The Future of EU-Finances

Edited by
THIESS BÜTTNER
and MICHAEL THÖNE

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Mohr Siebeck

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The Future of EU-Finances – Synopsis*

Thiess Büttner and Michael Thöne

In order to initiate academic research on the EU revenue system and to enrich the current political debate about possible reforms, the German Federal Ministry of Finance has sponsored a research project on the future of EU finances. It brought together a group of scholars mainly from an economic but also from a law background and from different European countries who explore both the need and the options for reforms of the EU revenue system from different perspectives. The project resulted in a collection of policy papers on various specific topics that shed light on strengths and weaknesses of the current system of funding the EU. First drafts of the papers were discussed at a workshop that took place in July 2015 in Berlin. In the light of the discussion the papers were revised and reviewed and this volume includes the finalized papers that have been put together for the Brussels symposium on the 'The Future of EU Finances' on 14 January 2016. This synopsis gives an overview about the findings and draws some conclusions with regard to the reform of the EU revenue system. On the occasion of the Brussels Symposium, English and German versions of the working papers were released digitally. This book presents the revised and final versions of the articles for the first time.

1 Introduction

After a tedious bargaining process between European Council, European Commission and European Parliament, the key parameters of EU Budget for the next seven years, the 'multi annual financial framework', have been settled in 2013. Subsequently, the European institutions have initiated a debate about reforming the funding of the European Union in the future. In February 2014 a high-level group on own resources (HLGOR) comprised of ten members appointed by the Parliament, the Commission and the Council has been set

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up, whose job is to review strengths and limitations of the revenue system and explore alternatives for the future.

The first HLGOR-report issued on 17 December 2014 highlights four general problems associated with the current system, i.e. lack of simplicity, of transparency, of fairness and of democratic accountability. This indicates that the debate does not deal exclusively with the revenue side, but takes a broader perspective. One stance in the debate is, for example, that reforming the EU funding system might also help to redirect the spending priorities on the expenditure side of the budget. Despite a gradual shift of priorities in the current financial framework, still large parts of the European funds are used for transfers and subsidies to specific sectors and/or countries. Critics of the own resource system argue that a reform of the funding system might help to shift priorities towards providing services with European added value.

Important new political challenges, such as the EU's policies towards international conflicts and the refugee crisis, indicate that there is much potential for a stronger role of the EU. Reforming the revenue system may be an important step to ensure that the EU is able to meet these demands. However, it must not be overlooked that there are also important political differences between EU member states. Most dramatically, this is exemplified by the 'Brexit'-decision of the United Kingdom leading the country into an uncertain future outside the Union. From this perspective, a revenue reform that is just another step towards creating an 'ever closer Union' may not be suited to overcome these challenges.

The papers of the research project basically use three different approaches to discuss the need and the options for reforming the EU revenue system. The first straightforward approach is to assess whether the current system is useful and consistent given the present "integration architecture" of the EU, i.e. the present set of institutions and treaties. A second perspective on the finances of the EU is to explore the extent to which the EU funding system differs from existing unions and federations and to discuss whether this gap should be closed. This approach is useful in particular since the question of whether a stronger central power is advisable and necessary for the further development of the Union is a fundamental issue behind the debate on the own resources system. The third, more practical approach is to consider the options for a radical change that involves the introduction of an EU tax.

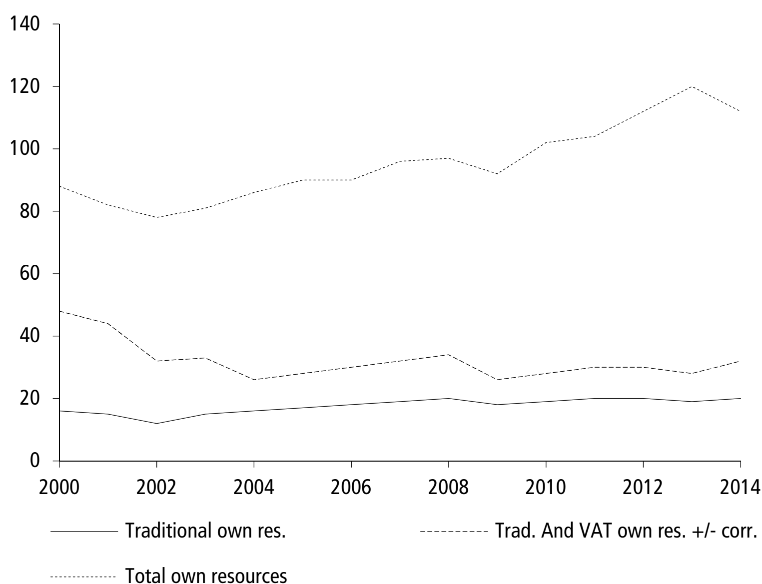
The following three sections briefly summarize the papers taking these approaches and discuss their findings before a last section provides some conclusions regarding the reform of the EU-finances.

2 Assessing the Current System

Despite frequent criticism, the EU revenue system has continuously been able to generate revenues sufficient to ensure that the EU budget is operated in accordance with the "multiannual financial framework". In 2014 this system generated own revenues of about 133 Billion Euros (see Figure 1).

Over the last decade the funding from so-called "traditional own resources" (customs duties as well as agricultural and sugar levies) has stagnated even in nominal terms, VAT own resources have declined. The nominal increase in the EU budget is due to the strong increase in GNI-contributions.[1] This fourth own resource basically determines contributions by the Member States proportional to the Member States' Gross National Income (GNI).

Figure 1: Funding of the EU budget (in Billion EUR)



Source: European Commission and own Calculations

The shift towards GNI-contributions basically reflects two trends, the declining importance of customs duties as well as the increase in the size of the EU budget. The latter factor points to an important characteristic of the EU

[1] At the time of its introduction in 1988, this resource was based on gross national product (GNP); from 2002 onwards, the reference to GNP has been replaced by Gross National Income (GNI).

budget. Unlike the budgeting of national governments, where the effective decision on current expenditures might simply follow the revenue development, the determination of the EU budget involves a joint decision on spending and revenues. If EU commission and parliament together with the Member States agree on the total budget available for the EU, the agreement also includes the commitment of the Member States to provide sufficient funding. Though this kind of agreement differs in important ways from budgeting at the national level, it seems broadly consistent with the supranational nature of the EU. It should also be noted that this procedure is at least in one respect more consistent with the criteria of simplicity and transparency than a tax-financed budget that is characteristic for national governments: whereas expenditure decisions for tax-financed budgets require revenue forecasts that are associated with substantial uncertainty, revenue uncertainty does not plague the decision about the EU Budget.

As Vilen Lipatov and Alfons Weichenrieder note in chapter two of this volume entitled "*The Subsidiarity Principle as a Guideline for Financing the European Budget*", the funding of the EU budget via GNI-contributions from the Member States is also consistent with the fundamental principles underlying the assignment of responsibilities in the EU. According to the principle of subsidiarity (Article 5 of the TEU), any government task should be assigned to the lowest level of government that can be expected to cope adequately with this responsibility. Following this principle, in economic terms, public policies should be in accordance with the so-called "decentralization theorem": Policies should be decentralized unless EU action is more effective than actions taken at national, regional or local level. The principle of subsidiarity received rather little attention in the discussion of the revenue side of the European budget. It has been applied predominantly to discuss the allocation of assignments on the expenditure side between the EU and the Member States. However, the notion that underlies this principle, namely that centralization of a policy may lead to a uniformity that harms the citizens/societies in the associated heterogeneous jurisdictions seems also convincing when the revenue side of the European public sector is considered.

The funding via contributions enables the Member States to decide on their own how the burden of financing the EU is distributed among individual tax payers. There are several reasons why such a differentiation may provide advantages. First of all, Member States' tax systems differ substantially in important respects – reflecting different traditions, institutions etc. There are also different preferences for administrative processes (e.g. high or low tolerance for taxpayer transparency or tax-evasion) and different administrative traditions (centralized versus decentralized tax administration). Moreover, local demand elasticities for goods and leisure may differ, and in different societies

different redistributive preferences may exist. From this perspective, the current system of financing the EU budget is consistent with the subsidiarity principle. Of course, Lipatov and Weichenrieder also note that this argument needs to be qualified: If uncoordinated tax policies were associated with major inefficiencies, central collection of taxes to fund the EU could be associated with welfare gains. For example, a low effective rate of corporate taxation may have negative effects on other Member States that lose tax revenue when firms and capital are attracted by the low-tax Member State. But how important is this qualification? If there are spillover effects of a tax, the centralization of this tax – implying a uniform tax base with a common tax schedule and the allocation of the full revenue to the central budget – is just one of several potential measures to respond to these spillovers and to the strategic incentives for national tax policy that arise from them. In many cases, less far-reaching, well-dosed measures such as harmonized lower limits for tax rates may easily suffice to neutralise all relevant spillovers. Moreover, while the economic literature points to important inefficiencies with decentralized taxation in the context of corporate taxation, other taxes that raise much more revenues such as labour income taxes, may need much less coordination in Europe.

The chapter "*Revenue Smoothing by the EU Funding System*" by Thiess Buettner points to a valuable feature of the increasing importance of GNI-contributions in funding the EU budget. Since the burden of financing the EU budget is distributed according to the actual or realized income, the contributions serve as a shock absorber for the budgets of the Member States. The empirical analysis presented in this paper considers the last Multiannual Financial Framework 2007–2013. The results indicate that the current system of funding yields significant smoothing effects of the Member States' revenues net of the funds transferred to the EU. Due to the strong reliance on GNI-contributions the current system reduces the variance in per-capita revenues by about 5%. The theoretical analysis shows that this amount of smoothing is close to the limit that a linear income dependent transfer system could possibly obtain given the size of the EU budget. To provide even stronger smoothing effects on Member States' net-revenues would require replacing the system of income dependent contributions by contributions that depend on some measure of the tax capacity as is practiced in federal countries employing revenue sharing or fiscal equalization. While applied to the EU, tax capacity would capture the revenues that each of the Member States would collect at some standard level of tax effort. However, in the current setting, where tax law differs substantially among Member States, a proper definition of tax capacity is plagued with vast difficulties. A precondition for a move to tax capacity dependent contributions is therefore to harmonize taxation to an extent that makes it possible to really ascertain the tax capacity of the Member

States. Thus, leaving aside non-linear systems, without deeper harmonization of tax systems, the current system of EU funding with its emphasis on GNI-contributions is providing almost the maximum possible degree of revenue smoothing.

3 Europe as a Federation

Much of the academic criticism of the EU budget and the way it is financed emphasizes the differences between the EU and federal countries. Whereas in federal countries a central government exists that uses own taxes, the EU Budget is predominantly financed with contributions. As Christos Kotsogiannis notes in the chapter "*European Union and Own Revenue Resources: (Brief) Lessons from Fiscally Decentralized Economies*", even though the EU operates a single market its funding system differs also from common prescriptions in the theory of fiscal federalism which provides the appropriate conceptual approach to analyse public finances in integrated economies. If there are important inefficiencies associated with decentralized taxation, the central government could use own tax instruments to prevent such inefficiencies. This would point indeed to a more active role of the EU in designing revenues than currently observed. However, Kotsogiannis notes that the task to identify appropriate revenue instruments is complicated. Whereas horizontal tax competition is commonly associated with a downward pressure on tax rates resulting in inefficiently low levels of tax effort, the case of *vertical* tax competition is different. Intuitively, if the same tax base is shared by more than one level of government, the impact of taxation by each level on the revenues of the other will tend to be neglected, resulting in an overuse of the tax. With regard to normative implications, Kotsogiannis emphasizes that an EU own tax should derive from access to the single market. In addition, co-occupation of tax bases should be avoided to minimize efficiency losses associated with vertical tax externalities. From this perspective, the potential introduction of EU taxes in a multilevel system with diversified tax bases which are already intensively used by the Member States and their lower levels might need to actually reconsider the revenue instruments used by the Member States.

Also Massimo Bordignon and Simona Scabrosetti start their consideration in the chapter "*The Political Economy of Financing the EU budget*" with the notion that the EU budget differs fundamentally from the budget of central governments in federations. Only a small fraction of EU expenditures is used to fund European public goods. This state of affairs should be regarded as a consequence of the balance of powers between the Union and the Member States and of the ensuing political economy of the EU budget. The revenue

system might be an important determinant of expenditures if it affects the bargaining position of the EU Parliament with respect to the Council in future budget negotiations. According to Bordignon and Scabrosetti even a limited change in the sources for funding the EU budget, moving in the direction of an EU tax paid directly by the citizens to the EU budget, may lead to a dynamic process that strengthens the Union with respect to the Member States. The anticipation of these future political dynamics may be the main reason why some member countries resist the change, while the EU Parliament is pressing for it. However, the authors note that the criticism that is raised against the present system of funding of the EU budget makes little sense if one takes the view that the EU is a supranational agency cooperating in providing some common goods and bargaining on some side-payments that ensure implementation of EU-wide policies by compensating member states. In this case, triggering a dynamic political process that ultimately transforms the EU more to a federation may be the wrong idea. However, the authors argue that a move in this direction could be helpful as a catalyst of further changes that help to overcome the legitimacy crisis that the EU is facing currently. Yet, the authors also note that given the present low level of consensus towards the European project, it might be risky to pursue a reform that makes European citizens more aware of the cost of the EU budget by financing it with an EU tax.

A contrasting view on the role of the EU funding system in shaping the outcome of the EU budget is provided by Friedrich Heinemann in the chapter "*Strategies for a European EU Budget*". Heinemann shares the critical view by Bordignon and Scabrosetti on the Union's spending priorities. He also notes that an EU budget that follows the prescriptions from fiscal federalism would result in a rather different structure: From a normative perspective, a much lower importance should be assigned to today's big resource absorbers Cohesion and Common Agricultural Policies. These corrections would free the funds needed to foster policies with more obvious properties of European public goods (EPG), e.g. defence, foreign policy, research and innovation. However, Heinemann strongly argues against the view that a reform of the funding system would steer the incentives of budgetary decision makers in a desirable direction. Promising reforms would need to directly address the disincentives for policy makers that result in a spending bias towards public goods of local rather than European nature. Thus, Heinemann maintains that reforms are needed which increase the relative attractiveness for the policy makers of European public goods over projects with a strong local impact but little European value added. For this purpose, he proposes the use of strategies which directly make the benefits of European public goods (EPG) more visible, increase the costs of local goods relative to EPG or

strengthen those actors in the budgetary process who have a less parochial perspective.

4 EU Taxes

A final set of papers discusses the options to implement an EU tax and the challenges to be faced in this endeavour. In the chapter "*Transferring Taxes to the Union: The Case of European Road Transport Fuel Taxes*" Michael Thöne considers employing an existing tax as an EU tax. Since the only taxes for the EU level foreseen by the Treaties are "provisions primarily of a fiscal nature" in environmental policy (Art 192 TFEU), the paper discusses the effects of a European environmental tax focusing on transport sector excises. The focus is on the transfer and the subsequent reform of the excise duties on gasoline and diesel. The current situation is characterized with vastly differing tax rates on gasoline and diesel due to harmonization failure. As this gives rise to distortions in fuel consumption and to problems of cross-border shopping there are important potential advantages of centralizing these taxes on the supranational level. Yet the hurdles to be taken are high. Effective unanimity must be reached because each single Member State must forego the right to tax transport fuels. Thus, identifying taxes whose transfer to the central level may improve welfare and efficiency is a necessary, but not a sufficient condition for a successful revenue reform. Adequate compensation for the transfer of the tax, for instance by reductions of customary own resources, may also be required in order to reimburse the Member States for the tax revenues foregone. Using data for current revenues across EU Member States the paper shows that the transfer of fuel taxes to the EU has some counterintuitive effects. The large heterogeneity of taxes may justify the centralization of fuel taxes economically, but it also leads to a setting where difficult asymmetric compensation would be required: The taxes most attractive for centralization are particularly difficult to transfer because the necessary compensations regularly exceed the tax revenue.

The chapter "*Light for Europe – An Electricity Tax for the European Union Budget*" by Kai Konrad explores the case of an electricity tax as a new tax. More specifically, the chapter discusses options how this tax could be implemented, and considers the revenue consequences. The proposed tax is fairly simple: a unit tax on the use of electricity by all consumers, including households, small businesses, companies and the public sector. To arrive at the amount needed to close the gap between current budget size and the amount of import taxes and duties, a tax of approximately 3–4 cent per KWh of electricity consumption would be required. Konrad conducts a first assessment of

the electricity tax following the criteria put forward by the HLGOR. A good own revenue source should be simple, transparent, and fair as well as strengthen democratic accountability. Konrad compares the electricity tax with a financial transaction tax (FTT) levied on the value of financial assets traded or of a subset of financial transactions. The results of the criteria-based appraisal turn out to be quite strong: The financial transaction tax would not fulfil any of the criteria suggested by the HLGOR. An EU tax on electricity, in contrast, meets these criteria quite closely: it is in conformity with the ability-to-pay-principle, it has reasonable efficiency properties, the tax revenue is fairly predictable, and is likely to have a low volatility. Moreover, the tax is a transparent tax for the tax payers, and the set of tax payers mostly overlaps with the set of beneficiaries of EU expenditures and with the set of voters in the European Union. These properties of transparency and accountability make such a levy a particularly attractive candidate for an EU tax.

The final chapter by Christian Waldhoff "*Legal Restrictions and Possibilities for greater Revenue Autonomy of the EU*" addresses the options to implement an EU Tax given the legal constraints. From a legal point of view, this problem has to be examined on multiple levels: Which measures of promoting revenue autonomy are feasible without changing primary Union law (i.e. TEU and TFEU)? If changing primary Union law is discussed, this raises (from a German perspective at least) the follow-up question which limitations the Member States' constitutional orders draw to such a redesign of European law. Waldhoff finds that own EU taxes with full legislative and revenue authority of the Union beyond customs and the taxation of EU officials are only possible within narrow limits under the current Treaties: particularly as Pigouvian or steering taxes that are not primarily fiscally motivated, provided that the respective policy issue permits this course of action. Hence, these taxes must not be introduced with the main motivation of funding the EU's budget. A new own resources decision could also be used to introduce EU taxes. However, these taxes would not substantially improve the revenue autonomy of the Union, as they would stay within the framework and system of the own resources decisions, which require unanimous adoption by all Member States. From a German perspective, there are, however, constitutional limits to own rights to tax that stem from the dual legitimation structure of the Union and that are spelled out in particular in the jurisprudence of the German Federal Constitutional Court on this topic.