**Abstract and Executive Summary**

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# Reform Options for the EU Own Resources System

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# Abstract

This study develops a reform proposal for the future revenue system of the EU budget. In a first step a critical review of assessment criteria for an efficient own resource system is given which are partially biased and only loosely linked to theory. On the basis of an improved set of criteria the status quo is assessed. The fact that the current system establishes a strong link between the EU budget and national budgets is identified to be a key advantage since it sets strong incentives for the Council to control spending at the EU level. A weakness, however, is associated with the inflation of rebates and special provisions and the neglect of policies on a European public goods type. Simulation results establish that the distribution problem has its roots at the expenditure side while the revenue side distribution serves as a buffer to partially compensate for the expenditure side effects.

Our findings strongly reject the idea that a reform based on an EU tax based own resource would remedy current problems. In particular, our quantifications show that the distributive consequences of an EU tax would be immense and would therefore, in a counterproductive way, create new necessities for compensation.

Based on the status quo analysis and the screening of the reform options suggested in the literature we present an own reform model. This includes the complete phasing out of the VAT resource, a financing of the budget fully on the basis of the GNI resource (in addition to Traditional Own Resources) and a generalised but limited correction mechanism (GLCM). We regard a correction mechanism as indispensable as long as substantial restructuring of expenditures is not realistic. However, a GLCM has many advantages over the current UK centred rebate or a generalised but unlimited mechanism. In particular, it limits correction to those policies which are the most problematic under distributive aspects. Moreover, it would set the system on a path towards a diminishing importance of correction once restructuring of expenditures advance.

In addition to these core elements of the reform proposal we suggest that a move towards a stronger financial contribution of regions to EU spending is assessed and that nominal metrics are used in EU budgetary policy instead of the current practice, which defines the budget size in % of GNI and in real Euro.

# Executive Summary

## 1 Introduction

The agreement on the EU financial framework for the years 2007-2013 has been received with mixed feelings both in the political and academic debate. The agreement does not include any far reaching reforms neither on the expenditure side nor on the revenue side although the need for reforms is hardly debatable for either side of the budget. Since the heads of states and governments themselves had to acknowledge the limits of the budgetary settlement they agreed on a comprehensive reassessment of the financial framework. This study aims at contributing to the 2008/09 review with a clear focus on the revenue side of the budget. Key questions addressed in this study refer to the preferable types of own resources, fundamental alternatives to the existing sources and the justification and specification of an appropriate correction mechanism.

Our work advances the existing literature in some important respects. First, we base our analysis on a comprehensive study of the incentives faced by all budgetary players. Secondly, we take the distribution issue into account as an important restriction to any politically realistic reform.

## 2 Criteria for a fair and efficient own resource system

Our starting point for judging the status quo and deriving reform options is a critical review of assessment criteria used in the literature and a suggestion for improvements. It is shown that the prominent list of criteria used by the authors of the Commission's own resource report of 2004 is not without problems: It includes a criterion such as "financial autonomy" which is clearly biased towards the Commission's institutional self-interest. Other criteria such as "sufficiency" are at the very least open for misunderstandings insofar as scarcity of own resources is a desirable restriction under the objective of fiscal discipline. A more fundamental weakness of existing criteria lists is that their link to theory is fairly loose, that political-economic considerations are widely ignored and that they are often applied narrowly without taking into account the full incentives of the EU budgetary system as a whole.

In contrast to the above, we base our assessment criteria on theoretical and empirical insights of the literature on fiscal federalism and public choice theory and identify four main requirements the EU budgetary system should fulfil. The system is geared to fostering the efficient provision of public goods, it aims to constrain narrow self-interests and create budgetary discipline, it is designed to be conducive to the integration process and it should be consistent with general principles of taxation grounded on welfare theory.

## 3 Assessing the status quo

This section is devoted to an analysis of the status quo of the system of EU own resources including its historical evolution. A look at the history of the own resource system shows that the perception of expenditure side misbalances have been the major determinants of innovations to the own resource system including rebates.

*Incentives of budgetary players and the common pool problem*

The section also briefly summarises the main institutional features of the system including the decisions taken for the financial framework 2007-2013. On that basis, an analysis of incentives is presented for all important budgetary players. A key challenge in the design of any rational budgetary system is to induce decision makers to give equal weights to both the benefits and the costs of public spending. Misguided budgetary incentives typically become virulent if a budget also finances projects from which only a regional (or sectoral) subsection of voters benefits. On that condition the so called “common pool” problem arises which is nowadays a standard explanation for fundamental incentive problems in national budgetary decisions. By analysing the incentives with regard to EU spending of the European Council, the European Parliament, the European Commission and the European regions, we clarify that the common pool problem is highly relevant for the EU budget as well.

These insights are helpful in evaluating the advantages and disadvantages of the current EU budget financing. The disadvantages are clearly connected to the neglect of funding European public goods, i.e. goods whose beneficiaries can not be localised directly. Nevertheless, there are considerable advantages of the current system as well. First of all, there is a ceiling on the budget, which constitutes a successful “contract approach” limiting the negative effects of the common pool problem for excessive spending. In addition, the current own resource system has beneficial consequences with regard to guaranteeing fiscal discipline: The GNI resource links the EU budget directly to the national budgets. This constitutes a high incentive for net contributors to cap the budget.

*The drivers of redistribution*

In its quantitative part, the status quo analysis introduces a detailed simulation model for the EU budgetary system of EU-27. This simulation model is then used to analyse the drivers of distribution under the status quo. A clear understanding of distributive effects is important because of the political importance of these effects alone. Reform options diverging too far from the distributive situation of the status quo are hardly politically feasible. The quantifications lead to the following two main results:

- Distribution of the overall EU budgetary system is largely driven by the expenditure side, while the revenue side effects are relatively small. While distribution resulting from structural funds has a progressive character with respect to the countries' increasing per capita income, distribution effects of the Common Agricultural Policy are arbitrary if compared to relative country wealth.
- On the revenue side, the UK rebate's impact is associated with the largest redistribution effects. The revenue side counteracts the expenditure side redistribution to a small extent and moves the net positions closer to a balanced GNI ratio. Thus, the revenue side's distribution is obviously used as a buffer against distributive effects of the expenditure side which are obviously politically inacceptable. This clarifies that the leeway for revenue side reforms is not independent from expenditure side changes.

Subsequent to this scrutiny of the system's incentives and distributive effects as a whole, the single own resource items are discussed in detail. GNI resources are judged to be a flexible and cost-efficient revenue type with reasonable statistical reliability. The VAT resource and Traditional Own Resources (TOR) are more costly in administrative terms. While there is for the time being still a case for allocating TOR to the EU budget due to the regional arbitrariness of this source's revenues, the VAT existence is more controversial. Due to the series of adjustments, the regressivity of the VAT resource has been limited, nevertheless disadvantages such as high administrative costs and limited reliability of underlying statistics remain.

*Strengths and weaknesses of the status quo*

The status quo analysis draws a mixed conclusion on the current state of the own resource system. The contribution based link between the EU budget and the national budgets is a key advantage of the status quo. This feature establishes a strong and beneficial incentive for Council members to press for fiscal discipline at the EU level. A further not unimportant fiscal federalism advantage of the current system is that it does not interfere with national tax system and redistribution preferences. Member states are free to refinance own resource payments through autonomous tax policies reflecting their citizens' tax preferences. Looking at general principles of taxation, it is fair to say that the system performs increasingly better because of the continuously rising importance of GNI resources. The GNI resource has favourable characteristics with respect to most principles of taxation.

Serious disadvantages are related to spending incentives within the capped budget: Here, the common pool problem biases expenditure policies against policies of a European public goods type. With regard to the criterion of integration compatibility, the current system is characterised by an inflation of rebates and special provisions which impairs credibility, thus undermining the perceived fairness and acceptance of the system.

## 4 Background Analyses

Before the report proceeds to the analysis of reform options for the revenue side two background analyses are presented. First, the degree of tax system and tax preference heterogeneity within the EU is scrutinised. Secondly, an overview is given on revenue systems of international and supranational organisations is given.

*Tax system heterogeneity*

The study on tax system heterogeneity sheds light on the question to which extent a continuing divergence of national tax preferences in Europe exists. It thus evaluates the empirical weight of one of the discussed advantages of the status quo which gives member countries free choice of how to refinance their payments to the EU budget. Surprisingly, the issue of international tax preferences heterogeneity is a largely under-researched issue. Our empirical study is based both on a direct observation of value judgements related to the design of a tax system and on time series of key parameters of the national tax systems. Even though the results leave many questions open, they indicate a substantial and stable (or even increasing) heterogeneity of tax preferences among EU countries:

- First, tax parameter convergence is less observable in fields where countries do not face pressure from tax competition or harmonisation rules.
- Secondly, direct indicators on tax preferences derived from surveys reveal substantial differences on how voters across EU member countries judge certain trade-offs which are essential in determining a tax system.
- Thirdly, the unique tax model of new EU member countries indicates that the spectre of tax system preferences has become more diverse with enlargement.

This excursus indicates that the current own resource system's flexibility of member countries with respect to refinancing EU contributions is indeed a relevant advantage.

*Financing systems of international organizations*

A glance at international organisations (IO) can serve as a source of inspiration for the development of EU reform options. Across IOs a variety of models can be observed. The choice of the revenue system is clearly linked to the scope of tasks. Systems based on the principle of equivalence try to establish a link between contributions and the specific utility derived from national membership. Systems based on the principle of ability-to-pay link contributions to a country's economic capacity. Equivalence based systems only play a role for IOs with a clearly focused set of tasks while ability-to-pay approaches generally dominate cases involving a broad variety of tasks.

Given that the EU has achieved a much deeper level of integration compared to any other international organisation, naïve comparisons would be inadequate. However, this does not preclude the usefulness of these case studies. A first conclusion is that an ability-to-pay approach is clearly appropriate for the revenue system of the EU. Given the variety of policies the EU has taken responsibility for it is unrealistic to quantify contributions based on the principle of equivalence. A revenue system related to relative GNI is therefore also a reasonable element of an EU revenue system in this comparative perspective. Beyond this insight the OECD type structuring of the budget might offer inspiration for the European reform perspective. Here we differentiate between the financing of programmes which have the character of benefiting a limited number of members and a more general budget. Although we do not believe that this approach should be copied for the EU, it may hint at a promising direction of reform: differentiating the revenue formula by policy fields.

## 5 Reform approaches

In this section, a thorough analysis of important existing reform options for the revenue side of the EU budget is presented, including an assessment of an EU tax based reform, parametric changes within the current system and variants for the rebate system.

*The link of expenditure and revenue reform debates*

As both our historical analysis and the quantifications presented in section 3 have revealed, many revenue side characteristics reflect compensation measures for perceived expenditure side misbalances. Therefore the chances for fundamental reforms on the revenue side are conditional on changes on the expenditure side. Although our working assumption is that no far reaching expenditure reforms will materialise in the near future, we present a short excursus on how expenditure reforms would impact on the distributive situation. Here, we simulate co-financing of CAP, phasing-out of CAP and the full concentration of structural spending on convergence and cohesion. CAP reforms have the most pronounced consequences. The overall redistribution is reduced and the net positions of several countries which are currently net payers of the CAP are improved and put in line with other countries of similar wealth. Thus, the case for special provisions only benefiting single countries would be resolved in a just manner.

*Pros and cons of an EU tax*

Due to its prominent role in the reform debate, we approach the idea of basing the own resource system at least partially on an EU tax with great caution. In a first step we critically review the arguments used in favour of and against. We show that some of the traditional pro-arguments are seriously flawed. While it is correct that visibility of financial burden is desirable, only few of the discussed tax types would really be visible and tangible. Revenue autonomy of EU institutions is no desirable objective in itself, since political economy considerations hint at the risks of a softer budget constraint.

The claim that an EU tax would end the “juste retour” thinking does not hold up under closer scrutiny. The perception of unfair burden sharing hinges crucially on the regional and sectoral focus of large shares of expenditures, so that a tax based system would not solve the problem. On the contrary, any conceivable EU tax would create new demand for mechanisms correcting the distributive outcomes. We present empirical calculations for the distributive effects of shifting the proceeds of the following taxes at least partially to the EU budget: VAT, tobacco taxes, alcohol taxes, fuel taxes, CO2 taxes, kerosene taxes, foreign exchange taxes, personal income taxes and corporate income taxes. The results show that the resulting distribution diverges substantially and in most cases even dramatically from GNI proportionality. We conclude that any EU tax necessitates the introduction of new compensation measures and, hence, must even be seen as counter-productive with respect to the “juste retour” problem.

Further disadvantages of an EU tax are pointed out. The EU tax would tend to cut the link between national budgets and the EU budget, thus reducing the Council’s incentives to monitor the EU budget which would reduce fiscal discipline at the EU level. Necessarily a tax based system would inevitably set limits to taking account of different national tax preferences. In addition, interference with national federal results could be the outcome. Finally, there is no conclusive solution of how to meet the problem of instable payments from an EU tax, as this would either further increase the danger of declining budgetary discipline by giving the EU the right to borrow or increasing the flexibility of spending, or it would remove any gain in sight by adding further resources as residual.

Taken together all these considerations lead us to conclude that an EU tax based reform of the own resource system is neither desirable nor politically feasible. Nor do we regard a “declaratory tax” as a promising step where the refinancing burden of EU contributions is signalled to taxpayers by putting an EU-label on (the share of) some national tax. Due to diverging tax systems this would communicate incorrect individual differences in cost burden.

*Parametric adjustments within the status quo*

The most frequently proposed starting point for adjustments within the status quo is the elimination of the VAT resource and the extension of the GNI resource. Many deficiencies of the VAT resource can be observed compared to a system exclusively based on GNI resources (plus the traditional own resources). It seems that the GNI is a better and more transparent indicator for the national contribution capacity than the harmonised VAT base. Moreover, reducing the number of revenue sources is also desirable in order to reduce the complexity which is immanent in the current system of own resources. Our simulation results show that the distributive effects of the elimination of the VAT resource are small apart from the effect related to the current reduced rate of call for some countries. This problem could be dealt with through other instruments so that there are hardly any convincing arguments in favour of sticking to the VAT own resource.

With regard to the GNI resource, a change of the base towards GDP or purchasing power standards (PPS) has been suggested in the past. A GDP base would penalise Ireland and Luxembourg but also most of the new member countries so that political feasibility is not given. Similar problems arise for an approach based on purchasing power which would lead to a dramatically increasing revenue burden for the less developed countries which are characterised by low price levels. We conclude that there is hardly an alternative to using GNI as the base for the fourth resource.

ECB seigniorage as a new source of EU finance would have in common with Traditional Own Resources that its revenue cannot be allocated to single member countries in a meaningful way and that it is raised in the context of a truly European policy field. However, we do not regard this move as desirable and feasible. An important reason is that this would require changes to the monetary constitution of EMU and may be criticised as limiting the independence of the ESCB.

*Reforming the correction mechanism*

Doubtlessly, the existing abatements for several countries are one major criticism of the current EU system of own resources. However, we reject the seemingly straightforward solution of completely phasing-out any correction. As argued extensively above the need for correction is caused by expenditure side imbalances. Without major expenditure reforms uncorrected revenues would produce arbitrary net balances given the yardstick of relative country wealth. It is an undeniable fact that such an outcome would be perceived as unfair by voters in the disadvantaged countries. Although the “juste retour” thinking is regularly criticised in academic contributions it nevertheless is a fact of political life. Reform options neglecting this fact risk political feasibility.

Even if a correction mechanism is assumed to be necessary, the current mechanism is far from being perfect. It has shortcomings given its UK focus and the associated inflation of special provisions for other countries such as reduced VAT call rates or discounts on GNI resource payments. The principle flaws of the UK rebate can not be solved by mere parametric adjustments. Instead, a generalised correction mechanism (GCM) is the more promising starting point for a reform. Alternatives to a GCM discussed in the literature, such as systems based on limiting gross contributions or distribution oriented corrections on the expenditure side do not fulfil the requirements of an efficient system.

Based on a GCM of the type which has been suggested by the European Commission in 2004, numerous variants are simulated to demonstrate the flexibility of a GCM. In particular, a GCM is able to partially compensate countries which would face strongly increasing gross contributions in the case of the abolishment of the UK rebate and the other abatements. If the political will were there, a GCM could also easily be developed towards a system with pre-defined net positions linked to a country's relative wealth according to a suggestion from the Padoa-Schioppa report of 1987.

Although a GCM offers this flexibility, the models discussed so far also have their weaknesses. Apart from an undeniable arbitrariness in the calculation of the net balance, a GCM also has undesirable side-effects. It corrects any kind of distributive effects irrespective of whether effects are consistent with political objectives or not. The fact that convergence funding redistributes resources from rich to poor countries certainly receives larger acceptance than the distributive effects of CAP which are often unrelated to relative wealth. A GCM treats both effects in an identical way.

## 6 Reform proposal

Although the definition of feasible reform proposals is limited by many political and economic restrictions, there is room for manoeuvring EU finances towards a more efficient and integration compatible system. Our proposal is based on the following three key elements which are based on the preceding assessments:

- Complete phasing-out of the VAT resource,
- Accepting the GNI resource as the dominant and permanent source of finance,
- Establishing a generalised, but limited correction mechanism (GLCM).

The GLCM would be general because no country would be privileged, it would be limited in the sense that not all allocatable expenditures are taken account of in the correction. The advantages of a generalised correction mechanism compared to the selective one of the status quo are obvious: If there is a need to correct burden sharing in the Community the extent and structure of correction payments will be identifiable on the basis of objective and measurable country data. Any such generalised approach will clearly beat the current UK rebate with regard to the system's perceived fairness. Limiting the correction mechanism to certain policy fields has further advantages: Correction can be confined to those fields in which distributive consequences are politically hard to accept.

For this purpose, two baskets are to be defined:

- Basket 1 includes the policies whose distributive effects are either not measurable or are politically accepted. The financing of basket 1 would be based on GNI resources (in addition to TOR).
- Basket 2 includes those policies whose distributive effects are not regarded as acceptable. While the first step financing is based on GNI resources, a correction mechanism corrects the resulting distribution profile associated with these basket 2 policies.

The decision to assign policies to basket 1 or basket 2 will ultimately be a political decision. However, clear favourites for basket 1 policies are the following: First, policies where spending can not be allocated to individual countries due to the nature of payments. Secondly, policies where payment flows into individual countries may be identifiable but this payment structure is no sensible proxy for the share of country benefits from that policy. Thirdly, policies where payment flows into individual countries are identifiable and also indicate the countries' relative benefits from an EU policy, but where the distributive effects are generally accepted.

Favourites for basket 2 policies are policies which are deemed to be desirable on grounds unrelated to distribution but which produce substantial distributive effects as a by-product which are politically not regarded as acceptable. Without a doubt, the CAP is the clearest candidate for basket 2 since its distributive consequences are largely responsible for the unequal budgetary positions of different member states with similar GNI. Moreover, other policy areas with unsystematic distribution patterns could be selected, for instance some parts of the structural policy.

The GLCM has the advantage that for those policies included in basket 2, the common pool problem and the national engagement for larger benefits from these policies could be contained. Since the mechanism corrects a country's excessive benefits from basket 2 policies, it reduces incentives for countries to fight for an expansion of these policies. Moreover, an evolution of the spending side with a constant relative diminution of CAP would automatically diminish the correction mechanism's relevance. Hence, the introduction of a GLCM would set the system on a path where – without a further necessary discretionary change – the correction mechanism would be phased out continuously. Hence this reform option would overcome the status quo bias associated with the current system (and also associated with any other unlimited correction mechanism).

*Parametric specification and simulation*

In the empirical part we present a couple of simulations in order to demonstrate which distributive patterns could be achieved and that these patterns can be brought close to the status quo which is a precondition for our proposal's political chances. These simulations show that depending on the choice of parameters, specific distributive outcomes that vary largely can be achieved. This demonstrates the flexibility of this approach which is important from the political perspective. In particular, results can be achieved which are not too different from the status quo albeit with one qualification: A higher burden for the UK, privileged under the current system, is to a certain extent a necessary characteristic of any approach based on a generalisation of the correction principle. However, it must be stressed that the GCLM addresses exactly those distributive characteristics of the status quo which are heavily criticised by the British side and regularly used to defend the UK rebate, namely the distributive consequences of agricultural policies. Taking these British concerns seriously, a GCLM compensating for the CAP's distribution effect should therefore be acceptable for the UK.

*Reform suggestions for the sub-national dimension*

Expert interviews revealed that in most EU member states with the exception of Austria the EU contributions are paid exclusively by the national level. This dominating institutional solution is problematic insofar as the regional actors do not have an incentive to take account of the costs resulting from an EU financed project. Against this background it seems possible to increase budgetary efficiency by making the regional level participate in the financing of the EU budget. Obviously, the decision of how to share the financial burden intra-nationally is taken by each member country independently. We would recommend reassessing the possibility of a regional contribution to EU own resource payments in order to ensure that regions are aware of the financial burden of EU spending.

*Changing the wording in EU budgetary policy*

A final recommendation for reform concerns a seemingly unimportant side aspect related to terminology. It is an established practice of EU finance to define the size of the budget in per cent of GDP. In addition, a corresponding table of commitments of appropriation is agreed upon, which is defined in real terms, i.e. for constant prices of a basis year. This practice is fundamentally different from budgetary practices in most member countries where budgetary planning refers to the nominal size of the budget. Insights from behavioural economics suggest that these differences can be expected to have real consequences in negotiations and decisions and can be expected to bias the budgetary outcomes towards an expansion of the European budget compared to the national level.

We recommend the following innovation with regard to the metrics used in EU budgeting: Future negotiations should be framed in terms of nominal Euro amounts both with regard to the own resource ceiling and to the single expenditure items. However, the resulting nominal table could be supplemented by an adjustment clause that would trigger automatic upward or downward adjustments to these nominal amounts whenever inflation or real growth would leave predefined bands. In order to guarantee self-interest of budgetary authorities into low inflation rates, the trigger clause should be designed asymmetrically with respect to inflation: while a downward adjustment as a consequence of lower than expected inflation is desirable, an upward adjustment for a higher than expected inflation rate should be absent.

## 7 Final remarks

Our reform proposal would imply changes far from a revolutionary upheaval of the system but which nevertheless address key current problems. We have clarified that well established and functioning elements of the status quo should be retained, such as the contribution based link between national budgets and the European budget. This feature is particularly helpful in setting up incentives to foster fiscal discipline and it constitutes a certain counterweight to the common pool problem which is also virulent at the EU level.

A fundamental difference between our proposal and many other far reaching visions in the literature is most certainly that we accept the distribution issue as an undeniable fact of life in European budgetary politics. We also think that a GLCM can be readily presented as a fair system which is important in gaining acceptance from the voter. This improved fairness perception would also reduce political pressure on governments of member countries to fight for higher spending shares in expenditure negotiations. Hence, collective European goods will have better chances to prevail over transfer policies once the system change has occurred. Therefore, we would claim that our reform proposal is not only politically realistic because it is related to prevalent fairness criteria but it would also boost budgetary efficiency at the EU level.