

*“Requisitions upon the States [have] the inevitable tendency [...] to enfeeble the Union, and sow the seeds of discord and contention between the federal head and its members, and between the members themselves”.*

Alexander Hamilton, 1787

**EUSA Eleventh Biennial International Conference  
Los Angeles, 23 April 2009**

**EU FINANCING REFORM**

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**1. Introduction**

In accordance with the conclusions of the European Council of 15-16 December 2005, the Commission has been invited to *"undertake a full, wide-ranging review covering all aspects of EU spending, including the Common Agricultural Policy, and of resources, including the United Kingdom rebate, and to report in 2008/2009"*<sup>2</sup>.

Preparation of this budget review has given rise to a vast public consultation, numerous debates and an important political conference on the future of the EU budget, including the issue of EU financing system<sup>3</sup>.

The debate on a reform of the EU financing system encompasses two main dimensions:

- The structure of EU financing and, in particular, whether the Union should be financed via "genuine own resources", such as customs duties, and/or through some forms of Member States contributions, such as the VAT- and GNI-based contributions ;
- The correction mechanisms and the way to either eliminate or adapt them.

In addition, a less debated element of the EU financing system is the mechanism(s) used to ensure budget balance and their link to the other features of the financing system.

These dimensions are systematically analysed in this paper in the light, notably, of recent debates in the context of the budget review preparation.

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<sup>2</sup> See Declaration 3 to the Interinstitutional Agreement between the European Parliament, the Council and the Commission on budgetary discipline and sound financial management, 2006/C 139/01, 14.6.2006.

<sup>3</sup> Extended information on the budget review process can be found on the European Commission website on [http://ec.europa.eu/budget/reform/index\\_en.htm](http://ec.europa.eu/budget/reform/index_en.htm).

We start with a short presentation and assessment of the current system in section 2. Options for reforming own resources are examined in section 3. The issue of corrections and equalization mechanisms comes next (section 4). The issue of budget balance is covered by section 5. An overview of issues and their interdependence is presented in section 6.

## 2. Key facts and assessment of the current financing system

### 2.1. Own resources

Total EU revenue has to be equal to total expenditure and is required to stay within agreed legal limits, currently 1.31% of the EU gross national income (GNI) for appropriations for commitments and 1.24% of EU GNI for appropriations for payments.

There are three main own resources<sup>4</sup>:

- The first own resource ("traditional own resource" or TOR) are customs duties and resources of agricultural origin (sugar levies). A 25 % flat-rate deduction is retained at source by the Member States as collection costs.
- The second resource results from the application of a uniform rate to Member States' value added tax (VAT) bases. This rate is applied to harmonised VAT bases that are restricted (capped) to 50 % of the same Member State's GNI<sup>5</sup>.
- The third resource, the "additional" resource, results from the application of a uniform rate to Member States' GNI bases, which is calculated in such a way as to cover the balance of total expenditure not covered by the other resources.

Type of revenue	Budget 2008		Budget 2009	
	EUR million	%	EUR million	%
Customs duties and sugar levies	16936,3	14,6	19206,1	16,5
VAT-based resource	18096,8	15,6	19616,1	16,9
GNI-based resource	73290,3	63,3	75914,1	65,4
Other revenue	7447,9	6,5	1359,72	1,2
<b>Total</b>	<b>115771,3</b>	<b>100,0</b>	<b>116096,0</b>	<b>100,0</b>

Source: General budget of the European Union for the financial year 2009

As noted in the consultation paper on the budget reform<sup>6</sup>, "*the own resources system has evolved significantly since the beginning of the first financial framework. In 1988, the GNI resource made up less than 11% of EU financing, compared to 28% provided by custom duties and agricultural levies and 57% by the VAT-based own resource. In 2013, the GNI resource will provide about 74% of the EU financing, against 13% for customs and agricultural levies and 12% for the VAT-based resource*" (see annex I).

<sup>4</sup> The EU financing system has recently been modified with the entry into force of the Own Resources Decision 2007 (2007/436/EC, Euratom - OJ L 163 of 23/06/2007).

<sup>5</sup> 13 Member States had their VAT bases capped in 2008: Bulgaria, the Czech Republic, Estonia, Ireland, Greece, Spain, Cyprus, Latvia, Luxembourg, Malta, Poland, Portugal and Slovenia.

<sup>6</sup> See Communication from the Commission "Reforming the budget, changing Europe. A public consultation paper in view of the 2008/2009 budget review", SEC(2007)1188 final, 12.9.2007.

The overall composition of the Union's own resources system, and the interaction with correction mechanisms, will be an important element of the budget review.

## 2.2. *Corrections*

Mechanisms of correction and the issue of net contributions were discussed from the UK accession to the EC. At the time a large budgetary imbalance for the UK was caused by two main factors: a relatively small agricultural sector, different from those of other Member States, resulted in lower CAP payments in the UK and a relatively large UK contribution to the Community budget financing was due to a high UK share in the harmonised VAT base compared to the other Member States<sup>7</sup>.

The main causes of budgetary imbalances for the UK have been attenuated. In 2013, CAP expenditure (both direct support and rural development) will represent around 40% of EU expenditure compared with 70% when the rebate system was introduced. One could therefore argue that one of the most important justifications for the existence of the current rebate system has therefore changed significantly. Yet, the attention paid to net balances in EU budget negotiations has increased over time. In the years since the 1984 Fontainebleau agreement, according to which *"any Member State sustaining a budgetary burden which is excessive in relation to its relative prosperity may benefit from a correction at the appropriate time"*, several permanent or temporary correction mechanisms have been introduced.

Correction mechanisms now exist on both the expenditure and the revenue side of the budget and they benefit to a large number of Member States (see Annex II). An own initiative resolution of the European Parliament ("the Lamassoure resolution") identified 41 exceptions introduced by the European Council in December 2005 on the expenditure and revenue side of the budget<sup>8</sup>.

On the expenditure side, various ad hoc payments over the years have, *de facto*, had the objective of altering the net positions of the Member States. They constitute a significant part of cohesion policy. In practice, correction mechanisms partially undo the impact of certain expenditure policies. Member States benefiting from redistributive packages, such as the cohesion policy going to the poorer regions, see their benefit reduced through increased contributions to the budget to finance the corrections on the revenue side. Some of the corrections on the expenditure side in turn increase the UK correction.

The most important correction mechanisms, though, are on the revenue side. The corrections on the revenue side present a collection of diverse measures, resulting from a series of successive negotiations, each time adding new measures on top of the body of existing corrections and characterized by a consistent reluctance to ever turn back the clock. The mechanisms include the UK correction, the differentiated call-up rates for the VAT-based contribution and the charges for collecting TOR as well as lump sums for NL and SE.

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<sup>7</sup> See European Commission, DG Budget (2008), *European Union Public Finance* (4<sup>th</sup> ed.), OPOCE, Luxembourg, chapter 2.

<sup>8</sup> See European Parliament resolution of 29 March 2007 on the future of the European Union's own resources (2006/2205(INI)) - P6\_TA-PROV(2007)0098.

Overall, the total impact of the correction mechanisms is clear: they reduce the financial solidarity (total net transfers in percentage of GNI) operated through the EU budget. Moreover, there is a convergence of the net contributor's positions. However, a striking feature of the current system is that, for a similar level of GNI per capita, two Member States may be in totally different net positions with regard to the EU budget<sup>9</sup>.

### 2.3. *Assessment of the EU financing system*

Reviewing the current financing system and proposing reforms requires robust assessment criteria<sup>10</sup>. It is essential to identify quickly and clearly the main pros and cons related to constituting elements of a financing system – that is, the individual own resources as well as the correction mechanisms –, but also to the system as a whole, taking into account the interrelation between these elements.

Possible categories of criteria include

- Budgetary criteria: ensuring a sufficient and stable EU financing and budgetary discipline.
- Integration criteria: ensuring financial autonomy, transparency and a link to EU policies. Another important aspect of this criterion is the principle of fiscal equivalence for the provision of (public) goods and services, i.e. that primarily those benefiting from certain spending programmes should also be those financing it.
- Efficiency criteria: internalising externalities, implementing the subsidiarity principle, limiting operating costs of the system;
- Equity criteria: ensuring fairness at the level of Member States and horizontal and vertical equity for the taxpayers.

There are a number of important advantages related to the existing financing system. In particular, the current financing system performs very well in terms of budgetary criteria. Indeed, the existence of a GNI-based residual contribution in combination with the Inter-institutional agreement has ensured a smooth adoption of the EU budget since 1988. The size of the EU budget is now constrained by agreements on expenditure rather than scarcity of funding. This contrasts with the situation observed before<sup>11</sup>. It should be noted, however, that this excellent performance on budgetary criteria could be achieved even with a very small residual GNI-based contribution (or with another type of residual contribution) and in combination with tax-based resources. Moreover, the reliance on mainly VAT- and GNI-based contributions from

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<sup>9</sup> See Richter, S. (2008), "Facing the monster 'juste retour': on the net financial position of Member States vis-à-vis the EU budget and a proposal for reform", wiiw Research Reports, 348, May 2008.

<sup>10</sup> See, for instance, Cattoir, Ph. (2004), "Tax-based EU own resources: an assessment", European Commission DG Taxation and customs union, *Taxation Papers*, Working paper N°1/2004 or the ZEW study "Reform options for the EU own resource system" – research project 8/06, 4/12/2007.

<sup>11</sup> See European Commission, DG Budget (2008), *European Union Public Finance* (4<sup>th</sup> ed.), OPOCE, Luxembourg, chapter 2 *et seq.*

the Member States imposes very limited operating costs and it is widely recognized that the procedures for calculating these resources work well.

On the other hand, the current financing system performs poorly with regard to all other relevant criteria.

First, the two largest sources of revenue – the VAT and GNI based own resources – display many of the characteristics of national contributions and are often perceived as such. They are provided by national Treasuries and are sometimes presented as an expenditure item in national budgets. In this sense, one can say that the financial autonomy of the Union is limited. This has a major negative consequence, as Member States often tend to judge EU policies and initiatives in terms of returns compared to their national contributions, rather than looking first at the overall value of pursuing certain policies at the European level<sup>12</sup>.

Second, the combination of Member States contributions and numerous correction mechanisms have considerably reduced the simplicity and transparency of the EU financing system. As a result, it is almost impossible for EU citizens to ascertain who – citizens or interest groups – effectively bears the cost of financing the EU. In particular, *"the 'VAT-based' resource is levied on a 'virtual' basis... which is complex to the point of incomprehensibility"*<sup>13</sup>. This raises doubts about the current funding scheme when it is assessed in terms of accountability. Indeed, according to the Court of Auditors, the current financing system is simply *"not fully auditable"*. Furthermore, the EU budget is often presented as an insatiable and very costly Leviathan, sucking national resources to finance useless, or even harmful policies that benefit a few well-organized lobbies of producers – but when it comes to how much it actually levies on individual taxpayers, the amount quoted are usually grossly exaggerated. However, the issue of visibility could be envisaged in a completely different way: EU expenditures, and EU activities in general, tend to be visible to relatively small constituencies such as farmers, policymakers or some NGOs. It is mostly infrastructure projects that enjoy high visibility, but they are often not clearly marked as receiving EU funding. Given that it is difficult to make EU expenditure as visible as the introduction of any EU tax, there is a risk that the average citizen would imagine that he is paying 'more' for something from which he is not benefiting.

Third, except for the traditional own resources the current financing sources of the Union do not contribute to- or support EU policies. Whereas tax-based instruments can have impact on taxpayers' behaviours and contribute to specific policy objectives, for instance in the environmental or energy areas, the VAT- and GNI-based contributions do not relate to EU policy objectives.

Fourth, despite a strong link to GNI and the progressive inclusion of numerous correction mechanisms in the financing system, many Member States still perceive their contribution to- or benefits from the EU budget as being unfair (see Box 1 –

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<sup>12</sup> For an interesting discussion on the benefits drawn from the EU budget, see Le Cacheux, J. (2005), "The poisonous budget rebate debate", *Notre Europe*, Studies & Research, N°41.

<sup>13</sup> Contribution of the European Court of Auditors to the budget review consultation, §26-28, 9 April 2008. All the contributions made for the budget review consultation can be found on the Commission website at [http://ec.europa.eu/budget/reform/issues/read\\_en.htm](http://ec.europa.eu/budget/reform/issues/read_en.htm)

Abstract from the Polish contribution to the budget review<sup>14</sup>). The increasing focus placed on a narrow 'accounting' approach with the main objective of maximising returns – to which past reforms of the own resources systems towards a contributions system have contributed –, has led to tensions between Member States and has coloured the public debate about the value of EU spending and the benefits of EU membership itself. The reliance on Member States' contributions and the accumulation of numerous mechanisms of corrections over the years gives rise to a pervasive tendency for Member States to favour the most visible financial transfers to specific constituencies at the expense of less prominent programs displaying a high EU added value.

Fifth, the GNI resource gives the wrong impression that effective financial burdens are actually distributed according to each country's 'income' and hence ability to pay. However, GNI is a rather crude and imperfect tool to measure economic prosperity. Measurement problems can notably arise in the following areas: the underground economy; capital gains and losses (a capital income that is usually not counted in GNI); household services (meal preparation, cleaning, repairs and maintenance, child and adult care...); volunteer work; non-reproducible natural resources (extraction of a mineral resource should be subtracted from the stock of capital since it cannot be replaced); imputed elements (outputs consumed by their producers, such as imputed residential rents from housing occupied by their owner and farm products); commuters/cross-border work<sup>15</sup>. The difficulties in establishing the Greek GNI are a clear illustration of these measurement issues. Overall, when it comes to the GNI-based resource, the harmonization of "*macro-economic statistics... could still be improved*"<sup>16</sup>.

Last, the ultimate impact of the Member States contributions differs among taxpayers of various Member States, which raises issues of equity among taxpayers<sup>17</sup>. Indeed, a closer look at national structures shows that incomes tax burdens and their interpersonal distribution vary greatly from country to country; the share and rates of VAT and other indirect taxes in total tax receipts also differ widely from one country to the other, so that the amount effectively paid by domestic consumers, but also the amount effectively borne by foreign producers for those taxes levied on imports (VAT) are actually very far from the apparent distribution of tax burdens.

Against this backdrop, following the mandate of the European Council and the Inter-institutional agreement, the forthcoming budget review will take a close look at the various sources of financing and whether and to what extent the various correction mechanisms which have emerged and their underlying principles are still justified.

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<sup>14</sup> Contribution of the Polish government made on 9.4.2008, pp. 8-9.

<sup>15</sup> See Aubut, J. and F. Vaillancourt (2001), "Using GDP in equalization calculations: are there meaningful measurement issues?", October 2001.

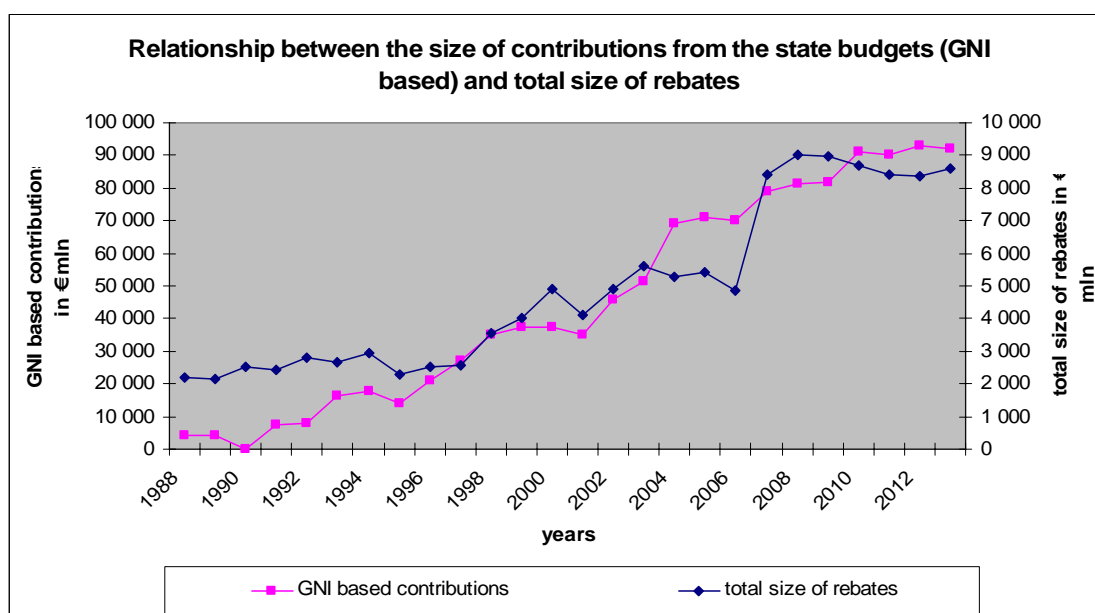
<sup>16</sup> Contribution of the European Court of Auditors to the budget review consultation, §26, 9 April 2008.

<sup>17</sup> See Begg, I., Enderlein, H., Le Cacheux, J. and M. Mrak (2008), "Financing of the European Union Budget", Study for the European Commission, Directorate general for Budget (contract N°30-CE-0122101/00-72, 29 April 2008.

### Box 1 – Abstract from the Polish contribution to the budget review

*"An opinion has been expressed many times that own resources system based on GNI-based payments is not only the simplest but also the fairest one. Linking budget contributions to GNI is supposed to ensure connection between contribution level and affluence of the member states and their citizens. However, practice of the operation of own resources system proves that growth of payments into the EU budget based on GNI leads to a result contradictory with the one intended – relative encumbrance with contributions to the budget from less affluent states go up.*

*This is so because an increase of contributions to the EU budget based on GNI reinforces the pressure on increasing the total size of rebates granted to most affluent member states. Own resource based on GNI deepens unjust own resources system ensuing from juste retour logic.*



*As a result, while tax systems in almost all member states are of progressive character, i.e. they impose the largest burdens on the wealthiest tax-payers, as a result of the applied correction mechanisms the Community own resources system is of degressive character, imposing greater burdens on less affluent member states and citizens. As an example in 2006 the contribution paid by the 8th wealthiest member state was the lowest in relation to GNI (0.54% GNI). At the same time the contribution paid by the 23rd wealthiest member states amounted to 0.89% GNI. Degressive character of own resources system results from existence of rebates."*

### 3. Reforming the own resources system

Ideas to replace or supplement existing resources include the extension of the GNI resource, or the creation of new, possibly tax-based, own resources in replacement of existing own resources. New possible resources mentioned in the past included a modulated VAT; resources related to corporate income (EUCIT); energy or pollution charges, including the auctioning of emission allowances in the framework of the European Emission Trading Scheme; excise duties on tobacco and alcohol; the

transfer of seignorage revenue; communication charges, including on telephony; resources related to personal income and financial transactions. One could also add potential revenues from EU policies or spending programmes eventually generating revenues themselves, such as revenues from charging users of EU-(co)financed infrastructures or royalties from Galileo.

Studies and reports that have examined these options<sup>18</sup> in respect of relevant criteria have highlighted the pros and cons of various potential own resources. Clearly, there is no such thing as a perfect own resource for the EU: the main possible EU own resources perform well according to some criteria and less well according to others<sup>19</sup>. In short, it is difficult to conceive an 'ideal' funding system, even more so when there is a mix of different resources and these are complemented by correction or equalization mechanisms (see section 4). The decision as to which criteria are essential and which secondary is political and should ultimately determine the choice between possible own resources.

Three approaches for a reform of the own resource system, which closely relate to the three first categories of criteria described in section 2.3, have emerged in the past years:

- The first approach focuses on budgetary criteria, and in particular ensuring a stable and sufficient financing of the Union in line with the Member States financial capacity. This approach underlines the growing importance of the GNI-based resource (from 11% of EU financing in 1988 to an estimated 74% in 2013) and suggests relying even more on this resource in the future.
- The second approach focuses on the creation of a direct financial relationship between the EU budget and EU citizens. *"The shift towards individuals and economic operators as contributors, and the corresponding reduction of Member States' contributions to the financing of the EU budget would entail higher visibility towards citizens and thus increased political accountability of the budgetary authority for their expenditure decisions. It would also contribute to shifting the political discussion away from the narrow focus on national contributions towards the merit of EU policies and the general European interest"*<sup>20</sup>.
- The third approach focuses on efficiency. An own resource should be attributed to the EU level only if this allowed for an increase in efficiency, for instance through decreased administrative costs, or effectiveness if it contributed to the achievement of important Community objectives. This approach would be in line with the subsidiarity principle.

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<sup>18</sup> Useful references in this area include the report "Financing the European Union", Commission report on the operation of the own resources system, COM(2004)505 Vol. I of 14 July 2004, the special report of European Economy on "The economics of Community Public Finance" (1993) and the Commission report on the operation of the own resource system (2000) as well as the external study "own resources: evolution of the system in a EU of 25" undertaken for the European Parliament (project IP/D/Budg/ST/2004-26).

<sup>19</sup> See Cattoir, Ph. (2004), "Tax-based EU own resources: an assessment", European Commission DG Taxation and customs union, *Taxation Papers*, Working paper N° 1/2004.

<sup>20</sup> "Financing the European Union", Commission report on the operation of the own resources system, COM(2004)505 Vol. I of 14 July 2004.

Before examining these three options in turn, an important remark needs to be made in relation to the fourth category of criteria mentioned above. Issues of fairness are an essential part of any discussion to reform the EU budget. Fairness, however, is a concept that takes into account the budget in its entirety, including the own resources, possible correction or equalization mechanisms, and the structure and organization of expenditure. Therefore, the fact that some possible alternative own resources would lead to fair or unfair *gross* contributions, does not allow drawing firm conclusions on the fairness of the budget taken as a whole. This issue will be examined more closely in section 4. At the same time, the question of an 'EU tax' is only logical if the whole approach to financing the budget is revised away from the present reliance on Member States contributions to a system of fiscal autonomy. This would provide a means (albeit not perfect) to get away from existing correction mechanisms and to try to concentrate budget decision on the financing needs of EU policies and common objectives as compared to Member States' net budgetary position. The political resistance to such a move should not be under-estimated.

As indicated in the above-mentioned consultation paper, "*alternative own resources should be examined very carefully, taking into account the national sovereignty on fiscal policy and, for instance, the cross-border mobility of some tax bases and the impact of such resources on related EU policies*". It should be indicated from the outset of this analysis that the reform proposals envisaged below would not entail treaty changes and thus respect fully the current sharing of competences between the Union and the Member States. National tax sovereignty would be fully respected as the main elements of the proposals below could be defined in an own resource Decision adopted with unanimity by the Member States and ratified by their national parliaments. At the same time, the detail working of the financing system could be defined in a regulation implementing the own resource decision adopted with QMV by the Council with EP consent. This articulation of elements would thus ensure a full democratic control by parliaments both at national and European level. Even so, however, one should not underestimate the political implications of introducing a new, tax-based, own resource to finance the EU budget as any attempt to introduce a new source of taxation to finance EU expenditure could generate a certain degree of anti-EU resentment.

### ***3.1 A sufficient and stable financing system***

If the main objective of EU financing was to ensure a stable and financing source of revenue – that is, to fulfil in priority budgetary criteria – expanding further the GNI-based contribution would appear legitimate. Indeed, the principal attraction of the GNI resource is that it assures a sufficient and stable flow of funding for the EU budget. Key to these attributes is the residual character of the resource, with calls on it that are determined by the amount of expenditure: if more expenditure is agreed the amount Member States have to raise from the resource expands. Calls on the resource are limited only by the own resources ceiling.

An additional advantage of a GNI-based system is that, insofar as fairness between Member States in *gross* contributions to the EU budget is a desired characteristic<sup>21</sup>, the GNI resource is effective because the (pre-corrections) take up rate is set to take equal proportions of national income from each country. Moreover, in general the amounts due under the resource are easily calculated and obligations in terms of monthly payments are clear to Member States.

Expanding GNI would most likely be done at the expense of the VAT-based resource, which could bring about some advantages. Indeed, calculating the VAT resource is far from straightforward, lacks transparency and is relatively unpopular with Finance Ministries. So there could be a simplification gain. Moreover, the VAT base usually correlates relatively closely with GNI, so the redistributive issues stemming from its replacement should *prima facie* not be insurmountable<sup>22</sup>. On the other hand, the political payoff from this measure could be limited. It should also be considered that the abolition of the VAT resource could be seen as marking a step back from the aim of granting the EU a real own resource, which is an enshrined EU long-term objective (although the Lamassoure report denies the relevance of such a precedent).

A GNI-based contribution could also lend itself to reforms in order to support specific EU objectives. For instance, the use of complementary indicators to GDP/GNI to determine a Member States' capacity to contribute should be explored in the longer term, e.g. the use of a Genuine Progress Indicator<sup>23</sup>. Going one step further, it is sometimes suggested that GNI contributions could be modulated as a function of the attainment of important EU policy objectives, e.g. energy efficiency or CO2 emission reduction. The implementation of such a modulation would, however, raise a host of conceptual and practical questions. Finally, one could also envisage making the GNI-based contributions more or less progressive than is currently the case. Progressivity could be on a banding system (for example, by setting bands of 0.8% of GNI, 1% and 1.2%) or could be a smoother curve that gradually increases the rate up to a maximum level<sup>24</sup>.

The GNI resource has also serious drawbacks. The first concern is that GNI itself is not an ideal measure of ability to pay, the tax principle that most obviously underpins its use (see section 2.3). Current-price GNI does not fully reflect differences in living standards, especially in a group of countries with widely different standards of living. Moreover, GNI as a concept does not equate to national well-being, and there are elements of economic activity which either are included (spending on heating, for example) or not included (unpaid household work, but also environmental degradation) about which there are methodological doubts.

Moreover, being used for political purposes, this statistical measurement evolves constantly. In the future, GNI will reflect something different than today, i.e. for

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<sup>21</sup> Currently most Member States focus on *net* contributions, not *gross* contributions, in line with the Fontainebleau principle.

<sup>22</sup> One possible deviation could be related to countries where non-residents account for a high share of consumption, as e.g. in Luxembourg.

<sup>23</sup> Reflection in this area can be found on the following website: <http://www.beyond-gdp.eu>.

<sup>24</sup> See "Efficiency, stability and equity: a strategy for the evolution of the economic system of the European Community", Report of a study group appointed by the Commission of the European Communities and presided by T. Padoa-Schioppa, April 1987.

instance following the next national accounts reform. Political manipulations of the GNI cannot be excluded either. Constant monitoring from a GNI committee and a system that ensures that the amounts countries pay are adjusted following data revisions are safeguards, but major revisions of GNI, such as that for Greece in 2007, cannot be excluded.

More fundamentally, it is often argued that EU financing taking the form of contributions – such as a GNI-based contribution – contributed to widespread dissatisfaction expressed by most EU Council members, the EU Commission, the European Parliament, and many analysts about the outcome of the latest round of negotiations over the multiannual financial framework 2007-2013, leading to the call for a thorough budget review in 2008/9. The major problem lies in the linkage of decisions on expenditures and on their financing by national payments, which is made very explicit and immediate in the current funding scheme<sup>25</sup>. National administrations would still be able to calculate national (gross and net) contributions under some alternative schemes relying on genuine own resources; but the debates would likely be more in terms of the distribution of effective tax burdens on categories of taxpayers, which is more appropriate from a political accountability point of view, than in terms of distribution across national budgets.

This brief analysis highlights that, from a pure budgetary viewpoint, the GNI-based contribution is very effective. However, technical budgetary arguments are not all that matters when it comes to EU financing. The focus on (net) national contributions can only be exacerbated by GNI-based financing, thus calling for additional or reformed correction mechanisms (see below). And as a statistical measure GNI is not exempt from criticism.

To conclude on this option, it should be noted that an alternative would be to expand the VAT-based contribution instead of the GNI-based contribution and use this resource as the residual resource. However, the GNI-based resource is simpler to operate, does not entail a series of compensations, corrections, capping, differentiated call-rates and, ultimately, seemed preferred by most Member States as appears from past evolutions. Ultimately, if deemed politically realistic, this proposal would have the considerable merit of supporting a greater uniformity of the VAT base, which has been a stated Commission objective for many years.

### ***3.2. A more efficient financing system, contributing to the effectiveness of EU policies***

Promoting a better allocation of tax competencies and more economically efficient financing systems for the Union and the Member States could be deemed more important than the need for a simple and easy to administer or a more visible and transparent financing system. The budgetary criterion of sufficiency or stability of each individual resource would not be relevant to the same extent because a basket of resources could be envisaged.

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<sup>25</sup> See Begg, I., Enderlein, H., Le Cacheux, J. and M. Mrak (2008), "Financing of the European Union Budget", Study for the European Commission, Directorate general for Budget (contract N°30-CE-0122101/00-72, 29 April 2008.

In principle, "*the existence of regional arbitrariness<sup>26</sup> or the presence of cross-border externalities are strong arguments for harmonising tax bases and rates, which could also justify assigning all or part of the corresponding tax revenue to the EU level. This could contribute to reducing inefficient allocation of economic resources*"<sup>27</sup>. For instance, in case of mobile tax bases EU involvement could contribute to contain tax evasion and avoid race-to-the-bottom phenomenon. Moreover, shifting a part of pro-cyclical tax bases (e.g. corporate taxes) to the EU level could create a fiscal link between the Member State economies and, thus, serve as automatic stabiliser.

Following this approach, a resource would be attributed to the EU level only if this allowed for decreased costs in administration or a better allocation of resources in the EU, or if it contributed to achieving the policy objectives of the EU. In particular, it has been suggested that the Commission could intensify its efforts towards consolidating present own resources based on policies of exclusive Community competence (customs duties and agricultural levies) and towards exploring avenues capable of securing new ones (ECB seignorage revenue, kerosene tax,...).

The main possible candidates<sup>28</sup> for own resources under this approach are:

**(a) Energy taxation – motor fuel used for professional road transport.**

In the past decades, the Commission has put forward several proposals for directives in the field of CO<sub>2</sub> or energy taxation in order to facilitate the functioning of the Internal Market and to develop a more environmental- and employment-friendly taxation policy in the EU.

In practice, considering the content of the energy directive, the tax base for a new EU own resource could include motor fuel used for road transport, that is, a part only of energy sources covered by the directive, i.e. leaded and unleaded petrol, diesel, kerosene, LPG and natural gas used for transport. The EU tax rates, that is, the rates used for the own resource revenue collection, could be set at levels equivalent to the minimum rates defined in the directive or at different rates, depending on budgetary needs and other objectives attached to the EU tax. The Member States could be left free to impose national surcharges.

There would be a number of advantages related to energy taxation. First, revenue from energy taxes currently amounts to about twice EU expenditure, so this would potentially be a buoyant source of revenue. Second, many Member States currently maintain relatively low excise duties on fuel used in haulage due to the high mobility of this tax base. As a consequence, the negative externalities linked to road transport are not well reflected in prices (prices are lower than would be optimal from an efficiency point of view).

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<sup>26</sup> Regional arbitrariness refers to a situation where it is difficult to determine the exact share of a tax base to be allocated to individual Member States or where there is a high (potential) mismatch between the country collecting the tax and the country of residence of the economic agents bearing the burden of the tax.

<sup>27</sup> "Financing the European Union", Commission report on the operation of the own resources system, COM(2004)505 Vol. I of 14 July 2004.

<sup>28</sup> We have not included seignorage income in this analysis since the eurozone only comprises slightly more than half of the Member States.

Introducing an EU rate which could better reflect these externalities compared to the current minimum rate, could contribute to a better functioning internal market and help mitigating emissions related to road transport, notably via reduced "tank tourism"<sup>29</sup>. Furthermore, the basis for energy taxation has been regulated by an EU directive, but rates differ widely<sup>30</sup>, creating additional price distortions. Adopting an EU energy tax could offer an opportunity for imposing a more uniform rate of energy taxation, which would be more economically efficient than the current situation. However, ultimately these efficiency gains would only be possible if the total rates resulting from the EU rate combined with Member States surcharges are more harmonized than the current rates applied by the Member States. This is not obvious and it would probably require imposing a relatively high EU rate and, perhaps, some limits on the Member States surcharges<sup>31</sup>. Third, due to the raising importance of issues regarding energy, which is also reflected in the Lisbon treaty, increased EU involvement for energy taxation policy would seem justified: this solution would tie EU financing to a policy priority, global warming, that is currently viewed favourably by the public. The tax instrument could therefore also contribute to achieving EU objectives in the energy area. Last, an EU energy tax based on the current structure and (minimum) rates of excise duties for motor fuel used for road transport would be relatively straightforward to implement. It would be visible to the taxpayers and lead to enhanced EU financing autonomy.

An important disadvantage of energy taxation is that, contrarily to the broad-based options affecting a very large number of EU citizens in a somewhat diffuse manner, such a targeted option would have a particular impact on specific economic sectors or operators. On the other hand, it could be argued that motor fuel taxes are also sufficiently broad-based to affect almost every citizen. Moreover, an EU tax on energy use would by nature concentrate taxation on countries with higher energy intensity. This would tend to particularly hit the new Member States in relative terms. Moreover, when it comes to the political link between expenditure and revenues, given a number of precedents it can be questioned whether linking EU financing to EU energy policy objectives would really reinforce both. It is conceivable that the end result of such a linkage, politically, would be counterproductive. The same type of arguments can be applied to the following options as well.

## **(b) Revenue from auctioning of emission allowances**

Tradable permits related to greenhouse gas emissions are an important market-based instrument aimed at fighting against climate change. The EU Emission Trading System (ETS)<sup>32</sup> has been in operation since 2005 (1<sup>st</sup> trading period). Since 1

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<sup>29</sup> Tank tourism is about detours, when a truck drives more to fill up the tank where fuel taxes are the lowest.

<sup>30</sup> In 2005, energy tax revenue per ton of oil equivalent ranged from a minimum of €60 to a maximum of €21 in the Union.

<sup>31</sup> As an alternative to this rather hypothetical approach, the Commission has proposed a "Greening transport package" in July 2008.

See [http://ec.europa.eu/transport/strategies/2008\\_greening\\_transport\\_en.htm](http://ec.europa.eu/transport/strategies/2008_greening_transport_en.htm).

<sup>32</sup> Extended information on the EU ETS can be found on the following European Commission website: [http://ec.europa.eu/environment/climat/emission/index\\_en.htm](http://ec.europa.eu/environment/climat/emission/index_en.htm). For a US perspective, see also

January 2008 (2<sup>nd</sup> trading period) it applies to all EU Member States<sup>33</sup>. It currently covers over 10,000 installations in the energy and industrial sectors which are collectively responsible for close to 50% of the EU CO<sub>2</sub> emissions and 40% of its total greenhouse gas emissions. An amendment to the EU ETS Directive agreed in July 2008 will bring the aviation sector into the system from 2012. In December 2008 the European Council took important decisions on the 3<sup>rd</sup> trading period extending from 2013 to 2020, and beyond. In particular, there will be an annually declining emissions cap for the whole EU. A share of emission allowances will be auctioned (allowances not auctioned are distributed for free but can be traded). Rules will differ depending on the type of industry<sup>34</sup>.

It is usually assumed that revenues accruing from emission allowances auctioning would enter the Member States budgets, not the EU budget. However, it should be recalled that the European Council of 11-12 December 2008 took note of the willingness of Member States "*to use at least half of [the revenues generated from the allowances in the ETS] to reduce greenhouse gas emissions, mitigate and adapt to climate change, for measures to avoid deforestation, to develop renewable energies, energy efficiency as well as other technologies contributing to the transition to a safe and sustainable low-carbon economy...*". The current discussion on how the proceeds from auctioning should be used does not, at this stage, exclude the possibility that some form of EU climate-energy fund would be set up, if only to collect money from the EU and Member States budgets and redistribute it in the many funds or projects that are being set up in the context of a prospective post-Kyoto agreement. From a theoretical or technical point of view, there is not much of a way to go from there to the development of an own resource possibly earmarked for specific expenditures.

Allocating auctioning revenues of emission allowances to the EU budget could be justified for a number of reasons. First, the EU ETS is an EU scheme and relates closely to the *acquis*. Given the existence of an EU cluster in the international emission reduction efforts and the high level of externalities involved in CO<sub>2</sub> emissions, it could be argued that the EU should play a very important role in running the ETS and should thus also collect the revenue. Second, corresponding revenue is not a *tax* revenue. This could make it easier to sell politically. Third, the administration of the ETS is increasingly centralized, thus highlighting the administrative benefits of coordination for such a scheme. A centralized auctioning mechanism could likewise lead to economies of scale and lower operating costs for both administrations and operators.

These arguments have to be weighted against a number of other specific arguments. First, according to Begg et al. (2008)<sup>35</sup> there is no exclusive EU competence in this field, thus raising the question of an implicit shift of

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Ellerman, A.D. and P. L. Joskow (2008), "The European Union's Emissions Trading System in perspective", Pew Center on Global Climate Change, May 2008.

<sup>33</sup> It also applies to the other members of the European Economic Area, i.e. Norway, Iceland and Liechtenstein.

<sup>34</sup> For instance, 100% auctioning is the rule from 2013 onwards for electricity generators. However, Member States have the *option* to temporarily deviate from this rule with respect to existing power plants.

<sup>35</sup> *Op. cit.*

competencies to the EU level should this revenue be allocated to the EU budget. Second, the question of the long-term stability of such a revenue flow could also be raised. In the long term, the number of emission allowances to be auctioned will evolve as a result of the combined reduction of the total EU cap and the increased share of emissions subject to auctioning. At the same time, the price of allowances is expected to grow, at least for the foreseeable future. Overall, after a likely increase in revenue over the first decade, the trajectory of auctioning revenues appears more uncertain. However, the lack of predictability of revenues from auctioning does not constitute a convincing argument for rejecting it as a potential EU own resource: as long as the GNI-based resource exists, variations in proceeds would be compensated by variations of the GNI resource. Budgetary risks related to the emission auctioning would be borne by the Member States in any event, whether they fully receive the revenues from auctioning or whether they compensate revenues variations via the GNI-based resource. Third, it is sometimes argued that countries such as Poland would be important losers if the EU was financed partially via auctioning revenue rather than, say, the GNI-based resource – as the share of these countries in EU emissions is higher than their share in EU GNI. This problem would therefore call for some form of compensation. This is precisely what is already foreseen in the European Council conclusions of December 2008: 10% of total allowances will be allocated between certain Member States "*in the interest of solidarity and growth*". An additional 2% will benefit in practice to heavy emitters among the new Member States. The allocation system thus already contains an explicit equalization mechanism. Furthermore, assuming that auctioning revenues would be earmarked for expenditures on energy and climate, it would seem most likely that heavy emitters would benefit from a share of expenditures higher than their share of GNI. A redistribution of benefits would therefore also occur on the spending side. Lastly, the revenue from the ETS would be largely financed by specific sectors in society (energy, transport, etc.). While those sectors could certainly pass-on their costs to citizens, issues of equity and transparency would have to be discussed. Yet a key point is that as long as ETS is going ahead anyway, these issues will arise, in much the same way as the equity dimensions of TOR are secondary to the need for common trade instruments.

**(c) Charges on aviation**

The tax burden on aviation is currently limited. The legal framework of international aviation<sup>36</sup> foresees that fuel on board an aircraft on arrival in a State shall be exempt from customs duty, inspection fees or similar national or local duties or charges. Furthermore, bilateral air service agreements typically include a mutual agreement not to tax aviation fuel. In the EU, however, there is now no direct legal impediment to the taxation, by mutual agreement, of aviation fuels used on flights between EU Member States. Charges such as departure taxes or air passenger duties have been developed by a number of Member States, e.g. France, the Netherlands and the United Kingdom, in recent years. Furthermore, in order to mitigate - to some degree<sup>37</sup> - the

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<sup>36</sup> See Article 24 of the 1944 Convention on International Civil Aviation (the Chicago Convention).

<sup>37</sup> EU ETS covers only carbon dioxide (CO<sub>2</sub>) emissions leaving aside other components characteristic for aviation such as NO<sub>x</sub>, water vapour emitted at high altitude and sulphate and soot particles.

contribution of aviation to climate change<sup>38</sup>, aviation will be included in the EU ETS from 2012.

Despite the inclusion of aviation in the EU ETS, it could be argued that there remain important justifications for taxing this sector. Furthermore, it should be recalled that aviation is the most transnational mode of transport, therefore justifying action at regional (i.e. EU) or even international level. Since aviation is predominantly an activity that takes place and has effects across and beyond the frontiers of individual countries, there would be a strong intuitive logic in the idea of allocating revenues from an aviation-related charge to the EU level. According to M. Keen and J. Strand (2006)<sup>39</sup>, the central arguments in favour of enhanced taxation of aviation, especially international aviation, are easily stated. *"Such taxes are currently low. Yet aviation causes significant border-crossing environmental damage, including air pollution (to a large extent on the macro, regional, or global scale) and noise (largely on the micro scale, depending on the location of airports). There may also be a case for a corrective tax on aviation to address greenhouse effects—emissions related to international aviation are, notably, excluded from the [Kyoto Protocol]. Even apart from border-crossing environmental harm, however, taxes on international aviation may be inefficiently low as a result of tax competition, with countries independently choosing to set taxes lower than they would if they behaved in concert, so as to avoid jeopardizing domestic carriers and/or tourist sectors"*. In the EU context, it could furthermore be argued that there is currently a form of distortion of competition between aviation, which is almost exempt from taxation, and other modes of transportation, which are taxed. Therefore, introducing aviation taxation could contribute to a better functioning of the Internal market. Moreover, aviation taxation is sometimes argued on the ground that EU Open skies policy has brought important benefits to the aviation industry. The latter also benefits from important support in the context of EU policies, for instance related to research<sup>40</sup>. It could, in this line of reasoning, therefore also contribute to the financing of EU policies.

Important issues need to be considered. First, legal barriers to develop taxation are numerous and, at best, could limit the choice of options available. Second, in the EU context, it may seem inappropriate to raise such a possibility even before aviation fully participates in the EU ETS. The mere fact that aviation will be part of the scheme also weakens one of the main arguments (i.e. the fight against climate change) for taxing aviation. Another objection is that duties related to aviation penalise geographically more remote areas and are

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<sup>38</sup> Aviation is currently responsible for 3% of the world's GHG emissions and this is expected to rise as air traffic doubles by 2020. This figure does not include indirect warming effects, such as those from nitrogen oxide (NOx) emissions, contrails and cirrus cloud effects. The overall impact – according to the Intergovernmental Panel on Climate Change - is therefore about 2 to 4 times higher with cirrus clouds effect included. While the EU's total greenhouse gas emissions fell by 5.7% from 1990 to 2005, emissions from civil aviation increased by almost 79%. Source: "EU energy and transport in figures. Statistical pocketbook 2007/2008", p. 186.

<sup>39</sup> Keen, M. and J. Strand (2006), "Indirect Taxes on International Aviation", International Monetary Fund, Working Paper, WP/06/124.

<sup>40</sup> The "Clean Sky Joint Technology Initiative" aims at halving noise, fuel consumption and carbon dioxide emissions, as well as slashing nitrogen oxide emissions by 80%. It amounts to €1.6 billion.

inadequately related to ability to pay. The tourism sector could be particularly hit in some Member States, e.g. Malta, Cyprus, Spain or Greece. Larger countries with a substantial number of internal flights may also be opposed to EU initiatives to tax aviation. Lastly, an aviation tax would likely bring relatively limited revenues and contribute to only a modest part of the total EU budget. On the other hand, the existing schemes for charging the aviation industry for traffic management fees and other similar charges could be easily expanded to take into account possible tax requirements. Therefore the introduction of a tax related to aviation may not entail significant additional administrative cost and it could be particularly cost efficient.

**(d) EU corporate income taxation (EUCIT)**

The existence of 27 separate national tax systems imposes very high compliance costs both on companies operating across borders in the EU and on national tax administrations<sup>41</sup>. Furthermore, EU companies face many obstacles to their cross-border activities as a result of the current lack of coordination among the various corporation tax systems operated in the EU. These include the lack of cross-border loss-offset and the risk of double taxation or/and over-taxation as a result of conflicting rights between taxing jurisdictions. To tackle these problems the Commission has been advocating for years that transnational companies should be able to use one single tax base for their EU-wide activities. The Commission has gone a long way in the preparation of a legislative proposal bearing on a Common Consolidated Corporate Tax Base (CCCTB), which could be used on an optional basis by transnational companies operating in the EU<sup>42</sup>.

Besides, Commission analyses also demonstrated that differences of tax rates among the Member States are the prime factor in explaining diverging effective tax rates – and the related tax distortions in the Internal market<sup>43</sup>. Therefore, it is sometimes suggested that a harmonization of tax bases *and* tax rates would be preferable from an economic (allocative) efficiency viewpoint compared to a tax base harmonization only. Hence, it has been argued that setting up an EU corporate income tax (EUCIT) with harmonised bases and rates would bring important benefits for the European Union. Furthermore, it has also been argued that since companies are among the prime beneficiaries of EU integration and due to the cross-border nature of their activities, an EU corporate income tax as a means of financing the EU budget would be justified<sup>44</sup>. And an important advantage of using EUCIT would be that it could

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<sup>41</sup> European Commission, DG Taxation and Customs Union (2004), "European Tax Survey", SEC(2004)1128/2 of 10 september 2004.

<sup>42</sup> In September 2004 Ministers of Finance agreed at an informal ECOFIN-Council that the discussions on the development of a CCCTB should progress in a Commission Working Group (the CCCTB WG). This WG was set up in November 2004 and held quarterly meetings until April 2008. See [http://ec.europa.eu/taxation\\_customs/taxation/company\\_tax/common\\_tax\\_base/index\\_en.htm](http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm).

<sup>43</sup> European Commission, DG Taxation and Customs Union (2001), Company taxation in the internal market, Commission staff working paper, COM(2001)582 final.

<sup>44</sup> From an economic point of view, this is debatable as what matters is the incidence of the tax. But the argument has nevertheless played a role in political debates.

bring about important revenues<sup>45</sup>. However, its susceptibility to the business cycle would require keeping a robust system for smoothing out the revenue cycle such as the residual GNI-based resource.

Beyond these fairly general considerations, the analysis of the pros and cons of EUCIT would depend on the specificities of the system put in place and, in particular, the scope of the tax and the degree of harmonisation achieved<sup>46</sup>.

- Regarding the scope of the tax, an important question would be whether the tax would apply only to multinational enterprises (MNEs) or to all companies. In the first case, there would be level-playing field concerns as companies would pay different taxes on the same territory depending on whether they are MNEs or not. On the other hand, if the system was applied to all companies, the vast majority of which are SMEs active only in one Member State, one could argue that the measure was disproportionate in view of the objectives pursued (a limitation of costs related to cross-border activities and more allocative efficiency in the EU Internal market). Furthermore, the justification that the companies are the main beneficiaries of the Internal market and should therefore contribute to the EU budget would appear unconvincing.
- The degree of harmonisation entailed by EUCIT would be another critical issue. If a “split-system”<sup>47</sup> was put in place, Member States would be free to set their preferred tax rates on top of the EU rate. In this case, harmonisation of rates could end up being very limited, as today, and so would the efficiency gains related to EUCIT. On the other hand, if the system was fully harmonised (tax base *and* tax rates), it is likely that revenues collected would largely exceed the revenues necessary to finance the (current) EU Budget. A system to redistribute a part of the revenue would need to be developed.

Overall, whereas EUCIT could in theory ensure a more efficient allocation of investments in the internal market, this would only be the case provided that the scheme ensured an approximation of the effective rates of taxation, i.e. this would likely exclude a split system. At the same time, the global impact of EUCIT on compliance costs for companies is unknown. In all likelihood, it would be more favourable if a tax base harmonisation also entailed a consolidation of accounts. From a political economy viewpoint, besides the general objections to an EU tax, with a EUCIT corporations would be put

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<sup>45</sup> Corporate income tax revenues amounted to 3.0% of GDP (weighted average, EU27) in 2006. Source: European Commission (2008), "Taxation trends in the European Union. Data for the EU Member States and Norway", Eurostat statistical books, OPOCE, Luxembourg.

<sup>46</sup> A considerable amount of research has been developed in the last years to analyse both the technical options for a common tax base and its economic effects. Although these researches mainly bear on the CCCTB, they can also shed light on possible issues linked to a EUCIT. See Agúndez-García, A. (2006), "The Delineation and Apportionment of an EU Consolidated Tax Base for Multi-jurisdictional Corporate Income Taxation: a Review of Issues and Options", Taxation Paper N° 9 for a review of the literature.

<sup>47</sup> In a split system, a small percentage (ie the EU tax rate) of the common tax base of all EU companies would go to financing the EU budget and the rest of the revenue collected would accrue to the Member States.

under a strong incentive to lobby for limitations to EU spending, as any expenditure reduction would result in immediate and significant cuts to the CIT rate. For example, independently of the fact that the tax burden on corporations would not change with the reform, as the EU tax would replace equivalent national taxation, opposition to, say, the Common Agricultural Policy might intensify as the business community may resent being taxed to support agriculture.

A EUCIT proposal would likely encounter considerable opposition due to marked national differences and diverging preferences in the area of corporate taxation. This is well illustrated by the difficult progress towards a CCCTB<sup>48</sup>. Given stiff opposition in a few Member States to this project, current thinking envisages adopting a flexible approach on the CCCTB, whereas a link with EU financing would require a high degree of harmonization. Therefore, linking these two issues could create more harm than good. A great number of technical and political issues could thus be expected on the way to setting up an EU corporate income tax. This explains why the Commission considered in 2004 that "*a fiscal resource based on corporate income is to be seen as a much longer-term option*" than an option based on VAT or energy consumption. In fact, the extent of problems is such that it is hard to imagine a unified corporate income taxation regime applicable to all multinational companies across the Union without significant political changes. These could require a treaty reform and a more extended shift of tax sovereignty towards the Union – a radical move which does not appear necessary with the other options considered here.

The above analysis of four options motivated by efficiency considerations highlights that there are strong economic arguments to levy a tax or charge at EU rather than at Member State level. These options all bear on cross-border activities and relate closely to EU policies involving important externalities. Due to the cross-border nature of the related tax bases the specific "contribution" of each Member State to the common EU revenue would be difficult to determine. Hence, debates related to fairness could in theory partly shift to other issues such as the incidence of the tax and its role in achieving EU policy goals. However, any EU tax would always be levied by the Member States and the corresponding revenues transferred to the EU budget. So long as the Member States have a precise notion of the revenue collected on their territory, this amount will tend to be seen as a "contribution". Furthermore, would the Member States really be likely to pay less interest to the geographical distribution of spending, just because the financing would come from, say, a tax on EU companies rather than a GNI contribution? This seems doubtful; a discussion on the expenditure side will likely always take place and will keep having the nature of a zero-sum game. As Member States would no doubt be aware of the geographical origin of the revenue, the discussion - and the acrimony - would simply focus on the incidence of the tax. This, however, could be seen as a crucial – and favourable – element of a reform.

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<sup>48</sup> It should also be recalled that, for the same reason, the Commission always refused to propose tax rate harmonization for corporate taxation.

### 3.3 *A more transparent system bringing citizens closer to the Union*

If one wants to create a direct link between the citizen and the Union and to make the citizen aware of the cost of Europe in a transparent<sup>49</sup> and simpler system, the EU budget must be financed with one single, wide-based, resource. A "cocktail" of European taxes and other resources to replace the present mix of resources consisting mainly of national contributions would not fully achieve these goals.

In this respect, the only way to maintain simplicity while spreading the burden equitably would be to adopt a tax with a very wide base, such as the personal income tax or the VAT, two options we examine in turn:

#### (a) **A genuine EU VAT**

Instead of using a notional or statistical VAT-based contribution, one could envisage using a share of the Member States ("genuine") VAT to finance the EU budget. This option has been frequently advocated, notably by the European Parliament. The Langes Report as early as 1994 suggested that "a proportion of a largely harmonised VAT, imposed on the basis of tax declarations and clearly denoted on each individual invoice as EU taxation" could be envisaged.

An EU rate of 2% would for example suffice to raise sufficient revenues to cover the entire EU budget<sup>50</sup>. An advantage of the EU VAT is that fiscal neutrality for citizens could easily - and visibly - be assured through an equivalent reduction of the national rate. Past work of the Commission has highlighted that a genuine EU VAT could be introduced following a short technical preparation.

The main drawback of this option relate to potentially difficult discussions on the degree of harmonization required prior to introducing the new scheme. A full harmonization of all rules and practices regarding VAT in the EU would create specific political and administrative problems, in particular as taxing zero-rated goods would entail that in some Member States whole economic sectors move from *de facto* exemption to taxation. An alternative would be to introduce an EU modulated VAT, which does not presuppose prior VAT harmonization. Several EU VAT rates could be applied, with a modulation depending on the type of goods taxed. In order to facilitate the implementation of the system and to respect the preference of Member States, zero-rated goods would be exempted from both national and EU taxation; goods subject to parking rates, super-reduced rates and reduced rates could be subject to a reduced EU rate, e.g. 1%; all the goods subject to standard rates would be subject to a higher EU rate, e.g. 2%. However, such a system creates a

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<sup>49</sup> The need for more transparency of the EU budget also calls for measures ensuring the visibility of the benefits brought by the budget. This issue is beyond the scope of this note but could intervene in the context of the budget review.

<sup>50</sup> There could also be several EU VAT rates, for example a 1.0% rate for the basic necessities corresponding to so-called reduced rates in the Member States, a 2.0% rate for goods and services taxed with the normal rates in the Member States. Zero-rated goods could fall outside the scope of the EU VAT, which would be consistent with a respect of national specificities in tax matters

problem of horizontal equity (not all EU taxpayers are faced with the same VAT on the same goods).

It should be noted that VAT, as suggested by surveys and anecdotal evidence, has proven unpopular with Finance Ministries because of its regressive impacts. Furthermore, some Member States with comparable GNIs per capita display very different VAT bases. In other words, with comparable levels of GNI per capita, some Member States would clearly contribute more than others. And overall, there is a slight negative relationship between revenues from a modulated VAT and GNI per capita. These issues cannot be fully solved by modifying the structure of EU VAT rates alone: they call for a specific response, either in the form of a reform of expenditures or some form of formula-based equalization or compensation mechanism.

#### **(b) EU Personal Income Tax**

Studies<sup>51</sup> have identified two main options, either an EU surcharge on national PIT or a specific EU tax. An EU PIT would undoubtedly be very visible and most likely to create a link between the citizens and the EU.

However, these options present substantial technical difficulties and, politically, seem to be out of the question. If an EU surcharge was established, the main problems would be the differences in Member States tax bases, which would require a specific surcharge for each country. A specific EU PIT would lead to considerable compliance and administrative costs since presumably citizens would have to complete two tax returns, such as happens in Quebec and in various parts of the US. For these reasons, EU PIT is not examined further in this paper.

This analysis highlights that a genuine EU VAT could be set up relatively quickly and it could also improve substantially the visibility of EU financing. Whether such a visibility is desirable and would lead to changes in EU budget matters is a political question beyond the scope of this analysis.

A drawback of this option (and most others) would relate to fairness in *gross* contributions. The fact that the Member States Treasuries would collect the tax on behalf of the Union would lead to detailed scrutiny of the Member States' "contributions" to the budget. This could call for some form of rebalancing element in the overall reform of the budget (see section 4.3).

#### **4. Main options to reform the correction mechanisms**

*"Since the UK started in the 1970s to object to what it saw as (and what was ultimately recognised to be) an unfair burden towards the EU budget, the notion of juste retour has come to dominate the strategic settlement of the financial perspectives. Juste retour is essentially about net contributions. This, in turn, is the result of both deliberate choices about policies such as cohesion that call for net*

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<sup>51</sup> See for instance Cattoir, Ph. (2004), *op. cit.*

*fiscal transfers, as well as the incidence of other policies on gross receipts and the funding instruments on gross payments*<sup>52</sup>.

Several, sometimes complementary, approaches have been considered to solve the issue of *juste retour* and the associated correction mechanisms:

- Solving the root cause of the perceived net imbalances through an in-depth reform of expenditures;
- Reforming radically the own resources system, in order to shift the focus from net contributions to the incidence of the resource on taxpayers;
- Introducing a formula-based equalization mechanism as a way to solve some imbalances and focusing on European solidarity rather than net contributions;
- Simplifying and streamlining the current corrections bazaar. This could be done by introducing a generalised correction mechanism (GCM) or its variant, a generalised limited correction mechanism (GLCM), limiting net transfers for all the net contributors, or by defining ex ante contributions and expenditures targets based on GNI.

We examine and discuss these approaches in turn.

#### **4.1. Solving the root cause – adjusting expenditures**

If the formulae for funding the budget using the existing four own resources had been applied without any corrections, the *gross*, ex-ante contributions of Member States would have been roughly proportional to GNI. Based on this observation, it is often argued that existing corrections to the financing of the EU budget are not primarily intended to address inequities in the financing system. Their root cause would lie in a lack of political consensus on the overall composition of EU budgetary expenditure, causing Member States to call into question the size of their contribution. In the framework of reaching a genuine political consensus on the content and structure of EU budgetary expenditure, the elimination of corrections can be examined and should even be considered an essential element of reform.

A central question, which is not examined in much detail in this note on EU financing, is whether it would be possible to reach a new European consensus on the structure of expenditures. This in turn, could require agreeing on what are the genuine EU public goods – that is, public goods which offer benefits to the entire EU independently of where the money ultimately ends up. In this respect, it is interesting to note that, in the calculation of the UK net rebate, only two elements of the EU budget are not taken into account: the traditional own resources and expenditure related to the EU external action. The other revenues and expenditures are therefore somehow considered as the source of (unwanted) net transfers requiring a correction (UK correction and rebates on the rebate). This includes, for instance, expenditures related to the EU administration, which are not seen as a common public good but rather as expenditures to the benefit of, mainly, Belgium and Luxembourg. However, in the

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<sup>52</sup> See Begg *et al.* (2008), *op. cit.*

own resources Decision 2007, a political factor that applied to the amendment of the UK correction for the 2007-13 Multiannual Financial Framework was that all non-agricultural expenditure in the recently acceded Member States was left out of the formula.

The apparent incapacity of Member States to identify EU public goods is further compounded by the fact that net beneficiaries of specific policies are unlikely to acknowledge the fact that these policies may be of limited interest for the EU as a whole compared to other policies. Path dependency is crucial here.

Instead of defining from scratch what are "genuine" EU public goods and other areas of expenditure, it has been suggested to vary the rate at which EU policies are financed by the Community budget as opposed to the national budgets, given that co-financing is a feature of many EU expenditure programmes. Varied co-financing rates are already applied for cohesion expenditure and could be envisaged for other policies, especially the CAP. Co-financing would be seen as a way to re-nationalize some policies for which net financial transfers are considered excessive. This, however, may end up not having much of an impact on net balances, while it would most likely put into question the relevance of such policies at EU level.

Overall, past experience suggests that reforms in the expenditure structure occur in small steps. It is possible to envisage shifts towards more consensual expenditures, widely considered as EU public goods, and a partial re-nationalization of some policies. But it is unlikely that a unanimous agreement would ever be found by the Member States on a set of expenditures considered as pure EU public goods, without discussion on the ultimate "*retour*" of policies. Hence the calls for a reform of correction mechanisms, the introduction of an equalization mechanism, or the reform of EU own resources, as complements to a reform of expenditures.

In this context it is important to keep in mind that there is a strong political link between the CAP and the UK correction as illustrated in the above-referred Declaration 3 to the Interinstitutional Agreement. A reform of one of these will be intrinsically linked to a reform of the other. In particular, one may wonder whether a fundamental CAP reform would be sufficient to eliminate the UK correction and the related rebates. From a purely budgetary point of view, it is clear that the parallel elimination of CAP and the UK correction could lead to a financial loss for the UK. The UK may therefore set additional demands before accepting the elimination of its correction.

#### **4.2. *Reforming radically the own resources system***

It is often suggested that transforming radically the structure of the own resource system, away from Member States contributions, could reduce the current focus on net balances. In particular, "*in a tax-based system, the requirement of inter-country equity would take second seat behind the criterion of inter-personal equity. Having said this, most scholars agree that inter-country fairness will never be totally*

*disregarded, as an EU tax creating unwarranted inter-country differences in the number of taxpayers and/or level of revenues will not be politically acceptable*"<sup>53</sup>.

However, not all options considered for a reform of the own resources system would have the same impact on the *juste retour* debate.

- Some possible alternative resources, such as aviation or maritime transport charges, corporate income taxation (on transnational companies), excise duties on motor fuel for (professional) road transport are characterised by a high degree of regional arbitrariness. This means that it is difficult to know where the tax base arises. When the tax exists, governments sometimes have to devise complex tax base-sharing mechanisms. This is the case, most notably, for corporate income taxation. In other cases, such as for aviation taxation, the cross-border nature of the activity to tax is such that taxing the activity unilaterally at national level is very difficult<sup>54</sup>. In these cases, which are treated in section 3.2 above, EU intervention could be justified on efficiency grounds and would, in addition, blur the debate on *juste retour*.
- On the other hand, highly visible taxes, such as a shared VAT (see section 3.3) would not have the same impact as the origin of the tax basis is well identified. Debates on net contributions would not change much with this resource compared to the current system.

In any event, introducing a new system of own resources could call for some form of equalization system related to the "tax effort" borne by the Member States' taxpayers (see next section).

#### **4.3. A formula-based adjustment – equalization mechanisms**

Instead of developing further correction mechanisms, an alternative to reduce imbalances between Member States could be to use some form of equalization mechanism. Equalization mechanisms are financial mechanisms featured in most Member States<sup>55</sup>. They permit financial transfer to political entities – for instance regions or local authorities –, which suffer from relatively low financial capacities or from excessive costs in the provision of public goods and services. Introducing such an equalization mechanism, calculated on the basis of objective variables, such as relative GNI or VAT per capita, could contribute to fairness between the Member States. It should also be noted that an equalization mechanism can be organized either on the revenue or the expenditure side of the budget, which could introduce an additional margin for manoeuvre on the way to a budget reform. In effect, corrections and equalization payments can, to a considerable degree, be considered to be two sides of the same coin: they aim at avoiding some forms of imbalances and rely on formulae – but there is one key difference: equalization mechanisms do not rely on an

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<sup>53</sup> Rubio, E. (2008), "The case for a European tax: benefits, practical aspects and options for endowing the EU with a veritable own resource", *Notre Europe*, January 2008.

<sup>54</sup> *In casu*, the complexity is compounded by the Chicago convention, which limits possibilities to introduce taxes related to aviation.

<sup>55</sup> For instance, the German Grundgesetz indicates that a "law shall ensure a reasonable equalisation of the disparate financial capacities of the Länder, with due regard for the financial capacities and needs of municipalities".

accounting approach (of net balances) and a notion of *juste retour*, but rather on relative fiscal capacities or needs.

Two main options for an equalization mechanism seem possible in the EU budget context.

- An equalization mechanism based on relative GNI. Such a mechanism would ensure a financial benefit to Member States with a lower per capita GNI than the average.

One could introduce an element of progressivity in gross payments on the revenue side, rather than proportionality as at present. It is sometimes argued that building in a degree of overt equalization into the revenue side of the budget would be a means of legitimating imbalances and thus weakening the case for a correction. As indicated in section 3.1, progressivity could be on a banding system or could be a smoother curve that gradually increases the rate up to a maximum level as proposed in the Padoa-Schioppa report (1987). One major drawback of such proposal is that, seen from a net contributor's perspective, the net balances issue would be aggravated rather than mitigated, *ceteris paribus*.

An alternative, proposed by S. Richter, would be possible to solve the net balance issue without using a net balances-based formula<sup>56</sup>. This could be done by agreeing at the start of Multiannual Financial Framework (MFF) negotiations that each Member State would pay an equal share of its GNI to the EU budget, e.g. 1%. Each Member State would then benefit from expenditures on its territory equivalent to the same percentage, e.g. 1%, of the average EU GNI per capita multiplied by its population. This would ensure a balanced budget, and an automatic redistribution between the Member States in line with their economic development<sup>57</sup>. The Member State would be left free to decide in which areas of EU policy, e.g. CAP, cohesion policy or R&D, the pre-allocated EU funds would then be spent. Although this approach proposes a simple way to organise – and set clear limits to – financial solidarity between Member States, it also presents important drawbacks. In particular, since each Member State would be able to choose its own 'menu' of EU spending on its territory, pressure to simply re-nationalise these policies may increase.

Another approach would focus on the expenditure side, where (a part) of the cohesion policy would be reformed to make it a more explicit, formula-based, equalization mechanism. Although, cohesion policy was set-up primarily as a crucial element of the Single European Act/ Delors I package deal<sup>58</sup> and it helped some countries on the path towards a monetary union, in practice it can

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<sup>56</sup> Richter, S. (2008), "Facing the monster 'fair return'. On the net financial position of Member States vis-à-vis the EU budget and a proposal for reform", Wiener Institut für Internationale Wirtschaftsvergleiche (WIIW), Vienna, February 2008.

<sup>57</sup> The net contribution to the budget would be the difference of GNI per capita between the Member State and the EU average multiplied by the Member States' population.

<sup>58</sup> whereby some countries would benefit from financial transfers and, in return, would open their markets to foreign, more competitive, goods.

be argued that at least a part of cohesion policy is already an equalization mechanism. Indeed, the eligibility criteria for most cohesion instruments are clearly based on relative economic affluence or needs and cohesion policy focuses on States or regions (not individuals or companies) as actors of economic and social development. There is also a clear link between the relative Member State and regional prosperity and financial transfers in the context of cohesion policy. Thinking beyond 2013, the historical arguments for cohesion policy could leave room for a new approach centred on equalization. Transfers to Member States could be based on a formula, which could limit some of the current perceived imbalances in the EU Budget. However, the political feasibility of inter-governmental lump-sum grants appears rather limited for the time being.

- An equalization mechanism based on relative tax capacity. Such a mechanism would ensure a financial benefit to Member States with a lower per capita revenue than the average for a specific own resource used for the budget.

It should be seen as a response to a widely spread concern that a partial replacement of the GNI-based resource by taxes or other resources such as revenues from ETS auctioning could potentially lead to problems of fairness, especially with respect to relatively poorer countries. If this is the case, a certain correction of Member States' contributions might be politically desirable.

Indeed, the various proposals for alternative own resources would lead to imbalances in *gross* contributions to the EU budget. Some Member States with fairly comparable GNIs would end up with marked differences in their share of own resource transferred to the EU budget, *ceteris paribus*. Although it is the *net* contributions that ultimately matter for the Member States, it is likely that significant imbalances of *gross* contributions would generate opposition to financing reforms if they were not accompanied by some form of equalizing mechanism or a reform on the expenditure side. However, as indicated above this argument appears less relevant for options involving resources characterized by a high degree of regional arbitrariness or if the EU would directly collect the revenues.

In order to organize such a mechanism one would either need to adjust a residual GNI resource by taking into account the difference in *gross* contributions related to the (new) own resource(s). However, the new financial system would appear at least as complex as now. A more radical approach would consist in eliminating both the current VAT- and GNI-based resources, replacing them by a genuine own resource and ensure a small budget surplus to be redistributed to the Member States in the context of the equalization mechanism. This would be particularly relevant for options related to VAT and energy taxation.

Introducing an explicit notion of equalization in the EU budget could play a useful role in shifting the attention from the issue of *juste retour* and net contributions to one of European solidarity. This would permit the shift from a financing system based on Member States' contributions and corrections to a system based on a 'genuine' own

resource complemented by a mechanism ensuring fairness between the Member States. An equalization mechanism could be a necessary complement to a substantial reform of the structure of EU financing. This would also be in line with experience in countries such as Germany, where equalization goes hand in hand with the organisation of shared taxes<sup>59</sup>. In addition, one should not overlook possibilities of reform of cohesion policy that could arise from the introduction of an explicit equalization mechanism related to relative GNI or needs. Although this issue mainly concerns the expenditure side of the budget, one cannot ignore the potential impact on the *juste retour* debate and the corrections on the financing side.

#### **4.4. Extending and reforming the UK correction – a generalised correction mechanism**

The existence of correction mechanisms could be seen as an unavoidable feature of a budget where the interplay of expenditures and revenues will always lead to some form of imbalances in Member States net positions. Hence, the argument goes, instead of trying to get rid of correction mechanisms, one should at least seek to avoid some of the negative side effects of ad hoc correction mechanisms and promote a level playing field among the Member States.

One way of doing so is by replacing the current corrections and rebates of all kinds by a generalised correction mechanism (GCM)<sup>60</sup> or its variant, a generalised limited correction mechanism (GLCM). These mechanisms would be applicable in the same way to all Member States. They would avoid a situation where Member States with comparable levels of *GNI* end up paying significantly different net contributions to the EU budget. The simplification of the current system would also lead to a more transparent budget.

Three main elements need to be taken into account in any generalised correction mechanism:

- The expenditures and revenues included in the calculation of net balances. In its 2004 proposal to create a GCM, the Commission suggested keeping the rather broad concept used for the calculation of UK net balances. However, several recent researches suggested using a less extended concept when calculating net balances, thus leading to a generalised *limited* correction mechanism. It has notably been suggested to create two baskets of expenditures, one of which would correspond to policies whose distributive effects are either not measurable or are politically accepted (e.g. external policies) and the other to policies whose distributive effects are not regarded as acceptable (e.g. policies such as CAP which produce substantial distributive effects)<sup>61</sup>. An alternative distinction could be made between "*European public*

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<sup>59</sup> Assuming that some form of tax-based financing would be created, for instance a shared VAT between the Member States and the EU, transfers would be organised between Member States with high tax capacity (e.g. relatively large VAT per capita) and those with a lower tax capacity ("German model"). A more complex mechanism could take into account several tax bases, looking in particular at differences of Member States situation compared to a "representative" country or group of countries ("Canadian model").

<sup>60</sup> Such a system has been proposed in "Financing the European Union", Commission report on the operation of the own resources system, COM(2004)505 Vol. I and II of 14 July 2004.

<sup>61</sup> Reform Options for the EU Own Resource System, ZEW, Mannheim 4.12.2007, p.131-133.

*goods*", whose benefits cannot be attributed to one single Member State (such as administrative expenditure, expenditure aimed at external relations or the Solidarity fund), and "*expenditure with localised benefits*"<sup>62</sup>.

- Once net balances are calculated, several parameters need to be defined to calculate the rebate for Member States. These include (i) the threshold above which the rebate would be applicable, i.e. whether there should be some incompressible element of solidarity through the EU budget; (ii) the percentage rebate on net contributions<sup>63</sup>; (iii) the ceiling above which a 100% rebate would be applied, i.e. whether there should be an absolute maximum level of financial solidarity through the EU budget; (iv) possibly, the overall cap on the total correction. In 2004, the Commission made very specific proposals for all these aspects.
- Another issue is whether a generalised correction mechanism should be defined *ex ante* or *ex post*<sup>64</sup>. In theory, defining the extent of redistribution between net contributors and net beneficiaries *ex ante*, that is, before the structure of policies is defined, could facilitate a reform<sup>65</sup>. Indeed, any "*expenditure with localised benefits*" would be ultimately compensated through the correction mechanism. The Member States would then have a much stronger incentive to focus on the content and EU added value of policies rather than the local "return" of these policies. In practice<sup>66</sup>, the Member States would need to agree exclusively on the extent of redistribution, in absolute terms, between net receiver and net contributor countries, and as a consequence, on the 'target net financial positions' of every Member State. In a second phase, Member States would need to agree on (i) individual policies which would be financed from the budget, which would sum up to the overall size of the EU budget, (ii) sources of financing, and (iii) the '*spontaneous net financial positions*' of individual Member States. In a third and final phase of the process, the '*spontaneous net financial positions*' of individual Member States, determined in the second phase, would be brought in line with the 'target net financial positions', agreed in the first phase, through a fiscal transfer mechanism.

A major drawback of generalised correction mechanisms is that every single parameter entering into the correction calculation would give rise to important arguments. For instance, a GLCM would require defining two baskets of expenditures: those that would give rise to corrections and the others. In practice, this could lead to endless discussions on which expenditures to include in each basket. Since almost any type of expenditure can ultimately prove more favourable to one Member State than others, the former basket might well cover all the EU internal

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<sup>62</sup> *EU Budget Review: An Opportunity for a Thorough Reform or Minor Adjustments?* Executive Summary of the Final Report of the Slovenian EU Budget Reform Taskforce, coordinator Mojmir Mrak, October 2007.

<sup>63</sup> This could also include an element of progressivity or regressivity.

<sup>64</sup> The GCM proposed by the Commission in 2004 proposed an *ex post* approach.

<sup>65</sup> See De la Fuente, A. and Domenech, R. (2001), '*The Redistributive Effects of the EU Budget: An Analysis and Proposal for Reform*', *Journal of Common Market Studies*, Vol. 39, No. 2, pp. 307-330.

<sup>66</sup> According to the Slovenian Task force on EU budget reform.

policies. Ultimately, a coalition of net contributors would likely arise to limit the global net transfers organised through the EU budget.

In addition, the generalised correction mechanisms rely on a formula based on a calculation of net balances. Once in place, such a mechanism would likely render the issue of net balances even more prominent than is currently the case. All countries would have an immediate, directly measurable, and opposite interest in the terms used for the mechanism. This is why this concept has been opposed, notably, by the European Parliament in the Lamassoure resolution of 29 March 2007. The Parliament "*is convinced... that generalising the rebate even when accompanying it by a ceiling for the net budgetary balances would be a double mistake since it would only strengthen the anti-communitarian character of the system and cement the short-sighted approach of a quantifiable 'juste retour'; [it] insists that the only possible solution is the abolition of the net balances system once and for all in parallel with a reform of the pattern of expenditure...*".

Moreover, it should also be stressed that using a system based on (*ex post*) net balances, such as the UK correction or the GCM proposed by the Commission in 2004, can affect the spending behaviour of Member States, compared to a system based on *ex ante* redistribution decisions, such as the lower VAT call rates for AT, DE and NL or the lump sum for the NL and SE in the own resource Decision of 2007. Once net balances are based on effective spending, the net return from any spending made on a Member State territory is lower than the gross return. For instance, two-third of EU spending in the UK is indirectly financed by the UK through (a reduction in) its rebate. This reduces the incentive for this country to spend EU funds<sup>67</sup>. It would not be the case had the UK benefited from lump sum compensations. Extending the UK system to all Member States could well have a marked global impact on EU expenditures.

There are several other criticisms of the generalised correction mechanism. In particular, the GCM tackles only excessive deficits but not excessive surpluses. It does not take into account the relative prosperity of net contributors (as measured, for instance, by their GNI per capita). As a result, the contribution of a GCM to fairness would be quite limited as it would mitigate (but not eliminate) differences of treatment across Member States only at one tail of the income distribution. Its effect on incentives would be reduced by its limited applicability to a small subset of Member States, by the capping mechanism and by the threshold and partial rebate features<sup>68</sup>.

This analysis of reformed correction mechanisms suggests that the current system of ad hoc corrections could be simplified and made more transparent by introducing a generalised correction mechanism. However, it is equally clear that using a formula based on net balance calculations would enshrine a bit more the "*poisonous*"<sup>69</sup> logic of *juste retour* into the EU budget negotiations. Should a generalised correction mechanism be put in place, it would in any event be advisable to define *ex ante* the

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<sup>67</sup> This issue was raised recently in the context of EU Solidarity Fund spending.

<sup>68</sup> See de la Fuente, A., Doménech, R. and V. Rant (2008), "Addressing the net balances problem as a prerequisite for Budget reform: a proposal", February 2008, preliminary draft.

<sup>69</sup> Le Cacheux, J. (2005), "European budget: the poisonous budget rebate debate", Notre Europe, 02/12/2005.

extent of financial solidarity between the Member States and to make the mechanism transitory – for instance by ensuring that corrections automatically decrease over time. However, both these aspects appear very much as wishful thinking.

## **5. Balancing the EU budget**

The obligation of budgetary balance is imposed on the EU budget by the EC Treaty. An important feature of the financing system since 1988 has been the built-in guarantee, through the residual GNI-based contribution, that the EU automatically disposes of sufficient resources to finance the authorised level of expenditure.

Such an automatic balancing of the EU budget is sometimes criticized. For instance, in order to ensure macroeconomic stabilisation it is sometimes proposed to allow the EU budget running into deficits during recessions as it is usually the case for national budgets. However, this option does not appear convincing. Additional funds resulting from a deficit of an EU budget of the current size would arguably have hardly any significant impact on the European economy. Thus, for making this mechanism effective in smoothing economic disturbances, a relatively large community budget would be required. Moreover, it appears questionable that the EU policies are suitable to respond flexibly to economic shocks. And the prospects of potential deficits would make agreements on the budget probably even more difficult. Another argument for changing the balanced budget rule, at least in the short run, relates to the cyclical variations of a number of potential own resources. Instead of setting up budget balancing mechanisms, short term deficits or surpluses could be allowed.

Since the balanced budget rule is widely accepted, enshrined in the treaties, and its revision would likely lead to public outcry, it seems reasonable to consider that future changes to the financing system should not compromise this rule. It would therefore be imperative that any financing system would continue to contain an element of automatic equilibrium.

Several mechanisms can achieve this objective. But they have to be tailored to take into account the type of own resources financing the EU budget.

- If the financing system remains dominated by the VAT- and GNI-based resources, a system of residual contribution, such as the GNI-based contribution, is very effective to ensure that own resources match with expenditures.
- Even if new own resources are introduced in replacement of the VAT-based contribution and part of the GNI-based contribution, a system of residual contribution similar to the current system is advisable.
- In case a new own resource with a very large tax base, e.g. an EU VAT, energy tax or EUCIT, or a basket of new resources would be envisaged, alternative approaches could be considered to cope with revenue variations. Firstly, in case of insufficient resources a residual GNI-based contribution could be triggered. But in case of excess revenue, a partial reimbursement of own resources could be envisaged. This could be done on the basis of the Member States' shares in EU GNI or as part of an equalisation mechanism (see

section 4.3). Secondly, a system of "rainy-day fund" could be set in place in order to avoid a system of residual contribution or equalization<sup>70</sup>. This fund would accumulate budgetary reserves in periods of buoyancy and this reserve would then be used in case of revenue slowdown.

Although the current system is quite effective in order to maintain a budgetary balance, alternative systems can clearly be envisaged – and would in some cases be necessary – should the system of own resources be radically transformed in order to increase the EU's financial autonomy. As indicated in the last hyphen, a slight budget surplus could even be used to finance an equalization mechanism. However, the Member States' resistance to tax-based revenues exceeding the expenditure (prior to equalization) should not be underestimated.

## **6. Conclusion and way forward - Towards equally valid scenarios for a financing reform?**

The above analysis highlights that the current financing system could undergo important, and radically different, reforms. A political choice would need to be made, taking into account the pros and cons related to each option.

Another important feature of our analysis is to highlight the interaction of the various constituting elements of the financing system. A reform of own resources would have implications for corrections and the way to ensure budget balance, and conversely. It goes without saying that the interaction between the financing side and the expenditure side is equally important. Treating these issues as separate, independent building blocks can, therefore, be misleading.

Only a limited number of combinations of reforms of the constituting elements of the financing system or the budget at large would seem feasible. We try below to highlight some of these combinations, which we qualify as 'equally valid' scenarios, as they all make sense from a technical point of view. This does not mean that, from a political point of view, they would be equally acceptable or interesting. The timing issue could also play a role: some options may be more relevant in a long-term perspective than others.

The table below presents six scenarios combining in a coherent way the various elements of the financing system (own resources, corrections) and the balancing method.

In general, the indications put in the table are meant at stimulating further reflection rather than highlighting conclusive analyses.

- Scenario 1 presents a situation pushing to its extreme the past trend towards more inter-governmentalism on the financing side, the development of more correction mechanisms and the increase of the share of GNI-based contribution. Under such a scenario of expanding GNI-based resource, a logical step would be the elimination of the VAT-based contribution. In such

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<sup>70</sup> Le Cacheux, J. (2007), "Funding the EU budget with a genuine own resource: the case for a European tax", *Notre Europe*, Paris.

case, *ceteris paribus*, it seems likely that more net contributors would ask to benefit from correction mechanisms, thus increasing further the need for some form of generalised correction mechanism. In an extreme variant, one could even envisage the elimination of traditional own resources to finance the EU budget, a step that would be seen favourably by some net contributors.

- Scenario 2 presents the status quo situation.
- Scenario 3 (a, b, c) suggests an in-depth reform of the financing system reflecting a more communitarian approach to the EU budget. Either a basket of new own resources (3a) or a single genuine own resource (3b, 3c) would be introduced in the financing system. The VAT-based contribution would be eliminated. The share of the GNI-based resource would decrease in the EU financing. It could even be fully eliminated for cases of new own resources bringing about sufficient revenue to finance the entire budget. This could be in particular the case for scenarios related to VAT and energy taxation. In all these scenarios some corrections may still be needed due to perceived imbalances in the EU expenditures. In addition, a system of equalization related to the tax effort could also be envisaged, in particular for resources that are not characterized by much regional arbitrariness, i.e. VAT and energy taxation.
- Scenario 4 proposes a longer-term possibility where an EU corporate income tax would be created. In order to be viable, it would probably require the elimination of Member States corporate income tax system or a very high degree of harmonization. Such a scenario should not necessarily be seen as the next step following the introduction of scenarios 3a, 3b or 3c.

If anything, this partial overview highlights the technical and political complexity of the debate on a possible reform and the many questions ahead.

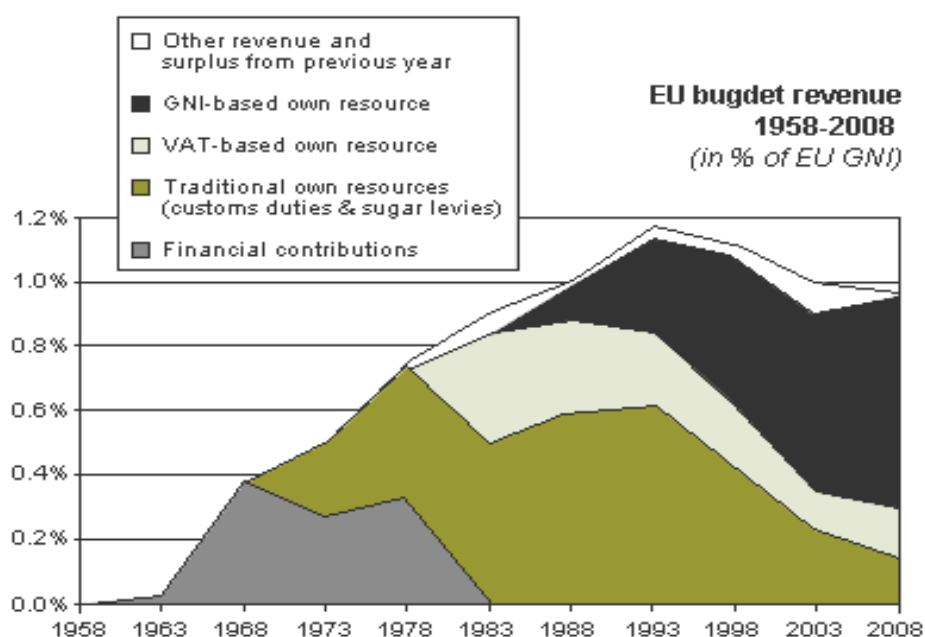
Scenario	EU financing			Balancing method
	Genuine Own resources	Member States 'contributions'	Corrections	
1 More inter-governmental	TOR unchanged or eliminated	GNI-based contribution only	GCM, GLCM or Richter proposal	GNI-based contribution as balancing item
2 Status quo	TOR unchanged	GNI- and VAT-based contributions	Ad hoc corrections	GNI-based contribution as balancing item
3a More communitarian	TOR unchanged Basket of new OR: Emission allowances auctioning; aviation duties	Reduced GNI- or VAT-based contribution as balancing item	Simplified Ad hoc corrections	Reduced GNI- or VAT-based contribution as balancing item
3b More communitarian	TOR unchanged  Shared tax: Energy	-	Phasing-out ad hoc corrections	Limited surplus redistributed to MS (equalization mechanism related to tax effort and/or GNI)
3c More communitarian	TOR unchanged  Shared tax: EU VAT	-		
4 Quasi-federal (treaty change)	TOR unchanged  Single new OR: EUCIT	-	No corrections	or rainy-day fund

## ANNEX I

### Evolving structure of own resources

In 1988, the GNI resource made up less than 11% of EU financing, compared to 28% provided by custom duties and agricultural levies and 57% by the VAT-based own resource.

The own resources system has evolved significantly since the beginning of the first financial framework. Since 1988, the principal developments of the system have been the progressive decline in the share of total funding coming from the TOR and the VAT resource and the parallel increase in the proportion from the GNI resource.



Source: DG Budg web-site, European Commission (2007)

The main source to finance the EU budget is now a resource based on the Member States' gross national income. This has grown to surpass the other sources, customs duties and agricultural levies ("traditional own resources"), and a resource based on a value added tax base. The traditional own resources have also fallen in importance since the 1980s, and certainly since their share peaked in the mid-1970s, but have stabilised in recent years.

In 2013, the GNI resource will provide about 74% of the EU financing, against 13% for customs and agricultural levies and 12% for the VAT-based resource.

## ANNEX II OVERVIEW OF CORRECTIONS IN THE EU BUDGET

### 1. Corrections on the financing side

#### 1.1. *Traditional own resources (TOR)*

Member States retain a fixed percentage of all traditional own resources collected. This percentage was fixed at 10% when these resources were first transferred to the EU budget in the early seventies. In 1999 the Berlin European Council decided to increase it to 25%.

The actual collection costs incurred by Member States have never been quantified and the collection costs retained are automatic and do not have to be justified. While the 10% could reasonably be considered to be a compensation for expenses incurred by Member States (customs and audit services,...), this is probably no longer the case for the 25% collection costs, which were agreed to allow certain Member States to decrease their payments to the EU budget. Indeed, for Member States that collect a large share of customs duties at important EU entry points, an increase of the collection costs represents a net decrease of their financial contribution to the EU budget (since the increase of the GNI contribution is smaller than the increase in the collection costs retained).

#### 1.2. *VAT-based own resource*

The VAT assessment base, on which the VAT-based own resource is calculated, has been capped since 1988. This capping has become more important over the years as both the 1994 and the 2000 Own Resources Decisions (ORD) further lowered the level of capping. It currently stands at 50% of GNI for all Member States.

The capping of the VAT base is supposed to reflect the intention of remedying the regressive aspects of the VAT-based own resource, which is seen as disproportionately penalising the less affluent Member States because the proportion of consumption in GNI tends to be higher in less prosperous Member States. However, the size of the VAT base and therefore the effect of the capping is not proportional to Member States' GNI. Some of the poorest Member States are not capped while some of the richest, such as Luxembourg and Ireland, are subject to capping and thus see their contributions reduced.

#### 1.3. *The UK correction*

The UK correction was agreed by the 1984 Fontainebleau European Council. Although the mechanism has been modified in the successive ORDs, in its essence it has remained unchanged:

- to reimburse to the UK 66% of the difference between what the UK pays to the EU budget (except TOR) and what it receives from the budget;
- in addition, any benefit or cost accruing to the UK from modifications introduced in the successive ORDs are neutralized.

The financing of the UK correction has also been modified over time, granting what is commonly known as 'the rebates on the rebate' to the traditionally most important net contributors to the EU budget. Since 2001, Germany, Austria, the Netherlands and Sweden pay only 25% of their normal financing share of the UK correction (Germany paid 2/3 of its normal financing from 1985 until 2000).

The December 2005 European Council decided to adjust the UK correction and agreed that non-agricultural expenditure in the new Member States will no longer be included in its calculation base. This is introduced progressively over the period 2009-2011. The maximum cost to the UK of this measure cannot exceed €10.5 billion (in 2004 prices) over the period 2007-2013.

#### ***1.4. Further corrections introduced by the 2005 December European Council***

While Member States will normally contribute 0.3% of their VAT assessment base to the EU budget, this percentage has been reduced for 4 Member States (for the period 2007-2013 only):

Germany:	0.15%
Netherlands:	0.10%
Austria:	0.225%
Sweden:	0.10%

Both the Netherlands and Sweden receive, for the period 2007-2013 only, a gross reduction of their GNI contribution of (in 2004 prices):

Netherlands:	€605 million
Sweden:	€150 million

## **2. Corrections on the expenditure side**

Apart from the specific corrective measures resulting from the Acts of Accession, such as budgetary compensation, cash-flow facility, Schengen facility and nuclear decommissioning, which result from the accession negotiations and are in principle temporary in nature, corrections to the EU expenditure are mainly concentrated in the areas of cohesion policy and rural development.

The cohesion envelope is calculated according to a series of allocation rules, which are generally applicable across all Member States and based on a number of objective criteria such as relative prosperity, unemployment, population and surface area. However, as a result of intense political negotiations, a long list of corrective measures is added on top of these generally applicable rules. These corrections can be:

- Generally defined but not inherent to the general allocation rules; *For example, in Member States with a GDP lower than 85% of the community average a number of exceptions apply, such as higher co-financing rates, eligibility of non-recoverable VAT, an n+3 rule defines the deadline for community reimbursement instead of the normal n+2 rule.*
- Generally defined, but 'de facto' only applying to 1 Member State; *For example, the phasing-out of the cohesion fund.*

- Region-specific corrections, presented with justification; *For example, additional funds are allocated for the outermost and sparsely populated regions as well as to, the poorest regions. Revised statistics are taken into account in exceptional cases, as are exchange rate fluctuations.*
- Region-specific corrections, presented without justification; *A long list of regions (and Member States) receive additional allocations purely as a result of political negotiations.*

Similarly, while the rural development envelope is calculated according to allocation rules based on agricultural surface and agricultural population, the December 2005 European Council saw fit, again as a result of political negotiations, to additionally allocate lump sum amounts to a series of Member States<sup>71</sup>.

### **3. Global assessment**

Taken as a whole, the combined corrections on the revenue and the expenditure side of the budget do not appear to be very consistent. The corrections on the revenue side present a collection of diverse measures, resulting from a series of successive negotiations, each time adding new measures on top of the body of existing corrections and characterized by a consistent reluctance to ever turn back the clock.

Moreover, the corrections on the revenue side partially undo the impact of certain expenditure policies. It appears at best inconsistent that Member States benefiting from redistributive packages, such as the cohesion policy going to the poorer regions, see their benefit reduced through increased contributions to the budget to finance the corrections on the revenue side. Some of the corrections on the expenditure side would in turn increase the UK correction. Finally, some Member States receive corrections on both sides of the budget.

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<sup>71</sup> This logic holds for the part of the rural development envelope originating from the EAGGF Guarantee instrument.