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EU Enlargement: The Financial Consequences

This paper deals with the financial consequences of EU enlargement and the implications for EU regional policy and the Common Agricultural Policy. The political and institutional aspects of EU enlargement are covered in a complementary paper 98/55. Both papers update Research Paper 97/86, *EU Enlargement*, which appeared shortly before the publication by the European Commission of *Agenda 2000* and the Commission's Opinions on the applicant states on 16 July 1997.

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I Summary

The European Commission recommends in *Agenda 2000* that negotiations start for admitting a first wave of five applicants from Central and Eastern Europe: the Czech Republic, Estonia, Hungary, Poland and Slovenia. The Commission had already indicated that negotiations for admitting Cyprus would start six months after the end of the Inter-Governmental Conference. The financial calculations in *Agenda 2000* are based on the assumption that the first wave of applicants accedes to the Union in 2002. This paper considers the financial consequences of EU enlargement and its possible effect on the EU's regional policy and the Common Agricultural Policy. The political process of EU enlargement is the subject of a separate paper (*EU Enlargement: The Political Process*, Research Paper. 98/55)

In its *Agenda 2000* communication, the European Commission issued outline proposals for the next Financial Perspective for the period 2000 to 2006 and for reform of existing EU policies. The Commission has since adopted a report on the working of the Interinstitutional Agreement (IIA) and the proposals for the Financial Perspective. These later proposals for the Financial Perspective closely follow those in *Agenda 2000*: the figures are, however, presented in 1999 prices rather than in current prices and 1997 prices as in *Agenda 2000*. The Commission has also replaced the use of the European Currency Unit (ecu) with euro (EUR), presumably in anticipation of EMU. This Library Paper uses the official currency symbol • to denote amounts in euro.[1]

Over the period 2000 to 2006 the Commission is planning to provide • 79.9 billion in 1999 prices to applicant countries. This amount represents about 11% of the total payments throughout the period 2000 to 2006 or just over twice the amount that the Commission expects to spend on administration.[2] Of this • 79.9 billion, • 61.8 billion will be transferred to the new members, leaving • 18.1 billion to the other applicants. The Commission is planning to meet these additional costs from within the existing budget ceiling of 1.27% of the EU's GNP. Since the EC budget must be self-financing, a limit on own resources is also a limit on spending.

The Commission's financial framework depends critically upon the EU15 achieving a certain rate of economic growth and certain reforms being made to major spending programmes. This paper examines the proposed changes to the EU's regional policy and the Common Agricultural Policy. The risk of a financing gap developing between the spending levels associated with accession and the level of available funds is assessed. Other potential sources of finance, including reducing or eliminating the UK rebate, are discussed.

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1 To provide some indication of the amounts in sterling at present exchange rates for the Ecu, it is useful to note that average rate for the ecu for 1997 was £0.689 and is currently valued at £0.648 (17 April 1998). A crude but useful way of converting • amounts into sterling is to reduce any • amount by one-third.

2 Spending on Administration for the period is expected to be • 35 billion.

II Background

Agenda 2000 stated:

> On the basis of a comprehensive and objective evaluation of the extent to which the ten applicant countries meet these criteria, the Commission recommends that accession negotiations start with **Hungary, Poland, Estonia, the Czech Republic and Slovenia**. Cyprus has already received assurances from the European Council that its accession negotiations will start six months after the completion of the IGC, following the positive opinion from the Commission in 1993.

Enlargement has successfully taken place under Article 237 of the Treaty of Rome on four successive occasions.[3] Before 1990, discussion of enlargement primarily focused on applicant states from the EU's southern periphery and northern European Free Trade Area (EFTA). With the fall of communism and the spread of democratisation through central and eastern Europe, however, together with the collapse of the Soviet Union and the disintegration of the former Yugoslavia, the EU has become a pole of attraction to the former COMECON states.

Over the next ten to twenty years the European Union is set to increase its membership from fifteen to at least twenty-six. Enlargement of the European Union, particularly eastward, is seen as one of the key challenges currently facing Europe. It will have a profound effect on both the EU and the current applicant states.

Under previous accessions, the onus has been on the acceding states to adapt to the EC, rather than vice versa. Indeed the whole history of enlargement negotiations has been one of the EC imposing its *acquis*[4] on new members. While the conditions of entry for new members in the early 1990s were stringent, this time around the EU also has had to shoulder some of the burden of adaptation. The European Council meeting in Copenhagen in June 1993 concluded that

> the Union's capacity to absorb new members, while maintaining the momentum of European integration, is also an important consideration in the general interest of both the Union and the candidate countries.[5]

The Union's ability to agree on new institutional and financial arrangements will, in part, determine its capacity to absorb new members. In addition, the Union will need to consider the implications for the EU's regional policy and Common Agricultural Policy. Key changes will be

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3 The United Kingdom, Ireland and Denmark in 1973; Greece in 1981; Spain and Portugal in 1986; and Austria, Finland and Sweden in 1995.

4 The body of primary and secondary legislation making up the Community legal and policy framework

5 *Copenhagen Presidency Conclusions*, June 1993

required since established arrangements will not be appropriate for incorporating up to twelve new states and possibly more. It has taken some time for the EU to develop an enlargement strategy due to differing views between member states about the future development of the Union, as well as differences as to the extent and speed of enlargement and associated institutional and policy changes.

As noted above, the EU has had to consider the case of twelve applicants: Turkey, Cyprus, Poland, Hungary, the Czech Republic, Slovakia, Slovenia, Bulgaria, Romania, Estonia, Latvia and Lithuania. In the past, the EU had intimated to the Central and Eastern European Countries (CEECs) and the Baltic states that if they were deemed to be ready, they could begin membership negotiations along with Malta and Cyprus, both of which have received assurances that talks would begin six months after the conclusion of the IGC.[6]

The Commission published its Opinions on the applicant states on 16 July 1997 in *Agenda 2000.* Accession negotiations with the first wave of five Central and Eastern European countries (Hungary, Poland, Estonia, the Czech Republic and Slovenia) plus Cyprus started on 31 March 1998.

In the case of the other applicants, except Turkey, the Commission concluded that accession negotiations should be opened with each applicant as soon as it had made sufficient progress in satisfying the conditions of membership defined by the Copenhagen European Council.[7] Each applicant would also be helped to prepare to meet the obligations of membership for accession under a reinforced pre-accession strategy and to take action to improve the shortcomings identified in the Opinions. The Commission will present a report no later than the end of 1998 on the progress achieved by each applicant state and will report annually thereafter.

In the case of Turkey, the Commission and the Luxembourg European Council reaffirmed Turkey's eligibility for EU membership in principle but effectively put Turkey's application in a separate category from the other applicants.

A complementary paper, *EU Enlargement: the political process* (Research paper 98/55), covers *Agenda 2000* proposals on the enlargement process, the Commission's Opinions on the applicant countries and subsequent developments in the enlargement process.

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6 Although following the victory of the Labour Party in parliamentary elections in Malta in October 1996, Malta has suspended its application for the time being.

7 See Library Research Paper, *EU Enlargement: The Political Process*, 98/55.

III The Financial Consequences of Enlargement

Agenda 2000 stated:

> The number of applicant countries and the differences between them are greater than ever before and they will all be net recipients of Community funds. Moreover, both policy reforms and the absorption of new members will have to be accommodated in a tight budgetary framework.

A. Effects of Successive Enlargements

The effects of successive enlargements of the EU are set out in table 1. The last enlargement involved Austria, Finland and Sweden - three relatively small, rich states without large agricultural sectors. The accession of the 10 Central and Eastern European Countries (CEEC10) plus Cyprus would be similar in area and population to the total of all previous enlargements. Another similarity is that from the first enlargements, successive enlargements have reduced the Union's average per capita GDP.

There are significant differences between the EU15 and the CEEC10. For example, in terms of GDP per capita and of the proportion of the workforce employed in agriculture. If the EU15 GDP per capita (at purchasing power standards) in 1995 was 100, the CEEC10 was just over 30. The CEEC10 have per capita GDPs less than half that of the four poorest countries of the present EU, which together stand at 74% of the EU average. The percentage of employment in agriculture in the EU15 and the CEEC10 in 1995 were 5.3% and 22.5% respectively.

If all ten applicant countries[8] acceded to the EU, the Union's population would grow from 371.6 million to 476.9 million; and the area of the Union would expand from 3.236 million km² to 4.314 million km²: both population and area would therefore expand by roughly one third. In other words, the Union would grow by over 100 million people whose standard of living in 1995 was little over one third of that of the existing EU population.[9] The problems of absorbing the CEEC10 into the EU can be indicated by considering that even with an average growth of 2.5 per cent among the EU15 and 4 per cent among applicant countries, it would take about 25 years for the latter to achieve 50 per cent of the 15's average GDP per head.

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8 Cyprus is excluded from the analysis

9 HoL, Select Committee on the European Communities, *The Financial Consequences of Enlargement*, HL 41, 1997-98

The individual position of each applicant country varies somewhat. Agenda 2000 stated:

> The GDP per capita at purchasing power standards ranged from 59 per cent of the EU15 average in Slovenia through 31 per cent in Poland to 18 per cent in Latvia. The percentage of employment in agriculture ranged from 34.4 in Romania through 26.6 in Poland to 6.3 in the Czech Republic.[10]

Nevertheless, there are some characteristics common to all the applicant countries: the countries are relatively poor with large agricultural sectors and weakened industrial sectors.

As noted above, the Commission recommends that negotiations start for admitting a first wave of five applicants from Central and Eastern Europe: the Czech Republic, Estonia, Hungary, Poland and Slovenia, plus Cyprus. The effect of enlarging the Union from EU15 to EU20 is set out in table 1. Area and population increase by 17% whereas the EU economy is enlarged by 6%. The average per capita falls to 81% of the EU6 average. Overall, as expected, a less severe effect on the EU occurs when the EU15 enlarges to EU20 than when all applicant countries are admitted.

Table 1

Impact of successive enlargements of the EU

based on 1995 data	Increase in area	Increase in population	Increase in total GDP (a)	Change in per capita GDP	Average per capita GDP (EUR 6= 100)
EUR 9/EUR 6	31%	32%	29%	-3%	97
EUR 12/EUR 9	48%	22%	15%	-6%	91
EUR15/EUR 12 (b)	43%	11%	8%	-3%	89
EUR 20/EUR 15	**17%**	**17%**	**6%**	**-9%**	**81**
EUR 26/EUR 15	34%	29%	9%	-16%	75

Note:
(a) in purchasing power parities
(b) including German reunification
Source: Agenda 2000. Volume II and own calculations

The future enlargement of the EU will be quantitatively and qualitatively different from previous enlargements. There were no significant financial consequences for the existing members when Sweden, Finland and Austria acceded. Indeed, the budgetary position of existing members improved. In contrast, the accession of CEECs will inevitably cause some deterioration in the budgetary positions of all current member States.

[10] *ibid*

B. The New Financial Perspective[11]

In its *Agenda 2000* communication, the European Commission issued outline proposals for the next Financial Perspective for the period 2000-2006 and for reform of existing EU policies. The Commission has since adopted a report on the working of the Interinstitutional Agreement (IIA) and the proposals for the Financial Perspective. These later proposals for the Financial Perspective closely follow those in *Agenda 2000*: the figures are, however, presented in 1999 prices rather than current prices and 1997 prices as in *Agenda 2000*. As requested by the Luxembourg European Council, the Financial Perspective is presented on an EU15 basis leaving sufficient margin to finance enlargement but with an accompanying table to estimate the costs associated with enlargement and their financing.[12] The figures are set out in table 2.

[11] Figures are expressed in 1999 prices unless stated otherwise.

[12] Communication from the Commission to the Council and European Parliament on the establishment of a new Financial Perspective for the period 2000-2006, COM(1998) 164 final

Table 2

Overview of the new financial framework 2000-2006

Enlargement starts **EUR millions -1999 prices**

	Appropriations for commitments		1999	2000	2001	2002	2003	2004	2005	2006	2000-2006
1	**Agriculture (guideline)**		**45,210**	**46,050**	**46,920**	**47,820**	**48,730**	**49,670**	**50,630**	**51,610**	**341,430**
a	*Of which:* ***EU15***	*(1)*	40,400	41,330	43,500	44,400	45,020	44,410	42,900	42,260	303,820
	Reformed CAP market measures		37,800	37,010	38,790	39,740	40,400	39,840	38,440	37,850	272,080
	Accompanying rural development/fisheries mea		2,600	4,660	4,610	4,570	4,520	4,480	4,370	4,320	31,530
e	**Pre-accession aid**		**0**	**520**	**520**	**520**	**520**	**520**	**520**	**520**	**3,640**
	Margin	*(2)*	4,810	4,210	2,930	2,950	3,310	4,930	6,630	8,370	33,310
b	**Memo: New Members States**		0	0	0	1,600	2,030	2,450	2,930	3,400	12,410
2	**Structural operations**	*(3)*	**39,030**	**36,640**	**37,470**	**36,640**	**35,600**	**34,450**	**33,410**	**32,470**	**246,680**
a	*Of which: EU15*	*(4)*	*35,730*	*35,600*	*36,430*	*35,600*	*34,560*	*33,410*	*32,370*	*31,430*	*239,400*
c	*Pre-accession structural instrument*		*0*	*1,040*	*1,040*	*1,040*	*1,040*	*1,040*	*1,040*	*1,040*	7,280
	adjustment	*(6)*	*3,290*	*0*	*0*	*0*	*0*	*0*	*0*	*0*	*0*
	Memo: New Members	*(5)*	*0*	*0*	*0*	*3,750*	*5,830*	*7,920*	*10,000*	*12,080*	*39,580*
3	**Internal policies**		**6,390**	**6,390**	**6,710**	**6,880**	**7,050**	**7,230**	**7,410**	**7,600**	***49,270***
	Memo: New members		***0***	***0***	***0***	***730***	***760***	***790***	***820***	***850***	***3,950***
4	**External Action**		**6,870**	**6,870**	**7,070**	**7,250**	**7,430**	**7,610**	**7,790**	**7,900**	**51,920**
	Of which: Pre-accession aid		*0*	1,560	1,560	1,560	1,560	1,560	1,560	1,560	10,920
	Memo: New members			**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**
5	**Administration**		**4,720**	**4,730**	**4,820**	**4,910**	**5,010**	**5,100**	**5,200**	**5,300**	**35,070**
	Memo: New members		*0*	*0*	*0*	370	410	450	450	450	2,130
6	**Reserves**		1,190	850	850	600	350	350	350	350	3,700
7	**Appropriations for commitments- total**		**103,400**	**101,530**	**103,840**	**104,100**	**104,170**	**104,410**	**104,790**	**105,230**	**728,070**
8	**Appropriations for payments - total**		**96,380**	**98,800**	**101,650**	**102,930**	**103,520**	**103,810**	**104,170**	**104,560**	**719,440**
9	*Appropriations for payments as % of GNP*		1.23	1.24	1.24	1.22	1.20	1.18	1.15	1.13	
	Margin %		0.04	0.03	0.03	0.03	0.03	0.03	0.03	0.03	
	Available for accession %		0	0	0	0.02	0.04	0.06	0.09	0.11	
	Available for accession EUR million)		**0**	**0**	**0**	**1,740**	**3,570**	**5,490**	**8,440**	**10,580**	**29,820**
10	*Own resource ceiling*		1.27	1.27	1.27	1.27	1.27	1.27	1.27	1.27	
	Memo:										
	EU GNP (EUR billion 1999) *(7)*		7,800	8,000	8,200	8,700	8,920	9,150	9,380	9,620	61,960
11	*Own resource ceiling (EUR million)*		106,736	109,404	104,130	106,740	109,400	112,140	114,940	117,820	766,760
12	Margin in EUR million		**10,356**	**10,604**	2,480	3,810	5,880	8,330	10,770	13,260	47,320
13	*Margin*		*0.13%*	*0.13%*	*0.03%*	*0.04%*	*0.07%*	*0.09%*	*0.11%*	*0.14%*	-

Notes:

(1) From 2000, this includes about Ecu 2 billion for new development accompanying measures and horizontal fisheries measures and assumes reformed CAP which increases by Ecu 2.5 billion in current prices between 2002 and 2006

(2) This is the difference between the agricultural spending (commitments) and the Guideline (ceiling).

(3) Structural Operations excluding past adjustments Ecu 1.8 bn in 1999, otherwise ecu 36.1 billion

(4) Includes Ecu 2.9 billion per year for Cohesion Fund

(5) Includes participation in Cohesion Fund

(6) Including the amount in respect of the EEA financial mechanism and the adjustment proposed by Commission for implementaiton of 1997 budget.

(7) GNP increases in year 2002 as New Members join EU. Growth EU15=".5% for period, new members growth=4%. Growth in enlarged EU=2.6%. Deflator-=2%

Source: Based on Agenda 2000 (COM(97) 2000 final vol 1and 2

In general the main points are:

- The Commission proposes no change in the own resources ceiling. Since the EC budget must be self-financing, a limit on EU's own resources is also a limit on EU spending. The Commission is therefore planning to meet the additional costs associated with accession from within the existing budget ceiling of 1.27% of the EU's GNP. Of course, the amount of • in current prices will increase in line with increases in the nominal growth of the EU economy.

- *Agenda 2000* estimates an annual growth rate of 2.5 per cent for the EU15 and 4 per cent per year for the CEEC10 over the period 2000-2006. The financial calculations in *Agenda 2000* are based on the assumption that the "first wave" of applicants accedes to the Union in 2002.

- Agenda 2000 proposed that a fixed limit of 4 per cent of national GNP should be established on EC receipts for any one country. This limit has been criticised by some as respecting too much the constraints on the EC budget rather than the justifiable needs of member states. To some, a case by case approach would be preferable to a fixed limit.[13]

- The main table in the Financial Perspective sets ceilings for six categories of expenditure (agriculture, structural policies, external, administration and reserves). It indicates a growing unused margin between the spending ceilings and the ceiling for the EU's revenues (or own resources) of 1.27% of GNP.

- Over the period 2000 to 2006 the Commission is planning to provide • 79.9 billion in 1999 prices to applicant countries.[14] Of the • 79.9 billion, • 61.8 billion will be transferred to the new members leaving • 18.1 billion to the other (5) applicants.

C. Overall Financial Perspective

The Financial Perspective as set out in table 2 indicates two forms of appropriations: appropriations for commitments[15]and appropriations for payments.[16] The overall ceiling on appropriations for commitments will rise from • 103.4 billion in 1999 to • 105.2 billion in

[13] See evidence by Mr Samland (Chairman of European Parliament's Budget Committee) to HoL sub Committee A, *The Financial Consequences of Enlargement*, HL 41, 1997-98

[14] As noted in the summary, the Commission provides the amounts in • presumably in anticipation of EMU. This paper used • to denote the euro. To provide some indication of the amounts in sterling the average rate for the ecu for 1997 was £0.689 and is currently valued at £0.648 (17 April 1998). A crude but useful way of converting • amounts into sterling is to reduce any • amount by one-third.

[15] Commitments appropriations are the total cost of legal obligations which can be entered into during the current and future financial years.

[16] Payment appropriations refers to the amount of money that is available to be spent during the year arising from commitments in the budgets for the current or preceding year.

2006, an average annual growth rate of 0.2% in real terms, including pre-accession aid. These spending ceilings include the total sum of the agricultural guideline and should leave a significant unused margin for commitments.

The ceiling on appropriations for payments rises from • 96.4 billion in 1999 to • 104.6 billion in 2006, an average of 1.2% per year.[17] On the basis of the economic forecasts used by the Commission, the ceiling falls from 1.23% of EU GNP in 1999 to 1.13% in 2006. This leaves a substantial margin of 0.14% of EU GNP in 2006 (• 13.3 billion in 1999 prices) below the level set by the own resources ceiling. The Commission proposes that 0.03% of Community GNP be available for unforeseen expenditure and in the event that the rate of economic growth falls below that projected. The remainder of the margin (• 10.5 billion in 2006 and • 28.8 billion for the period 2002 to 2006) is to be available for accession in the EU15 financial perspective.[18]

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[17] See line 8 in table 2.

[18] The figures are estimates provided by the Commission and only approximate the % of EU GNP indicated by the Commission in other parts of the proposals.

D. Main Categories

This section describes the main categories of spending in the proposed Financial Perspective. All figures are in constant 1999 prices unless otherwise stated. The heading numbers are those used by the Commission.

1. Agriculture (Heading 1)

The Commission proposes that the agricultural guideline that limits increases in spending to the rate of inflation plus 74 per cent of the real GNP growth should continue. Within this level, some programmes that are presently classified as structural operations should be brought within the guideline from 2000. On the basis of the economic forecasts used by the Commission, spending under heading 1 should increase by 1.9% a year in real terms and thus rise by around • 6.4 billion from • 45.2 billion in 1999 to • 51.6 billion in 2006.[19]

Margin

The Commission estimates that, owing to Common Agricultural Policy (CAP) reforms, actual agricultural spending will be some • 4.8 billion below the agricultural guideline in 1999 and some • 8.4 billion in 1999.[20] The Commission considers that this margin could provide some cover for enlargement-related costs and be sufficient to deal with market uncertainties. The ceiling could be reviewed in 2005.[21]

Reformed CAP market measures

Market spending on the reformed CAP should increase from • 37.8 in 1999 to • 43.7 billion in 2006 in current prices. In 1999 prices, the spending remains broadly flat.

Rural development Policy

Reform of the CAP is to be accompanied by a strengthened rural development policy. This new rural development policy will group together measures in the 1992 reform (afforestation, early retirement and agric-environmental measures), aid to less favoured areas under objective 5a and similar measures under objective 1. In current prices spending on this new rural policy will increase from • 2.6 billion in 1999 to • 4.7 billion in 2000, rising to some • 5

19 COM(1998) 164 final, para. 3.1.

20 In 1999 prcies. But the margin in 2006 is estimated to be • 9.7 billion in current prices. See annex B in COM(1998) 164 final for agricultural spending in current prices.

21 COM(1998) 164 final, para. 3.1.

billion in 2006.[22] In addition, a total of • 12.4 billion in current prices will be provided to new members.

Agricultural pre-accession instrument

The Commission is presenting a proposal for a regulation establishing an agricultural pre-accession instrument, which would authorise spending to improve farm structures, processing and marketing of agricultural and fish products, inspections and rural development measures in the applicant countries. The agricultural pre-accession instrument will be allocated a constant • 520 million a year in 1999 prices.[23]

2. Structural Operations (Heading 2)

Spending on structural policies is to be limited to 0.46% of the EU's GNP. This would mean that total spending throughout the period (2000-2006) would rise to • 247 billion compared with • 208 billion for the current period (1993-1999). This represents a rise of 16% in total. Of the • 247 billion, nearly • 240 billion is to be available to the EU15 with another • 7.3 billion (• 1,040 million per year) available to applicant countries under a pre-accession structural instrument. In addition some • 39.6 billion is to be available to new members. The proposals for reform of the structural funds are outlined in section IV.

3. Internal Policies (Heading 3)

The total allocation for internal polices in the EU will gradually increase 2.5% a year from • 6,390 million in 1999 to • 7,600 million in 2006 making a total increase over the period of • 49.3 billion. In addition new members will receive • 3,950 million over the period. Over the period the ceiling is raised by • 1.2 billion, 19%, the highest rate of increase in the new financial perspective. This is justified by the Commission in terms of its increased support for growth, employment, the single market and operations under justice and home affairs. The five priorities of the Commission are trans-European networks, research and innovation, education and training, introduction of environment-friendly technologies and measures to support smaller businesses. Trans-European networks are expected to account for a growing proportion of heading 3 funding. The proportion spent on research and innovation is expected be the same as that for the fourth research framework programme. Spending on education and training is expected to rise above the 1999 level.

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[22] In 1999 prices the spending increases from • 2.6 billion in 1999 to • 4.7 billion in 2000, falling to some • 4.3 billion in 2006.

[23] See line c in table 2.

4. External Action[24] (Heading 4)

The overall allocation for external actions will rise from • 6,870 million in 1999 to • 7,900 million in 2006, an average real increase of 2% per year. A separate sub-heading within this allocation of • 1,560 million will be available to finance the pre-accession strategy through the Phare programme.[25] Over the period to 2006, this allocation of • 10.9 billion will represent about half of the total pre-accession aid. The higher ceiling from 2001 will allow the EU to support certain regions. However, this higher ceiling does not allow for the European Development Fund (EDF) to be financed from within the EC budget.[26]

EU enlargement will result in some shifts in the external actions of the EU. For example, more support is likely to be given to the Republics of the former Soviet Union, the former Yugoslavia, Albania and non-members Mediterranean countries as these are adjacent to applicant countries. However, the Commission considers that these priorities should not be at the expense of co-operation in other areas.[27]

5. Administration (Heading 5)

The overall allocation for administrative spending for the EU15 will rise from • 4,730 million in 1999 to • 5,3000 million in 2006, an average real increase of 1.7% a year. The increases of • 550 over the period will start from 2001. According to the Commission, • 260 million will be required on present arrangements for pensions by 2006. Other items of administrative spending will not be able to exceed real increases of 1% a year on average. Staff numbers are expected to remain broadly unchanged.

6. Reserves (Heading 6)

The allocation to reserves will fall from • 1,190 million in 1999 to • 350 million in 2006. Changes in the three reserves are outlined below.

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[24] Includes the Phare programme.

[25] The Phare Programme is a European Community initiative to support reform in the countries of central Europe. The main priorities for Phare fundings are common to all countries, and include restructuring of state enterprises including agriculture, private sector development, reform of institutions, legislation and public administration, reform of social services, employment, education and health, development of energy, transport and telecommunications infrastructure, and environment and nuclear safety. For countries that have signed Europe Agreements, Phare is the financial instrument of the European Union's pre-accession strategy which will lead them to full membership.

[26] EDF provides funds for the EU's development programme. The EDF is financed separately and outside the EC budget. Budgetisation is the technical term for putting the cost of financing the EDF onto the EC budget This whole issue is to be reviewed in 2005.

[27] COM (98) 164 final

Monetary Reserve

Agenda 2000 proposed that the monetary reserve be gradually abandoned as CAP reform should make refunds and agricultural spending less sensitive to changes in the euro/dollar rate. It is proposed that the monetary reserve remains at its present level of • 500 million in current prices in 2000 and 2001 and be reduced to • 200 million in 2002 and eliminated altogether in 2003.

Reserve for Emergency Aid

It is proposed that the reserve for Emergency Aid be restored to its original purpose of meeting genuinely new and unforeseeable emergencies. The Commission considers that it should be possible to reduce the reserve to • 200 million a year by 2000, although this will require corresponding increases in areas under heading 4.

Reserve for Loan guarantees

These funds endow the Guarantee Fund so that direct payments can be made in the event that the Fund has insufficient resources. For a number of reasons the Commission proposes that the level of the reserve be reduced to • 150 million in 2000.

IV Financing the Costs of Accession

The financial calculations in *Agenda 2000* are based on the assumption that the first wave of applicants accedes to the Union in 2002. Costs arising from enlargement would fall into two main categories: those occurring in the pre-accession phase as assistance is provided to applicants as they prepare for accession; and other costs arising after accession the new Member States become eligible for Community programmes.

Table 3 shows the total amount of expenditure (• 79.9 billion) connected with accession of new member States and pre-accession of other applicants for the period 2000 to 2006 as proposed under *Agenda 2000.* This amount represents about 11% of the total payments throughout the period 2000 to 2006 or just over twice the amount that the Commission expects to spend on administration.[28] Of the • 79.9 billion, some • 58 billion is proposed for the countries of the "first wave" once they become new members from 2002. The rest of the amount (• 21.8 billion) is Total Pre-accession Aid, which is clearly for both the countries of the "first wave" and other applicants prior to their joining the EU. Of the • 21.8 billion the "first wave" countries would receive • 3.9 billion as pre-accession aid, masking a total transfer to the "first wave" countries of • 61.8 billion with • 18.1 billion for the other applicants.

The sum of • 79.9 billion allocated for enlargement is expected to be spent in a number of ways. These are set out in the lower part of table 3. • 16 billion is expected to relate to agricultural spending with • 3.6 billion in the form of Pre-accession Aid and a further • 12.4 billion being provided to "first wave" of new members from 2002 to 2006. Over the same period some • 39.6 billion will go to the "first wave" of new members from 2002 to 2006 under structural operations. A further • 7.3 billion will be provided under structural operations as pre-accession aid, making a total • 46.8 billion for structural operations. Under internal policies, new member states will receive some • 3.9 billion from 2002 to 2006. • 10.9 billion, or half, of the Total Pre-accession Aid from 2000 to 2006 will be provided as external action (Phare programme). New members will also receive • 2.1 billion under the Administration heading.

A. Sources of Financing

As noted above, of the • 79.9 billion, some • 58 billion is proposed for the countries of the "first wave" once they become new members from 2002. The Commission has explicitly identified three sources of finance for the • 58 billion expenditure associated with the

[28] Spending on Administration for the period is expected to be • 35 billion.

accession of the "first wave" of members. These are set out in table 4 and include the following.

- Agricultural funds available from a spending margin beneath the agricultural guideline, which over the period from 2002 to 2006 is expected to provide • 12.4 billion.[29]

- Funds earmarked in the financial perspective for the EU15, which the Commission estimates will be • 28.8 billion over the period 2000 to 2006.[30]

- Funds available as a result of an enlargement of Community GNP, which the Commission estimates will be • 17 .9 billion over the period.[31]

[29] See line 8 table 4
[30] See line 9 table 4
[31] See line 10, table 4

Table 3

Expenditure and transfers connected with Accession of New Member States

EUR billion -1999 prices			Total 2000-2006
Expenditure:			
Total Pre-accession aid			**21,840**
Amounts for New Member States		*(1)*	**58,070**
Total			**79,910**
For period 2000-2006 distributed to:			
New members receive		61,810 *(2)*	
Other applicants		18,100 *(2)*	
			79,910
Planned Transfers:			
Agriculture			
Pre-accession		3,640	
New Member States	*(1)*	12,410	
			16,050
Structural Operations			
Pre-accession		7,280	
New Member States	*(1)*	39,580	
			46,860
Internal Policies			
Pre-accession			
New Member States	*(1)*	3,950	
			3,950
External Action			
Pre-accession		10,920	
New Member States	*(1)*		
			10,920
Administration			
Pre-accession			
New Member States	*(1)*	2,130	
			2,130
Total			**79,910**

(1) Expenditure from 2002 to 2006

(2) New members also receive some EUR 3.9 as pre-accession aid before 2002

Source: Based on table 4, Agenda 2000 COM(97) 2000 final vol. 1 and COM(1998) 164 final

Table 4

Expenditure Resulting from Accession and its Financing

	EUR million -1999 prices	**2002**	**2003**	**2004**	**2005**	**2006**	**Total 2000-2006**
1	Agriculture *(Heading 1)*	1,600	2,030	2,450	2,930	3,400	12,410
2	Structural operations *(Heading 2)*	3,750	5,830	7,920	10,000	12,080	39,580
3	Internal policies *(Heading 3)*	730	760	790	820	850	3,950
4	Administration *(Heading 5)*	370	410	450	450	450	2,130
5	**Total appropriations for commitments for New Member States**	**6,450**	**9,030**	**11,610**	**14,200**	**16,780**	**58,070**
6	**(1) Total appropriations for payments for New Member States**	**4,140**	**6,710**	**8,890**	**11,440**	**14,220**	**45,400**
7	**Sources of Financing available:**						
8	Agricultural sums in the margin available beneath the agricultural guideline	1,600	2,030	2,450	2,930	3,400	12,410
9	Sums earmarked for accession in EU15 financial perspective (Commission estimate)	1,280	3,300	5,680	8,060	10,470	28,790
10	Increase in own resources from enlargement of EU GNP (Commission estimate)	3,440	3,510	3,580	3,660	3,740	17,930
11	**(2) Total Financing Available**	**6,320**	**8,840**	**11,710**	**14,650**	**17,610**	**59,130**
12	**Changes in the Margins beneath the Own Resources Ceiling:**						
13	Margin (2) minus (1)	2,180	2,130	2,820	3,210	3,390	13,730
14	Margin in framework of EU15 (.03% of EU15 GNP)	2,520	2,580	2,650	2,720	2,780	13,250
15	Total Margin available in an enlarged Community/estimate	4,700	4,710	5,470	5,930	6,170	26,980
16	Total Margin as % of GNP of enlarged Community	0.05%	0.05%	0.06%	0.06%	0.06%	0.06%

Source: Commission, COM(98) 164 final, table 2

B. Financial Uncertainties

The figures in *Agenda 2000* for the costs associated with accession are projections. More reliable figures will be available at the end of the accession negotiations and any transitional period.[32]

The necessary funds for the costs of enlargement are generated by the Commission calculating that the EU15 will grow at 2½% p.a. and that the applicant countries will grow at 4% p.a. for over the period 2000-2006. These growth forecasts have been greeted with some scepticism.[33] If the growth rate falls significantly below that projected by the Commission, the EU budget will have insufficient funds to make the projected transfers to the applicant countries.

Mr Samland, chairman of the European Parliament's Committee on Budgets, gave an indication of the importance of the rate of economic growth in evidence to the Lords select committee on the European Communities.[34] He said that the Commission required an annual growth rate of at least 1.67 per cent in order to finance the policies for existing members. The margin between this 1.67% rate and the projected 2½% growth would generate the resources to finance two-thirds of the pre-accession phase of the enlargement. Of course if the economic performance of the EU economy falls below the assumed growth of 2½%, then the margin for financing EU enlargement would also fall. In a supplementary note to the Lords Committee, the Treasury estimated that the margin in the EC budget would be only 0.01 per cent (ecu 1 billion) if the annual growth rate of the EU15 fell to 2 per cent from the projected 2½%. Lower than expected growth rates for the applicant countries are of little consequence, reflecting their small contributions to the EC budget.

C. Other Potential Sources of Financing the Spending Resulting From Accession

As noted above, the Commission's financial framework depends critically upon the EU15 reaching a certain rate of economic growth and certain reforms being made to major spending programmes. There is also a small margin between the projected spending levels and the total permitted level set by the own resources ceiling. Failure to meet any of these conditions could cause a financing gap to arise between the level of spending resulting from accession and the level of available funds. This financing gap, if it arises, could possibly be bridged by

32 Report on *Agenda 2000*, European parliament, 29 October 1997 Doc-en.\rr\338\338783

33 HoL, Select Committee on the European Communities, *The Financial Consequences of Enlargement*, HL 41, 1997-98

34 HoL, Select Committee on European Communities, sub-Committee A, 15 October 1997

increasing the EU's own resource ceiling or reducing yet further the sums available to the existing EU members. This would effectively mean reducing their receipts from the CAP, structural and cohesion funds. Another option would be to find some other source of finance, such as reducing or eliminating the UK rebate.

1. The UK Rebate

The UK receives an abatement under the 1984 Fontainebleau arrangement. The abatement was agreed because the structure of EC spending and the method of raising revenue was particularly ill-suited to the UK. Without the abatement the UK would, with its small farming sector and reliance on external trade, become the major contributor to the budget despite being one of the less prosperous members. The Fontainebleau abatement is calculated through a rather complex formula, which, in broad terms, is equivalent to 66% of the difference between, on the one hand, what the UK would have paid if the Community had been financed entirely by VAT and, on the other, UK receipts from the budget. The abatement applies only in respect of spending within the Community (it excludes expenditure outside the Community - mainly development assistance, which amounts to 6 to 7 per cent of the total Budget); and is deducted from the UK's VAT contribution a year in arrears.

The Commission is entirely responsible for determining the level of the abatement each year. It is calculated on the basis of forecasts of member States' contributions to the Budget and payments from the Budget to member States. It is then corrected in the light of outturn figures, and corrections can be made up to four years in arrears. *Agenda 2000* stated:

> The uncertainties surrounding the future relative prosperity situation of the United Kingdom, however, lead the Commission to propose postponing a re-examination of the rebate mechanism until immediately after the first enlargement.
>
> At that moment, it will be possible to proceed to an assessment of the situation on the basis of more reliable data. If the relative prosperity of this country were to be above the Union's average, it would be appropriate to review the current arrangements and to foresee a gradual reduction of the current rebate.

And later

> At the time of the enlargement, it will be necessary to adapt the definition of the expenditure on which the calculation of the rebate is based to avoid an unjustified increase in its amount due to purely statistical changes. This is made necessary by the fact that with enlargement some expenditure flows directed to the new member States, which are now considered "external expenditure" and therefore do not enter into the calculation, will be replaced by payments under internal policies, which enter into the calculation.[35]

[35] *Agenda 2000, For a Stronger and Wider Union*, part III, (COM(97) 2000).

The rebate has aroused some criticism from some other member states. Any shortage of EU funds to meet the costs associated with accession may reinforce calls for the UK rebate to be reduced or eliminated since some members, including Germany and Netherlands consider the UK rebate system as unfair. The UK government's view is that the UK rebate system is written in stone and cannot be changed without the agreement of the UK. Enlargement would boost the size of the UK rebate as some external spending that hitherto was excluded is taken into account when calculating the size of the rebate. The existence of the UK rebate is likely to attract even more critical attention as its size increases, especially if a financing gap should emerge. A detailed analysis of EC finance may be found in a Library Paper.[36] One of the conclusions of that Paper is that over the most recent five year period the UK was the fifth poorest member but the fifth largest net contributor, suggesting that it was paying a relatively high net contribution even with its rebate.

2. Raising the Own Resources Ceiling

The present financial perspective, covering the period 1993-1999, was agreed at the Edinburgh European Council in December 1992. The Council agreed the Delors II package, which had staged increase in the own resources ceiling, reaching 1.27 per cent of Community GNP by 1999.[37] As noted above, the Commission is proposing to finance the costs of enlargement from within the existing own resources ceiling of 1.27% of EU GNP.

Raising the own resources ceiling is one way of providing more funds for accession. However, there is no evidence that members wish to see an increase in the own resources ceiling. This is hardly surprising since enlargement is likely to cause a deterioration in the budgetary position of existing members. Any additional burden on public finances will be unwelcome at a time when member states are endeavouring to maintain tight control of their public finances for domestic reasons and in order to comply with the Maastricht convergence criteria.

D. Reforming Existing EC Programmes

The Prime Minister said:[38]

> For enlargement to be successful there must be reform. The CAP must be modernised. Of course, government will have to go on spending money to keep people in rural areas, and preserve our rural environment. But the present system is a manifest absurdity,

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36 Library Paper 97/137, *EC Finance*

37 For details see Library Paper 93/48, *The Maashricht Debate: Future Financing of the European Community*

38 Speech by Prime Minister at the Annual friends of Nieuwspoort Dinner, Ridderzaal, The Hague, 20 January 1998.

> which discredits Europe and its institutions. It does not encourage competitive farming or serve our consumers well. It is time to grasp fully the nettle of reform.
>
> Reform of the Structural and Cohesion Funds also cannot be ducked. We have to free resources for the inevitable needs of the much poorer new members. We cannot afford to exceed the present spending limits. The results need to be fair and equitable for existing and new Members States alike, durable thought and after enlargement, and affordable.

The Commission assumes that significant reform of the Common Agricultural Policy and the Structural Funds will help finance the costs of accession within the present ceiling. These two programmes account for some 80% of the EC expenditure. A House of Lords Committee described the position as follows.[39]

> Enlargement would be paid for within that ceiling in two ways: by growth of the economies of the member States and by some reductions in the amounts of the Budget devoted to the Common Agricultural Policy and the EU15's structural operations - the Community policies which absorb between them about 80 per cent of the Budget. In rough terms, about two thirds of the additional costs to the Union of enlargement would come from growth and one third from changes to these two major policies.[40] Moreover, actual payments from the Budget would not reach the own resources ceiling: payments, as a proportion of the EU15 GNP would decline from 1.25 per cent in 1999 through 1.24 per cent in 2000 and 2001 to 1.22 per cent in the years 2002-2006. There would, therefore, always be a margin below the 1.27 per cent ceiling. The Commission express the opinion *Agenda 2000* that this margin would most likely be more than sufficient to cover requirements should economic growth turn out lower than forecast.

The Commission's proposals for financing the cost of EU enlargement depend crucially upon the reform of agricultural policy, reform of the structural policy and realisation of the projected growth rates.

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[39] HoL, Select Committee on the European Communities, *The Financial Consequences of Enlargement*, HL 41, 1997-98

[40] There are a number of possible ways of calculating how the funds for accession will be provided. The Committee are using figures quoted by Mr Samland but it is not obvious how this one-third and two third split was arrived at.

V Reform of Structural Funds

The structural funds lie at the heart of EU regional assistance. The four Structural Funds are the European Regional Development Fund (ERDF), the European Social Fund (ESF), the European Agricultural Guidance and Guarantee Fund (EAGGF) Guidance Section and the Financial Instrument for Fisheries Guidance (FIFG).[41] The aim of the Cohesion Fund is to channel financial assistance to the four poorest states with a per capita GDP of less than 90% of the Union's average (Greece, Spain, Ireland and Portugal). Eligible projects have to be in the fields of the environment and trans-European networks.

The four Structural Funds are the European Regional Development Fund (ERDF), the European Social Fund (ESF), the European Agricultural Guidance and Guarantee Fund (EAGGF) Guidance Section and the Financial Instrument for Fisheries Guidance (FIFG).[42]

Resources[43] of ERDF amount to ecu 80.5 bn for 1994-99, as against ecu 35.4 bn in the period 1989-93. ERDF is some 48% of the four Structural Funds. Spain (24.1% of ERDF resources), Italy (15.2%), Greece (12.4%), Germany (12.2%) and Portugal (12.4%) are currently the largest recipients.[44] The ESF accounts for 30% of Community interventions in the current period (1994-99). Spain (20%) and Germany (15.9%) are the largest recipients. The Guidance Section of the EAGGF accounts for ecu 23.7 bn or 15.4% of Community Funds in the current period. FIFG was granted ecu 2.9 bn in 1994, 19% of Community funding. Spain, Italy, France and Portugal are the principal beneficiaries, sharing 69% of the available funds.

Although not strictly a regional fund, the ESF will by its nature have a regional effect in that it will help disadvantageous regions. And under the 1989 and 1993 regulations the ESF is required to act with a regional bias.[45]

Six major financial instruments generally support the European Union’s Community cohesion policies. The Cohesion Fund and the loans from the European Investment Bank are based on a project-financing approach and are governed by their own rules, while four (inter-related)

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41 FIFG is concerned solely with programmes under Objective 5(a). The Cohesion Fund is only applicable to the "poor four": Greece, Spain, Ireland and Portugal under the provisions of the Maastricht Treaty, but cannot be used to finance projects which receive support from the ERDF, the ESF or the guidance section of the EAGGF.

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43 All figures in paragraph are in 1997 prices.

44 *First Cohesion Report*, Commission, Com(96) 542 final, November 1996.

45 *Regional policy of the EU,* Harvey Armstrong (article).

Structural Funds operate within a single Community-wide framework according to common principles, such as additionality and partnership.

The following outlines the Four regional Objectives, which absorb 85% of the funding:

Objective 1 - this is for development and structural adjustment for regions, which are lagging behind, including rural areas. This constitutes the major priority of Community structural policies. About 26.6% of the Community population live in regions covered by this Objective and they account for more than two thirds of the funding.[46] Funding is provided from the ERDF, ESF and EAGGF (Guidance).

Objective 2 - this is for the conversion of areas affected by the decline of traditional industries and is the Community's second regional policy priority. Some 11% of the total financial means are reserved for this Objective which covers about 16.4% of the Community population. Funding is provided from the ERDF and ESF.

Objective 5b - this is for development and structural adjustment of rural areas. Some 5% of total funding is earmarked for this Objective which covers 8.8% of Community population. Funding is provided from the ERDF, ESF and EAGGF (Guidance).

Objective 6 - this is for the problems associated with very sparsely populated areas, such as parts of Scandinavia. This covers 0.4% of the Community population and 0.5% of the total financial resources. Funding is provided from the ERDF, ESF and EAGGF (Guidance).

In addition there are **three Community wide Objectives** which absorb 15% of total financial resources.

Objective 3 - this facilitates the integration of young people and people who are long term unemployed into the labour market, while reducing social exclusion. Some 9.4% of total resources are devoted o this Objective. Young people unemployed and the long-term unemployed represent 1.3% and 2.4% of the total Community population respectively. Funding is provided from the ESF.

Objective 4 - this is to help the adaptation of workers to industrial change. Some 1.6% of total resources is earmarked for this Objective. Funding is provided from the ESF.

[46] *First Cohesion Report*, Commission, Com(96) 542 final, November 1996

Objective 5a - this helps to promote their adjustment of the agricultural and fisheries sectors. Some 4.4% of total resources are devoted to this Objective, outside the Objective 1 areas, with 3.8% for the larger agricultural sector and 0.6% for the fisheries sector. About 2% of the Community population are employed in the primary sector. Funding is provided from the EAGGF (Guidance).

In addition to these main objectives, some 9% of the Structural funds are reserved for a range of ***Community initiatives*** such as Rechar (for former coal-mining areas), Resider (for areas affected by closures in the steel industry) and Konver (for areas seriously affected by the contraction of the defence industry). These initiatives follow a thematic approach such as: helping areas to diversify which are heavily dependent on certain industries such as coal, textiles or steel; helping small and medium sized enterprises; and helping experimental policies for the environment or urban areas.

The present round of funding from the Structural Funds is due to expire in 1999. Any reform to Structural Funds will clearly need to accommodate future EU enlargement. In the past there has been a connection between the growth of EU regional spending and the accession of new members. For example, the ERDF was created in 1975, in the wake of the accession of Britain, Ireland and Denmark. At the Edinburgh summit in 1992 it was agreed to double spending on structural and cohesion polices and in the following year accession negotiations were started between Austria, Finland and Sweden and the EU. Although further EU enlargement will generate further demands for increased spending on structural operations, any additional spending is likely to be accompanied by some reallocation of spending.

Agenda 2000 provides the starting point for the review of the Structural Funds and regional policy. Some of the key proposals in the document are as follows:

- Objective 1 and 2 areas will cover between 35% and 40% of the Union population, against 51% currently (there will be greater concentration of expenditure).

- The Commission proposes **strict** application of the GDP criterion by which assistance will only go to regions whose per capita GDP is less than 75% of the Union average.

- For all the regions confronted with major economic and social restructuring needs, the Commission proposes a "new" Objective 2. The areas could be rural or urban or dependent on the fishing industry. It would replace the old Objectives 2 and 5(b)[47], but eligibility would be more precisely and narrowly targeted. This Objective will take

[47] The EAGGF helps to support early retirement, to convert or diversify production, to build up the rural infrastructure, to improve communications and irrigation, to encourage tourism, to protect and conserve the environment and to increase woodlands and forest, are all eligible for support.

particular account of the unemployment rate, of the level and rate of change of industrial employment and agricultural activity, including changes linked to fisheries, as well as the degree of social exclusion. The 'new' objective 2 will incorporate much of the work currently being undertaken through the various Community Initiatives, such as Rechar, Resider and Konver.

- A new Objective 3 will apply to regions not covered by Objectives 1 and 2 in order to help member States adapt and modernise their systems of education, training and employment.

- Separate amounts of expenditure have been allocated for the existing fifteen member states (• 239 billion over the period 2000-06) and for potential new members (• 40 billion). Thus the existing member states will only be affected to the extent that • 40 billion has been "reserved" for new accessions to the EU; the number of countries that actually join should not affect the amounts available.

- The Cohesion Fund is to be maintained in its present form after 1999: countries whose per capita GNP is less than 90 per cent of the EU average would be eligible, subject to compliance with the Stability and Growth Pact for those taking part in the third phase of EMU. It is suggested that a review of eligibility under the per capita GNP criterion should be carried out half way through the period 2000-2006. The total amount available for all the Fund's beneficiaries should be some • 3 billion a year. If there is no agreement on the extension of the Cohesion Fund, then it will lapse in 1999.[48]

Clearly a number of regions currently benefiting from EU funds will lose their present eligibility. In the UK:

> Britain's case is particularly hard. It has never done well under Objective 1, the most lucrative category: this time Northern Ireland and the Scottish Highlands and Islands are likely to be out, South Yorkshire may be in, and Merseyside may keep its Objective 1 status. More seriously, the new Objective 2, including categories under which Britain normally does better - areas of industrial and rural decline, plus some urban and fishing areas - will be decided mainly according to levels of unemployment. Since British unemployment is well below the EU average, it could lose out badly. Britain argues that unemployment is a poor measure of deprivation because it is cyclical. This is weakened by the fact that there were few complaints last time round, six years ago, when the UK did well because its unemployment was high. The government does, however, have an argument when it points out that the Commission's proposals do not reflect adequately the fact that Britain is the EU's fourth-poorest country. It has little option but to continue pressing the Commission to apply the guidelines more flexibly. The Commission has responded by suggesting that the criteria used should be half community ones, and half national ones, allowing

[48] HL 41, *The Financial Consequences of Enlargement*, HL 41, 1997-98, Evidence given by Mr Samland, European Parliament's Budget Committee

> governments to take their own criteria into account in proposing lists of qualifying areas to the Commission. The crunch will come when the Commission decides what proportion of the UK population can be covered by Objective 2.[49]

On 18 March 1998 the European Commission published drafts of the regulations that will govern the operation of EU regional aid for the period 2000 to 2006.[50] It is proposed that there will be just two regional objectives, and a third horizontal objective for areas not covered by the former group.

The renegotiations of the programmes of assistance under the European Structural Funds, including the UK concerns about the proposed eligibility criteria, will be subject of a forthcoming Library Paper.

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[49] Reporting Britain: Regional aid losers must face their fate: Viewpoint, *Financial Times*, *Survey* ,19 February, 1998

[50] Draft Council Regulation (EC) N° /98 of 1998 Establishing an Instrument for Structural Policies for Pre-Accession.

VI Reform of the Common Agricultural Policy

A. What the Commission is trying to achieve

Reform of the CAP is an important part of *Agenda 2000*, because it would be extremely expensive to extend the existing CAP to the new entrant countries. In addition, the huge boost to agriculture would distort their economies and result in a shift of resources out of other types of economic activity. The position of Agriculture Commissioner, Franz Fischler, has been clear for some years. He wants to move agricultural assistance away from price support towards income support. This idea was already the basis of the 1992 reform of the CAP, but support prices remained well above world prices, except for an untypical surge in world grain prices in 1994 and 1995. Fischler sees such a move as the answer to the main problems facing the CAP.

First, the cost of enlargement can be kept within reasonable limits because he argues that the income support is paid as compensation for price cuts. The new entrants will have had no price cuts and therefore need no income support.[51] Second, a policy based upon income support can be made compatible with the demands of the World Trade Organisation, and can therefore allow EU exports to increase to match the expected growth in world markets. Third, a policy based on low prices and income support does not impose any cost upon the consumer, although there is a cost to the taxpayer.

Few would therefore disagree with the direction of Fischler's policy, although many dislike the particular reforms on offer. Most European agriculture ministers argue that they go too far, while the US Government, the House of Commons Agriculture Committee and environmentalists argue that they do not go far enough. Fischler stresses the importance of internal challenges facing the CAP and plays down the role of enlargement. In other words, he argues that the CAP needed reform in any case. This is reminiscent of the position before the 1992 CAP reform, when the European Commission continually stressed internal reasons for reform rather than the need to resolve the Uruguay Round of the GATT negotiations.

Fischler has always argued that the CAP would not be an obstacle to enlargement. His solution – to pay income support to existing EU countries but not to new entrants – is open to two main objections. Income support has not simply been paid as compensation for price cuts. After the 1992 reform, world grain prices were unusually high but EU farmers still received their income support even though their prices had not fallen. The second problem is that, under the *Agenda 2000* plans, a situation would be reached where, for example, a French

[51] Speech to a conference of European conservative Parties in Helsinki, *Agra Europe*, 30 August 1996 E/6

farmer growing 30 hectares of wheat would receive income support but a Polish farmer growing 30 hectares of wheat would not. That might make sense if the support came from national policies, in which case the French government could choose its level of support, subject only to the need to avoid distorting competition. It does seem paradoxical, however, that a European policy should achieve that end. Fischler's answer to such objections is that enlargement does present problems of income distribution which the EU may choose to solve in a different way – for example via the structural fund – but that that is not primarily an agricultural problem.

B. An overview of the March 1998 proposals[52]

The proposals in March 1998 were a more detailed version of the *Agenda 2000* proposals of July 1997. For cereals they are virtually unchanged, but there are slight changes in the premium increases in the beef sector. The milk quota proposals in March contained a sharper decline in prices (15% rather than 10% over 6 years) but balanced by some increase in milk quota.

1. Arable Crops

- Cereals intervention price to be reduced by 20% in one step in the year 2000.
- Direct aid to be increased to 66 ECU/tonne from 54 ECU/tonne
- Special protein crop aid of 6.5 ECU/tonne in addition to arable aid.
- Compulsory set-aside retained but the basic rate set at zero. Voluntary set aside will be maintained at the same level of payment as cereals and may be guaranteed for five years.

2. Beef

- Intervention price will be cut by 30% in four stages over the years 2000-2003
- Intervention to end in 2003 and be replaced by private storage aid
- Premia will be increased by 2002 to 220 ECU for bulls, 170 ECU for steers, 180 ECU for suckler cows and 35 ECU for dairy cows.
- In addition to these basic amounts, member States can make additional payments within limits and according to common rules.

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[52] Cons Doc (77073/98), summarised in *Agra Europe*, 20 March 1998 EP/5. The ECU figures are in current prices.

3. Dairy

- Intervention prices for butter and skimmed milk powder to be cut by 15% in four steps between 2000 and 2003.

- Compensation to be based on number of premium units determined by dividing quotas by the average Community milk yield of 5,800 litres per cow. Direct payments will be made up of a basic payment of 100 ECU per premium unit and an additional payment of 45 ECU per unit.

- Milk quotas to be retained until 31 March 2006 but increased by 2% in four steps. The increase will be shared between young farmers and mountain/Nordic producers.

4. Modulation/cross-compliance

- Member States must link direct payments to environmental objectives which they can determine themselves under Community rules. Member States may withhold up to 20% of payments from farmers who fail to meet these standards and the money can be used by national authorities to fund other agri-environmental schemes.

- Member States are also able to cap aid payments to farmers within certain limits after taking into account the level of employment on a farm.

- The Commission is also planning to introduce a degressive overall ceiling on aid payments. Total aid payments between 100,000 and 200,000 ECU would be reduced by 20% and payments above 200,000 ECU by 25%.

C. Reaction to the proposals

1. Reaction abroad

The proposals were generally criticised at a meeting of the Council of Agriculture Ministers.[53] The German Minister Jochen Borchert criticised the proposals saying they would lead to higher expenditure, lower incomes for farmers, more red tape and a greater dependence on direct state payments. The French Minister Louis Le Pensec warned that the higher direct aids planned in the proposals might be swept aside in the next round of the World Trade Organisation international trade talks. The Irish Agriculture Minister, Joe Walsh, rejected the proposals outright, saying that "major Irish economic interests are at stake", because of the economic importance of beef and milk to Ireland. Moderate support

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[53] *Agra Europe*, 3 April 1998 EP/1

for the proposals came from the UK, Sweden and Denmark whose Ministers all urged the Commission to go further in reform.

French opposition has been strengthened by criticism from both Prime Minister Jospin and President Chirac.[54] One commentator pointed out that the French Government seemed to have abandoned the traditional view that France had a vocation as an exporter of agricultural produce, since the only way that that could return was by a reduction in support prices to the level of world prices.[55]

Italy is a potential loser, because the proposals to not anticipate any increase in spending on Mediterranean produce. The only positive point for Italy is the probable 2.9% increase in milk quotas.[56] Spanish comment seems to have concentrated on the proposals to freeze support payments for olive oil, considered to be very much against Spanish interests, rather than the more general *Agenda 2000* proposals. As with Italy, the only positive aspect is seen as the increase in the milk quota.[57]

In the USA the reaction to the earlier version of the proposals was very different, with economists from the US Department of Agriculture estimating that output of cereals would increase substantially under the *Agenda 2000* proposals, partly because of the zero rate for set aside.[58] The US Agriculture Secretary Dan Glickman called for the EU to take “a giant leap towards market orientation and a more open, free and fair marketplace”.[59]

2. British reaction

Dr Cunningham, UK Agriculture Minister, has welcomed the March 1998 proposals:[60]

> From the national viewpoint, the proposals go very much in the direction we favour. Consumers will be a major beneficiary, saving over £1 billion a year from the proposed cuts in support prices. The rural environment will also benefit from the reforms. Farmers will gain from a more sustainable, market-led policy and the ending of the requirement to set land aside from production.

A fuller statement from Lord Donoughue contained the five key points for the UK during negotiations on the proposals:[61]

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54 *Agra Europe*, 9 April 1998 EP/4
55 *Le Monde*, 8 April 1998
56 *La Stampa*, 19 March 1998
57 *El Pais*, 19 March 1998
58 *Agra Europe*, 16 January 1998 A/1
59 Speech at Oxford Farming Conference, January 1998
60 MAFF News Release, 18 March 1998
61 MAFF News Release, 31 March 1998

> 1 A European agriculture that is sustainable, competitive, dynamic and can match third country producers on world and domestic markets.
> 2 Reform must safeguard the environment whilst continuing measures to promote the rural economy and rural development.
> 3 Reform must pave the way for early and successful enlargement of EU. Must also be sufficiently robust and thorough to enable the EU to adopt forward looking and sustainable position in forthcoming World Trade Organisation talks.
> 4 Reform must be affordable – not just in the narrow budgetary sense. It must bring real benefits to consumers and in the medium term lead to significant reduction in the taxpayers burden.
> 5 It is essential that reform is fair, genuinely simplifies a highly complex policy and introduces a real degree of subsidiarity.

There has been some criticism of the original *Agenda 2000* proposals, partly from environmentalists disappointed at the low priority for the environment and partly from farmers fearing loss of income. For example, the RSPB has called for CAP reform to pay more attention to the environment and to rural policy generally.[62] For farmers, the NFU has estimated that farm incomes in England and Wales might fall by some £440m a year: £330m for combinable crops; £20m for dairy; £90m for beef.[63] For Scotland, the Scottish NFU estimated a loss of £100m a year, some 25% of net income.[64] However, estimates of that type depend entirely upon the compensation package for price cuts, and assumptions about the likely trend of international prices.

The Agriculture Select Committee has produced a report on CAP reform: *Agenda 2000*[65] (1997/98 HC 311), with the following conclusions, referring to the earlier version of the proposals:

> 94. We stress that this Report represents our initial response to the *Agenda 2000* proposals in their generality: as the package is translated into proposed legal instruments so the detail of the proposals will become clearer, and things may change. We particularly welcome the support price cuts proposed in the cereals and beef sectors, although we are profoundly disappointed by the timidity of the proposals for the dairy sector, and by the absence of proposals for reform of the sheepmeat and sugar regimes. Only if direct compensatory payments to producers decline over time will it be possible to respond to the external challenges to the CAP posed by the WTO and enlargement of the EU, as well as to release expenditure to construct a truly integrated rural policy for Europe. Though the Commission does have a vision for transforming the CAP into a more integrated rural policy, they appear to have judged that the Agriculture Council would not share or accept that vision at this stage of the reform process. A more positive

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62 *Birdlife International, An agenda for action: reform of the CAP*, (1997)
63 *Scotsman*, 17 July 1997
64 *Herald*, 31 October 1997
65 1997/98 HC 311

> lead from the Commission would have forced the Agriculture Council to confront these issues directly, and it is regrettable that the Commission has not felt able or willing to provide such a lead in *Agenda 2000*. We endorse the Government's basic negotiating position on CAP reform, and urge them to maintain the pressure for radical reform of the CAP during the current UK Presidency and thereafter.

The Committee went on to insist that direct payments, acting as compensatory or adjustment aid to farmers, should be time-limited. They also noted

> Far from reducing CAP budgetary expenditure, it is clear that the Commission, in *Agenda 2000,* is resigned to increasing it. This is totally unacceptable. It could have been avoided by reducing direct payments over time.

The Committee also called for the abolition of milk quotas by the year 2006.

D. What will happen to the proposals?

With so much hostility to the proposals, it might seem that they have no chance of success, and certainly the type of radical reform wanted by many British commentators - with price cuts to world prices and limited compensation linked to environmental benefits - appear way off the agenda. However, what normally happens in negotiations of this type, as in 1992, is that the Commission prepares in advance a small concession for each country. The proposals are therefore eventually accepted, but at a cost of greater expenditure and considerable movement away from the original objectives.

In this case, Fischler faces two problems, one financial and the other relating to world trade. The original proposals are not, as might be imagined, radical cost-cutting measures. There is no suggestion among Fischler's objectives of saving money. The nearest he gets is including in his model of what European Agriculture should be like:[66]

> An agricultural policy which makes clear that the expenditure it involves is justified by the services which society at large expects farmers to provide.

Therefore, when a series of concessions is added to the original cost, one can expect an agricultural budget as high as is allowed by present rules.

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[66] Fischler's website http://europa.eu.int/en/comm/dg06/ag2000/agprop/mot-en.htm

The second problem relates to international trade and the World Trade Organisation. In 1996 the USA passed the Federal Agricultural Improvement and Reform Act 1996 (FAIR), which maintained a high level of subsidies to US farmers but decoupled them from the level of production, thereby making them acceptable under GATT rules. The EU position is much less decoupled, since arable subsidies depend upon the acreage planted. The USA can therefore increase production so as to increase sales in markets across the world, which are likely to be buoyant in the medium term. The EU cannot do this, because increases in production would merely result in increases in subsidised exports, and consequently a clash with the Uruguay Round Agreement. The increasing strength of the World Trade Organisation means that this could be a problem. Decisions by WTO disputes panels cannot be vetoed by a single country, in the way that the decisions of GATT panels could be.

The *Agenda 2000* proposals do not entirely resolve that problem, because income support for arable farmers is dependent upon sowing the crop, and therefore linked to the level of production. The USA is already moving ahead with phased reductions in agricultural subsidies, although US Agriculture Secretary Dan Glickman has stressed the need to retain a "sturdy safety net"for farmers.[67] Therefore the renegotiation of the next GATT Round to cover the years after 2000 is likely to be difficult.

E. Conclusion

Some version of these proposals for CAP reform will be accepted, because there are several different reasons why they are needed. On the other hand, amendments must be likely in view of the strong opposition already lined up. It proved very difficult to achieve even moderate reform of the CAP in 1992 and it will not be easy this time.

[67] Speech at Oxford Farming Conference, January 1998