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Administrator at the European Commission, he works on the preparation of the next multiannual financial framework in DG Budget after dealing with EU taxation policy in DG Taxation and Customs Union.

Cooperation, Competition, Solidarity

Options for an EU Financing reform

This paper presents a reflection on the future of the EU budget, with a particular focus on EU financing. The debate on a reform of the EU financing system encompasses two main dimensions: on the one hand, the structure of EU financing and, in particular, whether the Union should be financed via «genuine own resources» or not; on the other hand, the correction mechanisms and the way to either eliminate or adapt them. These dimensions are analysed in depth in the paper. This allows presenting three main medium- to long-term scenarios for a financing reform.

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Options for an EU financing reform

Philippe CATTOIR

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Options for an EU financing reform

by Philippe CATTOIR



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Introduction

“Requisitions upon the States [have] the inevitable tendency [...] to enfeeble the Union, and sow the seeds of discord and contention between the federal head and its members, and between the members themselves”.

Alexander Hamilton, 1787

In accordance with the conclusions of the European Council of 15-16 December 2005, the Commission has been invited to “undertake a full, wide-ranging review covering all aspects of EU spending, including the Common Agricultural Policy, and of resources, including the United Kingdom rebate”¹.

1. See Declaration 3 to the Interinstitutional Agreement between the European Parliament, the Council and the Commission on budgetary discipline and sound financial management, 2006/C 139/01, 14.6.2006. The budget review is expected to take place during the first half of 2010, following the appointment of a new Commission.

The preparation of this budget review has given rise to a vast public consultation, numerous debates and an important political conference on the future of the EU budget². This paper constitutes one additional contribution to the reflection on the future of the EU budget, with a particular focus on the EU financing.

The debate on a reform of the EU financing system encompasses two main dimensions:

- The structure of EU financing and, in particular, whether the Union should be preferably financed via “genuine own resources”, such as customs duties, or through some forms of Member States contributions, such as the VAT- and GNI-based contributions ;
- The correction mechanisms and the way to either eliminate or adapt them.

In addition, a less debated element of the EU financing system is the mechanism(s) used to ensure budget balance and their link to the other features of the financing system.

These dimensions are systematically analysed in the paper. It presents and analyses the various constituting elements of the EU financing system as well as their interaction. This allows presenting three main medium- to long-term scenarios for a financing reform covering all these issues in a coherent way.

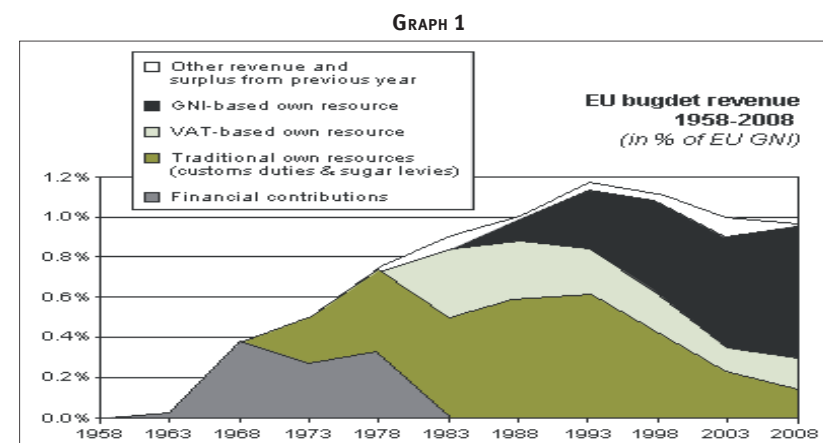
The paper starts with a short presentation and assessment of the current system in section 1 and 2. Options for reforming own resources are examined in section 3. The issue of corrections and equalization mechanisms comes next (section 4). The issue of budget balance is covered by section 5. Scenarios are presented in section 6. Section 7 concludes.

2. Extended information on the budget review process can be found on the European Commission website on http://ec.europa.eu/budget/reform/index_en.htm.

I - An overview of the current financing system

1.1. Key facts on the own resources

EU financing evolved considerably over time. Revenue increased continuously from 1958 until 1993 as a percentage of GNI and the system progressively shifted from a system of financial contributions to a system of own resources (see graph 1).



SOURCE: DG BUDGET WEB-SITE, EUROPEAN COMMISSION (2007)

According to the EU treaties, total EU revenue has to be equal to total expenditure and is required to stay within agreed legal limits, currently set at 1.31% of the EU gross national income (GNI) for appropriations for commitments and 1.24% of EU GNI for appropriations for payments.

There are three main own resources³:

- The first own resource (“traditional own resource” or TOR) are customs duties and resources of agricultural origin (sugar levies). A 25 % flat-rate deduction is retained at source by the Member States as collection costs.
- The second resource results from the application of a uniform rate to Member States’ value added tax (VAT) bases. This rate is applied to harmonised VAT bases that are restricted (capped) to 50% of the Member State’s GNI⁴.
- The third resource, the “additional” resource, results from the application of a uniform rate to Member States’ GNI bases, which is calculated in such a way as to cover the balance of total expenditure not covered by the other resources.

As noted in the consultation paper on the budget reform⁵, “*the own resources system has evolved significantly since the beginning of the first financial framework. In 1988, the GNI resource made up less than 11% of EU financing, compared to 28% provided by custom duties and agricultural levies and 57% by the VAT-based own resource. In 2013, the GNI resource will provide about 74% of the EU financing, against 13% for customs and agricultural levies and 12% for the VAT-based resource*”.

3. The EU financing system has recently been modified with the entry into force on 1st March 2009 of the Own Resources Decision 2007 (2007/436/EC, Euratom - OJ L 163 of 23/06/2007).

4. 13 Member States had their VAT bases capped in 2008: Bulgaria, the Czech Republic, Estonia, Ireland, Greece, Spain, Cyprus, Latvia, Luxembourg, Malta, Poland, Portugal and Slovenia.

5. See European Commission (2007).

TABLE 1

TYPE OF REVENUE	BUDGET 1988		BUDGET 2000		BUDGET 2010	
	EUR BILLION		EUR BILLION		EUR BILLION	
CUSTOMS DUTIES AND SUGAR LEVIES	11.9	28%	15.3	17%	14.2	12%
VAT OWN RESOURCE	25.0	57%	35.2	39%	14.0	11%
GNI OWN RESOURCE	4.2	11%	37.6	42%	92.7	76%
OTHER REVENUE	0.5	1%	1.6	2%	1.4	1%
TOTAL	41.6	100%	89.7	100%	122.3	100%

SOURCE: EU BUDGET FINANCIAL REPORT & PDB 2010

1.2. Key facts on the correction mechanisms

The existence of correction mechanisms is a specificity of the EU budget. Correction mechanisms were first introduced in the 1980s to solve, it was hoped, problems related to budgetary imbalances.

Since the 1984 Fontainebleau agreement –according to which “any Member State sustaining a budgetary burden which is excessive in relation to its relative prosperity may benefit from a correction at the appropriate time”– several permanent or temporary correction mechanisms have been introduced.

Corrections now exist on both the expenditure and the revenue side of the budget and they benefit to a large number of Member States. An own initiative resolution of the European Parliament (“the Lamassoure resolution”) identified 41 exceptions introduced by the European Council in December 2005 on the expenditure and revenue side of the budget⁶.

The most important correction mechanisms are on the revenue side. They present a collection of diverse measures, resulting from a series of succes-

6. See European Parliament resolution of 29 March 2007 on the future of the European Union’s own resources (2006/2205(INI)) - P6_TA-PROV(2007)0098.

sive negotiations, each time adding new measures on top of the body of existing corrections and characterized by a consistent reluctance to ever turn back the clock. The mechanisms include:

- The UK correction. It was agreed by the 1984 Fontainebleau European Council. Although the mechanism has been modified in the successive Own Resource Decisions (ORDs) its basic principle remained unchanged, namely to reimburse to the UK 66% of the difference between what the UK pays to the EU budget (except TOR) and what it receives from the budget⁷. The financing of the UK correction has also been modified over time, extending and reinforcing what is commonly known as “the rebates on the rebate” to the traditionally most important net contributors to the EU budget⁸. The December 2005 European Council decided to adjust the UK correction and agreed that non-agricultural expenditure in the new Member States will no longer be included in its calculation base⁹.
- The differentiated call-up rates for the VAT-based contribution. While Member States normally contribute 0,3% of their VAT assessment base to the EU budget, this percentage has been reduced for 4 Member States for the period 2007-2013 only¹⁰.
- Member States retain a fixed percentage of all traditional own resources collected. This percentage was fixed at 10% when these resources were first transferred to the EU budget in the early seventies. In 1999 the Berlin European Council decided to increase it to 25%.
- A further correction introduced by the 2005 December European Council is that both the Netherlands and Sweden receive, for the period 2007-2013 only, a gross reduction of their GNI contribution¹¹.

7. Any benefit or cost for the UK resulting from modifications introduced in the successive ORDs has been neutralized.

8. Since 2001, Germany, Austria, the Netherlands and Sweden pay only 25% of their normal financing share of the UK correction (Germany paid 2/3 of its normal financing from 1985 until 2000).

9. This is introduced progressively over the period 2009-2011. The maximum cost to the UK of this measure cannot exceed €10.5 billion (in 2004 prices) over the period 2007-2013.

10. Germany: 0,15%; Netherlands: 0,10%; Austria: 0,225%; Sweden: 0,10%.

11. The Netherlands €605 million and Sweden €150 million in 2004 prices.

On the expenditure side, various *ad hoc* payments have been granted to individual Member States or regions over the years (see the Lamassoure resolution). In practice, Member States benefiting from redistributive packages, such as the cohesion policy going to the poorer regions, see their benefit reduced through increased contributions to the budget to finance the corrections on the revenue side. Some of the corrections on the expenditure side in turn increase the UK correction.

II - Assessment of the current EU financing system

2.1. Assessment criteria

Reviewing the current financing system and proposing reforms requires robust assessment criteria¹². It is essential to identify quickly and clearly the main pros and cons related to constituting elements of a financing system –that is, the individual own resources as well as the correction mechanisms–, but also to the system as a whole, taking into account the interrelation between these elements.

Possible categories of criteria include:

- Budgetary criteria: ensuring a sufficient and stable EU financing and budgetary discipline.
- Integration criteria: ensuring financial autonomy, transparency and a link to EU policies. Another important aspect of this criterion is

12. See, for instance, Cattoir, Ph. (2004).

the principle of fiscal equivalence for the provision of (public) goods and services, i.e. that primarily those individuals benefiting from certain spending programmes should also be those financing it.

- Efficiency criteria: internalising externalities, implementing the subsidiarity principle, limiting operating costs of the system.
- Equity criteria: ensuring fairness at the level of Member States and horizontal and vertical equity for the taxpayers.

We examine these four dimensions in turn.

2.2. Budgetary criteria

The current financing system performs well in terms of budgetary criteria. The existence of a GNI-based residual contribution in combination with the Inter-institutional agreement, not least the existence of a multiannual financial framework, has ensured budgetary discipline and a smooth adoption of the EU budget since 1988. The size of the EU budget is now constrained by agreements on expenditure rather than scarcity of funding. This contrasts with the situation observed before¹³.

It should be noted, however, that this good performance on budgetary criteria could be achieved even with a very small residual GNI-based contribution (or with another type of residual contribution) and in combination with tax-based resources.

13. See European Commission (2008c), chapter 2 *et seq.*

2.3. Integration criteria

The current financing system performs very poorly in terms of integration criteria.

The financial autonomy of the Union is limited. The two largest sources of revenue –the VAT and GNI based own resources– display many of the characteristics of national contributions and are often perceived as such. They are provided by national Treasuries and are sometimes presented as an expenditure item in national budgets. In this sense, one can say that the financial autonomy of the Union is limited. This has a major negative consequence, as Member States often tend to judge EU policies and initiatives in terms of returns compared to their national contributions, rather than looking first at the overall value of pursuing certain policies at the European level.

Justifications for any notion of *juste retour* or net balances are rather weak. Le Cacheux (2005) demonstrates that the conventions which determine net balances calculations are fairly arbitrary. Revenue and expenditure allocation assumptions are highly questionable. This can be illustrated by European programmes such as Erasmus, under which exchanges of students between member countries of the Union are organised and financed. “*Do student exchanges benefit the state of origin of students leaving to study in another member state or the latter country? It is difficult to break down expenditure by beneficiary Member State except in very special cases*”. Furthermore, “*a geographical cost-benefit analysis in an economic and monetary union does not show what the net balances alone would appear to indicate*”: Community policies financed by the EU budget generate ‘mutual benefits’. In these positive sum games, the sum of the winners’ gains always represent more than the losses suffered by losers.¹⁴

14. See Le Cacheux, J. (2005).

The financing system is opaque and very complex. As a result, it is almost impossible for EU citizens to ascertain who effectively bears the cost of financing the EU. In particular, *“the ‘VAT-based’ resource is levied on a ‘virtual’ basis... which is complex to the point of incomprehensibility”*¹⁵. This raises doubts about the current funding scheme when it is assessed in terms of accountability. Indeed, according to the Court of Auditors, the current financing system is simply *“not fully auditable”*¹⁶. Furthermore, the EU budget is often presented as *“an insatiable and very costly Leviathan, sucking national resources to finance useless, or even harmful policies that benefit a few well-organized lobbies of producers –but when it comes to how much it actually levies on individual taxpayers, the amount quoted are usually grossly exaggerated”*¹⁷.

Lastly, except for the traditional own resources the current financing sources of the Union do not contribute to- or support EU policies. Some alternative own resources could contribute to achieving key EU policy objectives.

2.4. Efficiency criteria

The current system presents a mixed record in terms of efficiency criteria.

On the one hand, the reliance on mainly VAT- and GNI-based contributions from the Member States imposes limited operating costs and it is widely recognized that the procedures for calculating these resources work well.

On the other hand, contrarily to market-based instruments, the VAT- and GNI-based contributions do not seem to have an impact on behaviours.

15. Contribution of the European Court of Auditors to the budget review consultation, §26-28, 9 April 2008. All the contributions made for the budget review consultation can be found on the Commission website at http://ec.europa.eu/budget/reform/issues/read_en.htm

16. It should, however, be underlined that revenue is one section of the budget which has been granted unqualified discharge for many years.

17. See Begg *et al.* (2008).

As discussed in the next section, the use of alternative financing sources at EU level –such as tradable permits or taxes– could lead to efficiency gains in the form of economies of scale, reduced administrative costs or by taking into account cross-border externalities.

2.5. Equity criteria

The current system performs very poorly in terms of equity criteria.

Many Member States still perceive their contribution to- or benefits from the EU budget as being unfair¹⁸. Among the numerous inconsistencies and problems related to the correction mechanisms, it is useful to recall the following issues in particular:

- The main causes which led to set up the UK rebate have been largely attenuated. In the 1980s, a large budgetary imbalance for the UK was caused by two main factors: a relatively small agricultural sector, resulting in lower CAP payments in the UK, and a relatively high UK share in the harmonised VAT base, resulting in larger UK contributions to the Community budget financing, compared to the other Member States¹⁹. In 2013, CAP expenditure (both direct support and rural development) will represent around 40% of EU expenditure compared with 70% when the rebate system was introduced. The VAT-based resource is also much smaller as a proportion of EU revenues than in the 1980s. One could therefore argue that the two most important justifications for the existence of the current rebate system have changed significantly.

18. The contribution of the Polish government to the budget review (9.4.2008, pp. 8-9) states, for instance, that *“an increase of contributions to the EU budget based on GNI reinforces the pressure on increasing the total size of rebates granted to most affluent member states... the applied correction mechanisms the Community own resources system is of degressive character, imposing greater burdens on less affluent member states and citizens. Degressive character of own resources system results from [the] existence of rebates.”*

19. See European Commission (2008c).

- The corrections on the revenue side partially undo the impact of certain expenditure policies. It appears at best inconsistent that Member States benefiting from redistributive packages, such as the cohesion policy going to the poorer regions, see their benefit reduced through increased contributions to the budget to finance the corrections on the revenue side. Some of the corrections on the expenditure side would in turn increase the UK correction. Finally, some Member States receive corrections on both sides of the budget.
- The capping of the VAT-base is supposed to reflect the intention of remedying the regressive aspects of the VAT-based own resource, which is seen as disproportionately penalising the less affluent Member States, where the proportion of consumption as % of GNI tends to be higher. However, in practice, the size of the VAT base and therefore the effect of the capping is not proportional to Member States' GNI. Some of the richest Member States, such as Luxembourg and Ireland, are subject to capping and thus see their contributions reduced.
- The actual collection costs incurred by Member States have never been quantified and the collection costs retained are automatic and do not have to be justified. While the 10% retained until 2000 could reasonably be considered to be a compensation for expenses incurred by Member States (customs and audit services,...), this is probably no longer the case for the 25% collection costs, which were agreed to allow certain Member States to decrease their payments to the EU budget. For Member States that collect a large share of customs duties at important EU entry points, an increase of the collection costs represents a net decrease of their financial contribution to the EU budget (since the increase of the GNI contribution is smaller than the increase in the collection costs retained).

Overall, the focus on *juste retour* issues is probably an important factor explaining why the financial solidarity (total net transfers in percentage of GNI) operated through the EU budget has decreased over time²⁰.

Besides, it should be recalled that GNI is a rather crude and imperfect tool to measure economic prosperity and hence ability to pay in the context of EU financing²¹. Apart from these methodological measurement issues, there are also practical measurement issues, illustrated for instance by the considerable revaluation (around 10%) of the Greek GNI series in mid-2007. Overall, like for most statistical indicators, the harmonization of “*macro-economic statistics... could still be improved*”²². It should also be noted that agreed improvements in GNI measurement may not be easily applied to the calculation of own resources as appears from lengthy discussions on FISIM²³.

Lastly, the ultimate impact of Member States' contributions differs among taxpayers of various Member States, which raises issues of horizontal equity among EU taxpayers²⁴. Indeed, a closer look at national structures shows that income tax burdens and their interpersonal distribution vary greatly from country to country and the share and rates of VAT and other indirect taxes in total tax receipts also differ widely from one country to the other. Thus, the amount effectively paid by domestic consumers, but also the amount effectively borne by foreign producers for those taxes levied on imports (VAT) are actually very far from the apparent distribution of tax burdens.

20. See Richter, S. (2008).

21. Measurement problems can notably arise in the following areas: the underground economy; capital gains and losses (a capital income that is usually not counted in GNI); household services (meal preparation, cleaning, repairs and maintenance, child and adult care...); volunteer work; non-renewable natural resources (extraction of a mineral resource should be subtracted from the stock of capital since it cannot be replaced); imputed elements (outputs consumed by their producers, such as imputed residential rents from housing occupied by their owner and farm products); commuters/cross-border work.

See Aubut, J. and F. Vaillancourt (2001).

22. Contribution of the European Court of Auditors to the budget review consultation, §26, 9 April 2008.

23. See Council Regulation No 448/98, which completed and amended the European System of Accounts (ESA 95, as laid out in Commission Regulation No 2223/96 subsequently modified).

24. See Begg *et al.* (2008).

2.6. Overall assessment of the current financing system

Seen from a purely technical budgetary point of view, the current financing system is good. However, a similar performance could be achieved even with a very small residual GNI-based contribution and in combination with other resources. Another advantage of this system based on contributions is that the administration costs are limited.

The current financing system performs poorly with regard to all other relevant criteria. In particular, the current system is extremely complex and opaque. The increasing focus placed on a narrow ‘accounting’ approach with the main objective of maximising returns has led to tensions between Member States and has coloured the public debate about the value of EU spending and the benefits of EU membership itself. The reliance on Member States’ contributions could also reinforce Member States’ pervasive tendency to favour the most visible financial transfers to specific constituencies at the expense of less prominent programs displaying a higher EU added value. Lastly, national contributions display no link to- nor do they contribute to EU policies.

Faced with these arguments, it appears only legitimate to envisage alternative financial systems which guarantee sufficient resources for the EU budget while solving some of the issues highlighted here. Quantification through statistical and accounting-based indicators may be necessary but it should only be one factor among many others to define the future of the EU budget.

III - Reforming the own resources system

3.1. Approaches and criteria to reform own resources

Ideas to replace or supplement existing resources include the extension of the GNI resource or the creation of new, possibly tax-based, own resources in replacement of existing own resources. New possible resources mentioned in the past included a modulated VAT; resources related to corporate income (EUCIT); energy or pollution charges, including the auctioning of emission allowances in the framework of the European Emission Trading Scheme; excise duties on tobacco and alcohol; the transfer of seignorage revenue; communication charges (for instance on SMS); resources related to personal income and financial transactions. One could also add potential revenues from EU policies or spending programmes eventually generating revenues themselves, such as revenues from charging users of EU-(co)financed infrastructures or royalties from Galileo. Studies and

reports that have examined these options²⁵ in respect of relevant criteria have highlighted the pros and cons of various potential own resources. Clearly, “there is no such a thing as a perfect own resource for the EU: the main possible EU own resources perform well according to some criteria and less well according to others”²⁶. In short, it is difficult to conceive an ideal funding system, even more so when there is a mix of different resources and these are complemented by correction or equalization mechanisms (see section 3). The decision as to which criteria are essential and which secondary is political and should ultimately determine the choice between possible own resources.

This paper proposes to have a fresh look at some of these proposals. The analysis is structured around three approaches based on the categories of criteria described in section 2.1:

- The first approach focuses on budgetary criteria, and in particular on ensuring a stable and sufficient financing of the Union in line with the Member States financial capacity. This approach underlines the growing importance of the GNI-based resource (from 11% of EU financing in 1988 to around 76% in 2010) and suggests relying even more on this resource in the future.
- The second approach focuses on efficiency. An own resource should be attributed to the EU level only if this allowed for an increase in efficiency, for instance through decreased administrative costs, or effectiveness if it contributed to the achievement of important Community objectives. Potential resources examined in this context are based on energy taxation, charges on aviation, revenues from auctioning of emission allowances and EU corporate income taxation.

25. Useful references in this area include European Commission (2004a), European Commission (1993), European Commission (1998) as well as the external study “own resources: evolution of the system in a EU of 25” undertaken for the European Parliament (project IP/D/Budg/ST/2004-26).

26. See Cattoir, Ph. (2004).

- The third approach focuses on the creation of a direct financial relationship between the EU budget and EU citizens. “*The shift towards individuals and economic operators as contributors, and the corresponding reduction of Member States’ contributions to the financing of the EU budget would entail higher visibility towards citizens and thus increased political accountability of the budgetary authority for their expenditure decisions. It would also contribute to shifting the political discussion away from the narrow focus on national contributions towards the merit of EU policies and the general European interest*”²⁷. It examines in particular the case for an EU VAT.

The analysis does not pretend to be exhaustive: only some of the potential reform options that could be conceived are examined below. These options have been chosen on the basis of past Commission orientations, in particular those retained in July 2004²⁸, and the opinions expressed by Member States in the consultation for the Budget Review. In particular, several Member States referred to an extension of the GNI-based resource at the expense of the VAT-based resource. Several others mentioned the possible use of a resource linked to climate change, such as the revenues from auctioning of EU emission allowances. Both approaches are therefore included in the analysis. Another important element determining the choice of potential resources examined in this paper is the state of preparatory work and harmonization in the areas concerned²⁹.

27. See European Commission (2004a).

28. “*The Commission proposes three main candidates as possible future fiscal own resources: a resource based on 1. energy consumption, 2. national VAT bases and 3. corporate income. A resource based on energy consumption and conceived as an EU levy on motor fuel for road transport would be a sufficient and stable financing source for the EU budget and would create a direct link to the citizens. The tax base is already harmonised at EU level. It could be complemented by an EU levy on aviation fuel or the related emissions thus ending the current tax exemption for jet fuel and setting a price on the environmental costs of aviation.*”

29. In particular, the financial transaction tax is not examined in this paper. However, interest for such a resource has been fostered by the recent financial crisis. According to its proponents it would render short term transactions more costly and it could limit disruptive market fluctuations. As an EU own resource conceived in the context of a broad international agreement, it could therefore contribute to EU policy objectives while potentially generate considerable revenues. See, for instance, Schulmeister, S. (2009).

Before examining these approaches in turn, an important remark needs to be made in relation to the fourth category of criteria mentioned above. Issues of fairness are an essential part of any discussion to reform the EU budget. Fairness, however, is a concept that takes into account the budget in its entirety, including the own resources, possible correction or equalization mechanisms, and the structure and organization of expenditure. The fact that some possible alternative own resources could bear more heavily on some Member than on others, e.g. in relation to their relative prosperity, does not allow drawing firm conclusions on the fairness of the budget as a whole. At the same time, revising the budget away from the present reliance on Member States' contributions to a system with genuine financial autonomy for EU financing could provide a means (albeit not perfect) to get away from existing correction mechanisms and to concentrate budget decisions on the financing needs of EU policies and common objectives rather than on Member States' net budgetary position.

As indicated in the above-mentioned consultation paper, *“alternative own resources should be examined very carefully, taking into account the national sovereignty on fiscal policy and, for instance, the cross-border mobility of some tax bases and the impact of such resources on related EU policies”*. It should be indicated from the outset of this analysis that the reform proposals envisaged below would respect the current sharing of competences between the Union and the Member States. National (tax) sovereignty would be fully respected as the main features of the EU financing system would need to be defined in an own resource Decision adopted by unanimity and ratified by all the Member States. At the same time, the detail working of the financing system could be defined in a regulation implementing the own resource decision adopted by qualified majority in the Council with the European Parliament's consent. This articulation of elements would thus ensure a full democratic control by parliaments both at national and European level.

3.2. A sufficient and stable financing system

If the main objective of EU financing was to ensure (i) a sufficient and stable source of revenue –that is, to fulfil in priority budgetary criteria– with minimum operating costs and (ii) a *gross* financing of the EU in line with GNI, expanding further the GNI-based contribution would appear legitimate:

- The principal attraction of the GNI resource is that it assures a sufficient and stable flow of funding for the EU budget. Key to these attributes is the residual character of the resource, with calls on it that are determined by the amount of expenditure: if more expenditure is agreed the amount Member States have to raise from the resource expands (within the limits set by the own resources Decision).
- An additional advantage of a GNI-based system is that, insofar as fairness between Member States in *gross* contributions to the EU budget is a desired characteristic³⁰, the GNI resource is effective because the (pre-corrections) take up rate is set to take equal proportions of national income from each Member State. Moreover, in general the amounts due under the resource are easily calculated and obligations in terms of monthly payments are clear to Member States.

Expanding the GNI-based resource would most likely be done at the expense of the VAT-based resource, which could bring about some advantages. Indeed, calculating the VAT resource is far from straightforward, lacks transparency and is relatively unpopular in Finance Ministries. So there could be a simplification gain. Moreover, the VAT base, especially when it is capped, is correlated with GNI so the redistributive issues stemming from its replacement should *prima facie* not be insurmountable.

30. Currently most Member States focus on *net* contributions, not *gross* contributions, in line with the Fontainebleau principle.

able³¹. Furthermore, the share of the VAT own resource in total EU budget financing has been considerably reduced: it now represents only 11% of the total. On the other hand, the political payoff from this measure could be limited. It should also be considered that the abolition of the VAT resource could be seen as marking a step back from the aim of granting the EU a real own resource.

A GNI-based contribution could in theory also be reformed so as to support specific EU objectives. For instance, the use of complementary indicators to GDP/GNI to determine Member States' capacity to contribute, e.g. the use of a Genuine Progress Indicator³², could be explored in the longer term. Going one step further, it is sometimes suggested that GNI contributions could be modulated as a function of the attainment of important EU policy objectives, e.g. energy efficiency or CO₂ emissions reduction. The implementation of such a modulation would, however, raise a host of conceptual and practical questions. Finally, one could also envisage making the GNI-based contributions more or less progressive than is currently the case. Progressivity could be on a banding system (for example, by setting bands of 0.8% of GNI, 1% and 1.2%) or could be a smoother curve that gradually increases the rate up to a maximum level³³.

The GNI resource has also serious drawbacks. The first concern is that GNI itself is not an ideal measure of ability to pay, the tax principle that most obviously underpins its use. Current-price GNI does not fully reflect differences in living standards, especially in a group of countries with widely different standards of living. Moreover, GNI as a concept does not equate to national well-being, and there are elements of economic activity which either are included (spending on heating, for example) or not included

(unpaid household work, but also environmental degradation) about which there are methodological doubts (see section 2.5).

Moreover, being used for political purposes and as any complex statistical indicator, this measurement evolves constantly. In the future, GNI may reflect something different than today, for instance following the next national accounts reform. Besides, in order to limit any form of political manipulation, strong safeguards are to be maintained and reinforced, such as the constant monitoring from a GNI committee and a system that ensures that the amounts countries pay are adjusted following data revisions.

More fundamentally, it is sometimes argued that EU financing taking the form of contributions contributed to *“widespread dissatisfaction expressed by most EU Council members, the EU Commission, the European Parliament, and many analysts about the outcome of the latest round of negotiations over the medium-term financial perspectives for 2007-2013, leading to the call for a thorough mid-term review in 2008/9. The major problem would seem to lie in the linkage of decisions on expenditures and on their financing by national payments, which is made very explicit and immediate in the current funding scheme. National administrations would still be able to calculate national (gross and net) contributions under some alternative schemes relying on genuine own resources; but the debates would likely be more in terms of the distribution of effective tax burdens on categories of taxpayers, which is more appropriate from a political accountability point of view, than in terms of distribution across national budgets”*³⁴.

31. One possible deviation could be related to countries where non-residents account for a high share of consumption, as e.g. in Luxembourg.

32. Reflection in this area can be found on the following website: <http://www.beyond-gdp.eu>. See also European Commission (2009).

33. See Padoa-Schioppa, T. *et al.* (1987) and European Commission (1998).

34. See Begg *et al.* (2008).

3.3. A more efficient financing system, contributing to the effectiveness of EU policies

Promoting a better allocation of tax competencies and more economically efficient financing systems for the Union and the Member States could be deemed more important than the need for a simple and easy-to-administer or a more visible and transparent financing system. In this case, the budgetary criterion of sufficiency or stability of each individual resource would not be relevant to the same extent because a basket of resources could be envisaged.

In principle, *“the existence of regional arbitrariness³⁵ or the presence of cross-border externalities are strong arguments for harmonising tax bases and rates, which could also justify assigning all or part of the corresponding tax revenue to the EU level. This could contribute to reducing inefficient allocation of economic resources”³⁶*. For instance, in case of mobile tax bases EU involvement could contribute to contain tax evasion and avoid race-to-the-bottom phenomenon. Moreover, shifting a part of pro-cyclical tax bases (e.g. corporate taxes) to the EU level could create a fiscal link between Member State’s economies and, thus, serve as automatic stabiliser.

Following this approach, a resource would be attributed to the EU level only if this allowed for decreased costs in administration or a better allocation of resources in the EU, or if it contributed to achieving the policy objectives of the EU. In particular, it has been suggested that the Commission could intensify its efforts towards consolidating present own resources based on policies of exclusive Community competence or resulting from the implementation of the *acquis*.

35. Regional arbitrariness refers to a situation where it is difficult to determine the exact share of a tax base to be allocated to individual Member States or where there is a high (potential) mismatch between the country collecting the tax and the country of residence of the economic agents bearing the burden of the tax.

36. See European Commission (2004a).

Four options are examined here:

a) Energy taxation

In the past decades, the Commission has put forward several proposals for directives in the field of CO₂ or energy taxation in order to facilitate the functioning of the Internal Market and to develop a more environmental- and employment-friendly taxation policy in the EU.

The option considered here focuses on a limited tax base and it relates closely to the existing regulatory framework at EU level. In practice, considering the content of the energy directive³⁷, the tax base for a new EU own resource could include motor fuel used for road transport –that is, a part only of energy sources covered by the directive– i.e. leaded and unleaded petrol, diesel, kerosene, LPG and natural gas used for transport. The EU tax rates –that is, the rates used for the own resource revenue collection– could be set at levels equivalent to the minimum rates defined in the directive or at different rates, depending on budgetary needs and other EU policy objectives attached to the EU tax. The Member States could be left free to impose national surcharges.

There would be a number of advantages related to energy taxation. First, this would potentially be a buoyant source of revenue. Second, an EU tax could contribute to a better functioning internal market by imposing a more uniform rate of energy taxation to the Member States³⁸ and it would help mitigating emissions related to road transport, notably via reduced “tank tourism”³⁹. However, these efficiency gains would only be possible if the total rates resulting from the EU rate combined with Member States

37. Directive 2003/96/EC of 27 October 2003.

38. In 2005, energy tax revenue per ton of oil equivalent ranged from a minimum of €60 to a maximum of €321 in the Union.

39. Tank tourism is about detours, when a truck drives more to fill up the tank where fuel taxes are the lowest. The EU energy tax could be set with regards to the impact of propellants in terms of greenhouse gas emissions.

surcharges were more harmonized than the current rates applied by the Member States⁴⁰. Third, increased EU involvement in energy taxation policy would tie EU financing to EU policy priorities on climate and energy. This could contribute to achieving EU objectives in these areas. Last, an EU energy tax based on the current structure and (minimum) rates of excise duties for motor fuel used for road transport would be relatively straightforward to implement. It would be visible to the taxpayers as the contribution to the EU budget could be indicated on each bill, and it could also lead to enhanced EU financing autonomy.

A disadvantage of energy taxation is that, contrarily to the broad-based options affecting a very large number of EU citizens, such a targeted option would have a particular impact on specific economic sectors or consumers. On the other hand, it could be argued that motor fuel taxes are also sufficiently broad-based to affect most citizens. Moreover, an EU tax on energy use would by nature concentrate taxation on countries with higher energy intensity. This issue, which also appears in discussions on EU greenhouse gas emissions allowances auctioning, is dealt with in section (c) below. Regarding the political link between expenditure and revenues, it can be questioned whether linking EU financing to EU energy policy objectives would really reinforce both. It is conceivable that the end result of such a linkage, politically, would be counterproductive.

b) Charges on aviation

The tax burden on aviation is currently limited. Most bilateral air service agreements foresee that fuel on board an aircraft on arrival in a State is exempted from taxation⁴¹. In the EU, however, there is now no other direct

legal impediment to the taxation of aviation fuels used on flights between EU Member States. Charges such as departure taxes or air passenger duties have been developed by a number of Member States, e.g. France, the Netherlands and the United Kingdom in recent years. Furthermore, in order to mitigate –to some degree⁴²– the contribution of aviation to climate change⁴³, aviation will be included in the EU ETS from 2012.

Despite the inclusion of aviation in the EU ETS, it can be argued that there remain important justifications for taxing this sector. According to M. Keen and J. Strand (2006), the central arguments in favour of enhanced taxation of aviation, especially international aviation, are easily stated. “*Such taxes are currently low. Yet aviation causes significant border-crossing environmental damage, including air pollution (to a large extent on the macro, regional, or global scale) and noise (largely on the micro scale, depending on the location of airports). There may also be a case for a corrective tax on aviation to address greenhouse effects—emissions related to international aviation are, notably, excluded from the [Kyoto Protocol]. Even apart from border-crossing environmental harm, however, taxes on international aviation may be inefficiently low as a result of tax competition, with countries independently choosing to set taxes lower than they would if they behaved in concert, so as to avoid jeopardizing domestic carriers and/or tourist sectors*”. In the EU context, it is furthermore sometimes argued that there is a form of distortion of competition between aviation, which is almost exempt from taxation, and other modes of transportation, which are taxed. Member States have notably exempted international flights from VAT. Aviation taxation could therefore contribute to a better function-

40. As an alternative to this rather hypothetical approach, the Commission has proposed a “Greening transport package” in July 2008.

See http://ec.europa.eu/transport/strategies/2008_greening_transport_en.htm.

41. The EU is working to remove these exemptions, but they remain in key ASAs such as with the US. Article 24 of the 1944 Convention on International Civil Aviation (the Chicago Convention) does not prohibit tax on fuel supply to aircrafts.

42. EU ETS covers only carbon dioxide (CO₂) emissions leaving aside other components characteristic for aviation such as NO_x, water vapour emitted at high altitude and sulphate and soot particles.

43. Aviation is currently responsible for 3% of the world’s GHG emissions and this is expected to rise as air traffic doubles by 2020. This figure does not include indirect warming effects, such as those from nitrogen oxide (NO_x) emissions, contrails and cirrus cloud effects. The overall impact –according to the Intergovernmental Panel on Climate Change– is therefore about 2 to 4 times higher with cirrus clouds effect included. While the EU’s total greenhouse gas emissions fell by 5.7% from 1990 to 2005, emissions from civil aviation increased by almost 79%.

Source: *EU energy and transport in figures. Statistical pocketbook 2007/2008*, p. 186.

ing of the internal market. Moreover, aviation taxation is also suggested on the ground that the EU “Open Skies” policy has brought important benefits to the aviation industry. The latter also benefits from important support in the context of other EU policies, for instance related to research⁴⁴. It could, in this line of reasoning, also contribute to the financing of EU policies. Lastly, the existing schemes for charging the aviation industry for traffic management fees and other similar charges could be easily expanded to take into account possible tax requirements.

Important issues need to be considered. First, legal barriers to develop taxation are not yet removed and, currently, could limit the choice of options available. Second, in the EU context, it may seem inappropriate to raise such a possibility even before aviation fully participates in the EU ETS. The mere fact that aviation will be part of the scheme weakens one important argument for taxing aviation, i.e. the fight against climate change. Another objection is that duties related to aviation penalise geographically more remote areas and could have an impact on the tourism sector in some Member States. Lastly, an aviation tax would likely bring relatively limited revenues and contribute to only a modest part of the total EU budget.

c) Revenue from auctioning of emission allowances

Tradable permits related to greenhouse gas emissions are an important market-based instrument aimed at fighting against climate change. The EU Emission Trading System (EU ETS)⁴⁵ has been in operation since 2005 (1st trading period). Since 1 January 2008 (2nd trading period) it applies to all EU Member States⁴⁶. It currently covers over 10,000 installations in the energy and industrial sectors which are collectively responsible for

close to 50% of the EU CO₂ emissions and 40% of its total greenhouse gas emissions. An amendment to the EU ETS Directive agreed in July 2008 will bring the aviation sector into the system from 2012. In December 2008 the European Council took important decisions on the 3rd trading period extending from 2013 to 2020 and beyond. In particular, there will be an annually declining emissions cap for the whole EU. A high share of emission allowances will be auctioned (allowances not auctioned are distributed for free but can be traded). Rules will differ depending on the type of industry⁴⁷.

Allocating future auctioning revenues of emission allowances to the EU budget could be justified for a number of reasons. First, the EU ETS is an EU scheme and relates closely to the *acquis*. Given the existence of an EU cluster in the international emission reduction efforts and the high level of externalities involved in CO₂ emissions, it could be argued that the EU should play a very important role in running the EU ETS and should thus also collect the revenue in the future. Second, the corresponding revenue is not a *tax* revenue. It relates closely to pollution by economic operators. It should be noted that the Lisbon Treaty includes a provision on the polluter-payer principle⁴⁸. This could therefore make it easier to sell politically as an EU own resource. Third, the administration of the EU ETS is increasingly centralized, thus highlighting the administrative benefits of coordination for such a scheme. Also, for additional sectors likely to be included in the EU ETS such as the maritime sector, Member States have been reluctant to take responsibilities for their emissions at national level. Lastly, in the context of a possible development of an OECD-wide carbon market through the linking of cap-and-trade systems and the subsequent extension of this market to more advanced developing countries, there would be further

44. The «Clean Sky Joint Technology Initiative» aims at halving noise, fuel consumption and carbon dioxide emissions, as well as slashing nitrogen oxide emissions by 80%. It amounts to € 1.6 billion.

45. Extended information on the EU ETS can be found on the following European Commission website: http://ec.europa.eu/environment/climat/emission/index_en.htm. For a US perspective, see also Ellerman, A.D. and P. L. Joskow (2008).

46. It also applies to the other members of the European Economic Area, i.e. Norway, Iceland and Liechtenstein.

47. For instance, 100% auctioning is the rule from 2013 onwards for electricity generators. However, Member States have the option to temporarily deviate from this rule with respect to existing power plants.

48. Art 191, §2 of the treaty on the functioning of the European Union states that “Union policy on the environment... shall be based on the precautionary principle and on the principles that preventive action should be taken, that environmental damage should as a priority be rectified at source and that the polluter should pay”.

arguments for handling revenues centrally rather than in 27 Member States as other systems are likely to do.

These arguments have to be weighted against a number of other specific arguments. First, it is sometimes argued that the revenue flow related to emissions auctioning will decrease over time as emissions diminish. Therefore, the question of the long-term stability of such a revenue flow could be raised. This argument appears unconvincing for the decades to come as the scope of the EU ETS and the price of carbon will increase. In addition, the lack of predictability of revenues does not constitute a convincing argument for rejecting it as a potential EU own resource: as long as the GNI-based residual resource exists, variations in proceeds would be compensated by variations of the GNI resource. Budgetary risks related to the emission auctioning would thus be borne by the Member States. Second, it is sometimes argued that some countries would be important losers if the EU was financed partially via auctioning revenue rather than, say, the GNI-based resource –as the share of these countries in EU emissions is higher than their share in EU GNI. This issue of fairness of *gross* contributions is not specific to this resource and would therefore need to be examined in the broader context of the budget reform. However, assuming that the budget reform would give more importance to energy and climate priorities, such as support to renewable energies and energy efficiency, it could be expected that heavy emitters would also benefit from a share of expenditures higher than their share of GNI. An implicit redistribution of benefits could therefore occur on the spending side without the need for any explicit compensation mechanism. Lastly, the revenue from the EU ETS would be largely financed by specific sectors in society (energy, aviation, etc.). While those sectors could certainly pass-on their costs to citizens, issues of equity and transparency would have to be discussed. Yet, a key point is that as long as the EU ETS is going ahead anyway these issues will arise, in much the same way as the equity dimensions of TOR are secondary to the need for common trade instruments.

d) EU corporate income taxation (EUCIT)

The existence of 27 separate national tax systems puts EU multinational enterprises at a disadvantage compared to companies operating in only one Member State or in large countries such as the US. EU companies face many obstacles to their cross-border activities and may suffer from double taxation as a result of the current lack of coordination among the various corporation tax systems in the EU. The current system imposes significantly higher compliance costs both on companies operating across borders in the EU and on national tax administrations⁴⁹. To tackle these problems the Commission is preparing a legislative proposal bearing on a Common Consolidated Corporate Tax Base (CCCTB), which suggests harmonizing the tax base across countries while allowing the Member States to apply their individual corporate tax rates⁵⁰.

Besides, Commission analyses demonstrated that differences of tax rates among the Member States are the prime factor in explaining diverging effective tax rates –and the related distortions in the internal market⁵¹. Therefore, it is sometimes suggested that harmonization of tax bases *and* tax rates would be preferable from an economic (allocative) efficiency viewpoint compared to a tax base harmonization only. Hence, setting up an EU corporate income tax (EUCIT) with harmonised bases and rates would bring important benefits for the European Union. Furthermore, it has been argued that since companies are among the prime beneficiaries of EU integration and due to the cross-border nature of their activities, an EU corporate income tax as a means of financing the EU budget would be justified⁵². Lastly, EUCIT could bring about important revenues⁵³. However, its

49. See European Commission (2004b).

50. See http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm.

51. See European Commission (2001).

52. From an economic point of view, this is debatable since what matters at the end of the day is the incidence of the tax.

53. Corporate income tax revenues amounted to 3.0% of GDP (weighted average, EU27) in 2006. Source: European Commission (2008b).

susceptibility to the business cycle would require keeping a robust system such as the residual GNI-based resource for smoothing out the revenue cycle.

Beyond these fairly general considerations, the analysis of the pros and cons of EUCIT would depend on the specificities of the system put in place and, in particular, the scope of the tax and the degree of harmonisation achieved⁵⁴. Regarding the scope of the tax, if the tax applied only to multinational enterprises (MNEs), there would be level-playing field concerns as companies would pay different taxes on the same territory depending on whether they are MNEs or not. On the other hand, if the system was applied to all companies, the vast majority of which are SMEs active only in one Member State, one could argue that the measure would be disproportionate in view of the objectives pursued. The degree of harmonisation entailed by EUCIT would be another critical issue. If a “split-system” was put in place, Member States would be free to set their preferred tax rates on top of the EU rate. In this case, harmonisation of rates could end up being very limited, as today, and so would the efficiency gains related to EUCIT.

From a political economy viewpoint, an EUCIT would give corporations a strong incentive to lobby for limitations to EU spending, as any expenditure reduction would result in immediate and significant cuts to the CIT rate. Opposition to the Common Agricultural Policy, for instance, might intensify as the business community may resent being taxed to support agriculture.

Overall, a EUCIT proposal is likely to encounter considerable opposition due to marked national differences and diverging preferences in the area of corporate taxation. This is well illustrated by the difficult progress

towards a CCCTB⁵⁵. This explains why the Commission considered in 2004 that “a *fiscal resource based on corporate income is to be seen as a much longer-term option*” than an option based on VAT or energy consumption.

3.4. A more transparent system bringing citizens closer to the Union

If one wants to create a direct link between the citizen and the Union and to make citizens aware of the cost of Europe with a transparent⁵⁶ and simpler system, the EU budget should ideally be financed with one single, wide-based, resource such as VAT. A “cocktail” of European taxes and other resources to replace the present mix of resources –consisting mainly of national contributions– would not fully achieve these goals.

Instead of using a notional or statistical VAT-based contribution, one could envisage using a share of Member States’ (“genuine”) VAT to finance the EU budget. This option has been frequently advocated, notably by the European Parliament. The Langes Report, for instance, suggested as early as 1994 that “a proportion of a largely harmonised VAT, imposed on the basis of tax declarations and clearly denoted on each individual invoice as EU taxation” could be envisaged.

An EU rate of 2% would for example suffice to raise sufficient revenues to cover the entire EU budget. An advantage of the EU VAT is that fiscal neutrality for citizens could easily –and visibly– be assured through an equivalent reduction of the national rate. Past work of the Commission has

54. A considerable amount of research has been developed in the last years to analyse both the technical options for a common tax base and its economic effects.
See Agúndez-García, A. (2006) for a review of the literature.

55. Given stiff opposition in a few Member States to this project, current thinking envisages adopting a flexible approach on the CCCTB, whereas a link with EU financing would require a high degree of harmonization. It should also be recalled that, for the same reason, the Commission always refused to propose tax rate harmonization for corporate taxation.
56. The need for more transparency of the EU budget also calls for measures ensuring the visibility of the benefits brought by the budget. This issue is beyond the scope of this paper.

highlighted that a genuine EU VAT could be introduced following a short technical preparation.

Given the remaining differences between national VAT systems, the main drawback of this option relates to potentially difficult discussions on the degree of harmonization required prior to introducing the new scheme. A full harmonization of all rules and practices regarding VAT would create specific political and administrative problems, in particular as taxing zero-rated goods would entail that, in some Member States, whole economic sectors move from *de facto* exemption to taxation. An alternative would be to introduce an EU modulated VAT, which does not presuppose prior VAT harmonization. Several EU VAT rates could be applied, with a modulation depending on the type of goods taxed. In order to facilitate the implementation of the system and to respect the preference of Member States, zero-rated goods could be exempted from both national and EU taxation. Goods subject to parking rates, super-reduced rates and reduced rates could be subject to a reduced EU rate, e.g. 1% whereas all the goods subject to standard rates could be subject to a higher EU rate, e.g. 2%. However, such a system creates a problem of horizontal equity (not all EU taxpayers are faced with the same VAT for a number of goods).

An EU VAT would also raise a problem of fairness. Member States with comparable GNIs per capita display very different VAT bases. In other words, with comparable levels of GNI per capita, some Member States would clearly contribute more than others to the EU budget, as it happens today. Indeed, there could be a slight negative relationship between revenues from a modulated VAT as a percentage of GNI and GNI per capita, as VAT is regressive. These issues could not be fully solved by modifying the structure of EU VAT rates alone: they would call for a specific response, either in the form of a reform of expenditures or some form of formula-based equalization or compensation mechanism (see below).

3.5. Overview of the alternative own resources

This brief analysis highlights that the GNI-based contribution is very effective in ensuring fair *gross* Member States contributions to the EU budget. It could potentially be refined in the long term to take into account redistributive or environmental objectives. On the other hand, focus on (net) national contributions appears to be exacerbated by GNI-based financing, thus calling for additional or reformed correction mechanisms. Furthermore, budgetary discipline and budget stability could also be obtained with a much smaller residual resource and with a different mix of own resources.

The analysis of four options underpinned by efficiency considerations –energy taxation, aviation levies, auctioning of emission allowances and EUCIT– highlights that there are strong economic arguments to levy a tax or charge at EU rather than at Member State level. These options all bear on cross-border activities and relate closely to EU policies involving important externalities.

This analysis also highlights that a genuine EU VAT could improve substantially the visibility of EU financing. Whether such a visibility is desirable and would lead to changes in EU budget matters is a political question beyond the scope of this analysis.

Substantial differences appear regarding the degree of harmonization achieved at EU level. In the areas of energy taxation and VAT, a large degree of harmonization has been achieved in the past. A number of differences remain among the Member States, the most important being the existence of zero-rated goods for VAT purposes in some Member States. In the area of emissions trading, a very rapid integration process is occurring both in the EU and beyond. The trend is clearly towards more EU and international harmonization. In two other areas, corporate income and aviation taxation,

despite recurring debates much remains to be done to define a harmonized frame of taxation.

IV - Main options to reform the correction mechanisms

*“Since the UK started in the 1970s to object to what it saw as (and what was ultimately recognised to be) an unfair burden towards the EU budget, the notion of *juste retour* has come to dominate the strategic settlement of the financial perspectives. *Juste retour* is essentially about net contributions. This, in turn, is the result of both deliberate choices about policies such as cohesion that call for net fiscal transfers, as well as the incidence of other policies on gross receipts and the funding instruments on gross payments”⁵⁷.*

Several, sometimes complementary, approaches have been considered to solve the issue of *juste retour* and the associated correction mechanisms:

- solving the main root cause of the perceived net imbalances through an in-depth reform of expenditures;
- reforming radically the own resources system in order to shift the

57. See Begg *et al.* (2008).

- focus from net contributions to the incidence of the resource;
- introducing a formula-based equalization mechanism as a way to solve some imbalances and changing the underpinning of financial transfers;
- reforming the current corrections bazaar either by introducing one generalised correction mechanism (GCM) or its variant, a generalised limited correction mechanism (GLCM), setting a cap on net transfers for all the net contributors, or by defining *ex ante* contributions and expenditures targets based on GNI.

These approaches are examined and discussed in turn.

4.1. Solving the main root cause – adjusting expenditures

If the rules for funding the budget using the existing three own resources were applied without any corrections, the *gross, ex ante* contributions of Member States would be roughly proportional to GNI⁵⁸. Based on this observation, it is often argued that existing corrections to the financing of the EU budget are not primarily intended to address inequities in the financing system. Their main root cause would lie in a lack of political consensus on the overall structure and allocation of EU expenditure, causing Member States to call into question the size of their contribution.

Therefore, eliminating corrections would first require a genuine political consensus on the content and structure of EU budgetary expenditure. This in turn would require agreeing on what are the genuine EU public goods. It is interesting to note that, until recently, in the calculation of the UK correction only two elements of the EU budget were not taken into account:

58. The situation was different prior to the introduction of the GNI-based resource. When the UK correction was introduced, there were also perceived imbalances related to the VAT-based resource and traditional own resources. The origin of the net balances discussion can certainly not be limited to problems related to expenditures.

the traditional own resources and expenditure related to the EU external action⁵⁹. It can therefore be assumed that the other revenues and expenditures have somehow been considered as the source of (unwanted) net transfers requiring a correction. This includes, for instance, expenditures related to the EU administration, which are not seen as a common public good but rather as expenditures to the benefit of, mainly, Belgium and Luxembourg.

The apparent difficulty for Member States to jointly agree on what are exactly EU public goods is compounded by the fact that net beneficiaries of specific policies appear unlikely to recognize that these policies may be of limited interest for the EU as a whole compared to other policies. Path dependency is crucial here.

Instead of defining from scratch what are “genuine” EU public goods and other areas of expenditure, it has instead been suggested to vary the rate at which EU policies are financed by the Community budget, given that co-financing is a feature of many EU expenditure programmes. Varied co-financing rates are already applied for cohesion expenditure and could be envisaged for other policies. However, co-financing could also be seen as a way to re-nationalize some policies for which net financial transfers are considered excessive⁶⁰. Besides, such an approach may end up not having much of an impact on net balances.

Overall, past experience suggests that reforms in the expenditure structure occur in small steps. It is possible to envisage shifts towards more consensual expenditures, widely considered as EU public goods, and a partial co-financing (or re-nationalization) of some policies. But it is unlikely that a

59. In the own resources Decision 2007, a political factor that applies to the amendment of the UK correction for the 2007-13 Multiannual Financial Framework is that all non-agricultural expenditure in the recently acceded Member States are left out of the formula.

60. This argument does not appear fully convincing as several important EU policies have been subject to a co-financing system without there being particular calls for their complete re-nationalization.

unanimous agreement would ever be found among Member States on a set of expenditures considered as pure EU public goods, without discussion on the ultimate “retour” of policies. Hence the calls for a reform of correction mechanisms, the introduction of an equalization mechanism, or the reform of EU own resources, as complements or preconditions to a reform of expenditures.

In this context, it is important to keep in mind that there is a strong political link between the CAP and the UK correction as illustrated by Declaration 3 to the Interinstitutional Agreement. A reform of one of these could be intrinsically linked to a reform of the other.

4.2. Reforming radically the own resources system

It is sometimes suggested that transforming radically the structure of the own resource system, away from Member States’ contributions, could reduce the current focus on net balances. In particular, *“in a tax-based system, the requirement of inter-country equity would take second seat behind the criterion of inter-personal equity. Having said this, most scholars agree that inter-country fairness will never be totally disregarded, as an EU tax creating unwarranted inter-country differences in the number of taxpayers and/or level of revenues will not be politically acceptable”*⁶¹. A new EU own resource would likely be levied by the Member States and the corresponding revenues transferred to the EU budget. As Member States would be aware of the geographical origin of the revenue, the discussion –and the acrimony– would simply focus on the incidence of the tax. This, however, could be seen as a crucial –and favourable– element of a reform.

61. See Rubio, E. (2008).

Not all options considered for a reform of the own resources system would have the same impact on the *juste retour* debate.

- Some possible alternative resources, such as aviation or maritime transport charges, corporate income taxation on transnational companies, excise duties on motor fuel for (professional) road transport are characterised by a high degree of regional arbitrariness. This means that it is difficult to know where the tax base arises. When the tax exists, governments sometimes have to devise complex tax base-sharing mechanisms. This is the case, most notably, for corporate income taxation. In other cases, such as for aviation taxation, the cross-border nature of the activity to tax is such that taxing the activity unilaterally at national level is very difficult⁶².
- On the other hand, highly visible taxes, such as a shared VAT would not have the same impact as the origin of the tax basis is well identified. Debates on net contributions would not change much with this resource compared to the current system.

4.3. A formula-based adjustment – equalization mechanisms

Instead of developing further correction mechanisms, an alternative to reduce undesired imbalances between Member States could be to use some form of equalization mechanism. Equalization mechanisms are financial mechanisms featured in most Member States⁶³. They permit financial transfers to political entities –for instance regions or local authorities–, which suffer from relatively low financial capacities or from excessive costs in the provision of public goods and services. Introducing

62. *In casu*, the complexity is compounded by the Chicago convention, which limits possibilities to introduce taxes related to aviation.

63. For instance, the German Grundgesetz indicates that a “law shall ensure a reasonable equalisation of the disparate financial capacities of the Länder, with due regard for the financial capacities and needs of municipalities”.

such an equalization mechanism, calculated on the basis of objective variables, such as relative GNI or tax effort, could contribute to fairness between the Member States.

It should also be noted that an equalization mechanism can be organized either on the revenue or the expenditure side of the budget, which could introduce an additional margin for manoeuvre on the way to a budget reform. In effect, corrections and equalization payments can, to a considerable degree, be considered as two sides of the same coin: they aim at avoiding some forms of imbalances and rely on formulae. But there is one key difference: equalization mechanisms are *not* underpinned by an accounting approach of net balances or a notion of *juste retour*, but rather by relative fiscal capacities, efforts or needs.

Two main options for an equalization mechanism seem possible in the EU budget context.

a) An equalization mechanism based on relative GNI

This mechanism would ensure a financial benefit to Member States with a lower per capita GNI than the average by introducing an element of progressivity in gross payments on the revenue side, rather than proportionality as at present. As indicated in section 3.2, progressivity could be on a banding system or could be a smoother curve that gradually increases the rate up to a maximum level as proposed in the Padoa-Schioppa report (1987). It is sometimes argued that building in a degree of overt equalization into the revenue side of the budget would be a means of legitimating imbalances and thus weakening the case for a correction. However, one major drawback of such proposal could be that, seen from a net contributor's perspective, the net balances issue would be aggravated rather than mitigated, *ceteris paribus*.

An alternative, proposed by S. Richter (2008), would be to solve the net balance issue without using a net balances-based formula. This could be done by agreeing at the start of multi-annual financial framework negotiations that each Member State would pay an equal share of its GNI to the EU budget, e.g. 1%. Each Member State would then benefit from expenditures on its territory equivalent to the same percentage of the average EU GNI *per capita* multiplied by its population. This would ensure a balanced budget, and an automatic redistribution between the Member States in line with their economic development⁶⁴. In a second stage, the Member State would be left free to decide in which areas of EU policy –e.g. CAP, cohesion policy or R&D– the pre-allocated EU funds would then be spent. Although this approach proposes a simple way to organise –and set clear limits to– financial solidarity between Member States, it also presents considerable drawbacks. In particular, since each Member State would be able to choose its own ‘menu’ of EU spending on its territory, pressure to simply re-nationalise these policies would likely increase.

Another approach would focus on the expenditure side. Cohesion transfers to Member States could be based on a simple formula, which could limit some of the current perceived imbalances in the EU Budget. However, the political feasibility of inter-governmental lump-sum grants appears very limited for the foreseeable future. Many positive aspects related to the current cohesion policy –e.g. the long-term planning for public programmes, the requirements in terms of governance at all levels, the promotion of the Lisbon strategy throughout the Union– would need to be maintained to make sure that money is spent in a sound and efficient manner.

64. The net contribution to the budget would be the difference of GNI *per capita* between the Member State and the EU average multiplied by the Member States' population.

b) An equalization mechanism based on relative tax capacity

This mechanism would provide a financial benefit to Member States with lower per capita revenue than the average for one or several own resource(s) used for the budget. It should be seen as a response to a widely spread concern that a partial replacement of the GNI-based resource by taxes or other resources such as revenues from VAT or ETS auctioning could potentially lead to problems of fairness, especially with respect to relatively poorer countries.

In order to organize such a mechanism one could adjust a residual GNI resource by taking into account the difference in *gross* contributions related to the (new) own resource(s).

A more radical approach would consist in eliminating both the current VAT- and GNI-based resources, replacing them by a genuine own resource. A very small budget surplus could be redistributed to the Member States in the context of the equalization mechanism, i.e. the *ex ante* budget balance rule would be maintained and the budget size would be left unchanged. This could be relevant for options related to VAT and energy taxation, which would potentially generate large revenues.

4.4. Extending and reforming the UK correction – a generalised correction mechanism

The existence of correction mechanisms could be seen as an unavoidable feature of a budget where the interplay of expenditures and revenues will always lead to some form of imbalances in Member States' net positions. Hence, the argument goes, instead of trying to get rid of correction mechanisms, one should at least seek to avoid some of the negative side effects

of *ad hoc* correction mechanisms and promote a level playing field among the Member States.

One way of doing so would be by replacing the current corrections and rebates of all kinds by a generalised correction mechanism (GCM)⁶⁵ or its variant, a generalised limited correction mechanism (GLCM). These mechanisms would be applicable in the same way to all Member States. They would avoid a situation where Member States with comparable levels of GNI end up paying significantly different net contributions to the EU budget. According to its proponents, the assumed simplification of the current system would also lead to a more transparent budget.

Three main elements need to be taken into account in any generalised correction mechanism:

- The expenditures and revenues included in the calculation of net balances. In its 2004 proposal to create a GCM, the Commission suggested keeping the rather broad concept used for the calculation of UK net balances. However, several recent researches suggested using a less extended concept when calculating net balances, thus leading to a generalised *limited* correction mechanism. It has notably been suggested to create two baskets of expenditures, one of which would correspond to policies whose distributive effects are either not measurable or are politically accepted, e.g. external policies, and the other to policies whose distributive effects are not regarded as acceptable, e.g. policies such as CAP which produce substantial distributive effects⁶⁶. An alternative distinction could be made between “European public goods”, whose benefits cannot be attributed to one single Member State such as administrative

65. Such a system was proposed in European Commission (2004a).

66. See Heinemann *et al.* (2008).

expenditure, expenditure aimed at external relations, and “expenditure with localised benefits”⁶⁷.

- Once net balances are calculated, several parameters need to be defined to calculate the rebate for Member States. These include (i) the threshold above which the rebate would be applicable, i.e. whether there should be some incompressible element of solidarity through the EU budget; (ii) the percentage rebate on net contributions⁶⁸; (iii) the ceiling above which a 100% rebate would be applied, i.e. whether there should be an absolute maximum level of financial solidarity through the EU budget; (iv) possibly, the overall cap on the total correction. In 2004, the Commission made very specific proposals for all these aspects.
- Another issue is whether a generalised correction mechanism should be defined *ex ante* or *ex post*⁶⁹. Using a system based on (*ex post*) net balances, such as the UK correction or the GCM proposed by the Commission in 2004, can affect the spending behaviour of Member States, compared to a system based on *ex ante* redistribution decisions, such as the lower VAT call rates for Austria, Germany and the Netherlands or the lump sum for the Netherlands and Sweden in the own resource Decision of 2007. Once net balances are based on effective spending, the net budgetary “return” from any spending made on a Member State territory is lower than the gross “return”. For instance, two-third of EU spending in the UK is indirectly financed by the UK through (a reduction in) its rebate. This reduces the incentive for this country to spend EU funds⁷⁰. Extending the UK system to all Member States could therefore have a marked global impact on EU expenditures.

This is why recent proposals focus on defining the extent of redistribution between net contributors and net beneficiaries *ex ante*, that is, before the structure of policies is defined⁷¹. This could facilitate a reform since any “expenditure with localised benefits” would be ultimately compensated through the correction mechanism. The Member States could then have a much stronger incentive to focus on the content and EU added value of policies rather than the local “return” of these policies. However, fixing net balances *ex ante* might also create distortions in decisions on EU spending. Indeed, once the net position of a Member State is fixed, the country has two options –either fighting to obtain more EU spending on its territory, or simply letting its net budgetary position worsen. In this latter case, the country will receive the guaranteed compensation in form of cash, i.e. a reduced contribution to the budget (thus not subject to any rules). In the two cases the amount of money spent in the Member State will be similar. This could in turn lead to under-spending for EU programmes having an EU added value⁷².

A major drawback of generalised correction mechanisms is that every single parameter entering into the correction calculation can give rise to arguments. For instance, a GLCM would require defining two baskets of expenditures: those that would give rise to corrections and the others. Since almost any type of expenditure can ultimately prove more favourable to one Member State than others, the former basket might well cover all the EU internal policies, i.e. the GLCM would turn into a GCM.

In addition, the generalised correction mechanisms rely on a formula based on a calculation of net balances. Once in place, such a mechanism would likely render the issue of net balances even more prominent than is currently the case. All countries would have an immediate, directly mea-

67. *EU Budget Review: An Opportunity for a Thorough Reform or Minor Adjustments?* Executive Summary of the Final Report of the Slovenian EU Budget Reform Taskforce, coordinator Mojmir Mrak, October 2007.

68. This could also include an element of progressivity or regressivity.

69. The GCM proposed by the Commission in 2004 proposed an *ex post* approach.

70. This issue was raised recently in the context of EU Solidarity Fund spending.

71. See De la Fuente, A. and Domenech, R. (2001).

72. On this point see Notre Europe (2009). To prevent this from happening one should subject use of the compensation transfers to the same conditions as those governing the use of EU spending. This appears difficult to achieve in practice.

surable, and opposite interest in the terms used for the mechanism. This is why this concept has been opposed, notably, by the European Parliament in the Lamassoure resolution of 29 March 2007. The Parliament “*is convinced... that generalising the rebate even when accompanying it by a ceiling for the net budgetary balances would be a double mistake since it would only strengthen the anti-communitarian character of the system and cement the short-sighted approach of a quantifiable ‘juste retour’; [it] insists that the only possible solution is the abolition of the net balances system once and for all in parallel with a reform of the pattern of expenditure...*”. Ultimately, a coalition of net contributors would likely arise to limit the global net transfers organised through the EU budget.

Lastly, the GCM would tackle only excessive deficits but not excessive surpluses. It would not take into account the relative prosperity of net beneficiaries (as measured, for instance, by their GNI per capita). As a result, the contribution of a GCM to fairness would be limited as it would mitigate (but not eliminate) differences of treatment across Member States only at one tail of the income distribution. Its effect on incentives would be reduced by its limited applicability to a small subset of Member States, by the capping mechanism and by the threshold and partial rebate features⁷³.

Overall, the current system of *ad hoc* corrections could be reformed by introducing a generalised correction mechanism. However, it is clear that using a formula based on net balance calculations would enshrine a bit more the “poisonous”⁷⁴ logic of *juste retour* into the EU budget negotiations. Should a generalised correction mechanism be put into place, it could in any event be advisable to make the mechanism transitory –for instance by ensuring that corrections automatically decrease over time.

73. See de la Fuente, A., Doménech, R. and V. Rant (2008).

74. See Le Cacheux, J. (2005).

V - Balancing the EU budget

The obligation of budgetary balance is imposed on the EU budget by the EC Treaty. An important feature of the financing system since 1988 has been the built-in guarantee, through the residual GNI-based contribution, that the EU automatically benefits of sufficient resources to finance the authorised level of expenditure.

Such an automatic balancing of the EU budget is sometimes criticized. For instance, in order to ensure macroeconomic stabilisation it is sometimes proposed to allow the EU budget running into deficits during recessions as it is usually the case for national budgets. However, this idea does not appear convincing. Additional funds resulting from a deficit of an EU budget of the current size would arguably have limited impact on the European economy. Making this mechanism effective in smoothing economic disturbances

would require a relatively large community budget or borrowing capacity⁷⁵. Moreover, it appears questionable that the EU policies are suitable to respond flexibly to economic shocks due to the long term planning which characterizes many programmes. The prospect of potential deficits would make agreements on the EU budget probably even more difficult.

Since the balanced budget rule is widely accepted, enshrined in the treaties, and its revision would likely lead to public outcry, it seems reasonable to consider that future changes to the financing system should not compromise this rule. It would therefore be imperative that any financing system continue to contain an element of automatic equilibrium.

Several mechanisms can achieve this objective. But they have to be tailored to take into account the type of own resources financing the EU budget.

- If the financing system remains dominated by the VAT- and/or GNI-based resources, a system of residual contribution (such as the GNI-based contribution) is very effective to ensure that own resources match expenditures.
- Even if new own resources are introduced in replacement of the VAT-based contribution and/or part of the GNI-based contribution, a system of residual contribution similar to the current system is advisable.
- In case a new own resource with a very large tax base, e.g. an EU VAT, energy tax or EUCIT, or a basket of new resources is envisaged, alternative approaches can be considered to cope with revenue variations. Firstly, in case of insufficient resources a residual GNI-based contribution could be triggered. But in case of excess revenue, a partial reimbursement of own resources could be envisaged. This could be done on the basis of Member States' shares in EU GNI, i.e.

there would be a negative GNI residual contribution, or as part of an equalisation mechanism (see section 4.3). Secondly, a system of “rainy-day fund” could be set in place in order to avoid a system of residual contribution or equalization⁷⁶. This fund would accumulate budgetary reserves in periods of buoyancy and this reserve would then be used in case of revenue slowdown.

Although the current system is quite effective in maintaining a budgetary balance, several alternative systems can be envisaged. As indicated in the last hyphen, a slight surplus of revenues over budgeted spending could even be used to finance an equalization mechanism to ensure a balanced budget. However, Member States' resistance to tax-based revenues exceeding the expenditure (prior to equalization) should not be underestimated.

75. In a quite different approach, Iozzo *et al.* (2009) propose to create a specific chapter for capital operations in the EU budget, “to include common projects that today are mainly financed by current revenues but that instead –due to their nature of capital investment– should be financed by issuing Community bonds in capital markets”.

76. See Le Cacheux, J. (2007).

VI - Medium-term scenarios for a financing reform

6.1. Towards equally valid scenarios

The analysis above highlights the interactions of the various elements of the EU financing system. The constituting parts of this system are not stand-alone elements which can be modified independently of other elements. As a consequence, only a limited number of combinations of reforms of the constituting elements of the financing system (own resources, corrections) or the budget at large appear feasible⁷⁷.

Three main scenarios are presented in the table below. These scenarios do not exclude alternative options. They are meant at stimulating further reflection rather than highlighting conclusive analyses. And they should certainly not be considered as political choices. Rather, they represent

77. In what follows, the focus is placed on revenue. However, a reform of the financing system is unlikely to happen independently from a reform of expenditures.

what the author currently views as some of the main potential avenues for a reform of the EU financing system.

These scenarios can be considered as “equally valid” since:

- They are all feasible from a technical point of view. This does not mean that, from a political point of view, they would be equally acceptable or find equal support from the Member States or the EU institutions. Responses to the public consultation on the budget reform have highlighted considerable differences of views among stakeholders: *“Overall, several models seem to be considered. The most popular one among Member States is a model based on GNI with the elimination of all corrections and the elimination of the VAT-based contribution. A minority model among Member States would be to develop alternative financing sources while also eliminating all the corrections. Some Member States suggest that this could come as a second step after extending the GNI-based resource or in a longer term perspective. The two models are found in close proportions in the responses of other public bodies, while the latter is clearly favoured by NGOs, academics and other respondents. Respondents from academia or other types of respondents often favour the development of alternative own resources”*⁷⁸.
- They could all be implemented with the existing treaty framework. However, except for the *status quo* scenario, changes would be required to the Own Resource Decision and, possibly, to other legal acts, such as Directives in the area of taxation.
- Independently from the necessary political preparation, from a technical point of view they could all be undertaken in the medium term following few years of preparation. Therefore, the scenarios below do not refer to other potentially interesting options, such as the creation of a EUCIT, aviation or financial transactions taxation,

which would probably require a longer time-frame to ensure the necessary preparation.

- They would be compatible with various EU budget sizes. The choice of the own resources should not impact in itself on the size of the EU budget. Furthermore, it is assumed that the budget balance rule would be respected in all three scenarios.

6.2. “Full GNI” scenario

Scenario 1 presents a situation where trends observed in past years for the EU financing system are prolonged in the future –and pushed to their limits. Such a scenario is notably built under the assumption that the central motivation of Member States in budgetary negotiations is to minimize their contributions to- or maximize their (budgetary) return from the EU budget⁷⁹.

A key element of this scenario is a further increase in the share of GNI-based contribution in total EU financing at the expense of other resources. Under such a scenario, the VAT-based contribution –sometimes considered as a complex and outdated contribution mechanism related to past attempts to finance the EU budget via a genuine EU VAT– is eliminated. In an extreme variant, one could even envisage the elimination of traditional own resources to finance the EU budget, a step that would be seen favourably by some net contributors.

In this approach, more net contributors could ask benefiting from correction mechanisms, if only to compensate potential deteriorations of their net balances due to increased GNI-based financing. Therefore, it is sometimes suggested that some form of generalised correction mechanism be set

78. See European Commission (2008a).

79. See for instance Osterloh, S., Heinemann, F. and Ph. Mohl (2008).

up in order to ensure more “fairness” (in the narrow meaning of a similar treatment of net contributors with a similar level of economic development) and, possibly, transparency in the mechanisms of correction. Whether this could be a generalised *limited* correction mechanism remains to be seen as it is likely to be difficult for the Member States to define by unanimity which expenditures should be excluded from a generalized correction mechanism⁸⁰.

Due to the persistent focus on *juste retour*, it would also appear reasonable to expect significant expenditures with clearly allocated national or regional benefits rather than unallocated policies or cross-border programmes with higher EU added value. However, should a GLCM be defined *ex ante*, such a situation would be less likely to occur. Although the possibility to envisage separate discussions on financial solidarity and the content of programmes and policies cannot be completely ruled out in theory, it may be difficult to achieve in practice. First, discussions on financial solidarity would likely entail very serious conflicts between the Member States even before discussing a common EU project. Second, precisely because such a separate discussion could lead to a radical reform of a number of existing EU policies, some Member States might oppose it as it could harm important vested interests.

Overall, this scenario would have the advantage of reducing the number and the complexity of own resources. It would increase the weight of financing based on GNI, thus reinforcing the link between economic development and EU financing. On the other hand, it could increase further potential conflicts related to net balances as the system would rely even more than today on forms of Member States contributions. Even though the system of corrections could be somewhat streamlined through the use

80. As recalled above a number of expenditures are already excluded from the UK correction formula, e.g. expenditures related to external relations (heading 4 of the multiannual financial framework). The question really is whether other categories of expenditures could be excluded from a net balances-based formula.

of one single formula applicable to all net contributors, creating a generalized correction mechanism could make it even more difficult to eliminate correction mechanisms at a later stage. Furthermore, serious arguments could be expected on the extent of financial solidarity organized through this system. Lastly, unless financial solidarity could be defined *ex ante*, a bias towards allocated expenditures could be expected.

6.3. Status quo scenario

Despite the widespread recognition of the need for a reform of the financing system, there is not a clear consensus, at this stage, as to what a reform should consist in⁸¹. Due to the need to reach decisions by unanimity, there is a strong *status quo* bias.

As a consequence, adjustments to the current financing system may be fairly limited and there is a possibility of ending up with a status quo scenario. This is why the current system has been represented in the table as a reference point. The analysis of the pros and cons of the current system as well as the rationale for reform can be found in section 2 above.

6.4. “Genuine Own Resource” scenario

The following scenario assumes that, notably as a result of past difficulties to agree on the EU financing system, a radical reform away from past trends should be set up. A key element of this scenario is the introduction of one of the following new own resources in the financing system:

- a resource based on auctioning revenue related to emissions allowances. This resource could be introduced in the EU budget, taking

81. This is a clear result of the Budget Review consultation. See European Commission (2008a).

into account the development of the auctioning mechanisms in the EU and beyond. The new stream of revenues⁸² could be closely related to- and support the EU policies and priorities in the climate and energy areas;

- a resource based on energy taxation, namely motor fuel used for road transport. This resource could ensure a visible financing of the EU. It would relate to important EU policies in the transport, energy and climate areas;
- a modulated EU VAT. This resource would ensure a highly visible financing of the EU budget, thus fostering debates on EU policies and possibly increasing public interest for EU budget matters.

The existing VAT-based resource would be replaced by the new own resource. This would simplify somewhat the Member States contributions (and corrections).

The share of the GNI-based resource in the EU financing would decrease in all cases. However, the timing and budgetary impact of the resources could differ widely between the three options:

- In the case of the progressive increase of resources related to emission allowances auctioning, the share of GNI-based financing would remain substantial for a number of years. Even in the long run, it would likely remain a significant EU own resource and serve as a residual element to ensure budget balance.
- In the case of an EU VAT or a resource based on energy, the link with the GNI-based resource could be more complex. These two potential own resources could potentially bring larger revenues than the current or foreseeable needs of the EU budget⁸³. This could lead to a situation where the GNI-based resource could either be

used as residual resource or become irrelevant depending on the size of the new own resource⁸⁴.

In order to move away from a *juste retour* approach, a progressive phasing out of the existing correction mechanisms could be envisaged. A central element could be the elimination of any correction mechanism based on a calculation of net balances and the use, instead, of transparent and decreasing lump sums operated over a limited period of time, e.g. the duration of one or two multiannual financial frameworks. As a complement, a system of equalization related to the tax effort or other variables could be envisaged, in particular for resources that are not characterized by much regional arbitrariness. In any event, use of net balances calculations should be excluded.

A central element of this reform could be the increased attention devoted to the EU added value of expenditures and to the link between EU policies and EU financing. A form of parallelism between EU financing reform –and in particular the phasing out of all correction mechanisms– and reform of certain expenditure policies, most notably the least consensual parts of CAP, could be necessary to facilitate a global agreement on a reform.

Overall, the approach envisaged under this scenario could foster a dynamic where less focus would be placed on net balances and more on the incidence of the new own resources and their impact on EU policy objectives. The increased visibility of EU financing could increase the debate on the value added of EU spending. On the downside, it is clear that a certain degree of technical complexity may be necessary in the transition to a new financing system. Most importantly, political resistance to the introduction of a new own resource to finance the EU budget could be significant. And increased

82. In order to increase revenue and facilitate efficient taxation of the modes of transport in Europe, duties related to aviation could be added to this resource.

83. For instance, the genuine EU VAT would bring revenue equivalent to around 1% of EU GNI for a 2% EU VAT rate.

84. Should the new own resource lead to revenues larger than foreseen expenditures, a reimbursement to Member States could be organized to ensure budget balance. In this case, the residual GNI resource would become negative, i.e. each Member State would benefit from a reimbursement in proportion to its GNI.

visibility of EU financing may also increase citizens' resentment towards the EU even if the measure does not lead to a change in the EU budget size.

SCENARIOS	EU FINANCING			CORRECTIONS	BALANCING METHOD	IMPACT ON EXPENDITURES
	NEW OWN RESOURCES	TRADITIONAL OWN RESOURCES	MEMBER STATES ‘CONTRIBUTIONS’			
FULL GNI	---	UNCHANGED OR ELIMINATED	GNI-BASED CONTRIBUTION ONLY	GCM OR GLCM	GNI-BASED CONTRIBUTION AS BALANCING ITEM	CLEAR TENDENCY TO FAVOUR ALLOCATED EXPENDITURES (UNLESS AN EX ANTE CORRECTION MECHANISM IS SET UP)
STATUS QUO	---	UNCHANGED	GNI- AND VAT-BASED CONTRIBUTIONS	AD HOC CORRECTIONS	GNI-BASED CONTRIBUTION AS BALANCING ITEM	UNCHANGED
GENUINE OWN RESOURCE	EMISSION ALLOWANCES AUCTIONING	UNCHANGED	DECREASING GNI-BASED CONTRIBUTION	SIMPLIFICATION AND PHASING-OUT OF AD HOC CORRECTIONS (POSSIBLY LINKED TO EXPENDITURE REFORM)	GNI- BASED CONTRIBUTION AS BALANCING ITEM	LESS DEPENDENCY ON ‘CONTRIBUTIONS’, FOCUS ON INCIDENCE OF EU OWN RESOURCES AND EQUALIZATION SYSTEM COULD FACILITATE A DISCUSSION ON EU ADDED VALUE
	ENERGY (ROAD TRANSPORT)		SMALL OR NO GNI-BASED CONTRIBUTION		GNI-BASED CONTRIBUTION AS BALANCING ITEM AND/OR	
	MODULATED VAT				EQUALIZATION MECHANISM	

VII - Conclusions

The current EU financing system works: the existing own resources are sufficient to finance EU expenditures with minimal operating costs.

Yet, dissatisfaction with EU financing is widespread. Criticism covers a wide range of issues: the extreme complexity and opacity of the system and the limited accountability it entails; the lack of fairness of existing correction mechanisms and their impact on the “poisonous” debate on net balances; the lack of a political link between most EU own resources and EU policy objectives; the limited incentive for Member States to favour expenditures with a clear EU added value compared to expenditures with allocated benefits. For these reasons and others, there has been a widespread consensus among the Member States to recognize that a reform would be desirable.

Recognition of a need for reform does not necessarily entail an agreement on the way to achieve it. Many proposals have been made in the past,

notably in the context of the budget review consultation process. The first objective of this paper has been to present a structured overview of some of these proposals and to identify the main avenues for reform related to the various constituent parts of the EU financing system.

Regarding own resources, the paper highlights potential trade-offs between the main options. In a nutshell, a simple budgetary approach would suggest reinforcing the GNI-based own resource at the expense of the VAT-based resource. If, however, the main objective is to increase visibility of EU financing and EU citizens' interest for EU budget issues, the development of a resource based on VAT appears preferable. Lastly, efficiency and subsidiarity arguments, as well as the link to EU policies, suggest collecting revenue related to, for instance, auctioning of emission allowances or energy at EU level. Other options could also be envisaged in a longer-term perspective.

The analysis of options for reform of correction mechanisms is of a different nature. Whereas all options somewhat relate to the need to cope with the net balances issue, the perspective taken in the various proposals differ widely. A reform of expenditures would reduce net contributions and would, according to its proponents, reduce the source of the net balances issue. Others consider this issue as unsolvable and rather suggest setting up a generalised correction mechanism to ensure similar treatments of net contributors. The development of alternative own resources, possibly combined with an equalization mechanism, is seen as a way to broaden and enrich debates on EU budget, thus reducing the focus on net balances. Contrarily to the choice to be made on own resources, several options regarding correction mechanisms are not mutually exclusive but could be combined.

The paper places some emphasis on the potential articulation of various building blocks for a reform. The evolution of own resources is likely to have an impact on correction mechanisms and the budget balancing

mechanism. Based on past evolutions, it seems unlikely that a further increase in GNI-based contributions would go parallel with a reduction in the number or the extent of corrections mechanisms. An EU financing based on national contributions is also more likely to focus on the national return of EU expenditures: it may ultimately lead to less, rather than more, policies with a high EU added value. On the other hand, this analysis suggests that developing alternative financing sources, as part of a broader reform package, may contribute to solving the net balances issue. First, it would force Member States to look more at the impact of the new resource(s) on EU policy objectives and at the incidence of the resource. Second, it could increase the EU citizens' interest for the use made with the resource and to debate its impact. Developing new resources may also facilitate the phasing-out of existing correction mechanisms based on net balances, possibly through the creation of an equalization mechanism.

Ultimately, this analysis makes it clear that there is no simple solution to the complex EU financing problems. A budget reform will need to look at revenues, corrections and expenditures simultaneously. This, in turn, will require a clear and shared EU vision of the potential pros and cons of any avenue for reform.

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