

# **Reforming the EU Budget: How to Increase Financial Autonomy?**

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## **Abstract**

In this paper, we address the ongoing debate on the questions of the composition and financing of the European Union's common budget, which has recently been the object of a new impulse by the European Commission.

We start by describing the current situation with regard to the size of the EU budget, the composition of its expenses and the way it is being financed. Then, by considering the main current challenges for the EU, together with some major lessons from the fiscal federalism theory, we argue in favour of a significant enlargement of the budget, together with a profound reform of its composition and financing.

Regarding this last aspect, we analyse several recent proposals, with a special emphasis on the possibility of creating a true new "own resource", namely a European tax. The analysis of the involved costs and benefits allows us to argue in favour of an EU surcharge on national personal income tax, which would give the EU an important degree of financial autonomy, as well as more transparency in its financing and an increased feeling of belonging to European citizens. A simulation for the financing of the EU budget is then made, in line with this proposal.

**Keywords:** EU budget, fiscal federalism, own resources, surcharge on national personal income tax

**JEL classification:** F02, H61, H77.

*“The EU’s 2008 budget (Eur 129,1 billion) for the 495 million citizens of Europe is roughly equivalent to the overall public spending of Austria, a little less than that of Belgium, half as much as that of Netherlands, three times less than that of Spain, four times less than that of the United Kingdom, six times less than that of Italy, nine times less than that of France and ten times less than that of Germany.” (PSE, 2008)*

## **1. Introduction**

Like any State or group of States, the European Union has a budget (the community budget), with which it finances the functioning of its institutions and organs and the development of common policies. The EU budget contemplates the set of expenses to be made by the Union, as well as its revenue.

The theme of the need and how to reform the EU budget has been discussed several times along the last years, but any tentative to make a profound reform has failed. Nowadays there is an ongoing debate on the questions of the composition and financing of the EU budget, with an important impulse from the European Commission.

This paper is focused mainly in the latter issue, i.e., how to finance the EU budget. The question of the (re)composition of the common expenditure is important and probably more likely to be addressed by the common institutions and the national governments in the near future. However, we think (and we will try to argue) that the effectiveness of response from the EU to its present challenges and deficits requires an increase in the size of the common budget, which requires the search for new financial resources.

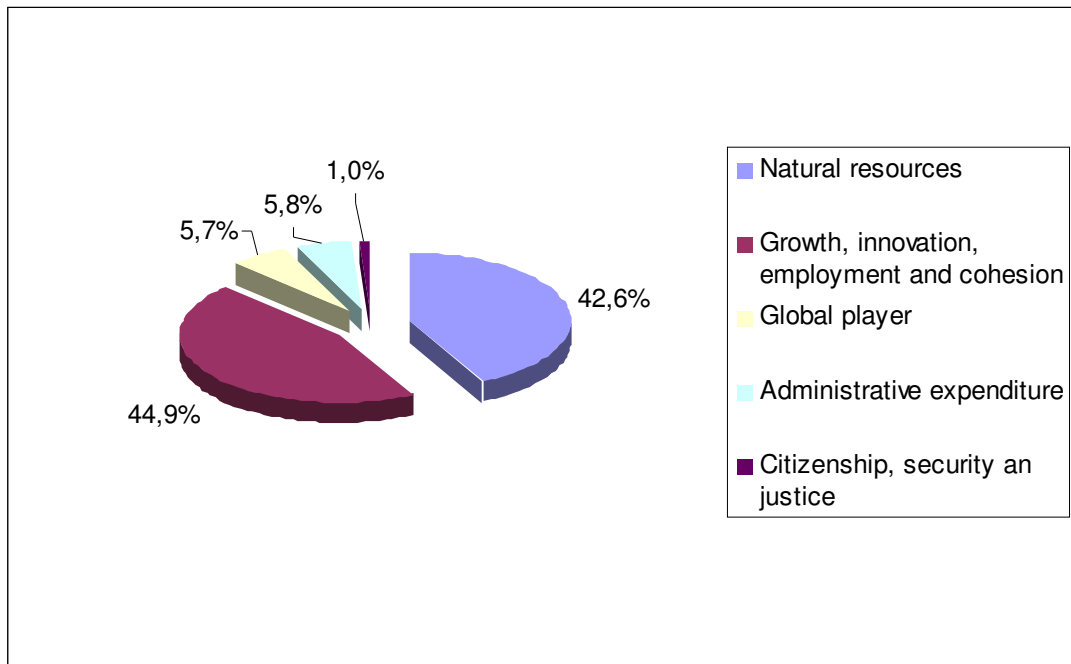
The paper is developed over six sections. In section 2, we present the present situation of the EU budget, analysing its structure in terms of revenue and expenditure. In section 3, we suggest the need for an important change in the composition and financing of the EU budget, based on the main challenges facing the EU in the present/near future and on relevant aspects of the fiscal federalism theory. In section 4, our attention turns to the reform of EU budget financing, and we present the main proposals that have been made these last years. The same issue is the object of section 5, in which we defend an EU surcharge on national personal income tax and a simulation is given on its possible value in the present situation. Section 6 presents some conclusions.

## 2. The EU budget: current situation

As above mentioned, the EU budget contemplates the set of expenses to be made by the Union, as well as its revenue. With regard to the type and structure of the former, it is worth mentioning that:

- (i) they include two types: compulsory expenses, which result from Treaties' commitments, and non-compulsory expenses, arising from the budget's operating areas;
- (ii) despite having increased with the reforms implemented with the so-called "Delors Packages" (I and II), the set of expenses covered by the community budget is low in volume, never exceeding 1.3% of the Union's GNP; that is, the size of the community budget is similar only to some governmental departments of certain large EU countries; note also that the small size of the community budget contrasts with what happens in most geographic areas with a single currency;

**Figure 1 – Distribution of the EU budgetary expenditure**



Source: PSE (2008)

(iii) as can be seen in fig. 1, a highly significant part of the expenses corresponds to the Common Agricultural Policy (CAP), one of the most problematic (and possibly unfair) in the Union, which still accounts for over 40% of the community budget, although this has

been reduced following successive reforms (not always fruitful) of this common policy; this is followed by expenses related to Regional Policy and, with a significant increase in the most recent years, expenses related to Research and Development; in any case, note that, in 2008, the joint objective of growth, innovation, employment and cohesion is already the most important.

With regard to the budgetary resources, an initial phase of national contributions was replaced, from 1970 on, by a system of own resources. These are considered the revenue of a fiscal nature attributed once and for all to the Community to finance its budget, with the duty being conceded to it without the need for any further decision from the national authorities.

As fig. 2 shows, the system of own resources involves mainly:

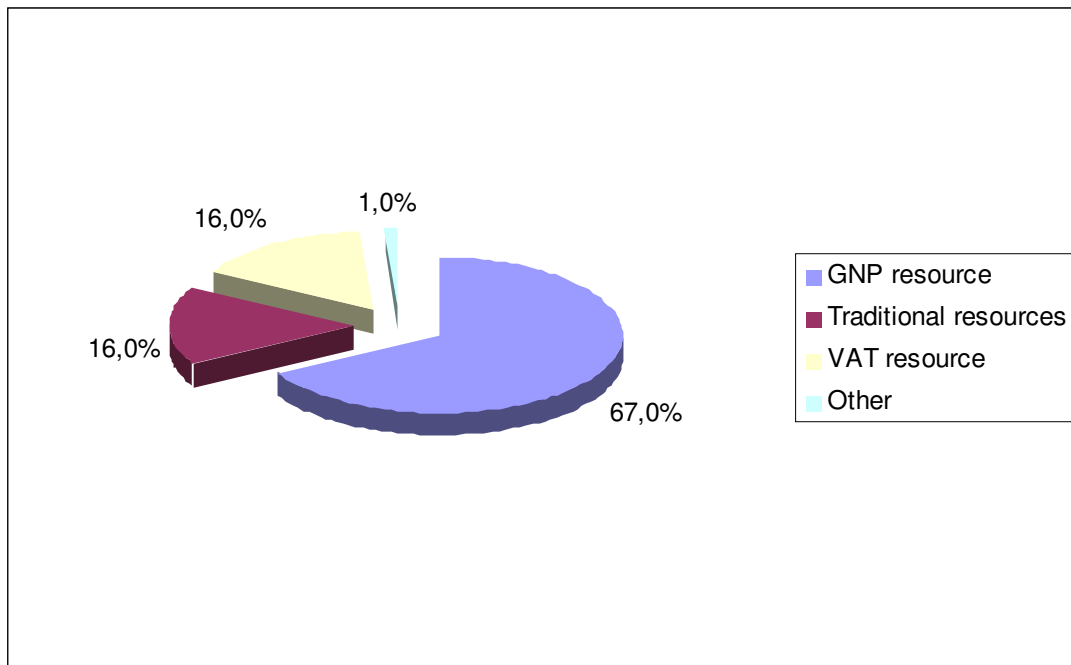
(i) the “traditional resources”, considered own resources “by nature”, because they are revenue obtained within the scope of common policies, and not revenue from the Member States calculated as national contributions. They thus include customs duties, resulting from the application of the common tariffs and agricultural duties, resulting from the imports of agricultural products from non-member and linked to the CAP.

(ii) the “VAT (Value Added Tax) resource”, created in April 1970, when it was clear that the traditional own resources were not enough to finance the community budget. Due to the difficulties of ensuring its harmonisation, the resource was only applied from 1980, and it is obtained from the application of a uniform rate to the national VAT revenue. The value of such rate has varied and it has been situated at 0.50% since 2004.

(iii) the “GNP (Gross National Product) resource”, created in June 1988 as a resource for balancing the budget, corresponding globally to the difference between the expenses and the revenue of the other own resources and “shared” according to the GNP of each Member State.

Fig. 2 also shows that the “GNP resource” is presently by far the most relevant resource in the EU budgetary framework, in an evolution that has been accentuated as VAT mobilisation rates have dropped and the amounts of “traditional duties” have progressively fallen.

**Figure 2 – Breakdown of EU own resources**



Source: PSE (2008)

### **3. The EU budget: why reform it?**

Some elements suggest that there is only a slight possibility, in the very near future, of a significant change in the situation described in the previous section. These include:

(i) In September 2004, the European Commission presented a report on the evolution of own resources (European Commission, 2004). In this report, it admitted that there were possible advantages in gradually substituting the present model with another one more directly oriented towards citizens. However, it manifested no intention of proposing a new own resource in the scope of the financial perspectives for the subsequent period: this has in fact happened.

(ii) The financial framework for the period 2007-2013 did not bring about significant changes either in terms of the composition of expenses or in terms of the origin of resources.

In the first case, it is true that expenses related to the common agricultural policy continue to fall and that there is heavier investment in areas such as cohesion, competitiveness and growth, but fields such as security, justice, defence or citizenship

still have highly unsatisfactory figures (little more than 1% of the budget over the entire period). In the same way, the EU foreign action also has very little weight, although it will be increased by 1 percentage point at the end of the period when compared to the beginning.

In the second case, the maximum ceiling for revenue (and naturally expenses, since the budget must be balanced) remains at 1.24% EU's GNP throughout the period, though it is expected that not even this figure will be effectively reached.

(iii) The Lisbon Treaty, which is in the process of ratification, brings no change to the existing framework of the own resources system.

(iii) As it is mentioned in section 4., a "taboo-free" debate is open on the question of the EU budget reform, led by the European Commission. However, the positions that have become known of the main European political blocks indicate that the debate may be focused more on reformulating the composition of expenses rather than on the central issue of community budget size.

There are, however, several factors that allow us to argue in favour of a profound reform of the community budget. These include:

(i) The need to give the EU greater financial autonomy, so that it can deal efficiently with the new challenges it faces. As mentioned, for example, in Alves (2007), it seems essential for the EU to reduce the divergence between the high level of economic integration and the low level of political integration. Strengthening the political component would be relevant for reducing the deficit of political importance on the international scene, also as for increasing democratic participation and citizenship or the capacity to take decisions and action. But this seems difficult to fit into a budget as small as the present one.

(ii) In the same vein, an analysis of the fiscal federalism theory (Alves and Afonso, 2008) seems to indicate that it would be beneficial to have greater intervention at the community level in what concerns the supply of goods and services that are clearly supranational in nature (defence, security, etc.), thus constituting an exception to Oates (1972)'s theory of decentralisation. The theory would also point towards an increase in

relevance in inter-regional distribution, namely via transfers through the EU budget, particularly after the latest enlargements (e.g., Deltas and Van der Beek, 2003; Fuest and Huber, 2006).

(iii) The possibility of a real exercise of the macroeconomic stabilisation function, in the same way as the central budgets assume in the main federations, also requires an increase in the size of the community budget along with the demand for new own resources.

The literature in the scope of fiscal federalism traditionally postulates an important role of “insurance” for the central budget, which seems to exercise an important degree of stabilisation, through transfer mechanisms between the States/regions positively affected by asymmetric shocks and the States/regions negatively affected by the same shocks. In fact, this is shown by various studies, in the wake of the analyses of Sachs and Sala-i-Martin (1992), Italianer and Pisani-Ferry (1994) and Bayoumi and Masson (1995), who estimated, based on different methodologies, a significant degree of stabilisation in the absorption of shocks by the North-American federal budget.

The same kind of role has been mentioned by subscribers to the theory of optimal currency areas. They considered that, once the monetary and exchange rate instruments were lost, an efficient response to the negative effects of specific and asymmetric shocks, in the context of a monetary union, would be obtained by mobilising a broad central budget (e.g., de Grauwe, 2007; Horvath, 2003).

(iv) If we admit that an effective response to the new challenges includes a profound change in the EU’s political and institutional model (as we defend, in fact, in previous studies mentioned above), in the sense of creating a “Federation of Nation States”, such a change will imply an equally profound reform at the level of community budget: in fact, political federalism must be accompanied by fiscal federalism.

An important reform of the EU budget seems therefore justified for all these reasons. It could occur progressively or simply in the medium or long run, namely because of political reasons. Whatever the scenario might be, it will have to involve changes in the composition of the expenditure, as well as the reinforcement of financial resources, that is, of the autonomy of EU action:

(i) In the first case, the application of the fiscal federalism theory and an analysis of what happens, with significant success, in other political entities with a single currency, may help in putting together a catalogue of exclusive and shared competencies for the EU, which will result in the (re)composition of expenses. Some proposals along these lines have been presented, including Alves (2008), based on the fiscal federalism theory, and Figueira (2008), based on a multidisciplinary approach, combining public sector economics, fiscal federalism, political science and literature on the concept of subsidiarity.

(ii) In the second case, it seems difficult to solve some of the Union's more relevant challenges and to achieve the aims of solidarity and economic and social cohesion while maintaining the present size of the community budget, that is, without assuming the discussion of a new *truly* own resource. That is the focus of the next sections.

#### **4. How to reform the budget: main proposals**

The reform of the present model, replacing it with a more efficient and transparent model, both from the point of view of resources and from the point of view of composition of expenditure, is, in fact, the concern of the debate recently launched by the European Commission and above mentioned. This debate, in which European citizens and entities were invited to take part ([http://ec.europa.eu/budget/reform/issues/issues\\_en.htm](http://ec.europa.eu/budget/reform/issues/issues_en.htm)), comes in the wake of a joint decision by the three main community institutions for the Commission to undertake a fundamental review of the EU budget, including both the guidelines for future expenses and how to obtain the resources necessary for financing the EU's political priorities.

The consultation will end by the middle of this year, with the Commission then producing a report. This immediately brings the advantage of generating an assessment on a long time horizon, to see how the budget can be shaped to serve EU policies and to meet the challenges of the decades ahead. This means an assessment that is not involved in a (always difficult) financial negotiation for a multi-annual framework. In fact, the task of proposing the multi-annual financial framework for the period 2014-2020 will be left

to the next Commission, so that in this review, the present Commission will not decide on the global volume or on the detailed breakdown of the EU budget.

Taking into account the importance of this present debate and the defended need to increase the community budget, there is room for a brief analysis of the main reform proposals that have been put forward for the case of common budget revenues.<sup>3</sup>

These proposals have been made along two fundamental lines: (i) simplification of the present system of own resources; (ii) enlargement of the fiscal bases, namely with the introduction of new (and real) own resources.

With regard to the first line, it seems possible to establish three hypothesis: (i) substitution of traditional own resources by the GNP-based resource, with the former going back to the Member-States in which the final consumption of the respective goods and services takes place; (ii) simplification of the method of calculating resources based on VAT, eliminating their association with the British rebate and introducing a uniform VAT rate for all Member-States; (iii) full substitution of the present set of own resources by the GNP resource.<sup>4</sup>

Any of the above possibilities, particularly the latter, would lead to a relevant simplification of the determination of EU budget resources. In any case, it would not necessarily mean that the budget size would be strengthened, something that would be justified, accordingly to what was said in section 3.

In this context, the relevant debate moves on to the definition of new own resources. In this line of reform, in the aforementioned study (European Commission, 2004), the Commission suggested, in the medium-run, the introduction of a new own resource based on taxes. This resource would have to substitute the present resource based on VAT and finance a significant part of the community budget, enabling the main disadvantages of the present system to be overcome, including the overwhelming dependence on transfers from national budgets. In this context, the Commission also considered that the resource based on GNP should continue to play an important role, though it would come to represent a smaller part of the total own resources than in the present system.

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<sup>3</sup> For further development of this aspect, see, e.g., European Commission (2004) and Cattoir (2004).

<sup>4</sup> For further development of this aspect, see, e.g., Cieslukowski and Alves (2006).

In the same report, the Commission mentioned three kinds of tax more likely to become new own resources in the future: (i) a tax based on energy consumption; (ii) modulated VAT (proposal already made in the Langes Report, European Parliament, 1994); (iii) a tax based on corporate income. Any of these would be generically in line with the main conclusions of the fiscal federalism theory in the field of taxation, particularly with the criteria introduced by Musgrave (1983).

The tax based on energy consumption could be conceived in two ways: as a tax with a broad base (coal, gas, oil, etc) or as a EU tax on fuel for road transport. The tax would be paid by consumers through the energy suppliers, creating a direct link between the EU budget and European citizens. This would certainly constitute a stable source of financing for the community budget and enough for a level of needs close to that of the present (European Parliament, 1997). Either of the two ways, would, however, require a definition of tax rates at European level.

In the case of modulated VAT, the VAT paid by the consumer would result in a combination of national VAT and European VAT, with the rate of the former defined by the national parliament and the latter by the EU – a rate of 2% was initially suggested for the European case, and may be raised as community responsibilities evolve. This proposal would make EU financing quite visible for EU citizens, also offering as advantages the fact that the harmonisation in the context of VAT is quite advanced and the possibility of constituting a sufficient and stable source of revenue. On the other hand, it would also be evolutive since it would give rise to a reform of the current provisions instead of introducing a completely new resource. From the administrative point of view, its introduction would also not appear to present any unsurpassable difficulties.

The third possibility, resulting from the application of an uniform tax over corporate income taxation would also allow an adequate form of financing for the community budget, though it would probably only cover less than half the present budget expenditure. However, considering the poor community harmonisation in this area, it

could only be taken as a long-term option, unlike the previous two, which could be performed in the medium run.<sup>5</sup>

Other proposals have also been studied and put forward. For example, Cattoir (2004) analysed, in addition to those mentioned above, the possibilities related to: (i) specific taxes on tobacco, alcohol and mineral oil; (ii) transfer of revenue from seignorage (from the ECB); (iii) taxation of communications services; (iv) tax on financial transactions on the European stock markets; (v) tax on aviation, making it internalise the negative effects on the climate resulting from its activity; (vi) tax on personal income.

Cattoir (2004) assesses these proposals, based on criteria of sufficiency and stability for the European budget in the long run, efficiency (including visibility, administrative costs and the effects on the assignment of resources) and horizontal and vertical equity, and concludes in the same way as the cited European Commission's study. In his opinion, which we share, excluding the case of the personal income tax, any of the proposals mentioned here would be less desirable, for various reasons. Thus, among others, we could mention: insufficiency and lack of stability, in the case of taxation on aviation or on financial transactions; lack of visibility in the case of the latter and of the income from seignorage; lack of vertical equity in the case of specific taxes.

## **5. A possible solution to increase own resources: an EU surcharge on national personal income tax**

One possibility that seems particularly interesting is that of creating an own European resource based on the taxation of personal income, because "*personal taxes constitute one of the most direct and visible links between taxpayers/citizens and elected authorities*" (Cattoir, 2004, p.30).

Thus, in addition to strengthening the system's transparency mechanisms, the creation of such a resource could help towards the true appearance of a feeling of belonging to a new space of political loyalty. This would be particularly relevant in the case of an evolution towards a politically stronger model, possibly of a federal nature, as we defended in other

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<sup>5</sup> For further development of the various issues involved in a proposal of this kind, see, for example, Albi *et al.* (1997).

studies (Alves, 2007; Alves and Afonso, 2008). On the other hand, this kind of proposal seems to behave well in the other assessment criteria applied by Cattoir (2004) to the mentioned proposals.

With regard to its implementation, it would be possible to discern at least three alternatives:

(i) In the first place, a certain amount of tax could be established for each European citizen to pay. For 2008, for instance, considering the forecasts of European Economy (2007) for the population size of the EU and for the European GNP and allowing for a community budget size close to that of the present (around 1% of the European GNP), a tax of little more than 255 euros per person would cover the present spectrum of community expenses.

In this case, there would be the advantage of dealing with a highly visible, simple and efficient resource. In terms of visibility and simplicity, in fact, it would seem to be difficult to find a more satisfactory resource. In any case, it would immediately pose problems of equity<sup>6</sup> and, given similar experiences (Cattoir, 2004, gives as an example the disaster of the poll tax in the United Kingdom) it would present great political difficulties of implementation.

(ii) As a second possibility, a European tax could be created on personal income, separate from the national one, also with deductions, progressivity, etc. Citizens would have to fill in two declarations, one for the State in which they are resident and another for the EU, in a similar way to what happens in Quebec, for example, with the payment of separate personal income taxes for the province and for the federation.

In this case, it would also be easy to ensure sufficient amounts for the present size of the community budget, without excessively burdening citizens. Cattoir (2004) says that, since the revenue from taxes on personal income from the group of the (then) 15 Member States represented around 10% of the EU's GNP (2001), a tax equivalent to around 10% of the equivalent in the Member-States would produce a total revenue of approximately

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<sup>6</sup> Immediately, because the level of income per capita varies significantly from country to country within the EU. On the other hand, the figure mentioned is per person and not per taxpayer, so it would have to be modulated according to certain variables, namely the number of people in the household.

1% of the EU's GNP. Equity would also be generically ensured, both horizontal (that is, between taxpayers resident in different Member-States), and vertical (since the taxation could be progressive).

The biggest problem, aside from, as in other cases, the question of political will, would be the high costs of administration, execution and control of this tax, to a certain extent duplicating the national situation.

(iii) As a third alternative, a surcharge could be applied to the amount of national income tax owed by each individual and the revenue would revert directly to the community budget.

This case would have the advantage of not implying high costs of administration, execution and control and it would enable a volume of resources identical to that of the previous proposal. On the other hand, the surcharge would be clear on each individual declaration (and notice of payment), enabling, as in other cases, taxpayers to know the value of their contribution to the EU budget.

However, the proposal could present some problems from the point of view of horizontal equity: although progressivity would be kept within each Member-State, the use of an identical surcharge for all could lead to an unacceptable inequity between countries, resulting from differences in their taxation systems.

This situation could be resolved in two ways. On the one hand, harmonisation of the systems could be significantly improved, which seems a somewhat complicated task, even in the medium term. On the other hand, and more feasible, the surcharge could be modulated taking into account national differences.

At this level, some proposals have already been put forward, namely by Biehl (1990) or El-Agraa (1990), involving a two-stage procedure: (i) determination of the value of the contribution of each Member-State, based on certain relevant variables (for instance, per capita income) and taking into account some progressivity in terms of the level of each State's development; (ii) determination of the surcharge on the payment of the personal income tax in each State, so as to produce the objective volume of revenue.

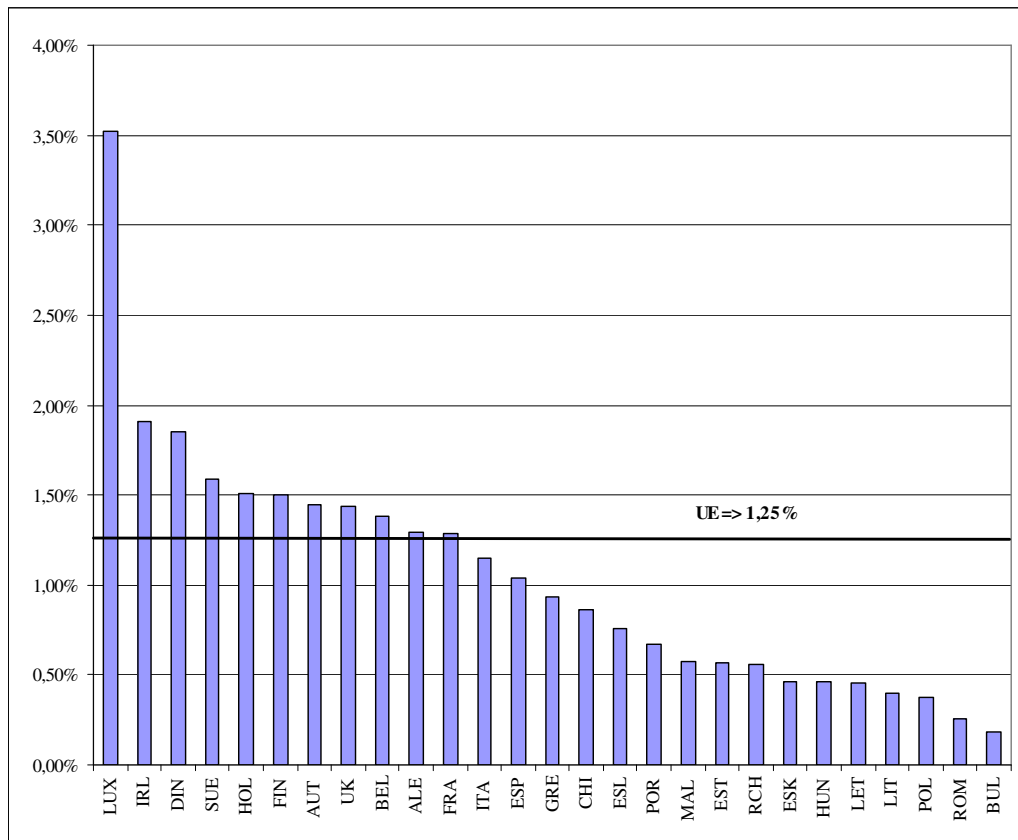
Of the three possibilities presented, the latter seems likely to have the greatest chance of being introduced successfully, since it guarantees the same advantages as the previous ones at the same time as enabling the consideration of equity mechanisms and the non-occurrence of high operating costs.

In this context, the proposals of Biehl (1990) and El-Agraa (1990) are now taken up, simulating the meaning of this surcharge for the year 2008, with the EU composed of the present 27 Member-States and assuming a community budget equivalent to 1.25% of the EU's GNP (that is, approximately the maximum foreseen in the financial perspectives for the period 2007-2013), covered entirely by this resource. Note that the same values would be valid for the case of adding this resource to the existing ones, increasing the size of the community budget to a maximum of around 2.5% of the Union's GNP (that is, similar to that recommended in the MacDougall Report – Commission des Communautés Européennes, 1977 – as a minimum prerequisite for the successful functioning of a monetary union in Europe.).

Fig. 3 summarises the main results of the simulation, showing the value of the contributions per country, in percentage of their GNP. These figures would correspond to the overall increase in payments of personal income tax that would occur in each country. The amounts do not seem too heavy, varying between 0.18% in Bulgaria and 1.91% in Ireland, with the Luxembourg case clearly being an outlier.

From the overall value of the contribution, the surcharge would be determined for each country, thus allowing to vary according to the characteristics of the respective taxation system and its level of economic development. In any case, assuming an average size for the value of taxation on personal income similar to those mentioned in hypothesis (ii), that is, around 10% of the product, the average value of the surcharge would be around 12.5%. Finally, note that the relation between the value of the surcharge in the country and the average in the EU would allow the degree of progressivity of this scheme to be observed.

**Figure 3 – Payments in 2008, from a surcharge on personal income tax (% GNP)**



Source: European Economy (2007), authors' calculations.

## 6. Concluding remarks

In a situation that is clearly different from other political entities with a single currency and from what would be characterised by following the teachings of the fiscal federalism theory, the EU at present has rather low financial autonomy.

This is a situation that needs to be reformed, should the EU really wish to take on new objectives effectively (justice, security, foreign affairs, citizenship, etc.), develop relevant tasks at the level of macroeconomic stabilisation, or focus on actions in the area of economic and social cohesion. It is unlikely that these tasks will be achieved unless there are more financial resources, even if the size of these barely reached values higher than 3% to 5% of the GNP. Equally, the move towards stronger political integration (possibly a “Federation of Nation-States”) would require strengthening of the central budget.

In this context, a significant change in the financing framework of the EU would become necessary. Throughout this paper, we have gone through the possible lines of reform, sustained fundamentally on proposals that have been put forward in recent years, both by independent economists and by the European Commission itself. These proposals have been developed along two main lines: on the one hand, simplification of the present regime of own resources; on the other hand, expansion of the revenue including the introduction of new own resources. Our attention has been focused on this latter aspect.

At this level, the application of the principles of taxation proposed in the fiscal federalism theory seem to validate some of the proposals considered by the European Commission as being potentially more successful, particularly resources based on the taxation of energy consumption or the income of corporations and the modulated VAT resource.

In any case, it seems to us that, from the point of view of visibility and approximation of citizens to the financing and functioning of the EU, a resource based on the taxation of personal income would be ideal.

Since it would seem that the possibility of determining an identical amount for all EU citizens would have to be disregarded for reasons of equity, and the possibility of a double determination of the tax (with two declarations, one European and another national) seems unviable because of the operating costs involved, a good possibility would be the application of a surcharge on the amounts paid as a national tax, with the revenue from this going directly to the EU budget.

As we have seen, any of these possibilities (and, in particular, the latter) would allow for full financing of the community budget with its present size without greatly increasing the tax burden.

An increase in its size could, in a first stage, involve adding the new resource to the present ones. This situation, as well as any other meaning a deeper adjustment of the size of the community budget, should necessarily involve some reduction in the tax burden aimed at national budgets. This would be justified by the fact that part of the national competencies will also be transferred to the domain of the Union, in more clearly supranational areas. And this is a very interesting aspect that is open to future research.

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