An EU tax

Overdue reform or federalist fantasy?

IAIN BEGG
February 2011[1]

1. New ideas for changing the status quo of financing the EU budget

Expenditure by the EU today is financed predominantly by direct contributions from Member States, rather than by taxes or other resources that accrue directly to the EU. This is despite the fact that the Treaty stipulates, in Article 311 TFEU, that the »budget shall be financed wholly from own resources«. Indeed, the trend over the last two decades has been for the share of national contributions to increase and, without any change in the mix resources, it is set to exceed 90 percent beyond the expiry in 2013 of the current Medium-term Financial Framework (MFF). Calls for genuine EU taxes to provide the bulk of the EU's revenue have been frequently heard over the years and the completion of the mid-term review of the current MFF has again stimulated fresh debate on this matter. EU Budget Commissioner Janusz Lewandowski set the ball rolling in an interview in August 2010 in which he issued a cautious call for an EU tax, then the October 2010 Commission communication on the budget review reinforced the message, putting forward a number of options.

National leaders from several Member States were quick to object and, although the European Parliament in particular has regularly advocated the introduction of an EU tax, the »power to tax« is one that neither governments nor national parliaments show much disposition to surrender. Although one of the ideas put forward by Commissioner Lewandowski, using a financial transactions tax (FTT) to fund the budget, struck a chord in some national capitals, it is clear that any attempt to introduce an EU tax will face a steep uphill battle.

1. This paper is a short version of the recently published study by Iain Begg: An EU tax: overdue reform or federalist fantasy, Friedrich-Ebert-Stiftung, February 2011, http://library.fes.de/pdf-files/id/ipa/07819.pdf

2. Criteria for choosing a suitable EU funding instrument: a difficult task

Deciding how to raise the money to finance public expenditure is never easy. Potential resources have to be (and be seen to be) fair, have to avoid adverse economic effects and to fulfil a variety of administrative criteria, and there are political imperatives that have to be respected. In the EU, the political dimension is often especially salient because of the delicate balances that have to be struck between national and EU-wide interests.

In this regard, one of the most contentious issues is how much autonomy the EU level should have in public finance. At present, it has a significant say in shaping public expenditure, with the European Parliament having gained new powers in the Lisbon Treaty. By contrast decisions on EU resources remain firmly in the hands of the Member States through the Council. Inverting the well-known phrase, this model has been characterised as »representation without taxation«.

Apart from autonomy, a whole array of other criteria warrant attention. Plainly, a vital one is that any new system should reliably fund EU expenditure, ensuring both stable and sufficient revenue. At the same time, the funding burden has to be fairly distributed.

What constitutes fairness in public revenue raising is a difficult question. It implies that citizens in equivalent circumstances should be treated similarly (horizontal equity), and that the burden on different individuals should reflect their ability to pay, with the rich paying proportionally more of their income than the poor (vertical equity).

In the EU, two further facets of fairness loom large: an equitable sharing of the burden among Member States and fairness in how the yield from particular taxes is appropriated by different jurisdictions. Some Member States complain, for example, that income generated by their citizens or companies may generate revenue for other countries because of favourable tax regimes.

Both the Commission and the European Parliament argue for connecting how the EU is funded to the policies it pursues. The Parliament has also emphasised that the visibility and transparency of EU funding matters because the present system is too easily obfuscated in a way that encourages myths about the burdens imposed on Member States or citizens.

3. Strengths and weaknesses of the current system

A great strength of the current EU financing system is that it works. The EU budget is assured of its income, so that the European Commission does not have to fret about how to raise income to finance its expenditure commitments. Through the operation of the GNI resource, the system also ensures that the EU budget will always balance, because of the feature that the call on the GNI resource is deliberately designed to be just enough to match spending. The current system of revenue raising is also tolerably fair in the burden it imposes on Member States.

However, it is criticised because it is opaque and fosters a *juste retour* mentality in which Member States appear to be more concerned with net accounting balances than with whether or not EU public finances are well-conceived. As a result, many of main battles on the revenue side are about »corrections« – the UK rebate and the many other devices used to reduce the net payments of certain other Member States.

With many criteria affecting decisions on how to finance the EU budget, it is inevitable that there will be conflicting views on what attributes a good EU resource should have, and that even where there is agreement, several of the expectations will pull in different directions. There is some consensus about the range of taxes and other resources that could be used to fund the EU budget, and the Commission budget review communication again lists several of them.

However, less attention has tended to be paid to the normative question of what characteristics are most important. Rather than starting from the potential resource and testing it against the various criteria, a better approach would be to establish what is wanted from an EU resource, then try to find the option that comes closest to meeting these desired features. It should be stressed that there is unlikely ever to be an ideal »tax for Europe« and that someone will object to even the most appealing contenders.

4. Plausible options for new resources

Any of the options suggested in the Commission communication could, in principle, become EU resources, so long as there was the political will to implement them and enough time to iron out predictable difficulties. Any new EU tax (or comparable resource) will, though, have to be durable and will inevitably introduce new complications, such as having a less predictable yield than the current system and making the achievement of budget balance harder. Administrative challenges would arise in defining a common tax base and in ensuring that the chosen instrument lived up to expectations on criteria other than revenue raising.

To illustrate what is at stake in calling for a new EU tax, three distinctive options are examined: carbon / energy taxes, a corporate income tax and a financial transactions tax. All have connections to EU policies and could be expected to be more visible to citizens, but they also differ markedly in other respects.

4.1 Carbon or energy taxes

Generically, carbon / energy taxes are intuitively appealing as EU taxes for the simple reason that they chime with a »grand challenge« that the EU has to confront, encompassing not just a response to climate change but also concerns about energy security. It follows that a resource based on carbon / energy, insofar as any tax can be popular, is likely to be supported and would be visible to citizens. On political criteria, therefore, carbon / energy resources would fare well, although they could take many different forms, target different tax bases (for example, producers in the case of a carbon emissions levy or consumers if it falls on final-use energy markets) and thus exhibit diverse properties.

Moreover, there are drawbacks in other respects and many potential economic and administrative hurdles to overcome, ranging from harmonisation of tax bases, through avoidance of damage to competitiveness vis-à-vis other parts of the world that do not levy such charges, to the risks of raising prices and aggravating »fuel poverty«. The fairness of a carbon/energy resources would depend very much on the details, and there could be conflict between their role in deterring energy use and their reliability in funding the EU budget. Two specific examples are therefore considered.

1. The first is a levy on air transport, something that has been canvassed in a variety of contexts, building on the fact that it is a growing yet polluting sector of activity and would therefore offer a stable revenue base while higher taxes on it would have some impact on an environmental goal. There is also a perception that the sector is under-taxed. A levy paid by departing passengers has been in place in the UK since 1994 and has recently also been introduced in Germany on very similar lines, in both cases in the teeth of opposition from the tourist and aviation industries.

Extrapolation from the UK yield suggests that an EU wide levy could raise around 0.2 percent of EU GDP, especially if it were extended to freight traffic as well as passenger services. This would only be enough to finance a proportion of the EU budget and thus a drawback, but it could be seen as an amount large enough to establish the principle of a new EU tax without intruding on politically more sensitive areas of tax policy. It would also be fairly simple to design and collect, and would work better at EU level because the scope for avoidance by switching hub airports would be negated (only Zurich airport would be a likely competitor and its air space and capacity are already under pressure), but might be contrary to horizontal equity and somewhat unfair on Member States to the extent that residents of different countries fly more or less.

2. A tax on motor vehicle fuels is in use in all Member States and would combine a sizeable revenue raising capacity with »green« aims. There are differences in the national design of these taxes, partly reflecting different national preferences, which would make harmonisation somewhat more awkward, and there are also both horizontal and vertical equity concerns, because car use may be a necessity (for instance in rural areas) rather than a choice. Because motor vehicle fuel taxes typically raise more than would be needed to finance the EU budget, procedures for apportioning surplus revenue would be needed if it were assigned as an EU tax. But in principle these concerns should not prevent relatively rapid adoption as an EU tax.

4.2 A corporate income tax

Corporate income tax (CIT) is another resource that is both levied in all Member States and would yield more than enough revenue to fund current EU spending. Its great attraction as an EU resource would be that it is consistent with the single market and would, indeed, reduce the inequity of inter-Member State appropriation of the yield from the tax. This would be economically efficient to the extent that it would deter companies from selecting a location just for tax reasons. Its main technical drawback is that there is no common tax base and this leads to a political resistance among the Member States to agreeing such a base because the structure of tax systems is designed to reflect national preferences. In contrast to the two previous examples, the need to resolve these issues suggests that CIT could only become viable in the longer term.

4.3 A financial transaction tax

Public resentment of banks and of the costs they have inflicted on tax-payers during the crisis has led to many calls for banks to be reined-in and one potential new revenue source that manifestly resonates with citizens is a financial transactions tax (FTT). Recent investigations suggest that some of the administrative worries about an FTT, notably that it would too easily be avoided and can only work if agreed at global level, may have been exaggerated and that FTT could readily raise around 0.3 percent of EU GDP. It would also be consistent with vertical equity in taking more from the rich.

However, a major stumbling-block is that a high share of total EU financial transactions take place in UK markets, with the result that much of the revenue would appear to be generated from the UK. Even if it is accepted that many of the transactions in question actually represent business on behalf of clients from outside the UK, the fact that, on one published estimate, as much as 70 per-cent of the yield would come from the City of London is politically highly problematic. Little imagination is need-ed to guess what the tabloid press headlines would say. Taxing transactions rather than value added can also be at odds with economic efficiency considerations.

5. Making a choice of EU resource: comparing the options

The debate on an EU tax tends to be characterised by entrenched positions, prejudice and arguments that are frequently specious or exaggerated, but is really a political contest about who should possess the power to tax and how much genuine autonomy the EU should be granted as a fiscal entity. In addition, the fact that any new EU tax would allow a reduction in national contributions is routinely forgotten, and many of the rational arguments for and against are prone to be over-shadowed.

As a technical proposition, there is no over-arching obstacle to an EU tax (or taxes) and there are plenty of options that could be viable, although some com-plications would have to be expected in harmonising tax bases and establishing the necessary administrative structures. Equally, there is unlikely ever to be a contender that is »the« ideal EU tax, because any conceivable in-strument will have attributes that someone will, with good reason, oppose.

The choice of EU resource will depend on what attributes decision-makers want to favour in such a resource, so that it is instructive to compare the options. Any comparison of the four potential EU taxes discussed above also has to be benchmarked against the current system, and advocacy of change must start from determining what is wanted from the revenue side of the budget. Thus:

- If reliable revenue raising and inter-Member State fairness are seen as the most important attributes, the current system will be hard to beat;

- Connecting revenue raising to EU policies, raising the visibility of the EU level of governance and improving vertical and horizontal equity would point, instead, to-wards some of the potential EU taxes discussed above.

6. Conclusion: there is less to fear than expected

A shift towards an EU tax (or taxes) is bound to result in winners and losers, whether among citizens or Member States and will require fresh thinking about certain obli-gations, including those needed to achieve budget bal-ance. For these and other reasons, the introduction of an EU tax is likely to be a messy exercise. It may therefore make sense to proceed by stages, perhaps by bringing in a new tax to substitute for part of the GNI resource in the short-term – say for the next multi-annual budget deal – then extending an EU tax subsequently.

Neither citizens nor Member State governments will be easily convinced that any EU tax makes sense and its likely impact should not be over-stated. It will not, on its own, resolve the intractable problems of net balances and the resulting corrections, but it might help to lessen the acrimony surrounding the issue. Nor will giving the EU more autonomy in revenue raising precipitate a fed-eral super-state, although it would be more consistent with the Treaty.

Yet what a dispassionate analysis also shows is that there is much less to fear from turning to a new tax to fund at least part of the EU's expenditure than some of the more strident opponents suggest. Will the EU's leaders be prepared to take the plunge?

ISBN 978-3-86872-639-8

About the author

Iain Begg is a Professorial Research Fellow at the European Institute of the London School of Economics and Political Sciences, London.

Friedrich-Ebert-Stiftung | International Policy Analysis
Hiroshimastraße 28 | 10785 Berlin | Germany | Tel.: ++49-30-269-35-7745 | Fax: ++49-30-269-35-9248
E-Mail: info.ipa@fes.de | www.fes.de/ipa