STUDY ON THE POTENTIAL AND LIMITATIONS OF REFORMING THE FINANCING OF THE EU BUDGET

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with

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Glossary

BoP	Balance of payments
CAP	Common Agricultural Policy
CAT	Carbon added tax
CCCTB	Common consolidated corporate tax base
CIT	Corporate income tax
CJEU	Court of Justice of the European Union
EAFRD	European Agricultural Fund for Rural Development
EEA	European Environment Agency
EEC	European Economic Community
EEEF	European Energy Efficiency Funds
EESC	European Economic and Social Committee
EFSF	European Financial Stability Facility
EFSI	European Fund for Strategic Investments
EFSM	European Financial Stability Mechanism
EIB	European Investment Bank
EMU	Economic and monetary union
ERDF	European Regional Development Fund
ESA	European System of National and Regional Accounts
ESIF	European Structural and Investment Funds
ESM	European Stabilisation Mechanism
ETS	Emissions Trading System
FDI	Foreign direct investment
FP7	Seventh Framework Programme
FTT	Financial transaction tax
GATT	General Agreement on Tariffs and Trade
GNI	Gross national income
GNP	Gross national product
IGC	Intergovernmental Conference
LIFE	LIFE Programme for the Environment and Climate Change
MFA	Macro-Financial Assistance
MFF	Multiannual Financial Framework

RAL	*Reste à liquider*
RSFF	Risk-sharing finance facility
SMEs	Small and medium-sized enterprises
TARIC	Integrated tariff of the European Union
TEU	Treaty on European Union
TFEU	Treaty on the Functioning of the European Union
TOR	Traditional own resources

EXECUTIVE SUMMARY

The arguments in favour of genuine own resources are stated in the European Commission's analyses accompanying the proposals for reform, and have been reiterated in the assessment report by the High Level Group on Own Resources. Academics and politicians alike generally consider that reform is necessary. Yet despite a multitude of studies demonstrating the need to reform the own resources, the net balance approach of governments to the EU budget remains prevalent. While it is widely acknowledged that the system cannot remain as it is, this realisation is far from enough to ensure reform. The net balance 'instinct' immediately kicks in when any new financial decisions are taken, even for very urgent and clearly EU-level common challenges like the migration crisis.

The present situation concerning own resources is still closely linked to the nature of the budget at the time it was established. The net balance approach and the UK rebate were a consequence of the weak economic justification for many of its operations and the principle of additionality was not sought. Its projects often lacked a solid economic rationale. In 1984, the Fontainebleau agreement anchored the concept that Member States can be excess contributors, without any clarity on what this means in practice or how such excess is to be assessed. The excess is based on the simple accounting practice of deducting the returns from contributions to the EU budget. It disregards the impacts of such funding or the actual agreed objectives of the EU that the budget underpins.

Thirty years later, after several enlargements and numerous reforms of the budget, the basic logic of net budgetary balances and the UK rebate remains in place. This has arguably affected the functioning of the policies and contributed to a growing divergence between the objectives of EU budget expenditures and the challenges confronted by the EU. From a public point of view, the EU budget seems to be a budget for 'Brussels' and not a European budget to address the actual concerns of EU citizens.

The EU budget has changed considerably. The net balance approach, far from ensuring fairness and equity among Member States, is solely a resources-oriented solution that is not functional.

Attempting to move away from the net balance approach exclusively through the introduction of new tax-based own resources is too simplistic. The net balance approach is intertwined with expenditure allocation. For a new own resources system to gain acceptance, the entrenched mentality on EU budget expenditures and the 'net balancing' of resources needs to change. This may be possible today for two reasons:

1) Despite the similarity in the names of budget headings, there have been many advances towards refocusing spending on areas of EU added value. The changes have been very important in many areas of funding and deep enough to mount a credible challenge to the net balance approach, because it is against the interests of a number of Member States. These advances can be furthered if, on the resources side, a more rational approach to financing the budget is introduced.

2) The net balances have become increasingly distant from reflecting equity principles, even in the vague wording of the Luxembourg compromise. Financial flows mobilised by the EU budget, particularly those linked with innovative financial instruments, are changing the distribution of the level of investment. Looking purely at national public contributions as a measure of fairness is no longer acceptable. In addition, a large part of the EU budget pursues EU-level objectives. Regional policy has become a tool to finance the adoption of EU standards and to achieve EU objectives.

The EU is also under pressure to intervene in areas hardly covered by the budget. Increasing trade competition, the financial crisis, migration, energy and climate change challenges as well as growing security concerns call for modern policies and better and more effective common action. It is not outlandish to point out that the failure of an effective financial arm to support common action in these important areas could considerably damage the EU construct and have wider serious implications.

This report has the objective of being ground-breaking, moving away from well-trodden and fruitless arguments in favour of new own resources. It also places the EU budget in a modern context. It takes the concerns of net contributors seriously into account, as there is no political position that is not grounded on something more serious than a mere wish of governments to have the money sent returning back. Some of the solutions proposed are novel and none of them uncontroversial, but they aim at addressing some of the fundamental dysfunctions of the budget resources system by tackling the sources of the problem, and not merely the symptoms.

There is a window of opportunity from a political perspective

At first glance, it appears that the current own resources system presents insurmountable obstacles to its own reform under the present Treaty. Nevertheless, agreement on reform has been achieved in the past. To this end, the study reviews the experience of previous reforms to own resources, the current set of asymmetrical Treaty rules and the role of national parliaments in the reform process.

The 1970 agreement established own resources as part of a package deal that met the differing needs and demands of the then six Member States. All sides made concessions and managed to find a policy outcome that satisfied them all for a permanent form of financing to enable the European Community to develop and enlarge. The 1988 reform allowed for an increase in finance to underpin the new spending needs of the single market programme and the Community's further enlargement during the 1980s. This met the competing needs and demands of Member States and addressed issues of both spending and revenue.

Such reforms were achieved despite the need for unanimity in the Council and for parliamentary ratification at the national level, the latter of which to respect national sovereignty. The key is to pitch a reform proposal at a level where collective benefit is recognised. Although national ratification may be difficult, other rules on the EU's finances facilitate rapid implementation. The Treaty also strongly urges the establishment of independent EU finances, and creates an obligation to provide finance for agreed policies.

The powers over EU finances are exercised asymmetrically. This means that the European Parliament and the Commission have limited leverage. Engaging with national parliaments or their relevant specialist committees and providing them with the necessary information are important steps, since national parliaments can approve or reject changes to own resources. The national parliament procedures for approving the Own Resources Decision of 2014 and any future such decision are shown in a case study of one Member State, the UK. Since members of national parliaments will also serve on an Inter-parliamentary Conference on Own Resources, the example of the role of national parliamentarians in the Convention on the Future of Europe is also assessed.

…but is introducing 'variable geometry' in the budget, particularly with the financial transaction tax, realistic?

Despite the objective to build a union in which all Member States apply the same rules, differential treatment is rather frequent within primary supranational regulations binding EU

Member States. Budgetary matters are no exception, given the rather non-innovative and blunt corrections, rebates and rebates on rebates ratified through Council agreements in successive own resources decisions. The European Commission's proposal for implementing the financial transaction tax (FTT) imposes dealing with and analysing Member States' differentiated contributions to the EU budget from a novel perspective: enhanced cooperation. As such, the provisions of the Commission's proposal are based on Art. 20 of the Treaty on European Union (TEU) towards enhanced cooperation and Art. 113 of the Treaty on the Functioning of the European Union (TFEU) as the pertinent legal basis for the proposed directive in particular. The latter must comply with the general rules of the TEU and the TFEU, i.e. contribute to the strict observance and the development of (customary) international law (Art. 3(5) TEU), and respect the special rules of Arts. 326–34 TFEU on enhanced cooperation.

In a first stage, this study has verified whether the Commission's proposal, among other considerations,

- meets the conditions for the application of enhanced cooperation;
- provides evidence for Art. 113 TFEU as an undisputed, pertinent legal basis for its application, notably on Council unanimity for the adoption of provisions and on the harmonisation of legislation concerning turnover taxes/indirect taxation, and whether this harmonisation is necessary to ensure the establishment and functioning of the single market and to avoid the distortion of competition;
- respects non-participating Member States' rights and solely binds participating Member States, thereby complying with the principle of sovereignty on taxation matters and avoiding issues on the extraterritorial exercise of jurisdiction;
- complies with Treaty rules on fundamental freedoms (notably free movement of capital and freedom of establishment); and
- does not undermine the single market or economic, social and territorial cohesion, does not constitute a barrier to or discrimination in trade among Member States, and does not distort competition between them.

The analysis reaches a preliminary conclusion that the conditions for the application of enhanced cooperation appear to be met concerning the notion of 'last resort' for authorising enhanced cooperation, and compliance with the required minimum number of nine participating Member States (there is currently no serious indication that two of the now ten cooperating Member States are likely to back off). It takes note of the Commission's objective in the proposal to harmonise legislation on the indirect taxation of financial transactions, even in a context of a limited number of Member States implementing the FTT. The report also reaches the conclusion that in this respect, cases of double taxation of transactions falling under the scope of the European Commission's proposal are not illegal, from either an international customary or an EU legal perspective.

However, further analysis is required to assess the proposed FTT impacts, especially those of the 'counterparty principle' and 'deemed establishment principle', on non-participating Member States' sovereignty in the cases of distortionary tax competition, the functioning of the single market (e.g. impacts on parties' treasury needs) and potential limits to the free movement of capital.

Building a budget for the 21st century goes beyond improving the resources mechanism

There are many tax instruments that could potentially be mobilised to either replace or complement the current EU budget resources, but there is no panacea, no single optimal solution or first best. The selection of potential candidates should be guided by a list of criteria or objectives, which by nature cannot be for the short term. They include economic criteria (sufficiency and stability of the revenue, efficiency in the various dimensions), conformity with EU objectives (completion of the single market, promoting employment, fighting climate change, etc.), political and institutional criteria (visibility, transparency, accountability), as well as equity or fairness criteria (among Member States and among individual citizens). These criteria are, to some extent, contradictory, so the choice should be guided by a dual process: assessing and comparing the performance of each potential resource with respect to each criterion and then weighing the various criteria – a process that depends on decision-makers' objectives.

The study has reviewed potential new own resources, but has shortlisted four instruments: value added tax (VAT), corporate income tax (CIT), the FTT and options for carbon levies. The economic efficiency aspects of these four instruments and their various possible specifications are considerable. The first two taxes already exist in all Member States and raise issues of horizontal and vertical externalities: both an EU VAT and an EU CIT would be an additional levy on a tax base that is already taxed by national – and sometimes infra-national – governments. The strategic interplay between tax authorities at various levels generate forces pointing in opposite directions: while horizontal externalities, currently at play, generate tax competition, the vertical externalities that would result from using these instruments at the EU level would mitigate tax competition, and in most cases lead to an outcome closer to optimum in terms of public goods provision by the various levels of government.

Although CIT appears attractive, especially in the present context of fighting aggressive tax optimisation by multinational corporations and base-erosion practices, it also poses technical and macroeconomic difficulties. First, the tax bases are currently quite different among Member States, which probably makes use of CIT as an EU resource conditional on some harmonisation of the base, the most obvious solution being the proposal for a common consolidated corporate tax base already put forward by the Commission.

The pros and cons of an FTT have been described in various studies, in particular in the Commission's proposal. In the current context, it is not clear that this instrument would meet most of the economic criteria. In addition, it is likely to be accepted by only a minority of Member States, raising the issue of variable geometry in the EU budget or its financing (or both).

With respect to carbon levies, many aspects of the criteria listed above would be met, making it an attractive solution, though technically more demanding than the previous ones. Various options may be considered: allocating the auction revenue from the EU Emissions Trading System to the EU budget; adding a carbon-based element to existing fuel taxes, based on the 2011 Commission's proposed revision of the energy taxation directive (2003/96/EC); and instituting a genuine EU carbon tax, here too with several possible formulas, including a carbon tax based on the destination principle. The advantages of such instruments in terms of economic efficiency and conformity with EU objectives are clear, but the political and technical obstacles are not minor, and special attention should be dedicated to equity considerations and possible package deals.

Given existing Treaty provisions, new resources would have to be complemented by a residual GNI resource. The distributional consequences of each instrument could also provoke demands for some form of rebalancing or correction. If the tax resource is not fully accepted as owned by the EU, the use of the GNI resource as a rebalancing instrument could become a very difficult policy problem. Resources levied by a tax and by a transfer from the national accounts are not equivalent.

This report also shows how, in the case of variable geometry, it would be difficult to find a mechanism to collect contributions from non-participating Member States. First, the tax incidence would be variable among participating Member States. Non-participating countries would have to make up for shortfalls in their contributions through government budgets, which is very different from direct collection from tax sectors. In what way should a non-participating country be taxed? Its share of GNI, an estimation of the revenue generated if the Member State were a participant? For certain taxes, such as corporate taxation, non-participation may be driven by tax competitiveness reasons, which again undermines the functioning of the single market.

Finally, the report recommends an improvement on the treatment of the GNI resource, harmonising the way it is recorded in national accounts.

More flexibility is needed in the budget, as the instruments in place are not able to handle the challenges facing the EU

The EU budget has been facing unprecedented demands, first with the long term climate and energy challenges, then from lingering economic and financial crisis and lately the difficulties with migration at Europe's borders, the duration and severity of which in is also uncertain. More challenges are already expected. In 2014 and 2015, the budget shifted funding between headings and mobilised over €12 billion for unexpected needs in an unprecedented manner. The European Commission managed to finance the European Fund for Strategic Investments, compensate farmers affected by the Russian ban and help those affected by the milk price crisis, support Greece, fund actions to support Ukraine, frontload funding for the Youth Employment Initiative, and raise funding for the migrant crisis. In addition, the late adoption of EU funding programmes in Member States led to a shift of commitment appropriations to 2015 and 2016. But needs exceeded the EU budget's capacity (including from emergency headings outside the Multiannual Financial Framework, MFF), so for example, some external actions are being financed by trust funds outside the budget, i.e. the regional Trust Fund for Syria and the Trust Fund for the Central African Republic.

While this has been an impressive show of flexibility, unfortunately it cannot be repeated. The rules have already been stretched and the margins that have been used cannot be found again. In the future, however, the number of 'asymmetric shocks' potentially facing the EU owing to global instability, economic shocks or climatic events are numerous, while the EU budget has not been designed to face such events effectively. The financial margins available for 2017–20 are lower than the level of funds mobilised between 2014 and 2016.

There is already a need to enhance flexibility in the years leading up to the next MFF and maybe revise the payment ceilings. There is a potential risk that the RAL (*reste à liquider*) could increase considerably, creating a payment crisis. Some of the present flexibility options may exacerbate this. First and most importantly, some inconsistencies in the budget can be quickly removed, for example the reimbursement by the European Commission of revenues from fines, which could either be used as a reserve for unexpected events or as income for the budget in the following year.

A key proposal for the future is to create a well-endowed budget line for unforeseen events (above €10 billion). The logic would be similar to the Solidarity Fund, but should be an actual fund quickly deployable and within the budget ceilings of the MFF, and subject to co-decision.

The rules should be strict on its use and only allow for action for serious unforeseen events affecting the Union as a whole or several Member States in combination. The fund should not be used for balance-of-payments support or to replace support for emergency aid for agriculture or to cover the RAL. This fund would be replenished year-by-year, and unspent funds rolled over. Surpluses, sanctions, fines and penalties could also be used to maintain it. This fund could additionally replace the existing emergency funds outside the MFF.

A reform of the own resources can only be achieved if the logic of excessive net contributions is clarified. This means the clear linking of any corrections to those expenditures that cause the demand for it.

A reform of the own resources based solely on new tax-based mechanisms is unlikely to go forward, because it does not address the remaining concerns of Member States about policy quality. The net balance 'instinct' is also too strong and would soon undermine reforms. Thus, apart from demonstrating that net balances are obsolete measures of 'fairness', the report proposes novel approaches that could be added to package deals.

A way forward would be to link those rebates with a clear justification to specific policies. This would direct the debate towards more focused reforms. At this stage, while for example the Common Agricultural Policy (CAP) is highlighted as the reason for the UK rebate, the method of calculation is not linked to it.

A possible approach to resolve the net balance dispute on the CAP would be to change the way it is financed, regardless of a policy reform. The report presents a novel co-financing system of the CAP based on the principle of cohesion, with poorer countries being attributed a higher co-financing rate. This would trigger a healthy debate on priorities in spending.

Reaching a solution with a package deal

Package deals are a necessary ingredient for successful reform, insofar as any conceivable reform of the resources of the EU budget will arouse opposition. This opposition will not merely come from Eurosceptics, who are against the principle of a genuine 'own' resource in the form of an EU tax instrument, but also from those who are dissatisfied with the current working of the EU budget and those who stand to suffer negative distributional consequences of a new resource. Package deals should be designed to address such opposition, to offer compensation and possibly to make progress on issues where there is a shared view that the status quo is unsatisfactory, because of its high political costs. In the past, reforms on the funding side of the budget have usually been accompanied by major changes in either the expenditures or other aspects of the EU's functioning.

Possible package deals may involve reforms on the expenditure side of the budget, compensating changes in the resources or correction mechanisms or progress in other areas of the European institutional architecture (or all of these). Care must be taken that 'corrections' do not further reinforce the net balance approach and link even more strongly the expenditure allocation to the resources, which is an implicit violation of the universality of the resources. Corrections need to be methodologically sound and relate to the resolution of actual policy disagreements, not a 'net' ceiling determined in an aleatory manner. The report clearly shows that net balances are not a measure of the impacts of financial flows from the budget.

Reforms of the main expenditure items – the CAP and structural funds – should aim at generating genuine EU added value. A financial system based on cohesion can be devised, with reforms in expenditure areas being accompanied by reforms in resources, using transitional periods. A gradual introduction of co-financing or other reforms in agriculture could reduce agreed corrections or allow the increased use of genuine own resources. Carbon levies could be introduced with stronger decarbonisation assistance for the most affected countries.

A solution would also have to be found to the difficulties arising from the combination of a new own resource with the residual GNI resource that might have to be maintained – first, if the resources do not cover the whole budget, and second, if the resources are not accepted as fully owned by the EU and factored in the national contributions or the new resource is not adopted by all Member States (variable geometry).

Given the inevitable distributional consequences of each possible new resource, a compensation scheme might have to be part of the package as well. These schemes should avoid the numerous pitfalls of existing correction mechanisms and mobilise either lump-sum payments or a progressive schedule for the residual GNI resource. Finally, because substituting an own resource for at least some of the GNI resource would automatically reduce Member States' public deficits, some deals involving the Fiscal Pact would necessarily have to be agreed.

A look into the future – Should there be a separate eurozone budget?

In addition to covering the finances of the EU budget as it stands today, the report explores the potential implications of a eurozone budget. This eurozone budget could be financed by cyclically sensitive revenue sources (such as a eurozone CIT or even VAT) and could fund cyclically sensitive expenditures (such as a eurozone-wide unemployment insurance scheme). It would have a built-in automatic stabiliser impact on eurozone economic activity. The aggregate fiscal stance for the eurozone could also be set more easily in line with business cycle conditions, and possibly with the monetary policy stance set by the European Central Bank.

Another major rationale for the creation of a separate eurozone budget is directly inspired by the theory of optimal currency areas. In this line of reasoning, member countries of a currency union may be hit by asymmetric macroeconomic shocks; yet because they can no longer use exchange rate adjustments, and because the other channels of adjustments – such as labour mobility and wage flexibility or capital mobility – may prove insufficient, the existence of a common budget would facilitate adjustment. For this to take place, the revenue levied by the common budget from each Member State would have to be sensitive to cyclical fluctuations in that country and the same would apply to expenditures directed towards that specific country. The common budget would then function as a device for inter-country, automatic fiscal stabilisation, much as the federal budget does in existing federations.

1 INTRODUCTION

The European Parliament, the European Commission and a number of academics have called for genuine own resources to reduce the level of distortions caused by the net balance positions of Member States. The arguments in favour of reform tend to be based on the fact that the own resources system has become complicated, opaque and corrupted by correction mechanisms originating from imbalances in both resource collection and expenditure allocation over the years. There is a widely held perception that changing the present system into one based on resources levied through direct taxation of economic actors, rather than indirectly through GNI contributions, could free the EU resources from the disputes over net budgetary balances and increase the transparency and accountability of the budget.

Such a system would be in line with Art. 311 of the Treaty on the Functioning of the European Union (TFEU), which stipulates that "the EU budget shall be financed wholly from own resources". Traditional own resources (TOR) and the VAT resource were at inception clearly in line with the spirit of the article.[1] With time, however, a 'residual funding source' for needs exceeding the resources collected by the TOR and the VAT keys now covers over 80% of the resources. The use of the GNI share, while legally an 'own resource', is in practice questionably treated by Member States as a transfer from the treasuries and open to negotiation. The resource has been implicitly linked to the distribution of expenditures in the net balance disputes. The VAT resource itself has also been reformed several times to accommodate a number of equity concerns of Member States, leading to an artificial, virtual VAT calculation, ultimately resulting in a contribution share that is similar to having a simple extension of the GNI key. While the VAT resource should have created a link to citizens as contributors, today's VAT resource has been tweaked to align it to a large extent with a contribution based on GNI. Here, we identify a first concern about the present system of own resources. The EU is supranational and is based on equality of rights and obligations towards its citizens. Yet the resources represent equity only at the national level, and how the resources are levied for the EU budget is not an EU matter.

Moreover, interpersonal equity is not the only victim of the system. The use of transfers from national treasures may be an important factor in the pressure of Member States to guarantee a certain net return from the EU budget. The '*juste retour*' argument has dominated the budget for decades, whereby Member States require that the EU guarantees a level of financial return through either policies or corrections to the contributions. The rationale and size of the corrections is politically determined with no clear specification about what the net contributions should be. The net balance approach has led to a budget dominated by pre-allocated funds managed by Member States.

The arguments in favour of genuine own resources are clearly stated in the European Commission's studies and the analyses accompanying numerous proposals for reform. They are also stated in a more political form in a special report by MEPs Jutta Haug, Alain Lamassoure and Guy Verhofstadt (2011), supported by academics. Despite studies demonstrating the need to reform the own resources and that the benefits of the EU outweigh the contributions to the budget for all Member States, the net balance approach of governments is still prevalent today.

[1] Then it was Art. 269 of the Treaty on the European Community.

The net balance 'instinct' is deeply ingrained and kicks in when any new financial decisions are taken, even for very urgent and clearly EU-level common challenges.

Altogether, this leads to a very complex situation, which this report seeks to unravel. In fact, the lack of consensus about the resources mechanism and the role of the budget, combined with rigid decision-making rules on the EU budget, make substantial reforms that affect the distribution of the expenditures or resources close to impossible. Fundamental to the blockage are two aspects:

- The decisions on own resources are directly linked to the allocation of expenditures, fuelling a net balance mentality reinforced by the introduction of corrections. The net balance approach is entrenched in the budgetary negotiation process, on both the expenditure and resources sides.
- In the negotiations on the budget and the own resources, most Member States seek what could be called a Pareto optimal outcome, i.e. all Member States have to win from the outcome of the negotiations. That is not necessarily wrong, if it were not for the fact that it takes place in the very narrow sense of public financial flows through the budget, i.e. the net of what flows out and what flows into the EU budget. Of course, major political priorities, such as EU enlargement, impose changes and disrupt this approach. However, once the necessary adjustment has taken place to accommodate a major change, the search for such Pareto solutions restarts, which leads to a minimisation of shifts in a new net balances equilibrium.

These two aspects lead to the following results:

- Reforms to expenditure priorities happen mostly within existing budget headings and avoid changing the overall financial envelopes pre-allocated to Member States.
- They reinforce the interest of net contributors in focusing not only on net balances, but also on blocking or even reducing the size of the EU budget.
- New needs and priorities of the EU, especially those that cannot be pre-allocated, will tend to be underfunded.
- Unexpected critical needs may be financed out of the Multiannual Financial Framework (MFF) or in a different institutional setting altogether, not without a considerable loss of energy and often at a political cost.
- The flawed approach of Pareto optimality based on financial flows encourages Member States to prefer the GNI or equivalent resources, which can easily be combined with corrections.

While the points above are rather simplistic, they subsequently lead to some very negative outcomes in relation to reforms:

- a rejection of legalistic arguments for reform – arguments based on the literal interpretation of 'own resources' in the Treaty;
- a rejection of the economic arguments for reform that the EU brings more benefits to net contributors based on the core-to-periphery theories of economic growth. These are not motivating change; and

- a signal to the public that the EU is sclerotic. The lack of a dynamic budget able to address EU challenges sends the message that the budget is for 'Brussels' rather than a budget for 'Europe'.

Nevertheless, and despite the seemingly impossible barriers to reform and the dominance of net balance concerns over decades, this report argues that the time is ripe for reform. This is mainly because there have been fundamental changes to the EU budget that the present own resources system does not reflect. These important changes cannot be ignored on the resources side without considerable cost to the EU and Member States. The costs of no reform are very high and Member States may be induced to seek a new, more rational budget mechanism. The present system does, in fact, a disservice to *all* Member States – net contributors as well as net beneficiaries. It affects the efficiency of the budget and is based on a view of the budget that is not grounded on reality.

This report places the EU budget in a modern context. A well-designed reform of the own resources system could be a real driver of positive change, which could accommodate the interests of net contributors and net beneficiaries alike. The solutions proposed are in several cases rather novel, even if none of them uncontroversial. They seek to address the fundamental dysfunctions of the budget that form some of the core concerns of Member States.

To facilitate navigation in this comprehensive report, it is divided into five parts. Part I outlines the present status, what has changed over the last years and the need for a budget to enable the EU to face its present difficulties. Part II looks at the challenges and opportunities for reforming the budget from a political and legal perspective. Part III goes into detail about the potential elements of a reform, from an assessment of new resources to reforms connected with expenditure-side improvements. It sets out the features of a potential package deal later analysed in Part IV and also discusses pitfalls. Part IV is the core of the report, where possible package deals are discussed. It links potential own resources reforms with options for expenditure reforms translated into possible transitional approaches. Ultimately, the proposals are based on the premise that all Member States can benefit from such reforms. Part V discusses further wider issues concerning the role of the EU budget in the eurozone and additional considerations, such as the duration of the MFF.

PART I. TIME TO BREAK WITH THE PAST – ARE WE READY?

2 OVERVIEW OF THE PRESENT STATE OF OWN RESOURCES AND THE NET BALANCE LOGIC

Chapter 2 in a nutshell

- The own resources mechanism is opaque and very complex.
- The multiple adjustments and corrections introduced lack a solid rationale.
- The net balance approach does not take into account the real costs and benefits emanating from the budget interventions for Member States.
- The present system of own resources impairs efficiency on the expenditure side.
- The own resources mechanism is dysfunctional and well past the 'best before' date.

This chapter gives an overview of the present own resources mechanism and the basis for today's net balance approach by EU Member States. It answers the 'why' of the net balance approach and pinpoints those areas of the resources and expenditures that have led to this situation. It first presents a short overview of today's mechanism and follows with an explanation of the weaknesses of the system.

2.1 TODAY'S STATUS – JUST THREE RESOURCES BUT HIGHLY COMPLEX

The EU's system of own resources and its evolution over the years were described in detail in the first assessment report published by the High Level Group on Own Resources (2014a). A second detailed presentation of the resources is thus unnecessary. It is important, however, to note some key characteristics in order to identify the problem areas that this report addresses.

There are three main resources – the TOR, the VAT resource and the GNI resource. Despite the low number of resources, the method to estimate and collect these resources has become complex and opaque. In summary, the resources are as follows (updated text from Mortensen, Núñez Ferrer and Infelise, 2013, p. 11):

1. *TOR*. These are the original resources composed of common customs duties and sugar levies. They are regarded as resources fully owned by the EU. Of the TOR receipts, 20% are retained by Member States to cover the administrative and collection costs. The 20% retention is controversial, as it may be excessive in relation to the collection costs; the retention was 10% before the year 2000.

2. *VAT resource.* Value added tax-based contributions were introduced in 1977 to compensate for the insufficiency of TOR. These contributions are calculated on a harmonised VAT base. The VAT rate-of-call contribution to the budget was originally set at 0.5% of GNI. The 2007–13 financial perspective cut the cap to 0.3% of GNI from 2007 onwards, with deeper cuts for Austria (0.225%), Germany (0.15%) and the Netherlands and Sweden (0.1%). In addition, a cap was imposed on the base of 50% of each Member State's GNI, to avoid potential imbalances deriving from different levels of consumption across Member States (especially to avoid penalising poorer Member States where the share of consumption over total wealth is typically higher). However, the combination of the changes has led to a reduced share of the VAT contribution in the budget and to making the contribution close to equivalent to a GNI-based contribution.

3. *GNI resource*. A residual resource based on the GNI of Member States was created in 1988 to cover the residual budget needs that could not be covered through TOR and VAT. Today this resource covers close to 80% of the budget. This resource has a number of rebates for some Member States: Germany, the Netherlands, Austria and Sweden benefit from reductions to their contributions to the UK rebate, while Denmark, the Netherlands, Sweden and Austria will benefit from gross reductions to their gross. The most important rebate, anyway, is that for the UK, and it deserves special consideration.

2.2 ORIGINS AND RATIONALE OF THE NET BALANCE APPROACH AND CORRECTIONS

In the 1980s, the UK was a net contributor to the budget despite being one of the poorest Member States of the European Economic Community (EEC). A central cause of this was the design of the Common Agricultural Policy (CAP), which benefited the agricultural products and structures of some Member States more than others. The UK did not benefit from this policy as much as its partners, a fact that triggered the demand for a rebate on the grounds of equity.

The basic mechanism of the UK rebate was decided at Fontainebleau in June 1984[2] and given effect by the Council Decision of 7 May 1985.[3] It stipulated that the contribution of the UK to the Community budget would be reduced by an amount equal to 66% of its net balance. The net balance calculation is based on the so-called 'operational budgetary balances', which exclude from the calculation the TOR and expenditures on external operations and administration. These are the net balances reported by the Commission before and after the rebate. The rebate itself, however, oddly includes administrative expenditures, as it uses all 'allocated expenditure'.[4] Figure 2-1 and Figure 2-2 show the revenues and expenditures by Member State and the net balances for the period 2007–13.

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[2] The general principle of the Fontainebleau agreement is that "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" (European Council, Conclusions of the Session of the European Council at Fontainebleau, 25-26 June 1984).

[3] See Council Decision 85/257/EEC, Euratom of 7 May 1985 on the Communities' system of own resources, OJ L 128, 14.5.1985.

[4] Allocated expenditure includes the agricultural policy, structural policies, internal policies (among which is research) and administrative expenditures.

Figure 2-1. Average, annual, operational budgetary balances (€ million), 2000–06

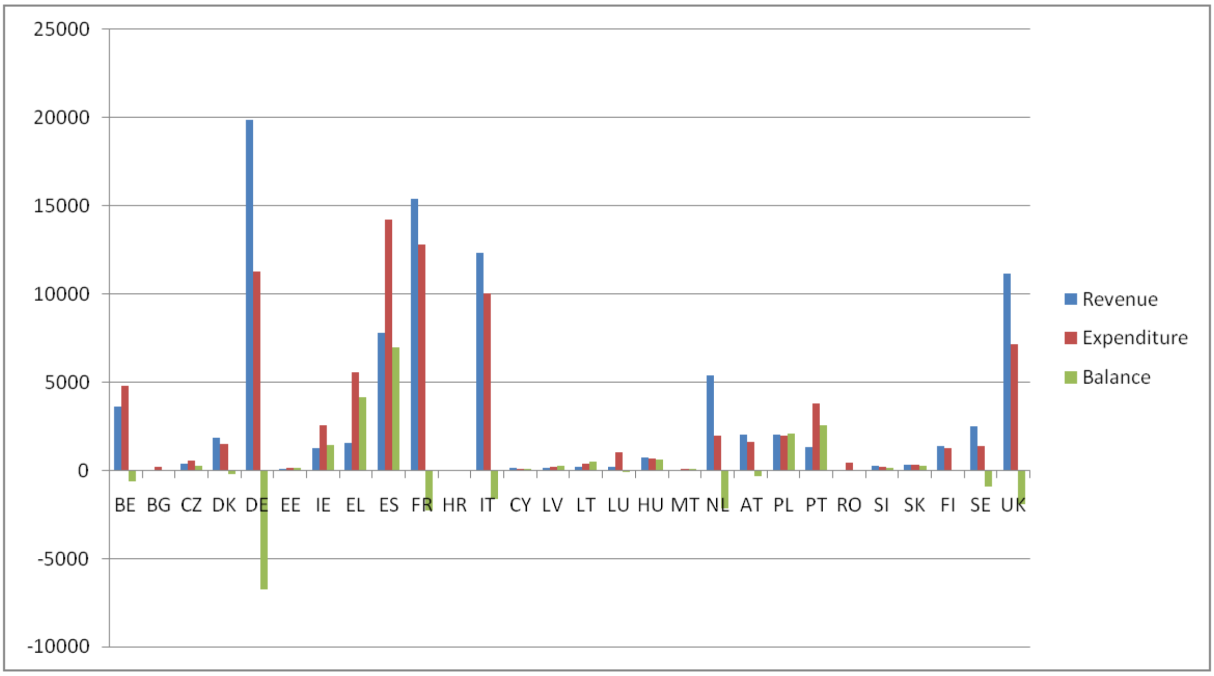
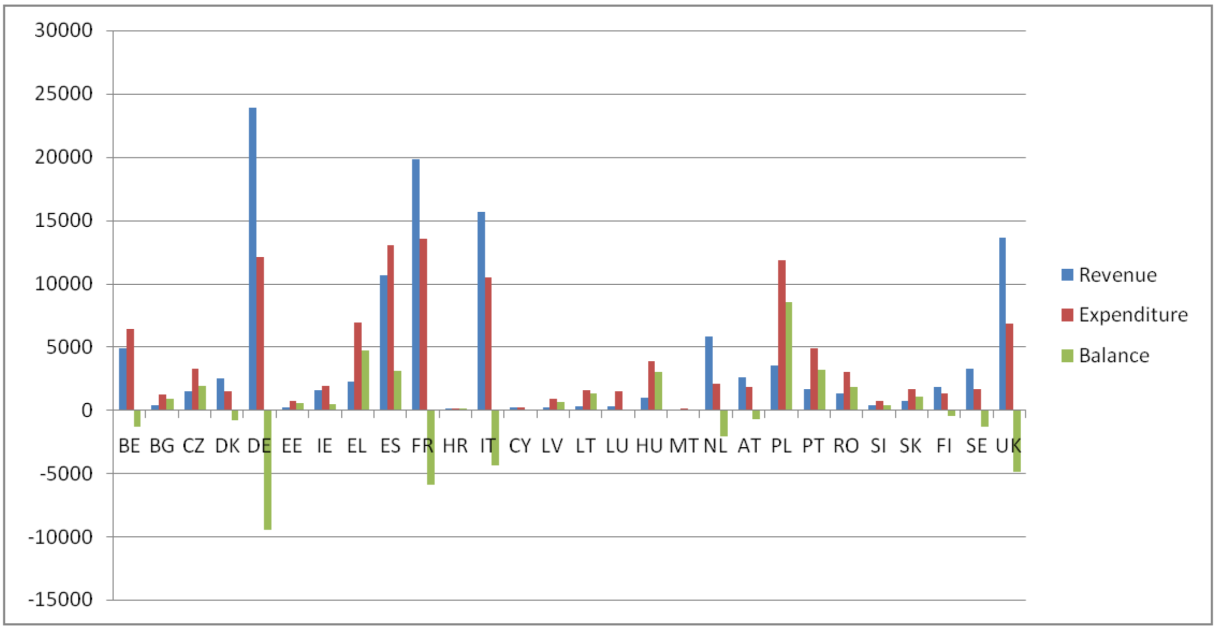


Figure 2-2. Average, annual, operational budgetary balances (€ million), 2007–13



Source: *Financial Reports*, European Commission.

The precise calculation of the net balances and the UK correction was complex at inception, but it has developed into an extremely laborious and opaque exercise due to the numerous adjustments introduced over the years to counterbalance the effects of changes in the own resources system. In fact, the rebate is no longer calculated on the actual budget expenditures and receipts, but on a fictional contribution to the EU mimicking the system in place at its inception (to eliminate the so-called 'UK advantage' stemming from changes in the composition of the resources). The impact of this virtual budgetary mechanism is not very substantial financially, but it certainly makes the calculations complex. The UK also agreed to remove from the calculation of the rebate a level of funds equivalent to the pre-accession expenditure that new Member States had benefited from (as this funding was classified as external action and therefore not part of the rebate calculation), as well as support from the Cohesion Policy, but not the CAP. Furthermore, it was foreseen that the UK's contribution would not exceed an additional €10.5 billion over the 2007–13 MFF, compared with the continued application of the previous rebate mechanism. This last provision has expired, but the remaining rules are in force.

In addition to the correction for the UK, other net contributors demanded corrections to reduce their net balances, which have resulted in the concessions listed in point three of the previous section. These originate from a perceived unfairness in the collection level of the VAT resource, or are designed as reductions to counterbalance the cost of the UK rebate.

A deeper historical background can be found in Annex I, with further illustrations and descriptions of the net balances for the MFFs for 2000–06 and 2007–13.

2.2.1 Assessing the rationale for net balances and corrections

As indicated in the introduction, when the net balance mechanism was devised, the EU budget consisted mainly of transfers to Member States to finance the agricultural policy or projects of local interest. The concept of budget financing objectives with EU added value was not really considered. Much of the budget was in any case designed to compensate Member States and sectors considered to be losing from the integration process.

The 'official' net balance approach to the budget started in 1984, but the behaviour of Member States towards the European Community had already been controversial. In 1977, on the occasion of a speech to the European Parliament, Roy Jenkins, a British politician who served as president of the European Commission from 1977 to 1981, denounced the undesirable behaviour of Member States seeking to "strike a narrow arithmetical balance as to exactly how much day-to-day profit or loss each country is getting out of the Community".[5] This behaviour took official form in budgetary matters with the decision of the 1984 European Council at Fontainebleau, which introduced a calculation method apparently aimed at stressing budgetary imbalances (and as a consequence, at having them corrected), which has subsequently become deeply embedded.[6]

With Member States seeking to maximise local benefits from European integration, that they then wished to ensure a *juste retour* is a normal outcome. While a certain level of solidarity was accepted – leading to the existence of net beneficiaries and net contributors – it was rare until the enlargement to the new Member States that the net contributors did not receive more than 50% of their contributions to the EU in return. In some cases, wealthy Member States were even net beneficiaries (see Baldwin, 2005; Núñez Ferrer, 2007), mainly due to the CAP.

With the years, instead of an increased focus on common policies and a reduction of the importance of net balances, the net balance approach was strengthened in line with an increase in the share of revenues from the GNI resource. Some events also caused mistrust in the European Commission as a managing body for the budget, particularly the budgetary scandals

[5] Quoted in Cipriani and Pisani (2004).

[6] The Council stated that "[a]ny Member State sustaining a budgetary burden which is excessive in relation to its relative prosperity may benefit from a correction at the appropriate time".

surrounding the European Commission led by Jacques Santer, which resulted in the mass resignation of the College of Commissioners.

The negotiations on the budget, combined with the enlargement process, were influenced by a negative view of the EU's budget, which reinforced the net balance approach. As a result, the Berlin Summit in 1999[7] confirmed the concepts of 'net contributor' and 'net beneficiary' and allowed a growing number of Member States to apply a deduction to their contributions. Several countries were granted ad hoc rebates. The net balance approach to the budget was thus strengthened, as was the shift away from 'real' own resources. The capped and reduced statistical VAT resource is now nearly identical to a GNI share.

But the reputational drama of the budget did not stop with the Santer Commission. The new Commission asked a team of specialists led by André Sapir to analyse the EU's capacity to grow. The report (Sapir et al., 2003) was scathing when addressing the role of the EU budget: "As it stands today, the EU budget is a historical relic. Expenditures, revenues and procedures are all inconsistent with the present and future state of EU integration" (p. 172).

While hard-hitting with respect to the budget, the report also presented a concept that is still shaping the discussions on its future, the so-called 'EU added value'. Some policies financed by the EU have added more value to the EU than separate national policies. It also made Member States more conscious of the need to use the budget to tackle goals, and particularly to focus more on growth, with the budget increasingly contributing first to the Lisbon Agenda (or Strategy) adopted in the year 2000 by the Council,[8] and today to the Europe 2020 objectives (European Commission, 2010a).

While the EU budget has undergone considerable reforms since then, the present expenditure priorities are still not fully convincing. This is reflected in the recent paper by Heinemann (2015), in which he argues that there are still too many projects that only produce local added value. While for the EU budget these projects are suboptimal, they are often those most attractive to politicians looking to gain popular support by attracting EU funding for locally visible projects. This would justify Member State requests for a *juste retour* on their contributions and their focus on the benefits accruing to them from the transfers they agreed to make to the EU.

As a counterargument, analysts often deplore that while Member States use net balances as a key indicator of the benefits and costs of the EU budget, they rarely cite any beneficial impacts from the policies. Interventions by the EU budget not only trigger further investments through public and private co-financing, and attract private capital, but also have often important, longer-term effects. Furthermore, the effects often extend beyond a local context and can trigger positive cross-border spillovers. There have been studies, for example, on the second-round effects of the EU Cohesion Policy. An improvement in the growth rates of beneficiary countries often generates cross-border benefits. The increased demand induced by the projects inflates EU aggregate demand, which benefits EU exporting countries and not only the regions receiving the support. This is described in more detail in section 3.1.

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[7] See European Council, Presidency Conclusions of the Berlin European Council, 24–25 March 1999.

[8] See European Council, Presidency Conclusions of the Extraordinary Lisbon European Council, 23 and 24 March 2000.

2.2.2 *Are the own resources mechanism and corrections in line with current budget needs?*

The basic structure of the own resources decision is still based on the logic of net balances and *juste retour* emerging from 1984 Fontainebleau agreement. Is there a justification for such an approach? The decision at the time was rational given the circumstances, and as this report discusses in more detail, the arguments for corrections cannot just be dismissed. Nevertheless, while a new solution has to be sought to balance the interests of Member States and the EU as a whole, the present mechanism is well past the 'best before' date. There is a widening gulf between the arguments for corrections and the actual budget operations, as described in more detail in chapter 3, but some fundamental principles can be expressed here.

A net balance approach to the EU budget, or *juste retour* logic of the net balances, can be justified if:

a) the EU contributions to the Member States generate only local benefits without cross-border spillovers. This means that the contributors to the EU budget do not benefit from the policies they finance in other countries; or

b) the distribution of the funds is unfair. Citizens in the same situation are treated differently across Member States within the same policy. If an EU common policy has a target group across Europe and wants to tackle a common problem, it has to have rules that apply to all in a fair manner. Some Member States may consider that this is not the case.

Over the years, the justifications for both arguments have weakened considerably. Chapter 3 looks more closely at why the multiple changes in the budget are close to rendering point a) obsolete. For point b), there are areas of concern, and they are mainly related to the way the CAP is designed, based on rather obsolete formulas linked to a distribution of support in the 1980s. A more thorough explanation is given in section 9.3.

Thus, while the stance of the UK is to some extent understandable, the way this is handled through the own resources mechanism is rather blunt and questionable, and it should be reformed.

2.3 INCREASING CALLS FOR NEW OWN RESOURCES

The calls for new own resources have been numerous and can be traced back to the crises arising from the methods used for funding the agricultural policy of the European Community in the 1960s. A very important decision was the creation of the VAT resource as a replacement for Member States' contributions.[9] The VAT resource was created to avoid having Member States contribute through transfers from their treasuries. It resulted in independence of the EU budget from national treasuries, or simply a budget financed by real own resources. It is interesting how this decision has been sidelined by subsequent events, with the introduction of the GNI resource to make up for shortfalls in the resources collected. This was also combined with repeated reforms weakening the VAT resource, despite its potential to finance the whole of the budget with a small share of the receipts (approximately 2% for today's EU budget).

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[9] See the Council Decision of 21 April 1970 on the replacement of financial contributions from Member States by the Communities' own resource, OJ L94, 28.04.1970.

The autonomous character of the EU budget, with GNI contributions now covering close to 80% of the resources (up to 90% if one takes into account the VAT resource), has been transformed into virtually the equivalent of a GNI transfer.

The increase in the share of the GNI resource over the years has also led to the emergence of calls for a *juste retour* and the multiplication of complex corrections, among them the UK rebate. Meanwhile, the EU budget has faced increasing challenges to address the complex needs of the EU, which have led to a transformation of its objectives and functioning, and hence to the need for rational reforms (see, e.g. Haug et al., 2011; European Parliament, 2010; Núñez Ferrer, 2007; Le Cacheux, 2005).

2.3.1 Development of proposals for new own resources

The capacity of the EU to finance the enlargement led to considerable discussions on the mechanism of own resources in the late 1990s. This led the European Commission to present a report on own resources (European Commission, 1998). Mandated by the conclusions of the Berlin European Council on 24–25 March 1999,[10] that same year the Commission presented its first proposals for a reform of the own resources mechanisms introducing new tax-based own resources. No agreement was reached on a reform for the MFF for 2000–07, but the Council's conclusions called for the European Commission to undertake a general review accompanied by appropriate proposals. In 2004, the Commission released a comprehensive report on own resources (European Commission, 2004) and tabled groundbreaking proposals to reform the own resources for the 2007–13 MFF, which again were not adopted. The list of suggested resources in the different proposals is presented in more detail in chapter 5.

The growing complexity of the own resources and general dissatisfaction with the system led to the introduction of new provisions in the Treaties and to a renewed attempt to introduce reforms with the European Commission's proposals of 2011. The provisions are outlined below.

2.3.2 The Lisbon Treaty, budget review and European Commission's 2011 proposals

The Lisbon Treaty introduced new provisions for an own resources reform in Art. 311, in addition to the reiteration that the EU should be financed by own resources (without clarifying what 'own' exactly means):

- Art. 311(3) TFEU establishes that "the Council may establish new categories of own resources or abolish an existing category".
- Art. 311(4) TFEU establishes that the Council "acting by means of regulations in accordance with a special legislative procedure, shall lay down implementing measures for the Union's resources system in so far as this is provided for in the decision".

These are quoted by the Commission in the 2011 proposals as important novelties (European Commission, 2011a); in practice though, a reform of the own resources remains a case for unanimity and provides more of a clarification than a real departure from the past. Chapter 5 explores the legal provisions for an own resources reform, but does not present a substantially easier mechanism to agree on new own resources. It is in fact telling that the 2010 budget review by the European Commission (2010b) does not even mention the Treaty changes when it addressed, even if rather superficially, the candidates for own resources.

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[10] See European Council, Presidency Conclusions of the Berlin European Council, 1999 (op. cit.)

Shortly before the actual reform proposals, the European Commission produced a detailed analysis of the following potential candidates (European Commission, 2011d):

- a financial transaction tax (FTT),
- a financial activities tax,
- auctioning revenue from the EU Emissions Trading System (ETS),
- charges related to air transport,
- a new VAT resource,
- an energy tax, and
- an EU corporate income tax (CIT).

Despite the length of the list of options, the 2011 Commission proposals included only the first two of the above-mentioned candidates: the FTT and a new VAT resource.

The proposals also foresaw a reformed system of correction mechanisms, based on a lump-sum gross reduction of GNI contributions to the budget. These would be ad hoc negotiated transfers based on a 'demonstrated' excessive budgetary burden (without a clear methodology for how to assess the excess). The Commission also proposed a generalised correction mechanism as an alternative, but strongly discouraged it because of the complexity of such a system and the rigidities that would ensue.

Again, no agreement was reached in the Council, but the High Level Group on Own Resources was established by the three European institutions (the Council, Parliament and Commission) to seek a solution for which this report has been prepared. The report tries to offer a consolidated but detailed analysis of the present situation, the options and a way forward to reach a realistic agreement.

3 WHY THE NET BALANCE APPROACH IS (EVEN MORE) ILLOGICAL TODAY

Chapter 3 in a nutshell

- Over the last two decades the EU budget has been reformed considerably within the constraints of the net balances.
- As a result, in distributing support to Member States, not only the Cohesion Policy in particular but also others have become more closely aligned with EU objectives and transformed into instruments to achieve them. The budget thus no longer represents a mere transfer to poorer regions.
- The *acquis*, which was designed for the 'old' Member States, is also costly and requires considerable investment.
- With EU policies increasing their EU added value, the net balance arguments are weakened, even if more should be done to further improve expenditure policies.
- The net balance approach damages the rationale of the budget, given that today it is more aligned with EU objectives.
- The net balance approach is based on flows from national treasuries and fails to account not only for the benefits of expenditures, but also for actual real flows of investment.
- The financial flows generated by the EU budget have changed in nature over the last 15 years. Those flowing from financial instruments and the reinforced innovation policy benefits net contributors considerably.
- The investment flows can no longer be ignored when balances are calculated. The real investment flows are very substantial.

The net balance approach to the EU budget negotiations by the Member States has fundamental flaws that have been increasing in magnitude over the years. The rationale, based exclusively on the amounts of public money shifted through Brussels, misses three very important aspects of the EU budget: one well documented but which never seemed to affect the position of Member States, and two new ones.

This chapter elaborates on these three aspects (outlined below), but with a focus on the last two, which have not been sufficiently considered until now:

1) The net balances of the EU do not reflect the distribution of the benefits from the budget.
2) The EU budget reforms over the last two decades have increased the EU added value of its interventions substantially.
3) The EU financial instruments are mobilising funding that in size rivals the EU budget. The distribution of the investment is not related to the flows of 'public funding' from the Member States.

These three points together and particularly the last one put into question the present net balance approach to the EU budget and the system of corrections. The own resource rationale is more than just politically detrimental – *it is fundamentally flawed*. The present system is no longer a balanced solution regardless of the metrics used.

It is also worth mentioning that the ranking of net contributors or beneficiaries depends on the metrics used for comparison (value in euros, shares in GNI, per capita GDP in purchasing power parity…). There is no one true 'net balance'.

This chapter demonstrates that contrary to common perception, the net balances do not reflect the distribution of costs and benefits of the EU budget. The net balances neither reflect the fact that the share of projects with a real EU added value has increased considerably across budget headings, nor the fact that the financial flows for investments supported by the EU budget have changed in size and location.

3.1 Economic and cross-border impacts of the EU budget are ignored

A problematical issue is that Member States appear more prone to base any decision on what funding they can recover from the budget than on building a comprehensive view that would take into account 'second-level benefits' and positive, cross-border external effects.

Different and enriched methodologies could more accurately reflect real impacts and modify the results to a great extent, in a way that integrates the mutual benefits that could be expected from EU policies and more careful of the long-run collective interest.

In this respect, Cipriani and Pisani (2004) used input–output tables and commercial trade flows to produce a macro analysis able to yield estimates of the change in the demand for goods and services generated by EU expenditure (Box 3.1).

Box 3.1 Modelling economic impact of the EU budget

The starting point of this work is the assumption that each unit of such expenditure gives rise to an increase in production, which can be divided among agriculture, industry, services and building. The authors use Member States' input–output data as well as the data depicting the expenditure they receive from the EU budget. The global benefit of the EU expenditure can be split among the amounts of domestic and foreign production due to exports. The input–output model is a matrix in which the horizontal rows show how the output of each sector of the economy is distributed among the others, and the vertical columns show how each sector obtains from the others its needed input of goods and services. Intermediary consumption and added value are thus apprehended. These additional resources can come from domestic or foreign production.

Source: Cipriani and Pisani (2004).

In the report for the Commission on own resources in 2005, Le Cacheux quotes studies such as that undertaken by the DREE (2004), which have shown that EU expenditures provide additional growth for all Member States, including net contributors. The real burden of a transfer and the real benefit triggered by expenditure are different from the accounting approach for net balances. That is precisely why the current accounting mechanism of operating budgetary balances not only lacks comprehensiveness, but is also misleading.

Recent studies reinforce this position. Evaluations of the Cohesion Policy over the 2007–13 period estimate that this policy achieved a substantial contribution to growth and jobs, with larger long-run effects. Many tools have been used: quantitative information, evaluation of particular programmes or interventions, econometric techniques and counterfactual impact evaluation with, for example, macro models that simulate how the economy would have evolved in the absence of the policy and compare the potential situation with the way it actually developed. In a recent report for the European Parliament (Núñez Ferrer and Katarivas, 2014), these are reviewed and show that the EU budget has considerable impact on the EU Member

States' economies and the EU as a whole. The improvements in strategic planning and the increased use of financial instruments to leverage private funding and direct investment to key productive areas is increasing the EU budget's impact.

Despite the results of studies on the impact on economic output and the cross-border spillovers, political decisions on the own resources are not based on secondary effects, and it is unrealistic to expect that such an approach would work now. Still, the next two sections present some new developments that render the net balance approach particularly meaningless.

3.2 AN IMPORTANT SHIFT FROM LOCAL TO EU OBJECTIVES

The debate on net balances originates from a time when the freedom of Member States to allocate the funding to purely national and local priorities was much greater than today. The EU budget transfer was mainly a tool to beef up the national budget with little requirement for the 'European' nature of the expenditure.

Since the 1980s, however, *the nature of EU expenditures in Member States has radically changed*. The Cohesion, Structural and Rural Development Funds have increasingly become instruments to achieve EU objectives in important areas, such as energy and transport, environmental protection and innovation. Member State programming now entails a minimum reallocation of funds to different EU priority objectives, considerably stricter strategic planning and a process that requires Member States to link almost all actions to Europe 2020 objectives. Indeed, the EU Structural and Cohesion Funds are now tools to ensure the implementation of the EU *acquis* and the growing EU-level objectives. Many of the environmental and energy objectives of the EU have been designed and led by countries with high standards, which tend to be the largest contributors to the EU budget.

The restriction of the strategic freedom of Member States has reached a new height with the creation of 11 thematic objectives, and complex, strategic planning requirements. EU regional and rural funding is being used to achieve common objectives, such as reducing greenhouse gas emissions and attaining high levels of environmental protection. EU standards often exceed the rules that countries with a lower level of GDP would have adopted. The EU budget de facto partially compensates countries for stringent standards that they would not have adopted at their state of economic development. At the same time, EU support also requires co-financing, which creates opportunity costs by directing limited public funds to achieve EU objectives that then cannot be used elsewhere.

Over the years, net contributors have requested that the EU budget focuses more on EU added value. By so doing, these Member States have admitted that expenditures where added value is higher are worth undertaking regardless of their location. An example would be reducing emissions from power stations or from cities. It would follow logic to conclude that interventions, regardless of the budget line, that aim at EU added value should be excluded from net balance considerations. That is not the case, however. Not even centrally planned funds, such as those for research or the Connecting Europe Facility, are excluded from net balance calculations and the corrections arising from them.

3.2.1 *Brief overview of the increasing EU added value*

The Common Provisions Regulation (No 1303/2013) for the European Structural and Investment Funds (ESIF)[11] are much more *dirigiste* than past fund provisions. Member States benefiting from the funds have to develop strategies that are in line with higher-level EU objectives. The requirements can be summarised as follows:

- a more coherent use of available funds, aligned with national reform programmes;
- a menu of 11 thematic objectives in the Structural Funds' strategy programmes;
- the need for a comprehensive investment strategy aligned with Europe 2020 objectives;
- the development, where appropriate, of integrated packages of actions at the local, regional and national levels, leading to better coordination between Cohesion Policy, research and development, rural development, maritime and fisheries funds;
- orientation towards results using relevant objectives and indicators to measure progress towards Europe 2020 targets;
- effectiveness supported by a new performance framework;
- a strengthening of administrative capacity and a reduction of red tape; and
- a strengthening of territorial cohesion.

These requirements are not negligible and represent a strong departure from the past. The reforms started with the 2007–13 MFF and have been consolidated for the present framework. The required actions emanating from the 11 thematic objectives are listed in ***Table 3-1***. The expectations are considerable for all of the objectives if the thematic guidance provided by the European Commission[12] is followed. For each objective, there are specific targets and requirements for each fund (European Regional Development Fund (ERDF), Cohesion Fund (CF), European Agricultural Fund for Rural Development (EAFRD), and the European Maritime and Fisheries Fund (EMFF)). The first thematic objective is also linked to a national, coordinated, Smart Specialisation Strategy, which incorporates the Horizon 2020 programmes. In fact, the new rules also encourage the mix of support measures to reach new, higher impact levels, and include the combination with the European Fund for Strategic Investments (EFSI).

[11] Regulation (EU) No 1303/2013 of 17 December 2013 laying down common provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund and laying down general provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund and the European Maritime and Fisheries Fund, OJ L 347/320

[12] See the "Guidance on European Structural and Investment funds 2014–2020" (http://ec.europa.eu/regional_policy/en/information/legislation/guidance/).

Table 3-1. Thematic objectives for the ESIF, 2014–20

Thematic objectives	
1)	Strengthening research, technological development and innovation;
2)	Enhancing access to, and use and quality of ICT;
3)	Enhancing the competitiveness of small and medium-sized enterprises, the agricultural sector (for the EAFRD) and the fisheries and aquaculture sector (for the European Maritime and Fisheries Fund);
4)	Supporting the shift towards a low-carbon economy in all sectors;
5)	Promoting climate change adaptation, risk prevention and management;
6)	Protecting the environment and promoting resource efficiency;
7)	Promoting sustainable transport and removing bottlenecks in key network infrastructures;
8)	Promoting employment and supporting labour mobility;
9)	Promoting social inclusion and combating poverty;
10)	Investing in education, skills & lifelong learning; and
11)	Enhancing institutional capacity building & efficient public administrations.

Source: Art. 9 Common Provision Regulation (EU) No 1303/2013

Consequently, it is important that Member States abstract themselves from considering transfers to other countries as exclusively benefiting the recipients.

It is also worth pointing out that EU support generates demand for technical knowhow and technologies from contributing Member States. Developing the economies of poorer Member States brings benefits to the Union as a whole, and more than just financially. Avoiding the formation of backward regions within the EU generates political stability, and reduces social tensions and internal migration.

3.2.2 Reinforcing EU added value

This section states that EU budget support has an EU added value that can be defended. However, all is not in order, and there is a need for further reflection. As Heinemann (2015) points out, the EU budget is still financing too many projects with questionable EU added value. Some of these may well be 'compatible' with the thematic objectives or other EU objectives. This is partially due to path dependency. Cohesion Policy, like the CAP, was originally developed in response to a number of national requests. The policies responded to local needs, and not to EU-level objectives. The goal of regional convergence was perfectly compatible with investments focusing on local benefits without a link to a wider EU objective. The need to link investment to 'European' added value is recent. The EU budget also thought to 'compensate' Member States for the possible negative impacts of integration on specific groups in society. As a consequence, for many years the European Commission has been adding as permissible actions those that are questionable from the point of view of the fiscal division of powers in a multi-level governance framework.

Therefore, this report includes a recommendation for how to combine an in-depth review and phased modifications of EU budget policies. Reforming the EU own resources could theoretically be done independently of reforms at the expenditure level. At the same time, good reforms are unlikely without a new deal that better targets EU added value, and a new deal on the financial responsibilities of Member States in policy areas with more local added value. A phased approach taking into account transitional reform agreements is needed. This report proposes some options in light of the political realities associated with the EU budget and phasing in own resources reforms connected with agreed improvements to the expenditure policies. While the report does not propose specific reforms on the expenditure side, which would require an exhaustive analysis, it proposes methods to approach the review of the budget in Part II.

3.3 REVIEWING THE FACTS RELATED TO FINANCIAL FLOWS

Despite all its imperfections, the net balance approach in the 1980s and 1990s had some rationale. A euro transferred from one Member State to another was connected locally to a public euro to achieve a national objective with limited leverage and limited direct cross-border benefits. A net balance approach was a rational political development, even if it was against the logic of public financial allocation, which should be independent from the origin of the resources. As previously discussed, with EU policies aiming at higher-level EU objectives, this approach is questionable. Yet new developments make net balances more than just questionable; they invalidate them.

The EU budget has modernised its instruments, linking them more to market-based mechanisms. The reforms correctly identify that there is a need to maximise the reach of the budget where necessary. It has also been addressing the concerns of investors since the start of the financial crisis, not only due to sluggish growth, but also to an increasingly volatile market and risk aversion.

The EU has considerably expanded the use of financial instruments, transforming them from a marginal intervention into a powerful tool to generate investment. Their flows do not correspond to the traditional co-financing of Cohesion Policy grants, agricultural subsidies or even R&D grants. While investments supported by financial instruments are expected to crowd in private investors, the final impact is considerable because of the leverage effect. The EFSI alone aims at mobilising investments that rival the size of the Cohesion Policy, while the sum of all funds mobilised by financial instruments could rival the whole budget by the end of the MFF.

The problem with the net balance approach is that many financial instruments are (correctly) not pre-allocated geographically, and the financial flows generated vary from project to project. Furthermore, given the nature of the investments, some of the projects are powerful economic boosters in the areas where they are undertaken. A country receiving more from grants is thus not necessarily the country benefiting most from the EU budget intervention. This chapter describes how serious this is in terms of the 'fairness' of EU budget contributions. The budget expenditure side has modernised considerably. However, to paraphrase the Sapir report, the own resources mechanism is certainly a historical relic.

3.3.1 Net balance vs financial flow analysis

The budget is no longer a simple grant distribution tool transferring public money from one country to another, but is also a mobiliser of private investments, often cross-border. This means that while €1 transferred in the past mobilised domestically on average €1–2, today it can be a multiple. These flows of project funding are not based on the GDP of the country, but on the viability of the investments. The flows of 'investment' elements of the budget are no longer 'rich to poor'.

This report argues that in time, with such instruments gaining importance, the net balance arguments will be unsustainable, as the levels of investment mobilised will not be inversely correlated to a Member State or region's wealth. The opposite may even be true at the present economic conjuncture. With the demand side of the poorer Member States suppressed, the most attractive investment areas are not the underdeveloped regions of the EU, but the most developed. According to economic theory, the return on investments on additional infrastructure declines for a given level of GDP (Gros, 2014). Europe's capital-to-GDP ratio is rather high compared with the US, and is considerably higher in EU cohesion countries. The latest disinvestments in infrastructure seem to have affected growth potential more often than not in the wealthier Member States, where the capital-to-GDP ratio has fallen.

Similar arguments can be given for a number of areas. In R&D, the returns on investment and attraction of capital are higher in advanced economies (see sections 3.6 and 3.7). For investment in small and medium-sized enterprises (SMEs), the support would also be more successful in countries in better economic condition, owing to the stronger demand-side stimulus. With the financial instruments, the dynamics created by the EU budget have been altered. That is not a criticism, as financial instruments can be growth generators for the EU as a whole. Yet they are not instruments specifically designed to favour regions that are catching up, but rather to counter suboptimal investment situations wherever they arise.

Núñez Ferrer and Katarivas (2014) have reviewed the leverage and multiplier effects of the EU budget and how these are increasing in importance and falling into a different distribution compared with the past. Financial instruments and an increase in R&D spending are the main reasons for the shifts in financial flows.

These shifts have been strengthened with the EFSI (also known as the 'Juncker Plan'), which uses the EU budget outside of the budgetary framework to guarantee and mobilise private investment. It is still early to judge the overall future performance, but the first projects of the infrastructure and SME support elements confirm that EU financial instruments generate large flows, and that these cannot be accommodated to a philosophy of net budgetary reforms.

3.4 CENTRALLY MANAGED FINANCIAL INSTRUMENTS

In this section, we review the investments by centrally planned financial instruments and estimate the impact of the EFSI. Only in 2015, EFSI instruments alone raised €60 billion. This is a substantial sum. With such a performance the EU budget could contribute to mobilising through financial instrument investments a sum well above the EFSI target of €315 billion, and more if the EFSI mandate is extended. Today, centrally planned financial instruments rival the size of the Cohesion Policy in terms of the investment flows they generate, and may easily overtake it. This is a significant change.

Let us start with EFSI performance, given the large leverage expected in the near future. It promises to be more dynamic than the financial instruments presently in place. The objectives of the EFSI are to promote investment in the EU economy in line with the Europe 2020 objectives. It is designed to attract private investment to suboptimal investment situations where they arise. Even if the EFSI has introduced limits to sectorial and geographical concentration, its role is not redistributive and should not be seen as such.

Some aspects of the nature of all non-pre-allocated financial instruments, including the EFSI, will determine their incidence:

- the location of key infrastructure needs, which can generate a return on the investment; and
- the administrative capacity to develop projects that can use the EFSI.

Not surprisingly, in the first stages the geographical allocation of financial instruments has tended to benefit the wealthier Member States, which is not necessarily a negative feature.

Figure 3-1 and Figure 3-2 show the flows for approved projects and those in the pipeline for signature at the end of March 2016. There is little doubt that the bulk of the investments mobilised is in net contributing countries. Billions of investments are generated for countries that are dissatisfied with their net balance, which do not take these flows into account.

Again, that is not a criticism of the existence of the EFSI, but rather an observation prompting the question of who benefits today from the EU budget with the expansion of centrally managed headings and financial instruments. Is it those who receive more transfers, or those who mobilise the most funding from support triggered by the EU budget? This pattern is also found on the SME side of the EFSI.

With time, as the capacity to use financial instruments increases, the geographical incidence may well change. In addition, if global economic prospects increase, the competitiveness of the cohesion countries may also increase, shifting the investments with financial instruments towards them. What is clear is that tracking the location of the financial flows created by the budget will grow more difficult.

Figure 3-1. EFSI funds approved for infrastructure investments

Country	Number of projects	Total estimated investments (mEUR)
UK	3	3.402
Italy	5	3.270
France	4	2.133
Denmark	1	2.010
Spain	2	567
Belgium	1	542
Netherlands	1	336
Germany	1	309
Finland	1	281
Multinational	1	120
9 Countries	TOTAL number of projects - 20	Total estimated investments: EUR 12.969 m

Source: European Commission (data from 31 March 2016).

Figure 3-2. EFSI funds approved and waiting for signature for infrastructure investments

Country	Number of projects	Total investments estimated (mEUR)
France	5	4.267
UK	2	2.271
Italy	3	1.436
Slovakia	1	1.332
Belgium	1	1.155
Ireland	2	562
Germany	2	535
Netherlands	1	257
Croatia	1	100
Poland	1	75
Austria	1	74
Sweden	1	38
Multinational	5	2000
12 Countries	TOTAL number of projects - 26	Total investments estimated: EUR 15.127m

Source: European Commission (data from 31 March 2016).

The present allocation of funding does not imply that in the future the same distribution is to be expected. Investments go to where the economic environment is reassuring for investors, which may change. Under a more stable, global economic environment, the largest returns on investment are often in countries that are catching up, as a result of growing but lower wages and higher demand-side growth. The EFSI funds contribute to only one of three goals of the investment plan for Europe, the other two being to support investment in the real economy (i.e. through the set-up of the European Investment Advisory Hub, which offers technical assistance to project promoters) and to create an investment-friendly environment (by removing regulatory and non-regulatory barriers). The last goal can only be reached if structural reforms are undertaken in all of the Member States. An improvement in the growth potential of countries and successful structural reforms can shift investment to other countries.

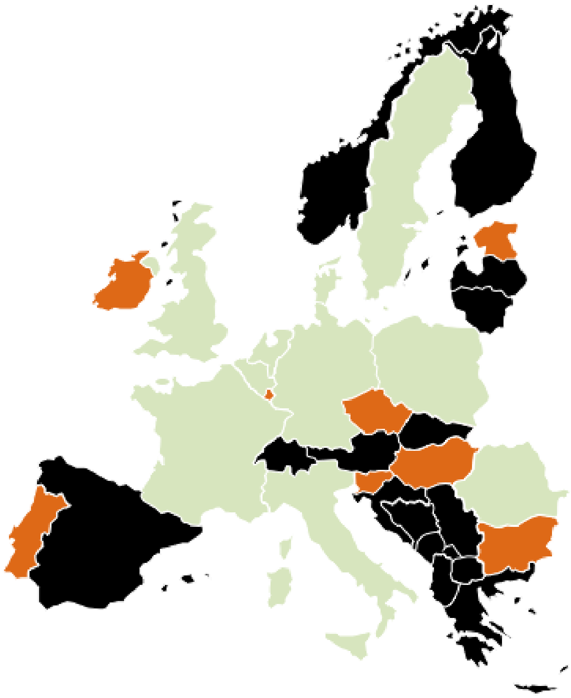
Figure 3-3 shows the allocation of funding under the SME window of the EFSI. The green table shows the number of funds created and potential investments in SMEs that are expected to be completed. At this stage of EFSI implementation, an important share of EFSI funds has been allocated to countries with the least amount of SME-financing difficulties. This is particularly the case for Germany, where bank credit did not tighten during the crisis probably because of the fall of the German Bund rates, as presented in an analysis published by the Centre for Economic Policy Research (Giovannini et al., 2014). The orange table lists the number of SMEs that have been assisted and the funds mobilised where the programmes have started.

This report does not evaluate the appropriateness of the funding, but shows that the EU budget allocation is departing considerably from the zero-sum game that justifies a net balance approach.

Figure 3-3. EFSI-approved funds for SME support

Country	Number of funds per country	Total investments expected (estimate in mEUR)
Germany	9	4110
France	7	1990
Italy	7	1929
UK	4	1269.3
Poland	4	662.8
Belgium	5	573.3
Netherlands	2	84.5
Romania	1	76.4
Denmark	1	67.2
Sweden	1	26.6
**Multi-country	17	3085
10 countries (not including multi-country projects)	TOTAL number of funds - 58	TOTAL - EUR 13.874 m

Country	Number of SMEs and Start-Ups per country	Total investments allocated (estimate in mEUR)
Portugal	590	588
Czech Republic	1840	579
Slovenia	1500	388
Estonia	900	336
Luxemburg	176	154
Ireland	50	140
Hungary	1500	135
Bulgaria	1000	100
8 countries	TOTAL number of SMEs and Start-Ups – 7.556	TOTAL EUR 2.420 m



Source: European Commission (data from 31 March 2016).

3.4.1 Other centrally managed financial instruments for infrastructure

The experience of the EFSI is reflected in other centrally managed funds. Table 3-2 presents the funding committed by the EU budget and the cumulative financing supported by EU intervention. An overview of the allocation of these funds shows that the distribution of the projects does not support the net balance approach to the EU budget flows.

Table 3-2. Centrally planned financial instruments for infrastructure

Financial instrument	Aggregate EU commitments (in €)	Cumulative financing supported (in €)	
		2007–13	2014
Project Bond Initiative	230,000,000	1,078,500,000	2,108,000,000
Loan Guarantee Instrument for Trans-European Transport Networks	250,000,000	11,716,000,000	12,097,000,000
European Energy Efficiency Funds	146,334,644,5	n/a	216,000,000
Marguerite Fund	80,000,000	3,892,980,000	4,922,000,000

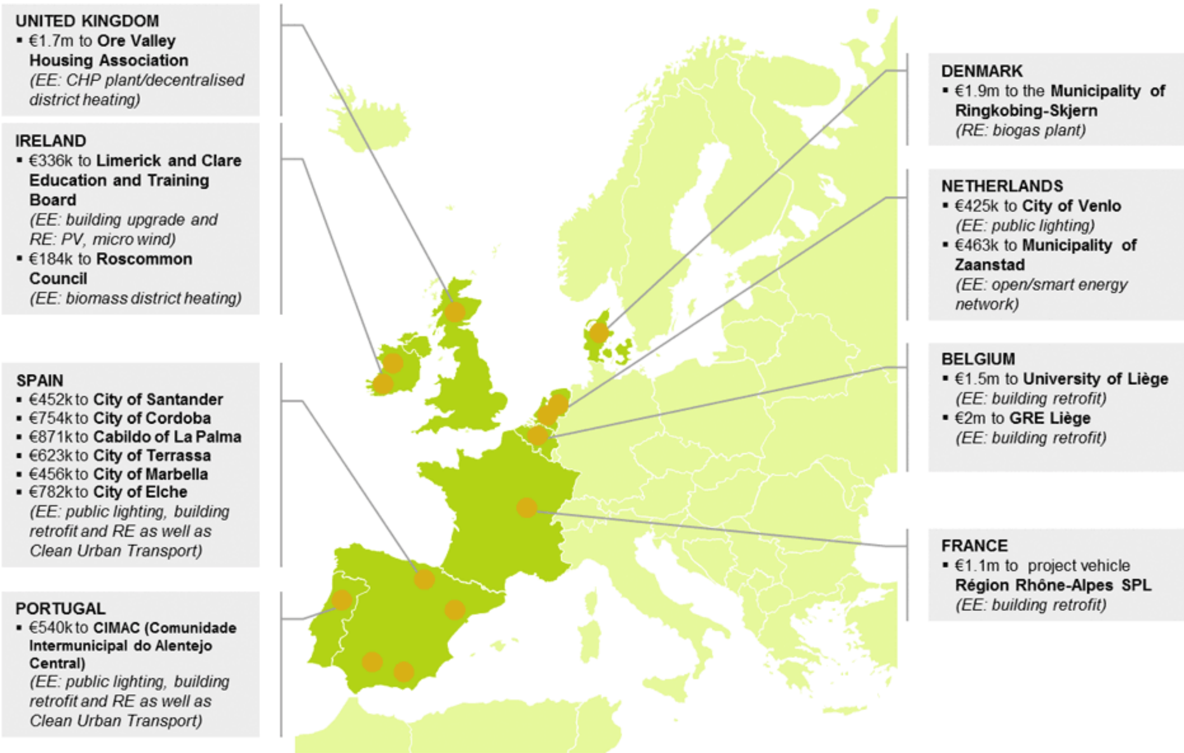
Source: European Commission.

The Project Bond Initiative is closing its pilot phase with eight projects approved since 2013. The support of €230 million has mobilised €2.1 billion in projects, three of them in the UK, two in France, one in Germany, one in Belgium and one in Spain.

The funding for the Loan Guarantee Instrument for Trans-European Transport Networks during the period 2007–14 has raised €12.1 billion for projects in France, Spain, Germany, Portugal and the UK.

The European Energy Efficiency Funds (EEEF) supported projects with a value of €216 million in 2014, again concentrated in Western Europe, as Figure 3-4 presents.

Figure 3-4. Distribution of the EEEF in the EU



Source: EEEF-Geographic overview (www.eeef.lu).

The Marguerite Fund, which supports long-term infrastructure investments, mobilised close to €5 billion between 2007 and 2014, with some success in the geographical spread of the projects.

Figure ***3-5*** presents the location of the projects, with one in most countries, but two in Poland and two in France.

Figure 3-5. Projects financed by the Marguerite Fund, by location

Source: Marguerite Fund website (www.marguerite.com).

3.5 CENTRALLY MANAGED FINANCIAL INSTRUMENTS FOR RESEARCH AND INNOVATION

Under the previous Seventh Framework Programme (FP7) and the present Horizon 2020 programme, the EU budget supports the EIB in lending and further leveraging funds for innovative projects (Table 3-3) . During the period of the MFF, the risk-sharing finance facility (RSFF) and Risk Sharing Instrument (RSI) raised over €10 billion. In 2014, the follower programme (InnovFin – EU finance for innovators) additionally raised over €1 billion. Special guarantee, loan and venture capital instruments have been created to help SMEs and mid-caps to access funds.

Table 3-3. Risk-sharing finance facility under FP7 and Horizon 2020

Financial instrument	Aggregate EU commitments (in € million)	Cumulative financing supported (in € million)		Number of final recipients benefitting	
		2007–13	2014	2007–13	2014
RSFF	960.7	9,556	n/a	98	n/a
RSI	270	831	n/a	1,376	n/a
InnovFin	551.6	n/a	1,168.7	n/a	36

Source: European Commission.

This funding also shows a certain geographical concentration. The geographical distribution of the RSFF, while covering 23 countries according to the second interim evaluation of 2013, has

48% of the funding concentrated in France, Germany and Spain. The distribution is presented in Figure 3-6.

Figure 3-6. Portfolio breakdown by country as a percentage of cumulative breakdown

Country	RSFF Funds (mEUR)	Percentage (%) of RSFF amount per country
Germany	2.400	24%
Spain	1.400	14%
France	1.000	10%
UK	800	8%
Italy	800	8%
Sweden	800	8%
Netherlands	600	6%
Belgium	400	4%
Others	1.800	18%
	Total RSFF amount (mEUR) €*10.073*	TOTAL – 100%

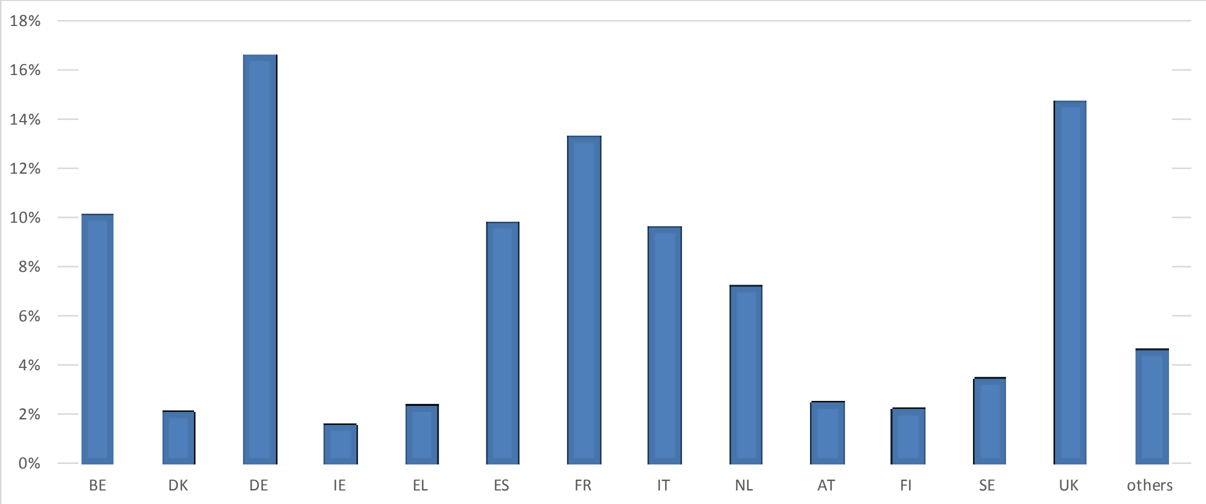
Source: European Commission.

3.6 Distribution and impact of the research and innovation budget

Wealthier Member States have a comparative advantage in attracting funding for R&D and innovation, and this is reflected in the distribution of the FP7 funds disbursed from 2007 until June 2014. The chart below is based on the information provided by the European Commission on the funding received by the institutions involved in EU research programmes.

Figure 3-7 is self-explanatory: 13 countries received 95% of the FP7 funding. Among the countries, Germany, the UK, France, Belgium, Spain, Italy and the Netherlands dominated.

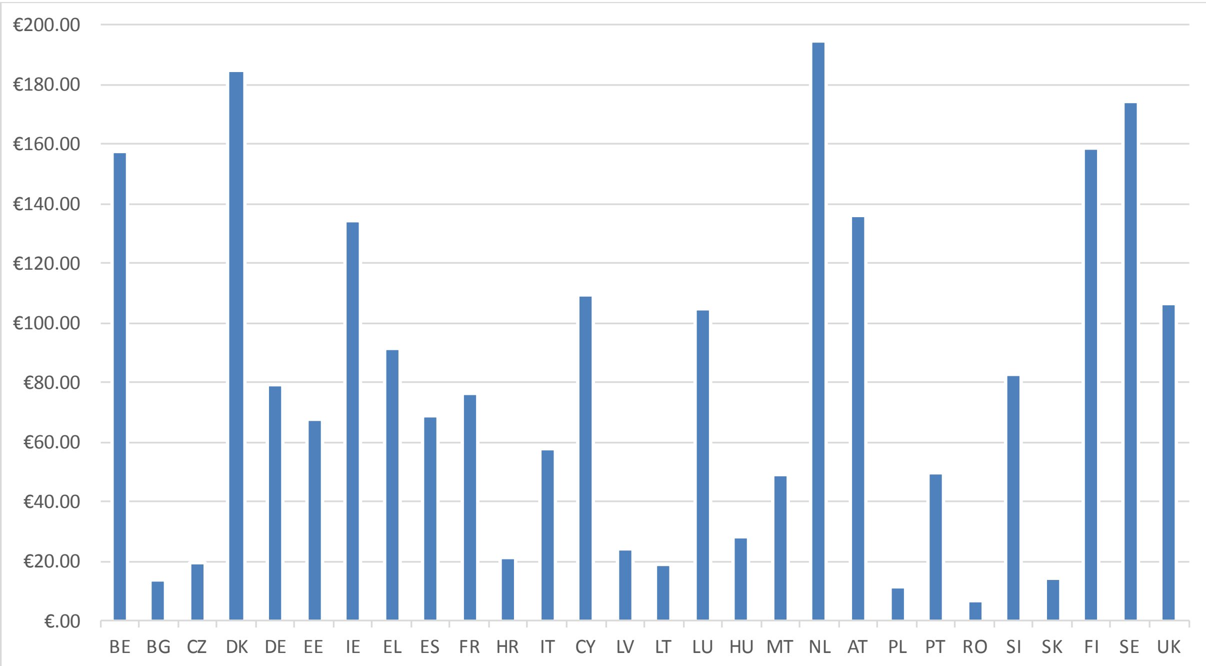
Figure 3-7. Share of funding allocated from EU FP7 funding to institutes by country (as a %), 2007–June 2014



Source: European Commission.

It is interesting to look at the per capita distribution in Figure 3-8, which changes the ranking to some extent, putting the Netherlands, Denmark, Sweden, Finland and Belgium ahead.

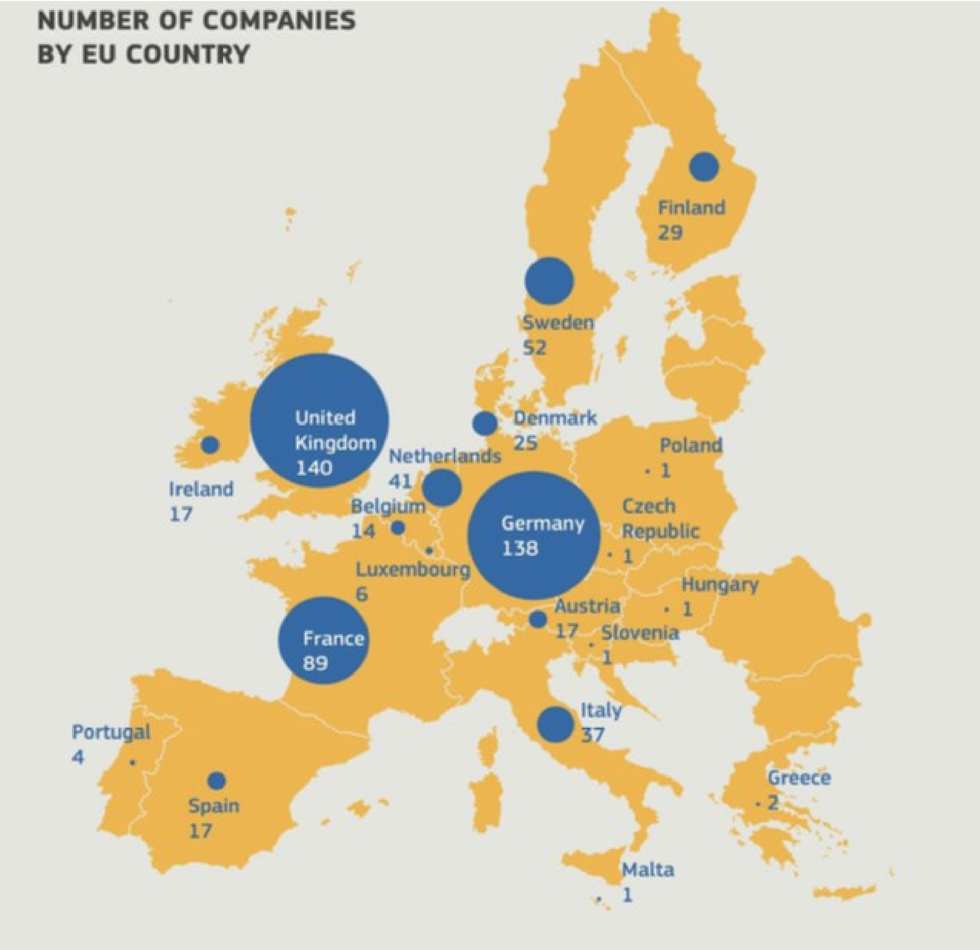
Figure 3-8. Distribution per capita of EU FP7 research funding, 2007–June 2014



Source: Own calculations based on figures from the country profiles published by the European Commission (http://ec.europa.eu/research/fp7/index_en.cfm?pg=country-profile).

Funding for research and innovation is regarded as a key driver for growth. Thus, it is important to consider the economic returns of the research investment. Using an OECD model developed by Guellec and Van Pottelsberghe (2004), the Joint Research Centre estimated the effects of the Sixth and Seventh Framework Programmes on the growth of total factor productivity of the EU and associate countries. The results show that on average, for every €1 invested by the EU research programme, €13 was generated in increased added value in the business sector. The impact depended on the structure of the country, the market size and the industry structure. This suggests that benefits are likely higher in the most advanced countries with the largest markets. The EU industry R&D scoreboard for 2014 shows that of the world's 2,500 leading companies in terms of investment in innovation (which invested more than €15.5 million in R&D in 2013), 633 are in Europe. A glance at the distribution of these companies gives an idea of where the centres with the highest investments and with highest potential returns are (Figure 3-9).

Figure 3-9. Location and number of the top 633 companies investing in R&D



Source: 2014 EU industry R&D scoreboard.

It is important to reiterate that this report does not judge the distribution of spending as negative. It is encouraging to see the importance of investments in companies and that the EU Framework Programme is supporting centres of excellence. The EU's redistributive policies and those focusing on competitiveness each have their place and function. The present financial framework also requires Member States to use the Cohesion Policy to boost their ability to use the financial instruments and research and innovation funds. If successful, the maps and graphs presented above will be different in the future.

What this report does judge is the erroneous position of some Member States that consider that they do not benefit from contributing to the EU budget based solely on the public fund flows.

3.7 Financial instruments under shared management

The use of financial instruments for structural policies (i.e. the ESIF) has been expanding and under the new MFF the operations should increase considerably, intervening in all areas covered by EU policies.

Given the number of funds and the pre-allocated distribution of the financial instruments to Member States, the issue of geographical concentration is not the same. Nevertheless, a number of rules and difficulties can affect the performance of the funds, and the European Commission (2014b) reports that some Member States have not been very successful. Because the funds of financial instruments can be placed with intermediary bodies (also considered beneficiaries) that handle the lending operations, it is difficult to assess the total funding mobilised. This report thus does not focus on shared-management financial instruments in any detail.

However, given the nature of the funds, the most successful countries will have a higher leverage effect. Such flows may need to be acknowledged when claims are made about who benefits from the EU budget. Figures from the implementation presented by the European Commission (ibid.) show that there has been a problem in some countries. Initial, unexpected regulatory barriers (some of which have been removed) and a lack of quality projects have stranded some funds in non-performing funds of funds. There is a risk that a non-negligible sum attributed to these funds will have to be de-committed in 2017. Complex funds, such as urban funds, have been some of the most affected.

Financial instruments are not a panacea, and there is no way to hide that the projects need to be of a certain quality to attract investment, and have good administrative capacity. Attaining these attributes can be more complex in poorer areas, while an economic downturn cannot be successfully counteracted by financial instruments, because in such conditions projects become particularly risky and private investment would need considerable guarantees. Financial instruments have a risk threshold and also cannot afford many projects failing. This is a basic economic reality. It is, however, unclear how this has affected the design of the instruments.

As of December 2013, of the €17 billion allocated to financial instruments in the Cohesion Policy between 2007 and 2013, 43% had yet to reach beneficiaries. The annual report of the Court of Auditors for 2014, together with the European Commission's reply, clearly state the difficulties of using the funds in some countries.

> "The Commission notes that a detailed analysis by Member States requires an assessment of the various constraints affecting the implementation of each FI [financial instrument] and should in particular also take into account that the ERDF FIs in Bulgaria, Greece, Spain, Romania and Slovakia are severely hit by the economic and financial crisis" (op. cit., 6.49)[13].

This assessment indicates that when the economy is severely hit, financial instruments are not tools that can be deployed successfully.

The pattern of success in the use of financial instruments in other countries varies and is strongly affected by, for example, the quality of the institutional set-up and administrative capacity, but could also be from other factors. For example, Poland, Estonia and Germany show some success, while in the Netherlands these instruments perform poorly, despite the absence

[13] Court of Auditors (2014)

of administrative capacity problems. The Netherlands also has very successful domestic financial schemes.

3.8 CONCLUDING REMARKS ON NET BALANCES, ADDED VALUE AND FINANCIAL INSTRUMENTS

The above data show that future decisions on own resources for the EU need a much better approach than net balances. This chapter proves that benefits from the EU budget cannot be deducted solely from the accounting of public flows through the budget.

The chapter also shows that much of the EU budget is dedicated to fulfilling EU objectives rather than the choices of beneficiary countries. Many of the objectives have been the result of policy preferences of net contributors to the budget.

The number and reach of financial instruments supported by the EU budget has increased substantially, with sizeable funds mobilised. The location of the investments and their size varies geographically and also over time, making it impossible to measure any exact flows and benefits to Member States. For this first phase, however, we can see a greater benefit to wealthier Member States. What is clear is that with hundreds of billions of euros mobilised by financial instruments, the use of net balances to identify 'excessive net contributors' becomes senseless.

This report also conveys how powerful the benefits from research and innovation investments are in terms of returns on investment, and that there is a clear and expected concentration of the funds in a subgroup of countries, overwhelmingly wealthier and net contributors. It is nonsensical again to look at the mere budgetary flows as a measure of benefits. The Fontainebleau concept of an 'excessive net budgetary burden' has no defendable place in today's budget, because from the viewpoint of return on investment and also the attraction of investment in projects and products, the EU budget is benefiting the net contributors. Using net balances to calculate corrections, which then have to be covered by poorer Member States, is not only against the spirit of solidarity, but also unfounded from the standpoint of returns on investment and the generation of added value. Ad hoc decisions on a 'politicised perception' of excessive contributions and basing the EU budget contributions on non-negotiable deals through veto power undermine the functioning of the EU budget, as well as the fairness of the EU construct in general.

Finally, the mid-term review needs to go into more detail to evaluate the added value of EU budget sub-headings and actions, and clearly identify what the benefits are and where the policies are questionable. A rational debate on the budget needs to be based on a detailed analysis. The review could offer some insights on where the added value is, and where the slack is in the budgetary items.

4 REASONS FOR THE FAILURE OR SUCCESS OF PREVIOUS REFORMS TO OWN RESOURCES

Chapter 4 in a nutshell

- A number of barriers make reforms extremely complex:
  - fiscal heterogeneity,
  - power and voting rules,
  - institutional structures, and
  - interplays with other EU processes that restrict the budget.
- Yet fiscal heterogeneity can bring about collaboration to avoid distortions, which may lead to new EU own resources.
- Pressures and interaction with other areas of EU policy may drive reforms.

Public choice theories teach us that it is difficult, not to say impossible (Arrow, 1951), to obtain unanimity from the aggregation of heterogeneous preferences. Without surprise, the unanimity rule since the Luxembourg compromise has been the prime problem for any reform that would hurt at least one Member State's interests or stances. But even with the qualified majority rule, decision-making has been hard in the Council. To better understand the lack of reform, two separate elements involved in any collective decision are analysed successively: the voters and the voting rule.

4.1 FISCAL HETEROGENEITY AMONG MEMBER STATES

Because the direct reasons hindering the introduction of genuine own resources have been analysed in previous chapters, here we present the indirect ones by describing how Member States are heterogeneous regarding their own resources, objectives and instruments.

The issues here are in many ways similar to those analysed in the literature on the size of government in the national context. Various theories have been proposed to explain the differing views of nations on the size of their governments. As the influential factors can also explain the gridlock on changing the own resources, they are worth noting:

- *Economic development* (Wagner's law). Economic growth leads to a more complex economy requiring more expensive public goods (a better education, regulation, etc.) among which some are 'luxury' goods (e.g. health).
- *Openness and specialisation* (Rodrik, 1998). Depending on their specialisation, some nations are more open than others and since in these countries the incomes of households are dependent on firms that operate abroad, they are subject to greater external risk. When these firms are multinational firms that set higher wages than domestic competitors, an increase in income inequality occurs (Helpman, Itovsky and Redding, 2013). As a result, the increase in government tax revenues as a share of GDP serves as a form of insurance against risk and mitigates the effect of openness on inequality.
- *Country size* (Alesina and Wacziarg, 1998; Baldwin and Krugman, 2004; Laurent and Le Cacheux, 2010). The benefits of sharing (non-rival) public goods over a larger population imply that large countries can set smaller taxes in proportion to GDP. However, this effect can be overcome by the higher expenditure on public goods linked to the greater

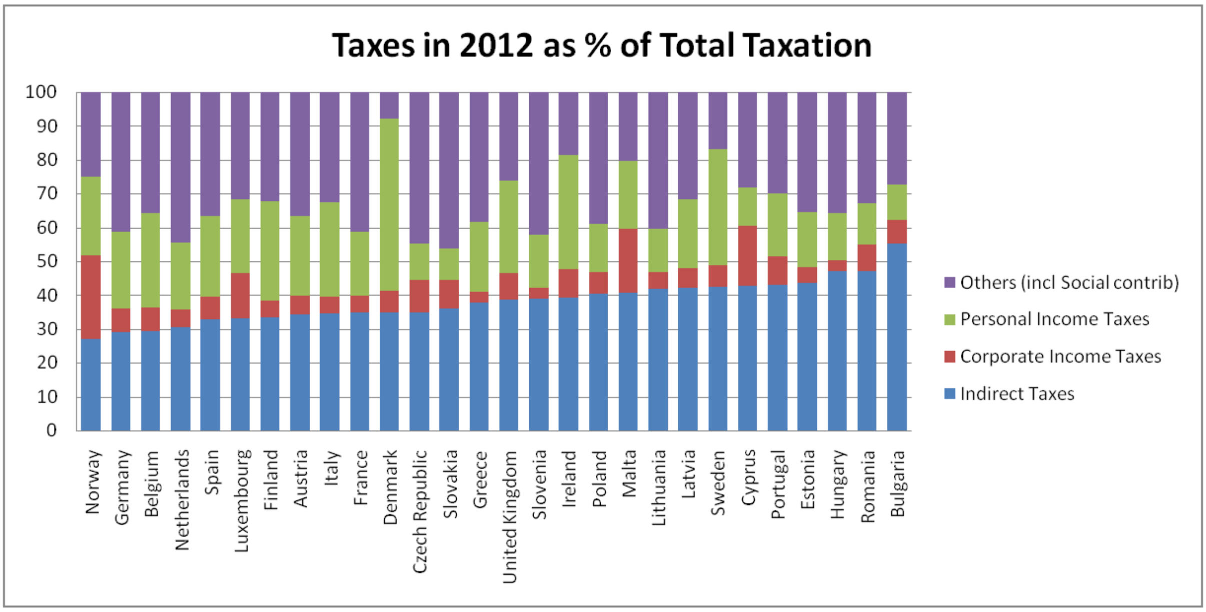
heterogeneity of preferences in large countries. In addition, large countries generate economies of scale and a taxable rent that is higher than in small countries.

- *Fragmentation* (Easterly and Levine, 1997). Fragmentation of the population into different social and spatial groups is problematic regarding budget choice. Conflicts and a lack of consensus can lead to inaction in the provision of some public goods or to logrolling in order to increase targeted expenditure (or both).
- *Institutions* (Perrson and Tabellini, 1999). Legislative structures and other aspects of the political institutions (presidential versus parliamentary) can influence competition between policy-makers and thus influence the level of spending. Moreover, the level of decentralisation can impact on vertical and horizontal competition between governments.

All these differences between Member States, among which many are intrinsic, structural and linked to different political histories, are candidates for explaining why unanimity has been hard to reach. Discussion on the VAT in 1995 concerning the limit of the tax base to 50% of GNI for states with a per capita GNI below 90% reflected difficulties owing to different levels of development. The Empty Chair crisis and the notion of ‘fair return’ are typical examples of how specialisation is problematic for building a common club. Fragmentation is certainly the mother of all problems in Europe, which explains inefficient logrolling, as in the case of rebates.

The favourite tax instruments at the domestic level also differ from one Member State to another (Figure 4-1), which may account for why it is so hard to find an agreement on one particular tax at the upper level. For instance, corporate income taxes representing a small share of the budget in some countries (e.g. Slovenia and Greece) have institutional roots (tax competition, lobbies, etc.) that can explain opposition to setting an own resource on this base. Lastly, tax competition between asymmetric countries matters. Low levels of taxes on corporate income and on capital in order to attract a large tax base represent a significant part of the budget of countries like Luxembourg. Many small countries view their lower level of taxation as an advantage to attract firms and generate activities in order to stimulate growth. We later develop this point in more detail, but in this discussion on the heterogeneity of Member States, the study by Wasserfallen (2013) is notable. Through an analysis of the Maastricht, Nice and Lisbon negotiations, the study found that resistance against tax harmonisation came predominantly from low-tax countries. The study also found that the prospects of harmonising tax policy starkly decreased after the accession of the Central and Eastern European countries.

Figure 4-1. Taxes as a percentage of total taxation, 2012

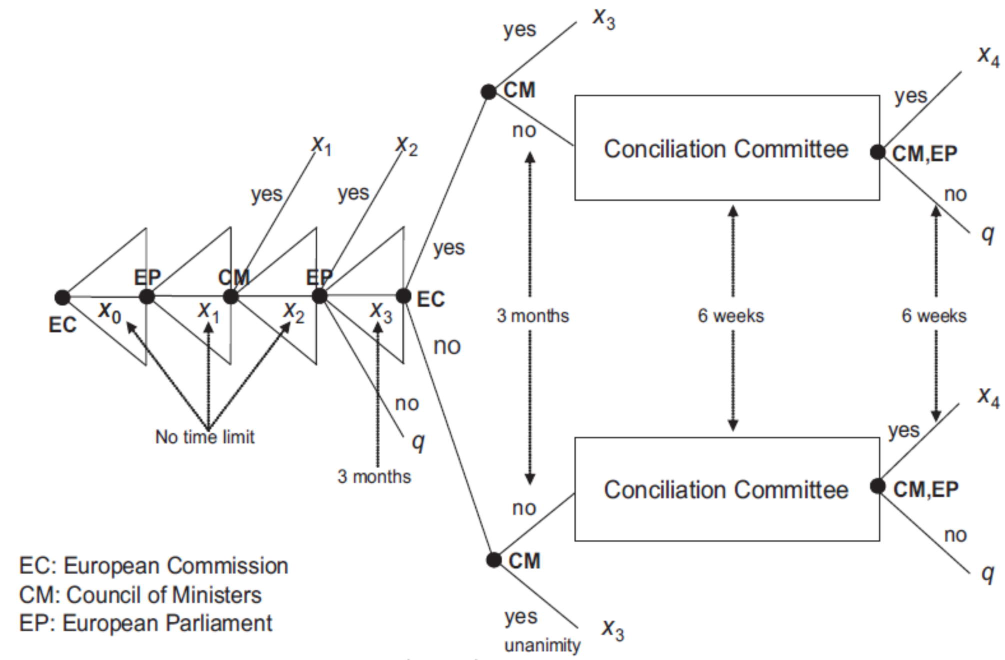


4.2 POWER AND VOTING RULES

Three decision-making mechanisms have been important in the building of the EU. The Treaty of Rome defined the consultation procedure, the Single European Act of 1986 instituted the cooperation procedure and the Maastricht Treaty established the co-decision procedure. Concerning the EU's budget, the Luxembourg Treaty of 1970 introduced a budgetary procedure that involved the European Parliament, and the Lisbon Treaty transformed this into a version of the co-decision procedure.

Hence, for a long time (1957–86) the consultation procedure was the only decision-making process. In this scheme, the decision depends upon the Commission, in charge of a proposal, and the Council, which takes the decision. The role of the European Parliament was limited to an advisory role. The cooperation procedure was the first step giving more power to the European Parliament. The passage of a proposal depends on the European Parliament's vote and this organ has the right to propose amendments to the preliminary decision of the Council. With an absolute majority, the European Parliament can reject the common position of the Council, and only unanimity in the Council can overrule the European Parliament's rejection. This procedure generalises the unconditional veto right of all organs. In the case of rejection, a conciliatory committee is formed with the aim of finding a compromise that must be approved by a qualified majority of the Council and an absolute majority of the European Parliament. The co-decision procedure further increases the power of the European Parliament, as a unanimous Council cannot overrule the European Parliament's veto. Schematically, these three decision-making procedures can be represented as extensive game trees. Figure 4-2 represents them for the co-decision game.

Figure 4-2. Co-decision procedure tree, game theory tree



Source: Napel and Widgrén (2006)

An extensive body of literature has explored these games, highlighting the growing but still limited power of the European Parliament. A major, robust result obtained is that the Council is by far the most powerful organ (see Laruelle and Widgrén, 1997; Napel and Widgrén, 2006). The version of co-decision that was applied to the decision-making procedure for the EU's annual budget by the Lisbon Treaty also reinforced the powers of the Council (Benedetto, 2013). If the Council and the European Parliament do not reach an agreement on the annual budget, the Council is able to set the figure that is rolled over from the previous year's budget, which the European Parliament cannot increase (Art. 315 TFEU).

As underlined by Widgrén (2009), the main problem with this leadership is that members of the Council follow national views, while members of the European Parliament and of the Commission represent citizens and the general interest of the EU.

Now, regarding internal decisions made by the Council, from the Treaty of Rome to the Treaty of Nice, simple weighted voting was applied (except on critical subjects requiring unanimity) that almost followed the logarithm of populations (see Widgrén, 1994). The Treaty of Nice introduced a major revision by reallocating voting rights from the smallest to the largest nations. This Treaty maintains the framework of qualified majority voting, but increases the vote threshold and establishes that a simple majority of Member States must represent 62% of the EU population for the acceptance of a proposal. The modifications have not been significant (see Baldwin et al., 2001; Felsenthal and Machover, 2001), the distribution of voting rights has been quite rigid, making the Nice Treaty a 'Nice Try' for nothing (Baldwin, 2001). For instance, one particular problem of the enlargement was the growing and disproportional gain of power by small Member States. The Nice Treaty succeeded in introducing some fairness by increasing the relative power of large countries, but at the same time, this Treaty provides strong power to intermediate countries (Poland and Spain), explaining why decisions still require so much bargaining and cumbersome, marathon negotiations.

Furthermore, since the determination of voting weights was still based on clustering, which has not been modified, France and Germany still belong to the same cluster despite a large difference in terms of population. The Constitutional Treaty written in 2004 had the objective of revising this weighted voting towards a dual majority system with additional requirements. Initially set at 50% of the Member States and 50% of the EU population, the majority thresholds have eventually been raised to 55% of the states (16 out of 28 at present), representing at least 65% of the EU's population. Yet in practice, the threshold could be lower, because at least four Member States representing at least 35% of the EU's population are necessary for blocking an agreement. Referenda in France and Germany rejected this proposition, subsequently renamed the Lisbon Treaty in 2009. Still, the implementation of this new procedure has been postponed until 2017, implying that the EU continues to live under the rule of the Nice Treaty.

The fact that small and intermediate size countries have a more powerful role in the region is quite problematic (Laurent and Le Cacheux, 2004). Starting from La Fontaine's famous written work, but reverting the fable of "The Frog who Aspired to Become as Big as the Ox", Laurent and Le Cacheux (2007) warned European countries about the critical danger of trying to become what they were not. The EU is essentially a large closed economy but the lack of internal rules, for instance regarding social and tax competition, leads the Union to follow the rule of small countries. The ox takes the risk of becoming a frog, jumping heavily from one problem to another and generating instability, instead of building a solid foundation from which all countries can grow.

More specifically, the tools that are appropriate to adjust to a negative macroeconomic shock are not the same for small as for large countries. Small countries are outward-oriented and thus tend to promote policies improving the competitiveness of the national economy. As confirmed by IMF analyses, traditional fiscal policy of the Keynesian kind has limited success in these economies, while these policies matter a lot in large countries, particularly in a period of crisis. When large countries behave against their nature like small countries, the race to the bottom in terms of taxation and labour costs leads to a reduction in domestic demand, which is the main engine of European growth.

4.3 NECESSARY CONTEXTUAL CHANGES

The decision-making procedures are central to the functioning of the EU. The ability of the EU to align the EU budget with the needs of the EU and the public, especially in the challenging domestic and international environment, depends on the institutional setting. This section presents points of reflection on the contextual changes that need to be considered.

4.3.1 Points directly pertaining to the budgetary decision-making process

The MFF (Interinstitutional Agreement between the Council, Commission and European Parliament)[14]

Although enhancing stability and visibility, such binding, medium-term financial procedures lead to inertia and make rules prevail over discretion, which may hamper efficiency. Significant trouble stems from the fact that, because the MFFs cover a seven-year period, those who draw up and validate the budget are not those who will execute the decisions taken. This effect is

[14] The 'Paquet Delors I' in 1987 introduced the notion of the multiannual financial perspectives. An interinstitutional agreement set the priorities and the framework for the Community expenditures. The total revenue is capped to a percentage of GDP. The second Paquet Delors gave even more power to the states (a veto over future spending decisions).

exacerbated by the discrepancies in the different lengths of the institutions' mandates. The rigidity inherent to this kind of planning is to some extent relaxed thanks to flexibility measures obtained by the European Parliament, but the methods for using special instruments instigate disagreements between the Commission and the Parliament on the one hand, and Member States on the other hand.

It appears that the current MFF (2014–20) has given rise to controversy and disagreement, and has been more difficult to implement than the previous four ones.

There have been many difficulties in the adoption of an EU budget since the beginning (in 1979, 1984, 1985 and 1987, for instance). Revenue has decreased as a share of GNI, whereas expenditures have kept on rising until recent years. The annual budget must cope with the MFF of the period (seven years long). The Commission presents a draft budget to the Council, which communicates its position to the European Parliament. A Conciliation Committee enables both institutions to reach an agreement. Otherwise, the EU is financed on the basis of the budget appropriations of the previous year, though since the entry into force of the Lisbon Treaty the Council by qualified majority may cut the appropriations that are rolled over (Art. 315 TFEU; Benedetto, 2013), making non-agreement very costly for the European Parliament.

Although the receipts are not subject to an annual vote, the own resources decision is adopted for the length of the MFF. As a result, the financing structure of the EU remains in the hands of the Member States and evolves only at a very slow rate.

Rules and decisions relative to own resources

Despite Art. 311 TFEU, which states that the Union must be financed through own resources and that it is possible to create new categories or suppress an existing one, genuine own resources are not at the core of the budget. The creation of own resources by unanimous agreement of the Member States was addressed in Art. 201 of the Treaty establishing the European Economic Community.[15]

A change would have to face the double unanimity constraint of the Council (after consultation with the Parliament) and the approbation of Member States according to their constitutional rules. Unanimity voting rules prevent any collective action.

4.4 Issues deriving from the budgetary decision-making process

The sharing of the fiscal burden became a root of divergence very early on. Some mechanisms cause particular trouble in that they prevent the relevant conduct of EU fiscal policy (on both the revenue side and the expenditure side).

Indeed, opportunistic strategies led by national self-interest and 'net contributor' calculations affect the functioning and the success of EU institutions in achieving objectives. According to Le Cacheux (2005), "[t]he obsession with net balances, maximizing them in the case of those that benefit from them, and minimizing them in the case of those who are net contributors, in the end diverts attention away from the real challenges of collective decision-making, e.g. common

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[15] In 1970, the Luxembourg compromise (France refused to grant more power to European institutions) constrained the Council to adopting decisions unanimously, enhanced the European Parliament competences and decided the financing through own resources (though with no tax service for the Commission).

policies and financial solidarity". Distributive battles prevail instead of taking into account EU added value.

Moreover, although correction mechanisms were introduced and allowed (the 1985 Dublin European Council granted the UK a correction mechanism), it appears that not only are they no longer justified on economic grounds, but also that they used to be subject to strict conditions that have never been fulfilled. Yet, the methods for calculating the British rebate are to remain the same for the 2014–20 period, despite equity concerns.

Some repercussions have been denounced as the Rotterdam-Antwerp effect (most often goods enter the EU through the North Sea, but most extra-EU imports are transhipped, which affects the calculation of net contributions) and the Netherlands Distortion (relative to investments, special purpose entities).

All these elements foster the formation of coalitions and specific arrangements.

4.5 INTERACTIONS WITH OTHER EU POLICY AREAS AND PROCESSES

In the aftermath of the subprime crisis and the sovereign debt crisis, the EU extended the monitoring process through the Six Pack and the Macroeconomic Imbalance Procedure (which, for instance, include the European Semester). As a result, in some circumstances (the absence or insufficiency of a corrective action plan) and on the basis of the European Commission's analysis, if the Council decides that an in-depth review must be conducted, sanctions may be taken with reverse qualified majority voting.

In July 2014, the incoming Commission chaired by Jean-Claude Junker launched the Investment Plan for Europe. As described in chapter 3, the EFSI instrument financially relies on the EU budget. It has also led to the introduction of an exception in the calculation of Member States' public sector deficits that are submitted under EU fiscal rules.

These two developments may well modify the relationships between institutions and Member States, just like recent events in taxation (LuxLeaks, the OECD Base Erosion and Profit Shifting project, etc.). They may open the way to new opportunities for reforming the EU budget financing and striking new deals.

PART II. POLITICAL AND LEGAL BASIS FOR NEW OWN RESOURCES

5 ROLE OF THE LEGAL FRAMEWORK AND INSTITUTIONAL BALANCES: SPARKS OF HOPE FOR OWN RESOURCES REFORMS?

Chapter 5 in a nutshell

- The experience of previous reforms, when all parties preferred reform to the status quo, gives hope for the future.
- Possible reforms for new resources and the constraints that may block their approval.
- EU institutions, Member States and the asymmetry of influence over reform may reinforce the status quo.
- National parliaments as partners may open the door to the reform of own resources.

At first glance, it appears that the current own resources system presents insurmountable obstacles to its own reform under the present Treaty. Agreement has been achieved in the past, however, notably on the establishment of the TOR in 1970, the delayed implementation of the VAT resource and GNI percentage transfers after 1988. The context of the reform of 1970 was the desire to provide security for the CAP and to support the EU's first enlargement, while that of 1988 was the need to finance redistribution within a single market amid the then recent enlargements in southern Europe. For future reform, unanimity among the Member States will be needed to overcome challenges whose magnitude is at least equal to those of 1970 and 1988.

This chapter reviews the experience of previous reforms to own resources, the current set of Treaty rules, the institutional asymmetry in budgets and own resources, and the role of national parliaments in the reform process.

5.1 IMPLICATIONS OF THE REFORMS OF 1970 AND 1988 FOR THE CURRENT INSTITUTIONAL PROCESS

The Luxembourg Treaty of 1970 ended a period of uncertainty and conflict that had started in 1962 with the establishment of the CAP, and which had contributed to the Empty Chair crisis of 1965, when the French government was boycotting European Community meetings. The dispute centred on an inability to agree a permanent form of financing for the Community's spending. In 1970, the package deal established a system of own resources to underpin agriculture, a phasing-in of the new system over five years and the protection of agricultural spending through its definition as compulsory expenditure, exempt from oversight by the European Parliament, all of which met the preferences of France. The package enabled parliamentary control of the new non-compulsory expenditure and French agreement to the accession of the UK, though some of the other five Member States had wanted a more integrationist outcome for the budget and they had to make concessions (Rittberger, 2005, ch. 4).

If the agreement of 1970 released stable financing for agriculture, increased the accountability of spending through the European Parliament and paved the way to the Community's first enlargement, it also set the stage for future contradiction. Revenue was and remains super-intergovernmental according to the current Art. 311(3) TFEU, whereas annual spending is supranational. On the revenue and spending sides, challenges often start on one side but can only be resolved by linking both sides. Yet, new own resources decisions require unanimous Council agreement plus ratification by national parliaments, a very high political cost, particularly when there is uncertainty about the effects of change. This situation blocked further change until 1988 and was compounded by the strong preferences of the UK, which had acceded in 1973.

Lindner (2006) shows that the period of stasis continued until a point when the European Council intervened because the costs of stasis were greater than the costs of change, while more incremental attempts at reform had failed. The European Parliament and the Member States that had joined in 1973 had differing preferences from the original Member States, and this led to regular disputes with the Parliament. Meanwhile, the UK's dissatisfaction with own resources was addressed at Fontainebleau in 1984. The enlargements to Greece, Portugal and Spain and the agreement of the Single European Act brought with them financing demands that the existing own resources could not meet, were considered inequitable and were in any case shrinking (Flaesch-Mougin, 1986). Too much political capital had been spent on budget disputes, which would have been better directed at the single market programme, while there was a danger that short-term budget considerations could reduce the collective gains of the single market.

The 1988 reform reduced conflict and addressed both the spending and revenue sides of the budget. The package provided longer-term stability through the financial perspectives approved by the Parliament, an increase in expenditure financed through the GNI resource – which the Member States approved unanimously (Ackrill and Kay, 2006; Benedetto, 2012; Lindner, 2006) – and the introduction of spending ceilings for agriculture, which satisfied those Member States that emphasise lower spending.

Since the entry into force of the Lisbon Treaty, budget disputes have increased. Conciliation agreements for annual budgets have failed in alternate years, the MFF for 2014–20 was agreed as late as December 2013 and disputes have focused on amounts rather than policy. The questions of eurozone governance, the migrant crisis and the creation of single digital, energy and capital markets are challenges that exceed those of the past, which had generated the revenue reforms as part of package deals in 1970 and 1988.

A reform to own resources is most likely when accompanied by a reform to spending – or by future changes to spending - and when the Council and the Parliament can reach an agreement that addresses the needs of the Council's different constituencies, net contributors, net beneficiaries and a core of older Member States, which together with the Parliament currently pull in different directions. The coalition for change would need to make an agreement where the gains outweigh the costs for all, whether those costs are financial or political.

5.2 POSSIBLE REFORMS UNDER THE PRESENT TREATY FRAMEWORK

Reforms under the present Treaty depend on unanimous decision-making and ratification at the national level under Art. 311 TFEU. This establishes the principle of the EU's financial independence from Member States:

- "The Union shall provide itself with the means necessary to attain its objectives and carry through its policies" (Art. 311(1)).
- "Without prejudice to other revenue, the budget shall be financed wholly from own resources" (Art. 311(2)).

Although Art. 311 cannot be used to force the Council or Member States to grant new or sufficient own resources, its legal principles should not be overlooked. Whereas some have previously considered that the Court of Justice of the European Union (CJEU) could not review the legality of a decision on own resources because it is approved by the Member States, in the *Pringle* case (C-370/12), the Court reviewed the validity of an act of an institution that had been subject to the approval of Member States.

There are legal and political arguments to contest the GNI-based resource, including the deletion by the Maastricht Treaty of Art. 200 (financial contributions) of the European Community Treaty. However, it is unlikely that in the future the CJEU will give a precise definition of the concept of own resources. In this regard, it should give a wide margin to the Council. It is true that in the *Schräder* case (C-265/87, 1989-02237) the Court defined own resources in this way: "only revenue which is intended to finance the Community's general budget, to the exclusion of agricultural charges which apply in a specific agricultural sector and are allocated to the financing of costs in that sector alone". In so ruling, the Court respected in reality the decision on own resources, which provides that "[t]he revenue…shall be used without distinction to finance all expenditure entered in the Union's annual budget".

Other Treaty articles do not offer solutions to the need for unanimity.

Although Art. 322(2) specifies a Council double majority for making funds available from own resources and the power to impose conditions for releasing those funds, it simply provides for the technical means to make funds available. Own resources still have to be paid if agreed under Art. 311.

Art. 323 specifies a contractual obligation to pay bills, but this cannot be used to force through new own resources. Member States certainly have an obligation to financially assist the EU in the case of exhaustion of own resources, which is what the GNI resource does as a residual after VAT and TOR have been exhausted.

Institutionally, we know that agreement to change own resources will be difficult owing to the need for unanimity among Member States and ratification by national parliaments. In referring to Member State ratification in terms of their "constitutional requirements" and without mentioning national parliaments, Art. 311 is intentionally vague but affirms the relevance of national sovereignty for deciding own resources. "Constitutional requirements" signify approval by national parliaments unless referendums should take their place. The constitutional requirement can also empower national constitutional courts to review the national validity of any fiscal changes. In the British case, the European Union Act 2011 of the British Parliament declares that an own resources decision must be passed in the form of legislation by the British Parliament.

Nevertheless, ambitious changes have been made in the past despite unanimity, as discussed above.

5.2.1 A new own resources decision

This subsection looks at what can be achieved within the constraints of Art. 311. As discussed in section 5.1, new own resources have been approved in the past. The passerelle clause (Art. 48(7) of the Treaty on European Union, TEU) is a mechanism that allows for some EU policy areas decided by unanimity in the Council to be reclassified as areas that can be decided by qualified majority. Still, this offers no exit from the constraints of Art. 311, because Art. 353 exempts it from the passerelle clause.

The definition of the own resources system remains under the control of each Member State (Art. 311(3)). This question is 'constitutional' because it affects national fiscal sovereignty. Only an ordinary treaty revision may allow a change in the decision-making process (Art. 48(2-5)). A treaty change could also be problematic because, in its decision of 30 June 2009 concerning the

Lisbon Treaty, the German Constitutional Court ruled that only the Bundestag may set tax rates. The result is that each Member State complies with its constitutional requirements to approve new own resources.

The Treaty introduces some flexibility by enabling the adoption of implementing regulations by a double majority in the Council, which can be interpreted only as a means to speed up the eventual implementation of long and arduous changes to own resources (Art. 311(4)). Double majority voting in the Council is applicable to the procedure for making available own resources and to the measures to meet cash requirements (Art. 322(3)).

5.2.2 Could approval of the annual budget (Arts. 314 and 315) or MFF (Art. 312) be linked to own resources reform?

The European Parliament attempted precisely to do this just after ratification of the Lisbon Treaty. During 2010, the Parliament tried to link agreement on the annual budget for 2011 to other agreements for enhancing its future role in negotiating the next MFF and in securing reform to own resources. The strategy failed (Benedetto, 2013) in 2010, other than achieving an undertaking that the Council would keep the Parliament updated on the progress of MFF negotiations, but it was partially successful in 2013, when the Parliament could link approval of the 2014–20 MFF to securing its preferences on the 2014 budget and on amending budgets for 2013 (Benedetto, 2016). In other words, the Parliament could not use its annual budgetary powers to force change in the MFF or own resources negotiations, but it succeeded in using its right to say no to the MFF as a bargaining chip to secure its preferences in two annual budgets.

The European Parliament's capacities to play hardball are limited. For the MFF, the Treaty imposes no date limit for adoption. It provides for an extension mechanism in the absence of a new financial framework, meaning that a parliamentary rejection of the MFF results in continuity. For the annual budget, again the Treaty also imposes no date limit for adoption. Art. 315 provides for an interim mechanism in the absence of a budget at the beginning of the year. In the context of the annual budgetary procedure, Parliament can amend, although this does not affect the system of own resources. Yet, parliamentarians could refuse to adopt a joint text on payment appropriations during the meeting of the Council–Parliament conciliation committee if, for example, there is no reform of own resources.

5.2.3 Unexpected threats or opportunities: Potential of Member States to influence reform

Member States can exercise veto power or proposal power – and in the past this has led to a change in own resources (Lindner, 2006; Rittberger, 2005, ch. 4) as in the cases reviewed in section 5.1. For example, in the 1960s the preferences of France collided with those of other Member States on the subjects of permanent financing for agriculture and the role of the European Parliament in budgetary decision-making, to which a solution was found in 1970 by creating own resources and non-compulsory expenditure (Rittberger, 2005, ch. 4). Intractable positions in the 1980s also led to a compromise in 1988 that stabilised and increased the spending and revenue. Member States can therefore interact with threats and opportunities in a way that may lead to the collapse or creation of own resources.

The eurozone crisis, the effect of the UN Climate Change Conference of 2015 in Paris, the LuxLeaks scandal, a new intergovernmental conference to change the governance of the eurozone, or a British exit from the EU are all examples of threats or opportunities that may lead to the creation of new resources. New governance structures for the eurozone and a eurozone budget could lead to the selection of sources of revenue from the financial sector, popular with those Member States that are already planning to introduce the FTT. Corporation income taxes, reflecting the opportunities of the single market for transnational corporations, could be more easily adopted as part of EU-wide revenue if the UK chooses to leave the EU. The consensus at the UN Climate Change Conference for reductions in carbon emissions or reforms to the ETS could also lead to harmonisation of carbon taxes in the EU and their adoption as a source of EU revenue. The latter could be politically popular in Member States that are sceptical of EU budgetary expansion but where public opinion expresses anxiety about climate change.

5.2.4 Reforms that require a treaty change

As already noted, a passerelle cannot apply to Art. 311 due to Art. 353. Therefore, the only way to change the rules of Art. 311 is through amendment of the TFEU; however, tax harmonisation (Art. 113) requires not treaty change but unanimity in the Council. Harmonisation of taxes that are on the agenda for own resources, such as corporation income tax or carbon taxes, could be the first step to setting these up as European own resources.

British exit and other threats and opportunities could lead to treaty change. A treaty change could therefore adopt a double majority system for Art. 311. It should be noted that a threshold lower than unanimity for agreeing change to own resources may not transform policy. Qualified majorities in the Council have not always formed on contentious questions. Examples include the inability of the Council to agree on annual budgets when there is a large enough minority of Member States in the Council to block a decision, as initially for the annual budgets of 2011, 2013 and 2015.

5.3 ASYMMETRICAL COMPETENCES OF THE COUNCIL AND PARLIAMENT AND THEIR IMPACT

The European Parliament has fewer powers than the Council and the Member States to determine own resources and other budgetary questions. This section addresses the challenge of budgetary asymmetry.

In the annual budget, Council–Parliament relations are asymmetrical (Benedetto and Høyland, 2007; Benedetto, 2013; Benedetto, 2016). Although Art. 314 appears to grant equality to both institutions, if there is disagreement, the Council can confront the Parliament with a choice to take whatever spending figure the Council chooses or to take a series of uncertain, monthly budgets in which the Council may reduce expenditure but the Parliament may only prevent increases (Art. 315; Benedetto, 2013). In 2010, the Parliament tried to link agreement of the 2011 budget to an increased influence for itself in negotiating the MFF of 2014–20 and new own resources. The Council blocked this and the payments and commitments for 2011 were much lower than the amounts that the Parliament had requested.

During 2013, the Parliament also discovered further limits to its influence over the new MFF and own resources. Its power over the MFF is limited to approval or rejection of the plan (Art. 312) and there was no link between this and its right to be consulted over own resources (Art. 311).

The asymmetry and power only of consultation poses a liability/accountability problem for the European Parliament, which is elected and is a branch of the budgetary authority but has no decision-making power regarding the own resources system (Jacque, 1986). Furthermore, if the Parliament had to approve the decision on own resources, it would likely reject the 'correction' mechanisms. This would provoke conflict with those Member States like the UK that receive corrections.

Despite the difficulties posed by the asymmetry in which the elected Parliament finds itself, the status quo of Art. 311 may be legitimate. In view of the fact that the revenue side of the EU budget is grounded in national sovereignty, the unanimity of Member States through national ratification is unavoidable.

5.3.1 *Does blockage occur because of the institutions' differing powers or solely because of the Council?*

Blockage cannot stem from the Parliament or the Commission, whose powers are to propose and consult. It solely comes from the Member States and the Council. It is too general to conclude that the Council is responsible as an institution because of the role of the constitutional requirements of Member States in Art. 311. In this instance, the role of national parliaments comes into play.

Opposition to new own resources may occur in several Member States where EU budget-scepticism is present (Benedetto, 2015). Yet, pessimism about the acceptability of own resources legislation may be mistaken. The UK is often identified as sceptical towards EU budgetary activity. As a case study, what was the effect of the UK on the Own Resources Decision of 2014? The Decision conserved the British 'correction' at the same level as the Decision of 2007. The legislation to enact the Decision was passed rapidly, less than two months after the national elections of May 2015 and without parliamentary opposition or referral to parliamentary committee. Indeed, no roll call vote was held in the House of Commons during the two readings of 11 and 23 June 2015 as the legislation was adopted by acclamation.[16] Although the British correction was maintained, we might still have expected the opposition of some Eurosceptics but this failed to materialise. A controversial matter can therefore be approved by some national parliaments where the government controls the agenda.

Can asymmetry problems be remedied without treaty reform?

The role of national parliaments is addressed in section 5.4. Greater involvement of national parliaments and partnership between them and the European Parliament could increase the flexibility of the outcome and reduce the effects of asymmetry analysed above. Art. 311(3) on the constitutional requirements of Member States respects sovereignty, so partnership is needed to bridge gaps where non-agreement would otherwise be likely.

It is the case that "constitutional requirements" include Council unanimity and respect of national sovereignty, though the latter is not specified. For example, the European Union Act 2011 passed by the British Parliament foresaw the risk that non-specific "constitutional requirements" could bypass it and so it requires any new own resources decision to be approved as national (UK) legislation.

Any other reform to the asymmetry would require amendment to the Treaties.

5.4 Could the chances of reform increase if national parliaments were drawn into the negotiations earlier, and if so how?

Own resources decisions are agreed subject to the constitutional requirements of all 28 Member States, and this means by parliamentary vote or referendum. Engaging with relevant parliamentary committees in the Member States, and deploying the national expertise of members of the European Parliament's Budget and Budgetary Control Committees is therefore vital. A key part of this is to transmit more accurate information where this is currently lacking. The other approach discussed below is to use the model of the Inter-parliamentary Conference on Own Resources that will meet in 2016.

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[16] See the European Union Finance Act 2015 (http://services.parliament.uk/bills/2015-16/europeanunionfinance/stages.html).

5.4.1 *Fulfilling national constitutional requirements under Art. 311(3): A case study of the UK*

This subsection offers a case study of the current decision-making procedure in the UK, one of the strongest opponents to budget change, for the Own Resources Decision of 2014. What role do the House of Commons, House of Lords and their committees play in the process? This could inform approaches for the EU institutions that may also be appropriate for interaction with other national parliaments.

In financial matters, the bicameral British Parliament is effectively unicameral since the House of Lords is excluded from 'money bills'. (The same is also true of the Irish Senate compared with the Irish Dail.) The Lords, however, debate financial matters and their committees can hold investigations. EU financial legislation, including transfers from the GNI or VAT bases in the British annual budget can be discussed in the EU Select Committee of the House of Commons, which is the lower chamber, though its Treasury Select Committee can also hold its own debates if it wants. The Commons committees do not normally publish in-depth reports or studies of the type considered by committees in the House of Lords, which is more consensual and expertise-oriented. The Lords are home to many EU subcommittees (including one on EU Economic and Financial Affairs)[17] that do not exist in the Commons. Whereas the full EU Committee in the Lords debated the MFF of 2014–20, over which national parliaments have no formal power (Art. 312 TFEU), deliberation on the Own Resources Decision, where any national parliament has the power to say 'no', was delegated to the subcommittee on EU Economic and Financial Affairs.[18]

The Own Resources Decision of 2014 was adopted by the British Parliament as the EU Finance Act 2015 in June 2015. As a money bill, the Lords subcommittee debated its contents but had no vote. As discussed in the previous section, this Act was passed rapidly after the British election of 2015 and without any opposition or consideration by the committees of the House of Commons as a result of tight government control of the parliamentary agenda.

The ability of the consultative House of Lords to investigate and debate proposals in advance and through a specialist committee may have reassured more sceptical political elements in the British Parliament of the acceptability of the Own Resources Decision of 2014. The British Parliament's European Union Act 2011 also specifies that "constitutional requirements" for approving new own resources means the passage of parliamentary legislation.

5.4.2 *National legitimacy: Could this help national governments to agree on changes?*

Attaining national legitimacy through national parliaments is vital for agreeing changes. Part of this is to look for improved relations with specialised committees in national parliaments even if their role is only consultative. EU affairs committees are present in every national parliament of the EU (Raunio, 2009) and are a necessary point of contact for matters of own resources reform. The limitations on this are that the parliamentary committee systems across the 28 national parliaments differ significantly, as do legislative–executive relations. Bilateral relations with national parliaments are therefore liable to be asymmetrical between the countries and

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[17] See the "EU Economic and Financial Affairs Sub-Committee (Sub-Committee A)" (http://www.parliament.uk/business/committees/committees-a-z/lords-select/eu-economic-and-financial-affairs-and-international-trade-sub-committee-a/).

[18] Derived from an interview with an official working on budgetary matters in the British Parliament, London, 3 September 2015.

parliaments concerned. As a means for promoting dialogue and building consensus for reform, EU institutions should provide information of better quality to national parliamentary committees that are otherwise in a weaker position in terms of involvement and information.

The Inter-parliamentary Conference on Own Resources, for which delegates from national parliaments will be members, provides a method for politics at the level of the Member States to shape own resources reform. There is a precedent of a similarly-constituted Convention on the Future of Europe, which drafted an EU Constitution in 2003. Research has shown that integral to that Convention's membership were representatives from national parliaments who played a vital role in drafting the constitutional document (Crum, 2004; Hug and König, 2007; König and Hug, 2006; Maurer, 2004).

The evidence presented here lends credence to the opportunity for reform of own resources offered by national parliamentary committees and by the Inter-parliamentary Conference of 2016.

6 POTENTIAL USE OF VARIABLE GEOMETRY FOR OWN RESOURCES: IS IT AN OPTION?

Chapter 6 in a nutshell

- The CJEU considers that the enhanced cooperation procedure is a legitimate mechanism to implement the FTT in participating Member States.
- Some legal issues are still pending, however, raising risks of Member State challenges and legal uncertainty, namely:
  - if the FTT exceeds participating Member States' jurisdiction for taxation due to impacts on non-participating Member States; and
  - it may infringe the competences of non-participating Member States on taxation.
- Variable geometry suffers from limitations in achieving global EU policy objectives because of the limited number of participating Member States.
- The rules on the use and democratic control of the revenues generated by the FTT depend on their transfer to the EU budget as an own resource. As such, the tax would abide by the principles of universality and unity. It would fall under the European Parliament's prerogatives and powers at the levels of scrutiny and implementation.
- The coordination and potential correction mechanisms the FTT would require cannot be systematically addressed under the current EU regulatory framework.

This chapter addresses the relevance of mechanisms for the differentiated treatment of Member States within or outside the Treaties, in terms of their potential as legal bases for the asymmetric adoption of own resources while meeting economic and monetary union (EMU) objectives.

Even if some candidate own resources fail to reach unanimous acceptance by all of the EU-28, some may still be considered viable under enhanced cooperation, i.e. legally adopted by only some Member States based on Art. 20 TEU. In this context, the process from the design to the adoption of resources raises concerns not only about their assessment as an own resource, but also more generally about their coherence and compliance with principles of democratic accountability, fair treatment, etc., given the non-participation of some Member States.

The analysis of the issues linked to variable geometry is undertaken at three levels:

- *compliance at the level of regulatory principles* – fundamental freedoms (notably the free movement of capital and services, and the freedom of establishment), sovereignty, unanimity/legislative act adoption principles, extraterritorial impacts, non-discrimination, respect of non-participating Member States' rights, limiting the impacts to participating Member States, equity/fair treatment, other provisions of the TEU/TFEU (notable for enhanced cooperation are last resort, nine Member States and the area of EU non-exclusive competences), universality of the EU budget vs assigned revenue, etc.;
- *impact at the economic level (extended to legal issues where relevant)* – economic distortion, potential discrimination, achievement of EMU objectives, harmonisation and proper functioning of the single market, double taxation, EU budget sufficiency, stability and budgetary discipline (e.g. tax potential/share within the global EU budget, risk of tax evasion and profit shifting), tax efficiency, etc.; and

- *impact at the implementation/organisational level* – cohesion of the global system and effects on trust in the EU, coordination of the system at the EU level, transparency and simplicity, flexibility, risks of opaque correction mechanisms, consequences for the design of GNI-based own resources and related reductions of Member State contributions, etc.

The analysis focuses on the FTT, considered so far to be the most developed legal framework among candidate own resources, in order to identify matters for attention and highlight key findings and lessons on the concept of variable geometry in general.

6.1 Forms of variable geometry since the 1980s

Cases of differentiated treatment of Member States in the framework of the Treaties have been characteristic of the EU since the mid-1980s (Table 6-1). The Treaties have progressively incorporated the possibilities of variable geometry through decision or adoption of mechanisms concerning opt-outs, corrections/rebates and provisions specific to Member States whose currency is the euro, as well as closer/enhanced cooperation. In addition has been the implementation of other mechanisms outside the Treaties through international agreements and instruments outside the MFF.

Table 6-1. Illustration of existing cases of variable geometry

Nature	Events	Period
Opt-outs (UK)	Maastricht Treaty	1992
Corrections/rebates	Fontainebleau/subsequent Council agreements Own Resources Decision 2007/2014	1984 onwards
International Agreements outside the EU Treaties	Schengen Agreements	1985
	Eurozone	
Provisions specific to Member States using the euro	Art. 136 TFEU	–
Instruments outside the MFF	European Development Fund: successive conventions of Yaoundé, Lomé and Cotonou	1959 onwards
Closer cooperation	Treaty of Amsterdam Treaty of Nice	1997 2000
Enhanced cooperation	Treaty of Lisbon . divorce law . unitary patent . FTT	2009

Source: Authors’ own compilation

6.2 Variable geometry through enhanced cooperation

The present section focuses on the FTT, as put forward in the European Commission’s (2013a) proposal.

The Commission’s initial proposal to implement the FTT in the EU-27 was subject to intense discussions, but eventually failed to reach unanimity at the level of the Council. Nevertheless, a significant number of Member States still expressed their willingness to implement a common FTT and formally requested to proceed through enhanced cooperation. The Commission undertook an assessment of the criteria for enhanced cooperation and formulated a proposal in

October 2012, further backed by the European Parliament and ultimately agreed at the level of the Council in January 2013.[19]

The Commission issued on 14 February 2013 a proposal for a Council Directive implementing enhanced cooperation on a financial transaction tax. Enhanced cooperation must comply with the rules and conditions set out in Art. 20 TEU and Arts. 326–34 TFEU. The Commission's 2013 proposal refers to Art. 113 TFEU as the pertinent legal basis for the proposed directive.

The provisions of the Commission's proposal must comply with the general rules of the TEU and the TFEU, contribute to the strict observance and the development of (customary) international law (Art. 3(5) TEU) and also comply with the special rule of Art. 327 TFEU on enhanced cooperation.

While raising optimism about its adoption through *enhanced cooperation* within the EU budgetary environment by 2017, several elements of the proposal continue to face criticism from both legal/regulatory and economic perspectives from variety of players. Such criticism was or is reflected in the diverging positions of the Council's Legal Service[20] and the Commission's Legal Service,[21] the European Parliament's request for amendments[22] and the European Economic and Social Committee's (EESC) opinion.[23] It is also apparent in the pending case laws/rulings submitted to the CJEU (notably on the UK),[24] national authorities' decisions

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[19] See the Council Decision of 22 January 2013 authorising enhanced cooperation in the area of financial transaction tax (2013/52/EU), OJ L 22/11, 25.1.2013.

[20] See Council, Opinion of the Legal Services, Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax (FTT), 13412/13 Limite (JUR 448/FISC 163/ECOFIN 771), Brussels, 6 September 2013.

[21] See "Implementing enhanced cooperation in the area of Financial Transaction Tax – Response to the opinion of the Legal Service of the Council on the legality of the counterparty-based deemed establishment of financial institutions (Art. 4(1) point f) of the FTT proposal COM(2013) 71 final)", Non-Paper by the Commission Services (n.d.).

[22] See the European Parliament legislative resolution of 3 July 2013 on the proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax (COM(2013)0071 – C7-0049/2013 – 2013/0045(CNS)) (Special legislative procedure – consultation). See also European Parliament, Opinion of the Committee on Budgets, for the Committee on Economic and Monetary Affairs, on the proposal for a Council directive implementing enhanced cooperation in the area of financial transaction tax (COM(2013)0071 – C7-0049/2013 – 2013/0045(CNS)), 16 May 2013 (http://linklaters.de/fileadmin/redaktion/Steuerrecht/Gesetzesmaterialien/Finanztransaktionssteuer/20130516_FTT_Opinion_Comittee_Budget.pdf).

[23] See the Opinion of the European Economic and Social Committee on the Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC COM(2011) 594 final, OJ C 181, 21.6.2012.

[24] See the judgment of the Court (Second Chamber) of 30 April 2014 in Case C-209/13, *United Kingdom v. Council,* Common system of financial transaction tax – Authorisation of enhanced cooperation under Art. 329(1) TFEU – Decision 2013/52/EU – Action for annulment in respect of infringement of Articles 327 TFEU and 332 TFEU and of customary international law (http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:62013CJ0209&from=EN).

and reports (e.g. the UK House of Commons)[25] and numerous academic studies and other position papers reflecting the views of defenders[26] and opponents.[27]

6.2.1 Assessment of the conditions for enhanced cooperation

The framework set out in Art. 20 TEU defines conditions and rules for enhanced cooperation. The compliance of the Commission's proposal with these is assessed in this subsection.

Art. 20.1 states that "Member States which wish to establish enhanced cooperation between themselves within the framework of the Union's non-exclusive competences may make use of its institutions and exercise those competences by applying the relevant provisions of the Treaties". Enhanced cooperation must comply with the rules and conditions set out in Art. 20 TEU and Arts. 326–34 TFEU.

The framework of the EU's non-exclusive competences

It appears that implementing the FTT through enhanced cooperation would not fall under any of the areas of the EU's exclusive competences as defined in Art. 3.1 TFEU.[28]

Enhanced cooperation shall aim to further the objectives of the Union, protect its interests and reinforce its integration process

The European Commission's (2013a) FTT proposal sets out three major objectives:

- to avoid fragmentation of the single market for financial services, bearing in mind the increasing number of uncoordinated national tax measures being put in place;
- to ensure that financial institutions make a fair contribution to covering the costs of the recent crisis and to ensure a level playing field with other sectors from a taxation point of view; and
- to create appropriate disincentives for those transactions that do not enhance the efficiency of financial markets, thereby complementing regulatory measures aimed at avoiding future crises.

No particular challenges have arisen relative to Art. 20(1) TEU about the coherence of the FTT objectives under enhanced cooperation with the objectives of the Union, i.e. the protection of its interests and the reinforcement of its integration process.

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[25] See the UK Parliament, *Fourth Report of Session 2013-14 – European Scrutiny Committee*, 5 June 2013 (http://www.publications.parliament.uk/pa/cm201314/cmselect/cmeuleg/83-iv/8304.htm). See also "4 Taxation: A financial transaction tax" in UK Parliament, *European Scrutiny Committee – Forty-Fourth Report*, 26 October 2011 (http://www.publications.parliament.uk/pa/cm201012/cmselect/cmeuleg/428-xxxix/42806.htm).

[26] See for example, Twarowska and Szołno-Koguc (2015) (http://www.toknowpress.net/ISBN/978-961-6914-13-0/papers/ML15-148.pdf).

[27] See for instance, Scone (2013) (http://www.juridicainternational.eu/public/pdf/ji_2013_1_188.pdf).

[28] More specifically, these refer to the customs union, establishing the competition rules necessary for the functioning of the internal market and monetary policy for the Member States whose currency is the euro, the conservation of marine biological resources under the common fisheries policy and common commercial policy.

Challenges do arise concerning the legal basis for and practical effects of the FTT's implementation under enhanced cooperation relative to the provisions of the TFEU, notably:

- the relevance of Art. 113 TFEU as a legal basis for the proposed directive, notably towards the necessity of harmonising legislation to ensure proper functioning of the single market and to avoid distortion of competition – which directly concerns the FTT itself and indirectly enhanced cooperation;
- assurance that the FTT legal framework, its adoption and implementation under enhanced cooperation comply with the provisions of Art. 326 TFEU (avoid undermining the functioning of the single market, distortion of competition, etc.) and Art. 327 TFEU (respecting competences, rights and obligations of non-participating Member States);
- the decision authorising enhanced cooperation adopted by the Council as a 'last resort' when it has established that the objectives of such cooperation cannot be attained within a reasonable period by the EU as a whole – this requirement is acknowledged in the Council Decision of 22 January 2013 in its Recital 9;[29] and
- at least nine Member States must participate in the cooperation.

The phrase "participation in the cooperation" seems clear enough to indicate that the minimum number of nine participants must be met at all stages – not only in the Council decision authorising enhanced cooperation, but also in the final decision and common implementation.

The withdrawal in December 2015 of Estonia[30] from the group of 11 Member States involved in the enhanced cooperation sends a negative signal in this respect. It narrows the margin left in the framework of the next negotiation rounds – especially considering that in its current state, the agreement reached by the ten remaining, participating Member States is limited to core principles and has yet to demonstrate concrete agreements on the tax bases and implementing mechanisms.

The reason for Estonia's withdrawal ("the cost of collecting the tax compared with the revenues would not make the tax worth it")[31] is moreover worrying, as it reflects a weakness in the budget criterion on efficiency.

- Such cooperation shall be open at any time to all Member States, in accordance with Art. 328 TFEU.
- The Council shall act in accordance with the procedure laid down in Art. 329 TFEU.

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[29] "It was recorded at the Council meeting on 29 June 2012 and confirmed on 10 July 2012 that the objective to adopt a common system of FTT cannot be attained within a reasonable period by the Union as a whole. Consequently, the requirement set out in Article 20(2) TEU that enhanced cooperation may be adopted only as a last resort is fulfilled."

[30] See "EU financial transaction tax on life support", *EUobserver*, Brussels, 8 December 2015 (https://euobserver.com/economic/131435).

[31] Ibid.

- All members of the Council may participate in its deliberations, but only members of the Council representing the Member States participating in enhanced cooperation shall take part in the vote. The voting rules are set out in Art. 330 TFEU.

- Acts adopted in the framework of enhanced cooperation shall bind only participating Member States. They shall not be regarded as part of the *acquis*, which has to be accepted by candidate states for accession to the Union.

There is no consensus on the fact that the FTT proposal binds participating Member States only. Arguments and counter-arguments reflected in the positions of the Council Legal Service and the Commission Legal Service require further scrutiny to conclude which side reasonable conclusions will favour. In addition, pending case law must also be considered in this analytical exercise.

6.2.2 Compliance with the rules and conditions of Arts. 326–34 TFEU

6.2.2.1 Assessment in relation to Art. 326 TFEU

Art. 326 TFEU provides that "[a]ny enhanced cooperation shall comply with the Treaties and Union law. Such cooperation shall not undermine the single market or economic, social and territorial cohesion. It shall not constitute a barrier to or discrimination in trade between Member States, nor shall it distort competition between them."

The Council Legal Service concludes "that the criterion for deemed establishment of an institution which Article 4(1) point (f) of the proposed Directive…is discriminatory and likely to lead to distortion of competition to the detriment of Non-participating Member States".

Double taxation and distortion of competition

It is undisputedly acknowledged that the European Commission's proposal, in Art. 4(1) point (f), exposes financial institutions established in non-participating Member States that are parties to financial transactions taxable under the regime of the proposal to risks of effective double taxation.

Double taxation of international (cross-border) activities may not be considered illegal per se, as the CJEU's jurisprudence continually reminds us.[32] It is conversely a frequent phenomenon that cannot find a legal prohibitive basis either in international customary law or in EU primary law, precisely resulting from (Member) States' competences on tax matters.

In this respect, non-prohibition of international double taxation is a rule, but for the EU the following points merit attention:

- It calls for looking for mechanisms aimed at broad fiscal harmonisation. In the case of the FTT under enhanced cooperation, there are hardly sustainable arguments why it should be treated differently from any other situation of double taxation of international activities, i.e. in the framework of preventive bilateral conventions.

- It limits the significance of arguments on the potential distortion of competition that may arise, because they would highlight the need to reconsider from a legal/regulatory perspective all cases of double taxation of international activities.

[32] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:62013CJ0209&from=EN

Compatibility with the principles of free movement of capital

Restrictions to free movement of capital are prohibited by TFEU Art. 63.1, which states that "all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited".

The Council Legal Service considers that

> [t]he proposed 'counterparty principle' would render less attractive financial transactions with financial institutions located outside the participating Member States, since these institutions would have to pay the FTT at different rates in different countries and the counterparty may be unwilling to be liable for that tax and to face, on these grounds, legal uncertainty and possible disputes with the authorities of the participating Member State.

The Commission's Legal Service refutes this conclusion by referring to CJEU case law on double taxation (see above).

Discriminatory treatment of financial institutions

This is an issue that needs analysing in more detail, but requires a wider study.

6.2.2.2 Assessment in relation to Art. 327 TFEU

Art. 327 TFEU provides that "[a]ny enhanced cooperation shall respect the competences, rights and obligations of those Member States which do not participate in it. Those Member States shall not impede its implementation by the participating Member States."

Art. 327 sets out duties on non-participating Member States to ensure that they do not take actions that impede implementation by participating Member States. Conversely, non-participating Member States shall see their competences, rights and obligations respected.

The FTT raises several issues connected with non-participating Member States' competences, rights and obligations, which are still pending. Moreover, recent declarations by UK Chancellor of the Exchequer George Osborne point to the possible undesirable outcome of the legal uncertainties.[33]

The compatibility of the European Commission's proposal with the principles and criteria of Art. 327 has to be analysed particularly in light of its Arts. 4(1)(f)[34] (the "counterparty principle") and 4(3)[35] (the "escape clause"), setting the principles of financial institutions' "deemed

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[33] See "EU financial transaction tax on life support", *EUobserver*, op. cit. (https://euobserver.com/economic/131435): "I make it very clear that if the proposal impacts on the UK, other non-participating states and on the single markets, we will have to go to court."

[34] "1. For the purposes of this Directive, a financial institution shall be deemed to be established in the territory of a participating Member State where any of the following conditions is fulfilled:

(f) it is party, acting either for its own account or for the account of another person, or is acting in the name of a party to the transaction, to a financial transaction with another financial institution established in that Member State pursuant to points (a) (b) (c) (d) or (e), or with a party established in the territory of that Member State and which is not a financial institution".

[35] "3. Notwithstanding paragraphs 1 and 2, a financial institution or a person which is not a financial institution shall not be deemed to be established within the meaning of those paragraphs, where the

establishment", "deemed established counterparty" and derogations to eliminate situations with insufficient nexus. The opinions of the Council[36] and the Commission's[37] Legal Services significantly diverge on the possible legal issues at stake and it is to be noted that the European Parliament's proposed amendments to the European Commission's proposal[38] address none of these provisions.

The Council's Legal Service concludes "that the criterion for deemed establishment of an institution which Article 4(1) point (f) of the proposed Directive contains:

1) exceeds Member States' jurisdiction for taxation under the norms of international customary law as they are understood by the Union;
2) is not compatible with Article 327 TFEU as it infringes upon the taxing competences of non-participating Member States;".

Respect of customary international law/extraterritorial exercise of jurisdiction

The question of the compatibility with customary international law and notably of the possible illegal extraterritorial exercise of jurisdiction by participating Member States was addressed in the judgment of the CJEU of 30 April 2014,[39] after the UK's challenges concerning the European Council's Decision 2013/52/EU to authorise the enhanced cooperation procedure for the FTT.

The Court's judgment unambiguously argues in favour of the conceivability of variable geometry, as it considers that the enhanced cooperation procedure authorised in the Council Decision of 22 January 2013 is a legitimate mechanism to implement an FTT in participating Member States.

The judgment, however, does not definitively prevent further legal challenges, as the Court made clear it could not review the legality of the FTT proposal to be adopted.

Infringement of the taxing competences of non-participating Member States (sovereignty) and the burden imposed on their markets

Although there is need for further detailed analysis, these issues are addressed respectively in the present and following subsections.

6.2.2.3 Assessment in relation to Art. 332 TFEU

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person liable for payment of FTT proves that there is no link between the economic substance of the transaction and the territory of any participating Member State."

[36] See Council, Opinion of the Legal Services, Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax (FTT), 13412/13 (2013), op. cit.

[37] See "Implementing enhanced cooperation in the area of Financial Transaction Tax – Response to the opinion of the Legal Service of the Council on the legality of the counterparty-based deemed establishment of financial institutions", Non-Paper by the Commission Services (n.d.), op. cit.

[38] See the European Parliament legislative resolution of 3 July 2013 on the proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax (COM(2013)0071 – C7-0049/2013 – 2013/0045(CNS)) (Special legislative procedure – consultation).

[39] See the judgment of the Court (Second Chamber) of 30 April 2014 in Case C-209/13, *United Kingdom v. Council*, op. cit.

Art. 332 TFEU provides that "[e]xpenditure resulting from implementation of enhanced cooperation, other than administrative costs entailed for the institutions, shall be borne by the participating Member States, unless all members of the Council, acting unanimously after consulting the European Parliament, decide otherwise".

The original European Commission proposal imposed on financial institutions established in non-participating Member States or third countries, and party to a financial transaction subject to the tax, the obligation to collect the tax and proceed with its payment to the participating Member States where the other party is located. This raised several issues (sovereignty, extraterritoriality, costs, etc.).

The proposal was amended and presently ensures that the tax collection and payment complies with the Treaty.

6.2.3 Impact on the budgetary principles of universality and unity

Principle of universality

The European Commission's 2013 proposal elaborates the FTT as an own resource of a general nature,[40] which means that as a rule, it does not have the purpose of funding specific policies.

As stated in Commissioner Pierre Moscovici's answer to Parliamentary questions of 1 September 2015,

> [t]he Commission proposal for a Council Directive of 14 February 2013 implementing enhanced cooperation in the area of financial transaction tax (FTT) does not include rules on the use of the revenue generated by such FTT. …In February 2013 the European Council invited the participating Member States to examine whether the FTT could become the basis for a new own resource of the EU budget. If (parts of) the proceeds of the FTT were to become an own resource for the EU budget, the *principle of universality* (total general revenue covers total payment appropriations) *would a priori preclude any earmarking* for a specific expenditure priority.[41]

The transfer of the FTT to the EU budget as an own resource requires, according to Art. 311(a)(l.3) TFEU, that

> [t]he Council, acting in accordance with a special legislative procedure, shall *unanimously* and after consulting the European Parliament adopt a decision laying down the provisions relating to the system of own resources of the Union. In this context it may establish new categories of own resources or abolish an existing category. That decision shall not enter into force until it is *approved by the Member States* in accordance with their respective *constitutional requirements*.[42]

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40 See European Commission (2013a), pp. 4, 15, 33 and 39.

41 Emphasis added.

42 Emphasis added.

Non-participating Member States could therefore oppose establishing the FTT as a new category of own resources, which would make it impossible to use enhanced cooperation to avoid a unanimous decision and its constraints and consequences.

To the extent that that the FTT is transferred to the budget as an own resource, the rules of the Own Resources Decision do not in principle leave any option for derogating from the principle of universality.

Principle of unity

In the same manner as for the principle of universality, the transfer of the FTT as a resource for the EU automatically requires the enforcement of the unity principle, notably pertaining to the prerogatives[43] and powers of scrutiny of the European Parliament.[44] The key elements identified in the impact analysis concerning the principle of universality above equally apply in this regard.

6.2.4 Art. 113 TFEU as the legal basis for the FTT under enhanced cooperation

The European Commission's (2013a) proposal refers to Art. 113 TFEU as the pertinent legal basis for the proposed directive. Art. 113 TFEU stipulates that

> [t]he Council shall, acting unanimously in accordance with a special legislative procedure and after consulting the European Parliament and the Economic and Social Committee, adopt provisions for the harmonisation of legislation concerning turnover taxes, excise duties and other forms of indirect taxation to the extent that such harmonisation is necessary to ensure the establishment and the functioning of the internal market and to avoid distortion of competition.

The Commission's proposal formulates the FTT's objective as

> harmonising legislation concerning indirect taxation on financial transactions, which is needed to ensure the proper functioning of the internal market and to avoid distortion of competition. Non-participating states' financial institutions will benefit from the enhanced cooperation, as they will be confronted with only one common system of FTT applicable in the participating Member States instead of a multitude of systems.

Are the FTT characteristics proposed by the European Commission those of turnover taxes, excise duties and other forms of indirect taxation in line with legislation?

Although some analysts[45] have challenged whether the FTT could undisputedly and fully fall under one of these categories, no diverging points of view or further issues have been raised to date by the legal experts of public authorities. It must be noted, for instance, that from the

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[43] The transfer of the FTT to the EU budget as an own resource is a condition for the application of Art. 311(4) TFEU, in particular concerning implementing regulations: "The Council, acting by means of regulations in accordance with a special legislative procedure, shall lay down implementing measures for the Union's own resources system in so far as this is provided for in the decision adopted on the basis of the third paragraph. The Council shall act after obtaining the consent of the European Parliament."

[44] See notably, Iara (2015), p. 18 (http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_papers/taxation_paper_54.pdf).

[45] See for example, Scone (2013) (http://www.juridicainternational.eu/public/pdf/ji_2013_1_188.pdf).

perspective of current tax environments at the national level, the FTT is regarded in France as a *taxe spéciale sur le chiffre d'affaires*.[46] Another indicator of compliance is the fact that at the level of the Council, tax questions inherent to the FTT fall under the prerogatives of the Indirect Taxation subgroup of the Working Party on Tax Questions.[47]

Is such harmonisation necessary to ensure the establishment and the functioning of the single market?

This issue needs analysing in more detail, but requires a wider study. Nonetheless, it appears that the principle of fair contribution to the collective efforts to generate public finances (notably from the financial sector), together with the causes and responsibilities associated with the financial crisis, are strong arguments for a positive answer to this question.

Is such harmonisation necessary to avoid distortion of competition?

Notwithstanding the analysis and key findings presented in subsection 10.2.2, this issue needs analysing in more detail, yet again requires a wider study. It must be noted, however, that by its very nature enhanced cooperation is unlikely to increase the harmonisation of the single market globally, only doing so among the participating Member States. Still, this does not mean that the proposed FTT can be considered non-compliant with the provisions of the Treaty.

6.2.5 Alternatives to Art. 113 TFEU in relation to variable geometry in general

While the *lex generalis* measures in Art. 114 TFEU allow for qualified majority voting to adopt legislation, Art. 114(2) TFEU expressly excludes fiscal matters, making this article null and void in the context of the FTT. Art. 115 TFEU requires unanimity for other measures of Treaty competence. This could work in theory, although at present unanimity cannot be achieved. Art. 352 TFEU allows for measures not previously included within the Treaty to be adopted, but with unanimity.

6.3 FTT IMPLEMENTATION AND COORDINATION

The coordination of the FTT is important for meeting the objectives of coherence, simplicity and transparency, and to ensure the tax ultimately meets its objectives and is linked with other EU policies.

Several issues arise concerning the principles of equity and fairness that should be foreseen in the directive. But it is unlikely that the directive will resolve all issues, notably those connected with double taxation and their potential impacts on economic actors. It would be advisable that a broader analysis, notably of corrective mechanisms preventing double taxation in the framework of bilateral conventions, completes the picture of FTT implementation.

[46] See the Direction générale des finances publiques, Bulletin BOI-TCA-20120912, 12 September 2012 (http://bofip.impots.gouv.fr/bofip/7765-PGP.html).

[47] See "Working Party on Tax Questions" (http://www.consilium.europa.eu/en/council-eu/preparatory-bodies/working-party-tax-questions/).

6.4 Key lessons on mechanisms of variable geometry and their extension to other candidates for new own resources

The previous sections analyse the limits, potential and pending issues relating to the conceivability and feasibility of differentiated treatment of Member States under enhanced cooperation from a neutral perspective, i.e. based on the current and given characteristics of the FTT. As such, there is no indication that related findings and conclusions are not valid for the limits and potential for Member States' differentiated treatment as part of the design, adoption and implementation of other candidates for new own resources – as long as they present the same characteristics as the FTT.

As stated throughout this chapter, variable geometry is a characteristic of Union integration in that it

- is fundamental rather than exceptional;
- goes beyond budgetary matters;
- is driven by ideological, political, economic or practical matters;
- finds ways within or outside the Treaty frameworks, and leads to designing and adopting diverse, ad hoc legal bases to generate consensus while ensuring compliance with the provisions of the Treaties;
- is primarily ruled by decisions based on Member State unanimity, which further establishes a balance between Member States' powers, rights and obligations;
- may be driven by top-down (e.g. opt-outs, through which the regulatory environment is first designed on a relatively detailed basis and exceptions to its application are explicitly outlined afterwards) or bottom-up approaches (e.g. enhanced cooperation, through which there is a preliminary unanimous consensus based on high-level objectives and further details are designed by participating Member States at a second stage);
- may give rise to discriminatory and distortionary situations that are not necessarily illegal, but call for correction mechanisms; and
- may face challenges throughout its elaboration and adoption lifecycle, related to pragmatic considerations, especially concerning budget criteria (as in the recent withdrawal of Estonia from the FTT dialogue).

Considering these statements, the question of the conceivability and feasibility of and need for differentiated Member State treatments may at all times concern candidates for new own resources – for various reasons and calling for various solutions. Moreover, these questions undoubtedly require a continual dialectic approach, considering that differentiated Member State treatment on budgetary matters may be inspired by a context of risk and Member State opposition or seen as an opportunity.

From a supranational regulatory perspective, it is clear that variable geometry under enhanced cooperation cannot be applied to all candidates for new own resources, because the scope of implementation of Art. 113 TFEU is restricted to turnover taxes, excise duties and other forms of indirect taxation – thereby excluding direct taxes such as corporate income taxes.

More generally, the Treaty constraints with respect to harmonisation of the single market, non-discrimination, distortion of competition and so forth should always be soundly scrutinised from a holistic perspective, from the objectives of the European Commission's proposals to the concrete impacts of their implementation.

6.5 CONCLUDING REMARKS

The feasibility of using enhanced cooperation for the adoption of the FTT is considered legitimate by the CJEU. Legal issues are still pending, however, and with little consensus today, thereby creating legal uncertainty.

Legal cases also reveal interesting findings pertaining to misalignments between the regulatory perspectives of the Treaties and global EU policy objectives, which could be extrapolated to any case of variable geometry.

In particular, the risks of distortions inherent to a system implemented in a limited number of Member States are not necessarily illegal, notably those resulting from cases of double taxation. As such, it appears that the nature of the variable geometry is characterised by intrinsic limitations to a proper functioning of the single market, which call for a sound analysis on the role and the coherence of the EU budget.

PART III DEVELOPING AN OWN RESOURCES MECHANISM FOR THE 21ST CENTURY – BUILDING BLOCKS FOR A PACKAGE DEAL

7 OPTIONS FOR NEW OWN RESOURCES

Chapter 7 in a nutshell

- This report defines as an own resource a share of a tax resource levied nationally that is attributed to the EU.
- Based on this study, the most attractive candidates for a new, genuine own resource are VAT, CIT and a carbon levy (a carbon tax or the redirection of EU ETS revenue, or both).
- The criteria for selecting the new resource are numerous, and no instrument is optimal.
- Evaluating the total revenue and cross-country distribution of the main candidates is not straightforward, except for the carbon levy.
- A simple tool may be used to assess and rank the four alternatives, once preferences are specified.
- Even if new resources are created, a residual GNI resource will still be necessary unless the EU is permitted to borrow and run deficits and surpluses.
- The GNI resource offers a number of benefits, but also serious drawbacks owing to impacts on horizontal equity for citizens, a lack of transparency and perverse incentives in decision-making.

This chapter reviews the main tax instruments that may be contemplated, either in isolation or combined, as possible sources of revenue for the EU budget. There are potentially many, and the selection has been guided by several considerations: proposals made in the past either by the Commission or by the European Parliament, and sometimes also by analysts; existing tax instruments or at least instruments for which feasibility studies have been conducted; and lastly, instruments that have a reasonable degree of homogeneity over a significant number of Member States. The latter criterion has led to the exclusion of personal income taxes from the list, although they are currently in place in all Member States, insofar as the nature of taxpayers – individuals versus families – the tax bases and the rate structures (or progressivity) are profoundly different across Member States and have been varying considerably over time, reflecting heterogeneous and changing preferences.

Personal income taxes could in principle be shared with the EU. All countries impose personal income taxes, albeit at rates that vary substantially from one Member State to another, but assessment and collection systems are well established. Most national tax systems are progressive, but with differing bands, tapers and allowances, although a minority of Member States has opted for flat taxes, while marginal rates differ substantially. From the perspective of sufficiency, there should be no great difficulty in using the income tax base, even though the number of citizens who pay income tax is substantially smaller than the population as a whole. Income tax has a pivotal role in national systems of redistribution, yet one that varies hugely depending on the interplay between rates, allowances, thresholds and so on. For these reasons, it is a sensitive tax in national political economy, undermining its credentials as a tax to fund the

EU. However, tax avoidance – particularly by those with the means to transfer their wealth offshore or their official residence – is a critical problem requiring an EU approach and even beyond Europe.

The introduction of 'genuine' own resources has been repeatedly discussed by the Commission. Table 7-1 summarises the various resources analysed by the European Commission in its reports (European Commission, 1998, 2004 and 2010). The resources have also been scrutinised by researchers, such as Cattoir (2004), Le Cacheux (2007), Begg et al. (2008) and Schratzenstaller (2014).

Table 7-1. Candidates for own resources, studies by the European Commission

European Commission (1998)	European Commission (2004)	European Commission (2011b)
CO_2 or energy tax	EU energy tax	EU energy tax
Modified VAT	EU VAT	EU VAT
EU corporate income tax	EU corporate income tax	EU corporate income tax
Tax on transport and telecommunication services	–	Taxes on the financial sector (FTT and financial activity tax)
Income tax; interest rate income tax	–	Revenues from auctioning under the ETS
Tax on ECB gains from seigniorage	–	Charge related to air transport
Excises on tobacco, alcohol and mineral oil	–	–

Source: *Authors' own classification*

Reviewing the past reform proposals by the Commission and the Parliament and the state of discussions of the potential new own resources, this report shortlists four instruments: VAT, CIT, the FTT and carbon levies (which include the revenues of the ETS and a tax on fossil fuel energy sources). This list is close to the proposals of the Commission. The aviation tax is not assessed, because it is largely covered under the ETS. We do not see other promising tax-based resources, but consider the handling of the package deal to phase in any of these resources to be central. Their interplay with the GNI resource and the corrections needs more careful treatment.

What do these resources have that others do not? A 'euro VAT' would be an obvious solution given its strong revenue-raising power and has frequently been advocated (Gros and Micossi, 2005). Its feasibility was examined in depth in the 2004 own resources report. Certainly, VAT is likely to be more stable than either personal income or corporate income taxes, which are more cyclical in their yield and which entail much greater differences in the nature of the tax systems and tax bases. Proponents of VAT as an EU resource argue that these considerations, together with the fact that yields are relatively even across the EU, mean that it would be the most promising choice among the major tax bases as an EU resource (for example, Gros and Micossi, 2005; Le Cacheux, 2007; Cipriani, 2014). By contrast, excise duties are widely seen as much more politically sensitive than VAT because they are used for social policy purposes (such as curbing alcohol consumption), effectively ruling them out as options for the EU, except perhaps for excise duties on fossil fuels. In principle, taxes on capital, especially a CIT, are more credible, partly because in an integrated single market it becomes very difficult to determine where the tax base (corporate profits) is actually generated, as opposed to where it is declared. Indeed, some countries have quite deliberately sought to attract corporate HQs precisely because they can then obtain more yield from corporate taxation.

While it does not exist formally in all Member States, some form of carbon levy (a carbon tax, although there may be a number of technical ways of levying revenue from carbon emissions) seems worth studying as well. That is partly because the EU carbon market (the ETS) was instituted in 2005 and is currently in operation, and partly because climate policy is high on the EU agenda. An FTT could be adopted by a subset of Member States (ten currently), but raises serious considerations stemming from introducing variable geometry in the financing of the EU budget.

7.1 WHAT SELECTION CRITERIA?

Given that the Treaty (Art. 311 TFEU) stipulates that the EU "shall be financed wholly from own resources" it is useful to consider how the expression is to be interpreted. Conceptually, there are, arguably, four characteristics of an 'owned' resource that are germane to the EU debate. The simplest is that the proceeds of the revenue stream are assigned to the level of government in question. Three others (as discussed in Bird, 2000) are on the tier of government that has the power to

- assess the revenue source;
- set the rate for it; and
- collect the revenue.

As Bird puts it (in the context of sub-national government), "many taxes may possess only one or two of these characteristics, and the 'ownership' of the levy may be unclear". Equally, it is important to separate the major political decisions surrounding a revenue source from what might just be an agency role in administering it. If the four present EU own resources are examined from this perspective, it immediately becomes clear that the picture is, indeed, very fuzzy. The VAT resource is manifestly not 'owned' by the EU level insofar as the definition of its base and the rate at which it is charged (although subject to constraints imposed at the EU level) are both Member State decisions. Moreover, because the take-up of VAT as an EU own resource is subject to a variety of corrections designed to ensure comparability across Member States, and now has different rates applied to ensure de facto rebates to certain countries, it has become even less of an EU-owned resource.

There are also many different types of (actual or potential) own resources:

- taxes;
- clearly assigned non-tax revenue streams that result from impositions on economic actors, direct user charges for services provided by a government;
- earnings from assets/endowments (as in the case of the World Bank and the IMF);
- the intermediation margin earned from the provision of loans to members; and
- fines inflicted by the Commission in application of EU legislation (competition policy).

The weights attributed to the various criteria listed above may differ according to preferences. It may therefore be useful to establish rankings of the various resources dependent on those weights. Begg et al. (2008) offer a simple tool that may easily be adapted for this purpose. In the following sections we analyse the candidate resources against these criteria and rank them.

Given that tax competences fall into the hands of national authorities, the definition of own resource is, in the case of the EU proposals, a tax or a share of a tax levied nationally attributed to the EU. The rate collected of the tax will be agreed by the Member States in the Council. The European Commission or the European Parliament cannot decide on a tax or tax rate and impose it on Member States. The only exception is the customs revenues, for which the EU has the legislative authority on tariffs and revenue as per Art. 28 TFEU. This means, as Waldhoff (2016) notes, that although new tax resources attributed to the EU can be created, the control over their establishment and rates will remain in the hands of Member States, as the Treaty provisions do not permit the EU institutions to wield taxation powers. While that is true, the agreement on attributing resources to the EU budget from commonly agreed tax bases to the EU budget would introduce some more transparency on the EU's resource structure.

7.1.1 Market efficiency aspects

If one extends the reasoning put forward by Olson (1969), initially set in terms of assignment of expenditures, a modified 'principle of fiscal equivalence' would look at the location and mobility of tax bases and tailor the assignment of tax powers among different government levels to the various degrees and span of mobility. Choosing a new own resource could create the opportunity to assign revenue-raising powers for the EU to areas where the mobility of the tax base is higher. Thus, while a legal or private person may avoid a tax in one country by shifting to another, the impact could be neutralised by a supranational tax. Offering the EU the capacity to raise its income from mobile tax bases could enable the improvement of the overall taxation system, with Member States not needing to use revenue from less mobile tax bases to finance the EU. An overall efficiency improvement is thus possible and addresses some of the concerns about unfair tax competition and tax evasion. This would require a common tax base, such as the common consolidated corporate tax base (CCCTB) that has been proposed by the Commission. It would provide clarity and transparency on the effective tax rates.

7.1.1.1 Improving the functioning of the EU single market

Economic analysis of taxation deals extensively with the effects of tax instruments on incentives, and hence on private sector choices to supply work, to save and consume, to invest, etc. Two instruments do not fall victim to such effects on incentives, namely the taxation of economic rents and lump-sum taxes in general. However, for the EU such taxation as an own resource is for two reasons not appropriate. First, the EU is not rich with natural resources, which makes one major source of rent-taxation unavailable and the resources tend to be location-specific, making such a tax controversial and most likely resisted by countries owning the resource.

The other option is imposing levies on other economic rents, which is difficult in practice, but would be in some specific cases rational at the EU level. It may be argued that whenever public policies generate benefits to some categories of private agents, the induced rents may be partially taxed away, a principle close in theory to the notion of user charges. Although difficult to evaluate, these policy-induced economic rents certainly exist in the EU single market. Hence, some have argued in favour of taxing the benefits accruing to firms from the existence of the single market. But in theory this can be expanded, as such benefits should be very widespread, and accrue not only to firms, but also to consumers.

Resorting to lump-sum taxation, either at the level of individuals or of Member States may be tempting, but would undoubtedly be vigorously opposed by many on equity grounds, as has always been the case with attempts to use lump-sum taxation in a national context – and as Margaret Thatcher learned to her cost after introducing a poll tax to finance local government.

Apart from such taxes, it is recognised that all forms of taxation introduce relative price distortions that may generate inefficiencies in the allocation of resources by the private sector and deadweight losses. Hence, it is impossible to conceive of a tax system that is costless. But economic analysis also demonstrates that this inefficiency is related to the magnitude of the price distortion, itself dependent on the marginal effective rate of taxation. Therefore, a tax system that aims at minimising inefficiency should be characterised by broad bases and low marginal rates. In addition, as was demonstrated long ago by Ramsey (1927), the more price-inelastic the tax base is – i.e. the less it changes in reaction to relative price or tax rate modifications – the less inefficient the tax instrument.

Turning back to the Ramsey criterion, in the current European context, characterised by internally mobile tax bases, but also by the international mobility of some of them, the logic needs to be extended to the mobility of tax bases. Because some tax bases are obviously more mobile than others – one may especially think of financial capital and firms – assigning tax powers over these mobile bases to the EU level would entail the triple benefit of mitigating the Ramsey problem and lessening the pressure of horizontal tax competition (see, e.g. Le Cacheux, 2000; Saint-Etienne and Le Cacheux, 2005). It would reduce the magnitude of distortions introduced by the existence of different national tax bases and rates affecting the decisions of private actors on the location, and would lessen the possibilities of fraud or evasion. It would provide the EU budget with a resource that is levied over the whole area over which the benefits of European public goods accrue, thus minimising spillover effects, in the spirit of Olson's fiscal equivalence. That being stated, the extent of the triple benefit has to be put into the perspective of the relatively small size of the EU budget. Still, the effort of creating common tax bases could help Member States in improving tax cooperation efforts regardless of the size of the EU component of the taxes.

7.1.1.2 Remedying market failures

In a number of well-defined circumstances, efficiency may imply deliberately introducing price distortions: whenever there are negative external effects, market prices do not properly reflect social costs, and the so-called 'Pigouvian' solution to restore efficiency entails introducing distortionary taxation in order to correct externalities and produce the right incentives; this is the well-known case for many forms of environmental taxation. Two distinct arguments can be put forward for such taxes to be decided and operated at the EU level rather than at the national level: one is the collective decision-making argument, in terms of potential free riding; the other is in terms of the smooth functioning of the EU single market and ensuring a level playing field for private agents operating in this integrated area. Even though it may be argued that many major environmental protection issues – and most prominently the fight against climate change – are worldwide public goods, they clearly also have a European dimension, especially if the EU is to take unilateral action on some such policies. The EU's commitments to reduce greenhouse gas emissions by 20% by 2020 and by 40% by 2030 are policy objectives that need instruments for implementation (Laurent and Le Cacheux, 2009).

The inability of the EU to introduce genuine own resources and its use of mainly a GNI-based resource restricts the EU in using fiscal instruments to promote changes in the market. There are fiscal incentives generated by EU policies, but the revenues are not accruing to the EU. The most interesting case is the ETS, which has such an effect and is a pure EU levy, but ironically does not contribute to the EU budget, with revenues remaining in the hands of national authorities.

7.1.1.3 Tax externalities and tax competition

Ever since the completion of the EU single market, tax competition has been on the rise. In the late 1980s, after adoption of the Single European Act, the Commission expressed concern that tax harmonisation might be needed, at least on some of the tax instruments most directly impacted by increased mobility of tax bases. Of particular concern was VAT, for which the 1991 Directive foresaw a switch from the destination to the origin principle, the destination principle being maintained in the 'transitory regime' that eventually became perennial. Later on, in the late 1990s, renewed concern was expressed by the Commission and a number of Member State governments about 'harmful tax competition' in the fields of corporate taxation and the taxation of incomes from personal financial investments (Primarolo Report, 1999). As a response, two important measures were adopted: the 'Code of Conduct', prohibiting 'damaging' tax competition – essentially discriminatory tax treatment of foreign firms – on corporate taxation, and the Savings Directive (2003/48/EC), which introduced mandatory information exchange on incomes from interest-bearing assets held by non-resident EU citizens.

With further progress in completing the single market, and the increasing number and size of multinational corporations, as well as the building of trans-European networks for passenger transport (e.g. Eurostar and Thalys), the Internet and the development of firms selling services that cannot easily be located in one country or another, tax competition has apparently become more severe on the most mobile tax bases (Saint-Etienne and Le Cacheux, 2005). There has indeed been a 'race to the bottom' on statutory tax rates for high-income earners and corporations, as well as a persistence of discriminatory tax treatments, as revealed by LuxLeaks. Since the 2009 Great Recession, tax competition has tended to grow worse, with the tendency of those eurozone countries caught in severe recessions and having to consolidate their public finances to resort to 'internal devaluations' – usually a mix of wage moderation, reductions in social contributions and consumption tax hikes. A 'race to the top' on VAT rates has also been observed since 2010 (Le Cacheux and Laurent, 2015).

Of course, tax competition is not necessarily bad, from an economic efficiency viewpoint. It undoubtedly has beneficial effects: by pushing rates down, it reduces the distortions on market price signals, and hence the deadweight loss generated by taxation, and may force governments to be more efficient in the provision of public goods and better cater to the preferences of their citizens. But in the presence of discriminatory tax treatments, there are – often large – efficiency losses due to distortions in firms' location decisions and other costs related to efforts by firms to 'optimise' their tax burdens, as exemplified by the recent cases of tax-motivated mega-mergers. In addition, a robust conclusion of the literature on horizontal tax competition (i.e. competition among governments at the same level in a multitier government structure) is that, with a limited number of governments competing for a mobile tax base, the equilibrium outcome will be suboptimality in the provision of public goods – insufficient in volume and quality compared with an equilibrium with centralised taxation – owing to the existence of horizontal tax externalities.[48]

When tax bases are shared among governments at different levels in a multitier government structure – such as a federation or the EU – a vertical tax externality also exists, in the sense that decisions to tax at one level will have an incidence on the size of the tax base for governments at other levels. This creates a strategic interdependence, whose effects in general counteract those of horizontal tax competition; hence, vertical tax competition tends to mitigate the race to the bottom induced by horizontal tax competition and may partially restore optimality in the provision of public goods. The literature on vertical tax competition is more recent and less abundant than that on horizontal competition (Annex II); the conclusions are less clear-cut and it suggests that outcomes depend to a large extent on institutional design and informational

[48] See Wilson (1986) and Zodrow and Mieszkowski (1986); for a survey of theory and evidence in the EU, see Saint-Etienne and Le Cacheux (2005).

structure. But the general conclusion that introducing a more centralised power to tax mitigates the inefficiency in public goods provision is broadly valid.

7.1.1.4 Efficient stabilisation and growth

The case for equipping the EU budget with instruments, especially on the revenue side, that play a role in macroeconomic stabilisation has long been made in some quarters, at least since the MacDougall report (1977).[49] The case for having automatic stabilisers, especially on the revenue side of the budget, has been restated forcefully with new arguments (see, in particular, Aghion and Marinescu, 2007; Dullien and Schwarzer, 2007) and the difficulties of coordinating fiscal policies in the face of the 2009 Great Recession may be regarded as additional evidence in favour of a common stabilisation instrument (Le Cacheux and Laurent, 2015). Although facing the difficulty that some EU countries are not members of the eurozone, this would plead in favour of having a resource in the EU budget whose revenue is sensitive to business fluctuations. Stabilisation may imply breaching the balanced budget rule by allowing deficit financing at the EU level, or else establishing some sort of 'rainy-day fund' that would be built up in good times and spent in bad times, thereby potentially raising problems related to political control and possible temptations to spend the money in good times.

7.1.2 Distributional consequences and the equity dimension

Efficiency is not the only criterion for a 'good' tax system. It should also fulfil some 'equity' requirement. Yet there are differing ways of interpreting equity and this gives rise to further layers of complication in assessing potential revenue instruments.

7.1.2.1 Inter-individual vs interstate horizontal equity

In relation to individual citizens, equity has two distinct meanings: either 'horizontal equity' (the equivalent in matters of taxation of the principle of 'equal treatment of equals'); or 'vertical equity' (traditionally understood to refer to the ability to pay, and often also to some form of progressiveness in individual tax burdens).

7.1.2.2 Fairness in the EU context

In theory, horizontal equity means the equal treatment of equals, referring to individuals. In multi-level governmental settings and in particular in federations or pseudo-federal contexts, however, this notion is complicated by the consideration of another notion of 'fairness' that refers to the component constituencies: the ability to pay is often assessed at the level of Member States, not of individuals. The two usually differ immensely, insofar as income distributions within Member States are different. Any supranational tax therefore has to result from a compromise between at least two notions of fairness, not to mention the regional component, which is so central in structural policies funded by the EU budget.

In the case of the EU budget, the initial situation is one in which the second meaning of fairness has been given considerable attention. The previous reform of the own resource system in effect exclusively emphasised this meaning by choosing the GNI-based national contribution formula. And the protracted intergovernmental negotiations over the latest medium-term financial perspectives have shown that an exacerbated measure of 'fair' national contributions,

[49] See also Goodhart and Smith and the other contributions in the collective volume in the Reports and Studies series of *European Economy*, No. 5, 1993.

understood as 'net national contributions', leads to a messy compromise and to a distribution of financial burdens that gives no weight to individual horizontal equity, and indeed not much to regional horizontal equity. The fact that a limited and dubious measure of the 'fairness among Member States' (accounting balances) has been used so far by no means implies that this notion is irrelevant or ill founded. Indeed, some acceptable burden sharing for the financing of the EU budget will have to be found if an EU tax is to be deemed acceptable by all. Some key questions to be answered in this context relate to whether and how progressivity could be brought more clearly into discussions on the EU budget and whether there should be a cap for contributions.

7.1.3 Democratic legitimacy and efficient decision-making on the EU budget with a sound financing scheme

The history of multi-level government structures offers some lessons and it is interesting to note that the issue of financial resources for the common budget has occurred in all existing and defunct federal structures. Most started out with a system that closely resembles the current EU scheme for funding the budget: a relatively small amount of genuine own resources, usually from tariffs. In the context of the 19th century, tariffs used to represent a higher relative share of total financial needs than today, given the more protectionist stance of all governments at the time and the relatively smaller share of GDP spent through public budgets. The remaining revenue came from vertical grants from the national budgets of Member States to the central budget. Yet most federations eventually felt it necessary to reform such funding schemes, mainly because they wanted to increase the role of the central budget in the provision of public goods and to achieve more financial solidarity, and at times also more redistribution, in sharing the financial burden.

But it may be argued that the ultimate reason for switching from a system based on vertical financial transfers to genuine, mostly tax-based own resources for the central budget was effectiveness in collective decision-making. Indeed, when comparing the history of two important Central European federations – the German Reich and the Austro-Hungarian Empire – in the last decades of the 19th century and the first years of the 20th century, the diverging routes they took in terms of financial burden-sharing and decision-making procedures over common expenditures for federal, public goods and most notably defence, may probably explain a good deal of the differences observed in the functioning of these federal systems and their performance. That holds for both economic growth and development and more generally for delivering on public policies. The Austro-Hungarian Empire, with the Agreements of 1878, adopted a decision-making mechanism and a financing scheme that bears a close resemblance to the current EU ones, relying almost exclusively on automatic, formula-based, vertical transfers from the constituent kingdoms' budgets to the imperial budget. By contrast, the German Reich quickly moved away from an initial financial arrangement that, in 1871, had grounded the financing of the central budget on tariffs, supplemented by vertical transfers, to the adoption of a modern system of federal, personal income tax, one of the first on the Continent.

One major line of reasoning in favour of assigning autonomous own resource powers at the EU level, instead of relying on the current mechanisms of automatic vertical grants, rests on the respective properties of various funding schemes in terms of efficiency of the political decision-making process over expenditures and financing. First, the current system is notoriously opaque, making it almost impossible for EU citizens to ascertain the actual amount of their individual contribution to the EU budget: this feature alone would be enough to raise doubts about the current funding scheme when it is assessed in terms of accountability. The EU budget is often (and often cynically) portrayed as an insatiable and very costly Leviathan, sucking national resources to finance useless or even harmful policies that benefit a few well-organised lobbies of producers; but when it comes to how much it actually levies on individual taxpayers, the amounts quoted are usually grossly exaggerated. This is so, not only because the GNI resource is not based on a specific tax, but also because, being treated as general expenditure in the national budgets of Member States, it is impossible to ascertain who – citizens or interest groups – effectively bears the cost of financing the EU.

Because its effective incidence differs from country to country, according to the structure of general taxation in each Member State, the presumption is usually that it is being paid by everybody. That is not fully correct. Indeed, the GNI resource gives the wrong impression that effective financial burdens on citizens are actually distributed according to each country's 'income' and hence ability to pay. A closer look at national tax structures, however, shows that this is highly unlikely: income 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 another, 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.

Thus, it would seem that the major objection to the current state of affairs stemming from an analysis in terms of the political economy of collective decision-making has to do with the issue of incentives bearing on decision-makers. The major problem lies in the automatic linkage introduced between any expenditure decision and the distribution of the corresponding financial burden across Member States' national budgets. Comparing the current EU budget decision-making process with the ones in use in all democracies may help identify the source of the problem: in most national parliaments, the elected representatives make separate decisions over expenditures and over the financing of the overall budgets. In many cases, the constitution formally forbids the allocation of the proceeds of a specific tax to a specific expenditure, and actually this is a major foundation for having a general budget, funded from general taxation, rather than separate accounts for each single function, financed by distinct resource instruments. The idea behind such a clear separation between spending decisions and decisions over their financing would seem to be precisely that it prevents MPs from making the explicit linkage between spending and the distribution of the financing burden across jurisdictions. It does not imply that such distributional considerations are absent when they vote on common expenditures, but the direct implications of any specific decision in terms of inter-jurisdictional distribution are not so easily ascertained.

On the other hand, the accountability aspect of the process may be said to be better secured when the funding scheme rests on a well-identified tax resource, insofar as debates in the decision-making bodies will then clearly be conducted in terms of effective tax prices for the various categories of taxpayers, rather than in terms of national net benefits or costs.

Accountability should be both to those who pay and to those who receive – not often the same groups. It implies awareness (Bird, 2000) of

- what is done,
- how it is done,
- how much it costs, and
- who paid for it.

The arguments for fiscal transparency concern not just holding the government to account for what it does and how it does it, but also to engage the public in determining priorities. Politicians, however, often prefer to keep public finances hidden. Bird argues that transparency is even more vital in multi-level governance systems, but also observes that the search for an ideal may be misplaced. Principles matter, and while often easier to expound than to implement, they nonetheless deserve some attention in thinking about how to fund the EU budget. A possible implication is that despite the political difficulties and the reluctance of many to put the issue on the table, transparency should be a more prominent facet of the choices around funding.

If a new genuine own resource were to be introduced in the form of an EU tax, accountability would have to concern those who make decisions over the tax rate and spending, i.e. the European Parliament, Council and Commission. Insofar as the effective decision power of the Parliament would be increased compared with the current institutional framework – in which it effectively has no say on the financing side of the budget – special attention should be dedicated to the accountability of the European Parliament. A major improvement would result from shortening the period of the MFF from seven to five years, thus having it coincide with the legislature.

Yet, envisaging the increase in the European Parliament's power in setting tax rates is difficult under the present Treaty provisions. As Waldhoff (2016) points out, the present Treaty conditions do not allow a substantial improvement of budgetary autonomy, and even if the rates were to be proposed by the European Parliament, the own resources decision still requires adoption by unanimity by the Council. The level of power of the European Parliament may be increased in the own resources decision, but the Council is unlikely to unanimously vote in favour of transferring a considerable degree of decision-making on tax rates to the European Parliament. Any such decision may also bring up issues of compatibility with national constitutions. There is nevertheless no barrier to having Member States allow the attribution of a share of proceeds from specific tax revenues directly to the EU.

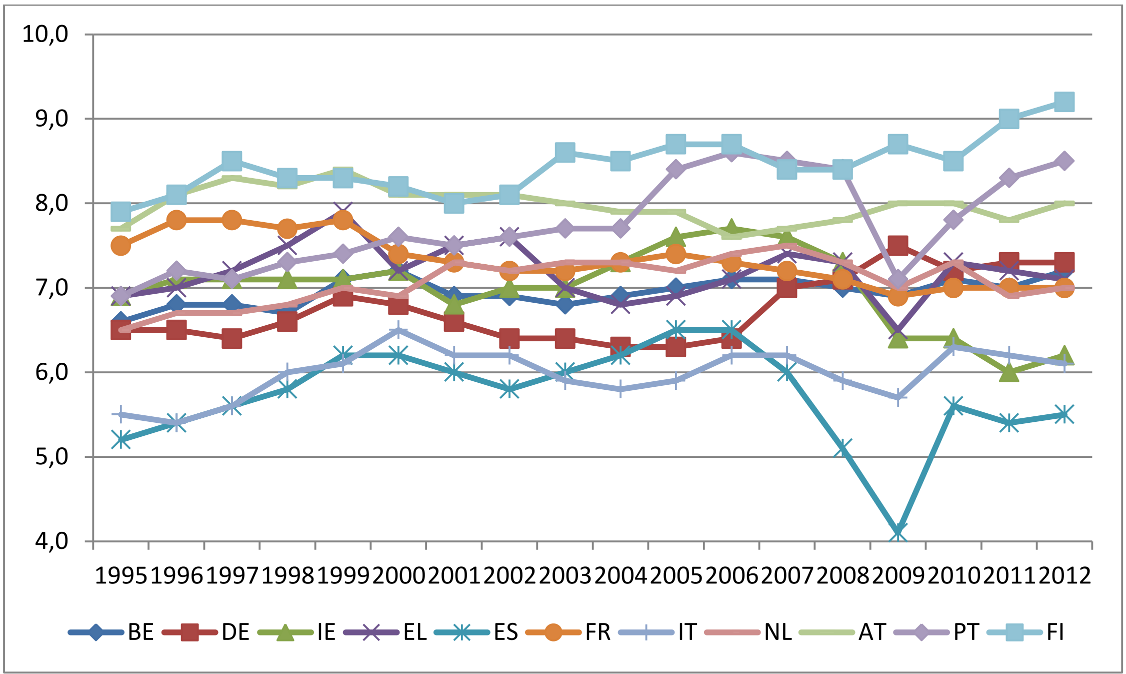
7.2 EU VAT

Every country imposes VAT and there is a passable degree of uniformity in the coverage of the tax. An irony, though, is that the EU budget already has a VAT resource, though one which it has proved necessary to manipulate so as to harmonise the tax burden among the Member States. The dilemma here is that if VAT is seen as a viable option, it would only really be fair as a potential EU resource if there were a common rate and coverage of VAT across all Member States. The much-canvassed option of adding an EU component to the existing VAT rate in each country does not deal with this problem, and if an imperative is to adjust the receipts by correcting the actual VAT to reflect differences in Member State implementation of the tax, the direct link between the tax and revenue for the EU would be broken. Indeed, the VAT resource is now seen by many as a de facto GNI resource. Still, from the perspective of improving visibility, a manipulated VAT would, arguably, be an improvement so long as the manipulation is only a minor element in the yield. On other grounds, notably the scope for raising enough revenue, VAT has much to commend it.

VAT was generalised to all EU countries in the course of the 1970s, and adopted by all new Member States during their transformation into market economies in the early 1990s. Two EU directives, in 1977 and 1991, have imposed relatively uniform taxation practices; the latter has also made some progress in the direction of harmonising tax bases and imposed floors on the two major national rates – 15% for the 'normal' rate and 5% for the 'reduced' rate. In a number of member countries, VAT is shared by the central and sub-national government levels. But VAT has retained the 'destination principle', so that it maintains a distinction between intra-European trade and domestic sales, hence some form of distortion in the single market. This causes revenue shortfalls, as it opens the door to VAT evasion and VAT optimisation by companies able to take advantage of differences in national VAT rates.

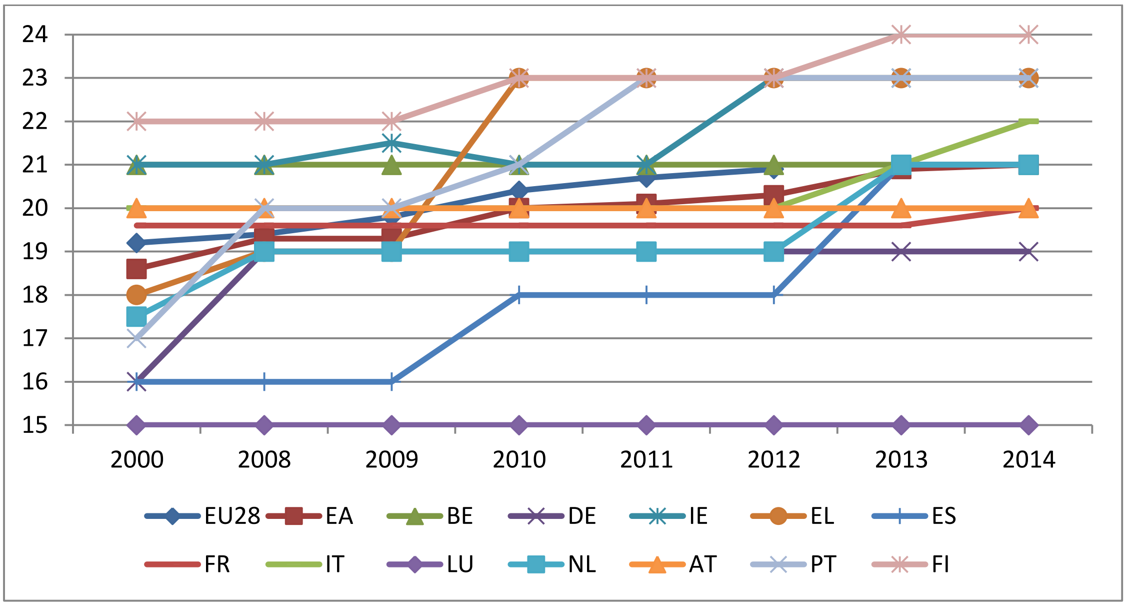
As shown in Figures 7-1, 7-2 and 7-3, a majority of EU Member states have increased VAT rates in the aftermath of the 2009 Great recession, as part of their effort to consolidate national public finances. Being a general tax on consumption, with a large base and relatively low rates, VAT may be regarded as one of the most neutral forms of taxation. To the extent that it does not tax savings, it corresponds to the ideal general consumption tax, such that many analysts (Hines, 2007) and policy-makers have been advocating it even to replace personal income taxes, in the US in particular. At the same time, VAT is also often deemed unfair, as it taxes low-income individuals, who tend to consume a larger fraction of their income and save less, relative to high-income individuals. This vertical inequity of VAT is mitigated by the existence of reduced rates on staples and other basic consumption goods and may be counteracted by other redistributive instruments, as exemplified in North America by food stamps.

Figure 7-1. VAT receipts in eurozone Member States (% of GDP)



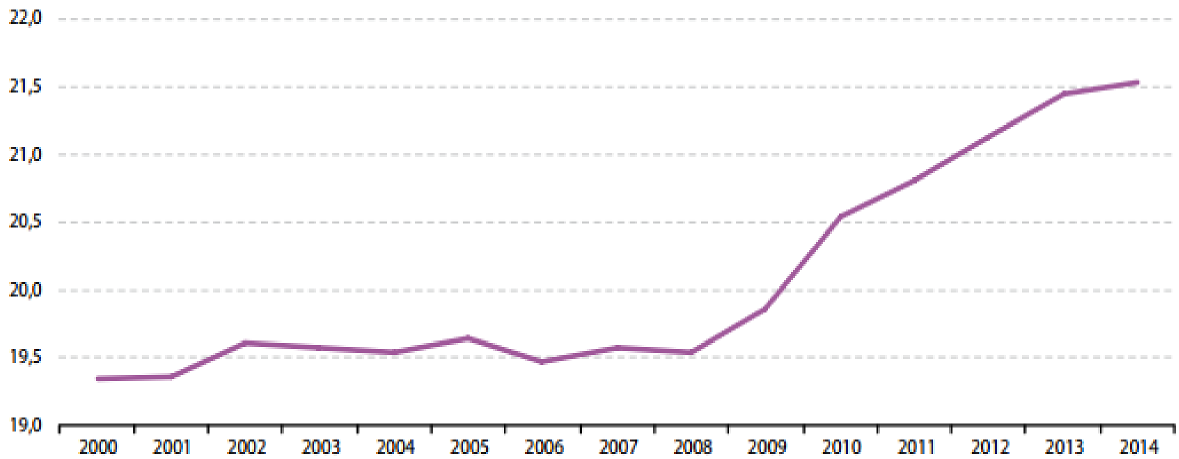
Source: Eurostat.

Figure 7-2. VAT standard rates in eurozone Member States (%)



Source: European Commission.

Figure 7-3. Development of the average standard VAT rate in the EU-28, 2000–14



Source: European Commission.

Transferring a ‘slice’ of VAT to the EU budget has been suggested by many (Cipriani, 2014; Mortensen et al., 2014; Haug et al., 2011), including, recently, the European Parliament. It would be relatively easy, technically. If EU decision-makers wanted to make the transition almost unnoticeable, it could be done without, initially, translating into any change in the overall rates of VAT taxation, so that EU taxpayers would barely notice it. The European Parliament would then be responsible for voting on the rate for this EU VAT. Apart from these advantages in terms of simplicity and transparency, the adoption of such an instrument would introduce a clear and relatively neutral principle of taxation, based on resident consumption expenditures, with distribution of the national tax burdens being determined by a simple, non-manipulable mechanism. Moreover, the yield from VAT taxation is directly related to economic activity, though less subject to cyclical fluctuations than many other taxes, which gives this instrument relatively good automatic-stabiliser properties, without generating unduly large imbalances in case of economic downturns, slowdowns or recessions.

Even figures quoted by Gros and Micossi (2005) in support of their advocacy show that VAT yields vary between 6% and 9% of GDP across the EU-25 Member States, while private consumption (essentially, the tax base) as a share of GDP ranges from 42% to 67%. More recent data from DG TAXUD (2007) showed that these disparities have been maintained, but that one of the newest EU Member States (Bulgaria) had the highest VAT yield, rising to 12.4% of GDP in 2005. Although there is some correlation between the VAT rate and the yield, the relationship is far from linear, and the notion that VAT is regressive among Member States (that is, raising more in poorer Member States than in richer ones) is also partly contradicted by the relatively high VAT yield in the Nordic countries as well as among the least prosperous Member States. The implication of all this is that if the proposed model of taking a slice of each country's VAT for the EU were applied, it would have an uneven incidence on the Member States. Thus, even for a tax that is relatively harmonised, the disparities between Member States remain significant. VAT is also, unfortunately, considerably prone to fraud with estimates across countries ranging from 2% to 20% of the tax yield. In presenting the new action plan for reforming VAT on 7 April 2016, Commissioner Moscovici argued that the total revenue shortfall for VAT in the EU amounts to approximately €170 billion, while cross-border fraud is estimated at about €40 billion. This factor can cause friction between Member States, if there is a perception of inequitable treatment.

The risk with a VAT resource is that, even if agreed, it would soon be 'adapted' to handle any of such inequitable effects, leading in time to a situation like that of the present VAT resource, which highly resembles, after all the call rate changes and caps, a GNI resource.

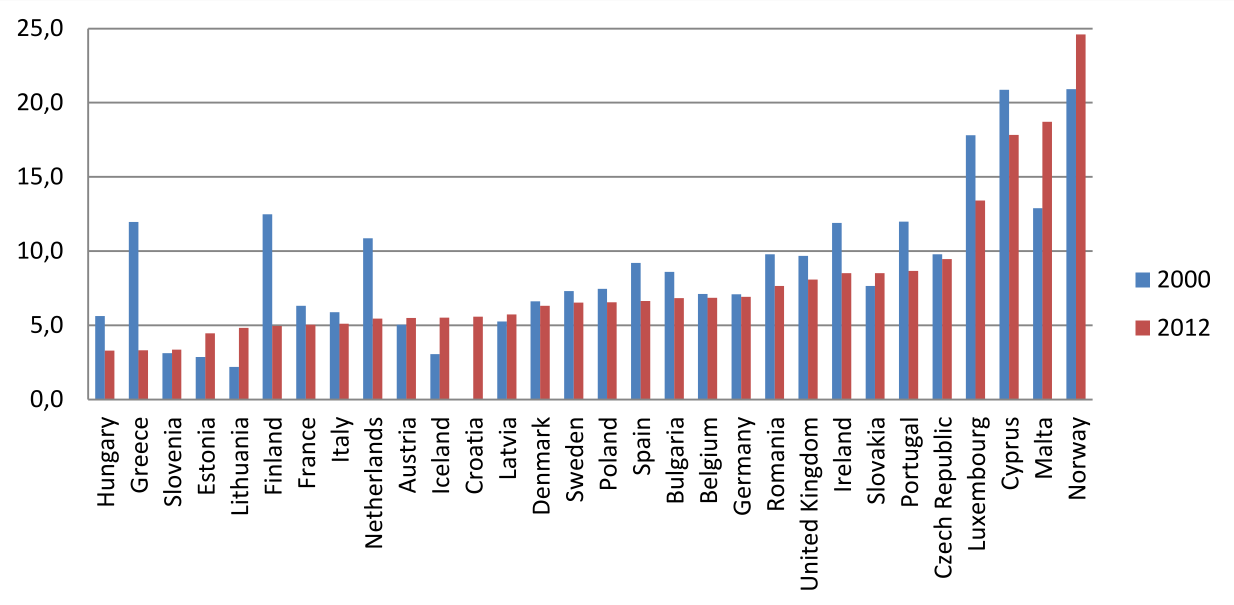
An interesting alternative approach addressing the issue of transparency related to using VAT is to present the cost of the EU budget to citizens by identifying the cost share on the VAT bills, but only for information at least in the transition to other resources. This approach, presented by Fuest et al. (2015), may be taken for either the national GNI contribution or the overall cost of the budget. While the proposal has its merits, it is unclear how to legally present a tax share that actually is not levied, but it highlights the need to have a way to communicate the true size of the EU budget.

7.3 CORPORATE TAXES

Corporate income tax rates and allowances vary more extensively than consumption taxes across the EU and are also less stable over time. Currently, the revenue from CIT represents 2.4% of EU-28 GDP (Eurostat, 2014 data), but with very large dispersion across Member States, ranging from 1.4% of GDP in Hungary, Lithuania and Slovenia, up to 4.4% in Luxembourg, 6.3% in Malta and 6.4% in Cyprus. Similar results can be observed regarding the CIT as a percentage of taxation. Figure 7-4 reports these ratios for the years 2000 and 2012; it is striking to observe a convergence to the bottom in the use of the CIT (Figure 7-5 and Figure 7-6). This widespread decrease indicates that progressively all the European countries are moving away from using CIT as a key resource, most likely driven by the fear of a competitive disadvantage. Indeed, the downward trend in CIT statutory rates in the EU has been much more pronounced than in the rest of the OECD countries, suggesting that there is a specifically European component in it. Tax competition to attract businesses or tax bases in the context of the single market is the most plausible explanation for this downward movement. The UK government recently announced that the CIT rate, standing at 30% in 2008, has been lowered to 20%, and is planned to reach 17% in 2020.

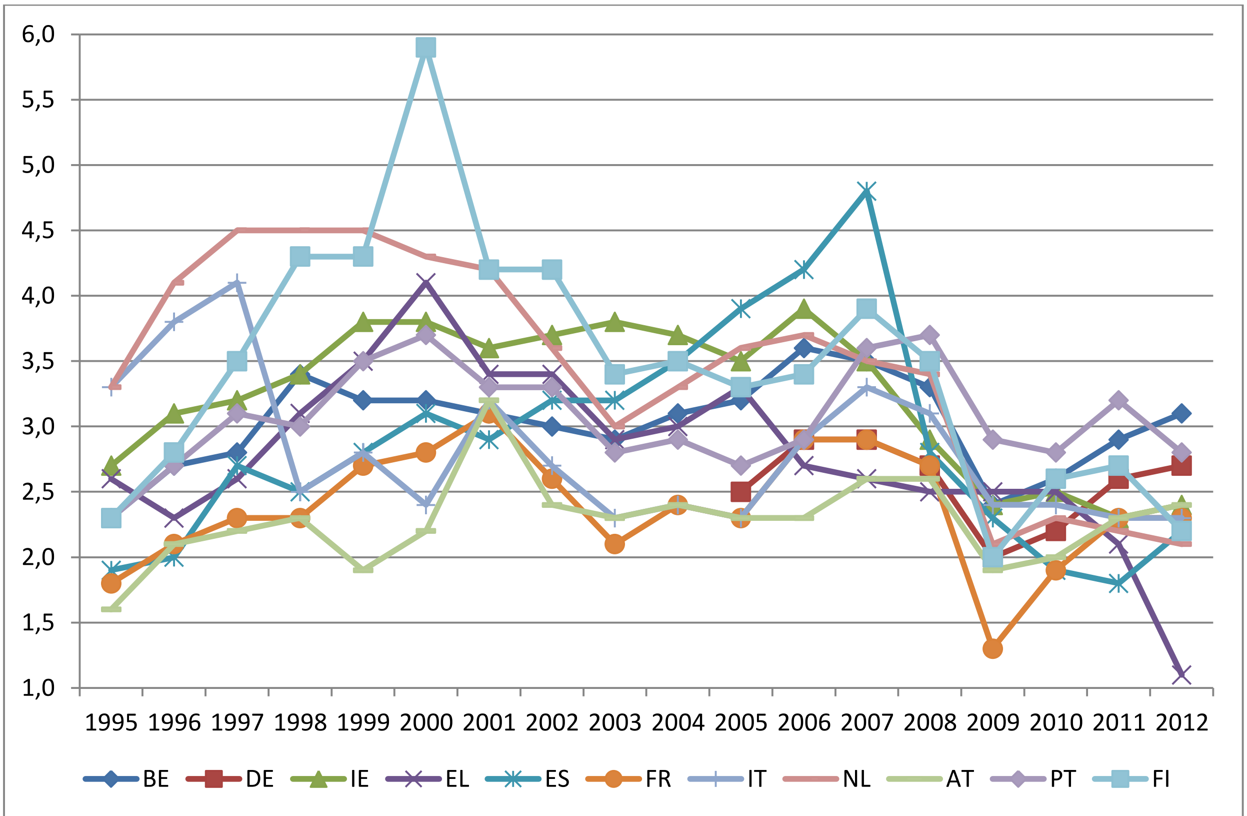
Many empirical studies have identified corporate tax competition among European countries. Chatelais and Peryat (2008) show that small countries located in the centre of the EU are the leaders of this tax competition. This competition is more or less intense depending on the sector considered. For instance, Lawless et al. (2014) show that firms in the financial sector are much more prone to relocation regarding CIT with an estimated marginal effect that is twice as large in this sector as in manufacturing. In addition, Crabbé and Vanderbussche (2008) and Cassette and Paty (2008) show that EU-15 countries in the neighbourhood of Central and Eastern Europe experienced more tax competition.

Figure 7-4. Corporate income tax as a percentage of total taxation



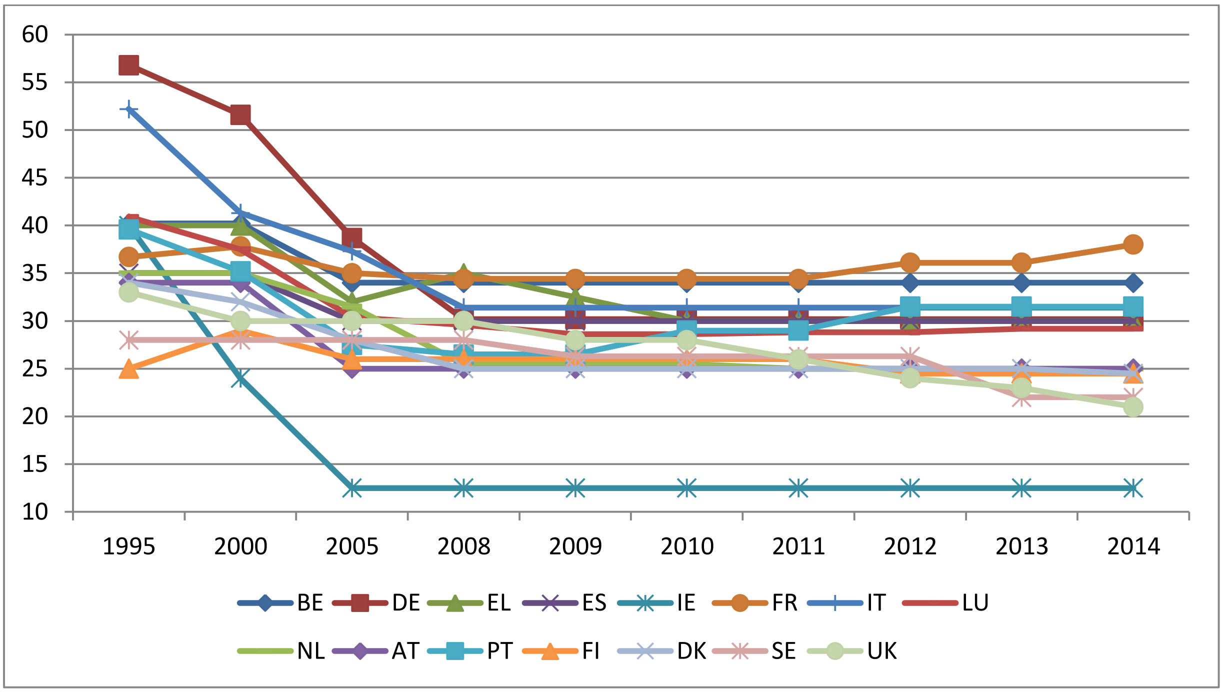
Source: Eurostat.

Figure 7-5. CIT receipts in eurozone Member States (% of GDP)



Source: Eurostat.

Figure 7-6. CIT-adjusted statutory rates in some EU Member States (%)



Source: European Commission (2014d).

The practical aspects of introducing an EU CIT would have to include moving to the CCCTB (proposed by the Commission), making it compulsory for the companies concerned, and deciding on a common rate for funding the EU budget. It would be an open question whether the tax should belong wholly to the EU level, with any surplus redistributed or shared. In the latter case, those Member State governments wanting to raise their own national CIT would be allowed to do so without limits, and the share of the consolidated tax base upon which national CITs are levied would then be determined according to a formula-apportionment scheme, much as in the US.

Whatever the implementation, such a reform may be regarded as necessary in terms of fairness, since multinational corporations pay a lower effective tax rate than smaller and medium-sized companies in Europe, and in terms of efficiency and growth. The move to the CCCTB would reduce opportunities for 'aggressive' tax optimisation and likely increase the total yield of CIT in the EU. Such new resources could provide an opportunity to relieve the burden of taxation on labour with a potentially positive effect on unemployment.

In a context of increased awareness of public opinion, informed by such revelations as LuxLeaks and more recently the Panama Papers, the Commission proposed on 12 April 2016 to enforce a country-by-country reporting of profits for multinational firms, an initiative that may, if adopted, pave the way towards a CCCTB and possibly an EU CIT.

7.4 Carbon levies

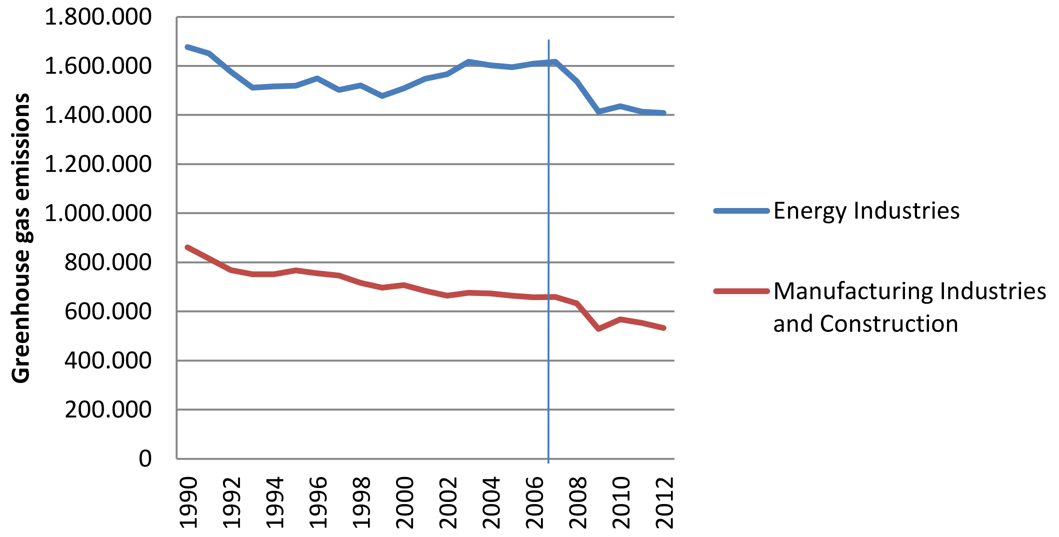
Energy taxes and carbon taxes have been proposed by the Commission repeatedly since 1991. These taxes could be legitimated to fund a stable budget for reasons of their low short-term volatility and high long-term elasticity. These taxes also have the property of internalising cross-border externalities and may reduce carbon leakages once set at the EU level. Indeed, the fight against pollution at the level of Member States has been quite disappointing until now. While emissions from manufacturing industries and construction decreased by 327 million tons of CO_2 equivalent between 1990 and 2012 (see Figure 7-7), transport emissions increased by 221 million (see Figure 7-8).

These results are problematic for at least two reasons.

The first one is that the reduction in emissions from manufacturing industries does not exclusively come from progress in technologies, but also may come from relocation outside the EU and thus can symbolise carbon leakage instead of carbon reduction.

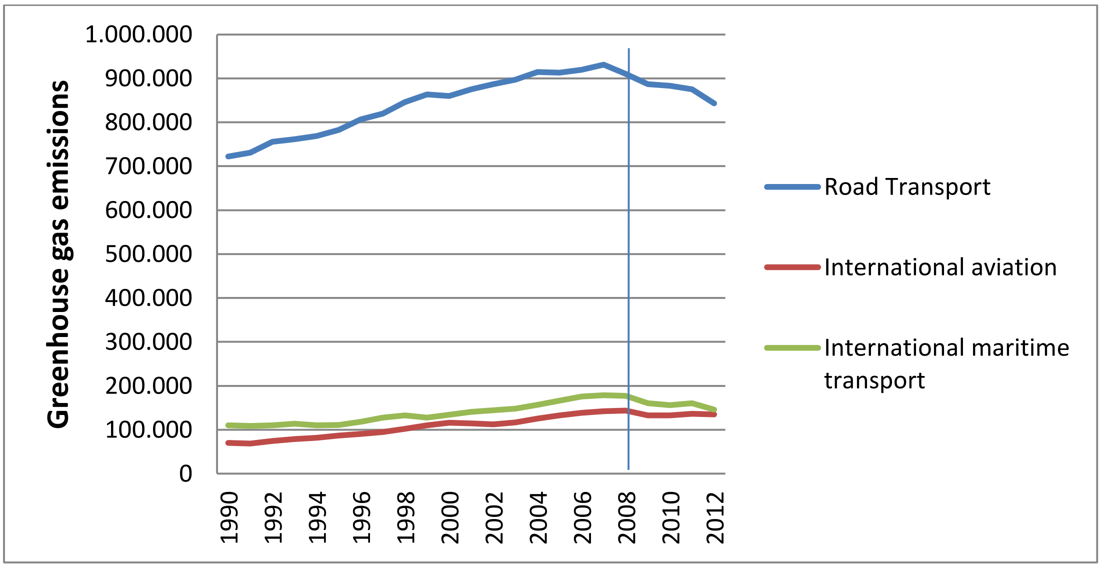
The second one is that the increase of emissions in transportation does not come from a small polluting sector: transportation accounted for about 20% of total EU emissions in 2012, and according to technological lock-in, no strong reduction is expected in the decade to come.

Figure 7-7. Greenhouse gas emissions in energy, industry and construction for the EU-28



Source: Eurostat.

Figure 7-8. Greenhouse gas emissions in transportation for the EU-28



Source: Eurostat.

Lastly, it is striking to observe from the two graphs that the recent advance in the reduction of greenhouse gas emissions coincides with the 2009 Great Recession. Much of the decrease may be attributed to the lower level of growth, rather than to a structural shift resulting from technological change and environmental policies.

As a result, in order to meet the '20-20-20' targets and beyond – the recently adopted 40% reduction by 2030 and 85–90% by 2050 – appropriate EU environmental policies are necessary. The universal agreement recently reached at the COP21 (UN Climate Change Conference of 2015 in Paris) can only strengthen the case for an EU instrument to reach these objectives.

7.5 TAXES ON FOSSIL FUELS

An EU excise duty on fossil fuels, or an EU tax on gasoline and diesel, could provide a reliable yield (at least in the short run), a relatively low administration cost and a price incentive to induce a general reduction in activities generating greenhouse gases from such sources. Moreover, because such fuels are for the most part imported into the EU from the rest of the world, it would have an incidence partly on the rest of the world: in other words, exporters of fuels to the EU would bear part of the tax burden, which then acts as an import duty.

Taxation on fuel is often viewed as a way to finance infrastructure such as roads. Since an important share of the EU budget has been devoted to infrastructure, such a tax at the EU level to finance these public goods may seem justifiable. Indeed, the lack of marginal cost pricing in transportation distorts the price of road travel, and the use of the automobile and road transport for merchandise becomes artificially too cheap, which generates a degradation of infrastructure.

Fuel taxes were not designed at the origin as environmental taxes, but their role as an instrument of climate change policy should be fully appreciated, as they are one of the few tools that have succeeded in reducing fuel consumption in many countries and in particular in Europe. Even if the counterfactual analysis without taxes involved various assumptions, economists agree in considering that these taxes have fostered behavioural as well as technological change (e.g. more efficient engines, etc.). For instance, Sterner (2007) estimates that if all OECD countries had taxes as low as the US (i.e. the country with the lowest taxes on fuel), then the total OECD fuel use would have been 30% higher. Another way to grasp that changes in price strongly affect the demand for fuel is to observe that the price elasticity for gasoline, though low in the short run, is quite high, around 0.8% in the long run according to Graham and Gleister (2004).

The case against a tax on fuel concerns its regressive aspect. Like all taxes on consumption, this instrument is indeed unfair if people with different levels of income pay the same tax. But the fact that fuel taxes are strongly regressive should not be taken for granted; it depends on the mode of transport used by individuals with different classes of income. In countries where poor people massively use public transport, the regressivity can be softened. Poterba (1989, 1991) was the first to show that low-expenditure households in the US devote a smaller share of their budget to gasoline than the middle class. In the UK, Santos and Catchesides (2005) show that fuel taxes are regressive when considering only households owning a car, but almost neutral when the whole distribution is taken into account. Sterner (2012), analysing the distributional effects of taxes on gasoline and diesel in seven countries (France, Germany, the UK, Italy, Serbia, Spain and Sweden), finds very weak evidence of regressivity. These studies, however, do not analyse the indirect impact of fuel taxes on other goods. Because many necessary goods have a small content involving fuel, the regressivity can even be reversed by using input–output models. For instance, Datta (2010) finds that these taxes are progressive in India. While to our knowledge this kind of analysis on the total tax burden of fuel taxes has not been led in Europe, it indicates that such a tax can be far less regressive than conventional analyses suggest.

Obviously these results hold on average, and the spatial economy of nations plays a key role – poor people in rural areas would certainly be hit more by such a tax. This aspect can be taken into account in the policy design to some extent, but fuel taxes are already one of the biggest price components in Europe and an additional EU component would not have any impact that is not already present with national fuel taxes. The proposed revision of the fuel tax directive of 2011 which, however, failed to win enough support in the Council, would have imposed minimum levies on carbon content might, if adopted, constitute a basis for the introduction of an EU component in fuel taxation.

7.5.1 Carbon tax

More general than a tax on fossil fuels, a carbon tax imposed on all sources of greenhouse gas emissions would greatly alter relative prices and costs towards a greener economy. [50] Hence, it would affect incentives for private producers and consumers, with results that have sometimes been termed a 'double dividend'. Such a carbon tax could be linked with the existing market for emission permit trading, in order to bring more revenue for the EU budget and a coherent – and probably rising – price for carbon emissions.

The Commission report (European Commission, 2008) on the instruments for reducing greenhouse gas emissions did consider its introduction, and doing so at the EU level would clearly be coherent with policy priorities, as well as mitigating the tax competition consequences that may arise if such an instrument is introduced in a decentralised way by Member States on a voluntary basis.

In 2012, the total yield of environmental taxes in the EU-27 amounted to 2.6% of GDP, but the instruments under this heading are quite diverse, so this figure gives little indication about the potential yield of a carbon tax set at the EU level. It is nonetheless obvious that an EU carbon tax could easily raise the kind of amount that is required to fund part or even the bulk of an EU budget of the current size, or even slightly larger.

At least two different kinds of carbon taxes can be considered. The first one, based on emissions, raises the issues of fairness and acceptability with marked effect on how the burden of 'paying for Europe' is shared among the Member States, especially pronounced for a minority of countries. One of the main winners would be France, which would see its contribution fall, due to the large nuclear power component in the energy mix, while Poland would be a massive loser (Begg et al., 2008). More generally, such a switch would be to the benefit of the richer Member States and to the detriment of the poorer Member States that often rely more on 'dirty' coal for power generation. As a result, it is self-evident that there is a risk that countries like Poland would veto such a shift unless some compensating tax were introduced simultaneously, or some correction mechanism were to be operated on gross contributions (see below).

The second one, based on the carbon content of goods, has the advantage of resolving problems of carbon leakage and could be less detrimental for countries like Poland. Laurent and Le Cacheux (2009) propose a "European carbon added tax" or CAT, on all goods and services

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[50] See the European Commission report on eco-taxation (European Commission, 2007) as well as Hines (2007). In a recent contribution, Godard (2007) convincingly argues that a carbon tax ought to be complemented by import duties on high-carbon imports from third countries, making the point that such 'tariffs' would not be contrary to WTO rules. They would then also be a welcome contributor to the revenue side of the EU budget.

marketed in the single market, whether they are produced in the EU or imported from the rest of the world. It closely resembles the one that the EESC elaborated in a position paper in June 2015[51] and is based on the destination principle. The EESC members ultimately voted down the proposed text.

The proposed carbon tax would be a universal tax on transactions, modelled on the same principles as the VAT, except that added carbon content would be the tax base. It would be levied on all transactions intervening in the production, transportation and retailing of all goods and services, either on a national basis, or preferably at the EU level. If the former solution were to prevail – which is likely under the current decision-making rules for tax policy in the EU – it would be necessary to coordinate national carbon taxation by having, at the very least, some minimum standards, in the spirit of what currently exists in the EU for VAT.

The only requirement for implementing the CAT is the evaluation of the quantity of carbon emissions to be imputed to each economic agent in the production and distribution chain. Arguably, this is not entirely straightforward, and necessitates the elaboration of a full-fledged and standardised carbon accounting system. That is probably not as far out of reach as may appear at first sight, as an increasing number of firms have been establishing carbon balance sheets for their various activities over the past few years. In addition, it has historically always been the case that the introduction of a new tax has inevitably entailed the necessity of developing and progressively generalising new accounting practices – the introduction of VAT is a good example, showing that transitory lump-sum levies for some categories of taxpayers not yet acquainted with the full carbon accounting rules are perfectly feasible.

Ideally, this ‘carbon price’ should be uniform. But, it is also conceivable to allow for some differentiation in rates, if one wanted to favour some types of consumption goods.

The proposed CAT would be perfectly compatible with the existing EU ETS, provided the share of carbon emissions already accounted for by the permits is properly discounted, and therefore not subjected to the tax. Of course, the ‘carbon prices’ that are set in these two, largely independent, mechanisms cannot be made to perfectly coincide at all times; but it would probably be wise to make sure that they evolve in close correlation, an additional argument in favour of an EU-wide or highly harmonised CAT.

Imports would be subjected to the same CAT as the domestically produced goods and services; this would provide a simple solution to at least part of the problem of carbon leakage.

Of course, imputing carbon emissions to imported goods might prove technically more difficult than for domestically produced goods; but at the very least, the amount of carbon emitted in transporting the goods can be ascertained, and the traceability of an ever larger number of goods will make it easier to evaluate carbon contents. Thus, the CAT would dispense with the introduction of a ‘border carbon levy’, as well as of the current system of free distribution of emission quotas for those firms that can prove they are suffering from foreign competition.

A tricky issue arises with respect to exports: Should they be tax exempt, as in the case of VAT? This solution would be favoured by exporters, and would completely solve the carbon leakage problem. Yet from the point of view of the ultimate goal of the carbon tax, which is the fight

[51] EESC (2015), “A European tax as an EU own resource”, revised preliminary draft opinion, unpublished, discussed at a public hearing on 1 June 2015.

against global climate change, hence the reduction in total, worldwide emissions, subjecting exports to the CAT would prove more efficient, though costly from a short-run competitiveness standpoint, if other countries do not impose similar carbon pricing devices.

Another difficulty encountered by the CAT, particularly as proposed by EESC, is the accounting method for the carbon contents. The first was the system proposed to classify carbon contents of product categories to determine the tax. This means that the producers of the same kind of goods, one with a low-carbon content and the other with more, would pay the same tax. Apart from distorting prices against product groups (e.g. cars) it does not give the incentives for producers to reduce their carbon contents to compete against producers with higher emissions. Furthermore, even if differentiation were introduced, producers often shift suppliers of components, which would make tracking difficult. Solutions could have been implemented whereby a tax by product category is introduced that could be partially or fully exonerated if the producer manages to certify a low-carbon production process.

Clearly, any change towards an EU carbon tax may have sizeable (though not always easily predictable) distributive consequences that do not necessarily coincide with equity objectives. Indeed, in a comprehensive examination, Heinemann et al. (2008) argue that the *ex ante* distributive effects of all the options they review are unappealing, not least because none would closely approximate GNI proportionality (which they consider to be an appropriate benchmark for fairness). Most, if not all excise duties and eco-taxes tend to have uneven distributional consequences, including when assessed from the point of view of inter-country apparent distribution of tax burdens. Such effects could be alleviated, for example by lump-sum transfers or an equilibrating GNI residual mechanism. Ultimately, one of the key objectives is to alter behaviour. Thus, when a government increases the taxation on tobacco, it has a strong distributional impact, but the proclaimed aim is precisely to hit smokers' purses. The same would apply to pollution abatement instruments. The design of lump-sum or GNI-based 'corrections' need to take into account the risk of governments losing the motivation to act in reducing emissions, i.e. the loss of a 'rebate' may be politically more important than solving the problem addressed by the tax.

7.5.2 Inclusion of the ETS

The EU ETS was set up in 2005 and has been in operation for ten years. It covers the largest production emitters located in the EU, as well as airlines serving the EU. During most of its existence, it has not raised much revenue, insofar as carbon emission permits were allocated (and even over-allocated) for free. But in recent years, the share of permits auctioned to firms has been increasing and should be further increased in the near future, according to the Climate & Energy Package adopted in 2009 and revised in 2014. Small but significant and potentially growing amounts are therefore being levied from this instrument and estimations for the future show revenue potential of approximately €20 billion from 2020 onwards (European Commission, 2015) the exact amounts depend on the price of carbon generated by the auctioning, which is influenced by the number of permits allocated.

The next question is the use of the revenues. Following a decision of the Council in 2010, this revenue is currently being shared among Member States, thus accruing to national budgets. It would of course be possible, and indeed easy and logical, to assign this revenue to the EU budget, to the extent that it meets a majority of the criteria discussed above. Similar to other carbon tax solutions, the incidence of the ETS varies across Member States. As long as revenue has accrued to Member States and not to the EU, this has not been a major barrier. It could be if it is transferred to the EU.

Another concern in the transfer of this resource to the EU is the earmarking. The Member States are encouraged to invest at least 50% of the revenues towards climate action. The EU budget, however, applies the principle of universality of the budget resources, which in principle prevents the earmarking of the revenues.

7.6 FINANCIAL TRANSACTION TAX

Proposals for the creation of a tax on the financial sector or on banks have flourished since the 2007 subprime crisis. In many countries, special tax instruments on banks have actually been introduced in the aftermath of the crisis. Financial transaction taxes have also existed or currently exist in many countries. The proposal for instituting an EU FTT takes inspiration from the so-called 'Tobin tax' scheme, initially expounded by the late Nobel Prize winner James Tobin (1978).

The Commission has put forward a specific proposal and currently ten Member States have declared willingness to join the system. The FTT is a controversial issue among Member States and the EU has decided to leave the adoption to the enhanced cooperation procedure. As a consequence, it is likely that an FTT own resource would not be levied in all Member States. This creates considerable legal challenges, as well as a problem to determine the contribution key of non-participating countries, which is treated in chapter 6 and section 7.10. What is the GNI share to be imposed on non-participating countries? Let us assume all members of the eurozone participate. If among the participating countries a few raise a large share of the total EU budget, the GNI contribution of the other eurozone members would fall as a percentage of GNI. Will other non-eurozone members agree to pay their 'GNI' share of the EU budget (let us say 1%) if some eurozone members pay less thanks to the FTT? This promises to be a complex issue.

The recent lack of agreement in the Council and among the eurozone Member States suggests that an FTT may not be established anytime soon even under enhanced cooperation.

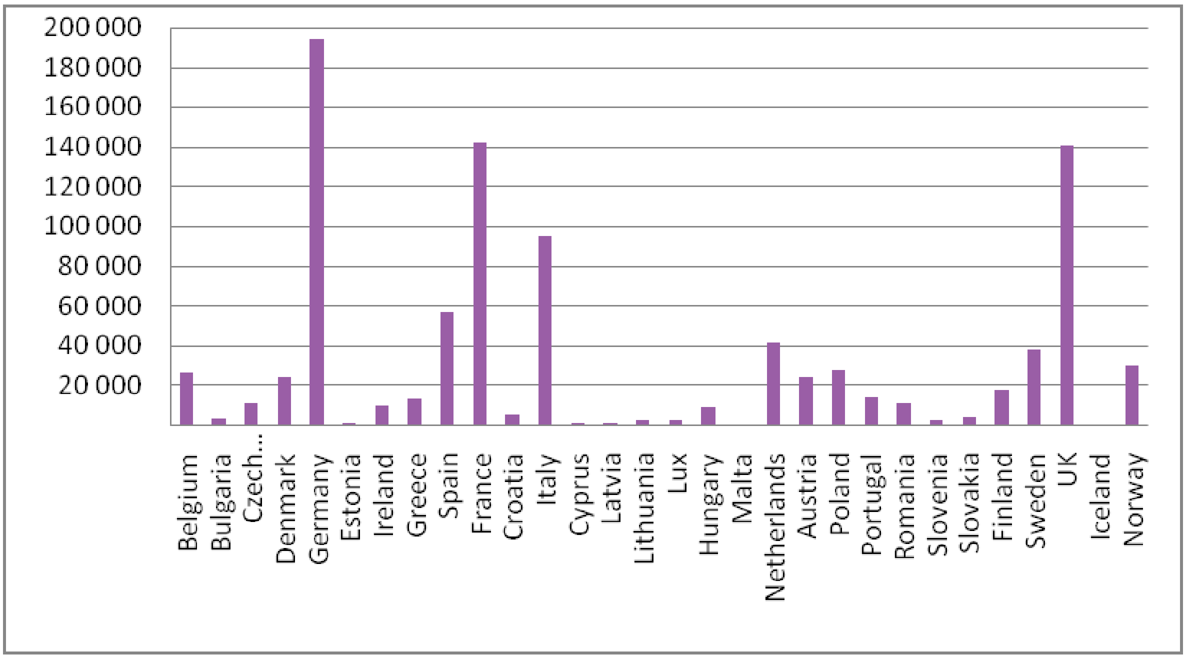
7.7 ESTIMATING REVENUE AND DISTRIBUTION OF THE MAIN TAX CANDIDATES

Although it is probably not possible to precisely evaluate the total revenue and distribution among Member States of the various options that have been presented and discussed in the previous sections, it is important to offer orders of magnitude. In this section, we propose estimates for the yield and country distribution of a carbon levy or tax, based on existing recent data. For VAT and CIT, we briefly discuss potential redistribution.

7.7.1 VAT

VAT is a major source of revenue in all Member States, but with significant differences across countries (Figure 7-9). Its base is, in principle, harmonised, but there is a lot of heterogeneity with respect to standard rates and rate structures.

Figure 7-9. Valued added taxes in the EU-28 (€ million), 2012



Source: "Taxation and Customs Union", European Commission website.

VAT provides relatively stable revenue, even in deep recessions. The large revenue losses appearing in the Figure 7-1 in the crisis years are, for the most, imputable to temporary rate cuts in the context of fiscal stimulus plans.

In the aftermath of the Great Recession, in an effort to consolidate public finances, most EU Member States have increased their standard VAT rate.

Estimating the total revenue and cross-country distribution of an EU VAT would require a precise evaluation of national tax bases and of the scope of the EU levy: Would it be levied on all goods and services, or only on some categories – e.g. those subject to standard rates? Given the experience of the existing VAT resource, it may nevertheless be expected that a uniform rate would have significant distributional consequences, if only because private consumption does not represent the same share of GDP in all countries. One may therefore conclude that any EU VAT would have to be accompanied by a correction mechanism, lest falling victim to a fate similar to that of the VAT 'own' resource.

Revenue and country distribution of a genuine EU VAT – as opposed to the current VAT-based resource – are not easily evaluated, as they entirely depend on the precise implementation of the instrument. Given the wide variety of rates, various options are available – only on goods and services taxed at standard VAT rates, or on all goods and services for example – yielding different distributions. A rough estimate of total revenue may be based on current yield: given that in 2014, total revenue from VAT in the EU amounted to almost €1,000 billion, i.e. 7% of GDP, for an average standard rate of 21.5%, a 2% EU VAT rate might yield around 7% of GDP. But given existing large differences across countries with respect to VAT tax bases, distribution is likely to be very uneven.

7.7.2 Corporate income tax

Evaluating total revenue and distribution of an EU CIT first requires making an assumption about the scheme retained for prior harmonisation. We have chosen to base our estimates on the CCCTB proposal, which includes a formula-apportionment scheme for imputing the consolidated tax base to the various countries where firms have production facilities. A number of studies offer evaluations of the potential impact on total revenue and cross-country distribution of introducing the CCCTB while keeping the national statutory rates at their pre-reform level (Spengel et al., 2008; Spengel et al., 2012; PWC, 2008; Ernst & Young, 2011). In most cases, the reform is shown to have a minor impact on corporate effective tax rates and on overall CIT revenue, but some studies find a non-negligible redistribution across countries. These results are highly dependent on the selected apportionment formula and could probably be compensated either by modifying the formula or by some correction mechanism at the EU budget level (see below). In addition, because a number of multinational corporations have been benefiting from specific – and sometimes extremely favourable – tax treatments in some countries, it may be assumed that total revenue from a CCCTB would be higher than the sum of current national revenues from CIT. Given the uncertainties surrounding the reallocation of tax bases and the changes in effective tax rates for some large corporations, evaluating the total revenue and cross-country distribution of an EU CIT would require additional assumptions.

In 2012, revenue from CIT represented between 2% and 3% of GDP in all Member States, except for Greece (1%). National statutory rates were all in the 20–35% range except for France (36%) and Ireland (12.5%) and the particular case of Estonia, where corporation taxes are 0% but 20% is applied on the distribution of profits to shareholders.

If one were to finance the EU budget – or part of it – with a CIT, the EU rate would have to be set at a moderate level, compared with existing national statutory rates. Taking inspiration from what has been in existence in the US for decades, individual Member States would be allowed to levy their own CIT on the same base at their preferred statutory rate, in addition.

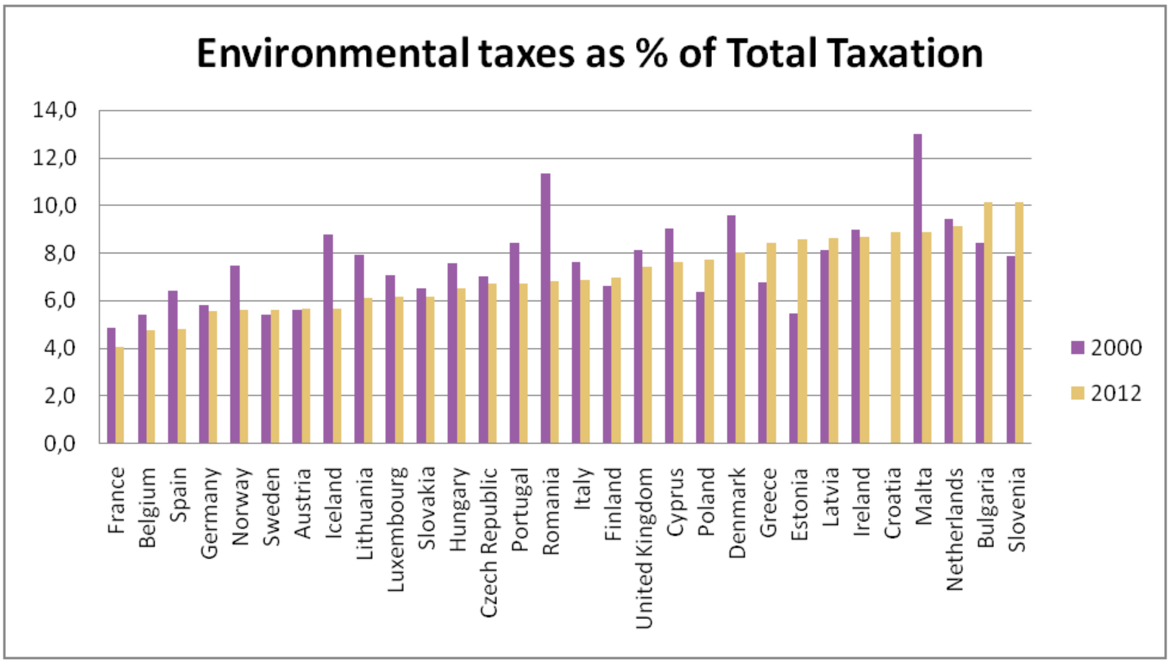
The European Commission performed a rough estimation in the accompanying working paper to the proposal for an own resources reform in 2011 (European Commission, 2011a). The estimation is that a 2% corporate tax rate would raise €15 billion in revenue for the budget.

A review of CCCTB issues can be found in Annex IV.

7.7.3 Carbon levies

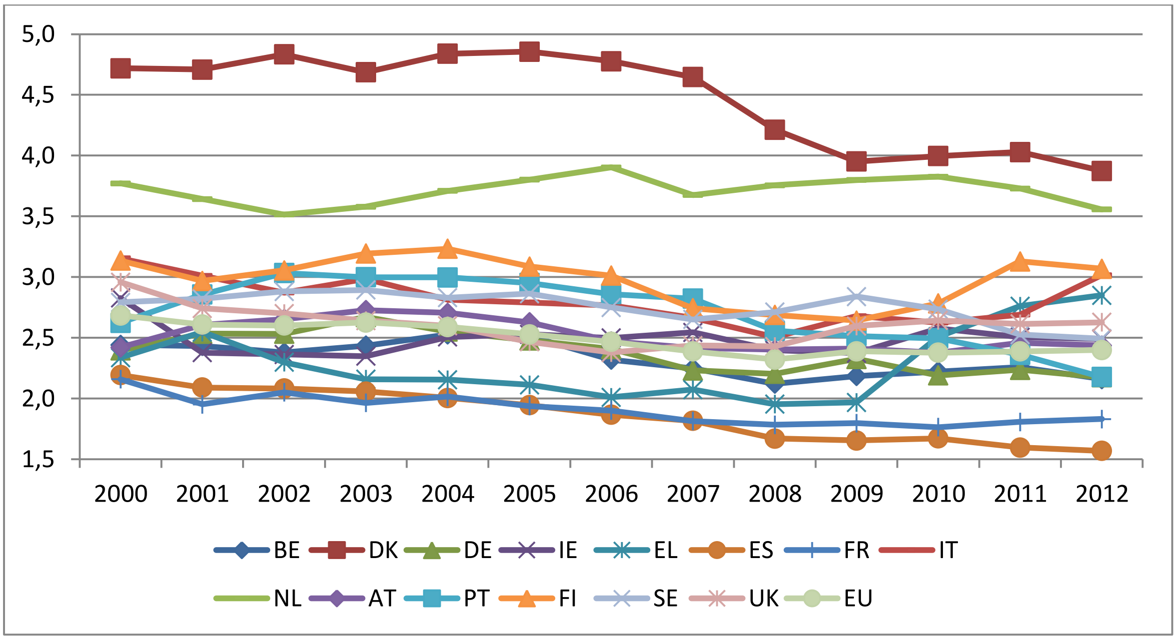
Reliance on environmental taxation is, on average, low in EU Member States, and has been declining over recent years in most countries, which may signal the existence of tax competition and would further strengthen the case for an EU carbon levy. Figure 7-10 and Figure 7-11 list the share and revenues of environmental taxes in the EU and the declining trends.

Figure 7-10. Environmental taxes as a percentage of total taxation, 2000 and 2012



Source: Eurostat.

Figure 7-11. Receipts from environmental taxation in EU countries (% of GDP)



Source: Eurostat.

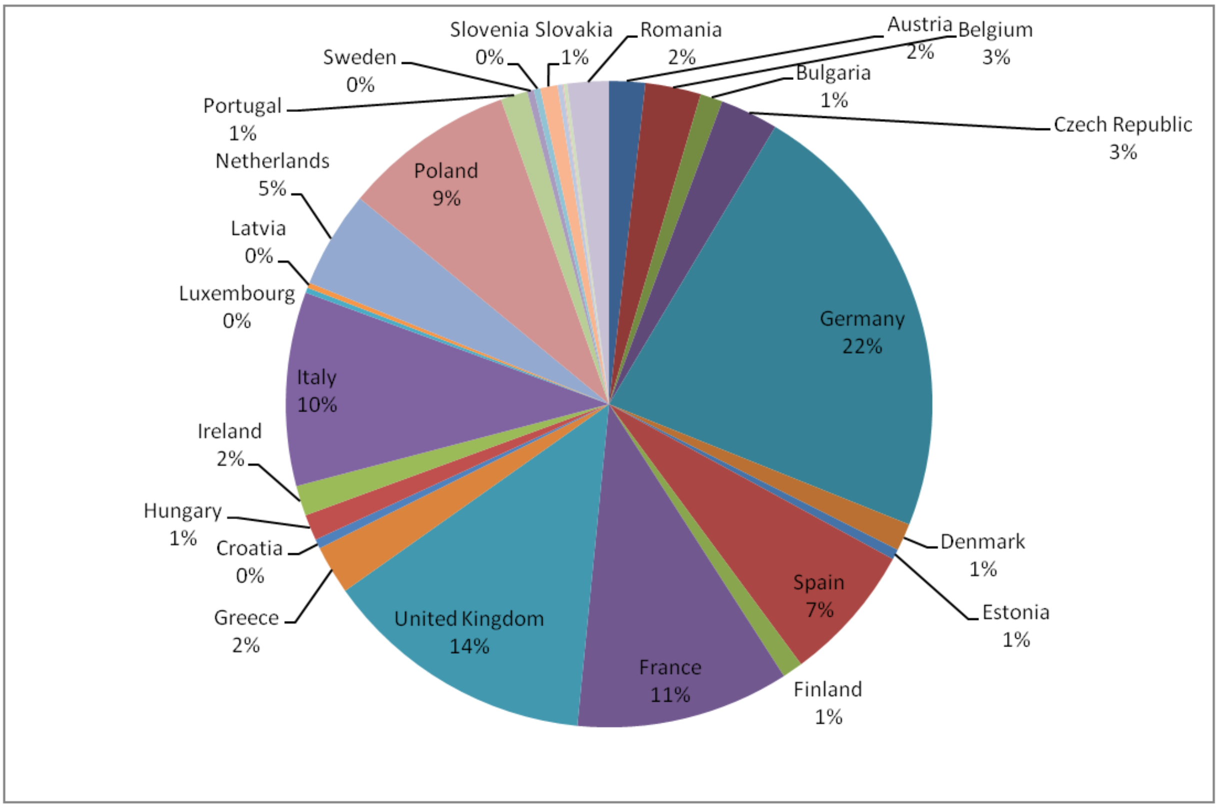
For the sake of estimating the revenue and country distribution of a carbon levy, we have assumed that this levy replaces most other sources of financing the EU budget, and yields total revenue approximately equal to the budget size for the year corresponding to our emission data, i.e. €120 billion in 2013. Depending on the tax base chosen (see below), the corresponding carbon prices are between 20 €/t and 30 €/t, a range that looks reasonable compared with most available estimates of the warranted carbon price, much below the highest existing national carbon tax (Sweden, 137 €/t), but well above the current price of carbon under the EU ETS (around 8 €/t). If one wanted to use this instrument to finance only a fraction of the EU budget, a proportional reduction in all figures would yield the corresponding cross-country distribution.

There are two possibilities for measuring a country's carbon emissions: production-based, corresponding to a carbon levy according to the origin principle (such as the current EU ETS, or indeed most existing carbon taxes) and consumption-based, corresponding to a carbon levy according to the destination principle (the CAT proposed above).

Data for the distribution of production-based emissions in the EU are available for 2013 from two different sources, yielding a slightly different total, hence a slightly different carbon price in our calculations.

The European Environment Agency (EEA) gives the following distribution displayed in Figure 7-12.

Figure 7-12. Total greenhouse gas emissions, 2013

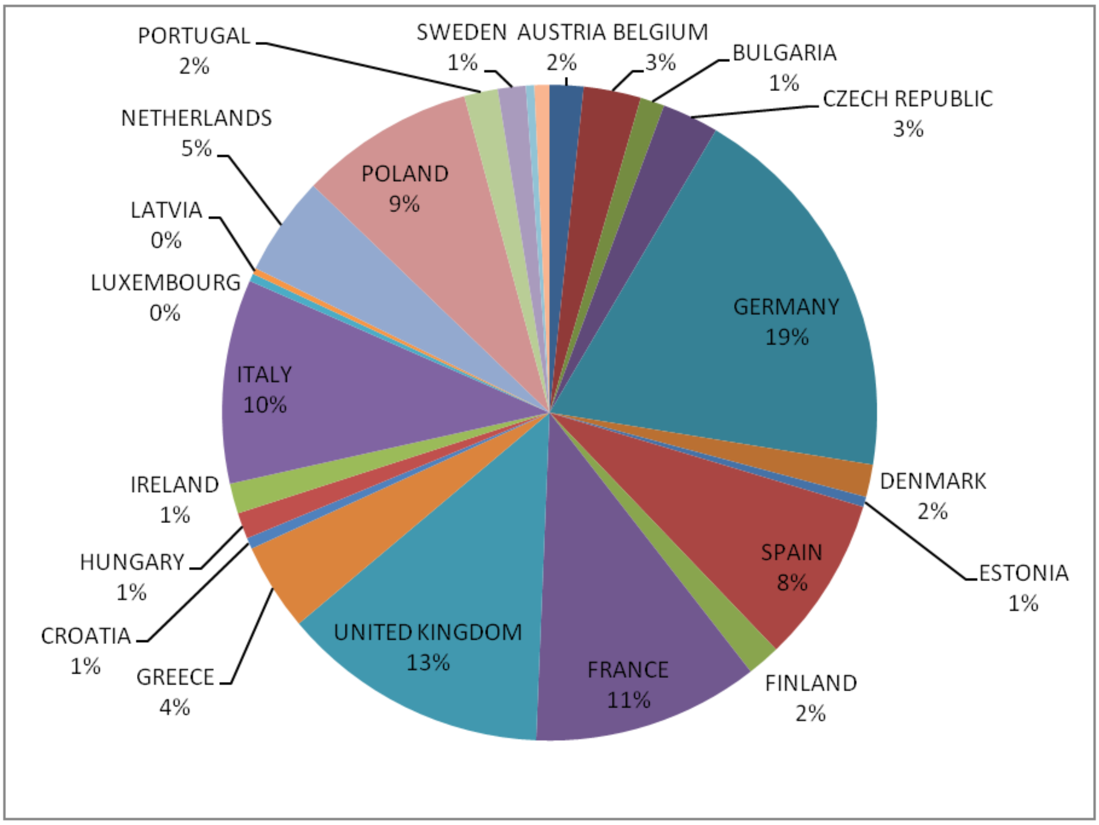


Note: Shares under 1% appear as 0%

Source: Eurostat (env_air_GGE), European Energy Agency.

We also use production-based data computed by GTAP (Figure 7-13) (Andrews and Peters, 2013), because they provide comparable data for consumption emissions (Figure 7-14). Their total production emissions figure is slightly smaller than the one given by the EEA, and the distribution slightly different. The distribution of consumption-based emissions – excluding emissions for producing exports and including the emission content of imports – is also different from that of the EEA.

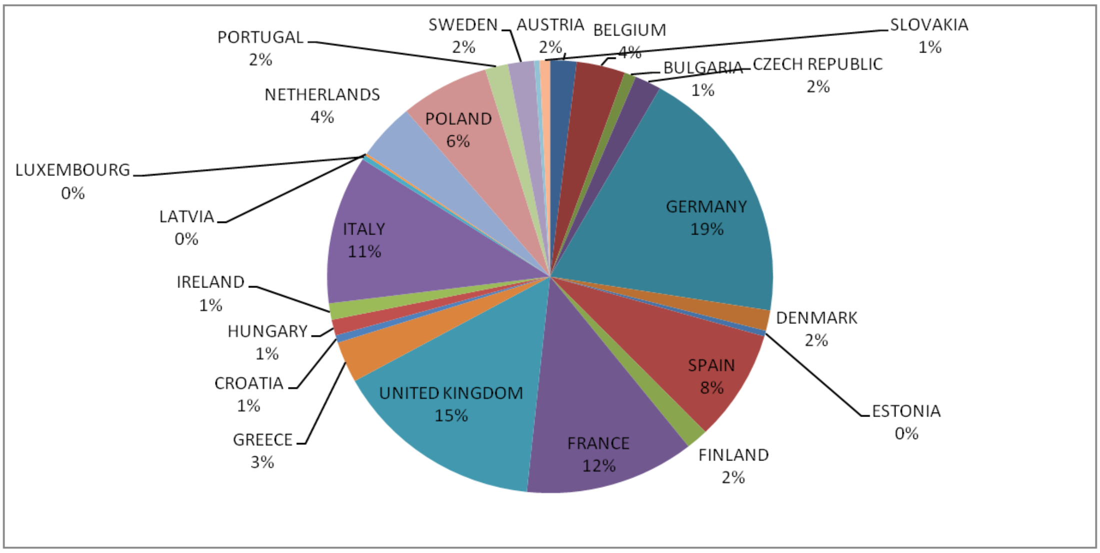
Figure 7-13. Production-based greenhouse gas emissions, 2013



Note: Shares under 1% appear as 0%

Source: GTAP.

Figure 7-14. Consumption-based greenhouse gas emissions, 2013

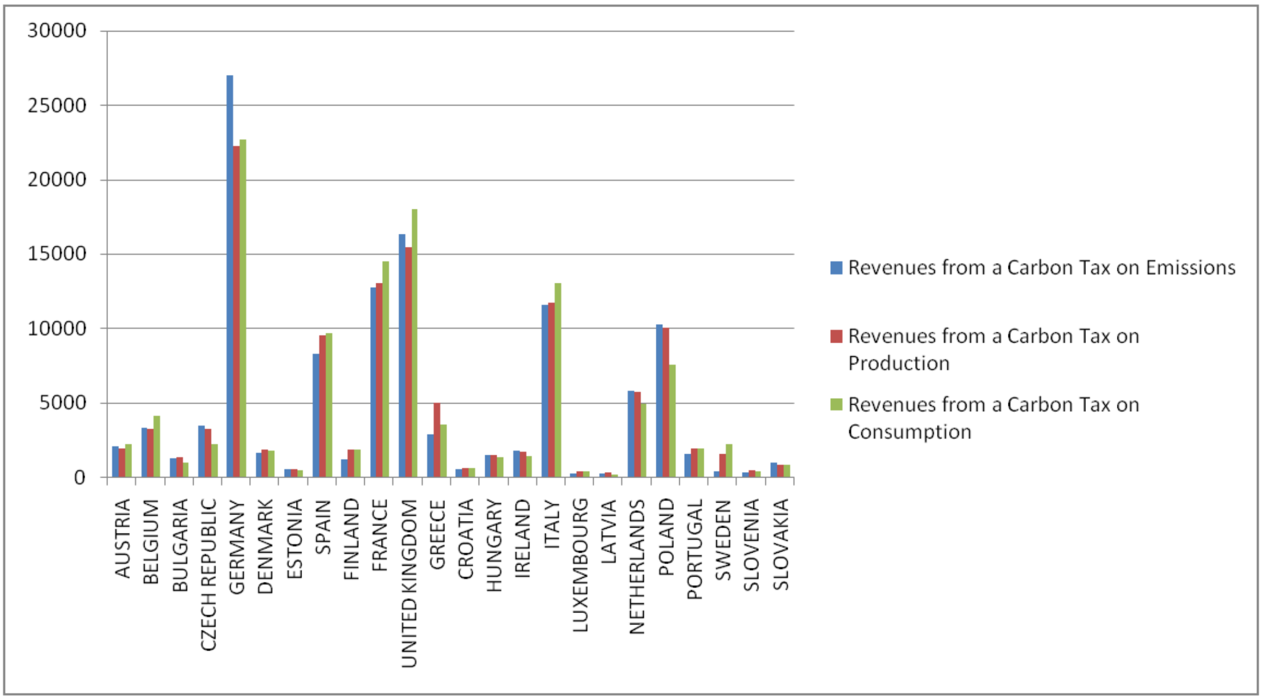


Note: Shares under 1% appear as 0%

Source: GTAP.

The revenue from a carbon levy that would have yielded €120 billion is then calculated and distributed across Member States according to each of these three distributions, leading to the following results shown in Figure 7-15.

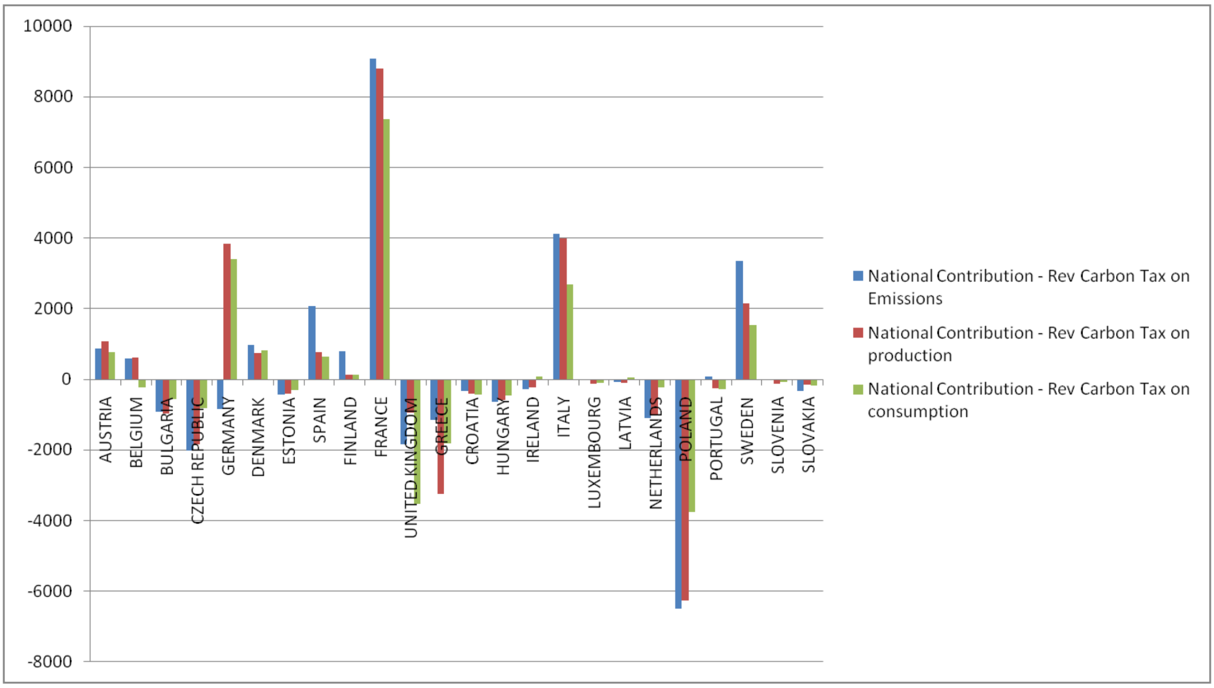
Figure 7-15. Carbon levy (€ million)



Source: Authors.

Comparing this country distribution with the national contributions to the 2013 EU budget yields the following 'redistribution' induced by switching from the current resource scheme to a carbon levy according to each of the three calculation methods methods (Figure 7-16).

Figure 7-16. Redistribution of contributions induced by a carbon levy



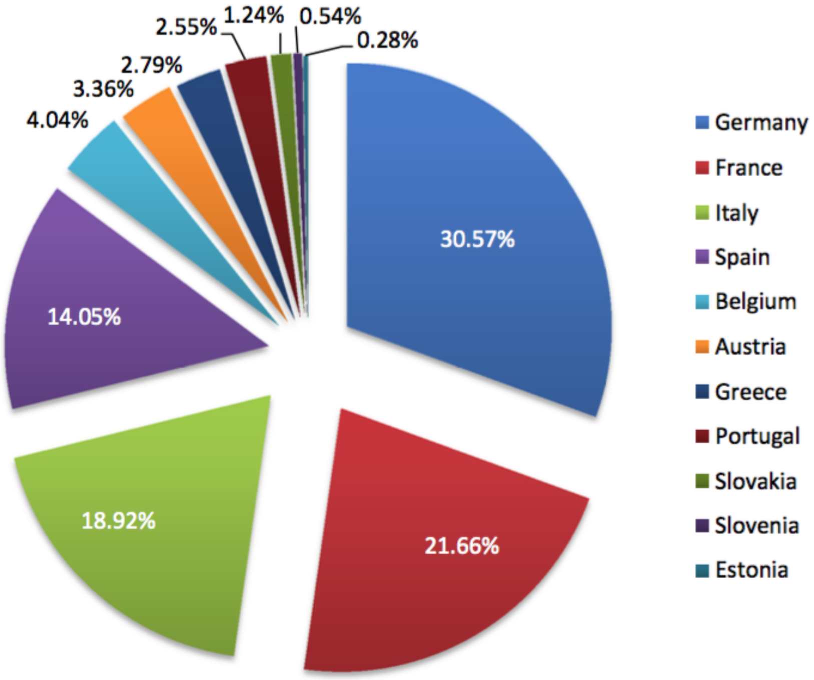
Source: Authors.

Independently of the precise instrument selected, the main beneficiaries would be France and Italy, as well as Sweden, Austria, Denmark, Spain and Finland, whereas Germany and Belgium would either lose or gain depending on whether the tax is production- or consumption-based. Large losses would be incurred in all cases by Poland, the UK and the Czech Republic, as well as most other new Member States from Central and Eastern Europe. Such a redistribution of the national financial burden would unlikely be acceptable as such, and would lead to requests for compensation (see section 7.10).

7.7.4 Financial transaction tax

The potential of the FTT has been estimated by the European Commission in the impact assessment as ranging from €30 billion to €35 billion. The breakdown of the revenues is presented in Figure 7-17 by country as estimated by the Commission in 2013, therefore the figure includes Estonia, but it does not significantly affect the results.

Figure 7-17. Breakdown of revenues according to GDP in PPS (2011) in Member States participating in enhanced cooperation on FTT



Source: European Commission (2013b), p. 24.

However, as the European Commission admits in the calculation, the FTT revenue is rather unpredictable. From this point of view, the FTT does not seem able to fulfil the resource criteria of maturity and stability (Cipriani, 2014, p. 44).

7.8 ASSESSING AND RANKING NEW OWN RESOURCES

Given the multiplicity of criteria and the variety of preferences with respect to weights – a political choice – it is not possible to establish an invariant assessment and ranking of own resource instruments. In order to assess and rank the various options for own resources, we use an amended version of the device developed by Begg et al. (2008).

Assessment is based on a simple weighting and ranking method: the weights for the various criteria are first chosen to reflect the decision-maker's own preferences. The scores of the various own resources are 'objective' scores meant to capture 'intrinsic' characteristics. The aggregation is then simply made by calculating a weighted average, thus allowing for a ranking of the various instruments.

Please note that the FTT is not evaluated, as the legal implications are complex and hence it requires a separate assessment, which is described below.

Table 7-2. Resources ranking and assessment scoreboard

Criterion	Score out of 100	Weight	Weighted score, sub-area	Weighted score, total
Economic considerations				
Economic efficiency/distortion effects	0	100	0	0
Vertical equity in promoting redistribution	0	50	0	0
Horizontal equity among equivalent citizens	0	50	0	0
Fairness among Member States	0	200	0	0
Any additional criterion?	0	0	0	0
Sub-total		*400*	0	0
Political and administrative factors				
Sufficiency of revenue	0	50	0	0
Stability as revenue source	0	100	0	0
Other administrative considerations	0	50	0	0
Link to EU policy concerns	0	200	0	0
Visibility and transparency to taxpayers	0	200	0	0
Any additional criterion?	0	0	0	0
Sub-total		*600*	*0*	*0*
Political economy adjustment factor	1			
Total		**1,000**		**0**

Source: Authors

Table 7-3 illustrates this process and its outcomes for own resources, the GNI resource and three out of the four candidates considered (VAT, CIT and the carbon levy) with arbitrary weighting schemes. It should be clear that a different set of weights would yield a different ranking. Given the exceptional nature of the FTT, we present a more detailed assessment in the next subsection and do not perform this ranking.

Table 7-3. Resources ranking and assessment scoreboard for the TOR, GNI, VAT, CIT and carbon levy (for illustration)

Summary of scores	Economic	Political/admin.	Total
TOR	62	46	54
GNI	70	61	66
VAT	59	74	67
CIT	56	58	57
Carbon levy	68	70	69

Source: Authors' own calculations

Of course, the multiplicity of criteria and the arbitrary weights retained in this assessment end up with all existing and potential instruments being a very close call.

7.8.1 *Assessment of the proposed FTT in relation to budgetary criteria*

With regard to budget **sufficiency**, the amount that the FTT could in theory generate is substantial and could become a major component of the contribution to EU budget resources. The Commission has estimated annual revenues to be around €30–35 billion, or 0.4–0.5% of the GDP of the participating Member States.[52] Yet this estimation is by nature uncertain,[53] and has moreover become questionable, especially in light of the current context:

- Forecasts are impacted by future economic uncertainty.
- The taxable activities have not been agreed upon.
- Financial market reactions are difficult to anticipate (not least towards their risk-averse behaviour as well as their capacity to circumvent the FTT through fiscal engineering or tax evasion through activity relocation).
- The positive impact of the FTT on the single market functioning, harmonisation and global EU-28 GDP growth rates is limited by the fact that its implementation is foreseen only at the EU-10 level.[54]
- The FTT tax base and rates to be implemented at the national level of participating Member States are still to be determined.
- The discouraging effect that the FTT could have on the investment of foreign companies in participating Member States is difficult to estimate.[55]

Consequently, the impact of the FTT on own resources **stability** is equally uncertain (considering also the instability of stock markets), which is likely to introduce complexity in the set-up of a mechanism for GNI-based contribution deductions applicable to the budget. The issue of how the remaining budget is financed would be complex, as presented in subsection 7.10.3.

The conception of the FTT as a genuine own resource should in principle impact positively on **financial autonomy** at the EU budget level. There are, however, considerations of vertical fairness among Member States, notably because the weight of the financial sector differs in each economy. It would lead to the banking sector of Germany and some other participating Member

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52 See "Taxation of the Financial Sector" (http://ec.europa.eu/taxation_customs/taxation/other_taxes/financial_sector/index_en.htm).

53 French Minister Bernard Cazeneuve estimated in 2012 that FTT could raise between €10 and 13 billion annually – see "Financial transaction tax should bring in EUR 10 bn: France", *EUbusiness*, 23 October 2012 (http://www.eubusiness.com/news-eu/finance-france.k7c).

54 The European Commission estimates a negative impact on growth. The EESC (p. 3, 1.11) tempers this with the view that it could be positive +0.25%, referring notably to two studies: Schulmeister (2011) and Griffith-Jones and Persaud (2012).

55 The EESC, however, "believes that slowing down the pace of highly speculative transactions by introducing the FTT would have a significant stabilising effect on price fluctuations on the financial markets and would offer companies operating in the real economy more stable financial scenarios for their own investments". See the Opinion of the European Economic and Social Committee on the Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC COM(2011) 594 final, 29 March 2012, p. 2, 1.7.1.

States contributing relatively more than others to the total FTT-based resource. This may revive debates on *juste retour* and lead to claims for correction mechanisms.

Concerning the **transparency** of the tax and its visibility to EU citizens, it is likely that awareness of contributing to the tax would be limited to financial institutions and investors falling within the scope of the tax, as most of EU citizens are not concerned by the tax.

The coherence between the objectives of the FTT proposal and **EU policies** is established at three major levels: avoiding fragmentation in the single market for financial services, ensuring fair contribution of the financial sector to covering the costs of the recent crisis while better aligning the financial sector's taxation level with other economic sectors, and creating disincentives for excessively risky (speculative) behaviours. The previous sections address the capacity of the FTT to meet these criteria. It is clear, ultimately, that the performance relative to these criteria would or could be hampered by at least two factors:

- the FTT's implementation is foreseen in (now) ten Member States and not at an EU-28 level; and
- the risk of seeing financial institutions passing on the tax burden to the final consumer. Although from this perspective, the tax impacts would fall on final consumers mostly represented by financial institutions themselves, and by consumers adopting excessively risky behaviours.

The **economic efficiency** of the tax depends on a large number of factors that are difficult to assess beforehand: How powerful would it be in discouraging excessively speculative behaviour and fostering risk adversity? How far would financial actors go in their attempts to circumvent the tax through the relocation of their activities? What would be the real level of double taxation and the cascading effects? To what extent could foreign institutions be discouraged from investing in participating Member States? What would be the real impact of the tax on Member States' GDP? Countries that have implemented the FTT show widely varied success in this respect (Sweden vs South Africa, India, Brazil, South Korea…).

From an administrative perspective, it is probable that the **operating costs** for FTT collection would be rather limited, as most transactions are carried out electronically and likewise the tax could be collected electronically and at the source. The Commission has estimated collection costs to be less than 1% of the revenue raised, especially when good use could be made of the existing market infrastructure, e.g. with the help of trading platforms, trade repositories and clearing houses.[56] Still, specific measures and collaborative mechanisms between Member States to address situations of tax evasion, information exchange or assistance for tax recovery could affect operating costs.

With respect to **vertical fairness among Member States**, in theory there is a positive correlation between investments in shares, the development of capital markets and GDP. Yet, a high degree of capital mobility across borders induces a regional arbitrariness that makes it difficult to assess the contribution of participating Member States to the tax (Cattoir, 2004). That is not necessarily a negative factor; it would actually be aligned with the criterion of regional

[56] See European Commission, Technical Fiche, Tax Collection (n.d.) (http://ec.europa.eu/danmark/documents/alle_emner/toldunion/120424-tax_collection_en.pdf).

arbitrariness, encouraging the treatment of the FTT as a 'real' own resource, as is the case of the customs tariff.

A concern is that variable geometry generates another difficulty: How to determine the contributions of the non-participating Member States? It would be possible to separate the contributions of the participating Member States from those of non-participants, ensuring that the non-participants contribute, **as their proportion of** GNI, a share that is equivalent to the percentage of GNI contributed by the participating Member States as a group (see subsection 7.10.3).

The fact that the FTT would be implemented under enhanced cooperation in a limited number of Member States hinders fulfilment of the criterion of **horizontal fairness among Member States**, because of the differentiated treatment of the financial sector and institutions according to their establishment in or out of the FTT zone. But this principle is likely to be mitigated through the principle of taxation based on residence. Conversely, horizontal fairness would increase within the FTT zone through the effect of the harmonisation.

Concerning the criterion of **vertical equity among the Union's taxpayers and citizens** (i.e. taxpayers' increasing tax burden based on their contribution capacity), several factors need to be accounted for, from the original conceptual objectives of European Commission's proposal down to the concrete effects at the implementation level. As for other indirect taxes, the performance of the FTT with regard to vertical equity is not to be achieved through progressive tax rates, but it seems logical that the richer the economic actors are, the more likely they are to fall under the scope of application of the FTT. Nevertheless, more complex and unpredictable issues should also be considered, requiring a sound analysis that exceeds the scope of this report, especially with regard (but not limited) to the following questions:

- To what extent could (and would) financial institutions find ways to pass the tax burden on to final consumers in order to maintain their margins, and through which mechanisms?
- How could it be verified and guaranteed that such cost repercussions on final consumers do not affect operations that are obviously exempt from (excessively) speculative behaviour and excluded from the scope of the FTT?
- Ultimately, what would be the impact on achieving the objective of the European Commission's proposal to "to ensure that the financial sector fairly and substantially contributes to the costs of the crisis and that it is taxed in a fair way vis-à-vis other sectors for the future view" (European Commission (2013a)?

The restrictive geographical nature of enhanced cooperation introduces biases in relation to the criterion of **horizontal equity among EU citizens,** whereby individuals in similar circumstances should be treated equally. More specifically, equal treatment would be reinforced among residents within participating Member States, but discrimination could arise between residents of participating and non-participating Member States (either by introducing cases for double taxation or by fully excluding financial transactions from the scope of the FTT).

7.9 ACCOUNTING AND FISCAL RULES

Switching from national contributions to own resources in the form of EU-owned taxes would entail a significant change in accounting for the corresponding amounts in the national and public accounts of Member States. As a rule, these amounts should no longer be counted as expenditures in the national budgets, and would directly be imputed to the EU budget, as is currently the case for the TOR. Due to such a change in accounting, the national public deficits should automatically be reduced by the same amount: if, for instance, the new own resource represents, say, 0.5% of a given country's GNI, this country's public sector deficit should be reduced by 0.5% of GNI.

This outcome would have to be taken into consideration when negotiating the new funding mechanism, as it would directly impact on the whole set of criteria written in the Fiscal Pact and all EU fiscal rules (see Annex III). In the cases in which the new resource is based on an existing tax base (VAT and CIT), the tax-neutral reform would decrease the national public deficit by the same amount as the reduction in national GNI contribution: with unchanged fiscal rules, it would thus grant additional margins of manoeuvre for national fiscal policies.

7.10 Asymmetric impacts of tax resources and the GNI residual

The tax candidates have been analysed earlier in chapter 7 and do not need to be discussed here. The introduction of own resources if these are not fully recognised by the Member States as 'owned' by the EU could create a conundrum in the calculation of the residuals, particularly in the case of a tax agreed under enhanced cooperation for a subgroup of countries, such as the FTT. Even if the resources were fully accepted as owned by the EU, a problem would arise on the treatment of countries not participating in a tax resource in the case of variable geometry.

Here is a simplified example of the complications that could be faced. Let us imagine a union of five Member States that have identical levels of GDP. The total budget is €100 billion and they originally all contribute €20 billion.

7.10.1 Tax fully accepted as owned by the EU

Now a tax is introduced to finance the budget that has a different impact on the Member States, which is shown in Table 7-4 as covering a percentage of their contribution. Once the tax is paid there is a residual of €66 billion. The option now is that the Member States just distribute the residual according to the GNI share, just as the EU does for the TOR. As long as the Member States accept the tax as owned by the EU and the differences in yields are acceptable, the story finishes there. As we can see in the impact on the total contribution, the countries end up contributing different amounts, but the state treasuries pay the same (case 1).

Table 7-4. Case 1 – New resources full accepted as owned by EU

	A	B	C	D	E
Amount of original €100 billion; all countries have the same GNI (€)	20	20	20	20	20
With tax where all participate					
Tax covering contribution (by %)	30	50	40	20	30
(in € billion)	6	10	8	4	6
***Remaining* €66 billion**					
GNI-based *residual payment* (€ billion)	14.4	14.4	14.4	14.4	14.4
Impact on total contribution (€ billion)	20.4	24.4	22.4	18.4	14.4

Source: *Authors' own calculations*

7.10.2 Tax incidence not accepted by Member States

We know that the EU has not accepted even the relatively small discrepancies for the VAT key. Taxes such as the FTT, environmental or corporate taxes would have considerably different impacts on Member States. If there is no acceptance of the tax as a fully owned by the EU and they integrate it into the calculation of the contribution, the results vary considerably. Now each country contributes the same in terms of GNI with the tax (case 2, Table 7-5). But this is probably a controversial result too, as the costs to the treasury would be different. Countries disadvantaged are most likely going to claim that given the mobile cross-border nature of some taxes (the FTT or corporate taxes), or the EU nature of the item taxed (e.g. emissions), their higher national contribution is not acceptable.

Table 7-5. Case 2 – Resource calculated as share of GNI contribution

	A	B	C	D	E
Amount of original €100 billion; all countries have the same GNI (€)	20	20	20	20	20
With tax where all participate					
Tax covering contribution (by %)	30	50	40	20	30
(in € billion)	6	10	8	4	6
Remaining €68 billion					
GNI-based *residual payment* (€ billion)	14	10	12	16	14
Impact on total contribution (€ billion)	20	20	20	20	20

Source: *Authors' own calculations*

It is nevertheless ironic that taxes that ensure equity among citizens will often have an incidence that is unequal at the Member State level. As already mentioned in Strengths and shortfalls of the GNI resource, and the need to improve it, the share of the GNI contribution can have very a different incidence at the level of individuals or organisations, depending on the tax bases and national resource on which the contribution is levied.

7.10.3 Use of variable geometry in resources

This leads to alternative case 3 (Table 7-6), where we assume that one of the Member States refuses to participate in the tax, so variable geometry is accepted. This could be, for example, the FTT. Only countries A, B, C and D implement the tax, which we assume raises €28 billion leaving a residual of €72 billion.

Table 7-6. Case 3 – FTT fully owned but with variable geometry

	A	B	C	D	E
Amount of original €100 billion; all countries have the same GNI (€)	20	20	20	20	20
Tax covering contribution (by %)	30	50	40	20	–
(in € billion)	6	10	8	4	0
Remaining €72 billion					
GNI-based *residual payment*	14.4	14.4	14.4	14.4	14.4

(€ billion)					
Impact on total contribution (€ billion)	20.4	24.4	22.4	18.4	14.4

Source: Authors' own calculations

If the tax is considered an own resource and the residual is shared by all Member States, the total contribution of citizens and companies in the non-participating Member State would be clearly inferior to the contribution of those of other countries. Countries would benefit from not participating. It is unlikely that this is going to be accepted by those implementing the tax, but what system could be used?

Case 4 (Table 7-7) addresses this by requiring that country E pays an amount equivalent to the GNI share of the whole budget. In this case, it would pay €20 billion. The issue here is that in terms of national budget contribution, E pays considerably more *from the treasury*. This could easily develop into a gross and net balance issue. If that happens, there would be a difficulty, because once the tax is added to see the overall contribution, it is not clear why E should pay less or more. Even if A, B, C and D agreed that the tax is owned by the EU, the contribution of E would become a problematic issue, particularly for B and C, which would need to justify their participation to the electorate.

Table 7-7. Case 4 – variable geometry, non participants of FTT have to pay GNI compensation

Case 4 with variable geometry	A	B	C	D	E
Amount of original €100 billion; all countries have the same GNI (€)	20	20	20	20	20
Tax covering contribution (by %)	30	50	40	20	–
(in € billion)	6	10	8	4	0
Remaining €72 billion					
GNI-based *residual payment* (€ billion)	13	13	13	13	20
Impact on total contribution (€ billion)	19	23	21	17	20

Source: Authors' own calculations

An option would be to levy from the Member State a contribution through the GNI 'equivalent' of the amount the tax would have yielded. This, of course, would again be highly controversial. First, it would require the virtual estimation of the yield, which in some cases could be complex. It means that non-participating Member States would need to either harmonise the tax base or estimate a yield on that base. It would also drive Member States where the sector taxed is larger as a share of GNI to avoid participating and to use only virtual calculations, and to lobby for ceilings and restrictions, thus resulting in a situation similar to that of the VAT resource today.

Finally, in case 5 (Table 7-8) Member States may decide that the total contribution including the tax has to be in line with the GNI level. This means that all countries would go back to the default contribution level.

Table 7-8. Case 5 with variable geometry – FTT becomes part of GNI contribution

	A	B	C	D	E

Amount of original €100 billion; all countries have the same GNI (€)	20	20	20	20	20
Tax covering contribution (by %)	30	50	40	20	–
(in € billion)	6	10	8	4	0
***Remaining* €72 billion**					
Compensatory GNI-based residual and E has to pay a proportional GNI share (€ billion)	14	10	12	16	20
Impact on total contribution (€ billion)	20	20	20	20	20

Source: *Authors' own calculations*

In this case all contributions end at the same level, but tensions may easily arise from the fact that the *national budgets* end up paying very different amounts. Also, the absence of a tax in the non-participating country may be considered an unfair comparative advantage or even a hidden subsidy to its corporates, banks or other operators that are exempt from the tax. In case 5, the main effect of the presence of the tax in countries A, B, C and D is to deliver a policy steer, for example by dissuading particular types of financial transactions or encouraging more efficient carbon use, whereas there would be no impact on the cross-country distribution of the financial burden compared with the initial situation.

7.10.4 Conclusion on the workability of variable geometry

This assessment leads to the conclusion that the best resource is one that is introduced in all Member States and is universally accepted as a common resource. The second best alternative is a tax that all Member States introduce but treat as a share of their GNI resource. It eliminates the ownership of the resource by the EU, but when the role is one of sending signals to the market (as with the carbon price), this may be an acceptable, even if suboptimal, compromise. The use of a virtual tax resource calculation for non-participating countries is possible, but it is not the second best option, because the incentives for Member States could be wrong. A simple example would be to transform the ETS revenues into a resource. There are also ways to handle the different incidence of some resources and this is addressed in the next section, where we take into account differences in GNI between Member States.

7.11 A PROGRESSIVE GNI-BASED RESOURCE?

The current redistributive dimension of the EU budget essentially relies on the expenditure side, and more specifically on the structural funds and cohesion policies, subject to per-capita GDP conditions. It would be possible, however, to build some degree of cross-country redistribution into the financing instruments. If there is to be a reform of at least some of the expenditure items, or else if the tax instrument selected as a new own resource has some undesirable regressive properties, it may be that an appropriate automatic correction mechanism could be found in a simple, progressive schedule applied to the remaining GNI resource.

The carbon levy case evaluated above provides an illustration: apart from the UK – due to the current rebate – all Member States standing to lose from substituting, even partially, the current GNI-based resource with some instrument based on carbon emissions are relatively poorer than the EU average, in terms of per-capita GNI (see chapter 6). Complementing the carbon levy with a progressive GNI national contribution would therefore at least partly offset the losses, with the additional advantages that such a correction mechanism would not introduce perverse incentives and would be self-extinguishing for countries catching up with the EU average.

Case 6 (Table 7-9) presents a simple example of such a compensating scheme with a progressive GNI contribution rate. The case represented is one in which there are two large and three small countries – in terms of total GNI. Significant inequalities in per-capita GNI have been assumed in order to make the case. With a well-chosen progressive schedule for the calculation of GNI-based national contributions, the impact of the reform on the initial distribution of national contributions may be calculated to be zero. Yet, the funding rules are 'virtuous', in the sense that any progress made in the reduction of carbon emissions in one country would reduce its total contribution to the EU budget if per-capita GNI is unchanged compared with the EU average.

Table 7-9. Case 6 with a progressive GNI levy

	A	B	C	D	E
Initial contributions (€ billion)	35	35	10	10	10
Per-capita GNI (% of EU average)	110	80	120	80	80
Carbon levy (€ billion)	14	21	4	6	6
***Remaining* €51 billion**					
Progressive GNI-based contribution schedule (%)	0.6	0.4	0.6	0.4	0.4
Progressive GNI-based contributions (€ billion)	21	14	6	4	4
Total contribution (€ billion)	35	35	10	10	10

Source: *Authors' own calculations*

Alternatively, programmes for decarbonisation could be introduced in the EU budget to help those countries that are at a disadvantage. The modernisation fund introduced in the ETS to get all countries on board is an example of such a deal.[57] In the case of carbon, rebates could also compensate gross contributions above a certain threshold, if they were tied to co-financing other EU spending priorities in the Member State concerned.

7.12 Strengths and shortfalls of the GNI resource, and the need to improve it

Proposals for own resources generally focus only on new resources yet fail to analyse the GNI resource, not as a resource 'option' but how closely it represents actual GNI and what it means in terms of 'equity'. As mentioned in the introduction of this report, and despite the well-known limitations of a GNI resource, it has benefits that need to be considered when shifting to a new resource mechanism. Changing to a more overtly tax-based system may forgo some of the benefits of the present system. Furthermore, the GNI resource is unlikely to just vanish in the short term; thus, reviewing its functioning and proposing potential improvements if necessary, is important.

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[57] This is explained by the European Commission in its Fact Sheet, "Questions and answers on the proposal to revise the EU emissions trading system (EU ETS)", Brussels, 15 July 2015 (http://europa.eu/rapid/press-release_MEMO-15-5352_en.htm).

In praise of the GNI resource…

The principal attraction of the GNI resource is that it assures a sufficient and stable flow of funding for the EU budget, at least in theory. 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. In principle, another, possibly more visible resource could fulfil this residual function, but the likelihood is that it would have to be calibrated to GNI, so that it might as well be the current one. Recently, however, the reluctance of some national governments to cover unexpected expenditures has made this argument less convincing.

Insofar as fairness between Member States in gross contributions to the EU budget is a desired characteristic, the GNI resource is very effective because the (pre-corrections) take-up rate is set to take equal proportions of national income from each country. Although the amounts are not often made very visible to taxpayers in Member States, they certainly could be and it can be argued that the resource, as a defined proportion of GNI, can be made perfectly transparent, contrary to often-articulated criticisms.

In cash-flow terms, the resource is straightforward for the Commission, in its capacity as the EU's executive, to administer. Even with the complications introduced by the UK abatement and the lower call-up rates granted to the Netherlands and Sweden for the 2007–13 MFF, the amounts due under the resource are easily calculated and obligations in terms of monthly payments are clear to Member States. The main issue is the possible end-year adjustment.

There is a firm legal base for the GNI resource in the Own Resources Decision (which is usually revised at the start of the MFF), an arrangement that militates against any conceivable threat that a Member State might renege on its commitments. Thus, although the GNI resource is, in practice, an intergovernmental transfer rather than a conventional 'own' tax as understood in the tax policy literature, in strictly legal terms it fulfils the Treaty obligation that the budget should be funded by own resources.

Thus, the benefits can be summarised as follows:

- simplicity and cost-effectiveness;
- long-term stability and predictability (in theory, although politics have even affected these features);
- a guarantee of budgetary balance (again in theory, as long as Member States fulfil their commitments to the budget); and
- a distribution among Member States that does not differ markedly from their shares in EU GNP (vertical equity).

Unless the EU can have a budget out of balance and is able to borrow, or have a surplus, it is also clear that the GNI resource will most likely be here to stay for the foreseeable future, to ensure

- coverage for any shortfall of resources;
- the possibility to respond to new challenges through extraordinary requests to Member States when common action is needed; and
- operation as a rebalancing instrument, if new taxation instruments (or a part of them) are not considered full common resources but part of the financing of the Member States

(the combined tax and GNI contribution of each Member State is capped to ensure it does not exceed its share in EU GNI).

… but the shortfalls are important

Why replace the current GNI resource? It seems to be widely accepted by governments and national administrations. It also provides adequate financing for the EU budget with a simple and straightforward mechanism. Why is it that, at least apparently, both the Commission and the European Parliament seem to consider the current funding scheme one of the major obstacles to achieving better decisions over the EU budget? The case against the GNI resource rests on at least two distinct arguments: one is in terms of the efficiency of decision-making processes; the other has to do with the notion of 'net national contributions', and also relates to the notion of horizontal equity.

Efficiency in financing any budget should be understood in two ways: one concerns distortions in private sector incentives, and hence decisions; the other relates to efficient public decision-making rules and procedures. Referring to the first meaning, it may be argued that the GNI resource is a source of more distortions in private incentives than a genuine own resource, which would be levied uniformly on all taxpayers across the whole EU. The reason is simply that national structures differ, so the effective burden of financing even an exactly equal percentage of GNI with national taxation will not be distributed evenly across categories of taxpayers and will thus introduce – admittedly small – exceptions to the rule of a 'level playing field', which is widely regarded as a major guideline of EU policies on the single market and on competition. There will thus be distortions in private allocation decisions, most likely for mobile tax bases, such as firms and financial investments. This effect is admittedly small, given the current small size of the GNI levy; it would be more of a problem in the case of a significant increase in the EU budget size financed by a higher GNI contribution.

In terms of public decision-making, efficiency should be understood not so much as a notion of cost-effectiveness from an administrative point of view, as the capacity of the whole process of decision-making to cater to public demands and deliver public policies that are in line with individual citizens' preferences. On these grounds, the record of the current financing scheme is clearly not very good, at least judging by the widespread dissatisfaction expressed by most Council members, the Commission, the European Parliament and many analysts about the outcome of the round of negotiations over the medium-term financial perspectives for 2007–13. This dissatisfaction led to the call for a thorough mid-term review, and again in 2013 after the adoption of the 2014–20 financial framework, it prompted the set-up of the High Level Group on Own Resources. The major problem would seem to lie in the linkage of decisions on expenditures and their financing by national payments, which is made very explicit and immediate in the current funding scheme. National administrations would still be able to calculate national (gross and net) contributions under alternative schemes relying on genuine own resources; however, 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.

The second argument is related to the notion of 'net national contributions' and its interpretation. Indeed, relying on a system of bottom-up vertical grants to fund the EU budget is a very effective way of emphasising the amount that is being transferred and of inducing members of national governments, national civil servants and members of national parliaments to regard it as an expenditure item in national budgets. Although this may be seen as a welcome incentive for them to exert control over the use of national taxpayers' money by the supranational bodies, it is not so in practice, because of the medium-term financial framework procedure. This procedure makes the role of national parliaments negligible in practice, especially because, once it has been adopted, the financial framework is binding and makes annual national contributions automatic, therefore not subject to national parliaments' control. Much more damaging (see Le Cacheux, 2005) is the erroneous interpretation of the net contributions as being a measure of the effective distribution of net benefits and costs from the EU budget: the geographical incidence of the taxes levied is actually not what it appears to be from the GNI contributions, just as the effective distribution of benefits from expenditures is seldom what is reflected in the geographical split of expenditures used by the Commission and Member States.

A third concern is that GNI itself is not an ideal measure of ability to pay, the tax principle that most obviously underpins its use, even with the obligation on Member States to conform to the European System of National and Regional Accounts (ESA) standard for reporting. Continual 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 or the changes made in 2013 to national accounting conventions, cause greater problems. In addition, 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 that are either included (spending on heating, for example) or not included (unpaid household work, but also environmental degradation), about which there are methodological doubts. According to evidence given to the House of Lords (2007), a specific element of GNI (FISIM, i.e. the imputed income of financial intermediaries) is not included in the definition of GNI used for calculating Member States' payments, but might add only one or two percentage points to the GNI of certain countries and thus only marginally affects what different countries pay, though for Luxembourg it could be more substantial.

7.13 Increasing transparency and aligning the GNI resource with the concept of own resources

Regardless of whether new own resources are agreed, the GNI key is not treated according to the concept of an own resource. A review of the central government budgets shows a high degree of diversity in the ways Member States handle the accounting for the contribution to the EU. Only in a very few countries is the EU contribution classified in the general budget as a resource attributed to the EU. In most countries, it is recorded as an expenditure of the central government.

Furthermore, two Member States, notably the UK and Romania, record the net balance as a cost or benefit in the national accounts, despite the fact that some of the funding is not transmitted through the treasury.

For transparency and simplicity, the GNI gross contribution should be recorded as revenue attributed to the EU. All EU revenues should be classified in the same manner. This approach would also help national parliamentarians and any interested citizens to easily see the contribution to the EU budget. The clarity of other contributions in national budgetary accounts would also be enhanced by a standardised presentation of the figures.

In general, the way in which Member States' contributions to, and monetary benefits from, the EU are distinguished should be fully harmonised for the purpose of transparency. The situation on the expenditure side is also highly unsatisfactory in terms of the way the funding is recorded in the national budgets (Mortensen et al., 2014). Again, for the sake of transparency and accountability, this should also be reviewed, but the matter is beyond the remit of this report.

8 ENHANCING FLEXIBILITY TO ADDRESS UNEXPECTED EVENTS

Chapter 8 in a nutshell

- The present degree of flexibility was crucial to handle the challenges of this MFF, but is already too limited and will not suffice under similar pressures in the years to come.
- The current flexibility mechanisms are not designed to meet the needs of persistent multiple crises.
- There is a latent risk of an accumulation of unpaid commitments in the years to come, as the payments ceiling is potentially going to fail to cover the commitments undertaken and realised.
- Some reforms could and preferably should be undertaken in the present MFF.
- A sizeable provision of funds for unexpected events should be factored into the budget in the future MFF.

Another area for reform has to do with flexibility. In 2014 and 2015, the budget shifted headings and mobilised over €12 billion for unexpected needs in an unprecedented manner. The European Commission managed to finance the EFSI, compensate farmers affected by the Russian ban and help those affected by the milk price crisis, support Greece, fund actions to support Ukraine, frontload funding for the Youth Employment Initiative, and raise funding for the migrant crisis. In addition, the late adoption of EU funding programmes in Member States led to a shift of commitment appropriations initially programmed for 2014–15 and 2016 and a commensurate revision of the relevant MFF ceilings. But needs exceeded the EU budget's capacity (including from emergency instruments outside the MFF), so for instance some external actions are being financed by trust funds outside the budget, such as the regional Trust Fund for Syria and the Trust Fund for the Central African Republic.

This show of flexibility has been impressive. However, it is doubtful whether such arrangements could be repeated, as the rules have already been stretched and the margins that have been used cannot be found again in the present framework. In the future, however, the number of 'asymmetric shocks' potentially facing the EU from global instability, economic shocks or climatic events are numerous, while the EU budget has not been designed to face such events effectively. The financial (MFF) margins available for 2017–20 are lower than the level of funds mobilised between 2014 and 2016.

Some future financial obligations have already been decided while the sources of the funding remain unclear. The first problem is of course the increasing costs related to refugees, with €10.1 billion being mobilised in 2015 and 2016, of which €2.3 billion is to be channelled through the extra-budgetary Trust Funds for Syria and Africa. Now the EU has agreed twice to an additional €3 billion of support to Turkey for refugees, on top of the €1 billion that was transferred from 'pre-accession' funding in 2015. Of the first €3 billion to be deployed until 2017, some will be financed by the EU budget and the remaining by additional Member State contributions. For the €3 billion after 2018, no decisions have been taken yet.

This chapter looks at how the use of flexibility instruments has evolved, the challenges ahead and some proposals for improvement.

8.1 PRESENT FLEXIBILITY INSTRUMENTS

Table 8-1 lists the existing flexibility instruments in the budget, including the ad hoc instruments created recently, with their pros and cons. It presents the flexibility instruments listed in Council Regulation (EU, Euratom) No. 1311/2013 on the MFF, divided into those that shift funding between headings and are within the MFF budget and those that are external to the budget. The table excludes flexibility provisions allowing redistribution *within* the budget headings.

Table 8-1. Pros and cons of existing instruments allowing for flexibility in spending

Budgeted within the MFF		
Instrument	**Description (figures in 2011 prices)**	**Strengths and weaknesses**
Exceptional reprogramming and the transfer of commitments	Due to delays in the implementation of operational programmes in the first year, unused commitment appropriations were exceptionally carried forward from 2014 to 2015.	This is a recurrent problem caused by delays in the approval of some programmes. The Art. 19 revision was swiftly adopted, preventing major disruptions in the MFF implementation.
Global margin for payments (Art. 5)	The payment ceiling is adjusted upwards with the margin available in year n-1 (limited to €7 billion in 2018, €9 billion in 2019 and €10 billion in 2020).	This instrument is useful for handling the accumulation of payments in the last years of the MFF, and serves to rescue unused payment margins in n-1. It thus helps to mitigate bottlenecks arising from an overall underestimation of commitments that become payable and additional expenditures that can lead to the accumulation of RAL (see note).
Contingency margin instrument (Art. 13)	This instrument allows an increase of the commitment or payment appropriations over the ceiling of 0.03% of GNI to be offset with one or more future commitment or payment ceiling reductions. It is a last resort instrument.	This is an instrument that allows the commitment or payment ceiling to be exceeded in a given year, but requires a reduction in the ceiling of future payments. It can be mobilised only for payment appropriations, thus slowing down the accumulation of RAL (*reste à liquider*). However, if used for unexpected expenditures, it increases the risk of RAL accumulation.
Global margin for commitments for growth and employment, in particular youth employment (Art. 14)	This instrument allows the unused margins of commitment appropriations, commitments for growth and employment, and in particular youth employment, of 2014–17 to be reallocated to the commitments in 2016–20 in the areas of growth and employment.	This is an ad hoc decision to transfer unused commitments to the future. It makes sure that precious margins are not lost along the way and allows – within limits – the shifting of available margins between headings and years. But by avoiding the lapse of unused commitment appropriations, some of the underlying assumptions for the profile of the payment ceilings are compromised. The impacts will depend on the actual uptake and

		implementation of these commitments.
Frontloading of the Youth Employment Initiative, education and research (Art. 15)	A total of €2,543 million is to be frontloaded in 2014 and 2015 (with a corresponding backloading of other items to respect the ceilings).	This is an ad hoc decision to allow fast intervention, but if successful and not replenished it will drain the funds for this policy in the last years of the MFF.
European Fund for Strategic Investment	Funds totalling €8 billion from the Connection Europe Facility (€3.3 billion), Horizon (€2.7 billion) and unallocated margins (including the Global Margin for commitments of €2 billion) have been allocated to the EFSI.	This is a landmark decision, creating a large financing instrument outside the budget with guarantees provided by budget headings. While 'unthinkable' in the past, necessity has prevailed and prompted surprising flexibility when needed. A weakness of EFSI is that the funds for it have been levied from budget headings with high EU added value.
Additional flexibility instruments external to the MFF		
Flexibility instrument (Art. 11)	This instrument allows for a maximum of €471 million per year (at 2011 prices). Unused amounts in year n can be used until n+3.	While it constitutes a sizeable increase compared with 2007–13, the sum of this instrument is very limited given the needs that have emerged.
EU Solidarity Fund (Art. 10)	At €500 million per year, this fund has been developed to release financial aid to Member States and candidate countries in response to major disasters.	While reasonable, this instrument is limited to specific areas. It has been the subject of criticism, owing to the cumbersome rules and methods of mobilisation (requiring an amending budget).
European Globalisation Adjustment Fund (Art. 12)	This fund, with €150 million per year, is to support workers who need to reintegrate into the labour market after being displaced by structural changes in the economy caused by world trade patterns.	This instrument is controversial and has been challenged by some Member States, with questions over how to determine the source of problems in a sector. It has also been criticised for cumbersome rules and methods of mobilisation (requiring an amending budget).
Emergency aid reserve (Art. 9)	This reserve consists of €280 million per year for external action, in particular humanitarian aid.	The enlarged the scope of intervention envisaged has not been made use of so far.
New instruments created to react to unexpected needs (not considered when the MFF was adopted)		
Regional Trust Fund in response to the Syrian crisis	This fund has been set up to address the most critical needs and gaps in aid to refugees for stabilisation and resilience, along with their host communities in Iraq, Lebanon, Jordan, Turkey and Egypt.	With €300 million from the EU budget and the European Development Fund, this fund is to be topped up by Member State contributions. At this stage, however, it is unable to finance the €5 billion offered to Turkey until 2020 (of €6 billion in total).
Emergency Trust Fund for Africa	This trust fund was set up to address the root causes of the migration flows in Africa.	The fund comprises €1.8 billion from the EU budget and European Development Fund, which is to be topped up by Member State contributions. So far, the

		contributions from Member States or third donors have been very limited.
Other trust funds	While such funds are not considered in the budget itself, there are instruments supporting external blending facilities with European financial institutions (e.g. the EIB and KFW), but are beyond the direct scope of this study.	These funds have enabled better coordination of the role of financial institutions and national aid programmes with EU aid.

Note: RAL refers to the signed commitments that the EU will eventually have to honour unless they are de-committed.

Source: Authors

The table above shows the multiplication of instruments put into place to face recent emergency situations, in both a systematic and an ad hoc manner, though they have not been designed specifically to address issues like the migration crisis. In addition, while there are instruments that allow for the reallocation of unused commitments to the future, other instruments allow for the advance of payment appropriations (the contingency margin instrument), which actually reduces the capacity to honour commitments in the future. The gap between commitments and payments is rather large and risks resulting in a growing RAL or – in other words – an accumulation of unpaid bills that corresponds to a form of 'deficit' in the EU budget. Of course, this does not translate into borrowing, which is forbidden by the Treaty, but provokes complex and avoidable disputes over the budget. This situation can be avoided by having more realistic payment ceilings considering that the commitments are de facto guaranteed by the EU, i.e. the Member States. Low payment ceilings do not reduce the obligation of the EU to honour its commitments. Flexibility instruments should also be designed to ensure that the budget is provided with the right margins at the right time. Presently, the flexibility instruments are not guaranteeing this enough.

The implementation reports of the Commission show that appropriations for commitments are used by Member States at a level close to 100%, as the financial crisis led Member States to maximise the use of EU funds. If those commitments then become actual payment requests, the risk of insufficient payment appropriations becomes a real possibility.

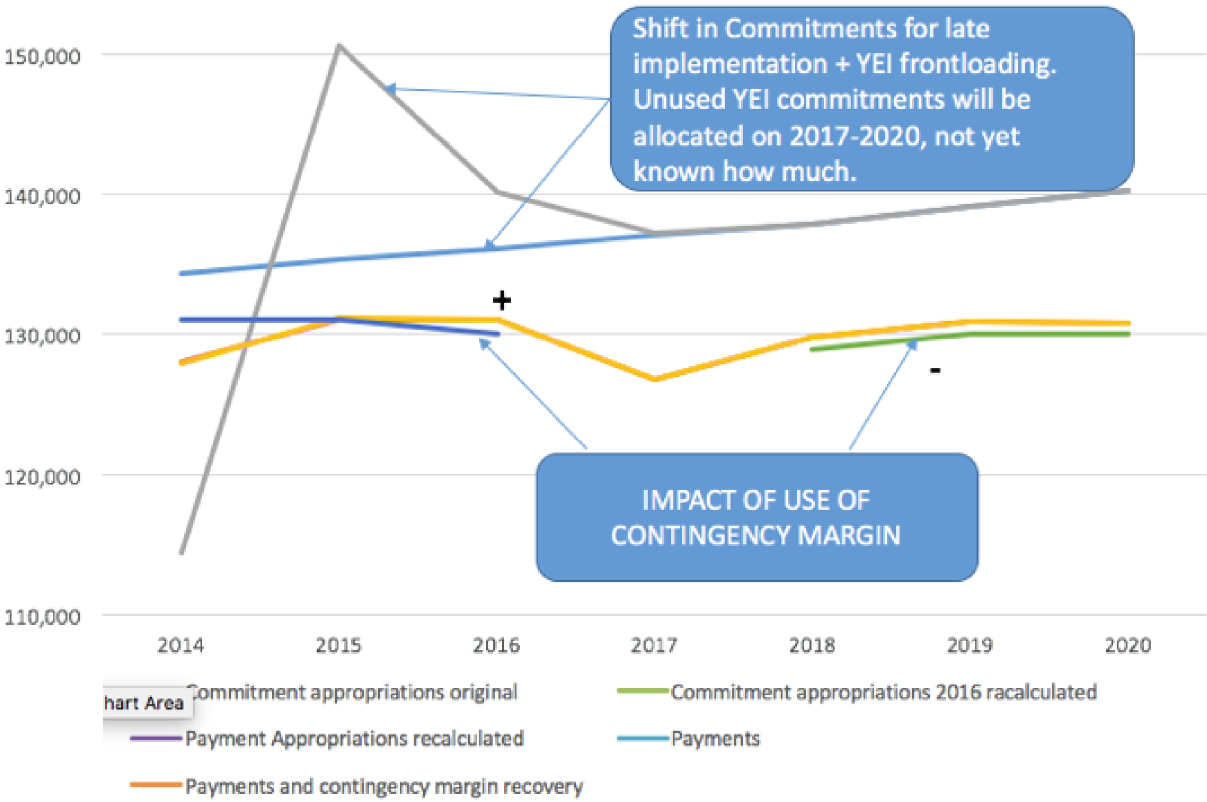
There are other rules that could easily be amended, such as the fact that revenue generated by the EU from sanctions and fines has to be reimbursed to the Member States as a percentage of their GNI. The same happens with revenues from VAT and TOR that exceed estimations, leading to a downward recalculation of the GNI contribution. Moreover, this may take place simultaneously with negotiations to find funding for unexpected needs in the areas of migration or border security.

8.2 Analysis of the use of flexibility instruments in the present MFF

Figure 8-1 presents the shifts within the MFF to address the challenges caused by the delay of the national programming of EU funds, which led to a shift of commitment appropriations to 2015 and 2016 and to the frontloading of commitments for the Youth Employment Initiative. In addition, to address urgent payment requirements, the contingency margin instrument was used for payments and future payment appropriations were shifted forward for 2014–16. It goes without saying that shifting payment commitments forward leads to a greater risk of a potential shortage of payments in the future.

In the shift presented, some non-visible changes should be mentioned, i.e. the use of EU funds to build the EFSI guarantee, which remain in the budget but are de facto allocated to an external instrument.

Figure 8-1. Amendments to commitments and payments to the budget ceilings (€ million), 2011 prices

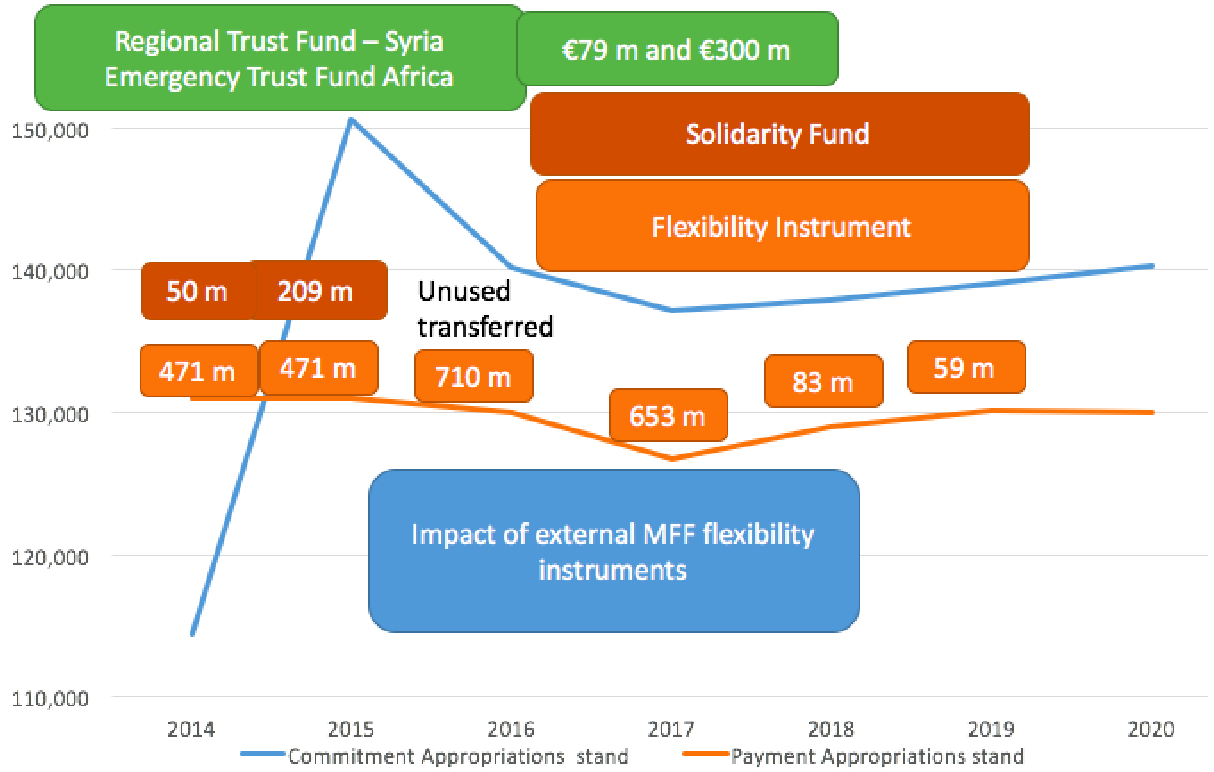


Note: YEI refers to the Youth Employment Initiative.

Source: Data from the European Commission's online documentation on amending budgets.

Figure 8-2 presents the funds mobilised from the external flexibility instruments, including newly created trust funds that combine EU funds as well as national voluntary contributions. Overall, the mobilisation of funds has been impressive. The question, however, is to what extent the budget is able to react in the future to unexpected events. This is discussed in the next section.

Figure 8-2. Use of flexibility instruments outside the MFF (€ million), 2011 prices



Source: Data from the European Commission's online documentation on amending budgets.

8.3 ENHANCING FLEXIBILITY – SOME POSSIBLE SOLUTIONS

The instruments currently available were not designed for prolonged or multiple crises, but to respond to specific and time-limited events. Some have multiple limitations, such as the use of future payment or commitment appropriations to beef up the budget in any given year. Not only does this weaken the budget in the future, but also it is difficult to envisage its use in the later years of the MFF. Which margins can the EU budget bring forward in 2019 or 2020, and from which future budgets?

Table 8-2 shows a number of possible solutions for the future to improve the capacity of the EU to respond to unforeseen events. The budget is already at risk of further crises in the months and years to come until 2020, a worsening of the migration crisis, potentially disruptive events due to natural disasters or increased security demands. Many of the reforms proposed could be envisaged for the present MFF.

Numerous options could be introduced today without much controversy, but unless a decision is taken to also allow the payment ceiling to increase in absolute terms, flexible instruments cannot reduce the real potential risk of a considerable RAL.

In the next MFF it is realistic to consider that a reserve should be made available to facilitate rapid responses to crisis situations. It is actually important that the commitment and payment appropriations are isolated from emergencies, which should not monopolise margins needed to implement the normal MFF programmes.

Table 8-2. Potential reforms to increase the response capacity of the budget

Reform option	Rationale
Retain funds from sanctions, fines and penalties	Allow the funds recovered from sanctions, fines and penalties to be used as a reserve to cover exceptional needs. In 2015 alone, €1.95 billion was collected by 30 June 2015 and then redistributed to Member States. Fines and penalties are a clear resource for the EU, which could either be carried over or put into reserve for unexpected events. The money would have covered the costs of the Trust Funds or the EU budget's share of support for Turkey.
Automatically transfer unspent margins to the next year	It is also rational to consider the use of unspent margins in pre-allocated budget lines for the unexpected needs. The same logic would apply to any surplus.
Allow the use of unspent margins to be redeployed	The margins of the budget lines under shared management, i.e. agricultural and structural policies, cannot be accessed easily, leading to situations in which underspent margins in those policies during the year cannot be redeployed for emergencies. This should be reconsidered.
Keep the GNI contributions stable when the revenues of TOR and VAT increase	Higher resources from the TOR (custom tariffs) and VAT have led to reductions in Member States' contributions based on GNI. But as these additional revenues from the TOR and VAT do not affect Member States' revenues negatively, the excess revenues could be used to develop an emergency fund. A problem would arise, however, if those revenues fell.
Expand the use of financial instruments	These instruments can play a role in bolstering the EU economy in sectors with high returns on investment. Yet they are not the best instruments for rapid reaction in times of crisis and do not come without additional costs. Their function is different from that of grants. Still, more effort could be directed at to further identifying areas where subsidies could be reduced in favour of such instruments, freeing up grant funding for pressing needs, but this would more likely be the case in wealthier regions with a good administrative capacities and solid private sector.
Create a financial budget line for unforeseen events	A rational option is to set up a well-funded budget line for unforeseen events (above €10 billion). The logic would be similar to the Solidarity Fund, but should result in an actual fund quickly deployable and within the budget ceilings of the MFF, and be subject to co-decision. The rules should be strict on its use and only allow for action for serious unforeseen events affecting the Union as a whole or several Member States in combination. The fund should not be used for balance-of-payments support (see note) or to replace support for emergency aid to agriculture or to cover the RAL. This fund would be replenished year-by-year and unspent funds rolled over. Surpluses, sanctions, fines and penalties could also be used to maintain or expand it. This fund could replace the existing emergency funds.

Note: The EU budget should not be used for this, only the ESM; the EFSM should no longer exist. The BoP and MFA instruments should both be guaranteed by funds under the heading for external action.

Source: *Authors*

9 *Dissociating* expenditures from resources – By confronting them

Chapter 9 in a nutshell

- Reform proposals for new own resources have repeatedly failed. Some of the causes are to be found on the expenditure side and the implicit link with resources through net balances.
- Generalised correction mechanisms do not improve policy-making.
- Own resources reforms can be achieved if there is dissociation with the expenditure side.
- The dissociation first requires a new agreement on which headings should be removed from correction considerations, based on EU added value.
- A co-financing of the CAP using a cohesion-based approach to the financing system could provide a good solution that would benefit net contributors and recipients alike.

The debates on reforming the own resources have been going on for decades, but little headway has been achieved. The concept of ensuring a maximum net return from the contributions transferred to the EU budget remains alive and well. Instruments to mitigate net balances, such as the UK rebate and other rebates on the rebate have nearly taken a life of their own, with corrections based on rather loose arguments lacking any solid methodology.

If the rebates from the EU budget were based on a fundamental disagreement over the added value of the instruments, such as the frequent argument by the UK that the CAP is misallocated, then the rebate should be closely linked to specific expenditure headings. That is not the case. The UK rebate is calculated as a percentage reduction on the so-called 'allocated expenditure', regardless of the actual function of the policy or whether the UK supports it. This does not mean that all of the UK's arguments are incorrect, but having a rebate that is not calculated through a formula linked to the concerns expressed blunts the debate about the priorities of the EU budget.

Thus, if the Member States have the interests of the EU in mind and seek actual compromises on common policies, then the debates about who pays for what and how much need to relate to the priorities of the budget more directly. If, for example, the CAP's direct payments are contentious, then the correction has to be directly tied to it. It is indeed odd that all corrections directly or indirectly include such items as research and development, justice and home affairs, and administrative costs. Furthermore, the UK, Ireland and Denmark benefit from a reduction to their contribution to the EU budget based on their opt-out in the area of justice and home affairs. Corrections should likewise be based on similar criteria. In addition, it is odd that today we have a financial opt-out for a policy that is later included in the correction calculations.

That is why the use of generalised correction mechanisms is highly questionable. First, because they simply justify that there is such a notion as a minimum return from contributing to EU objectives. Once this notion becomes fixed, the accounting link between the resources and expenditures will practically be set in stone and pre-allocated budget items will remain dominant. It is time that the EU budget matures. Yet, this does not mean that the concerns of net contributors to the EU budget should go unheard. Member States have the right to be concerned about the priorities of the budget, and proposing any reforms that ignore those concerns is counterproductive.

For these reasons, changing the nature of the own resources may only be accomplished over time and may require revisiting the expenditure side of the budget. Let us assume that the net balance is an inefficient proxy for the willingness of the Member States to contribute to EU policies – inefficient because the rebates have been created without firm criteria or relation to any detailed assessment of the 'excessive contribution'. It is excessive for which policy? What objective? In an equivalent manner, we should ask ourselves what is the minimum 'return' from the EU budget, based on what criteria?

We consider that the ceilings and rebates reflect more than a plain refusal to contribute to the EU objectives by Member States, and a deeper discontent with the mechanisms and priorities of the budget. The discontent over the quality of the objectives of the EU budget emanating not only from politicians but also the number of academic publications on this matter is more than considerable. The academic concerns may not match those of the governments, but they leave little doubt that the budget is not effective enough in addressing EU objectives to dismiss the net contributors' ceilings and rebates as a form of 'national selfishness'. Ultimately, we are witnessing a fall in the popularity of the EU and its policies, and governments need to justify their contribution to the EU. Any reform of own resources has to take this factor into account. To assume that governments or the public will just be more willing to accept paying for EU policies directly than indirectly without addressing this factor is myopic.

This report, however, is not going to defend the argument that an expenditure reform has to precede an own resources reform. We are at risk of falling into a 'catch 22' situation in which reforms on the resources side are hampered by those on the expenditure side and vice-versa, leading to paralysis. A potential solution is to *encourage a gradual* review and reform of policies through the step-by-step reform of the mechanism of own resources. To do so, we need to identify the policies that pose the most concerns to the largest net contributors and ensure that any corrections are attached to specific policies. This approach may be considered a challenge to the principle of universality of the EU budget (Art. 20 of the Financial Regulation (EU Regulation No. 2015/1929). Formally it may be deemed an aberration, but in fact the UK has often claimed that the rebate reflects its refusal to fully finance the CAP.

9.1 WHY GENERALISED CORRECTION MECHANISMS ARE NOT A SATISFACTORY ANSWER

A number of proposals have been made to introduce a generalised correction mechanism. This report recommends avoiding such a solution for the following reasons:

1) There is no rationale for determining a 'net balance ceiling' or an 'excessive net balance'.

2) It would entrench the notion of an excessive net balance, while, as this report makes amply clear in chapter 3, the developments in the budget make such an approach increasingly nonsensical.

3) Automatic correction mechanisms can lead to absurd outcomes. If, for example, as some Member States have proposed, the support for wealthier Member States were to be cut, a reduction in the budget would also trigger higher corrections. While gross contributions to the EU budget would fall, the net would deteriorate as a percentage of GNI for wealthier net contributors.

Point 3, while seemingly counterintuitive, is not a highly unrealistic situation. Let us take the case of a wealthy Member State that contributes €10 billion to the EU budget (assumed here to be 1% of the country's GNI) and receives €5 billion in return through various policies corresponding to a negative net balance of 0.5% of GNI. Let us imagine that after a cut in the EU budget on policies for richer regions, the country receives €2 billion less, while the overall contribution to the EU falls by €1 billion. The negative net balance of the country then is €6 billion or 0.6% of GNI, despite the fact that the EU budget has been cut in real and nominal terms and the gross contribution has fallen! For some net contributors this would be the case if the CAP were to be cut or if the Cohesion Policy support to wealthier regions were cut.

Any net balance correction mechanism only makes sense in a relatively static policy environment. The correction mechanism only ensures that marginal increases in one policy, for example for poorer regions, are accompanied by increases in other policies that assure stable net balances. It is incompatible with real policy changes. It also causes perverse incentives, e.g. increases in funding for policies benefitting the country that obtains a rebate reduce the net correction that the country obtains. This leads to the strange situation in which a net contributor may refuse policies they would benefit from simply because of a net balance accounting factor. Correction mechanisms that are dissociated from the policies that originally 'justified' them simply lead to the EU budget becoming sclerotic and unable to react to changes and new challenges.

Nevertheless, targeted corrections that are attached to specific policies and have better criteria can be developed to allow transitory periods to negotiate expenditure-side solutions, as described in more detail below.

9.2 HOW TO DISSOCIATE RESOURCES FROM EXPENDITURES?

The problem with net balances is they clearly link EU resources to expenditures. An efficient resources system should, with rare exceptions, be completely dissociated from the allocation of expenditure. In efficient national revenue systems, the public does not have an *a priori* claim for a return of the tax contribution. In most international organisations there is no connection between the funding for the organisation and the operations of the organisation. The EU is, from the point of view of an international organisation, rather unique. Some EU Member States contribute similar sums to international aid as to the EU budget, and they do not request that aid assistance be given to them in exchange. In 2014, the UK government spent close to 0.7% of its GNI on development aid, meeting the 0.7% goal. No net return was required. Therefore, in terms of net contributions, the UK has offered more in foreign aid than it has contributed to the EU budget, and so have other Member States, such as Denmark and the Netherlands. Why are contributions to the EU budget so controversial then? It would seem that Member States consider that some of the EU budget is not spent efficiently on worthwhile objectives.

Undoubtedly, some EU policies are very controversial, and the demands for rebates based on those policies are understandable, at least from a political point of view. Yet the present system of corrections is not conducive to any rational solution, but rather a worsening of the rationale for the budget. The formulas for the UK rebate and other corrections are not based on any specific expenditure item. The UK rebate is calculated on the aggregate contribution and returns on all internal policies of the EU, including administrative expenditure. This formula makes it close to impossible to discuss the substance of the matter, e.g. finding new policy solutions to the CAP design or agreeing on aspects of the EU regional policy.

Consequently, there is a need to link corrections directly, and with a justification, to the policy area that is under question. That brings us to the notion of selective correction instruments that target and review the financing of specific policies.

9.2.1 Removing headings from rebates and net balance calculations

Presently, the UK rebate, and by proxy all other rebates, reduce the contributions of Member States to policies of an intrinsic European character and high EU added value, such as for heading 3a "Freedom, security and justice", research and development, support for competitiveness, the trans-European networks and support for the environment. Member States are not questioning the value of these policies.

It is thus rational to exclude such headings from the calculation of any rebate. If that were done, the net balance issue would be fought on specific policy matters, creating a more rational link between policies and the problem of financing them. Any corrections – be it rebates, lump-sum transfers or any other measure agreed for the benefit of any particular country – would be undertaken for the specific policies. The rebate or transfer would be decided by the Council based on a methodology related to the costs of the policies in the budget. This would be in line with the Commission's own declaration in a staff document accompanying the proposals for new resources in 2011. More specifically, it stated that the "correction mechanism will need to be carefully justified, not only by way of debatable accounting measurements, but in view of the overall balance of benefits brought by the EU budget and policies",[58] a condition the European Commission did not follow in the actual proposal, as the Court of Auditors correctly points out.[59]

The selection of the headings to keep in or out of any correction mechanism would first be determined by the nature and EU added value of the policies. That is easier said than done. Tarschys (2005 and 2011), Núñez Ferrer and Tarschys (2012) and Heinemann (2015) address the difficulty of conceptualising what EU added value means in practice. Without clear criteria most expenditures can be specified as generating 'EU added value'. Maybe the present combined pressures in the areas of energy, climate, security, competitiveness and economic growth are already hinting that a limited budget needs a flexible approach to how added value changes with circumstances.

An agreement on those parts of the budget that address EU added value would need to be guided by a number of criteria:

- Is the value generated higher than would be the case from separate national actions?
- Who are the beneficiaries of these actions and is the distribution of funding and risk between the public and private sector appropriate?[60]
- Related to the above, what is the public good nature of the investment?
- What is the cross-border element of the investment?
- Are the costs in line with the proportionality principle?

In the case of support for cohesion, the funding is provided to support the financial burden of poorer countries to develop their economies and to achieve EU standards and objectives. In this case, for more local added value, it is important to ask the following questions:

[58] See European Commission (2011a), which accompanies the amended proposal for a Council Decision, p. 44.

[59] See the Court of Auditors, Opinion No. 2/2012 of 20 March 2012, point 43.

[60] The word 'appropriate' is used, because in practice it is very difficult to find the 'correct' distribution. Financial instruments are one of the modes today in the search for balanced risk approaches.

- Are the investments undertaken having a real impact on the economy or assisting the achievement of EU standards and objectives?
- Is the project in line with the additionality principle?
- Is the project in line with the proportionality principle?
- Is the financing in line with a 'financial' subsidiarity/solidarity principle, i.e. the local financial means do not allow the investment to perform?

These are just some of the questions that need consideration when reviewing the EU budget. Measures will need to be taken to ensure disagreements on the expenditure side are dissociated from the resources, putting an end to the net balance approach to the EU budget.

Another aspect that can be taken into account is the potential of common policies to generate savings for Member States. With the crisis, the Member States called for the EU to reflect efforts to cut national budgets by cutting the EU budget expenditures. This seemingly reasonable request is contrary to the nature of the EU budget. The rigid and mostly pre-allocated funding structure impedes such 'cuts'. In addition, most of the expenditure is based on multiannual programmes with signed commitments. In the end, the only areas where restrictive measures could be undertaken are budget lines that are not pre-allocated, generally those with higher EU added value that *reduce the cost of action compared with separate national actions*. In the same manner that the benefits of EU membership have largely been ignored in negotiations on the EU budget resources, economies of scale and savings have not been properly assessed.

While a lot of work and analysis is needed, there are headings that are easy to exclude from net balance calculations. Of course, those headings already outside the UK correction mechanism should be excluded, such as all expenditures for external action.

Heading 1a – Competitiveness for growth and jobs

This heading is by and large pursuing policies with EU added value and should not be part of a rebate system. In addition, many of these policies are for the benefit of net contributors and it is strange that it is included in the present UK rebate, as the country is a considerable beneficiary.

Heading 1b – Economic, social and territorial cohesion

This policy is part of the principle of solidarity of the EU and while the policy may need further refinement, many of its objectives are structured today to achieve EU objectives and standards often defined by more advanced, wealthier EU countries. It is therefore justifiable that less developed regions are supported to pursue those objectives. Developing regions that lag behind can also improve social cohesion, which has an added value for the EU.

Undoubtedly, improvements can always be made, but already the policy's focus, strategic quality and its controls have improved markedly in the last two decades.

Heading 2 – Sustainable growth and natural resources

This heading and particularly its sub-heading "Market-related expenditure and direct payments" of the CAP, is certainly by far the most controversial in the budget. The UK has pointed out numerous times that the CAP is at the core of the justification for the rebate. There is a rationale for this claim, as the policy was designed as a support system benefiting certain farm structures and products more than others at its inception, and the present support system is still linked to the original distribution. CAP reforms and the decoupling of support did not remove the original distribution bias. The funding distribution is still tied to historical levels and to the provision of support either by farm or region.

The UK, because of its farm structures and products, benefited and still benefits less than other Member States, which has led to the net contribution dispute that triggered the rebate. Studies have shown that the CAP is a regressive distributional policy (see Núñez Ferrer and Kaditi, 2007) at the farm level as well as in terms of the GDP per capita of countries. Despite the fact that the CAP is presented as support for a struggling sector, the relationship between the added value of farms and the support level does not show solidarity with farmers in need. This anomaly ensures that some wealthy Member States are low net contributors.

Other sub-headings, such as the LIFE Programme and partially the rural development funds, when clearly focused on attaining the objectives and standards of the EU, can be regarded as having EU added value.

Heading 3 – Security and citizenship

This heading is plainly of high EU added value and is surprisingly underfunded, as the migration crisis has exposed. It is a policy that many academics view as suffering from the incoherent logic of the net balance approach to the EU budget. Including this heading in the rebate calculations makes little sense. It is possible that those Member States that have opted out of Schengen or specific provisions would consider a rebate justifiable. Yet, having some Member States not participate also generates costs for the overall system.

Heading 5 – Administration

It is reasonable to exclude the administrative expenditure from any correction mechanism, as the EU's administration has the competences that Member States have bestowed on it. It does not seem rational to have any correction for such expenditure. It may be that for the future, a slight differentiation in contributions could be agreed for areas where a Member State does not participate in a policy (actions under enhanced cooperation), but the impacts are bound to be minimal.

9.3 Removing headings – Impacts on corrections

The impact on the UK rebate of limiting it to specific budget headings, and on other Member States of losing their 'correction on the UK correction', would greatly depend on the methodology used. As it stands today, the rebate does not fully include the regional development funds for the 'new' Member States. Depending on the design of a more rational 'correction' on the CAP, the change may not be so significant as it may seem. What is important is that such an approach would enable the identification of areas for future negotiation and reform. It would pinpoint the de facto connection to the budgetary lines that generate the so-called 'excess budgetary imbalance' and attach the rebate to specific policies, facilitating more rational negotiations on the contents of the budget. This in turn would foster better discussions on the resources and any corrections, which would have to be justified.

As an illustration, the subsections below analyse the impact on the UK and the rebate, and what would happen if the funding for the CAP were changed. It is based on a concept developed in Núñez Ferrer (2008) using only the EU-15; here the concept is expanded to 28 countries using the budget implementation of 2014 for the illustration.

9.3.1 Reforming the financial model of the CAP

The distribution of CAP support is a historical construct that has little to do with the needs of today's farms. The size of the payments is neither based on farm income, nor on real costs, but on a now-distant formula to compensate for 'intervention price' falls agreed 1992 as a consequence of the General Agreement on Tariffs and Trade (GATT) of 1991. The calculation was based on products and yield levels in historical 'base years', which have been losing relevance with the passage of time. Today's direct payments are not calculated based on actual practices or by focusing on specific financial needs. The support is also regressive when compared with the added value of farms and GDP per capita of countries and regions. Support more often than not is higher in regions with larger, wealthier farms in a smaller farm community (see Baldwin, 2005; Núñez Ferrer and Kaditi, 2007; Núñez Ferrer, 2007).

The agricultural sector is important given its impact on nature across a large territory of the EU and the intrinsic link between the sector and food safety for the public. Agriculture requires in many areas common standards necessary for the single market. In fact, a single market needs a regulatory framework for product standards and business practices. However, it is a misconception to claim that having a common policy requires that funding should be centralised at the EU level. Rules on agricultural support may be common without requiring a common budget.

This report does not propose to 'renationalise' or abolish the CAP. It is also not the role of this report to propose reforms to the policy instruments. But it is the role of this report to consider alternative methods of financing the policy.

Reforming the CAP financing system also makes sense from the point of view of fiscal federalism. CAP subsidy benefits are largely local in nature. In fact, why should a Portuguese, British, Austrian or even Croatian taxpayer support the successful producers in France, Denmark or Ireland? Fiscal federalism theory would consider that such support largely has to be financed nationally.

The CAP's allocation of funding, particularly for direct payments, is often presented as the cause of the UK rebate and should thus be addressed in any own resources reform. This was clearly stated by the UK House of Lords in its 2005 and 2014 opinions on the MFF discussions. In 2005, it expressed the following observation: "Almost all of Britain's excessive budget contribution is now attributable to its low share of receipts, specially CAP receipts" (2005, para. 120). This view was then phrased even more clearly in 2014: "The UK abatement is justified and will stay, until the CAP is reformed and the rebate a residual, fades away" (2014, para. 294). The next subsection analyses whether the UK rebate is justified given the distribution of the funds and illustrates some possible solutions.

9.3.2 What is the impact of the CAP on net balances? Does it justify corrections?

Table 9-1 presents a calculation of the gross contributions to the CAP (only direct payments) in 2014 as a percentage of GNI, assuming that the GNI key is paying for it. In column (1) it shows the contribution to the CAP as share of GNI. Column (2) shows the receipts and (3) the net contribution/receipt to/from this policy.[61] Columns (4) and (5) show what happens to the total

[61] These are direct payment receipts minus the contribution to the CAP, calculated based on their share of EU GNI.

contribution to the EU budget with or without the CAP *before any rebate*. Columns (6) and (7) show the results as a share of GNI.

Table 9-1. Share of contributions to the CAP and net contributions to the policy, 2014

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	Estimated contribution to the CAP as share of GNI	Receipts from the CAP	Net contribution /receipt to/from CAP	Total contribution to the budget (no rebate) operational	Total contribution (no rebate, no CAP) operational	Net contribution as a GNI % (CAP before rebate)	Net contribution as a GNI % (no CAP)
BE	1,173.8	552.4	-621.4	3,020.8	2,069.2	-0.29	0.00
BG	119.4	578.7	459.2	314.3	217.5	4.59	4.88
CZ	421.2	878.7	457.5	1,085.1	743.6	2.15	2.44
DK	772.1	916.8	144.7	1,924.9	1,298.9	-0.29	0.00
DE	8,664.3	5,101.4	-3,562.9	22,241.9	15,217.4	-0.49	-0.20
EE	55.5	99.1	43.5	144.5	99.5	2.58	2.87
IE	465.6	1,226.8	761.2	1,195.6	818.1	0.08	0.37
EL	520.0	2,246.4	1,726.3	1,399.0	977.4	3.05	3.35
ES	3,067.4	4,914.9	1,847.4	7,947.1	5,460.2	0.21	0.51
FR	6,352.5	7,139.6	787.1	16,552.1	11,401.9	-0.27	0.02
HR	121.8	93.2	-28.6	323.6	224.8	0.48	0.78
IT	4,704.4	3,704.6	-999.9	11,828.8	8,014.7	-0.20	0.09
CY	48.3	51.7	3.3	126.5	87.3	0.70	1.00
LV	69.58	143.8	74.2	181.4	125.0	3.53	3.83
LT	102.6	374.1	271.5	259.9	176.7	4.47	4.76
LU	85.9	33.1	-52.8	222.4	152.7	0.22	0.51
HU	293.5	1,284.7	991.2	746.3	508.4	5.70	5.99
MT	22.2	5.3	-17.0	58.2	40.1	2.36	2.66
NL	1,931.1	805.8	-1,125.3	4,951.7	3,386.0	-0.58	-0.28
AT	958.8	695.3	-263.5	2,504.9	1,727.6	-0.41	-0.12
PL	1,154.5	2,982.4	1,827.9	2,916.1	1,980.1	3.54	3.83
PT	498.8	634.5	135.7	1,309.9	905.5	1.99	2.28
RO	427.0	1,259.6	832.7	1,075.1	728.9	3.19	3.48
SI	106.9	130.5	23.6	281.7	195.0	2.20	2.50
SK	215.3	371.5	156.3	529.8	355.3	1.41	1.70
FI	594.6	519.4	-75.2	1,543.1	1,061.0	-0.37	-0.08
SE	1,297.7	679.4	-618.4	3,330.4	2,278.2	-0.49	-0.20
UK	6,338.3	3,160.0	-3,178.3	16,437.6	11,298.9	-0.56	-0.27
Total	40,583.7	40,583.7	0	112,133	71,549	–	–

Source: Authors' calculations using the EU budget tables and data for 2014 from the European Commission's website.

Is the UK rebate justified? That depends on how this is analysed. Some net contributors are net beneficiaries of the CAP, while others, like Germany, are not. In fact, the distribution of CAP direct payments is not directly related to the wealth of a Member State; however, in practice, analyses show an overall regressive relationship, due to the lower yields in most poorer Member States when the reference years were fixed to determine compensatory payments after the 1992 MacSharry reform of the CAP. The original relative level of support for different agricultural products also affects the distribution of the funding today.

The CAP does not favour the UK (as many other Member States) because of the historical allocations based on specific products that were supported more than others. It is also not surprising that those net contributors to the EU budget that receive a 'rebate' on their contribution to the UK rebate are themselves also net contributors to the CAP. At the same time, some other countries in a similar situation do not get a rebate, as a result of receipts from other headings. Overall, the agreements on corrections seem to be merely based on 'tolerable' net balances agreed on an ad hoc basis and mainly a result of the CAP distribution directly or indirectly.

Let us therefore look at the UK case in isolation if the CAP direct payments were abolished. Just using the methodology of operational budgetary balances and looking at the situation *before the rebate*, the fall in the UK's contribution shows that the country would see its gross contribution (excluding external action) fall by an amount similar to the average rebate for the MFF (2007–13) (€5,493 million), namely €5.2 billion (UK column (4) minus column (5)).

Does this amount justify the rebate then? No, because if the CAP were not abolished the UK would also continue to receive payments. The UK receives direct payments (just over €3 billion in 2014). If the CAP were the only reason for a rebate, then the rebate is excessive by more than half its value. Then it may stem from the funding to wealthier regions, which the UK has already considered unjustified on numerous occasions. Yet, the House of Lords has not used this heading to justify the rebate, although, and as mentioned in earlier chapters, the investment generated in the UK from the EU's 'competitiveness funds' may well bring more benefits than costs. Particularly for some instruments, rather than 'excessive, negative net balances', we may be facing 'excessive net investment benefits' in favour of countries benefiting from corrections to their contributions.

What is particularly interesting, if the CAP and the UK rebate were to be abolished, are the positive effects for many net contributors, particularly in the case of France. Despite being a large beneficiary of the CAP, France also takes the brunt of the UK rebate, which is higher than the positive net receipts it enjoys from the CAP.

9.4 FINANCING THE CAP DIFFERENTLY MAY LEAD TO A BETTER BUDGET AND POLICY

Fundamental reforms of the CAP are practically impossible as they would affect net balances, and the lack of reforms in turn blocks own resources reforms. How can the budget be liberated from this chicken-and-egg situation? The first option is to formally link the rebate or part of it to the CAP, but that is not going to suffice. The second option is to rethink the way the CAP is financed.

Instead of the co-financing systems the European Commission has proposed for the CAP, a rational reform to financing the CAP would be to base it on cohesion – a fiscal solidarity approach. Until now the EU has considered co-financing rules while ignoring the financial capacity of the Member States. Poorer Member States that have inherited a CAP and its costly standards would have to pay more for the agricultural sector under this co-financing system as a share of GNI, while already de facto paying for the UK rebate (and corrections on the UK rebate). It is reasonable to consider that support for farming should have a stronger element of cohesion, based on the share of GDP per capita of Member States.

9.4.1 A cohesion-based system of direct payments

A simple example has been devised where the co-financing rates are based on GDP per capita in PPP. For illustration, countries whose GDP per capita is above 100% of the EU average would pay the full, direct payment support, those from 90 to 100% would pay 80%, those between 75 and 90% would pay 50% and below 75% (the cohesion countries) would be fully covered by the EU budget.

The first effect of applying a cohesion-based, GDP per capita formula (in Table 9-2) would be a drastic reduction of the direct payment costs of the CAP – down from €40 billion to under €11 billion under the assumptions above. That is not surprising, given the regressivity of the CAP budget. If we take out the 11 Member States from the 28 that have a GDP per capita of over 100% of the EU average, the budget would fall by more than half. For example, the link with the historical endowments based on farm structures enables France alone to receive nearly a fifth of the funding. While France stands out, it is sometimes less in terms of population size or agricultural land size than other smaller net beneficiaries of the policy that receive considerable transfers even when their farm sector is well developed. The real costs of the CAP are not generated by the restructuring of the farms in newer Member States with the largest problems in the sector, but by a historical legacy of the kind of farming that was most subsidised decades ago.

Under the co-financing system proposed here, the gross contribution to the EU budget for the CAP would fall considerably for a number of Member States. In the case of the UK, the fall would be equivalent to over €4.5 billion, but the actual reduction in the cost to the exchequer would be around €3 billion after co-financing, enough to reconsider the UK rebate. Co-financing should be considered part of a package deal, given the benefits it brings, involving a more rational policy discussion and the removal of barriers for better resources and a better budget.

Of course, this solution does not fully comply with the UK House of Lords opinion (2005 and 2014), that a change in the rebate should be accompanied by a reform of the CAP. *This proposal offers as a first step a change in how the CAP is financed, not the way it works.* Fundamental reform, however, is only possible if the resources and expenditures are dissociated and the main beneficiaries are also responsible for its costs nationally. The conflict on the costs of the CAP is also mainly a dispute between wealthy Member States – mainly between today's net contributors.

Table 9-2. Share of contributions to the CAP and net contributions to the policy, 2014, "cohesion" approach

	(1) National contribution to the CAP now	(2) New contribution to the CAP	(3) Change in contribution	(4) Net CAP balance	(5) Net balance (no rebate today) (%)	(6) Net balance (with rebate today) (%)	(7) New net (no rebate) (%)
BE	1,173.8	309.4	-864.4	-309.4	-0.29	-0.37	-0.08
BG	119.4	31.5	-88.0	547.2	4.59	4.45	4.80
CZ	421.2	111.0	-310.1	328.3	2.15	2.08	2.36
DK	772.1	203.6	-568.6	-203.6	-0.29	-0.32	-0.08
DE	8,664.3	2,284.1	-6,380.2	-2,284.1	-0.49	-0.52	-0.27
EE	55.5	14.6	-40.9	84.4	2.58	2.49	2.80
IE	465.6	122.8	-342.9	-122.8	0.08	0.02	0.30
EL	520.0	137.1	-382.9	986.1	3.05	2.89	3.27
ES	3,067.4	808.6	-2,258.8	174.3	0.21	0.10	0.43
FR	6,352.5	1,674.7	-4,677.9	-1,674.7	-0.27	-0.33	-0.06
HR	121.8	32.1	-89.7	61.1	0.48	0.42	0.70
IT	4,704.4	1,240.2	-3,464.2	-499.3	-0.20	-0.28	0.01
CY	48.3	12.7	-35.6	13.1	0.70	0.69	0.92
LV	69.6	18.3	-51.2	125.4	3.53	3.35	3.75
LT	102.6	27.1	-75.6	347.1	4.47	4.38	4.69
LU	85.9	22.7	-63.3	-22.7	0.22	0.27	0.43
HU	293.5	77.4	-216.2	1,207.3	5.70	5.64	5.91
MT	22.2	5.9	-16.4	-3.2	2.36	2.35	2.58
NL	1,931.2	509.1	-1,422.1	-509.1	-0.58	-0.71	-0.36
AT	958.8	252.8	-706.0	-252.8	-0.41	-0.38	-0.19
PL	1,154.6	304.4	-850.2	2,678.1	3.54	3.47	3.76
PT	498.8	131.5	-367.3	185.8	1.99	1.88	2.20
RO	427.0	112.6	-314.4	1,147.1	3.19	3.09	3.41
SI	106.9	28.2	-78.7	37.1	2.20	2.17	2.42
SK	215.3	56.8	-158.5	129.0	1.41	1.37	1.63
FI	594.6	156.8	-437.9	-156.8	-0.37	-0.40	-0.15
SE	1,297.7	342.1	-955.6	-342.1	-0.49	-0.52	-0.28
UK	6,338.3	1,670.9	-4,667.4	-1,670.9	-0.56	-0.23	-0.34
sum	40,583.7	10,698.8	-29,885.0		–	–	–

Source: Authors' calculations using the EU budget tables and data for 2014 from the European Commission's website.

9.4.2 An alternative co-financing system

There are a number of variations that could also be adopted and one of these is presented in Núñez Ferrer (2008) for the EU-15, based on the added value of farming in Member States. This system makes the EU co-financing level more progressive. The concept is that the rate of EU co-financing is inversely correlated with the added value of the sector. This means that indirectly, the wealthier the farming sector in a country and the more it contributes to the nation's wealth, the more this generated wealth is used to finance its own subsidy. The results are complex, but it more clearly reveals the imbalances within the agricultural sector in the subsidy levels and encourages debate on a more rational allocation of support.

9.4.3 Additional arguments in favour of such an alternative co-financing system

Short of reforming the CAP, the approaches presented above alleviate the net balance problems of the EU budget and open the door to a new (and likely healthier) policy debate. Detractors would likely claim that such approaches represent a distortion of the markets. That is not true, first because the support levels would not change without a reform agreement. The approaches change how the support is paid, not how much is paid. Second, the direct payments are decoupled, and the EU defends them at the WTO as non-market distortive. The payments cannot be defended externally by the EU as non-distortive while claiming internally that if co-financed they would be a market distortion.

Of course, reforming the way the policy is financed would most likely spark a debate on reform, which may well be very healthy. The CAP policy as it is today is distorting the agricultural sector. It presents elements of regressivity in the support levels and distribution, generating actual unfair competition at the EU level between farmers. These effects stem from the link to historical allocation levels to support the farming sector, based on a logic that is no longer valid. Adjacent regions in Europe with similar farming structures can have widely different support levels per farm despite similar cost structures, only because they fall on different sides of a national (or sometimes even regional) border. A single market needs single support systems treating farmers the same based on justified and estimated needs. What this reform might well do is launch a debate as part of an active search for a better policy, rather than for ways to ‘maximise payments from Brussels’ while seeking to avoid ‘excessive’ net balances based on ad hoc political decisions.

PART IV. REACHING AN AGREEMENT – THE BUILDING OF A PACKAGE DEAL

10 BUILDING A PACKAGE DEAL

Chapter 10 in a nutshell

- Negotiating a reform of the EU budget financing in package deals will make it more palatable to possible opponents.
- Past reforms have always involved package deals.
- Reforming at least some expenditure items – especially the CAP and structural funds – to better focus the budget on EU added value is probably necessary to make a new resource acceptable.
- The distributional consequences of the new resource may have to be addressed, but need to take into account more than just net balances and should be linked to actual issues on the expenditure side.
- The costs of the status quo and the opportunities offered by an inter-parliamentary conference could create the political impetus necessary to make progress in reforming the own resources.

Part III presented the foundations for novel package deals, yet it is important that deals combine a number of tools that make sense for Member States. Individual elements may be rejected by those who feel disadvantaged, but a package of measures may well reduce the resistance to change.

Changes can only occur if the following points are acknowledged in any discussion of the EU budget:

- The fact that the EU budget has changed dramatically over the last decades, particularly in its objectives, must be taken into account.
- If Member States are concerned about the net balances – the benefits and costs of the EU budget – the new system needs to consider the wider financial flows generated, e.g. by financial instruments.
- It is time to review what the EU budget should be for in a rapidly changing internal and international environment. What should the EU finance centrally and what could it live without? This means reviewing the EU budget headings, in particular the costs of policies like the CAP and also possibly cohesion.
- Existing rebates are today only vaguely justified. It is important that they are made part of the package deal and are tied to specific policies or explicit distribution objectives.

This chapter addresses various aspects of the reform strategy. There are specific criteria that need to be applied in future discussions on the EU budget own resources:

- Many of the budget expenditures used today in the calculation of net balances are now targeting key EU objectives. Even for the expenditures allocated to Member States, particularly the Cohesion Policy, that is the case. They have an EU added value with many of their parameters set by 'older' Member States, many of them net contributors. It is inadequate to include in the net balance calculations and corrections any of the funding targeting key EU objectives.

- The financing of headings with high EU added value, which are managed at the EU level, such as Horizon 2020 or the Connecting Europe Facility, should not be included in the net balances. Similarly, administrative expenditures should not be part of any correction mechanism.
- Corrections to the contributions of Member States should not be based on net balances, but clearly linked to policies that specific Member States demanding a rebate wish to be improved.
- An own resources agreement could then also include clauses on reviews and reforms of specific policies in a particular timeline.

This report offers enough evidence to demonstrate that a net balance approach is no longer tenable and the Member States should shift from a net balance mentality to one centred on impacts, at least for a large part of the budget.

The only possible approach to introducing reforms in the right direction is through package deals connecting the own resources reforms to step-by-step improvements on the expenditure side. Given past experience, reform proposals for own resources in the MFF negotiations have not been very successful. Thus, a new strategy is needed when linking own resources with changes in expenditures. How could this work?

First, it is of paramount importance to identify the policies that Member States do not perceive as having EU added value. The abolition of corrections could be made 'subject to' reforms with specific outcomes for specific contentious policies. The novel approach presented earlier could be used for this purpose. Some authors advocate lump-sum corrections that are independent of policies and just guarantee a certain level of net balances, such as the enhanced correction mechanism reviewed by Benedetto (2012). Yet such mechanisms just magnify the ad hoc nature of corrections and do little to encourage improvements in expenditure policies. They also keep the budget anchored on the idea that countries 'deserve' a return from the budget, regardless of the wealth of the country or the purpose of the policy. Apart from making the EU budget probably more opaque and complex, the benefits are scant. Also unaccounted for are the full financial flows or any benefits from the EU or the EU budget from investments.

In their edited volume on *European Union Budget Reform*, Benedetto and Milio (2012) analysed the options for reforming the division of spending in the MFF. Package deals, including ones more ambitious than those considered in the negotiations leading to the MFF, are viable and were proposed. Whereas it is easier to deliver these reforms in spending, notably during the review of the MFF in 2016, linking changes to revenue with other policy outcomes may be more productive.

The specific problems of the eurozone, notably in macroeconomic management, may also provide opportunities for package deals relying on enhanced cooperation and involving only this subset of EU Member States. Indeed, in recent years, the idea of a 'fiscal union' that would complete the monetary union has been aired in various circles, and the Council presidency has attempted to provide a roadmap. Additionally, there have been various proposals to create specific funds to address common problems of eurozone countries, such as an EU unemployment insurance and a public debt redemption fund. The possible ways in which a reform of the financing instruments may gain momentum if combined with other policy innovations in the eurozone or in other domains of common interest, like the migrant crisis or security, are analysed in this chapter.

10.1 Reaching an agreement – Lessons from the past

As discussed in section 5.1, a reform to own resources is most likely when accompanied by a reform to spending. It could also be made conditional on subsequent changes to expenditure or, in the case of corrections for Member States, economic growth. A coalition for change (Lindner, 2006) may be successful if it coordinates its work with demands for change in other sectors. For example, the net beneficiaries could support a reduction of the GNI resource, which presently encourages net contributors to seek spending decreases, even though the GNI resource keeps the contribution of net beneficiaries very low. This is more probable when the costs of stasis rise and – besides budget conflict, immobility and the needs to address crises or to extend the single market into new policy areas – these costs include intergovernmental instruments outside the EU, such as the EFSI and European Stabilisation Mechanism (ESM), which contribute to a de facto budget well above 1% of GNI.

The probability of change increases when Member States confront the fact that the costs of stasis rise. Budget conflicts, immobility and failure to address crises in combination can make the situation unacceptably volatile. Even the existence of the High Level Group on Own Resources and the quick start on the 2014-2020 MFF were unprecedented and clearly signal that the future of the EU finances is a serious subject. In addition, the multiplication of 'emergency' instruments, such as the ESM as well as the EFSI, demonstrate that the actual finances of the EU have little to do with the EU budget and raises questions of governance. In total, running the EU (and particularly the eurozone) has not been a 1% of GNI deal.

Intractable positions in the 1960s and 1980s eventually led, respectively, to the introduction of own resources (Rittberger, 2005) and to their changes (Lindner, 2006). In 1970, this concerned conflict on the financing for agriculture and the budgetary powers of the European Parliament, which was solved. In the 1980s, the questions of the UK's budgetary loss and the need to finance the single market and the enlargements to southern Europe were also addressed .

10.1.1 Link to external developments

Whichever way the people of the United Kingdom decide in the referendum on EU membership, afterwards it may be easier to make plans on own resources reform. This will accompany reforms to the architecture of the eurozone and, concerning the financial sector, a response to the questions raised by controversies such as the LuxLeaks scandal. The FTT and the adoption of corporation income taxes as an own resource come into the mix. Carbon taxes and the ETS are relevant with regard to any policy effect from the conclusions of the UN Climate Change Conference of 2015 in Paris.

An example from the past is the already recognised need to reform the CAP combined with the pressure (or opportunity) of the GATT negotiations, which led to the groundbreaking 1992 reforms (Swinbank and Tanner, 1997). These started the decoupling of support of the policy and a long succession of reforms with profound impacts on the EU budget.

10.1.2 The opportunities an inter-parliamentary conference offers for reaching a deal

The model of the Convention on the Future of Europe of 2002–03 could be used in the Inter-parliamentary Conference, for which delegates from national parliaments will be members. Members of national parliaments at the Convention on the Future of Europe participated in the deliberations alongside the representatives of national governments, MEPs and the European Commission; they joined political groups and the Convention's working groups. Research on the Convention (Crum, 2004; Hug and König, 2007; König and Hug, 2006; Maurer, 2004) has shown that they were important conduits between national and EU-level constitutional decision-making.

Magnette and Nicolaïdis (2004, p. 387) estimate that a third of the delegates from national parliaments at the Convention favoured European integration significantly more than their national governments. The involvement of national parliamentarians in the Convention also gave more power to smaller Member States whose influence at the Intergovernmental Conferences of Maastricht, Amsterdam and Nice had been marginal.

In 2003, the Convention agreed a draft text of an EU Constitution. When representatives from certain national governments signalled their concerns related to some questions on the basis of national interest, they were not joined by their respective national parliamentary delegates. As Crum (2004, p. 10) explains,

> the parliamentarians closed ranks, realising that as the Convention was about to deliver its work to the IGC [Intergovernmental Conference], it was crucial to maintain a united front. Each of the two parliamentary components (national and European) sought to define a limited number of outstanding priorities that were then co-ordinated between the two groups and issued as joint memos.

Delegates from national parliaments were therefore an important part of the coalition that approved the draft EU Constitution.

The research of Tsebelis and Proksch (2007) showed that agreement of a neat Constitutional text was due to tight agenda control by the Convention's presidency, which urged the membership not to take votes but to reach agreement by consensus – a consensus that was sometimes short of unanimity. The presidency also made efforts to include the different types of delegates in the deliberations.

10.2 Negotiating reforms in package deals

Linking the reform of the financing of the EU budget to one or several reforms in other areas would appear to be an effective way to address opposition from different categories of Member States that might be willing to trade off perceived losses on the budget issue against gains on other matters, whether pecuniary or political gains. Such a reform strategy has indeed been resorted to in the past, especially when new resource instruments were introduced in the financing. But not all types of package deals are equally feasible in the present context and some would appear more desirable or more likely to succeed than others.

10.2.1 Past experiences with such package deals

Over the past decades, there have not been many reforms of the budget, especially of its financing. But those that have eventually been adopted, notably the creation of new resources (VAT and GNI in the 1980s) were sometimes accompanied by significant changes in other areas, either within the budget or in other policy fields.

For one thing, the various reform proposals have usually met with opposition from Member States, on different grounds: some have been aroused by Euroscepticism, others by the potential distributional implications of the proposed changes to the financing instruments. The overall cap on the EU budget size, now written into the Treaty as a ceiling on resources, may be seen as a response to both concerns, in that it ensures that net horizontal transfers, however measured, will not be too large. It should be noted in this respect that net contributors have consistently advocated that the overall size of the EU budget should be kept much lower (at around 1% of GNI) than the ceiling of 1.23% written in the Treaty.

In the initial cases, the package deal also involved other commitments to reforms of the expenditure items in the budget. One example is when the VAT own resource was introduced, coinciding with a number of changes in the CAP and in structural policies.

To mitigate opposition from Member States fearing potentially adverse distributional consequences, compensation schemes in the form of various correction mechanisms were progressively introduced, starting with the British rebate decided in the 1984 agreement at Fontainebleau. Over recent years, there has been a flourishing of such rebates on national contributions, with ever more complexity. And in an effort to gain acceptance for a larger budget and introduce more homogeneity in the calculation of rebates, in 2004 the Commission proposed a generalised correction mechanism that would have capped net contributions as a proportion of GNI.

10.2.2 Identifying possible domains for such package deals

Possible areas for package deals in the reform of the own resources may be grouped under four major headings, according to the main kinds of objections that the deals address:

- Concerns about the overall size of the EU budget or possible further infringements of EU policies over national sovereignty may be satisfied by setting stricter limits to revenue or expenditures (or both), either at the aggregate level (total budget), as is currently the case, or at the level of expenditure items, as has been decided for CAP expenditures in the current MFF. It should be clear though that a tighter overall ceiling would run counter to other aspirations, pointing to the need to broaden the realm of EU involvement in common concerns or collective goods, such as the collective handling of migration or security issues, unless it involves reallocations within the budget, i.e. reforms to some common policies (the CAP or structural policies).

- Package deals involving reforms of common policies may also be negotiated for their own sake, i.e. making these policies more efficient and more acceptable by opponents of a reform in the revenue sources of the EU budget. There are many possible avenues, among which those advocated in the Sapir report (Sapir et al., 2003) are probably the most articulated from the point of view of economic analysis, even though they are also debatable.

- Concerns over the distributional consequences of an own resource reform across Member States may be dealt with by means of correction mechanisms, by redesigning the distributional aspects of existing common policies or by instituting compensating transfers. The first avenue was the one chosen by the Commission in 2004 with the generalised correction mechanism. It should be clear, however, that given the conceptual weaknesses and arbitrariness in the current mode of calculation of net contributions, that such compensations or corrections would have to be based not on net balances, but on a more reliable and better suited fairness indicator (such as GNI) and a real link to disputed headings (see section 9.1). Resorting to lump-sum transfers to compensate for the distributional impact of an EU tax would in general be more appropriate from an economic efficiency (incentive) standpoint, but again the rationale should be more solid than the proposals presented by the European Commission in 2011. These limited considerations lead to the conclusion that mechanism design and incentives would be key ingredients in the creation of such generalised correction mechanisms.

- Introducing more than one new own resource may also lead to broader agreement. Indeed, as shown in previous chapters, each of the candidates reviewed would entail a specific distribution of financial burdens among Member States and have a specific incidence on various categories of economic agents. Combining two instruments, in addition to the residual GNI contribution, might be an effective way of gaining support. An additional advantage of such packages would be the choice of initially very moderate rates for the new own resource instruments. An example of such a package would be a combination of an EU CIT and a carbon levy of some form.

- In the specific case of a separate budget for the eurozone, there may be many elements to include in possible package deals. One major consideration pertains to the change that (partly) substituting national contributions with genuine own resources would make in the calculation of national public deficits. In general, of course, if macroeconomic stabilisation of various kinds (see below) is to be an objective of the eurozone budget, then the way in which the aggregate fiscal stance of the eurozone is assessed becomes important. Addressing the eurozone budget would require a much wider analysis and the legal and practical problems go far beyond the implications of finding new resources for the EU budget. In chapter 11, section 11.1, we discuss the elements of a eurozone budget.

10.3 REFORMING RESOURCES IN ISOLATION OR IN CONJUNCTION WITH EXPENDITURE REFORM?

Restricting reform solely to the revenue side of the EU budget has many advantages. First and most importantly is that it does not open the Pandora's box of rethinking the nature and distribution of EU expenditures. Another advantage lies in the procedural separation between decisions on expenditures and decisions on financing, a feature that is common to many (most?) parliamentary processes.

The pros of negotiating a joint reform of the revenue and expenditure sides of the EU budget have to do with at least two, somewhat interrelated, reasons. One is the political aspect of disagreements over the budget: those Member State governments that more strongly oppose reforming the current financing scheme are often also those most critical of the present structure of expenditures; it might thus be easier to reach an agreement on a joint reform than on reforming just the revenue side. The second reason has to do with distributive issues: most, if not all conceivable reforms of the financing of the EU budget would lead to distributions of financing burdens that differ from the current scheme; trying to reach a satisfactory balance by acting on both revenue and expenditure could therefore ease the negotiation.

The nature of expenditures in the EU budget is, to a significant extent, redistributive. Various items in the structural and regional funds are explicitly so, among regions. And expenditures in the first pillar of the CAP are pure income support for farmers. On the other hand, potential increases in some existing expenditure items, such as the research policy, the Connecting Europe Facility, centrally managed innovation and competitiveness funds and financial instruments, those under the Juncker plan or the plan to fight youth unemployment are partially counterbalancing the redistributive, pre-allocated budget items (see chapter 3).

The already altered balance between funding supported by the budget for redistribution and non-geographically reallocated funding requires a rethinking of the relationship between the resources and expenditure headings.

Linking the resources and expenditure sides of the EU budget in a package deal does not need to require simultaneous reforms on both sides, but an agreement where the phasing-in of a new resource system is subject to progress on the expenditure side.

10.4 COMBINING THE ELEMENTS OF A PACKAGE DEAL

Package deals in own resources proposals in the past generally concentrated on offering correction mechanisms or lump-sum transfers to Member States unhappy with the net contributory impacts. These approaches failed, because the proposed mechanisms did not address the causes of dysfunction of the present system. The House of Lords reports on the MFF make it overwhelmingly clear that without a reform of the CAP or phasing it out of the EU budget there will be no reform of the rebate, which means no sensible solution on own resources.

A successful package deal, combining a number of elements that can be agreed by all Member States, is possible, even if highly complex. ***Table 10-1*** lists the elements emerging from the different chapters of this report. The package could combine all of them or only a few.

Table 10-1. Potential elements of a package deal

Element	Description of package element
1)	Commit to a budget driven by EU added value and clear objectives with better monitoring and flexible approaches. The commitment has to be accompanied by a deep and detailed review of measures financed by the EU in the Mid-Term Review – going beyond the main headings to the level of actions that the EU budget allows.
2)	Commit to agree to a substantial reform of the expenditure based on the results of the Mid-Term Review, making parts of the own resources agreement subject to steps in the reforms. New resources could be phased in according to milestones achieved in reforms.
3).	Identify all headings that have to be excluded from any correction calculation (which could go down to sub-headings) in addition to the heading for external action, such as R&D support, administrative expenditure, the Connecting Europe Facility, funds allocated for financial instruments, internal policies, structural funds for EU objectives and EU added value.
4)	Introduce a co-financing system for the CAP, preferably with an emphasis on cohesion or linked to the added value generated by farms (the level of co-financing would be based on the level of added value (wealth) generated by the sector to the economy). The EU co-financing would be lower, the higher the added value.
5)	Link any corrections to specific headings that Member States do not agree fulfil EU added value criteria, and in cases where costs or benefits are disproportionate compared with Member States in a similar situation. Corrections have in all cases to be justified, and terms agreed on reform targets and explicit conditions for removing the corrections. Corrections would remain or fade depending on the progress in resolving the policy bias negatively affecting the Member State(s) concerned.
6)	Increase flexibility substantially, possibly through the creation of a funded budget heading for unforeseen events.
7)	Incorporate the ETS revenues as own resources for the EU budget.
8)	Institute a carbon tax, which could be combined for those disadvantaged with investment in decarbonisation programmes.
9)	Introduce a corporate income tax after a common base has been established.
10)	Introduce of a real VAT rate for those items where all Member States apply VAT.

11)	Use a GNI key either to finance the residual on a simple GNI share base or other adapted wealth-based approach, but while accepting that the resources are fully owned by the EU.
12)	If some of the resources are not accepted as fully owned, calculate the residual GNI contribution so as to ensure that all pay the same share.
13)	Introduce the FTT in those countries that wish to join an enhanced cooperation procedure. The funding raised could be treated like fully owned resources. Other Member States would then pay the residual through a GNI resource.
14)	If item 13 above is not accepted because of the benefits for those not participating, agree on a compensatory additional contribution to the EU budget by non-participating Member States, based on some common method of calculation. This may be on a GNI share based on the case where the budget would have been fully financed by the GNI resource.
15)	Possibly exclude EU budget contributions from the stability pact, as this revenue is attributed to the EU budget.

Source:

What the above list implies in its first lines is that a deal offering steps for expenditure reform in exchange for changes in the resources is most likely the only approach to move forward and with a diplomatic effort starting as early as possible.

The identification of headings that are not to be covered by rebates could open the door to own resources that approximately cover the expenditures with a recognised high EU added value or commonly agreed as an EU objective. This means that the new resources attributed to these expenditure items fully preserve the universality principle. If the Member States agreed that 60% of the budget could be considered uncontroversial, then own resources that raise 30, 40, 50 or up to 60% of the budget should not be too controversial either.

Immediate candidates for careful review on the expenditure side of the EU budget are the CAP and structural funds, jointly accounting for almost three-quarters of the total. The study by Sapir et al. (2003) and critical replies by a number of scholars (e.g. Le Cacheux and Sterdyniak, 2003), as well as more recent analyses (e.g. Núñez Ferrer and Tarschys, 2012) discuss in some detail the reasons for wanting to reorient expenditures. In particular, some degree of renationalisation of the expenditures under the CAP first pillar in line with chapter 9 might be considered, and the distributive consequences could be balanced against those of adopting a new financing scheme for the EU budget. This would change the dynamics in the policy while maintaining a level of policy coherence.

PART V. A VIEW TOWARDS THE FUTURE – OWN RESOURCES FOR WHICH UNION(S)?

This part looks beyond the EU budget, considering the realities relative to the existence of the eurozone, which needs specific instruments for stability. What role should the EU budget have in the stability of the eurozone? What other areas should the EU budget cover, if any?

11 THE THORNY QUESTION OF THE EUROZONE BUDGET

Chapter 11 in a nutshell

- The EU budget was not designed to handle sudden changes or a balance-of-payments (BoP) crisis, but it has used the budgetary margins to guarantee operations in the financial markets to offer BoP support.
- The lack of sufficient margins and the deepening of the crisis have led to the creation of the ESM, which can be considered the embryonic stage of a eurozone budget.
- From a macroeconomic policy standpoint, a eurozone budget is necessary, but its development is fraught with institutional and political challenges.
- An issue to address is its mandate: How would it operate? Would it have automatic stabilisers? Unemployment support systems?

The EU budget was not designed to address stability in the eurozone. Despite arrangements to use the margins between the commitment ceiling and the EU budget ceiling, the crisis could not be managed, leading to the creation of an external stabilisation mechanism and ultimately the present ESM, de facto an embryonic eurozone budget carrying some degree of public debt mutualisation.

Integrating the needs of the eurozone into the EU budget would require a fundamental transformation. One option could be to increase the EU budget ceiling considerably, which now stands at 1.23% of GNI, to up to 2 or 3% of EU GNI. This option would require altering the payment and commitment ceilings of the EU budget operations. New rules on the way stabilisation transfer could operate through the EU budget would need to be set up, clearly delineating the obligations and exceptions of non-eurozone Member States. The first section of this chapter presents the way the EU budget has operated as a stabilisation mechanism for the BoP crisis, and the development during the financial crisis. The subsequent sections discuss the potential role of a separate eurozone budget.

The institutional implications are considerable. The eurozone problems cannot be easily 'fitted' into the EU budget, but the crisis has highlighted the failure of the EU to develop a fiscal capacity that matches the challenges of the EU.

11.1 A SINGLE BUDGET? A EUROZONE BUDGET?

It is difficult to find a direct relevance of the EU own resources question for the eurozone, except insofar as the choice of a revenue source entails specific considerations in this context. But it is certainly true that the eurozone has suffered severely from the lack of a unified 'fiscal pillar', which is regarded as a requirement for a single currency area.

The budget of the EU has been the subject of quasi-permanent changes from the very beginning of the European Coal and Steel Community until today. The creation of the EEC, Euratom, the fusion of the three communities, the successive enlargements and the introduction of new policies and new financing instruments all resulted in important changes to the budget as did, also, the introduction of the ERDF.

Yet, up to the establishment of the EMU, each country entered with its own currency, creating a need for a common currency unit, termed the Unit of Account and later the ECU. A country entered also with its specific structure of institutions and governance, existing policies, laws and regulations, standards of performance, accounting, and intra-government fiscal and monetary relations. And not least, a country entered with the Treaty obligation to adopt the single market *acquis*, but not to introduce new systems of governance or European standards of reporting and accounting.

More than a decade later, however, the relative success of the European Monetary System gave rise to the launch of effort to move towards a comprehensive EMU and the creation of a common currency. The report on EMU written in 1989 by the Delors Committee presented a number of warnings that a monetary union without substantial fiscal integration would be an incomplete and dangerous monster. The EMU was nevertheless agreed by a number of EEC Member States in Maastricht and the EMU came into being in 1999 without any increase in the EU budget and without fiscal integration, with the exception of a protocol fixing limits for government debt and deficits, the so-called Maastricht criteria. Calls in the Delors report for rules giving the Council the right to take binding decisions were met only with the later adoption of a stability and growth pact as a framework for intensified coordination (Mortensen, 2013 and 1990).

11.2 THE EUROZONE AND MACROECONOMIC STABILITY IMPLICATIONS FOR THE BUDGET AND OWN RESOURCES

The absence of a 'fiscal capacity' has had repercussions in the sovereign debt crisis that followed the 2009 recession in the eurozone. The crisis has forced Member States and the EU institutions to create a series of new macro-financial stability instruments leading to the ESM. Such action could have been avoided, along with some of the damage from the crisis, if the EU budget had included, in addition to its functions of transferring funds between Member States and funding some limited programmes, specific budget lines for fiscal stability like those of federal states (Giovannini et al., 2012). Of course, the budget lines would have needed appropriate countercyclical funding and this is relevant to the own resources question. As a consequence of the lack of a 'fiscal pillar', the eurozone has experienced an episode of severe macroeconomic and financial instability unseen anywhere else. To be correct, the EU budget already had a very limited instrument for supporting BoP facilities for non-euro members: a very small and opaque instrument mobilising unused margins of the EU budget as guarantees for funds raised for macro-financial assistance. It was an instrument too small for the EU to use in the case of a major crisis and legally unavailable for assistance within the eurozone.

The difficulties encountered to stabilise the eurozone have raised the question of whether the EU should not have a separate budget for the eurozone, consisting of cyclical revenues (e.g. taxes such as those on corporate income) and used to finance countercyclical spending (assistance to areas in need, support for the unemployed) – a kind of federal budget the ESM cannot emulate. In other words, having a eurozone budget that behaves like a federal budget in parallel with the EU multiannual programme and project-based budget. A detailed proposal was prepared by the French Ministry of Economy and Finances (2013). Such a budget has not transpired and we only have the ESM, which does not operate in this way. The eurozone budget presented by the French government could be considered an enhanced EU budget with real countercyclical own resources. The task is to explore both the extent to which the EU budget could exercise a stabilising function in the eurozone with the appropriate resource mechanism and the implications for the EU budget financing of the set of fiscal rules (Six Pack, Two Pack and Fiscal Compact) (Mortensen, 2013).

11.3 THE BUDGET IN A CHANGING EUROPE

The EU has seen momentous changes since the creation of the EEC, such as deeper integration, the emergence of the single market, several rounds of enlargement and the introduction of the single currency. The EU has evolved dramatically since the CAP was introduced, the UK rebate was devised and the Cohesion Policy was launched. The EU budget however, seems to have remained relatively static in terms of the proportion of EU GNI, priorities and headings. Similarly, the own resources mechanism has not evolved, retaining the logic of 'excessive' net contributions, a questionable term within a single market and among countries in a single currency area. To some extent, the own resources have regressed from a political point of view, from being largely financed by EU-owned resources (resources raised and allocated to the EU) to one of transfers from Member State treasuries.

This growing mismatch between the structure and operations of the EU budget and the needs of the EU led the well-known Sapir report of 2003 to present the EU budget as a "historical relic" (Sapir et al., 2003). Twelve years later and after the greatest crisis since the Great Depression we have not seen many advances.

11.4 ROLE OF THE EU BUDGET IN MACRO-FINANCIAL STABILITY

No instrument was set up to address the impact of imbalances in the eurozone and the financial crisis has revealed the eurozone weaknesses in this respect. The EU budget was and still is not designed to handle such shocks and has been largely ineffective in responding, even if a number of ad hoc measures have been introduced.

Consequently, Europe has paid dearly for the lack of a fiscal and budgetary capacity of the EU to address imbalances in the single market and the eurozone when hit by the crisis. The lack of coordination and the long lag in devising responses have most likely deepened the crisis and slowed down recovery.

Many problems in the eurozone area were to be expected – the need for an appropriate instrument for a single currency area has been well documented and the findings of the 1977 MacDougall report are as valid today as they were then (MacDougall et al., 1977). Many analysts have subsequently confirmed this, before and after the shock of the crisis. The introduction of the euro has taken place without a fiscal support structure to handle imbalances in the eurozone. With funding pre-allocated geographically and committed to support automatic payments in sectors (agriculture) or multiannual programmes in regions, it simply is largely inappropriate to mobilise funding rapidly where needed to stabilise markets, refinance banks and rescue governments from BoP crises. Once the financial crisis hit the EU, it became apparent that the design and inflexibility of the budget made it ineffective as a response mechanism for the imbalances in the eurozone. This inflexibility is visible in relation to both revenues and expenditures.

Nevertheless, and much to the credit of the European Commission, the limited margins of flexibility of the EU budget on the resources and the expenditure sides were used and stretched considerably, changing the co-financing rates for the worst stricken countries. But it remains a fact that the response to the financial crisis has been patchy, controversial and too limited. The EU was not equipped to react and the EU budget was not designed to handle any significant crisis, which, from a public perception point of view, has affected the image of the EU and its budget. Still, even if the EU budget had been larger or doubled in line with the MacDougall report, and had a mandate to intervene, Obstfeld (2013) notes that banking systems have become too big for any national budget and thus also for the EU budget.

It is interesting to note the resilience of the EU budget resources and expenditure mechanisms in the face of the gravest financial crisis since 1929. It would have been rational to expect that given the exceptional circumstances and the existence of a budget review in 2010, one of the hardest years of the crisis, Member States would have agreed to seriously reform the own resources and the budget structure. That, however, has not been the case; the decision-making mechanism is designed in such a way that it creates strong disincentives for Member States to agree on radical changes.

The measures have been partial: on the expenditure side there have been reductions in the co-financing requirements for Greece in the Cohesion Policy, some limited reallocation of resources between headings and the introduction of more budget guarantees for financial instruments. On the resources side, the use of present and estimated future EU budget margins has been increased as guarantees for macro-financial assistance.

While this flurry of partial measures is undoubtedly without precedence and 'revolutionary' compared with the usual state of affairs of the EU budget, they can hardly be seen as commensurate with the challenges faced by the EU. It is thus no surprise that separate, sizable mechanisms worth a multiple of the EU budget (e.g. the ESM) have emerged to face macroeconomic imbalances and that the idea of establishing a eurozone budget has been circulating.

11.4.1 The functioning of macro-financial instruments linked to the EU budget

Until the financial crisis, only two instruments for macro-financial stability existed, but only for non-eurozone Member States and non-EU countries – the BoP assistance mechanism for non-eurozone Member States and Macro-Financial Assistance (MFA), established in 2002 (Council Regulation (EC) No. 332/202). In fact, the BoP mechanism was adopted in 1988 (Council Regulation (EEC) No. 1969/88).[62] The instrument was designed to intervene before the introduction of the single currency, which was expected to cancel the need for such instruments. The Regulation only remained in force until 1999 with the entry of the euro. It was later reactivated in view of the enlargement and the risks of new Member States needing assistance. It was revived and amended in 2002 (Council Regulation (EC) No. 332/2002)[63] for non-euro Member States and with a support ceiling that was even slightly reduced compared with the original (€12 billion compared with the real value of €16 billion of the 1988 instrument).

The MFA instrument was specifically designed to support partner non-EU countries experiencing financial crises, and has been in action since 1990.

Both instruments are supported by the EU budget, but are largely unknown, as the implications for the expenditures are indirect and the financial mechanism complex and opaque. They represent, however, the model on which the first stability mechanism for the eurozone was based.

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[62] See Council Regulation (EEC) No. 1969/88 of 24 June 1988 establishing a single facility providing medium-term financial assistance for Member States' balances of payments, OJ L 178, 8.7.1988.

[63] See Council Regulation (EC) No. 332/2002 of 18 February 2002 establishing a facility providing medium-term financial assistance for Member States' balances of payments, OJ L 53/1, 23.2.2002.

11.4.2 Legal barriers to stabilisation mechanisms

At the outset of the eurozone crisis, two legal provisions seemed to contradict one another on the role of a possible mechanism for eurozone fiscal stabilisation. On the one hand, the EU is required as specified in the Treaty (Art. 143 TFEU) to intervene when a country encounters financial difficulties or threats to its economic stability. On the other hand, the so-called 'no bailout' clause (Art. 125 TFEU) seems to prohibit EU assistance to eurozone Member States (or at least guarantees for their national debts). In effect, this has limited assistance to the non-eurozone members.

Eurozone members de facto considered (and against economic theory claiming the contrary) that the stability and growth pact (based on Arts. 121–26) would ensure the stability and effective budgetary oversight of the eurozone, something the crisis demonstrated to be untrue.

After various failed attempts to manage the impacts of the crisis without challenging the existing provisions, i.e. having Member States handle the crisis without coordination, the Member States agreed that additional specific mechanisms had to be designed. The Greek crisis had already forced the EU to take extraordinary action by launching the Greek loan facility. In 2010, and based on the mechanism in place for the BoP assistance, the EU introduced the European Financial Stability Mechanism (EFSM) (Council Regulation (EC) No. 407/2010).[64]

These responses were clearly not sufficient to enable the eurozone to respond to the unfolding crisis. A temporary mechanism was created outside the EU budget, the European Financial Stability Facility (EFSF) by the eurozone Member States that provided assistance to Ireland, Portugal and Greece. The European Council adopted an amendment to the TFEU on 25 March 2011, adding a new paragraph to Art. 136: "The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the eurozone as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality." This amendment allowed the subsequent establishment of the permanent ESM that replaced the EFSF, also not linked to the EU budget.

What, however, are the implications of these mechanisms for the EU own resources? The BoP, EFSM and MFA have in common the fact that it is the EU budget that guarantees the support given. The European Commission (in accordance with the Council) is authorised to borrow on the capital markets or from financial institutions in order to finance the loans, as was the case with the BoP. This happens mainly by issuing notes under the Euro Medium-Term Note Programme. They are intended primarily for securities. EU assistance is of a medium-term nature – ranging normally from 5 to 10 years, but can go up to 15 years, according to the particular conditions of the loans.

Since the activation of the EFSM for Ireland and Portugal, the EU has become a frequent benchmark issuer (Figure 11-1): since 2011, around €54 billion has been raised through 15 issues of bonds. The funds raised are in principle lent back-to-back to the beneficiary country, i.e. with the same coupon, maturity and amount. Annual interest and principal obligations range from €1.3 billion in 2012 to a maximum of €10 billion in 2021.

[64] See Council Regulation (EU) No. 407/2010 of 11 May 2010 establishing a European financial stabilisation mechanism, OJ L 118/1, 15.5.2010.

Table 11-1. EFSM operations

Amount (€ billion)	Maturity (years)	Raised on	Beneficiary	Disbursement on
5.0	5	5 Jan. 2011	Ireland	12 Jan. 2011
3.4	7	17 Mar. 2011	Ireland	24 Mar. 2011
4.75	10	24 May 2011	€3 billion for Ireland; €1.75 billion for Portugal	31 May 2011
4.75	5	25 May 2011	Portugal	1 Jun. 2011
5.0	10	14 Sept. 2011	Portugal	21 Sept. 2011
4.0	15	22 Sept. 2011	€2 billion for Ireland; €2 billion for Portugal	29 Sept. 2011
1.1	7	29 Sept. 2011	€0.5 billion for Ireland; €0.6 billion for Portugal	6 Oct. 2011
3.0	30	9 Jan. 2012	€1.5 billion for Ireland; €1.5 billion for Portugal	16 Jan. 2012
3.0	20	27 Feb. 2012	Ireland	5 Mar. 2012
1.8	26	17 Apr. 2012	Portugal	24 Apr. 2012
2.7	10	26 Apr. 2012	Portugal	4 May 2012
2.3	15	26 Jun. 2012	Ireland	3 July 2012
3.0	15	23 Oct. 2012	€1 billion Ireland; €2 billion Portugal	30 Oct. 2012
2.6	10	18 Mar. 2014	€0.8 billion Ireland; €1.8 billion Portugal	25 Mar. 2014
0.4	15	5 Nov. 2014	Portugal	12 Nov. 2014
7.16	15	–	Greece	20 June 2015

Source: European Commission, DG ECFIN website.

How can the EU budget guarantee such operations? The BoP can lend up to €12 billion, but the EFSM can loan up to €80 billion and even be increased to €110 billion (European Commission, 2010c). The EFSM was designed for supporting eurozone Member States, but does not exclude support to non-eurozone countries.

The BoP and EFSM cannot be guaranteed by blocking the EU budget repayments for the year, given the considerable side effects on the budget appropriations within the budget ceilings for payments and commitments. That occurs only for the MFA, it is rather modest and the guarantee required is blocked yearly in the EU budget; thus, a default on a payment is secured without an impact on the EU budget size. But that is not the case for the BoP and the EFSM, which are guaranteed by the margin between the EU budget's own resources ceiling of 1.23% of GNI and the payment appropriations. This margin cannot cover the whole loan, but the annual repayment default risk. Of course, the EU budget margin is limited every year and cannot grow to be an efficient lender for rescue packages as required. External mechanisms have therefore been set up for the rescue packages. Those mechanisms, the EFSF and subsequently the ESM are or have been guaranteed directly by the Member States and imply no consequences for the EU budget, and hence are not discussed here.

11.4.3 Impact of the macro-financial instruments on own resources

The budget lines for the BoP, EFSM and MFA loans are listed under heading 01 04 01 ("European Community Guarantees for lending operations and for EIB [European Investment Bank] lending operations"):

- *01 04 01 01* – European Union guarantee for Union borrowings for balance-of-payments support;
- *01 04 01 03* – European Union guarantee for Union borrowings for financial assistance under the European Financial Stabilisation Mechanism; and
- *01 04 01 04* – European Union guarantee for Union borrowings for Macro-Financial Assistance to third countries.

Each line includes references to the volumes, the duration and the basic acts. In addition, budget line 01 04 01 14 shows the sum of the "Provisioning of the Guarantee Fund" for all Union and Euratom borrowing operations and for EIB lending operations.

The risk exposure of the MFA is very limited, because it is recorded as part of the EU budget expenditures in the Guarantee Fund for external actions (as a safety net), which is also used to guarantee loans by the EIB to third countries. The amounts of the financial assistance provided in grants under the MFA must be consistent with the budget appropriations established in the MFF, in accordance with Council Regulation (EC, Euratom) 480/2009 of 25 May 2009 on the Guarantee Fund for external actions.[65]

That is not the case for BoP and EFSM assistance. Here the EU budget sets aside the guaranteed annual repayment obligations of countries to the EU budget in the EU budget's margin between payment appropriations and the EU budget ceiling. It is under a 'token entry' or *pour memoria*. Thus, budget lines 800 for BoP and 802 for the EFSM have been created on the revenue side to account for any potential reimbursements after an initial default or for any other revenue arising in connection with the guarantee provided by the EU budget. In other words, if a default happens, the Member States must add to their EU budget contributions their share of the costs of a default in line with the own resource procedures.

11.5 RISKS TO WHICH THE EU BUDGET IS EXPOSED BY THE BOP AND EFSM FACILITIES

Giovannini et al. (2012) summarise and analyse the exposure of the EU budget to risks, based on the European Commission's working document on guarantees covered by the EU budget (European Commission, 2011c). The risks noted by the Commission are market or currency risks, interest rate risks, credit risk and liquidity risks (ibid.). Undoubtedly, the design of the BoP and EFSM mechanisms ensures that the risks are greatly minimised, so that the EU budget is exposed to a clearly 'ring-fenced' risk. One risk the Commission does not discuss is political risk.

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[65] See Council Regulation (EC, Euratom) 480/2009 of 25 May 2009 establishing the Guarantee Fund for external actions, OJ L 145/10, 10.06.2009.

Market risk. This is mainly an exchange rate risk, and is important if the assistance is not in the euro currency. Both the BoP facility and the EFSM assistance are provided in euros and exchange rate fluctuations are to be borne in full by the country benefiting from the assistance. This element would have greatly concerned Greece, for example, in the case of an exit from the eurozone. A devaluing national currency would actually increase the debt value in euros, making the country bear all costs and reducing any potential advantage of such devaluations, especially when the debt-to-GDP ratio is very high.

Interest rate risk. The terms of repayment are determined back-to-back, mirroring the requirements of the bonds issued or any form of loan raised in the markets, including any management costs or interest. The EU budget is protected against the interest rate risk, as the EU is just an intermediary channel. In principle, the EU budget would never have to be called upon to cover unforeseen events in addition to an actual default of the Member States in its commitments, and the terms and interest rates are well known.

Credit risk. This represents the most important risk that the EU budget has to bear under the budget ceiling of 1.23% of GNI. When the margin between commitments and payments is large there is no problem. However, there are two risks: unforeseen events may affect the margins, owing to the need to increase the payment appropriations if these have been underestimated either because the implementation of commitments is higher than expected or because additional expenditures were needed. The credit risk is not just theoretical. The recent problems with annual budgetary procedures caused by the accumulated commitments surpassing the estimated appropriations for payments show that margins can be under pressure. The practice of placing guarantees using margins on future MFFs is questionable.

Liquidity risk. This risk is absent in principle as the beneficiaries are expected to repay their loans 14 days in advance of the date the European Commission has to pay the sums to creditors, thus securing the liquidity management.

In case of a default on a payment by the assisted country, Council Regulation (EC, Euratom) No. 1150/2000 of 22 May 2000[66] on the system of the European Communities own resources stipulates that the Commission would initially draw on its cash reserves to service the debt provisionally. It then has to amend the annual budget to incorporate the refinancing need. The TFEU obliges Member States to provide the funds necessary to meet all of the EU's obligations (Arts. 310 and 323 TFEU).

Yet that raises the issue of *political risk*. The EU budget expenditures are a sensitive issue and the next subsections address the extent to which the BoP and EFSM may have political repercussions.

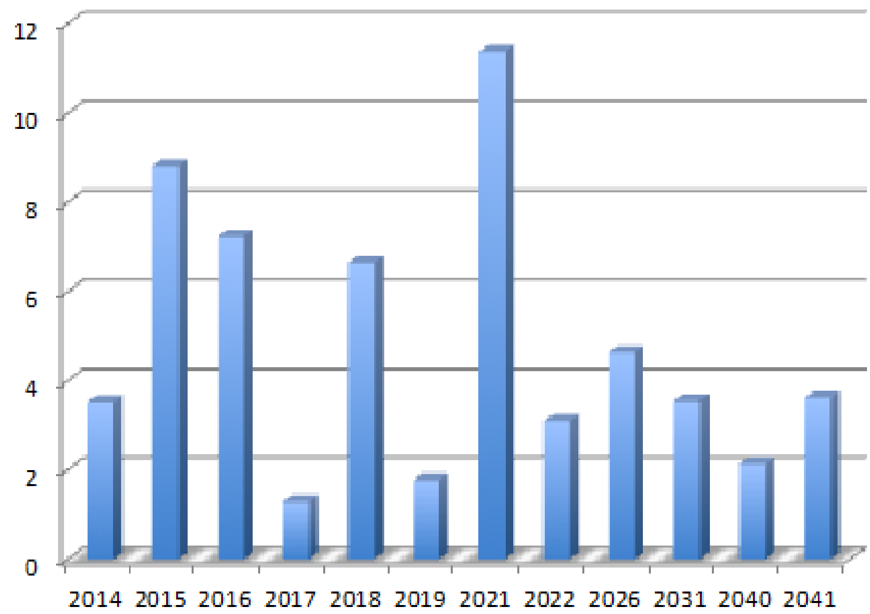
11.5.1 Annual risk exposure of the budget from the BoP and EFSM

The yearly risk exposure is limited due to the spread of the reimbursement commitments and the activation of the ESM reduces the chances of recourse to this instrument. Nevertheless, the EFSM has been used to bail out Greece in recent months with a €7.16 billion loan and thus is still considered an instrument for disbursement.

[66] See Council Regulation (EC, Euratom) No. 1150/2000 of 22 May 2000 on the system of the European Communities own resources, OJ L 130, 31.5.2000.

Figure 11-1 shows the risk exposure calculated based on the outstanding loan amounts per year, including the interest costs (nominal amounts with estimated interest costs based on initial terms) for assistance given until 2012 (Giovannini et al., 2012). It appears that owing to the increasing activity of the two instruments for macro-financial stability, in the coming years the exposure from a default risk is expected to increase for the EU budget, even if not in a constant way during the period considered (2014–41).

Figure 11-1. Risk exposure of the budget based on bond maturity dates and interest rates (€ billion)



Source: Giovannini et al. (2012)

The potential risk (i.e. the possibility for the EU budget to be unable to cover potential losses with the margin) is inherently linked to the future evolution of the multiannual financial framework, since most of the repayments fall beyond the present MFF and even beyond the next one. Still, at the moment there is no way to say what the needs will be in the future MFFs. For the 2014–20 MFF, the margins available between the payment appropriations and the own resources ceiling are estimated to be over 0.2% of GNI for most years, well above the risks for the present MFF.

Nevertheless, care should be taken to avoid accumulating bond maturities for single specific years. In 2021, for example, there is again a spike of commitments, at nearly €11.5 billion and the new loans still need to be added to the figure above. For that period, there is no MFF programme to estimate the available margins, but imagining a situation in which the EU faces particularly significant challenges and where an agreement for a new MFF allows a substantial increase in payment appropriations, such a token budget entry could be limiting in practice unless the ceiling of own resources is also increased. It is too early to speculate on a post-2020 MFF, but history has not been kind to the EU budget ceilings.

11.6 THE POLITICAL ISSUE OF FINANCING DEFAULTS AT THE EU LEVEL

The analysis shows that the risks are very limited to the stability of the budget. The EFSM, however, arguably does not represent the most appropriate instrument to operate as a guarantee for large assistance programmes. The inability of the EU budget to raise funding autonomously limits the EU budget's capacity to play a larger role in macroeconomic stabilisation.

More worrying are not the formal financial risks, especially when the ceilings are not in danger, but the considerable consequences that a default could have. The rules and official documents do not mention the inappropriateness of the own resources mechanism for such instruments and the potential political crisis a default could trigger. Theoretically available margins and theoretical obligations of Member States do not ensure a smooth operation. For over 20 years the EU budget has not breached the own resources ceiling and has managed to keep payments under control as agreed in the payments ceiling. Be that as it may, the political statements of Member States often portray the EU budget as an uncontrolled expenditure item even though the resulting perceptions do not reflect reality.

Raising, in any specific year, the payment ceilings to cover any default would generate frictions and a political backlash with ramifications well above the value of the default. Furthermore, the mechanism to pay for the default is highly controversial. The Own Resources Decision does not exclude the BoP or EFSM from the UK's correction mechanism, for example. The UK House of Commons estimated (Thompson and Harari, 2013) that the UK's contribution to a possible default would be equivalent to its share of the EU budget contribution, including the rebate. This thinking would then also apply to the contributions of all Member States, including the reduced contributions to the rebate by Austria, Germany, Sweden and the Netherlands, shifting the weight of covering the default to the poorer Member States.[67] Consequently, the share of the cost borne by other (mostly poorer) Member States would ultimately contribute to the default a sum higher than the share based on GNI. Also, the defaulting country would have to contribute to its own default. Of course, the default would in principle not be written off, with the Member State required to repay at a later stage through a new rescue package or delayed payment, neutralising the impact. Given the annual budgetary disputes and the recent controversy with the UK on the recalculation of its GNI contribution, the latest difficulties over such matters are not a simple formality.

11.7 A separate arrangement for the eurozone – Macroeconomic and other arguments in favour of a eurozone budget

A more ambitious reform of the EU budgetary framework would entail the creation of a separate budget for the eurozone, a project sometimes referred to as 'fiscal union', which has been advocated for many years, starting with MacDougall report (1977), and more recently by the Five Presidents' Report. The reasons for such a novel institution are mostly to be found in the realm of macroeconomic management of a currency union, requiring a specific budget displaying flexibility and responsiveness to aggregate conditions, in both the eurozone as a whole and its Member State economies, or else in relation to public debt management. The serious difficulties plaguing the eurozone since the onset of the Great Recession have made reflections on this issue more numerous and several proposals have recently been put forward.[68]

[67] See Council Decision 2007/436/EC, Euratom of 7 June 2007 on the system of the European Communities' own resources, OJ L 163/17, 23.6.2007.

[68] For a recent one, including references to other major proposals, see that by the French Treasury (2014).

11.7.1 *Macroeconomic policy mix and overall fiscal stance of the eurozone*

One of the shortcomings in the current institutional setting for macroeconomic policy-making in the eurozone is the absence of fiscal policy coordination or a common fiscal instrument that would allow the implementation of a proper policy mix. This lack had already been underlined before the 2008–09 crisis (see, e.g. Fitoussi and Le Cacheux, 2010), but became even more apparent when eurozone countries had to face the Great Recession: decentralised fiscal stimuli proved to be of insufficient magnitude, in part due to free-riding national strategies, and they ended up inflating national public debt ratios. At the inception of the Great Recession, in November 2008, the Commission called for an aggregate fiscal stimulus package amounting to 3% of EU GDP. But when adding up the various national plans for fiscal stimulus of eurozone countries, it only amounted to 1.8% of GDP, well below what had been injected in the US economy by the federal government and also what the IMF had been repeatedly recommending.

A eurozone budget financed by cyclically sensitive revenue sources (such as a eurozone CIT or even VAT) and funding cyclically sensitive expenditures (such as a eurozone-wide unemployment insurance scheme – see Thuillier (2014)) would have a built-in automatic stabiliser impact on eurozone economic activity.[69] The aggregate fiscal stance for the eurozone could also be set more easily in line with business cycle conditions, and possibly with the monetary policy stance set by the ECB, hence opening up the possibility of having a better macroeconomic policy mix.

11.7.2 *Cushioning asymmetric shocks*

Another major rationale for the creation of a separate eurozone budget is directly inspired by the theory of optimal currency areas.[70] In this line of reasoning, member countries of a currency union may be hit by asymmetric macroeconomic shocks. Because they can no longer realign internal parities, and because the other channels of adjustments – such as labour mobility and wage flexibility or capital mobility – may prove insufficient, the existence of a common budget would facilitate adjustment. For this to take place, the revenue levied by the common budget on each Member State would have to be sensitive to cyclical fluctuations in that country – again CIT, or to a lesser extent, VAT – and the same for expenditures directed towards that specific country. The common budget of the eurozone would then function as an inter-country, automatic fiscal stabilisation device, much as the federal budget does in existing federations.[71]

11.7.3 *Partial pooling of public debt*

In addition, as stressed in chapter 4, the need to possibly pool at least a fraction of public debts of eurozone Member States may require the creation of a specific budget to amortise the

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[69] The required magnitude of such automatic fiscal stabilisers is estimated and discussed in a number of recent contributions. See in particular the one by the French Treasury (2014).

[70] The pioneering contribution in this field is of course Mundell (1961). For a review of the reasoning in terms of optimal currency area theory, see Le Cacheux (2007).

[71] The automatic stabiliser effects of central budgets in existing federations were studied empirically in the early 1990s, when the prospects of creating of European monetary union became more certain. Sala-i-Martin and Sachs (1992) provides estimates for the US, and a review of the empirical literature is offered by Zumer (1998). Created during the New Deal, the US federal unemployment insurance scheme is obviously a source of inspiration.

common debt.[72] This option, which in some sense is more limited in scope than the previous ones, would also require common revenue sources. Several schemes of debt redemption funds have been proposed in recent years.

In all cases, designing an appropriate budget instrument for the eurozone is fraught with difficulty. And it would obviously require major political and institutional changes in the eurozone, hence a new treaty, especially if the eurozone budget is meant to have a macroeconomic stabilisation function, in which case issues of both size and the possibility of a budget deficit would have to be addressed. From the point of the view of selecting own resource instruments though, the financing of a separate budget for the eurozone is distinct from that of the EU budget essentially in two respects. One is the political will and motivations behind the 'fiscal union' project, which should make the adoption of a common revenue source somewhat easier. The other has to do with the specific objective(s) pursued in the creation of a eurozone budget: if the main objective is macroeconomic stabilisation, the financing instrument should yield revenue that is as sensitive as possible to fluctuations in economic activity; if instead the objective is common management of at least a fraction of public debts, the financing instrument should have a stable and reliable yield.

[72] Several proposals for debt pooling or for the creation of a 'redemption fund' have been made in recent years. See, for instance, the German Council of Economic Experts (2011). See also Sargent (2012) for such a plea, offering a parallel between the public finance situation of the newly independent United States of America in 1790 and that of the eurozone today.

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ANNEX I. ADDITIONAL BACKGROUND ON 'GENUINE' OWN RESOURCES

The Treaty of Rome, and indeed all of the European Treaties since then, stipulated that the EEC would have its own budget and that it would be financed by own resources. Initially financed by the revenues from customs duties and levies on agricultural imports – in line with the two main areas of European integration, the single market and the CAP – the EU budget progressively drifted away from 'genuine' own resources towards a mode of financing essentially based on national contributions. This occurred first with the own resources derived from VAT, and then with the currently dominant resources based on GNI. The immediate cause of this progressive change in the nature of the financing was the insufficiency of revenue from the initial instruments, due to both the increasing size of the budget during the 1970s and 1980s, and the decline in the yields of customs tariffs and agricultural levies. This annex recalls the major steps and decisions leading to the current financing structure.

The pros and cons of genuine own resources vs GNI-based national contributions are discussed at length in the literature,[73] and in various reports by the European Commission and the European Parliament. This annex analyses the strengths and weaknesses of existing budget resources, such aspects of the current EU budgetary procedure as the periodicity of the MFF, the resource ceiling and the budget balancing mechanisms are taken into account.

HISTORICAL ANALYSIS OF OWN RESOURCES

At origin of the EEC, the principle of financing the budget of the Community was stated in Art. 201 of the Treaty of Rome: "without prejudice to other revenue, the budget shall be financed wholly from own resources". From 1958 to 1970, the European budgets were exclusively financed by Member States' contributions, but this mechanism was considered temporary. Yet new proposals by the Commission to develop own resources and to improve Community governance (with additional budgetary powers given to the European Parliament and an increased role for the Commission) were the starting point of the first institutional gridlock. In 1965, France, boycotting European institutions (in the Empty Chair crisis), manifested its opposition to majority voting being enforced in the Council. Such a development was considered an unacceptable loss of sovereignty. Some months later, a compromise was presented by Luxembourg Prime Minister and President of the Council, Pierre Werner. This Luxembourg compromise recognised the unanimity rule pertaining to 'vital' interests of Member States. Consequently, the right to veto initiatives has limited the actions of the European Commission and has led to inertia in the process of integration. In 1970, the Council adopted a decision to assign finance to a single budget (following the Merger Treaty of 1965) through 'traditional' own resources (agricultural levies and customs duties) and a resource based on VAT. The need to harmonise the VAT base resulted in a delay in the collection of VAT until 1979.

Interestingly, the European Commission proposed two methods to put this policy into force, the returns method (also called 'base-on-base' or the 'declaration method') and the revenue method (also called the 'statistical method'). The former method implied that the EU percentage of the VAT would be written on any invoice. The advantage of this approach was transparency, establishing a direct link between the Union and taxpayers. The statistical method, consisting of applying the EU percentage on the total value of goods, was eventually adopted because of the

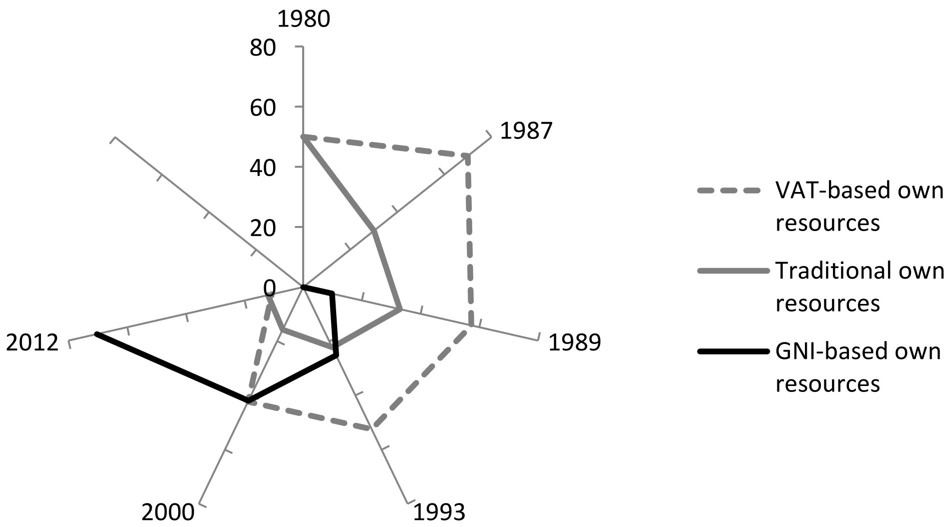
[73] They are summarised in, e.g. Cattoir (2006), Le Cacheux (2007), Begg et al. (2008), Haug et al. (2011), Núñez Ferrer et al. (2007) and Núñez Ferrer (2008) and Cipriani (2007, 2010 and 2014).

high administrative costs of the declaration method and also certainly because of Member States' opposition. The Cornelissen Report of 1985 pointed out the position of the Parliament in this discussion:

> Can parliament tolerate the fact that revenue from VAT is being increasingly watered down to a national financial contribution following the necessary abandonment of the principle of the uniform VAT rate and can it accept that the establishment of the uniform VAT base is ultimately reduced to a statistical calculation? Or must every effort be made in connection with the calculation of the VAT base to revive the communities' own resources system and the financial autonomy of the Community which is dependent thereupon?

Despite its apparent success during the 1980s (Figure A-1), this resource became unpopular among some Member States. To illustrate the opposition, we successively analyse changes that have been implemented to the tax base and to the tax rate.

Figure A-1. Shares of resources over time



Initially, the tax base was capped at 55% of GDP. But this scheme was considered unfair for poor countries and in 1995 the limit was set at 50% of GNP for states with a per capita GNP below 90% of the Community average. Between 1995 and 1999, this exception became the rule: the rate of 50% was extended to all countries.

Concerning the tax rate, the Own Resources Decision of 1970 limited the maximum call-in rate to 1% of the base. The Own Resources Decision (of 1985) raised the ceiling to 1.4%, to coincide with the accession of Spain and Portugal. This increase was designed to meet the costs of enlargement. The Own Resources Decision of 2000 finally cut the maximum call-in rate to 0.5% of the harmonised and capped VAT base. Lastly, in 2007 the call rate was reduced to the current level of 0.3%, with an additional rebate for Germany (0.15%), Sweden (0.1%), the Netherlands (0.1%) and Austria (0.225%).

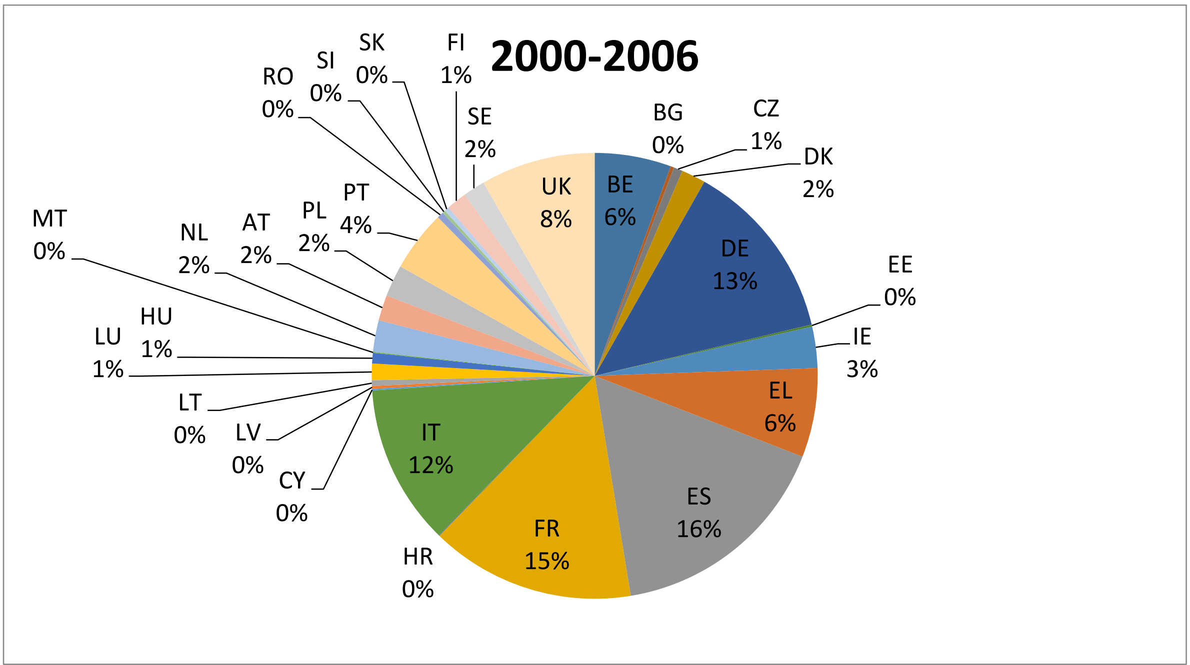
Almost immediately after its implementation, it became clear that the VAT system was inadequate to finance the Union. Since the 1980s, increasing expenditures have triggered discussions on new sources of revenue. In 1988, as part of preparations for the first financial perspective, the European Council agreed to establish a new resource, consisting of direct transfers. To reduce the growth of expenditures, the own resources were also subjected to an annual ceiling of 1.2% of GDP in 1993, later changed to 1.27% of GNI in 1999.

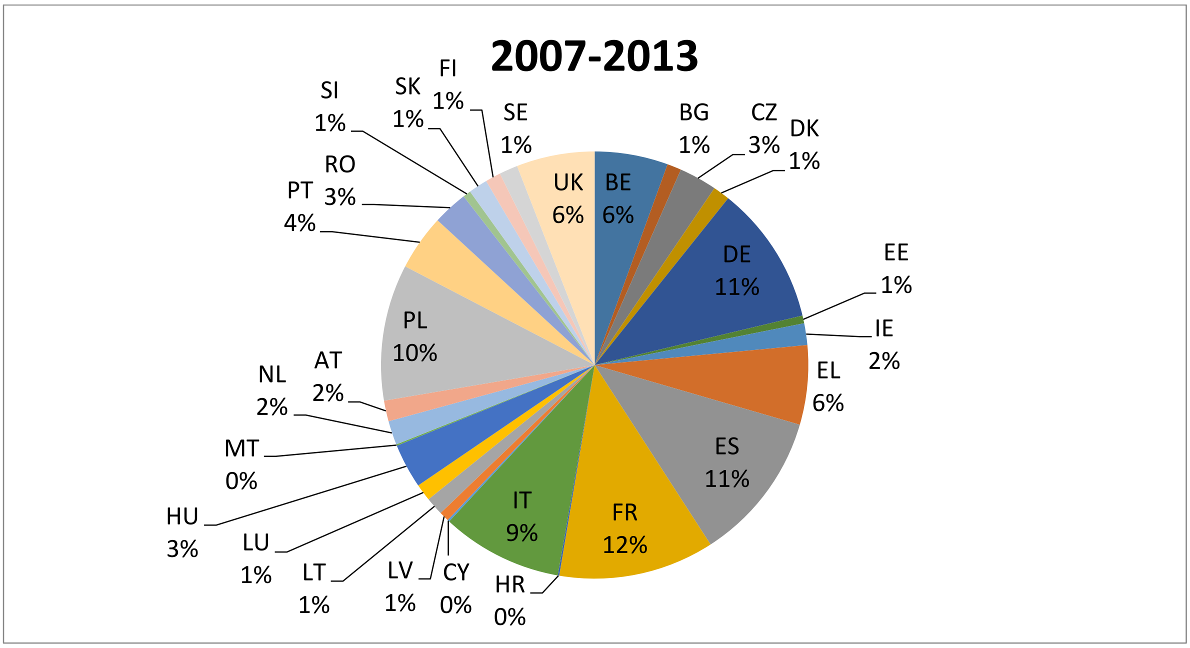
What is clear about the trend over the last two decades is that the proportion of funding raised from resources explicitly 'owned' at the EU level has diminished markedly, while the share of intergovernmental transfers has grown. This evolution raises two main issues. First, the progressive erosion of the VAT resource has cast doubt on its continued use, especially as the harmonisation process has broken the direct link to what VAT *actually* raises in each Member State. Second, the increasing reliance on intergovernmental transfers, rather than on genuine EU revenue instruments, is seen by many as problematic. The GNI resource in particular has been subject to considerable criticism, yet it manifestly remains the preferred option for many Member States.

BUDGETARY BALANCES

Figures A2 through A10 present different aspects of the budgetary balances (in € million and as shares of GNI), as well the financial transfers generated by the UK correction and the additional corrections linked to it (the impact of reduced VAT rates or lump-sum concessions through expenditure policies, e.g. additional funding for Poland, are not included).

Figure A-2. Member States' shares of EU budget expenditure, 2000–06 and 2007–13

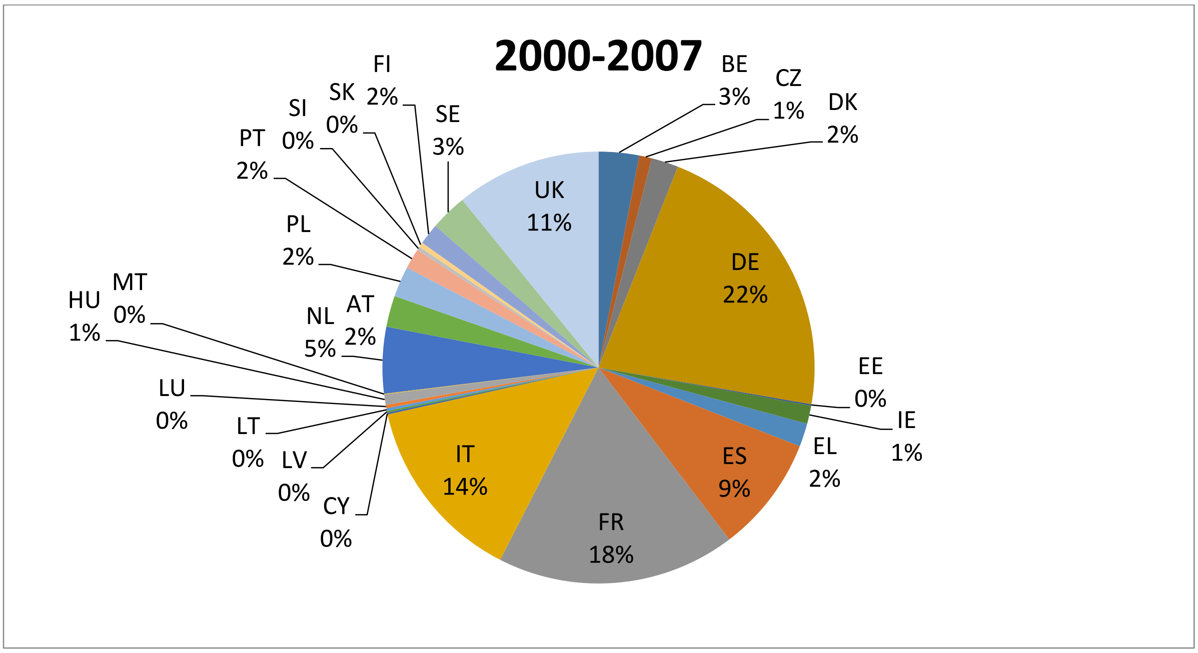


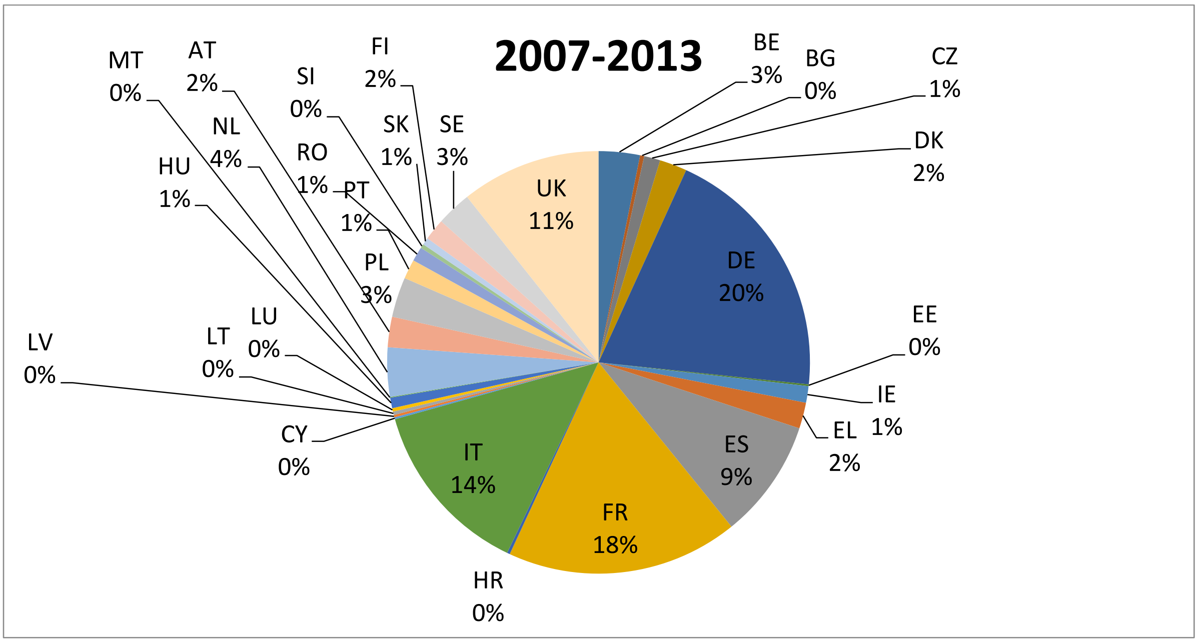


Source: *Financial Reports*, European Commission.

Figures under 1% are displayed as 0%

Figure A-3. Member States' shares of contributions to the EU budget (excluding TOR), 2000–13

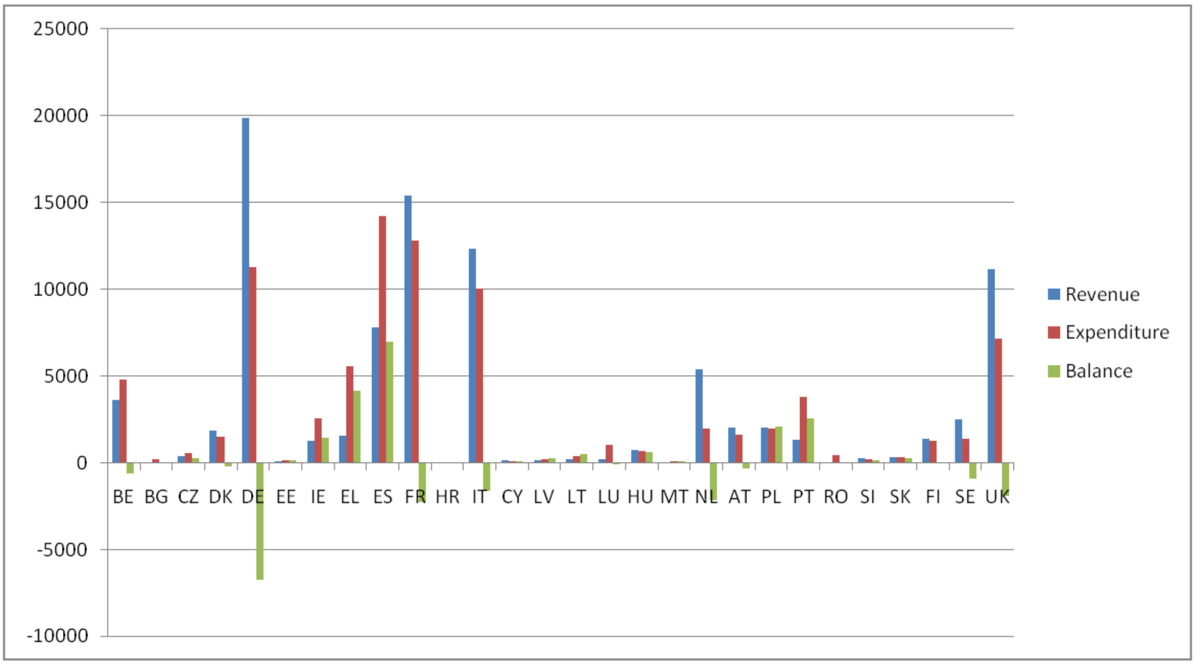




Source: *Financial Reports*, European Commission.

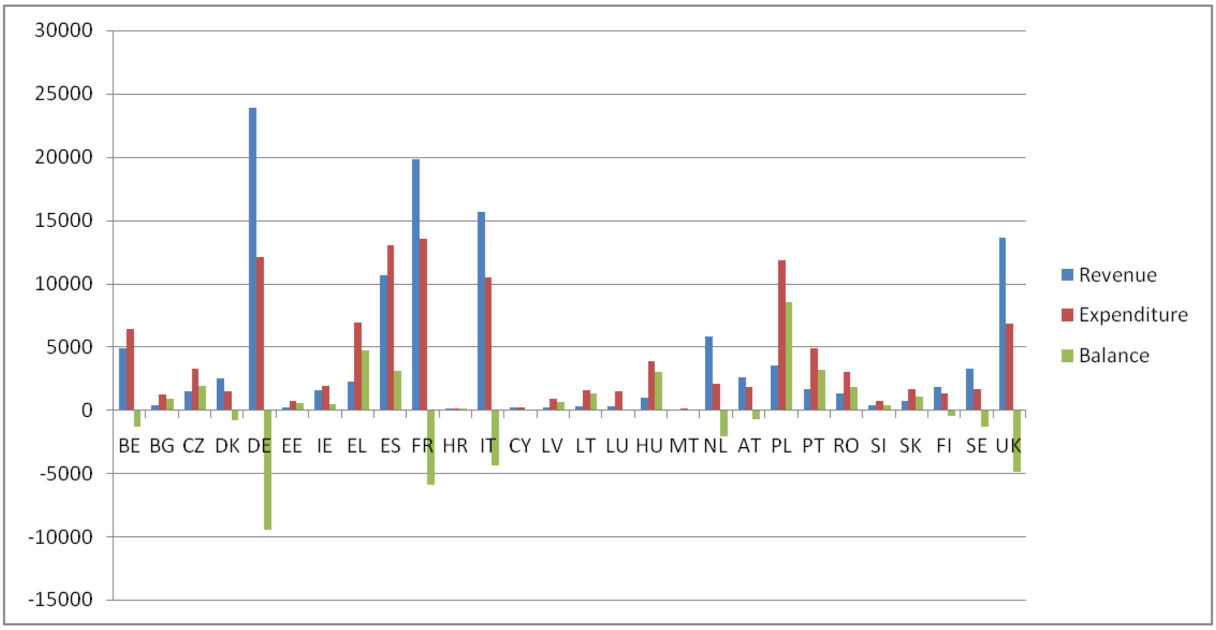
Figures under 1% are displayed as 0%

Figure A-4. Average, annual, operational budgetary balances (€ million), 2000–06



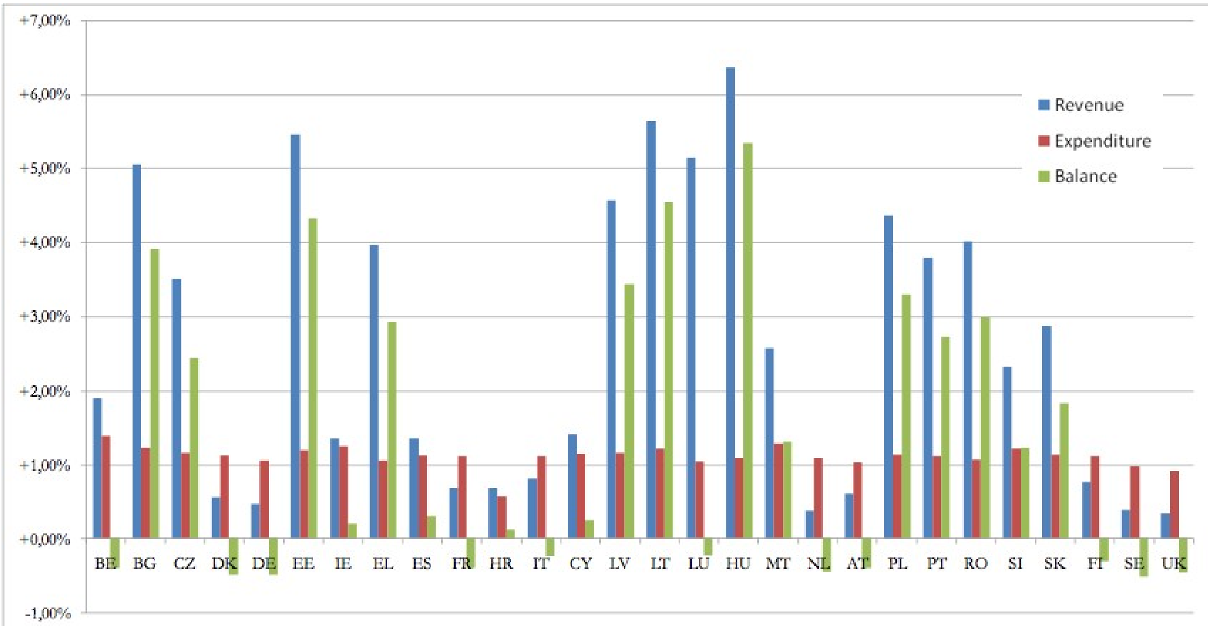
Source: *Financial Reports*, European Commission.

Figure A-5. Average, annual, operational budgetary balances (€ million), 2007–13



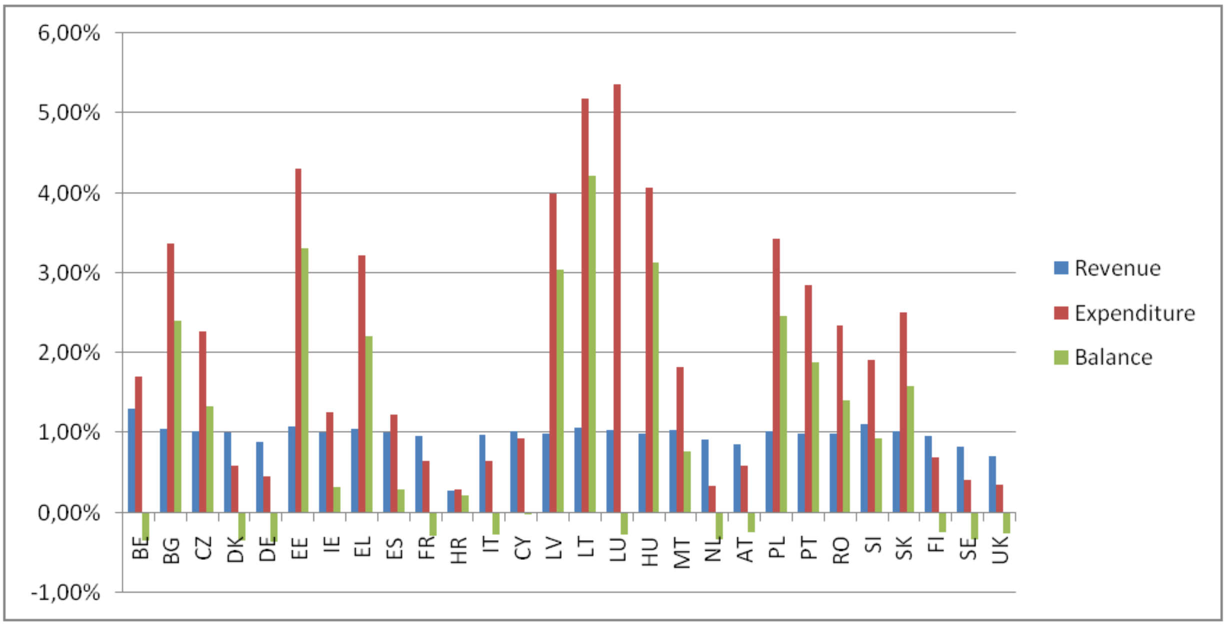
Source: *Financial Reports*, European Commission.

Figure A-6. Average, annual, operational budgetary balances (% of GNI), 2000–06



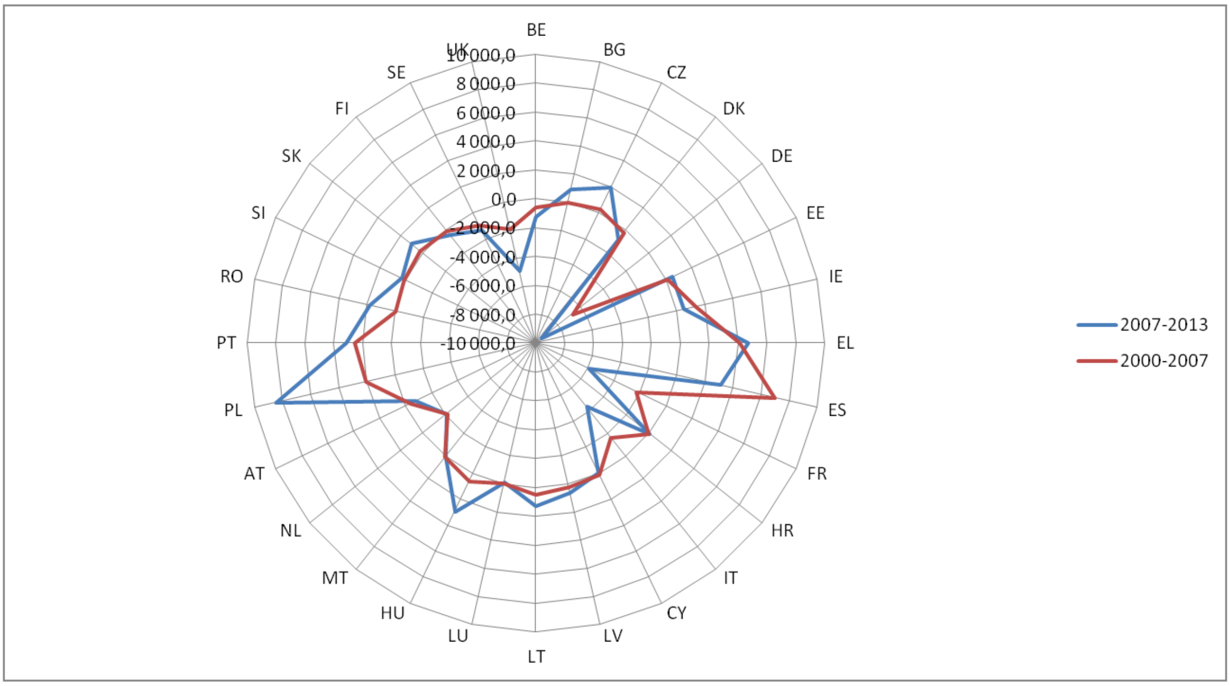
Source: *Financial Reports*, European Commission.

Figure A-7. Average, annual, operational budgetary balances (% of GNI), 2007–13



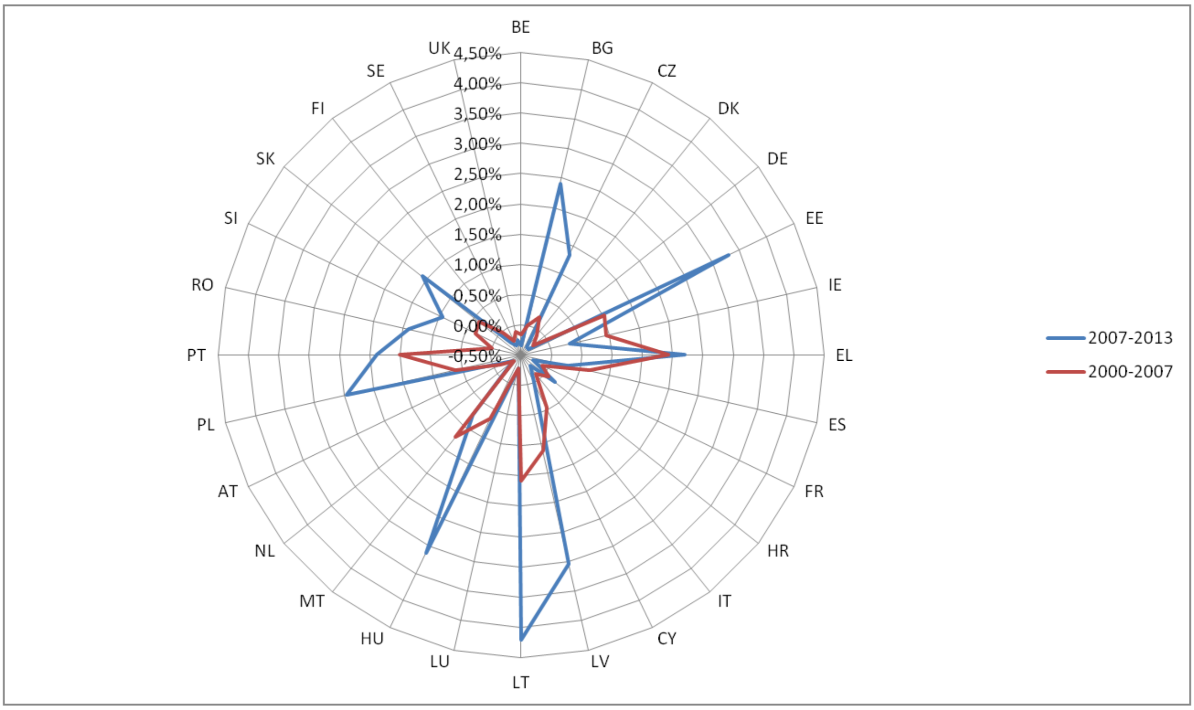
Source: *Financial Reports*, European Commission.

Figure A-8. Average, annual, operational budgetary balances (€ million), 2000–13



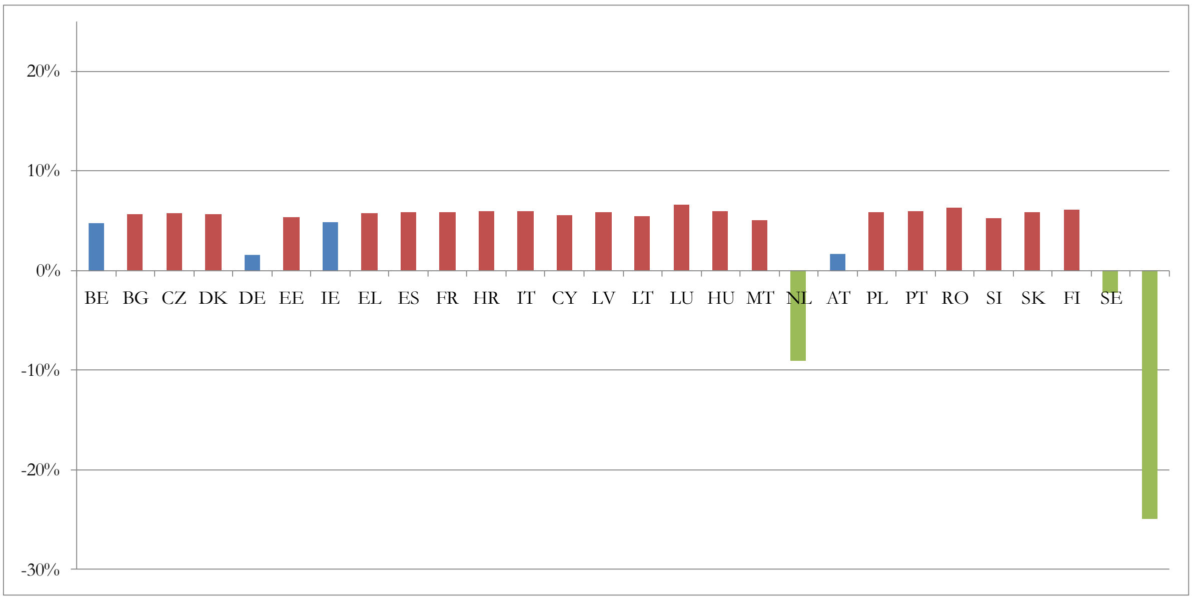
Source: *Financial Reports*, European Commission.

Figure A-9. Average, annual, operational budgetary balances (% of GNI), 2000–13



Source: *Financial Reports*, European Commission.

Figure A-10. Shares of the correction in total own resources, 2013



Source: *EU Budget 2013*, *Financial Report*, European Commission (2014c).

Table A-1. Operating budgetary balances (€ million), 2007–13

	2007	2008	2009	2010	2011	2012	2013
BE	-868,2	-720,6	-1.663,9	-1.466,4	-1.369,6	-1.493,7	-1.541,1
BG	+335,1	+669,6	+624,2	+895,5	+725,4	+1.329,7	+1.529,0
CZ	+656,7	+1.178,0	+1.702,5	+2.079,3	+1.455,2	+3.045,2	+3.401,1
DK	-604,4	-543,2	-969,5	-615,3	-836,6	-1.126,0	-1.277,1
DE	-7.415,2	-8.774,3	-6.357,5	-9.223,6	-9.002,5	-11.953,8	-13.824,8
EE	+226,2	+227,4	+573,0	+672,7	+350,4	+785,3	+771,4
IE	+662,1	+566,1	-47,5	+803,9	+383,8	+670,6	+279,1
EL	+5.437,2	+6.279,7	+3.121,0	+3.597,4	+4.622,6	+4.544,9	+5.340,7
ES	+3.651,8	+2.813,2	+1.181,7	+4.100,9	+2.995,0	+3.999,0	+3.058,3
FR	-2.997,3	-3.842,7	-5.872,7	-5.534,8	-6.405,8	-8.297,5	-8.445,7
HR							+49,6
IT	-2.013,5	-4.101,4	-5.058,5	-4.534,0	-5.933,0	-5.058,1	-3.789,9
CY	-10,5	-17,7	-2,3	+10,6	+6,9	-25,2	+40,4
LV	+488,8	+407,0	+501,5	+674,2	+731,3	+955,9	+801,2
LT	+793,2	+842,6	+1.493,3	+1.358,4	+1.368,0	+1.514,0	+1.514,5
LU	-139,8	-22,1	-100,2	-41,9	-75,0	-79,5	-69,4
HU	+1.605,9	+1.111,7	+2.719,4	+2.748,4	+4.418,3	+3.280,4	+4.954,5
MT	+28,1	+30,0	+8,6	+52,9	+67,0	+71,4	+88,0
NL	-2.864,3	-2.678,2	+117,7	-1.833,1	-2.214,0	-2.364,5	-2.675,1
AT	-563,2	-356,4	-402,1	-677,0	-805,1	-1.073,3	-1.251,7
PL	+5.136,4	+4.441,7	+6.337,1	+8.427,5	+10.975,1	+11.997,2	+12.237,1
PT	+2.474,4	+2.695,1	+2.150,7	+2.622,6	+2.983,7	+5.027,2	+4.416,7
RO	+595,8	+1.581,0	+1.692,5	+1.245,2	+1.451,5	+2.031,6	+4.142,8
SI	+88,6	+113,8	+241,9	+424,1	+490,1	+572,2	+429,2
SK	+617,8	+725,6	+542,1	+1.349,6	+1.160,6	+1.597,0	+1.287,4
FI	-171,6	-318,5	-544,2	-300,2	-652,1	-658,8	-604,0
SE	-994,8	-1.463,1	-85,6	-1.211,4	-1.325,4	-1.925,1	-2.220,7
UK	-4.155,3	-844,3	-1.903,3	-5.625,9	-5.565,6	-7.366,1	-8.641,7

Source: DG Budget

Table A-2. Operating budgetary balances (% of GNI), 2007–13

	2007	2008	2009	2010	2011	2012	2013
BE	-0,25%	-0,20%	-0,48%	-0,39%	-0,36%	-0,38%	-0,39%
BG	+1,13%	+1,92%	+1,77%	+2,50%	+1,88%	+3,32%	+3,80%
CZ	+0,51%	+0,78%	+1,23%	+1,44%	+0,96%	+2,02%	+2,33%
DK	-0,26%	-0,22%	-0,42%	-0,25%	-0,33%	-0,44%	-0,49%
DE	-0,29%	-0,34%	-0,25%	-0,35%	-0,33%	-0,42%	-0,48%
EE	+1,50%	+1,46%	+4,18%	+4,82%	+2,25%	+4,64%	+4,22%
IE	+0,39%	+0,35%	-0,03%	+0,58%	+0,27%	+0,47%	+0,19%
EL	+2,40%	+2,68%	+1,35%	+1,62%	+2,29%	+2,33%	+2,93%
ES	+0,35%	+0,26%	+0,11%	+0,38%	+0,28%	+0,38%	+0,29%
FR	-0,15%	-0,19%	-0,30%	-0,27%	-0,30%	-0,39%	-0,39%
HR							+0,12%
IT	-0,12%	-0,25%	-0,32%	-0,28%	-0,36%	-0,31%	-0,24%
CY	-0,06%	-0,10%	-0,01%	+0,06%	+0,03%	-0,13%	+0,23%
LV	+2,23%	+1,69%	+2,49%	+3,70%	+3,62%	+4,33%	+3,46%
LT	+2,84%	+2,67%	+5,44%	+4,94%	+4,55%	+4,69%	+4,45%
LU	-0,48%	-0,07%	-0,42%	-0,16%	-0,27%	-0,28%	-0,24%
HU	+1,70%	+1,11%	+3,05%	+2,95%	+4,62%	+3,47%	+5,08%
MT	+0,50%	+0,50%	+0,15%	+0,84%	+1,00%	+1,03%	+1,21%
NL	-0,47%	-0,43%	+0,02%	-0,29%	-0,34%	-0,36%	-0,42%
AT	-0,20%	-0,12%	-0,14%	-0,23%	-0,26%	-0,34%	-0,39%
PL	+1,70%	+1,25%	+2,09%	+2,43%	+3,03%	+3,24%	+3,22%
PT	+1,46%	+1,57%	+1,27%	+1,51%	+1,73%	+3,06%	+2,63%
RO	+0,49%	+1,14%	+1,42%	+0,99%	+1,10%	+1,55%	+2,94%
SI	+0,26%	+0,31%	+0,68%	+1,18%	+1,34%	+1,60%	+1,20%
SK	+1,13%	+1,13%	+0,85%	+2,06%	+1,69%	+2,26%	+1,78%
FI	-0,09%	-0,16%	-0,30%	-0,16%	-0,33%	-0,33%	-0,30%
SE	-0,27%	-0,40%	-0,03%	-0,32%	-0,32%	-0,44%	-0,49%
UK	-0,19%	-0,04%	-0,11%	-0,31%	-0,30%	-0,36%	-0,43%

Source:Dg Budget

ANNEX II. TAX EXTERNALITIES AND EFFICIENCY IN THE FINANCING OF EUROPEAN PUBLIC GOODS: A LITERATURE SURVEY

The fiscal relationships between different levels of government arise as a particularly acute issue in the context of shaping the EU's future and its budget through a potential own tax resource. The importance of EU initiatives (on infrastructure, research, security, migration and so forth) and the corresponding increasing demands on the EU budget call for a genuine own resource, which means giving the EU some power to tax.

Moreover, the combination of tax competition among Member States and the tax avoidance/optimisation behaviour of multinational firms that spread their activities across various countries results in revenue losses and may be shown to be suboptimal. An EU tax could be a useful tool to tackle both the own resources and tax compliance issues.

The current context seems especially favourable for addressing tax competition or evasion. Recent scandals, such as LuxLeaks and more recently the Panama Papers, have led the European Commission to investigate 'tax rulings' and issue new tax legislation on per-country reporting. In addition is the OECD Base Erosion and Profit Shifting project (launched in 2013 in partnership with the G20) and the proposition of US President Barack Obama to apply a 14% tax rate to profits realised abroad by US-based multinationals.

The addition of a new tax at the EU level would affect the amount of national tax receipts, the choice of national tax rates and thus national fiscal imbalances. Indeed, the decisions taken by these different authorities are interdependent owing to the existence of tax externalities, either when these decision-makers belong to different tiers of government (vertical externalities) or when they are at the same level (horizontal externalities). If the EU were to tax bases upon which the Member States already levy taxes, such as the CIT, both types of tax externalities would be present and interact.

If the CIT were to be shared between EU and national governments, the most likely procedure would be some variant of the CCCTB, whereby the tax base would be determined by an EU directive, along with formula apportionment. As to the decision on the common tax rate, various options are conceivable. One of them is inspired by France, which delegates power to tax to local governments, but which retains tax sovereignty at the national level, defines the tax base at the national level and revenue collection as well, and imposes limits on the ability of authorities with delegated power to set tax rates. In such a procedure, the Council would decide on a range for the EU rate, and then the European Parliament would choose the rate within the predefined boundaries (possibly in collaboration with national parliaments).

VERTICAL AND HORIZONTAL TAX EXTERNALITIES

Brief survey of horizontal tax competition

Mobile tax bases are at the root of strategic tax competition, both within and between countries. Indeed, the existence of mobile tax bases seeking to optimally localise in order to obtain the highest possible after-tax return triggers some competition among policy-makers. This mechanism induces horizontal tax externalities among same-level governments. To a large extent, vying for mobile tax bases has been shown to put downward pressure on the degree of taxation. When a decision-maker unilaterally and independently raises the tax rate, part of the mobile base will move to neighbouring jurisdictions (since the net capital return becomes lower), thereby reducing the amount of tax receipts that can be collected in the locality that implemented a hike. If the first mover does not take this effect into account, the perceived marginal cost of public funds is higher than the real social cost. In the traditional, normative literature based on the Pigouvian approach, which sees the government as a benevolent social planner (Wilson, 1986; Zodrow and Mieszkowski, 1986), the tax rates are set at a level lower than the level that would allow the provision of the optimal amount of local public good. However, when the policy-makers are Leviathan, horizontal tax competition may improve social welfare (Brennan and Buchanan, 1977).

Another strand of tax competition literature points to mechanisms leading to opposite outcomes. Political yardstick competition (Salmon, 2006), in which voters are allowed to use the performances of neighbouring governments as a yardstick to assess the efficiency of their representative officials and decide accordingly whether to re-elect them or not, may lead to higher tax rates because some kind of collusion process can appear. A wider set of outcomes is also allowed through works taking into account the interest of public goods for firms and thus considering that, as they value public goods and services, governments can compete by increasing public good provision. For instance, starting from the standard Zodrow-Mieszkowski (1986) model, Dhillon, Wooders and Zissimos (2007) assume that the public good enters the production process of firms and that it is valued by the latter as it may enhance capital productivity. The result of this game can be efficiency or over-taxation and over-provision of public goods (i.e. a race to the top), depending upon such factors as the degree of complementarity between capital and public good.

Since the early 1990s, common agency game models have introduced informational asymmetries, starting with Laussel and Lebreton (1993, 1994). In the first one, the authors consider a single large investor that does not reside in the jurisdictions where it can invest, and the setting is a delegated common agency game: capital can be allocated in one or both jurisdictions or in none of them. The amount of total capital available is private information of the firm, whereas the policy-makers of the two jurisdictions that compete for capital only have *a priori* assumptions relative to this parameter. These principals are assumed to maximise their tax income. They choose simultaneously and non-cooperatively the tax schedules they want to implement. The problem of the investor consists of deciding which levels of capital it is willing to invest in each jurisdiction, given the tax schedules proposed and provided that the amount of capital invested does not exceed the amount it owns. The equilibrium is the outcome where the firm optimally determines its investment choices, considering diversification as the best strategy, and the two competing governments choose simultaneously the tax schedules that will maximise their tax revenues. This equilibrium is unique and all capital ends up being invested and equally divided between both jurisdictions. Laussel and Lebreton (1994) tackle the same issue with a continuum of investors and examine the uniqueness condition for the equilibrium. In the same strand of literature, additional results are provided. Olsen and Osmundsen (2001) analyse a model based upon a process of tax competition between two jurisdictions eager to capture the rents of a large investor partly owned by local shareholders that may divide capital among both jurisdictions and redirect part of it towards one of the two. The firm has private information about its operational efficiency in both jurisdictions, whereas governments only can observe the levels of investment in each one. The interaction between local governments is modelled through the introduction of a joint cost. Policy-makers are assumed to maximise expected domestic social welfare and thus integrate into their objective function the firm's profits, a part of which accrues to local shareholders. An equity externality arises that can make tax competition lead to results quite different from traditional common agency outcomes: lower investment levels and higher tax rates. Olsen and Osmundsen (2003) also take into account spillovers correlated with the firm's productivity or an outside investment option; in this context, tax competition may entail lower investment for inefficient types and higher investment for efficient ones compared with tax coordination.

Main findings about vertical tax externalities

Multilevel governments represent a common feature of fiscal arrangements, not only in federations or in unitary states, but also in areas of cooperation among countries, such as the EMU. The "potential dependence of the tax base of each level of government on the tax policies pursued by the other" (Keen, 1998) triggers vertical externalities. The mechanism of vertical tax externality stemming from the co-occupancy of tax bases between several tiers of government was first analysed by Cassing and Hillman (1982). The federal government of Australia levies taxes on both coal output and exports. Tax receipts are thus collected on the coal transported by train up to the harbour. Meanwhile, the state of Queensland holds a monopoly on railroads and taxes freight. With respect to a cooperative situation, the competition between these two Leviathan public decision-makers leads to a shrinkage in the potential amount of tax receipts and increases the deadweight losses, as a same resource is taxed twice. These conclusions were highlighted by the pioneer work of Flowers (1988), based on Brennan and Buchanan (1980). This model examines a situation in which two different layers of government eager to maximise their fiscal revenue tax a common mobile base. With respect to a unique government setting, the addition of a second authority endowed with tax powers induces an erosion of the common base. As each layer ignores the revenue losses incurred by the other policy-maker when raising the rate, the marginal cost of raising tax revenue from the common base is underestimated and the global tax rate is thereby excessively high. Furthermore, as demonstrated by Sobel (1997), the distortion is strengthened in a sequential framework, as the Stackelberg leader anticipates the revenue reduction and seeks to compensate for this effect through a hike in its tax level. The study by Keen (1998) in a framework of consumption taxes, provides an exhaustive presentation of the main effects stemming from tax stacking. The author shows that when the lower level is Leviathan, federal and local taxes are strategic complements if the price-elasticity of the good demand is constant. If local decision-makers are benevolent, two additional effects appear: a decrease in demand for the good because of the consumer price rise (which lessens the loss of consumer welfare), and the reduced production of the local public good due to the shrinkage of the tax base (which makes the increase of local public good through higher tax rates more attractive). These main conclusions were generalised by Flochel and Madiès (2002) in a context borrowed from industrial organisation. With Leviathan governments and imperfect mobility of the taxed base, that is capital, the global tax rate to which the common base is subject results as a growing function of stacked layers.

Empirical work yields results that vary according to the assumptions of the model studied. Indeed, in order to check the existence of such effects in a hierarchically nested government framework, Besley and Rosen (1998) propose an empirical analysis on excise taxes in the US. They estimate the impact of changes in federal tax policy on state tax decisions. Four kinds of reactions can appear:

- a revenue effect that describes the local government reaction to maintain its revenue when the federal government raises its tax rate;
- the deadweight loss effect related to the fact that, all things being equal, the marginal disutility of tax increases with the rate (that is, taxes are complements);
- the tax complement or substitution effect when demand cannot be differentiated; and
- a spending effect, according to which tax receipts decrease when the federal tax rate is raised. An increase of 10% in the unitary federal tax rate on cigarettes triggers an increase of 2.8% of the local unitary tax rate; the same increase for gasoline induces a 4.1% rise of the local tax.

Esteller-Moré and Solé-Olé (2001) analysed personal income and general sales taxes. They found that US state taxes reacted positively to increases in federal taxes. Likewise, examining Canadian income taxes, Esteller-Moré and Solé-Olé (2002) stressed a positive response of provincial tax rates to changes in the federal tax rates. On the other hand, Hayashi and Boadway (2001) found a negative correlation, also found by Goodspeed (2000) in a panel of OECD countries.

Concurrent horizontal and vertical tax externalities

Because both horizontal and vertical tax external effects come into play in territorial organisations, it appears relevant to take them into account simultaneously and to analyse the interactions between them.

Keen (1998) shows that both externalities exert countervailing effects when a tax base overlap is combined with horizontal tax competition and that the economy may end up on the downward sloping side of the Laffer curve. However, the net impact of the interaction between horizontal and vertical externalities appears rather ambiguous and assumption-dependent.

Keen and Kotsogiannis (2002 and 2004) tackle this issue through a model of benevolent governments, based on Zodrow and Mieszkowski (1986), with the addition of a higher level of policy-maker and an endogenous supply of capital. They show that the final effect depends on the elasticity of savings supply, capital demand, the level of income taxation, households' preferences for local or national public goods, and the degree of mobility of the tax base. In a Leviathan policy-maker's framework, Keen and Kotsogiannis (2003) prove that receipts are strictly higher for both local and federal governments if the tax rate is reduced by at least one of them and that social welfare improves when the public goods provided by different layers of governments are substitute. Brülhart and Jametti (2004) adopt a similar approach in an international setting and confirm this latter effect. In addition, they show that the domination of the vertical externality depends on the way the local public good enters the utility function, on the relative elasticity of capital. If the decision-maker is not benevolent, one tier of government at least must reduce its rate in order to raise receipts.

With revenue-maximising decision-makers, Flochel and Madiès (2002) conclude that the competition between same-level policy-makers reduces the cumulated tax rate, but cannot totally offset the vertical externality. Similar to analyses of horizontal tax competition, some authors have shown that the conclusions could be greatly modified if productivity-enhancing public goods were introduced. For instance, Dhalby and Wilson (1998, 2003) show that an insufficient supply of public good can emerge if state and federal governments apply a tax on wages and produce a public good that improves labour productivity. Thanks to a model based on Keen and Kotsogiannis (2002), Madiès (2004) demonstrates that if states provide such a public good whereas the central government provides a residential public good, a fiscal feedback effect may arise and the resulting dominant effect is not clear-cut. To put it in a nutshell, the net impact of the interaction between horizontal and vertical externalities appears rather ambiguous and assumption-dependent.

Indeed, Revelli (2003) analyses the UK local structure, made of two stacked levels of governments that share spending and taxing responsibilities, and demonstrates that the horizontal effect is in fact a reaction to the actions of the upper level. Leprince, Paty and Reulier (2005), for the French case, show that a strategic complementarity between *départements* and municipalities arises. Goodspeed (2000) examines how a federation tax structure is affected by both a vertical externality and a horizontal one. The second effect is controlled through the choice of a poverty index that may represent a measure of mobility. The estimation realised on a sample of 13 OECD countries over the period 1975–84 indicates that a rise in the federal tax triggers a decrease in the local tax rate. Also, a reduction in the poverty rate induces a cut in income tax as horizontal competition is strengthened. Goodspeed (2002) shows that a higher national tax rate can reduce tax base disparities, and through the horizontal interaction, and indirectly lead to higher local tax rates. In their adaptation of Keen and Kotsogiannis (2002), Brülhart and Jametti (2004) study the Swiss case for income taxes and take into account states' asymmetry. They show that the vertical externality dominates, but if the analysis is led on business taxes, the horizontal effect is stronger. Rizzo (2003) examines which effect results from the interaction between horizontal and vertical externalities when the cigarettes and the retail markets are considered, in the US and Canada, for the period 1984–94. States are assumed to be identical in terms of population. The results show that a rise in federal taxes reduces the external effect induced by the mobility of the tax base. Complementary to this work, the study by Devereux, Lockwood and Redoano (2004) shows that when the demand price-elasticity is weak and horizontal competition strong, the horizontal externality dominates and the link between federal and state taxes is not significant.

TAKING INFORMATIONAL ASYMMETRIES INTO ACCOUNT

Informational issues can represent a key element in the relationship between taxpayers and governments, and they may modify incentives and add new effects.

Informational constraints prevent public decision-makers from implementing their preferred policies, and constrain them to design strategies and mechanisms likely to bring the outcome closer to the one they consider optimal. Two kinds of asymmetries of information can be examined. One is adverse selection, which corresponds to the fact that the base, i.e. the firm, possesses an informational advantage over the government with respect to an exogenous feature, such as the amount of capital available for investment or the amount of pollution created. The second type of informational problem that may arise and create a gap between the firm and the policy-maker emanates from a moral hazard process. In this process, some endogenous variables of the firm cannot be observed by the government: for instance, the firm may choose to allocate capital towards a use other than local investment; alternatively, it may decide to implement clean technologies. These asymmetries of information create scope for a rent that the principals have to abandon to the better-informed agent, i.e. the firm.

Envisaging such schemes allows for more general frameworks and better suits actual systems. The robustness of complete information results can be checked and new informational effects are included that tend to lessen the magnitude of the vertical externalities.

It seems particularly interesting to use such approaches to analyse the various, potential EU taxation schemes.

Tax externalities and the financing of the EU budget

Two essays tackle this issue (Lachet-Touya 2016a and 2016b) and compare a system similar to the current system with other potential mechanisms, such as the addition of an EU tax or the devolution of the tax authority to the EU level for some bases. Both show that implementing a scheme conferring only the EU the power to tax a mobile base would represent the best system from a social welfare point of view.

In a model adopting a multi-principal approach derived from Martimort (1996) and addressing explicitly vertical tax externalities,[74] we consider as a benchmark a situation that authorises only one benevolent decision-maker to exert some taxing power upon a mobile base, such as capital. Social welfare is maximised in such a setting. We compare this equilibrium first with a system similar to the current one, in which Member States collect the tax, transfer a fraction of the receipts to the EU tier and receive a part of the expenditure undertaken at the EU level. In a second case, we compare it with a setting in which both levels of government (EU and national) tax the same base. It appears that the first system examined leads to inefficiently low levels of taxation; indeed, when a part of the tax receipts is transferred to the EU level, Member States may consider they would not fully benefit from a rise in tax rates and hence reduce their tax rate. In the second case, when the base is taxed twice, at the country level and at the EU tier, total taxation increases and results into higher global tax than in the benchmark case.

Thus, when considering simultaneously horizontal and vertical tax interactions in a common agency game setting, in which the agent (the firm) holds private information about the amount of capital available, whereas governments (both Member States and the EU) are the imperfectly informed principals, and involving nonlinear instruments, it can be shown that the global tax rate would be higher than in a system where only the upper-level policy-maker is allowed to tax the base, while national authorities compete through other instruments to attract firms. The result holds regardless of governments' objective function.

The final global tax rate resulting from the interplay of both kinds of external effects is set at an intermediate level between the level that would result from horizontal competition in the absence of an upper-tier authority and the tax rate induced by the double taxation of a common base by two decision-makers belonging to different layers of government. It appears that the tax rate borne by firms would be higher with a stacking of two taxes than with the EU tier applying a tax on firms and distributing the receipts collected among Member States according a distribution key. The level of public investment would also be lower in the latter case than in the first case. Hence, allowing the EU alone to tax would yield the optimal outcome, while sharing the tax base between the EU and national levels would lead to a less favourable equilibrium, though better than the current one in which only national governments are levying the tax.

[74] Horizontal tax externalities are not explicitly taken into account; yet, they can be regarded as indirectly tackled through the EU public expenditures from which each country can benefit.

Annex III. Accounting and fiscal rules

According to Tommaso Padoa-Schioppa, "[a]n increase in the EU budget today is perceived as a subtraction of resources from the national budgets. And indeed, in accounting terms, this is the case because revenues accrue to the EU budget from national budgets."[75]

As shown by Mortensen et al. (2014), there is a "striking diversity within the EU as regards Member States' handling of their contribution to the EU budget".

At the EU level, a marked improvement in terms of harmonising accounting rules has been realised through adoption of the ESA in 2010 (Regulation (EU) No. 549/2013). From now on, the same classification should be applied to the contributions of Member States.

Rules of accounting of the transactions between the national governments and the EU

As a general rule, the transactions between any resident unit of a country and the EU are classified in the account of the rest of the world.

Before observing accounting rules concerning TOR and own resources, we present a simplified accounting framework to illustrate the consequences of these rules on the deficit of the public sector.

A simplified sequence of national accounts of the public sector

For the sake of simplification, we shall assume for the rest of this work that the public sector is a non-profit institution. The underlying reasoning is not affected by this hypothesis, which highlights the nature of the accounting balances and the potential effects of a change in the recording of the own resources.

The first account in the sequence of accounts, or Production Account, describes the production activity of the public sector, or sector of public administrations. The accounting balance of the production account is the added value (evaluated at basic prices), obtained by subtracting intermediate consumption from production.

The sum of the value added of all the institutional sectors of the nation, evaluated at market prices, i.e. VAT included, is equal to the GDP.

The Generation of Income Account is the following account. The operating surplus of the government is obtained by subtracting the compensation for employees from the added value. When the public sector is a non-profit institution, the operating surplus will be equal to zero or nearly equal to zero. This conclusion is obvious for non-profit institutions because the operating surplus corresponds to a gross profit.

The third account, namely the account of Allocation of Primary Income, provides the balance of primary income, or the income accruing to the government before the implementation of the national redistributive policies. The most important expenditure at this level is the interest due on the cost of incurring liabilities, notably on loans, bills, notes and bonds. The main resources consist of the VAT (and other taxes on production) and other indirect taxes, such as excise duties.

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[75] Derived from an interview of Padoa-Schioppa by Notre Europe, "Conversation on the eve of the 2010 European December Council", 12 December 2010.

The disposable income of the public administrations appears in the account of secondary distribution of income.

The Use of income account shows how the disposable income is divided between final consumption expenditure and saving. For the public sector, by definition, final consumption of the public administrations is equal to their production.

Finally, the Capital account gives the net lending (+) or net borrowing (-) of the public sector, obtained, roughly, by subtracting investment from saving.

Figure A-11. Sequence of accounts of the public sector

Sequence of accounts of the public sector Production Account	
Uses	Resources
Intermediate Consumption Balancing item: Value Added	Production
Generation of Income Account	
Compensation Employees Balancing item: Operating Surplus (0)	Value Added
Allocation of Primary Income Account	
Interest Balancing item: Primary Income	Operating Surplus Taxes on production
Secondary Distribution of Income Account	
Social Benefits Balancing item: Disposable Income	Primary Income Taxes on Income, Social Contributions
Use of Disposable Income Account	
Final Consumption (= production) Balancing item: Saving	Disposable Income
Capital Account	
Investment Net lending/net Borrowing (Budget surplus/budget deficit)	Saving

Rules of accounting of the contributions from national governments to the institutions of the EU

The recording of specific transactions between national residents and institutions of the EU obeys the rules outlined below.

Taxes

Some taxes on products, such as import duties and excises, are payable to institutions of the EU. They form three categories:

- those payable directly, such as the past European Coal and Steel Community levy on mining and on iron- and steel-producing entities, which are recorded directly (genuine own resources);
- those collectable by the national governments acting on behalf of the institutions of the EU or other supranational organisations, but where the tax is judged as payable directly by the resident producers. Examples are levies on imported agricultural products, monetary compensatory amounts levied on imports and exports, sugar production levies and the tax on isoglucose, co-responsibility taxes on milk and cereals, and custom duties levied on the basis of the integrated tariff of the European Union (TARIC). Such items are recorded directly from the producers to the supranational organisation, with the government's role as an intermediary recorded as a financial transaction; and
- receivables of VAT in each Member State (VAT-based own resource). These are recorded as receivable by national governments, with the amounts that Member States provide to the EU recorded as a current transfer.

Miscellaneous current transfers

Contributions to the EU budget from Member States for the third and fourth types of payment, VAT- and GNI-based own resources, are considered to be compulsory transfers from governments towards the EU.

The recording of TOR and own resources in national accounts

The recording of TOR. The traditional own resources are included in the heading D2: taxes on production and imports. They are defined as compulsory, unrequited payments, in cash or in kind, which are levied by the general government or by the institutions of the EU, in respect of the production and importation of goods and services, the employment of labour, the ownership or use of land, buildings or other assets used in production.[76]

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[76] The taxes on production and imports are comprised of the components outlined below.

(a) Taxes on products (D.21):

(1) value added type taxes (VAT) (D.211);

(2) taxes and duties on imports excluding VAT (D.212);

– import duties (D.2121),

– taxes on imports excluding VAT and duties (D.2122);

(3) taxes on products, except VAT and import taxes (D.214); and

(b) Other taxes on production (D.29).

The taxes on production and imports paid to the institutions of the EU include the following taxes collected by national governments on the behalf of the institutions of the EU:

- receipts from the CAP levies on imported agricultural products, monetary compensatory amounts levied on exports and imports, sugar production levies and the tax on isoglucose, co-responsibility taxes on milk and cereals; and
- receipts from trade with third countries – customs duties levied on the basis of the TARIC.

TOR are recorded in the account of allocation of primary income of the government. They are recorded twice: on the resources side, Taxes on Production and Imports Receivable; and on the uses side, Taxes on Production and Imports Payable. The complete sequence of registering the TOR is shown below (Figure A.12).

Taxes and duties on imports excluding VAT (D.212) comprise compulsory payments levied by general government or the institutions of the EU on imported goods, excluding VAT, in order to admit them to free circulation on the economic territory, and on services provided to resident units by non-resident units. The compulsory payments include the following taxes and duties:

(a) import duties (D.2121) (these consist of customs duties, or other import charges, payable according to customs tariff schedules on goods of a particular type when they enter for use in the economic territory of the country of utilisation); and

(b) taxes on imports, excluding VAT and import duties (D.2122). This heading is further specified:

(1) levies on imported agricultural products;

(2) monetary compensatory amounts levied on imports;

(3) excise duties and special taxes on certain imported products, provided such duties and taxes on similar products of domestic origin are paid by the producer branch itself;

(4) general sales taxes payable on imports of goods and services;

(5) taxes on specific services provided by non-resident enterprises to resident units within the economic territory; and

(6) profits of public enterprises exercising a monopoly over the imports of some goods or services, which are transferred to the state.

Figure A-12. Generation of Income of the Total Economy

Uses	Resources
TOR	

Allocation of Primary Income of the Government

Uses	Resources
TOR (payable)	TOR (receivable)

External account of primary incomes and current transfers

Rest of the World

Uses	Resources
	TOR

	TOR

The TOR simply transit through the accounts of the general governments, which act merely as tax collectors on behalf of the EU. Consequently, they have no effect on the balancing items of subsequent accounts. They are budgetary neutral.

That is why, in France for example, since 2010 the TOR have not been included in the French contribution to the financing of the EU institutions, namely the PSR-UE (Prélèvement sur recettes à destination de l'Union européenne), according to a decision of the Court of Auditors of 7 June 2007. In fact, TOR do not constitute resources for the governments, they are regarded as a tax directly paid by individuals to the EU institutions.[77] They appear nowhere in the budget of the French public sector,[78] and so are excluded from the budgetary debate. This decision also sought to put an end to an unjustified inconsistency between budgetary accounting and general accounts, because according to general accounts, since their origin TOR have been treated in separate third-party accounts.[79] So, a genuine own resource should absolutely share this characteristic and should never transit through the accounts of the public sector. The choice of potential tax candidates for this role should take this constraint into account.

The recording of VAT- and GNI-based own resources. VAT-based and GNI-based resources are recorded on the uses side of the account of secondary distribution of income of the government (heading D.76, distributive transactions). According to the national accounts, the VAT- and GNI-based own resources are considered current transfers paid by the government of each Member State to the EU institutions (heading D.761 for the VAT-based resource (D.761) and heading

[77] See Relations financières avec l'Union Européenne, jaune, Annexe au projet de loi de finances pour 2015.

[78] See L'application intégrale de cette décision n'a eu lieu qu'en 2011, Cour des comptes, Résultats et gestion budgétaire de l'Etat exercice 2011, mai 2012.

[79] See Cour des comptes, Résultats et gestion budgétaire de l'Etat exercice 2009, mai 2010.

D762 for the GNI-based own resource (D.762)). VAT- and GNI-based own resources are recorded when they are due to be paid.

In summary, VAT- and GNI-based third and fourth own resources are recorded as a) uses in the account of secondary distribution of income of the government (Figure A.13), and b) resources in the external account of primary incomes and current transfers (Account of Rest of the World).

Figure A-13. Secondary distribution of income account of the general government

Uses	Resources
VAT- and GNI-based Own Resources	

External Account of Primary Income and Current Transfers

Uses	Resources
	VAT- and GNI-based Own Resources

For national governments, VAT is a resource of the Allocation of Primary Income Account. Although VAT is paid by individual consumers, VAT is, as its name indicates, a tax on value added (fundamentally a tax on gross domestic product expressed at market prices, or GDP, more precisely on the final consumption, which is one of the components of the aggregate final demand). Indeed, the VAT and GNI contributions are not very different by nature, especially as the VAT contribution can be viewed, at least partially, as depending on the GNI of the Member States.

Being obviously a loss of revenue, the VAT- and GNI-based resources lead to a reduction of the disposable income of each Member State and exert an indirect impact on the budget deficit. As final consumption and savings are the only two possible uses of the disposable income, and moreover, as the final consumption is equal by definition to the production of the public sector, a small marginal reduction of the disposable income, for a given public production (or consumption), will bring about an equivalent reduction of the public savings and a worsening of the budget surplus or of the budget deficit of the public sector, according to the case. Member States will be prompted to react by reducing their consumption (roughly equal to their production) and perhaps their investment. As public production or public consumption are equal to the sum of the intermediate consumption and of the compensation for employees, wages will be used as an adjustment variable, leading to a reduction of this part of the global public spending (production plus investment), which stimulates economic growth in the short term. A third solution would be to increase the national tax pressure, to try to balance the effects of the losses of income resulting from the attribution of national receipts to the EU, but the final result will be the same. This constraint is strengthened if the Member States have implemented a rule seeking the stabilisation of the public expenditures ('zero value rule' for example).

Mortensen et al. (2014) have shown that only France, Germany, Bulgaria and Austria classify the EU contribution as an attribution of receipts to the EU, "in line with the design of the system of own resources" and not as an expenditure. So, they conclude that "the handling by Member States' contributions to the EU must be fully harmonised in the sense of ensuring that all Member States classify this contribution as an attribution of government receipts to the EU and not as an expenditure". No matter how the VAT and GNI own resources are recorded or named, they represent a deadweight loss for the Member States to the benefit of the rest of the world.

Even in France, the attribution of government receipts to the EU (PSR-UE) is considered an expenditure, as this is literally expressed in the financial statements supplied by the government to the parliament. That is why, in national accounting, the VAT- and GNI-based resources are only registered on the uses side of the account of secondary distribution of income, without any registration on the resources side of the same account. The VAT- and GNI-based own resources represent distributive transactions at the expense of Member States.

Rules of accounting concerning the amounts received from the EU

A distinction is to be made between the aids promoting investment and the subsidies.

Capital and current transfers received from the EU

In accounting terms, the investment grants are classified as capital transfers, whereas subsidies are classified as current transfers. The subsidies granted by the institutions of the EU cover only current transfers made directly by them to resident producer units.

Investment grants are defined as follows: they are capital transfers in cash or in kind made by governments or the rest of the world to other resident or non-resident institutional units to finance all or part of the costs of their acquiring fixed assets. Investment grants (D.92) (a subset of capital transfers (D.9)) paid directly by the institutions of the EU (e.g. transfers made by the European Agricultural Guarantee Fund (EAGF) and the EAFRD or through structural funds, such as the European Social Fund, the ERDF and the Cohesion Fund), are included in the investment grants received from the rest of the world.

Investment grants are recorded as a) changes in liabilities and net worth (-) in the capital account of general government; b) changes in liabilities and net worth (+) in the capital account of the sectors receiving the grants; and c) changes in liabilities and net worth in the capital account of the rest of the world.

Share of receipts from the EU registered in the accounts of the public sector

Only a very small share of the receipts from the EU appears in Member States' accounts as resources. The justification of this accounting rule is that the EU policies are not implemented in the interest of the Member States but in the interest of the EU.

If, once again, we consider the case of France as an illustration, Table A-3 shows the grant amounts that France has received through the CAP.

Table A-3. Receipts from the EU through the CAP

€ million	2008	2009	2010	2011	2012
EAGGF-guarantee	9,208.7	9,824.8	9,545.1	9,504.6	9,508.3
Amounts recorded as resources for the state	0	0	0	0	0

Source: *National Accounts of France*

These funds spent by the government in favour of the institutions in charge of managing these aids, only transit through national accounts and have no impact on the budget deficit. In fact, in France, they have not appeared in the accounts since 2005, being recorded in a third-party account, as is the case for the TOR.

The structural funds are treated in the same way. It is only when the state is in charge of the investment or projects that the grants are registered as resources in the accounts of the government (Table A-4).

Table A-4. Structural funds received from the EU

€ million	2008	2009	2010	2011	2012
ERDF	1,157	968.4	810.8	1,221.9	744.3
European Social Fund	948	940.6	536.9	383.1	589.6
EAGGF-Guidance	72	16.3	0	184	1.1
EMFF	39	1.5	0.03	0	0
Total:	3,216	1,926.8	1,367.73	1,623.4	1,335.2
Registered	104.7	173.5	95.3	81.4	117.5

Source: national accounts

Table A-5 provides the global amount of structural funds recorded as resources by the French government.

Table A-5. Structural funds recorded as resources by the state

€ million	2008	2009	2010	2011	2012
Structural funds	104.7	173.5	95.3	81.4	117.5
Others	122.4	63	65.1	33.9	67.3
Total	227.1	236.5	160.4	115.3	184.8

Source: *National Accounts France*

As a consequence, the global contribution of each Member State (TOR excluded, co-financed operations included) and not the 'net national balance' is the true or good estimation of the part of the national public deficit resulting from the transactions with the EU, thus contributions to the EU budget appear only on the expenditure side of national budgets, while possible benefits from the EU budget expenditures do not show anywhere. Of course, some Member States have perhaps chosen other accounting rules and do not use third-party accounts. But in terms of the public deficit, algebraically, the result should be the same.

The expected benefits, in terms of the public deficit, resulting from a shift of the present system towards a new system based on 'genuine' own resources, should be evaluated in the same way, almost independently of the amounts spent by the EU. This is a powerful argument in favour of the adoption of such a reform. In economic terminology, we have a kind of Pareto improvement. In financial terms, for each national government there is everything to gain from such a reform. In political terms, a Pareto improvement is likely to meet the requirement of unanimity among the voters, i.e. the Member States. It is a necessary condition, although not sufficient.

Tables A-14 and A-15 present the impact of changing the adjusting the way flows are recorded. Of course, the countries registering the most important gains in terms of net borrowing or net lending are the main contributors (but not necessarily the main net contributors), namely Germany, France and Italy. The UK correction (€6,066.3 million in 2014), and to a lesser extent, the justice and home affairs adjustments for Denmark, Ireland and the UK, explain why (especially in the case of the UK), the gains from the reform are so small. If the reform had taken place in 2014, some countries would have de facto satisfied the criterion of Maastricht concerning the compulsory limit of 3% of GDP for the deficit – Belgium, Greece, France, Poland and Finland. The Czech Republic, Ireland, Spain, Croatia and Slovenia would have greatly improved their financial balance, contrary to Cyprus, Portugal and the UK. Lithuania is the only country for which the deficit would have been transformed into a surplus. This ranking can perhaps provide an outline of the opponents and the supporters of such a project. If any country starts to gain, those that already have a surplus could be more reluctant.

Figure A-14. Actual and adjusted deficit/surplus (€ million), 2014

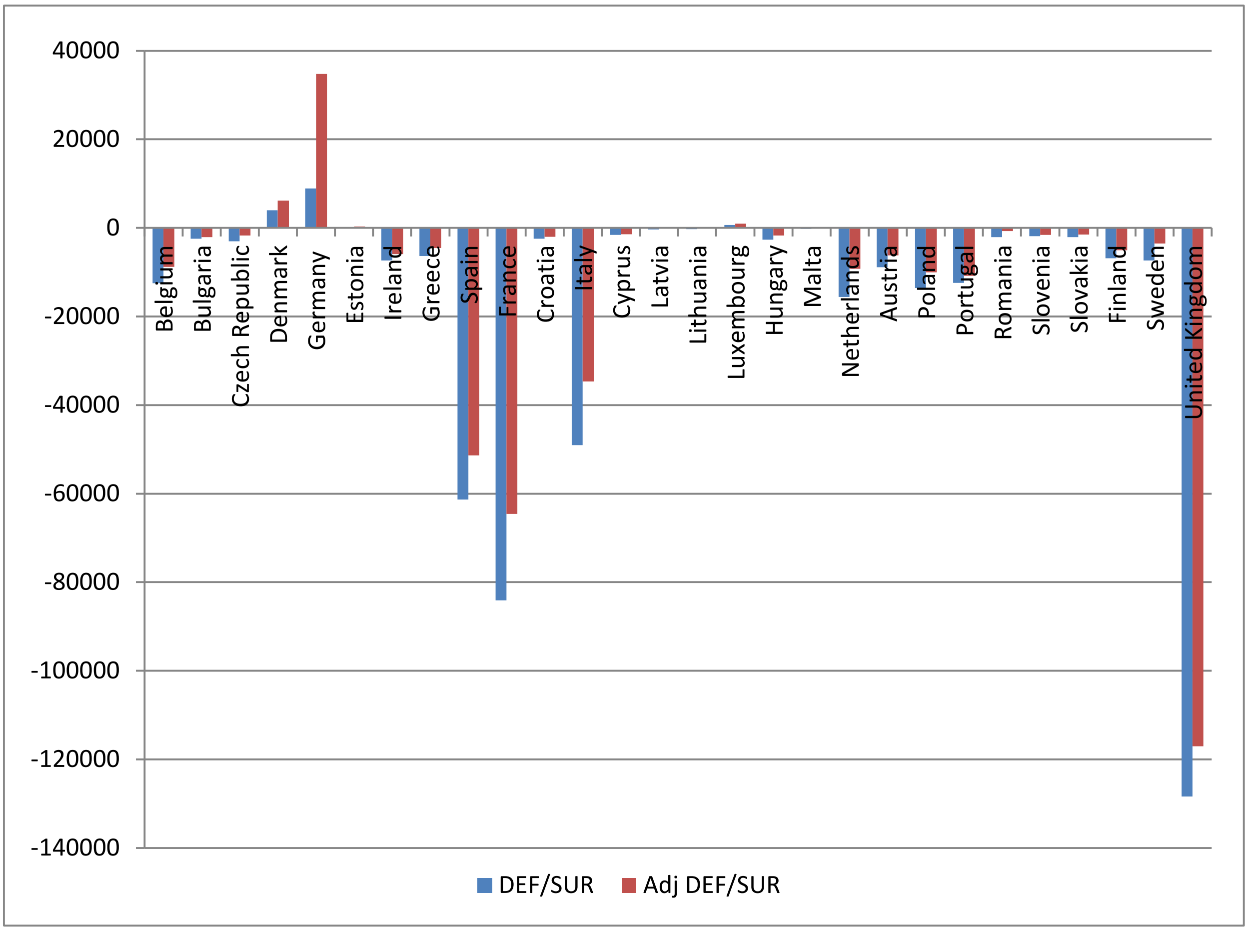
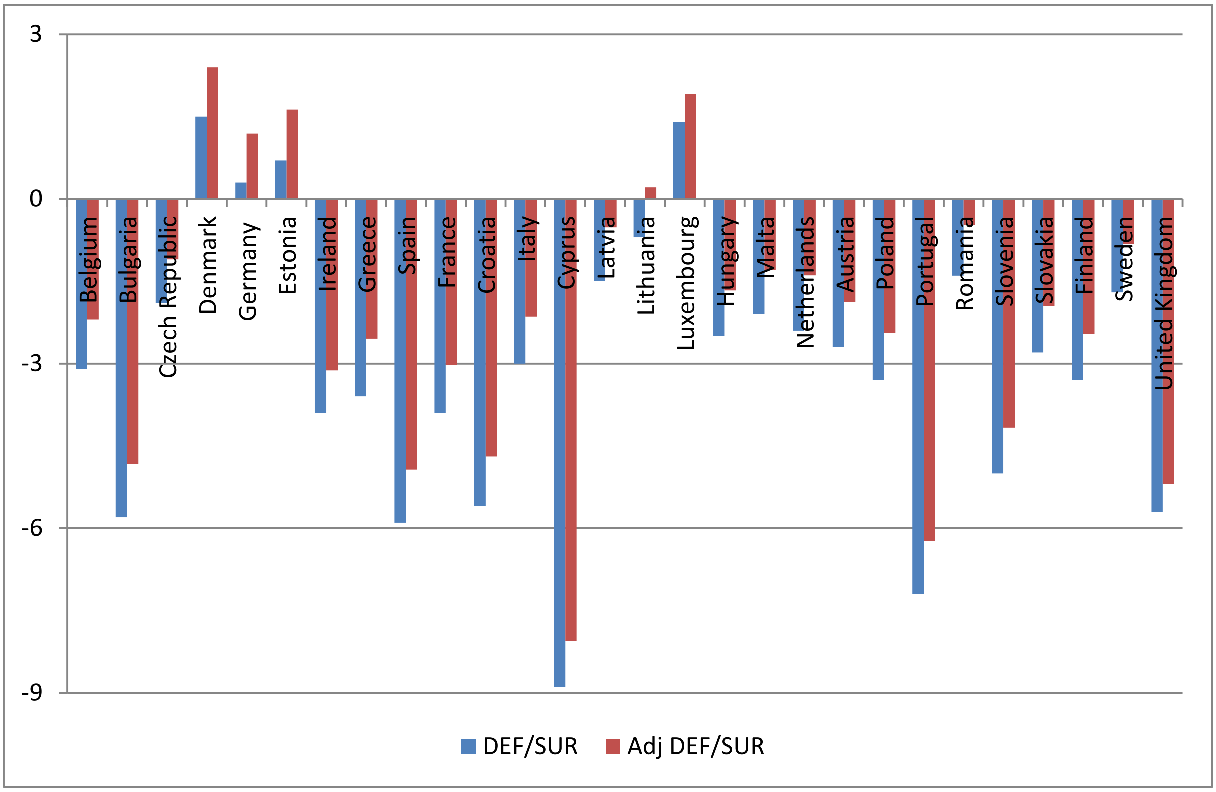


Figure A-15. Actual and adjusted deficit/surplus (% of GDP), 2014



Annex IV. Review of issues related to the common consolidated corporate tax base

The European Commission is re-launching the CCCTB project, which aims at enabling groups of firms to set taxable income according to common EU rules, and to consolidate and share it across the Member States in which they operate. Indeed, formula apportionment would determine this distribution, and the corporate tax rate applicable in each Member State would continue to be applied as the process only deals with the base.

The main expected benefits concern the elimination of transfer prices and a reduced administrative burden.

Most authors agree on the need for all countries take part in the reform

Many studies have been undertaken to assess the impacts of the CCCTB project. Let us look at the results of some of them in Table A-6.

Table A-6. Summary of existing studies on CCCTB

Study	Focus/methodology	Main findings
Spengel et al. (2012)	This study uses average effective tax rates and the European Tax Analyser model-firm simulation (to quantify the change in effective tax burdens).	**There would be no significant change on average in the EU-27 effective tax burden (-0.06%).** Yet, some countries would experience a rise (such as Portugal and Romania), and others a fall (Italy, Ireland and Cyprus).
Bettendorf et al. (2009)	The CORTAX computable general equilibrium model is used to assess the economic impact of various proposals. Indeed, enhanced cooperation is viewed as the way towards harmonisation.	**The welfare gain expected is quite limited and not all countries would benefit from this new system.** Actually, the welfare gain resulting from applying a common base is only 0.006% of EU-27 GDP (it is derived from improved capital export neutrality), but the effects may vary significantly across countries according to the change induced in the tax base size (for instance, +0.4% of GDP for Poland and Spain). With consolidation and formula apportionment, a small aggregate welfare gain (0.1% of GDP) may emerge thanks to the corporate tax cut induced by loss consolidation (this gain vanishes if other taxes are used to offset the loss of revenues), but with a strong heterogeneity among countries.
Cline et al. (2008)	The potential impact of the CCCTB on Member States' tax revenue is assessed from both a static point of view and a dynamic one (i.e. taking into account behavioural effects and the impact on	The impact on global static revenue is minor and thought of as redistribution movements in economic activity. A compulsory CCCTB for all Member States would raise EU corporate tax revenue as a whole, as would be the case

	economic activity). Three scenarios are analysed: first all Member States are required to adopt the CCCTB; second, all of them are willing to do so; and third, it is mandatory for only nine of them to implement this reform.	with some kind of enhanced cooperation, whereas the implementation of a voluntary CCCTB scenario would induce a reduction in global corporate tax collection. The dynamic economic analysis displays changes in employment or foreign direct investment (FDI) (as improvements for France and Spain and a deterioration for other countries). **A compulsory implementation of the CCCTB would lead to a deterioration in overall EU activity (a reduction of employment, GDP and FDI by 0.3%, 0.2% and 1.1% respectively). These losses are smaller in a voluntary scenario (employment and GDP 0.1%, FDI 0.5%).** The CCCTB thus appears to be a zero-sum game little able to enhance the "overall economic 'pie'". Nevertheless, important distributive effects would appear among countries, related to economic variables and depending on the number of participating countries.
Van der Horst et al. (2007)	The applied general equilibrium model, CORTAX (describing the 27 EU countries, the US and Japan), enables a simulation of the economic implications of corporate tax policies and focuses on the long-run effects in the steady state. A welfare analysis is provided.	The study shows that efficiency gains may arise thanks to lower compliance costs and the elimination of transfer prices, but on the other hand, new distortions may well emerge mainly owing to the uneven treatment of firms and strengthened tax competition. Differences between large and small firms are also observed and distributional effects among countries are introduced. The authors point to the need to avoid the heterogeneity stemming from a non-compulsory implementation, also in the interest of harmonisation. As a result, **welfare is hardly improved (0.02% of GDP).** Through consolidation of the base, GDP is slightly strengthened, but that is not the case for employment.
Bettendorf et al. (2007)	This study uses an applied general equilibrium model (CORTAX).	Beyond the limited expected effects of a common corporate tax base on welfare (a broader base and a reduced tax rate), consolidation is regarded as likely to reduce compliance costs, to enable the consolidation of losses and avoid some

		profit allocation distortions. Together with formula apportionment, this **slightly improves welfare at the global level (0.1% of GDP), but at the expense of distribution among countries.**
Fuest, Hemmelgarn and Ramb (2006)	German data are derived from the dataset of Deutsche Bundesbank's Foreign Direct Investment data (MiDi) and corporate balance sheet data (Ustan and Hoppenstedt) are used for the tax base estimations.	The results suggest that a distributional effect appears in countries' tax bases, as an effect of the overall size of the European tax base, namely a decrease (by 20%) in the sample studied (only a part of the EU tax base is assessed).
Ernst & Young (2011)	This case study looks at the potential impacts of the CCCTB on compliance costs and effective tax rates (for existing groups with significant European operations). Enhanced cooperation is examined.	Compliance costs would rise. Overall changes would be limited.
Spengel et al. (2008)	This study uses average effective tax rates and the European Tax Analyser model-firm simulation to assess the impact of a CCCTB. There is differentiation between the most comprehensive approach, including cross-border consolidation, and loss compensation mechanisms (CCCTB) from the common corporate tax base.	Only the CCCTB system is assessed. There is an increase of the average tax base, due to depreciation to a great extent.
Devereux and Loretz (2008)	Market neutrality and capital export neutrality are the focus of this study. The assessment is based on effective average tax rates.	Market neutrality would be improved as would capital neutrality, but to a lesser extent.

Source: *Authors*

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