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Reforming the Financing of the European Union: A Proposal

1. Introduction

The current system needs to be reformed

The debate about reforms of the EU budget and the system of own resources has a long history. Many reform proposals have been made. Some of them are restricted to marginal adjustments of the existing system, others suggest fundamental change. Public spending and taxation belong to the core of state sovereignty. Therefore, reforms of the EU financing system have to be seen against the backdrop of the particular institutional setup of the EU.

The EU is a unique institution. It combines governance structures known from international organisations with elements of federalism. In the area of public finance, the current setup is based on the fiscal sovereignty of the member states. In particular, national parliaments have the right to levy taxes, and there is currently no consensus in sight that this should change. This paper makes a reform proposal which takes the fundamental institutional setup of the EU as given. However, assuming that the current institutional structure of the EU remains in place does not mean that it will not evolve in the future. Nor does it mean that the current division of powers and responsibilities between EU institutions needs to remain exactly as it is. In fact we do think that there is need for change. The current system for the financing of the EU needs to be reformed. There is need for change on the revenue and the expenditure side of the budget. A reform of the system needs to address various institutional issues, in particular the roles played by the Council and the European Parliament.

Reform proposal

In this paper we propose a reform of the EU financing system. The two most important elements of our proposal are i) to make the contribution of taxpayers to the EU budget more visible by showing an EU VAT share on receipts and ii) to increase the power of the European Parliament in the determination of the structure of EU expenditures by limiting the multiannual financial framework to the overall size of the EU budget while the structure of expenditures will be determined annually. It is the objective of the second reform element to give greater weight to policies with EU wide benefits and to crowd back the influence of 'juste retour' thinking on EU expenditures.

The setup of this paper is as follows. In section 2 we briefly summarize the current structure of EU revenues and expenditures. Section 3 discusses the critique of the current system and perspectives for reform. In section 4, we present our reform proposal and section 5 concludes.

2. EU Finances: The Current System

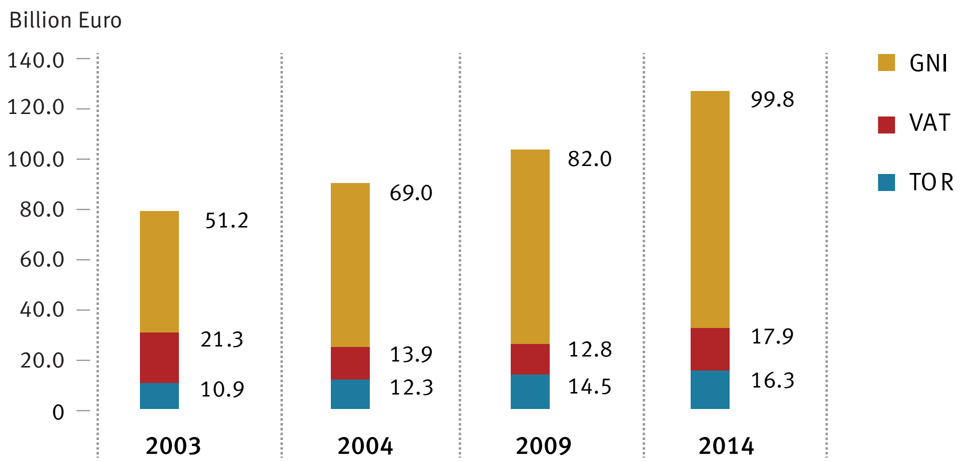
EU budget is financed through own resources

Currently the EU budget is essentially financed through the system of own resources.[1] Own resources are revenues which accrue to the EU and do not depend on discretionary decisions of member states. Own resources can be a share of custom duties or a share of some harmonized tax. The EU budget is always balanced and the level of expenditures is limited by the expenditure ceilings fixed in the multiannual financial framework, which currently covers the time span 2014-2020. For this period the expenditure ceiling has been set to 1.23 per cent of gross national income (GNI). There are three types of own resources:

- The so called traditional own resources (TOR), consisting of customs duties and agricultural levies,
- the VAT based resource, which is essentially a contribution by the member states calculated with reference to a hypothetical value added tax base with various corrections, and
- the GNI based resource, which balances the budget.

Figure 1 illustrates the weight of the different revenue sources in the EU budget. Over time the VAT resource has lost importance while the weight of the GNI resource has increased.
The expenditure side of the budget has traditionally been dominated by agricultural subsidies and spending on cohesion, i.e. regional and structural policies. Although the role of agricultural subsidies has declined over time, they still absorb roughly 40 per cent of the budget. Expenditure on cohesion policies is the other large block in the budget (see figure 2).
How is the financing burden distributed across member states? Figure 3 illustrates how a country's share in the contribution to the EU budget is related to its share in EU GNI. The contributions are roughly proportional to GNI but some countries show deviations.[2]

Figure 1: EU Own Resources 2003-2014



Data: European Commission

1 Next to these own resources, the EU has other revenues, which include, for instance, taxes on salaries of EU staff, fines for breaches of EU regulations or contributions from non EU countries which participate in certain EU programs.
2 Croatia joined the EU in July 2013 so that the number is distorted since the contributions reflect membership during six months while the GNI number is for the whole year.

Figure 2: EU Budget Expenditure 2013 (Billion Euro)

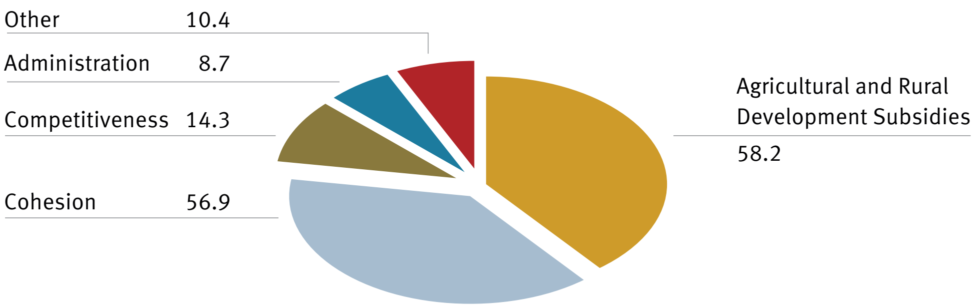
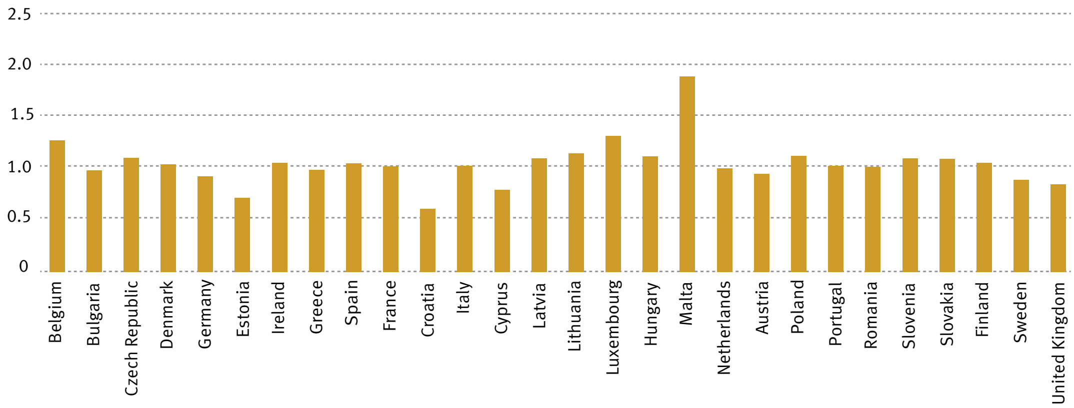
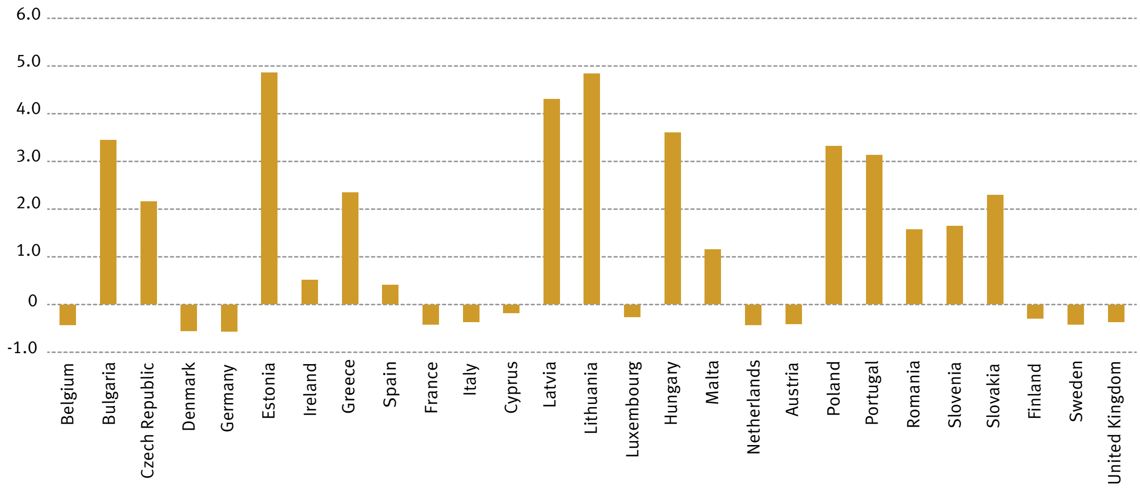


Figure 3: EU Budget Financing Share/GNI Share 2013



Data: European Commission

Figure 4: EU Budget Net Balances 2012 (% of GNI)



Data: European Commission

The budget net balance is defined according to the financial report methodology of the European Commission. The net operating balance (after UK rebate) of each Member State is established by calculating the difference between the operating expenditure (excluding administration) allocated to each Member State, and the adjusted 'national contribution' of each Member State. For more detailed information, please refer to: http://ec.europa.eu/budget/financialreport/2013/annex/3/index_en.html.

A different picture emerges when net balances are considered. Figure 4 (see page 3) shows the net balances in per cent of GNI for the year 2012. Net balances do to a large extent reflect that the financial flows of the EU budget favor the poorer member states.

To summarize, figures 1-4 illustrate four stylized facts about the EU budget: i) the growing importance of GNI contributions and the declining role the VAT based own resource, ii) the large weight of redistributive expenditures in the form of agricultural subsidies and regional and structural policy funds, iii) the fact that the financing contributions of the member states are not exactly proportional to GNI and certainly not progressive in per capita GNI and iv) the fact that net balances are in most cases inversely related to prosperity.

3. The Critique of the Status Quo and the Need for Reform

There is a consensus among a large number of both policy makers and academics that EU policies should focus on areas where common interests of the member states are at stake and where the EU can achieve policy objectives more effectively than the member states acting alone. The costs of these policies should be distributed fairly. At the same time the EU budget should be as transparent and democratically accountable as possible. Citizens should understand what they contribute to the EU budget and what they get in return.

The existing financing system is often criticized for failing to achieve these objectives. The critique can be summarized in four points:

EU spends money on the wrong policies

Firstly, the EU spends its money on the wrong policies.[3] Some of the largest spending items in the EU budget are difficult to justify. This includes in particular the huge share of spending on agriculture. There is no convincing reason why the EU should spend 40 per cent of its budget on a sector of declining importance. But there is more. As shown in the preceding section, the second largest item in the EU budget is spending on regional and structural policies. This is justifiable when it comes to the development of border crossing activities like infrastructure networks or when regional policy subsidies go to poor EU member states. But many projects are carried out in countries that do not need EU support. For instance, the EU has recently co-financed the renovation of drinking water reservoirs in Brandenburg, Germany.[4] Drinking water is important but the benefits of the renovation are restricted to the local area, and there is no doubt that Germany has the means to finance the renovation of drinking water tanks. No border crossing interests arise and there is no wider European interest in this investment. Other examples are the transformation of disused industrial sites in Nuremberg, Bavaria[5], or the support of IT investment of small and medium enterprises in Baden-Württemberg.[6] Similar cases can be found in many EU countries.

More concentration on the provision of EU wide public goods is needed

At the same time, more EU involvement would be required in the provision of EU wide public goods. This includes areas like foreign policy, external and internal security, military procurement and development aid. These are policy fields where individual member states have neither the incentives nor the resources to act appropriately. Here, the EU could generate added value, generate important efficiency improvements and make sure that European interests are represented effectively.[7]

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3 This verdict is a common thread of numerous analyses that apply fiscal federalism criteria to the EU budget: Alesina and Wacziarg (1999), Sapir Report (2004), Alesina et al. (2005), Heinemann and Begg (2006), ECORYS et al. (2008), Ederveen et al. (2008).

4 http://ec.europa.eu/regional_policy/index.cfm/en/projects/germany/drinking-water-reservoir-gets-new-lease-of-life, downloaded May 2, 2015.

5 http://ec.europa.eu/regional_policy/index.cfm/en/projects/germany/a-second-chance-for-disused-industrial-sites, May 2, 2015.

6 http://ec.europa.eu/regional_policy/index.cfm/en/projects/germany/getting-businesses-moving-with-it, May 2, 2015.

7 For the potential of cost savings through a europeanization of defense and embassies or consulates see Weiss (2013).

The fact that these policies are neglected while the redistributive policies dominate is often explained by the circumstance that regional policy projects or agricultural subsidies lead to visible benefits in individual member states while the benefits of the provision of EU wide public goods are less directly visible (e.g. de la Fuente and Doménech, 2001; Osterloh et al., 2009). National governments, who dominate decision making at the EU level through the Council, have incentives to use their political influence to make sure that their country gets a 'fair share' of these spending items. Lending political support to spending on EU wide public goods is less attractive.

Under the current decision rules the Council has a particularly strong position vis-à-vis the Parliament through its crucial first draft of the multiannual financial framework (MFF). Although the MFF requires the subsequent consent from the Parliament, the experience with the decision on the 2014-2020 MFF once again indicates that the initial Council position creates facts which can only marginally be changed by the Parliament in the further proceedings. Moreover, since the MFF broadly defines the expenditure structure it also constrains the possibilities of the Parliament to shift resources towards European public goods in the course of the annual budget legislation. This relatively weak position of the Parliament compared to the Council helps to explain the persistence of redistributive policies with large national visibility, rather than spending on items of EU wide interest. There is evidence that the net-receiver and net-payer positions explain preferences and coalition formation in the Council much better than the party orientation of national governments (Zimmer et al., 2005; Rant and Mrak, 2010). By contrast, for the voting behavior in the Parliament transnational party lines are more important (Hix 2002; Hix and Noury, 2008; Hix et al. 2007; Kreppel and Tsebelis 1999). Accordingly, as long as the "national" Council effectively has a larger say in budgetary issues than the "partisan" Parliament it is unlikely that the 'juste retour' thinking will lose impact.

A second point of critique is the argument that the burden sharing between member states is unfair. As shown in figure 3, some of the more prosperous EU member states contribute less to the EU household than what corresponds to their share in EU wide GNI. In particular the rebate for the United Kingdom is often criticized as being unfair because it no longer reflects the distribution of prosperity in the EU. At the same time, the UK and other countries point to the fact that net balances do suggest that the EU budget redistributes significantly in favor of the poor member states. Clearly, if a larger part of the budget was spent on EU wide public goods, rather than redistributive items with local impact only, net balances would be less relevant as an indicator of how individual member states benefit from the EU budget.

EU financing system is unnecessarily complex and opaque

The third point of critique is that the existing financing system is unnecessarily complex and opaque. This applies in particular to the VAT based resource. It is essentially a contribution by the member states, but its calculation is extremely complex. It is clearly less transparent than the GNI resource. Another source of opacity is the system of national rebates. In particular the calculation of the rebate for the United Kingdom is complex. Since it is linked to the VAT based own resource, reforms of this particular own resource are difficult to achieve.

Finally, the fourth issue is a lack of democratic accountability and the absence of a direct link between the EU budget and European citizens. Most citizens are poorly informed about the magnitude of the budget and the tax burden associated with it. Also benefits of at least some forms of spending are far from being well-known.[8] The lacking transparency on the costs of EU activities precludes a comprehensive and balanced cost-benefit calculation on the side of voters.

8 Some forms of spending are very visible, in particular infrastructure spending where EU involvement is usually well advertised.

4. A Reform of the EU Financing System

We propose a reform of the EU financing system which addresses the weaknesses of the system but, at the same time, does not require a fundamental change in the institutional setup of the EU, as mentioned in the introduction. In particular, our proposal does not question the sovereignty of the member states in the area of taxation. Most individual elements of our reform proposal have been discussed or proposed in other contexts. The key issue is that their combination leads to a concept which we believe to be well balanced. Our proposal includes five elements:

The five elements of the reform proposal

- The decision on the MFF should in future be limited to the budget ceiling. Hence, the Council will continue to have a strong say on the level of spending, but will lose its power to predetermine the spending structure for the full duration of the MFF. Decisions on how to spend the money (up to the pre-determined ceiling) will be completely left to the annual budgetary procedure with its joint decision making of Council and Parliament.
- The existing VAT own resource will be abolished.
- The traditional own resources will be preserved. The GNI based resource will compensate the revenue losses due to the abolition of the VAT based resource.
- All EU member states will make the contribution of citizens to the EU budget visible on VAT receipts by showing some percentage points of VAT labelled as the EU share in VAT. The purpose of this 'EU VAT rate' is exclusively to make the financing burden of the EU budget visible to the citizens. It shall not to be the basis of real financial flows. This could happen at a later reform stage, as we point out further below, but not currently. There are two options for determining the 'EU-VAT rate'. The first option would be to make the respective national contribution visible. The true national contribution to the overall budget would take the form of the GNI based own resource. The VAT rate shown on the receipt would simply translate the national GNI based contribution into the EU VAT rate. The second option would be to determine the EU VAT rate by translating the GNI contributions of all member states into an EU-wide and uniform EU-VAT rate. The advantage of the first option is that the EU VAT rate would illustrate the true contribution citizens of any country make to the EU budget. Maybe a disadvantage is that the EU VAT rate would then differ across member states. The second option would avoid this and the EU VAT rate would be the same in the entire EU. The disadvantage would be that the true contribution per member state would not be reflected in the EU VAT rate. We prefer option 2 because it could be interpreted as illustrating the contribution of taxpayers as EU citizens, not as citizens of their respective member states.

  The rate could be adjusted each year or less frequently, depending on how the budget and the tax base change. It is important to emphasize that showing the 'EU tax' on the receipts would not imply that member states would automatically pass on the VAT revenue to the EU. The difference between revenue from traditional own resources and the overall EU budget will be covered by GNI own resources. The EU share in VAT is exclusively an instrument for communication. If VAT harmonization proceeds, one option for the future would be to transform the EU VAT rate into a true own resource. But the reform we suggest here should not be postponed until VAT harmonization proceeds because that may last a long time.
- The system of rebates should be simplified. The rebates will ultimately be a matter of negotiations. The net balances could provide a guideline, but expenditures without clearly identifiable benefits which accrue to individual member states should be left out of the calculation of net balances.

This reform proposal offers a number of improvements. Abolishing the VAT based own resource and simplifying the system of rebates has been proposed repeatedly. Here, the key obstacle is that the UK rebate is linked to the VAT own resource. It will be difficult but hopefully not impossible to convince the UK that change is necessary.

The two more controversial elements of our proposal are the change in the budgetary process and the introduction of the EU VAT share which is made visible on invoices. Variants of both elements have been proposed by other authors.[9]

The limitation of the initial MFF decision to the spending ceiling would prevent the Council from effectively fixing the expenditure structure over seven years through its initial decision. Instead, the budgetary structure would then be negotiated by the partners Council and Parliament in the annual budgetary process with equal weights. This innovation would imply an increase of power for the Parliament regarding the structure of EU expenditures. It has the purpose to give greater weight to policies with EU wide benefits and to crowd back the influence of 'juste retour' thinking. As shown above there is evidence that national perspectives and interests are more influential in the Council than in the European Parliament.

European Parliament should have stronger say on expenditure structure

Of course, we cannot preclude that members of the European Parliament focus on policies which favor their particular voters in their constituencies. This could lead to a process of logrolling with similar results as negotiations between national governments. However, voting on the budget is likely to happen along party lines, so that it will be difficult to organize the particular interests of individual members of the European Parliament.[10] If that is correct, the greater influence of the Parliament in decision making about the expenditure structure will enhance both democratic accountability at the EU level and the weight attributed to expenditures on items of interest to Europe as a whole. This could imply a restructuring of expenditures away from agricultural sector spending towards European infrastructure networks and internal and external security policies.

Without doubt, there is a need for multi-annual spending programs in order to develop long-run investment strategies like it is indispensable for cohesion spending or infrastructure. But this kind of long-run programming can be done in the annual budgeting, as well, and is no necessary element of the binding MFF. In most national budget systems no binding long-run budgetary plans exist but, nevertheless, annual spending follows well-defined long-run investment strategies.

Introducing an EU VAT share to be made visible on invoices is likely to be controversial for a number of reasons. It would undoubtedly raise transparency and awareness for the costs of the EU budget. The EU would need to justify the budget and citizens would engage more and be more interested in the decisions made by the European Parliament. One concern could be that the costs of EU policies would become more visible to citizens while the benefits might not. Here the greater power of the European Parliament regarding the structure of expenditure is important. Greater exposure to scrutiny by the public would go along with greater decision making powers. Increased pressures and critique of the budget would be welcome. EU spending would have to be explained better and the most likely outcome is that spending on questionable items, such as agricultural subsidies, would finally be crowded back.

An important objection to the EU VAT share would be that it would simulate a form of taxation which is not real. This might give rise to misunderstandings. The alternative to just making the EU VAT share visible on invoices would be to introduce a real own resource in the form of a share in VAT which goes to the EU budget. The main obstacle is that, as mentioned above, the VAT is not fully

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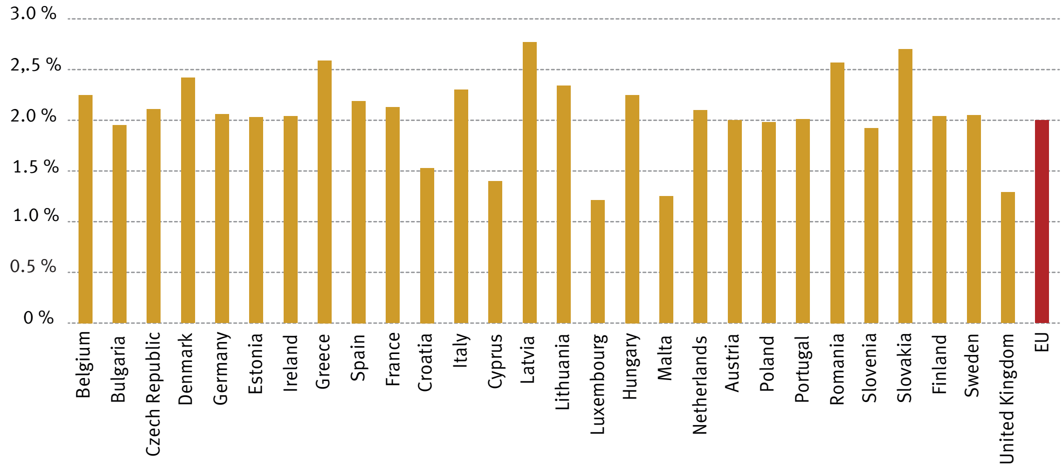
9 Letting the European Council set the ceiling for the EU budget while the European Parliament determines the expenditure structure has been proposed, for instance, by Gros and Micossi (2005). Making the revenue side of the EU budget visible through a share in a national tax like VAT has been proposed by Caesar (2001), Schick and Märkt (2002) and, recently, Cipriani (2014).

10 Two further institutional innovations could counterbalance the incentives of MEPs to attract funds for their local constituencies: first, pan-European party lists and, second, higher local or national co-financing rates. Pan-European party lists would foster a European perspective in election campaigns and higher co-financing helps to internalize the costs of local pork barrels.

harmonized across Europe. As long as this is the case, individual countries would have incentives to exempt more goods from VAT so that their contribution to the EU budget declines. To address this issue the GNI own resource levied from each country could be calculated so that VAT own resources contributed in the country could be credited against the GNI resource. This would eliminate the incentive to narrow the VAT base. To the extent that VAT harmonization proceeds, the crediting against the GNI based resource could be reduced and eventually abolished.

Back of the envelope calculations illustrate the new system (Figure 5): Translating national shares in own resource payments (including rebates, excluding traditional own resources) into country-specific VAT shares (option 1) would lead to a range between 1.2 and 2.7 percentage points. A uniform EU-wide VAT tax share (option 2) would amount to 2.0 percentage points.

Figure 5: Declaratory EU Tax 2014 (% of VAT Base)



Source: Own Calculations

5. Conclusions

Central advantages of the reform proposal

What does our reform proposal achieve? Two advantages are of key importance: Firstly, the shift of responsibility for the structure of EU spending to the European Parliament has the potential to reduce the focus on 'juste retour' and policies generating visible advantages in individual member states. Instead, policy areas where interests of Europe as a whole are at stake and where EU involvement can yield added value may find more political support. Secondly, making the contribution of taxpayers to the EU budget visible through an EU VAT share shown on VAT receipts would strengthen the links between citizens and the EU budget and foster debate and democratic accountability.

Thus, this limited reform would already suffice to realize a major pay-off from an EU tax, which is cost transparency for voters. This substantial progress could be achieved without a cut-back of national tax sovereignty so that current political constraints are respected. At the same time, this reform would constitute an evolutionary step preparing the ground for a possibly more fundamental reform in the future with a true EU VAT.

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