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Can the EU Status-quo Bias in Budgetary Matters Lead to Change?

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1. Introduction and The Puzzle

While studying the European Union has the advantage that most areas change rapidly, one area in particular is most suited for the study of change because of the controversy around its development. In the literature on EU decision-making, the processes and outcomes of EU budgetary negotiations have puzzled social scientists because of several reasons. First, the history of the EU budget showed that change was possible in spite of the high potential to stagnate and even break down the Union. Second, like any negotiations on the allocation and distribution of scarce resources, extremely intense political bargaining characterized EU budgetary negotiations but still agreement was reached and certain outcomes prevailed. Third, the European Union was not a state but still it attempted to have an autonomous source of financing that resembled a national budget. Fourth, the interplay between intergovernmental and supranational institutions seemed to be inhibiting change in budgetary matters, especially because contentious national politics were brought into the EU arena.

This puzzle is best encompassed by the question: are we witnessing a deadlock in EU public finances? or is change possible in EU budgetary matters? At the heart of the puzzle lie the two meanings of the concept of 'deadlock'. On one hand, deadlock means status quo bias, which is characterized by the impossibility of change due to either the lock-in effect of some institutions introduced in the past or the existence of two opposing coalitions – payers and receivers – that block change. On the other hand, deadlock means the impossibility to agree on a budget, in other words a gridlock in negotiations that prevents the emergence of an outcome.

Subsequently, the question that arises is: How do we recognize deadlock when we see it? In order to answer this question one needs to look for evidence of the two meanings of the term 'deadlock', no change and no agreement, respectively. On one hand, we are in deadlock when no change of the rules governing the EU budget is possible: because of the lock-in effect of previous institutions, no innovation is possible therefore we do not see any new rules on the budget. An example of this is the 2003-2004 proposal of a new institution by the Commission – a generalized correction mechanism – which was not agreed upon, thus providing evidence for the argument that no new institutions are possible on the budget. On the other hand, when there is deadlock, we see veto players bringing EU budgetary negotiations into a halt – there is no agreement and negotiations are postponed – budgets are rejected by the budgetary authority and court cases on the budget are brought in front of the European Court of Justice. We see numerous examples of these in the early 1980s.

The emerging literature on the EU budget has tried to explain and bring evidence of the existence of deadlock in EU finances, but no agreement was reached on the conceptual meaning of deadlock. Lindner (2006) presents statistics showing the existence of conflict in the annual budgetary procedure for thirteen years during the period between 1978 and 1997. Using a historical-institutionalist approach of institutional change, Laffan (1997), Laffan and Lindner (2005) and Lindner (2006) argue that the reduction in conflict on the EU annual budgets is a result of the lock-in effect of the introduction of the Financial Framework (FF) in 1988, which created a specific institutional framework for budgetary negotiations, such that instead of fighting every year for EU funds, the big bargains occurred every five to seven years. Shackleton also states that the 1988 decision

"marked the end of a long period of bitter argument about the financing of the EC and generated a widespread feeling that the Community had been dramatically reinvigorated." (Shackleton 1990, 1)

In this literature, the existence of a status quo bias is explained by actor-centered institutionalism²: member states have specific preferences which interact and produce an outcome that cements the lock-in effect by institutions; change on the budget was possible in the past but the lock-in effect of these past institutions hinders current change and thus leads to a status quo bias. The institutional lock-ins that happened are agriculture in the early 1960s, the own resources decision and the budget treaty in the 1970s, the introduction of the UK rebate in 1984 and the Financial Framework (FF) in 1988.

Another explanation of budgetary deadlock is given by Blankart and Koester (2009)³ who argue that the historical development of decision-making on the EU budget has resulted in a re-distributive deadlock: "[...] two different historically formed coalitions now have an incentive to veto changes on the financing and the expenditure side, which leads to budget deadlock and prohibits a change [...]." (Blankart and Koester 2009, 3) Trying to explain why some member states are consistently net payers while others are net receivers, the authors show that the threat of exit played an important role in the development of the budgetary deadlock. In the authors' view, deadlock is defined in the following way: net receivers object to any reallocation of resources away from their individual interests, whereas net payers, anticipating net receivers' power to attract additional resources, veto any increase in their financial burden. However, net payers

² The account of the actor-centered institutional approach is based on Brigid Laffan's contribution to the Workshop *The political economy of EU public finances* organized by BEPA on February 5, 2009.

³ "Refocusing the EU Budget – An Institutional View" – paper presented at the Bureau of European Policy Advisers Workshop *The political economy of EU public finances: designing governance for change*, Brussels, February 5, 2009.

cannot enforce a decrease of their burden, as this would be objected by net receivers. This leads to a status quo that is a stable equilibrium. (Blankart and Koester 2009, 13-15)

Kauppi and Widgren (2009) define the status quo bias in the EU budget on the basis of a game theoretic power distribution that specifies the relative voting power of each member state in the Council of Ministers, assuming that each state's share in the budget derives from its votes. The authors find that France, Germany, Spain and Greece have excess power, as they systematically receive more funds than their power distribution implies; by contrast, Austria, Finland, Sweden, the Netherlands, Denmark, UK, Belgium and Luxembourg have excess negative power. In the authors' view, a high status quo bias is given by high excess power: countries with high excess power want an increase in funds, but countries with negative excess power will block any increase. This explains the stability – no change – of the budget over time. (Kauppi and Widgren 2009, 3)

Ackrill and Kay (2006) define deadlock in a slightly different way. Since changes in the budget are a zero-sum game, member states' interest is to safeguard their shares of the EU budget: every member state wants to maximize its budget share, but short of that preserving a member state's share is the second best outcome. This implies that the status quo is always maintained and no changes are possible, hence the EU budgetary negotiations have recently shifted to a debate on maintaining or even reducing the size of the budget: the 1999 inter-institutional agreement has made unexpected spending increases very difficult and the Lisbon Treaty tightens the budget rules even further. However, the authors argue that there is pressure leading to institutional change, and this pressure is endogenous to the EU budget. (Ackrill and Kay 2006, 128-130) Since reform

of the policy framework is costly, the authors conceive change as additional institutions being layered on top of existing ones. (Ackrill and Kay 2006, 113-114)

The other meaning of deadlock, as mentioned above, is the impossibility to obtain agreement on the budget. This was a hotly debated issue before last enlargement and has re-emerged with the global financial crisis. Before 2004, some policy-makers in Brussels and the EU-15 and some social scientists argued that, as more countries join the EU, the decision-making mechanisms become more complex, hence the increased likelihood to end in deadlock, especially in a field where money is involved: “The conventional view is that the increase in the number of member states and the greater diversity of their views will not only create pressure for financial transfers, it will also trigger breakdown or gridlock in the EU’s decision-making process.” (Moravcsik and Vachudova 2003, 54)

In the 1980s and in the first half of the 1990s, there were numerous cases of no agreement (i.e. deadlock) on the EC/EU⁴ budgets, as they were rejected or contested quite often. Lindner (2006) presents statistics showing the existence of deadlock – rejections of the budget or court cases involving budgetary decisions– in the annual budgetary procedure for thirteen years during the period between 1978 and 1997.

Thomson and Hosli (2006) emphasize the danger of deadlock by giving examples of the challenges European decision-makers face in reaching political agreements. The authors argue that the deadlock from the June 2005 negotiations on the 2007-2013 FF was a result of the French and Dutch referenda that rejected the Constitutional Treaty: forced by the referendum, the Dutch Prime Minister asked for a sizeable reduction in the Dutch net payments to the budget, the UK refused to discuss its correction mechanism

⁴ European Communities before 1994.

and “agreement failed due to negative votes of the UK, the Netherlands, Spain, Sweden and Finland.” (Thomson and Hosli 2006, 1-2)

It is worth emphasizing the importance of studying deadlock in EU budgetary negotiations. First, a study of the EU budgetary deadlock contributes to the institutionalist literature that explains change and thus answers the question: how can we change institutions that are locked-in? Second, answering the question on the existence of deadlock in EU finances explains the interaction between EU member states (and institutions) in an area conducive to conflict - bargaining over money – and where agreement is difficult because of the increased heterogeneity of players. In this respect, analyzing deadlock contributes to the rational choice literature on negotiations because it shows how agreement is obtained and who influences the outcome. Third, such an enterprise increases transparency on EU decision-making by explaining the interaction between member states and institutions within the EU institutional framework: while it is difficult to obtain an exact account of what happened, some theoretical lenses could help us understand the dynamics of negotiations. Fourth, while the budget has little macroeconomic significance for the Union as a whole, it is very important for the member states that benefit from EU funds. (Laffan and Lindner 2005, 193) The EU budget with its independent resources has also been a very important tool in the economic integration of the Union. Last but not least, studying the possibility of change in EU budgetary matters could help contribute to the 2008/2009 budgetary review.

There is also a normative component of the deadlock issue but there is no agreement on if it is good or bad to keep the status quo; the opportunity costs of keeping the status quo have not been properly identified. Coalition theory argues that the larger

the coalition needed to change the status quo, the more public goods are provided, whereas the smaller the size of the winning coalition, the higher the likelihood of bribery and clientele spending. When unanimity is the rule, it is clear that the EU has a high threshold for changing the status quo, like the US, therefore the EU should produce more public goods and less pork barrel, according to the theory. However, this contradicts the distributive nature of the EU budget, locked-in by the opposing coalition of net contributors and net beneficiaries, hence the additional puzzle – if deadlock exists, is it good?

Given the rules that govern the EU budgetary processes over time and the influence of actors on outcomes, rational choice historical institutionalism is the appropriate theoretical approach for the study of EU budgetary negotiations. Rational choice historical institutionalism is part of the new institutionalism⁵ and focuses on the choices made by rational actors over time. The rational choice element posits that decisions are the result of the interactions between goal-oriented players that are constrained by institutions and want to obtain an outcome as close as possible to their own preferences; this approach deals with the way in which observed behavior deviates from a general prediction. On the contrary, the historical element answers empirical puzzles derived from observed events. Blending history into a rational choice institutionalist approach is useful because it eliminates the following critique. First, rational choice approaches use history as illustrative material for general theories, whereas historical institutionalism uses only historical narratives at the expense of theory-

⁵ New institutionalism blends intergovernmentalist state primacy with the role of institutions shaping individual and collective policy choices (Pollack, 1996); institutions are considered intervening variables between actor preferences and policy outcomes. (Hall and Taylor 1996; Peters 1999; Aspinwall and Schneider 2000)

building. Second, even though historical institutionalism claims that social science research should be historically grounded, most of its proponents look at relatively fixed institutions, leaving the historical part unclear. Third, rational choice institutionalism offers analytical tools like strategic calculations and rationality for analyzing temporal dimensions, but usually leaves out issues of ordering and sequence (Thelen 1999).

When compared with the generality of the existing theories of European integration – informed by theories of international relations and regional integration – rational choice historical institutionalism appears as most suitable for analyzing the specificity of EU decision-making. Rational choice historical institutionalism is the only tool well equipped for analyzing the processes through which actors solve their differences to reach legislative/policy outcomes. (Thomson and Hosli 2006, 7-8)

Historical institutionalism adds value to an institutional approach by providing the context used by rational choice; as this approach seeks to explain the creation of institutions in past contexts, it explores the interactions between the institutions' creators and the contextual structure. Historical institutionalism defines institutions as formal and informal rules, compliance procedures, codes of behavior, norms and symbols that structure the relationship between individual units and the environment of the polity. The goals and the preferences of actors are endogenous, they are shaped by institutions.

Different from historical institutionalism, rational choice institutionalism treats preferences as being exogenous and explores individual strategic actions within institutional contexts: institutions constitute the rules of the game and determine the behavior of actors, whose strategic choices lead to policy outcomes. Institutions constrain the actors' abilities to realize their interests and provide incentives for the actors to

change the rules and recalculate their behavior and strategies. In the EU context, institutions affect the choices of member states, and differences between member states' preferences provide an opportunity for institutional activity.

Within rational choice institutionalism, the use of formal models is a methodological tool that allows the identification of the processes through which EU legislation and policies come into being. In contrast to verbally formulated theories that describe processes, formal models have the advantage of detecting logical inconsistencies in theory formulation: a verbal theory is not equipped with a mechanism that could check logical consistency. However, contrary to descriptive theories, formal theorists need to be explicit about the propositions and the assumptions they make about decision-making. Deductive reasoning is used to obtain the implications of formal propositions, and any parameter variation can be analyzed and compared. The main strength of formal theories is that they give a general prediction and the empirical task of the researcher is to check if and how observed behavior deviates from it. It is worth emphasizing that descriptive theories⁶ have enriched the study of EU decision-making and have indicated to formal modelers which features to include in their models and how to reduce the level of abstraction in a particular model. (Thomson and Hosli 2006, 10)

Formal theory deals with actors' ideal preferences, their revealed positions in bargaining and their subsequent voting records; the distance between initial positions and final outcomes is a measure of bargaining success. Given that outcomes are the result of interactions between strategic actors operating under institutional constraints, the

⁶ Nugent (1989); Westlake (1994); Wallace and Wallace (1996); Richardson (1996); Peterson and Bomberg (1999); Dinan (1999); etc.

outcomes are sensitive to the modeler's interpretation of the rules of a particular procedure.

In order to answer the puzzle on the existence of deadlock in EU budgetary negotiations I propose the following research questions: Is agreement possible? If yes, how are the budgetary bargains obtained? Is change impossible? If change is not possible because of both net payers and net contributors, then which are the actors and the factors influencing agreement? In order to answer if change is possible in budgetary negotiations, I argue that, with enlargement, the outcome on EU budgets has become more influenced by the net contributors – i.e. the payers of the budget become the drivers of change. Using a rational choice historical institutional approach with formal theory and case studies I create a model that shows that, as new countries join the EU, the outcome on the budget goes out of deadlock through the influence of net contributors and their making use of issue-linkage in negotiations. This project is intended to test the existence of budgetary deadlock meaning both 'no change' and 'no agreement'. In the next section I develop my theory and the game-theoretic model, which are then empirically tested with two case studies; the last section discusses the findings and their implications for policy recommendations.

2. Theory

My answer to the puzzle on the existence of deadlock in EU budgetary negotiations is that enlargement has unlocked the deadlock on the EU budget by changing the preferences of the net contributors. Using a rational choice historical institutional approach with formal theory, I create a model that shows that, as new countries join the EU, the outcome on the budget goes out of deadlock through the influence of net

contributors and their making use of issue-linkages in negotiations to obtain agreement on new institutions. Even though conflict between players is high, issue-linkage offers a way out of deadlock. As enlargement progressed, the issue of ‘net balance’ became more and more salient for the main contributors to the EU budget; in successive rounds of negotiations, this salience determined them to use issue-linkage in position exchanges in order to obtain a favorable agreement – change the budgetary rules in their favor.

The causal inference in my theory is the impact of enlargement on the EU actors’ preferences – positions and saliences over issues – which then interact and create exchanges between actors that lead out of deadlock into the final outcome. The positions and saliences of EU actors have been historically constructed since the early days of the Union. The pressure created by every enlargement led to institutional change through a change in actors' preferences, in particular those of net contributors. The pressure leading to institutional change is thus endogenous to enlargement, and not endogenous to EU budget, as Ackrill and Kay argue (2006, 128).

The rational choice component of my approach is based on formal theory and thus allows a logical, precise description of players’ strategies in every round of negotiations and their influence on the final outcome. Without the tools offered by game theory it would have been difficult to analyze the way in which players influence each other through issue-linkages in order to reach a compromise. The formal model proposed is a stylized version of reality and contains specifications that are essential to the search for generalizations in political science.

From a rational choice point of view, I assume that institutions are a set of budgetary/voting rules that constrain actors’ behavior and influence policy outcomes: at

the moment negotiations start, the rules are exogenous⁷ – previously decided by the actors through historic negotiations. However, given the specificity of EU decision-making, according to Ackrill and Kay (2006) every decision outcome has an institutional component, which in this case is endogenous: every agreement introduces new rules (or changes the previous ones) and these will constrain the future behavior of actors. My approach features both the formal and informal institutions of the complex EU budgetary decision-making system: while formal institutions are stipulated by EU treaties, the informal institutions – bilateral and multilateral meetings – constitute practices that facilitate bargaining and agreement on the EU budget.

The main assumption of rationality holds in my approach: actors are rational, they act based on their preferences over outcomes, they choose strategies that best satisfy their interests and their overall goal is to obtain an agreement as close as possible to their own preferences. The actors are considered unitary – the EU member states, the European Commission and the EP aggregate the preferences of their members and act as one single entity and choose between alternative actions according to their preferences. From this point of view, the individuals that represent the member states or the EU institutions are the agents that carry the interests of the respective unitary actors. Two caveats are worth mentioning. First, there is an underlying principal-agent framework due to the nature of EU inter-institutional politics: member states could be considered the principals that delegated authority to the agents – the EU institutions – which have gradually gained autonomy and acquired institutional interests manifested through the roles of agenda-setter, honest broker or veto player. Second, domestic constraints are taken into account

⁷ The distinction between institutions as exogenous (independent variable) and endogenous (dependent variable) is made by Jupille and Caporaso (1999, 432-433).

in my model but are not explicitly modeled. The two-level games literature argues that politicians behave strategically on the EU scene because of domestic constraints; in particular, high domestic constraints (i.e. referenda) increase the bargaining power of politicians on EU fora. (Putnam 1988) Because of the nature of the budgetary game, domestic constraints are part of the actors' preference: the interest in benefits from agriculture or regional aid is a domestic requirement, as is the concern with net balances – how much money a country has to pay to the EU out of its national budget.

The preferences of actors are critical for determining policy outcomes in my approach. Preferences are considered measurable and reflect what individual actors want. The goal of every player is to obtain an outcome as close as possible to its preferences; through successive rounds of negotiations, the actors who are most influential pull the outcome towards their ideal positions: “member governments grappled with their desire to reach agreement, on the one hand, and with their determination that the terms of the agreement be as favorable as possible to their own viewpoint, on the other hand.” (Laffan and Lindner 2005, 200) Further, preferences are assumed to be uniformly distributed: all interests that member states or EU institutions have are equally likely. The most important feature of preferences in my approach is that preferences are formed historically. This answers the main critique of game theoretical models – that preferences are fixed – taken as given. I use a historical institutional approach to build the two input variables that represent preferences: a player's position (classic view of preferences) and the salience of the issue negotiated; the interaction between these variables and institutions create the collective outcomes represented by the game theoretical model.

Both position and salience are part of the general notion of preference but they are conceptually and empirically distinct. The ideal position on an issue represents a player's most preferred outcome on that issue, whereas salience is defined as the importance a player attaches to an issue negotiated. Given that position and salience are characteristics of the unitary actor (i.e. country), they feature in member states' national interests: salience shows how high a given issue is ranked among a country's national interests whereas position shows the precise outcome on the issue that a country would like to obtain. While it is intuitively plausible for actors with extreme positions on issues to also attach high salience to those, it is possible for an actor to take a moderate position on an issue to which it attaches high salience.

The predicted outcomes are compromises between actors with diverging preferences. If conflict between players is defined as competition for resources⁸, the increase in the heterogeneity of EU players increases conflict on how much to spend on various EU policies. Indeed, empirical evidence shows that the last EU waves of enlargement have intensified competition for resources: both the Southern member states that joined in the 1980s and the 2004-2007 new member states claimed more resources through both regional development and agriculture. This competition over resources led to the need to reform the EU largest spenders – regional and agricultural policies; in fact, the accession of Spain and Portugal was the first to create the possibility of issue-linkage between regional policy and agriculture. Starting with the 1980s, the divergence of member states preferences increased conflict on the budget.

The existence of diverging interests makes coalitions difficult, especially when the voting rule is unanimity. "In the EU, shifting interests across issues mean that states

⁸ This definition is according to Deutsch, also used by Lindner (2006).

have permanent interests but no permanent friends.” (Achen 2006) On the contrary, the striking feature of EU decision-making is the search for consensus – an agreement acceptable to all. The reversion point is the status quo and represents the disagreement outcome – or deadlock – in general less desirable to players. In budgetary matters the reversion point is the last agreement on the budget:

“Should the two arms of the budgetary authority fail to agree on a new financial perspective, and unless the existing financial perspective is expressly denounced by one of the parties to this Agreement, the ceilings for the last year covered by the existing financial perspective will be adjusted in accordance with paragraph 15 by applying to these amounts the average rate of increase observed over the preceding period, excluding any adjustments made to take account of enlargement of the Union.” (Inter Institutional Agreement of 6 May 1999 C172/1).

Since the net contributors have proven to be the drivers of change in EU budgetary outcomes, the meaning of ‘net contributor’ needs to be properly understood. The concept of net contributor derives from the concept of net balance with the EU budget – an accounting exercise that shows the difference between the amounts a country contributes to the EU budget and the funds it receives from the EU budget through spending programs. It follows that a net contributor is a member state whose contribution to the EU budget exceeds the benefits it receives from the budget. However, the issue of net balance is more complicated than it actually seems because of its technical nature. On one hand, every country’s contribution to the EU revenues is paid every month by the respective finance ministry based on forecasts of the VAT base and the GNI and corrections are made the following year. This contribution to EU revenues needs to be calculated into the national budget, since it is a constant payment made from the national

budget. An increase in a state's contribution to the EU would mean an increase in its budgetary deficit, hence the concerns of breaking the rules of the Stability and Growth Pact. On the other hand, the funds that a country receives from the EU budget do not go as revenues into the national budget; on the contrary, for most program payments the conditionality of co-financing applies, therefore the national budget has to specify these co-financing amounts as payments from the national budget. The funds disbursed from the EU budget go through national paying agencies to the beneficiaries, therefore the finance ministry has difficulties in calculating with precision the net balance with the EU budget.

Ackrill and Kay (2006) acknowledge this shift in positions by arguing that the EU budget debate has shifted from distribution on policies and programs to the overall size of the budget and the net balance of each member state. On the contrary, Bache's (2002) argument on why there were no net balance concerns before 1992 is too simplistic and ignores the behavior of the other net contributors: in Bache's view, Germany did not let its Eastern Germany reconstruction efforts affect its EU budgetary contribution and thus offered to be the main payer for European integration. Ultimately, the preferences of the net payers point to an old dilemma of funding: the ones who pay also want to be the ones who make the rules. The concerns with equity, embodied by the idea of 'juste retour', are just the packaging for an utility maximization argument in a zero-sum game: the net contributors want to increase their benefits from the EU and a way to do this is to decrease the benefits of those who are at the same level of development – i.e. rich. In the early days of European integration, the founding countries supported one another in the after-war recovery effort and none of them was concerned with who paid most; after the

number of poor regions started to accumulate, net payers' positions started to gravitate on the 'balance' issue.

In my theory, the dependent variable is derived from the meaning of deadlock and is conceived as agreement on the budget; if agreement is not obtained, the status quo (last year's budget or the last FF) prevails. This binary dependent variable addresses directly the puzzle surrounding the existence of deadlock in EU budgetary negotiations: if agreement is obtained, there is no deadlock and institutional change occurs; on the contrary, if the players cannot agree, deadlock prevails. One issue that needs to be addressed is the possibility of every player to veto an agreement when unanimity is the rule (i.e. the FF negotiations). Players are utility maximizers, they increase their utility by entering in exchanges on different issues in successive rounds of negotiations. Therefore it is more likely for a player to veto an agreement early in the negotiations either because there are no profitable exchanges she could make or because she has not entered any such exchanges yet. This de facto situation reduces the possibility of vetoes as negotiations progress, such that agreement through issue-linkages becomes smoother and can be reached in a timely manner, in spite of the initial conflict caused by the increased heterogeneity of players. One caveat should be mentioned: when players make exchanges, they increase their utilities but sometimes they can produce negative externalities for the players not involved in exchanges; these externalities could lead to a veto by the players affected. However, what we see empirically is that agreements contain a 'shopping list', whose goal is to address these negative externalities.

My main independent variable is enlargement, conceived in a broader sense as being more than the simple addition of new members: in addition to more members into

the union, enlargement is understood together with its effect of increasing heterogeneity and thus creating tensions between different levels of economic development (when poorer countries join) and different degrees of economic integration (when richer countries join). Conceptualizing enlargement in this way offers the advantage that it adds an economic dimension to the simple expansion of the union that can control for confounding variables related to domestic constraints for instance. Over time, this tension encompassed by enlargement affects the preferences of players – positions and saliences – which are the intervening variables that influence the exchanges between players and the subsequent outcome. With every round of enlargement, the issue of net balance becomes more salient to net contributors and pushes their positions towards a more conservative budget; similarly, the issues of regional aid or agriculture become more salient to the net beneficiaries. A change in preferences due to enlargement influences the FF negotiations immediately following the respective enlargement (e.g. at time t) and thus the outcome results in institutional change. However, this institutional change becomes a factor that has an effect on the formation of preferences for the negotiations of the following FF, at time $t+1$. Empirically, this institutional change can be seen in the reform of the agricultural policy, the adjustments of regional policy but mostly in the gradual reductions of the net contributors' burden: first only Germany obtained a reduced contribution to the VAT resource (implying a reduced contribution to the UK rebate), then all net contributors obtained such a reduction, which was increased over time, and finally some of the net contributors obtained a more obvious provision – i.e. cash back.

It is worth emphasizing that my theory does not deal with the impact of the FF on the annual budget, which has been studied in the EU budget literature. Whereas Lindner

(2006) looks at the stability effect the FF has had on the annual budget, I am interested in the effect enlargement has on the FF (and annual) negotiations; I am exploring the way in which enlargement changes players' preferences, which leads to change in budgetary institutions. Figure 1 summarizes the causal path of my theory. It is worth emphasizing that there is disagreement in the literature on the stabilizing effect of the FF: Ackrill and Kay (2006) argue that the introduction of the FF was actually not enough to keep EU annual expenditures under control, hence the need of the 1992 MacSharry reform or the changes proposed by the Lisbon Treaty.

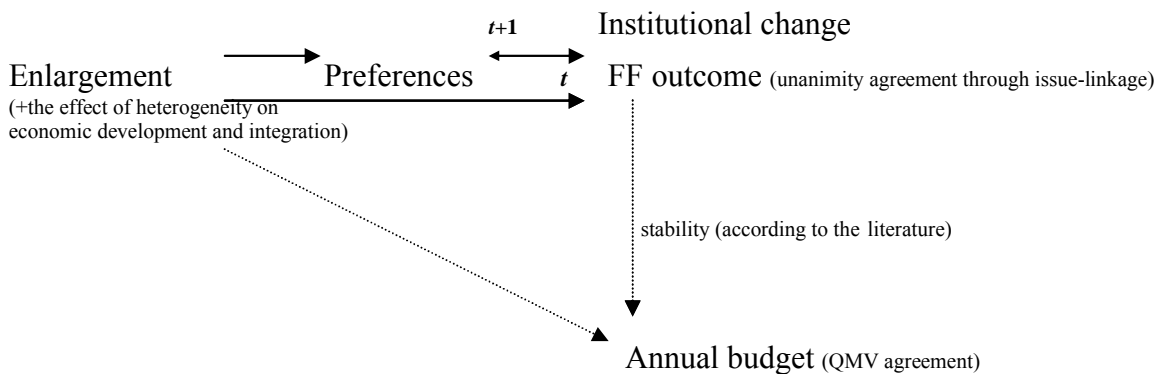


Figure 1 – Impact of enlargement on EU budgetary negotiations

My theory disagrees with the claims of Baldwin and Portes (1997) who argue that small overrepresented countries are the winners of the budgetary game: when they enter

the union, they change the budgetary rules in their favor. As in my theory issue-linkage represents the way out of deadlock in budgetary negotiations, issue-linkage has indeed the effect found in the literature: the issues that are linked are those for which players have different saliences (Morgan 1990; Sebenius 1983) and bargaining is facilitated when there are blocks of players with similar preferences or when a particular group gains more players; (Tollison and Willett 1979). Hix (1998) rightly argues that issue-linkage offers to net contributors a compensation for their negative balance with the EU budget, hence their favorably changing the rules on the VAT rate or the UK rebate; the FF negotiations are about allocation and allocation problems are solved by issue-linkages: some win on some issues and lose on others that are less important to them.

In order to see how players' preferences, affected by enlargement, impact the EU budgetary outcomes and the implied institutional change, I model the FF negotiations using a bargaining model. In the following sections I describe the model and then I test it empirically with two case studies.

3. A Model of the EU Budgetary Negotiations on the Financial Framework

The rational choice institutionalist literature explaining EU decision-making proposes some useful models that use different assumptions and propositions about the processes through which actors' policy preferences become collective outcomes embodied by the EU legislation. These models do not simply attest that a consensus was reached, they investigate the process by which agreement was arrived at. A unifying assumption of these models is that decision outcomes are the result of interactions

between goal-oriented actors operating under formal and/or informal institutional constraints. (Thomson and Hosli 2006, 5-9)

Bargaining models rely on cooperative game theory (e.g. the Nash bargaining solution) and look at informal institutions such as pre-voting bargaining in committees, logrolling, power strategies and exchanges in search of a compromise. The importance attached to the 'consensus' culture is based on the empirical finding that voting is rather rare in the Council. The exact sequence by which decision outcomes are reached is not specified; the bargaining process is treated as a black box inputting actors' power, preferences, and the salience attached to different issues.

A well known bargaining model is Bueno de Mesquita's (1994) expected utility / challenge model that assumes that players put effort into strengthening the coalition around their favored policy positions and challenge others based on expected utility; the decision outcome is the weighted median voter position. In Stockman and Van Oosten's (1994) exchange model, actors exchange positions on issues and thus influence the outcome. Van den Bos' (1991) compromise model predicts outcomes at the mean of actors' policy positions on all issues in the same proposal, weighted by their capabilities and the salience attached to issues. In Achen's (2006) institutional realist⁹ model, all actors must work to reach an agreement or else end up with the undesired status-quo; Achen argues that the Nash bargaining solution implies that the compromise model's formula of predicting EU decisions is a very good approximation. (Thomson and Hosli 2006, 21)

⁹ Institutional realism is based on the idea that the relative power of governmental institutions determines political outcomes. (Thomson and Hosli 2006, 21)

Thomson et al (2006) employ empirical tests and find that bargaining models (emphasizing informal rules) perform better than procedural ones (formal rules), possibly because actors are willing to compromise for the sake of reaching a common position, as bargaining models show, whereas procedural models consist of single-shot events in which actors maximize their own self-interest. As researchers are interested to see how consensus was reached – what mechanisms are at work – empirical studies have found that consensus is used in the Council because member states and especially the Presidency know when QMV is reached (each representative has the sheet with voting weights on the table), therefore there is no need to waste time with a formal vote.

An appropriate model describing the dynamics of the FF negotiations is a rational choice bargaining model that allows players to shift their policy positions through exchanges on different issues with the view of reaching agreement in the final (voting) stage: while players' initial positions tend to be more extreme, once they realize what is feasible, their positions converge towards agreement. Empirical evidence, including my own, has shown the importance of informal discussions prior to formal voting plenaries, especially when the decision rule is unanimity. This bargaining model has the advantage that it emphasizes the importance of informal rules but yet acknowledges the importance of formal institutions, which set the rules of the game.

The position exchange model proposed by Stokman and Van Oosten (1994) is a bargaining model that distinguishes between two stages of the decision-making process: during the first stage, players try to influence each other in order to obtain an outcome as close as possible to their own policy positions; then, the decision or voting phase produces the outcome. In the influence phase, pairs of actors make exchanges on pairs of

issues: a player agrees to shift her position on an issue of less importance to her in exchange of the other player making a concession on an issue of higher importance to the former player. (Stokman and Van Oosten 1994, 109) This influence stage is in agreement with the conditions for issue-linkage described by Tollison and Willett (1979) and Morgan (1994): exchanges happen when relative saliences differs. Each actor investigates the potential exchanges with all the other actors on all possible pairs of issues and then tries to realize her best potential exchange. Mutually beneficial exchanges are possible only for actors on opposite sides of the expected outcome of both issues, as actors being on the same side can increase their utility just by choosing more extreme positions without having to give in on another issue. The exchange rate is equal utility gain for both actors involved in an exchange. In order to obtain the maximum gain, one actor needs to completely shift to the position of the other, whereas the latter shifts only partially to the position of the former; the complete shift can be realized in subsequent bilateral exchanges. All exchanges are binding and those with the highest utility gains are realized first. (Stokman and Van Oosten 1994, 110).

This bargaining model relies on several assumptions. First, like in any rational choice model, actors are assumed to be expected utility maximizers: they choose the strategy (i.e. the exchange) that produces the highest utility on a given issue. Second, the utility functions of the actors are single-peaked and each issue is unidimensional, even though the model implies multidimensional linkages across issues. This implies that players' preferences over outcomes can be represented on a line segment; the preferences with their associated utility diminish steadily the farther the Euclidian distance between the outcome and the player's ideal policy position. Actors differ in their preferences over

outcomes and in the salience they attach to different issues under negotiation. The expected utility for each player i is a utility loss linear function of the salience s_{ia} attached to the issue a by player i and the distance between the decision outcome on the issue X_a and the player's ideal policy position on issue a P_{ia} , such that:

$$EU_{ia} = - s_{ia} |X_a - P_{ia}|$$

The total expected utility for an actor i over all m issues is assumed to be the sum of her utilities over all issues:

$$EU_i = \sum_{a=1}^m - s_{ia} |X_a - P_{ia}| \quad (\text{Stokman and Van Oosten 1994, 108-109})$$

The third assumption is that policy and voting positions, as well as the saliences on all issues are assumed to be common knowledge. This assumption is supported by both practitioners and the literature (Achen 2006; Thomson and Stokman 2006; Arregui, Stokman and Thomson 2006) arguing that the 'consensual' atmosphere in the EU leads to member states' claims and interests being revealed beforehand, especially in the case of extreme positions; in some cases, member states even insist on announcing their positions. As with any model, all the above mentioned simplifying assumptions are not essential to the approach chosen; if the model results in predictions that are unsustainable empirically, then the assumptions need to be relaxed to build the model further.

The model proposed by Stokman and Van Oosten (1994) predicts decision outcomes according to a 'base model' that takes into account the voting power of actors and their policy positions. Stokman and Van Oosten's position exchange model adds an intermediate exchange phase to Van den Bos (1991) compromise model and thus extends the compromise model from one to m issues. Accordingly, in the first stage of the position exchange model the expected outcomes on every issue are determined according

to the compromise model; after exchanges have taken place and players have moved to revised positions, in the last stage the compromise model is used again to generate the

final outcome¹⁰: $X_a = \frac{\sum_{i=1}^n p_{ia} v_{ia} s_{ia}}{\sum_{i=1}^n v_{ia} s_{ia}}$ (Stokman and Van Oosten 1994, 114)

Stokman and Van Oosten (1994, 115) stress the fact that both the position exchange model and the compromise model could be applied to decision involving numerical positions, like amounts of money to be spent, but cannot be used for binary outcomes (e.g. support for a proposal). Both models are appropriate for EU decision-making because they take into account an essential EU feature: common interests are more important than divergent interests, therefore there is a high pressure to reach an agreement acceptable to all. In addition, both models take into account the role of the Presidency, whose work has proven critical in reaching an agreement between players with conflicting interests. While the compromise model emphasizes cooperation and the importance of information-based networks, the position exchange model takes the compromise model further by allowing issue-linkages and thus analyzing the way in which decisions are reached. (Arregui, Stokman and Thomson 2006, 132-133)

In order to analyze the dynamic negotiations on the FF, I use and adapt the position exchange model described above. Since the FF is decided under unanimity at European Councils, the players are the member states, with the Commission as agenda-setter.

The position exchange model is appropriate for modeling the FF negotiations for several reasons. First, there are no precise formal rules for the FF negotiations written down in the Treaties. As there is no strict procedure to follow, the negotiations take place

¹⁰ v_{ia} denotes the capabilities/resources of players.

between member states in an ‘informal’ way and culminate with agreement in European Councils. The Commission makes an initial proposal and then the country holding the Council Presidency reacts to it by proposing a compromise to which the other member states respond; if no agreement is reached, the following country holding the Presidency proposes a new compromise and this procedure continues until agreement is reached. While there is no clear deadline, agreement must be reached before the ongoing FF ends, otherwise the ceilings of the previous FF apply. Since the position exchange model is a bargaining model that stresses the importance of informal institutions, it is the most appropriate model for the description of the institutional framework that characterizes the FF negotiations. It is worth noting that, by contrast, the annual budgetary procedure takes place according to rules stipulated by the Treaties, therefore a procedural model is more appropriate for analyzing it.

Second, during the FF negotiations member states shift their positions; initially, their preferences are more extreme but after several bargaining rounds they realize what is feasible and thus their positions converge towards a compromise. While EU collective decision-making is characterized by pressure to have agreement (the ‘consensual’ culture), member states still follow their national interests: “member governments grappled with their desire to reach agreement, on the one hand, and with their determination that the terms of the agreement be as favorable as possible to their own viewpoint, on the other hand.” (Laffan and Lindner 2005, 200) The position exchange model has the advantage that it allows players to shift positions in order to increase their utility.

Third, the convergence towards an outcome is facilitated by the ‘horse-trading’ that players engage in. There is empirical evidence that member states use bilateral meetings in which they attempt to influence each other, such that the final FF outcome is a compromise in which countries have moved away from their initial positions. The position exchange game is a bargaining model that describes the way in which players link different issues to which they attach different saliences in order to increase their utility.

Fourth, the position exchange model performs better than other bargaining models (the compromise model, the challenging model) applied to EU decision-making. This model is “the only model that is insensitive to the level of measurement on the issues.” (Arregui, Stokman and Thomson 2006, 152) Given that the measurement of member states’ preferences (positions and saliences) might contain some noise, as pointed out in the previous section, this finding is particularly reassuring. Equally reassuring is the proposed solution for the equilibrium outcome: Achen (2006, 92-120) demonstrates that Van den Bos’ (1991) ‘compromise formula’ for computing decision outcomes closely approximates the Nash bargaining solution when disagreement is the least desirable alternative and Thomson and Hosli (2006, 21) state that: “this modest and straightforward compromise formula embodies the best case study wisdom of the last century.”

I adapt the position exchange model in order to account for the unanimity rule that governs the FF negotiations. Under unanimity, all member states have equal voting power, no matter if they are large or small, therefore they have equal weights in influencing the collective outcome. Consequently, I assume that member states’ power deriving from their voting weights need not be taken into account when unanimity is the

voting rule, as all countries have in theory the same veto power. Therefore, I adapt the compromise model so that the expected outcome on issue a is a function of the n players' ideal positions p_{ia} and the salience s_{ia} they attach to the issues negotiated under the FF framework:

$$X_a = \frac{\sum_{i=1}^n p_{ia} s_{ia}}{\sum_{i=1}^n s_{ia}} \quad (1)$$

Players' preferences are represented by the utility loss function proposed by Stokman and Van Oosten (1994, 108):

$$EU_{ia} = - s_{ia} |P_{ia} - X_a| \quad (2)$$

The n players of the game are the EU member states at the moment when FF negotiations start; given the history of the EU integration and the FF, $n \in [12, 27]$. For example, the current FF was negotiated with 25 member states, as negotiations started soon after the 2004 enlargement and ended before the 2007 accession of Romania and Bulgaria.

The issues that players make exchanges on are viewed as uni-dimensional continua and represent the main elements of the debates raised during negotiations; these are the most controversial issues and do not include subordinate/auxiliary points. The points on the issue continuum are alternative decision outcomes that players favor or possible compromise outcomes. These issues are in fact policy questions on which at least some of the actors involved take different positions; if the actors take the same positions on an issue then there is no political problem to be analyzed. Players' preferences are defined over these issues rather than on underlying dimensions of preferences, like a 'left-right' dimension or an 'integration' dimension, on which it would have been more difficult to align players.

In budgetary matters, the issues have a scale level of measurement, such that all points on the continuum have meanings – they refer to the size of the budget to be allocated to a particular policy/program. The FF has a maximum of 8 headings, to which the overall size of the budget is added, therefore the possible m issues are defined as $m \in [1, 9]$. However, not all issues are debated politically; the most controversial issues are agriculture and regional aid (structural funds and cohesion) which make up roughly 90% of the EU budget and the overall size of the budget, defined as a percentage of EU GDP/GNI, hence $m = 3$ and the measurement scale is 0-100 such that $P_{ia} \in [0, 100]$ and $X_a \in [0, 100]$.

A player's salience s_{ia} has a measurement scale 0-100: $s_{ia} \in [0, 100]$; it represents the importance a player attaches to a given issue, therefore a score of 0 means no importance whatsoever, 100 is the highest importance and 50 represents an average level of priority. The absolute values of salience matter less, as the critical differences are those between different actors on an issue and between different issues for the same actors.

The game proceeds as follows. At the beginning of the game, players express their ideal positions in response to a proposal made by the Commission. After the initial proposal, the Commission does not participate in negotiations and thus cannot influence the outcome. In the first stage of the game, the member state holding the Presidency proposes a compromise package that represents the mean of all players' ideal positions on every issue weighted by the saliences they attached to each issue; this compromise outcome is computed by equation (1). Member states react to the Presidency proposal by computing their expected utility on every issue according to equation (2); then, they start inquiring if they could increase their utility by making some exchanges with other players

on some issues. As mentioned above, (Stokman and Van Oosten 1994) for two actors to engage in an exchange on a pair of issues they must attach different saliences to these issues: an actor shifts her position on an issue that is less important to her in order to obtain gains on an issue that is more salient to her. For the issue-linkage to take place, both actors must be on opposite sides of the expected outcome on both issues and their utility gains from the exchange must be equal; the exchanges that bring the highest utility gains take place first, thus foregoing some possible exchanges with lower utility; maximum utility gain is obtained when an actor shifts to the position of another actor on the less salient issue, while the latter partially shifts toward the former on the issue more salient to the former; these shifts can be obtained in subsequent exchanges. As the Presidency's stated goal is to obtain agreement among all member states, after some issue-linkages take place, the Presidency might propose a follow-up package that is equivalent to a new compromise outcome calculated by equation (1) based on players' revised positions. Or, if agreement has not been reached in 6 months, the incoming Presidency will propose a new compromise outcome based on players' revised positions. Due to their substantial funding, the most prominent issues where linkages occur in the FF are structural actions (cohesion), agriculture and the overall size of the budget (net balance). For instance, the Netherlands is a net contributor to the budget and prefers a reduced overall budget and lower funding for structural actions, whereas Spain is the main beneficiary from structural funds, and thus prefers a large budget for this issue but also a considerable increase in the overall budget. If they are on opposite sides of the expected outcome on both issues and if they attach different saliences to these two issues, the Netherlands and Spain could engage in a mutually beneficial trade, where, in

exchange for getting support for a large structural action budget, Spain agrees to a reduction in the total budget and thus moves to the Dutch position on this issue, while the Netherlands moves towards Spain on structural actions.

Once issues have been linked (in between the European Councils organized by each Presidency) and players have switched to their revised positions, agreement is reached in the second and last stage of the game which for the FF is the last European Council of the ongoing FF period. The outcome X_{FF} on every issue is given by equation (1), where the revised positions have replaced players' initial preferences.

The position exchange model applied to the FF reveals the process through which actors reach agreement on the FF. The saliences over issues and the initial positions of players are historically constructed before the negotiations on each FF start. After the Commission has made the FF proposal and the Presidency has proposed a compromise, actors shift their positions during the informal bargaining phase of negotiations in order to obtain a compromise in the final stage of voting.

Besides their gains, actors engaged in an exchange might cause positive or negative externalities for the other players of the game. Arregui et al (2006, 147) note that, when negative externalities are larger than the utility gains generated by the game, exchanges between pairs of actors serve parochial interests, rather than producing agreements acceptable to all. Empirical evidence on the FF negotiations shows that, in order to correct for these externalities, a so-called 'shopping list' has been added to the final agreement.

In order to test the formal model of EU budgetary negotiations described above one needs to test the predictive power of the model – i.e. if the model is able to predict

the actual outcome of EU decision-making. For this purpose, one needs to check the error between the model's equilibrium prediction and the FF ceilings actually adopted. The implicit hypothesis to be tested is therefore: the bargaining model describing the FF negotiations accurately predicts the actual FF outcome. In order to empirically test this hypothesis, I use a case study and a shadow case.

Before empirically testing my theory, it is worth emphasizing that applying the theoretical models to data poses some challenging issues of measurement. Given the extreme difficulty of conducting technical interviews to construct utility functions, the actors' preferences (positions and saliences over issues) must be assessed by experts and observers familiar with them. External assessment of the most preferred point seems to be straightforward. However, "there is no guarantee that experts used the measurement scales in precisely the same way that any one interpretation of the theory might require."(Achen 2006, 121) In order to collect historical data on positions and salience, I used data on member states' contributions to the EU budget¹¹, EU document analysis and semi-structured interviews with officials from the Commission, the member states and the EP¹². The caveat is that, in spite of how carefully positions and salience are measured, they might be somewhat noisy.

4. Empirical analysis

4.1. Players' Preferences

In order to test the predictive accuracy of the bargaining model proposed for the FF negotiations I illustrate the model with a case study on the latest negotiation rounds on

¹¹ The estimates of country positions on cohesion are based on Alina-Stefania Ujupan. 2007. *Interests, Power Resources and Strategies in the Council of Ministers of the European Union: the 2007-2013 Cohesion Policy Negotiations*. PhD Thesis, University of Ulster.

¹² The interviews were conducted for the project Dana Adriana Puia. 2009. *The More the Merrier: The Impact of Enlargement on EU Budgetary Negotiations*. PhD Thesis, University of Pittsburgh.

the 2007-2013 FF and a shadow case on the 2000-2006 FF. Given that the negotiations for 2000-2006 FF took place before the 2004/2007 enlargement, the pressure of enlargement on players' preferences should be more intense in the 2007-2013 FF negotiations than in the 2000-2006 FF negotiations. If enlargement has indeed an impact on the preferences of players, then the differences between these two negotiations should show this effect.

As specified in the theoretical section, the issues over which preferences are defined are agriculture (the expenditure ceilings for agriculture) and 'cohesion' (the expenditure ceilings for structural funds and the cohesion fund). The third issue is the overall size of the budget, expressed as a percentage of EU GNI; given that the EU budget cannot be in deficit, the overall size of the budget is the same for expenditure and revenue; since corrections for net contributors happen on the revenue side and are linked to the UK rebate and the VAT resource, this issue can be called 'corrections' or alternatively 'balance'. The appellation 'balance' is preferred because it emphasizes the link with the net balance concern of the net contributors – this balance is reduced when the net contributors obtain corrections.

The positions of players and their saliences over issues vis-à-vis the Commission proposal at the start of the 2000-2006 FF and the 2007-2013 FF negotiations, respectively are not taken as given but constructed historically. The saliences and the positions of players on each of the three issues are critical for determining the expenditure ceilings of the FF. The goal of every member state is to obtain an outcome as close as possible to its preferences; through successive rounds of negotiations, the actors who are most influential manage to pull the outcome towards their ideal positions.

As the theoretical section argues, the main historical finding is that, as enlargement progressed, the issue of ‘balance’ became more and more salient for the main contributors to the EU budget and their positions consolidated on a conservative budget. The net beneficiaries of regional aid (Spain, Portugal, Greece, the new member states) assigned a high salience to structural funds/cohesion, for which their position was ‘increased expenditure’ from the very beginning (i.e. since their accession), whereas for France and Poland agriculture was very salient from the very beginning. The empirical evidence shows that the successive waves of enlargement are responsible for both the change and the lack of variation in players’ preferences, which intensified the competition over resources and created the need to reform the EU largest spenders – regional and agricultural programs.

From its accession in 1972, UK’s position and salience on balance developed gradually due to the fact that it was not a significant beneficiary from EU agricultural expenditure. The introduction of the UK rebate in 1984 represents a maximum in terms of salience on ‘balance’. “The 1984 introduction of the UK rebate was accepted because the Community needed to increase the own resources, and UK prime-minister Thatcher agreed to vote for the increase only in exchange of reducing her ‘unacceptable’ contribution”. (Butler¹³ 1995, 35) The UK rebate¹⁴ opened Pandora’s box on net balances. This represents the first instance of a net contributor with a preference of ‘juste retour’: obtain at least what they put in. This is also the first case of ‘pressure’ due to

¹³ Michael Butler, former UK representative, and Hans Tietmeyer are the ‘inventors’ of the UK rebate system.

¹⁴ At its introduction, the UK rebate was calculated as a correction of the UK own resources payments: “66% of total EU allocated expenditure multiplied by the difference between the UK share of the EU uncapped VAT base and the UK share of total EU allocated expenditure.” (Commission Document 2005, 6)

enlargement: the accession of the UK created budgetary imbalances because the UK had to pay for the exploding costs for Community agriculture but had a small agricultural sector and therefore was getting little money back, hence the concerns with 'juste retour' (Laffan 1997, 51-54) Given that the UK did not enjoy the benefits of agriculture and cohesion, the UK has been favoring a renationalization of both regional aid and agriculture. While the other member states consider the UK rebate as an unfair correction, the UK's position is that an alternative to the current system would be net contributions based on prosperity, but that would be extremely hard to negotiate. (Butler 1995, 36)

As enlargement progressed, the pressure on financial flows increased: "the Mediterranean enlargement brought pressure for more progressive budgetary transfers." (Laffan and Lindner 2005, 192) One of the main consequences of the 1988 budgetary reform was to significantly increase the amounts of regional spending, from which the new members benefited mostly. The reform led to the introduction of an additional resource based on the GNP of member states and reduced the role of the VAT resource through the capping of the VAT base at 55 % of the GNP of each member state. The calculation of the UK correction was modified so that its financing could be split among the other member states according to their share in total EC GNP, the share of Germany being reduced. (Council Decision 88/376).

This institutional change led to a significant increase in Germany's net contribution to the EU budget, in spite of the correction it got on its contribution to the UK rebate¹⁵; as a result, the issue of net balance became very salient. Germany's

¹⁵ While the other member states pay their contribution to the rebate in full, Germany obtained a correction from the beginning: "the share of Germany being reduced by •", where "•" is supposed to be two thirds of its normal contribution to the UK rebate, so that Germany would have to pay only one third. (Commission Document 2005, 6)

financial burden was accentuated in 1992, when the Delors-2 package was negotiated. The final agreement led to increases in structural expenditures with 41% and introduced the Cohesion Fund to help the newer members: Portugal, Greece and Spain and the older but less wealthy Ireland. A 1994 Decision introduced a progressive reduction over the period 1995-1999 of the capping of the VAT base down to 50 % and of the maximum VAT call rate down to 1 %, while leaving the calculation of the UK rebate unchanged. (Council Decision 94/728).

Germany's position consolidated on conservative spending from the EU budget. In spite of the benefits for Eastern Germany after unification, Germany benefited much less from the policies financed at EU level as compared to the financial flows transferred to the EU budget. This financial burden was complicated by the fact that German unification brought the country to the sixth place in terms of GDP per capita. (Laffan 1997, 55) Since the German Lander directly contributed to the EU budget, both the Lander and the federal government started to feature 'juste retour' as a preference. This pressure on Germany was complementary to the role Germany had as a hegemonic stabilizer in the region: the theory of hegemonic stability posits that the hegemon agrees to pay for integration because it benefits from the stability in the area and a larger market. (Krasner 1989; Kindleberger 1996)

Germany's position is that it is not fair that Germany contributes more to the EU budget than the UK and France combined, which are relatively rich countries; the revenue system should take both GDP and population into account, especially because Germany's contribution to the EU budget is still higher than its share in EU GDP. In agriculture, Germany supported a market system in agriculture – supply and demand

should determine prices and production – hence no necessity of agricultural spending from the EU budget (Friedmann 1995, 48). Germany’s position consolidated on the argument that EU funding should focus on regions with specific structural problems, like the German Lander (funded under Objective 1 of structural funds) affected by the statistical effect. As a consequence, Germany started to promote the replacement of structural assistance with subsidized loans or tax reductions for investment, arguing that the numerous cases of fraud showed that German taxpayers’ money was not properly spent, as the beneficiary member states did not properly control the spending of EU money due to a lack of appropriate incentives: if irregularities were uncovered, the beneficiaries just had to return the money. (Bernhard Friedmann¹⁶ 1995, 46) Like the UK, Germany has a ‘lopsided’ position on the EU allocation of expenditures: Germany benefits mainly politically and indirectly economically from the single market, as it exports goods, services and capital to the new member states. (Richter 2005, 103) As a result of all these developments influenced by enlargement, the issue of net balance became very salient for Germany; this high salience is underscored by the fact that Germany requested to deduct the deficit on the EU budget from the general government deficit in order to comply with the Stability and Growth Pact. (Richter 2005, 110) Germany’s position for the 2007-2013 FF was that expenditure should be kept under 1% of EU GNI in commitment appropriations.

Starting with 1990, the position of Netherlands suffered a dramatic change from net beneficiary in 1988 (mainly from agricultural funds) to the second largest net contributor in 1993 and the largest per capita contributor in 1995. Like Belgium and Ireland, the Netherlands pays a relative large amount of custom duties to the EU budget

¹⁶ Bernhard Friedmann is a member of the European Court of Auditors.

because of the size and composition of her imports. (Hendrik Jan Brouwer¹⁷ 1995, 19)

The Dutch did not benefit from the increase in structural funds that happened in 1988 and 1992, as the Netherlands was one of the wealthiest member states. This consolidated the Dutch position on arguing that the inefficient redistribution of cohesion funds to non-cohesion countries led to a situation in which richer countries benefited from EU aid: the Netherlands and the UK received less per capita funds than Germany, France and Italy, which had a higher or similar per capita income. (Brouwer 1995, 21). Like Denmark, Finland and the UK, the Netherlands promoted the ‘whole-country’ approach for cohesion support, in order to avoid a situation in which poor regions in rich countries still benefit (Richter 2005). Given that the MacSharry CAP reform did not cover most of the Dutch production sectors, the Netherlands supported a revision of CAP by limiting the agricultural budget and returning some responsibility to national level (partial nationalization to respect the principle of subsidiarity). Consequently, the position of the Netherlands is to stop the increase of the EU budget and create a general system of compensations to ease the financial burden of the net contributors.

The 1995 accession of Austria, Finland and Sweden brought more net contributors into the Union. Like Germany, Austria became a net payer whose contribution to the EU budget was higher than its share in EU GDP, therefore Austria’s position is that prosperous countries should use fewer EU resources but does not support the radical Dutch and UK approach that ‘rich’ countries do not need cohesion support. Unlike Germany, Austria had a balanced position in terms of allocation of expenditures, benefiting from both agriculture and cohesion. As Austria has one region that benefited from Objective 1 funding since accession, Austria found that the effect of cohesion

¹⁷ Hendrik Jan Brouwer is the Treasurer-General of the Dutch Ministry of Finance in 1994-1995.

transfers was important to citizens, also alleviating the fear of relocation of production away to the newer member states. (Richter 2005,104-106)

The two other countries that joined the Union with Austria, Sweden and Finland, have a position similar to an older Northern member – Denmark. As the Northern countries have the highest level of development, they do not benefit from cohesion, except Finland whose scarcely populated areas are covered by Objective 1. These countries believe in the partial renationalization of both agriculture and cohesion and argue that EU funds should be used instead on research and development¹⁸. Both Sweden and Austria attach a high level of salience to the ‘balance’ issue.

By the time Agenda 2000 was negotiated, the net contributors were well aware of their financial burden and their position was reduced spending from the budget. Richter (2005) rightly argues that enlargement brings poorer countries into the EU that puts financial pressure on the newcomers. This was especially important because Agenda 2000 was laying the ground for the biggest enlargement in the history of the Union and the EMU convergence criteria started to weigh on national budgets. The agreement led to subsequent important changes: while transfers to cohesion were marginally reduced to account for enlargement, the reference to GNP was replaced by a reference to GNI; a further progressive reduction over the period 2002-2004 of the maximum VAT call rate was made down to 0.5 % and the collection costs for traditional own resources increased from 10 % to 25 %. The net contributors (Germany, the Netherlands, Austria and Sweden) obtained a reduction of their contributions to the UK rebate to $\frac{1}{4}$ of their normal shares, while the remaining $\frac{3}{4}$ of their contribution to the UK rebate had to be financed

¹⁸ Interviews with the Swedish and Danish representatives in the budget committee of the Council, May 2006.

by the remaining member states. (Council Decision 2000/597) This reduction represents an example of how the net contributors influenced the agreement and managed to change the rules in their favor. The same influence of net contributors can explain why “the FF packages Delors-1 and Delors-2 massively increased EU financial resources, whereas the increases in Agenda 2000 were not of similar magnitude.” (Laffan and Lindner 2005, 193-194)

Ireland is the member state that has benefited the longest time from structural and cohesion funds and agricultural subsidies. While in the 1980s and 1990s it was part of the cohesion countries, in the 2000s it reached a level of development that decreased its salience for ‘cohesion’: after the 2004 enlargement, Ireland’s position was to ask for transitory provisions for the regions that were phased out from cohesion but insist on agricultural subsidies. While the effect of enlargement on the Irish preferences is apparent through this ‘statistical effect’, Ireland represents an outlier in the sense that its accession to the EU (i.e. ‘enlargement’) led to economic development and thus a change in preferences.

Belgium and Luxembourg are two special cases in the sense that they benefit from having the seats of the EU institutions on their territory. With every enlargement, this benefits increased, such that Belgium and Luxembourg over time became ‘honest brokers’ (neutral on balance) and supporters of the Commission’s proposals. Belgium’s preference on cohesion is given by the fact that one of its regions (Wallonie) benefits from Objective 1 funding, whereas Luxembourg is interested in the social dimension of Cohesion (Objective 3).

Like Portugal, Spain has been a long time beneficiary of regional aid and has been known as a fierce advocate of cohesion funding, arguably in order to secure the success of enlargement and of the economic and monetary union. (Carlos Westendorp Cabeza¹⁹ 1995) While enlargement maintained this high salience of cohesion, the last enlargement placed Spain in the category of countries affected by the statistical effect, therefore Spain's position is for a very high budget for cohesion so that the phased out transition regions could profit as well.

Greece has been a long time beneficiary of cohesion and therefore its position is to maintain the same levels of flows from the structural funds from before that last enlargement. Like Spain, Greece wants an increase in cohesion expenditure to ensure it is not phased out by the newer member states. (Efthymios Christodoulou²⁰, 1995)

The 2004 member states tend to have relatively homogeneous positions and saliences on the three issues. There are slight differences on cohesion: the Visegrad group (Hungary, Poland, the Czech Republic and Slovakia) and Lithuania favor high level of expenditures for cohesion (more than 4% of GDP), whereas Latvia favors regional aid for infrastructure.

Slovenia is the most prosperous of the new member states, therefore in principle it supports the net contributors, provided that the expenditure cuts should affect structural policy but agriculture as well (Slovenia has limited arable area and considers the CAP over-dimensioned and inefficient, therefore some of the agricultural resources should be shifted to structural policy). In terms of the 'statistical effect', Slovenia rejects the idea of distinguishing between old and new countries and finds it unacceptable that the old

¹⁹Carlos Westendorp Cabeza was Secretary of State for European Affairs in 1995.

²⁰ Efthymios Christodoulou is MEP and former Governor of the Bank of Greece.

cohesion countries, having been at a level of development similar to Slovenia, received structural funds for many years, whereas Slovenia will be 'phased out' in 3 years after accession, without being fully 'phased in'. (Richter 2005, 94)

Poland is less prosperous but the largest of the new member states, therefore it used its political weight in the final accession negotiations at the Copenhagen Summit (December 2002) and in the Lisbon treaty debate. Richter (2005) argues that Poland was surprisingly flexible in the FF negotiations: it wanted the highest possible level of own resources (1,24%) but it was also not opposed to 1%, as a higher budget implies a higher national contribution. (Richter 2005, 97-99) While Poland did not accept a reduction of direct payments to farmers and supported an increase in the share of rural development under the agriculture heading. Poland rejected both a conflict between old and new member states and the focus on the neediest countries, but supported special claims by groups of states. Poland was against the (partial) re-nationalization of regional policy²¹, considering that solidarity was important to the EU construction and re-nationalization would constitute a first step towards withdrawal from integration. However, Poland argued for fairness in the allocation of structural aid: transfers/capita for the regions affected by the statistical effect should not exceed those of the regions of the poorest member states. Poland proposed lower national co-financing rate for programs related to the Lisbon Strategy and her position was that the EU budget should serve to finance common policies from Community sources and not as a battleground for net contributions.

²¹ The argument for the (partial) re-nationalization of regional policy is that member states with per capita GDP higher than 90% of EU average should take care of their own regional problems using their national resources.

Hungary supported the Commission proposal of 1.24% and rejected the 1% threshold, arguing that the EU policies need appropriate funding and budgetary discipline should not be achieved by reducing the EU budget. Hungary claimed that there were two conflicts of interests: net payers versus net beneficiaries on the size of the budget but also the allocation problem between old and new member states. On the former, Hungary was against any correction mechanism, seen as a regressive contribution where poorer states pay more. On the latter, Hungary wanted to keep the agreement on CAP up to 2013 and argued for rural development but its main interest was cohesion: like Lithuania, it requested an increase in the 4% of EU GDP to be spent on Cohesion. (Richter 2005, 99-103) Hungary argued that, in practice a country's eligibility was calculated anyway below the 4% limit due to the difference between the official exchange rate and purchasing power parity. In terms of the Berlin methodology used to calculate transfers for individual regions, Hungary argues for the reduction of payments for the regions of old prosperous member states, but requested a reduction of co-financing for structural funds for new member states from 25% to 20%.

Given that member states respond to the Commission's proposal, it is worth noting the Commission's position on the three issues position. In the 1990s, the Commission favored an increase in the democratic control of spending, a phasing out of the UK rebate and an adjustment of the balance of costs and benefits. (Christiane Scrivener²² 1995) The Commission has always favored an increase in the resources for European policies, hence an increased budget for agriculture and cohesion. While opposed to calculating net balances, the Commission argued that in 1999 gross contributions to the budget were reasonably proportional to member states' GNI: the UK,

²² Christiane Scrivener is a former Commissioner for Taxation and Customs.

because of the rebate, paid the least, then Italy paid the next smallest contribution, whereas the Dutch contributed the most. “The Commission, not without reason, argues that the gains from economic integration greatly outweigh the (fairly modest) net financial contributions, with the result that the focus on ‘juste retour’ is especially unhelpful.” (Begg 1999, 14)

The negotiations for the 2007-2013 FF took place under the full-blown pressure of enlargement, to which slower growth rates and the Lisbon goals (increase competitiveness and invest in research and technology) were added. The positions of the net contributors were consolidated in being openly opposed to any increases in expenditure, while the net beneficiaries supported the expenditure increases proposed by the Commission in the name of solidarity. The position of the older beneficiaries of regional aid was to denounce the so-called ‘statistical effect’ and demand transitional support. The positions of the newer member states were that the conservative spending promoted by the net contributors would reduce their financial benefits. The agreement obtained had the ceilings for own resources maintained at their levels of 1.31% of EU GNI for commitments and 1.24% of EU GNI for payments and a new decision was to follow stipulating the rate of call for the VAT resource at 0.30%. The outcome of the negotiations shows a high influence of the net contributors on the overall size of the budget (the net balance issue), as the final agreement is very close to their ideal positions. However, it is worth emphasizing that the fact that the net contributors are influential on the issue that is most salient to them does not mean that the net beneficiaries do not influence the agreement at all; on the contrary, because cohesion is highly salient for the net beneficiaries, they drive the outcome on cohesion: the ‘shopping list’ on Cohesion

that is contained in the final agreement shows that the net beneficiaries got additional funding, for example from the ERDF and the regions falling under the Regional Competitiveness and Employment Objective. It is through the exchanges that happen on these two issues – cohesion and balance – that the final agreement is obtained: net contributors give up their position on cohesion in exchange for the net beneficiaries agreeing on a reduced budget. Because the balance issue represents the overall size of the budget, one could argue that the net contributors are more influential. This influence is justified by the fact that the issues of agriculture and cohesion, when negotiated separately, cause negative externalities for the net contributors – i.e. they end up paying more into the budget. A high salience on the balance issue and sometimes extreme positions on balance determine exchanges that help the net contributors eliminate these negative externalities.

While the new member states obtained the exclusion of their share of CAP market expenditure from the calculation of the UK rebate, the net contributors obtained significant changes only for the 2007-2013 period in the rules applying to their UK rebate contribution, as follows. The rate of call of the VAT resource for Austria was fixed at 0.225%, for Germany at 0.15% and for the Netherlands and Sweden at 0.10%; in addition, the Netherlands benefited from a € 605 million reduction in its annual GNI contribution, while Sweden benefited from a reduction of € 150 million. Article 77 of the final agreement shows how the strong positions of the UK, Germany, the Netherlands, Sweden and Austria gravitated around the issue of correction mechanisms:

The own resources arrangements should be guided by the overall objective of equity.

These arrangements should therefore ensure, in line with the relevant conclusions of the 1984 Fontainebleau European Council, that no Member State sustains a budgetary burden

which is excessive in relation to its relative prosperity. These arrangements should accordingly introduce provisions covering specific Member States. (Article 77 of the European Council December 05 Note, 29-30)

One can argue that the UK rebate dominates the ‘balance’ issue. While the UK compares its receipts to the EU average and claims that it was the fifth poorest member state before the 2004 enlargement, the UK rebate creates perverse incentives. This is because every enlargement increases the UK rebate: the more member states enter the Union, the more the UK gains in compensation. This creates the anomaly that a relatively developed member state like the UK does not contribute to the EU budget in a manner proportional to its economic development.

The above-mentioned institutional changes left France as the main contributor to the UK rebate – approximately one third – as a price for keeping the agricultural payments. The exchange of positions between France and the UK led to the agreement on a budgetary reform to follow:

The European Council therefore invites the Commission to undertake a full, wide ranging review covering all aspects of EU spending, including the CAP, and of resources, including the UK rebate, to report in 2008/9. On the basis of such a review, the European Council can take decisions on all the subjects covered by the review. The review will also be taken into account in the preparatory work on the following Financial Perspective. (Article 80 of the European Council December 05 Note, 32)

The pressure enlargement puts on the preferences of the incumbent member states is visible in the exchanges that lead to the institutional outcome of the FF. The richer countries voted for enlargement and agreed to pay for European integration but their

financial burden cannot increase indefinitely. When countries decide to join the union, they make a cost-benefit analysis and decide to join because the benefits from joining are higher than the costs of doing so. Relatively rich countries like Austria, Finland and Sweden, but also Slovenia and Cyprus made claims when acceding on structural funds for some of their less prosperous regions, thus showing that in the FF negotiations following their accession they could enter an exchange cohesion-balance.

The last wave of EU enlargement has been so spectacular that it offers answers for both scholars of European integration and practitioners. If enlargement has indeed an impact on the EU budgetary processes, then one should look for evidence in this last round, as the effect of enlarging the Union with 10+2 countries is of such a magnitude that makes it easier to observe. In addition, if one wants to learn something from the way in which the EU solves the problems of resource allocation and redistribution, then one needs to look at the EU with 27 member states, where these problems are indeed acute.

The main effect of enlargement on players' preferences is that enlargement determines more 'extreme' preferences and a higher salience on 'balance' for the net contributors, who argue that the EU budgetary system is too unbalanced: their gains from integration (market and capital movements) in an enlarged union have been exceeded by the financial costs of the EU budget contribution. While the 'balance' issue is polarized by conservative expenditure versus an increase in spending (especially cohesion), it is dominated by the UK rebate. The effect of enlargement on net contributors is particularly visible on this issue due to the way in which the UK rebate is designed and calculated: every enlargement increases the amount the UK is compensated through the rebate: the more member states enter the union, the more the UK receives back.

In 1999, net contributors argued for a decrease in financing, while net beneficiaries opposed any national co-financing of CAP or regional spending. In 2005, the main effect of enlargement is that the positions of the ‘old’ beneficiaries from cohesion (Spain, Portugal, Greece, Finland, Luxembourg, Italy) became more extreme because of the ‘phasing out’ of their less developed regions: they emphasized the gains per capita, argued that the least off regions should be helped to maintain public investment and advocated greater progressivity in gross contributions²³.

The positions of the net contributors were clearly expressed in 2004 by the “letter of the six” who argued that the EU budget should not exceed 1% of EU-GNI, at that time not specifying whether in commitment appropriations or payments. All the other member states wanted a counterweight vis-a-vis the block of 6 – which represented more than 70% of both population and contribution – so they positioned themselves close to the Commission’s proposal and signaled they could accept a compromise around 1.10% – 1.15% of EU GNI. Even though agriculture was decided by the December 2002 deal, the Netherlands and the UK wanted the question reopened, arguing that Romania and Bulgaria could be accommodated under the ceilings foreseen for EU-25. Since rural development had not been decided in 2002, for the new member states most of rural development money came from Cohesion transfers, hence their main interest in Cohesion.

The initial positions of players and the saliences they attach to the three issues are presented in Table 1 and Figure 3 below. Given that there was a change in the denomination of the FF headings in the 2007-2013 FF, the cohesion issue includes all

²³ The estimates of country positions on cohesion are based on Alina-Stefania Ujupan. 2007. *Interests, Power Resources and Strategies in the Council of Ministers of the European Union: the 2007-2013 Cohesion Policy Negotiations*. PhD Thesis, University of Ulster.

expenditure under heading 1 and the agriculture issue consists of all heading 2 expenditure. As described above, the scale on positions and saliences is from 0 to 100. For the agriculture and cohesion issues, 0 means an ideal position where players favor no increase in EU funding for the issue in question (the status quo – last FF ceiling), whereas 100 stands for as much EU funding as possible. On the ‘balance’ issue, 0 is the position of a player who favors a reduced level of the EU budget revenue (the status quo equal to the last FF) and therefore a high level of compensations, a position of 50 implies a moderate level of revenue and indifference on the correction mechanism and 100 is the position of players who want a high revenue level (1.24% of EU GNI²⁴) and therefore a low level of compensations. On the salience measure, 0 is given when players pay no attention to the issue in question, 50 when the issue stands for an average priority (the country is neutral on the issue) and finally 100 represents an issue of the highest importance.

Table 1 presents the positions and saliences for the 2007-13 FF negotiations. The figures in red signal a change from the 2000-06 FF negotiations, as indicated below. Germany is the main contributor to the EU budget, therefore it favors a reduced budget of 1% and corrections, hence the position of 20 on ‘balance’. Germany’s salience for the issue of ‘balance’ has increased from 70 in 1999 to 90 in 2004. The Netherlands is a net contributor with the highest contribution per capita, therefore its position on ‘balance’ is at 15 (slightly more conservative than Germany). Similarly to Germany, its salience on ‘balance’ has increased from 70 in 1999 to 90 in 2004. The salience on ‘balance’ of the other two main contributors, Austria and Sweden also increases from 60 in 1999 to 80 in

²⁴The EU possible expenditure ranges between 0.9%, minimum of expenditure, and 1.24% of EU GNI - the maximum established by the rules (interview with a Commission official from DG Budget, September 2007).

2004. Ireland's position on cohesion decreases from 70 in 1999 to 50 in 2004, whereas its salience changes from 60 in 1999 to 40 in 2004. The main beneficiaries of cohesion in 1999 – Spain, Portugal and Greece – are phased out in 2007-13, therefore they change their positions from 80 in 1999 to 90 in 2004. Because of the UK rebate, the UK ranks at 100 on the salience of ‘balance’, whereas its position on balance is at 10 (low revenue and high compensation). France attaches the highest importance to agriculture, therefore it ranks at 100 on the salience of agriculture; however, its salience on balance increases from 60 in 1999 to 70 in 2004. In 2004, the preferences of the newer member states were somewhat homogeneous: their salience on balance was 50 (neutral in terms of the importance of correction mechanisms and revenue level), but most of them were at position 70 on balance (higher level of revenue).

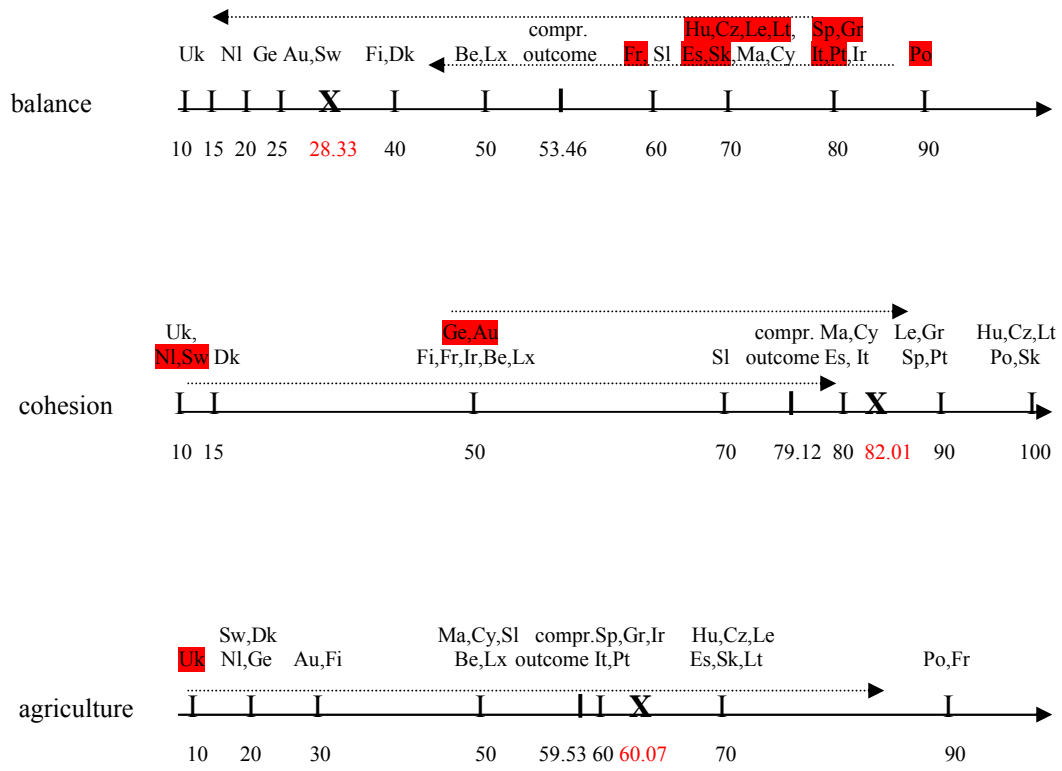


Figure 3 – Positions and exchanges in the 2007-13 FF negotiations

country	Salience Balance	Salience Cohesion	Salience Agriculture	Position Balance	Position Cohesion	Position Agriculture
Germany	90	40	10	20	50	20
UK	100	10	10	10	10	10
France	70	40	100	60	50	90
Spain	60	80	70	80	90	60
Italy	60	70	60	80	80	60
Portugal	60	70	60	80	90	60
Ireland	60	40	80	80	50	60
Greece	60	70	80	80	90	60
Denmark	60	15	40	40	15	20
Sweden	80	10	40	25	10	20
Finland	60	70	60	40	50	30
Austria	80	50	50	25	50	30
Netherlands	90	10	40	15	10	20
Luxembourg	10	20	50	50	50	50
Belgium	10	60	50	50	50	50
Poland	50	90	90	90	100	90
Hungary	50	90	80	70	100	70
Czech Rep	50	90	80	70	100	70
Malta	50	70	40	70	80	50
Cyprus	50	70	40	70	80	50
Letonia	50	80	80	70	90	70
Lithuania	50	90	80	70	100	70
Estonia	50	70	80	70	80	70
Slovakia	50	90	80	70	100	70
Slovenia	50	60	40	60	70	50

Table 1: Country saliences and positions for the 2007-13 FF negotiations

4.2. Negotiations on the 2000-2006 FF

The 1999 negotiations on the 2000-2006 FF took place in a difficult context. The net contributors expressed their preferences: reduced CAP intervention prices (low saliences and positions on agriculture), change in the rules for structural actions (moderate positions and saliences) and compensations on the ‘balance’ issue (low position and high salience). The Commission was aware of the pressure of enlargement

on the net contributors, therefore in the proposal for the 2000-2006 FF it proposed a generalized system of corrections that would be 'equitable' and acceptable to all. It is worth noting that the Commission tried to pass the same proposal in 2004, but without success.

During the first stage of the position exchange game, equation (1) is used to compute the expected outcome on all three issues, according to the compromise model: the average of the ideal positions weighted by salience. The predictions of the compromise model are position 46.34 on the balance issue, position 62.11 on cohesion and position 51.25 on agriculture. According to equation (2), players compute their expected utilities from these expected outcomes and identify mutual beneficial exchanges on pairs of issues. The most prominent exchanges happen when players are farther away from the expected outcomes and attach different saliences to the issues traded; the comparison of saliences determines the direction of exchange – which actors will move in which direction during the exchange. Players can enter a trade only if they are on opposite sides of both issues traded, otherwise they can increase their utility just by choosing a more extreme position. Table 2 shows the position of actors in relation to the expected outcome and identifies the potential exchanges of voting positions. According to the table, the most likely exchange partners are the net contributors, on the left side of the expected outcomes on all issues and the net beneficiaries, on the right side of the expected outcomes on all issues.

One of the likely exchanges is that between France and the net contributors, given that France has no possible linkages other than agriculture and balance (on the latter Germany and the Netherlands have the highest saliences). Consequently, France is

willing to move on balance in exchange of influencing the outcome on agriculture, whereas Germany is willing to move on agriculture (saliency 10) in exchange of increasing her utility on balance. Germany moves to the position of France on agriculture and in exchange France moves towards Germany's position on balance and ends up in position 42.1. The rate of the exchange is equal utility gain, equal to 87.5, according to equation (2) of the position exchange model. The new prediction is 52.125 on agriculture and 45.09 on balance, calculated by applying equation (1) to the new positions.

Of the net beneficiaries, Spain attaches the highest saliency to cohesion (80), therefore a likely exchange is between Spain and the net contributors on the issues of cohesion and balance. Given that, of the two net contributors with the highest saliency on balance (70), Germany has the presidency, the exchange will happen between Spain and Germany. Spain moves towards Germany's position on balance ending up in position 50.9 and in exchange Germany moves to Spain's position on cohesion. The utility gain of the trade is 142.222. The new prediction is 63.889 on cohesion and 43.058 on balance.

In subsequent exchanges, France continues to move towards the position of the remaining net contributors (the Netherlands, Sweden and Austria), while they move towards France's position on agriculture. The final predictions are 63.89 on cohesion, 55.375 on agriculture and 41.17 on balance.

Issue 1: balance	Issue 2: agriculture		
		left	right
	left	Uk, Ge, NI, Dk, Sw, Au, Fi	
	right	Be, Lx	Fr, Gr, Ir, It, Sp, Pt
Issue 1: balance	Issue 3: cohesion		
		left	right
	left	Uk, Ge, NI, Dk, Sw, Au, Fi	
	right	Be, Lx, Fr	Gr, Ir, It, Sp, Pt
Issue 3: cohesion	Issue 2: agriculture		
		left	right
	left	Uk, Ge, NI, Dk, Sw, Au, Fi, Be, Lx	Fr
	right		Gr, Ir, It, Sp, Pt

Table 2 - Potential exchanges of positions 1999

The model can be empirically tested in two ways. First, one needs to check if the predicted exchanges are indeed the linkages that happened between players during negotiations. Empirical evidence shows that Germany, who had the presidency during negotiations, orchestrated the main issue linkages. One of this exchanges happens with France on agriculture: “Following a bilateral meeting between the French and the German Agricultural Ministers [...], a representative of the German government finally conceded that cofinancing had little chance of surviving as a part of the package given the continuing opposition of the French.” (Laffan 2000, 12) In exchange, France had to agree to support a higher share of the financing of the UK rebate (35% instead of 24%), thus increasing France’s contribution by 263 million per year, traded for a 75% reduction of the four main contributors’ financing of the UK rebate. From the exchange with

Germany, Spain obtained a 5.6 % increase in structural aid: in exchange of its support on the balance issue, Spain maintained substantial net transfers. (Begg 1999, 16-17)

Second, one needs to check the difference between the prediction of the model and the actual outcome of the final Berlin agreement in 1999. On the agriculture issue, the prediction of 55.375 represents a moderate budget for agriculture, which corresponds to the agreed reduction in CAP intervention prices (arable cultures, milk and beef), compensated by an increase in direct aids to producers. Given that the UK did not exchange positions with any of the players, the UK rebate was maintained. When compared to the initial prediction of the model (46.34), the prediction of 41.17 on the balance issue represents an outcome in favor of net contributors, even though modest in magnitude. This measure of their success means that they managed to stabilize the budget – i.e. no sizeable increases, including the 4% GDP cap for regional aid – even though the expenditure are higher than their ideal positions. However, the net contributors did obtain corrections in their favor – a payment of only 25% of their UK rebate share and a progressive reduction of the VAT call rate to 0.75% in 2002 and 0.50% in 2004. Evidence of the fact that the exchanges took place between pairs of actors and did not involve the net contributors as a group is the fact that the compensations for the net contributors differ: Germany benefits the least, the Netherlands profits from an additional increase of the collection rate on customs duties to 25%, and Austria and Sweden receive different types of ad hoc payments through structural funds (mainly under objectives 1 and 3). The side-payments for Austria and Sweden are part of a ‘shopping list’ with 13 ‘specific situations’, added to the agreement on cohesion/structural funds; these compensations correct for the negative externalities that the model predicts, in this case

the regions no longer eligible and a reduction in the Cohesion Fund depending on progress towards convergence. (Bache 1999)

4.3. Negotiations on the 2007-2013 FF

The negotiations on the 2007-2013 FF took place under the full effect of enlargement. Compared to 1999, the 2007-2013 FF negotiations exhibited a more pronounced interest on the balance issue due to the arrival of the new member states. Some officials argued that the situation was even clearer than in 1999 because the net contributors had expressed their positions well in advance, before the negotiations started. Even though in February 2004 the Commission proposed a package²⁵ for the FF with an overall level of 1.26% of EU GNI in commitments and 1.14% in payments, negotiations actually started much earlier in 2002 when the accession packages were agreed on with the candidate countries. Although the candidate countries were in a much weaker negotiating position and no issue-linkages per se were possible, the agreement reached in December 2002 fixed agricultural support until 2013 and technically eliminated the agriculture issue from the subsequent FF negotiations. However, as negotiations progressed, some member states thought about reopening negotiations to trade agriculture with other issues.

In December 2003 a group of six countries (Germany, the Netherlands, Austria, Sweden, the UK and France) wrote a letter advocating a maximum of 1% of EU GNI for the EU budget. While it was not clear if the 1% referred to commitments or payments, as negotiations progressed, 1% became the reference for commitments with an equivalent

²⁵ Commission's proposal changed the titles of headings, while keeping agriculture and structural aid as the most funded issues: the new Headings 1 and 2 contained sustainable development with cohesion and competitiveness and natural resources, respectively, Heading 3 was strengthening European citizenship and Heading 4 – Europe as a global partner.

0.9% in payments – a dramatic cut in the budget²⁶. This letter is the evidence for the pressure exercised by enlargement on the preferences of net contributors. By announcing their positions ahead of the main rounds of negotiations, the net contributors signaled the high salience they attached to the balance issue, their low positions on the issue and their dissatisfaction with the status quo. In the group of six, the UK was the net contributor in the best position, as it received a huge correction through the UK rebate; the UK signed the letter to signal the high salience it attached to the UK rebate. Well aware that enlargement increased the UK rebate, France had opposing interest to the UK: it wanted to decrease its share in the financing of the UK rebate while still preserving the benefits from agricultural funding, hence its higher position on balance (60).

For net beneficiaries, given that the deal on agriculture was closed, cohesion was the most salient issue. While net contributors argued that rich countries should support their poor regions, the beneficiaries equated cohesion with solidarity between all regions and citizens: more developed member states should help the less developed ones. Given that the funding available under cohesion was capped at 4% of GNI, most new member states fixed their ideal positions according to this figure: the Visegrad countries wanted an increase in the 4% (position 100 on cohesion), Letonia was very interested in receiving the full 4% (90) while Estonia was more interested in the innovation aspect of cohesion (80).

The main effect of enlargement was that the older member states previously benefiting from cohesion were phased out due to the statistical effect, therefore their position was to maintain their pre-enlargement level of benefits (position 90 for Spain,

²⁶ 1% in commitments and 0.9% in payments represented a 9 billion Euro cut in the 2007 budget as compared to 2006.

Portugal and Greece). In fact, the Commission wanted to avoid this conflict between old and new cohesion countries and proposed an approximate 50:50 division of funds.

After the May 2004 enlargement, the Irish and Dutch presidencies examined the Commission proposals in detail but did not start the real negotiations. The Dutch presidency proposed some ‘building blocks’ on different policies, with cohesion being the most important one, which in fact clarified the major issues to be negotiated and the ideal positions of member states. The first real rounds of negotiations started under the Luxembourg presidency in the first half of 2005.

The Luxembourg presidency was very active in organizing bilateral meetings, which facilitated the exchanges between pairs of actors on the main issues: cohesion and balance. As with the previous negotiations, in the position exchange model equation (1) is used to compute the expected outcome (the average of the positions weighted by salience) on both cohesion and balance, according to the compromise model; the predictions are position 53.46 on the balance issue and 79.12 on cohesion (the outcome on agriculture, previously decided, remains at 59.53). Players compute their expected utilities according to equation (2) and identify mutual beneficial exchanges, under the conditions that players are on opposite sides of the expected outcomes and attach different saliences to the issues traded. Table 3 shows the positions of the actors in relation to the expected outcomes and identifies the potential exchanges. The difference in saliences determines the direction of trade – which actors will move more on which issues. As with the previous negotiations, the net contributors attach higher salience to the balance issue, therefore they are interested in shifting their positions on cohesion in exchange for obtaining support on balance. As before, the potential trading partners are

the net contributors – on the left side of the expected outcome – and the cohesion countries – on the right side, who attach a higher salience to cohesion than to balance. The most prominent exchange happens between the countries with the highest salience on both issues and the most extreme positions, Spain and the Netherlands. The Netherlands moves to Spain’s position on cohesion (90) and in exchange Spain moves towards the Dutch position on balance, ending up at position 68.1; the exchange rate is an equal utility gain of 43.99. The new predictions are 79.67 on cohesion and 52.97 on balance, calculated by applying equation (1) to the new positions. Similar exchanges happen between Spain and Germany, Spain and Sweden, such that Spain continues to drift towards the net contributors (through positions 44.3, 30.9) until it ends in position 14.2. Similar successive exchanges happen between pairs of net contributors and the Visegrad countries, Italy, Portugal, Greece, Latvia, Lithuania and Estonia. The new predictions are 82.01 on cohesion and 28.87 on balance.

Issue 1: balance	Issue 2: agriculture		
		left	right
	left	Uk, Ge, Nl, Dk, Sw, Au, Fi, Be, Lx	
	right	Ma, Cy, Sl	Fr, Gr, Ir, It, Sp, Pt, Po, Hu, Cz, Le, Lt, Es, Sk
Issue 1: balance	Issue 3: cohesion		
		left	right
	left	Uk, Ge, Nl, Dk, Sw, Au, Fi, Be, Lx, Fr	
	right	Fr, Ir, Sl	Gr, It, Sp, Pt, Po, Hu, Cz, Le, Lt, Es, Sk, Ma, Cy
Issue 3: cohesion	Issue 2: agriculture		
		left	right
	left	Uk, Ge, Nl, Dk, Sw, Au, Fi, Be, Lx, Sl,	Fr, Ir
	right	Ma, Cy	Gr, It, Sp, Pt, Po, Hu, Cz, Le, Lt, Es, Sk

Table 3 - Potential exchanges of positions 2004-2005

In spite of the fact that the Luxembourg presidency predicted an agreement, negotiations failed on June 17, 2005. Luxembourg officials argued that in June 2005 the delegations were very close to an agreement, as the main differences on the overall level of FF had been smoothed out, with the exception of the UK who had declared that the approach on the UK rebate was unacceptable. As mentioned before, UK's position was motivated by the fact that enlargement increased the benefits from the UK rebate and the UK wanted to keep those benefits. Montagnon²⁷ (2006, 441) argues that the demand of budgetary reform, which meant a reform of agriculture, had not been previously debated and the UK used it in a surprising way to block an agreement in June 2005 and then decided not to analyze it in depth in order to increase the chances of agreement in December 2005 under the UK presidency.

From the point of view of the position exchange game, agreement was not obtained because member states had not exhausted all possibilities of trade that would increase their utilities. In fact, the UK had not been engaged in exchanges during the first half of 2005 and, like Germany in 1999, it used the opportunity of the presidency in the second half of 2005 to engage in issue-linkages. From this perspective, June 2005 marks the end of a negotiation round and the start of a new round.

The next negotiation round started de facto in November 2005, when President Barroso sent a letter to the Presidents of the Council and the EP emphasizing the balance issue and its global character; this letter mentioned the 'clause de rendez-vous' for the budgetary reform 2008/2009. This was an opportunity for the UK to reopen the

²⁷ Montagnon (2006) is citing officials involved in negotiations.

agriculture deal and trade the reform of agriculture with the UK rebate, since agriculture was the historic cause behind this correction mechanism. Since France was the country with the highest salience on agriculture, the UK entered an exchange with France on balance and agriculture: France wanted the UK to decrease its compensation obtained through the UK rebate, whereas the UK wanted France to reform agriculture in order to reduce the EU funds spent on farmers. Consequently, the UK moves to France's position on agriculture in successive stages and France moves towards the UK's position on balance ending up at position 48.8; the utility gain is 53,69. The new prediction is 28.33 on balance and 60.07 on agriculture, calculated by applying equation (1) to the new positions.

In order to estimate the predictive power of the position exchange model, one needs to test the predicted exchanges and the outcomes of the game with those that happened in negotiations. One official emphasized the utility of a weighted average model in computing the outcome and argued that the compromise proposed by the Luxembourg presidency – 1.056% of EU GNI – was indeed computed as a weighted average, taking into account the Commission proposal of 1.21% of EU GNI and the net contributors arguing for 1%. While it is difficult to compare the 28.87 outcome on balance in the Luxembourg negotiations with the Luxembourg package, one could compare the two outcomes with the initial positions. On one hand, given how close the 1.056% is to 1%, one could argue that the Luxembourg package was strongly influenced by the net contributors. On the other hand, the initial prediction of the 'compromise' model is 53.46, whereas the position exchange model predicts 28.87 for the Luxembourg compromise – a move of approximately 50% towards the net contributors. The magnitude

of this distance is considerable compared to the distances between the outcomes and the initial positions on the other issues, therefore one could conclude that the position exchange model accurately predicts an outcome heavily favoring the net contributors. The same is true about the final outcome of the game – 28.33 – and the final expenditure ceiling adopted for the 2007-13 FF – 1.045% of EU GNI (862.3 billion Euro²⁸ in commitments and 0.99% EU GNI in payments – 819.4 billion Euro). While empirical evidence confirms that the actual FF outcome was driven by Germany, the prediction of the game shows a heavy influence by the net contributors. In fact, if one considers 1% as being close to 0 on the balance issue and 100 representing 1.24% (maximum possible expenditure), then 28.33 would be equivalent to approximately 1.068%. It follows that the prediction error of the position exchange model applied to the FF negotiations is 0.023%. On the 0-100 scale, this prediction error²⁹ is 9.43, smaller comparable to the average error of 23.4 reported by Arregui et al (2006, 143) for scale issues and 20 players.

The actual outcome adjusts the own resources system in favor of net contributors as follows: while the rate on the VAT resource is frozen at 0.30%, Germany obtained a reduction of 0.15%, Austria 0.225%, and the Netherlands and Sweden 0.10%; further, the contribution of the Netherlands is reduced with 605 million Euro per year and that of Sweden with 150 million per year. (Montagnon 2006, 441 -442) This difference in the compensations obtained by the net contributors is further evidence for the fact that the

²⁸ Since the initial proposal of the Commission was tabled in February 2004, all the figures are expressed in 2004 prices to avoid further confusion. Given that the annual budgets are established in current prices, the Commission will make technical adjustments to the Financial Framework ceilings each year using a deflator of 2% a year.

²⁹ On the 0-100 scale, the 1.045% outcome represents a point of 18.9, hence the prediction error is $28.33 - 18.9 = 9.43$.

exchanges took place between pairs of actors and did not involve the net contributors as a group.

Empirical evidence also confirms that Luxembourg presidency favored bilateral talks and thus encouraged exchanges. The Netherlands and Sweden were extremely keen on obtaining money back on balance, the Netherlands had requested 1 billion Euro per year and so did Sweden; since the most possible cuts were on cohesion, they were ready to trade; the Spanish officials were also keen on making issue linkages involving cohesion. The other cohesion countries followed the examples of the Spanish in making issue linkages, with Poland being the most prominent example. The shopping list containing 17 ‘cadeaux’ stipulating transition measures for cohesion is a result of the bilateral trades of the cohesion beneficiaries.

The exchange between the UK and France is empirically illustrated by the successive exchanges that happened in December 2005. First, the UK proposed a 1.5 billion/year cut in the rebate, accompanied by a 10% cut in the regional aid to enlargement countries (as negative externality), in exchange of a reform of the system of direct payments in agriculture; then the UK offered a 8 billion cut for the entire period. In exchange for accepting the review of the budget and thus a reform of the agricultural system, France asked for a 14 billion cut in the UK rebate. The final deal agreed was a budget review 2008/2009 and a 12 billion cut – a 10.5 billion cut in the UK rebate and a reduction of 1.5 billion in the funding received by enlargement countries³⁰. To compensate for this negative externality that decreased the utility of new member states, and given that the UK rebate augments significantly as a result of enlargement – 15%

³⁰ *Financial Times* December 2005.

increase in 2004 and 64% in 2007-2013 – the rebate will not be calculated on the agricultural expenditure for the new member states³¹. While the 2008/2009 budget review was intended to overhaul EU agricultural funds, given the influence of the net contributors on the outcome, there is a high likelihood they will take the opportunity to further influence the outcome in their favor.

The position exchange model performs reasonably well when applied to the two subsequent FF negotiations; it is also a model that emphasizes well the role of the presidency in facilitating issue-linkages and proposing compromise packages. The global character of the balance issue makes it relevant for testing the influence of net contributors on the outcome. The pressure of enlargement has increased the salience of the balance issue for the net contributors, hence their increase propensity towards issue-linkages. In 1999, before the big enlargement of 2004, the outcome of negotiations on balance was 41.17, whereas in 2005 the outcome decreased to 28.33, thus moving closer to the positions of net contributors. For a weighted average model, this difference between the two outcomes is substantial. While comparing the exchanges realized in 1999 and 2005, one could see that with more players more issue-linkages are possible (as the literature on issue-linkages argues) hence a larger scope for the influential players to draw agreement towards their preferred outcome. This suggests that the influence of the net contributors has increased substantially with enlargement.

³¹ In 2003, 40% of the UK rebate represented agricultural expenditure, according to DG Budget officials.

5. Conclusions

The empirical analysis has shown that, as new countries join the EU, the outcome on the EU budget goes out of deadlock through the influence of net contributors and their making use of issue-linkages in negotiations to obtain agreement on institutional change. Even though conflict between players is high, issue-linkage offers a way out of deadlock. As enlargement progressed, the issue of ‘balance’ became more and more salient for the main contributors to the EU budget, and this salience determined them to exchange positions in order to obtain a favorable agreement in budgetary negotiations. In this way, the net contributors succeeded to change the budgetary rules in their favor.

Given the empirical results, the answer to the puzzle on the existence of deadlock is that the EU finances are not in deadlock. While there is a lock-in effect of some institutions introduced in the past and there are actors with diverging interests, enlargement has helped unlock the ‘status quo bias’ by increasing the influence of net contributors. The outcome of the most recent FF bargains demonstrates that the net contributors have managed to stop the massive increases in EU finances. This result refutes the argument that the net payers cannot enforce a decrease of their burden, as this would be objected by net receivers: not only did the net payers manage to keep a low level of EU finances – very close to 1% – they also succeeded to get correction mechanisms that reduced their financial burden.

The two case studies on the FF negotiations are intended to test the predictions of the bargaining model and the impact of the difference in preferences on both the exchanges between players and the outcome. The effect of the 2004 enlargement is visible on players’ preferences, which affect the negotiations’ dynamics and the

outcomes. The negotiations of the last FF in particular could be taken as an example of how a very heterogeneous collective body solves the problems of resource allocation. With net contributors' increase in salience on balance and more players with a high salience on cohesion, the number of possible exchanges increases. The exchanges that happen are such that the net contributors give up their position on cohesion in exchange for the net beneficiaries agreeing to move on balance towards the positions of the net contributors. Because the balance issue represents the overall size of the budget, an outcome on this issue that is close to the position of the net contributors gives the measure of success for their influence. This influence of the net contributors on the size of the budget does not imply that the players with high salience on agriculture and cohesion are not influential on the respective issues. On the contrary, given the directions of the exchanges, the outcomes on those two issues are influenced by the net beneficiaries; however, the magnitude of this influence (computed as the difference between the initial prediction of the 'compromise model' and the final prediction of the game) is much smaller and it represents the concessions ('shopping list') obtained by the net beneficiaries.

This study of the influence of the net contributors contributes to the literature on the EU budget but also to the institutionalist literature that brings together rational choice and historical approaches. The rational choice approach allows a logical and precise description of players' strategies in every round of negotiations, their influence on each other through issue-linkages, and their influence on the final outcome. The bargaining and procedural models proposed contain specifications of EU decision-making that could be applied to other legislative negotiations, thus accommodating the search for

generalizations in political science. The preferences of actors are critical for determining policy outcomes, as the goal of every player is to obtain an outcome as close as possible to its preferences. By considering the historic constitution of preferences as opposed to the common rational choice practice of taking preferences as given the influence of enlargement is revealed on the two input variables that represent preferences: a player's position and the salience it attaches to the issue negotiated. Without a historical approach it would have been very difficult to see the impact of enlargement on these variables and hence on the collective outcomes represented by the game theoretical models.

The importance of the findings on the EU budgetary negotiations is highlighted by several facts. First, these findings help to explain European integration, in particular economic and financial integration: the story of the EU budgets shows how integration has progressed through the EU budget and how it was affected by enlargement. The findings are also telling for the prospects of future enlargements because it reveals the in-depth of the cost-benefit calculations for both old and new members: a country that joins the union as a net contributor could have a significant impact on the dynamics of the EU budgetary negotiations, whereas a potential net beneficiary would further polarize the issue of balance.

Second, the solution offered by the EU budgetary negotiations on the allocation of scarce resources even when agreement seems difficult because of the increased heterogeneity of players, contributes to the literature on negotiations. Obtaining agreement through issue-linkage is a good solution in politically difficult bargaining situations and could be replicated in other situations where players have equal weights (i.e. unanimity is the voting rule).

Third, while the budget is small compared to national budgets and has little macroeconomic significance for the Union, it represents a very important autonomous source of financing for the European policies. These European policies have had a tremendous impact on the development of EU member states, hence the acrimonious battles over the ‘tiny’ pool that is the EU budget. The results of EU budgetary negotiations demonstrate that any increase in this pool would have to be initiated by the net contributors.

Fourth, the findings increase the transparency on EU budgets and EU decision-making by explaining the interplay between intergovernmental and supranational institutions: while it is difficult to obtain an exact account of what happened, some theoretical lenses like rational choice historical institutionalism could be useful for understanding EU decision-making. In particular, the outcomes of the EU budgetary negotiations prove that the intergovernmental aspect of EU decision-making is critical. This is a useful lesson for the supranational bodies, the Commission and the EP, if they want to increase their influence on EU policy outcomes. In this respect, a role to be followed is that of the Presidency: the Commission and the EP could try to boost their power by facilitating issue-linkages in the same way the presidency did in the FF negotiations.

Last but not least, the findings contribute to the institutionalist literature that explains how locked-in institutions can be changed. The history of the EU budget proves that change is possible in spite of high competition for scarce resources. The outcome of the last FF negotiations represents change, even though incremental, and in addition contains a clause for change – the 2008/2009 budgetary review. In other words,

agreement was reached on the promise of change. The 2008/2009 budgetary review has the task of proposing change by taking into account the diverging preferences of the EU actors. While altering distribution seems unlikely, change could be accomplished by a reform of the main EU policies.

Some caveats on the possibility of change need to be emphasized. While net contributors are extremely influential in obtaining change in the form of distributive corrections, this does not mean that all budgetary institutions can be changed. It is fair to say that some parts of the budgetary framework are difficult to change, for example the governance of the EU budget– the rule of unanimity voting in the FF negotiations. However, the so-called ‘passarelle clause’ of the Lisbon Treaty tries to offer a solution of change for this governance problem: while the decisions on own resources still require unanimity in the Council, the Council may act by qualified majority on the FF but only following a unanimous decision of the European Council.

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