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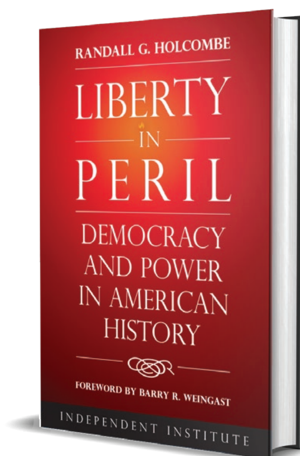

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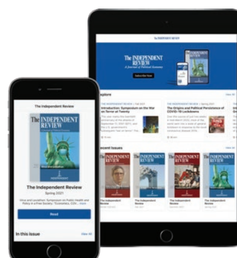

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Creating a Common Market for Fraud in the European Union

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CAROLYN M. WARNER

The preamble to the Treaties of Rome, which founded the European Economic Community (EEC), now part of the European Union (EU), declares that the treaties have as their goal the creation of an "ever closer union" among the peoples of Europe.[1] Considering the actual operations of the EU's major programs, however, it appears that what they really created was ever greater opportunities for legal and illegal rent seeking within Europe. The EU's structures and the means by which its authority is delegated and its programs implemented seem to reflect almost a deliberate effort by the member states to protect special interests that profit from opportunities to collect legal and illegal rents, for which the unorganized taxpayers across Europe pay. In fact, it might be argued that the member states have manifested benign neglect toward fraud, corruption, and regulatory enforcement.

Fraud can be thought of as the deliberate cheating of others in violation of legal rules, which has the effect of illegally producing financial gain. It is corruption when committed by those acting in the public interest who subvert the role of their office to obtain private benefits or benefits for a political party. Since the early 1990s, the EU's budget has been approximately 90 million euros per year (roughly equivalent to $105 billion). Detected fraud amounts to approximately 2 percent of the budget; estimates of actual fraud range from 1 percent to 20 percent, but many authorities refuse to try to establish a number, saying it is impossible to do so (House of Lords 1989,

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1. Though currently known as the European Union in order to include the multilateral arrangements for some cooperation on justice and home affairs and on foreign and defense policy, the organization has its main budget and regulatory activity within the EEC.

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17; House of Lords 1992, 1; Giordano 1990, 55; UCLAF interviews by the author, June 4, 1998).[2] The additional monetary cost of fraud and corruption associated with deliberate avoidance or nonapplication of the EU's many regulations, especially in the areas of competition policy and public-works contracting (areas in which the EEC's regulatory emphasis is on creating open, transparent competition), is unknown, but it may be enormous.

Institutions of the EEC/EU

Established in 1958 as the European Economic Community, the EU originally consisted of the Commission, the Council, the Parliament, and the Court of Justice. The Commission's responsibility has been to propose and oversee the implementation of "legislation" and to oversee and enforce the member states' adherence to the treaties. It now has twenty commissioners, who act essentially as cabinet ministers overseeing a set of "general directorates" responsible for the day-to-day operations of the EU. Upon unanimous nomination by the member states, and after approval en bloc by the Parliament, the commissioners are appointed collectively to a five-year term.

The Council of the European Union, which has long been the primary locus of power in the EU, comprises the member states' cabinet ministers, by topic under consideration, who vote on and amend proposals coming from the Commission. Starting with the Single European Act of 1986, the Council has gradually been required to take into account, through various complex procedures, the views and sometimes the votes of the European Parliament, but it retains heavy influence over EU "legislation." To some extent, that influence is enhanced by the twice yearly formal meetings of the unfortunately named European Council, composed of the member states' prime ministers (and the French head of state). This institution is responsible for setting the EU's broad policy goals, for attempting to reach agreement on difficult issues (such as monetary union), and for giving direction to the Commission. The European Parliament initially was nothing more than an advisory body, or a nod to "democracy." Its members began to be elected directly by citizens in 1979, but not until 1993 did it gain any significant influence on EU policymaking. The European Court of Justice was established to keep the supranational institutions in check and to enforce the member states' adherence to the treaties and regulations. In addition, it has acquired responsibility for interpreting the treaties.

In 1977, almost twenty years after the EEC's founding and in response to adverse publicity about fraud, the member states established the Court of Auditors to provide audits of the EU's budget. In 1992, they accorded this court status as a completely independent institution with the obligation to provide a statement of assurance as to the regularity and legality of expenditures in the EU's budget. In 1988, in response to continuing adverse publicity, this time via press reports on findings of the

2. UCLAF is Unité Coordinatif de la Lutte Anti-Fraude, an EU "antifraud" organization.

Court of Auditors, the EU created a separate "antifraud" unit (UCLAF) to facilitate the Commission's efforts to coordinate the detection and prosecution of fraud against EEC programs within the member states.

EU Budget and Programs

The EU's 90 billion euro annual budget reflects the EU's hybrid nature and the extent to which the member states try to retain control over the supranational organization and institutions they have created. Initially financed by direct contributions from the member states, then by funds from customs duties, agricultural tariffs, and a percentage of each states' value-added tax (VAT), the EU increased state contributions through a percentage of gross national product (GNP), with special concessions for less-wealthy states, and, for a time, with a rebate to the United Kingdom. Various agencies of the member states collect all of these resources and then transfer them to the EU. Arrangements for the first decade of the twenty-first century include reductions in the GNP and VAT percentages and an increase in the amounts the states retain to cover their collection costs. In essence, at the same time that the member states have noticeably increased the regulatory scope of the EU and the range of issues it covers, they have decreased its financing relative to the wealth of the member states.

The lion's share of the budget goes to agricultural subsidies and to regional development programs. The EU's financing in typical areas of government (education, infrastructure, defense, welfare) is anemic. Given that the creation of new types of EU-funded programs, ranging from foreign aid to job training, has been accompanied by new patterns of fraud (Roche-Pire and Delmas-Marty 1982; Commission 1996, 74–77), this paucity is perhaps just as well.[3] One might think that, given the member states' zeal in limiting the expansion of the EU budget, and their contentious debates about state contributions, they would then steward carefully the funds they get "back" from the EU. Yet, as the Court of Auditors has noted, the states tend to treat EU funds as theirs to use as they wish once they have them. The states' sense of accountability to the EU for EU funds is somewhat limited.

Significant for this essay is the fact that the EU's peculiar institutional arrangements contribute to fraud and explain why more and better action has not been taken to deal with it. The Commission drafts the budget proposal but is constrained by the preferences of the member states (in the Council). Although the Commission is charged with monitoring budget expenditures, 80 percent of the disbursement thereof is in the hands of the member states. Each state has had a free hand in deciding how to administer and oversee EU programs within its territory. The funds for the EU's budget, such as those obtained from the Common External Tariff and the VAT, are collected for the EU by the states. Thus, should a member state find it politically

3. Also, the expansion of the EU's governing institutions has not been matched by an offsetting contraction in the scale of government at the member-state level.

useful to tolerate fraud in a particular economic sector (agriculture, for example), its jurisdiction over the collection and distribution of EU funds lowers the risk of discovery. The Commission, despite its duty to oversee the budget and to adhere to the treaties, has no means of actually investigating cases in which it suspects irregularities or fraud. It must ask the member state to do so and obtain permission to join the investigation. Thus, most of the detection of fraud and corruption, as well as the prosecution of it, are reserved to the separate policing and legal systems of the specific member states. As the Commission has long recognized but can do little about, relying on the member states to prosecute fraud against the EEC budget is woefully inadequate. In most cases, the loss is to the EEC, whereas the state incurs the costs of investigation and prosecution (author interview, European Court of Auditors, February 2, 2001). Thus, the states have little or no incentive to prosecute.

Although most scholars of international relations assume that states do not join international organizations if no adequate means of preventing other states from cheating on the agreement exist, the EU's structure suggests that all states, provided they have similar opportunities for cheating, may create international organizations with little regard for rule enforcement. Indeed, the EU originated with very weak legal enforcement mechanisms pertaining to member states' actions. Access to EU legal remedies is generally weak throughout the member states and uneven across them. The member states have established costly subsidy programs but no accompanying policing mechanisms. Only the states that have been major net contributors to the EEC budget, such as the United Kingdom, have pushed hard to increase antifraud enforcement procedures and investigations (Leigh 1993, 71). The beneficiaries of EU programs are for the most part members of well-organized rent-seeking groups, and those who pay for the programs are not. The extent of subsidies, the tolerance for abuse, the lack of cooperation with EU authorities investigating such abuse, and the fact that EU citizens have a voice only in the weakest of EU institutions (the European Parliament)[4] might lead us to question member states' intentions: Do they regard fraud merely as an externality?

As the U.K. House of Lords noted in 1988, "Member States have been unwilling to notify the Commission of established fraud unless they are certain to collect the amounts due [from the fraudster], or unless they will not be required to pay up the sums to the Community. The result is that the Commission 'has little idea of what is actually going on'" (House of Lords1989, 13, quotation from a European Parliament report). In the 1980s, the Commission, recognizing the states' lack of incentive to report fraud and other budget irregularities, actually began to release states from their obligations to cover the lost sums, in the hopes of gaining more accurate information. In effect, EU fraud is a collective-action problem: member states can defraud

4. Were the European Parliament a more powerful institution, it might itself become plagued by rent-seeking activities. However, it is also the only institution directly accountable (albeit only once every five years) to voters, and, perhaps from a position of relative weakness, it has taken upon itself the role of budget watchdog. Its criticisms led to an investigation of the Santer Commission, which in turn resulted in the resignation of the commission in 1999.

the EU because the harm is dispersed across all the states' taxpayers, whereas the gains are country and constituency specific.

States also have little incentive to prosecute when the "suspects" are members of major special-interest groups. In a rare case (exceeding the "milk quota" in Italy) in which the Commission did decide to impose and collect fines, the national government paid out of its general budget rather than collect from the dairy farmers (author interview, European Court of Auditors, February 2, 2001). The exception seems to prove the rule: in late fall 2001, concerns about terrorism overcame concerns about sovereignty, and the EU states reached agreement on a European arrest warrant. Here, too, protecting special interests was an issue as the Italian prime minister, Silvio Berlusconi, feared that he himself might become a target of such a warrant in relation to a corruption investigation in Spain. Italy conceded only after Berlusconi achieved guarantees that would exempt him from extradition ("Italy at Odds" 2001; author interview, anonymous Italian prosecutor, Ministry of Justice, Italy, February 26, 2003).

A Word about Corruption

Because elections, including those for the European Parliament, are still member-state based and because the bulk of revenue collection and public spending takes place within the individual states, corruption is for the most part a member-state problem, not, despite the extensive publicity in 1999, a problem within the supranational EU institutions, such as the Commission. Newsworthy cases—such as those of Elf in France, Enimont in Italy, and allegedly shady financing of Helmut Kohl's party in Germany—and the less-known but more frequent local and regional cases have at their base efforts by political parties and politicians to attain more financing. Decentralization in the name of democratization in many European countries has brought with it the need for more elections (to regional and local governments) and, inevitably, for more parties, politicians, and their campaigns to be funded. Although those needs have not been met adequately with legal funding, neither has the need for more oversight. Corruption most often occurs through kickback schemes on public-works contracts, which account for 10–20 percent of the combined gross domestic product (GDP) of the EU states (Cecchini 1988, 16; EuroStrategy Consultants 1997, 110). To the extent that these collusive arrangements violate the EU's many regulations on public procurement, it is here that corruption in the states affects the EU.

Fraud in the EU

The bulk of the EU's budget goes toward agriculture subsidies, known as the Common Agricultural Policy (CAP). French president Charles de Gaulle's main argument for creating the CAP was that French industry could not afford to subsidize its agriculture on its own. There was no question of *not* subsidizing agriculture; it was merely a matter of spreading the costs. Germany agreed. Until the 1980s, the CAP grew to

consume almost 80 percent of the EU's budget. At that point, some CAP programs were reworked and put under the "Structural Funds" rubric, making it appear that agriculture was taking up less of the annual budget (now approximately 50 percent, with another 10–20 percent granted via the structural funds).

The substantial differences between EU and world-market prices, as well as the dependence of duties paid (or avoided) on country of origin or destination and on product composition and quality, create significant incentives to commit fraud. Through the 1980s, there were four hundred different classifications for milk and eighty for beef. For example, import duties may vary by 15 percent per kilo depending on whether the product is frozen high-quality prime beef or frozen offal. With EU prices often five to ten times higher than world-market prices and with the exporter eligible for a "refund" to compensate for his "loss" from not selling within the EU, export fraud in dairy, beef, and cereals has been substantial.

Further contributing to the potential for fraud is the fact that in many member states, including several of the biggest agricultural producers (France, Germany, Italy), agricultural policy and administration are heavily influenced by the very groups meant to be regulated. In France, for example, the national farmers' unions have official voice on the many national, regional, and local farm administrative bodies that write the rules and manage the programs. Further, the states are allowed to set up their own monitoring systems, which seem to be "rigorous only on paper" (Giordano 1990, 56). In many countries, for the purposes of various subsidies and crop "interventions" (in which the product never goes to market but is put in storage or destroyed), the local farmers' cooperative "verifies" the size of the crop and issues the subsidy check to the farmer. In the rare event of an inspection by a government agent, the farmer and the cooperative typically receive many more than the maximum allowable two days of notice, during which time they can easily regularize their activities. As an Italian judge and legal scholar said of the situation in Italy, the monitoring system is "absurd" (Giordano 1990, 56).

In one sense, it appears that through fraud the EU has indeed produced an "ever closer union" of Europeans. EU fraud cases typically involve nationals from at least two and often from three or more member states, and the EU nationals usually work in coordination with non-EU nationals in eastern Europe or the Third World. Ironically, businessmen sometimes admit that because competition in the EU has become keen, fraud against EU-funded projects and transactions has become a low-risk tool of business strategy (Sieber 1998, 13).

Weakness of Enforcement Mechanisms

An indication of the extent of the problem is evident in the fact that the EU has no commonly applied definition of fraud.[5] Thus, what constitutes fraud in Germany may

5. In 1995, the member states agreed to a "convention" that includes a common definition of fraud. As of 1999, only Germany and the Netherlands had ratified it; as of 2001, a few more states had, but the Commission would not list the states that had not ratified it.

not constitute fraud in Belgium. There is considerable variation across states in how the EEC's interests may be represented in a legal procedure concerning its funds. By dint of their legal systems, Belgium, France, Luxembourg, and Spain accord the EEC better standing than do other member states. Applicable penalties also vary substantially, with member states obligated only to ensure that penalties have a deterrent effect. European legal scholars have raised doubts about the effectiveness of the states' existing penalties. The states' priorities, however, are clear: it was thirty-seven years from the founding of the EEC to the first framework legislation meant to harmonize penalties for fraud against EU funds, and as of 2002 the states had not followed through with actual harmonization. This situation, along with the open borders of the internal market, encourages "forum shopping" (Grasso 1990, 255). So too does variation in the effectiveness of member states' legal systems: it is perhaps no surprise that Italy seems to have a comparative advantage in "producing" fraud.

Despite an increase in the powers of the European Court of Justice and of the European Parliament, the Commission's only means of "enforcement" has been to bring member states before the court for infringements of the EU treaties or regulations. Yet even in cases of obvious corruption, such as a Greek minister's attempt to cover up a case of fraud involving EU funds in 1986, the court has never had the power to impose penalties. Only recently did the member states, via the Council, agree to give the Commission the right to levy and collect fines for violations of market competition rules and to withhold future subsidies in agriculture and regional development. As late as 1989, no EU regulations existed for minimum standards of customs inspections of goods leaving or entering the EU: the individual states had their own implementing provisions. The same is true for the administration of agricultural programs, in which, on the basis of unverified statements by the states of their need, the Commission automatically grants funds to the states. Only later, during the EU's annual audit by the Court of Auditors, are the states required to justify expenditures and report irregularities. At that point, with the money spent, they have no incentive to make any such report: should they not be able to recover funds from the individual or business in question, they would owe the EU those funds.

Aggravating the situation is the fact that whereas most agricultural and other trade is transnational, both within the EU and between it and third countries, administrative and judicial systems are national. As one member of the Court of Auditors stated, "the national control systems did not appear capable of providing a consistent response to the problem of fraud, which is no respecter of frontiers" (Angioi 1990, 318). Notwithstanding ad hoc efforts and some work by the Commission to improve coordination, the member-state governments have done little to overcome the significant gap between the scope of the EU's internal market (and international trade) and their nation-state-based legal and administrative systems (Commission 2001; Corte dei Conti 2001). Gathering of evidence requires cooperation between numerous national and local jurisdictions, and evidence admissible in one state may not be in another; the suspect(s) may have to be extradited (which generally does not happen in revenue crimes), and the bank accounts may be in

Switzerland (not an EU member) or offshore. These conditions have allowed not only domestic special interests but also organized crime and third-country nationals to take advantage of EU programs.

The Commission is well aware of these problems and has proposed the creation of an office of public prosecutor for crimes against the EU budget. Hanging over any institutional solution is the member states' reluctance to cede further sovereignty to the EU and to eliminate electorally popular subsidy programs. Even were they enthusiastic, the obstacles to changing the legal systems of the fifteen member states (and soon ten new members as well) are significant. In their efforts to protect key economic sectors and to increase internal trade while preserving state sovereignty represented by separate, autonomous customs authorities, police, and judicial systems, they in effect have created a market for fraud. Perhaps if, owing to increased intra-EEC trade and expansion to eastern Europe, property rights become less secure and less enforceable to the detriment of domestic organized economic interests, member-state governments will be motivated to rectify a situation from which until now they apparently have profited, or at least have deemed an acceptable cost of "constructing Europe." Until then, it is unlikely that the EU will acquire anytime soon the means to combat one of the very factors that leads many Europeans to regard the EU as, at best, a necessary evil: fraud.

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