EUROPE FOR GROWTH

FOR A RADICAL CHANGE IN FINANCING THE EU

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DEDICATION

This book is published in homage to Tommaso Padoa-Schioppa, president of Notre Europe from 2005, who was associated with our project since the outset. His sudden death, on 18 December 2010, is a great loss for Europe. He was also a highly respected figure in international monetary policy-making and financial reform. Among the numerous and prestigious positions that Tommaso Padoa-Schioppa held during his life are those of member of the European Central Bank's first executive board (1998-2005), Italian Minister for economy and finance (2006-2008) and chairman of the International Monetary and Financial Committee at the IMF (2007-2008). A great European, Tommaso Padoa-Schioppa was one of the founding fathers of the Economic and Monetary Union (EMU). A few days before his death, in an interview with Notre Europe, he emphasized the need to reform the system for financing the EU. His words could have served as an introduction to this paper:

> An increase in the EU budget today is perceived as a subtraction of resources from the national budgets. And indeed, in accounting terms, this is the case because revenues accrue to the EU budget from national budgets. This state of affairs, however, is not inevitable. It is an unfortunate consequence of the lack of autonomy that member states have imposed upon the EU budget. It would be much more appropriate – and consistent with sound principles of fiscal federalism – if the EU budget was financed with genuine own resources, going from the taxpayer to the EU, without transiting through national budgets.
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> Tommaso Padoa-Schioppa, Interview with Notre Europe
> "Conversation on the eve of the 2010 European December Council"
> 12 December 2010

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INTRODUCTION

The budget of the European Union amounts to around 1% of the EU gross national income (GNI), a size that has remained modest and stable over the last decade, even though the scope of its activities has grown ever wider during the same period. For 2011, it is set at €126.5 billion in payments (€141 billion in commitments).

And yet, year after year, the negotiation of the annual budget by the two arms of the budgetary authority proves to be extremely difficult. Every year, during the budgetary procedure, the Council adopts an accountant-like approach and makes horizontal cuts to the draft budget proposed by the Commission, thus contesting the very financial programming it agreed to when setting the multiannual financial framework.

Even more strangely, this does not dissuade the European Council from making public commitments, with potential additional financial implications. But when the time comes to implement them, these promises fail to receive the necessary financial backing from the same member states.

For instance, the Treaty of Lisbon gives the European Union competences for new policies such as energy, space, the fight against climate change. This Treaty entered into force in December 2009, but these new competences have not yet received a budgetary response. The latest decision of the European Council with a tangible financial impact is the EU 2020 strategy, which aims at providing the EU with a new growth strategy for the coming decade to help it become a smart, sustainable and inclusive economy. Decided in 2010, this strategy has not yet received a single euro!

One might think that the negotiation of the next financial framework would, on the basis of a clear assessment of its needs, enable the EU to be provided with more realistic resources for the future, but nothing is less sure. Indeed, five Heads of State and Government sent a letter to the President of the European Commission, in which they requested the freezing of the budget in the next multiannual financial framework, stating that Europe is currently experiencing a period of severe austerity and that national budgets are under great constraint.

The real problem of the European budget is in fact the structure of its resources. Today, the EU budget is predominantly financed by national contributions, which, at the outset, was not the initial purpose of the European Economic Community (EEC), the precursor to the EU. Indeed, when the European Communities were first established, the GNI resource was supposed to be transitional. However, while fully replaced in 1970 by genuine own resources – agricultural and import duties – national contributions were reintroduced in 1988 in order to complement a decrease in the own resource revenue, a budgetary deficit being prohibited by the Treaty. But what was supposed to be a transitional solution was prolonged and even reinforced over the years and, as a consequence, the European Union has progressively lost its financial autonomy.

The greater the share of the GNI contribution is, the more member states conceive of it as a transfer from their national treasury to Brussels, rather than as an own resource of the European Union, and the more importance they attach to what they get in return. Financed at almost 75% by contributions coming from national treasuries, which are today experiencing severe deficits given the current economic crisis, it is not a surprise that member states have difficulties in respecting their financial commitment to the European Union.

The opposition between net contributors and net receivers and the increasing emphasis on the concept of fair return has, step by step, transformed the multiannual financial framework negotiations into a confrontation of different national claims, resulting in various rebates and compensations, of which the Council agreement on the current multiannual financial framework (2007-2013) is the point of culmination. And every year, during the annual budgetary procedure, the Council comes again with an accounting approach.

Last but not least, the extreme complexity of the system and the damaging lack of transparency, which results from it, render the system totally incomprehensible to the European citizen, who, in the end, is the main loser in such a system. Indeed, the presentation in the Official Journal is of no less than nine pages of indigestible calculations, in order to translate into legislation the alchemist's recipe elaborated by the member states, behind closed doors, and composed of various rebates, compensations or exemptions! And, on top of this, contrary to what is the common rule in any democratic body, the European Parliament, while directly elected by European citizens, has no say in the decisions on EU resources: according to the Treaty, the European Parliament and the Council of Ministers share the budgetary power ... but only as regards spending.

For all these reasons, the financing system of the European Union is today on its last legs. A radical change of its orientation is necessary if we want the EU budget to be reconciled with the solidarity role it should play, to prepare the ground for a strong economic recovery as well as to give the EU the means to properly address future challenges.

Fully funding the European Union with independent sources of revenue is the only way to put an end to the fair return approach. This will then make the necessary change to its spending possible in order to provide the EU with adequate means to meet its needs. This is the key for the success of the EU 2020 strategy.

Such a radical change is possible. In fact it is a question of political will. This is what we aim to demonstrate in this paper. After an historical review of the evolution of the European financing system (chapter 1), we explain in detail its current extreme complexity, unfairness and lack of transparency (chapter 2). Against this background, we then present the three components of the reform that we propose to bring to EU financing: first a radical change to the system of own resources (chapter 3), second the creation of European project bonds to finance investments for huge European infrastructures (chapter 4), and thirdly more synergies and rationality in the budget as it stands today, economies of scale being a non-negligible tool for budgetary efficiency (chapter 5).

1. HISTORY OF THE SYSTEM OF COMMUNITY OWN RESOURCES: HOW DID THE EU BUDGET LOSE ITS FINANCIAL AUTONOMY?[1]

1.1 1957-1970: From a system based on national contributions to the emergence of own resources

From the European Coal and Steel Community to the European Economic Community

The Coal and Steel Community (ECSC), set up in 1951, was financed by means of levies on coal and steel production which were paid directly to the ECSC without passing via national budgets, as ECSC own resources.

When the European Economic Community (EEC) replaced the ECSC in 1957, it was concerned not with any specific product but with the economy as a whole. Unlike the ECSC, the EEC did not initially have any own resources. However, an aspiration to financial autonomy existed from the outset, as expressed in Article 201 of the Treaty of Rome:

> The Commission shall examine the conditions under which the financial contributions of member states provided for in Article 200 could be replaced by the Community's own resources, in particular by revenue accruing from the common customs tariff, when it has been finally introduced. To this end, the Commission shall submit proposals to the Council….

In its early days the EEC was therefore financed by levies or contributions from the budgets of the member states. It would therefore be

[1] This chapter is based on a note written by Dr. Harry Notenboom, entitled "Opbouw en afbraak van het stelsel van Eigen Middelen van de Europese Unie", Venlo, 2009.

necessary to develop the own resources system step by step, as it became possible to achieve unanimity on the proposals made.

Although customs levies were mentioned in the Treaty of Rome, it was agricultural levies that constituted the first own resource of the EEC, from 1962,[2] the year in which the Common Agricultural Policy (CAP) was established. The CAP transferred the bulk of the national agricultural policies of the six member states to the EEC, with the corollary that the corresponding expenditure was removed from national budgets. In part, the CAP was financed on the basis of revenue from levies on imports into the member states of certain agricultural products from third countries. It was the levy on imports of agricultural products which was transferred to the EEC budget.

However, as agricultural levies were not sufficient to finance the Community, financial contributions from the member states continued to exist in parallel.

The 'empty chair' crisis and its resolution

The financial autonomy of the Communities, and hence the cessation of annual financial dependence on the member states, was always an objective pursued by the European Commission and the European Parliament. One corollary of this financial autonomy thanks to own resources was a parliament elected by direct universal suffrage, enabling those voters – European citizens – who wished to observe the use being made of the funds, which they were paying directly to the European Community, to exert influence over the financing of European policies. It was in this spirit that in 1965 the European Commission formulated joint proposals on the financing of the CAP, the EEC's own resources and expanding Parliament's powers. These proposals met with strong opposition from France, which saw the CAP as catering for its interests.

In token of its disagreement, France decided in 1965 to pursue an 'empty chair' policy at the Council of Ministers. The only way of resolving this crisis was by adopting the Luxembourg compromise in 1966. This compromise was neither more nor less than an agreement to disagree, which would in future compel the Council of Ministers to take its decisions unanimously, even in cases where the Treaty provided for majority voting.

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[2] Council regulation of 4 April 1962 regarding the financing of the Common Agricultural Policy, Official Journal of the European Communities No. 30, 20.04.1962.

It was only at a conference of Heads of State and Government (the future European Council) on 1 and 2 December 1969 that it proved possible to achieve a breakthrough to overcome the budgetary deadlock, thanks to the pressure constantly exerted by the European Parliament on the Commission and Council, with the support of national parliaments. This breakthrough led to the Treaty of Luxembourg of 21 April 1970, amending the Treaty of Rome and the Treaty merging the Community institutions. This treaty amending the Treaty of Rome expanded the European Parliament's budgetary powers considerably. At this Council, the member states also took a 'Decision on the replacement of financial contributions from member states by the Communities' own resources'.[3] This decision formally identified as such the Community's own resources: customs duties and agricultural levies, as well as a third own resource comprising an annually adjusted percentage of the harmonised VAT base. This decision entailed the abolition of contributions from the budgets of the member states and resulted in financial autonomy for the Community.

This first decision on own resources was of such importance, as well as forming such a vital part of the 'institutional framework' of the Community, that it required the approval of the parliaments of all the member states.

1.2 1970-1988: The own resources system increasingly questioned

How the VAT resource was diverted from its initial objective

The gradual establishment of the VAT resource

The decision of 1970 defined the VAT resource as follows: 'revenues accruing from value added tax (VAT), obtained by applying a rate not exceeding 1% to an assessment basis to be determined in a uniform manner for member states according to Community rules'.

In order to ensure the proper functioning of this system, a high degree of harmonisation was required. It was with this aim in mind that the 'Sixth VAT Directive', concerning the harmonisation of the tax base, was adopted.

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[3] Council decision of 21 April 1970 on the replacement of financial contributions from Member States by the Communities' own resource, OJ L N°94, 28.04.1970.

The total expenditure provided for in the budget now had to be financed from the three own resources. Agricultural levies and import duties could be estimated (and were calculated in retrospect on the basis of the revenue actually levied). The VAT resource then had to cover the remainder, as the European Community was not allowed to run a deficit. The percentage could be determined on the basis of an estimate of the added value generated in the member states. If this percentage was for example set at 0.75%, which figure was then adopted by the President of Parliament, the amounts obtained by applying this percentage of the tax base were allocated to the European Community. Insofar as the member states were free (within certain limits established by the VAT Directive) to set the rates, the revenue was allocated as follows: if the rate was 19%, 0.75% of the value of the product or service subject to VAT was allocated to the EEC and 18.25% to the budget of the member state concerned. The European share was independent of the setting of the rate, which remained a matter for decision at national level.

The principle of the national and European shares of VAT once having been established, it was then necessary to put this allocation into practice. In order to do so the European Commission proposed two methods: the declaration method and the statistical method.

Under the declaration method, any receipt/invoice made out had to indicate the two percentages, the national percentage and the European percentage. The addition and subtraction of all of these returns then led to the two totals: the national share and the share to be transferred to the Community. The consumer could see, on every invoice, precisely how much VAT was being paid to the national treasury and how much to Europe. This was certainly the most precise method, and was also the method preferred by the European Commission. The amount of administration it entailed, however, was enormous, in a period when computerisation was still in its infancy, and this acted as a brake on its implementation.

According to the statistical approach, the European portion of the VAT was determined by applying the European percentage (different each year, depending on the budget) to the total value of the goods and services consumed, as obtained according to statistical methods.

The Council of Ministers decided, for the time being, to leave the member states free to choose between the two methods, but ultimately only the statistical method was applied.

The transitional period for the introduction of the VAT resource had to be extended several times, and it was 1980 before the resources flowed into the budget from all member states in the form of a percentage of the uniform VAT base, as a third own resource.

Decision by the member states to collect European levies

The member states were responsible for collecting and transferring levies to the European Commission.[4] The collection costs were estimated at an average of 5%, yet the Commission returned 10% to the member states in the event that the transfers had been executed correctly. This approach meant that the individual member states each still had a minimal interest in ensuring that the European own resources were collected correctly.

After some years, however, it was decided that the member states would be permitted to deduct the collection costs immediately and transfer just 90% to 'Brussels'. This was not just a technical issue, despite appearances. The decision had the direct effect of depriving the European Economic Community of its means of verifying the correctness of the process, as having to claim money back later, where relevant, is potentially more complex and fosters resistance. Moreover, transferring just 90% ignored the fact that the EC had full title to the own resources from the moment that they were levied from the liable person.

Changes in the rate of call of the VAT-based own resource

It proved possible to operate for some ten years (from 1975) with the maximum of 1% of VAT, but tensions grew as the ceiling came closer. The Council was not disposed to raise the ceiling without debate. The question of 'future financing' surfaced again on various occasions.

Against the background of recurrent agricultural surpluses, Parliament called for the VAT ceiling to be raised in conjunction with measures to eliminate structural agricultural surpluses. The European Commission proposed an immediate increase in the ceiling to 1.4% and the option of a subsequent further rise of 0.4%.

Parliament did not accept a revision based on a variable percentage of VAT geared to the shares of Community agricultural appropriations spent in the member states. The Council ruled out any increase in excess of 1.4%,

[4] From the very beginning, it was decided that the European Community would not established its own tax authority.

but the Commission argued in favour of a ceiling of 2% in order not to be dependent on obtaining approval from all the national parliaments each year. For the 1984 and 1985 budgets, it was necessary to resort to supplementary financing obtained by means of intergovernmental arrangements approved by national parliaments. The European Parliament was confronted with the realities of the limits to financial autonomy. After many debates and consultations, in May 1985 the Council took a second decision on own resources, raising the ceiling from 1% to 1.4%[5], an increase which however was immediately swallowed up by the supplementary preliminary draft budget of 1986. Spain and Portugal were to join the EEC on 1 January 1986.

The British rebate

In 1973, the United Kingdom, Denmark and Ireland joined the EEC. In accordance with the transitional period which the new member states had negotiated for the initial years after the entry into force of the accession treaty, the own resource levies were discounted on a gradually decreasing scale.

Following this transition period, the United Kingdom became agitated about what it paid to the EEC and what it received in return. It was importing a relatively large volume of agricultural products from third countries and had a relatively small agricultural sector itself. By way of compensation, a system of specific expenditure (regional support and funding of infrastructure) was established for the benefit of the UK.

But Prime Minister Margaret Thatcher did not consider this arrangement to be sufficient, and made her famous statement: ‘I want my money back’. However, it was not ‘her money’, because what the United Kingdom had paid to Brussels was the EEC’s own resources.

Mrs Thatcher’s statement therefore went to the very heart of the financing of the Community budget. However, the Fontainebleau agreement (1984) conceded the UK’s case by granting it a rebate on the difference between its share of the VAT revenue and its share of Community expenditure. This ‘correction’ was performed by reducing the UK’s VAT base, at the expense of all the member states, in proportion to each State’s share in VAT transfers, with the exception of Germany, which

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[5] Council decision of 7 May 1985 on the Communities' system of own resources, OJ L 128, 14 May 1985.

was allowed to contribute only two thirds of its normal share to the correction (the balance being shared among the other member states).

Three VAT percentages therefore had to be determined: one for the UK, one for Germany and a third for the other member states.

This decision, which was originally intended to be transitional, ultimately survived and remains in force to this day. It strongly promoted the concept of the 'just return' in relations between member states and the European Union. Since the rebate was granted, the accounting logic of the member states has remained in constant development. Bit by bit, the Community financing system has been transformed into a complex set of rebates and miscellaneous calculations, rendering it totally incomprehensible for non-initiates.

1.3 From 1988 to the present day: Propagation and domination of the concept of the just return

As explained above, in the early 1980s the maximum figure of 1% for the VAT base was attained, and the rise in the rate to 1.40% was immediately swallowed up by the accession of Spain and Portugal.

In these years, the Commission was even compelled to submit a preliminary draft budget covering 10 months rather than 12, because the funds were then not sufficient for 12 months. This draft budget was nonetheless rejected on the basis of the Treaty, which required a budget to be adopted covering 12 months. An intergovernmental loan then had to be negotiated for two years in order to fill the gaps in the budget, as the Treaty did not permit any budget deficit.

The constantly growing tensions between the two arms of the budgetary authority led to the annual budget's being rejected on three occasions (1979, 1982, 1984) and to recourse to the system of provisional twelfths, which enabled the EC to continue to function, but prevented any new initiatives or policies from being adopted.

In response to this budgetary impasse, a reform of the own resources system was urgent. Unfortunately, this revision put an end to the already badly eroded autonomy of Community revenue.

1988: The Single European Act and the establishment of a 4th 'own resource'

Indeed, in order to put a stop to this recurrent tussling over the budget, Jacques Delors, then President of the European Commission, had the idea of creating the first Financial Perspective, covering the period 1988-1992, i.e. a period of five years. This Financial Perspective, which was based on the Single European Act and governed by an Interinstitutional Agreement, imposed, from 1988, annual ceilings on expenditure and the Community's own resources for five years, which the Commission was empowered to call on annually. In future the European budget could no longer exceed a ceiling indexed to the GNP of all the member states. In 1992, the ceiling on payments to be made during that year was 1.2% of the total GNP of the member states: the expenditure to be budgeted for, which could not exceed this ceiling, was financed from four sources: the three existing sources and a new own resource, based on 'the application of a percentage, determined during the budgetary procedure in consideration of the total of all other revenues, to an additional base that is the sum of the GNP'. The European share of VAT remained fixed at 1.4% of the Community base.[6]

The intended aim of introducing the Financial Perspective system was to ensure the budgetary stability necessary for the establishment of the internal market. But the price to be paid by Parliament in exchange for this financial stability was a loss of its influence over the Community budget. Above all, the fourth own resource greatly weakened the Community's financial autonomy.

1994: Establishment of the GNI resource

An important meeting of the European Council was held in Edinburgh in 1992, towards the end of the period covered by the first Financial Perspective, at which decisions were taken concerning the forthcoming period, particularly an unprecedented increase in the budget allocated to the Structural Funds.[7] After this Council, the Commission formulated proposals resulting in fresh multiannual perspectives, but, in fact, the

[6] Council decision of 24 June 1988 on the system of the European Communities' own resources, OJ L 185, 15.07.1988.

[7] In the 1987 budget, the amount reserved for the Structural Funds was ECU 6.5 billion; in the 1994 budget it was ECU 23 billion; both budgets were for 12 member states.

power of decision rested with the European Council, deciding unanimously on the multiannual financial framework.

As in 1988, the Council linked its agreement on the second Financial Perspective (1993-1999) to a fourth decision on the own resources system, adopted on 31 October 1994.[8]

Under this new decision, own resources (i.e. total own resources) were subject to an annual ceiling of 1.2% of GNP in 1993 and 1.27% of GNP in 1999. The fourth own resource, based on GNP, remained in existence, but was now accompanied by formulae, ceilings and caps, as well as the ever present 'British rebate'.

The maximum VAT transfer was gradually reduced from 1.4% to 1%. The VAT percentage was no longer dependent on the size of the budget, but rather a fixed percentage. The percentage that varied according to the budget was now that of the fourth own resource, which was based on GNP.

1999: The Berlin Summit: recognition of the concepts of the 'net contributor' and the 'net beneficiary'

It was during this period that member states began to heavily advertise their 'net positions' and the fact that they were the 'highest payers' in the EU. For a long time, the Commission opposed the concepts of the 'net contributor' and the 'net beneficiary', but in the member states it became increasingly common to use the term 'contribution' to designate the European funds which the member states transferred to Brussels after collecting them. These amounts thus reappeared in the national budgets of nearly all member states as expenditure conceded to Europe. This approach to accounting placed European funds in competition with national spending.

In 1999, at the Berlin European Council, which resulted in Agenda 2000 and the third Financial Perspective (2000-2006), the financial advantages negotiated by the countries making the demands were largely achieved through further erosion of the concept of structural own resources and of transparency for citizens. For example, the percentages that the member states were permitted to deduct from the traditional own resources were increased to 25%. Originally 5% had been felt to be

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[8] Council Decision of 31 October 1994 on the system of the European Communities' own resources, OJ L 293, 12.11.1994.

adequate as a reimbursement to member states of the collection costs, but the amount was fixed at 10% to provide some small encouragement for correct collection of the resources to support Europe. Twenty-five percent bore no relation whatsoever to the actual costs, but was simply the outcome of a complex calculation that benefited the Netherlands and simply had not been vetoed by other countries. The term ‘collection costs’ had lost all the meaning it initially had in the Own Resources Decision. The agreement also stipulated that Germany, the Netherlands, Austria and Sweden only had to contribute one quarter of the normal costs paid by all member states toward the British ‘rebate’, which was still being maintained. This was all laid down in legal provisions in the fifth Own Resources Decision of the Council of 29 September 2000,[9] thus de facto establishing the concepts of the ‘net contributor’ and the ‘net beneficiary’. The recitals in the Decision included a reference to the decision of the Berlin European Council. The maximum payment based on the VAT base was lowered from 1% to 0.75% in 2002 and 2003 and to 0.50% from 2004. The VAT base of the member states remained capped at 50% of their GNP in order to avoid a ‘regressive levy’. The GNI resource was maintained.

Once the battle had been lost in Berlin, the Commission was no longer able to check the idea of the ‘net contribution’.

Over the years, the substance of what continued to be referred to as ‘own resources’ was transformed considerably. With the rise of the World Trade Organisation, customs duties were greatly reduced worldwide. As for the reforms of the CAP and as for world market prices, they led to a reduction in agricultural levies, which were now referred to as ‘agricultural duties’. The own resource resulting from the GNP base became by far the largest source of income for the EU budget.

2007: The sixth decision on own resources, apotheosis of the just return

On 15 December 2003, as negotiations began on the next multiannual financial framework (2007-2013), the Heads of State or Government of the UK, Germany, France, the Netherlands, Austria and Sweden – all net contributors – wrote a letter to the President of the Commission, José Manuel Barroso, calling for Community expenditure to be limited to 1% of GNI in the next Financial Perspective.

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[9] Council Decision of 29 September 2000 on the system of the European communities' own resources, OJ L 253, 7.10.2000.

This set the tone for the forthcoming negotiations, and it was in this context that the conclusions of the Brussels European Council of December 2005 again strengthened the position of the net contributors. The rate of call of the VAT-based own resource was frozen at 0.30%, reference was made to the European Council decisions of December 2005 providing for a reduced rate of call for the Netherlands, Austria, Germany and Sweden, and it was also decided that the Netherlands should be granted a gross rebate of €605 million on its GNI-based annual contribution. Sweden obtained a gross rebate of €150 million on its GNI-based annual contribution over the same period. Lastly, the British rebate and the corresponding correction for the Netherlands, Germany, Sweden and Austria were maintained and the participation of the UK in the financing of the cost of enlargement was deferred until '2013 at the latest'.[10]

The sixth decision on the own resources system was taken on 7 June 2007,[11] barely two years after the long negotiations at the Brussels summit. Its text, which reflects the conclusions on the subject of revenue adopted by the European Council in December 2005, is virtually unreadable, due to its complexity and the numerous exceptions. The outcome of a complex mathematical calculation is that the UK keeps its correction arrangement, as do Germany, Austria, Sweden and the Netherlands, whose rebate on their participation in the financing of Britain's rebate is maintained.

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[10] European Council Decision of 16 and 17 December 2005 on the Financial Perspective for 2007-2013 – document no 15915/05.

[11] Council decision of 7 June 2007 on the system of the European Communities' own resources, OJ L 163, 23.06.2007.

2. PITFALLS IN THE CURRENT SYSTEM OF FINANCING THE EU

2.1 Why bother about the EU financing system?

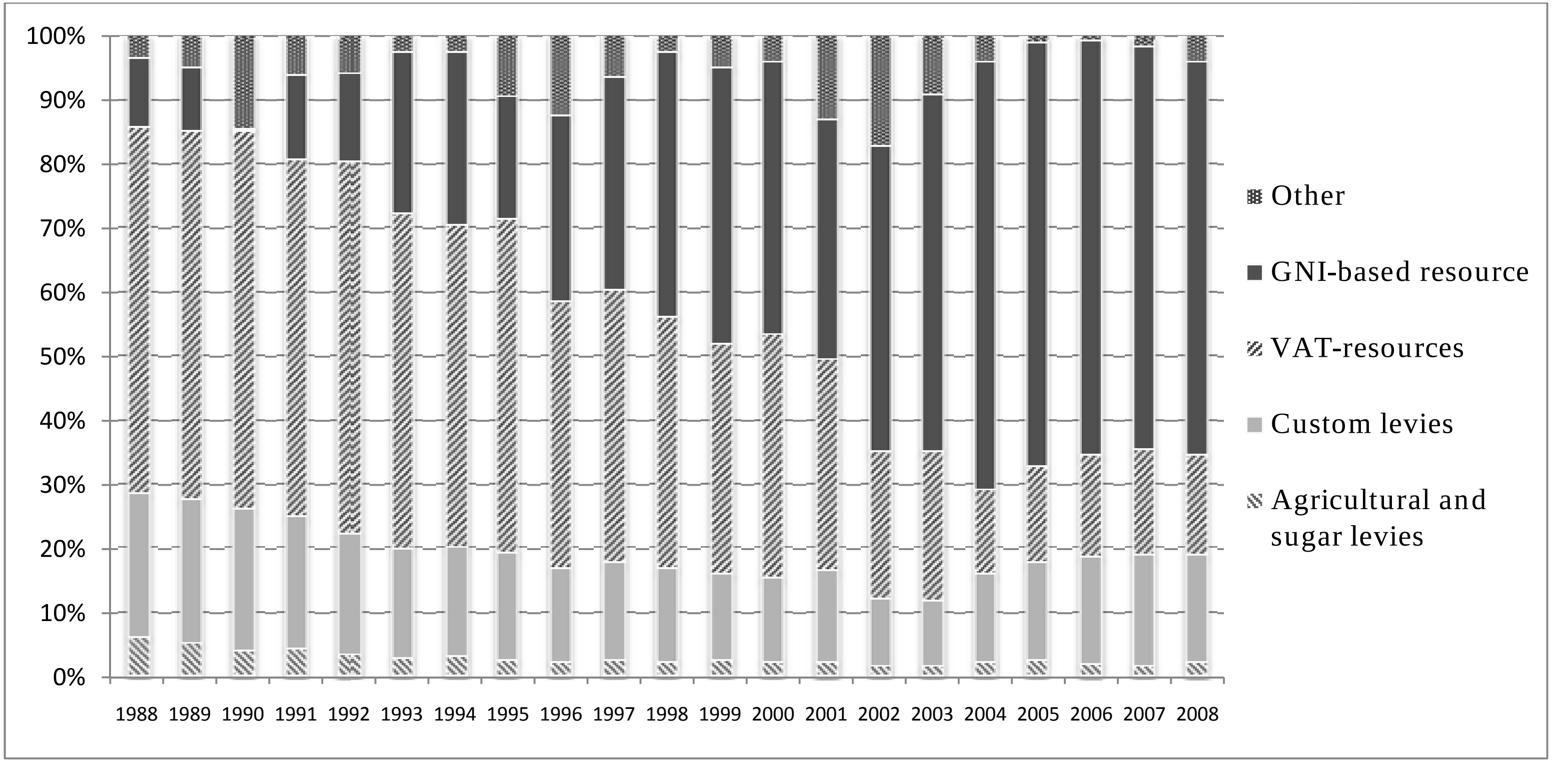
An idea that pervades much of the discussion of EU budget reform is that the problems essentially fall on the expenditure side. The EU budget, it is argued, is a "relic of the past". It is heavily titled towards agriculture and cohesion and does not provide adequate finance to address today's most acute EU challenges – global competitiveness, security or climate change. Budget reform is urgently needed, it is claimed, to "focus EU spending on the right areas".

No one can neglect the importance of revising the EU spending priorities. Yet a narrow focus on expenditures alone is a recipe for failure. History reminds us that previous attempts to undertake an ambitious reform of EU finances have only succeeded when tackling simultaneously all the elements of the budgetary system: expenditures, revenues and procedures.[12] We can endlessly debate EU spending priorities, but this will serve to no avail if we do not address simultaneously the structural factors explaining the path-dependency characteristics of EU budgetary negotiations.

One of these factors is the structure of the revenues. The EU is currently financed by three revenue sources: i) custom and agricultural levies (the so-called TOR, or 'traditional own resources'); ii) a levy on national Value Added Tax (VAT) receipts and iii) member states' contributions paid according to levels of gross national income (GNI). While initially conceived to play a residual role, over the last decade this GNI resource has come to represent the dominant share of total EU revenues (see Figure 1).

[12] See Laffan (2000) and Lindner (2006).

Figure 1. Community revenues, 1988-2008, by type of resource (% of total revenues)



Source: Data presented in the European Parliament report on the Future of Own Resources in the European Union, adopted on 29 March 2007, complemented by data available in the 2009 EU Financial Report.

The overwhelming dependency of the EU budget on national contributions has an influence on the way EU spending decisions are taken. The overt character of national contributions, which have a clear link to national treasuries, accentuates member states' tendency to calculate their net budgetary return (that is, the difference between what they pay and what they receive from the EU). The result is a decision-making process conducive to status quo, with 'net contributors' blocking any increase in the overall budget ceiling for fear of having their contributions increased and 'net recipients' defending existing expenditure programs.

The dominance of the 'net return' logic has not only prevented a rational allocation of EU resources, but it has also made the system very complex. In effect, the necessary payments to secure the approval of the financial package have resulted in a proliferation of rebates, preferential clauses and ad hoc exemptions aimed at 'correcting' national budgetary positions. The result is an EU financing system that is extremely complex, opaque and completely incomprehensible to European citizens.

2.2 An illustration of how the 'net return' logic blocks a major EU budget reform: The latest 2007-2013 financial perspective negotiation

A clear illustration of the pernicious effects of the 'net return' logic can be found in the negotiations leading to the approval of the latest financial perspectives package (2007-2013).

The Commission's proposal, presented in February 2004, contained a pronounced shift in the allocation of resources towards "growth and employment with a focus on knowledge-based activities such as research and innovation".[13] In particular, three fields of intervention foresaw important increases in spending: heading 1a, "competitiveness for growth and employment", heading 3, "citizenship, freedom, security and justice" and heading 4, "the EU as a global partner".

It should be noted that, in drafting its proposal, the Commission found itself constrained by two factors. On the one hand, there was the agreement taken by the Council in December 2002 to freeze CAP spending

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[13] Cf. European Commission: New proposals for growth and jobs under the next Financial Framework 2007–2013, Brussels, 6 April 2005 (IP/05/389).

up to 2013.[14] The latter supposed in practice that the major budget heading had to be exempted from any downward adjustment. On the other hand, two months before the presentation of the Commission's proposal, six member states (all 'net contributors')[15] had warned the Commission that they would not accept a budget above 1% of EU GNI with a letter sent to the president of the Commission (the so-called 'letter of the six').

With CAP spending politically locked and cohesion spending deemed important after the Eastern enlargement, devoting additional resources to key new areas appeared only possible by increasing the overall amount of EU spending. Aware of this fact, and taking note of the 'letter of the six', the Commission proposed a slight increase of EU spending. It foresaw an overall EU budget of €1.025 billion, representing 1.16% of EU GNI in payment appropriations (1.26% in commitment appropriations).

The negotiations in the Council were particularly acrimonious. Right from the start, the six net contributors made it clear that their figure of 1% of GNI did not refer to appropriations for spending but to commitments. In response to this, the Luxembourg presidency proposed reducing the budget to 1.05 % of EU GNI, by cutting €50 billion from the Lisbon agenda programme (heading 1a) and €40 billion from regional aid (heading 1b). In addition, the UK rebate would be frozen, thereby reducing the contributions of the rest of net contributors.

By welcoming the cuts on the budget, the UK stressed that the rebate was out of negotiation. Facing a strong pressure to eliminate the rebate, UK Prime Minister Blair adopted the strategy of conditioning any cut in the rebate to cuts on CAP. This, however, was considered unacceptable for France as well as for other countries that opposed the idea of re-visiting the agreement on CAP spending set in 2002.

Faced with this impasse, in the weeks before the June 2005 EU Council the Luxembourg presidency proposed a new compromise. The compromise allowed the UK rebate to remain unchanged insofar as the 15

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[14] This decision had its roots in a Franco-German agreement reached during the final stage of the negotiations preceding the Eastern enlargement. With this deal, Germany secured an agreement to cap CAP spending until 2013 (preventing the explosion of CAP expenditure which would otherwise surely have happened after the entrance of the new member states into the system), whereas France ensured the financial support to French farmers until 2013.

[15] Germany, Austria, the United Kingdom, France, the Netherlands and Sweden.

older member states were concerned, but obliged the UK to co-finance, as any other member state, the part of cohesion spending directed to the new member states. The UK categorically rejected this proposal, and the EU summit finished in a stalemate (see Hearl, 2006).

In July 2005, the UK assumed the EU's 6-month rotating Presidency. Prior to the formal start of the Presidency, Tony Blair gave a widely praised speech at the European Parliament calling for "a future-oriented EU budget".[16] In spite of that, the UK position did not change during its Presidency. Instead of leading a wide-ranging debate on EU priorities, it spent most of its energies defending the British rebate.

In December 2005, some days before the EU Council, the UK presented a new proposal for the 2007-2013 financial package. This entailed a reduction of the overall budget to 1.03% of EU GNI, basically by cutting the regional aid planned for Central and Eastern Europe. While conceding the possibility of cutting its rebate, the UK continued to insist on linking it to reductions in CAP spending. During the negotiations, the idea of touching CAP spending was again opposed by a majority of countries, and the UK finally had to give up, taking comfort in the engagement taken to organize a mid-term comprehensive re-assessment of the financial perspectives, "including both the UK review and CAP spending".[17]

After a long night of negotiations, an agreement on the financial perspectives was finally reached. The deal set overall EU expenditures at 1.045% of EU GNI. It included a temporal cut of the British rebate during the 2007-2013 period (to "ensure the UK's fair contribution to the costs of enlargement") and a €16 billion reduction in aid to Eastern Europe (Whitman, 2006). The Polish government opposed this deal until the very last minute, and the final agreement was only reached when the German chancellor Angela Merkel proposed that funds earmarked for regional assistance in East Germany be given to Poland. Ironically, the Polish Prime Minister said afterwards that it was "a beautiful gesture, hard to measure in zloty or euro because it is a gesture of solidarity".[18]

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[16] Speech of the UK Prime Minister Tony Blair to the European Parliament, 23 June 2005.

[17] This was indeed the origin of the 2008-2009 EU budgetary review.

[18] Reported on the eurobserver.com website on 17 December 2005 (Whitman 2006, footnote 5).

Table 1. Financial Perspectives 2007-2013: Initial proposals and final results (in € billion, 2004 prices)

	Commission proposal (10 February 2004)	European Parliament (8 June 2005)	European Council (17 December 2005)	Inter-institutional agreement (May 2006)	Difference IIA - COM proposal (€ million)	Difference IIA - COM proposal (%)
1. Sustainable growth	458,015	459,035	379,739	382,139	-75,876	-16.6
(1a) Competitiveness for growth and employment	121,685	120,563	72,120	74,098	-47,587	- 39.1
(1b) Cohesion for growth and employment	336,330	338,472	307,619	308.1	-28,289	-8.4
2. Preservation and management of natural resources	400,275	396,248	371,245	371.3	-28,931	-7.2
of which: Agriculture-market support measures and direct aid payments	301,074	293,105	293,105	293,105	-7,969	-2.6
3. Citizenship, freedom, security and justice	20,945	19,437	10,270	10.7	-10,175	-48.6
4. The EU as a global partner	87,890	70,697	50,010	49.4	-38,427	-43.7
5. Administration	57,670	28,620	50,300	49.8	-7,870	-13.6
6. Compensation (Bulgaria, Romania)	240	800	800	800	560	+233.3
Total Commitment Appropriations	1,025,035	974,837	862,364	864,316	160,719	-15.7
in % of GNI	1.26	1.18	1.05	1.05		

Source: Schild (2008).

As shown in Table 1, the final agreement reached by the Council in December 2005, barely modified by the Parliament in May 2006, differed notably from the Commission's initial proposal. First, the size of the budget was well below what the Commission had requested, amounting only to 1.05% of the EU's GNP. Moreover, the redeployment of resources to new objectives, while real, was less than what the Commission had requested. Consequently, the profile of community spending did not change considerably compared with the 2000-2006 period (see Table 2).

Table 2. Community spending profile: Comparison between 2000-2006 and 2007-2013 (in commitment appropriations)

Financial Framework headings (in % of the total - 2004 prices)	**2000-2006* Average**	**2007-2013 Average**
1a. Competitiveness for growth and employment	6.1%	8.6%
1b. Cohesion for growth and employment	38.4%	35.6%
2. Preservation and management of natural resources	44.5%	43%
3. Citizenship, freedom, security and justice	0.8%	1.2%
4. The EU as a global partner	4.5%	5.7%
5. Administration	5.1%	5.7%
6. Reserves	0.005%	---
7. Compensation	0.5%	0.1%

*As the title of headings changed from one period to the other, the comparison is based on the authors' own calculations and provides only rough estimates.
Source: Bertoncini (2007).

2.3 The extreme complexity of the system: Does anyone understand anything?

As said above, the agreement on the 2007-13 financial perspectives was reached after a long night of negotiation. As the vote on the financial framework is submitted to unanimity rule, and given member states' obsession in improving their own 'net balances', the final deal was only possible to reach by including various compensation 'gifts' and 'ad hoc' exemptions aimed at 'correcting' the budgetary position of individual states.

While the introduction of special clauses has happened before, in the latest financial framework the number of such clauses was exorbitant. A resolution of the European Parliament[19] identifies 41 exemptions introduced by the European Council in December 2005, both on the revenue and the expenditure side of the budget. All these measures add up to the corrections and rebates that were already in place (such as the UK rebate), resulting into a system that is opaque and extremely complex, and in which the way costs and benefits are shared does not correspond to any logical rule.

As the situation now stands, there are the following special treatment measures in the EU budget.

On the revenue side, the UK rebate remains in place. Agreed in 1984, it allows the UK to be reimbursed 66% of the difference between what it pays to the EU budget (national contribution) and what it receives in the form of spending. In the latest financial perspective, the UK correction has been amended by excluding from the calculus the regional spending to the new member states.

Apart from the UK rebate, there are the so-called 'rebates of the rebate', various correction measures included over the time to reduce the negative balances of the other 'net contributors'. In 1999, it was agreed that Germany, Austria, the Netherlands and Sweden would pay only 25% of their normal financing share of the UK correction. Also in 1999, in order to correct the budgetary balance of the Netherlands, it was decided that the 'fee' paid to member states for collecting customs duties would be increased from 10% to 25%.

New corrections have been included in the 2007-2013 budget agreement. Whereas member states normally pay 0.3% of their VAT assessment base, this percentage has been reduced for the four 'net contributors' for the period 2007-2013 only. To make things more complex, a different percentage has been set for each of these countries (0.15 for Germany, 0.10 for the Netherlands, 0.225 for Austria and 0.10 for Sweden). In addition, a further correction has been introduced for the Netherlands and Sweden: both countries have been granted an annual reduction of their GNI contribution during the 2007-13 period (a reduction of €605 million and €150 million, respectively).

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[19] European Parliament Resolution of 29 March 2007 on the future of the European Union's own resources.

On the expenditure side, the 2007-2013 financial framework contains many ad hoc payments under the Structural Funds that violate the general allocation rule, and which are included without any explanation. There are, for instance, unexplained special payments to Bavaria (€75 million), to the Hungarian Region of Közép-Magyarország (€140 million) and to the city of Prague (€200 million). There are also special treatment clauses for particular States, which constitute blatant violations to the general rules concerning the functioning of the structural funds (i.e. Poland is granted a higher absorption rate to use structural funding and Cyprus, despite never being an objective 1 region, is entitled to 'phase 2' support).

Box 1. Exceptions introduced by the European Council in December 2005 on the expenditure and income side of the budget

Earmarked for Projects

- €865 million for the nuclear power plant Ignalina (Lithuania) and €375 million for the nuclear power plant Bohunice (Slovakia)
- €200 million for the peace process in Northern Ireland (United Kingdom)

Earmarked for Regions

- €879 million for five Polish Objective 2 regions (€107 per citizen)
- €140 million for a Hungarian region (Közép-Magyarország)
- €200 million for Prague
- "phasing-out" support for a Finnish Region and Madeira, which were originally "phasing-in" regions
- €100 million for the Canary Islands
- €150 million for Austrian border regions
- €75 million for Bavaria
- €50 million for Ceuta and Melilla (Spain)
- €225 million for eastern German Länder
- €136 million for the most remote regions (€35 per citizen)
- €150 million for the Swedish regions in Objective "Competitiveness and Employment"

Special Funds for Member States

- absorption rate for Poland raised by 4%
- "phasing-in" support for Cyprus, despite never being Objective 1 region
- €2,000 million for Spain, to be distributed freely among Structural Fund Objectives
- €1,400 million for Italy (predefined distribution)
- €100 million for France (Objective: "Regional Competitiveness and Employment")
- €47 million for Estonia (€35 per citizen)

- €81 million for Lithuania (€35 per citizen)
- additional payments from rural development:
  €1,350 million for Austria
  €460 million for Finland
  €500 million for Ireland
  €500 million for Italy
  €20 million for Luxembourg
  €100 million for France
  €820 million for Sweden
  €320 million for Portugal

Special Conditions

- 50% increased support for the former exterior borders to Romania and Bulgaria, compared to regular support for border regions
- private co-financing can be counted in for Structural Fund supported projects in new Member States (per capita GDP <85% of EU average) and eastern German Länder
- in the new Member States (<85%), VAT can be considered eligible cost for Structural Fund projects

Special Conditions in Legal Bases

- departing from "n+2" rule for new Member States (<85%) in 2007-2010
- building projects are eligible for support in the new Member States (EU10 + Romania, Bulgaria)
- 20% of funds from the first pillar (Agriculture) can be used by each country for rural development, disregarding general rules such as co-financing
- special funds for rural development in Portugal (€320 million), without co-financing

Special Conditions for Financing the Budget

- rate-of-call for VAT own resources contribution is reduced by 25% for Austria
- rate-of-call for VAT own resources contribution is reduced by 50% for Germany
- rate-of-call for VAT own resources contribution is reduced by 66% for Sweden and the Netherlands
- the Netherlands get €4,230 million (GNI 'own-resources')
- Sweden gets €1,050 million (GNI 'own resources')
- the rebate for the UK is kept, reduced by certain phased-in payments for the new Member States.

Source: Extract from the annex to the Report of the European Parliament on the future of own resources adopted on 29 March 2007, P6_TA(2007)0098.

2.4 If at least it was rooted on sound economic basis... (or why 'net returns' calculations are devoid of economic meaning)

As seen above, member states' obsession to take their own 'net balance' as the decisive criterion to assess any potential outcome in EU budgetary negotiations leads to sub-optimal results. These could be more or less tolerated or accepted if 'net balance' demands were founded on legitimate grounds. But the fact is that the justification of any notion of 'net balances' is weak (Le Cacheux, 2005).

To start with, the way budget balances are calculated is fairly arbitrary, as they are based on questionable assumptions concerning the geographical allocation of expenditures and receipts. Thus, for instance, it is common practice for member states with ports serving as an entry point to the single market (Rotterdam in the Netherlands is the clearest example) to include the receipts from customs duties and agriculture levies which are imposed in their countries as part of their national contributions to the EU budget. This is clearly wrong, as most of the time the final purchaser of these goods (and thus the one that ultimately bears the cost of the import tax) is a citizen from another EU country.[20] As concerns expenditures, there are many programmes for which it is equally difficult to geographically allocate the beneficiaries. The clearest example is the award of mobility grants to students (under the Erasmus programme). Who benefits from Erasmus? The students themselves, the university in which the students are enrolled or the university that receives them? Probably all of them in different degrees. Or take for instance the case of the External Borders Fund, in heading 3 of the budget ("citizenship, freedom, security and justice"), which co-finances investment in infrastructures, equipment and training to secure the external borders of the EU and Schengen. Who benefits from this expenditure: the countries having external borders or all member states?

Apart from the arbitrary nature of the geographical allocation rules, a more fundamental criticism to the 'net balances' approach is that it totally neglects the second-level benefits of EU expenditures. In effect, the 'net returns' calculus takes only into consideration the initial direct beneficiaries

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[20] A study published by the European Commission in 1998 estimated that nearly 50% of goods on which excise duty is levied at the ports of Antwerp and Rotterdam are destined for other European Union countries (Verbecke et al., 1998, cited by Le Cacheux, 2005, p. 13).

of the EU expenditure, that is, those receiving the money. However, many EU expenditures have other beneficiaries rather than direct recipients. Take for instance the EU structural and cohesion spending. An important part of this spending is earmarked for infrastructure investment projects. As these contracts are awarded on a competitive basis through an EU open tender, an important percentage of these contracts are won by large companies based on the so-called 'net contributors' countries. At a more aggregate level, the demand triggered by the EU structural and cohesion spending in poorer countries benefits the companies of richer countries, who face larger demand for their exports. This is particularly true if we take into account that many of the countries currently receiving structural and cohesion spending are among the most integrated economies in terms of imports.[21]

For other EU expenditure possessing the properties of 'public good', the existence of ultimate beneficiaries other than the recipients is even more evident. For instance, a pure accounting net balance approach fails to recognise the public benefits of the LIFE+ programme, which supports projects aimed at preserving the biodiversity and provides grants for demonstration projects on reducing greenhouse gas emissions.

Ultimately, as pointed out by Le Cacheux (2005), the fundamental flaw of the concept of 'net returns' is the underlying assumption on which it is based concerning the gains of the process of integration. In effect, the narrow-minded accounting approach is rooted in a vision of the process of European integration as a 'zero-sum' game, in which what some countries win is always at the expense of the others. It fails to understand that most EU policies, and the process of integration itself, generate mutual benefits. As noted by Le Cacheux, "if by chance some countries or regions are losers on one particular issue, the overall net gain is, so to speak, sufficient to offset their losses. These processes are therefore positive sum games, with the sum of the winners' gain always representing more than the losses suffered by the losers" (2005: 18).

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[21] According to a recent Commission document, intra-EU imports in many new member states account for 40-50% of GDP, whereas the average ERU 27 ratio is around 17% (Commission Staff Working Document – technical annex accompanying the Communication from the Commission on "The EU Budget Review", SEC (2010) 7000 final).

2.5 Why the shift towards a real EU own resource-based system is the only way to resolve the 'net returns' problem

Some people consider that the arguments provided above are not sufficient to justify a major reform of the EU financing system. They argue that the current funding system, based on GNI-based national contributions, works reasonably well and that a shift towards a real own resource-based system is not warranted. There are in fact two types of objections to the need to move towards an own resource-based system.

Some question that the shift towards a system based on owned fiscal means, i.e. EU taxes, will eliminate the net balance disputes. According to them, as national administrations will be those responsible for collecting the receipts from any potential EU own resource, they will still be tempted to calculate 'their' contribution to the EU budget. Indeed, they argue, the fact is that national governments already include the receipts from EU customs and agricultural levies collected in their territory into their calculus of budgetary returns.

This objection does not seem quite convincing. While it is true that national administrations will be those collecting the receipts from a new EU own resource, there is a fundamental difference between the existing national GNI-based contribution and the receipts of any potential real EU own revenue. In the latter, revenues would be collected by the member states but once collected they will directly go to the EU coffers instead of passing through the national budgets. Thus, national governments will be less tempted to perceive these revenues as 'their own money'. No doubt, they will still be sensitive to the geographical allocation of receipts, but the debate would likely be more in terms of the distribution of effective tax burdens on categories of taxpayers than in terms of distribution across national budgets.

Others accept that the problem of 'net returns' is related to the dominance of national contributions in the EU financing system, but consider that any attempt of eliminating 'net resources' is politically unrealistic and naïve. Instead of trying to get rid of it, they argue, we should spend our energy in trying to minimise the undesirable side effects of the 'net return' logic. The multiple proposals to create a 'generalised correction mechanism' respond to this way of seeing things. These proposals received some attention some years ago (particularly in 2004, when the Commission itself proposed a generalised correction mechanism), but they did not attract much interest as they did not suppose a real advantage in terms of simplification nor did they eliminate the distortive effects of the 'net returns' logic on EU spending decisions.

Recently, a proposal that has received some attention is the idea of creating a system in which member states negotiate their net balances in advance, and once these are fixed, they discuss the structure of EU spending. Afterwards, a system of horizontal transfers compensates member states from any deviations from the pre-fixed budgetary position (De la Fuente et al., 2008, Salvemini et al., 2009).

Those proposing this solution argue that, by isolating the discussion on 'net returns' from the rest of the negotiation, member states will have no incentive "to distort expenditure policies in order to achieve an acceptable distribution of net financial contributions" (De la Fuente et al., 2009). However, the idea that, by fixing net returns ex ante, member states will discuss EU spending programmes on their own merits and not in terms of their budgetary interest is highly questionable. In fact, a system like this might create other types of distortions. Imagine a 'net beneficiary' country that succeeds in guaranteeing a certain budgetary return. Once the net return is pre-fixed, the country has two options: either fighting in the subsequent negotiation to obtain more EU spending on its territory (submitted to strict rules of co-financing, additionality, etc.) or simply letting its net budgetary position worsen. In this latter case, the country will receive the guaranteed compensation in form of cash (thus not subject to any rule). As the second option is clearly preferable (it would receive the same amount of money but free of conditions), the incentive for this country will be not to fight for more, but for less EU spending in its territory. The result is a decision-making process conducive to an under-supply of EU programmes having an EU added value.

2.6 Conclusions

While the first 'net balances' calculations date back to the 1980s, it is over the last two decades that the 'net balances' criteria has come to dominate all other considerations in EU budgetary negotiations, with very negative consequences in terms of efficiency, equity and transparency. This has happened at a time when national contributions have come to represent far more than half of total EU revenue. The coincidence in time, together with the special nature of the GNI-based revenue (which, although formally labelled as 'own resource', is frequently perceived as a member states' payment), reinforce the belief that the current system of EU financing is one of the variables explaining the absolute dominance of the 'net balance' approach in EU budgetary negotiations.

Member states' concerns over the distributional outcome of budgetary negotiations are to a certain extent legitimate, and will probably remain regardless of the type of EU financing system in place. However, there are grounds to believe that a shift towards a real own resources-based financing system might help to move the debates away from a limited and dubious conception of 'horizontal fairness' (based on a purely accounting logic of 'net national contributions') towards well-founded discussions on horizontal and vertical fairness and efficiency considerations. A new EU financing system based on own resources would also provide important advantages in terms of simplicity, transparency and political accountability.

3. Financing the European Union: Reform for own resources

3.1 Possible new own resources: The European Commission's proposals

As shown in previous chapters, successive decisions on own resources have gradually moved the system of financing the EU budget further and further away from the original goal of the Treaty of Rome, which provided for the European budget to be entirely financed by own resources. The culmination of this process was the most recent decision in 2007, which implemented the Conclusions of the European Council meeting in December 2005. The repercussions of these developments are increasingly weighing on the decision-making process of the European Union, and are making root-and-branch reform of the system of financing the EU not only essential but also urgent.

It is not just a question of guaranteeing independent financing for the European Union, i.e. based entirely on proper own resources, but also of simplifying the system and making it more transparent and visible to European citizens.

In its Communication of 19 October 2010 on the EU Budget Review, the European Commission sets out the shortcomings of the EU's current system of financing and proposes an option for reform, which would involve simplifying the current system and progressively introducing, in parallel, one or more own resources linked to EU policies.

This budget review exercise undertaken by the Commission is provided for in Declaration No. 3 annexed to the Interinstitutional Agreement on budgetary discipline and sound financial management of 17 May 2006, according to which the Commission is invited to "undertake a full, wide-ranging review covering all aspects of EU spending, including the Common Agricultural Policy, and of resources, including the United Kingdom rebate, and to report in 2008 / 2009”.

The ‘simplification’ phase proposed by the Commission involves ending the VAT-based resource in its current form (the complexity and impenetrability of which was highlighted previously).

The European Commission proposes to offset ending the VAT-based resource in its current form by progressively introducing one or more new own resources. It details six options, namely:

- EU taxation of the financial sector,
- EU revenues from auctioning under the greenhouse gas emissions trading system,
- EU charge related to air transport,
- EU VAT,
- EU energy tax and
- EU corporate income tax.

The criteria used by the Commission to draw up this selection were as follows:

- close link to the *acquis* and the objectives of the EU,
- cross-border in nature and based on a system covering the whole internal market,
- calculation on a harmonised base,
- if feasible, collected directly by the EU outside national budgets,
- equitable application,
- account taken of their cumulative impact on particular sectors and
- no new or heavy administrative responsibility for the EU in terms of collection.

The Commission actually proposed a reform of the system of financing the EU budget in 2004, based on the introduction of a new own resources. At that time, the Commission limited its proposal to three options: EU VAT, EU energy tax and EU corporate income tax.

The Commission’s current proposal should also be viewed in the context of the European Parliament’s report on the future of the European Union’s own resources, adopted on 29 March 2007.[22] This report, drawn up following in-depth consultations with the national parliaments, puts

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[22] Report of the European Parliament (Rapporteur: Alain Lamassoure) on the future of the European Union’s own resources, adopted on 29 March 2007, P6_TA(2007)0098.

forward four options for a possible own resource, namely: energy tax, EU VAT, corporate income tax and an excise duty on tobacco or alcohol.

The Commission's latest proposals for new own resources therefore follow on from its 2004 proposals and from the European Parliament's proposals.

However, the criteria used to select the Commission's proposals in 2004 and the European Parliament's proposals in 2007 differ somewhat from those indicated by the Commission in its recent budget review.

In 2004 the Commission put forward the following seven assessment criteria:

- visibility and simplicity,
- financial autonomy,
- efficient allocation of resources,
- sufficiency,
- cost-effectiveness in relation to administrative costs,
- stability and
- fair contributions.

The criteria used by Parliament in its March 2007 report nearly match the criteria used by the European Commission in 2004:

- sufficiency,
- stability,
- visibility and simplicity,
- low operating costs,
- efficient allocation of resources,
- vertical equity,
- horizontal equity and
- fair contributions.

It therefore seems appropriate to assess the six candidate new own resources listed by the European Commission in its EU budget review with regard to these eight EP criteria, which means answering the following questions:

- Sufficiency. Could this new resource provide sufficient revenues in the long term to finance the EU budget?
- Stability. Could this new resource bring about sufficiently stable revenues to finance the EU budget?

- Visibility and simplicity. Would this new resource be sufficiently visible to European citizens and easy for them to understand?
- Low operating costs. Would the introduction and collection of such a resource involve excessive operating costs?
- Efficient allocation of resources. Is there a risk of this new tax altering the behaviour of economic operators and unbalancing the geographical distribution of investments in Europe? Might this new tax result in the introduction of European policies encouraging a change in the behaviour of individuals?
- Vertical equity. Would this tax involve income redistribution?
- Horizontal equity. Would this tax have the same impact on taxpayers who are in the same situation but live in different member countries?
- Fair contributions. Would this new tax raise revenues from member states in line with their economic development?

Financial sector taxation

The Commission distinguishes between two types of taxation for the financial sector: the financial transaction tax which is designed to tax the value of single transactions, and the financial activities tax, proposed by the International Monetary Fund, whose aim is to tax total profit and wages or can specifically target economic rents and / or risk.

Volumes of financial transactions have increased dramatically in the past years. Taxation on the financial sector could in theory provide a significant source of revenue given the large number of financial transactions, but the activity in the financial sector is inherently unstable and depends on a number of economic, technological, legislative and political factors. The Commission believes that a financial transaction tax (FTT) levied on exchange traded equity and bonds with a rate of 0.1% could generate some €20 billion per year for the EU-27.[23]

Nevertheless, the possible implications of such taxation should be analysed with great accuracy. In fact, if the rate of this tax were too high or if the European Union decided to introduce taxation on financial transactions, separately from the rest of the world, this might incite financial markets to relocate to geographic areas not subject to a financial transaction tax.

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[23] See COM(2010) 549 on the taxation of the financial sector.

Visible to investors and operators in the financial market, this tax would only affect a small part of the population. However, as a consequence of the economic and financial crisis, support among the European population in favour of a tax on the financial sector has increased. The implementation of this type of tax should be relatively simple, as it could operate as a withholding tax on financial transactions.

As stated above, the high sensitivity of financial markets to taxation requires great care in choosing rates. The rate should be as low as possible to avoid any imbalance between the EU financial centres as well as those outside the EU (such as Switzerland). The very definition of the level below which these charges would be considered low enough not to affect the operation of financial markets is a particularly difficult and sensitive exercise. However, a transaction financial tax could be a complementary element in the field of European financial regulation and the integration that has been reached in European financial markets could also facilitate a common tax approach.

As regards the criteria of vertical equity, the impact in terms of redistribution of revenue becomes particularly clear at this point, as taxation on financial transactions mainly affects high-income households. Additionally, a fairer distribution of the tax burden could be guaranteed since so far labour, environment and goods are taxed while financial transactions are not taxed everywhere. If the same rate is applied across the European Union, and if the tax is applied to the same financial products, one could presume that a financial transaction tax would fulfil the criterion of horizontal equity.

Lastly, administrative costs relating to the collection of this tax should not be high, as this tax would just be part of the trading platforms, which are all automated.

EU revenues from auctioning under the greenhouse gas emissions trading system (EU ETS)

Under the European Union greenhouse gas (GHG) emissions trading scheme (ETS), valid from 2013 to 2020, the ceiling for CO_2 emissions in the EU will gradually decrease, while the rights of auctioned permits will increase. According to the Commission proposal, the product of these auctions could possibly constitute a new own resource for the Community budget. At present, these revenues are allocated to national budgets. The proposal of the Commission would then simply consist of redirecting existing revenues to the EU budget. However, it is worth remembering that an agreement in Council on the EU ETS has been possible only on the condition that the revenue of the auctioning of GHG emissions were allocated to national budgets.

The European Commission expects that, by 2020, auctioning under the EU ETS could well generate €20 billion a year. However, this estimate only includes power generation and energy-intensive manufacturing industries. What is more, everything suggests that future revenues could increase, as the gradual reduction of quotas (EU allowances) should lead to higher bids, and that by 2013 the aviation sector will also be included in the EU ETS, while other sectors may follow suit, e.g. shipping. It should however not necessarily be expected that the coverage in a 2020 perspective may dramatically increase, as many other areas with substantial emissions (e.g. agriculture, waste, transport other than aviation) typically are not characterised by large point source emissions, which are easy to measure. In response to those who foresee a decrease in this income bearing in mind that the very purpose of the ETS is to reduce greenhouse gas emissions, the Commission has stated that this decline should be offset by the progressive increase in the price of allowances, which will result from the gradual reduction of quotas.

It seems that income from such taxation would not only be significant but should also be sufficiently stable. Nevertheless, analysis highlights the risk of volatility in the price of a tonne of CO_2. For instance, Le Cacheux and Laurent (2009) recall the fall in prices, from €29.75 on 18 April 2006 to €10.14 on 12 May 2006, following the over-allocation of licences by national governments. After some measures taken by the Commission, the prices recovered, but then the economic crisis struck, which led to lower CO_2 emissions. This resulted in a further decline in the CO_2 per tonne price, from €28 in July 2008 to €7.9 in February 2009. Since then, the price has increased again, and seems to be more stable at €15 per tonne of CO_2, but given past experience, one must remain cautious about the stability of this revenue.

If one considers the sensitivity expressed by European citizens in relation to environmental issues and their support of policies relating to the fight against climate change, we could say that this resource meets the visibility criteria. It is relatively simple, as it represents the proceeds from the auctioning of allowances for greenhouse gas emissions, whose ceiling will be common throughout Europe by 2013.

Moreover, the correlation between this resource and the political objectives of the European Union is obvious. But is the ecological efficiency of the European market for greenhouse gases emissions sufficient to achieve the European Union objectives in this area? As demonstrated by Le Cacheux and Laurent (2009), this tax is in line with the ideal of what should be a Pigouvian tax, although, for other experts, it is too early to predict whether it would help the EU in reaching the target of a cut of greenhouse gas emissions by 20% by 2020.

As regards vertical equity, European citizens should not be directly affected by this tax. But given the fact that electricity generators pass the cost of allowances on to consumers, although electricity consumption costs are generally more strongly felt by people on low incomes, the cost of this auction spread over all consumers should have little impact on household invoices, as the final electricity price is mainly a result of taxes and grid costs. The impact on households with the same consumption of electricity might differ according to the energy mix used to produce electricity (which differs widely across member countries). One could also argue that the ETS approach would not achieve horizontal equity. However, if one accepts that the tax base is really CO_2 emissions, then this tax would fulfil the criterion of horizontal equity (this is also the key underlying issue regarding the equity of the carbon tax discussed below).

Laying down a different emissions ceiling for each member state rather than a common one in 2013 could reduce the equity contributions among member states. However, this effect could be diminished by the decision to redistribute 10% of states' emissions licences with the highest GDP per capita to those with a lower GDP per capita.

Finally, today this revenue already exists and is allocated to national budgets. Its redirection to the EU budget should not create excessive administrative costs, but it will of course engender fierce political resistance.

EU charge related to air transport

This concerns the imposition of a charge on air freight and passenger transport operating in and / or leaving European air space. It is not a tax per passenger or a charge associated with the consumption of kerosene, but a charge calculated per flight depending on mileage. In its proposal the Commission is considering the possibility of the charge also depending on the technical characteristics of the aircraft used.

According to Commission estimates, a €1 charge per kilometre would have allowed for €12.8 billion to be collected in 2006. The forecast growth in air travel resulting from the liberalisation of this sector strengthens the correlation of such a resource with the sufficiency criterion.

Due to the expected growth in air transport, own resources based on an air fee would also provide a sufficiently stable income.

This fee applies to air passengers and users of air freight services and, given the projected expansion of air transport in the future, it should reach an increasing number of users. The amount being small (a few euros) and specified on the invoice, passengers would be informed of the contribution they are making to the Community budget and would be able to see for themselves that it only forms a small amount in relation to the total cost of their ticket.

Applied to all flights from the European Union, set at a very low amount and distributed equally between users, such a tax should not distort competition. Moreover, such a tax would serve many EU purposes, such as the fight against pollution, and lower distortion of competition in the transport sector.[24]

While it has become more affordable in recent years, air transport is mainly used by consumers with higher incomes. This means that taxation on air transport should correspond to the vertical equity criterion. A tax on air transport would also be in line with the criterion of horizontal equity if the same aviation charge is applied on the whole EU territory.

On the contrary, the correlation between this tax and the equity contributions criterion is low. In fact, the number of passengers and flights by country depends on a number of parameters that do not necessarily coincide with the wealth level of member states. These include: the role of tourism (Spain, Greece and Portugal for instance), geographical location which can justify higher air flow (the Netherlands, Great Britain and Germany) and the number of airports (France, Germany, Italy, Finland and Sweden).[25]

Last but not least, such a fee would automatically apply to each ticket. According to the Commission, Eurocontrol could become responsible for the collection of the fee, meaning that, among other benefits, the administrative costs relating to this would be very low.

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[24] See Commission Budget Review Communication, p. 34.

[25] See Table A1 in the annex at the end of this chapter.

EU VAT rate

The proposal of the European Commission is for the VAT rate to include a national and a European rate. The European rate would be determined by the decision on own resources and/or its rules of implementation, while the national rate would remain the exclusive right of each member state. The European VAT rate would be specified on each receipt/invoice, along with the national rate, so that each European citizen is duly informed of his or her contribution to the EU budget.

A European VAT rate would provide a significant resource to the EU budget. The Commission estimates that a 1% VAT rate, combined with the abolition of the current VAT resource and not applied to products currently exempt from VAT, could fund almost half the current EU budget.

A European VAT rate should also provide a relatively stable source of funding for the Community budget. A consumption tax would at least be more stable than a contribution based on GDP, subject to economic fluctuations (trade balance, level of and return on investment, economic growth, etc.).

Another advantage of a European VAT rate is its visibility to the citizens. The idea is to apply a European rate on VAT separate from the national VAT rate and differentiate these two rates on the bills. All European citizens would then have a clear idea of their contribution to financing for the European Union. This neither allows for national contribution based on GDP, nor for the current VAT statistics resource.

Resource allocation efficiency is questionable as far as the European VAT rate is concerned. On the one hand, VAT is directly related to the internal market and its development. On the other hand, the rate should be low and VAT applies to the vast majority of consumer goods. Harmonisation of the VAT rate in Europe would erase the differences currently prevailing between member states (such as the question of zero-rated goods).

The vertical equity of a European VAT rate has often been questioned since the poorest consumers devote a larger part of their income to consumption, and therefore have a higher VAT base. However, this assertion does not seem to have been proven. In fact, according to data provided by Eurostat (see Table A2 in the Annex to this chapter), countries with the highest VAT revenue as a proportion of GDP include both rich countries (Sweden, Finland) and others with lower national income

(Bulgaria, Cyprus). The same applies to countries with low VAT revenue as a proportion of GDP: Spain, the Cohesion Fund beneficiary vis-à-vis Italy, with per capita GDP above the EU average.

The best way to ensure the respect of the horizontal equity of an EU VAT would be to harmonise the VAT base across Europe. The question of zero-rated goods would also need to be addressed in that perspective.

Also based on Table A2, if we compare the VAT rate as a percentage of GDP, there is a 6-point gap between the lowest (Spain: 5.1%) and highest (Cyprus: 11.1%) VAT rate. Nevertheless, this difference is moderated by the fact that only 3 out of 27 member states exceed the 10% rate: Bulgaria, Denmark and Cyprus. The vast majority of member states are in the 6.5-9.2% rate, which represents a smaller gap. However, one has to be extremely cautious when quoting these figures because the local consumption of tourists (which is high in countries such as Cyprus, Malta and Ireland, for instance) is part of the harmonised base while, in reality, only the consumption of the country's residents should be taken into account.

As VAT already exists, the creation and emergence of a European rate should not lead to additional collection costs likely to challenge the establishment of a European VAT rate. Moreover, the computer tool would easily allow for the implementation of the declaration method.

EU tax on transport (energy related to transport)

In the technical annex to its budget review, the Commission also discusses the possibility of redirecting the revenues from existing taxes on energy consumption, in particular on motor fuel, as a new own resource. As far as the Commission is concerned, not all of these taxes would necessarily have to be transferred to the EU budget; just a part of them could well be enough.

The high rate of car ownership in the European Union (See Table A3) suggests that a tax on transportation energy would provide sufficient income to cover a significant part of the EU budget. According to Commission estimates, a fee of €330 per 1000 litres of fuel would provide an annual income of €109.8 billion.

In addition, a tax on the amount of energy consumed in transportation is sufficiently stable and also a lot more stable than a tax based on the price of the energy in question.

Moreover, such a tax can be regarded as sufficiently visible, given the high sensitivity of public opinion in relation to energy prices, as well as issues related to pollution. Its implementation, through harmonisation, should also be simple as such taxes are already in place in member states.

Such a tax would also contribute to a number of EU policies, such as the internal market, energy policy, transport policy and environmental policy. What is more, bearing in mind that a large part of CO_2 emissions comes from transport, such a tax would help meet the EU objective to reduce CO_2 emissions.

Table A3, in the annex, demonstrates the correlation between per capita GDP and the number of cars per 1000 inhabitants for 21 out of 27 member states. A tax on energy transport therefore meets the vertical equity criterion. To ensure horizontal equity of an EU energy transport tax, it would be necessary to ensure the harmonisation of such a levy.

Table A4 reveals that, at present, there is a great disparity between member states as regards the share of transport-related environmental taxes in the GDP (an average of 0.55% for the whole of the EU, the smallest ratio prevailing in the Czech Republic with 0.16%, the largest one prevailing in Denmark with 1.85%). But as the part to be sent to the EU budget would be the same for every country, this should not constitute a handicap.

A tax on transportation energy should also be relatively easy to implement, and the cost of the implementation would be very low. The Commission for example underlines that the implementation of this option would be simple and facilitated by the fact that such a tax already exists with a high level of harmonisation.

EU corporate income tax

The idea put forward here is to establish a common taxation for corporations retaining a uniform and relatively low product rate to be transferred to the EU budget. Even though the concept of a European corporate income tax dates from the early 1960s, it has never come to fruition, testifying to the complexity of such a project. The main obstacles identified are the difficulties faced with regard to the harmonisation of the different national systems, as well as the reluctance shown by member states when it comes to addressing national tax competences.

According to the European Commission, corporate income tax represents some 2–3% of the EU GDP, and would therefore provide sufficient income for the EU budget even with a low rate. But, given the high sensitivity of this tax to fluctuations of the economy, it is not certain that the stability of this resource will be guaranteed.

In terms of visibility, one could imagine a system similar to that of an EU VAT rate: the EU corporate income tax rate would be differentiated from the national rate on the company’s tax statement. The amount transferred to the EU budget would therefore be clearly marked. However, corporate income tax visibility remains low because it only affects businesses, and its implementation is not simple. The fact that this issue has been under debate within the EU since 1962, in vain, provides proof of this.

The establishment of an EU corporate income tax could eliminate barriers to the development of cross-border economic activities (mergers and acquisitions) and thus enhance the operation of the internal market.

EU corporate income tax by nature meets the vertical equity criterion as tax is imposed on corporations in proportion to their turnover. A common EU rate would ensure that the criterion of horizontal equity is respected. This would be even more the case if the call for progress towards a ‘common consolidated corporate tax rate, enshrined in the Pact for the Euro at the European Council of 11 March 2011, were to be implemented.

The amounts that could potentially be collected as EU corporate income tax would not necessarily reflect economic development in the state in which the contribution is made, because of the openness of the economy and the possible correlation between the ratio of multinationals and the geographical impact of an EU corporate income tax.

As regards administrative costs, the harmonisation of corporate income tax at the European level, and the replacement of the 27 existing systems with one single system (a rate and form common to the whole of the EU), should help to significantly reduce administrative costs relating to the waiver of such tax and to make things easier for European companies. The advances being made in relation to management and accounting suggest that the collection and transfer of an EU corporate income tax should not result in excessive administrative costs. The French-German proposals to unify the base of the corporate income tax as part of the Pact for Competitiveness should help to reduce the administrative costs.

Conclusion

Table 3. Summary of correlation between the Commission's proposals and the 8 assessment criteria

	Tax on the financial sector	EU revenues from auctioning under the GHG emissions trading system	Charges relating to air transport	EU VAT	EU tax on energy related to transport	EU corporate income tax
Sufficiency	• •	• • •	• •	• • •	• • •	• • •
Stability	•	• •	• •	• • •	• • •	•
Visibility and simplicity	• • •	• • •	• • •	• • •	• • •	• •
Efficient allocation of resources	•	• • •	• • •	• •	• • •	• • •
Vertical equity	• • •	--	• • •	• • •	• •	• • •
Horizontal equity	• • •	• • •	• • •	• •	• •	• •
Fair contributions	• •	• •	• • •	• •	• • •	•
Low administrati ve costs	• •	• • •	• • •	• • •	• • •	• •

Legend: • • •: strong correlation / • •: average correlation / •: low correlation / --: no correlation.

3.2 Proposal for a radical change of the EU financing system

The above analysis and summary Table 3 show that while none of the own resources options fully meets all seven chosen criteria, some stand out, in particular because of their visibility to the individual citizen, their simplicity, their stability, or indeed their link with the political objectives Europe has set itself.

It is quite clear that the choice of a one, or more, new own resource around which reform of the European Union financing system could be built, will also largely depend on criteria of a political nature, particularly since any decision on European Union own resources requires unanimity within the Council.

The aim of reforming the Community own resources system must be to end national contributions, that is to say to produce an autonomous financing system for the Community budget.

It is possible to imagine that ultimately by 2020, after a transition period, European Union financing will no longer rely on national contributions but will be based entirely on own resources. How? By transforming the current VAT resource into a genuine European VAT, while introducing another own resource in parallel.

Increasing existing resources: Towards a genuine European VAT

As the above analysis shows, VAT performs very favourably against many evaluation criteria. That makes European VAT the principal option around which reform of the Community financing system could be structured.

The idea put forward by the Commission, and recommended by many experts, to apply a national rate and a European rate, would allow an end to the current statistical method, which makes the VAT resource resemble an additional national contribution, accentuating the issue of fair return.

In fact, while the VAT resource calculation follows a complicated method, which consists of applying a given rate[26] to a base determined in a uniform manner,[27] the interest of the declaration method is preferable in many respects. Under the declaration method, any invoice issued to the final consumer must mention two percentages: the national percentage and the European percentage. This gives a national VAT total and a European VAT total, with the member state VAT administrations having to pay the latter to the European Union, but revenues from European VAT would not transit via national budgets.

This method is extremely precise, simple and highly visible to European citizens. It could allow a very substantial amount of revenue to be collected. In fact, without increasing the size of the current budget, and based on the data shown in Table A2 on VAT and private consumption, a European VAT rate of 1% could be expected to produce income of €50-70 billion a year, financing around half of the Community budget.[28]

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[26] Currently 0.30%, compared with 1.4% between 1986 and 1994.

[27] Currently capped at 0.50% of member states' GNP.

[28] This estimate is based on the EU GDP in 2008 (€12,495 billion, Eurostat figure) and the ratio of private consumption to European GDP in 2008 (56.5%, Eurostat

The introduction of European VAT could be appropriately supported by strengthening VAT bases harmonisation in Europe. This is, moreover, one of the major projects currently being undertaken by the Commission, which has initiated a wide public consultation on the subject by publishing a 2010 Green Paper on the future of VAT.[29]

As explained above, the VAT fully respects the principle of equal treatment of equal citizens. The VAT is not regressive. Indeed, for instance, the three biggest countries (Germany, United Kingdom and France) all have a GDP per inhabitant higher than the EU average and make up half of the total GDP of the 27, but their share in the total EU 27 consumption is 3 percentage points higher.

Lastly, the introduction of a European VAT rate should not lead to an increase in the VAT rate generally, since the revenue generated by European VAT may be deducted from national GDP-based contributions to the Community budget.

For all of the above reasons, the revised VAT resource, as proposed by the Commission, would be an excellent instrument around which to base reform of the EU's own resources system. It would not lead to an additional tax burden on European citizens, would improve visibility and understanding of European Union financing and would greatly simplify the own resources system.

On pragmatic grounds, it seems reasonable to envisage a rate of 1%, which would allow a substantial reduction (approximately by half) in the burden currently imposed by GDP-based national contributions.

Options for an own resource to complement the VAT resource

For reasons linked to ease of implementation, and also because of their correlation with the political agenda of the European Union, their visibility and their simplicity, we have been particularly attracted by the option of a European eco-tax eventually complemented by the tax on financial transactions.

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figure): 1% of VAT would produce revenues of €70 billion, if goods with a zero rate are not taken into consideration. As a reminder, the Community budget for 2011 is €126.5 billion in payments (€141.9 billion in commitments).

[29] Green Paper on the future of VAT: Towards a simpler, more robust and efficient VAT system, COM(2010) 695/4.

A European eco-tax: Arguments for an EU carbon tax

A European tax on the environment would constitute an optimal tax from an economic point of view. In a study carried out for Notre Europe and entitled *Funding the EU Budget with a Genuine Own Resource: The Case for a European Tax*, Jacques Le Cacheux takes up and develops the Pigouvian model.

A Pigouvian tax[30] is a tax that aims to internalise the marginal social cost of economic activity, notably with regard to pollution. It seeks to integrate negative externalities into the market. The 'polluter pays' principle derives from this. A Pigouvian tax may, for example, be imposed on a type of industrial pollution to reintegrate the cost this pollution involves into the cost of production itself, firstly, to show externality to the economic agent more clearly, and, secondly, to generate income aimed at remedying the negative effects of the pollution. A carbon tax is an example of a Pigouvian tax, its application at EU level is justified by the fact that external effects (greenhouse effect) largely exceed the national framework. A true Pigouvian tax should cover all greenhouse emissions (or, at least, CO_2 emissions). For this reason, a generalised carbon tax would be preferable to any partial tax, such as taxes on transport or auctioning of greenhouse gas emissions allowances (which taxes only a part of industrial emissions).

The assignment to the EU budget of the auctioning under the scheme for greenhouse gas emissions allowance trading (EU ETS) might be useful and, in the end, justified, as climate change policy is an EU priority. But the revenues that could be raised according to the Commission's estimates (€20 billion by 2020[31]) have already been assigned to the national budgets, this assignment being the element which made possible an agreement on the EU ETS system (whose impact varies greatly from one country to another). For this reason the proposal of the Commission to assign to the EU budget the revenue raised from the EU ETS, while extremely interesting, does not seem realistic.

So, a genuine (and generalised) carbon tax appears to be the Pigouvian tax par excellence, and would also have the great advantage of promising considerable revenues. Today, the EU emits more or less 4

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[30] It takes its name from the British economist Arthur Pigou (1877–1959), who was the first to propose a tax correcting externalities in 1920.

[31] Estimates based on a price per emission permit set at €20.3 and auctioning of 65% of all permits.

billion tonnes of CO_2. A tax of €20 per tonne of CO_2 would raise in principle a total revenue of €80 billion a year, which would be more than necessary to feed the EU budget as a complement of an EU VAT revenue.

In the technical annex joined to the Budget review, in the section related to the "EU energy tax" option, the Commission briefly refers to the possibility that existing taxes on energy consumption "could be replaced by an EU levy on energy / CO_2 emissions". Thus, the Commission seems not to exclude the carbon tax. But this option as such is not analysed in the Commission document.

The carbon tax would be easy to implement. The consumption of fossil fuels being the sum of production plus imports, the implementation of such a tax would consist of taxing both the imports and the production of fuel, gas and coal. There are not many fossil fuel production and importation points (pipelines for gas, ports for fuel and for coal), so a system of control should not be too difficult to set up.

This tax would have a different impact on the cost of the different kinds of fossil fuels, as shown in Table A6. The reason for this is that coal is totally transformable into CO_2, which is not the case for gas or oil.

Finally, a carbon tax should satisfy the criteria selected above:

- Sufficiency. Even at a moderate rate this tax could raise more or less 0.5% of the EU GDP.
- Stability. Energy consumption is closely linked to the economic cycle. However this does not mean that this tax would be less stable than the current GNI contribution.
- Visibility and simplicity. This tax is very easy. Each fossil fuel is taxed according to its CO_2 content.
- Low implementation cost. Imports and production data are easy to draw up.
- Efficient allocation of resources. This tax constitutes an ideal Pigouvian tax.
- Vertical equality. Two consumers producing the same emissions would pay (indirectly) the same tax.
- Horizontal equity. It should be respected as this carbon tax would be the same across the EU.
- Fair contributions. Generally speaking, energy consumption increases together with the revenue size.

Tax on financial transactions

Financial transaction volumes have increased dramatically in recent years, this increase being boosted due to our ability to process information more efficiently and in real time. The increase in trading on financial markets and the resulting volatility, with its destabilising consequences have been proof that those markets need steering and transparency. The current and severe financial and economic crisis is an illustration of those consequences. It seems that in terms of financial market activity perhaps 'less' is better for the overall economic stability. This applies in particular to those financial transactions that take place within the financial sector and thus represent a zero sum gain for consumers of financial services.

Europe has been hit very hard by the crisis starting with the financial crisis in 2007, affecting the real economy in 2008 and finally affecting national budgets. The bail-outs and the stimulus programmes have led to a tremendous increase in public debt. The extreme pressure on national budgets has resulted in severe cutbacks in the public sector. It has also impacted the European budget, given the significant share of the GNI resource in the EU financing system. All the bail-outs of banks have been perceived as an unfair attempt to make citizens pay for the crisis, resulting in a momentum in public opinion for a taxation on the financial sector. For all these reasons, the financial transaction tax represents a serious candidate for a new EU own resource.

Economic analysis distinguishes between a financial activity tax (FAT) and a financial transaction tax (FTT). The International Monetary Fund (IMF) reached the conclusion that a FAT would be preferred, but this would be more difficult to use to finance the EU budget as this kind of tax would be levied on some part of the profit and loss account of financial institutions, which vary widely in terms of definitions across member states.

A financial transaction tax could be an interesting complementary element in the field of European financial regulation. It could contribute to enhancing the efficiency and stability of financial markets and reducing their volatility as well as the harmful effects of excessive risk-taking, by dissuading them from carrying out certain risky activities. In that sense the financial transaction tax is also a Pigouvian tax as it could help internalise potential negative externalities of financial sector activities.

A financial transaction tax could also be a significant revenue source. How much could be collected depends decisively on the exact definition of the tax, its base and the rate at which it is set. Some member states already have so-called ‘stamp duties’, which allow them to collect revenues that are significant at the member state level. The IMF and the Commission published studies with various options concerning the design of an FAT or FTT. With a rate set at 0.1%, an FTT applied only to exchange traded equity and bonds would generate €20 billion a year in the EU-27 according to the Communication of the Commission on taxation of the financial sector.[32]

However, aside from all these positive comments, one must remain cautious as regards one question in particular. Indeed, although for some the EU should not wait for a decision on the world stage to implement an FTT, and should implement it on its own, on the other hand, many voices are more cautious, warning against the inherent risk of delocalisation of financial markets to other places not subject to taxation on financial transaction in case the FTT is not implemented on a world scale.

An end to the various current forms of rebate and/or compensation and to end-of-year amending budgets

Bringing to an end GNI-based national contributions and the financing of the Community budget solely by means of own resources will overturn the accounting logic of fair return and render obsolete not just the British rebate but also the other forms of compensation regarding Germany, Austria, Sweden and the Netherlands, which derive from the ‘British cheque’.

An end to national contributions will also render obsolete the current practice that seeks, by means of an amending budget, to give member states the appropriations remaining unspent at the end of the financial year. The procedure followed today consists of reducing the GNI contribution of member states for the year N by the share of payment appropriations not used in year N-1 that is due to them. Once national contributions are abolished, this system becomes de facto obsolete. Unused appropriations will thus be transferred to the following year’s revenue, in this way constituting a supplementary own resource. On average, €4.9 billion of unspent payments appropriations per year were given back to member states between 2005 and 2009.[33]

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[32] See COM (2010) 549.

[33] See Table A5 annexed to this chapter.

Scenario for a reform

Our scenario for reform of the EU own resources system is based on the budget 2011 figures, i.e. a budget of €126.5 billion in payment appropriations, as well as on the own resources candidates selected above: a genuine EU VAT, a carbon tax and eventually also a financial transaction tax.

For existing resources, we take the system and the figures as they are in the 2011 budget. Concerning the new EU VAT, we set its rate at 1% and we assume that a collecting cost set at 5% is reasonable (it also corresponds to the initial rate set in 1970, when the VAT was first introduced as a resource to the EU budget).

As regards the financial transaction tax, we propose to apply a rate of at least 0.05% on exchange-traded equity and bonds only, which according to Commission estimations would enable €10 billion a year to be raised.

Concerning the carbon tax, CO_2 emissions amount at present to 4 billion tonnes in the EU27, of which 1.6 billion tonnes are already covered by the EU ETS, so that 2.4 billion tonnes remain available for taxation. Most experts consider that it will be necessary to set the price of a tonne of CO_2 at least at €20 for the tax to have an impact. Consequently, the potential revenue that could be derived from an EU carbon tax is at least €48 billion.

If a collection cost was to be applied to the carbon tax, a rate of 5% should be sufficient given that this tax could be levied at the point of entry (pipelines and tankers unloading in ports) or production (coal mines).[34] Of course the aim of the EU is to reduce CO_2 emissions by 20% as from 2020. This implies that the tax base would fall over time. But this could be compensated for by a corresponding increase in the tax rate per tonne, which would probably anyway be necessary to ensure that emissions do fall as projected under the 20/20/20 goals.

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[34] Fossil fuels importation entrance points are concentrated (pipelines and ports) and usually come in big units (large tankers, bulk freight ships). Hence collection costs should be smaller than for import duties. However, if member states decided in any event to apply the unrealistic rate of 25% for collection cost of the carbon tax, as they already do for import duties, the tax rate per tonne of CO_2 should be increased accordingly. For instance, in order to raise €52 billion for the EU budget while having a collection cost of 25%, the price of the tonne of CO_2 should be set at around €27 (compared to roughly €22 per tonne in the absence of a collection cost).

With a carbon tax, the need to impose stricter building costs and other regulation to achieve the planned reduction of emissions of 20% by 2020 would be much reduced as home isolation and other energy savings measures would pay for themselves much more rapidly. A carbon tax would thus enable the EU to reduce the administrative burden on the economy of reaching the emissions reduction goals of the EU.

With the abolition of the GNI resource, there is no longer any reason for unspent appropriations to be reimbursed to member states, so they should be entered in the budget (so that surpluses in one year can cover future shortfalls). Between 2005 and 2009, the annual average of unspent payments was of €4.9 billion, but we propose to set them at €3 billion, which represents the lowest amount in the period of reference.

The reform of the current VAT resource into a genuine EU VAT, together with the introduction of one new resource, i.e. an EU carbon tax, would be sufficient to finance a budget of the size it has today, without having recourse anymore to the GNI resource. This is easy to implement in the short term and would provide stable revenues to the EU budget.

Table 4. Genuine EU VAT + Carbon tax + End of GNI resource

		€ billion
Existing own resources		**18**
EU VAT (1%)		**57**
	1% of consumption	60
	5% collecting cost	-3
Carbon tax		**48.5**
Unspent payments of previous year		**3**
Total		**126.5**
	% of EU GNI	1.01

Source: Own calculations.

Once a financial transaction tax (FTT) has been introduced at the world level, then the financial transaction tax would become an additional own resource. The table below proposes a partial offsetting of the carbon tax by the financial transaction tax, but another possibility is that the FTT could, instead, replace the traditional own resources if the latter decrease in the future.

Table 5. Genuine EU VAT + Carbon tax + End of GNI resource + Financial Transaction Tax

		€ billion
Existing own resources		**18**
EU VAT (1%)		**57**
	1 % of consumption	60
	5% collecting cost	-3
Carbon tax		**38.5**
Financial transaction tax (FTT)		**10**
Unspent payments of previous year		**3**
Total		**126.5**
% of EU GNI		1.01

Source: Own calculations.

3.3 Conclusion

In conclusion, revision of the European own resources system is today within reach, provided that the political will exists. Our proposal for reform is no more than a return to the spirit and the letter of the Treaty of Rome, which contained a clear aspiration for financial autonomy, applied until the end of the 1980s.

Our calculations are that it would be possible to finance on a stable basis the current rate of expenditure of today's EU budget with a proper EU VAT (at 1%) plus one additional own resource like an EU carbon tax or also eventually a financial transaction tax (and keeping of course the existing own resources unchanged). The GNI resource could thus be abolished.

Both the carbon tax and the financial transaction tax help internalise potential negative externalities of CO_2 emissions and excessive financial sector activities. Both of them fit with two important EU political objectives: reduction of CO_2 emissions and the regulation of the financial sector.

As shown above, this reform would be as much in the interests of member states as of European citizens. Such a system would not add to the tax burden on European citizens and it would not undermine the fiscal sovereignty of the member states. It will help member states to cut their public expenditure. Financing of the Community budget would no longer place pressure on national public finances, making it possible to end the debate on fair return and, at the same time, dispense with the various correction and rebate mechanisms. By doing so, EU financing will meet the degree of independence it needs to enable a debate on the revision of EU spending priorities to take place.

Last but not least, the transparency, the simplicity and the visibility of such a system would increase the interest of the EU citizens in what they pay for and improve their link to the EU. Doing so will also participate in reducing the so-called ‘democratic deficit’.

Annex of Supplemental Tables

Table A1. Number of air passengers in the European Union and number of airports per member state, 2008

	Number of air passengers	**Number of airports (checking-in more than 15,000 passengers per year)**	**GDP/ inhabitant, (€ at current prices)**
European Union (27 countries)	798,330,585		25,100
Belgium	21,981,645	5	32,200
Bulgaria	6,417,873	3	4,700
Czech Republic	13,429,149	4	14,200
Denmark	24,629,204	6	42,500
Germany	166,095,390	75	30,200
Estonia	1,804,430	7	12,000
Ireland	30,018,287	9	40,500
Greece	34,404,278	:	21,100
Spain	161,400,952	40	23,900
France	122,723,531	778	30,400
Italy	105,216,903	44	26,200
Cyprus	7,218,073	2	21,800
Latvia	3,687,329	4	10,200
Lithuania	2,552,074	3	9,600
Luxembourg	1,713,003	:	81,200
Hungary	8,429,082	3	10,600
Malta	3,109,899	1	14,100
Netherlands	50,418,517	5	36,300
Austria	23,899,584	6	34,000
Poland	18,727,132	10	9,500
Portugal	25,180,382	10	16,200
Romania	8,031,267	9	6,500
Slovenia	1,648,977	3	18,400
Slovakia	2,596,334	6	11,900
Finland	14,850,682	29	34,800
Sweden	27,817,350	32	36,000
United Kingdom	213,888,122	55	29,600

Source: Eurostat, January 2010.

Table A2. Private consumption and VAT (% of GDP, 2008), current prices

	VAT/GDP	Private consumption/ GDP	Effective VAT rate on consumption (= VAT revenues/consumption)
EU - 27	6.80	57.50	11.8
EU - 16 (euro area)	6.60	56.60	11.7
Belgium	6.90	51.90	13.3
Bulgaria	10.80	66.40	16.3
Czech Republic	6.90	49.70	13.9
Denmark	10.10	48.30	20.9
Germany	7.00	57.00	12.3
Estonia	7.80	55.20	14.1
Ireland	7.10	50.70	14.0
Greece	7.00	74.50	9.4
Spain	5.10	57.20	8.9
France	6.90	57,00	12.1
Italy	5.80	59.30	9.8
Cyprus	11.10	68.60	16.2
Latvia	6.50	62.90	10.3
Lithuania	7.90	65.70	12.0
Luxembourg	5.80	32.30	18.0
Hungary	7.60	54.10	14.0
Malta	7.70	63.00	12.2
Netherlands	7.10	45.40	15.6
Austria	7.60	52.30	14.5
Poland	7.90	61.60	12.8
Portugal	8.20	67.30	12.2
Romania	7.80	64.90	12.0
Slovenia	8.20	53.00	15.5
Slovakia	6.80	57.10	11.9
Finland	8.20	51.70	15.9
Sweden	9.20	47.00	19.6
United Kingdom	6.20	64.20	9.7

Source: Eurostat, January 2010.

Table A3. Number of cars per 1000 inhabitants, 2006

	2006	**GDP/inhabitant (€ at current price)**
European Union (27 countries)	466	23,700
Belgium	470	30,200
Bulgaria	328	3,400
Czech Republic	399	11,100
Denmark	371	40,200
Germany (including former GDR from 1991)	566	28,200
Estonia	413	10,000
Ireland	412	41,600
Greece	407	19,000
Spain	464	22,300
France	489	28,500
Italy	597	25,200
Cyprus	479	19,000
Latvia	360	7,000
Lithuania	470	7,100
Luxembourg	656	71,800
Hungary	293	8,900
Malta	535	12,700
Netherlands	442	33,100
Austria	507	31,100
Poland	351	7,100
Portugal	405	15,100
Romania	167	4,500
Slovenia	488	15,500
Slovakia	247	8,300
Finland	475	31,500
Sweden	461	35,000
United Kingdom	471	32,200

Source: Eurostat.

Table A4. Environmental taxes in the EU linked to transport (% of GDP), 2008

	Environmental taxes linked to transport/GDP (%), 2008
European Union (27 countries)	0.55
Belgium	0.57
Bulgaria	0.33
Czech Republic	0.16
Denmark	1.85
Germany (including former GDR from 1991)	0.35
Estonia	0.04
Ireland	1.15
Greece	0.78
Spain	0.31
France	0.58
Italy	0.49
Cyprus	1.57
Latvia	0.23
Lithuania	0.05
Luxembourg	0.17
Hungary	0.58
Malta	1.69
Netherlands	1.3
Austria	0.75
Poland	0.25
Portugal	0.72
Romania	0.36
Slovenia	0.48
Slovakia	0.16
Finland	0.91
Sweden	0.51
United Kingdom	0.54

Source: Eurostat.

Table A5. Unspent payment appropriations and reimbursed to member states (€ billion)

	2009	2008	2007	2006	2005
Unspent payments calculated at end of year N (Amending Budget, end of year N)	2.769	4.891	1.651	4.706	650
Additional year N surplus (Amending budget, mid-year N+1)	2.254	1. 810	1. 542	1.857	2.415
Total unspent payments	5.023	6. 701	3.193	6.563	3.065

Source: Own calculations.

Table A6. Yield and price impact of a tax on CO_2 content of fossil fuels at €20 per tonne of CO_2

	Price per unit €without tax	Total CO_2 tax, yield (€ billion)	CO_2 tax per unit (€)	% Increase in price
Oil (barrels)	70	34.9	7	10
Gas (1000 m3)	240	19.8	43.2	18
Coal (avg) (short t)	91	21.4	37.2	40.8

Source: Own calculations.

4. EUROPEAN PROJECT BONDS: AN ENGINE FOR GROWTH

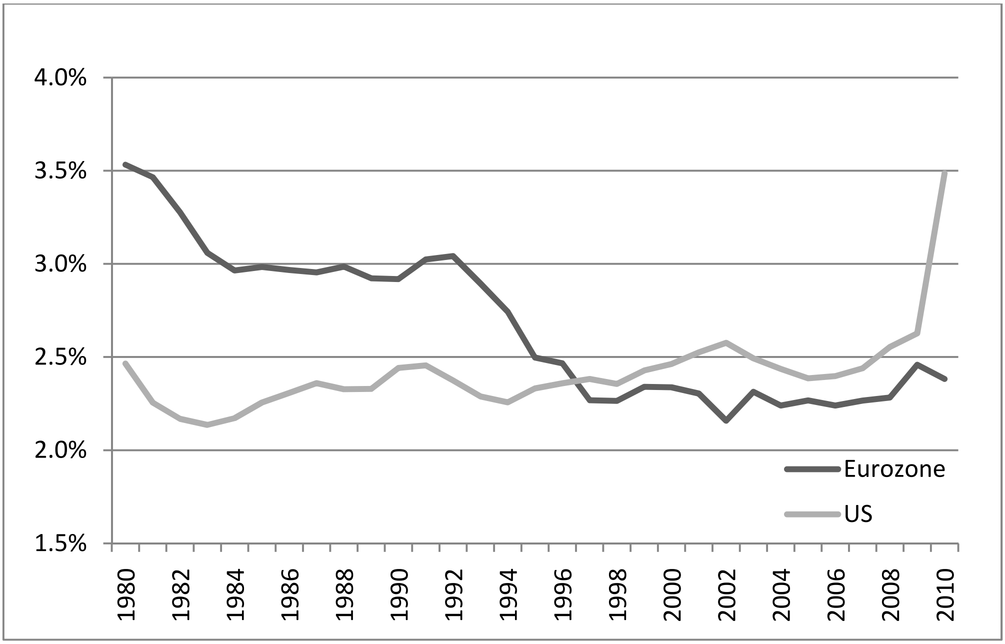
4.1 Introduction

One of the most striking developments in the trend of public investments in the eurozone is its systematic decline during the last few decades. Figure 2 illustrates the phenomenon. It shows how public investments in the seven eurozone countries (representing 81% of the eurozone's GDP) declined from more than 3.5% of GDP in 1980 to less than 2.5% in 2010. The sharpest decline occurred during the 1990s when the eurozone countries were forced to follow the Maastricht convergence criteria, in particular the criterion of debt and deficit reductions. The eurozone countries were quite successful in achieving these fiscal criteria. This came at a price, however: many member countries dramatically cut back on investment.

The contrast with developments in the US is striking. From less than 2.5% of GDP in 1980, US public investment increased to 3.5% of GDP in 2010. Note also the different reactions of the US and eurozone governments to the recent economic crisis. The former dramatically increased public investment, while the latter reduced them.

The raging debt crisis in the eurozone is forcing many of its governments to initiate drastic programmes of austerity. This leads to the risk that, as during the 1990s, public investment will be the first victim of the budgetary axes. As shown in Figure 2, this process is already going on, leading to the danger that history will repeat itself.

Figure 2. Public investment in 7 eurozone countries (% of GDP)



Note: Euro-7 = Belgium, France, Germany, Italy, Netherlands, Austria, Finland. Public investment data for the other eurozone countries (in particular Spain) are only available since the mid-1990s.

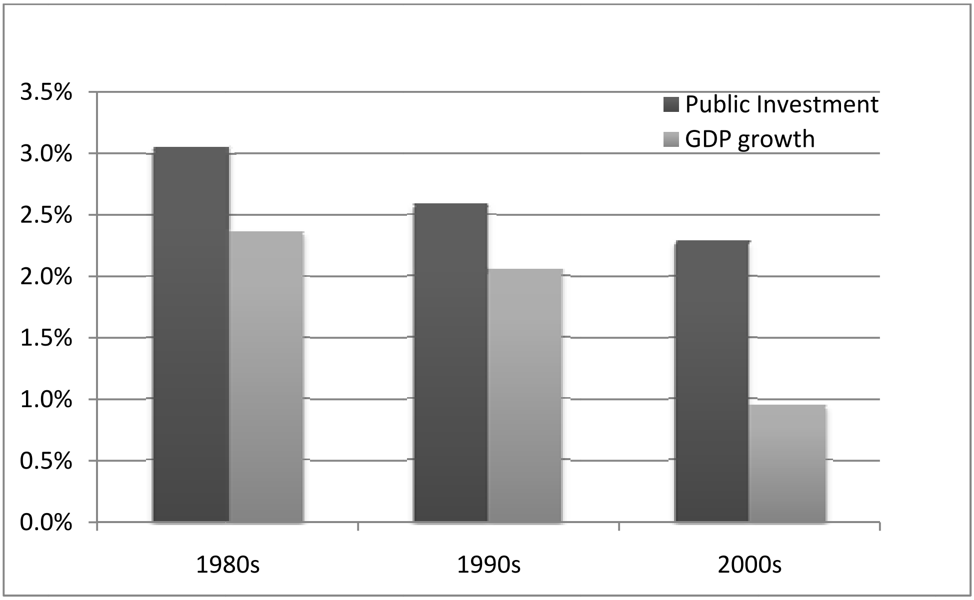
Source: European Commission, AMECO databank.

4.2 Public investment: An engine for growth

One of the most robust results from the theory and the empirical evidence of economic growth is that public investments are a very significant variable in boosting economic growth. This is the case both for public investment in infrastructure (physical capital) and in human capital (see Aschauer, 1990; Caselli, 2003). The reason why this is so is not difficult to understand. Public investment in infrastructure is essential for the efficient production of private goods and services. Thus, a good infrastructure (roads, bridges, railroads, airports, etc.) increases the productivity of the private sector and boosts economic growth. Similarly, investment in human capital (education) increases the skill and the knowledge of private sector workers, thereby boosting productivity. A large part of human capital generates collective benefits, i.e. benefits that accrue not only to the individuals with a better human capital (the highly educated) but also to the rest of the population with less skills. That's why public investment in education is key to boosting economic growth.

Unfortunately, as shown in the previous section, this strong positive relationship between public investment and economic growth has not prevented many European governments from cutting back on public investment more dramatically than many other spending items. There can be no doubt that the strong decline in public investment contributed to the productivity slowdown observed since the mid-1990s. This in turn explains a significant part of the decline in economic growth in the eurozone. This is shown in Figure 3. We observe the strong correlation between the declining government investment ratios and declining rates of economic growth during the last three decades. The eurozone has now become a low-growth zone, no doubt caused in a significant way by the decisions of its member governments to cut back on public investment.

Figure 3. Public investment (% of GDP) and GDP growth in euro-7



Note: Euro-7 = Belgium, France, Germany, Italy, Netherlands, Austria, Finland.

Source: European Commission, AMECO databank.

All this leads to the perception that the monetary union, per se, is the cause of low growth. There is nothing inherent in a monetary union that should lead it to become a low-growth union. Rather, it is the ill-conceived decision to cut back on public investment that has contributed to the fact that the eurozone has developed into a low-growth union.

How can these trends be reversed? It looks increasingly unlikely that the eurozone member countries will start boosting public investment programmes. Indeed, as mentioned earlier, it is more likely that they will continue to cut back on public investment. The trend can be reversed, however, by initiating programmes of public investment financed by issuing Eurobonds. We discuss how this can be done in the next sections. We start out by giving a taxonomy of Eurobonds.

4.3 Eurobonds: A taxonomy

It is useful to make a distinction between different types of Eurobonds by introducing two different dimensions. The first dimension is the purpose of the bond; the second dimension is the method of issuing the bond. We represent this in the following Table 6. The horizontal dimension focuses on the purpose of the bond, which can be to finance investment projects that boost economic growth or to finance government budget deficits. The former can conveniently be called 'project bonds', the latter 'budget bonds'. The vertical dimension focuses on how the bonds are issued. These can be issued by public institutions or by private ones.

Table 6. Eurobonds, EIB bonds, project bonds

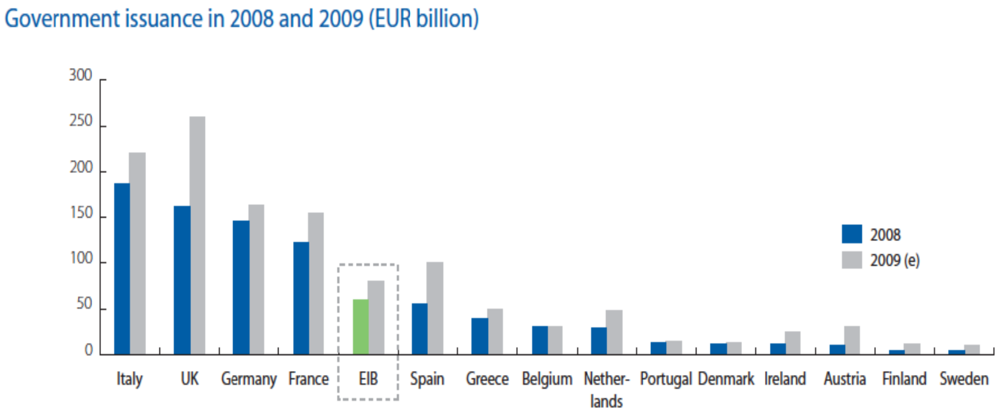
	Bonds issued by EU (or euro area) institution	**Bonds issued by private sector**
Bonds for financing investment projects	• EIB bonds • Delors bonds	• Project bonds (*proposed by President Barroso in "State of Union" speech, 07.09.10*)
Bonds for budget purposes	• EFSF/EFSM bonds • Eurobonds	

In the following we will concentrate on project bonds, i.e. Eurobonds that aim at financing investment projects. This is not to say that the budget Eurobonds aimed at solving eurozone countries budgetary problems are unimportant. They are, however, outside the scope of the present analysis. (see De Grauwe & Moesen, 2009; and Verhofstadt, 2009).

The most important project bonds are those issued by the European Investment Bank. In 2009, the EIB issued a total of €79 billion worth of bonds to finance investment projects both in the EU and in partner countries. Not all these issues were denominated in euros. Only 71% were euro-denominated bond issues. Thus the total amount of Eurobonds issued by the EIB was €57 billion.

The importance of the bond issue by the EIB is made very vivid in Figure 4. This shows the government bond issues of the EU member countries and compares these with the total EIB bond issues in 2008 and 2009. It can be seen that the EIB bond issue is of the same order of magnitude as the government bond issue of Spain.

Figure 4. Government issuance in 2008 and 2009 (€ billion)



Thus, although the EIB bond issue is significant, as a percent of the eurozone GDP, it remains limited, amounting to 0.8% in 2009.

As Table 6 suggests, there are other ways to issue Eurobonds. The Delors bonds proposed in 1993 aimed at financing major infrastructure projects in the EU. They were to be issued jointly by the governments of the EU member countries. Eurobonds could also be issued in partnership between governments and the private sector (Barroso bonds). Thus many formulas are possible (see also Verhofstadt, 2009). Nevertheless, whichever formulas will be chosen for future Eurobond (project bonds) issues, it would be wise to involve the EIB. The reason is that this institution has so much in-house expertise that it will be needed to channel funds raised in the capital markets into productive investment projects.

4.4 Euro project bonds: A proposal

We have noted that during the last three decades the public investment ratio in the eurozone has declined by more than 1% of GDP. This trend has contributed significantly to making the eurozone a low-growth area. This trend should be reversed. This can be done by a new programme of project bond issues aimed at raising the public investment ratio in the eurozone by 1% of GDP. Since the eurozone GDP amounts to approximately €10 trillion, this means that a new yearly Euro project bond issue of €100 billion aimed at financing public investment should be undertaken.

In line with the public consultation on the Europe 2020 Project Bond Initiative, recently launched by the European Commission,[35] our proposal is to make the EIB the agent of this new Euro-Project Bond issue. As argued earlier, the expertise of the EIB in channelling funding into productive investments is strong. There is no need to create new European institutions to replicate what the EIB is doing. In addition the EIB enjoys a very strong AAA rating allowing it to attract funding at the best possible conditions.

In order to maintain this favourable rating, the capital base of the EIB will have to increase. Today (2009) the EIB has a total balance sheet of €362 billion, with shareholders' equity of €38 billion. Thus its capital ratio amounts to 10.5%. Assuming an average five-year maturity of the EIB-loans, an additional yearly public investment programme of €100 billion over time will increase the balance sheet of the EIB by €500 billion. This is more than a doubling of today's balance sheet of the EIB. This will require an increase in the equity base of the EIB by approximately €52 billion, assuming that the EIB maintains a capital ratio of 10.5%. Thus the total equity commitment of the member states in the EIB over time will have to increase by €52 billion. This is a considerable amount, but this increase does not have to be realized at once. When spread over five years, it means that the new equity commitments must increase by €10 billion a year. This would not seem to create insurmountable problems.

Another issue is whether the capital markets will be able to absorb such a new issue of Eurobonds. According to the BIS (2010), the total amount of outstanding bonds issued by developed countries was €25 trillion in September 2010. Adding €100 billion does not seem to be much, considering also that during the last two years the net issue of new bonds

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[35] Stakeholder consultation paper on the Europe 2020 Project Bonds initiative, European Commission, Staff working document, 28.02.2011 (http://ec.europa.eu/economy_finance/consultation/index_en.htm).

amounted to more than €2 trillion per year. In addition, the desire of many Asian investors to diversify their portfolio away from the dollar guarantees that there will be sufficient world demand for new Eurobond issues.

There can be little doubt that a public investment programme of €100 billion a year can easily be financed by the issue of Eurobonds. The obstacles to such a programme therefore are not technical or financial. They are only political. These obstacles can be overcome if sufficient political will can be generated in Europe to use the integration process as an instrument to boost economic growth.

4.5 European project bonds: For what purpose?

The need for financing infrastructure projects will increase in the coming years. Until 2020, the Commission evaluates these needs at an estimated total of around €1,800 billion: €500 billion for TEN-T, between €38-58 billion and €181-268 billion to achieve the Commission's broadband targets and €1,100 billion for the energy sector (i.e. €400 billion for distribution networks and smart grids, €200 billion on transmission networks and storage and €500 billion to upgrade existing and build new generation capacity, particularly in renewable energy, between now and 2020).[36] These calculations do not include the financing of big R&D investments such as ITER, for which the EU institutions are currently looking for an extra €1.3 billion in addition to initial planning.

Facing the economic and financial crisis, private investors are reluctant to fund infrastructure projects. At the same time, as a result of budgetary constraints, national governments are not in a position to fund such projects, and indeed are looking for alternative investment financing solutions. The general atmosphere of austerity does not offer optimistic prospects for an adequate increase of the financial envelope of the next multiannual financial framework. Last but not least, delaying these infrastructure projects might lead to higher-cost solutions in the future.[37]

European projects bonds could thus be used to secure projects of key interest to the EU in transport, energy, information technology and research infrastructures. The issue of these bonds would also give a strong incentive to private investors to join in the funding of these major projects.

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[36] COM (2010) 700 final (Budget review).
[37] Ibid.

5. EUROPEAN FINANCING IN TIMES OF AUSTERITY: THE BENEFITS OF THE 'EUROPEAN DIVIDEND' AND BUDGETARY SIMPLIFICATION

Some 20 European countries have been unable to adhere to the Stability and Growth Pact criteria. Several of them have a budget deficit higher than 10% of GDP, others a national debt that exceeds 100%. Throughout the Union, all public authorities have had to launch austerity plans on a scale not seen since the last World War. How, in this situation, will it be possible to finance the European policies that the Union requires, the new powers that it has been given by the Lisbon Treaty and, looking forward, the common ambitions in the 2020 Agenda?

This unprecedented situation should give us the opportunity to tackle the question of the economies of scale that could result from better coordination between national and European budgets as well as from improved synergies.

5.1 The freezing of the Community budget and its consequences

The financing of European policies is at a dead end. Having failed to equip the Union with genuine own resources so far, the member states have condemned themselves to being its sole contributors as national budgets finance the biggest share of the European budget. As explained in previous chapters, this system is basically anti-Community as it obviously encourages each Finance Minister to demand a 'fair return' on the contribution of the member state he/she represents. As a result, the Community budget remains stuck at 1% of GDP. The national parliaments, for their part, are finding it increasingly difficult to understand why they should raise their taxes or increase their country's debt to finance policies that are decided elsewhere without their consent.

Yet, this is the very moment when Europe can no longer keep tightening its belt. In accordance with the Lisbon Treaty, a European External Action Service (EEAS) has been set up to conduct, a common European External Policy, under the authority of Catherine Ashton, EU High Representative for Foreign Affairs. This requires a minimum of administrative and operating appropriations. The Treaty of Lisbon also increases the Union's responsibilities in fields such as external relations, energy, space or the fight against climate change. But no additional financial means have yet been provided for these new competences.

Moreover, there is a risk that key large-scale industrial programmes that were decided upon years ago, such as the Galileo satellite network and the world centre for fusion energy research (ITER), might be disrupted if no additional funding is found.

Last but not least, the EU 2020 strategy, was recently decided by EU heads of state and government with the aim to foster EU growth and competitiveness. However, so far this political decision has not yet been financially translated into the EU budget.

Nevertheless, in order to combat the crisis, governments can find the means of financing new policies decided at European level. In 2010 the European Council decided to allocate no less than €2.4 billion a year, from 2010 onwards to helping developing countries combat the climate change. These sums will be mustered through contributions from each member state using an ad hoc allocation formula that differs from the normal Community scale.

It is regularly asked, given that it is the national taxpayer who will have to pay, or act as guarantor, why bother going via the Union budget? Well, as this contribution aims to show, there is a very simple way to avoid calling on national budgets, and that is for Europe to be given some new own resources.

The decision lies with the governments. If they prefer to rule out all new expenditure or all new taxes in their crisis exit strategies, the Union has no choice but to help apply these austerity measures; if, however, they consider it necessary to launch new budgetary initiatives, then the Union should be involved.

One key consideration that is ultimately overlooked is the fact that the budget is the true instrument for measuring the spirit of solidarity. And the European budget is also a measure of the trust placed by its stakeholders in this joint venture, the societal bond or *affectio societatis* that unites the European family. To cap the EU budget is to cap faith in Europe, and to slam the brakes on solidarity between Europeans. The unedifying squabbles about the very principle of helping Greece or Ireland are a sad illustration of this unfortunate state of affairs.

5.2 The interest of a common European approach for national budgets: The 'European dividend'

The European dimension can help member states emerge from the crisis better equipped to balance and maximise the efficiency of their finances.

All that is basically required is simply to apply the principle of subsidiarity in financial matters. Each time the Union exercises a power in the place of a member state, this should not only be done without imposing a new fiscal burden on the taxpayer but, all things being equal, it should also help reduce total expenditure. This is exactly what large industrial groups do: they pool common services to benefit from economies of scale.

There are then two approaches to designing the Union's new External Action Service, but a wide range of intermediate solutions exists between the options of creating a 28th diplomatic network and merging the existing 27 national networks within a unified European service. Whilst it is understandable that all member states want to be represented in Washington or Beijing, the presence of four EU member state embassies, in addition to an EU embassy in Botswana, is at least three too many. The same applies to consular services, as the Schengen agreements and European treaties establish the principle of unlimited consular cooperation between member states. Member states employ at present 93,912 staff members in their foreign services (55,441 nationals plus about 38,471 in local staff). The diplomatic service of the United States corresponds to 22,000 Americans and about 6,000 locals, for a total of about 28,000. Compared to these numbers, the EEAS, with its 3,700 employees, looks minuscule. But, on the contrary, compared to the US diplomatic service, the total staff employed in foreign affairs in the EU (at national and EU level) looks plethoric. In a very recent publication of the Centre for European Policy Studies, Emerson et al. (2011) make interesting calculations. They conclude: in the case of a moderate restructuring scenario, where national foreign services would be cut by 10% while the EEAS means would be doubled, this would represent a €227 million savings per annum (+€476 million for the EEAS and - €753 million for the member states); and in the case of a substantial restructuring, which means a cut in national foreign services by 25% together with a multiplication by 3 of the EEAS, the net savings would be €329 million per year (+€950 million for the EEAS and - €1880 million for the member states).

In the field of research, the Union allocates substantial funding of around €8 billion each year to a framework programme. On top of that, however, come national expenditures, the bulk of which are decided without knowing what one's neighbouring countries are doing, leading to duplication and fruitless competition. With today 1.86% of its GDP dedicated to R&D expenditure, the EU is far from its target of 3% of GDP, and behind the United States (2.66%) and Japan (3.18%).

The same applies to development aid. When the national budgets are added up, the figure produced is ten times that of the Community budget, which itself is duplicated by the intergovernmental budget of the European Development Fund. The EU is the biggest provider of development aid in the world (60% of the world development public assistance). However, the fragmentation of EU aid, between the EU development policy and the development policies of each EU member states, weakens the visibility and the weight of the total EU development effort. This fragmentation leads most of the time to duplication or, on the contrary, leaves some needs unmet.

Even in a sector of deep political integration, such as the European monetary policy, the duplication of effort in the euro area's central banking system entails an extra cost of around €3 to €4 billion a year in Europe. The 12 national central banks of the countries that first adopted the euro still now employ together over 44,000 people (down from 53,000 in 1999). This compares to a total of less than 18,000 in all Federal Reserve banks in the US. The total expenditure of the national central banks in the eurosystem amounts to over €7.5 billion per annum, compared to less than half of that sum in the US Federal Reserve banks (equivalent to around €3.6 billion).

Last but not least, the defence sector may be taboo, but it is an even more promising area for making savings. The risk of overlap between the European Union and NATO, which our American friends constantly go on about, should bring a wry smile compared to the scale of the redundancy that exists between our national armed forces. The 27 European armies have a combined total of 2 million personnel in uniform. Less than 5% of them are capable of carrying out a 'high-intensity action', as it is euphemistically known – i.e. fighting. How, in 2011, can we justify this pile up of disparate resources, the cost of which is disproportionate to their potential effectiveness which, in any case, will never be measured? The Afghan battlefield provides a cruel illustration of the true scale of comparative military capacity of all NATO members.

5.3 The vast complexity of funding European policies

Contrary to what people might think, the Union budget is far from being the only instrument for financing European policies and, by extension, actions related to common European objectives. In fact, in addition to the EU budget itself (€126 billion in 2011), there are no less than six additional categories of sources, each of which follows a different set of rules.

Firstly, the European Development Fund (EDF) finances aid to ACP (African, Caribbean and Pacific) countries. It is an inter-state fund but is managed under the fairly close political control of the European Parliament. Everyone agrees that it should eventually come under the Community budget, but each time a new multiannual financial framework is negotiated, the European Council gives up on the idea. Moreover ACP countries are also not very keen on merging the EDF into the EU budget as this would impact their role in the management of the fund.

Secondly, the decision of the European Council of 2010, mentioned above, of financing the aid promised to developing countries to combat climate change, has resulted in EU assistance to developing countries to combat climate change. However, unlike the European Development fund, this assistance is not currently a fund as such but only an agreement between the member states on the principle, the amount involved and the contributions by member states, without making use of the Community budget, without operating rules nor incentives for member states to ensure they will keep their promises.

The third instrument is the official contribution by the member states to financing European policies or institutions. It encompasses broad and diverse areas: the national co-financing of Community programmes such as the structural funds, the cohesion policy, the research and development framework programme; national funding that supplements Community programmes or is supplemented by the latter (financing of the ESA space programmes, financing of most of the European Agencies, for example); and expenditures committed by the member states to actions that parallel Union actions (for instance, peacekeeping operations where the civil expenses are borne by the EU budget, whilst each member state remains responsible for its expenditure on military operations - in those cases, member states that participate in such operations pay twice over - in their national budget and in their contribution to the common budget).

The fourth financing tool consists of the national expenditure contributing to the achievement of common European objectives. This is undoubtedly the largest category by size, but also the most difficult to pin down accurately. Common European objectives should be interpreted as areas in which the legal and financial competence basically remains in national hands, but in which the member states agree to assign themselves the same objectives. The Lisbon Strategy and now the EU 2020 strategy, the climate change and energy package the European Security Strategy are very good examples of this and arrangement.

Identifying and quantifying this expenditure is very important for two reasons. First, faced with the extreme difficulties involved in increasing the European budget, it is the only way of verifying that these major objectives can be financed. Secondly, the proper use of these funds poses a problem in terms of democratic control, and thus for coordination between the national parliaments that use the funds and the European Parliament, which is responsible for monitoring the achievement of the objectives set.

The fifth financial tool consists of loans of the European Investment Bank. These loans finance Community projects, often alongside European funds. The EIB is a unique institution which was created by the Treaty of Rome, but whose sole shareholders are the member states, and it is a powerful financer of investments decided in Brussels. Its role can only get stronger during a period of very poor budgetary performance.

The last decided instrument of financing European policies, in addition to the EU budget, concerns the loans granted by some member states to others experiencing financial difficulties.

On 9 May 2010, the Council agreed a package of measures worth up to €500 billion for a member state in difficulties or seriously threatened with severe difficulties caused by exceptional circumstances beyond its control. The package comprised:

- a European Financial Stabilisation Mechanism[38] (EFSM) allowing

[38] Council Regulation (EU) No 407/2010 of 11 May 2010 establishing a European financial stabilization mechanism, OJ L 118 of 12.5.2010, p.1.

financial assistance to a member state in the form of a loan or credit line guaranteed by the EU budget, up to a total of €60 billion.

- a Special Purpose Vehicle (SPV) providing extra resources to euro area member states in the form of bilateral loans, up to a total of €440 billion.

The IMF will participate in financing arrangements for the SPV and is expected to provide at least half as much as the EU contribution, taking the total package to €750 billion.

On 5 January 2011, the European Commission issued €5 billion of bonds in the framework of the EFSM, in order to finance the first financial assistance tranche for Ireland. This loan was contracted by the EU at a rate of interest of 2.59%. Ireland will reimburse it at a rate of 5.51%. This means that the mechanism is generating a revenue corresponding to the margin between the price of the EU loan and the price of reimbursement of this loan by the assisted country.

This revenue should be entered into the EU budget as the latter acts as a guarantee of those loans, but the member states rejected this idea. In fact, not only did the member states insist that this revenue is to be entirely redistributed between them but also that it first be inserted into the budget before being transferred back to them. Instead, in our view, it should go straight to the EU budget, thus constituting another own resource.

5.4 Conclusion

To put it in a nutshell, these few examples give an idea of the potentialities of the financial economies of scale that the EU and its member states could benefit from with a simplification of the EU financial means, which today are dispersed in different instruments and/or formulas, as well as from better synergies between national and European policies and budgets.

At this time of unprecedented crisis, characterised by the scarcity of financing resources, in combination with an urgent need to coordinate the EU member states' recovery actions and to create the necessary incentives in favour of significant investments supporting economic growth, these are issues that cannot be ignored.

Such economies, as well as the additional revenue that could be raised from the EFSM, could relieve part of the pressure on national public finances and would also make room to fund the EU's newly arising needs in order to face the challenges of the future. In the end, the revenue and economies resulting from the 'European dividend' could represent some other kind of EU own resources of a non-negligible magnitude.

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