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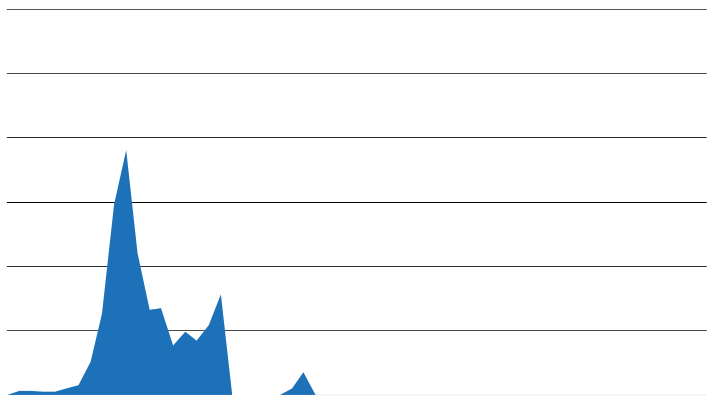
Introduction

e debate on the nancing of the European Union budget is never-ending. Because it is overly loaded with quasi-constitutional, and at any rate highly political considerations about the nature of the EU, it has consistently served as a battle eld between those who regard the EU as a confederation of sovereign states and those who believe in its federal destiny.

We have no intention of reopening the existential debate. But we posit that two new facts call for a pragmatic re-examination of the nancing of the EU budget:

- e decision by the European Council to launch the Next Generation EU (NGEU) recovery programme in response to the COVID-19 crisis [illegible]

Figure 1: Structure of own resources of the European Community/EU, 1958-2018



Source: European Commission, DG Budget.

Today, the GNI resource provides roughly two thirds of the overall financing of the EU budget. Given this revenue structure, it is fair to say that the EU budget is primarily financed through contributions made by the member states out of national tax revenue.

This instability results from a legal factor and an economic factor. The legal factor is that although Art. 311 of the Treaty on the Functioning of the European Union (TFEU) states that "*Without prejudice to other revenue, the budget shall be financed wholly from own resources*", it does not define what is meant by that, nor does it provide any detail on possible resources. It basically leaves to the Council the responsibility of deciding by unanimity what these resources should be: the Council "*may establish new categories of own resources or abolish an existing category*". The economic reason is that the genuine own resources the EU relied on after the 1970 decision to "*replace financial contributions from member states by the communities' own resources*" were unstable: revenues from tariffs dwindled as a consequence of trade liberalisation, and other specific revenues were too limited in the first place to provide stable revenue streams[1].

2 Why change the system of own resources?

In the debate about reform of the own resources system, it is important to distinguish two questions. The first is whether the EU should have its own – possibly limited – power to levy resources through taxation, rather than relying on the fiscal sovereignty of its member states. This debate is about fundamental changes to the institutional setup of the EU, which would move it closer to a federal structure. The other question is whether the system of own resources should be changed *given the current institutional setup*, with a fixed ceiling on expenditure, no deficit financing and national fiscal sovereignty as the bases for the financing of the EU. We focus on the second question, that is on reforming the own resources system, taking as given the current EU institutional setup.

1 Council decision of 21 April 1970

Discussions about reform of the EU own resources system often start from the (undisputable) observation that the existing system of financing is dominated by the GNI resource. Whether this dominance is good or bad is disputed. The GNI resource has a number of advantages: it is transparent, it leads to a distribution of the financing burden between member states that is proportional to their respective capacities, and it allows member states to finance their contributions through the taxes that are best suited to local conditions and local preferences, which is in line with the principle of subsidiarity.

There are two main critiques of the dominance of the GNI resource. First, it is perceived as having a distorting effect on political decisions in the member states about the EU budget. The High Level Group on Own Resources (HLGOR), which was created in 2014 to propose reforms to the own resources system, described this issue as follows:

> *"Member States that are net contributors to the EU budget first look at their contribution on the revenue side — and try to minimise this amount as much as*

the EU budget as given, introducing new own resources would imply a reshuffling of the burden of the financing of the EU across member states. GNI-based contributions would presumably keep the function of balancing the budget at the margin, but their weight would be mechanically reduced.

In the case of a new own resource based on existing national tax instruments, the impact would essentially be distributive, to the extent that the incidence across member states of the new resource differs from the distribution of GNI. There would be no first-order efficiency gain to speak of.

But if the tax base was genuinely EU-wide, or if it is sufficiently mobile to avoid taxation by individual member states, the introduction of the new own resource would lead to lower taxation on other factors. It would therefore result in a change in the structure of taxation and a reduction of existing tax rates, potentially yielding efficiency gains.

The decision to introduce new resources is ultimately political and the discussion about it is likely to involve strong distributional aspects. However, it is important that this decision be based on objective criteria. We suggest the following:

- Whether the origin of the revenue can be assigned to a particular member state;
- Whether the corresponding revenue can be raised in isolation or requires pan-European tax coordination;
- Whether the introduction of the new resource can help reduce tax distortions in the EU;
- Whether the resource is related to EU policies.

More than one of these criteria should be satisfied. For example, revenues that can be assigned to a member state and can be raised without coordination do not add anything to the public finance equation and therefore are not suited in any particular way to serve as an own resource, even if they correspond to the EU's political priorities.

The focus should be on where a strong case can be made for using tax instruments as a basis for own resources. This applies in particular to revenues that are European by nature because they can only be levied via a common decision, or cannot be ascribed to any particular member state in a meaningful way. The introduction of such resources would both broaden the tax base, potentially reducing distortions, and increase the proportion of the EU budget that is financed from 'truly' European revenue sources.

Customs duties, for instance, were particularly suited as an EU own resource because it would not be appropriate to allocate the revenue to the country where the port of entry for the imported goods is located. In addition, customs duties are related to trade policy, which is a competence of the EU.

At its meeting on 17-21 July 2020, the European Council decided that the EU should work towards the introduction of new own resources. The council conclusions explicitly mention a charge on non-recycled plastic, a carbon border adjustment mechanism, a digital tax, a reformed emissions trading system (ETS), and finally a financial transaction tax. The timing of these potential new own resources is important. The plastics charge is agreed to start already in 2021, the border adjustment mechanism and the digital levy are to be introduced in 2023. There is no specified timetable for the ETS. The financial transaction tax is mentioned as a potential project for the next MFF, which implies that it will play no role in the current reform of the own resources system. The revenues are to be used, among other things, to service the debt incurred for the EU Recovery Fund[4].

In the following, we focus primarily on the suitability of two types of potential new resources: carbon-related levies (through the auctioning of emission allowances within the framework of the ETS, and through a potential carbon border adjustment mechanism), and taxes on the profits or the revenues from the cross-border provision of digital services. We also discuss a number of other potential bases for own resources, albeit with less detail: the financial transaction tax, the tax on non-recycled plastic and the corporate income tax.

Some of the candidates for new own resources, such as a corporate income tax or financial transaction tax, have a presumably permanent character, while others have a temporary character, either because their tax base is set to shrink (not least because that is the very purpose of the taxation), as is the case for carbon levies, or because they are temporary fixes (as for the digital services tax, if international discussions on new cooperative arrangements for corporate income taxation lead to a comprehensive redefinition of taxing rights). Clearly, the EU budget should be financed by permanent resources, but as a consequence of recent decisions, temporary revenue is needed to service and pay down the debt incurred in the context of the NGEU Fund. Given this, a revenue source which is available for a limited amount of time may be appropriate. Of course, the EU will need own resources for other purposes, but using temporary resources for a transition period would buy time to develop other options.

4

If a CBA was indeed symmetric, it would by itself generate little revenue – in fact its

CBA system would probably collect significantly less revenue[11].

Finally, the fact that revenues from a CBA would be paid by importers does not mean that the burden of taxation would fall on foreign producers exclusively. Domestic consumers would face higher prices on imported final goods and, indirectly, on domestic final goods with a high content of carbon-rich imports. These higher prices would be the channel through which information on the carbon content of imported goods would reach the European consumer, and because of which consumers would tilt their consumption baskets in favour of less carbon-intensive domestic goods.

Overall, we do not primarily regard a carbon border adjustment mechanism as a direct source of revenue, but rather as a device intended to limit competitive distortions in a world in which countries do not move at the same speed towards decarbonisation. The primary objective in fighting global emissions is that the largest possible number of countries should strive to decarbonise their economies, in which case the CBA would raise no revenue whatsoever.

A CBA would however have major indirect revenue effects, through its impact on the ETS. From 2013 to 2020, only 46 percent of ETS allowances were sold or auctioned; the rest were allocated for free[12]. For 2021 to 2030, the goal is to increase the share of auctioned allowances to 57 percent, still far from complete coverage. Free allocations are essentially destined for carbon-intensive sectors facing international competition. In the presence of a CBA, they could be further reduced or possibly even abolished. As a result more revenue would be raised from the ETS.

6 Digital taxation

The European Council conclusions of July 2020 mentioned the possibility of an own resource based on a digital levy. In recent years the implications of digitisation for taxation have attracted great attention in the international tax policy debate. The view is widespread that current principles for allocating taxing rights are not suitable for companies with digital business models, and that as a consequence these companies do not pay taxes where they should and as they should. There is also growing evidence suggesting that existing international tax rules allow multinational companies to avoid taxes (Beer *et al*, 2020; Tørsløv *et al*, 2020; Fuest *et al*, 2020). This gives them a competitive advantage over national firms and brings into question the fairness of the overall tax system.

This applies in particular to corporate income taxation. Companies pay corporate income tax in the countries where they are legally resident or have a physical presence. Digital business models allow firms to operate in foreign countries without a physical presence and without legal residence.

Current rules about the international distribution of taxing rights do not foresee that firms pay corporate income taxes in countries where they sell their products. Income taxes are paid primarily in the countries in which corporations reside and where they develop and produce their products and services. According to these rules, it is appropriate that United States digital companies that develop and produce their services in the US do not pay corporate income taxes in Europe. In the same way, European automotive companies that export cars to

11. [illegible] *et al* (201[illegible]) [illegible]

12. [illegible], https://www.eea.europa.eu/data-and-maps/dashboards/emissions-trading-viewer-1.

the US should pay corporate income taxes primarily in Europe, not in the US.

e matter is being discussed at global and EU levels. e tax challenges of the digital economy are being addressed within the framework of the Organisation for Economic Co-operation and Development's base erosion and pro t shifting (BEPS) action programme. e aim is to agree on new principles for the allocation of taxing rights: a country in which digital companies operate without signi cant physical presence (a market jurisdiction) would be granted taxing rights on the basis of a formula determining that a share of the pro ts of multinational rms are to be taxed in the market countries where the company sells its products. Digital companies would not be subject to speci c taxation, but the new international architecture would be designed in such a way that part of the corresponding tax base would be reallocated to the jurisdictions were users of digital services are located (OECD Pillar I proposal).

At EU level, the matter is being addressed within the framework of long-standing discussions on the Common Consolidated Corporate Tax Base (CCCTB). e European Commission tabled in 2011, and relaunched in 2016, a proposal for a Common Consolidated Corporate Tax Base that would rede ne the tax base for multinational companies operating in the EU. In 2018,panies opopminineE0opd/-din revenues above €50 million would yield €5 billion annually[13]. The actual resource flow could be significantly lower, if the tax is levied on net turnover or if other amendments are introduced to accommodate US concerns. In its factsheet of May 2020, the Commission actually lowered its estimate to €1.3 billion annually[14].

The tax on non-recycled plastic, meanwhile, will be payable as of the start of 2021. In the light of the criteria discussed in section 3, this tax is not particularly suitable as an own resource. To start with, the revenue can easily be (and actually is) ascribed to the member state where it is collected. Moreover, the main purpose of the tax is to reduce plastic litter, which is primarily a local environmental issue.

The European Commission fact sheet of May also mentions a levy *"on operations of companies that draw huge benefits from the EU single market"* and mentions revenue of €10 billion annually. Although this would be significant, we regard this levy as a rather uncertain temporary substitute for the common consolidated taxation of corporate profits, and doubt it could be a stable resource for the EU finances.

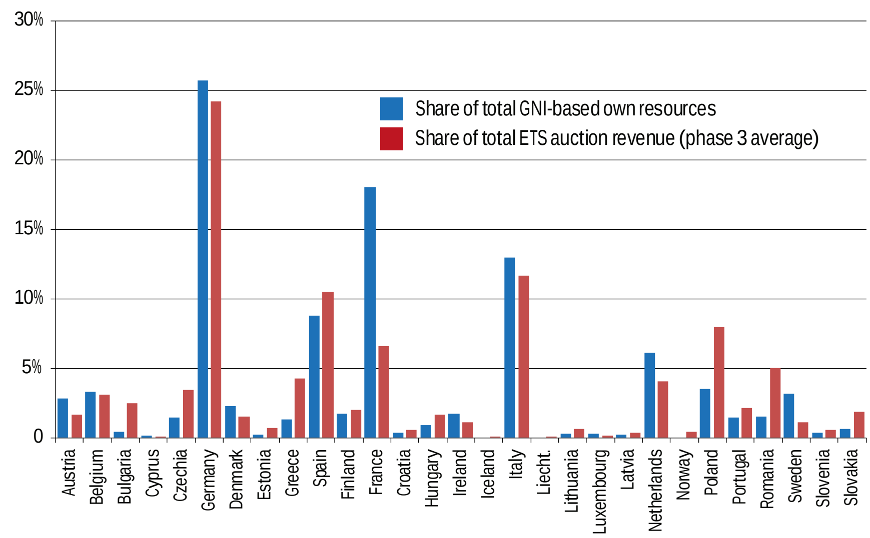
Finally, the introduction of a Common Consolidated Corporate Tax Base is primarily a project to reduce compliance costs for businesses operating across borders. Currently they have to deal with 27 different national tax systems, which is a burden in particular for small and medium-sized firms. In principle these benefits are independent of the use of this tax as a base for an own resource. In some ways, ascribing the revenue to the member states would be easier under a CCCTB than it is now, because the CCCTB would use formula apportionment rather than separate accounting, which is arguably more vulnerable to tax planning. In any case, using corporate taxes as a basis for own resources would require agreement on a common tax base. Past attempts to achieve this have not been successful; progress will take time. Moreover, in the area of corporate taxation, an additional and more fundamental consideration is that the flexibility to react to current developments, such as changes in international tax competition or economic crises and booms, is important. The question is whether this flexibility is compatible with the principle of unanimity in EU-level decision-making in taxation. Given this, corporate taxes could be a future candidate for own resources, but only after reforming the institutional framework and creating more room for decision as an EU own resource. Under the current practice of allocating more than 40 percent of the ETS allowances for free, the revenue raised would be small – the European Commission (2018a) estimated that between €1.2 billion and €3 billion annually would be raised for the EU budget, which is very little. Even if the share of free allocations was reduced signi cantly, the e ect on the overall composition of own resources would be small. But these are conservative estimates. Moreover, as we have explained, there are no convincing reasons why ETS allowance ownership and, as a consequence, auction revenues should be allocated to member states as they currently are. is suggests that the greatest part of the revenues could be used to fund the EU budget.

T a f ETS a c e e e a EU e ce a d ed c GNI c b d e a ca ea ca f ca b - e e e ca b - e e be a e

Transforming auction revenues into an EU resource and reducing GNI contributions accordingly would however entail signi cant reallocation from carbon-intensive to less carbon-intensive member states (Figure 2). ere are sound justi cations for such a reallocation: if the distribution of emission allowances across member states is kept constant, the rise in the ETS carbon price would result in major gains for some member states: for example, under the realistic scenario (scenario 3), ETS auction revenues for 2030 would amount to 0.51 percent of GNI for Bulgaria and 0.35 percent in Slovakia.

Anyhow, redistributing existing rights would be opposed by some member states, so at minimum, a transition period would be necessary. O setting excessive short-term redistributive e ects could furthermore require side payments, possibly through rebates or other compensation measures. But we see no reason why the EU should depart from the principle that revenue from ETS auctions has the character of a genuine own resource.

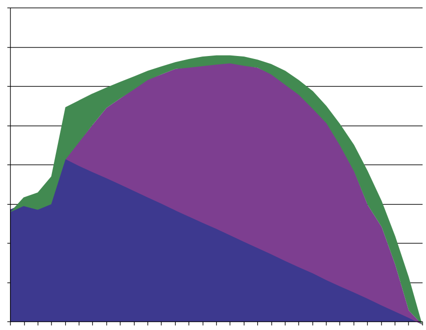
Figure 2: Comparative distribution of GNI contributions and ETS revenues



Source: Bruegel based on European Commission.

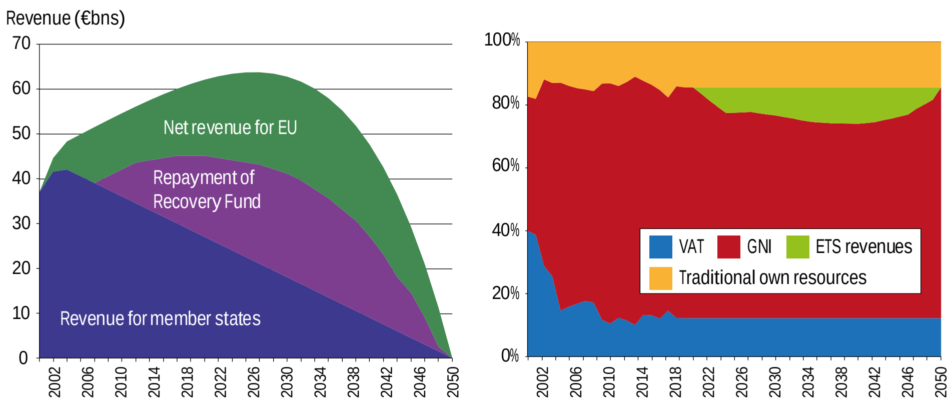
A way to avoid an abrupt shift in revenue from member states to the EU would be to transfer to the EU the whole proceeds from the auctioning of emission allowances, and to redirect annually to member states notional auctioned emissions revenues, computed as their share of 2019 auctioned emissions multiplied by the annual EU linear reduction factor and corrected for the impact of the MSR. ese notional auctions would be valued at a price capped at the level of the 2019 ETS carbon price. is would preserve countries' initial revenues while making room for a gradual increase in the revenue accruing to the EU. Such a formula would amount to a recognition that countries are entitled to a grandfathering right and should not be deprived of it. In addition, side payments from and to member states could be introduced to correct for any undesirable distributional e ects from the swapping of the GNI-based resource for ETS revenue.

Figure 3: Possible allocation of ETS revenues and structure of EU resources (net of debt repayment) under scenario 3



Source: Bruegel.

Figure 4: Possible allocation of ETS revenues and structure of EU resources (net of debt repayment) under scenario 5



Source: Bruegel.

9 Conclusions

At its July 2020 meeting, the European Council took the unprecedented decision to launch a new and ambitious recovery programme. is decision, taken in response to what the heads of state and government rightly regarded as a major threat to the future of the EU, has the character of a game-changer. Pre-existing discussions about the nancing of the EU budget must be reassessed in the light of this bold move. is applies in particular to the old discussion on EU own resources.

Our conclusion, after having examined the potential candidates for new EU own resources, is that only a swapping of GNI contributions for ETS revenues would match the spirit and magnitude of the decision taken in July. Other options may have merits and can be considered, but only the revenue from the ETS has both the economic characteristics of a genuine EU own resource and the potential to deliver quantitatively meaningful sums. Allocating it to the nancing of the budget would be a strong signal of the EU commitment to climate neutrality. Moreover, maintaining the status quo while accelerating the pace of decarbonisation would give rise to unjustifiable rents. The time to decide is now.

The distributional issues raised by our solution are significant, but solvable. We have offered one solution, but other options are possible. Under realistic assumptions, ETS revenues in the EU are set to increase significantly before they ultimately decline and dwindle. The corresponding revenue stream will most likely be sufficient to pay back the Next Generation EU debt, finance grandfather rights, and leave sufficient amounts for offsetting transfers to member states unfavourably affected by the swap. The EU has solved harder problems. It can tackle this one.

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