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Reform Options for the EU Own Resources System

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Authors
Dr. Friedrich Heinemann
Philipp Mohl
Steffen Osterloh

Centre for European Economic Research (ZEW)
L7, 1
68161 Mannheim
Germany

heinemann@zew.de
mohl@zew.de
osterloh@zew.de

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Preface

The general review of the European Union's budget scheduled for the years 2008 and 2009 offers a unique opportunity for reflections. Explicitly this review is "without taboos" so that also substantive changes can and should be debated.

Without doubt much better budgetary systems can be imagined compared to the status quo of the EU budget which is the outcome of a path-dependent process and where many details are only understandable by taking account of the historical context of past decisions. However, even if much better systems could be designed in theory, each reform suggestion, in the end, must pass the reality check of finding unanimous support from all 27 member countries. This restriction heavily limits the universe of available reform options.

Faced with that difficulty the ZEW project team embarked on the adventure to think about possible reform options for the future EU own resource system. This volume documents the conclusions. At first sight our reform suggestion may appear to be of a rather piecemeal nature since we recommend a reform model with strong ties to the status quo. Nevertheless, we are convinced that our seemingly minor changes will set the budget on a path towards a more rational European budget which, in the end, will create leeway for financing European policies with a true European value added.

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Mannheim, April 2008

Friedrich Heinemann, Philipp Mohl and Steffen Osterloh

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1 Introduction

The agreement on the EU financial framework for the years 2007-2013 has been received with mixed feelings both in the political and the academic debate. On the one hand, the very fact that the enlarged Union is able to reach a consensus on a highly contentious issue like the budget demonstrates that the financial constitution functions and safeguards the capability to act. On the other hand, the agreement does not include any far-reaching reforms neither on the expenditure side nor on the revenue side although the need for reforms is hardly debatable for either side of the budget. Furthermore, an inflation of special provisions has occurred which was obviously necessary to buy consensus from all involved parties. This has come at the cost of an increasing intransparency of the system which stands in sharp contrast to the aim of making the system more comprehensible for European voters and taxpayers.

Since the heads of states and governments themselves had to acknowledge the limits of the budgetary settlement, they agreed on "a comprehensive reassessment of the financial framework, covering both revenue and expenditure" which is to take place in the years 2008/2009 (European Council, 2005). This review will offer an opportunity which has not been given in earlier negotiations: the chance for fundamental reflections on reform options without the urgent pressure to instantly arrive at a final decision. In this sense the review can be seen as a chance to develop options which will be available at the next settlement which is due towards the end of the current financial framework.

This report aims at contributing to this review with a clear focus on the revenue side of the budget. Key questions addressed in this study refer to the preferable types of own resources, fundamental alternatives to the existing sources and the justification and specification of an appropriate correction mechanism. Although this report's analytical work is thus clearly targeted at the revenue side, it is nevertheless based on the understanding that budgetary reform must simultaneously relate to both sides of the budget. The suitability of certain solutions on the revenue side heavily depends on the achievable changes on the expenditure side.

Even though our work benefits from the preceding literature dealing with possible revenue side reforms, such as the Commission's own resource reports, it nevertheless advances this literature in some important respects. First, we base our analysis on a comprehensive study of the incentives faced by all budgetary players. As the literature on budgetary institutions for national states has clarified, institutionally determined incentives are crucial for the efficiency of budgetary policy. In particular, institutional safeguards against the so-called "common pool problem" are important. The common pool problem is linked to the fact that a jurisdiction's overall revenue is used to finance programmes for the benefit of particular constituencies. Up to now this problem has been widely ignored in the reform literature on the EU own resources system, even though its relevance for budgetary policy in general is an established fact in the literature. This perspective leads us to an important conclusion. In particular, the expectation that the mere establishment of a new tax-based own resource would advance fiscal discipline is shown to be too simplistic. Secondly, we take the distribution issue into account as an important restriction to any politically realistic reform. It may be regrettable but the "juste retour" thinking cannot be neglected and limits the set of available reform options. Any reform which would involve a substantial divergence in distributive effects from important reference points (which are either the status quo's distribution or a burden sharing corresponding to countries' relative wealth) will hardly reach a consensus.

We come to the conclusion that even when taking these severe restrictions into account, the own resource system can be improved. Our reform model, based on a complete elimination of the VAT resource and a generalised (with respect to the benefiting countries) but limited (with respect to the included types of expenditures) correction mechanism, not only sets the incentives right. It also creates a distributive outcome with a logical correspondence to relative wealth and does not diverge too far from the status quo.

2 Criteria for a Fair and Efficient Own Resources System

Both the evaluation of the own resource system's status quo and the reform suggestions should be based on well-defined assessment criteria. The explicit formulation of such criteria is indeed a common feature of many contributions to the literature on the own resource system (European Commission, 1998, 2004a; Caesar, 1990; Cattoir, 2004; Begg & Grimwade, 1998; Walthes, 1996; Henke, 1997; Heinemann, 2003).

However, with regard to these criteria lists alone, caution is required. The manner in which assessment criteria are defined and (explicitly or implicitly) weighted predetermines analytical results. Hence, the definition of criteria is a degree of freedom to influence subsequent recommendations. This problem is aggravated by the fact that an ad hoc approach often characterises the foundation of criteria lists: Plausible and appealing dimensions for assessment benchmarks are formulated without paying too much attention to their link to well-established theories.

Obviously, a certain degree of subjectivity in the definition of criteria is unavoidable since their choice and specification is also influenced by assumptions and value judgements, for example, with regard to the role of the state in the economy, the future model of the European Union or the importance of budgetary restrictions for politicians and bureaucrats. Nevertheless, these assumptions should be explicated as far as possible.

In the following, we exemplify by means of the Commission's own resources report of 2004, how problematic and incomplete some of the criteria lists are. We, then, proceed to specify our own list of assessment criteria. Although we are aware of the fact that our list is also influenced by subjective assumptions and value judgements, we attempt to be explicit about our assumptions and the link to theory. These links to the literature strands of fiscal federalism and public choice theories and other theoretical concepts are further developed in the appendix (see section 8.1).

Box 1. Assessment criteria of the own resources report 2004

Visibility and simplicity

Contents: The financing system should create a direct and visible link between the citizens and the EU budget. The system should be comprehensible for the citizens.

Main argument: Citizens should have a clear perception of the costs of the EU budget which would also make the European Parliament more accountable for the cost dimension of EU policy measures.

Financial autonomy

Contents: The EU budget should be financed from an autonomous manner. A significant dependence of the budget on national budgets should be avoided.

Main argument: The link between national budgets and the EU budget causes member states to follow "ill-defined concepts of national benefit" with regard to the financing of the budget.

Efficient allocation of economic resources

Contents: Own resources should impose as few economic distortions on relative prices or revenue collection incentives as possible. The system should contribute to internalising externalities arising, e.g., from pollution.

Main argument: Own resource system should not distort the functioning of the internal market.

Sufficiency and stability

Contents: The resources must be sufficient to finance the EU budget in the long run. Individual financing sources should, therefore, be significant in relation to the EU budget.

Main argument: The EU budget needs a stable and reliable financing source.

Cost-effectiveness

Contents: Administrative costs of any own resource should be low relative to its yield.

Main argument: Standard desideratum.

Equity

Contents: The budgetary burden – defined as gross contributions – should be distributed justly shared among both member states and citizens. The own resources report focusses on member states' equity and regards GNI as the appropriate benchmark.

Main argument: Fairness considerations.

Source: European Commission (2004a).

The criterion "visibility and simplicity" exclusively focusses on the link between citizens and the budget. Without a doubt, cost transparency on the side of citizens-taxpayers is a helpful element in guaranteeing incentives for balancing costs and benefits of public activities. However, this element is by no means a sufficient condition for efficient budgetary outcomes. As we will analyse in detail (see section 3.5), budgetary decision processes are confronted with many other problems which are virulent even if there is a clear tax link between citizens and the budget: Information problems on the side of voters, bureaucratic self-interests, lobby power and many other phenomena can impair budgetary efficiency and are not simply solved by a direct tax paid by citizens to the budget in question. Problems are aggravated if there is a discrepancy between the regional or sectoral concentration of those who benefit from a budget and those who pay for it (the "common pool problem") – a problem highly relevant in the context of the EU budget. A full analysis of the overall system's incentives is necessary to judge which improvements would optimise the budgetary outcomes.

The criterion "financial autonomy" is probably the clearest example that reflects the self-interest of the Commission's criteria list. It is obvious that autonomy in raising EU revenues is in the interest of the European bureaucracy. It is, however, much less obvious whether revenue autonomy of the EU level is really desirable without further conditions. The authors of the 2004 own resources report argue that today's own resources system with its de facto national contributions was responsible for the "narrow focus on national interest". This argument is hardly convincing. The net balance thinking of member states which indeed is an obstacle to the rational evolution of the system is not caused by the revenue side of the budget in the first place. It is rather a consequence of current spending priorities where the location of recipients is clearly identifiable. Simply transforming the revenue side of such a system towards financial autonomy would not reduce the member states' interests to fight for receipts from structural or agricultural transfer policies to be as high as possible. A further shortcoming of the report's argumentation in this regard is that it ignores the possibility that financial dependence on member states may have its merits with respect to budgetary discipline. Institutions such as the Stability and Growth Pact or constitutional debt or spending limits as they exist in many states indicate that unrestricted "financial autonomy" can be problematic. This kind of reasoning convincingly motivated, for example, by public choice theory (see section 8.1.3) is largely absent in the own resources report.

The "efficient allocation" criterion of the own resources report is also applied in a fairly restricted fashion and is only related to immediate distortions and incentives resulting from the specification of own resources. The insights are not unreasonable. Nevertheless, in a wider perspective, the efficient allocation criterion should be based on fiscal federalism insights and this theory's messages about the conditions for an efficient public goods provision (see section 8.1.2). In this wider perspective, the key question is whether marginal benefits from the provision of public goods match marginal costs in a federation and whether the resulting public goods provision reflects the true (and possibly heterogeneous) preferences of the citizens.

In this general formulation the criterion of "sufficiency" is also prone to misunderstandings. On the one hand, it is desirable that revenue sources' yields stand in a reasonable relation to the targeted budget size – also from the point of view of administrative cost-effectiveness. On the other hand, however, the perceived scarcity of resources is a desirable feature of any disciplining budgetary system. Frequent experiences in the field of budgetary policy show that the size of available revenues determines spending and not the other way round. Therefore, revenue reforms should avoid any movement towards a softer budget constraint. The national experience of recent years with serious budgetary restrictions has demonstrated how helpful revenue constraints are for boosting efficiency of public spending. If one assumes (quite realistically with a look at current spending priorities) that significant shares of EU expenditure are questionable with regard to the resulting European value added, "scarcity" of own resources would be no disadvantage. A new own resource giving substantial revenue leeway to the budget would risk, for example, a possible abatement of the beneficial budgetary reform pressure on the Common Agricultural Policies. Therefore, the sufficiency criterion should be applied with caution and should be understood as a mere screening criterion to exclude revenue sources with trivial yield in the view of the EU budget's dimension.

The "stability" criterion is hardly controversial. Given that EU spending priorities follow long-run objectives and given the absence of debt facilities, EU own resources should not be characterised by volatility. Not questionable is also the fact that the own resources should be characterised by a "cost-effectiveness" of administration.

Finally, fairness considerations do indeed deserve considerable large attention because an EU budgetary system which is perceived to be unfair puts the support for European integration at risk. However, also with respect to this criterion, the subtleties of specification are also crucial. In the Commission's own resources report the authors limit these considerations to the gross contributions ("equity in gross contribution"*)*. It is hardly possible to judge on fairness perceptions in an objective way. However, the implied isolated view at the own resources side of the budget hardly reflects fairness perceptions as they are politically relevant. We will demonstrate in section 3.6 that the own resources distributive patterns stand in a close logical relation to the distributive pattern of the expenditure side. It is neither logically convincing nor politically realistic to neglect this by limiting fairness considerations to the issue of gross contributions.

In summary, a criteria list as the one used by the authors of the Commission own resources report is open for improvement:

- It widely ignores the fact that the efficiency of budgetary outcomes cannot be pinned down to isolated aspects, such as revenue transparency, but must be safeguarded by well-balanced institutional constraints and incentives for all players in the "budgetary game".
- The criteria do not exploit the differentiated insights of the theory of fiscal federalism with respect to conditions for an efficient public goods production in a multi-layer system.

- The list and its motivation largely ignore political-economic considerations and problems associated, for example, with the budget-maximising motivations of bureaucrats or the fundamental common pool problems virulent in practically all budgetary contexts. With regard to political-economic aspects, the Commission approach is characterised by a subtle asymmetry: While “a narrow focus on national self-interest” is said to characterise national approaches to the EU budget, European actors are implicitly assumed to be European welfare maximisers. Here, a more balanced view is desirable.
- The list suffers from selective interpretations for which the equity interpretation is a prominent example.

Given these problems, we prefer to base our analysis of the status quo and reform options on an improved list of guiding criteria. Theoretical reference points are the following (for details, see section 8.1).

The Theory of Fiscal Federalism

This theory has developed a set of criteria such as preference homogeneity, spillovers or economies of scale in public goods production in order to decide on the optimum assignment of competencies in a multi-layer federal system. Corner stones are the decentralisation theorem by Wallace Oates (1972) and the principle of fiscal equivalence (Olson, 1969). The decentralisation theorem stresses the merits of lower level competencies in reflecting different public goods preferences, whereas the principle of fiscal equivalence demands the identity of public good’s users and payers in order to guarantee an efficient public goods production. The case for centralisation is supported by substantial externalities of decentralised competencies or economies of scale in the provision of public services. With regard to the debate on revenues this theory has at least two messages: First, a precondition for efficient public goods production is the correct simultaneous assignment of both revenue and spending competencies. Financing national or regional public goods by European resources contradicts the equivalence principle and fosters inefficiencies. Secondly, if there are substantial heterogeneities with regard to distributive and tax preferences, the own resources system should offer degrees of freedom to reflect this preference divergence.

Public Choice Approaches

Even if one does not accept the idea that politicians and bureaucrats are mere maximisers of narrow self-interest, any realistic analysis will take into account that in addition to general welfare motivations other aspects such as budget maximisation are relevant drivers of bureaucrats’ behaviour at all federal levels. Furthermore, politicians are realistically modelled to pay close attention to re-election chances which are not necessarily maximised by following long-run strategies to foster welfare. As a consequence of this balanced view, budgetary restrictions are an important element at the national and European level alike. In particular, the common pool problem associated with the financing of regional spending projects from a common pool of public revenues must be addressed.

Further theoretical considerations are related to the compatibility of an own resources system with a stable integration process (see section 8.1.4) and the merits of general taxation principles (see section 8.1.5). On that basis we summarise our assessment criteria for a rational own resources system as depicted in Box 2 (for further details and refinements, see section 8.1).

Box 2. Assessment criteria for a rational own resources system

Fostering efficient public goods provision

Theoretical basis: Theory of fiscal federalism

Desiderata:

- Allowing for heterogeneous tax preferences
- Internalisation of externalities
- Identity of users and payers of public goods
- Subsidiarity principle (based on decentralisation theorem)
- Respecting national federal systems

Constraining narrow self-interest and creating budgetary discipline

Theoretical basis: Public choice theory

Desiderata:

- Robust budgetary institutions counterbalancing narrow self-interest of bureaucrats, politicians or lobby power
- Solutions to the “common pool” problem of budgetary policy

Integration compatibility

Theoretical basis: Integration theory

Desiderata:

- Low transaction costs in the settlement of political conflicts
- Fairness according to generally accepted fairness judgements
- Transparency

General principles of taxation

Theoretical basis: Tax theory, welfare economics

Desiderata:

- Neutrality
- Stability
- Cost-effectiveness of administration
- Reliability

Fostering Efficient Public Good Provision

The appropriate assignment of political competencies to the different levels in a federation is crucial for the resulting efficiency of public goods provision. Nevertheless, the manner of financing the different government budgets in a federation offers additional handles to set efficiency-inducing incentives. The case for a high degree of revenue autonomy of the European level is weakened if tax preferences are heterogeneous among member countries or if EU spending priorities cannot be classified as European public goods.

Constraining Narrow Self-Interest and Creating Budgetary Discipline

The Community's revenue system should contribute to an institutional environment conducive for budgetary discipline and helpful in overcoming bureaucratic or political overspending incentives. This criterion can hardly be used in favour of or against a specific revenue source but must be applied to the overall budgetary system, its function, interdependencies and incentives for all relevant actors.

Integration Compatibility

Conflicts of interest will always be a fact of life in European budgetary politics as it continues to be the case in federal countries. Budgetary institutions and the revenue system should contribute to efficient and low transaction costs in the settlement of conflicts. The institution of the multi-annual financial framework is a good example for an institutional innovation which has significantly reduced transaction costs by relieving the annual budgetary process of distribution fights.

Since the political support of citizens is crucial for the long-run success of European integration, restrictions with regard to the perceived fairness and transparency of the budgetary system must be respected.

General Principles of Taxation

Once it comes to the scrutiny of single revenue items, general principles of taxation become helpful. If there is a choice between different revenue types which have similar desirable effects within the overall budgetary system, this choice will clearly be guided by criteria such as neutrality, cost-effectiveness, stability or reliability.

Compared to the European Commission's list, our assessment criteria clearly pay more attention to the incentives set by the own resources system within the context of the budgetary system as a whole. We are convinced that this holistic approach is the appropriate starting point to reflect the desirable evolution of the own resources system. In the following, these criteria will guide our analysis both in the assessment of the status quo and in the derivation of reform proposals.

3 Assessing the Status Quo

3.1 Introduction

This section is devoted to an analysis of the status quo of the EU system of own resources within the context of the overall budgetary system of the EU. Such a status quo analysis is indispensable for defining priorities for reform. In order to do justice to the current own resources system, it is necessary to look at it within its overall context. Many characteristics of the revenue side are hard to understand by themselves because they reflect adjustments deemed necessary with respect, for example, to spending side developments. Furthermore, it is essential to understand how the current own resources system, its instruments and definitions interact with the other budgetary institutions in the overall institutional context. Finally, it is important to develop an understanding of how the relevant players in EU budgetary policy may react to the incentives set by the design of the own resources system. This broad analytical perspective explains the section's structure. Before looking at the details of the own resources system and the single items, we start by summarising key institutional features of the system and identifying incentives of major players within that system. Furthermore, we briefly look into its historical evolution and analyse the extent and sources of redistribution arising before proceeding to the details of the own resources system. These analytical elements allow us to draw comprehensive conclusions about the strong and weak features of the system.

3.2 Key Institutional Features of the System

This section briefly presents the key institutional aspects of the EU budgetary system (for a more detailed description, see European Commission, 2002). Although this study concentrates on the analysis of the revenue side of the EU budget, a good understanding of the expenditure side is necessary for a profound analysis of the institutional set-up and the resulting budgetary incentives.

To begin with, the EU is almost entirely financed by the so-called own resources, which are collected by the member states but to which the EU is legally entitled. Generally, expenditures that are decided by the European Council have to be financed. Nevertheless, the power of the EU with regard to fiscal policy is lim-