



The Real Budget Battle

Une crise peut en cacher une autre

Richard Baldwin*

1. Introduction

The failure to reach a budget deal at the June summit may prove a blessing in disguise.

The spectacular failure of the European Council to agree the last-minute compromise on the 2007-2013 Financial Perspective generated massively negative media coverage. In the short run, it will create huge difficulties for the EU, but things might have been even worse had they agreed.

The point can be illustrated with an historical analogy. The EU's current budget framework was set in the early 1970s without any input from Britain. When the UK joined in 1973, it faced a *fait accompli* that made it a large net contributor despite its below-average income (the UK was poorer than France back then).¹ Few problems arose in the first years of British membership, but money started to matter as the honeymoon glow faded. The UK's budgetary imbalance grew worse as CAP spending exploded and when a new source of EU funding was added in 1979.

According to some (British) analysts, the EU system was intentionally aimed at disadvantaging the UK once it entered.² Whatever the truth may be, the British government and public felt that they were being treated as second-class citizens. This feeling fostered a climate of deadlock.

After a decade of bitter disputes and stalemate on most EU issues, EU leaders agreed the infamous 'UK rebate' that handed back about two-thirds of Britain's net contribution to London.³ Once the budget bitterness was sorted out, European integration thrived; the Single European Act was proposed and adopted in record time, and even before the 1992 Single Market Programme had been fully implemented, the EU committed itself to monetary union in the Maastricht Treaty. Of course, many other factors were important in allowing this rapid phase of integration, but it is quite clear that it would not have happened without the rebate.

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¹ The UK's agricultural situation was the cause of both imbalances. The British agricultural sector was a relatively small share of its economy compared to other members, so the UK got little of the EU's spending on agriculture, which accounted for 3/4th of the budget at the time. The UK also imported a larger share of its food from non-member nations. Since the import taxes charged on such imports are turned over to the EU budget, the UK faced a situation where it was a large net contributor to the budget.

² For example, Peet & Ussher (1999).

³ The crucial meeting was in June 1984 meeting in Fontainebleau.

What's that got to do with the current situation?

The main outlines of the 2007-2013 budget that the European Council rejected on 17 June 2005 were set in 2002 without the 10 new members at the negotiating table. The 2002 deal locked-in CAP spending and since this is half the budget, no fundamental rebalancing was possible. This is why the Commission failed to engage in the wide-ranging exploration of options that it did in the run up to the last 7-year budget plan (Agenda 2000). When enlargement occurred in 2004, new members faced a *fait accompli* in which their citizens receive distinctly below-par spending treatment (more on this below), despite their below-average incomes (all the new members' incomes are at or below that of the poorest EU15 member). Of course, their farmers and poor regions are getting EU cash and new money always creates a honeymoon, but the sub-par treatment will surely come to be a major source of friction as the glow faded.

Without a doubt, the Chirac-Schroeder 2002 deal was an attempt to skew EU spending in ways that disfavour the new members; in particular, it prevents the steady decline in CAP spending in favour of structural spending.

The EU now has time to re-evaluate its priorities in a more careful and rational setting. June 2005 was never the real deadline for this budget deal. The last 7-year plan was signed just months before it came into effect (May 1999 for January 2000). The current plan expires December 2006, so if a new plan is decided, early 2006 is the most likely date. Importantly, the existing plan covering the 2000-2006 period contains a fallback option. If a new 7-year plan cannot be agreed – the current agreement states that the current spending framework is to be extended mechanically.¹

I believe that the final outcome of this reflection will produce a 7-year plan that shifts budget priorities away from agriculture and towards structural spending, with the overall size of the budget reduced significantly. If my predictions come true, the French 2002 gambit to lock in CAP spending until 2013 will have come undone. This might have been expected.

A parable

One way to make the point is to relate a very telling parable that I heard when I was promoting EU membership in Finland in the early 1990s:

Three Finns – Kari, Matti and Petri – go for a week's ice fishing, each carrying a bottle of vodka. As they are cutting the hole in the ice, the issue of what to do with the vodka arises. They decide to settle it democratically. A vote is held and the outcome is two votes against one to drink Kari's bottle first. After Kari's bottle is finished, they vote on what to do next. The outcome again is two votes against one, but this time the decision is that each should drink his own bottle.²

The point, of course, is that it is impossible to know what will happen if the rules are subject to voting. The EU is a club that makes its own rules, so the rules change to fit the political power distribution among the membership. As the membership changes, political outcome will change.

Organisation of this essay

To explain my logic, this essay starts by describing what I believe is the heart of the budget battle and then argues that the newcomers' voting power will be the key to budget priorities set in next Financial Perspective (assuming one is eventually agreed). The essay concludes with some proposals for radical changes that would help the EU avoid episodic budget crises, and a prediction as to what actually will occur.

¹ Interinstitutional Agreement of 6 May 1999, paragraph 26.

² This is from Baldwin (1994, Chapter 8).

2. The heart of the conflict

The very public clashes between Blair and Chirac provided great material for headlines and an easy explanation for the media, but this conflict hides the real EU budget battle to come.³ The 2004 EU enlargement was an historic and noble achievement, but it also brought in 10 new members who are very different than the EU15 members from an economic perspective. To put it brutally, most of the 75 million new EU citizens are much poorer and much more agrarian than those living in the incumbent EU15 nations. This is a budget problem since 80% of the EU budget is spent on farmers and poor regions.

The true budgetary impact of enlargement was always underplayed to make enlargement more palatable politically. Enlargement was a noble goal that perhaps justified the financial legermain, but enlargement has happened and sleight-of-hand calculations will no longer work.

To understand this assertion, I turn to what I consider to be the heart of the conflict.

2.1 The EU's budget in a nutshell

EU members share a deep common appreciation that the EU is a noble endeavour that is critical to Europe's peace and prosperity. Nevertheless, it is natural that member states bicker over money – after all, citizens hire their national politicians to negotiate the best possible deal for their nation. Since common understanding on the benefits of the European Union is a dog-bites-postman story, while budget battles are postman-bites-dog stories, the media is filled with squabbling EU politicians even though 90% of EU decisions are consensual.

The EU budget sparks both solidarity and tension because of the way the money is raised and spent. The first task, therefore, is to review the ABC's of the Union's spending and revenue. As with so many things, understanding the EU budget in all its detail would take a lifetime, but understanding the basics takes just a few minutes. We start with EU spending.

2.1.1 EU spending

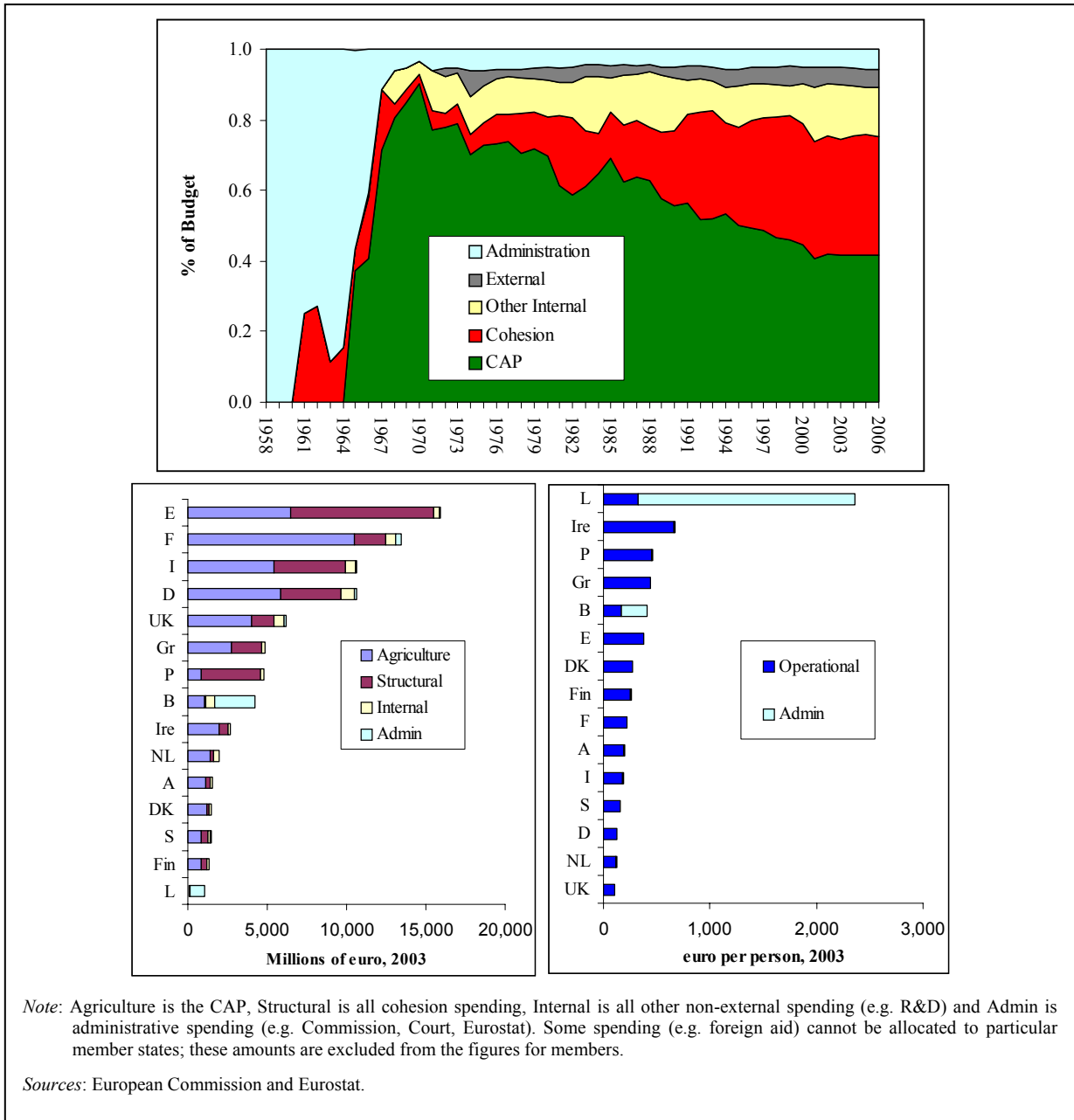
EU spending amounted to €100 billion, or about 1% of EU GDP, in 2003. Simplifying for clarity's sake, the budget pie has three slices – i) agriculture, ii) poor regions (called cohesion or structural spending in EU jargon) and iii) other things (administration, R&D, etc.). Agriculture takes up half of the budget, poor regions take a third and the remainder is split among many different uses. Spending priorities have evolved along with the changing membership as Figure 1 shows. Until 1965, the budget – tiny as it was – was spent mainly on administration (this was the period when all the European institutions were set up and the customs union was being implemented). CAP spending began in 1965 and soon came to dominate the budget. For almost a decade, farm spending regularly took 80% or more of total expenditures; at its peak in 1970, it made up 92% of the budget. From the date of the first enlargement – which marked the entry of the first poor nation (Ireland was poor back then) – cohesion spending grew, pushing down agriculture's share. Nevertheless, the sum of the CAP and cohesion shares has been steady since 1973 to 2000.

EU spending varies vastly across members, both in terms of the total amount and its nature. As the bottom-left panel of Figure 1 shows, Spain is the number one recipient with France, Italy and Germany close behind. Most of the French receipts come from the CAP, while Cohesion spending is the most important source for Greece. (Note that the EU does not like to encourage these sorts of calculations, so 2003 are the latest figures available at the level of detailed needed.⁴)

³ If fact the Blair-Chirac arguments are almost identical to those of 7 years ago and then the two found an acceptable compromise (see news.bbc.co.uk/1/hi/english/business/the_economy/newsid_303000/303439.stm).

⁴ A political agreement at the 1999 Berlin summit (where the current 7-year plan was agreed) dictates that the Commission exclude administrative spending 'for presentation purposes', so one has to dig a bit to get the real

Figure 1. EU historical spending (1958-2006) and by type, member state and per capita (2003)



The figures, however, are entirely different when we look at receipts per capita (see the light bars in bottom-right panel). By far the largest receiver per capita is Luxembourg – €2,359 per person – which sounds like a lot but since incomes are so high in the Grand Dutchy, about twice the EU average at over €50,000 per year in 2003, this EU spending does not have as large an impact as one might think. The Irish are also very large per capita recipients, about €700 per person, but even this is only a third of what the lucky Luxemburgers get. The EU average is €216 per person, which means Finland, France, Spain, Denmark, Portugal, Belgium, Greece, Ireland and Luxembourg are all above-average recipients.

numbers. Not hard to guess which nation held out for that ‘minor’ proviso – Luxembourg switches from a net contributor to the largest net recipient (per capita); Belgium also looks better with this accounting ruse.

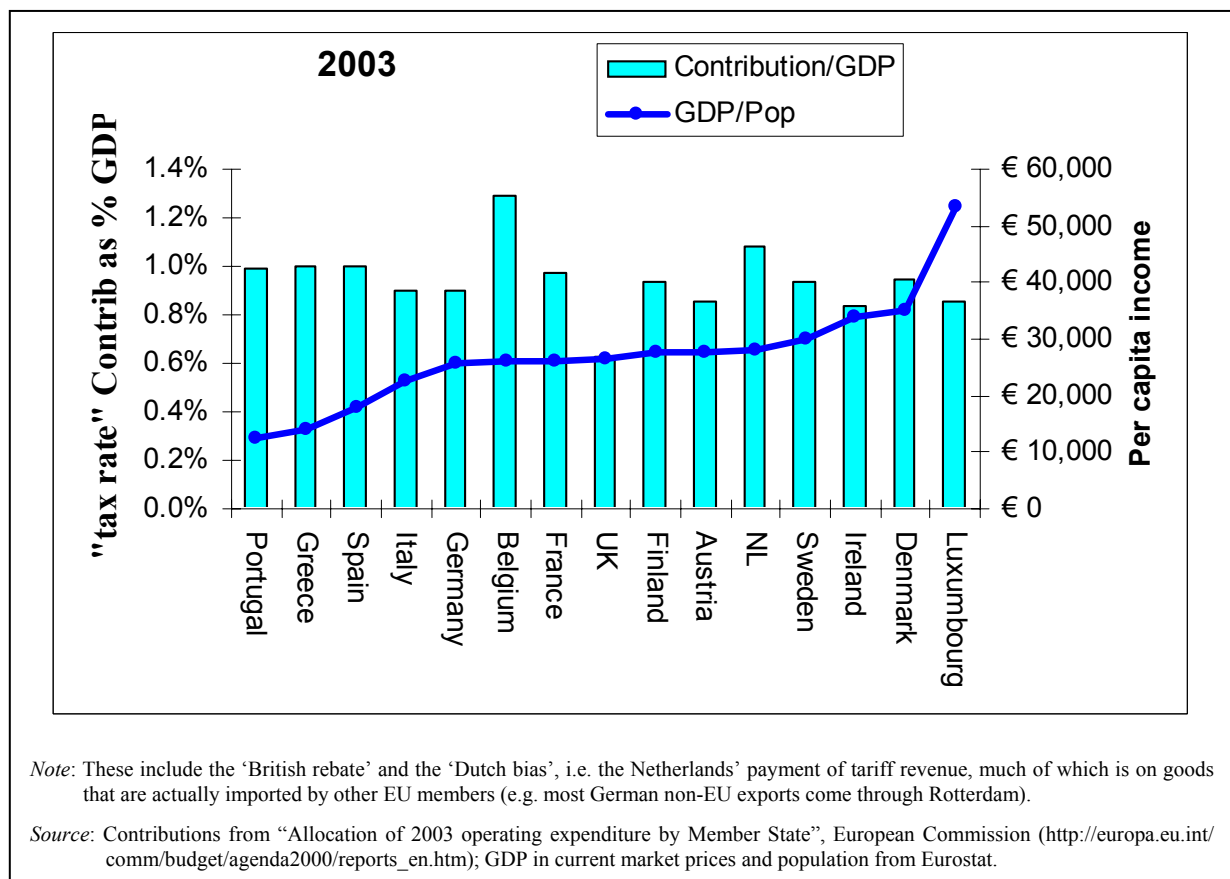
Why should rich nations like Luxembourg, Belgium, Denmark, Finland and France be above-average recipients of EU spending? The answer is power politics, a point that plays a key role in my arguments below.

2.1.2 Revenue

The EU's budget must, by law, balance every year. Up to 1970, the budget was financed by annual contribution from the members. A pair of treaties in the 1970s and a handful of landmark decisions by the European Council established the system we have today in which there are four main sources of revenue (See Baldwin & Wyplosz, 2003, for details.) The system is complex, but the result is simple – Europe has a flat tax. Each EU member pays in about 1% of its GDP.

The precise figures are shown in Figure 2 for 2003; the highest tax rate is 1.3% for Belgium; the lowest figure is Britain's 0.6% due to the UK rebate. Members are ordered by increasing per capita income.⁵ What the line shows is that there is basically no correlation between national income levels and the national 'tax rates', i.e. the contribution as a share of GDP.

Figure 2. Contribution vs. GDP by EU members, 2003

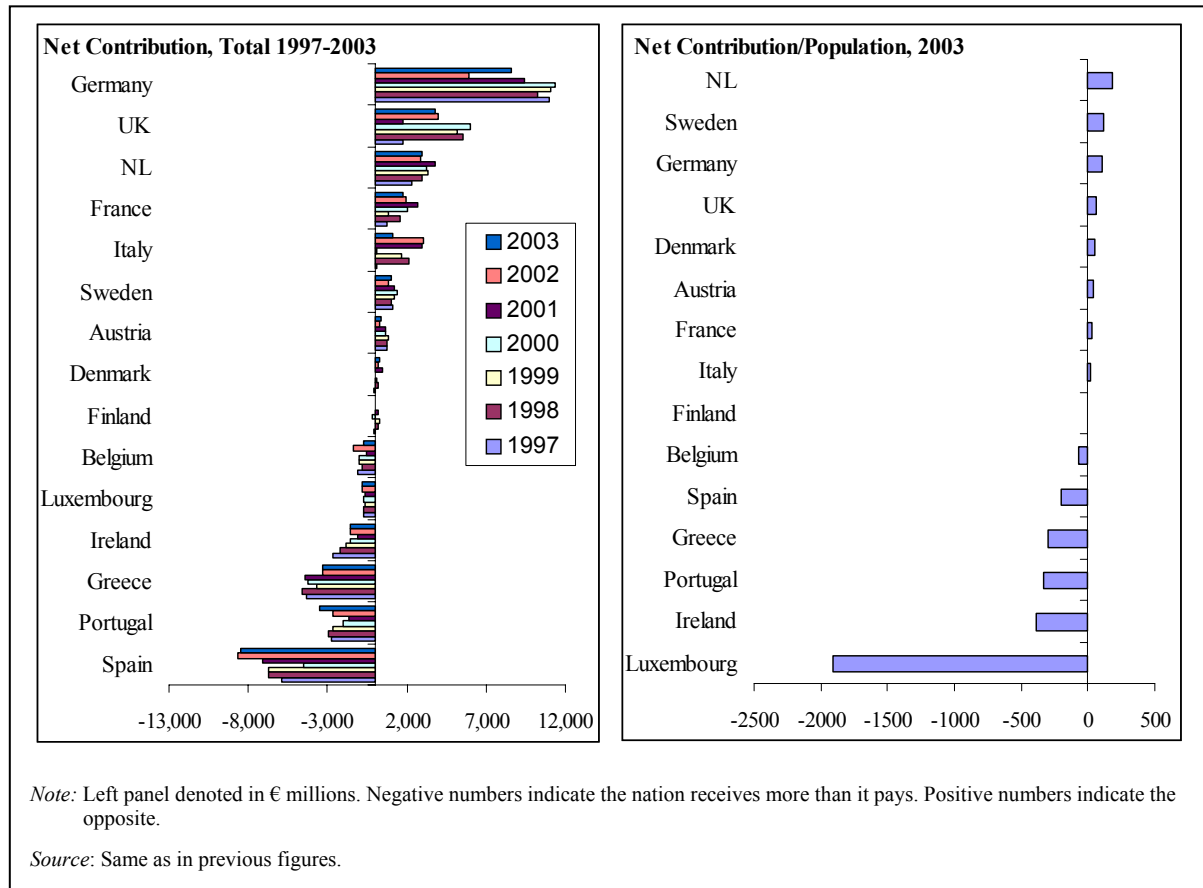


⁵ Incomes are not corrected for price differences. This is intentional. When nations set tax rates, they do not adjust for price differences. For example, despite the fact that living in a city is systematically more expensive than living in the countryside, national income taxes ignore price differences; rates are based on income per capita, or income per family.

2.1.3 Net contribution by member and per citizen

Net contributions by nation are shown in Figure 3. Seven of the EU15 are net contributors with Germany being by far the largest (Germany's 2003 net contribution was larger than that of the next three largest net contributors put together). The net recipients are Spain, Greece, Portugal, Belgium, Luxembourg, Finland, France and Denmark.

Figure 3. Net financial contribution by EU members, total and per capita



2.1.3.1 Net is much smaller than gross

Importantly, the net transfers are much, much smaller than the overall budget. In other words, most of the EU budget can be thought of as staying inside each nation. France paid €13.4 billion to the budget and received €15.2 million from it in 2003, so we can think of the French government as spending €13.4 billion on EU programmes that directly benefit its own citizens with Brussels sending only €1.8 billion to Paris to add to this. Even for the biggest contributor, Germany, most of its payment can be thought of as ending up spent on Germans.

The numbers for some of the net recipients, however, are quite different. For Luxembourg, Ireland, Greece, Portugal, Belgium and Spain, EU membership provides decisive financial advantages. For all of these nations, their net contributions are between one and four times the amount they pay to the EU, with Luxembourg taking the gold medal. Luxembourg's receipts correspond almost entirely to spending on EU institutions located there (the European Investment Bank, European Parliament offices, the EU Court of Justice, European Investment Bank, EU Court of Auditors, Eurostat, etc.)

Table 1 shows my calculations of net contributions from 1997 to 2003.

Table 1. Net and gross contributions (all spending and all contributions) 1997-2003

| | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|------------|--------|--------|--------|--------|--------|--------|--------|
| Spain | -5,936 | -6,697 | -6,734 | -4,482 | -7,057 | -8,666 | -8,455 |
| Portugal | -2,722 | -2,903 | -2,713 | -2,002 | -1,681 | -2,686 | -3,477 |
| Greece | -4,372 | -4,647 | -3,678 | -4,256 | -4,391 | -3,357 | -3,322 |
| Ireland | -2,677 | -2,242 | -1,850 | -1,551 | -1,108 | -1,581 | -1,563 |
| Luxembourg | -725 | -693 | -639 | -722 | -644 | -791 | -857 |
| Belgium | -1,079 | -802 | -984 | -969 | -518 | -1,355 | -745 |
| Finland | -56 | 171 | 274 | -171 | 213 | -18 | -9 |
| Denmark | -69 | 181 | 103 | 30 | 429 | 216 | 283 |
| Austria | 724 | 756 | 812 | 695 | 688 | 255 | 359 |
| Sweden | 1,129 | 1,039 | 1,184 | 1,418 | 1,245 | 841 | 1,047 |
| Italy | 61 | 2,091 | 1,685 | 120 | 2,920 | 3,039 | 1,093 |
| France | 781 | 1,532 | 878 | 2,057 | 2,720 | 1,929 | 1,725 |
| NL | 2,276 | 3,006 | 3,304 | 3,220 | 3,829 | 2,876 | 2,923 |
| UK | 1,799 | 5,556 | 5,165 | 5,971 | 1,806 | 3,985 | 3,755 |
| Germany | 10,944 | 10,225 | 11,074 | 11,399 | 9,380 | 5,897 | 8,566 |

Note: Receipts include all allocatable EU spending, i.e. administration and operational; Luxembourg and Belgium like to exclude administrative spending since it make them look like big beneficiaries. Since politicians fight hard to get administrative spending in their nation, we should count this spending along with CAP and rebate spending. The contributions include both the British rebate and the Dutch bias (i.e. the Dutch contribution is biased upwards by its payments of tariffs on imports from non-members that pass through Rotterdam on their way to Germany and other EU nations, e.g. most German imports from overseas arrive via Rotterdam and some of these goods pay tariffs in Holland. When the Netherlands hands this over to the Commission as per the Treaty of Rome, it counts as part of the Dutch contribution even though the tax incidence is on German citizens).

Source: European Commission for spending and contributions.

2.1.4 The UK rebate

To reduce the UK's persistently large net contribution to the EU budget, Margaret Thatcher won an agreement in 1984 to cut Britain's net contribution. Many politicians in her place would have asked extra spending in Britain – bigger allocations of milk quotas, special subsidies to Highland farmers, etc., but Thatcher, predictably, preferred a tax cut to a spending hike and the rebate was born.

The other EU leaders, however, set an elaborate political trap when they agreed to the UK rebate. The most sensible way to think about the UK rebate is a form of spending earmarked to a particular nation – much like the Cohesion Fund was earmarked for Ireland, Greece, Portugal and Spain. But there is a critical difference, the Cohesion Fund never specified who was paying for it, while the rebate deal specifies exactly how much the rebate costs each of the other members. The trap was that this ensures that whenever the rebate is raised in isolation, the argument is always the UK versus the rest. Notice how different this is politically, than, say, an agreement to maintain high levels of CAP spending. It specifies the beneficiaries without specifying the payers.

Roughly speaking, here is how the rebate functions. The Commission works out what the UK net contribution would have been without the rebate and then sends a cheque to London for 2/3rd the amount; this cheque is paid for by a formula that spreads the cost over other members – including the poorest EU members – a fact that creates frictions every year.⁶

⁶ The exact procedure for calculating the rebate is complex and results in a fairly wide fluctuation in the UK's net contribution (for more information, see "Annex 4" on http://europa.eu.int/comm/budget/agenda2000/reports_en.htm).

2.2 Enlargement on the Cheap⁷

The simple budgetary facts laid out above implied that the EU had two ways of dealing with Eastern enlargement:

- Reform its spending priorities, or
- Enlarge on the cheap.⁸

The reform option would have required leaders to reform EU farm and poor-region policies in a way that would have allowed the newcomers to be treated as equals. Since such an effort would have turned EU farmers and poor regions into implacable opponents of enlargement, this path was eschewed for the politically expedient enlargement-on-the-cheap option.

The clearest evidence for this comes from the budget that EU15 leaders agreed for the new members in December 2002.⁹ This is the budget that is currently in effect and will operate till the end of 2006. The spending on new members is broken down by major area. In the next two subsections, I show that these numbers imply sub-par treatment for the new members.

As an aside, I note that it would be useful to see the nation-by-nation allocations suggested in the failed compromise constructed by the Luxembourg Presidency – in particular it would be interesting to see whether the compromise reduces Luxembourg's amazingly large net benefit from the budget – but I have not been able to find the numbers in the public domain (the allocations by programme are readily available, but not the allocation by programme by member). Failing this, I have used the budget commitments for 2005 and 2006 that were agreed by the EU15 before the new members could vote in the Council of Ministers.

2.2.1 Second class treatment on structural funds

A quick look at what the EU15 leaders decided to allocate to the 10 new members reveals the point. As Figure 4 shows, the average annual allocation for the newcomers are not low compared to the EU15 as a whole, but they are substantially lower than what is allocated to the current poor EU members. And much lower than might be expected if the newcomers were treated in the same way as incumbents. How much lower?

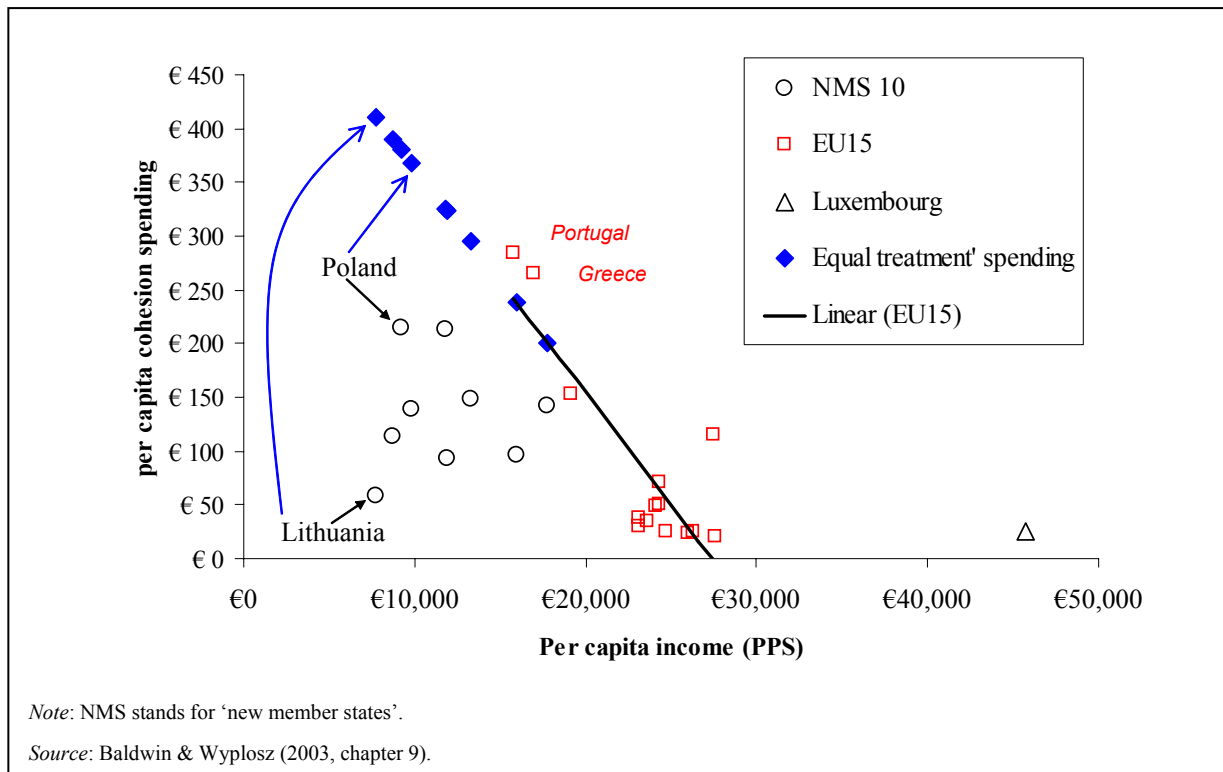
The line in the figure shows how cohesion-cash-per-person and per-capita-income are related in the EU15 (as usual, Luxembourg's extraordinarily high income makes it an outlier, so we exclude it when fitting the cash-income line). This 'trend line' has a negative slope as expected, since in the EU15, cohesion-cash-per-person rises as a nation's income falls. The line shows the average relationship. Observe that the promised treatment of every single newcomer is below this line. That is, given how poor they are, the income-cohesion-cash link in the EU15 suggests that they should get much more than the poor nations in the EU15. The diagram plots the 'equal treatment' cohesion-cash-per-person that is predicted by the trend line; Lithuania (the poorest of the newcomers) and Poland (the biggest of the newcomers) are identified explicitly. What this projection suggests is that Poland would have gotten €380 per person under 'equal treatment', instead of just €214. Lithuania would have received €411 instead of the €69 it was actually allocated.

⁷ This section draws on Baldwin & Wyplosz (2003).

⁸ See Baldwin (1994) for an early treatment of the dangers of the enlarge-on-the-cheap option.

⁹ See Conclusions of the Danish Presidency, 12-13 December 2002, Annex I.

Figure 4. Cohesion spending and income levels, EU15 vs. NMS10



2.2.2 Second-class treatment on the CAP

It was always known that the 2004 enlargement would be an earthquake for EU farm policy. The new members are blessed with an abundant quantity of farmland that is well suited to producing the products that the CAP supports most heavily – dairy, beef, wheat and sugar beets. Farm productivity is fairly low in the Central European nations, but this is due to a lack of investment and this could change. It is also worth pointing out that a much larger fraction of the newcomers' population works on the land. Basic facts are shown in Table 2.

We see that the 2004 enlargement will bring in almost 3.7 million new farms – about a 50% increase between the EU25 and the EU15. The number of farmers will rise by less – 60% – since the average farm in the newcomer states is much, much smaller: 9 hectares as opposed to the current EU15 average of 18.7. All three of these facts suggest that the enlargement will have a massive impact on the CAP, if the new EU farmers get anywhere near as much money as the average farmer in the old EU15.

The terms of accession that were finalised by EU leaders at their 2002 Copenhagen summit provided very limited budget resources for the newcomers' farmers. The agreement stipulated that CAP spending in the 10 new member nations can be no more than €3.7 billion in their first full year of membership, 2005, rising to €4.1 billion in 2006. To some extent, the numbers are low since some of the CAP payments are being phased in, but the precise numbers will not be set until the 2007-2013 Financial Perspective is agreed. Moreover, many experts believe that the newcomers' farms are not ready to meet the quality standards that the CAP now imposes as a condition for payments, so these low figures may well be realistic. This could change, however.

CAP spending has always been based on hard politics – not firm principles. Of course, the CAP does have principles, but these are bent and changed to fit political realities. This is possible because the CAP provided extremely uneven support to different types of farm goods. Sugar, for example, is hugely subsidised while eggs are not. The priorities are not set according to high-minded principles; rather, they are set by national politicians in the Council of Ministers who are trying to 'bring home

the bacon'. (The European Parliament is not allowed a say on CAP spending.) We can see this in the way Spain and Portugal's members altered CAP priorities to boost payments to their farmers.

Table 2. Basic agricultural facts for 2004 entrants

| | Farmland (million hectares) | Number of farms (000s) | Average farm size (hectares) | Agricultural employment (000s) | Ag. share of employment (%) | Ag. share of GDP (%) |
|-----------------|-----------------------------------|------------------------------|------------------------------------|--------------------------------------|-----------------------------------|----------------------------|
| Czech Republic | 3.7 | 54 | 67 | 212 | 4.5 | 1.1 |
| Estonia | 0.8 | 37 | 22 | 37 | 6.3 | 2.2 |
| Cyprus | 0.1 | 45 | 4 | 17 | 5.2 | 3.7 |
| Latvia | 1.6 | 141 | 10 | 146 | 14.6 | 2.1 |
| Lithuania | 2.5 | 279 | 9 | 276 | 18.7 | 2.6 |
| Hungary | 5.9 | 773 | 6 | 211 | 5.4 | 2.7 |
| Malta | 0.0 | 11 | 1 | 4 | 2.5 | 1.6 |
| Poland | 16.1 | 2,178 | 7 | 2485 | 18.2 | 2.3 |
| Slovenia | 0.5 | 77 | 6 | 75 | 8.4 | 1.6 |
| Slovak Republic | 2.2 | 72 | 30 | 130 | 6.0 | 1.2 |
| NMS10 | 33.5 | 3,667 | 9 | 3,593 | | |
| EU15 | 130.0 | 6,766 | 18.7 | 6,487 | 4.0 | 1.6 |

Notes: Agricultural employment is employment in agriculture, forestry, hunting and fishing (column 5). Part-time farmers who also work off the farm may not be classified as farmers (e.g. there are more holdings in Slovenia than people employed in agriculture).

Source: Table 2.0.1.2 in "Agriculture in the EU – Statistics and economic information", 2004, European Commission. Note: Number of EU15 farms and average farm size for 2000 report due to missing data for 2004.

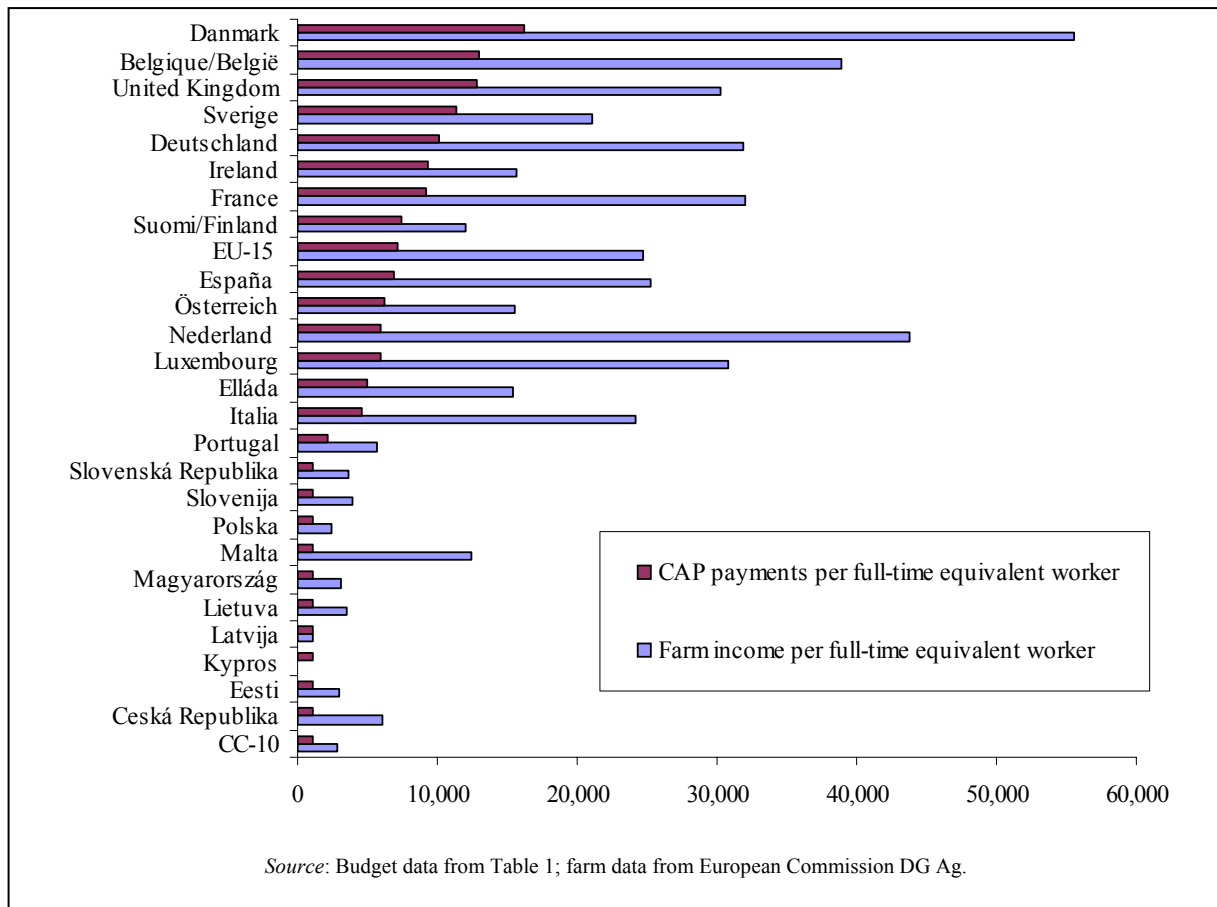
Northern European sugar beet farmers tend to be quite prosperous, while Southern Italian fruit and vegetable farmers tend to be poor, but sugar has always been heavily subsidised while fruits and vegetables never were – at least not until new members – Spain, Portugal and Greece – changed the balance of political power sufficiently to make more spending on fruits and vegetables necessary. This should not be a surprise to realists. CAP spending is decided by politicians in the Council of Ministers; fruits and vegetables only became 'worthy' of EU cash when a large enough coalition of Council members cared about fruit and vegetable farmers.

Under the 2002 Copenhagen deal, CAP spending per newcomer farm is just €172 apiece. This is so far below the EU15 average of €5,000 that political difficulties are inevitable. After all, why should a relatively poor nation like Poland contribute to a budget, a large part of which is paid to rich farmers in the rich EU nations.

Figure 5 shows that the amount of CAP receipts that the newcomers are scheduled to get is less than half the receipt of the EU15 member that gets the least (Portugal). This is even more striking when we see that the EU15 farmers who are getting the big payments are – at least by EU farm standards – the rich farmers. For example, Danish farmers on average get €16,234 from the CAP when their average income is €55,552. Polish farmers will get an average of €1,025 per farmer (although this include payments for rural development that will not end up in the farmers' pockets) while their average income is only €2,409.

One can certainly make the claim that the newcomer farmers are not ready for the big money, but such an inequality is unlikely to withstand the political pressure generated when the question is raised in the Council of Ministers: Why should rich Danish farmers get 16 times more money than poor Polish farmers?

Figure 5. Farm income & CAP spending per full-time equivalent farmer, EU15 vs. NMS10



2.2.2.1 Absolute subsidy vs. subsidy rate

When reading an early draft of this paper, Daniel Gros pointed out that the numbers in the preceding paragraph show that the subsidy rate is higher for poorer farmers. For example, the Danish farmer gets 30% of his income from the EU, while the Polish farmer gets about 40%. This is absolutely true. From this perspective, the amounts the newcomers are getting are not obviously unfair.

But this takes the structure of the CAP as given. My basic point is that new member state governments – either the current ones or ones that come into power between now and 2013 – will view the current situation as unfair. They will then invent new ways of spending new money. For example, under the current CAP, most money is paid directly to farmers, but the needs of the agricultural sector in the new member states are quite different. They are poor, in part, due to the terrible farm infrastructure; financing, storage, shipping, marketing, dissemination of green technology, farm-size rationalisation, etc. Thus one could imagine that the Polish government could find a very responsible way of spending a few thousand more euros per farmer per year without handing all of it over to the farmers directly. Indeed EAGGF, or FEOGA in French, stands for European Agricultural Guidance and Guarantee Fund. In Western Europe almost all the money has gone to the Guarantee part, but that was not the original intention. Central Europe farm sectors have huge ‘needs’ for the Guidance part. Or, more to the point, the newcomers could make a principled argument that they need, say the average of €5,000 per farmer to ensure that European integration does not leave rural Central Europe behind. This argument, combined with their massive voting power, would cause real frictions in the Council.

3. Budget determinants: Father Christmas vs. power politics

The argument so far has been that the current budget allocation is unfair to the new members. But what can they do about it? According to the ‘Father Christmas’ view of the EU budget, spending is based on high-minded principles – solidarity between urban workers and rural farmers and between rich regions and poor ones – that were established long before the 2004 enlargement. The newcomers knew what they were joining and so they will have to live with it.

I do not believe that this is even vaguely correct.

3.1 Power politics and the EU budget

To understand why voting power in the Council of Ministers is related to budgetary allocations, it is necessary to briefly review the EU budget process (see Baldwin & Wyplosz, 2003, chapter 2, for details).

3.1.1 The EU budget process: A thumbnail sketch

The EU’s annual budget must pass both the Council of Ministers and the European Parliament (EP); the annual budgets are constrained by 7-year budget plans called ‘Financial Perspectives’ (the current one covers 2000-2006). Financial Perspectives require unanimity in the Council, but the annual budgets are passed on the basis of qualified majority voting (QMV) and the Financial Perspective deals anticipate the QMV power of members. For both the Financial Perspectives and the annual budgets, EP decision-making is based on a simple majority. Because of this, the EP does not matter from a *national* power perspective. Since the EP’s majority threshold (50%) is much lower than the Council’s (over 70% under the Nice Treaty rules in effect now) and the allocation of MEP per nation in the EP is similar to the allocation of votes per nation in the Council, any coalition of nations that can pass a budget in the Council can also pass it in the Parliament.¹⁰ Of course, the Parliament’s vote can matter from a non-national perspective since the Council typically ignores that point of view. QMV power also matters for the budget since members can trade favours (‘back scratching’ and ‘horse trading’).

With this as background, we turn to the power-spending link.

3.1.2 Voting Power = Budget Cash

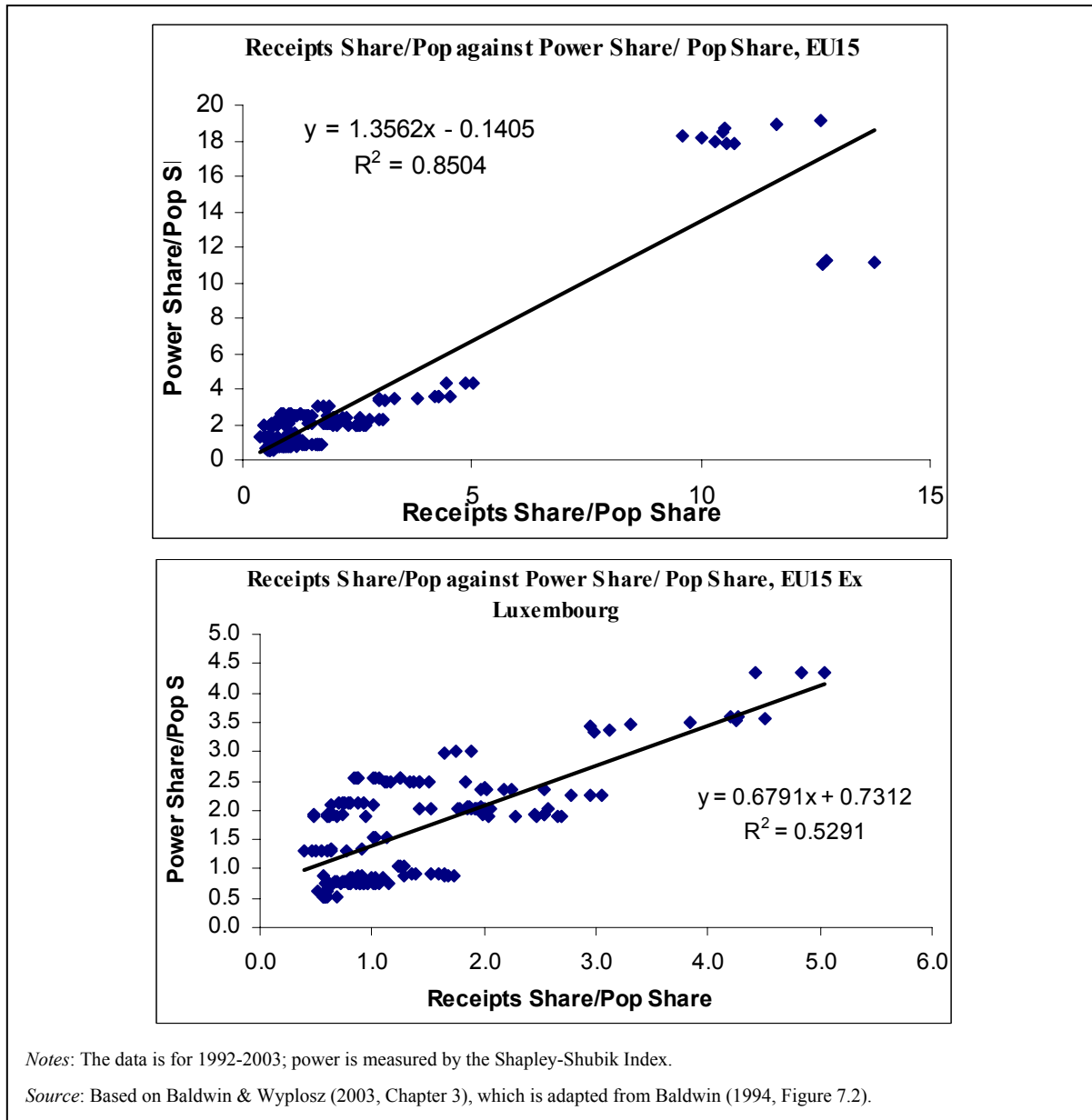
Citizens in EU nations, or at least some citizens, benefit when EU money is spent in their district. Successful politicians, responding to the desires of their citizens, use their political clout to direct money homewards. For example, suppose that countries ask for a little ‘gift’ each time they find themselves in a position that is critical to a winning coalition. In the data, the ‘gift’ ends up as EU spending, but the actual mechanism could be subtle, say a more favourable treatment in the allocation of EU subsidies to hillside farmers, a more generous allocation of milk quotas or inclusion of reindeer meat in the CAP’s price support mechanism. In this light, it seems natural that a country’s power measure would equal its expected fraction of all special gifts handed out. If one goes to the cynical extreme and views the whole EU budget as nothing more than a pile of ‘gifts’, then our power measures should meet the EU’s budget allocation perfectly. If high-minded principles such as helping out disadvantaged regions also matter, then the power measure should only partially explain the spending pattern.

As it turns out, Council voting shares go a long way towards solving the ‘puzzle’ of EU budget allocation shown in Figure 3. To see this, Figure 6 plots a measure of the ‘bias’ in each nation’s power per person; specifically, it plots the ratio of each nation’s share of Council votes to its share of EU15 population. To understand why this reflects the power bias, suppose a nation has a ratio of exactly 1.0.

¹⁰ See Baldwin & Wyplosz (2003, chapter 3) for more details on this point.

This would imply that the Council votes per citizen in that nation is exactly equal to the EU15 average. For example, Spain's vote share to population share ratio is 0.9. This means that Spaniards have slightly less than the average number of votes. Greece, on the other hand, has a ratio of 2.6 which means Greeks have 2.6 times more votes per person than the EU average.

Figure 6. EU15 per capita vote shares and budget share (average 1995-2000)



The vertical axis plots a measure of the bias in each nation's receipts per capita. Again, to put everything on a common scale, the precise measure we use is the ratio between the nation's share of EU spending and its share of the EU's population. As with the per capita power measure on the horizontal axis, 1.0 on the vertical axis implies the average receipts per person taking the EU15 as a whole.

Each point in the top panel indicates one of the EU15 members. There are two salient points here. First, there is a distinct positive relationship between power-per-person and receipts-per-person. In other words, it does look like politicians use their power in the Council of Ministers to direct EU

spending towards their home countries. Second, Luxembourg is a real outlier. Luxemburgers have 20 times more votes per person than the EU average and they get almost 11 times more spending per person than the EU average. Because a huge outlier can make it hard to see what is going on with the others, the bottom panel shows the same figure without Luxembourg.

The bottom panel confirms the positive relation between power and spending, but it also allows us to pick out a few more interesting features. Note that the newest EU members, Austria, Finland and Sweden are far below the average relationship between power and spending. In other words, given their level of votes per person, the relationship between power and spending that one sees in the older members (the EU12) suggests that they should be getting more EU spending per person. Perhaps this reflects the fact that these newcomers have not yet learned how to work EU politics in their favour, or maybe they have not had time to do enough ‘back scratching’. We can also see that the UK is the nation that receives the least per capita of all EU15 nations. It also has one of the lowest vote ratio, but not the lowest – Germany has that distinction.

3.1.2.1 More formal evidence

Note that the basic points made by these chart have been proved with formal econometric work in by Kauppi & Widgrén (2004). See Baldwin & Widgrén (2004) for much more detail on the power distribution under the Nice Treaty rules and under the Constitutional Treaty voting rules.

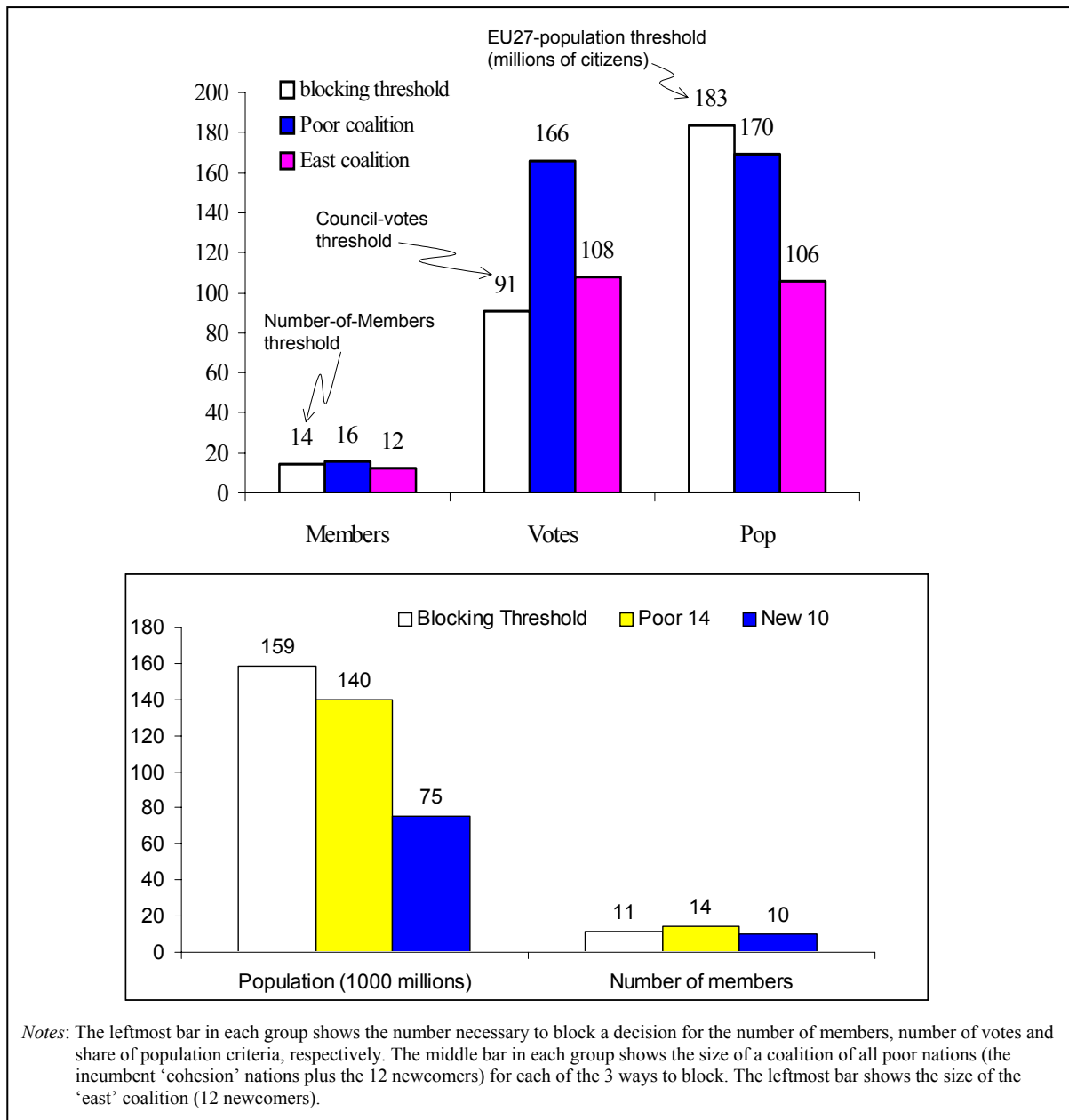
Using measures of voting power that allow for natural coalitions (e.g. Cohesion countries voting together), they explain about 90% of EU spending using power alone. The remaining 10% depends upon agricultural output.

3.1.3 How much power will the new members have?

It should be obvious that the 10 new members will have a lot of power in the Council of Ministers and they will have a common cause when it comes to getting more structural and agricultural spending. One way to make this point is to consider two blocking coalitions: the coalition of newcomers and a coalition of poor members under the Nice Treaty rules that will govern EU decision-making for the whole life of the current European Commission and European Parliament, regardless of the Constitution’s fate.

The top panel of Figure 7 shows that a coalition of new members would be able to block any decision in the Council. On the votes criterion they will have more votes than they would need to block any proposal. On the population and member-state criteria, they would not be able to block, but this does not matter; a measure can be blocked on any of the 3 thresholds. If the Constitutional Treaty rules come into effect, the newcomers’ power to block will be reduced, as the bottom panel of the figure shows. Nevertheless, if they vote as a block, they will need only one of the EU15 members to side with them in order to block. Thus with or without the Constitution’s voting rules, the newcomers will be in a position to get their way on fair treatment as far as the budget is concerned.

Figure 7. Blocking power of east and poor coalitions in the EU27, Nice rules



4. Decision-making 'train crash'

In 1994, I wrote that it would be at least two decades before the front-runner CEECs could be full EU members without threatening incumbent special interests – taking 1991 as the base year since that reflected the then latest data. As history would have it, the enlargement happened in 2004, not 2011 and most observers, including myself, regard this as a hugely positive outcome. The trick was to manipulate the budget numbers and negotiate limited budget allocations to the newcomers that made them second-class members in terms of the budget without making the unequal treatment obvious. Everyone wanted enlargement to happen and so all were happy to praise this Emperor's-new-clothes deal. I wrote more than a decade ago about the enlargement-on-the-cheap option:

Although this 'solution' sounds reasonable at first, it could create enormous political complications in the European Union. Giving votes to new entrants can have important, but unpredictable results. Giving votes to new entrants who may come to feel that they are being

mistreated is really asking for problems. The sorts of exclusions necessary to insulate incumbent special interests from an Eastern enlargement would be unprecedented. It would mean excluding Central and Eastern EU members from 80% of all EU spending.

To put it colloquially, unpleasantness is unavoidable when second-class ticket holders have a say in what the first-class passengers will have for dinner. ... The fact that CEECs might eagerly accept a decade-long exemption from CAP and cohesion cash does not mean that they would be docile in the European Council for ten years. There is a very natural tendency for assertiveness to increase after the wedding ring is on the finger.¹¹

The only things that need to be modified in this quote are the verb tenses and word ‘exclusion’, which proved to be too strong. As documented in the previous section, the new member states were not excluded from CAP and structural spending, but they were granted sub-par treatment. Moreover, the 2002 budget deal tried to lock this in until 2013. The basic logic of the ‘not before two decades’ remains as valid as ever, and it will assert itself in the coming years. Its first appearance will be during the tough negotiations over the new 7-year budget plan that will proceed over the next year or two.

EU leaders will face a hard deadline – the expiration of the current spending plan – in mid-2006 (the second-class treatment for newcomers I documented above will continue unless a new budget is agreed). If they fail then, the EU will find itself in the sort of ‘train wreck’ budget crises that were common in the 1980s.¹²

5. What will the new budget deal look like?

The new member states have a lot of power and surely they will use this to bring home a fairer share of the cash. But will it be CAP spending or structural spending?

I believe that they will push for much more structural spending even if it means agreeing to an overall downsizing of the CAP slice of the EU budget. The reason is simple. CAP spending is decided according to rules that are agreed in the Council of Ministers. These rules can be and routinely are reshaped in order to alter the national receipts of CAP cash, but they are agreed in Brussels. This contrasts sharply with structural spending. Structural spending goes to specific projects that are proposed by the member government itself. There is a minimum of checking by the Commission and oversight and control by EU institutions, but each member state’s governments is in the driver’s seat. For national politicians, of course, this ability to micro-manage the allocation of EU money among their voters is a political bonanza. They get to reward allies using money from the EU coffers.

This leads me to believe that the new political compromise over the 2007-2013 budget will super-size structural spending at the expense of the CAP. To keep the net payers – especially the Dutch, Swedes and Germans happy – the rise in structural spending will be less than the drop in CAP spending.

What part of the CAP could be cut? One possible political cover story for the CAP cut will be a ‘means testing’ of CAP payments. Almost all aspect of the CAP have an ‘Alice-in-Wonderland’ feeling about them, but one of the most topsy-turvy is the fact that the vast majority of CAP cash goes to big rich farmers, while the payments to small farmers are just big enough to keep them on the edge of bankruptcy.

There are 610 farms in the EU15 that earn more than three-quarters of a million euros a year from direct payments. These are the most efficient farms and there is little doubt that their owners are will to do (see Figure 5), or at least the corporations that own them find farming very profitable. The numbers at the other end of the size scale are also astounding. Over half of EU farms are in the smallest category, but taken altogether, they receive only 4.3% of all payments made in the EU; this works out to an average of €405 each. To put it differently, the group of the 2.4 million farms in the

¹¹ Baldwin (1994) (now freely downloadable from <http://hei.unige.ch/~baldwin/>).

¹² See http://europa.eu.int/comm/budget/financialfrwk/index_en.htm for a brief history of these crises and the solutions adopted.

smallest class get about the same amount as the group of 1,880 farms in the largest class – about 4% of the budget for each group. The inequity of the distribution varies somewhat across EU member states. Readers can check the situation in their favourite EU nation by downloading the original data from europa.eu.int/comm/agriculture/agrista/2002/table_en/full2002.zip

Table 3 shows the distribution of direct payments to farmers according to the size of the farm. The most startling number is the payment per farm for really big farms.

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Table 3. Inequity of direct payments, receipts per farm by farm size, 2000

| Size Class | Payment per farm | % of EU15 farms in size class | Number of farms in size class | % of EU15 payments to size class | Cumulative % of budget (from largest to smallest) | Cumulative % of farms (from largest to smallest) |
|--------------------|------------------|-------------------------------|-------------------------------|----------------------------------|---|--|
| 0 to 1.25 | €405 | 53.76% | 2,397,630 | 4.3% | 100.0% | 99.97% |
| 1.25 to 2 | €1,593 | 8.54% | 380,800 | 2.7% | 95.7% | 46.21% |
| 2 to 5 | €3,296 | 16.30% | 726,730 | 10.7% | 93.0% | 37.67% |
| 5 to 10 | €7,128 | 9.17% | 409,080 | 13.0% | 82.2% | 21.37% |
| 10 to 20 | €13,989 | 6.81% | 303,500 | 19.0% | 69.2% | 12.20% |
| 20 to 50 | €30,098 | 4.13% | 184,100 | 24.8% | 50.2% | 5.39% |
| 50 to 100 | €67,095 | 0.94% | 41,700 | 12.5% | 25.4% | 1.27% |
| 100 to 200 | €133,689 | 0.24% | 10,720 | 6.4% | 12.9% | 0.33% |
| 200 to 300 | €241,157 | 0.05% | 2,130 | 2.3% | 6.5% | 0.09% |
| 300 to 500 | €376,534 | 0.03% | 1,270 | 2.1% | 4.2% | 0.04% |
| over 500 | €768,333 | 0.01% | 610 | 2.1% | 2.1% | 0.01% |
| Average, All farms | €5,015 | | | | | |

Data Source: Table 3.6.1.10 in “Agriculture in the EU – Statistics and economic information, 2002, European Commission.

Source: Baldwin & Wyplosz (2003, Chapter 8) (see <http://hei.unige.ch/~baldwin/PapersBooks/BW/BW.html>).

Indeed, Freedom of Information Acts in various EU nations (e.g. Britain and Sweden) have allowed the public to see the names of people getting the big CAP cheques. As it turns out, almost any large landowner in the EU gets a big cheque. Since these are some of the wealthiest citizens in the EU, the CAP is a Robinhood-in-reverse policy. This is the part that could be cut to pay for more spending in really poor regions in the new member states.

The Commission has proposed something like this in the past. The EU could limit the upper bound on payment to any single farm, or farmer (in its most recent incarnation this was called ‘modulation’). Since a truly amazing fraction of the CAP goes to rich farmers in rich nations, even a mild restriction on such payments would allow the EU to continue paying money to most EU farmers and yet have enough left over to expand structural spending in the new member states. It is sad but probably

inevitable that even better ideas like boosting spending on R&D and competitiveness will fail in the CAP vs. Cohesion dogfight that we are likely to see in the coming years.

6. Solutions: Focus on the positive

What to do about this decision-making train crash? For quite a number of years, since I wrote my 1994 book on Eastern enlargement, I have been advocating a radical reorientation of the EU spending programmes that would allow the EU to focus on the positive. Here is the argument.

In the early decades of the EU, it made good political sense to spend the EU's cash on farmers. The CAP was really just rich Western nations subsidising their own farmers via the EU budget, and doing it through the EU budget facilitated European integration by providing some possibilities of side payments – political 'baksheesh', if you will. Likewise, when poor-region spending became significant in the late 1980s and early 1990s, it played an important role in facilitating European integration – in essence it was a side payment to Spain, Portugal, Ireland and Greece for agreeing to economic and monetary integration that many felt would mainly benefit the rich members. This allowed national leaders to convince their citizens in disadvantaged regions that Europe was also good for them.

Now, however, CAP and cohesion spending are getting in the way of European integration. Haggling over handouts to special interest groups should not be allowed to paralyse the enlarged Union. How to stop this?

One approach would be to fiddle with EU decision-making rules.¹³ The most direct approach, however, is much simpler and resembles the tactic used everyday by parents of squabbling siblings – remove the object of dispute. Reduce the EU budget by 50-80% and national contributions by the same proportion. The EU is now held together by the internal market and monetary union. Any significant increase in integration is surely going to take the form of enhanced cooperation arrangements (clubs within the club) and since these are voluntary, the EU will not need to make large side payments in order to proceed with European integration.

Of course this solution is too crazy to work, at least not before the enlarged Union struggles through a series of crises over the budget. As I argued above, my guess is that these crises will come while the EU is working on its next new 7-year budget plan. If EU leaders come to believe that the budget is a major hindrance to European integration, solutions that sound radical today may in fact come to sound quite natural.

6.1 Zero sum and positive sum activities

When a group of nations pool their sovereignty as the EU members have done, they undertake two types of activities – zero sum activities and positive sum activities. Positive sum activities are the dominant ones, with economic integration being the foremost example. When nations mutually remove barriers to the free movement of goods, services, people and capital, the economic efficiency of all participating nations tends to rise. To put it differently, although there will be winners and losers within each nation, the winners win more than the losers lose in each nation. Thus, nations – assuming they are governed wisely – can make economic integration into an 'everyone-a-winner' proposition.

Among the zero sum activities, the EU budget is a prime example. Some expenditures of the EU budget – like financing of EU institutions (Court, Commission, Parliament, etc.) – are positive sum activities since they create the institutional framework that is necessary to allow economic integration and other positive-sum activities to flourish. Cooperation on development aid, preferential trade arrangements with poor nations and some EU foreign policy initiatives are likewise examples of how the EU can be more than the sum of its members.

¹³ See, for example, Enderlein et al. (2005).

Others, however – and here the CAP is the prime suspect – are merely taxing some EU citizens in order to give transfers to other EU citizens. In the case of the CAP, most of the money goes to rich farmers.¹⁴ These are zero sum activities and they are the ones that will be responsible for most of the political difficulties in the coming years.

The EU should focus on the positive and eliminate the zero-sum activities. Here is one of many ways to do so.

Nationalise the CAP. EU-wide spending on the CAP should be eliminated and the members allowed to take over the payments. As long as nations respect single-market rules against distorting subsidies, EU members should be free to hand money to their farmers – just as they hand money to their artists, elderly and handicapped. Note that Switzerland and Norway subsidise their farmers at a much, much higher level than does the EU, so there is nothing to say that France could not give even more of French taxpayers' money to farmers (come to think of it, maybe this is one of the main reasons the French political elite would resist the idea).

Turn structural spending into project funding. The way structural funds are now allocated is highly political and of dubious effectiveness. Indeed, until the 1980s, EU structural spending was minimal – helping disadvantaged regions was the responsibility of member states, not the EU. Given the huge income disparities among members, and the massive impact of economic integration on the new members, there may be some logic to having an EU-wide structural programme, but the spending methods should be radically changed.

Since the earliest reaches of recorded history, mankind has struggled with the problem of giving away money. Two main models have emerged, charity and venture capital. Charity involves the well-to-do doling out money to the less-well-to-do. The keystone of this model is a means test at the individual level. If the scheme is to work, it is absolutely essential to ensure that the citizens receiving the money are indeed badly off. The 'venture capital' model is quite different. Paraphrasing one well-known parable, instead of giving fish to the poor, rich folks finance programmes that teach the poor how to fish. The keystone here is project evaluation. If this approach is to work, the projects on which the money is to be spent must be shown to be feasible, viable and at least to have a good chance of attaining the desired goals.

The main problem with EU handout programmes, such as the structural funds, is that are an awkward mix of the charity model and the venture capital model. The main test for the largest programme is based on income differences, but not on the incomes of those that receive the money. Under this programme, which is poetically known as Objective 1 spending, the test is whether a region's income is less than 75% of the EU's average. How the money is spent within a region, or even if it stays within the regions, is not subject to a 'means test' and anecdotal evidence suggests that much of the money ends up in the hands of rich owners of construction companies – some of them located in rich countries – rather than in the hands of poor citizens living in the region. All this would be fine, if the projects on which the money is spent could be shown to benefit the poor citizens. This however is not done. The EU does absolutely no systematic economic project evaluation, either before or after the money is spent.

As long as the main criterion is regional per capita income, enlarging the union to poor nations will be an expensive proposition. Moreover, the political fights over this money will certainly intensify with enlargement.

The solution to this is to radically overhaul structural spending. The EU should allocate all of this on the basis of economic and social evaluations of project proposals. This would automatically limit the cost of letting in new members since the process of project evaluation would screen out many demands for spending. Indeed, history has shown that nations have a great deal of trouble in absorbing more than 3% to 5% of their GDP in project assistance. Thus, this proposal would automatically, and

¹⁴ For example, the Duke of Bedfordshire (see Baldwin, 2005, and <http://hei.unige.ch/~baldwin/PapersBooks/BW/Updates/CAPreformJun03.pdf>).

justifiably, limit regional spending the newcomers. Who knows? It might even reduce the amount of wasted spending in the incumbent regions and/or increase the effectiveness of structural spending.

Slash the EU budget. This could be done once the big spending programmes were eliminated and/or radically downsized. I think a number like 80% would be just about right.

Adding good-works? Of course, another alternative would be to pay for good works around the world and inside the EU. How about a high-speed train network? More development aid? Or subsidies to reduce greenhouse gases? Come to think of it, that might make the European Union just the sort of thing that EU citizens could get excited about.

7. Concluding remarks

Imagine an EU that came to be known as a strong force for world peace and the alleviation of world poverty, that was widely viewed as a stellar example of social market capitalism and how closer cooperation among neighbours can promote the pursuit of noble goals. This is the sort of thing that could happen if the EU reoriented its spending towards the new-century demands, dropping the anachronistic focus on agriculture and poor regions in relatively rich nations.

But surely all this is a pipe dream. The most likely outcome is that EU leaders will continue to bicker about subjects that are far from the hearts of Europeans, like budget-rebate formulas, milk quotas and statistical adjustments for Objective 1 eligibility. Worse still, they will continue to blame ‘Brussels’ for all the tough compromises that they will have to make, thereby further disillusioning EU citizens from the European ideal.

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