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Alternative Financing Sources for the EU Budget

The EU budget is financed primarily by national contributions. Progressively deeper European integration and the need to finance "European public goods" and activities with positive cross-border external effects speak in favour of attributing dedicated taxes to the EU. Notably a tax on foreign exchange transactions and a kerosene tax lend themselves for that purpose. Abolishing the VAT-based revenue component while keeping Gross National Income (GNI) as a source of own revenue could be further key features of a reform of the EU financing system.

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In spring 2006, under Austrian Council Presidency, an agreement was reached after two years of negotiations on the EU Financial Perspectives for the period from 2007 to 2013. The new financial framework agreed upon by the European Parliament, the European Commission and the 25 member states represented in the Council follows the Financial Perspectives for 2000 to 2006 ("Agenda 2000"). During the tedious negotiation process, many of the member states' representatives involved as well as those from the European institutions and experts repeatedly deplored not only the small size of the EU budget[1], but also the existing system of EU own resources in need of reform.

Against the background of this reform debate, which dates back to before the last financial negotiations, some long-term trends of the level and composition of EU revenues and potential inherent problems are of immediate interest. This leads to the question of how to assess the most substantial reform proposal in the current debate, which has been advocated for years notably by the European Commission, namely to attribute an own tax sovereignty to the EU and to finance part of the EU budget through dedicated EU taxes and, in the affirmative, to review particular taxes in the light to their possible qualification as EU taxes.

Volume and composition of EU revenues

The EU, lacking financial sovereignty, does not have the right to raise taxes or contributions in order to finance its own tasks. Rather, tax sovereignty within the EU is conferred to the member states at the national or in some cases the sub-national level. Some (very small) parts of national tax revenues that member states raise for the financing of their own households, is being transferred to the EU. The EU has essentially three sources of revenues (see Box "The Overall EU Budget"): traditional own resources (agricultural tariffs, sugar customs duties, general tariffs), own resources from national VAT and own resources linked to GNI[2]. In addition, the EU receives a number of other-type revenues. EU expenditure may be financed exclusively from own resources, with the option of running a budget deficit being excluded by Art. 269 of the EU Treaty (in the version of the Treaty of Nice of 2001).

[1] For the expenditure of the EU see also Pitlik, H., "Spending priorities in the EU Budget 2007 to 2013: The perspective of fiscal federalism", in this issue, http://www.wifo.ac.at/wwa/jsp/index.jsp?fid=23923&id=28378&typeid=8&display_mode=2, and Fritz, O., Sinabell, F., "Die Kohäsions- und Agrarpolitik im neuen Finanzrahmen der EU", WIFO-Monatsberichte, 2006, 79(11), pp. 817-833, http://publikationen.wifo.ac.at/pls/wifosite/wifosite.wifo_search.get_abstract_type?p_language=1&pubid=27764&pub_language=-1&p_type=1.

[2] This financing source was formerly calculated on the basis of GNP (gross national product), but since 2000 on the basis of GNI (gross national income).

The Overall EU Budget

Apart from own resources, the EU receives revenues from interest from arrears, penalties, taxes on salaries of the employees of EU institutions, interest on financial assets etc. These "other" revenues amounted to € 3.6 billion in 2005. In addition, the budget surplus of the previous period is added to the overall budget (€ 2.7 billion in 2005; *European Commission*, 2006C). EU expenditure must be financed entirely by own resources, the option of a budget deficit is precluded by Art. 269 of the EU Treaty (in the version of the Treaty of Nice of 2001): "The budget is entirely financed by own resources, notwithstanding other revenues". Nevertheless, credit financing plays a certain role in the framework of EU activities, since certain institutions, notably the European Investment Bank (EIB), are entitled to extend loans and guarantees to public and private institutions up to a ceiling, and to take up credits to this end.

In order to calculate the revenues required, expenditures are projected first. In a second step, revenues from own resources are set such that the budget is ex ante in balance. "The different revenue sources are used sequentially, i.e., by calculating a series of successive balances. First, the expected yield from "other" revenues and the estimated surplus of the preceding fiscal year are deducted from the total of projected expenditure. The balance of expenditure is financed from own resources. Within the category of own resources, the estimated yield from traditional own revenues is deducted first. Subsequently, the VAT-based contributions obtained from the harmonised call rate (subject to the UK rebate) is deducted" (*European Commission*, 2002). The remainder is financed by applying the harmonised call rate on the GNI-based own resources.

Source: *European Commission* (2002), *European Union* (2006).

Both the kind and the scope of the generation of own resources as well as the taking over of own responsibilities by the EU have to be voted by unanimity by the European Council and by all member states according to their respective constitutional provisions. The rate for the VAT revenue component is currently set at 0.5 percent of the harmonised VAT tax base[3], while the rate for the GNI revenue component, uniform across member states, is derived as a residual ensuring the full coverage of expenditure. The current EU expenditure ceiling is defined by 1.31 percent of aggregate EU GNI (commitment appropriations) and 1.24 percent (payment appropriations), respectively. These ceilings are at the same time those for the EU own resources.

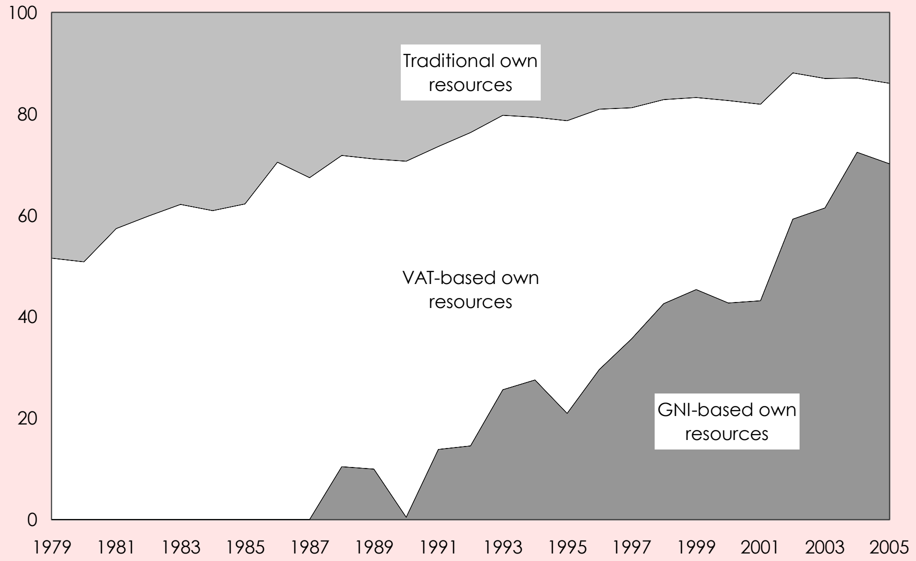
In practice, this ceiling was not reached in 2005, as shown by the flow of own resources as percent of GNI. As a rule, actual payments by the member states fall markedly below the ceiling. Thus, in 2004, total payments made by all member states only amounted to 0.91 percent of aggregate EU GNI (€ 95.1 billion) and to 0.93 percent (€ 100.8 billion) in 2005 (*European Commission*, 2006A).

As illustrated in Figure 1, the composition of own resources has shifted considerably over the last 25 years. The traditional own resources received directly by the EU have greatly lost importance: whereas in 1980 they had still accounted for nearly 50 percent of total revenues, that share has since fallen steadily, declining from 21 percent in 1995 to below 14 percent in 2005. In this way, the financing of the EU budget is increasingly supported by direct contributions from the member states' national budgets. The fall in customs revenues in the course of trade liberalisation and EU enlargement, coupled with a significant decline in the VAT revenue share translated into an increase in the GNI-based own revenue component, both in absolute and relative terms.

[3] In the context of the "UK compensation" to finance the "UK rebate", reduced VAT call rates are granted for a number of net contributors among member states (see Box "The Own Resources System of the EU)".

Figure 1: Composition of EU revenues from own resources

Share of total own resources in percent



Source: European Commission, distribution of EU expenditure 2005 by member state, September 2006; EU Financial Report 2005.

The Own Resources System of the EU

With the Council Decision of April 1970 (Official Journal No. L 94 of 28 October 1970), the national contributions of the individual EU member states were replaced by a financing system based on own resources. These revenues accrue to the EU directly, without any further decisions being necessary at the national level. The revenue total has been limited by the decision of June 1988 providing for a ceiling for the EU own resources. This ceiling has been lowered in 2000, with the changeover from ESA 79 to ESA 95, from 1.34 percent to 1.31 percent of EU GNI for commitment appropriations, and from 1.27 percent to 1.24 percent of EU GNI for payment appropriations (in 1992 it had been set at 1.2 percent of EU GNI, and from 1995 to 1999 it was raised in steps from 1.21 percent to 1.27 percent of EU GNI).

In its present form (2000/597/EG, Euratom), the system comprises the traditional own resources (in 2005 14 percent of own resources revenues), the VAT-based own resources (16 percent) and the GNI-based own resources (70 percent).

Until 1980, the traditional own resources, i.e., tariffs, agricultural tariffs (on imports of agricultural and other products from third countries) and sugar levies (paid by sugar producers to finance the compensations for sugar exports) were the only financial sources of the EU. They are collected by the member states on behalf of the EU and directly transferred to the EU budget (minus a discount of 25 percent remaining with the member states to cover the cost of revenue collection).

The VAT-based own resources were introduced in 1980, originally as a residual financing source with a uniform (in principle) call rate from a harmonised tax base. The call rate is applied to the harmonised tax base that is limited to 50 percent of national GNI. Between 1995 and 1999, this ceiling was reduced stepwise from 55 percent to 50 percent. At its introduction, the (maximum) call rate was fixed at 1 percent, in 1985 it was raised to 1.4 percent and between 1995 and 1999 reduced in steps to 1 percent. For 2002 and 2003 it was cut to 0.75 percent, and for the years from 2004 to 2006 to 0.5 percent. The financial framework 2007 to 2013 provides for a call rate of 0.3 percent. In the context of the financing of the "UK rebate", some net contributors have been granted for the period 2007 to 2013 a reduction of the call rate (Germany 0.15 percent, Sweden and the Netherlands 0.1 percent, Austria 0.225 percent).

The GNI-based own resources were introduced in 1988. As a residual source of financing, they serve to balance the budget subject to the own resources ceiling; as a consequence, the call rates that are the same for all member states are updated each year.

Source: *European Commission* (2001), *European Union* (2006).

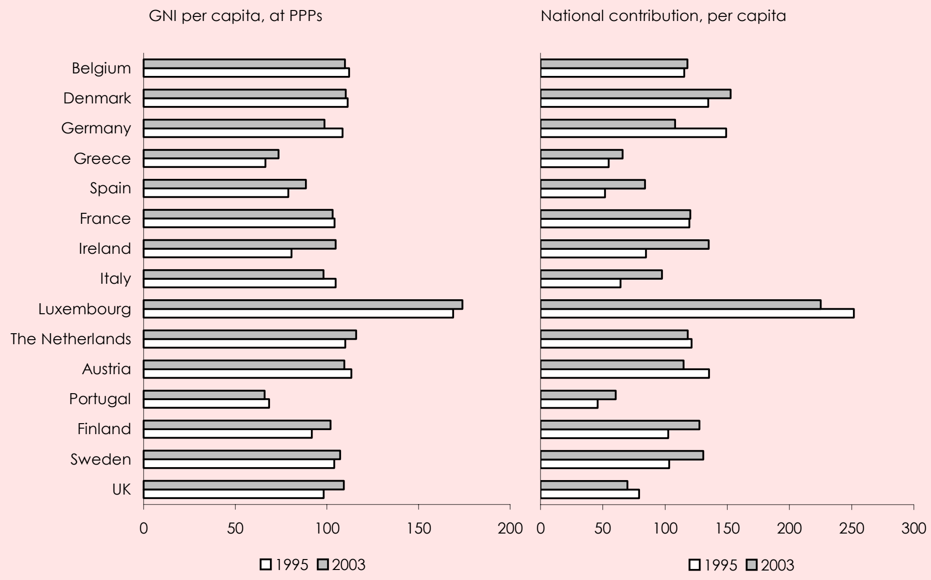
Two Council Decisions, from 1992 (effective as from 1995) and 1999 (effective 2002), have shifted the bulk of financing from the VAT- towards the GNI-based own resource component. Part of this move were stepwise cuts in the call rate for the VAT-based own resources (see Box "The Own Resources System of the EU") to meanwhile

0.5 percent of the harmonised tax base which itself had been reduced to 50 percent of national GNP over the same period. In parallel, the own resources ceiling was gradually raised until 1999 from 1.20 percent to 1.27 percent of GNP (calculated according to ESA 79 at the time, *European Commission*, 2001). One purpose of this move from VAT- towards GNI-based own revenues was to widen the financing scope of the EU budget, the easing of the financial burden for the economically weaker member states another: while contributions on the basis of VAT have a tendentially regressive effect, the contributions linked to GNI better reflect a country's economic capacity (*Deutsche Bundesbank*, 1999).

Whether in this way the economically weaker countries have actually been exonerated, cannot be examined and assessed here. But the trend of GNI per capita is not necessarily parallel to that of national contributions per capita (Figure 2: Luxembourg, Portugal, Italy, Denmark).

Figure 2: Per-capita GNI and per-capita national contribution of EU member states

Average EU 15 = 100



Source: Eurostat, New Cronos, September 2006; WIFO-calculations.

Until 2005, the year after enlargement by 10 new member states in May 2004, the EU budget rose to a total of € 100.8 billion, almost one-and-a half the size of the 1995 budget (€ 67.8 billion; Table 2). In the last ten years, Germany's share in total own resources fell from 31.4 percent to 20 percent, partly because Germany's share in aggregate EU GNI declined, but partly also due to a lowering of the contribution burden (see below). At the same time, the share of Spain increased markedly and those of Greece and Portugal slightly.

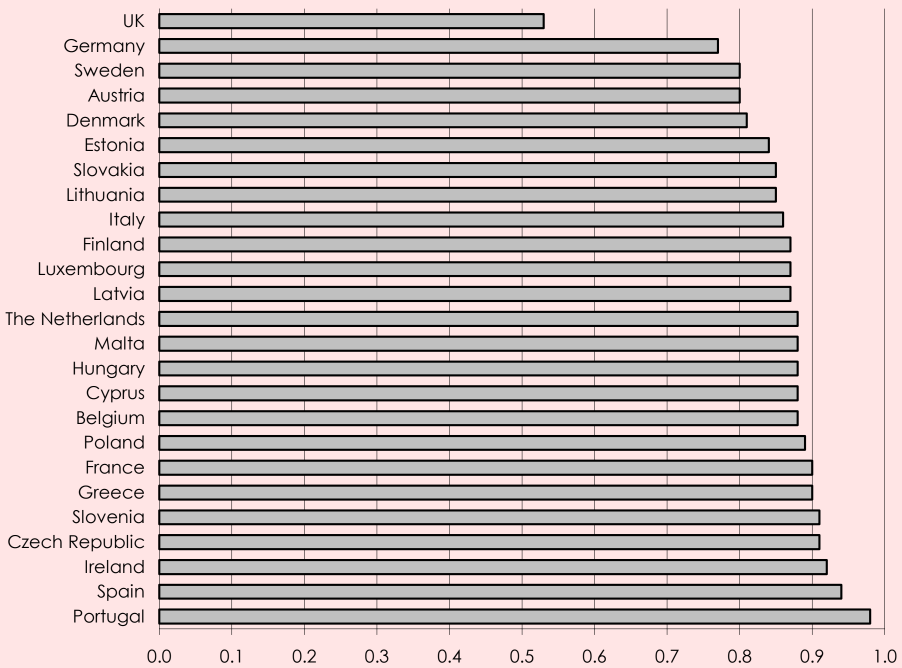
Contributions by the individual member states

The *gross contribution*, i.e., total payments made to the EU, is the most straightforward measure of a country's contribution towards financing the EU budget. If one deducts from that total the traditional own resources, one obtains the *national contribution*, consisting of the VAT-based and GNI-based own resources. The national contribution (Figure 2) lends itself better than the gross contribution to comparisons between member states, since it reflects the resources actually raised by the particular member states. Figure 3 shows the national contributions as percent of GNI (the UK rebate being included).

In the political discussion and in EU budget negotiations, the *net contribution position* of the different member states, as recorded in the national balance of payments statistics, plays a more important role than the national contribution. As the balance of financial transfers (VAT- and GNI-based own resources) paid to the EU and transfers received from the EU budget, it expresses the financial net benefit that a member state has drawn from the EU budget.

Figure 3: VAT- and GNI-based own resources of EU member states

2005, as a percentage of GNI



Source: European Commission, Distribution of EU expenditure 2005 by member states, September 2006.

Apart from the fact that the net contribution position alone cannot by far capture the entire economic impact of European integration upon the member states – beyond the direct transfers from the EU budget, EU membership carries a number of indirect economic effects, such as potential access to new export markets –, the calculation of this indicator is subject to a certain margin of uncertainty (*Clemens – Lemmer*, 2006): on the revenue side, customs revenues cannot be attributed with certainty to the country where payment has been made, since the final destination of the goods may be a different one ("Rotterdam effect"). For this reason, the traditional own resources are not included into the calculation of the net contribution position. On the expenditure side, spending on external policies (payments to third countries) cannot be directly assigned to particular member states. Subsidies for agricultural exports are statistically recorded in the country of export, not at the point of production. Administrative expenditures related to the EU institutions are by and large attributed to the geographical location of the latter (notably to Belgium) in the official Commission calculations (*Deutsche Bundesbank*, 2005). Such inaccuracies may lead to distortions[4].

Since the revenues that cannot be directly attributed to particular member states are larger than the non-attributable expenditures, all countries together seemingly pay less than what all of them receive back, such that each member state's net contribution position is distorted accordingly, with re-transfers from the budget gen-

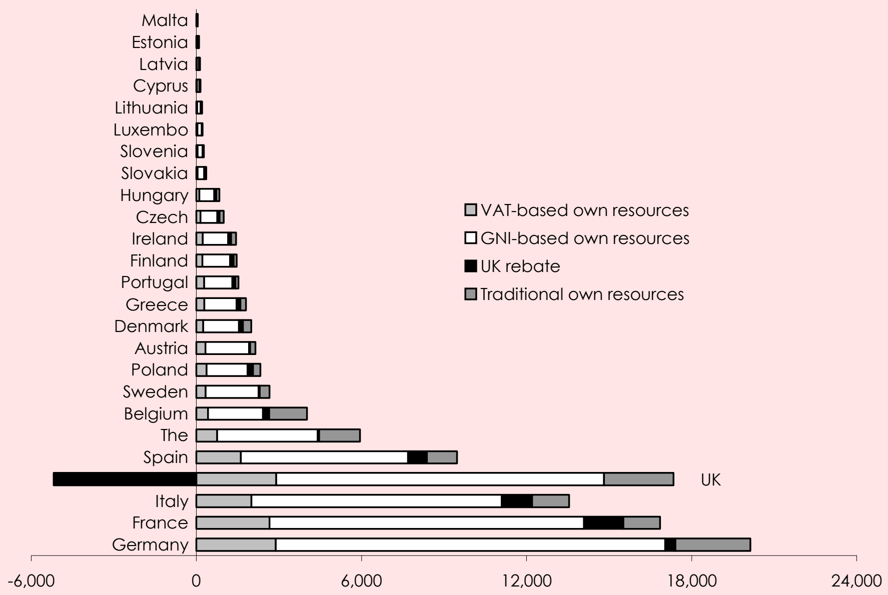
[4] Given that the principal EU institutions are located in Belgium, Luxembourg and France, these countries are the major recipients of administrative expenditures which predominantly consist of the salaries of the staff (of different nationality) of these institutions (*Deutsche Bundesbank*, 2005) and are therefore part of national GNI and ought to be counted as re-transfers to these countries from the EU budget. After all, these services are rendered to the benefit of all member states, their attribution to the countries hosting the EU institutions is therefore controversial.

erally over-stated[5]. This statistical effect is of particular relevance since the net contribution plays a key role in the political debate on the size and distribution of the EU budget. Although this statistical effect has no impact on the distribution between the member states, it makes the volume of the total redistribution induced by the EU budget look larger than it actually is. In order to correct for this factor, the Commission calculates "operative budget balances" which show the official net contribution positions (*European Commission*, 2006A). In these calculations, the administrative expenditures are deducted from the re-transfers to the member states ("operative expenditures"). Subsequently, the national contributions are adjusted in such a way that their total equals that of the operative expenditures[6]. In that case, the total of member states' net balances equals zero, with the distortion being eliminated.

Moreover, time lags may arise through differences between budgeted and actual payment flows within a fiscal year. Examples in this regard are transfers of payment obligations over time[7] or rebates on contributions due to variations in the surplus of the EU budget (*Deutsche Bundesbank*, 1999).

Figure 4: Own resources payments to the EU in 2005

Million €



Source: European Commission, Distribution of EU expenditure 2005 by member states, September 2006.

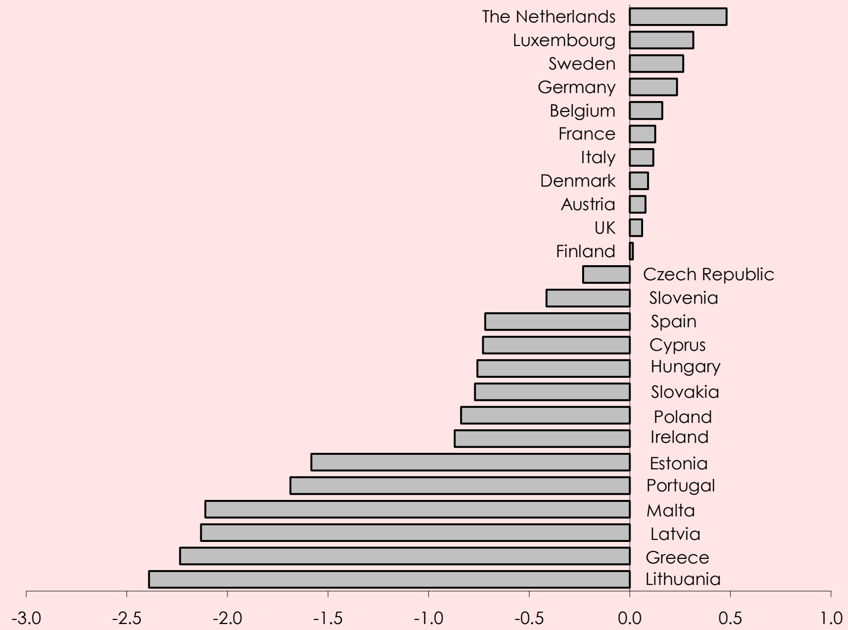
[5] One may argue that, if the EU did not exist, the expenditure on external policies and administration would accrue at least in part at the national level (*Deutsche Bundesbank,* 1999). However, the effect described here would thereby be even reinforced.

[6] In this way, for example, Austria's share of € 2 billion in total national contributions (€ 86.7 billion) was derived. This ratio of 2.2 percent was multiplied by the total of operative expenditure (€ 90.7 billion without administration). The result is the adjusted national contribution of € 2.04 billion. If one sets this figure against the operative expenditure received by Austria (€ 1.77 billion), one obtains a net contribution or operative budget balance of € 278 million.

[7] Whenever a project is co-financed by EU funds, national resourced have to be mobilised as well. If this is not done during the year foreseen, then the payment appropriations are transferred to the following budget period.

Figure 5: Net contributions 2005 by member states

As a percentage of GNI



Source: European Commission, Distribution of EU expenditure 2005 by member states, September 2006. Excluding traditional own resources and administrative expenditure.

Table 1: Own resources payments of EU member states as a percentage of GNI

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
					As a percentage of GNI						
Belgium	1.21	1.24	1.32	1.35	1.32	1.32	1.34	1.11	1.25	1.32	1.34
Czech Republic										0.68	1.06
Denmark	0.94	0.95	1.02	1.10	1.02	0.99	1.01	0.92	0.94	0.99	0.95
Germany	1.11	1.09	1.12	1.07	1.06	1.07	0.94	0.83	0.89	0.91	0.90
Estonia										0.66	1.00
Greece	1.06	1.10	1.07	1.17	1.13	1.05	1.02	0.94	1.00	1.04	1.01
Spain	0.82	0.95	1.09	1.11	1.11	1.03	0.99	0.91	0.97	1.02	1.06
France	0.99	1.00	1.04	1.02	1.01	0.99	0.96	0.91	0.95	0.97	0.98
Ireland	1.44	1.29	1.07	1.41	1.36	1.20	1.23	0.95	0.96	0.99	1.05
Italy	0.76	0.92	0.83	0.98	0.96	0.93	0.94	0.88	0.89	1.00	0.96
Cyprus										0.79	1.15
Latvia										0.62	1.03
Lithuania										0.68	1.02
Luxembourg	1.14	1.06	1.09	1.36	1.09	0.97	1.28	0.89	0.98	0.99	0.93
Hungary										0.70	1.01
Malta										0.78	1.15
The Netherlands	1.28	1.29	1.36	1.39	1.28	1.29	1.22	0.95	1.03	1.08	1.17
Austria	0.98	1.02	1.16	1.11	1.05	1.01	0.99	0.83	0.86	0.87	0.88
Poland										0.67	1.00
Portugal	1.00	0.92	1.10	1.06	1.09	1.05	1.01	0.89	0.95	0.94	1.05
Slovenia										0.66	1.01
Slovakia										0.67	0.97
Finland	0.92	0.98	0.99	1.01	1.02	0.95	0.91	0.84	0.94	0.97	0.94
Sweden	0.89	0.94	1.08	1.08	1.00	1.01	0.95	0.81	0.92	0.95	0.92
UK	1.07	0.88	0.76	0.98	0.81	0.89	0.48	0.60	0.61	0.67	0.67
EU 25	1.02	1.01	1.02	1.07	1.02	1.01	0.90	0.83	0.88	0.91	0.93
Own resources ceiling	1.21	1.22	1.24	1.26	1.27	1.24	1.24	1.24	1.24	1.24	1.24

Source: European Commission, Distribution of EU expenditure 2005 by member states, September 2006.

Table 2: Level and distribution of own resources payments by the EU member states

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
						Million €					
Belgium	2,680	2,751	2,971	3,131	3,196	3,389	3,532	3,018	3,486	3,849	4,024
Czech Republic										565	990
Denmark	1,295	1,369	1,506	1,695	1,656	1,685	1,778	1,688	1,778	1,940	1,989
Germany	21,324	20,743	21,217	20,633	21,069	21,775	19,727	17,582	19,203	20,230	20,136
Estonia										55	100
Greece	985	1,106	1,178	1,310	1,349	1,334	1,350	1,338	1,534	1,742	1,802
Spain	3,645	4,547	5,368	5,752	6,231	6,445	6,592	6,551	7,429	8,384	9,475
France	11,877	12,423	13,186	13,584	13,994	14,511	14,471	14,152	15,154	16,014	16,854
Ireland	665	682	687	985	1,060	1,074	1,211	1,019	1,128	1,251	1,443
Italy	6,414	9,005	8,667	10,581	10,766	11,000	11,613	11,280	11,759	13,786	13,547
Cyprus										95	150
Latvia										68	130
Lithuania										119	207
Luxembourg	168	161	171	217	194	185	257	184	205	231	227
Hungary										537	833
Malta										33	50
The Netherlands	4,350	4,436	4,838	5,105	5,091	5,497	5,517	4,467	4,920	5,269	5,947
Austria	1,763	1,874	2,110	2,086	2,054	2,094	2,091	1,809	1,936	2,047	2,144
Poland										1,311	2,327
Portugal	865	852	1,078	1,105	1,228	1,255	1,266	1,187	1,293	1,332	1,527
Slovenia										170	275
Slovakia										220	359
Finland	887	964	1,062	1,146	1,211	1,226	1,233	1,185	1,338	1,443	1,465
Sweden	1,658	1,969	2,326	2,383	2,349	2,633	2,338	2,086	2,501	2,681	2,654
UK	9,252	8,219	8,928	12,537	11,084	13,867	7,743	10,153	9,971	11,683	12,157
EU 25	67,828	71,099	75,293	82,249	82,531	87,969	80,718	77,698	83,632	95,053	100,811
						Percentage shares					
Belgium	4.0	3.9	3.9	3.8	3.9	3.9	4.4	3.9	4.2	4.0	4.0
Czech Republic										0.6	1.0
Denmark	1.9	1.9	2.0	2.1	2.0	1.9	2.2	2.2	2.1	2.0	2.0
Germany	31.4	29.2	28.2	25.1	25.5	24.8	24.4	22.6	23.0	21.3	20.0
Estonia										0.1	0.1
Greece	1.5	1.6	1.6	1.6	1.6	1.5	1.7	1.7	1.8	1.8	1.8
Spain	5.4	6.4	7.1	7.0	7.6	7.3	8.2	8.4	8.9	8.8	9.4
France	17.5	17.5	17.5	16.5	17.0	16.5	17.9	18.2	18.1	16.8	16.7
Ireland	1.0	1.0	0.9	1.2	1.3	1.2	1.5	1.3	1.3	1.3	1.4
Italy	9.5	12.7	11.5	12.9	13.0	12.5	14.4	14.5	14.1	14.5	13.4
Cyprus										0.1	0.2
Latvia										0.1	0.1
Lithuania										0.1	0.2
Luxembourg	0.3	0.2	0.2	0.3	0.2	0.2	0.3	0.2	0.2	0.2	0.2
Hungary										0.6	0.8
Malta										0.0	0.1
The Netherlands	6.4	6.2	6.4	6.2	6.2	6.2	6.8	5.8	5.9	5.5	5.9
Austria	2.6	2.6	2.8	2.5	2.5	2.4	2.6	2.3	2.3	2.2	2.1
Poland										1.4	2.3
Portugal	1.3	1.2	1.4	1.3	1.5	1.4	1.6	1.5	1.5	1.4	1.5
Slovenia										0.2	0.3
Slovakia										0.2	0.4
Finland	1.3	1.4	1.4	1.4	1.5	1.4	1.5	1.5	1.6	1.5	1.5
Sweden	2.4	2.8	3.1	2.9	2.8	3.0	2.9	2.7	3.0	2.8	2.6
UK	13.6	11.6	11.9	15.2	13.4	15.8	9.6	13.1	11.9	12.3	12.1
EU 25	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: European Commission, Distribution of EU expenditure 2005 by member states, September 2006.

During the last round of budget negotiations, the "UK rebate" returned as a topical issue in the context of the net contribution position. In 2005, the rebate amounted to € 5.2 billion (*European Commission*, 2006C). Pursuant a decision of the European Council of Fontainebleau in 1984, the UK is reimbursed two-thirds of its annual net contribution. The special provision was successfully negotiated by former Prime Minister Margaret Thatcher at a time when the UK had a relatively low per-capita income within the EU. Due to its relatively small agricultural sector, the country received considerably less in EU agricultural support than France, for example. The adjustment in favour of the UK is financed by the other member states according to their level of GNI. Since 2002, a special clause applies for the net contributors the

Netherlands, Germany, Austria and Sweden which together counter-finance the UK rebate only up to a ceiling of 25 percent (*Clemens – Lemmer*, 2006).

The impact of the UK rebate on the distribution of own resources payments in absolute terms is shown in Figure 4. The UK thereby moves down from the second to the fourth-largest contributor. In relative terms, its national contribution of 0.53 percent of GNI is even the smallest by far in the whole EU (Figure 3). The termination or at least reduction of the UK rebate which has been claimed for some time by almost all other member states is subject to the UK's consent which is unlikely to be obtained without a profound overhaul of the EU agricultural support system.

The largest net contributors in relation to their GDP are the Netherlands, Luxembourg and Sweden (Figure 5, with the net contributions excluding the traditional own resources and administrative expenditure, as referred to above). These countries hold the top ranks not so much because of their high gross payments, but rather because of the low re-transfers they receive from the EU budget. In absolute terms, Germany as the largest EU economy is by far also the largest net contributor, ahead of the Netherlands and France. While all new member states, unsurprisingly, are net recipients, re-transfers exceed gross contributions also for Spain, Portugal, Ireland and Greece.

Table 3: Own resources contributions by Austria

	1995	1996	1997	1998	1999	2000 Million €	2001	2002	2003	2004	2005
Traditional own resources	222	264	254	242	245	270	229	151	167	176	189
VAT-based own resources	1,106	947	1,036	864	776	818	762	554	512	248	326
GNP- or GNI-based own resources	379	560	738	868	915	893	848	1,070	1,212	1,597	1,589
"UK rebate"	57	104	82	113	119	112	252	35	46	25	40
Total	1,763	1,874	2,110	2,086	2,054	2,094	2,091	1,809	1,936	2,047	2,144
As a percentage of GNP or GNI	*0.96*	*1.01*	*1.15*	*1.00*	*1.03*	*1.00*	*0.97*	*0.82*	*0.86*	*0.87*	*0.88*

Source: European Commission, Distribution of EU expenditure 2005 by member states, September 2006.

Austria's gross financial contribution is relatively small as a proportion of its GNI (Table 1). As shown in Tables 2 and 3, both the GNI share and Austria's share in financing the EU budget are on a downward trend. Moreover, Austria's net contribution, as percent of its GNI, is lower than that of countries whose per-capita GNI is similarly high as Austria's, such as Denmark or the Netherlands. According to the new financial framework for 2007 to 2013, adopted on 17 May 2006, Austria will further benefit from the lowered correction factor to compensate for the UK rebate and from the cut in the call rate for the VAT-based contributions (0.225 percent of the harmonised tax base). According to first estimates from the Ministry of Finance, the new EU budget will nevertheless imply an increase of Austria's net contribution to around € 870 million or 0.3 percent of GNI per year[8].

Financial framework 2007 to 2013

The EU Treaty foresees an annual budgetary procedure for the EU household. For several reasons such as the maintenance of budgetary discipline, expenditure control or to support the setting of longer-term spending priorities, the "financial perspectives", a multi-annual planning process, have been introduced. An "inter-institutional agreement" between Commission, Council and Parliament establishes the financial framework within which the annual budgets will be set up. This procedure not only facilitates budgetary planning over the longer term, but also reins in recurrent political debates on the allocation of expenditure.

The financial framework 2007 to 2013, adopted by inter-institutional agreement (2006/C 139/01) of 16 June 2006, foresees no profound change for the EU's financing

[8] At what level the Austrian net contribution will eventually turn out will depend on the impact of the decision on own resources that has not yet been adopted, on the details of the allocation of resources to the different member states, as well as on the actual claim on resources during the next financial period.

system. The own resources ceiling is confirmed at 1.24 percent of GNI (for payment appropriations) and 1.31 percent of GNI (for commitment appropriations). Further maintained are also the correction mechanism for the UK contribution ("UK rebate") and the adjustment for its financing in favour of Germany, Austria, Sweden and the Netherlands. The UK therefore continues to benefit from its "rebate", except, however, with regard to the new member states: as from 2013 at the latest, the UK will fully participate in the financing of the cost of enlargement by those countries that have acceded to the EU after 30 April 2004. The call rate for the VAT-based own resources is reduced to 0.3 percent, with a number of net contributors benefiting from a lower rate only for the period 2007 to 2013 (Austria 0.225 percent; Germany 0.15 percent; the Netherlands and Sweden 0.10 percent). In addition, for Sweden and the Netherlands it has been decided to cut their GNI-based annual gross contributions by € 150 million and € 605 million, respectively (*European Commission*, 2006B).

In December 2005, the European Commission has been invited by the European Council to undertake a revision of the EU budget in the form of a "mid-term review", which should also include a review of the own resources system, and to report to the European Council by 2008-09. This review should feed into the preparations for the next financial perspectives. In this way, the need for reform of the EU financing system, generally felt across member states and the European institutions, has been taken up, without however an actual announcement or commitment to such reform being given.

The EU financing system in need of reform: an own tax sovereignty for the EU?

The financing system of the EU in the way it has evolved over the more than fifty years since the foundation of the European Coal and Steel Community (ECSC) in 1952, is characterised by a number of shortcomings that have their roots in the low and further decreasing revenue autonomy of the EU. While their correction has been on the political agenda for some time, the required unanimity vote in financial matters has so far stood in the way of a profound reform. However, the growing resistance notably on the part of the net contributors, which has recently led to a considerable delay in the negotiations for the new financial perspectives, adds to the pressure for seeking alternatives to the existing EU financing system.

Since the EU can neither raise its own taxes nor incur debt, its revenue autonomy has been curtailed from the outset. Meanwhile, it has become negligible since the traditional own resources have greatly lost importance. Nowadays, the own resources of the EU consist primarily of member states' contributions paid directly from the national budgets. Thereby, the EU budget has increasingly become the subject of political conflict, as most clearly revealed by the "net contributor debate". Finding an agreement on the medium-term financial framework is becoming more and more difficult, particularly with economic differentials widening in the last two (and any future) rounds of enlargement. This carries the risk of the EU household becoming chronically under-financed against the challenges facing the Community in the future such as the financing of future enlargement rounds or of expenditure related to the Lisbon Agenda (research and innovation, education, infrastructure etc.). Such risk is witnessed by the financial framework 2007 to 2013, whereby the total volume of expenditure is set to decline as a ratio of EU GDP, rather than being at least held constant as warranted by the current and future tasks of the EU.

In this context it should also be recalled that the financial resources at the disposal of the EU also serve to finance a number of "European public goods", i.e., goods or activities with positive cross-border external effects[9]. This concerns notably outlays in the areas of research, education and transport infrastructure, decided upon at the EU level. With a view to establishing fiscal equivalence it would be appropriate to also assign to the EU the taxes necessary in order to finance these outlays.

[9] Consider in this context also the debate of the last years on "global public goods" (see, e.g., *Kaul – Grunberg – Stern*, 1999).

Glossary of Terms

"UK rebate": the UK receives 66 percent of its net contribution reimbursed. The amount to be reimbursed is calculated as follows: (VAT own resources + GNI own resources – EU expenditure to the UK) x 0.66. This compensation is financed by the other member states. Austria, Germany, Sweden and the Netherlands only pay 25 percent of the calculated amount of compensation, the rest falls on the other member states.

Own resources: total payments by all member states to the EU budget. They comprise traditional own resources, VAT-based own resources and GNI-based own resources. While the revenues are not collected by the EU itself, the payments by the member states do not have to be approved by national decision. By contrast, the resources for the European Development Fund (EDF) and the disbursement of reserves need to be negotiated and adopted ad hoc.

Own resources ceiling: it normally refers to the actual total expenditure in a given year, i.e., the payments. As from the Financial Perspectives 2000 to 2006, the own resources ceiling amounts to 1.24 percent of aggregate GNI of the EU.

Total revenues: they include the own resources, other revenues and the budget surplus of the previous year. As to their use, a distinction is made between separate and non-separate resources.

Separate resources: may be disbursed over several years. Almost all kinds of expenditure fall into this category.

Non-separate resources: may only be disbursed in the current fiscal year, i.e., commitment and payment appropriations must correspond in this case. Non-separate resources serve to cover administrative costs, stabilise agricultural markets and finance direct agricultural support.

Resources for commitments: commitment appropriations for separate and non-separate resources. The total of commitment resources is given by the ceilings for the different expenditure categories according to the Financial Framework, and it is the benchmark that is politically negotiated. The ceiling for this medium-term financial plan is fixed at 1.31 percent of EU GNI. The Financial Framework 2007 to 2013 provides for planned expenditure to the amount of 1.048 percent of GNI, leaving room for manoeuvre for unforeseen expenditure. In the annual household debate, the final allocation of the agreed financial resources to the different expenditure categories is decided upon.

Resources for payments: payment appropriations for separate and non-separate resources. The ceiling for payment resources amounts to 1.24 percent of EU GNI. As a rule, payment resources are lower than commitment resources, since part of the funds for subsidies are not disbursed for various reasons.

The terms of "commitment resources" and "payment resources" refer to upper limits, with actual payments normally falling below. Commitment and payment appropriations are typically different in areas where financial commitments and actual payments diverge (longer-term programmes, mainly for structural support and rural development). The actual annual burden of the EU budget can thus only be derived from the payment resources, whereas the budgets of the member states are burdened by the contributions at the time of commitment.

Commitment appropriations: total of the commitments that may be incurred in a given fiscal year.

Payment appropriations: actual payments in a given fiscal year, resulting from the commitments of the current budget and those of preceding years.

Gross contribution: traditional own resources + VAT-based own resources + GNI-based own resources.

National contribution: VAT-based own resources + GNI-based own resources.

Net contribution (operative budget balance): adjusted national contribution – re-transfers from the EU budget (excluding administrative expenditure).

Inter-institutional agreement: agreement between Commission, Council and Parliament on the implementation of the financial framework for the future EU budget. It determines, for example, under which conditions the ceilings of the financial framework may be altered ex post. The execution of the budgetary procedure, i.e., the annual setting up of the EU budget, is not contingent upon the achievement of an inter-institutional agreement. If no consensus is found between Commission, Council and Parliament, the ceilings must be fixed annually in the context of the budgetary process. Such a solution is, however, politically and administratively much more cumbersome and costly.

Source: *European Commission* (2002), *European Union* (2006).

The lack of an own tax sovereignty for the EU is, moreover at variance with the trend towards deeper integration. Despite an increase in negative cross-border external effects (notably environmental damage) caused by ever closer economic ties between the member states, policy refrains from using the instrument of taxes at the European level to influence economic agents' behaviour.

Meanwhile, the EU revenue system is characterised by a considerable degree of complexity and lack of transparency. This is due first to the complicated way of implementing the VAT-based revenue component (assessment of the tax base, correction mechanism for the "UK rebate", lower call rates for some net contributors).

Second, the structural adjustments made since the early days of the European community are the result of political compromises (such as the correction mechanism for the financing of the "UK rebate"). Apart from the implicit administrative burden, this trend also undermines political credibility and the legitimacy for the national financial contributions, since the population of the different member states is less and less able to identify its own contribution to the financing of the EU budget and to realise the connection between revenue and expenditure.

In the longer-term perspective, budgetary room for manoeuvre is to be created for the financing of forward-looking tasks identified by the Lisbon Agenda, through further shifts in the composition of expenditure, notably the already initiated restraint on agricultural spending. The latter will also be an issue taken up in the 2008-09 Budgetary Mid-Term Review. Given the conflicting interests of member states it is nevertheless doubtful whether such shifts will progress at sufficient speed in order to create the desired financial leeway. All the more so, since agricultural support will (have to) remain a major responsibility for the EU, albeit with some adjustments in favour of organic farming, preservation of rural areas and promotion of tourism, reflecting the changing role of agriculture. Against this background, giving the EU a certain degree of tax sovereignty appears to be an option worth exploring, by substituting own EU tax revenues for part of the national financial contributions which face growing resistance, particularly with the net contributors.

Key elements of a reform of the EU system of own resources

Starting from the criticism referred to above of the existing EU own resources system, reform options have been considered for some time at the EU level. Following up on agreements reached in the context of the last financial perspectives 2000 to 2006 as well as previous ones, the European Commission has meanwhile submitted several reports on the functioning of the own resources system (e.g., *European Commission*, 1998, 2004). These documents also discuss the pros and cons of a number of financing alternatives. In principle, two alternative reform strategies may be envisaged (*European Commission*, 2004):

- reforms within the existing own resources system with the aim of streamlining it (in practice, this would lead to the abolition of the VAT-based contributions such that, given the steady loss in importance of the traditional own resources, the budget would in the long run be financed almost entirely through GNI-based own resources);
- introduction of dedicated EU taxes, as a (partial) compensation for the existing revenue sources. This option, favoured by the European Commission, would confer an own tax sovereignty to the EU.

The criticism advanced against the existing own resources system of the EU, as cited above, advises in favour of conferring to the EU some degree of tax sovereignty in general in combination with a reform of key features of the existing own resources system along the following lines[10]:

- abolition of the VAT-based own resources,
- attribution of dedicated taxes to the EU in compensation for the abolition of the VAT-based contributions and in recognition of the arguments in favour of an EU tax sovereignty, possibly as a supplementary source of revenue to finance a limited increase in the budget volume,
- reinforcement of own EU tax revenues through GNI-based own resources,
- reform of the correction mechanism to finance the UK rebate.

Starting from these key elements, the following considerations are devoted to a crucial aspect in the debate on alternative financing sources for the EU budget, i.e., the question what kind of taxes would lend themselves for the establishment of an

[10] These key features are also cited by the European Commission who nevertheless pleads in favour of the revenue-neutral introduction of a new own revenue source that should cover up to 50 percent of total expenditure (*European Commission,* 2004).

own EU tax sovereignty (or as a supplementary or alternative revenue source)[11]. A basic assumption is that financing the EU budget entirely and exclusively through own taxes is for the time being neither meaningful nor possible under the existing framework conditions. One argument against is the existing ban on incurring debt that requires an additional revenue source to balance the budget in case actual tax revenues fall short of projections. In addition, financing all EU responsibilities entirely by own taxes would require much deeper integration of the EU member states than is presently the case, leading more towards a federal state.

The attribution of relative weights between dedicated EU taxes on the one hand, and GNI-based own resources, on the other, is an issue beyond economic reasoning: it is rather a political decision of the member states, to what extent they see the Community eventually moving towards a federal state that in the end needs its own legal framework for fiscal relations and an own tax sovereignty. This is also a crucial factor for the degree and factual implementation of the tax sovereignty conferred to the EU[12]: it may either be confined to the power to decide on how to allocate its own resources, or it may extend to legislative powers in tax matters. In the first case, the EU would receive a certain fraction of national tax revenues or be granted the right to levy a supplementary rate on a given tax base, with the right of decision on tax bases and national tax rates essentially remaining with the member states. In the second case the EU would acquire the right to determine the tax base and the tax rate, with the member states possibly having the right to levy a supplement.

In its reports on the operation of the EU own resources system, the European Commission establishes seven criteria for the evaluation of own resources (*European Commission*, 2004):

- visibility and simplicity,
- financial autonomy,
- contribution towards an efficient allocation of economic resources,
- yield,
- cost efficiency with regard to tax administration,
- revenue stability,
- equitable gross burden.

These criteria may be applied only partially or in modified form for the following assessment of how different taxes lend themselves as financial sources for the EU budget. They will be supplemented by further criteria developed by the theory of fiscal federalism as a yardstick for assigning different taxes to the different levels of government (see, e.g., *Musgrave,* 1983, *Gordon,* 1983, *Inman – Rubinfeld,* 1996, *McLure,* 2001). Thus, for the assessment of whether a certain tax may qualify as European tax, the following criteria may be formulated[13]:

- Degree of regional attribution: the lower the possibility to determine the share of a particular member state in the tax base, or the lower the identity between the country where the tax revenue accrues and the country of residence of the tax subject, the higher the qualification for serving as European tax.
- Cross-border negative externalities: the higher they are, the higher the qualification as European tax, since the optimal tax rate from the national perspective is below the one from the European perspective.
- Mobility of the tax base: the higher it is, the higher in principle the qualification as European tax, since centralisation will prevent a possibly harmful "race to the bottom".

[11] See also *Richter* (2006).

[12] For elaboration of this point see *Becker* (2005).

[13] See also *European Commission* (1998, 2004).

- Short-term volatility: the higher it is, the lower the qualification as European tax; due to the ban on EU debt, the flow of own resources should be stable in the short term and as cyclically-insensitive as possible.
- Long-term yield (revenue elasticity): the higher it is, the higher the qualification as European tax, since with European integration progressing the range of tasks and therefore the financial needs will rise.
- Visibility: the more visible and sensitive a tax for the tax subjects, the higher its qualification as European tax, since the link between tax payment and return from the EU budget is made transparent.
- Equity of gross burden at the national level: the closer the link between the tax base (and therefore the tax burden) and national income, the higher the qualification as European tax.

The report by the European Commission of 1998 discusses eight kinds of potential own resources: CO_2- or energy tax; modified value added tax; excises on tobacco, alcohol and mineral oil; corporate tax; tax on transport and telecommunication services; income tax; interest income tax; and a tax on the ECB gains from seignorage (*European Commission,* 1998). The report of 2004 limits itself to three options, namely the combination of GNI-based own resources with revenues from energy tax, value added tax or corporate tax. On this basis, taxes on fuel used for transport (mineral oil, kerosene), value added tax and corporate tax, as well as a tax on foreign exchange transactions (which has recently come to the fore in the public debate) are examined herewith with a view to their qualification as dedicated EU tax (Table 4).

The evaluation of these taxes according to the criteria specified above (Table 5) gives only vague indications since it does not allow for a possible fine-tuning of the different criteria, but only distinguishes between "rather useful" or "rather less useful" as EU tax. For further considerations on the actual design of an own resources system based on an EU tax sovereignty, the analysis would therefore need to be refined.

None of the taxes briefly discussed below is deemed an "optimal" EU tax, since all of them miss one or more of the criteria defined above. Which of the taxes will actually be selected along these criteria, and the weight to be attributed to each of them, is in the final analysis a political decision.

Following the above criteria, transport fuel taxes (mineral oil, kerosene) would qualify best as EU taxes. They may internalise negative cross-border externalities (in this case climate-damaging emissions) and thereby lead to lower fuel consumption. At the same time it would rein in the possibility of tax avoidance on account of the mobility of tax subjects (cross-border arbitrage between different levels of fuel taxes). Its visibility for the consumer and the short- and long-term revenue stability and tax yield are further arguments in favour of a (partial) assignment of fuel taxes to the EU level. In particular the tax avoidance to be expected speaks in favour of earmarking the kerosene tax entirely for the EU: the tax rate should be fixed at the level of the EU and all revenues be channelled into the EU budget.

Arguments in favour of a tax on foreign exchange transactions to be assigned to the EU as own tax are twofold: the impossibility of a regional attribution of such a tax, and its prospective long-term yield[14]. Since unilateral implementation would be next to impossible because of widespread attempts to avoid the tax, it should be introduced as own EU tax. Also in favour of a centralised corporate tax it could be argued that the growing disconnection between value added and corporate location on the one hand, and profit and its taxation on the other, undermines the possibility of regional attribution of the tax and that corporate tax competition in the EU would intensify. The corporate tax is also characterised by a high yield in the longer term. In the short and medium run, it will certainly be easier to introduce a tax on foreign exchange transactions than to centralise the corporate tax. The latter would

[14] The tax on foreign exchange transactions should prove revenue elastic and generate sufficient yield in the long term, if only because the proposed tax rate is very low (table 4), following the concept of *Spahn* (2002). For a more comprehensive discussion of the options for introducing a tax on foreign exchange transactions in the EU see *Schratzenstaller* (2006).

require a harmonisation of the tax base and the introduction of a minimum tax rate which both appears unrealistic from the present perspective. Moreover, the European Commission declines the introduction of a minimum tax rate (e.g., *European Commission,* 2004).

Table 4: Potential EU taxes

Tax base	Characteristics	Potential yield
Fuel consumption in road transport (mineral oil tax)	• Tax on leaded and unleaded petrol, diesel, LPG and natural gas for transport purposes • Harmonised tax base • In addition to national taxation • EU tax rates: less than half the EU minimum tax rates according to energy taxation directive	50 percent of own resources (around € 50 billion)
Aviation fuel consumption (kerosene tax)	• Tax on hitherto tax exempt aviation fuel • Harmonised tax base • Taxation only at EU level • Tax rate: EU minimum tax rate for diesel	6 percent to 7 percent of own resources (around € 6 to 7 billion
Consumption (value added tax)	• Tax on national VAT tax base • Largely harmonised tax base • In addition to national taxation • EU tax rate: 1 percent (corresponding cut of national tax rate)	50 percent of own resources (around € 50 billion)
Profits of incorporated enterprises (corporate tax)	• Tax on national corporate tax base • Harmonised tax base • Attribution of one quarter of revenues collected EU-wide to the EU • Maintenance of national tax rates, introduction of a minimum tax rate	50 percent of own resources (around € 50 billion)on the basis of current yield
Foreign exchange transactions (foreign exchange transaction tax according to "Spahn-model")	• Tax on cash transactions and term contracts up to one month • Harmonised tax base • Taxation only at EU level • Tax rate: 0.02 percent, for large-scale traders 0.01 percent	20 percent of own resources (around € 20 billion)

Source: *European Commission* (2004), *Spahn* (2002), WIFO compilation.

Table 5: Criteria for qualification as EU tax

	Regional attribution		Negative cross-border externalities		Mobility of tax base		Short-term volatility		Long-term yield (revenue elasticity)		Visibility		Equity of gross burden at national level	
Mineral oil tax	High	–	High	+	High	+	Low	+	High	+	High	+	High	+
Kerosene tax	High	–	High	+	High	+	Low	+	High	+	High	+	Low	–
Value added tax	High	–	Low	–	Low	–	High	–	High	+	High	+	Low	–
Corporate tax	Low	+	Low	–	High	+	High	–	High	+	Low	–	Low	–
Foreign exchange transactions tax	Low	+	Low	–	High	+	High	–	High	+	Low	–	Low	–

Source: *European Commission* (2004), *Spahn* (2002), WIFO compilation... + . . . speaks rather in favour of being an EU tax. – . . speaks rather against being an EU tax

Finally, the value added tax would be a good candidate for an EU tax, given its long-term yield and its visibility for the tax subject. However, using it in part as EU tax would presuppose the harmonisation of the tax base, particularly with regard to the goods and services currently being exempt.

Therefore, if the EU were to be conferred tax sovereignty of its own, the straightforward short-term options would be a tax on foreign exchange transactions and a kerosene tax. Since both would be new taxes, no revenues would have to be re-affected from the national budgets towards the EU budget, as this would be the case for a (partial) transfer of corporate tax revenues (or its entire centralisation) in favour of the EU, or for an EU supplement on VAT. From the administrative point of view, both taxes could be implemented easily since there are no nationally different tax bases that would need to be harmonised beforehand. Both taxes together could cover nearly one-quarter of total EU expenditure. If the aim is to extend own tax financing of the EU budget even further, the introduction of an EU supplement on mineral oil tax would be another readily available solution.

If the tax sovereignty of the EU is to be reinforced – in favour of which a number of arguments may be advanced, as illustrated above – the Mid-term Review 2008-09 should elaborate a roadmap in this regard. The latter should include a detailed timetable for the introduction or (partial) conversion of the appropriate taxes as EU taxes and for the necessary preparatory steps such as the harmonisation of the tax base.

When designing a new financial framework for the EU, characterised by tax sovereignty, including institutional aspects and political decision- making processes, a number of caveats need to be considered that are often emphasised by the opponents of European tax autonomy. A major concern is that an own tax responsibility of the EU would lead to permanent upward pressure on expenditure, all the more so as the EU budget is dominated by the goal of redistribution. Moreover, the assignment of (a certain degree of) tax autonomy to the EU would require the reinforcement of the democratic legitimacy – i.e., strengthening the powers of the European Parliament – as well as a tightening of expenditure control and fight against fraud. Therefore, any major reform is likely to require a long lead time. Finally, also the political controversies likely to arise in the process of unwinding of the UK rebate system will require temporal leeway that is, however, limited to the period from 2009 to 2013, between the Mid-term review and the adoption of the financial framework 2014 to 2020. That window of opportunity should be made full use of.

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Alternative Financing Sources for the EU Budget – Summary

Without any tax sovereignty of its own and faced with a substantial decline in the volume of "traditional own resources" (customs duties, agricultural levies, sugar levies), the European Union is left with a very low level of revenue autonomy. The EU budget is financed primarily from national contributions by the member states. Hence, controversies are more and more likely to arise over the EU budget and, in the long run, the Union is at risk of being underfinanced. Moreover, there is a growing contradiction between the absence of EU tax sovereignty, on the one hand, and the intensified pace of European integration, on the other hand. Despite the associated increase of cross-border externalities (mainly environmental damage), no recourse is being taken to taxation at the European level as a steering instrument. Another point worth noting in this context is that EU funds are used to finance a range of "European public goods" and activities with positive cross-border externalities. This holds, in particular, for expenditure for research, education and the transport infrastructure, which is subject to decisions taken at the European level. With a view to fiscal equivalence, it would be appropriate also to collect the taxes required to finance such expenditure at the European level. In addition, any attempt to reform the EU's system of own resources should also be aimed at its simplification.

Against this background, a reform of the EU system of own resources ought to do away with the complicated system of VAT-based own resources and include measures to modify the mechanism for correcting the budgetary imbalance of the UK.

At the same time, the EU ought to be granted the authority to collect its own taxes. A foreign-exchange transaction tax and a kerosene tax, if introduced throughout the European Union, would be particularly well suited for this purpose. Considering that exclusive financing of the EU budget from taxes is neither desirable nor possible in the foreseeable future, own resources based on the gross national income (GNI) are to be maintained as an additional source of finance.

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