The Impact of New EU Own Resources on Regional and Local Governments

Note for the Temporary Ad hoc Commission
on the EU budget of the
Committee of the Regions

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Executive summary

This note tackles the question of own resources of the European Union, and analyses the potential impact of the introduction of new EU revenue on territorial entities. It has been produced by the European Policy Centre (EPC) under its Framework Contract with the Committee of the Regions (CoR), under which CoR is receiving expert support on issues related to the future budgetary resources of the Union, viewed with a territorial perspective.

In its communication on the EU Budget Review, the European Commission has re-launched the debate on the introduction of an EU tax. The question of introducing 'real' own resources is not new and has always been controversial, being strongly opposed by a number of Member States. The difficult economic context in which the next MFF negotiations will take place suggests that the EU tax will not seriously be on the table, even though the European Commission and the European Parliament (EP) are strongly in favour.

The present note reflects on the pros and cons of an EU tax, focusing in particular on possible impacts on regional and local authorities. Through an analysis of the most recent options considered by the European Commission in its Budget Review Communication, this note highlights the significant implementation obstacles that different types of revenues would encounter. From a territorial perspective, potential challenges are mainly related to the redistribution of economic resources and potential changes to national fiscal arrangements. However, given the rather vague indications given by the European Commission so far, it is difficult to assess in detail all possible consequences.

Instead, what seems to be needed is a more fundamental discussion of the real added value of an EU tax. It is being argued by the European Commission and the European Parliament that an EU tax would enhance the visibility of the Union and its democratic character. However, given the current economic context, it seems quite possible that the imposition of a tax would further alienate citizens. It is also questionable whether the introduction of an EU tax would solve the 'juste retour' problem. Furthermore, the current proposals do not set out how potential territorial or sectoral imbalances would be corrected and what the added value of this tax would be if the European institutions have no control over the level of spending. These questions have to be answered before deciding what direction the debate on the reform of own resources should take.

Introduction

This note has been produced by the European Policy Centre (EPC) under its Framework Contract with the Committee of the Regions (CoR), under which CoR is receiving expert support on issues related to the future budgetary resources of the Union, viewed with a territorial perspective. It aims to analyse possible policy options for the next Multi-Annual Financial Framework (MFF), highlighting the importance of multilevel governance for the future EU budget.

The project, which also foresees a workshop on better spending and multilevel governance, is composed of a series of studies and analysis. This note focuses on the issue of Own Resources and the possible impact their evolution could have on regional and local authorities (RLAs).

Deciding on the EU's financial resources, covering revenues as well as expenditure, is a crucial step in turning EU policy objectives into reality. But the question of how the EU budget is financed has always been subject to controversy. Budget austerity and a slowly recovering economy will not play in favour of an EU tax, even though the European Commission and the European Parliament have been trying to put the question onto the agenda. Even though the introduction of a 'European tax' is unlikely in the near future, it is important to chart the main issues at stake for territorial entities.

In order to set out the own resources debate, possible developments and their likely impact, this paper firstly presents a recap of the own resources system and discusses the Commission proposals. Secondly, the note analyses the current options for an EU tax and their possible impacts on regional and local authorities. Thirdly, the paper underlines the need to discuss the real added value of an EU tax, before taking any decision on new own resources.

1. EU 'own' resources?

Financing the EU budget

The discussion about financing the EU budget has been linked to the evolution of EU policies, often tied to a strengthening of the supranational component. The Treaty establishes that, "The Union shall provide itself with the means necessary to attain its objectives and carry through its policies. Without prejudice to other revenue, the budget shall be financed wholly from own

resources" (Art. 311, Treaty on the Functioning of the European Union). Since 1969[i], three main own resources have been financing the EU budget:

- Tariffs and custom duties[ii], also known as 'traditional own resource' (TOR);
- VAT, calculated from national tax bases; and
- GNI percentage contributions.

The contribution that the VAT own resource and traditional own resources make to total revenue has been decreasing over the last decades, increasingly replaced by the GNI contribution, which today represents around 70% of total EU revenues. The constant increase of these national contributions (GNI) has led many to argue that the term 'own resources' is not very accurate, as EU revenues are in effect a fixed transfer from the Member States. They ultimately remain in control of the process, leading many to question the current financing system.[iii] While the GNI resource ensures stability of the EU budget, it has been criticised for enhancing the well-know logic of 'juste retour'.[iv]

To ensure stability of revenues and at the same time foster stronger ownership, several proposals have been put forward over the years regarding a reform of own resources, including the establishment of a 'European tax'. It has become a sort of *leitmotiv* that the Commission puts out new ideas on possible own resources when starting the discussion about upcoming MFF negotiations. Yet, while the MacDougal Report in 1977 had already foreseen the possible evolution to the system of own resources, no significant modification to the principle structure of own resources has been made since then.

The European Commission and the European Parliament have argued for years that there is a need for what they call a 'real' 'own resource'. The principle of this 'real' revenue would be that the direct link to national treasuries is lost, in favour of a renewed one between the Union and citizens. In addition to this democratic argument, such an own resource is also seen as limiting the 'juste retour' argument. These arguments have been coupled with economic analysis to determine how best to ensure stability and effectiveness of EU revenues.

But a lack of political will on the Member States side has, so far, blocked any move in this direction. While the Lisbon Treaty has given the EP a greater say[v], the current institutional and economic context do not make the option of an EU tax more likely than in previous years.

The Commission proposal

The last Commission proposal on reform of own resources has been put forward in the EU Budget Review (The EU Budget Review, COM(2010)700final). In the Commission's opinion, "the introduction of new own resources would mirror the progressive shift of the budget structure towards policies closer to EU citizens and aiming at delivering European public goods and a higher EU added value". In the European Commission's understanding there seems to be an added value in an 'own resource', especially concerning the efficiency of EU spending.[vi]

Yet, this statement in favour of new own resource is not accompanied by an in-depth analysis, as the Communication only offers a non-exhaustive list of "financing means that could be possible candidates for own resources":

- EU taxation of the financial sector;
- EU revenues from auctioning under the greenhouse gas Emission Trading System;
- EU charge related to air transport;
- EU VAT;
- EU energy tax; and
- EU corporate income tax.

The European Commission has thus re-launched the debate concerning 'real' own resources, without describing what specific added values (or problems) these reforms would entail. It remains to be seen whether the Commission will put a more specific proposal on the table when proposing the new MFF in June 2011.

2. Own resources in the forthcoming MFF negotiations

The debate on new own resources needs to be brought into the wider context of the forthcoming MFF[vii] and how the proposals contained on the EU Budget Review have been received by other institutions and national capitals.

New EU revenues, as much as expenditure, need to be discussed in light of the current economic crisis and budget austerity. As set out previously (F. Zuleeg, 2011), there is a strong *status quo* risk in the forthcoming MFF negotiations, leaving little room for the introduction of a new EU revenue item. This *status*

quo bias, already noticeable at the end of the last negotiations over the financial framework 2007-2013, is being further reinforced by the difficult position of national public finances. At national level, several Member States had to address fiscal deficits through a (severe) reduction of public expenditure as well as the introduction of new taxes. The poor state of public finances and the need for budgetary austerity create a difficult political environment for the introduction of a 'new EU tax'. Proponents could argue convincingly that this 'EU own resource' would not be collected in addition to national taxes but as a replacement of national contributions – but it is very difficult to clearly convey this message to EU citizens, as taxpayers easily associate any 'new' tax to a further burden.

Immediately after the publication of the Commission's Communication several Member States voiced strong opposition to the introduction of a European tax. Besides the UK, whose opposition was inevitable in light of previous statements, German Chancellor Angela Merkel was also said to be 'against the idea of an EU tax' (EuObserver.com, 3 November 2010), ruling out the support of one of the biggest Member States. This German resistance could, in part, be explained as a manifestation of the 'biggest EU contributor' syndrome, ever more present within Berlin's EU discourse. The understandable concerns coupled with discontent of citizens with the current state of EU affairs, especially in light of the handling of the euro crisis, means that Berlin is unlikely to give approval to the introduction of an EU tax.

When, in the aftermath of the financial crisis, President Sarkozy re-launched the idea of a Tobin tax[viii] on financial transactions, some suggested that this could become a new source of revenue for the EU. But this suggestion, together with the original proposal, was left on hold, with French EU Affairs Minister Lellouche judging the Commission proposal on an EU tax "*parfaitement inopportune*".[ix] Among the older EU Member States, only Belgium openly supports the introduction of a new 'own resource', while most others have been opposed to giving such tax powers to the Union. Some new Member States have viewed the possibility of an EU tax more favourably, with Poland having argued for it in the Budget Review consultation process.[x]

Against this generally hostile background, it seems unlikely that Member States will wish to revitalise this discussion at the start of MFF negotiations. However, the EP is pushing strongly for discussion of own resources (as demonstrated in the negotiations around the 2011 budget). Even though the Parliament only has an advisory role in the decision concerning the Union's resources, several MEPs have been working on this issue over the last decade. Alain Lamassoure's (EPP/FR) report in 2007 already set out possible scenario for the medium and long term.[xi] New Member States might also push for a discussion of own

resources, especially since Poland will be holding the Presidency in the second half of 2011.

3. Analysing the options

The present chapter aims at analysing the economic rationale and political likelihood of the introduction of a new own resource, focusing in particular on the possible consequences for territorial entities. In order to do so, we elaborate on the most recurrent proposals which have been put forward both by EU institutions and experts, with a specific focus on the Budget Review Communication.

Most of the opportunities and drawbacks resulting from the introduction of a new EU tax will have different effects on different territorial entities, in a similar way as they would impact differently on Member States. Regional differences within countries and a specific system of fiscal federalism can nonetheless result in additional consequences for some Member States. Countries pursuing reforms aimed at more regional fiscal responsibilities, such as Italy, could experience a more significant impact of a proposed EU tax, as powers for previously national taxes are redistributed to the sub-national level (i.e. VAT).

In 2004 DG TAXUD presented a comprehensive report (Cattoir, 2004) on the possible options for a European tax, listing the following as criteria for the assessment of EU taxes:

1) Budgetary criteria
    a. Sufficiency
    b. Stability
2) Efficiency criteria
    a. Visibility
    b. Low operating costs
    c. Efficient allocation of resources
3) Equity criteria
    a. Horizontal equity
    b. Vertical equity
    c. Fair contribution[xii]

On the basis of this comprehensive list of criteria, the Commission elaborated an analysis which offers a good overview of the arguments in favour and against several options.[xiii] While this and several other studies have analysed the possible impacts of own resources on countries, not much is said about the specific consequences a tax could have on regions or local governments.

By going through the latest options[xiv] outlined by the Commission (EU Budget Review, COM(2010) 700final), we will try to underline whether there are territorial implications that should be taken into account. However, it is worth noting that all proposed new taxes are likely to have a differential impact across regions, as levels of development, sectoral focus and the business cycles differ. So for example, a region with below average GDP and lower levels of consumption is likely to be less affected by a VAT-based tax. Similarly, a region with a heavy reliance on airports would be disproportionately affected by a tax on aviation. But this could also be seen as desirable in terms of burden sharing across Europe, as those with higher economic activity will tend to pay proportionately more.

But what are the pros and cons of the different options brought into the debate by the European Commission?

A. EU taxation of the financial sector

Proposals aiming to impose additional taxes on the financial sector have gained momentum in the aftermath of the financial crisis, as the idea of making the financial sector 'pay' for the costs of the crisis has increasingly become politically attractive.[xv] Being a pioneer in advocating the need for such a tax could also positively reflect on the international status of the EU with respect to the principle of social justice advocated by parts of European society. The main drawback is that the EU would face a possible loss of competitiveness, in comparison to other regions of the world which are not ready to introduce such a tax, and this makes it highly controversial especially in countries/regions which have a high reliance on the financial sector.

The European Commission has not elaborated in detail on how such a tax would be raised, what exactly would be the tax base and how it would be collected, making it difficult to assess this proposal. However, taxing the financial sector only partially fulfils the budgetary criteria, as budgetary stability could be affected by economic cycles making the revenue highly uncertain. Moreover, the reaction of the market to the introduction of such a tax is difficult to estimate, and it could result in a decrease of transactions within the EU. Last but not least, it is likely that the burden would ultimately be on consumers.

In terms of efficiency and visibility, the tax would certainly be much appreciated by a vast majority of EU citizens given the current political context. However, administrative costs and the efficiency in resources distribution are difficult to estimate at this stage without having further details on the proposal, but the burden of collection should not be very high. As it would be a new tax, it would

not need any restructuring of national (sub-national) systems or the redistribution of resources between different levels of government.

B. EU revenues from auctioning under the greenhouse gas Emission Trading System (ETS)

Using the ETS system to raise EU revenue would fit well with the policy objectives of the EU, adding an element of legitimacy. As the ETS is already an EU-level policy tool, it could also be seen as a natural candidate for EU own resources. However, there are several problems linked to using the ETS as a source of revenue. Stability and sufficiency could not be guaranteed, as revenues will depend on carbon market activity and policy decisions on the desirable level of carbon emission. This is crucial: ETS does not have revenue raising as its principal objective, but rather is designed to achieve environmental objectives. Revenues would thus be determined by environmental criteria, making the revenue highly uncertain. If additional revenues are generated through the ETS than currently, one would have to ensure that there is no double taxation, i.e. companies paying for ETS certificates and paying a tax additionally.

In principle, such revenues would not directly impact on regional and local authorities (RLAs), as ETS already operates at EU level. However, depending on the composition of its industry, some regions and cities would be faced with a disproportionate impact and potentially the loss of industry to other locations outside the EU.

C. EU charge related to air transport

The option of an EU charge related to air transport refers to the possibility of taxing all freight and passenger flights entering, operating and/or leaving the European Flight Information Region.[xvi] The possible functioning of such a tax is at this stage very vague, not allowing for a comprehensive assessment. But the principle of this tax is to impose a relatively small levy on an activity characterised by many transactions, with only a marginal effect on individual passengers. This tax is likely to fulfil the criteria of sufficiency and stability.

While there could be possible consequences for RLAs from different collecting arrangements (for example, if local authorities would be responsible for the collection of the tax), this seems unlikely. However, there might be a reduction on activity which could hit local businesses (i.e. fewer flights); should this be the case, compensation/correction mechanisms might need to be put in place. Some have also argued that such a tax would correct a market failure, reducing

negative externalities from air traffic. However, this seems in contradiction with the marginal impact noted above.

D. EU VAT

A modulated VAT has been one of the most discussed options, in part because there is a certain degree of tax base harmonisation across Europe. This would make the implementation of an EU VAT surcharge easier than the other options discussed here, as national VAT systems would be untouched, with a European VAT percentage added.[xvii] In budgetary terms, such a resource would ensure a certain degree of sufficiency and stability, with the proviso that VAT depends on national/regional economic circumstances and business cycles.

A true VAT own resource[xviii] has been advocated by many as the best option for a true EU own resource. However, there are others who are concerned that a European VAT would suffer from the same inequalities problem which is present in the national systems. VAT tends to be regressive, with poorer people paying proportionally more of their income as they consume a greater proportion. This regressive character of VAT would also put a proportionally bigger burden on poorer regions, where the level of consumption as a proportion of overall GDP would tend to be higher.

From a territorial perspective, there might be a specific impact depending on national arrangements. In some countries, VAT revenues might be redistributed to regions, for example as forms of compensation for regional disparities.[xix] The introduction of an EU tax could potentially lead to a need to restructure national arrangements.

E. EU energy tax

The driving principle of this tax is the correction of market failures and on behaviours that might have market distorting effects. Tax revenues would depend extensively on the response of the market, as well as the broader economic environment. As a result, the amount of revenue raised would not fulfil the criterion of stability, only the criterion of sufficiency.

The tax base for energy taxation would be defined at EU level in order to ensure horizontal equality. However, this does not avoid the different impact it would have on countries and regions, depending on their economic environment, the resources available and national, regional and local political choices. Similar issues arise as discussed above in relation to ETS: the main function is not

revenue arising, but market failure correction and there could be double taxation issues.

F. EU corporate income tax

The idea of a European Union corporate income tax (EUCIT) has always been faced with strong opposition from Member States. In the current context, one could argue that, like the tax on financial transaction, this option might gain citizens' support in the aftermath of the crisis. However, even with political agreement, numerous problems would make the implementation of a EUCIT difficult.

Budgetary criteria would not be fulfilled, as sufficiency and stability could not be ensured. The tax would concern a limited number of economic actors, and the amount of tax raised will depend on their reaction and performance, which is cyclical. The biggest difficulty relates to the lack of harmonisation of tax bases around the EU. The political will to initiate a process of harmonisation is still missing, and the costs of restructuring national systems could be extremely high.

An EUCIT also risks having even more distorting effects than the financial sector tax. It is impossible to predict the reactions of corporates, but there might be negative consequences for regions where the current income tax is low.[xx] Moreover, from a territorial perspective, there might be impacts deriving from the replacement of national corporate income tax, as in some countries part of the collected revenue benefits RLAs.

4. EU added value?

Despite much debate on the different options, the political realities make the introduction of a 'real' own resource highly unlikely at this stage. But even if this could be achieved, there are some fundamental questions, which proponents of this reform need to answer for such a tax to benefit the EU. There are five key issues which need to be resolved, all hinging around the question of what such a tax is for beyond its symbolic character:

- Is the aim primarily revenue raising to finance EU operations, or is it to achieve a specific policy goal as in the taxation of activities with negative externalities (e.g. carbon emissions)?

- Do the mechanisms exist to accompany enhanced visibility of (unpopular) EU revenue raising with the opportunity to set out to citizens why such revenue might deliver added value?
- Will these proposals resolve the juste retour issue or achieve the wider goals of more EU-level control,[xxi] or will Member States continue to focus on their 'net position' irrespective of the actual sources of revenue?
- Are there proposals to counterbalance sectoral/regional distortions created by such a tax?
- Can any of the proposals be considered as a 'real' own resource if the overall level of expenditure, and by implication the tax rate, is determined elsewhere, and when EU institutions have political responsibility only for how the money is spent but not for the level of expenditure?

It could be argued that even small steps along the way represent progress towards a long-term goal, but, equally, such small steps could carry significant risk that the EU further alienates citizens and Member States. Given the low likelihood of achieving radical reform, it might be better to focus on a limited reform of the current own resource system (for example, abolition of the current VAT resource), and at the same time examine where more needs to be done to equip the EU with the additional policy tools it needs to achieve its long term policy goals.

Conclusions

Despite the low likelihood of radical reform of the EU's resources during the forthcoming MFF negotiations, the need for 'real' own resources will continue to be argued for by the European Commission and the European Parliament. This note has presented an analysis of possible implications of such reform for territorial authorities by discussing the most recent options put forward by the European Commission (*The EU Budget Review*, COM(2010)700final). The note has underlined the main obstacles linked to implementation of each option and how these could impact in national structures and on centre-periphery fiscal relations. The note also argues that many of the implications at Member State level, such as significant differences in the volume of tax collected in different territories, would be reproduced on a regional and local level. In addition, substantive differences among territories in terms of economic development and of fiscal arrangements could result in a more severe impact and issues of fiscal equity unless a balancing/correction mechanism exists at national or EU level.

The issue of EU own resources has always been very controversial, and Member States have been opposed to the idea of an EU tax for the past decades. In addition, the inherent status quo bias in the negotiation process will imply incremental change to the structure and governance of the EU budget, rather than a 'big bang' reform. Against this background, it seems very unlikely that the current economic and institutional context would allow for the introduction of such an EU tax. But there is also a more fundamental question: would the introduction of such an EU tax in the current environment benefit the EU? The European Commission and the European Parliament argue that an EU tax would enhance the visibility of the European Union. However, within the current economic context, it seems more reasonable to argue that introducing a new own resource would run the risk of further alienating citizens and Member States.

Rather, at this stage, the European Union needs to reflect on additional policy tools, which would allow it to achieve long term objectives with a real added value. It the EU manages to set down an effective path towards growth and prosperity, this can be a way to acquire legitimacy and therefore enhance visibility.

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Endnotes

[i] During its first years, the EEC was financed wholly by national contributions.
[ii] We include in these agricultural levies, which are one specific form of import tariffs.
[iii] Many experts and policy-makers have argued against the perpetuation of the system of GNI contribution in the long term, among them Gabriele Cipriani, official from the Court of Auditors. See, for instance, 'Rethinking the budget. Three unavoidable reforms', Centre for European Policy Study, CEPS Paperbacks, 2007
[iv] The concept of 'juste retour' is based on the idea that contributions to EU budget should be proportionally compensated by a return, especially for 'net contributors'. The idea, which has been developing following the introduction of the UK rebate, is based on an accounting-based calculation of how much money is given to the EU and how much comes back to the respective counties.
[v] With the Treaty of Lisbon, Article 311 of the Treaty on the Functioning of the European Union, the European Parliament is to be consulted on decision related to EU 'own-resources'.
[vi] See also Report from the European Commission on the Financing of the European Union and on the Functioning of the System of Own Resources, COM(2004) 505 final/2.
[vii] Zuleeg, F., (2011), In danger of breakdown: Is the EU approaching budget stalemate?, EPC Issue Paper No. 63
[viii] In 1972, the economist James Tobin suggested the introduction of a tax on financial transaction, which would be imposed on short-term exchanges in different currencies. This idea later became very popular and even a political engagement for groups such as the French 'Attac', an altermondialist movement.
[ix] Rtbf.be, 'La Belgique, elle, est favorable à un impôt européen', 10 August 2010, http://www.rtbf.be/info/economie/europe/vers-un-impot-europeen-244194
[x] Poland's reply to "A PUBLIC CONSULTATION PAPER IN VIEW OF THE 2008/2009 BUDGET REVIEW", http://ec.europa.eu/budget/reform/library/contributions/pgs/20080409_PGS_22_en.pdf
[xi] It also originated the proposal on taxation of SMS which was less than enthusiastically received.
xii For a comprehensive description of the criteria, see Cattoir, (2004), *Tax-based EU own resources : An assessment*, Taxation papers, 2004
[xiii] The paper presents a technical analysis of pros and cons of the main options for financing the EU budget. It concludes by stating that, while there is no such thing as a perfect EU tax, the broader political objectives of the European Union should give guidance as to decide whether to introduce a tax and which type of duty.
[xiv] Through the years numerous options have been put forward, by the Commission as well as by other institutions and experts. Our study being focused on the EU Budget Review, we will focus on the options outlined there.
[xv] It is, however, not necessarily the case that this would be paid by the financial sector, as additional charges might well end up being transferred to the customer.
[xvi] The proposal made by the European Commission in the technical annex to the Budget Review seems to be a compromise between the original proposal of a tax on companies and the more recent proposal of a tariff imposed directly on passengers (Begg, Enderlein et al., *Final Report on EU financing*, written for the EU Commission). The current proposal would amount to a few euros per passengers, which would be charged most probably in addition to the cost of the flight.
[xvii] Presumably, to be overall revenue neutral, there would be an equivalent reduction in the national rate.
[xviii] As we outlined in the first chapter, a percentage of national VAT, calculated on the tax base, is already contributing for almost 20% of total EU budget. In order to offer a compensation for its regressive character, the maximum call-in rate has been capped; the last own resources decision fix this rate at 0.5% of the harmonised and capped VAT base.
[xix] This could be the case in Italy, for instance, with the provisions concerning fiscal federalism.
[xx] While the EU tax rate would consist of a similar surcharge to be added in all countries, the marginal impact will differ significantly, depending on the prior level of taxation.
[xxi] See Heinemann, F., Mohl, P., Osterloh, S., (2008), *Reform Options for the EU Own Resources System, Paperback*, ZEW Economic Studies