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The British Position in the Negotiation of the Financial Framework

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This discussion paper further elaborates the topic which was firstly presented at a 'Seminar on the State of the Negotiations of the Financial Perspective of the European Union – Agenda 2007', at the *Stiftung Wissenschaft und Politik (SWP)* in Berlin on April 18, 2005

1. Introduction

The United Kingdom shares a reputation with France and Spain of being the most difficult negotiating partner on the budget of the European Union. This reputation has been gained over two decades of conflict, which started with Prime Minister Thatcher's negotiation of the British abatement in 1984.

The failure to find an agreement on the Financial Framework 2007-2013 at the European Council meeting in Brussels on June 16/17 2005 reinforced this impression. The United Kingdom took the position that while a change in the British abatement mechanism was not unnegotiable, this could only be considered if France was prepared to consider a further change in the funding of the Common Agricultural Policy – which in its turn France was not prepared to do.

The British Prime Minister argued that the Union budget was a budget for the past, whereas it should be used to support future economic development. This is a similar argument to that developed in the Sapir Report to the Commission.¹ 'To spend over 40% of the budget on agriculture was economic nonsense; Europe needs to spend money on research and development and other projects which will raise the competitiveness of European companies on world markets.'

The real problem was that a Prime Minister could not go home having accepted a cut in the budget rebate, while a President could not afford to return home having accepted a cut in CAP funding for his farmers. The clash had been pre-programmed by strong public statements from the British side on the non-negotiability of the budget rebate, while the French President had suddenly discovered that the British alone were really to blame for the French 'non' in the Referendum on the European Constitution.

The other 23 countries of the Union seated around the negotiating table in the European Council must have been rather perplexed by the fact that these arguments about the fundamental structure of the budget and therefore the nature of EU policy had not been seriously aired in the previous 12 months of negotiation. All seem to have accepted that a 'bad' deal had been done on CAP financing in Brussels in 2002 and that they were stuck with this until 2013.²

The failure of the summit leaves the Union with a major problem and, given domestic electoral timetables in each member state, little chance of agreeing a future budget until the 2007.

¹ Andre Sapir et al. An Agenda for a Growing Europe, European Commission, July 2003

² although there was an argument about whether the CAP costs for Bulgaria and Romania should be inside or outside the Brussels 2002 agreement

2. The overall economic situation

The European Commission estimates that the United Kingdom was the member state with the second highest gross national income per capita (in PPS) in 2003 at 111.2% of the EU-15 average. France was at 104.2% and Germany at 98.6%. With by far the largest part of own resources contributions determined by GDP today, the United Kingdom per capita contributions to the budget are higher than in most other countries. At the same time receipts from the budget are low, with the CAP and the Structural Funds absorbing around 80% of budgetary funds.

While the UK is a very significant gross contributor to own resources, as well as in net terms, it is in a more favourable fiscal situation than many of the continental member states. In 2004 the general government balance reached - 3.2% of GDP, while public debt was at 41.6% of GDP.³ This was combined with low unemployment and low inflation. However in the coming years the government deficit may well deteriorate, as growth is reduced, the decline in unemployment levels ends and as the high levels of investment in public services continue. While not a member of the Monetary Union, the UK is not subject to the penalties of the Stability and Growth Pact (original or revised versions), but is nevertheless expected to keep its Government deficit within the 3% of GDP level specified in the Maastricht conditions.

As in other member states therefore, transfers to Brussels are seen as aggravating the national fiscal position. These transfers do not win votes at the ballot box. However again, as other member states, the UK supports key policies in the Union and has an interest in seeing them financed.

3. British objectives; policy and politics

The United Kingdom, like all the other Member States, has relatively clear objectives with different levels of priority attached to each. Although the British negotiators would not sign up to a list of priority objectives, the shadow list probably is as follows:

- To defend the British abatement
- To reduce expenditure on agriculture
- To limit overall EU budget expenditure
- Within the Union to concentrate expenditure on the poorest counties
- Outside Europe to concentrate it on achieving the UN Millenium Development Goals

³ European Commission Spring Forecast 2005

Each of these goals is a complex mixture of political and financial objectives. The most political is the defence of the British abatement (often referred to as the British rebate).

The abatement is highly political because it was negotiated by Margaret Thatcher and considered by her as an object lesson of how to negotiate in the Union. It is assumed that if the current government were to give up the abatement, it would be punished severely by the voters, unless a major restructuring of the budget could be achieved at the same time. There are therefore two linked questions:

- what change might be acceptable to the UK Government and to the 24 other governments, given the political constraints
- given the electoral timetable, when should such a change be discussed

A logically closely related question in British eyes is how to reduce expenditure on agriculture in the Financial Framework and therefore in the EU budget. To some extent, the British abatement can be seen as a compensation for a very low allocation from the CAP (and from the structural funds). Agriculture today consumes around 47% of the EU budget and even on the proposal of the Commission will still be consuming around 35% of it in 2013. As the British Prime Minister made clear at the recent summit, the British Government agrees with the Sapir Report that this level of expenditure on a small and declining sector of the economy is absurd. It would therefore like to reopen the deal which was made at the European Council meeting in October 2002 (in fact a deal between President Chirac and Chancellor Schroeder), which limits increases to core CAP expenditure to 1% per annum in nominal terms.

Britain is a founder member of the 'Group of Six' net contributors to the EU Budget, which are pushing for the annual level of commitments in the Financial Framework to be limited to 1% of Gross National Income. While such a top-down limit does not appear very sensible on the surface - it is surely better to determine the needs of individual policies before deciding on the overall level - such a limit would be considered by the British Government as the only way of ensuring 'affordability' and efficiency at the Union level. The pressure to increase the size of the EU budget comes not only from centralising institutions like the Commission and the Parliament, but also from myriads of interest groups which live off the EU budget. Setting an overall limit forces all parties to prioritize budgetary demands.

At both the internal EU level and the external, the UK supports concentrating expenditure on the poorest countries. It sees no reason to distribute structural funds to the poor regions of rich countries. The British view is that the EU should help poorer member states, in the same way that the Cohesion Fund relates to member states. But regional problems should be the responsibility of national governments not the EU.

As far as external aid is concerned, the British Government would like to concentrate available resources on the achievement of the UN Millenium Development Goals. It would have a minimalist attitude to other external aid programmes, such as the proposed European Neighbourhood and Partnership Instrument.

The principles which the UK wishes to see applied to the EU budget are those which all member states and Community institutions sign up to: expenditure through the EU Budget should clearly demonstrate an EU value added, it should be proportionate and affordable and financial discipline and rigour should apply. The UK, as a more critical member state, has always felt more strongly about these principles than some other countries of the Union. Indeed there was a strange period when it was considered anti-European to think about the national net positions in the financing of the Union. The British never shared this feeling, as Mrs. Thatcher's 'I want my money back' period clearly showed.

The value added test should be applied to the conception of the programme but also to the implementation. While for instance, at the Brussels summit, Mr. Blair emphasized that EU spending on Research and Development was more justified than that on agriculture, this does not mean that the British will be automatically in favour of that spending. This will depend on the demonstration that spending at the EU level brings a greater return than at the national level. This has to be proved and not simply stated as a fact. And even if this can be shown, appropriate instruments for effective implementation have to be designed to ensure that the return on the investment is adequate.

4. Own resources

As the EU budget has to balance, the own resources side of the budget is determined by the size of planned expenditure and by the fixed key for contributions to own resources (traditional own resources, VAT and the GDP-related resource).

There really are only two significant topics on this side of the financial framework:

- The creation of a true own resource
- The British budget abatement and an abatement system for other major net contributors

The European institutions and some member states would prefer the creation of a direct real own resource, which would 'belong' to the Union, without the direct intervention of the member states (except as collector of taxes). This real own resource could take the form of a slice of direct or indirect taxation in the member states. The British position on such a proposal would be that it is at present not

politically acceptable – nobody will vote for ‘Europe tax’ – but beyond that it is unnecessary because the current system works well.

The ‘British abatement is not negotiable’ was the negotiating position of the British Government until the recent Brussels summit. This was obviously the strong position which the British would take at the outset of the negotiation. The abatement essentially protects the British from the full force of any new policy which has financial implications for the Union. For instance the enlargement of the Union to the east, for which the British have pleaded for so long, does not cost the British nearly as much as it costs the other member states because of the rebate.

This could however never be the final position as Prime Minister Blair explained in Brussels. The Union does not progress through the use of the veto.

The *raison d’être* of the British abatement was clear in 1984 and not too much has changed in the budget of the Union since then. Britain contributes in the same way as other countries to the budget but it does not benefit from any of the Union policies in a substantial way. This would lead to Britain being by far the largest net contributor without the abatement (table 1). It is really the external elements which have now changed. In 1984 Britain was amongst the poorest member states in per capita GDP. Britain is no longer amongst the poorest member states but the richest. However it still does not benefit from any of the main policies, with agriculture and the structural funds still redistributing 80% of the EU budget.

Today of course Germany could claim that it is in the position that Britain was in 1984. It is amongst the poorer of the old member states and does not receive substantial agricultural payments and structural fund transfers only for some parts of the New Länder. Yet Germany is by far the largest net contributor to the budget.

The Commission has tried to defuse this question by proposing that there should be a generalization of the abatement system to all net contributors. This would reduce the amount which a net contributor would have to pay after a certain threshold had been reached. This would lead to Britain becoming the largest net contributor though at a lower level than if there was no rebate system. This proposal faces a general refusal from the net beneficiaries, who do not see why richer countries should receive rebates which reduce their net receipts. The British also feel that they can do better than this if they negotiate well.

The most likely solution, which before the summit in Brussels seemed as if it could be acceptable to the British, was a continuation of the abatement at roughly today’s level in nominal terms, so that over time it falls in real terms, together with the exclusion of any new policies from the rebate system. Saving the rebate at the current level could be sold politically to the British voters, while

Table 1: Estimated net budgetary balances before and after UK correction

Country	Average 2008-2013 %GNI	
	Before	After
Luxembourg	5.89	5.80
Poland	3.85	3.76
Czech Rep.	3.26	3.17
Hungary	3.16	3.06
Belgium	1.32	1.21
Ireland	0.56	0.47
Spain	0.32	0.23
France	-0.27	-0.37
Italy	-0.29	-0.41
Austria	-0.37	-0.38
Sweden	-0.47	-0.50
Germany	-0.52	-0.54
Netherlands	-0.55	-0.56
UK	-0.62	-0.25

Source: European Commission

Table 2: Estimated net financing cost of UK rebate (EUR millions, 2004 prices)

Country	Ave. 2008-13
Luxembourg	25
Poland	248
Czech Rep.	98
Hungary	106
Belgium	325
Ireland	141
Spain	935
France	1893
Italy	1565
Austria	46
Sweden	57
Germany	443
Netherlands	93
UK	-6982

Source: European Commission

a decline in real terms might be sufficient to tempt 'the 24' to agree. The proposal of the Luxembourg Presidency in the final negotiation in the European Council however proposed an even better deal than this which would have almost but not quite matched the unreformed British abatement system. If it proves impossible to abolish rebates totally, some of the new member states would also probably prefer the continuation of a reformed, but temporary, British rebate to the institution of a new system of general rebates, which would be difficult to change.

Although no one was really warned before the summit, apparently the real aim of the British side is to use the budget to reform policy in the Union. A possible solution therefore would be to trade British agreement for a reduction in the British rebate against a more thorough reform of the CAP and a review of the Brussels agreement of 2002 on the financing of the CAP. It is after all really the CAP which leads to the UK's large negative budget balance. The reform could take the form of a reduction in the level of subsidy paid to farmers or, more likely, a 'renationalisation' (cofinancing) of agricultural expenditure. Following the success of the 'no' vote in the French referendum on the Constitutional Treaty, in which apparently French farmers played a part, such a reform looks today highly unlikely. Such a reform would also not be popular with the more agricultural new member states, which are happy to have been able to pass some agricultural subsidy to the EU budget. However for other member states, such a solution would be favourable, as Prime Minister Stoiber said after the failure of the summit.

5. Expenditure

The overall British position on the expenditure side of the budget is that commitments (and payments) should not exceed 1% of EU annual GDP. This should be achieved by ensuring that the principles of EU value added and budgetary efficiency are applied, as well as ensuring an adequate concentration of funds on real priorities in the structural funds and foreign aid.

The British were not happy with the Luxembourg Presidency, which they considered to have ignored the results of the discussions under the Dutch Presidency in the second half of 2004. Luxembourg attempted to retain the structure of the budget proposed by the Commission while reducing the overall size of the Financial Framework to around 1.07% in commitment appropriations over the whole period 2007-2013. The debate in the first half of 2005 took place on the basis of this Commission proposal, which divides the expenditure side into five major headings, which were treated by the Luxembourg Presidency as 7 separate headings:

- 1A - Competitiveness for growth and employment
- 1B - Cohesion for growth and employment
- 2 - Preservation and management of natural resources
- 3A - Freedom, security and justice
- 3B - Other internal policies
- 4 - The EU as a global player
- 5 - Administration

Heading 1A

The British are keenly attached to the Lisbon Agenda for improving the competitiveness of European enterprises and the productivity of the European economy. This was emphasized by Mr. Blair in his recent speech to the European Parliament outlining the aims of the British Presidency. This does not however mean that they are automatically in favour of expanding EU budgetary expenditure on the headline goals of Lisbon. Any expenditure must meet the criteria of value added and efficiency.

This consideration leads the British Government to accept some increase in EU research and development, though not as much as proposed by the Commission. However the other parts of this heading, including spending on Trans-European Networks (TENs) does not find the same level of British support.

In the Commission proposal this heading is to grow by a very substantial amount (almost three times between 2006 and 2013). Most of this growth comes in the research and development chapter and was poorly justified by the Commission. It appeared that the original proposal was a figure pulled out of thin air and justified only by the idea that more resources needed to be given to R & D in Europe, without a consideration of whether this increase could be more efficiently achieved through national spending. This is an unacceptable procedure for the British (and other delegations).

Heading 1B

The British view of cohesion spending is that it should be concentrated on the poorest countries of the Union; essentially the new Member States and Portugal and Greece. Poor regions in rich countries should be dealt with nationally and if necessary using national budgetary funds. Such a policy would eliminate structural fund spending outside the poorest group of countries and notably in Spain and Italy. This proposal is in line with a logic in which the Union deals essentially with its member states and member states with their regions. It would also concentrate scarce resources on the most acute needs.

This 'radical' change of policy has of course no chance of being agreed in the Council. Both those countries 'losing' their structural funds are against it, as are the Commission, which likes to have relations with sub-national bodies, and the Parliament, whose members like to be able to proclaim that they have attracted projects to their constituencies.

The British will therefore try to limit the scope and size of transitional arrangements for regions which now have a GDP per capita (in PPP) above 75% of the EU average and to reduce the size of the 'regional competitiveness and employment objective' (old 'objective 2').

Heading 2

Spending on the Common Agricultural Policy is a major problem for the British, who consider subsidizing a declining sector of the economy to be a waste of resources. It appeared however difficult politically, until the European Council meeting in June, to reopen the deal agreed at the Brussels European Council in 2002, which fixed an upper limit for CAP expenditure through to 2013 and especially so after the failure of the French referendum on the Constitution.

The most that could be obtained in the negotiations leading up to the Brussels summit was that the cost of the CAP in the two new member states expected to join in 2007 should be met within this upper limit.

The British now clearly to want to use the budgetary impasse for another major consideration of CAP expenditure.

Headings 3A and 3B

The British position on financing justice and home affairs-related matters (3A) is rather positive, as this is seen as an essential component for ensuring internal security in the EU, though of course the British would like the same tests of value-added and efficiency to be applied.

The proposals for a series of policies which in the view of the Commission are important for developing European citizenship are not viewed favourably by the British.

Heading 4

The British are skeptical about the value of foreign policy-related spending from the EU budget, considering that spending by Member States is more effective. Under heading 4, they would like to see a concentration of spending on the achievement of the UN's Millennium Development Goals. This means that they would be less generous on European Neighbourhood Policy or Pre-Accession instruments than many of their partners in the Union.

While these expenditure areas will form the backbone of any EU financial framework, the British Prime Minister appears to have announced that he wants to return to the whole question of the budget structure. This could result in major delays, as the budget structure reflects the policies of the Union and a real policy debate could take years. It will therefore be interesting to see if under the United Kingdom Presidency the debate continues on the basis of the original Commission proposal or whether a new basis for the discussion will be sought.

6. The domestic political agenda

As with all member states, the British position in the negotiations is affected by the domestic political situation.

The fact that the British abatement was negotiated by Prime Minister Thatcher gives it a symbolic value quite apart from its financial impact. As any change in the abatement can be vetoed by Britain, any concession involves the Government 'giving up what Thatcher fought for'. Any change which is agreed will therefore be condemned by the opposition in the British Parliament, even though it is very difficult to justify the continuation of a system designed when the Union and the British economy were in very different situations. Concessions can therefore only be made in return for significant, or apparently significant, changes in the elements which originally justified the rebate.

While Prime Minister Blair has just won a general election with a solid working majority in Parliament and while the opposition is still weak and will remain so for some time due to a leadership battle, he cannot relax. The ambitions of the Chancellor of the Exchequer to take over the leadership of the Labour Party are undiminished and the credibility problem caused by the Iraq War is still a worry. Success in getting reform in the European Union would therefore be an important achievement for the Prime Minister.

One should also not underestimate the reforming zeal of Government leaders including both Blair and Brown. The debate on the budget rebate in other member states has frequently suggested that the problem is simply a financial one – 'Blair, like Thatcher, wants his money back'. This is far from the truth. 'New Labour' came to power in 1997 with a strong reform agenda which they have been implementing at home. They see a danger to their policies at home, if reform is not carried out on the Continent. They consider solid economic growth based on flexible markets guaranteeing full or almost full employment to be the only basis on which to build a socially just society. Stagnant economies with high unemployment in the European Union lead to growing protectionism and ultimate decline in a globalised economy.

7. After the Brussels European Council

The Brussels European Council on June 16-17, 2005 will no doubt go down in history as one of the most significant in the development of the Union. That is not to say that it marks the end of the Franco-German dominance of the Union or the ascendancy of the UK to leadership in the Union – it may mean none of these things. What it has done is to put the whole question of the objectives of the Union back on the table. Should it be a motor behind economic reform, research and development and an assertive foreign policy or is it to continue to finance declining sectors? Why is the EU still paying agricultural subsidies which are essentially social payments? Should the Union be doing more to foster R & D and should structural transfers go only to the poorest countries and then only for a transitional period?

It is difficult to see at this moment how the British are going to get the financial framework negotiations back on the road. The Commission looks unlikely for obvious reasons to put another proposal on the table. Will the Presidency do it and who would support such a proposal? Not France for certain! And anyway why should negotiators from the other 24 member states waste even more time negotiating with the British, when they know that the political leadership may not support its own negotiators.

Nevertheless everyone must be interested in the finances of the Union agreed within a reasonable time to allow other business to carry on. Individual countries and groups of countries are already trying to see how they can put the new situation to their own advantage, although the British appear not to have made up their minds at this moment on the strategy to follow.

The problems for the British Presidency in the current situation are:

- How to ensure that the reform of the British abatement is paralleled by a further reform of CAP financing, in spite of the 2002 Brussels agreement.
- How to give planning certainty to the new member states that their Structural Fund transfers will start flowing from 2007, without which the British can never win over these countries as allies.
- How to win the public relations battle to ensure that Britain is seen as having driven forward reform in the Union while not wrecking its smooth operation by blocking its finances.

On the parallelism between CAP funding and the British rebate, the first step will be the search for allies in the Union and this is well under way, particularly in the new member states. A possible way forward would be to shorten the length of the Financial Framework to 3 or 4 years, with a guarantee that both problems would be resolved before a new medium-term budget was agreed. A similar solution might be a mid-term revision clause for both questions in a seven year

Financial Framework. The problem for all sides will be to ensure this parallelism of actions, in a climate of mutual distrust.

The most serious short-term problem for the British is the extreme disappointment felt in all the new member states that they have been once again treated as an 'Anhängsel' of the Union rather than full members. An Accession Treaty full of protectionist clauses to stop the free movement of workers and services, a loud debate in France and Germany about 'Polish plumbers' taking away jobs from real EU citizens, and unequal subsidies paid to farmers could all be accepted if the old member states were at least going to agree to significant capital transfers to help their development.

If the new Financial Framework is not agreed until 2007, it will be 2008 or probably 2009 before structural funds can be used by the new member states, even though these payments are not really contested by any member state of the Union. The British will no doubt attempt to find a way to give guarantees to the new members that they will receive their transfers in time to use them from 2007. This may well be very difficult however, because the predicament of the new member states can be used as a hostage to force the British into concessions elsewhere. Would Spain for instance, accept a partial deal for the new member states without guarantees for its own transfers from the Union? And would such a separate deal be legally possible anyway?

Finally on the public relations, there will be many member states harbouring grudges against the British after the collapse of the Brussels summit and therefore trying to ensure that they will not get a PR triumph. In the longer term it would appear likely that the British reform agenda will win through once some of the current leaders of other member states have been replaced. But this success will come at considerable cost.