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Reforming the Financing of the European Union: A Proposal

The current system for the financing of the EU needs to be reformed. This paper puts forth a reform proposal with two important elements: first, the addition of an EU VAT share on receipts; and second, a shift in power from the European Council to the European Parliament with regard to the determination of the structure of EU expenditures. The first element will make taxpayers' contributions to the EU more visible, thereby increasing their interest in the EU budget and fostering democratic accountability. The second element will shift spending priorities away from projects that generate visible advantages to individual member states and towards policies that benefit the EU as a whole.

The debate over 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, while others argue for 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 indication in sight that this will change any time soon. This paper proposes a reform which takes the fundamental institutional setup of the EU as given. However, this does not mean that the European institutions will not evolve in the future. Nor does it mean that the current division of powers and responsibilities among 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. This holds true for both the revenue and expenditure sides of the budget. A reform of the system must address various institutional issues, in particular the roles played by the Council and the Parliament.

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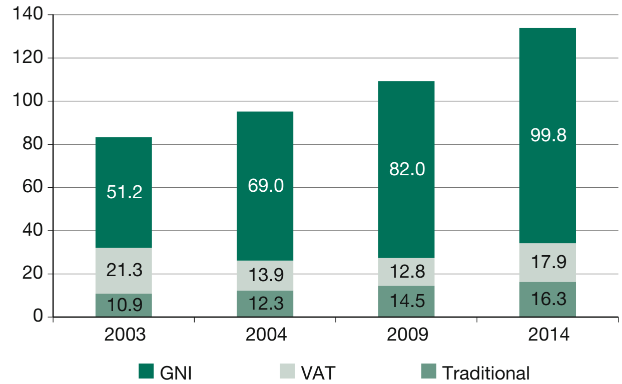
In this paper, we propose a reform of the EU financing system. The two most important elements of our proposal are as follows: first, in order to make the contribution of taxpayers to the EU budget more visible, it is necessary to show an EU VAT share on receipts; and second, we propose to increase the power of the European Parliament in determining the structure of EU expenditures by limiting the multiannual financial framework to the overall size of the EU budget and to determine the structure of expenditures annually. It is the objective of the second reform element to give greater weight to policies with EU-wide benefits and to limit the influence of *juste retour* thinking on EU expenditures.

The current system of EU finances

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. The EU budget is always balanced, and the level of expenditures is limited by the expenditure ceilings set in the multiannual financial framework, which currently covers the period 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:

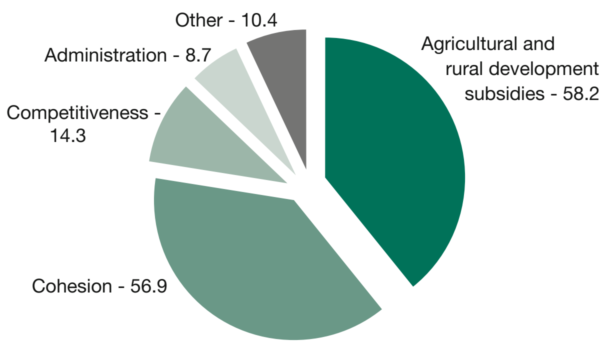
1 Next to these own resources, the EU has other revenue sources, which include, for instance, taxes on salaries of EU staff, fines for breaches of EU regulations and contributions from non-EU countries which participate in certain EU programs.

Figure 1
EU own resources, 2003-2014
in billion euros



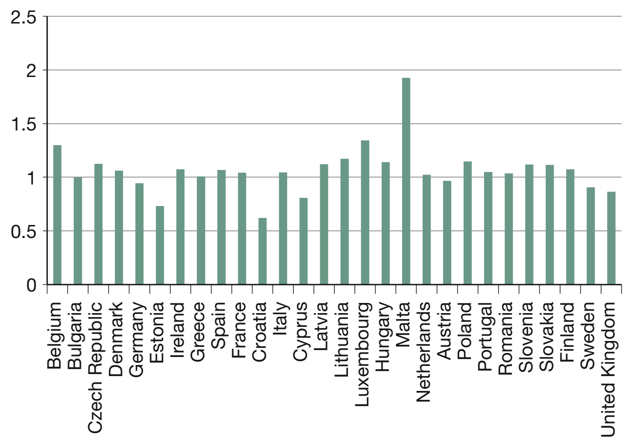
Source: European Commission.

Figure 2
EU budget expenditure, 2013
in billion euros



Source: European Commission.

Figure 3
EU budget financing share/GNI share, 2013
in billion euros



Note: Croatia joined the EU in July 2013, so the number is distorted since the contributions reflect membership during six months while the GNI number is for the whole year.

Source: European Commission.

- the so-called traditional own resources, consisting of customs duties and agricultural levies;
- the value added tax (VAT) resource, which is essentially a contribution by the member states calculated with reference to a hypothetical VAT base with various corrections;
- 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-based 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 of contributions to the EU budget is related to its share in the EU's GNI. The contributions are roughly proportional to GNI, but some countries show deviations.

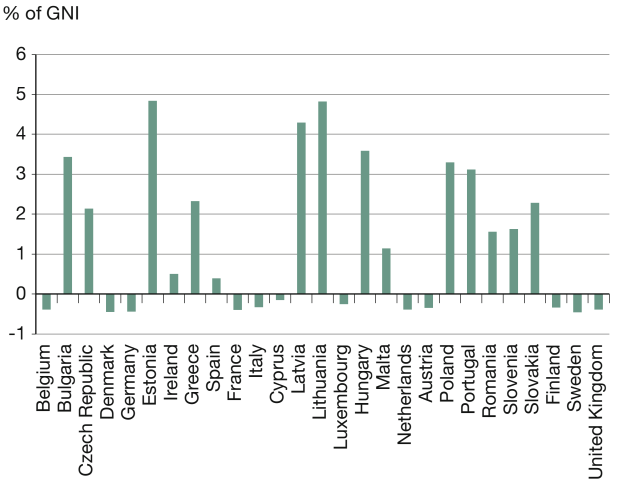
A different picture emerges when net balances are considered. Figure 4 shows the net balances in per cent of GNI for the year 2012. Net balances to a large extent reflect that the financial flows of the EU budget favour the poorer member states.

To summarise, Figures 1-4 illustrate four stylised facts about the EU budget: i) the growing importance of GNI contributions and the declining role of 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.

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

Figure 4
EU budget net balances, 2012



Note: 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.

Source: European Commission.

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 criticised for failing to achieve these objectives. The critique can be summarised in four points.

Firstly, the EU spends its money on the wrong policies.[2] 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 poorer EU member states. However, 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.[3] 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,[4] or the support of IT investment of small and medium enterprises in Baden Württemberg.[5] Similar cases can be found in many EU countries.

At the same time, more EU involvement would be required in the provision of EU-level public goods. This includes 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, improve efficiency and make sure that European interests are represented effectively.[6] That these policies are neglected while the redistributive policies dominate is often explained by the fact that regional policy projects or agricultural subsidies lead to visible benefits in individual member states, while the benefits of the provision of EU-level public goods are less directly visible.[7] National governments dominate decision-making at the EU level through the Council, and they 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-level public goods is less attractive.

2 This verdict is a common thread of numerous analyses that apply fiscal federalism criteria to the EU budget. See, for example, A. Alesina, R. Wacziarg: Is Europe Going Too Far?, NBER Working Paper 6883, 1999; A. Sapir, P. Aghion, G. Bertola, M. Hellwig, J. Pisani-Ferry, D. Rosati, J. Viñals, H. Wallace: An agenda for a growing Europe: The Sapir report, Oxford 2004, Oxford University Press; A. Alesina, I. Angeloni, L. Schuknecht: What does the European Union do?, in: Public Choice, Vol. 123, No. 3-4, 2005, pp. 275-319; F. Heinemann, I. Begg: New Budget, Old Dilemmas, Centre for European Reform Briefing Note, 22 February 2006, London; ECORYS, CPB, IFO: A Study on EU Spending, Final Report, Rotterdam 2008; S. Ederveen, G. Gelauff, J. Pelkmans: Assessing subsidiarity, in: G. Gelauff, I. Grilo, A. Lejour (eds.): Subsidiarity and Economic Reform in Europe, Berlin 2008, Springer, pp. 19-40.

3 http://ec.europa.eu/regional_policy/index.cfm/en/projects/germany/drinking-water-reservoir-gets-new-lease-of-life, accessed on 19 August 2015.

4 http://ec.europa.eu/regional_policy/index.cfm/en/projects/germany/a-second-chance-for-disused-industrial-sites, accessed on 19 August 2015.

5 http://ec.europa.eu/regional_policy/index.cfm/en/projects/germany/getting-businesses-moving-with-it, accessed on 19 August 2015.

6 For the potential of cost savings through a Europeanisation of defense and embassies or consulates, see S. Weiss (ed.): The European Added Value of EU Spending: Can the EU Help its Member States to Save Money?, Gütersloh 2013, Bertelsmann-Stiftung.

7 See, for example, A. de la Fuente, R. Doménech: The Redistributive Effects of the EU Budget: An Analysis and Proposal for Reform, in: Journal of Common Market Studies, Vol. 39, No. 2, 2001, pp. 307-330; S. Osterloh, F. Heinemann, P. Mohl: EU Budget Reform Options and the Common Pool Problem, in: Public Finance and Management, Vol. 9, No. 4, 2009, pp. 644-685.

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 consent from the Parliament, the experience with the decision on the 2014-2020 MFF once again indicates that the initial Council position creates a baseline which can be only marginally 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 EU 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-level 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.[8] By contrast, for the voting behaviour in the Parliament, transnational party lines are more important.[9] 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 criticism is the argument that the burden-sharing among member states is unfair. As shown in Figure 3, some of the more prosperous EU member states contribute less to the EU budget than their corresponding shares of EU GNI. In particular the rebate for the United Kingdom is often criticised 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 favour of the poorer member states. Clearly, if a larger part of the budget was spent on EU-level 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.

8 See C. Zimmer, G. Schneider, M. Dobbins: The contested council: conflict dimensions of an intergovernmental EU institution, in: Political Studies, Vol. 53, No. 2, 2005, pp. 403-422; V. Rant, M. Mrak: The 2007–13 Financial Perspective: Domination of National Interests, in: Journal of Common Market Studies, Vol. 48, No. 2, 2010, pp. 347-372.

9 S. Hix: Parliamentary behavior with two principals: preferences, parties, and voting in the European Parliament, in: American Journal of Political Science, Vol. 46, No. 3, 2002, pp. 688-698; S. Hix, A. Noury: After Enlargement: Voting Patterns in the Sixth European Parliament, in: Legislative Studies Quarterly, Vol. 34, No. 2, 2009, pp. 159-174; S. Hix, A. Noury, G. Roland: Democratic politics in the European Parliament, Cambridge 2007, Cambridge University Press; A. Kreppel, G. Tsebelis: Coalition formation in the European Parliament, in: Comparative Political Studies, Vol. 32, No. 8, 1999, pp. 933-966.

The third point of criticism 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 UK rebate 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 well known.[10] The lack of transparency on the costs of EU activities precludes a comprehensive and balanced cost-benefit calculation by voters.

A reform of the EU financing system

We propose a reform of the EU financing system that addresses the weaknesses of the system but, at the same time, does not require a fundamental change in the institutional setup of the EU. 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 put forward 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.

First, the decision on the MFF should in the 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 by the Council and Parliament.

Second, the existing VAT-based own resource should be abolished.

Third, the traditional own resources should be preserved. The GNI-based resource would compensate the revenue losses arising from the abolition of the VAT-based resource.

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

Fourth, all EU member states should 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. The purpose of labeling the EU VAT rate is exclusively to make the financing burden of the EU budget visible to the citizens. It shall not be the basis of real financial flows. This could happen at a later reform stage, as pointed out 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. One disadvantage is that the EU VAT rate would then differ across member states. The second option would avoid this, and the listed 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 the second option 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 emphasise that showing the EU tax on the receipts would not imply that member states would automatically pass on this VAT revenue to the EU. The difference between revenue from traditional own resources and the overall EU budget will be covered by GNI-based own resources. The EU share in VAT is exclusively an instrument for communication. If VAT harmonisation 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 harmonisation is completed because that may take a long time.

The fifth element of our proposal is that 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 over the current system. 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-based 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 labelling of the EU VAT share on invoices. Variants of both elements have been proposed by other authors.[11]

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 be negotiated by the 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 of giving greater weight to policies with EU-level 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.

Of course, we cannot preclude that members of the European Parliament focus on policies which favour their particular voters in their constituencies. This could lead to a process of logrolling that yields similar results as negotiations among national governments. However, voting on the budget is likely to be along party lines, which would make it difficult to organise the particular interests of individual members of the European Parliament.[12] 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 and

11 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 D. Gros, S. Micossi: A Better Budget for the European Union: More Value for Money, More Money for Value, CEPS Policy Brief No. 66, 2005. Making the revenue side of the EU budget visible through a share in a national tax like VAT has been proposed by R. Caesar: An EU Tax? – Not a Good Idea, in: Intereconomics, Vol. 36, No. 5, 2001, pp. 231-233; G. Schick, J. Märkt: Braucht die EU eine eigene Steuer?, in: Deutsche Steuer-Zeitung, Vol. 90, No. 1-2, 2002, pp. 27-25; and, recently, G. Cipriani: Financing the EU Budget. Moving forward or backwards?, CEPS, London 2014, Rowman & Littlefield.

12 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 internalise the costs of local pork-barrel spending.

towards European infrastructure networks and internal and external security policies.

Without doubt, there is a need for multiannual spending programs in order to develop long-run investment strategies like those necessary for cohesion spending or infrastructure. But this kind of long-run programming can also be done in the annual budgeting and is not a 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 of the costs of the EU budget. The EU would need to justify its 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 closer assessment 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.

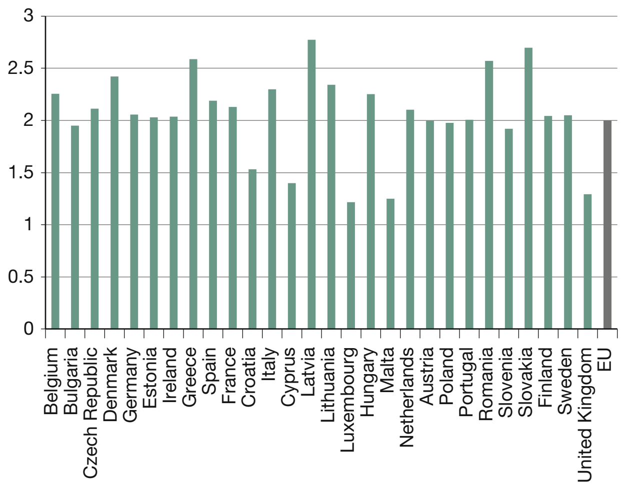
An important objection to the EU VAT share would be that it would simulate a form of taxation which is not real. This might give rise to misunderstandings. The alternative to just making the EU VAT share visible on invoices would be to introduce a real own resource in the form of a share of the VAT which goes to the EU budget. The main obstacle here is that, as mentioned above, the VAT is not fully harmonised across the EU. As long as this is the case, individual countries would have incentives to exempt more goods from the VAT so that their contribution to the EU budget declines. To address this issue, the GNI-based own resource levied from each country could be calculated so that the VAT own resources contributed by a country could be credited towards its GNI resource contribution. This would eliminate the incentive to narrow the VAT base. To the extent that VAT harmonisation proceeds, the crediting towards the GNI-based resource could be reduced and eventually abolished.

Figure 5 shows a back-of-the-envelope calculation to illustrate the new system. Translating national shares in own resource payments (including rebates, excluding traditional own resources) into country-specific VAT shares

Figure 5

Declaratory EU tax, 2014

in % of VAT base



Source: Own calculations.

(option 1) would lead to a range between 1.2 and 2.7 per cent. A uniform EU-wide VAT tax share (option 2) would amount to 2.0 per cent.

Conclusions

What does the reform proposed in this article seek to 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 the EU 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 realise a major pay-off from an EU tax, namely cost transparency for voters. This substantial progress could be achieved without a cutback 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.