NEW DIRECTION
THE FOUNDATION FOR EUROPEAN REFORM



50:50 for 2020

How the European Union's budget could be cut by half

Kaetana Leontjeva
February 2013

Lithuanian Free Market Institute

This report was produced by *New Direction – The Foundation for European Reform*, a free market, euro-realist think-tank established in 2010 in Brussels. It is affiliated to the Alliance of European Conservatives and Reformists (AECR). *New Direction* seeks to promote policies and values consistent with the 2009 Prague Declaration to help steer the European Union on a different course and to shape the views of governments and key opinion formers in EU member states and beyond.

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The report was produced with the support of the *Lithuanian Free Market Institute*, a private, non-profit, non-partisan organisation established in 1990 to promote the ideas of individual freedom and responsibility, free markets, and limited government. LFMI's goal is to help advance the general interests of the people of Lithuania who can best be realized in a free market as every individual pursues his or her objectives – without any privileges, protection or restrictions – by serving society and not relying on government.

Kaetana Leontjeva is a senior policy analyst specializing in the areas of public finance and pension reform.

This publication received funding from the European Parliament. However, the views expressed in it do not necessarily reflect those of the European Parliament.

February 2013

Printed in Belgium

ISBN: 978-2-87555-023-1

Publisher and copyright holder:
New Direction Foundation
Rue d'Arlon 40, 1000 Brussels, Belgium
Phone: +32 2 808 7847
Email: contact@newdirectionfoundation.org
www.newdirectionfoundation.org

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In Brief

The €130 billion+ annual European Union budget is contested fiercely by member states and various interest groups. But much needed radical thinking by the European Commission has not been forthcoming.

This paper examines the theory behind current and proposed revenue raising and expenditure and proposes an alternative budget based on sound economic principles at **half the cost** to EU taxpayers.

I. The EU budget – where does it come from and can it be justified?

The EU budget is raised from three main sources: 'traditional own resources', mostly trade levies imposed by the EU (13% of the total EU budget), a proportion of VAT raised by the member states (10%), and a further contribution based on their Gross National Income (75%).

- Taxing trade harms both EU consumers and trading partners.

- Income from VAT gives the EU an incentive to promote higher taxes, leads to double taxation and complexity in the EU budget.

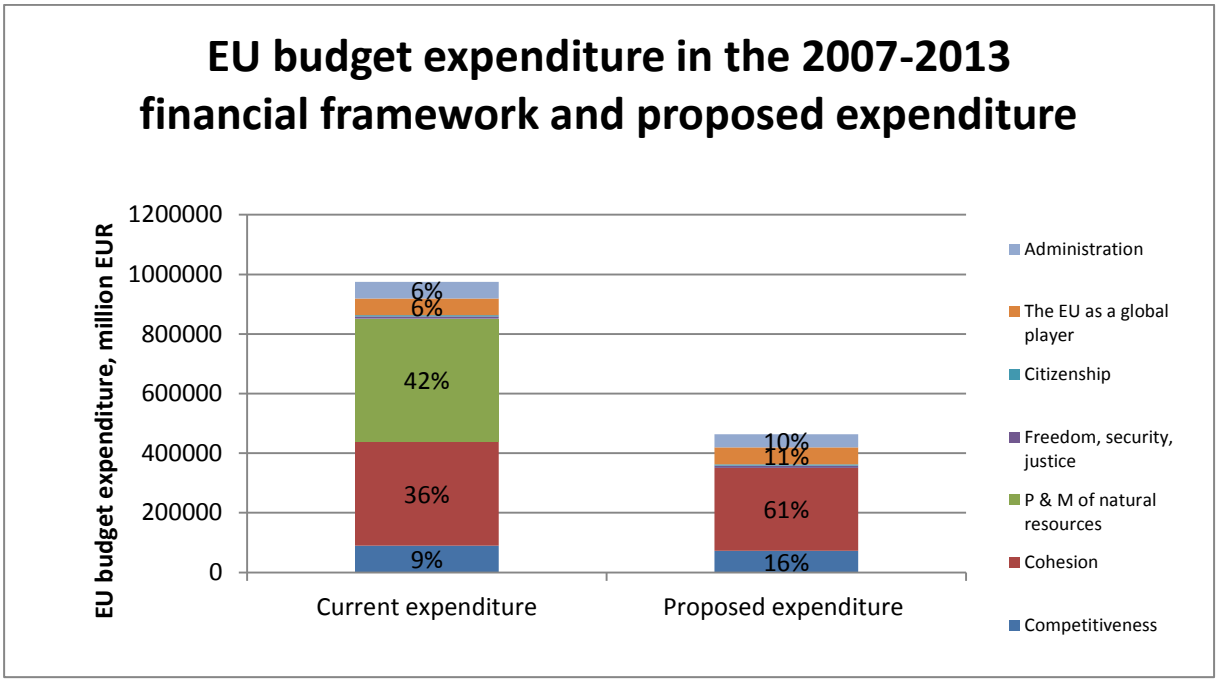
- The GNI contribution, by contrast, is proportionate to members' per capita wealth and gives the EU an incentive to promote growth (including lower taxes).

In addition, the Commission is advocating additional taxes that it could apply directly, including on the financial sector, VAT, various energy taxes and corporation tax.

But new EU taxes would likely increase citizens' dissatisfaction with the EU, would probably add to the overall tax burden, and would reduce tax competition. In particular, there is no evidence that systemic risks in the financial sector can be overcome by a new tax. Instead it would simply drive business away from the EU.

II. Expenditure – how it is spent and what impact it has

The main areas of EU spending are on competitiveness, cohesion (including regional development), and the preservation of natural resources (including the Common Agricultural and Fisheries policies). The EU also spends money on promoting citizenship, the EU as a global player (foreign policy) and its own administration.



Source: LFMI

- Competitiveness hinges on competition rather than public expenditure, so the EU budget is not addressing the real obstacles to competitiveness. With R&D, for example, the real problem arises when knowledge is not turned into money, rather than low expenditure per se.

- Most cohesion spending is not compatible with competitiveness. It reduces incentives for development, distorts competition, crowds out private investment, increases government spending, encourages corruption and causes inflation.

- By contrast, spending on trans-European transport and energy networks can improve the single market and should remain intact. However, transparency of such projects should improve.

- The CAP does not ensure price stability in agriculture, and hurts consumers with higher food prices and taxes.

- Instead of conservation and a sustainable use of marine resources, the CFP results in depletion of fish stocks.

- Spending on administration has increased by almost a third in this period at a time when member states are trying to control their budgets.

III. Main Recommendations

Much EU spending is contradictory in purpose and damaging in outcomes. A streamlined budget would involve a spending cut of 52%, boosting national budgets and economic growth.

- Levies and other duties originating from trade are distortionary and should be gradually removed. The VAT-based resource should be removed, leaving only the GNI-based resource at a lower level. This would be enough to finance the whole budget as envisaged here.

- Introduction of new 'own resources' would be counterproductive, make the revenue system more complex and increase the tax burden. Proposals for new EU taxes should be abandoned.

- EU spending on cohesion and competitiveness should be reformed and should focus primarily on trans-European transport and energy networks, ensuring the transparency of such projects.

- EU spending on preservation and management of natural resources – including the CAP – does not meet its core objectives and should therefore be discontinued.

- The increase in EU spending on administration has to be stopped by cutting the salaries, bonuses and lengthy holidays of the EU's employees and reducing its overall workforce.

Introduction

For many years the composition of the European Union budget has been an issue contested by member states and various interest groups. Member states seek to become net-recipients, while the interest groups lobby to increase spending on their pet programmes and initiatives. This pattern has not changed in the budget discussions of 2013. But the effects of a changing global economy on European growth have led even the EU itself to question whether the priorities and measures of the current EU budget are effective, and to ask if comprehensive reform of its expenditure and revenues is needed.

The EU budget is decided on a seven year cycle. Between 2007 and 2013 the EU spent nearly €1 trillion. The next cycle, 2013-2020, is the subject of fraught intergovernmental negotiation as this paper is being completed. But the groundwork was supposed to have been done in good time. In 2006, the European Commission was asked to undertake an extensive review of the EU budget. In late 2010, it presented its 'communication' (report) on EU budget reform where it suggested an introduction of new 'own resources' (revenue streams) and mild reform of EU spending. However, the document failed to propose radical and much needed changes to the EU budget. Authors of the EU budget review claim that 'so far, the EU budget has proved itself as an effective tool to realize the EU's aspirations and implement its policies'.[1] However, this claim may be challenged: is it really the case that the EU's goals have been reached and the EU is now a competitive and dynamic economy? If so, and if the EU's aspirations have been realized, then why continue funding what has been achieved?

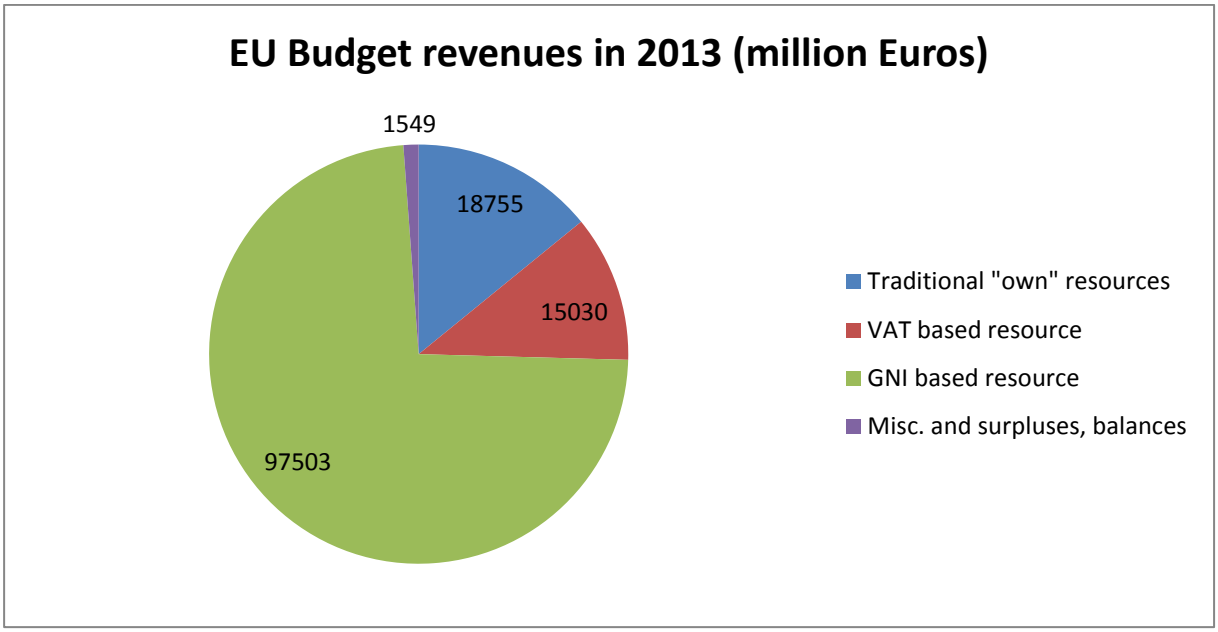
It is clear that the EU budget needs a comprehensive shake-up. Although the ambition of EU budget reform review was to "think outside the box", proposals did not live up to this. Proposals for the subsequent multiannual framework were submitted by the EC in mid-2011, but have still to be agreed upon by EU governments.

With that in mind, this paper is set out as follows: the first part is devoted to current and possible EU budget resources, examining their economic effects and drawing conclusions as to whether these revenue sources are reasonable and justified. Analysis of EU budget revenue sources is followed by proposed principles for the EU budget revenue system. EU budget expenditure is analyzed in the second part of the paper, including proposed principles for EU spending. Conclusions and recommendations for policy makers are put forward in the third part.

I. EU budget revenue

Current revenue sources

The EU budget is raised from three main sources: levies imposed by the EU, a proportion of VAT raised by the member states, and a further contribution based on their Gross National Income, a measure of economic output.



Source: LFMI

Revenue raising can have two goals: first, to provide financing for the budget, and second as a policy tool to achieve specific goals. In this section we evaluate the economic impact of these revenue streams according to both criteria.

Traditional 'own resources'

Traditional 'own resources', the original source of funds for EU institutions, consist of levies and Common Customs Tariff duties as well as other duties originating from trade with non-member countries such as customs duties on sugar and other products. In the current seven year financial framework (2007-13), traditional 'own resources' have accounted for less than a sixth of EU budget revenues, ranging from 12.8 to 14.9 percent of the total. In absolute terms, revenues from 'own resources' in that period have ranged from 14.6 to 18.8 billion euros per year.

Levies and other duties originating from trade are set up to protect the domestic producer. So in addition to being a financing source of the budget, these levies also act as a regulatory tool. These goals are contradictory and difficult to balance, because if levies were to be set high enough to completely protect domestic producers from competition against imports, their role as a source of revenue would diminish.

Levies and other duties originating from trade have negative effects both for the countries imposing the levies (in this case, all member states of the EU) and countries which have levies imposed on them (non-member countries). Protection from competition against foreign goods may seem beneficial to domestic industries, yet it is done at the expense of domestic consumers, who can no longer purchase cheaper foreign goods.

Numerous research studies suggest clear benefits from trade liberalization. For example, 2011 OECD Working Paper No. 107 analyzed the effects of a 50% reduction of applied tariffs by all countries, concluding that 'increased productivity on the long run allow[s] to further reap the benefits of trade liberalization resulting in higher increases in exports.'[2]

EU levies and other duties originating from trade have negative effects for non-member countries because they experience lower sales of their products, leading to lower economic growth in those economies. Since protection of trade in agricultural products obstructs less developed countries' trade with the EU, EU trade protection in effect hinders the economic development of those countries.

As is the case with all trade protection, EU trade protection results in a deadweight loss, so trade liberalization and revocation of all levies and other trade duties would create benefits both for the EU and non-member countries.

Originally, traditional 'own resources' could ensure a direct link between revenue and common EU policies. However, as the significance of 'own resources' has decreased over time compared to other EU budget revenue sources, that link has been broken. As the European Commission points out, 'the connection between the original 'own resources' and common EU policies has been lost, making the system less transparent and increasing doubts about fairness.'[3] It should be noted that the loss of a link between revenues and EU policies is not a negative occurrence in itself: the only goal of the revenue scheme should be to provide revenues for the EU budget, any additional goals such as trade restriction in the case of tariffs should not be pursued.

Since the presence of 'own resources' produces detrimental effects both for the EU member states and non-member countries, the existence of traditional 'own resources' as EU budget revenue source is unjustified and EU levies and other duties should be removed.

VAT-based revenue

The VAT-based 'own resource' was introduced in 1970. Its significance has gradually decreased during the current financial framework. In 2007 the VAT-based revenue stream amounted to 16.3 percent of total EU budget revenues, while in 2013 this fell to just over a tenth of all revenues. In absolute terms, revenues from the VAT-based revenue stream have declined from 18.5 billion in 2007 to 15 billion euros in 2013.

The amount of VAT-based 'own resources' paid by each member state is calculated as a proportion of total VAT revenues in each given country.[4]

This revenue stream comes from taxation of value added in all of the member states' economies. Although VAT is assumed to be a good way to promote tax neutrality, no tax can ever be completely neutral and VAT does create distortions in the relative prices of goods and services produced in an economy.

Since a proportion of total VAT revenues is channeled into the EU budget, the EU has an interest in higher rather than lower total VAT revenues of each member state. Member states, on the other hand, have a different interest. If a member state is choosing which tax to increase, it is less likely to increase the VAT rate because a part of it would be diverted into the EU budget, even though a VAT rise would be less distortionary to the overall economy compared to an increase in excise duties.

The EU prevents the member states from applying a standard rate of VAT lower than 15 percent, with the exception of reduced VAT rates applied on a particular set of goods and services (such as newspapers and children's clothes in the UK). The reason given is: 'to prevent divergences in the

standard rates of VAT applied by the Member States from leading to structural imbalances in the Community and distortions of competition in some sectors of activity, a minimum standard rate of 15% should be fixed, subject to review.'[5]

In addition to the distortionary effects of VAT, it is important to point out that both VAT- and GNI-based revenue sources are applied on the same base – the value added in each member state. The result is an overlap of the tax base, creating double taxation of the value added. Double taxation leads to the high complexity of EU budget revenue sources and their reduced transparency.

As highlighted in the Commission's own 'Communication' on the EU budget review, 'the current system is perceived as opaque and too complex, lacking fairness.'[6] The Communication calls for simplification of the current system of EU budget revenues. Since the VAT-based revenue stream is highly distortionary and overlaps with the GNI-based revenue source, the VAT-based revenue source should be eliminated. This is what the European Commission itself has proposed to do in its Communication "A Budget for Europe 2020".[7]

The GNI-based revenue stream

The GNI-based element was introduced in 1988. Its importance in the EU budget has been growing in recent years. In 2007 it comprised 62.5 percent of EU budget revenues, while in 2013 this figure reached 73.4 percent. In absolute terms the GNI-based stream grew by more than a third from 71.2 billion to 97.5 billion euros in the 2007-2013 period.

This revenue stream is calculated according to the value added created in each member state, so it is proportional to member states' national income. It is financed through direct taxes set at the national level, yet in contrast to the VAT-based resource it is not directly calculated as a share of tax inflows, so the EU has no incentive towards increased taxes revenues. Instead, in order to increase flows from this revenue stream, the EU benefits from higher economic growth (and so, if anything, lower taxes). Thus the effects of the GNI-based revenue stream on the member states' economies are less distortionary.

New revenue streams under consideration

In recent years, the idea of introducing new revenue streams for the EU has been attracting increasingly more attention. A 2007 report on the future of the European Union's resources called for 'the creation of a genuine own resource for the European Union to replace the existing mechanisms.'[8] The EC's EU budget review states that 'new own resources could fully replace the existing VAT-based own resource as well as reducing the scale of the GNI-based resource, taken directly from national treasuries'.[9] According to the report, the Commission considers the following taxes possible candidates for its 'own resources' that could gradually replace national contributions:

- EU taxation of the financial sector
- EU revenues from the greenhouse gas Emissions Trading System
- EU charges related to air transport
- EU VAT
- EU energy taxation
- EU corporation tax

The Commission does not present any underlying principles to show how it came up with this list of possible new taxes. The objectives of these levies appear to be eclectic and proposed as a reaction to current events and challenges, rather than based on a consistent rationale.

In its Communication "A Budget for Europe 2020", the Commission proposes a new 'own resource' system based on a financial transactions tax and a new VAT resource. The Commission does not provide details as to whether this taxation would be progressive, what would be the tax rates, or their likely economic impact. Although these taxes would obviously have to have a fiscal role, the regulatory aspect of possible new 'own resources' would likely be just as important.

Two main reasons have been put forward for introducing new EU taxes:

- To reinstate a link between the EU's revenue raising and its policies;
- To create a link between the EU and its citizens.

Regarding the link between the new taxes and common EU policies, we should remember that they would also act as a regulatory tool to achieve what the EU has identified as common goals (for instance regulating the financial sector), rather than solely as finance for new EU spending priorities. Moreover, the imposition of such a link would be potentially dangerous in that pan-European policies and regulations tend to be rigid and are extremely difficult to change, whatever their detrimental effects (such as the levies and other duties originating from trade). Even though the object of new regulation might be of temporary and passing interest to EU policy makers, taxation of the financial sector being a case in point, once in place it is likely such new regulations would be applied for a very long period of time.

It has been suggested that direct fiscal links between the EU and its citizens would 'enhanc[e] the political accountability of the EU and contribut[e] to the reduction of the perception of a 'democratic' deficit.'[10] However, increasing the tax burden is not a suitable way to reduce the perception of a 'democratic deficit'.

Besides, regarding most of these new taxes, a direct fiscal link would hardly be transparent. Citizens would most likely not identify themselves as direct contributors to the EU budget through EU taxes on the financial sector or greenhouse gas emissions, for instance. A direct fiscal link between an EU citizen and the EU would appear only in the case of a poll tax, a tax of fixed amount to be paid by every individual. However, any new EU tax to be paid by EU citizens would likely increase citizens' dissatisfaction with the EU rather than make them feel closer to shaping EU policies.

There are a number of additional reasons why introducing new EU 'own resources' would be a mistake:

- A new tax would most likely be an additional tax, unaccompanied by a reduction of other nationally levied taxes, thus increasing the tax burden;
- If the EU really requires more revenue, it would be less harmful and cheaper from the point of view of tax administration to increase existing rates rather than introduce new forms of taxation;
- New EU taxes would deepen tax harmonization, preventing tax competition which is beneficial to taxpayers and acts as a brake on unjustified increases in budget expenditure;

- New taxes would undermine the sovereignty of member states and strengthen anti-EU sentiments among EU citizens.

Of the six possible candidates for new taxes, the European Commission has proposed first introducing a financial transactions tax and a new VAT levy. Since EU auctioning of greenhouse emission allowances and an EU energy levy have also received considerable attention among various politicians, these four merit further investigation here.

EU taxation of the financial sector

A recent consultation paper "Taxation of the Financial Sector" proposes three possible taxation measures:

- A Financial transaction tax (FTT), based on the value of financial transactions and applied each time an asset is traded;
- A Financial activities tax (FAT), levied on the sum of profit and remuneration of banks and similar credit and savings institutions, credit card companies, insurance companies, etc. Three alternative FAT's exist: addition method FAT (designed to compensate for the VAT exemption), rent-taxing FAT (taxing profits above a certain level), or risk-taxing FAT (taxing a currently undefined excess return originating from risky activities);
- Bank levies, either asset-based or liabilities-based.[11]

In January 2013 eleven EU countries agreed to impose a financial transaction tax of 0.1 per cent on shares and bond trading and 0.01 per cent on derivatives trading, though revenue will be retained at the national level for the time being.

The consultation paper outlines three reasons as to why a special tax should be introduced on the financial sector:

- To help plug revenue shortfalls, particularly with the perception that the financial sector is 'under taxed';
- To curb excessive risk taking;
- Uncoordinated national measures to tax the financial sector may not be effective due to tax-driven relocation or unrelieved juridical double taxation.[12]

The first reason suggests that revenues from a new tax on the financial sector could help cushion the blow from falling tax revenues experienced in times of economic crisis. Governments are often tempted to deal with revenue shortfalls during recessions by increasing taxes or introducing new ones, yet this approach increases the tax burden on taxpayers and damages growth. It may appear as if government spending is stimulating economic growth, when it fact it is a simple case of redistributing resources. Resources which would have been spent by the private sector are shifted to the public sector, damaging productivity. Instead, governments facing the need for fiscal consolidation should be responding by spending cuts rather than increasing taxes or introducing new ones. A shortfall of revenue should not be a reason to introduce a new tax on a particular sector of the economy. Moreover, if this tax were introduced it would most likely become permanent while the need for additional revenue is temporary.

Under-taxation of the financial sector is also cited as a reason for new financial sector taxes because VAT is not levied on the financial sector. However, the Commission does not put forward any reasons why this problem could not be solved by levying VAT on financial services.

The Commission identified excessive risk taking as a possible reason for a financial sector tax. Systemic risk does exist in the financial sector; however, its causes are more fundamental, related to the underlying structures of banking[13] and the moral hazard of government guarantees of the system, rather than the cost of transactions.

The Commission indicates that the new taxes on the financial sector would be 'how the financial sector might contribute to costs of future crises.'[14] Bailouts of the financial sector are indeed costly to the taxpayers, yet these costs will materialize only if governments decide to bail out banks and other financial institutions. It is generally agreed that public bailouts of the financial sector create a moral hazard problem, which in turn encourages this excessive risk taking that the Commission is striving to eliminate. Therefore, the systemic risk of the financial sector should be dealt with by more fundamental reforms rather than introducing new taxes which may have effects contrary to what is aimed for.

The third reason given for EU-wide taxation of the financial sector is that uncoordinated national measures may not be very effective. Companies may choose to relocate to member states with a smaller tax burden on the financial sector, or double taxation may arise. But the EU should not be viewed as a closed system, completely separated from the rest of the world. If the EU were to introduce an EU-wide tax on financial institutions, the latter may choose to relocate their activities to other regions that do not levy special taxes on financial institutions, for example the United States of America, Southeast Asia, the Middle East, etc. Thus the EU would face even tougher competition from non-member states, while the competitiveness of its financial sector would decline. Potential losses from such relocation would be significant for the whole EU economy: outflow of jobs and capital, in turn implying lower tax revenues for national budgets.

The current moves towards an FTT in eleven EU states will no doubt provide a test case in this regard.

In summary, EU taxes on the financial sector are not justified and should not be introduced because:

- Fiscal consolidation of national budgets should be achieved through spending cuts rather than increasing taxes or introducing new ones;
- Taxation of the financial sector would increase the tax burden on the EU economy, leading to lower economic growth;
- Systemic risk of the financial sector cannot be overcome by a new tax;
- EU-wide taxation of the financial sector would create incentives for financial institutions to relocate to regions with lower financial sector taxation.

EU VAT

The Commission proposes that a combined VAT rate could consist of national and EU elements. National rates would continue to be determined by the member states, while an EU rate could be defined separately and clearly denoted on each individual invoice. EU VAT would be different from

the current VAT-based revenue stream in that it would be a separate tax rather than a national contribution based on statistical calculations.

Tax harmonization is put forward as the main reason for introducing an EU VAT: the Commission says it 'would bring a new impetus to the development of the internal market by reinforcing harmonization of national VAT systems.'[15] Another obvious reason is its fiscal impact: it is estimated that the new VAT resource could account for 18.1 percent of the EU budget in 2020.

But the EU would benefit from more tax competition rather than deeper tax harmonization, because the latter encourages unjustified increases in budget expenditure. And it should not be forgotten that deeper tax harmonization and a rising tax burden within the EU implies that some member states experience tougher tax competition with non-EU members.

EU auctioning of greenhouse gas emission allowances

As proposed in the Commission's EU budget review, the proceeds from greenhouse gas emission allowances auctioning could form a new 'own resource' for the EU budget. This would require the creation of a centralized auctioning system, whereby part of the revenue collected would be transferred back to the national budgets of member states 'to maintain the redistribution agreed in the legislation.'[16] Currently, at least 50 percent of the revenue generated from the auctioning of allowances has to be used on specific climate change-related policies, such as the reduction of greenhouse gases and measures to avoid deforestation.[17]

In short, a new centralized auctioning system would be expensive to create and would render the EU budget system even more opaque and complex because of these corrective transfers back to the national budgets. The introduction of such a complex scheme would contradict the EC's intention to introduce clarity into the EU budget revenue system.

The goals of such a system are contradictory: although it aims to reduce greenhouse gas emissions, countries seek to receive as many allowances as possible because the sale of unused allowances would increase their revenues. Research shows that this system can distort behaviour, for example, when allocations of emissions allowances 'are tied to future emissions through investment and closure decisions.'[18] If firms anticipate that the future allocations of allowances will be proportional to current emissions, they may decide to continue employing more carbon-intensive technologies. The allocation of new allowances is agreed in repeated negotiations, thus creating 'incentives for CO2-intensive plants to remain in operation in order to receive free allocations.'[19]

Moreover, the revenue potential from this new revenue source is difficult to predict and will vary depending on the amount of emission allowances auctioned and the carbon price. The Commission argues that 'varying revenue would be offset by the fact that the residual GNI-based resource would still be in place and could in any case compensate for any such possible volatility in this as in other resources', highlighting the fact that GNI-based resource would continue to be the most significant EU budget revenue source. The overall system of auctioning of greenhouse gas emissions and its potential as a stable revenue source is questionable.

The introduction of a new 'own resource' from greenhouse gas emission allowances is not justified, since its administration would make the EU budget revenue system even more complex and volatile.

EU energy levy

The Commission proposes that an EU energy levy could fully or partially replace existing taxes on energy consumption or that existing taxes could be replaced by an EU levy on energy/CO2 emissions. It is also suggested that 'Member States could apply national duties ('surcharges') on top of the EU duties.'[20]

According to the Commission, the main advantage of this new 'own resource' is that it would be applied to an existing tax base, implying easy implementation.

The introduction of an EU energy levy and a possible national duty on energy consumption would have the following effects:

- A higher tax burden on European taxpayers;
- Deeper harmonization of energy consumption taxation.

In order for national duties to offset the revenue fall from replacement of national taxes on energy with an EU energy levy, the size of the national duties would have to be as big as the existing taxes, otherwise they would have to balance the books from other sources, with negative consequences for European consumers and businesses. Partial harmonization of energy taxes within the EU only serves as a pretext for tax increases. Rising energy prices are already affecting the EU economy and EU taxation policy should not add any further strain to it.

Energy consumption taxation is already partially harmonized within the EU due to minimum excise duty rate requirements set by the Commission. It highlights there could be efficiency gains from producing a link between a tax and various Community policies, yet they 'would only be possible if the total rates resulting from the EU rate combined with Member States surcharges were more harmonized than the current rates or if a reform of the existing framework for energy taxation could be facilitated by linking it to a reform of own resources.'

Partial harmonization has revealed the inherent flaws of tax harmonization, and deeper harmonization would further amplify those flaws. Tax harmonization inhibits societies from having lower taxes and smaller and more efficient governments. Moreover, it takes away member states' abilities to adapt national tax rates to their unique social, economic and geographic conditions. Tax harmonization within the EU may bring about a similar tax rate, yet distortions are produced along the borders of the EU where stark differences in tax rates persist and are apparent. Such distortions create opportunities for economic agents to benefit from price differences, leading to smuggling of those products with the highest price differences (such as fuel, alcohol and cigarettes).[21] Smuggling distorts competition within those EU member states on the border, since producers and sellers of legal products cannot compete against much cheaper smuggled goods. Thus, tax harmonization would lead to tougher tax competition with non-member countries.

An EU levy on energy would create two divergent motivations for policy makers: if they want to reduce consumption of energy, the levy has to be high, but that would mean lower revenues. The tax burden would be uneven within the EU and the net payer is not yet known. It is likely that a higher tax burden would fall on the new member states that are generally less energy efficient and have lower incomes. However, this would contradict the EU's policy on the spending side, where spending

aims to allow the new member states to develop economically and reduce economic inequalities within the EU.

In summary, a levy on energy consumption is not justified and should not be introduced because:

- An EU levy on energy consumption would increase the tax burden and make it uneven, having significant negative consequences for the European consumers and businesses;
- Flaws of tax harmonization would be amplified, creating further distortions along the EU border and leading to tougher tax competition against non-member countries.

Proposed principles for the EU budget revenue system

To introduce consistency, transparency and economic rationality to its programme, the EU budget system should function according to the following principles:

- National rather than EU-wide contributions

This principle would ensure democratic financing of the EU, whereby the European Community is understood as an association of independent states rather than a federation of states. In turn, this implies that member states contribute to the EU budget, but the EU does not have a right to tax. Proper adherence to this principle would prevent the EU from introducing any new 'own resources'. It also implies the removal of EU levies and other duties originating from trade.

- Fair contributions

This principle would ensure that each member state pays contributions proportional to its gross national income. Currently, only the GNI-based resource adheres to this principle.

- Simplicity and transparency

This principle would ensure all EU citizens know how contributions to the EU budget are calculated. It would bring about accountability of the EU and make it more difficult to conceal whether a specific member state is a net recipient or net donor of the EU budget. In order to implement this principle, the number of EU budget revenue sources has to be reduced, abolishing overlapping revenue sources such as the VAT-based resource (which overlaps with the GNI-based own resource). This principle also implies that new 'own resources' should not be introduced, for they would make the EU budget revenue system more complex and less comprehensive to EU citizens.

- Ease of administration

This principle would ensure efficiency of the payments system, increasing transparency of the EU budget. In order to adhere to this principle, the number of EU revenue sources has to be reduced and calculation of the remaining source (the GNI-based resource) has to be simple and not overburdened with complex regulations. Again, this principle implies that new 'own resources' should not be introduced, for they would increase the burden of administration of EU budget revenues sources.

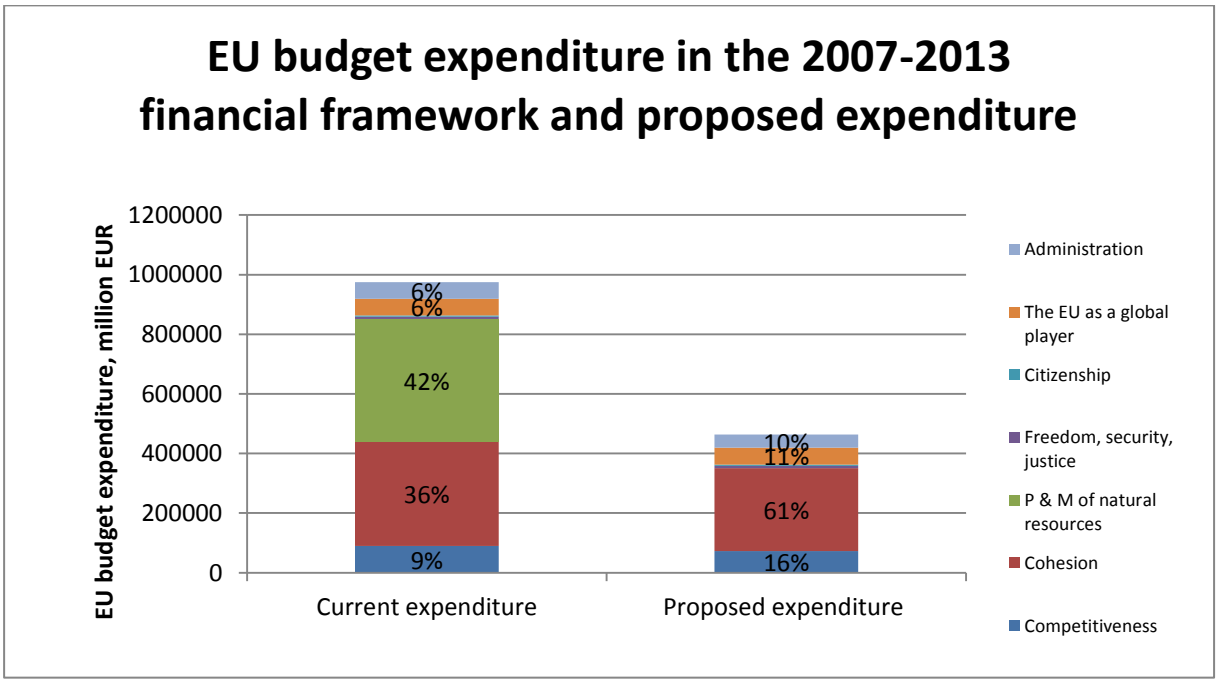
In summary, adherence to the following principles implies:

- GNI-based resource as the main EU budget revenue stream;
- Gradual removal of EU duties and other levies originating from trade;
- Abolishment of the VAT-based resource;
- No new 'own resources'.

II. EU Budget Expenditure

Justification and effects of current expenditure

Between 2007 and 2013 the EU will have spent nearly €1 trillion. On what and how effectively is it spent? This section summarises the main areas of EU spending and analyses its effectiveness before putting forward a set of revised principles for EU spending that results in a cut of about 50 per cent of its budget.



Source: LFMI

Sustainable Growth

Expenditure on sustainable growth amounts to nearly half of total EU budget expenditure. It is divided into competitiveness and cohesion spending.

Competitiveness for Growth and Employment

In the current financial framework, spending on competitiveness for growth and employment has ranged from 7.2 to 10.2 percent of total EU budget expenditure. In absolute terms, spending under this heading will increase from 8.9 billion euros in 2007 to 15.6 billion euros in 2013, a rise of 75 percent.

Competitiveness for growth and employment includes spending on research and innovation, education and training, trans-European transport and energy networks, social policy, the internal market and accompanying policies. The programme for research and technological development funds research on issues such as climate change or the ageing population, while the competitiveness and innovation framework programme aims to strengthen innovation among small and medium-sized enterprises, especially in information and communication technology (ICT)-based services and ecological innovation. Spending under this heading also includes the Galileo project – a European satellite positioning and timing system.

The Commission report "A Budget for Europe 2020" claims that the EU faces a significant innovation gap, and it proposes that future research and innovation funding be based on three main areas – excellence in the science base, tackling societal changes and creating industrial leadership and boosting competitiveness.[22]

The spending objectives under this heading are divergent and not entirely compatible: They seek to increase competitiveness while simultaneously to promote cohesion within the EU. A further problem arises over whether EU spending really can improve competitiveness. Competitiveness hinges on competition rather than public expenditure, so the EU budget is not addressing the real obstacles to competitiveness. For true competition to emerge, state-imposed barriers to the single market have to be removed. Public expenditure on competition projects or funds allocated to private projects will have little effect on competitiveness.

Regarding EU spending on research and development, it is important to recognize that private spending has the primary role in the economy. Public spending on R&D lacks incentives that the private sector has to use R&D expenditure efficiently, minimize resources being used and obtain maximum benefits. Advanced R&D findings do not always turn into business projects, which shows that the real problem arises when knowledge is not turned into money, rather than low R&D expenditure *per se*. However, the Commission plans to increase expenditure for R&D which may further undermine the effectiveness of the EU budget expenditure.

By contrast, spending on trans-European transport and energy networks is an appropriate way of achieving the goal of improving the single market and should therefore remain intact. However, transparency of such projects has to be improved and the presence of EU projects should not stifle private initiatives to pursue trans-European transport and energy projects.

Cohesion for Growth and Employment

In the current financial framework, spending on cohesion for growth and employment has ranged from 35 to 36.2 percent of total EU budget expenditure. In absolute terms, spending under this heading will increase from 45.1 billion euros in 2007 to 54.5 billion euros in 2013, an increase of 21 percent.

Spending on cohesion for growth and employment aims to 'enhance convergence of the least developed Member States and regions, to complement the EU strategy for sustainable development outside the less prosperous regions and to support inter-regional cooperation.' Spending under this heading includes funds allocated to the building or reconstruction of roads and railways, water treatment, improvement of the ICT infrastructure, and training the workforce in new skills.

Spending on these activities is primarily done through the following funds:

- the European Regional Development Fund (ERDF) gives assistance to the development of various regions, co-financing infrastructure and productive investment;
- the European Social Fund (ESF) promotes full employment, social inclusion and cohesion, and improvement in the quality and productivity of work;
- the Cohesion Fund spends on transport, energy and environmental infrastructure.

The chief aim of cohesion spending is to strengthen the economic and social cohesion of the EU by reducing 'disparities between the levels of development of the various regions and Member States and backwardness of the least favoured regions or islands, including rural areas.'

Authors of the EU budget review maintain that cohesion policy is a success, as it demonstrates the EU's 'commitment to solidarity', invests in modernization and contributes to economic growth.[23] However, "A Budget for Europe 2020" admits that the results of past spending 'also show some dispersion and lack of prioritization.'[24] For this reason the EC proposes 'to strengthen the focus on results and the effectiveness of cohesion spending by tying cohesion policy more systematically to the Europe 2020 objectives.'

It is important to recognize that despite efforts to 'strengthen the focus', Cohesion will still have divergent goals: economic growth of certain regions may result in wider disparities, yet funds are being allocated to reduce those disparities. These divergent goals are hardly compatible, undermining the overall efficiency of this kind of spending.

Moreover, the question of whether full cohesion can be achieved in principle, and whether state financial intervention can generate it, remains to be answered. In any case, it is apparent that disparities between the levels of development of the various regions and member states continue to persist despite increasing EU spending on cohesion and it is not clear how much more EU funding will be required to attain full cohesion (or if it ever will). A study on the effectiveness of EU structural funds has concluded that 'European support as such did not improve the countries' growth performance', so structural funds may not be a suitable tool to improve member states' growth.[25] EU spending on cohesion removes incentives for certain regions or countries to become more developed, because if their development increases, they lose their eligibility for these EU funds. This creates a situation of dependency on EU support and hinders the growth of underdeveloped regions.

In addition to serious doubts whether sustainable growth spending can achieve all of its divergent goals, it has a significant number of negative effects:

- Lower efficiency of public spending on investment compared to private

Investment decisions are best when they are taken by private individuals and companies, because they respond to market signals, aim to satisfy consumers' needs and seek to minimize inputs costs and maximize profit. In contrast to private investment, market forces do not apply to public spending on investment, and projects are selected according to political criteria. Therefore, public investment does not respond to market demand. All of the sustainable growth programmes and funds have priorities which may not coincide with the most immediate needs of a given country's inhabitants.

Only the market can decide which investment projects are needed and succeed, while the expediency and benefits of EU-funded projects are often doubtful.

- Distortion of competition and crowding out of private investment

EU spending on private projects may distort the efficient operation of markets. EU funding is given to those sectors of the economy that are regarded as priority sectors. Consequently, companies that did not obtain funding find it harder to compete in the market against companies that received EU funding. Competition is distorted by EU funding priority being given to certain sectors and by regulations and criteria for allocating EU funds which favour certain businesses and companies. As a result, EU expenditure becomes a state instrument designed to manipulate the market. In addition to distortions arising in sectors receiving EU funding, related fields such as the labour market and production of input material become distorted as well.

Competition may also be obstructed when publicly owned companies use EU funds to operate in markets where private companies already compete. This may lead to the crowding out of private investment and hindrance of private sector growth. Companies that receive EU funding find it easier to compete for resources against companies without EU funding. Higher flows of investment into a certain sector may push up input costs, so that companies without EU funding may find it more difficult to purchase resources, including hiring new workers.

In the current 2007-2013 framework, 100 million euros was allocated to creating vocational training centers. These allocations are used to finance modern vocational training equipment and create vocational training centers that will belong to the state. It is likely that EU-financed projects will crowd out potential public-private sector partnerships and hinder the development of private vocational training centers.

- Higher costs in the public and private sectors

The principle of additionality requires that EU-financed projects are co-financed with national contributions. This principle is meant to ensure that projects financed with EU funds are in line with the priorities of the state and to prevent inefficient use of EU funds. However, situations may arise when countries agree to funding more projects and hence increase national contributions in order to amplify total public spending. Spending on sustainable growth may reduce incentives to reduce national budget expenditure, encourage wasteful use of taxpayers' money and prevent a lower tax burden or a balanced budget.

The absorption of EU funds requires considerable administrative work. In order for companies to receive EU funding, both private and public sectors invest a lot of their time and resources. EU funds may distort incentives in the private sector: instead of using EU funds to overcome specific challenges companies face (such as low qualifications of employees), companies may begin to focus their attention on bidding for EU funds. This implies that the number of employees engaged in productive and value adding work decreases.

- Added inflation in poorer regions

Transfers from the EU budget to net-beneficiary states are in some cases considerable, amounting to a large share of money supply in the local economy. A growing money supply gives rise to inflation, whereby money supply grows at a faster rate than production of goods and services, leading to a rise in the price level. Inflation reduces the purchasing power of individuals, particularly hurting those with the lowest incomes. The flow of EU money into the smaller EU new member states such as the Baltic States has increased inflation.

- More corruption

Seeking to obtain EU funding, private companies may pressure or even bribe public officials to grant them money. Thus the allocation of EU funds may create conditions for corruption. Risk of corruption is higher when public officials have discrete powers to decide on the granting of EU funding.

In addition to corruption, serious administrative and accountability flaws are attributed to Cohesion spending. The European Court of Auditors highlights that the regulatory framework of Cohesion requires conformity with a variety of EU rules and regulations.[26] Despite the fact that audit and control provisions were strengthened for the 2007-2013 financial framework, serious errors persist.

According to the Annual Report for the financial year 2011, 59 percent of the 180 audited projects was affected by errors. A major proportion was attributed to eligibility errors, with the main cause being the inclusion of costs not eligible for reimbursement and serious failures to respect public procurement rules. Importantly, the report concluded that for at least 62 percent of the errors found, 'sufficient information was available for the Member State authorities […] to have detected and corrected the error prior to certifying the expenditure to the Commission.' Therefore, Cohesion spending contains persistent errors which have not been eradicated by tougher regulatory measures.

Preservation and management of natural resources – including CAP

Spending on the preservation and management of natural resources constitutes the largest share of EU budget expenditure. In the current framework, its share has decreased from 44.3 percent in 2007 to 40.2 in 2013. Yet it remains the biggest EU budget outlay. In absolute terms, spending has gone up by 11.1 percent from 55.1 billion euros in 2007 to 61.3 billion euros in 2013.

The budget outlay for preservation and management of natural resources is mainly devoted to financing the Common Agricultural Policy (CAP) and the Common Fishery Policy (CFP). Of this, the Common Agricultural Policy accounts for the lion's share, roughly 60 billion euros in 2013. The main instrument of the CFP is the European Fishery Fund. The EFF has a budget of €4.3 billion for 2007-2013.[27] The most important instruments of the CAP funds are the European Agricultural Guarantee Fund (EAGF) and the European Agricultural Fund for Rural Development (EARDF). While most of it goes to the EAGF, the EARDF has been allocated a budget of 96.3 billion euros for the period 2007-2013, or 20% of the funds dedicated to the CAP.[28]

85 percent of the budget for the Common Agriculture Policy (CAP) consists of direct payments to farmers, with the rest being used for interventions in agricultural markets. The objectives of the CAP are to 'ensure a fair standard of living in the farming community, stabilize markets and guarantee security of supplies.' Rural development focuses on improving the competitiveness of farming and forestry, land management to enhance the environment and the countryside, and improving the quality of life in rural areas. Two thirds of the budget for fishery and maritime affairs (€446 million in

2013[29]) is allocated to the European Fisheries Fund, which subsidizes the fishing industry and coastal communities.

The Commission's "A Budget for Europe 2020" puts forward a number of proposals to reform the CAP: to "green" direct payments by introducing a requirement that 30% of direct support is conditional on "greening", to converge payments across the EU, and cap the level of direct payments by limiting the basic layer of direct income support that large agricultural holdings may receive.[30]

Special interest groups have often been successful in lobbying in favour of programmes to ensure a 'fair standard of living' for particular sections of society. However, there are no justifications why the agricultural sector should be excluded and treated differently from all other sectors of the economy.

Throughout decades of existence of the CAP, the following negative effects have been recognized:

- The CAP hurts consumers due to higher food prices and taxes. EU consumers suffer due to import restrictions of agricultural products, which translate into higher prices on the domestic market. EU consumers are hurt once again in the form of higher taxes which are being transferred to the agricultural sector in the form of subsidies. EU budget revenues spent on subsidies to agriculture could have been used more beneficially for EU taxpayers. The CAP poses as an obstacle to agreements on free trade, inflicting serious damage on the world economy.
- The CAP does not meet its objective of ensuring a fair standard of living in the farming community. The term "fair standard of living" is ambiguous and lacks an objective definition. When the CAP was first set up, a "fair standard of living" no doubt had one meaning while today it is interpreted differently.
- Historical evidence shows that in the EU-15, income in the agricultural sector has had the same trend as general economic performance, similar to income in other sectors of the economy. It is entirely possible that income in the agricultural sector would have followed the general trend even without subsidies to this particular sector.
- Statistics do not show any clear evidence that the CAP has ensured price stability. On the contrary, food prices in Europe have risen despite the CAP and its objective to ensure price stability. It is high incomes and lower prices rather than the CAP that can protect European consumers against food price fluctuations. It should be noted that the CAP may in some cases prevent farmers from reacting to changing market conditions, because rigid rules do not allow farmers to switch to produce food that is more in demand.
- The CAP directs EU spending unfairly to wealthy members states with large and unproductive agricultural sectors, leading to the further distortions of balancing 'rebates' to other states such as the UK.

The European agricultural sector suffers from too much state intervention. Instead of the CAP, it needs better management, more effective investment and general restructuring. All of this suggests that the CAP should be gradually phased out rather than reformed, alongside member state rebates.

Spending on rural development overlaps with cohesion policies (namely the development of rural areas). The objectives of spending on rural development are ambiguous, while there are no clear and transparent targets set on what is being affected. Additionally, it is unclear whether these objectives can be reached using the measures employed. For example, the competitiveness of farming and forestry cannot be improved through EU subsidies, since competitiveness depends on competition

rather than budget transfers. For these reasons, spending on rural development should also be gradually phased out.

The European Fisheries Fund (EFF) is set up to attain the objectives of the Common Fisheries Policy (CFP). The chief objective of the CFP is to ensure the conservation and sustainable use of marine resources. The CFP establishes communal management of the waters in the Economic Zone (running from twelve miles off the member states' coast).

However, communal management of the waters and a lack of private property rights have had the opposite effect to the CFP's main objective. Instead of conservation and a sustainable use of marine resources, the CFP results in the depletion of fish stocks. The objectives agreed upon in 2002 to reform the CFP and achieve sustainable fisheries have not been met.[31] Few EU fleets are profitable and the CFP is to blame: 'overall poor performance is due to chronic overcapacity of which overfishing is both a cause and a consequence', this puts 'high political pressure to increase short-term fishing opportunities at the expense of the future sustainability of the industry.' Research shows that the economic cost of the CFP to the United Kingdom alone amounts to £2.81 billion.[32] Since the CFP's results have been contrary to its objective, the CFP should be abolished.

Citizenship, freedom, security, and justice

EU spending on citizenship, freedom, security, and justice has increased from 1 percent in 2007 to 1.6 percent in 2013. In absolute terms, it has almost doubled from 1.3 billion euros in 2007 to 2.4 billion euros in 2013.

Spending under this heading promotes active citizenship, health and consumer protection, usually in the form of grants. Freedom, security and justice spending allocates resources to the European External Borders Fund, European Refugee Fund, European Fund for the Integration of Third-country Nationals, the European Return Fund, and programmes to help prevent, prepare for and manage the consequences of terrorism.

The EU budget review suggests putting in place new initiatives, such as to develop the EU 'as an area of justice to eliminate obstacles for the good functioning of cross-border civil proceedings and business-to-consumer relations.'[33]

While the effectiveness of some of these projects is unproven, spending on citizenship, freedom, security, and justice has less impact on the EU's economy compared to other EU spending analyzed here. Meanwhile, initiatives such as effective border management are in the interests of EU citizens and they should continue to be funded.

Europe as a global player

Spending on the 'EU as a global player' initiative has increased from 5.3 percent of the EU budget in 2007 to 6.3 percent in 2013. In absolute terms, there has been an increase of 46 percent from 6.6 billion euros in 2007 to 9.6 billion euros in 2013.

External actions financed under this heading include pre-accession support for candidate countries and the western Balkans region, support for democracy and human rights around the world, and the provision of economic and development assistance.

The EU budget review stresses that this support helps ensure candidate countries prepare for EU membership and it should therefore continue to be used as a tool to promote successful enlargement of the EU.[34]

It should be noted that some EU policies may contradict spending on support for the candidate countries. As highlighted in a recent paper on the EU's trade policy towards Georgia, for example, the Commission's approach is damaging from the perspectives of development, commerce, and foreign policy. The paper concludes that the Commission 'requires Georgia to adopt and implement an enormous amount of imprecisely identified EU internal market regulations going way beyond strictly trade-related matters, with no attempt to identify those which make sound economic sense for Georgia […]. The burdensome regulatory changes imposed on Georgia are equivalent to taxing Georgian production – endangering her growth, the sustainability of her reforms and of her successful fight against corruption which is so crucial for her long term development.'[35] Such policies induce local Georgian consumers to import goods that Georgian producers can no longer sell because of EU regulations, resulting in damage to the Georgian economy.

It would help if the EU's external policy were implemented in accordance with spending to support candidate countries. Nonetheless it is difficult to evaluate whether the EU as a global player initiative has met its objectives.

Administration

EU budget expenditure on EU administration has grown from 5.7 percent of the EU budget in 2007 to 6 percent in 2013. Spending on administration has increased by almost a third in this period, from 7 billion euros in 2007 to 9.1 billion euros in 2013. Part of the increase in spending on administration is attributed to EU enlargement.

The EC's Communication "A Budget for Europe 2020" proposes to reduce the staffing levels of each institution/service by 5%, increase working hours without compensatory wage adjustments and increase the pension age.[36]

Most member states are implementing tough austerity measures to improve their fiscal balances. Countries are reducing their bureaucratic apparatus and cutting the salaries of public employees. Despite the ongoing economic recession, the EU has so far failed to reduce its bureaucratic apparatus or cut administration expenditure. Moreover, European parliamentary deputies voted in favour of a 3.7 percent pay rise backdated to the middle of 2009.[37] This means that as member states are implementing their austerity packages, their contributions to the EU are continuing to fund the lavish lifestyles of EU bureaucrats. It is important to reduce expenditure on administration and in order to do this, the EU should cut both the salaries, bonuses and lengthy holidays of its employees and reduce the workforce employed by the EU.

Proposed principles for EU budget expenditure

EU spending should be allocated according to the following principles:

- Subsidiarity: EU spending on EU goals

EU spending has to be done in accordance with the principle of subsidiarity. The EU budget should fund only those projects that are pan-European and bring about positive and tangible results to all citizens of the EU. This principle implies that projects which can be implemented on a national or local level should not be eligible for EU funding. It also implies that special interest policies should not be financed with EU budget revenues.

Since the single market brings positive and tangible results to all citizens of the EU and all member states, the EU should focus on improving and enhancing the single market, for example by building transport and energy links. EU funds should not be used for purposes that obstruct or hinder free movement within the EU.

- EU spending on specific goals rather national or special interests

The current system of the EU budget is best described as the funding of national or special interests. In order to end this highly politicized system of EU spending, the EU should finance the achievement of specific, objective and reasonable goals. The benefits of such projects should be higher than their costs. This principle implies that a number of presently financed projects and policies, such as the CAP and the CFP, should be discontinued.

- Allocation rather than redistribution

EU redistributive policies set up incentives for underdeveloped regions to remain underdeveloped, if they wish to continue receiving EU funds. Redistribution of funds therefore creates a situation of dependency on EU support and hinders development of underdeveloped regions. Redistributive policies should be replaced by funding of the best and most efficient projects that bring tangible benefits for all EU citizens.

III. Recommendations for policy makers

Our proposals are based on the figures from the outgoing financial framework, suggesting what spending could have been and what cuts can be made to produce a budget for the next seven years. If these recommendations are implemented, they imply overall savings of 512 billion euros in the 2007-2013 financial framework, and total EU spending could be 52.5 percent lower:[38]

- Levies and other duties originating from trade are distortionary and should be gradually removed. Since the VAT- and GNI-based resources overlap, the VAT-based resource should be removed, leaving only the GNI-based resource This could itself be reduced by as much as a third, leaving enough to finance the whole budget as envisaged here
- Introduction of new ‘own resources’ would be counterproductive, make the revenue system more complex and imply difficulties in ensuring adequate and continuous financing. Proposals for new EU taxes should be abandoned.
- EU spending on sustainable growth should primarily focus on trans-European transport and energy networks, ensuring transparency of such projects.
- EU budget expenditure on competitiveness, cohesion and administration would be reduced by 20 percent. This would be achieved through cuts to research and innovation, education and training, and social policy. A 20 percent cut in Cohesion spending could be achieved by

cutting spending on research and innovation (which constitutes 25 percent of Cohesion spending) in half and discontinuing support to both large and small businesses (which constitutes 8.1 percent of Cohesion spending). This would leave competitiveness and cohesion spending to focus on trans-European infrastructure projects such as transport and energy networks.

- EU spending on preservation and management of natural resources does not meet its core objectives and should therefore be discontinued.
- EU's external actions should not contradict its spending on support for the candidate countries.
- The increase in EU spending on administration has to be stopped by cutting the salaries, bonuses and lengthy holidays of the EU's employees and reducing its overall workforce by 20 percent.

	2007–2013 spending (million euros)	Proposed spending (million euros)	Savings (million euros)
Competitiveness	90 203	72 162	18 041
Cohesion	348 415	278 732	69 683
Preservation and management of natural resources	413 061	0	413 061
Freedom, security, justice	7 549	7 549	0
Citizenship	4 667	4 667	0
The EU as a global player	55 935	55 935	0
Administration	55 535	44 428	11 107
Total	975 777	463 473	512 304

Source: LFMI

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[4] It equals 0.30% of the harmonized VAT assessment bases, with lower uniform rates applied in the current financial framework to Austria, Germany, the Netherlands and Sweden.

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[13] According to Ludwig von Mises, systemic risk arises due to the existence of fractional reserve banking. Since banks are legally allowed to keep only a fraction (1 percent) of a bank's deposits as reserves, a possibility of a bank default is always present. Credit expansion in a system of fractional reserve banking is the main cause of economic crises. As he wrote in Human Action:

'The credit expansion boom is built on the sands of banknotes and deposits. It must collapse. The breakdown appears as soon as the banks become frightened by the accelerated pace of the boom and begin to abstain from further expansion of credit. The boom could continue only as long as the banks were ready to grant freely all those credits which business needed for the execution of its excessive projects […]. These illusory plans, suggested by the falsification of business calculation as brought about by the cheap money policy, can be pushed forward only if new credits can be obtained at gross market rates which are artificially lowered below the height they would reach at an unhampered loan market. It is this margin that gives them the deceptive appearance of profitability. The change in the banks' conduct does not create the crisis. It merely makes visible the havoc spread by the faults which businesses has committed in the boom period.' Mises 1996.

Institutions in the financial sector are extremely interdependent, and shocks to one institution may have ripple effects across the whole sector. It is impossible to diversify against the systemic risk inherent in fractional reserve banking, since a run on a certain bank would have repercussions for others. Strict regulations of the financial sector are aimed at dealing with this systemic risk, yet they have mostly failed.

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[38] Calculations were done based on the following assumptions: no EU spending on preservation and management of EU resources; EU spending on freedom, security, justice, citizenship and the EU as a global player remains the same; EU spending on competitiveness, cohesion and administration reduced by 20 percent.

NEW DIRECTION
THE FOUNDATION FOR EUROPEAN REFORM

February 2013
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New Direction – The Foundation for European Reform
Rue d'Arlon 40
1000 Brussels, Belgium
Telephone: +32 2 808 7847
contact@newdirectionfoundation.org