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Competition, Cooperation, Solidarity

Funding the EU Budget with a Genuine Own Ressource: The Case for a European Tax

This study aims to contribute to the current debate on the creation of a genuine EU own resource. The purpose is not to add new proposals to those already put forward by the Commission or by other scholars, but to clarify the economic and political criteria that will have to be brought to bear on the choice of an adequate tax instrument for the European Union. On the basis of these criteria, the various EU tax candidates are assessed and a rough estimate of their respective potential receipts is reported. The study also discusses the political and technical difficulties facing the introduction of an EU tax and explores the possible avenues for implementing the most promising EU tax proposals.

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By Jacques Le Cacheux

THIS PAPER WAS WRITTEN FOR *NOTRE EUROPE*. IT HAS GREATLY BENEFITED FROM COMMENTS ON EARLY DRAFTS BY TERESA BOMBA, STEPHEN BOUCHER AND EULALIA RUBIO, OF *NOTRE EUROPE*. THE AUTHOR IS ALSO GRATEFUL TO PARTICIPANTS TO A SEMINAR HELD IN BRUSSELS ON MARCH 14, 2007, FOR THEIR MANY CONSTRUCTIVE REMARKS AND ENCOURAGEMENTS. THE USUAL DISCLAIMER APPLIES.



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Since September 1996, he is *Professor of Economics*, Université de Pau et des Pays de l'Adour. He has been working at OFCE (Observatoire français des conjonctures économiques) since 1983 and has been the *Director* of its Economics Research Department since 1993. He also teaches at the Paris Institute for Political Science (IEPP/Sciences Po), Stanford University in Paris, European Online Academy, and Collège des Hautes Etudes Européennes. He has studied economics and political science in Paris and has the *Diploma of the IEPP* (Sciences Po) and the *Maîtrise d'économie* of the University of Paris I-Panthéon-Sorbonne. He took his *Ph.D* in economics at the *European University Institute* (Florence, Italy). He works on European integration issues, taxation and international macroeconomics. He has been a member of the *INGENUE Team* since the launching of the project, in 1999, and a member of various European research projects and networks financed by the EC Commission (*EUROMOD*, *MOCHO*, *EUROCAP*, *GOVECOP*, *CONNEX*, *EU-CONSENT*). He has published articles in many journals, including *Revue de l'OFCE*, *Revue économique*, *Revue d'économie politique*, *American Economic Review*, *Economic Modelling*, etc., and collective volumes. Editor of *Europe : La nouvelle vague – Perspectives économiques de l'élargissement*, (1996), Collection « Références/OFCE », Presses de Sciences. Co-author and co-editor, with Jean-Paul Fitoussi of the annual *L'état de l'Union européenne*, Fayard and Presses de Sciences Po, now also published in English by Palgrave (*Report on the state of the European Union*). Co-author, with Christian Saint-Etienne, of a tax reform proposal published with the title *Croissance équitable et concurrence fiscale*, by the CAE (Council of Economic Advisers of the Prime Minister) (*CAE Reports*, n°56, La Documentation française, October 2005).

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Foreword

The latest compromise on the EU financial perspectives for the period 2007-13 has been difficult to adopt and is notoriously unsatisfactory. One of the main reasons explaining the difficulties to reach an optimal agreement is member states' tendency to regard the EU budget as a sort of zero-sum bargaining game in which national net contributions should balance each other. This behaviour gives rise repeatedly to opportunistic strategies and national self-interest.

Notre Europe stressed this matter in 2005, with the publication of a study commissioned to Jacques Le Cacheux. In this first study, Prof. Le Cacheux highlighted the existence of a link between the EU dependency on national GDP-based contribution and the logic of 'net returns'. The argument was straightforward: so long as the EU budget is funded through national GDP-based contributions, it will be tempting for member states to calculate their 'national contributions' and to fall into an 'accountancy logic'. The study hence concluded the need to increase the EU's financial autonomy with a genuine EU own resource.

But is there a case for an EU tax? If so, it is possible to determine which tax instrument would be the most appropriate for the EU? And which sort of technical and political difficulties would such an introduction of an EU tax face? These are the key questions addressed in this second contribution of Jacques Le Cacheux to the debate on the EU budget reform. Through a clear and systematic description of the various drawbacks of the current funding system, the author convinces the reader on the need to plea for an EU tax. The paper makes clear that, no matter the instrument chosen, the move to a genuine own resource-funding scheme will improve budgetary decisions at the EU level. A move in this direction would not only reduce the EU dependency on national contributions, it would also introduce greater visibility and legitimacy into the EU funding scheme. In short, it would create a

direct fiscal link between the EU and its citizens, thus enhancing the political accountability of the EU and contributing to the reduction of the perception of a 'democratic deficit'.

The second important message of this paper is that the choice of an EU tax instrument is ultimately political. None of the proposals for an EU tax under debate is unequivocally better than the other. Each has its own advantages and drawbacks. The choice of an EU tax cannot be exclusively grounded on technical considerations: it requires making political compromises with respect to the relative weight given to different, sometimes contradictory, criteria. A tax exclusively grounded on economic efficiency considerations, for instance, would possibly score badly with respect to the criteria of equity, and vice versa.

The potential trade-offs in the selection of an EU tax however go much beyond the classical efficiency vs. equity trade-off. As the author points out, the selection of an EU tax should take into account a fairly large number of criteria. Some are regarded as 'universal', in the sense that they apply to any tax system – efficiency, interpersonal equity, buoyancy -, while others apply specifically to pseudo-federal governmental contexts such as the EU – in particular whether the tax helps prevent horizontal tax competition, whether it guarantees a fair distribution of the financial burden among the sub-federal entities, and whether it is used to induce sub-federal governments to adjust their policies to the federal policy goals. The importance of this second group of criteria should not be underestimated. This is no doubt the third important message of the analysis, which distinguishes it most from other papers reviewing and assessing the appropriateness of different EU tax candidates.

The announcement of a mid-term budgetary review for 2008/2009, "covering all aspects of EU spending (...) and of resources", has re-opened the debate on the reform of the EU funding system. With this study, Notre Europe expects to contribute to an informed and forward-looking discussion on the issue and the prospects of creating an EU tax. As the paper highlights, creating a tax for Europe would not be a big technical challenge. There are various perfectly credible proposals which satisfy the generally agreed requisites for an EU tax. The biggest challenge will be to convince all stakeholders – EU institutions, national governments, EU citizens – of the advantages of creating a genuine own-resource based scheme for Europe. This, in turn, will require efforts to neutralise widespread misconceptions, such as the idea that an EU tax would necessarily lead to an increase in the overall tax burden for citizens. It will also require a more extensive effort to publicise the advantages of having an EU tax, which are hardly understood by the majority of citizens and national politicians.

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Introduction

The EU budget is a reflection of the general state of the European integration process. Widespread dissatisfaction with its current mechanisms and achievements is therefore to be taken seriously. The protracted negotiations on the 2007-2013 EU medium-term financial perspectives and the almost unanimous, bi-partisan rejection in January 2006 by the European Parliament of the final December 2005 compromise painstakingly built by the EU Council have clearly provided ample evidence of the highly unsatisfactory character of the EU budgetary procedure and its outcomes. Indeed, while reporting on the “success” of the budget negotiations and on the happy end of a stalemate that had started with the failure of the June 2005 Council to agree on the financial perspectives, the December 2005 Council conclusions immediately called for a mid-term review in 2008-2009 and asked the Commission to prepare proposals for a reform of the EU budget resource system. Similarly, while eventually adopting a slightly amended budget proposal after a tri-institutional compromise in April 2006, the European Parliament decided to harden the mandate of the Commission for proposing the creation of a genuine own resource for the EU budget. In its June 2006 Report on the Council decision on the system of the European Communities’ own resources (EU Parliament, 2006), the Parliament explicitly makes the current system of national contributions responsible, at least in part, for what it regards as the unsatisfactory functioning and outcome of the recent European budgetary negotiations: “...the aim of such review should be to reach agreement on a new, comprehensive financial system ..., and pointed out that, in particular, the system of own resources as well as the expenditure side needed to be reformed urgently *in order to avoid the same painful experience of national bargaining for the next financial framework*.” (Amendment to Art. 5, italics added). That the European Parliament expressed such a strong position on the necessity to reform the budget and its funding should not come as a surprise: indeed, the long tradition of

Western representative democracy has been built on the principle that the power to tax is an essential ingredient of democracy, and should be exercised by the elected Parliament.

This study has the limited ambition of exploring only one aspect of the EU budget, namely the financing issue, in order to contribute to the upcoming debate. The aim is not to add new proposals to those already put forward by the Commission (2004) and extensively discussed in other studies (see especially: Cattoir, 2004; SGES, 2005), but rather to provide a systematic and synthetic review of the main options. This will shed light on the trade-offs that will have to be faced when making decisions. After recalling the major features of the current EU budget procedures and financing mechanisms and showing the numerous problems they give rise to and objections they raise (Section 1), Section 2 offers a brief analysis of the criteria that should reasonably be taken into account when selecting a tax instrument for financing the EU budget: it is shown that the list of such criteria does not exactly match the one that could be established for a national budget, according to standard public finance theory, due to the specific character of the EU and its peculiar brand of federalism. Section 3 goes on to review the main tax instruments that have been proposed and tries to assess how well each of them would fare according to the various criteria proposed in the previous section. Section 4 reports the results of an attempt at roughly estimating the amounts that might be raised with the various tax instruments discussed above, based on implicit tax rates calculated from the macroeconomic and tax receipt data. Section 5 offers a brief discussion of some of the difficulties facing the introduction of a European tax, and explores some of the possible avenues for practically implementing the most promising proposals. The final section contains a summary and concluding remarks.

I - Major Shortcomings and flaws in the current budgetary elaboration and decision-making procedures

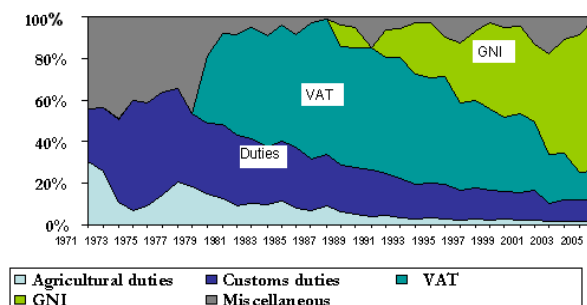
Dissatisfaction about the outcome of the recent budget negotiations, and hence general discontent with the main features of the 2007-2013 medium-term financial perspectives, even before they apply, are mostly due to the decision-making process, in which decisions concerning the expenditures and those concerning funding are made simultaneously for a long period of time. On the one hand, the way financing obligations are distributed amongst member states has increasingly been itself the object of negotiations, national governments trying to minimise national contributions. On the other hand, the rules and mores governing the elaboration of the budget financial framework are intrinsically conducive to biases that almost inevitably result in collectively inefficient outcomes.

1.1 - A brief history of the EU budget and its financing

In theory, the financing mechanisms of the EU budget have been based on a system of “own resources” since the early 1970s. In practice though, the so-called “traditional own resources” (TOR) – i.e. the receipts from the common external tariff on extra-European imports and the levy on agricultural imports – have been progressively dwarfed by the growing size of the EU budget and, more importantly still, the shrinking amounts derived from tariffs. This sharp and continuing decrease was itself engineered by the developments in the common trade policy, leading, in the global framework of the GATT agreements and, more recently, of the World Trade Organisation (WTO) negotiations, to a drastic reduction in external tariffs and agricultural import levies (converted into a fixed tariff since 1995). It also resulted from self-sufficiency in agriculture production and from the preferential treatment granted to many of the less-developed countries from which agricultural imports enter the EU internal market.

These weaknesses were already apparent in the late 1970s, when it was decided, in 1979, to add a new “own resource”, a levy on national VAT receipts, with, initially, a uniform call rate. The VAT had then just been generalised to all European Community member states, with its adoption by then new comers, including the UK, and the 1977 VAT directive had broadly harmonised the conditions under which it was being levied in all member states; in addition, it was widely regarded as a fairly neutral and buoyant tax instrument that would provide ample resources for the then rapidly inflating EU budget, eaten up by market support expenditures in the framework of the Common agricultural policy (CAP) and having to face growing demands on the newly introduced structural funds. Though convenient and, in many respects, satisfactory, the VAT own resource soon became insufficient for financing growing expenditure needs. It also became unpopular among some EU national governments, mostly because it was regarded as unfair, given the wide differences existing in tax bases.

Chart 1: European budget own resources (proportion of total revenue 1971-2005)



Source: European Commission.

The 1988 Brussels summit introduced a new “own resource”, namely the now dominant GNP/GNI resource (see Chart 1). Although the latter presented the clear advantage of providing a source of financing whose receipts would automatically grow along with the economies of member states, it also soon proved “too buoyant” and was increasingly regarded as unfair, feeding the then mounting controversies on “fairness” and “net national contributions”¹. This led many national governments to call for a cap on the overall size of the budget, also introduced at the 1988 Brussels summit. This limit was later to be raised to the current 1.27% of GDP (1.25% of GNI) ceiling by the Edinburgh agreement of December 1992.

Even though the current funding system, essentially fed by GNI-based national contributions, may be regarded as relatively satisfactory, because it is, at least apparently, simple and seems to provide adequate financing for EU expenditures, it has the major inconvenience of focusing the attention of national governments and national parliaments – who then have to vote every year on the national contribution, treated as an expenditure item in the national budgetary processes. It is therefore tempting to regard this contribution as a fee for membership in the EU “club”, and to compare it to an evaluation of the (private) benefits derived from being a member. Hence the domination, in the last two rounds of negotiations over the medium-term financial frameworks – that of “Agenda 2000”, covering the period 2000-2006 and painstakingly adopted in Berlin in April 1999, and the one covering the 2007-2013 period, whose elaboration and final adoption have taken more than two years and given rise to so many difficulties, both in the Council and in the EU Parliament — of what may be called an “accounting logic” (Fayolle and Le Cacheux, 1999) almost exclusively guided by the – largely meaningless and flawed — notions of “net national contributions” and “fair return” (Le Cacheux, 2005b).

More damaging still are the problems of visibility and legitimacy that are inherent in the current funding scheme. Indeed the European citizens are fully ignorant of the European budget: they do not have the slightest idea of the total amount it represents, of what it does, of how it is funded. And the almost exclusive reliance on national contributions makes it look like the financing of any international organisation, such as the UN, or even of faraway empires.

WITH THE CURRENT FUNDING SYSTEM, ESSENTIALLY FED BY GNI-BASED NATIONAL CONTRIBUTIONS, IT IS TEMPTING FOR MEMBER STATES TO CALCULATE THEIR ‘NET RETURN’.

¹ For a critical analysis of the notion of “net national contributions” and of the way EU budget negotiations have been dominated by requirements of “*juste retour*”, see Le Cacheux, 2004a and 2005b.

1.2 - Multi-annual budgeting and unanimity

Though initially designed with reasonable, and in some cases even commendable, objectives, the procedures for deciding over the EU budget have increasingly shown stark weaknesses and flaws in the recent episodes of negotiations over the current and the next medium-term financial perspectives. At least three features of the budgetary decision-making process, none of which was included in the initial institutional arrangements of the Rome treaty, may be regarded as sources of trouble, especially when taken together: the **binding medium-term financial planning**, the **unanimity rule**, and the **almost exclusive reliance on national contributions** for financing the EU budget.

1.2.1 - Planning for the medium-term

Initially conceived to provide visibility and stability to the process of expenditure planning, especially in such areas as public infrastructures, where the rule of “additionality” applies to EU financing, as well as to avoid annual stalemates resulting from recurrent conflicts between the European Parliament and the Council, the medium-term financial perspectives, first introduced by the then-president of the Commission Jacques Delors in 1988, have indeed had the effect of making budget decisions, hence also conflicts between EU institutions, less frequent. But as a counterpart, it has introduced considerable inertia in the budgetary process, which may be deemed damaging from at least two points of view.

One is **efficiency**, in the sense of adequacy of means with current goals and declared priorities. This first drawback may be simply illustrated by referring to the often-mentioned lack of adequate financing for the Lisbon strategy (see, e.g., Sapir et alii, 2004). The sequence of decisions is in itself telling: the current medium-term financial framework (“Agenda 2000”) was elaborated by the Santer Commission, even before the actual launching of the Euro and the conclusion of the enlargement negotiations with Central and Eastern European candidate countries, then negotiated by national representatives over the winter 1998-1999, to be finally adopted, with great difficulties, in the Berlin summit of April 1999, precisely at a time when, in the aftermath of the Russian financial crisis, some European economies, and especially Germany, were experiencing a marked slowdown in economic activity, which luckily appears, in retrospect, to have been very short and probably overestimated. Exactly one year later, in a context of euphoria about the “new economy” and booming economic activity all over Europe, while the first signs of a recession were being felt in the US, the Lisbon Council meeting, elated by the good economic performance of the EU and the success of the new currency, then widely believed to function as a shield protecting Europe from the negative effects of the US recession, adopted the ambitious objectives of the Lisbon strategy. But the structure of the EU budget had been frozen for seven years the year before...

The second major drawback of a medium-term financial framework that is actually **binding**, leaving almost no margin of manoeuvre for reallocations of resources in case of changing circumstances or

objectives, and that covers such a long time span², may be regarded as yet another illustration of the problematic character of imposing “rules rather than discretion”³, and hence of what is sometimes referred to as the “democratic deficit” of the EU decision-making process. Indeed, using again the case of the current financial framework, it was initially conceived by the Santer Commission, then adopted by the Council and the European Parliament in 1999, before the European elections. Then it went into application in 2000, under the Prodi Commission and with a newly elected Parliament, but ran well into the mandates of, and hence was also binding for the Parliament elected in 2004 and the Barroso Commission, until 2006. Not to mention the changes affecting the composition of the Council in the meantime. The next financial framework, elaborated by the Prodi Commission in 2003-2004, eventually adopted by the Council in December 2005 and by the European Parliament in April 2006, will start being implemented in 2007 by the Barroso Commission. But, barring major changes in the already decided mid-term review (and revision?), it would also constrain the choices of the Parliament to be elected in 2009 and of the next Commission, who would then have to elaborate the next financial perspectives, for 2014-2020, to be implemented by two other legislatures in Parliament, as well as the next two Commissions. Thus, the people in power in the major EU institutions when the budget is conceived and elaborated are almost never those who will execute the decisions. In most instances, they are led to make decisions that effectively bind their successors, which clearly is a problem, and does not contribute to make clear and transparent the stakes of the democratic debate for European citizens.

The most serious drawbacks of the multi-annual budgetary procedure stem from the difference in length between the mandate of the Parliament and the Commission, on the one hand, and the budget's medium-term financial framework, on the other. And the problem would be made more acute in the case of a “genuine own resource” –i.e. a European tax—that would have been voted by the European Parliament: then, the lack of synchronicity between European elections and the major decisions on taxation and financing the EU budget would indeed appear in stark contradiction with the fundamental democratic principle of “no taxation without representation”. **A simple solution would be to keep the multi-annual procedure, that has many advantages, and switch back to the initial, five-year periodicity.**

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² Initially, financial planning covered only five years (the so-called “Delors Package I”, 1989-1993), then six (“Delors Package II”, 1994-1999), and now seven.

³ This is, of course, a well-known and long-standing debate in economic policy-making. For a thorough analysis of this debate in the context of EU economic policies, see Fitoussi, 2002. For an application to the EU budget process, see Le Cacheux, 2005c.

1.2.2 - Unanimity and national contributions: The deadly cocktail

Submitting EU budgetary decisions to unanimity was not in the Rome treaty. It came later, in 1966, as part of the Luxembourg compromise, as a way out of the long crisis between the French government and the Commission over budget priorities. The unanimity decision rule was, in effect, imposed by France as a means of protecting its own agricultural interests, then regarded as vital. Since then, decisions over the budget in the Council have been submitted to the unanimity rule.

Starting with Wicksell (1897), economists have advocated the merits of unanimity rules when it comes to preserving what may be called individual “integrity” (Laurent and Le Cacheux, 2006), i.e. to ensure that collective decision-making does not violate individual preferences of the members of the group. But it is precisely because each member then has a veto power that **recourse to this decision rule should be strictly limited to contexts in which violating one member’s preferences is deemed very damaging**. This is so, in particular, when adopting constitutional rules (Buchanan and Tullock, 1962; Laurent and Le Cacheux, 2006).

Wicksell himself advocated the unanimity decision rule in public finance; but he was well aware of the restrictive bias thus introduced and his rationale was precisely to prevent public infringements onto the private domain by strictly limiting public finance to the provision of what was later defined as “pure public good” (Samuelson, 1954; Buchanan, 1968). When analysing the respective merits and flaws of various collective decision rules, modern economic theory has generally recognised that outside this ideal and highly unlikely case, unanimity voting rules will be inefficient, because they prevent any collective action (Phelps, 1985), especially in large and heterogeneous groups⁴. One reason is that in large groups, individual members, especially small ones, will be tempted by opportunistic, “free-rider” strategies. The other reason is that most collective goods are not “pure”, in the classical sense of the term, nor are they financed by lump-sum taxes levied on individual members: in many cases, the benefits from their consumption are unevenly distributed, and they are financed by taxes related to members’ economic situation; and many items of public expenditure are explicitly designed for redistribution purposes.

In the EU budget context, **the combination of unanimity and national contributions may be regarded as a major source of trouble in collective decision-making**, especially because decisions are made simultaneously on expenditures, many of which are easily located in one or the other member state, and their financing by member states’ contributions (Le Cacheux, 2005b and c). Minimising the overall size of the budget in order to minimise “net national contributions” is inevitably the most tempting strategy for “net contributors”, whereas “net beneficiaries” will try to get the largest possible overall budget and individual transfers. Moreover, it tends to encourage petty bargaining and “pork-barrel” politics, as clearly demonstrated by the contents of the list of individual projects and expenditure items included in the annex of the December 2005 Council conclusions.

⁴ The consequences of heterogeneity in preferences are well known. Those of heterogeneity in size are analysed in Le Cacheux (2005a) and Laurent and Le Cacheux (2006).

II - Criteria for selecting an EU tax instrument

In its proposed amendments to the December 2005 Council decision on the reform of the own resource system, the EU Parliament (2006) writes: “agreement on a new, comprehensive financial system which is fair, buoyant, progressive and transparent and which equips the European Union with the ability to match its aspirations with own resources rather than contributions by the Member States...” (Amendment to Art. 5, *italics added*). The Parliament first emphasises the need for any such system to be transparent and simple, while stressing the lack of such qualities in the most recent decisions of the Council itself regarding EU budget funding, in particular with respect to the change in the uniform VAT call rate enacted by the Council on the same day.

Before reviewing the various tax instruments that have been proposed to finance the EU budget, it seems appropriate to discuss the criteria that will have to be used in the assessment of the candidates. The traditional literature on public finance in national contexts offers some guidance, by suggesting simple criteria that any tax system should fulfil; but in the current EU context, given the peculiar brand of federalism that has evolved over the years and the, sometimes contradictory, requirements of “integrity” and “efficiency” (Laurent and Le Cacheux, 2006), as well as specific views of “fairness”, that are to be imposed on the budgetary procedures, additional criteria should probably be considered, making the selection process even more demanding and complex. **The choice of a tax instrument for a given level of government is a political choice**, in the sense of necessitating a multi-dimensional trade-off amongst a fairly large number of criteria, some of which may be regarded as “universal”, others that specifically apply to federal, or multilevel governmental contexts.

2.1 - Generally agreed requisites for a tax system in a democracy with a free-market economy

Any mechanism designed to provide resources to a public budget in order to fund some collectively defined expenditures, should fulfil a number of general criteria, some of which appear to be common sense, other being derived from economic efficiency considerations.

2.1.1 - General criteria

Simplicity and **transparency** are traditionally regarded as overriding criteria for any budget financing system, especially a democracy, where citizens, or their representatives, are supposed to express their willingness to pay taxes, the famous “consent” (Buchanan and Tullock, 1962). Though self-evident virtues of any tax system, these two requisites always have to be mitigated by other considerations, so that in general tax systems, even those that have been carefully designed to match these two criteria, end up being more complex and less transparent than initially planned.

Buoyancy also appears in most preambles and tax law textbooks as a needed characteristic of tax systems. It refers to the potential of a tax instrument to raise revenue, in a static framework, but also to the dynamism of tax revenues, in response to changing economic conditions. The underlying reasoning is that the public agent should be equipped with a revenue-raising instrument that allows it to keep in line with the private sector, i.e. revenues should not fall behind the incomes of private agents, so that the financial means of government are at least effectively maintained in relative terms without having to change the parameters of the tax system. This argument is all the more important in contemporary economies, in which economic agents have to plan their decisions over a long time span, and hence need to form expectations about the future, on the basis of reliable perspectives on tax burdens, implying that stability of the tax system is a major ingredient of long-term visibility, itself a necessary condition for capital accumulation, investment and saving, hence economic growth.

2.1.2 - Criteria derived from economic efficiency and equity considerations

Economic analysis of the effects of taxation on incentives, hence on private sector choices to supply work, to save and consume, to invest, etc., points to additional criteria that tax instruments should aim at fulfilling, or at least that should be taken into account in the tradeoffs made when designing such instruments. It is well known that, apart from lump-sum taxes, all forms of taxation introduce relative price distortions that generate inefficiencies in the allocation of resources by the private sector and deadweight losses. Hence, it is impossible to conceive a tax system that is costless. But economic analysis also demonstrates that this inefficiency is related to the magnitude of the price distortion, itself dependent on the marginal effective rate of taxation. Therefore, **a tax system that aims at minimising inefficiency should be characterised by broad bases and low marginal rates**. In addition, as was demonstrated long ago by Ramsey (1927), the more price-inelastic the tax base is – i.e. the less it changes in reaction to relative price or tax rate modifications –, the less inefficient the tax instrument. In the current European context, characterised by internally mobile tax

bases, but also by international mobility of some of them, this Ramsey criterion has to be extended and interpreted broadly to include considerations about mobility of tax bases.

In a number of well-defined circumstances, efficiency may imply deliberately introducing price distortions: whenever there are negative external effects, market prices do not properly reflect social costs, and the Pigouvian solution to restore efficiency consists in introducing distortionary taxation in order to correct externalities and produce the right incentives; this is the well-known case for eco taxation.

But of course, efficiency is not the only criterion for a “good” tax system. It should also fulfil some “equity” requirement. The latter may have two distinct meanings: either “**horizontal equity**” (the equivalent in matters of taxation of the principle of “equal treatment of equals”) or “**vertical equity**” (traditionally understood to refer to ability to pay, and often also to some form of progressiveness in individual tax burdens). Whereas the former requirement is usually considered straightforward, it raises specific difficulties in federal or pseudo-federal systems such as the EU (see below). And the latter, though explicitly mentioned in all declarations of intentions for tax reforms – including the amendment from the EU Parliament cited above –, is particularly elusive in practice.

Indeed, the unavoidable trade-off between “efficiency” and “equity”, understood mostly as “vertical equity”, is at the heart of the economic analysis in terms of optimal taxation⁵. Although not easily transposed onto EU taxation choices, this central trade-off will have to be faced when discussing the various options.

2.2 - Specific criteria for a pre-federal EU

Whereas the criteria briefly presented above are of general application, the EU context, with its pseudo-federal, or pre-federal⁶, features, imposes to add other considerations, both in terms of efficiency and equity of tax instrument assignments in multilevel governmental frameworks, and in terms of a possible use of EU tax instruments as incentives on national or sub-national entities.

⁵ Mirrlees (1971). See also Saint-Etienne and Le Cacheux (2005) for an application in the context of a reform proposal for the French tax system in response to tax competition.

⁶ Strictly speaking, the advocacy of a genuine EU budget, funded by a genuine own resource voted by the EU Parliament, implies that the EU moves closer to a federal system. In the tradition of the economic analysis of “fiscal federalism”, the use of this term is rather loose. The term “pre-federal” is borrowed from the proposals of the MacDougall Report (EU Commission, 1977) where it was used to refer to a stage in which the central (European) budget is autonomous but still much smaller than in existing federations: the authors of the report mentioned a budget representing initially 2% of GDP, then growing to an intermediate size of 5-7% of GDP. By their standards, the current stage of the EU would have to be labelled “pre-pre-federal”...

2.2.1 - Horizontal and vertical tax competition

Whether or not tax competition amongst national governments within the EU to attract mobile tax bases –i.e. horizontal tax competition—is regarded as a serious problem in the current institutional setting of the EU⁷, the introduction of an EU tax will almost certainly modify the incentives of national governments to engage in such strategies. If the tax instrument chosen for the EU budget own

resource is one that is currently subject to intense tax competition among member states – i.e. **horizontal tax competition**, which seems to be particularly the case of the corporate income tax and of taxes on income from private financial asset holdings –, then it is likely to mitigate the tendency to under-tax: according to economic analysis (see, e.g., Touya, 2006), having a supranational authority levy a tax –which would thus introduce **vertical tax competition**, i.e. public authorities of different levels competing to tax the same tax base– would somewhat alleviate the pressure resulting from horizontal tax competition to reduce tax burdens on mobile factors and to produce a “race to the bottom” in tax rates. The introduction of a European tax may even be regarded, from this point of view, as a way of fostering some beneficial forms of tax cooperation.

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FORMS OF TAX

2.2.2 - Fairness in the EU context

In theory, **horizontal equity** means the equal treatment of equals, referring to individuals. In multilevel governmental settings and in particular in federations or pseudo-federal contexts, however, this notion is complicated by the consideration of another notion of “fairness” which refers to the component constituencies: ability to pay is often appreciated at the level of member states, not of individuals. And of course, the two usually differ immensely, insofar as income distributions within member states are different. Any supranational tax therefore has to result from a compromise between at least two notions of “fairness”, not to mention the regional component, which is so central in structural policies funded by the EU budget.

In the case of the EU budget, the initial situation is one in which the second meaning of “fairness” has been given considerable attention. The previous reform of the “own resource system” in effect exclusively emphasised this meaning by choosing the GDP-based national contribution formula⁸. And the protracted intergovernmental negotiations over the latest medium-term financial perspectives have shown that an exacerbated – and largely unfounded (Le Cacheux, 2005b) – measure of “fair” national contributions, understood as “net national contributions”, leads to an almost

⁷ It is well known that tax competition may have good and bad effects on the behaviours and choices of national governments: On one hand, competition forces governments to be efficient and not to indulge in wasteful activities, thus “taming the Leviathan”; on the other hand, it sets a “race to the bottom” in motion and will often result in under-provision of collective goods and services, as well as in over-taxation of immobile tax bases. There is a vast literature, both theoretical and empirical (in particular applied to the EU), on tax competition. For surveys, see Le Cacheux (2000), Laurent (2006).

⁸ There is also mounting evidence of the use of this notion in European states that are not explicitly federal, but have been engaging in ambitious devolution programs. Hence, in Spain and in Italy, for instance, the debate over inter-regional “fairness”, sometimes even framed in the (erroneous) notion of “net contributions”, has gained momentum.

impossible compromise and to a distribution of financial burdens that gives no weight to individual horizontal equity, and indeed not much to regional horizontal equity. But of course, the fact that a wrong measure of the “**fairness amongst member states**” has been used so far by no means implies that this notion is irrelevant or ill-founded. Indeed, some acceptable burden sharing for the financing of the EU budget will have to be found if a European tax is to be deemed acceptable by all.

2.2.3 - A Pigouvian brand of fiscal federalism?

While the overall objectives of non-distortionary and neutral taxes are almost always set forth in any list of criteria that a “good” tax system should fulfil, there are also cases in which economic analysis pleads for the introduction of deliberate distortions in the price system in order to induce some behaviours and discourage others. As already mentioned above, this Pigouvian logic calls for manipulating relative prices: in cases in which there are (positive or negative) external effects of private (or indeed governmental) decisions, then subsidies and taxes may be used to correct the “wrong” incentives that are present in the decentralized price mechanism⁹.

But this logic may be broadened to apply to the EU brand of federalism, where a high degree of decentralisation and a small central budget are regarded, at least presently, as essential ingredients of any legitimate institutional arrangement. Indeed, applying the Pigouvian logic would mean using the tax and expenditure items of the EU budget as incentive mechanisms for national governments, in order to induce them to carry out the common policies that have been deemed desirable by EU decision-making bodies. In both cases though, whether the Pigouvian logic is applied at the level of individual, private economic agents or at the level of member states, it would entail a departure from equity considerations, much in the same way as taxing tobacco or fossil fuels is orthogonal to personal income distribution considerations, and indeed often anti-redistributive¹⁰.

AN EU TAX MAY
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INDUCE
NATIONAL
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TO CARRY OUT
THE EU POLICIES

⁹ For a recent advocacy of these Pigouvian principles, see the Commission's report on the eco-taxes (EU Commission, 2007).

¹⁰ In principle though, they could be made compatible, insofar as the Pigouvian logic is based on relative, marginal costs, whereas redistribution is concerned with averages. Hence the effects of Pigouvian taxes on income distribution could, in theory, be compensated by lump-sum transfers.

III - A list of possible EU tax instruments

The need to reform the EU budget own resource system and the quest for genuine tax instruments to equip the EU with sufficient and, according to some criteria, satisfactory sources of funds in order to pursue common policies and objectives has long been recognised and has given rise to an already long list of candidates, inspired by current practices in existing federations and/or by the current situation of tax structures within the EU itself. Some proposals date back to the immediate aftermath of the Single European Act of 1986, when it was becoming increasingly clear that tax competition would likely intensify, that harmonization of national tax systems would not easily be forthcoming, and that granting a tax instrument to the EU budget might appear as an attractive way out of the dangers of unfettered tax competition (see, for instance, Sterdyniak et alii, 1991; Le Cacheux, 2000). More recently, the European Commission (2004b, and Cattoir, 2004) and the European Parliament (SGES, 2005; and European Parliament, 2006) have provided more extensive and systematic analyses of the most serious candidates for becoming a European tax instrument. This section reviews and summarizes these studies and their major conclusions. It also ranks the proposals according to the criteria discussed in the previous section.

3.1 - An EU indirect tax: European VAT or an excise duty?

Consumption taxes are currently a major source of tax revenues in all member states, and they are increasingly popular amongst OECD governments. In many countries, they are already shared in some way among various levels of governments. Broadly speaking, they are of two varieties: general consumption tax, the archetype of which is the Value Added Tax (VAT), but also sales tax; and specific consumption taxes, mostly excises duties (on fuels, tobacco, alcohol, pollutants, etc.). Each of these two categories may be considered a possible choice for a European tax instrument, with pros and cons on each choice.

3.1.1 - A European VAT

VAT has been generalised to all EU countries in the course of the 1970s, and adopted by all new members during their transformation into market economies in the early 1990s. Two European directives, in 1977 and 1991, have imposed relatively uniform taxation practices; the latter has also made some progress in the direction of harmonising tax bases, and imposed floors on the two major national rates –16% for the “normal” rate, 5% for the “reduced” rate. In a number of member countries, VAT is shared by the central and sub-national government levels. But VAT has retained the “destination principle”, so that it maintains a distinction between intra-European trade and domestic sales, hence some form of distortion in the Single Market¹¹.

Being a general tax on consumption, with a large base and relatively low rates, **VAT may be regarded as one of the most neutral forms of taxation**, also insofar as it does not tax savings: it corresponds to the ideal general consumption tax that many analysts¹² and policymakers have been advocating, even to replace personal income taxes, in the US in particular. But VAT is also often deemed unfair, as it taxes low-income individuals, who tend to consume a larger fraction of their income and save less, relative to high-income individuals. This vertical inequity of VAT is mitigated by the existence of a reduced rate on staples and other basic consumption goods.

In addition, in a world of low inflation and barring complete indexation of wages of consumer prices, a VAT obeying the “destination principle”—hence exonerating exports—is an instrument for indirectly taxing imports, therefore also a substitute for tariffs, that tend to be banned by international agreements on trade in the framework of WTO, and for currency devaluations, that are no longer possible within the Euro-zone, and are currently not being used in the context of monetary relations between the Euro-zone and the rest of the world. Such a tax can therefore be regarded as an

instrument of intra-EU tax competition when used by one national government¹³, which would constitute yet another argument in favour of some (minor actually) centralisation: the vertical competition thus introduced by allowing different government levels to tax the same base would mitigate the effects of existing horizontal tax competition.

Transferring a slice of VAT to the EU budget would be relatively easy, technically. It would not, initially, translate into any change in the overall rates of VAT taxation, so that EU taxpayers would barely notice it. The EU Parliament would then be responsible for voting the rate for this EU VAT. Apart from these advantages in terms of simplicity and transparency, the adoption of such an instrument would introduce a clear and relatively neutral principle of taxation, based on resident consumption expenditures, with distribution of the national tax burdens being determined by a simple, non manipulable mechanism. Moreover, the yield from VAT taxation is directly related to economic growth and less fluctuating than that from other taxes.

THE CREATION
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EUROPEAN VAT
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EXISTING
HORIZONTAL TAX
COMPETITION

3.1.2 - Excises duties and eco-taxation

Rather than using a general, broad-based consumption tax, it may be tempting to endow the EU budget with a specific consumption tax instrument, precisely because it would induce distortions of a kind that the EU authorities may actually want, or because it would allow the EU to tax activities that are seen as benefiting most from the existence of a European single market. The first rationale would correspond to the case with any of the major excise duties that are presently collected by national governments on **alcohol, tobacco, and fuels** in all EU countries, with the double –and partly contradictory– objective of raising revenue and increasing the relative price of the good being taxed in order to discourage its consumption. The same principles apply to the – so far relatively limited – **eco-taxation**, i.e. the taxation of activities damaging the environment. The second rationale applies to proposals in favour of taxing SMS or mobile phone communications, for instance: these activities are fast expanding and seem to benefit, through economies of scale, from the existence of a large market; because their absolute price is falling, thanks to technical progress and scale economies, imposing a (small) tax on these consumptions, or on the cash flows generated by them, would be relatively painless and yield buoyant revenues.

For other excises duties, there would, obviously, be clear advantages in using specific consumption taxation at the EU level. In the same way as VAT, it would help mitigate the current existing problems of horizontal tax competition amongst national governments, and may also help reduce fraud. In addition to raising revenue, it would flag the priorities of the EU and produce warranted price distortions –what is sometimes called the “**double dividend**” in the literature on eco-taxation.

¹¹ Failure to agree on an “origin principle”, for good reasons –it would have made VAT a tax on production, rather than a consumption tax, with related problems of competitiveness–, has also induced a high level of tax evasion and fraud: estimates of missing receipts run at about 10 to 15 per cent of the total yield. According to a recent Commission estimate (EU Commission, 2006), total EU tax fraud may amount to as much as €200 billion, i.e. 2 to 2.5 per cent of EU GDP, which is significant and much higher than the total EU budget. While bearing in mind that there is a large margin of uncertainty.

¹² One of the first economists to speak in favour of adopting such an instrument as the single, or at least major, source of revenue for governments was the late British economist Nicholas Kaldor, in 1955. See also the recent critical survey by Hines (2007).

¹³ See Creel and Le Cacheux, 2006, for an analysis of national strategies of “competitive disinflation” using tax instruments, in particular hikes in VAT rates, with special reference to Germany. For a more general analysis of incentives for national governments to embark on such non cooperative strategies, see Fitoussi and Le Cacheux, eds., 2007.

An EU excise duty on **motor fuels** or **fossil fuels** in general, or on kerosene (plane fuels, that presently bear almost no tax), or on hot-house gas emissions would combine reliable yield – at least in the short-run –, a relatively low administration cost and a price incentive to induce a general reduction in the taxed consumption or activity. Moreover, because such fuels are for the most part imported in the EU from the rest of the world, it would have an incidence partly on the rest of the world: in other words, exporters of fuels to the EU would bear part of the tax burden, which then acts as an import duty¹⁴.

3.2 - A European corporate income tax

The idea of using corporate income tax (CIT) as the major, or indeed even single, instrument to finance the EU budget has long been contemplated or advocated (Sterdyniak et alii, 1991; EC Commission, 2002). It is attractive in many respects, including some of the criteria discussed in the previous section. One major argument in favour of making (part of) the corporate income a European tax is that differences in current national corporate tax systems, both in the definition of the tax base and in rates, are a major source of distortions in location decisions of firms within the internal market and/or of profit-shifting within EU multinational corporations. For these reasons, the corporate income tax is currently an important instrument of tax competition among national governments in the EU, that has clearly resulted in a "race to the bottom" in statutory rates as well as in marginal and average effective tax rates on corporate profits, bringing EU national tax rates below those observed in the

rest of OECD countries (see, e.g. Devereux and Sorensen, 2006; Laurent, 2006). Some analysts may find that having to compete to attract tax bases is a welcome incentive for national governments to manage public finances in an efficient way and not to indulge in Leviathan strategies¹⁵. It is however also widely recognised that compliance costs and other induced distortions for private firms may be very high. Many also stress the dangers of tax competition that is likely to yield sub-optimal levels of taxation and public goods provision, as well as unwanted distributions of tax burdens among different categories of taxpayers (see, e.g., Le Cacheux, 2000).

In addition to eliminating many of the above-mentioned distortions and difficulties, a European corporate income tax would not raise major issues of horizontal equity, and would make it very difficult, if not impossible, to ascertain the amounts paid by the various member countries, as a significant portion of the total tax yield would be paid by multinational corporations. Moreover, **the costs of administration of such a European tax would likely be relatively small**, given the fairly small number of

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CORPORATE TAX
SYSTEMS

¹⁴ See the recent Commission report on eco-taxation (EU Commission, 2007) as well as Hines (2007).

¹⁵ See Brennan and Buchanan (1980) for a classic exposition of arguments in favour of tax decentralisation in order to « tame the Leviathan ».

taxpayers. It could even become minute if, in the meantime, the Commission's proposal to harmonise the corporate income tax base¹⁶ has been adopted by all or at least by many member states¹⁷. And, the political acceptability of such a tax on businesses is probably higher, in most EU countries, than that of most other candidates.

If, in the coming years, the corporate income tax in the EU were to evolve into a broad-based¹⁸, fairly low rate¹⁹ tax on companies' profits, then making it, or part of it, a European tax would endow the EU budget with a resource instrument that would induce relatively little distortions, either in the owners of capital's decisions to save and invest in the EU economy, or in the economic decisions to invest, to produce, to hire workers, to locate in one EU country rather than another, etc. In addition, the definition of the tax base at the EU level, especially with regard to interest deductibility, depreciation allowances and other types of provisions allowed, would give EU tax policy the possibility of conducting a genuine industrial policy, making choices that would direct EU-based corporations towards certain types of investments – research, environmental protection, green-house gas emission limitations, etc.

In recent years, the receipts derived from corporate income taxation have, in most EU countries, and indeed in almost all OECD countries, been quite buoyant, so that the assignment of (part of) the corporate income tax to the EU budget would pass this criterion. **A difficulty would however be that business cycles induce relatively large fluctuations in the annual yield of the corporate income tax, which may conflict with the deficit ban on the EU budget.** This argument against this instrument may be mitigated in at least two respects: first, the fluctuations in CIT annual receipts have been much smaller over recent years than in the past (EC Commission and Eurostat, 2006); second, such fluctuations would not necessarily generate deficits, provided the initial scaling of the tax were chosen in such a way as to provide some excessive yield in "good times", that could be saved in a "buffer stock", or "rainy day" stabilization fund.

3.3 - Other tax instruments?

Other taxes have, at one stage or another of the debate on the EU budget's own resources, been considered as possible candidates. Among these, a European **personal income tax** on EU residents' private incomes has sometimes been advocated (e.g., Gil-Robles, 1998). The major advantages of such a solution would be that it would replace part of an existing, national tax

¹⁶ Since 2003, the Commission has been trying to push a proposal, called the Common Consolidated Corporate Harmonized Tax Base (CCCTHB). See, EU Commission, 2003.

¹⁷ Commissioner Kovacs, in charge of the Tax and Customs Union portfolio, has often advocated recourse to the enhanced cooperation procedure in the – highly likely – case in which the CCCTHB proposal would not gain unanimous support from member state governments.

¹⁸ See Devereux and Sorensen (2005) for an exhaustive analysis of the respective merits of various reform proposals for the corporate income tax.

¹⁹ It is argued in Saint-Etienne and Le Cacheux (2005) that the current trends in corporate income tax in the EU will probably lead to a statutory rate that, in most small EU member states will be around 12 to 15%.

instrument, would be broad-based and low rate, hence not very distortionary, and that it would make EU citizens aware of their financial participation in the functioning of the Union, an argument often found in discussions on the democratic character of EU institutions. But it is very likely that such a tax would fail to gain political support. It would also be objectionable from the point of view of equity, both horizontal and vertical: unless a thorough harmonisation of the tax base were agreed, a simple addition of an "EU surcharge" on existing national income taxes would make individual tax bills highly unequal for citizens in similar economic conditions, simply because of large differences in the definition of personal taxable income²⁰; and given the significant dispersion of living standards among EU countries, a flat-rate income tax might well be judged highly unfair from a vertical equity point of view, as it would hardly reflect ability to pay.

However, rather than a general income tax, a possibility may be to introduce a **European tax on income from personal financial assets**. Of course, many economists –and others—would object to an instrument that is often seen as penalising a "virtuous" choice on the part of individuals, and that is sometimes presented as "double taxation". But income from private asset holdings is currently taxed in all EU countries. The "savings directive" (2000) has to some extent harmonised the conditions in which non-residents' incomes from savings should be treated. And it seems that the implementation of the directive is highly problematic, especially with respect to the obligation for information exchanges among national tax authorities. As is well-known, the directive offers the countries that, for reasons of bank secrecy, do not want to comply with information exchange obligations, the option of applying a 15%²¹, flat-rate taxation on non-residents' incomes from savings invested in the country. Thus, there already is the premise of a single rate, acting as a floor on national tax rates, which could then be used as an EU tax instrument, which may be popular in some quarters, but the yield of which is, however, difficult to ascertain with existing data.

IV - Assessing the potential receipts from various EU taxes

Given the current size of the EU budget – a little less than 1.1% of EU GNI, i.e. about €115 billion in 2006 – and the very modest increase that has been decided in the next medium-term financial framework for the period 2007-2013 (the total budget is planned to end the period at 1% of GNI), **any EU tax instrument that is meant to cover the full cost, or a significant fraction of, total expenditure would not have to have a very high rate anyway**. For some of the previously discussed potential instruments, an assessment is relatively straightforward; for others, such as VAT, given the large differences in national rates and bases, an empirical estimate is less easy to obtain. Although a detailed assessment of each potential tax instrument's yield would require complex calculations to take account of specific characteristics of each national tax base and current rate, it is, in most cases, possible to get a rough idea of the required rate by using aggregate tax data from official (Eurostat) sources.

Thus, total receipts from VAT amounted to almost 7% of GDP in the EU25 in 2004, meaning that if it were decided to fund the EU budget entirely out of this resource, the European rate would have to be about 1/7 of the average current national rates. The average normal rate being around 20%, this would mean at least 2.5 percentage points of the normal VAT. However, this average hides a good deal of heterogeneity in national rates and bases, hence also in yields: the gap between the highest and the lowest share in GDP was a little less than 4 points of GDP in 2004.

Other types of indirect taxes on consumption or environmental taxes yield much lower receipts: the average yields of consumption and environmental taxes are very similar, at about 2.7% of GDP in 2004, with again a very marked heterogeneity amongst national situations. Based on averages, it

²⁰ Among many other differences, one may point to the many ways in which dependent children are taken into account in personal income tax calculations in the various EU countries (see, e.g., Marini, ed., 1999, for a review of current national practices).

²¹ The directive also includes the obligation for those countries to raise the rate to 20%, then to 25% in the next ten years, the idea being to induce non-information-exchanging countries to switch to information exchanges.

would be sufficient to set a European tax rate at about half of the current national rate to yield receipts of the order of magnitude of the EU budget size.

The present average yield of corporate income taxation in EU member states is also close to double the size of the EU budget – at 2.1% of GDP. Since the average statutory tax rate in the EU25 is currently about 20% - but, of course, with wide differences in nationally defined tax bases -, this suggests that a European corporate income tax rate at about 10%, i.e. at about the minimum level currently observed amongst national tax rates on corporate income in the EU, would suffice to fund the European budget. Just as is currently the case in the US, for instance, it would therefore be easy to introduce a European corporate income tax rate – after having harmonised the tax basis (cf. supra) -, then to leave national governments free to add up national corporate income taxation to this common tax rate, provided national governments all agree on some form of formula apportionment for the distribution of EU-wide tax base amongst national jurisdictions.

With regard to other mentioned tax instruments, evaluating the potential yield is even less straightforward, even approximately, insofar as there are no generally comparable data on the yield of corresponding national tax instruments. Because tax bases are highly dissimilar, a uniform EU rate would yield extremely uneven receipts, making these solutions much less attractive than the previous ones.

V – Practical aspects, political obstacles and feasibility issues

Opting for the introduction of a European tax, voted by the EU Parliament, would obviously imply solving a number of political and practical issues, some very important, others minor. In this section, only four such issues will be briefly mentioned: the number of tax instruments to be introduced at the EU level; the opportunities opened to national governments and parliaments by switching from the current funding mechanism based on national contributions to the European tax as an exclusive – or almost exclusive - own resource; the distributional issues involved; and the EU Balanced-budget rule.

Concerning the number of European tax instruments, it should be clear that the introduction of such a revolutionary move is politically so difficult as to avoid making the move more complicated by having several instruments: **a single European tax is therefore probably advisable, at least so long as the European budget is small and unique.** Obviously, having more than one instrument would make it easier to reach several objectives simultaneously; it would also mitigate the problem of receipt volatility (see below); but political feasibility clearly pleads in favour of simplicity. However, if the current split between the Euro-zone and the rest of the EU were to last for significantly longer than originally planned in the Maastricht treaty, then it may make sense to have two distinct budgets, fulfilling different functions and financed with separate tax instruments: hence, for instance, if the idea of creating a “European Community of Environment, Energy, and Research” (ECEER) (Fitoussi and Le Cacheux, 2007) were to materialize for the EU27, it would make sense for it to have a separate budget – just as the late European Coal and Steel Community (ECSC) had its own budget— financed by some variant of an eco-tax, while the Euro-zone would be better off with a budget of its own, that would serve other goals –in particular aiming at tighter financial solidarity, better cyclical

stabilization, and possibly at a lesser intensity of tax competition--, funded with the proceeds of, say, a European corporate income tax. Though this dual organization of the budget and its financing may look too complex, it would help clarify the different stakes of emerging forms of "enhanced co-operations".

In practice, **switching from the current funding scheme to a genuine own resource system, whatever the precise choice made will mean that national budgets are immediately ridded of a significant expenditure item**, so that national governments and Parliaments can instantaneously reduce total tax receipts by the same amount. But whether they effectively do it, rather than reducing national budget deficits, or indeed increasing expenditures on other items, should clearly be left to the sovereign choice of nationally elected, legitimate authorities. And if they choose to cut the national tax burden by an amount equivalent to the reduced expenditure, they may of course exactly compensate the new European tax by cutting the corresponding national tax rate—say in the case of corporate income taxation, for instance, the sum of the new national rate and the European rate being then equal to the previous national rate; but here again, they should be left free to choose to do otherwise, especially in the case where the new European tax is an eco tax, for instance, or more generally a tax that many national governments would want to increase if economically and politically feasible.

Funding the EU budget with a European tax will, in almost all cases, change the distribution of financing burdens across member states compared to the current one, based on GDP contributions, which is likely to be a significant obstacle in the way of adopting such a genuine own resource system for the EU budget. A few examples may help understand the nature and extent of the problem. Consider, first, a tax on carbon emissions: obviously, it would impose a heavier burden on national economies relying on fossil fuels as major sources of energy, and a lesser one on countries, such as France, relying at least in part on nuclear energy. This feature may seem unfair, but it is no different in nature from what results from the use of such taxes within national economies: after all, the objective is indeed to make the use of carbon-emitting sources of energy more expensive. A possible solution would be to set up a mechanism for giving back part of the revenue, in the form of a lump-sum transfer, to the countries that are deemed to bear an excessive burden. The same mechanism could indeed be implemented in most of the cases considered above: indeed, a generalized correction mechanism, similar to the one proposed by the Commission in its 2004 budget proposal, but applying to gross, not net national contributions, could be envisaged to overcome the distributional consequences of adopting a European tax.

The switch to a funding scheme exclusively relying on a single European tax instrument will also undoubtedly pose a problem for the balanced-budget rule currently imposed on the European budget: indeed, the yield of the various tax instruments discussed above is likely to vary with business conditions, and this is especially true for corporate income tax yields, that are especially volatile. On the other hand, it is not advisable to have expenditures vary in the same way according to business conditions; indeed, it is often argued by economists that precisely the opposite is an important mechanism of automatic stabilization introduced by the functioning of the budget. But then, what would be the solution? The obvious one would be to authorize budget deficits, hence borrowing, at the EU level; but of course such a possibility may not be welcomed by national governments and Parliaments at a time when they have been subjected to the discipline of the

Stability and Growth Pact which imposes ceilings on national budget deficits and advocates budget balance in the medium run. An alternative would be to opt for a slightly "too high" tax rate at the EU level, in order to accumulate budgetary reserves—the kind of "rainy-day fund" advocated by some economists for national budgets—that would be decumulated in cases when the yield of the EU tax would not cover expenditures. Yet another possibility would be to retain the GNI resource as a residual resource, to be called upon to complete the receipts derived from the EU tax instrument.

Concluding remarks

Given the dissatisfaction about the recent budgetary decisions at the EU level, and more generally about the kind of policies that the current budgetary procedures and funding mechanisms allow EU authorities to pursue, there is a need to advance thinking on the issues raised by the EU budget and its funding scheme is all the more. The mid-term review that has been programmed in the conclusions of the December 2005 summit that adopted the medium-term financial perspectives for 2007-2013 will be coming soon and it seems important to equip all decision-makers, at the national and at the European levels, with elements of analysis that can shed light on the choices they will be facing. Clearly, and unsurprisingly, the EU Parliament is currently the political institution that has expressed the strongest interest in a move to a genuine own resource-funding scheme, based on a European tax. But the issue is also of paramount importance for national governments and Parliaments. Introducing a European tax would be a major milestone in the European integration, as it would bring more substance to the political dimension of the process, possibly leading to a clearer sharing of competences between EU authorities and between government levels, but also to more legitimacy of the European Parliament.

Coming after a few other papers on this issue, this study has tried to shed light on the economic considerations that will have to be brought to bear on the choice of an adequate tax instrument to finance EU expenditures, without passing judgment on the opportunity of increasing the size of the budget or of changing the relative weights of various expenditure items. Our analysis shows that there exists an array of tax instruments that could be considered for funding the EU budget. None is obvious; each has advantages and drawbacks, and each one scores better on some criteria than on

others. Of course, some instruments, such as corporate income taxation, have a clear advantage on purely economic grounds, while others, such as eco-taxes, would seem to be better tools to promote common goals and to be in a better position to win broad political support. In such a situation, the choice will through weighting the various criteria according and make what will be judged the most appropriate trade-offs" (trade-off is not a verb).

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