertaken.

Score on principles of intervention for Trans European Networks

Compulsory	
Subsidiarity	**Pass:** however, in transport for planning, not always for funding
Proportionality	**Unclear:** for transport in wealthier Member States.
Additionality	**Pass:** but may fail in wealthier Member States.
Value for money	**Pass:** the possibilities to build up economies of scale are large, but for energy security, there is a need to look at a cost benefit analysis. What is the value?
Highly recommended	
European public good	**Pass**
European value added	**Pass**
Compatibility with growth objective	
Growth compatible	**Yes**

Intervention for SMEs

From a theoretical point of view the EU can play a role in assisting the development of SMEs when it is part of a European restructuring process. SME development also depends considerably on national incentives and regulations.

Public financing SME development can generally cause a substitution effect for private financial sources. The latest comprehensive evaluation financed by the European Commission claims that the policy has had very strong value added, and that without this intervention 75 percent of the assisted SMEs would never have formed.[102] A recently completed evaluation of some of the programs for SMEs[103] concludes that these are indeed an acceptable EU policy even if there is scope for improvement.

A thorough revision of the schemes to assist SMEs should be undertaken to ensure that the EU is not substituting for national or private funding schemes. There are sometimes puzzling concerns that SME schemes by the EU are not used in some regions because national schemes are easier to use. In those cases the EU schemes should simply not be offered, and should be regulated by state aid rules. EU actions should not substitute national aid or private financial institutions. Only in countries or regions with an under provision of support there may be a scope for EU intervention.

Score on principles of intervention for SME assistance

Compulsory	
Subsidiarity	**Pass**
Proportionality	**Unclear**
Additionality	**Unclear:** depends on quality of implementation. There is a risk of substitution of private finance or other aids.
Value for money	**Unclear**
Highly recommended	
European public good	**Pass:** if well devised
European value added	**Pass:** if effective
Compatibility with growth objective	
Growth compatible	**Yes**

4.4.5 Internal Policies and External action

Security, external action and defence are important areas of intervention in which the EU would be better placed to act. The financial allocation is far from enough and the policies too underdeveloped.

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102 *European Commission, Thematic Evaluation of Structural Funds Impact on SMEs, Brussels, 1999*

103 Renda, A. Schrefler, L. and van Dewall, F. A., *Ex post evaluation of the MAP 2001-2005: Initiative and suggestions for the CIP 2007-2013*, Special CEPS Reports , CEPS, www.ceps.be, Brussels, 2006

On external action, the EU budget does not reflect either the ambitions of the European Union abroad, nor provides the necessary means to fulfil its present needs. The European Union has an important interest to engage with its neighbourhood. Political stability and economic development of the neighbouring areas bring opportunities for the EU and is of crucial importance. The European Union is seen by most neighbours as an ideal to be followed. Membership of the European Union has been sought, with countries engaging into lengthy, difficult and costly reforms to have trade access or approach and adopt the EU *acquis communautaire*, which is heavily loaded with costly political and economic requirements.

The EU's influence in the neighbourhood relies heavily on persuasion rather than power. Access to Europe's markets, benefits of closer relationships and ultimately membership has changed the political geography of Eastern Europe at a record breaking speed. This is also largely due to the EU's introduction of conditionality to its programmes (PHARE, TACIS, CARDS, etc.). Its influence, however, spreads beyond the neighbourhood, through its international aid programmes. However, despite the heavy reliance of the EU on support through association agreements, pre-accession programmes and aid to secure stability, influence and future trade partnerships), the external action budget of the European Union is still very limited. The economies of scale that can be achieved in external action at EU level are very important, while the EU's weight in global security affairs is meagre without pooling of resources.

In addition, the EU is criticised for its lack of resources to handle the external programmes. The EU in fact relies heavily on external consultants with varying success. The Member States, however, paradoxically refuse to allow the EU administration to increase in line with the responsibilities they have bestowed on it.

As for internal security, the Member States have been remarkably unwilling to expend the EU's involvement in this field. Daniel Gros and Stefano Micossi[104] are surprised that an area where citizens are clearly demanding more coordinated action so little interest is being shown. The fact that this heading is so under-funded is in part due to the political unwillingness to shift resources from the CAP and structural funds to internal or external actions.

[104] Gross, D. and Micossi, S., *A Better Budget for the European Union – More Value for Money, More Money for Value*, CEPS Policy Brief, No. 66, www.ceps.be, 2005

The EU budget interventions in the new financial perspectives show that a **considerable part of the funds are used for interventions not in line with the fundamental principles EU policies** should posses **and are incompatible with a growth orientation of the funds**.

The Common Agricultural Policy is a particularly strong case. In its present, it not only fails to comply with the principles that EU policies should follow, but also that it has a very negative effect on the rationale of the EU budget.

Most of the **CAP direct payment support should thus be phased out**, leaving some space to support farmers with low incomes, based on means testing of the farm households.

The Cohesion policy and rural development policies do have a role to play in the EU budget, but the individual actions **need revisiting**.

R&D has an important role at the EU level but the optimum level of funding is unclear.

TENs These are potentially important investments, but those for transport need reassessing.

Funding for external action and internal policies is extremely low and should increase in line with better policies **given the large economies of scale**.

5 Tentative conclusions

There are three different types of considerations that may influence how effective a policy is from the viewpoint of growth. One is that a policy may be erroneously allocated between the EU and the Member States in relation to the goals to be realised (either inappropriate centralisation or decentralisation). The other is that the goal of the policy is not achieved owing to failures within other policy areas. There may be a lack of commitment, institutional shortcomings, difficulties of coordination, or inadequate tools at lower levels in the Member States which mean that it becomes impossible to achieve the EU objectives. The third consideration that may be analysed is the policy itself. Neither the strategy nor the goals or indeed the tools are adjusted to have an impact on growth. This forms a framework for assessing the policy capacity that exists for stimulating growth within the EU.

In respect of allocation of the responsibility between the EU and the Member States, in the current circumstances there is no given answer in respect of the optimum position. On the other hand, there are two costs that are associated with the policy system; firstly the confusion in the allocation of policy responsibility that this creates and, secondly, the difficulties in adapting rapidly to new circumstances. It is costly when lack of clarity impedes a proper response to the need for competition and distribution of resources. On the basis of a number of case studies, it has been established that the very design of the policy has an effect. Those policy measures that are based more on strong participation than delegation have been more problematic from an EU viewpoint. Elements that are emphasised in the Sapir Report include the fact that the formation of the Single Market has not succeeded in achieving enough within the financial sector (goods and services). Neither has the EU succeeded in creating a combination of central and regional action in order to establish a more dynamic and innovative economy. The innovation policy implemented has not delivered sufficiently good results.

There is no simple solution for increasing growth and living standards within the EU. Keys to stronger growth depend to a large degree on whether we can increase productivity and employment. A number of reforms are required in order to create better structural prerequisites for growth. The Kok report wishes to have an increased focus on reforming these areas.

Europe has largely developed its own model of how to develop economic and social welfare. The European model is an attempt to combine and create a balance between growth (productivity), social cohesion and the environment. The principal goal is to create sustainable development, but a number of studies show that there is a requirement for increased focus on growth issues and a need for increased determination to carry out the Lisbon strategy. The economic performance within the EU has not been sufficient. There remain structural weaknesses, above all on the supply side, which contributes to us not achieving the same economic success in Europe as in the USA or Asia. The perception from the Kok Report is that the ambition level is not set too high; indeed more ambition is needed than previously. The increasing global competition, the ageing population and the expansion of the EU limit our options. European growth needs to be strengthened in order to guarantee welfare and to develop a European model with the focus on achieving the principal goals we set through this co-operation.

The EU demonstrates better results than the USA in many areas, but work still remains if we are to develop the same competitive and innovative dynamics in European companies. In the USA over 70 percent of the 300 largest IT companies are to be found. If we rank companies according to R&D spending, it can be established that the USA includes 46 percent of the 300 top companies.[105] In Europe the export share of high-tech products is lower than in the USA and the number of employees in high-tech manufacture is also lower in Europe than in the USA. Here there is a requirement for increased input to strengthen the European knowledge economy and to ensure growth in the future. The expansion has meant that the EU's population has risen by 20 percent whereas European GDP has only risen by 5 percent. The new Member States are characterised by large inter-regional differences. The challenges for the EU are greater today in some ways. What is positive is that new Member States can contribute with rapid growth through so-called catch-up effects and thereby create new growth areas in Eastern Europe.

The Kok report emphasises the Lisbon strategy as the best path to meet the new challenges which confront the expanded Europe of today. It is a framework that offers guidance for which necessary changes are required in order to move Europe to the technological frontline and become a more innovative economy generating increased growth and employment.

The need to increase expenditure and invest in higher education and research leaves no room for doubt. There are studies that demonstrate that up to 40 percent of workforce productivity growth is generated by R&D spending and that this generates many spill-over effects in other parts of the economy.[106] In the Kok report it is observed that the significance of R&D investments has not acquired sufficient publicity at a European level and too little has been achieved. There remains much to be done in order to increase mobility and the inflow of researchers from other areas, to remove obstacles and enhance the conditions for successful researchers in Europe. Indeed, if Europe is to bring the best researchers here, a continued investment in improving the research environment is required. The task of creating free movement of persons, goods, services and capital must continue to be developed in order to create growth in future. The significance of R&D investment is nothing knew from a European level. Many countries are enthusiastic about investing in such a domain. However, a high share of investment in R&D investment can not by itself guarantee high growth. It is also very much about the quality of these investments.

Competitive financial markets are central to the improvement of economic performance and for creating a strong European growth in the economy. An effective financial market generates lower costs for companies and consumers. More competitive companies and a developed entrepreneurship are a guarantee for such a development. In the Kok report, it is asserted that the environment for stimulating entrepreneurship is insufficiently developed in Europe. There are too many obstacles for entrepreneurs and it is not attractive enough to carry out business. This leads to new growth opportunities not being sufficiently exploited. There is also a need for increased investments in a high-skilled labour force. Amongst the

[105] Commission of the European Communities, *Facing the Challenge: The Lisbon Strategy for Growth and Employment*, Report from the High Level Group, Chaired by Wim Kok, November 2004, p. 13

[106] Commission of the European Communities, *Facing the Challenge: The Lisbon Strategy for Growth and Employment*, Report from the High Level Group, Chaired by Wim Kok, November 2004, pp. 19-21

players that have analysed the economic conditions within the EU, and what needs to be done to strengthen growth, there is a fairly clear order of priorities for what needs to be done to get Europe to strengthen its competitiveness and capacity to perform better in the future. Much of the focus is placed on the employment market, business climate and development of the Single Market as central cornerstones to accelerate growth in Europe. The question in broad outline is whether these different elements must be coordinated more effectively in order to stimulate technological development at the leading edge.

For the forthcoming overview of the EU budget and our further work the following points summarize some of the major observations we have made with implications for future reforms with a greater emphasis on economic growth:

- **Economic growth is not mainly achieved at the EU level**

There is no uniform or simple interpretation of growth problems within the EU. Growth should be stimulated through advances on the supply side and continuing work to develop the institutional framework. Institutional regulations that strengthen technological development and competition within the EU may complement budget allocations. To move in the direction of less emphasis on redistribution without any particular link to economic growth is one of the implications of the study. Neither the so called subsidiarity- test, nor the principle of proportionality or any other criteria justifies any larger sums to be spent on redistribution. Both CAP and the cohesion funds might be questioned in their current form on this basis. They are not sufficiently oriented towards overall growth within the EU, with the possible exception of the means set off for convergence.

- **Growth orientation requires radical changes of the EU budget**

It has previously been difficult to change the institutional preconditions in order to mitigate conflict between the countries. Agricultural expenditure is an item that generates conflicts and, in this case, there are different perceptions that impede possibilities for more radical changes. It is clear from the analysis presented that the present CAP is incompatible with an efficient budget. The new proposals on changed budget priorities, an increased allocation of resources assigned for the implementation of the Lisbon agenda, will probably be insufficient to have a real impact on the overall European economy. The analysis of the budget components, a new budgetary structure and a timetable to reach this structure should be set.

- **The EU should intervene as a catalyser for growth**

The main responsibility to foster growth in the European Union is in the hands of the Member States and their domestic structural reforms. The EU budget has nevertheless a role to play to encourage growth in the EU where collective action shows economies of scale (increases efficiency and reduces costs). The EU cannot and should not be the main financial tool, but should intervene as a catalyser for sectors where there is a European public good with value added. Those sectors pinpointed in the literature are mainly, research and development, education, transport, infrastructure and environment for somewhat different reasons. For those policies where growth at EU level is not the main objective, efficiency and value for money are central criteria. Measures should be designed so that they minimises any negative impact on growth.

- **The significance of regulations**

The significance of regulations are most obvious in two fields; the completion of the internal market and competition policy. The primary gains of competition are well-known - open markets, undistorted competition which is supposed to lead to effective production and optimal prices. To complete the internal market is still a principal objective, open markets also in the field of services is of course part of this remaining task. Moreover, it is often neglected that mutual recognition may be a way to accept that consensus cannot be reached in certain areas. In such cases the EU shall not insist on action at the EU level.

- **Necessary to cut down on the number of goals**

The EU budget needs to undergo some changes in order to achieve a more efficient usage of common resources. Economic growth cannot reach the status as the only value-added property of the EU. There will always be other goals, for instance convergence, sustainability and cohesion which are relevant. However, more emphasis on growth may foster major improvements in terms of goal-orientation. It may also be instrumental in cutting down on the multiple goals linked to the same objectives and expenditures in the budget. Each time distribution of competences are discussed or additional expenditures are introduced at EU level, the obvious danger is that governments start to focus on net contributions to the budget basically reducing the inter-governmental negotiations to a zero-sum game. Naturally in these cases, the legitimacy of the EU policies may gradually be undermined.

- **Reinforcing growth orientation of other policies**

It has to be ensured that the non growth oriented policies are cost efficient and not in conflict with EU growth performance. For those policies which are not primarily directed to growth, their contribution, negative or positive, to growth should be taken into account. Thus the EU budget may finance a number of other objectives. The requirements of value for money, subsidiarity, proportionality and additionality should already guarantee that the policy do not have negative effects on growth. Coupled with the finance of a European public good with value added at European level should ensure that it creates a positive growth effect, at least for substituting less efficient national interventions. Consequently, there is a need to give higher priority to growth within existing policies not just in order to achieve higher per capita incomes but because a growing, competitive and dynamic economy is needed to finance a certain degree of cohesion in a durable manner.

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