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Rethinking How to Pay for Europe

Abstract

Although most of the debate on reform of the EU budget has centred on how EU money should be spent, it is important to recall that the mandate for the seemingly interminable 2008/9 (sic) review also called for a fresh look at 'resources, including the UK rebate'. For many commentators, the financing of the budget is seen as a matter of second or third order of importance compared with the highly contentious issues around EU spending. Yet it is an issue that can be just as fraught when it comes to the negotiations, not least because the accounting conventions mean that the vexed question of 'corrections' (the UK rebate and most of the other devices used to lower the net contributions of certain Member States) is deemed to be on the revenue side. An imaginative outcome to the budget review would see a willingness to countenance new forms of revenue instrument for the EU that would enable citizens more easily to see how the budget is funded, and the elimination of the anomaly of corrections within a few years. Yet the fear must be that EU leaders will shy away from bold decisions on funding the budget. This paper argues that there are credible options and good reasons to be more ambitious.

Background and current position

The EU budget is, formally, funded by own resources, that is revenue streams that 'belong' to the EU level of government. In its early days, the then EEC was funded by direct transfers from Member States, but this changed in 1971 with the implementation of new arrangements that were intended to ring-fence the EU's revenue. Nevertheless, even after the 1971 change, the EU's revenue has come from a combination of direct transfers from the Member States and the proceeds of specific resources formally assigned to the EU budget.

Constitutionally, this is now provided for in Art. 311 of the Lisbon Treaty, which states that 'without prejudice to other revenue, the budget shall be financed wholly from own resources', and is unchanged in wording from the corresponding article (269) in the Treaty on the European Communities. The article also provides for the Council to decide on a system of own resources, which it has done through a succession of Own Resources Decisions that have been adopted subsequent to the agreement of the Medium-Term Financial Framework. However, a comparison of the two articles shows (see box 1 on the next page) that the Lisbon Treaty introduces additional wording about the prospect of changing the categories of resources.

It is far from clear precisely how the new wording will alter the decision-making on EU financing and the subsequent implementation, if at all. It appears to leave the Council in the driving-seat, and to retain the national vetoes by requiring approval by Member States according to their constitutional requirements. The European Parliament has to give its consent to implementing measures, but only has to be consulted on the provisions, including the choice of resources. More intriguingly, despite explicitly mentioning new own resources or the abolition of existing ones, it does not seem to open the way for the Parliament to propose any such resources.

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BOX 1 TREATY PROVISIONS ON FUNDING THE EU BUDGET

Article 269 Treaty on the European Communities	Article 311 Lisbon Treaty
	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.	Without prejudice to other revenue, the budget shall be financed wholly from own resources.
The Council, acting unanimously on a proposal from the Commission and after consulting the European Parliament, shall lay down provisions relating to the system of own resources of the Community, which it shall recommend to the Member States for adoption in accordance with their respective constitutional requirements.	The Council, acting in accordance with a special legislative procedure, shall unanimously and after consulting the European Parliament adopt a decision laying down the provisions relating to the system of own resources of the Union. In this context it may establish new categories of own resources or abolish an existing category. That decision shall not enter into force until it is approved by the Member States in accordance with their respective constitutional requirements.
	The Council, acting by means of regulations in accordance with a special legislative procedure, shall lay down implementing measures for the Union's own resources system in so far as this is provided for in the decision adopted on the basis of the third paragraph. The Council shall act after obtaining the consent of the European Parliament.

The shifting mix of own resources

During the 1970s, the main EU own resources were customs duties and levies on agricultural imports (now known as the traditional own resources – TOR) which accounted for around two-thirds of the revenue when they reached their peak yield in the mid-1970s. However, it rapidly became clear that this source could not keep pace with EU spending[1] and, from 1979, a third resource based on a harmonised proportion of each Member State's revenue from VAT gradually became the principal funding source.

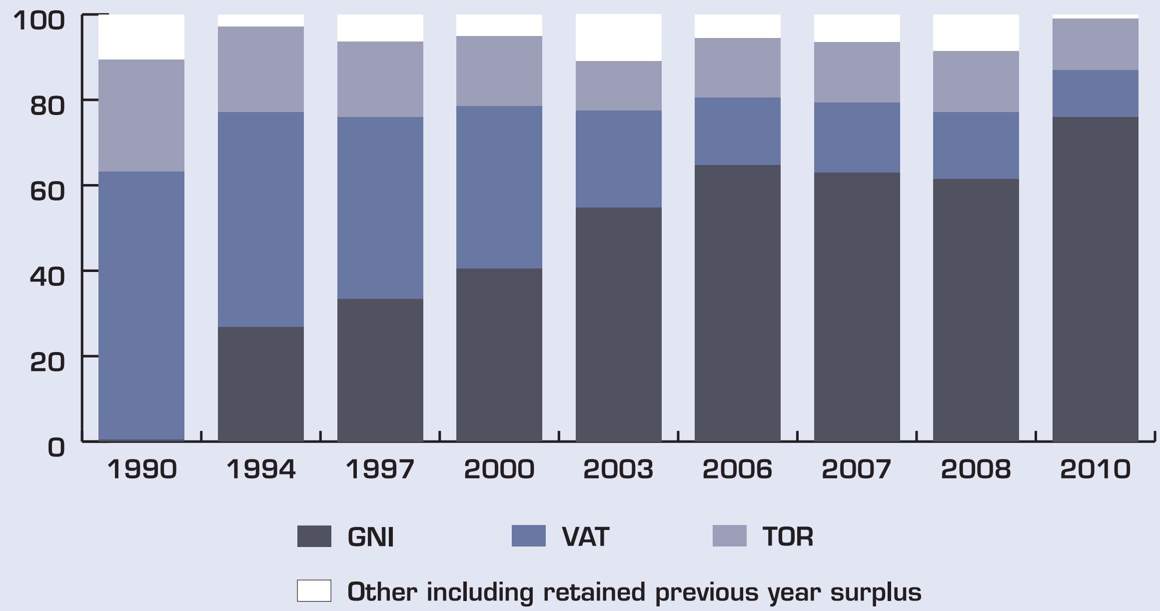
Although these three resources provided just about enough revenue over the following decade – the period when Mrs Thatcher's handbag was deployed to greatest effect – the further increases in the size of the EU budget agreed for the Delors years meant that additional funding would be required. Despite efforts to identify a fourth resource in the form of an identifiable revenue instrument (a tax or some other source) that would demonstrably belong to the EU level, the solution eventually adopted 1988 was to create a new revenue stream calibrated on each Member State's national income.

This fourth resource has a residual character in that it is only called upon when the revenue from the first three instruments falls short of expenditure. Its nature also reflects the Treaty obligation for the EU budget to be in balance, so that what is demanded is just enough to assure balance. When first introduced, it was barely called upon. Subsequently, the share of the TOR has fallen further, while adjustments to what is known as the take-up rate of the VAT resource have seen it fall from being the main funding stream to yielding barely more than the traditional own resources. The corollary is that most of the EU's revenue now comes from what is now known as the GNI (gross national income) resource which, on average over the last full budgeting cycle from 2000–06, covered 54% of EU funding – see figure 1 on the next page.

In the last two years it has remained above 60% and is projected to exceed 70% in 2010. In other words the EU budget is now funded principally from an intergovernmental transfer. Moreover, although the VAT resource has declined in relative importance, the fact that it is subject to a variety of adjustments means that it is also, *de facto*, a GNI resource insofar as the adjustments

[1] The reduction in tariff revenues as a result of multi-lateral trade deals was also a factor.

FIGURE 1 SOURCES OF EU REVENUE



Source: Commission (2009) and DG Budget web-site for provisional 2010 figures

make what each country pays broadly proportional to its GNI. These two resources are classified as 'national contributions' and shown as such in the EU's official presentation of the budget in, for example, the annual *Financial Report*. The upshot is that around 80% of the EU budget in recent years has come from national contributions, and only the small balance from the two resources that are described in the report as own resources and 'other revenue'.

That rebate and other 'corrections'

Since the UK acceded to the EEC in 1973, the issue of net contributions to the EU budget has been an especially sensitive one, not least because, throughout the 1980s, only the UK and Germany were consistently net contributors. Given the relatively low GDP per head of the UK then and the way EU spending was tilted against the UK, the inequity of the position was recognised by other Member States. Various ad hoc deals were struck in the early 1980s to reduce the imbalance, before the UK rebate that has remained since then (albeit with some adjustments) was introduced in 1984. Subsequently, redressing accounting imbalances through 'correction' mechanisms has become an increasingly prominent aspect of successive EU budget deals since the 1980s.

The UK rebate is the most long-standing and high profile 'correction' mechanism, but far from the only one – see box 2 on the next page. Indeed, the Netherlands, arguably, currently has four separate corrections, while Sweden has three. Moreover, the last budget agreement had a long list of special arrangements on the expenditure side that can be regarded as more to do with the net financial positions than a considered judgement on the content of policies.

The case for truly 'owned' resources

It is a moot point whether the current mix of own resources is consistent with the Treaty provision on how the EU budget should be funded. In purely legalistic terms, since the VAT resource and the GNI resource are included in the Own Resources Decision – the legal instrument that spells out the resources to be used – there is no doubt that they are resources that the EU is entitled to receive. A more tricky question is whether they conform to the spirit of 'own'. The national contributions are lumped together and paid directly by national finance ministries every month to the EU. In this respect, they closely resemble the inter-governmental transfers that central governments typically make to local government. In effect, this means that they are funded by the whole gamut of taxes under the control of the

BOX 2 PROLIFERATING CORRECTION MECHANISMS

The original 'abatement' was granted to the UK in 1984 to offset the fact that the UK received only a comparatively low share of EU spending and, by importing more from the rest of the world, paid more in customs duties, resulting in an unreasonably high net contribution.

Also in 1984, Germany (as the only other substantial net contributor) was asked to pay only a part-share of its ex-ante contribution to the UK rebate, with other countries having to make up the shortfall pro rata.

In the 1999 budget settlement, three other Member States (Austria, the Netherlands and Sweden) were also given rebates on their contributions to the UK abatement. This rebate on the rebate was retained for the 2007–13 period.

It was, further, agreed in 1999 that the 'fee' paid to Member States for collecting customs duties would be increased from 10% of the proceeds to 25%, a change that mainly benefited Belgium and the Netherlands because of the disproportionate share of imports from the rest of the world entering the EU through their ports (especially Antwerp and Rotterdam). The UK, however, undertook to forgo part of the windfall gain it would have received from this amendment.

In 1999, too, special payments under the Structural Funds were agreed for the Netherlands, Austria and Sweden with no more justification than, to cite the example of an allocation of €500 million to the Netherlands, a bland statement that this was 'to take account of the particular characteristics of labour market participation in the Netherlands'.

Further corrections were included in the 2007–13 budget settlement, in addition to a new clutch of ad hoc spending commitments (including €75 million for Bavaria) through:

- Reducing the call up rate on the VAT resource for the Netherlands and Sweden (cut to 0.10), Germany (down to 0.15) and Austria (set at 0.225), compared with a rate for all other Member States of 0.30.
- Reducing the call up rate on the 4th resource for the Netherlands by €605 million and for Sweden by €150 million over the period 2007–13 only.

national government, rather than being based on readily identifiable revenue sources. To put it another way, there is no single tax or other revenue that EU citizens can see being hypothecated towards EU expenditure.

Does any of this ultimately matter? 'Own' taxes are widely regarded in the public finance literature as being a useful device for improving the incentives and accountability of any government, whereas an intergovernmental transfer lacks such a direct link. At the same time, an inter-governmental transfer tends to confer a power of control on the authority that disburses the funds, thereby limiting the autonomy of the recipient. The implication is that the EU as a budgetary authority is more constrained than it would be if it had genuine own resources; some will find this re-assuring, but others might bemoan it.

The dominance of national contributions and the low proportion of true own resources is said to reinforce the propensity of Member States to look at the EU budget primarily in terms of *juste retour*, the notion that what matters most for any Member State in EU public finances is achieving an acceptable net accounting position vis-à-vis the EU finances, even if attaining it means distorting expenditure. From the perspective of a Finance Ministry, a focus on net gains is unsurprising, because they tend to regard being parsimonious with the nation's money as a virtue. But what risks being lost is a sharp enough focus on optimal EU spending. The allegation is that faced with a choice between EU spending that is for the greater good and securing 'my money back', the politically savvy finance Minister will always prefer the latter.

Juste retour and the corrections

The existence of corrections testifies to the failure to agree a budget that is acceptable to all Member States. As such, their use is a distant second-best solution for a delicate political problem. Although their political purpose and justification is obvious, they are a pretty bizarre way of organising public finances and it is hard to identify parallels in other jurisdictions. The root cause of imbalances is the uneven distribution of EU spending among the EU Member States, resulting from the mix of policies that the budget funds. This unevenness stems, in part, from policies (notably cohesion) that have the explicit distributive aim of steering resources to less prosperous Member States. But it also reflects the design and rules of policies (above all, the Common Agricultural Policy, though research funding is another EU policy area that has an uneven incidence) that systematically favour some Member States over others. The balance of advantage can shift if the policies in question are reformed, as happened with the MacSharry reforms of the CAP in the early 1990s which led to a substantial shift in net positions, notably that of the Netherlands. Similarly, the countries that acceded to the EU in 2004 and 2007 would benefit substantially after 2013 if they were to gain full entitlements to CAP direct payments that they have been denied in the present period.

The net balance, self-evidently, is the difference between what the Member State pays into the EU budget and what it receives from it. Yet what is beguilingly simple conceptually becomes disturbingly complex in practice, for all sorts of reasons. There are, first, purely technical problems in adding up the different flows. The simplest example is expenditure which occurs in a country, but not for the exclusive benefit of that country, such as EU administrative spending, disproportionate shares of which appear to accrue to Belgium and Luxembourg. Indeed, if administrative spending is included, Luxembourg receives the highest net per capita inflow from the EU budget, despite being the richest Member States as measured by having the highest level of per capita GNI.

A second technical issue is that agricultural levies and customs duties (the traditional own resources) are collected by national authorities (usually customs) who – in this capacity – act as agents for the EU. For performing this function, they are allowed to keep 25% of the proceeds as an administrative charge. Not surprisingly, many customs administrations maintain that this charge does not even cover their costs, but others argue that customs perform many other functions (not the least of which is policing illegal drugs) and that the marginal cost of collecting duties is relatively low.

In addition, since a high proportion of customs duties are collected at major ports of entry into the EU, the Member States in which they are located tend to 'book' higher levels of traditional own resources. In 2007, a fairly typical year, the Netherlands and Belgium collected some 35% and 25% more, respectively, (in cash terms, ***not*** relative to GNI) from traditional own resources than France or Spain. Unless it can be convincingly shown that the average Belgian or Dutch resident has a vastly greater appetite for imports from the rest of the world than those living in other EU nations, the only conclusion to draw is that the duties are being levied on imports that are ultimately trans-shipped to other Member States. Austria, a small open economy close in size to Belgium, but with only Vienna airport as a major point of entry from outside the EU, raised less than one eighth of the revenue raised by Belgium from this source.

Prior to corrections, the gross payments into the budget calculated for each Member State are broadly, but not precisely, proportional to GNI. The various corrections alter the picture because, while the total revenue requirement does not change, corrections that give 'money back' to selected Member States necessarily mean that others have to pay more. The upshot, and a politically very sensitive issue for the Member States in question, is that several of the least prosperous Member States end up paying a higher proportion of their GNI into the EU budget than their richer peers, making it an apparently regressive system. The understandable retort from the net contributors is that it is not the gross payments but the net receipts from the budget that matter, so that a Member State asked to pay, say, 1.2% of GNI into the budget should not complain if its net receipts are 3.6%. Both propositions are defensible, illustrating how easy it is for the debate on financing to descend into a *dialogue des sourds*.

More overtly political concerns about net balances fall into three main categories. Perhaps the most contentious is that by concentrating attention on net financial flows, the political purpose and autonomous role of the EU is neglected: by reducing the EU to an agent from which Member States look only to minimise the net cost, the Member States curb its power. This may be precisely what many critics of the EU want, but it may also constrain the EU more than is desirable.

A second political concern is that allowing net balances to dominate the debate can over-shadow the wider net benefits of EU membership and distract attention from the underlying objectives of integration. While the EU budget is a large sum of money, the net amounts at stake for any single Member State are low and the political damage to the EU of the disputes engendered may be out of proportion to the savings that individual finance ministers are able to claim. Moreover, estimates of how Member States benefit from EU membership (Gretschmann, 1998) suggest that the non financial benefits (for example of market access) greatly outweigh the narrow financial contributions.

More prosaically, a net balance mentality can create perverse incentives by inducing Member States to opt for EU expenditure that favours their net positions rather than what makes most sense for the purposes of the EU. The cohesion budget, for example, has routinely been used to mitigate the net contributions of certain richer Member States. The result may be to favour distributive spending over pure EU public goods, and one of the ironies of the 2005 settlement was that the area of competitiveness on which many net contributor countries wanted to boost EU spending was the one that was cut back most compared with the initial Commission proposal for the 2007–13 MFF, published in February 2004 (Commission, 2004). These issues are, manifestly, about EU expenditure, but because the convention is to treat corrections on the financing side, the ramifications fall on the latter.

Should changes occur?

There are several tiers to the debate on potential reform. A first, important proposition is that the present arrangements for EU revenue have one outstanding virtue which is that they ensure that planned expenditure can be financed. This follows inexorably from the residual nature of the GNI resource, which means that the EU does not have to fret about whether the yield from a particular tax on which it relies heavily will fall short. Apart from the unlikely contingency of a Member State withholding payment (as has happened with some international organisations, including the United Nations), the EU as a budgetary authority is in a position that many chief financial officers would envy enormously. One answer, strongly favoured by a majority of Finance Ministers and generally supported by the Member States that are net contributors to the budget, is therefore to leave well alone.

However, a budget dominated by national contributions breaks the direct link between the tax-payer and the spending authority and has a number of other shortcomings. It stretches the definition of own resources, because there is a clear difference between an inter-governmental transfer and a truly owned resource.

Almost any resource that might be used to fund the budget – whether in the form of a designated tax or another funding source which is not, strictly, a tax (hereafter, the term 'EU tax' is used as shorthand) – will entail complications of different sorts. Its yield is bound to be less certain than national contributions and that too will have ramifications: if the yield is subject to cyclical fluctuations and fell short of covering expenditure, some residual mechanism would be required because of the Treaty stipulation that the EU must balance its budget. This could, manifestly, be a scaled down GNI resource, as at present. If the yield of an EU tax exceeds the expenditure, the balanced budget rule would demand that money be returned – but to whom: the tax-payers or the Member States? Supporters of simplicity would, however, be entitled to ask what would be gained by adding an EU tax to the mix, even if the share of the GNI resource was much reduced.

Any EU tax will require a definition of the tax base, potentially raising problems of fairness, and a mechanism would be needed to set the tax rate. In most democracies, elected representatives set these parameters, but there are clearly wider political considerations involved in conferring a power to tax on the European Parliament. If it is the Council (and thus the Member States) that have the biggest say in these matters, the likelihood is that the negotiators would arrive with elaborate spreadsheets programmed to calculate national advantage, rather than the European interest.

In addition, using specific revenue instruments will undoubtedly make the calibration of net balances more difficult. If *juste retour* is expected to remain a central principle for EU public finances, shifting to an EU tax or taxes will make it harder to establish how much is raised from each Member State. Such difficulties are exemplified, as explained above, for the traditional own resources which are, in effect an EU import tax and would also arise for some of the other EU taxes that have been proposed.

The yield of a corporate income tax, for example, would appear to accrue to the Member State where the company declares its profits. Yet in an increasingly integrated economic system, those profits could be generated in any number of national markets, both inside and outside the EU and the true unfairness is that the countries with the favourable tax regimes obtain windfall benefits. Tax competition may also lead to under-taxation of corporate income, with the corollary that other tax bases have to shoulder a higher burden. There is, therefore, a certain irony in one of the arguments often adduced in favour of an EU tax, namely that *because* it would make it much harder to determine how much was raised from each Member State, it would diminish the 'poisonous' emphasis on *juste retour* (Le Cacheux, 2005). These are deep waters.

Funding from national contributions

Recognising that much depends on the details, there is a relatively simple choice to be made between funding the EU budget largely through national contributions or through own taxes. The primary attraction of national contributions is that they make it easy to ensure that what each Member State pays conforms to the agreed formula for distribution of the funding burden. Today, the formula is proportionality which requires that the call on each Member State is proportional to its level of prosperity. In simple terms, if the EU plans to spend 1% of aggregate GNI, a proportional payment would mean that each Member State would be asked to contribute 1% of its own GNI. However, if a political decision were taken to have a more progressive system linked, say, to relative prosperity as measured by GNI per head measured in purchasing power, it would not be an especially demanding challenge to devise a suitable formula. This could be to charge in bands according to relative prosperity (for instance: 0.8%) of GNI for the poorest, 1% for those in the middle and a top rate of 1.2% for the richest), or to have an equation that gradually increases the proportion as GNI per head rises, up to a maximum (as advocated in the 1987 Padoa-Schioppa report). After all, most national income tax systems do this in one way or another.

Nevertheless, there are good reasons for being sceptical about the merits of national contributions. In practice, assessing payments at the level of the Member State implies that the Member State is the taxpayer and that, therefore, only the aggregate position of the Member State should be considered in assessing how to pay for the EU budget. The corollary is that other criteria routinely used in assessing the distribution of tax burdens are neglected. Before the adjustments made to enable corrections, the national contribution is equivalent to a flat tax on the Member States, but no account is taken of the incidence of national contributions on different classes of citizens. It is, therefore, entirely possible that two EU citizens in identical circumstances in terms of income, could be taxed at different rates to pay for the EU if their respective national tax systems work differently.

A further political argument is that the EU is not just an inter-governmental organisation (like the United Nations) but also has a political standing and status of its own. The EU is defined in the Treaty as a Union of Member States and of citizens (Art. 1, Lisbon Treaty, which refers to the Union's task being to organise 'relations between the Member States and between their citizens'). Criticisms are frequently levelled at the EU for its lack of legitimacy and some argue that the nature of the funding system is a contributory factor (for example, Le Cacheux, 2007). There is, consequently, some strength in the argument that the decision-making process on EU finances exacerbates the poor image of the EU: clearly when the focus is on net financial balances, other imperatives become lost. While the root of the problem is on the expenditure side, the entrenchment of corrections and the reliance on national contributions has been a factor.

Is an EU tax conceivable?

'If it ain't broke, don't fix it' is a maxim that decision-makers ignore at their peril. It is certainly true that the current EU financing system has many attractions and, perhaps more tellingly, is of a second or third order of importance in much of the debate on reform of the budget. There is evident dissatisfaction with the UK rebate and the other corrections, but no obvious clamour for EU taxes to be introduced in place of the national contributions. Even so, the case for change should not be dismissed, even though any alternative system is likely to be messier or more complicated than the present one when judged purely in terms of its revenue raising capabilities.

There are several myths about EU taxes that deserve to be confronted. The first is that to impose one would represent a sea-change and would be the thin end of a wedge leading to an EU power to tax. Yet the reality is that, in the traditional own resources, there are already EU taxes, so that the principle is established. A second, related myth is that an EU tax would infringe on the primacy of Member States in taxation. But why should it? In unitary states, it is routine for central governments to assign particular taxes to lower tiers, yet the central government typically retains the authority to tax, while in federal systems, various devices for assigning taxes are deployed without compromising the ultimate power of the national legislature. Finance ministers have an instinctive reluctance to hypothecate taxes under any circumstances, but they do it. There is, nevertheless, a debate to be had about whether the European Parliament should have a greater say in revenue raising, since it is in a curious position that can be characterised as an inverted Boston tea party: it has representation (and, now, extensive spending authority) without taxation.

Third, there is the underlying fear that having EU taxes would lead inexorably to a ramping-up of EU spending. No doubt it could go that way, but the argument could just as easily run in the opposite direction: if citizens are able to connect what they pay through an identifiable tax (or taxes) to what they receive, they could vote to lower spending. Indeed, one of the strong messages from second-generation fiscal federalism is, precisely, that aligning revenue raising and spending improves accountability (see: Weingast, 2006; Begg, 2009).

A fourth myth is that there is no suitable tax. Certainly, it is important to recognise that there is unlikely to be a 'perfect' EU tax and that years of searching for one have not borne fruit. Yet the extensive literature on the subject has shown that there are credible candidates.

They include taking a slice of national VAT,[2] variants on carbon taxes, corporate income tax and excise taxes. It has also been argued that the seigniorage revenues and other monetary income of central banks or the proceeds of a robust emissions trading scheme at EU level could be used (for a recent overview, see Begg *et al*. (2008). Fifth, funding the budget via an EU tax would inevitably make the administration of EU revenue more complicated. It could, but need not. The three stages in raising revenue from any tax are, in fact, pretty straightforward: define a tax base, set a rate at which the tax is levied and ensure that it is collected.

EU taxes could, in addition, be used to promote economic and social objectives, notably through so-called 'Pigouvian' taxes that serve to alter behaviour. In particular, some variant on a carbon tax has long been canvassed to fund the EU and a persuasive argument in favour would be to achieve the 'double dividend' of not only raising income, but also deterring socially harmful consumption. Although critics assert that there are dangers in confusing revenue raising and what might pejoratively be called social engineering, taxes on alcohol, tobacco and, indeed, carbon consumption are routinely used – and rationalised in this way – in all Member States. More speculatively, an EU tax might, as Cattoir (2009) argues, even make it easier to focus on EU spending with high European added value if a link between the revenue source and the policy can be established.

Selecting an EU tax

How, then, should a 'good' EU tax be chosen? The scientific answer is to define a set of criteria and to use these criteria to appraise potential taxes (see, e.g., Begg and Grimwade, 1998; Cattoir, 2004; SEP/GEPE, 2005; Le Cacheux, 2007; Lamassoure, 2007). If a tax ticks enough boxes, it should be short-listed. Box 3 on page 9 presents a consolidated list of the sorts of criteria typically considered relevant, taken from a background study done for the Commission. Inevitably, any proposed EU tax will look better on some criteria than on others. For instance, an EU tax on corporate profits would tend to be fairer than leaving the tax at national level, insofar as Member States with lower tax rates or more generous tax regimes will induce companies to record profits in their jurisdictions, even though some of these profits are earned in other Member States (fulfilling criterion 5). But corporate income tax is notoriously volatile in its yield which tends to plummet during economic downturns (scoring badly on criterion 7). In a single market, however, a common tax regime is desirable (criterion 1), although the Member States most hostile to allowing an EU role in taxation might regard it as at odds with EU policy concerns (criterion 9).

It is also important to establish how much importance to assign to different criteria and, ultimately, to bring in normative and political judgements that reflect the anticipated impact of any tax. For example, using a variant on a carbon tax would penalise countries that rely most heavily on fossil fuels (especially those that emit most carbon) and favour those with a high share of renewables or nuclear electricity generation. If a substantial weight is accorded to a criterion of curbing the negative externality of carbon emissions (i.e the Pigouvian distortion of criterion 1), then a carbon tax would, indeed, be a strong contender. But if such an externality criterion were assigned only a low weight compared to the imperative of equity among Member States (criterion 5), a carbon tax that meant that Poland paid proportionally more than France (with its strong nuclear electricity industry) or Sweden (with its high share of renewables) would be much harder to defend. It could also be argued that if a carbon tax succeeds in deterring carbon emissions, its yield would shrink over time, rendering it incompatible with revenue sufficiency and stability (criteria 6 and 7).[3]

In much of the literature, an implicit weighting of criteria is used to assess the different contenders as EU revenue sources, but is rarely made explicit, with the result that the normative and the 'scientific/positive' considerations are prone to being conflated and confused. In addition, individual decision-makers are bound to have divergent views on the salience of different criteria and might – especially for the more political criteria – even disagree about whether a characteristic should be regarded as pro or anti. Thus, greater autonomy for the EU level (criterion 11) could be regarded as attractive by 'Brussels' but anathema by hard-nosed Finance Ministers.

It follows that hopes of identifying an ideal funding mechanism by analytic methods alone are misplaced. Instead, the solution proposed by Begg *et al*. (2008) is to *start* with the political economy of the issue by seeking agreement on the weighting of criteria, and only then to appraise possible taxes against the weighted criteria. To give an extreme example, if it were decided that all that really matters is fairness between Member States (criterion 4), then all the other criteria would be ignored and a variant on the current GNI resource would look like

[2] With the irony that the existing VAT resource has been allowed to atrophy.

[3] The experience of excise taxes on alcohol and tobacco suggests that higher rates could maintain revenue levels.

BOX 3 CRITERIA FOR ASSESSING POTENTIAL EU OWN RESOURCES

CRITERION	EXPLANATION
ECONOMIC CONSIDERATIONS	CRITERIA THAT REFLECT ANALYTIC FACTORS DERIVED FROM ECONOMIC THEORY
1. Economic efficiency/distortion effects	Does the resource affect only some sectors of economic activity, with adverse (or, in the case of 'Pigouvian' taxes, favourable) allocative effects?
2. Vertical equity in promoting redistribution	Ability to pay at the level of the citizen
3. Horizontal equity among equivalent citizens	Are individuals in similar circumstances treated equivalently?
4. Fairness between Member States – GNI per capita	Ability to pay at the level of the Member State
5. Fairness between MSs – appropriability of revenue	Does tax collection at the Member State level fail to reflect the true incidence of the tax among MSs?
POLITICAL AND ADMINISTRATIVE FACTORS	CRITERIA THAT ARE POLITICAL IN CHARACTER OR CONCERN IMPLEMENTATION
6. Sufficiency of revenue	Does the resource raise enough revenue to cover all, or a sizeable proportion of the total needed?
7. Stability as revenue source	Does the yield vary, e.g. over the economic cycle?
8. Other administrative considerations	Any other issues, such as susceptibility to evasion, collection costs, need for revenue sharing etc.
9. Link to EU policy concerns	How well does the proposed tax correspond to policy domains in which the EU is prominent?
10. Visibility and transparency to tax-payers	Will individual taxpayers be more aware that they are contributing to the EU when paying the tax?
11. Autonomy for the EU level of government	Is the resource genuinely 'owned' by the EU and where does the 'power to tax' effectively lie?

Source: Begg, Enderlein, Le Cacheux and Mrak (2008)

the best way forward. Moreover, even a shift from the current conception of 'fairness' as being proportional to each Member State's GNI would be easy to accommodate, for example by altering the take-up formula to make it more progressive. If, instead, fairness between citizens is the man concern, then criteria 2 and 3 should be stressed (possibly also criterion 10) and some sort of EU income tax might look like appealing.

To correct or not?

In a well-functioning system of public finances, a system of corrections would not be needed. Hence, the EU has to be regarded as anomalous – even bizarre, given the relatively small sums at stake – in devoting so much attention to rebates, and it is hard to think of any other polity in which corrections are a central feature of the system. Part of the explanation lies in the aphorism attributed to Jacques Delors that the EU is an unidentified political object. It is a club to which members pay subscription fees and from which they expect to obtain certain benefits. But it is undeniably also a political entity, albeit one which stops well short of being the federal tier of government of a united Europe.

In clubs, it is common-place to offer lower subscription rates or temporary discounts on full rates to occasional users of club services or those who sign-up only for selected benefits, members with lower resources or members deemed to deserve privileged rates. Arguably, the various correction mechanisms in the EU reflect the first of these rationales, but it would be hard to make the case that the richer Member States who receive the various rebates today either have a lesser ability to pay or should be regarded as privileged.

There are all sorts of ways of correcting net imbalances and a wide range of formulae have been advocated by contributors to the debate on reviewing the budget. Much creative energy has gone into finding a suitable formula or mechanism. Essentially, there are four main points of contention:

- Recasting the expenditure mix could forestall the demands for corrections and might therefore be the optimal way forward. For a majority of Member States, the CAP is seen as the principal *causus belli* – some defending it as resolutely as others attack it. While many believe that a 'modernisation' of expenditure to focus on priorities such as EU competitiveness or climate change would solve many of the problems, their faith may be misplaced. In reality, the underlying issue is about the balance in EU spending between investment in pan-European public goods and distributive transfers.
- A second option for dealing with the problem is to set ex-ante net contributions and then to work backwards to what is actually spent. In such schemes, the key decision from the perspective of the Member State would be the size of its net contribution to, or receipts from, the EU budget, and a second stage of negotiations would then massage spending under different programmes to conform to these over-arching limits. De la Fuente *et al*. (2008) offer a possible model for this – drawing on a number of similar proposals – in which EU expenditure is split into two categories: the first would be genuine EU level activities (such as administration or external action); and spending which largely accrues to individual Member States. The first category would be excluded from calculations of net positions, and only the second (much larger today, as it would include all redistributive policies) category counted. The resulting adjusted net position would then be compared with agreed benchmarks and annual expenditure adjusted to keep to these ex-ante limits. Plainly, such an approach would reinforce the *juste retour* mentality and (as Nuñez Ferrer (2008) argues), does not take sufficient account of the interactions between policy areas and the importance of horse-trading in lubricating EU decision-making.
- An alternative search has been for an ex-post correction mechanism that would kick-in if a Member State's net position becomes excessive – the UK rebate currently functions in this way. In practice this debate has been about lowering net contributions rather than finding a way of limiting net receipts. Although the actual calculation is more complex, the UK rebate effectively returns two-thirds of the ex-ante net contribution, with all other Member States having to make up the difference. Instead of having an arrangement only for the UK, the Commission, in 2004, floated the idea of a general correction mechanism to be triggered by net balances over a certain threshold, but subject to an aggregate limit. This proposal would have resulted in the UK becoming the largest net contributor, but would also have reduced the aggregate pool of money for corrections, so that it is no surprise that it was rapidly dismissed not only by the UK, but by other sizeable net contributors. Yet if ex-post correction is deemed to remain necessary, it is hard to avoid the conclusion that it would be better to have some variant on a generalised system.
- Aligning incentives better would also be a means of shifting the terms of the debate on net positions. Heinemann *et al*. (2010) suggest that rather than dwelling on the financial positions, a better way forward would be to recast incentives such that Member States focus more on EU public goods and less on championing EU spending from which they benefit disproportionately.

In all of these approaches, it is evident that that the distinctive character of the EU shapes the debate. Within Member States, there is inevitably grumbling from richer areas about the degree to which their taxes subsidise poorer areas, but the scale of net transfers is still vast and orders of magnitude higher than in the EU. Yet precisely because the EU is in the odd position of being neither a central government nor an international organisation, it is much harder to fit it into conventional models of multi-level public finances which, as Begg (2009) shows struggle to offer convincing answers for EU budget reform.

Conclusions: a way forward

Although the mandate for the review of the budget includes re-examination of the financing side, it has received much less attention than the expenditure side. Moreover, the responses to the consultation conducted by the Commission in 2007/8 suggest that the UK rebate and other corrections, rather than the mix of revenue sources, attract the most trenchant views on the financing side. It is, therefore, pertinent to ask what would be an optimal outcome and then to speculate on the prospects for its realisation.

Two 'aspects' of a future financing system are cardinal: it should assure the EU of sufficient, stable revenue that will, ideally, not be vulnerable to political disputes; and it should be, and be seen to be, fair from the perspectives of both citizens and Member States. Other aims that a well-conceived future financing system might target include promoting the wider aims of the EU, exploiting any scope for 'double dividends' (for example, by diminishing socially damaging externalities) and robust accountability. An optimal outcome would also see the demise of corrections and the increasingly Byzantine machinations to which they give rise.

A minimal reform would be to abolish the VAT resource, because the way it is calculated means that it is simply a second GNI resource that requires some additional administrative effort to collect. Doing so would remove one of the devices currently used to provide corrections for four Member States (the lower VAT take-up rates applied to Austria, German, the Netherlands and Sweden), but that is hardly an insuperable problem, as is demonstrated by the fact that the Netherlands and Sweden receive a parallel correction through the GNI resource. It could even be argued that if corrections must remain part of the financing system, transparency would be improved by curbing the proliferation of ad hoc mechanisms.

While no putative EU tax is likely to emerge as the prime candidate, there are plenty of options that would be satisfactory, albeit with some drawbacks. Introducing additional EU taxes could make sense, but would have to be justified much more on political grounds than because of superficially objective assessments of whether their use would fulfil more criteria for an optimal EU resource than the present arrangements. If decision-makers can agree on the attributes that they want from the revenue raising system, the likelihood is that they could be achieved in a number of ways.

There might, for instance, be agreement that a proportion of the revenue should continue to come from national contributions (in deference to the inter-governmental side of the EU), but that visibility to citizens should be enhanced by taxes (the EU as a union of citizens). There might, separately, be a desire to retain the administrative simplicity of the GNI resource, but to introduce an EU tax that connects to EU goals, such as deterring carbon emissions or underpinning the single market. A variety of packages could then be envisaged involving different combinations of national contributions and explicit EU taxes, reflecting these normative criteria.

The demand from the great majority of Member States to end corrections suggests a third priority for reform. The trouble is that corrections were introduced because EU expenditure flows so unevenly to Member States of similar levels of prosperity, implying that expenditure reform is a pre-condition for abolition of corrections and that financing reform will not be feasible without a comprehensive package that deals with both sides of the budget. As with EU taxes there is unlikely to be agreement on an ideal way forward because differences in the characteristics of correction systems would affect their incidence on different Member States, while also having political ramifications. A system that starts from the net balance would please those who emphasise *juste retour*, whereas a system that only makes a temporary and partial ex-post correction would be more appealing to those who want to counter the *juste retour* mentality. However, as Cattoir (2009) points out, the options are not mutually exclusive, although simplification and transparency imperatives would be reasons to avoid a system that has too many components. Consequently, a political decision, once again, has to precede the design of the mechanism.

Despite the various concerns, there seems to be little momentum for change on the financing side and it may be that the limited amount of political capital available to support budget reform will be consumed in obtaining changes in the expenditure side. If so, it will be no surprise to hear the same old tunes about the UK rebate, the corrections for other net contributors and the infelicities of the GNI resource being replayed in two years' time when the next round of budget negotiations gets serious.

Yet such an outcome would also be regrettable and an opportunity lost. The budget review was supposed to be devoid of taboos and to be the chance to put in place a modernised instrument of EU governance. A credible way of proceeding would include steps to eliminate corrections over the course of the next multi-annual financial framework and a gradual move towards a higher share of the funding coming from genuine own resources rather than inter-governmental transfers. It is time for a mature debate about such reforms rather than clinging to outdated concepts and intransigence about allowing the EU budget to come of age.

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