Department of Political Science

Master of Arts in International Relations

Chair of European Economics

The EU Budget- between present and future.

Analysis of possible reforms

Supervisor

Marcello Messori

Paola Scacciante

SID.627852

Co-Supervisor

Giuseppe De Arcangelis

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Introduction

Non négligeable en termes absolus, mais plutôt minuscule en termes relatifs, complètement déséquilibré en faveur d'une seule politique, le budget communautaire reflète la réalité d'une intégration financière (et politique) *très partielle et extrêmement ponctuelle. Il ne constitue actuellement ni l'instrument véritable du financement d'une gamme significative de politiques, ni un instrument de redistribution digne de ce nom, ni un instrument de stabilisation économique*. (Commission, 1978)

This is the statement made by the European Commission in 1978 expressing the weak points of the European Union budget which are still relevant today.

The debate over the EU revenue system and in particular over the nature of the financing resources of the budget has been harsh and controversial. It involved questions on the nature of the European Union budget, its size and resources that finance it (or could finance it in the future). The debate cannot ignore the condition of Union integration, its history and its evolution and the actual availability and will of Member States to advance on the road of integration. Member States are the main actors and therefore have the fundamental responsibility of every possible evolution.

In this historical moment the European Union is in turmoil. New challenges have emerged such as the refugee crisis, security and terrorism crisis. At the same time Eurosceptic and nationalist movements have gained or regained strength in many countries while the EU decision-making actors struggle to define a new vision of the European integration process. The present situation does not necessarily have to be a limit for the future of Europe. It can be an opportunity to fathom what future we want for the whole Union. The Commission White Paper (2017) identified the factors of change and five possible solutions to be implemented by 2025 in order to launch a fruitful debate with all the stakeholders involved.

The Union budget could play an important role in this evolving scenario. If, and only if, the system becomes *fairer, more transparent and more modern (Lewandowski, 2014).*

Thesis Structure

My work is led by two main research questions: How can the budget collaborate in the resolution of the EU problems and challenges? Which would be the right path to take in order to achieve this?

This work is divided into three main chapters: in the first one I try to make explicit the fundamental characteristics and evolution of the budget and its “own resources system”, outlining the motives that determine its peculiarity and its defects. I also try to emphasize the reasons why it is crucial for the European Union to initiate a reform.

The academic literature finds two possible paths that can be followed either reforming the system abiding by the current legal framework or acting outside the treaty in order to give a bigger budget to the EU thus taking a major step towards a more federalist Union.

In the second chapter, I investigate if it is feasible for the Union to follow a new path thus modifying the current structure of the Union budget: its size and composition or, in other words, whether a new and different division of competences and governmental functions between Member States and the European Union is acceptable. In this chapter I try to look at the federal proposal combining an economic analysis with a political one, attempting to demonstrate that the optimal economic approach unless supported by political will, will not have a positive outcome. At the end of this second chapter I report the interview with Professor Morlino who outlines the empirical differences between the EU and other Federal States stating that any reform regarding fiscal policies and the EU budget should be done abiding by the established legal framework.

In the third and last chapter I analyze the second viable reforming stream: acting inside the Treaties. Hence I analyze the most recent proposal put forward by The High Level Group on Own Resources, published in December 2016. I try to explain why such a proposal could represent a desirable compromise from the economic and political point of view and I see how this report could contribute to the negotiation process of the Multiannual Financial Framework (MFF) post 2020. The work carried out by the High Level Group on Own Resources chaired by Mario Monti went beyond the ordinary technical analysis of the various sources of revenue since it took into account the procedural and legal implications as well as political and institutional interdependencies. The Report meets the challenge to integrate different needs: the economic one giving a strong budgetary efficiency and the political one giving more accountability to the system without forcing any steps towards federalism.

The two drivers of the work are: making a feasible proposal that could be discussed and implemented for the near future and enhancing the link between the European policies/ challenges and objective and the European budget system.

At last I analyze the Reflection Paper on the future of EU finances where the Commission indicates the paths to follow in order to change the financing of the EU. The Reflection Paper gives a realistic analysis of the financial implications of the five scenarios forecasted by the Commission in the White Paper on the "Future of Europe (2017). In analyzing the scenarios I emphasize the common traits between Monti's report and the Commission Paper.
It is interesting to note that the Commission draws on key principles set up by Monti's Report, principles such as the EU added value that becomes the driver for any further discussion about the EU financing system, efficiency and transparency of European spending, modernization of spending programs, increasing action on transversal problems: migration, defense, physical terrorism and cyber terrorism, border controls and the fight to halt global warming (Environmental based own resources could be an important step). Combining the conclusion of the two I try to indicate what the priorities for MFF post 2020 should be in order to align the Budget Union with the *spirit of the Treaties.*

Chapter 1: The EU Budget Revenue system

Introduction

Recently the European Union celebrated the 60th anniversary of the Treaty of Rome, with which the European Economic Community was set up.
Many are the reasons to celebrate: after centuries of wars, political upheaval and mass killing, Europe has finally lived (a long) period of peace and democracy. Recently the European Union has welcomed eleven former Soviet countries successfully leading their transition to the post-Communist era. Also in an age of inequality, EU Member states have the lowest income inequalities in comparison to any other country in the world. (Rodrik, 2017)
Today, the European Union is going through a period of profound change trapped in a deep existential crisis and its future seems uncertain. Symptoms can be seen everywhere: Brexit, the intolerable levels of youth unemployment in Greece and Spain, the economic stagnation that has hit Italy, the rise of populist movements fighting the idea of Europe, the immigration and security crisis that are challenging the unity of the Union.
The European Union has encountered enormous difficulties in *addressing these challenges and redirecting the EU capacity of action over the last years*, *which serves to underline how crucial financial resources have become in solving pressing issues, internally and externally* (Monti, 2016). This is why the European Union needs a functional budget able to support the European common policies and objectives, underpinning the advancement of the *aquis communutaire.*

The debate about the nature of the European budget, its size and its resources (or how it could be financed in the future) cannot ignore the Union integration process, its history and its evolution, the availability and will of the Member states to advance on the road to build a Federal Union (Cipriani, 2003). Accordingly *the debate about any possible reforms of the EU Budget is really a debate about the nature of the European Union* (Bordignon, Scabrosetti, 2016).

The purpose of this chapter is to illustrate the fundamental characteristics of the European budget system and show both its strengthens and weakness.

1.1 EU revenue: historical background

Financing of the international organizations' budgets is traditionally based on national transfers, normally calculated on the basis of the Gross Domestic Product (GDP) of each Member State. However, the European Union cannot be compared to a regular international organization.

The European budget for the most part (98%) is funded by "own resources*",* that are the EU revenue, that allows the Union *pursue its objectives by appropriate means commensurate with the competences which are conferred upon it in the Treaties (*Article 3(6) of the Treaty on European Union). The role of own resources is further clarified in Article 311 of the Treaty on the functioning of the European Union (TFEU): *[t]he Union shall provide itself with the means necessary to attain its objectives and carry through its policies. Without prejudice to other revenue, the budget shall be financed wholly from own resources.*

As it is illustrated in Figure 1, there are three kinds of own resources, differently distributed: traditional own resources (custom duties and sugar levies), VAT based own resource and GNI based own resource.

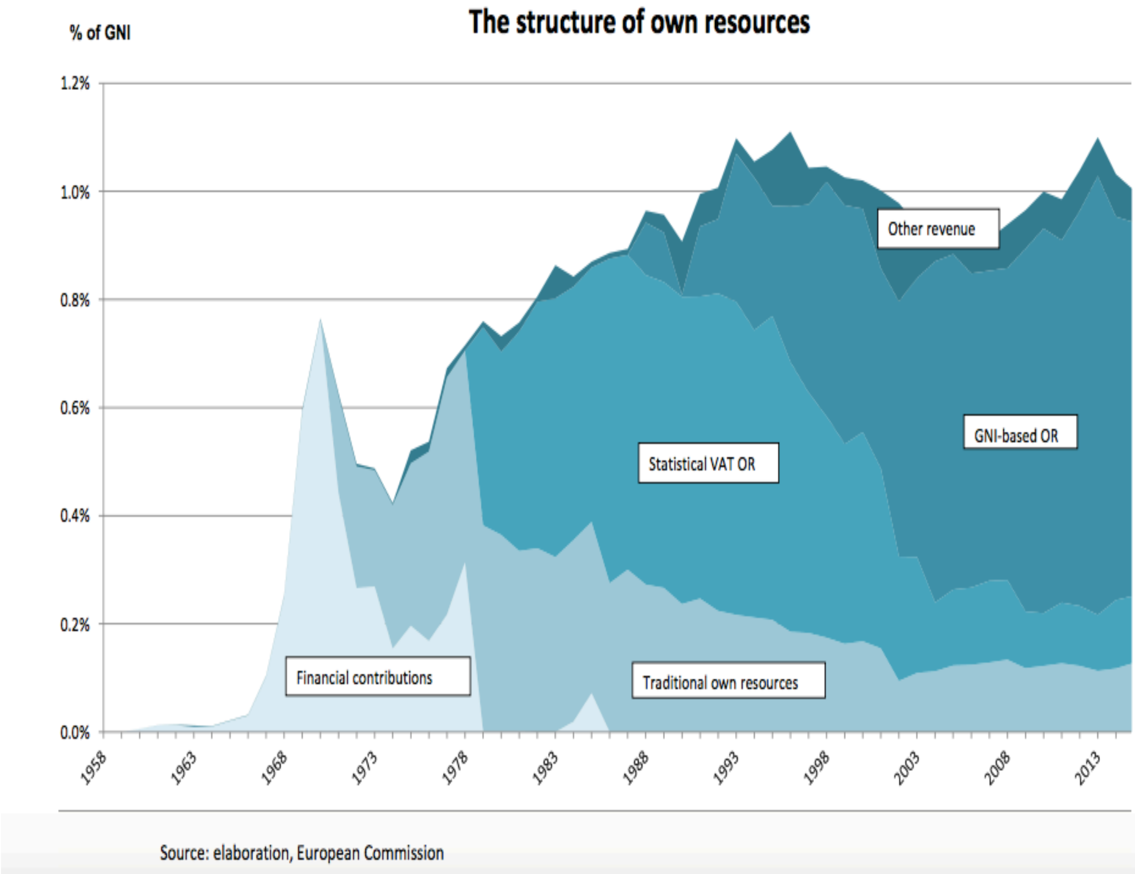

Figure 1: Structure own resources – Source European Commission

The evolution of the EU Budget financing follows a precise historical path. In the following paragraph I will analyze the most significant step of its development.

1952-1969

At the very beginning, the European Coal and Steel Community (ECSC) was autonomous from a financial point of view. The High Authority (today the Commission) was able to carry out its activities by imposing levies on coal and steel. Such "levies", established by the High Authority, were nothing more than taxes paid by producers. This constituted a strong bond between the ECSC and taxpayers. In this sense, it is surprising the modernity of the financial structure of the ECSC that already had an evident federal feature (Cipriani, 2010). The Treaty of Rome (1957) established a new logic, in order to respond to the need of a larger budget where all Member States could proportionally contribute. Initially, Member States' contributions had to finance the European Economic Community Budget (Art 200 ECC), following the repatriation of Figure 2. At a later stage, direct Member States contributions will be replaced by the own resources system (Art 201 ECC).

At that time, *Member States' contributions were based on a percentage scale provided by the Treaty, differentiated according to the type of expenditure (administrative or Social Fund)* (Cipriani, 2010). The scales were the result of a political agreement that takes into consideration countries 'share in GDP at that time.

Despite that, with unanimous agreement, the Council could intervene and change the scale: this used to happen to increase the funding in agricultural spending.

Member states	Administrative expenditure (%)	Social Fund (%)
Belgium	7.9	8.8
Germany	28	32
France	28	32
Italy	28	20
Luxembourg	0.2	0.2
Netherlands	7.9	7
TOT	100	100

Figure 2: Share of the ECC Budget

Source: Article 200 of the EEC Treaty.

1970-1984

On the 21st of April 1970 the first Own Resources Decision (ORD) was implemented: Member States agreed that *the Communities shall be allocated resources of their own* and *from 1 January 1975 the budget of the Communities shall, [...] be financed entirely from the Communities' own resources* (*C*ouncil Decision 70/243/ECSC).

As a result: Common Customs Tariff and Tariff on Sugar (Traditional Own Resources- TOR) were collected by Member States and gradually transferred to the common Budget. MSs could keep 10% of TOR in order cover the administrative expenses. Later, in 1980 VAT based payments were introduced: 1% of the VAT revenues were transferred to the Community Budget, this new revenue turned out to become the main source of financing for the whole budget.

1985-1987

In 1985 the VAT Based Resources increased from 1% to 1.4% and *a new principle was formalized: that any Member State bearing an excessive budgetary burden in relation to its relative prosperity may benefit at the appropriate time from a correction* (Cipriani, 2017). The United Kingdom, under the leadership of Prime Minister Margaret Thatcher, was the first country to negotiate a partial repayment of UK-funded funds to the European Community, the so-called "British Rebate". The main reason for this request was the allocation of the budget resources. A very high percentage of the European budget was devoted to the Common Agricultural Policy (CAP) and the Great Britain used to benefit less than other countries from the CAP funds since its economy was not based on the agricultural sector. Following the creation of the "UK rebate", other Member States claimed that their EU financial burden was excessive, thus demanding reductions in their contributions, including UK repayment funding. This has led to a complex permanent and temporary ad hoc correction system. Correction mechanisms have attracted a series of criticisms, not least that they make EU finances more complex, less transparent, less equitable and difficult to reform.

1988 – 2000

The overall picture of the 1970 Own Resources Decision remains largely in force even today, with two important exceptions: the Multiannual Financial Framework (MFF) and the GNP base own resources.

The first MFF was introduced with the package of reform known as *Delors I*. The MFF is a seven years framework that regulates the European Union annual budget setting the ceiling for each category of budget spending. The Multiannual Financial Framework is unanimously adopted by the Council after the Parliament consent.

In 1988 a new category of revenue was introduced[1]: the GNP[2] based resource. The reason for this latter resource is essentially linked to the concept of contribution capacity of MSs and the need to cope with the increase of the Community budget expenditures. *From now on, this "balancing item" automatically provided the necessary financing for the Community budget, within the limit of the own resources ceiling[3]. It was calculated by applying to a base, made up of the sum of the Member States' gross national product at market prices, a rate to be determined during the budgetary procedure in the light of the yield of all the other categories of own resources.* (Commission, 2008)

[1] *Delors I* was introduced with Council Decision 88/376/EEC, Euratom of 24 June 1988.

[2] *GNP results from adding to GDP the compensation of employees and the property income received from the rest of the world and by deducting the corresponding flows paid to the rest of the world.*
[2] *GNP results from adding to GDP the compensation of employees and the property income received from the rest of the world and by deducting the corresponding flows paid to the rest of the world.* (Blanchard, 2016)

[3] *The total amount of available own resources was no longer determined by the yield of traditional own resources combined with the ceiling of the VAT-based resource, but was expressed as a percentage of the Community total GNP, increasing from 1.15 % for 1988 to 1.20 % for 1992* (Commission, 2008).

2000-today

The GNP contributions were replaced by the GNI [4] ones. The GNI provides *the revenue required to cover expenditure in excess of the amount yielded by Traditional Own Resources and VAT- based contributions.*

In addition, the GNI based resource ensures that the budget is always balanced[5] and by doing so it can be considered as *the guarantor of the stability in budget revenues in the medium term* (Monti, 2015*), within the overall ceiling of the total own resources that can be collected for the EU budget* (Monti, 2015*).* Today the global ceiling[6] of own resources that can be collected is set at 1.23% of GNI.

In order to reduce the perceived imbalances of net contributors, corrections by means of lump sum reductions have been further implemented. For example, with the ORD 2007 the Netherlands and Sweden obtained a temporary reduction of their GNI resources contributions. Later with the ORD 2014 new corrections were agreed for the MFF 2014-2020, the Netherlands had an annual reduction of 695 million Euros, Sweden and Denmark respectively 185 and 130 million Euros. On the other hand, Austria gained a *phased- out lump sum of EUR 30, 20 and 10 million for 2014, 2015 and 2016*.

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[4] *GNI equals GDP minus primary income payable by resident institutional units to non-resident institutional units plus primary income receivable by resident institutional units from the rest of the world.* (Blanchard, 2016)

[5] As the budget is always balanced: revenues always equal liabilities, then if the GNI decreases also the expenditure decreases in order to respect global ceiling.

[6] *The annual ceiling is based on the sum of payments scheduled for each category of commitment appropriations, that is the sum of six heading ceiling*. (Commission, 2017)

1.2 A budget of its own kind

The first aspect that must be clarified is that the Union's budget has profound differences in comparison to other federal or national budgets. First of all, that of the Union is not a classic national budget given its size, characteristics and composition, and most important fiscal public finances remains primary responsibility of Member States.

The small size of the EU budget, equal to about 1% of EU GNP, dramatically affects its effects and potentials. The other national budgets of the main Western countries are typically above 40% of GNP (measured as a volume of spending) and on average 48% in the euro area (Rubio, 2015). The EU budget is therefore far from other size-scale budgets, having neither the quantitative relevance nor the economic impact of national or federal budgets. In the late 1977 the Mcdougall Report on *The role of public finance in European Integration* already indicated that the volume of GNP resources should have been in worst hypothesis around 2-2.5% in the best hypothesis around 5-7%. Not even the worst hypothesis expectations are met, since the current EU budget volume is close to 1% of GNP also taking into account that Union spending represents 2.2% of the total of Member States' budgets.

The modesty of the budget size presents a problem as it cannot efficiently contribute to improve any strategic sector of citizens life, (except for the agricultural sector), in such a way to have a real and perceptible impact on the economies of the Member States or on the aggregate European area (Cipriani, Marè, 2003). This is to say that the EU Budget does not have a perceived impact over citizens (Bordignon, Scabrosetti, 2016).

Furthermore the Community budget is characterized by extremely limited maneuverability and strong rigidity caused by three distinction dimensions. (Cipriani, 2016)

1. The volume of the budget *must respect the annual maximum amounts set out in the multiannual financial framework (ceilings).* According to the current

Own Resources Decision (ORD) the resources cannot be higher than the 1.23% of the gross national income (GNI) of the Union.

2. The budget is based on the principle of equilibrium: total expenditure has to be equal to total revenue of the budget, implying that the EU cannot have any kind of deficit. [7]
3. The EU spending has to be predictable. The MMF provides a framework for the financial programming and defines the discipline that has to be observed within the seven years.

Therefore, the budget cannot grow under control. It never runs deficit, never builds up debt and only spends what it receives. It is always balanced (Cipriani 2014).

The peculiarity of the Union budget is also evident on the expenditure side. For national or federal states, the expenditure forecast is, however, subject to the revenue trend and is obviously subject to any market backlash. At the EU level it is the opposite.

Another significant difference between national budgets and the EU budget consists in the capability of the budget management. Almost 90% of the budget resources are managed at the national level. Basically, national administrations manage both local and European resources. Such a construction, albeit singular, reflects both the complementary nature of the EU budget and the conceptual basis of the principle of subsidiarity. In fact, the essential elements of the revenue and expenditure of the Union budget are managed by the Member States (Cipriani, 2003).

The singularity of the budget is also reflected in its adoption procedure which is very rigid and complex. The adoption of the ORD follows a very precise path that has the aim of not overcoming MSs fiscal sovereignty in order to fully respect the principle of subsidiarity. Two are the main stages:

[7] All items of revenue and expenditure of the Union shall be included in estimates to be drawn up for each financial year and shall be shown in the budget. (Article 310(1) TFUE.

1. *The Council, acting in accordance with a special legislative procedure, shall unanimously and after consulting the European Parliament adopt a decision laying down the provisions relating to the system of own resources of the Union* (Art 311 TFUE)
2. The decisions' Council *shall not enter into force until it is approved by the Member States in accordance with their respective constitutional requirements.* (Ibidem)

Any kind of denial from any national parliament would re-start the negotiations.

On the other hand for the approval of own resources implementing measures the Council *shall act after obtaining the consent of the European Parliament* (Art 311 TFUE).

I have illustrated the macro differences between a regular state budget and the European budget. Now I will illustrate how the budget is composed.

1.3 Own Resources composition

Going beyond the macro peculiarities of the budget given above, it is important to analyze in detailed the different types of own resources: (TOR traditional own resources, VAT base own resources, GNI base own resources) in order to see how the budget machine works.

Many academic analyses agree on the fact that only TOR (representing 13% of "own resources") can be defined, as real own resources since TOR are the only duties that are levied as tax devolved directly to the EU Budget.

Traditional own resources (TOR) consist mainly *of customs duties on imports from outside the EU and sugar levies. EU Member States keep 20%*[8] *of the amounts as*

[8] This value can change from MFF to MFFs.

collection costs (Commission, 2017). With the implementation of the EU law of the Uruguay ground agreements[9] on trade with third countries, there is no real difference between agricultural and custom duties. Specifically this distinction was removed with the ORD of 2007.

The collection cost of these duties increased significantly over time, the percentage from 1970-2000 was around 10%, it increased up to 25% in 2001, and it decreased again to the current 20%. This increase may seem excessive if it is only related to the "tax collection" function. Instead, the substantial increase in the percentage retained by the Member States was decided in 1999 to allow some Member States to decrease their participation in the Community budget. (EU Commission, 2000)

By contrast the major amount of resources (about 87% of own resources) comes from VAT and GNI based resources. As previously anticipated these two resources are not collected but are at the disposal of the EU Budget, that is to say that the VAT and GNI based contributions are transfers from MSs, at the opposite TOR goes directly to the budget.

VAT-based own resource contributions derive from the application of a call rate[10] to Member States' VAT bases set according to harmonized rules. However, VAT bases are capped at 50% of GNI. The capping of the VAT base reflects the intention to remedy the regressive aspects of the VAT-based resource, which could be seen as penalizing the less wealthy Member States with higher shares of consumption. (High Level Group on Own resources, 2015). For example, in the ratified budget of 2014, the 50% "capping" was applied to Croatia, Cyprus Malta and Slovenia and Luxemburg[11]. On the other hand the VAT base for the other Member countries was

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9 The Uruguay Round was the 8th round of Multilateral Trade Negotiations. These negotiations led to the creation of the WTO in 1995.

10 *Call of rate. percentage of the proceeds of nationally collected VAT to go to the EU budget. Some Member States benefits from a "reduced call rate"* (Commission 2013).

11 *Luxembourg's contribution, which is the highest value in terms of euro per capita, is far below the average with a contribution of 0.68% of its GDP. However, Luxembourg's case can be seen as*

between 32% and 48% of GNI.

In order to reduce distortions due to diverging VAT systems, each Member State uses the "revenue method" to calculate the quota of VAT resources. *The establishment of each Member State assessment starts from the total net VAT revenue collected. The latter is divided by a "weighted average rate", meant to represent the statistical weighting of each VAT rate in the various categories of taxable goods and services subject to VAT. This intermediate base is finally adjusted with negative or positive compensations in order to obtain the final harmonized VAT base on which the EU call rate is applied.*

For the period that goes from 2014-2020 the call rate was fixed at 0.3% but Germany, the Netherlands, Austria and Sweden have a reduced rate, respectively 0,15%, 0,1%, 0,225% and 0,1%. These countries benefit from this reduction to compensate for what they consider excessive net contributions.

In conclusion the GNI based own resources are the cornerstone for the European budget for two main reasons.

- The GNI resource[12] provides the revenue needed to cover expenditures higher than the amount derived from traditional own resources and VAT payments each year. Accordingly, the GNI-based resource ensures that the EU budget is always balanced *ex-ante*.
- The GNI based resource ensures the stability of budget revenues in the

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particular as most of its GDP is the result of the work of commuters and, therefore, can explain its low percentage in terms of GDP in the financing of the EU budget. (European Parliament, 2016)

[12] *The GNI-based own resource is made available on the first working day of each month, usually at the rate of one-twelfth of the amount inscribed in the EU budget. This payment is guaranteed by Article 11 of Regulation (EC, Euratom) No 1150/2000, as last amended by Regulation (EC, Euratom) No 2028/2014 which provides that interest payments will be imposed on any Member State which fails to credit the amounts on time.* (High Level Group on Own Resources, 2016)

medium term, within the overall ceiling[13] of the total own resources that can be collected for the EU budget (today 1.23% of the EU GNI). ORD 1988 initially created a fixed ceiling, at 1.15 % of GNP in 1988 and raised it to 1.20 % in 1992, a level which was further raised by ORD 1994 from 1.21 % in 1995 to 1.27 % in 1999, later rearranged as 1.24 % of GNI in 2001, finally in 2010 reached today's level of 1.23% of the GNI.[14]

GNI is considered the best indicator to calculate the member state ability to contribute (Cipriani, 2015), and then it embodies the equity principles that is a core element that drives any decision concerning the budget.

1.4 Who pays and who gets paid

To wish to benefit from the success of the Community is a very good thing. But what is quite different, and indeed highly undesirable, is constantly to try to strike a narrow arithmetical balance as to exactly how much day-to-day profit or loss each country is

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13 *The percentage of the overall celing is updated every year on the basis of the latest available GNI forecasts in the framework of the technical adjustment of the financial framework for the following years. This makes it possible to check whether the EU's total estimated expenses (payments) are within the ceiling set by own resources decision also expressed as a percentage of GNI (1,23%).* (Commission, 2017)

14 *Under ORD 2007/436 the GNI base is established in accordance with the European System of Accounts (ESA 95). Since 1 January 2010, following a unanimous Council Decision, the ESA 95 GNI base for own resources purposes includes also the allocation of Financial Intermediation Services Indirectly Measured (FISIM). As a result the GNI was increased by around 1 % on average; however with a different impact on each Member State, and the own resources ceiling was reduced from 1.24 % of EU GNI to 1.23 % following a Commission communication in April 2010. Under the next ORD, the GNI base will be established on the basis of ESA 2010.* (Commission, 2015)

getting out of the Community. (...) The Community can and must be more than the sum of its parts. It can create and give more than it receives, but only if the Member States, people and governments alike, have the vision to ask what they can contribute, and not just what they can get. (Jenkis, 1977)

This statement sums up very well the MSs attitude *to calculate benefits and accrued from EU expenditure as the difference between their contributions to the receipts from the EU budget* (Cipriani, 2014). The UK was the first country to raise the issue of limiting its contributions to the Community budget, since a very high percentage of the European budget was devoted to the Common Agricultural Policy (CAP) and the United Kingdom used to benefit less than other countries from the CAP funds because its economy was not based on agricultural sector.

At the end of the 1970s, the British government had already asked to change its financial contribution to the budget. At first it obtained two temporary repayments for the periods that go from 1976 to 1980 and from 1981 to 1984.

The most prominent fighter of the battle against the European Community was the Prime Minister Margaret Thatcher; her request to the EC is summed up by the famous phrase "I want my money back" that pulls the trigger on the permanent reform of the EU budget calculation.

Finally in 1984 with the Fontainebleau agreement the former British Prime Minister was able to reach her goal: obtaining a permanent partial repayment of UK-funded funds to the European Community, this mechanism is known as "British Rebate. *More precisely the amount (the rebate) is calculated as the difference between UK share in the EU expenditure allocated to Member states and its share in the total Vat base. The difference in percentage points is multiplied by the total amount of EU expenditure allocated to Member States. The UK is reimbursed 66 % of this budgetary difference* (Commission, 2015). Thus, the rebate amount changes every year depending on UK GNI, VAT revenue and on the euro/pound exchange rate. Once the rebate from payments and receipts in a given year is calculated, the UK contribution based on GNI in the following year is reduced. *According to the Office of Budget Responsibility, the*

United Kingdom should have paid a net contribution (before any rebate) of around 13.3 billion pounds in 2015. 66% of this amount is 8.8 billion pounds. The UK rebate in 2016 was approximately equal to the difference between £ 13.3 billion and £ 8.8 billion: £ 4.5 billion. (Vernasca, 2016)

At this point, the terms of the Fontainebleau Agreement of 1984 deserve to be remembered to better understand the extremely complex mechanism that it triggered. The conclusions of the Council[15] affirm the following principle of correction stating that: *it is recognized that the full benefits of Union membership cannot be measured solely in budgetary terms, the Fontainebleau European Council acknowledged the possible existence of budgetary imbalances. These should, to the extent possible, be resolved by means of expenditure policy, although provision is made for the possibility of a correction for Member States sustaining a budgetary burden which is excessive in relation to their relative prosperity. The European Council acknowledges that there are various factors which act directly or indirectly on budgetary imbalances, such as the overall level of spending, the content of policy reforms, the composition of expenditure, and the own resources structure* (Council, 1999).

The principle of correction was therefore envisaged in the form of a reduction in budgetary contributions, but the Council pointed out the temporary nature of this exception and the need to act in the future through expenditure, it is evident that the temporary nature of this rebate was not taken into consideration by the UK (Begg, 2011).

After the 1984 all ORDs indicated the need for a re-examination of the UK correction[16]. The Commission tried several times to abolish it or at least reduce its impact. In 1987 the Commission proposed (without any success) to restrict the correction to the agriculture expenditure, since the United Kingdom's rebate was mainly due to the excessive contribution of the EU budget to the CAP. The correction would have been calculated by applying to the total of agricultural expenditure the difference between the UK share in the GNP and the part of this country in the agricultural expenditure. With the ORD of 1994 the system remains unchanged.

[15] This concept was reiterated at the Berlin European Council in 1999.

[16] A review of the UK rebate was made in 1988, 1992, 1998 and 2005.

In 1997 the Commission launched a broad proposal for the financial perspective for 2000-2006 that included a reduction of both CAP and UK rebate. After long negotiations obtained a considerably cut of CAP (from € 32.5 billion to € 29.1 billion) but it did not succeed in reducing the UK rebate. The only measure adopted, with ORD 2000, to lower the British privileges regarded the neutralization of windfalls gains[17] *resulting from changes extraneous to the UK correction mechanism but potentially benefiting the United Kingdom* (Commission, 2014).

From 2007 on, there has been growing pressure from various EU states to abolish the British rebate, for two important reasons: the percentage of funds allocated to the CAP has dropped considerably over the years from about 71% of the EU's total budget in 1984 to around 39% today. Currently, if the rebate was removed without changing the CAP, then Britain would start to pay a contribution to the EU budget higher than that of France, but with a slightly lower GDP than that of the latter. In particular, the UK contribution to the EU budget would become about 10 billion euros, against the current 3.86, to be compared with 6.46 in France (Commission, 2016). This kind of readjustment would reduce the complexity of the system and would become more equitable.
In the current situation, however, France contributes almost twice as much as Britain whilst having only a slightly higher GDP.

According to the terms of the Fontainebleau Agreement, such correction may be granted to each Member State *supportant une charge budgétaire excessive au regard de sa prosperité relative.* Accordingly the correction mechanism can be applied to all Member States (Ciprian, Marè, 2003). Many are the Members that over the years have reached different level of corrections. For example Germany, the Netherlands, Austria and Sweden pay only 25% of their normal financing share of the UK correction since

[17] *Windfall gains* (were) *related to the increase, from 10 % to 25 % as of 2001, in the share of traditional own resources retained as collection costs and windfall gains related to pre-accession expenditure in countries which joined the EU after 30 April 2004.* (European Commission, 2014)

they considered their contributions too high. In addition to that the Netherlands had an annual reduction of 695 million Euros, Sweden and Denmark respectively 185 and 130 million Euros. On the other hand Austria gained a *phased- out lump sum of EUR 30, 20 and 10 million for 2014, 2015 and 2016*.

It is worth to underline that the whole rebate system, explained above, will be deeply affected by Brexit. The EU will have to adapt its revenue and expenditure side to this change. The short-term cost will be very high, however, in the long term, the result could be different as the corrections mechanism could be reviewed. In the appendix I analyze Brexit consequences trying to understand if it is a threat or an opportunity for the European budget.

1.4.1 The Juste Retour logic

The legitimacy of the correction mechanism is a recurring theme. After the first correction granted to the United Kingdom the debate about the *just return* became predominant. The *EU revenue arrangements are highly influenced by the cash concept of 'net budgetary balances'*[18]*, or the difference between member states' contributions to the EU budget and the payments they expect to receive from the various EU policies. The concept translates into a zero-sum logic, where the accounting advantage of one member state is considered in practice to come at the expense of the other member states* (Cipriani, 2014). This kind of approach has very much influenced the development of Union spending and the evolution of the system of own resources. The underlying concept of the issue net budgetary balances is difficult to accept for various reasons. Firstly, it denies the principle of solidarity between richer Member States and less wealthy Member States legitimizing the

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18 *Member States' operating budgetary balances are calculated based on data on the allocation of EU expenditure by Member State and on Member States' contributions to the EU budget. It is, however, important to point out that estimating operating budgetary balances is merely an accounting exercise that shows certain financial costs and benefits derived from the EU by each Member State*. (Commission, 2017) For further details see European Commission - "Opertating Budgetary balances"

principle of the *juste retour* (Fabbrini, 2016). It is not surprising that the European Parliament has rejected the fundamentals of *juste retour* logic. The European Parliament in its Resolution of 4 December 1997 (point 15) rejects the *juste retour* idea, pointing out that the non-financial benefits of the Union membership had to be taken into account. Moreover the European Parliament in another Resolution of 11 March 1999 rejected once again the so-called *juste retour theory.* According to the Parliament Member States are involved in a broader Union that is founded on the Principle of *Solidarity, then the logic where the accounting advantage of one Member State is considered in practice to come at the expense of the other member* (Cipriani, 2014) *states* must be rejected. Despite the long-standing opposition of the European Parliament the formation of the budget still follows a different logic.

It should be stressed that the calculation of the budgetary balances is merely an accounting exercise of certain financial cost and benefit. *It does not give any indication at all of the benefits gained from EU policies contributing over and above the Union objectives* (Cipriani, 2014). Moreover budgetary balance calculations became a key benchmark for the MFF negotiations, Member States aimed to reach a favorable outcome that could be politically defensible at home. The European expenditure is seen as national contributions paid to the Union that in some way have to come back. This explains why (de-facto) EU expenditures a pre-allocated on a country base already in the MFF (Cipriani, Pisani, 2004).

The fact that Member States want to assess the benefit they get from the EU Budget is not wrong, what is actually wrong is the way to calculate the benefit in return.

The current method prefigures the existence of closed or protected national economies whether the effects and the benefits of the EU integration due to the single market have transnational effects. For example, EU funds spent to build a road investment in country X will generate an increase of production also in the countries whose economic actors participate in the construction by providing workforce, materials and machinery (Ibidem). Therefore an analysis of the impact of the EU expenditure would probably show a win-win scenario where the economies of Member States are positively affected by the EU budget expenditures.

1.5 Reasons for a reform

The main advantage of this system is that it works (Bordignon, Scabrosetti, 2015) that is to say that money flows regularly to the budget (despite some recent problems with delayed payments[19]), the whole expenditures are financed and the equilibrium between revenues and expenditures is always maintained. Maybe because of that many scholars and member states' representatives argue that the current system of own resources does not need to change.

However, *everybody* [should] *agrees that the current system is too opaque, too complex and, let's be frank, outdated. However, unanimous agreement on the need to improve the current system is one thing, finding a fairer, more transparent and more modern system likely to be agreed by all is another thing. (Lewandowski, 2014).*[20]

As Commissioner Lewandowski highlights, the budgetary system presents several limits. Many criticisms towards the present system come from the European Parliament, the Commission and the Court of Auditors (Iozzo, Micossi, Salvemini,

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[19] *Since 2011, a problem of a growing backlog of unpaid claims at year-end has become significant. The situation has continued to deteriorate, and in 2014 the payment backlog at year- end was estimated at approximately €26 billion (corresponding to roughly 19% of the payment appropriations authorized in the annual budget).* [...] *the issue may have negative and far-reaching consequences for beneficiaries of EU funding, as well as for the implementation and effectiveness of EU policies, nor is the potential for harm to the EU's reputation at home and abroad without significance. (European Parliament, 2015)*

[20] See "Towards a better, fairer and simpler funding of the EU budget", statement by Commissioner Janusz Lewandowski after the first meeting of the High level Group on Own Resources, 4 April 2014 (www.ec.europa.eu/commission_20102014/lewandowski/headlines/index_en.htm?id=201400001200&type=news)

2008). The reason for change has been provided by the MFF 2014-2020 that states four main criteria: simplicity, transparency, equity and democratic accountability[21].

Simplicity

Despite a simpler and linear collection system[22], the EU own resources system lacks in simplicity in the calculations of VAT and GNI[23] resources (Cipriani, 2015). In 2011 the European Commission puts forward a precise proposal in order to reform the system. Simplification was the leading principle of the whole proposal: three were the main aspects to reform: *simplification of Member States' contributions, the introduction of new own resources and the reform of correction mechanisms* (Commission, 2011). Notably also the Court of Auditors (Opinion No 2/2012 (2012/C 112/01) supported the Commission proposals to eliminate the VAT based own resources creating a simpler alternative.

Equity

The concept of equity touches different points of our discussion; it clearly involves the expenditure side of the budget, but it also refers to Member states and to citizens.
The equity of the current system is assessed at the member states level, and more importantly it is a proportional system rather than a progressive one.
Indeed the introduction of the GNP resource (later GNI) took place in order to create a more equal system of contributions; in fact, the GNP should be the most appropriate indicator to measure the prosperity of a country. In 1988 the Commission declared that *no own resource could be more equitable.*
However, the European system of Own Resources is often defined as unfair since the

[21] Joint Declaration on Own Resources by the European Parliament. the commission and the Council 15997/13, ADD 1 point 4. Brussels November 2013.

[22] TOR are the only revenue that the EU collects, GNI and VAT based own resources are transferred from national budgets to the EU. *The current system cam be considered as cost- effective if compared to a traditional fiscal system.* (Cipriani, 2015)

[23] See footnote 7

final allocation of the burden to pay to the EU violates the notion of horizontal equity[24] *across member countries, in fact final payments show a large variance both with respect to states GDP per capita and in their GNI* (Bordignon, Scabrosetti, 2015).

In this sense, Figure 3 shows the *deviation of each member state from the EU-27 average of 'national contributions' in proportion to the GNI, as well as in relation to the population (per capita contribution)* (Cipriani, 2014).

Point 0 of the graph below represents the European average values: 0,83% of the European GNI and €1,453 per capita (values based on cumulative data regarding the period that goes from 2007 to 2014). Analyzing Figure 3 in details we can notice that MSs are distributed into four categories.

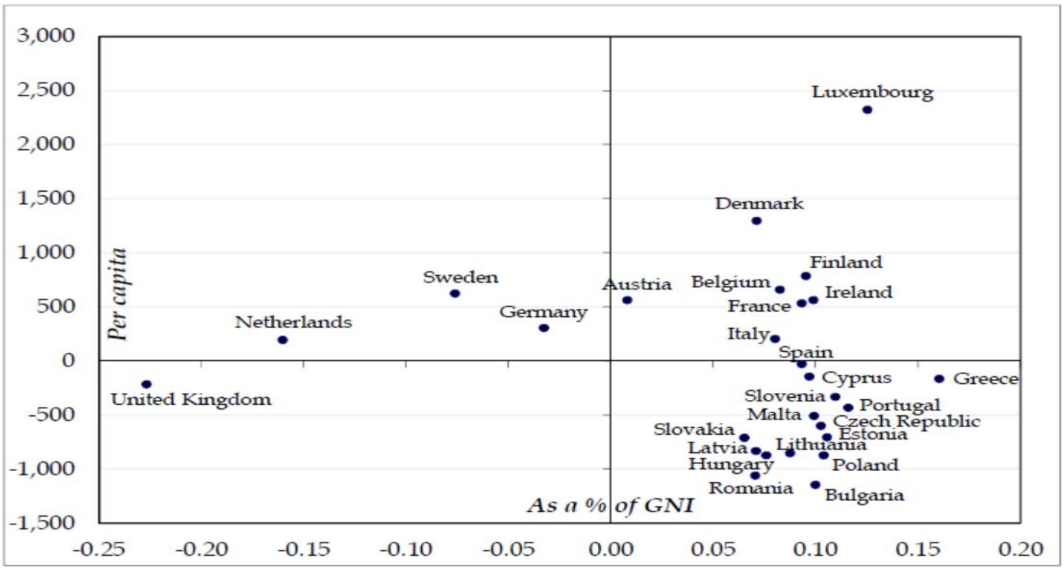

Figure 3: Contribution to the EU budget as % of GNI (2007-2014)
Source: Eurostat Data and European Commission

1. The UK is the only country that is part of this first category: with contributions that are below the GNI ratio and the per-capita contributions.

[24] *Horizontal equity in the sense that the burden should be shared among Member States according to an equal ability to contribute, is not fully respect.* (Cipriani, 2014)

2. Germany, Sweden and the Netherlands'contributions are above average in terms of per capita contributions but are below average in term of GNI.
3. Luxemburg, Italy Demark, Belgium, Finland, France, Austria and Ireland's contributions are above average for both GNI ratio and capital contributions.
4. Greece, Spain and Portugal's contribution are below average for per capita contributions but above GNI ratio.

Hence, there are huge discrepancies *among member states in comparison to a macroeconomic aggregate like GNI or on a per capita basis* (Ibidem) in particular, poorer countries in percentage pay a higher burden than the richer ones, in this way the system goes against the equity principle that should be the base of the European financing system. In this regard the European Parliament (2005) observed that the EU revenue system is *increasingly less equitable and has led to a financing system which has resulted in unacceptable inequalities between Member States*.

Democratic accountability and Transparency

Democratic accountability and transparency of the European institutions and systems is always a standing issue, especially when it regards the Union fiscal policies.

In particular the budget is considered to be *"one of the most significant tools to guarantee the accountability of the European Union towards its citizens (...); an accurate and accountable use of the EU resources is one of the essential means to reinforce the trust of the European citizens* (ECOFIN Council, 2010). Unfortunately *the decision-making process* [to approve the budget] *is obscured by complexity, when those whom the citizens can sanction are not always those who take the decisions or are reluctant to shoulder their share of responsibility before the people who voted them in"* (Commission, 2002). The complexity of the budget is, also, graphically illustrated in Figure 4, accordingly such complexity does not help strengthen the budget transparency.

Figure 4: The galaxy around the EU budget – an illustration of the complexity of the financing of EU activities. Source: Committee on Budgets of the European Parliament.

The transparency and visibility issue is also linked to the European democratic deficit. As the Commission stated (referring to the own resources system) *visibility to EU citizens has an important accountability dimension, their comprehension and monitoring of the present system is virtually absent. The lack of a direct relationship between citizen and budget is another manifestation of the democratic deficit.* Then more visibility would enhance the accountability of the system and would in some way reduce the democratic deficit. Clearly the decision to involve citizens in such a process is a political decision that could cost a lot. (Cipriani, 2016) Another feature of this lack of accountability regards the European Parliament[25]: it represents the European people but does not have a say in the size of the budget or in the allocation of the expenditure. On this regard the Parliament in the resolution of 23 October 2017 affirms that actual system of own resources deserves a democratic reform since at the moment the system is not subjected to parliamentary vote neither at the national or European level, thus it is violating *the letter and spirit of the Treaty.*

Concluding remarks

The EU budget revenue system is characterized by Member States transferring resources to the Union. EU financial autonomy depends on Member States fulfilling their obligation to finance the EU budget each year within the limits of the agreed ceiling in the MFF.

Furthermore the EU revenue agreements still require a formal approval from national parliaments, despite the EU has a European Parliament elected as an institution where *citizens are directly represented at Union level*.

The Union revenue is traditionally a matter limited to intergovernmental negotiations, where revenue and expenditure go together. This explains why most EU spending is pre-allocated on a geographic basis, as it represents the logic of the "just return" of the national contributions paid to the European budget. Following the just return logic, most of the time a number of corrections is negotiated to reach the unanimous agreement needed to approve the budget. This whole system does not evolve EU citizens who are totally unaware *that they contribute to the EU budget and by how much* (Cipriani, 2014).

[25] Art 311 of the TFEU states that the Council has just to consult the *European Parliament before approving a decision related to the system of own. Whether for the implementing measure of own resources the European Parliament consent is needed*

The concept of net balances between state contribution and European budget payments has become the cornerstone of the own resources settlement. The Commission heavily criticized the system defining it as *arbitrary* and *highly questionable,* since this calculation is very "state-orientated". Given these issues the "own resources" system must be reviewed in order to make the system simpler, more transparent, fairer and more democratically responsible. In the next chapter I will analyze one possible reform path.

Chapter 2: The EU Budget and the federalist integration

Introduction

I have analyzed the strengths and weaknesses of the current functioning of the EU budget, with a specific focus on own resources, and we have seen the reason why a reform is needed.

The academic literature finds two main possible paths that could eventually be followed either reforming the system respecting the current legal framework or acting outside the treaty (a treaty reform would be needed) to give a federal budget to the European Union.

It seems reasonable to investigate if there are any new ways to modify the current structure of the Union budget: its size and composition or, in other words, whether a new and different division of competences and governmental functions between Member States and the European Union is justified, which would see an increase in the role of the latter in a more federal direction.

In this chapter I will analyze the federalist proposal and I will see if there is any relations between the European stage of integration and the federal approach.

In the first part of the chapter I will analyze the federal proposal from an economic point of view, in the second part I will look at the federal approach from a political science point of view, attempting to demonstrate that the optimal economical approach unless supported by political will, will not have a positive outcome.

2.1 Fiscal Federalism

The theory of fiscal federalism presents elements of extreme interest. Although it has been mainly used to study well-consolidated federal contexts, it is undoubtedly an important reference point for European development and for the achievement of federalism of that sort within the EU.

Generally speaking, the starting point is the division of government functions carried out by Musgrave in 1959 and subsequently by Oates in 1972. The theory states that the central government should have the primary responsibility for macroeconomic stabilization and income distribution. In addition to these functions, the central government should provide national public or collective goods serving the entire population of the country (Musgrave, 1959).

Regional levels of government have their say in providing public goods and services whose production and consumption are limited to their jurisdictions. The economic argument for the supply of public goods at a subnational level was originally formulated in a decentralization theorem, stating that *the level of well-being will always be at least as high as the effective levels of Paretian consumption are provided in every jurisdiction. If not, any single and uniform level of consumption is maintained in all jurisdictions* (Oates, 1972).

In general, the conclusions of the theory of fiscal federalism are quite clear and simple: in a federation which unites states characterised by a high level of economic integration, it is best if the functions of macroeconomic stabilization and income redistribution, due to the effect of the significant externalities produced from their operation, are assigned to a central government. In contrast, resource allocation should be carried out at a regional or local level.

The main reason for decentralization and division of responsibilities between different levels of government is essentially linked to the divergence of territorial preferences within a federation. In addition, the decentralization lowers administrative and planning costs and most importantly, more efficient political measures can take place, as citizens are able to influence those who govern.

Therefore, it is obvious that the macroeconomic stabilization function must be assigned to a central government: especially considering the power the central government exacts in the matter of money supply and the exchange rate; the same could be said for the counter cyclical fiscal policy – which would have little effect if assigned to lower levels of the government.

The question arises whether the fiscal federalism theory as it stands is applicable to the European Union and whether it can adapt to the current level of integration. There are a few caveats which need mentioning.

It should first be said that the theory of fiscal federalism has always referred to federal contexts with strong, established central governments, setting forth regulations for the organisation of a federal financial system, whereas the European Union cannot be considered a federation[26] in the strict sense. Indeed the latest political and economic developments[27] would seem to have moved Europe further away from its federal ambitions.

The Union has a few of the characteristics of a federation: first of all a common currency in most of the member states, and a sufficiently high level of national economic integration, as well as a few policies administered collectively at EU level. But the following question remains: is the European Union is comparable to a confederation or is it quite simply an economic union.

In a way, fiscal federalism has also overlooked political economy, namely the division of competencies between the various levels of government: that is, the functioning of the institutions, the institutional and political mechanisms of the formation of public choices, the electoral systems. In particular, the collective choices are influenced by interest groups, which can sway decisions according to their preferences (centralisation vis à vis keeping the function at a state level) (Morlino, 2017). Even if centralisation is justified from an economical theory point of view, it doesn't necessarily mean that this is the path to take. At a national level there may be fears that this centralisation at a federal level (in this case that is the move of decision-making power from a member state government to that of Brussels) could reduce the

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[26] In 2002 Oates writes *fiscal federalism presumes a substantial and strong central government with monetary, fiscal and regulatory powers. As such, it doesn't seem to fit very well the cases of emerging "confederations" such as the European Union. Nevertheless, using the fiscal federalism model to think about the European Union does provide some useful insights.*

[27] I refer to the economic crisis, the security and migration crisis, and the rise of Eurosceptic movements.

well-being of the country and its citizens and more important such a shift might go against their interests.

An example of this could be the pension system. Think of all the different national systems which are specific to the demographic situation in each country, the number of special interest groups in each country and their fears of how a centralised solution could alter their ability to influence and sway the choices made for national pension schemes.

Therefore, if we give institutional matters and the formation of public choice a key role in the explanation of the division of competencies in the European Union, the regulatory requirements of the theory of fiscal federalism appear much weaker. It would seem more appropriate and possibly more realistic to adopt an approach which evaluates each single competence of a government, examines national availability and government preferences, and envisions a more flexible system of allocation, which apart from being theoretically more comprehensive would also hold in greater consideration the specificity of the European Union, the willingness of the member states, the level of integration and the federal development stage of the Union.

2.2 Where Does the European Union stand politically?

The European Union and especially the Euro area is the first case ever seen of a monetary union where monetary and fiscal policy do not go hand in hand: monetary policies are run by the Central Bank whereas the fiscal policy making is in the hands of Member States. The EU has a unique economic and institutional framework that is difficult to define.

In this paragraph I will start by analyzing the nature of the Union and the federal issue from a political point of view.

The European Union was founded thanks to the typical instrument of international cooperation: an international treaty signed up by the acceding countries. The

Community developments should be interpreted essentially in terms of conscious action for cooperation between states that pursue their own interests in order to solve their problems and then consolidate their economies and social being (Milward, 1992). The EU was primary designed to be an international institution in charge of regulating trade of goods and services, and the resulting flow of economic factor (Moravicsik, 2001). Over time, in addition to the rise of the institutions, there has been a sharp increase in inter-institutional relations; in particular there has been a marked increase in the legislative powers of the European Parliament. Despite this, the institutional framework is not distant from the asset given by the Treaty of Rome, we still have an institutional asset which envisages the presence of institutions where national governments are represented (Council of Ministers, European Council, COREPER) and others which have an autonomous status: Commission and Parliament. Member States have maintained a significant weight throughout the Union decision-making process through the presence of the Council of Ministers and then the European Council, thanks to the power to nominate Commissioners and above all the unanimity vote[28] which still remains a largely present principle (Morlino, 2008). Moreover MSs still have a crucial role in economics matters: MSs had been enormously involved in the resolution of the crisis. The advent of the economic crisis caused complex changes in the governance of the Union especially, on the institutional ground, the European Council gained visibility and powers, determining a new preponderant phase of intergovernmentalism.

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28 *The Council must vote unanimously on issues considered sensitive by the Member States: common foreign and security policy (excluding certain well-defined cases requiring a qualified majority, such as the appointment of a special representative); citizenship (granting new rights to EU citizens); accession to the EU; harmonization of national legislation on indirect taxation; EU funds (own resources, multiannual financial framework); some provisions on justice and home affairs (European Public Prosecutor's Office, family law, police cooperation at the operational level, etc.); harmonization of national legislation on social security and social protection. In addition, the Council is required to vote unanimously to depart from the Commission proposal when the latter is unable to accept the changes made to its proposal. This rule does not apply to acts which the Council must adopt on a recommendation from the Commission, for example in the field of economic policy coordination.* (www.consilium.europa.eu/media/29824/qc0415692enn.pdf)

In general, throughout the history of integration individual states have demonstrated how it is possible to block the decision-making system (as the empty chair crisis) or how to completely change the Union budget arrangement, this is the case with the system of budget corrections.

The European Union is a dynamic reality: this dynamism can be seen through two factors: territorial expansion to the east and the expansion of Union competences. Particularly important are the transformations that took place with the new Treaties (Treaty of Maastricht, Amsterdam, Nice and Lisbon). It is worth mentioning the completion of the integration of the internal market, which has led to an enormous development of regulation and deregulation policies, the launching and expansion of regional policies and, above all, monetary integration (Morlino, 2008). If we look at the substantial transformation, it is noticeable that it affected certain areas of public action more than others. The transformation has touched areas such as the regulation of the economic market far more than anything else and it has barely affected social or security policies.

Furthermore, as has been pointed out several times, European integration has been more a negative integration rather than a positive one: that is, it has proved to be more effective in eliminating customs duties, tariff and regulatory barriers between Member States rather than establishing equilibrium measures which could reduce economic and social disparities (Weiler; Sharpf, 1999). This means the new European policy presents characteristics that are very different from those typical of the last century's nation states. Nation states played an enormous role in the promotion of social well-being, basing their action on the principle of equality opportunity, distribution of wealth and social welfare. On the other hand, it can be argued that the European Union might be more in line with the recent developments of nation states that are reducing their intervention using the indirect ruling mechanism[29] (Majone, 1996). In

[29] Central State is involved in a process of reviewing traditional forms of intervention in the economy and society. The exercise of regulatory functions allows modern public powers to point out more externally (on the lives of citizens), thus affirming new perceptions of defining the public interest. (La Spina, Majone, 2000) p. 27

general, *this spectacular record of growth and achievements has sparked controversy. Euro-enthusiasts favor an emergent European federal state.* They argue that *the success of the EU […] clearly demonstrates not only that European integration has been successful, but that integration breeds more integration through myriad of spillovers* (Moravcsik, 1998).

2.3 The European Union unsuitable for federalism

Almost 60 years after Shuman's famous speech (Shuman, 1963) in which he illustrates the *European federation* as the ultimate step of the Union integration process, we can say that the process of integration is far from reaching this goal, for both economic and political and institutional reasons. The neofuctionalism, influential European integration theory which foresees; a continuous spillover of normative resources from national to supranational levels, to the transformation of European Union into a federal Europe seems to appear overrated (Majone, 2010).

In economic terms valuable advantages have been made. The Euro birth, which established the single currency in a part of the member countries, is the highest goal reached. On the other hand, the advances made in the economic field did not match those in the political field. The Union failed to establish a strong identity and to develop common actions with a similar impact spread all over the EU Member States.

This paragraph explores the reasons why the current institutional form and political system cannot fit with the political and institutional standards of the federal thought.

A federation may be defined as a political system in which at least two territorial levels of government share sovereign constitutional authority over their respective division and joint share of law-making powers; differently put, neither the federal government nor the relevant federative entities may unilaterally alter one another's powers without a process of constitutional amendment in which both levels of government participate (Watts, 1998).

In order to have strong democratic accountability the institutional system is characterized by a bicameral system of representation; usually you have a regional chamber, such as the Bundestrat in Germany (where the smallest regions are usually overrepresented) and a federal chamber such as the Bundesbag (Ibidem). Laws are made after the consent of both chambers and a double majority is required.

Compared with the existing international organizations the European Union has large competences but less if compared with a mature federal state. As we have seen the EU functions are limited to the trade of goods and services, movement of factors of production, production and trade in agriculture, monetary policies, moreover the Union is in charge of those policies concerning environment, competition, consumer and workplace policies. On the one hand it is remarkable the wide range of activities that the union has to carry out but on the other hand significant the lack of policies and powers to mark the EU as a Federation of states (Pollack, 2001). First of all, the European Union is not involved in provisions regarding social welfare. National states provide citizens with medical care, unemployment insurances, and pensions. Concerning this topic, the EU is only allowed to intervene when there are trans-border issues like the right of European citizens to get their pensions and invest them abroad. Most importantly the EU, as a whole, lacks in military defense and foreign policy[30]. As we have seen these features are the oldest and most fundamental features of modern states and in fact this feature largely remains in Member States' hands (Moravcsik, 2001). At the origins of the European Economic Community, there is a failure, in 1954, of the ambitious attempt to integrate MSs' European defense policies (CEDs). There are good reasons to believe that the development of integration in this area was blocked by NATO's consolidated presence in foreign policy and by the will

[30] The 7 June 2017 the Commission did a step forward in order to boost Union influence in the military and defence area. It launched an *ambitious European Defence Fund will contribute to a European Union that protects and defends its citizens, complementing other ongoing work strands, namely the Global Strategy's Implementation Plan on Security and Defence, which sets out a new level of ambition for the Union and identifies actions to fulfil it, as well as with the implementation of the EU-NATO Joint Declaration signed by the President of the European Council, the President of the Commission and the Secretary-General of NATO.* (Commission, 2017)

of the nation states to preserve under their control the essential element that distinguishes national sovereignty: the border defense (Morlino, 2008). Only in recent years have significant steps been made in this area: the Lisbon Treaty introduced some significant changes, such as the creation of the High Representative of the Union for Foreign Affairs and Security Policy as a permanent figure and the European External Action Service became a diplomatic and administrative apparatus that manages common foreign policy. Despite these changes, however, the CFSP continues to function essentially according to the intergovernmental approach, so the European Commission and the European Parliament have very limited powers in this area.

Another aspect that distances Europe from other federations is the lack of a significant education and cultural policy. The EU has no jurisdiction over Member States education systems. Regarding the school system and its main components: quality of education, financing of the system itself, the status of private schools. This aspect is important to emphasize because it is at school that a population is formed, and having students who feel part of a larger community would help increase support for the European Union.

Another crucial aspect that distances the EU unique system from any other federal system is its democratic deficit. The roots of the democratic deficit lie in a lack of balance between the European institutions and in the methods of integration pursued for over half a century: in the so-called Community method, which entrusts the monopoly of the legislative initiative to an executive body, without democratic legitimacy; this system has produced, a unicum in the history of modern democracies where there is a monetary unity without political union; there is a lack of transparency of decision-making processes (Majone, 2010). In fact, in any accountable system voters must *know who is responsible for making policy* and *have a fair opportunity to cast a meaningful vote for or against the policymakers* (Powell, 2000).

Many studies attempt to address the issue of the democratic deficit by strengthening the EU institutional system boosting the European Parliament powers. In this sense, it is true that the Lisbon Treaty has strengthened the role of the EP. Before the coming into force of the Lisbon treaty the EP was often accused of not being a real parliament because it did not play a role in the formation of the strongest institution such as the Commission, which is the closest institution that the Union has to a government. Moreover, the EP elections were considered of secondary importance due to the lack of a strong European party system. Additionally, as Figure 5 shows, during the years there has been a growing dissatisfaction in the EU that has led to a decrease in the voters participation in the European Parliament elections[31]. In order to increase its prestige two were the two were the aspects to be improved: increase the partisan confrontation and have a say in the formation of the Commission. In this sense the Lisbon Treaty represents a turning point. As a matter of fact, in the last elections of May 2014, the Commission President nomination came from a popular vote, rather than from a diplomatic negotiation within the European Council. In his first speech in front of the Parliament the new President of the Commission Jean-Claude Junker said: "*for the first time, a direct link has hereby been established between the outcome of the European Parliament elections and the proposal of the President of the European Commission. [...]* (This tie) *has the potential to insert a very necessary additional dose of democratic legitimacy into the European decision-making process, in line with the rules and practices of parliamentary democracy* (Junker, 2014*).*

[31] *During the years a steady decline in the rate of participation in the European elections: the average holding was 63 per cent of those entitled to vote (85.5 per cent in Italy), in 1989 it dropped to 58.5 and 56.8 in 1994 (81.5 and 74.8, respectively, in Italy). In the 1999 elections, the stake fell for the first time below the 50% threshold, with minimum values below 30%, not only in Great Britain but also in the Netherlands, one of the founding countries of European Union. The negative trend continued in the run-up to the June 2004 elections. In most EU members at 15, the percentage of voters was well below 50 per cent, while the gap between the last national elections and the 2004 European elections is was above thirty points in Sweden, Denmark Germany, Hungary, and the Netherlands. Finally, in the European elections in 2009, the participation rate fell further to 43.08 per cent, despite the considerable funding available from the EP for public relations. Participation in the 2014 European elections was 42.54% (43% in 2009). This European average has important differences between the 28 Member States which can reach 76.5 percentage points between Belgium (89.6%) and Slovakia (13.1%). It is therefore possible to see a significant increase in participation in seven countries, almost stable in six and a drop in participation in the other fifteen (mainly in most EU Member States from 2004, 2007 and 2013)* (European Parliament, 2014).

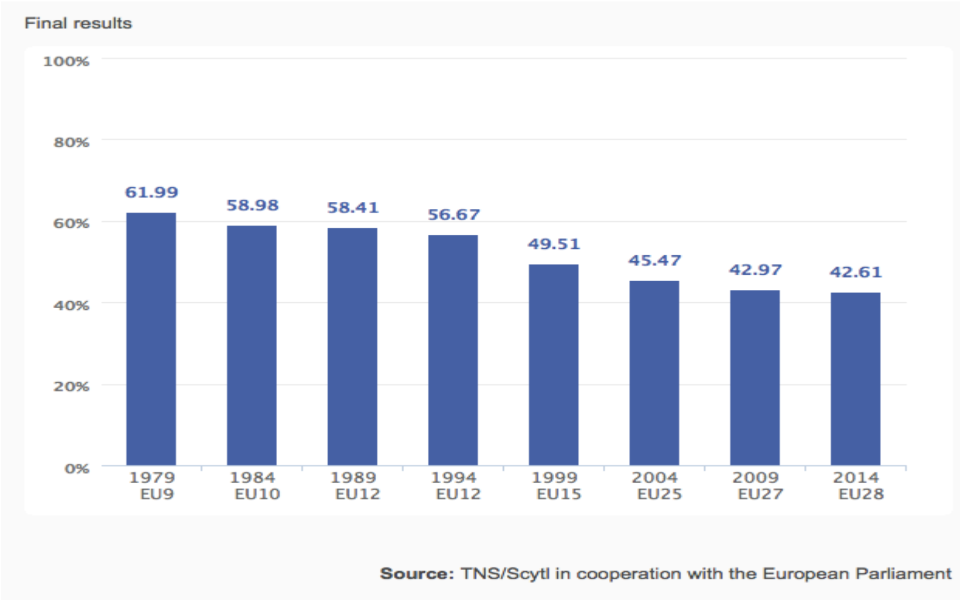


Figure 5: Popular participation to the European election from 1979 to 2014

President Junker was probably too optimistic in addressing the problem of democratic deficit. It is unquestionable that the Lisbon Treaty gave more accountability to the EU and accordingly addresses in some way the democratic deficit of the Union. The EP became the popular chamber and with the Council shares the co-decision power in the ordinary legislature procedure. However, the EP has powerful constraints, imposed on it by the Lisbon treaty itself. First of all, the Treaty excluded the EP from important policies such as economic and financial policies and foreign and security policies. The decisions regarding these fields have to be taken at the intergovernmental level therefore managed by the Council and by the European Council. Moreover, EU MSs are not willing to renounce to their power of representation within the Council and the decision-making power that they have especially within the European Council. A prominent Italian political scientist gives a comprehensive definition of what a parliamentary system should be, this definition can also be adapted to a federal system: *all the systems that we call parliamentary require governments to be* *appointed, supported and, as the case may be, discharged by parliamentary vote* (Sartori, 1994). According to this definition the European Union will never reach such an accomplishment or at least not with this institutional setting, for two main reasons: the relationship between the Commission and the European Council and between the EP and the Commission. The European Union has a government divided between two institutions: the Commission and the EU Council and this is true especially since the beginning of the economic financial crisis (Fabbrini, 2013). During the economic crisis the Commission used its power of initiative on many occasions: the instauration of the European Semester, the Six and Two Pack but the Commission did not act by itself, the main impulse came from the European Council. Basically, there is the European Council telling both, Council and Commission what to do and how to transform the political input into law. It is clear the reason why an institution such as the EU Council has gained so much power especially in a moment of crisis: the Union is an aggregation of independent states with different strategic needs and they do not want to be excluded from the decision making power, especially when it comes to fiscal and monetary policies. The other main obstacle to a possible formation of a European institutional system regards the relationship between the Commission and the EP (Fabbrini, 2015). In a democratic prospective the Commission components should be nominated by a parliament majority, and clearly this support would come from a political choice. In this case the Commission would lose MSs trust and in addition could not carry out its main duties such as: controlling the respect of the EU's norms or imposing to MSs budget cuts in order to be compliant with the EU rules. Finally, there is another issue regarding the formation of an accountable system: nowadays there is the increasing tendency to go back to national parliaments. There is a growing debate over the involvement of Eurozone's national parliaments into the decision-making process of the Union. This proposal weakens the EU Parliament credibility even more and would diminish its role in economic issues (Fabbrini, 2015).

There is another, further obstacle regarding the European Parliament that needs to be emphasized: the EP's inability to communicate with its citizens. This is another barrier towards the decrease of the Union democratic deficit. The activities of the Parliament have a limited resonance within the European public opinion. The legislative work done by the Parliament is enormous, sometimes it is even too much and often its main legislative work concerns the internal market regulations. This is, of course, an area that is far from the people interests. Moreover the Parliament often proceeds adopting a consensual method or dividing itself into national groups rather than following the traditional partisan division between left and right. In these circumstances there is no possibility of gaining any public attention. The remedy to gain more visibility in the media and among citizens could be on the one hand to limit the legislative production, this occurs also in the defense of the Principle of Subsidiarity, and on the other hand the Parliament should play more prominent role on fiscal matters giving a political imprint to this decisions. In general, the only decisions in Brussels that arouse the public interests are those regarding economic and fiscal policies, this is why the EP should try to enter more in these fields. The Parliament attempt to reform the budget system represents a first tiny step towards a revision of its role on economic and fiscal matters.

In conclusion, the European Union is far away from its past federal ambitions especially after the economic crisis. Despite that the Union has some characteristics of a federation: first of all a common currency is used in most Member States, and there is a sufficiently high degree of integration of national economies, as well as the presence of some collectively managed Community policies. However, it is far from being, comparable to a confederation - or simply to an economic union. (Cipriani, 2014)

2.4 Professor Morlino Interview: No possibility for a federal Europe

In the conclusion of this chapter, I include the interview with Professor Leonardo Morlino, full Professor at LUISS University of Rome and former President of the International Association of Political Science, he is an expert in the field of democratic studies and he is author of more than 30 volumes on the change and quality of democracy. The full version of the interview is in the Appendix, in this paragraph I will set forth the content and draw some conclusions on the topics addressed.

Professor Morlino has conducted numerous studies on democracy and on its main features, during our talk he clarifies that he does not see any empirical evidence that could bring the European Union towards becoming a federal union; too many are the *constraining conditions* within the European institutional and political structure. Any comparison with the Canadian or American model should be considered as inappropriate, as when these two federations were formed, their members were not consolidated democracies; the classical functions of democracy were not developed. Another obstacle that Morlino finds in the federal construction regards the nature of the EU itself. The EU is an International Organization made up of sovereign states and as Robert Dahl highlights in a "Preface of democratic theory"(1956) consolidated democracies cannot form larger democracies, since the movement to build the democracy itself has to come from the bottom and this is not the case of the European Union.

Professor Morlino, in order to stress the difference between the European Union and other Federal Unions, pays close attention to two new challenges that the Union is facing: migration and security. In this field we can see the real nature of the EU: that is an international organization governed by the intergovernmental method where stronger nation states prevail over the others. This is evident in the migration crisis where all the objective elements of an absence of unification emerge. There is no unanimous will to modify the Dublin Regulation[32] or to concretely help those Southern countries that suffer more because of the migration crisis. On the other hand the security crisis differs from the previous one for one main reason all Member states are hit so there is a wide interest in addressing the issue, but more importantly the most powerful countries are deeply touched by terrorism (France, Germany, the UK). This explains why the Union is moving towards a more cooperative approach. Once again within the EU Member States do not have the same degree of sovereignty. Morlino distinguishes between states that within the EU have full sovereignty with

[32] Regulation No. 604/2013

fully fledged decisional power (Germany, France, the Netherlands) and others that have some sovereignty and others that have zero sovereignty, amongst the latter Morlino mentions Italy and Greece.

Regarding the Fiscal Union Professor Morlino is very clear, he does not see the conditions for a broad fiscal union and neither for a more pervasive role of the European Parliament in this field. For two main reasons: the voter judges the elected politicians work, there is a direct mechanism of check and balance and in issues like Fiscal or Financial sector this bound is even stronger. The EU lacks of this kind of tie.

Morlino beyond the classical constraints towards a fiscal union and towards a stronger budget sees another obstacle: the group of interest action that represents a brake on too much "Europeanization" of fiscal matters, this is true for environmental, energy telecommunication and many others. It is problematic to study empirically in what measure the lobbying action is effective, but if in Brussels there are 9860 firms registered on the voluntary EU lobby register declaring a total of 91251 people involved in their lobbying activities this should mean something.

Professor Morlino closing comments highlighted that the political science empirical research is not able to indicate neither the present limit of the European integration nor the future limit, but any attempt to push it further is seen positively. In this sense the Mario Monti High Level Group final Report, that is going to be analyzed in the following chapter, is seen positively as it can bridge the gap between citizens and the action of Europe to illustrate the benefits that these actions can bring. It does so through existing tools without forcing a revolution, which is desired by no one involved.

Professor Morlino gives a lucid picture of the reasons why a federalist approach is not recommended, underlining empirical institutional and political constraints that are unavoidable obstacles towards the federalist transformation of the Union. Any reform at the European Level must respect the Union peculiarities and cannot overstep trying to impose federal features on a Union that cannot become a federal and neither completely democratic.

Concluding Remarks

In this chapter I have tried to show that, at the moment, fiscal federalism cannot represent a viable option since all the elements analyzed seem to indicate that the political direction of the EU is going, especially on economic matters, towards a more intergovernmental approach.

Moreover, it seems impossible to find mutually agreed rules able to draw up binding rules about the development path would take the Union from an economic to a federal entity[33]. The main issues regard the distribution of competences from both a political and economic point of view. On this regard, Federal path does not seem a feasible choice, but it gives us some guidelines (a larger budget with countercyclical functions, adoption of measures with high added value) to implement a budget reform within the current legal framework.

This path is embodied by Mario Monti High Level Group that from 2014 to the end of 2016 worked to formulate a budget reform that could address the weaknesses of the EU revenue system. This report focuses on the elements that can be reformed under the current institutional framework, bearing in mind that fiscal competences remain at national level and within the overall budgetary constraints of the budget so that the reform of own resources proposal does not create an additional tax burden on EU citizens.

In the next chapter I will analyze in depth the High Level Group proposal on own resources trying to explain why Monti's proposal could represent the first step towards a consistent reform of the fiscal system.

[33] It must be stated that nothing is written, therefore any additional step on the European integration process must be supported by the European peoples.

Chapter 3: A Feasible proposal to boost the EU financing system

Introduction

Commencing from the belief that the current system of own resources is far from achieving its goal in the *spirit of the Treaty* (Monti, 2016) and it presents some flaws that must be reviewed such as: its complexity and transparency, the genuineness of own resources (as already said 83% of the revenues come directly from Member States budget), the logic of the "just return" and the decision-making process of the budget approval. If no reform would take place there is a high risk that the EU budget is destined to become more and more irrelevant, losing its *raison d'etre* (Cipriani, 2014).

As we have seen in the previous chapter, for convinced federalists the budget should turn into a real federal budget, with the Union able to levy taxes and the decision making process should follow the community method rather that the intergovernmental one, but such prospective is the very reason why the most part of Member States would fight against autonomous budget. Accordingly the European Union is not ready for such a step, this is why if the system wants to improve we need meaningful measures that can receive broad support from Member States, and this is why a reform of the own resources must respect the current legal framework of the European Union.

Clearly a budget reform is not an easy task, as *everybody agrees in the abstract on the need for reform, as soon as the debate moves to concrete measures, there seems to be a strong bias in favor of the status quo (Barroso, 2009)*.
Mario Monti emphasizes the importance of the EU budget when introducing the work of his High Level Group, he sais: *the EU budget is one of the main tools for the EU to achieve its objectives - and needs in depth rethinking. It should focus more on*

common challenges such as securing our external borders, stabilizing our neighborhood or tackling climate change. At the same time, new resources would help us move to a more simple, transparent, fair and democratically accountable system. Now is the moment to make the financing of our European project fit for the future. Let's not waste this opportunity (Monti, 2017).
These words are key to the aim of this chapter since it takes into account the Final Report on “Future Finance of the EU” on Own Resources to provide an account for the urgent need of a budget reform.

In this chapter I analyze the most recent proposal put forward by The High Level Group on Own Resources, published in December 2016, I try to explain why such a proposal could represent a desirable compromise from the economic and political point of view and I see how this report could contribute to the negotiations process of post 2020.

3.1 Future financing of the EU- Final Report and Recommendation on Own Resources: realistic proposal to strength the Fiscal Union

The High Level Group chaired by Prime Minister Monti has been set up to analyze how to make the EU budget revenue simple, transparent, fair and democratically responsible. The will to call together a Group of specialists on own resources comes from the European Parliament impulse to review the whole system. During the MFF negotiations of 2014-2020, the Commission and the EP put forward two proposals to review the budget, but they were not successful, the status quo remained unchanged.

The Group was, appointed in 2014 by the former Presidents of the European Parliament Martin Schulz, by the Former President of the Council and of the Commission, respectively, Antonis Samars, and José Barroso. Each of them appointed three members and the chairman of the Group, Mario Monti was jointly appointed. The former Italian Prime Minister has highlighted in different occasions that the final report is not an academic one, meaning that the proposals put forward are not original, the Group instead designed a number of ways to make a package of measures, aimed to review the system of Own Resources. The High Level Group believes that the recommendations put forward are compatible with existing European treaties and their implementation could begin with the next MFF negotiations[34]. Moreover their proposals meet the challenge to integrate different needs: the economic one giving a strong budgetary efficiency and the political one giving more accountability to the system without forcing any steps towards federalism.

Monti's Group launches a comprehensive reform with a focus on both the spending and revenues sides of the budget. The cornerstone of the Report is the continuous attempt to stop thinking in terms of *net balance categories* (Monti, 2017) thus it tries to overcome the "just return logic". The Group clarifies why the budget must be considered as an "investment budget" rather than a zero sum game where some Member States win and others lose. Then States contributions to the budget should be considered as a broad investment in public goods that will create positive externalities all over Europe. On this regard Mario Monti (2017) said *in a context of redistributive budget like the current one, it is unavoidable that the judgment is based on the 'juste retour' principle. On the contrary, if the target, as we believe, should become the production of goods and services at the European level that our citizens expect in fields such as security and immigration, then it is necessary to endow the Union with the capacity to provide these services (Monti, 2016). Consequently, the proposal of possible own resources presented in the Report is linked to a policy area and is evaluated according to a series of criteria, but underlining that "own resources should not only be used to finance the EU budget in a sufficient, stable and fair manner. They should also be designed to support EU policies in key areas of EU competence: strengthening the Single Market, environmental protection and climate action, energy union, and reducing the fiscal heterogeneity in the Single Market.*

[34] The European Commission must draw up its proposals for the MFF post 2020, by the end of 2017.

It is worth pointing out that the Monti Group's proposal held a high level of consideration of the legislative proposal on own resources submitted by the Commission in 2011[35] during the negotiation for MFF package 2014-2020. The proposal emphasizes three main elements, elements taken into consideration in the First Assessment (2014) paper and in the Final Report of the Group:

- Simplification of the contribution system. Simplification process should start from the legal framework of own resources.
- Introduction of new own resources: elimination of the VAT resources, and introduction of new own resources aimed to lead the system to the original intention of the European treaties that is to use the EU budget to implement policies and face communitarian challenges (Moscovici, 2014).
- Correction mechanism's reform

Furthermore this Report focuses on the elements that can be reformed under the current institutional framework, bearing in mind that fiscal competences remain at national level and within the overall budgetary constraints of the budget so that the reform of own resources proposal does not create an additional tax burden on EU citizens.

As already mentioned, the work carried out went beyond the ordinary technical analysis of the various sources of revenues; it took into account the procedural and legal implications as well as political and institutional interdependencies. There are two leading principles of the work: making a feasible proposal that could be discussed and implemented for the next MFF and explain why the EU budget can bring an added value to the whole Union.

[35] COM(2011) 510 final: Proposal for a Council Decision on the system of own resources of the European Union, 29.6.2011

3.1.1 Guiding principles of the Report

The Group worked consistently with a set of criteria to evaluate and compare the different types of revenues. Mostly, these criteria are accepted and universally applied to public tax revenue. This is the case, for example, of efficiency, adequacy, stability of revenues and equity criteria. Another element that distinguishes this Report from the other works analyzing the European budget and own resources is the assessment of the political feasibility of its proposals. The Working Group tries to assess how easy it is to agree on the new own resources and how contentious the process of raising revenues could be. Another crucial attempt is to enhance the democratic accountability of the budget, every measure proposed must pass a democratic check, in order to do so every choice made has to follow two criteria: simplicity and transparency. The latter will contribute to making the budget more comprehensible for the European citizens.

The other leading criteria used as a guideline by the High Level Group are more related to the European funding principles.

- **Subsidiarity**. Any change proposed by the Group respects the power of national authorities, in fact any review proposed has to pass a sort of *subsidiarity test […] to determine the level at which at the spending should be undertaken.* (High Level Group, 2017)

- **Budget neutrality**: the size of the budget is determined primarily by the ceiling on own resources and, secondly, by the MFF, that is to say, on the expenditure side. The structure of EU funding does not, have an impact on the volume of the EU budget. Consequently, the introduction of new own resources or other types of revenue would lead to a reduction of the GNI-based contributions.

- **Overall Fiscal burden**: new own resources will not increase the tax burden on the EU taxpayer. Conversely, it would lead to a reduction of national contributions and to a better organized EU spending policies that could have a significant impact in different fields: security of external borders, defense and environment, thus the European governance will gain some strength.

- **Synergies:** given the EU budget constraints and the pressure on public spending in general, the most part of the European objectives should be pursued through complementarity at European and national levels. More attention should be paid to the synergies between the EU budget and national funding system, especially for those areas where European intervention could represent a real added value. This approach is essential to restoring the legitimacy of EU spending and public spending in general.

A reform based on these guiding principles would not only be fully justified, but would also have the advantage of providing a visible link with European policies and priorities.

3.1.2 The European added value

The European added value is part of the guiding principles of the Report on Own Resources and must be the heart of any financing reform. This principle is key to understanding the High Level Group proposal; this is why it needs a dedicated follow-up. The European Commission specified, the EU budget *should be targeted to best effect, managed to the highest standards, and that it succeeds in bringing tangible improvements to the daily lives of citizens* (Commission, 2007). On the other hand, the Report defines the European added value as: *the value resulting from an EU* *intervention which is additional to the value that would have been otherwise created by Member State action alone, can guide future budgetary decisions on the expenditure side* (High Level Group report, 2016). These two statements suggest that the EU spending added value should have three main features:

- The EU budget is expected to pool national resources at the EU level creating transnational positive externalities.
- The budget spending should be directed towards those investments that offer the best added- value.
- The budget should adopt a realistic approach, in order that its spending always meets the goals.

As Monnet (1978) said the European added value entails *a fusion of the interest of the European peoples and not merely another effort to maintain an equilibrium of those interests through additional machinery for negotiations.*

It is striking that, when it comes to taking into account the key data that each Member State uses to define its position in the budgetary negotiations, the European added value is completely ignored. The balance of the budget is simply calculated by offsetting what is allocated to a Member State on the expenditure side with its national contributions. As we have seen in the first chapter the EU budget is still seen as *a zero sum game* a*s long as a large part of the EU budget is dedicated to projects perceived as having only local value, with no cross-border or EU-wide benefits, Member States will continue to put a lot of emphasis on net balances* (Monti, 2017).

In the recent years European intervention has made the difference in many fields of the economic, social and cultural life of the whole Union. During the economic crisis the Union budget turned out to be a major source of investments, especially in the Southern countries. Furthermore the "European Fund for Strategic Investments" helped to direct private investments throughout the entire European Union. Figure 6 shows the improvements made in facing the evolving challenges of our time. The funding devoted to migration doubled to support Members such as Spain, Italy and Greece that receive thousands of immigrants every year. Looking ahead, migration is not the only challenge that the Union will face through its budget: terrorism, cyber security, the demographic deficit are some of the main issues to tackle. In all these areas the European Union can bring a significant added value. In fact the European action goes beyond the national efforts creating wide-spreading externalities (Oettinger, Cretu, 2017). For example, the European added value is concretely showed in the construction of transnational infrastructure: energy infrastructure, digital infrastructure from which all the European citizens can benefit. Similar benefits can come out of investments made in one specific region or in one Member State that could favor the macroeconomic stability and the economic growth of the entire Union. Moreover the great European added value is evident in the research and innovation field, in fact, investments made at the European level have a higher impact on the European society. In the MFF 2014-2020 the union increased the financing to science and innovation as it had noticed that in the past this resulted in increased excellence and open competition at EU level:

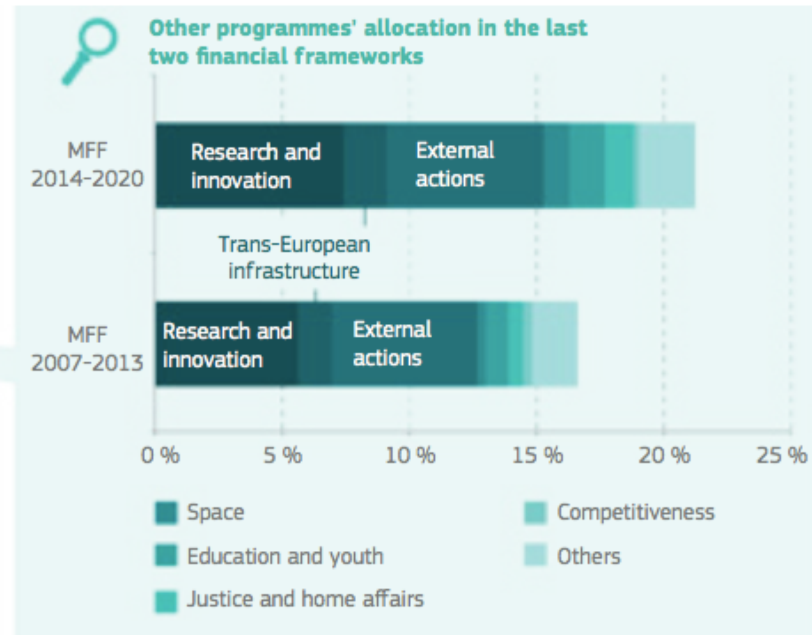


Figure 6: Programs allocation in the last two financial framework- Source Reflection Paper on the EU Financing. Source: EU Commission 2017

Based on this evidence, the High Level Group puts forward a proposal arguing in favor of the creation of a more comprehensive parameter that should measure the collective advantage derived from the European policies, economic synergies, cross-border effects. This would surely overcome the dilemma of the *just retour* that transformed the EU budget, and by extension the EU, into a zero-sum game rather than into an advantageous tool for everyone. Since this approach was legitimized with the calculation of the UK rebate, the UK's withdrawal from the European Union and the end of the so called "British rebate" should facilitate the reexamination of the actual cost and benefits of the EU.

3.2 What the Report proposes

The system is mostly criticized for two main raisons: the EU does not have real own resources, it depends, for the most part on national transfers and the correction mechanism.

Monti's Group, among the nine measures proposed to reform the system, makes four important recommendations in order to face them:

- *Replace most national contributions with genuine own resources:* The VAT based own resources should be abolished in its current form[36] and the GNI cannot remain the main financing tool of the EU budget.[37] In order to base the system on a more "genuine" own resources two criteria must be fulfilled: strong bond between new resources and the European competences

[36] The Vat-based own resources comes from the *application of a call rate to a notionally harmonized VAT base determined uniformly for the Member States in accordance with EU rules* (High Level Group, 2014). See also Chapter 1 paragraph 1.3

[37] *There are improvements to be made in order to make the GNI contributions more similar in nature to an own resource, which would address the high degree of diversity in the ways Member States handle the accounting of their contributions to the EU.*

(Environment, Single market). New own resources must go directly to the European budget; no Member States filters should be needed.

- Net budgetary balances can no longer be considered as a reliable metric to measure how much a Member State can contribute to the budget. A new indicator must be put into place in order to measure MSs losses and gains related to EU policies implemented by the budget resources.
- Abolish the correction mechanisms. This is crucial in order to simplify the revenue system. *The choice and configuration of revenue sources should ensure a fair burden-sharing. When this is temporarily not enough to avoid undue hardship, balance can be achieved through lump sum payments.* (Haas, 2017)
- Create some "differentiated integration projects not directly financed by the EU budget but from a special revenue fund, i.e. Euro countries increasing cooperation, enhancing defense cooperation.

Furthermore, the Group tries to conciliate the needs of new resources with new budgetary needs arising from the new EU responsibilities, (migration policy, security policy and climate change) (Majocchi, 2017). Therefore, the European Union is under strong pressure to intervene. The Group's Report results provide consistent ideas to support these new income needs, implicitly assuming parallel reductions in traditional spending, as no increase in the size of the budget is expected. However, taking into account the idea behind the Group's activity, that is to say that new own resources could be adopted to fund the EU budget only if they support the production of new public goods at European level, the results presented in the Report could be the basis for not only replacing national GNI-based contributions, but also to financing a future increase in the size of the budget to provide these public goods. (Ibidem)

For the time being, it seems more beneficial to present a wide range of revenue sources that could be applied as soon as possible and within the current legal framework. As mentioned in the first chapter the European system of own resources has some elements that work well that should be maintained and others that should be abandoned. The Group examined in detail various possible new sources of revenue that have also been identified by the most part of experts and exponents of the academic world. The Group's concrete proposals concern:

- Improvement of both Single market and fiscal coordination with reformed VAT based own resource, a corporate income tax (CCCTB) and a financial transaction tax (FTT).
- Promotion of a stronger energy union (involving transport and environmental policies) with the CO2 levy, inclusion of the European Emission Trading System proceeds, an electricity tax, a motor fuel levy (taxes on fossil fuels/excise duties), or indirect taxation on imported goods produced in third countries with high emissions and no carbon pricing.

3.2.1 Improvement of both Single market and fiscal coordination

The first block of measures would have the advantage of financing the EU budget, to help improve the function of the single market.

Proceeding in order the measures listed below require the following:

- **EU Corporate income tax (**CCCTB**):** it could represent a new own resources based *upon minimal harmonization of national corporate tax systems, in accordance with national fiscal competences* (High Level Group, 2016). Moreover it would increase transparency and simplicity since transparency is at the base of the CCCTB and the other measure would clearly simplify the system creating a harmonized framework for all the companies operating in the European market.

- **Financial Transaction Tax (FTT):** the idea of a Financial Transaction Tax was already advanced in 1936 by Keynes in order to discourage speculation that could cause market bubbles. A similar proposal was endorsed by James

Tobin who proposed to tax *short-term currency exchange transactions in order to reduce speculation in international currency markets*. (Ibidem)

The Commission also advanced the proposal to establish the FTT at the European Level in 2011[38] with the intention of ensuring that the financial sector makes contributions to the budget. According to it the FFT would reduce the MSs contributions to the EU budget and could be used as a *corrective tool* (Commission, 2011) as risky activity undertaken by financial institutions would be discouraged. In the Commission estimations the FTT could have provided 37 billion Euros by 2020 reducing significantly MSs contributions.

- **New VAT based own resource:** As I previously mentioned this represents one of the main priorities for the Working Group as the VAT based own resource is too complex and it represents a further obstacle for the transparency of the system. Two are the proposals to give credit to: the one put forward by the Commission in 2011. The plan to review the VAT- based own resources is *to apply a single EU rate of 1% on all the goods and services currently subject to the standard rate in each EU Member State.* (High Level Group, 2014). This new formula would simplify the system and create a link between the EU policies and the Member States' taxation system. This first option is based more on fairness, simplification and efficiency than the second option, which is the most desirable for the Group, is more orientated on tax harmonization and EU added value. The new Vat based own resources would consist in *applying the same fixed EU rate*[39] *to a wider harmonized VAT base* (High Level Group, 2016*).*

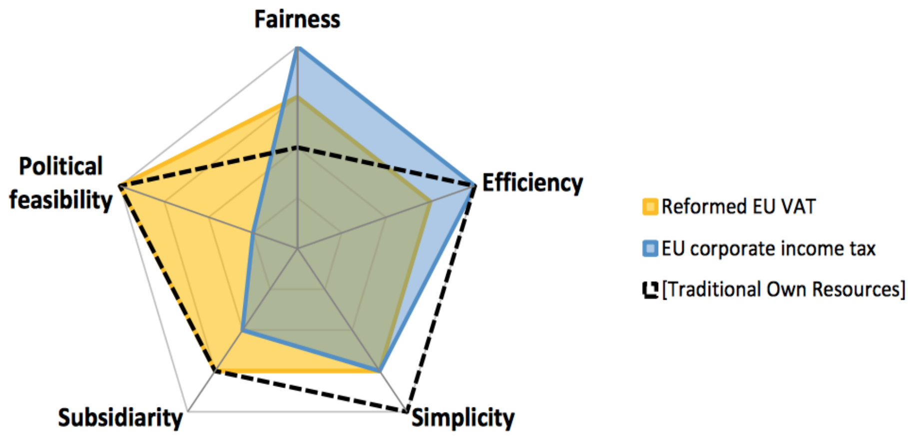
These new or revised sources are scored according the Report principles[40]. In the

[38] COM (2011) 510 final: Proposal for a Council Decision on the system of own resources of the European Union, 29.6.2011

[39] A fixed call rate would be lowered, as the base would be broader, since it would include all goods and transactions independent of their VAT national rate.

[40] See Chapter 3 paragraph 3.1.1

following figure I propose a representation of the measures score[41], using TOR as a benchmark. What immediately becomes evident is that there is no any perfect revenue source and combining all of them would just add complexity to the system. What should be done is to give priority to some principles such as political feasibility and simplicity in order to start reforming the system.



Source: Authors' representation, based on data from Monti et al. (2016).

Figure 7: *Possible EU revenue based on the Single Market*

3.2.2 Promotion of a stronger energy union

The second package of new own resources has the merit of linking the budget with the core of European policies. (Monti, 2017)

The EU has developed amongst the most stringent environmental standards in the world. Environmental policy contributes to making the EU economy more

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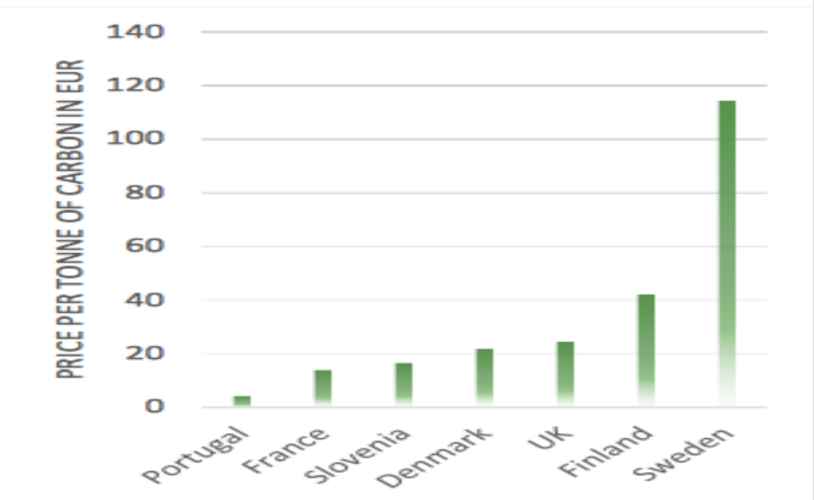
[41] In the Graph the FTT does not appear because I believe that such a measures will not be included in the next future in the new own resources framework.

environmentally friendly, protecting nature and safeguarding the health and the quality life of people.
The protection of the environment and the maintenance of a competitive EU presence on the global market can go hand in hand. In fact, environmental policy can play a key role in creating jobs and promoting investments. The EU in fact sponsors the so-called, "Green growth" (Commission, 2017) that involves the development of integrated policies aimed at promoting a sustainable environment. Environmental innovations can be applied and exported, making Europe more competitive and improving the quality of life of its citizens.
Many stakeholders strongly believe in the *sustainability –oriented EU taxes* (Krenek, Schratzenstaller, 2016) that could reduce the Member States contributions to the budget. On this regard Monti's Group stated that *a more sustainable own resources could play a constructive role in vertical fiscal coherence, and would establish [...] improving transparency/accountability dimensions.*
The Working group puts forward four main proposals:

- CO2 levy
- EU Emission Trading System proceeds
- Electricity tax
- Motor fuel levy (or, in general, a fossil fuel levy) and indirect tax levies on imported goods produced in high emission countries, (third world countries)

These options would help to improve the function of the single market if the EU institutions and Member States are able to create a single fiscal framework over these matters.
Of major importance is the introduction of CO2 tax. In 2011 the Commission proposed to revise the ETD (Energy Taxation Directive) to modernize the EU energy taxation attempting to reduce distortions in the energy sector.
The objectives of an EU own resource carbon tax would be to ensure consistent carbon pricing and to create a real level playing field between different energy sources, to provide an adapted taxation framework for renewable energy sources (Flues and Thomas, 2015). The carbon tax is levied on the carbon components of fuel and imposes a cost on each unit of greenhouse gas emissions. The carbon tax does not

guarantee a practicable level of reduced emissions but setting an adequate cost for carbon emissions could encourage taxpayers to reduce pollution. The carbon tax has already been implemented in different countries, specifically in Sweden, in the Netherlands, Portugal, Denmark, France, Ireland, Finland and the UK. An example of best practice is Sweden. In 1991 Sweden introduced the Carbon tax and as illustrated in the chart below is the country with the highest price per ton of carbon. At the same time Sweden has reached impressive reduction of GHG emissions and such a policy did not reduce its competitiveness within the global market (Sweden is still among the ten most competitive countries in the world), the figure below shows price per ton of carbon in Euro and the difference in price between Sweden and the other countries is plain.



Source: *World Bank (2015). State and Trends of Carbon Pricing 2015. World Bank Group and Ecofys study. Accessed 11.04.2016).*

Figure 8: Price per tone of carbon in Euro- Source World Bank

At the European level the adoption of a Carbon Tax would allow all Member States to meet the same targets and there would be no risk of *jeopardizing the internal market* (Commission, 2011). Specifically CO2 emissions would cost 20€ per ton to all sectors not covered by the ETS. Integrating such a tax within the own recourses framework the system would improve in a number of ways.

- First of all the energy market would become fairer and more equal since all the MSs will face the same target.
- Second, the introduction of a carbon tax could change the consumption pattern leading to a low-carbon economy.
- Third, the CO2 tax would replace part of the GNI-based own resources. The potential revenues coming from a EU energy levy are around 0.15 of the GNI revenues, but if the revenues were made fully available to the budget, it could cover 15% of it. (High Level Group, 2016)

Another measure that should be emphasized is the Electricity Tax: in this respect three are the possible taxes that could be implemented:

- Taxes on electricity production (paid by consumers)
- Taxes on electricity transport (paid by households and companies)
- Taxes on sale of electricity (paid by households and companies)

Such taxes would intensify the internal market integration which will lead to economies of scale, benefiting the production sector and consumers. Most of the analyses are in favor of an electricity consumption tax, since it is less costly and transparent all consumers are aware of their EU contributions through the monthly electricity bill. Moreover such a levy would respect the principle of equity and fairness since electricity consumption is strictly related to the consumers incomes, of course the EU should make a significant effort to ensure harmonization of the taxation level. The figure below shows the discrepancies amongst Member States' tax levied on electricity.

A further important aspect of such levy is that it could eventually be compatible with the legal framework concerning the EU budget and could be treated as those revenues coming from import taxes and duties (Konrad, 2015). But the regional breakdown of revenues is likely to be uneven. Consumption differences between countries are related to outcome differences in per-capita income or in pre-capita GDP, this diversity in consumption is a desirably property since *it causes a higher tax burden for persons or regions that have higher ability to pay*[42] (Konrad, 2015).

Moreover the electricity tax has the advantage of being difficult to avoid. Tax avoidance and tax evasion is a major problem in Europe and it is interesting to note that electricity consumption is one of the tools used to find any discrepancies between the declared and the effective income. (Konrad, 2015)

One of the most evident disadvantages of these new environmental resources is represented by the interest groups activities. For example in Germany interest group carried out intensive lobbying activity in order to avoid any change in the tax electricity consumption[43]. This suggests that any attempt to add tax energy revenue to the budget would have to deal with a strong lobbying action (Martin et all, 2014)

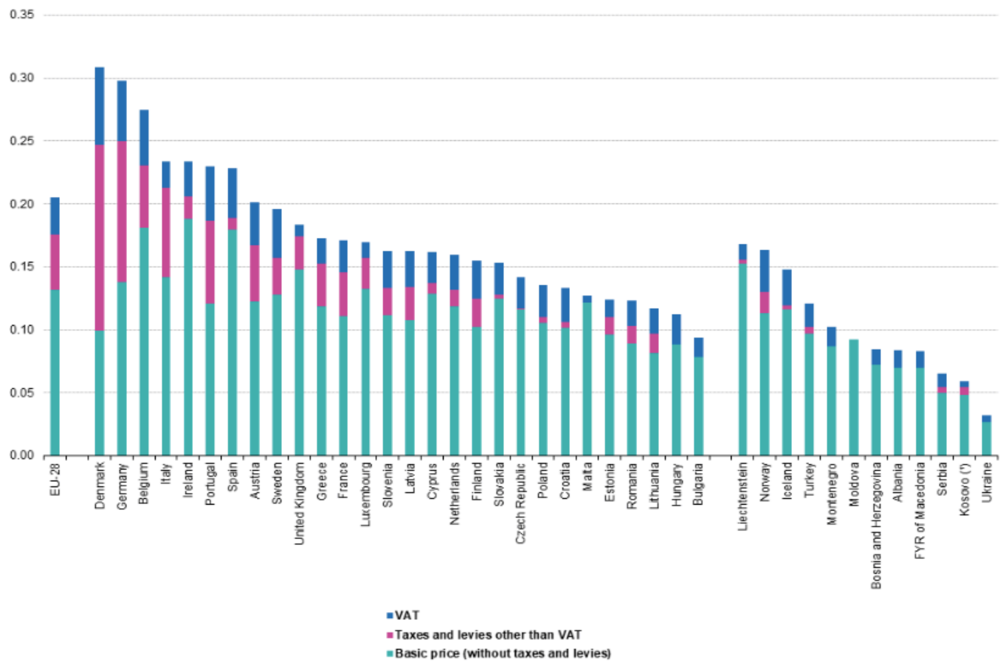


Figure 8: Electricity prices for household consumers, second half 2016 (EUR per kWh)
Source: Data From Eurostat

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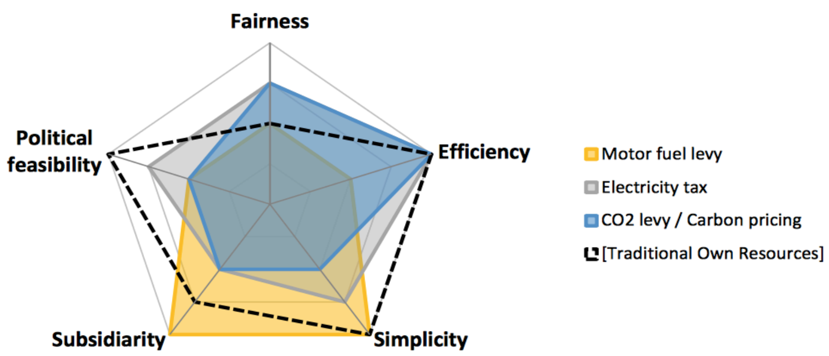
[42] Electricity tax is unevenly distributed also because electricity is used as for intensive production such as aluminum production.

[43] A new tax on electricity consumption was part of the so called Renewable Energy Sources Act or EEG this package promotes the generation of renewable electricity.

As in the four possible EU new own resources based on the Single Market, I display in Figure 9 the score of such measures. It is striking to see that they score very low with two principles: fairness and politically feasibility. This is key to understanding that the interests involved in this sector are many and the bargaining power of Europe is not strong enough to convince MSs to make the necessary compromises. With the negotiations of post 2020 some measures could be discussed especially on Carbon prices that seems the easier of the to put into place.



Source: Authors' representation, based on data from Monti et al. (2016).

Figure 9: possible EU revenues based on environmental goods

Finally, own resources are not the only possible revenue sources for the EU budget. The Working Group underlines the importance of the category of "other revenue" that has been ignored in the past reflections, but could become an additional element to finance the budget. "other revenue" lays down on Article 311 of TFUE when it says *without prejudice to other revenue, the budget shall be financed by own resources.* Other revenue cannot replace own resources, since the Treaty itself assigns a marginal place to them. If deployed more "other revenue" could become a real income source that could deal with specific problems affecting the whole Union: border controls, the single digital market, and environmental protection or energy efficiency.

In conclusion the Monti-Group with its proposal puts into practice President Junker's words who stated *We need a budget to achieve our aims. The budget for us is therefore not an accounting tool, but a means to achieve our political goals* (Junker, 2015).

The High Level Group work addresses new priorities, in both aspects of revenue and expenditure. The effectiveness of the EU's general budget depends on the capacity to address the EU priorities and to help our citizens overcome the challenges they face in their lifetime whether they are economic challenges, geopolitical, social or cultural. As we have seen, this effort is not favored by the current fiscal system, which has gradually become a system of national contributions in which the EU budget is perceived as a zero-sum game between "net contributors" and "net beneficiaries" (Monti, 2017).

A reformed system of own resources should contribute to achieving the political objectives of the Union by fulfilling, at the same time, its task of financing the EU budget and facilitating its adoption.

The Group tried to build up a sort of new path to change the current perception of the EU budget. The European added value of EU policies is often not recognized thus the European institutions are often blocked by MSs to intervene efficiently in fields such as internal and external security, climate change, research and defense.

As regards the revenue aspect Member States were swift to act against Monti's Report. Croatia, Latvia, Germany, the Netherlands, Greece, Poland and Denmark strongly defend the current system as it is considered vey efficient. Other countries such as Hungary and Romania asked to get rid of the VAT based own resources.[44] Regarding the budget traditional policies such as cohesion and agriculture Greece, Latvia, Hungary and Romania expressed, to the Council, their strong opposition against any reduction of these two budget expenses.

The German Government, in an official report issued by the Financial Ministry (2017), positions itself against any of new tax-based own resources auguring that any

[44] These countries did not express a clear opinion on new VAT own resources proposed by the High Level Group.

change in the revenue system of the Union should be based on a strong political debate, since any decision in this sense could broaden the European competences.
On the other hand, EU institutions warmly welcomed the final work of the High Level Group, the Budget Commissioner Oettinger is confident that most of the proposals put forward by the Group would be taken into considerations since it responds to the primary need of the budget: *whatever we do, each Euro invested in the EU budget must add value and have a positive impact on people's daily lives* (Oettinger, 2017).

In the next paragraph I analyze the reflection Paper on "The Future of the EU Financing", in order to show that there is a vivid interest in embarking on a new path of reform and that the Monti Group proposals have defined the right route.

3.3 The Report and its contribution to the reform debate

In June 2017 the Commission published a Reflection Paper on "The Future of the EU Financing", where it indicates the paths to follow in order to change the financing of the EU. Moreover the Reflection Paper gives a realistic analysis of the financial implications of the five scenarios forecasted by the Commission in the White Paper on the "Future of Europe" (2017).

3.3.1 The future of the European Budget: 5 possible scenarios

The White Paper published by the Commission forecasted five scenarios of Europe which are achievable by 2025.

1. ***Carrying on:*** *the EU-27 continue to deliver their positive reform agenda.*
2. ***Doing less together:*** *the EU-27 do less together in all policy areas.*
3. ***Some do more:*** *the EU-27 allow groups of Member States to do more in specific areas.*

4. ***Radical redesign:*** *the EU-27 do more in some areas, while doing less elsewhere.*
5. ***Doing much more together:*** *the EU-27 decide to do more together across all policy areas.*

Each of them could cause different implications on the EU Financing system; depending on what scenario we pick the *budget size, structure and degree of modernization change* (Commission, 2017). Despite the radical differences between these five settings. There are some factors common to all five: efficiency of spending with a proved added value, revision, in same case elimination, of CAP and cohesion funds, more flexibility, focus on new competences in order to face new global challenges. At last the rebates system must be reviewed and eliminated. Brexit[45] represents a large opportunity in this sense.

Scenario One

In budgetary terms, Scenario One would have less impact. States would maintain the status quo, the budget size would remain around 1% of States GNI and any change in the spending allocation would be constrained within the current rules. On the spending side, some revision has to be done in order to follow the roadmaps laid down by "The Bratislava Declaration[46]" European Council, 2016, "The Rome Declaration[47]" (European Council, 2017). The Union should play a major role in reducing unemployment and increase growth and should start managing border controls but, in order to comply with the budgetary ceiling, the spending allocation should change,

[45] All the consideration done by the Commission from 2017 on do not consider the UK.

[46] *The Bratislava Summit of 27 Member States has been devoted to diagnose the present state of the European Union and discuss* [the Union] *common future.* (European Council, 2016)

[47] Declaration signed the 25 March 2017, by 27 Member States the European Council, the European Parliament and the European Commission. Member States and Institutions agreed on some priorities to work on: security, growth and competitiveness, social progress, enhance Europe on the global scene. (European Council, 2017)

reducing CAP and Cohesion funds, but also some cuts should be made on research and infrastructures, fields where the EU added valued is tangible. (Rubio, Haas, 2017)
It is worth highlighting that such a scenario of maintaining the spending around 1%, becomes even more unrealistic if we think of the economic consequences of Brexit: it would leave a hole of €23 billion. So on top of the new expenditures, additional cuts would have to be made to cover this loss of funds. (Ibidem)
At this point, it seems unrealistic such confirmation of the status quo, as the EU needs a budget consistent with the evolution of the Union itself.
If the budget remains at 1% (for the post 2020 it is feasible that the threshold of 1% will not be overcome), a profound reform of the spending priorities should take place. And more in general, Member States will have to choose between a budget that could potentially create large positive externalities, (the elimination of the correction system is a priority) in the whole of Europe, or scale down the roadmaps goals reducing their ambitions. Ambitions, which are already low considering no major reform is planned

Scenario 2

In this case the EU budget is *refocused to finance essential functions needed for the single market* (Commission, 2017). This scenario is the less desired from the High Level Group that proposed measures to improve the system, rather that taking a step back. In this case the volume of the budget would be reduced and the focus on the single market would be enhanced. The Sapir Report of 2003 that proposed a budget focus on the internal market could give an idea of what such a scenario could look like. Firstly the complete abolition of CAP, in Europe this is not realistic but as forecasted by the Commission, the CAP will be significantly reduced. The Sapir Report would then rearrange the spending into three main voices: growth, convergence and reconstructing. This scheme is not too far from what the reality foreseen could be: from an economic point of view, the Union will *support only to maintain country cohesion and cross border cooperation* and will focus on social issues that would increase growth: social inclusion, unemployment, climate change policies. Other spending on infrastructure, and research will be deleted, and none of the roadmap goals would be taken into consideration. In this scenario the action capacity is very limited and the EU budget would lose its raison d'etre. (Rubio, Haas, 2017)

Scenario 3

This option entails that *the EU27 allows a group of member states to do more together in specific areas* (Commission, 2017). It is not odd that the European Union has financing outside the budget, especially in fields such as security and or other tools for Member States financial assistance (Blomeyer et al, 2017). The presence of these additional funds is seen as s *necessary evil* (Rubio, Haas, 2017) that increases the fragmentation of the system, and broadens the accountability gap. Overall a budget with a differentiated integration could finally solve, within the EMU, its macroeconomic stabilization function, and the demand for increasing cooperation on external action could be satisfied by those Members willing to go on with the integration process. These modifications would need a major reform of the legal framework, especially for that which regards the macroeconomic function (Repasi, 2015). At first, an increase in the budget ceiling would be mandatory. Moreover a stabilization mechanism could not respect the annual balance need required by the current budget rules since it *would need to accumulate money in good times and disburse it during economic downturns* (Rubio, Haas, 2017). On the institutional side, national parliaments would no longer be the budget supervisor; instead the Parliament could play this role. (Repasi, 2015) [48]

On the revenue side own resources could be implemented with the already proposed FTT or *with ad hoc financial contributions.*

[48] In this case another problem would rise: within the Parliament all the Union nations are represented, but the macroeconomic function would involve just EMU countries. Further reflections must face this issue.

Scenario 4

This scenario entails *significantly redesigned* (of the budget) *to fit the new priorities agreed at the level of the EU27* […] in order to deliver *more and faster in selected policy areas, while doing less elsewhere* (Commission, 2017). In other words, this scenario prevents waste resources and emphasizes the added value (in certain areas) of the European action. Funds for research and development, infrastructure, migration, defense and foreign policy will increase whereas CAP will be drastically reduced, and cohesion funding will be directed to the poorest Member States (in this way 8% of the current MFF would be saved). Furthermore the new budget will be enriched with new own resources that corresponds to the one proposed to the Monti's Group and an increase in the ceiling.

In order to improve the effectiveness of the spending as well, increasing the amount of resources does not seem to be enough. Conditionality could improve the system, for example cohesion funds and structural funds could be assigned depending on how MSs are working towards the EU objectives.

Scenario 5

This is the most difficult and at the same time desirable option for the EU budget. The EU budget would be *significantly modernized and increased, backed up by own resources; a euro area fiscal stabilization function is operational* (Commission, 2017). The EU budget would be changes in all its parts: as far as the revenue aspect is concerned, new own resources will be included, the same as outlined in scenario four, and the own resources ceiling will be enlarged. For the expenditure aspect the budget will be close to a classical national budget, with a macroeconomic stabilization function, with large funds to direct towards defense and social economic issues. Whilst for the Institutional aspect all the frameworks currently in place should change: no more unanimous vote, a Parliament with a decisive say in the budget negotiations.

It is interesting to note that the Commission draws on key principles set up by Monti's Report, principles such as the EU added value that becomes the driver for any further discussion about the EU financing system, efficiency and transparency of the

European spending, modernization of spending programs, increased action on transversal problems: migration, defense, physical terrorism and cyber terrorism, border controls and continued steps to halt global warming (Environmental based own resources could be an important step), and as states by the Report the budget as it is now cannot support a reform path. The EU added value seemed to be the core element for any European action, if this is the direction that the MFF takes for the post 2020, it is mandatory to find specific criteria able to measure the effective added value.
In addition, each scenario (second scenario excluded) puts lots of emphasis on the increase of the spending on EMU and defense, on this aspect the EU must conduct an honest debate assessing the political feasibility of such new measures.

The Commission will have the hard job to persuade Member States that the next Multiannual Financial Framework must follow a different approach, keeping the status quo cannot be an option. During the post-2020 MFF negotiations the Commission will have to deal with the classical tensions: institution friction between Council and Parliament, political tensions between the different political families, but also geopolitical tensions between northern and southern countries and western and eastern countries, and last but not least the battle between net contributors and net recipients
It is reasonable to think that the post-2020 MFF will represent a sort of *incremental adaptation to the current European challenge.* (Kaiser, Prange-Gstöhl, 2017) The structure is going to be maintained. As Commissioner Oettinger (2017) said *a large country will be departing. We need to look at shifting expenditures and making cuts.* Certainly cuts will involve CAP, cuts could be offset with the introduction of a co-financing system with Member States proposed by the Commission. In addition, there is high pressure to provide adequate resources to new challenges but there would be a very low mass of distribution (even with the aforementioned cuts to the CAP). Increasing revenues could be an option but is not likely to happen in the immediate future, as the political transaction cost would be too high. The only certainty is that EU action in the budget post- 2020 will be lead by the added value criteria, in this sense investments in research, innovation and infrastructure cannot be left out from the rearrangement of expenditure.

At last the rebates system could start changing if Denmark, the Netherlands, Sweden and Austria will be willing to negotiate.

All in all if the Commission is unable to mediate between the participants *it would run against both the declared priorities of leaders of Member States and the loud demands of citizens in the fields of social cohesion, economic growth and employment, migration, defense and external action* (Monti, 2017)

Concluding Remarks

In conclusion, the Monti High Level Group and then the White and Reflection paper diagnose the same disease and give the same cure: change the status quo in order to deliver much more efficient policies for the European citizens. In general, many are the proposals on the table, and in the next years Member States, institutions and experts will envisage from which measure it is better to start. But overall there are two certainties: the future reform will be successful if it will improve the effectiveness of the EU budget and if the budgetary decision discussion shifts from the logic of the *just return* to the EU added value criteria, that of course puts at the center of the discussion the citizens will and needs.

In the new circumstances, the preparatory work for the next Multiannual Financial Framework (MFF) is about to start. It will take place in a unique context that could help overcome traditional barriers to reform the EU Budget. The next MFF will offer the opportunity to rethink how the EU budget can support the EU Member States and citizens in a more efficient and effective way. (Monti, 2017)

Appendix Chapter 3: Brexit and the consequences for the European budget

On 26th of June 2017 British people voted to leave the European Union and in March 2017 Prime Minister May invoked Article 50 of the Treaty on the European Union to officially withdraw from the Union. Great Britain has always had a difficult relationship with the integration path of the European Union. At the end of World War II, the United Kingdom, with Winston Churchill, called for the creation of United States of Europe. The former President said *here is a remedy which would in a few years make all Europe free and happy. It is to recreate the European family […] under a structure under which it can dwell in peace, in safety and in freedom, we must build a kind of United states of Europe* (Churchill, 1946). Ten years later, when the European Community was about to be founded the same country refused to join. In 1961 the UK changed its mind and again asked to join the European Economic Community (EEC), in 1973 the UK was part of the Union but just two years later Prime Minister Edward Heath asked to renegotiate the participation agreements and hold a referendum to decide whether to stay or leave.

The same country claimed a further renegotiation under the conservative government of Margaret Thatcher in 1984, and then decided to stay out of the single currency project when the European Community Members signed the Maastricht Treaty in 1992.

After a year from withdrawal we are able to say that the English decision to leave will cost the EU a lot: 10-11 billion year hole in the budget. Günther Oettinger, the European commissioner for the budget says: *We won't have the UK with us any more, but they were net payers despite the Thatcher rebate, so we will have a gap of €10bn-€11bn a year* (Oettinger, 2017).

On the one hand the EU would save around 7 billion of Euros that is how much is spent to implement the European projects in Great Britain, then the EU will lose 3€ billion coming from the traditional own resources and 14€ billion of direct contributions. As shown in the graph below, overall the loss is about 10€ billion per year (Haas, Rubio, 2017).

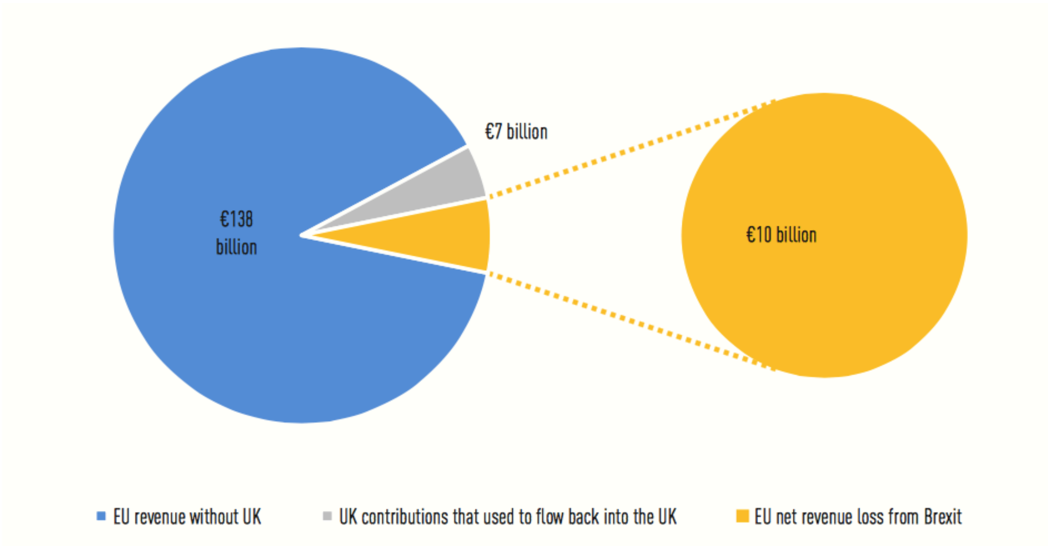


Figure 1- Brexit Gap- Calculations based on the European Commission data

The budget will have to adapt its revenue and expenditure side to this change and there are three possible scenarios. The first possible one regards an increase in contributions for the remaining 27 members.

This additional money which should cover the billion hole left by the UK could only come from an increase in the GNI and in the VAT based own resources. Figure 1 shows the effect of Brexit on the national contributions (GNI and VAT Resources). The countries most affected by this increase in contributions are those benefitting from the rebate.

The Netherlands contributions will rise by 16.5%, Germany instead is the country that will pay more in absolute terms, that is 3.5€ billion. On the other hand, member states not getting any rebate will have a lower increase around 5%-6%. From this data it is evident that the effort required by the remaining Member States is high then this scenario will be particularly difficult to apply. (Haas and Rubio, 2017)

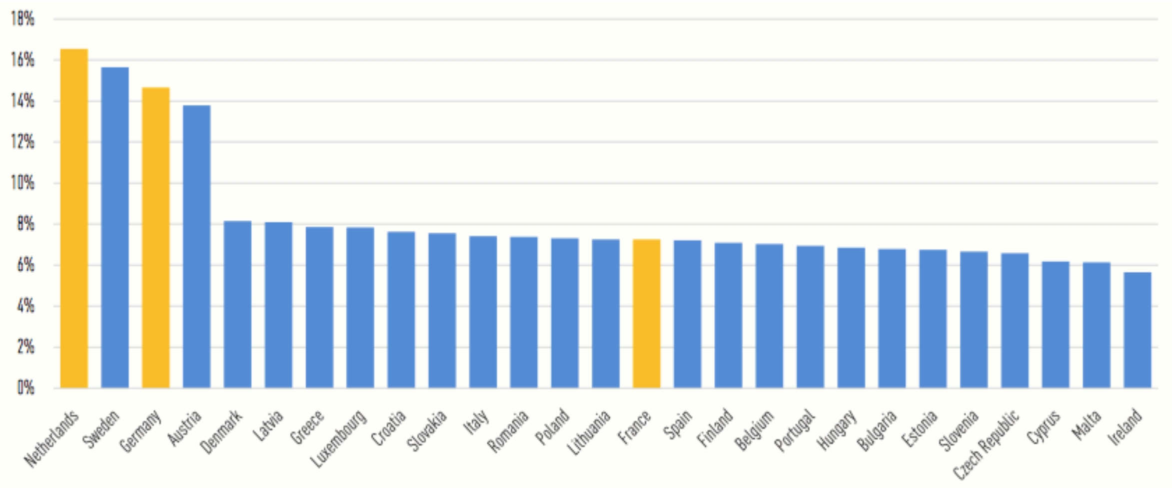


Figure 2: Increase in contributions compared to 2014-2015- Calculation based on European Commission data

However this is a short- term cost, in the long term the result could be different.

Brexit could mark the end of the correction mechanism, as the Report emphasizes *with the departure of the United Kingdom, the rebate that was introduced as a concession to that country in the past will become obsolete* (High Level Group, 2017). Moreover at the end of 2020 all the rebates are going to expire this represents an occasion to simplify the system and to review VAT based own resource and its capping.

Since the first scenario is not that easy to apply, the second scenario might be more feasible since it implies spending cuts of 10€ billion. 10billion represents a large cut *compared to what the EU spends on its most popular projects. This becomes especially clear when looking at those programs that are widely perceived as providing real added value at European level* (Haas and Rubio, 2017). 10 billion cut is equal to: the budget for "Global Europe" or the research endowment for "Horizon 2020" plus Funds for Asylum, Immigration and Integration or a 20% cut in the "Structural and cohesion fund". Accordingly the spending cut option would be the easier of the two to realize but as shown by the previous examples the impact on the projects financed by the European Budget would be difficult to take in.

The third scenario is a hybrid solution: a 5 billion cut plus an increase in national contributions. As shown in Figure 3 the distribution effect will be more equal. Unfortunately this scenario also presents a weakness since the distribution of the additional burden will be less equal than the first and the second scenario. The expiration of the “rebate on the rebate” in 2010 will lead to a redistribution of the financial burden between Member states, but the smaller the budget the larger the distribution will be in relative terms. As far we have seen the perfect scenario does not exist and at the moment the possibility that Member States and EU institutions will not find an agreement is high (Ibidem). The next MFF will certainly take place among 27 MSs and if they do not reach an agreement *the ceilings and other provisions in place for the final year of the expiring MFF shall be extended until such time as that act is adopted* as stated in Article 312.4 of the Treaty on the Functioning of the European Union. This means that until the time the parts involved do not reach an agreement the spending level of 2020 will be maintained.

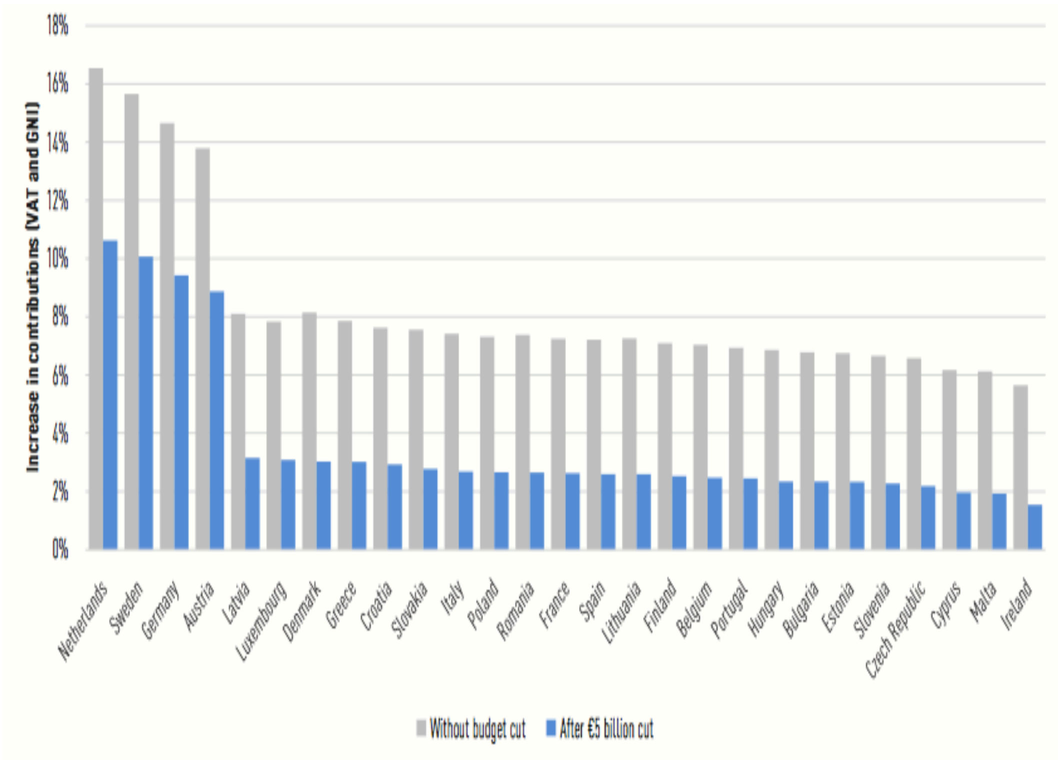


Figure 3: who will pay to cover half of the Brexit gap- Calculation based on European commission data

Conclusions

Jean Monnet, one of the founding fathers of the EU, once pronounced the famous statement: *Europe will be forged in crises, and will be the sum of the solutions adopted for those crises*. As underlined by Barber (2015), *the challenge for EU leaders is to prove him right*.

The economic crisis, the security and migration crisis have inflicted major damage on the European Union economy. The EU has encountered significant difficulties in addressing these new challenges and redirecting the European capacity of action over the last years, *which serves to underline how crucial financial resources have become in solving pressing issues internally and externally* (Monti, 2016). Accordingly a well-functioning European budget is essential.

This research attempts to analyze the possible paths to be taken to reform the budget. In order to properly analyze the different paths of reform, the work starts with the analysis of the current budget set up. As explained in Chapter 1 the budget has a limited size (€ 100 billion, or about 1% of Union GDP), it is essentially based on three revenue sources: traditional own resources (general tariffs, agricultural tariffs, sugar customs duties, agricultural tariffs), VAT and GNI based own resources. Since 1970 the traditional own resources have lost importance, financing of the common budget is increasingly dependent on direct contributions of Member States and especially on GNI based own resources. This strong dependence on Member States' contributions has made the budget a matter for political conflict. Reaching an agreement on the Multiannual Financial Framework is becoming difficult, particularly because Member States are focused on net returns from the EU budget. Member States are used to preserving those expenditure categories that maximize their specific interests; no one pushes towards an expenditure structure that could maximize the budget benefit for the whole European Union.

In Chapter 2 I detect two main possible paths that could eventually be followed to reform the EU budget: either reforming the system respecting the current legal framework or acting outside the treaty taking a major step towards a more federalist European Union. I conclude that a budget reform that goes towards a federalist direction is not feasible neither in the short nor long run. Under the federal umbrella the EU budget would change completely. There are different kinds of federations but there is always a core element: the ability of the federal government to collect its own revenues. The European system of own resources made no provisions for the autonomous collection of revenues. To achieve this the budget arrangements should change completely but for this to occur: MSs would have to accept some form of direct fiscal taxation and the unanimity principle that stands behind the approval of the budget would be transformed into a simple majority vote. In short, the European Union should transform itself from being a sophisticated International Organization to a federal nation state.
The federal path does not seem to be a feasible choice, but it gives us some guidelines (a larger budget with countercyclical functions, adoption of measures with high added value) to implement a budget reform within the current legal framework.

This path is embodied by Mario Monti High Level Group that worked to formulate a budget reform that could address the weaknesses of the EU revenue system. This report focuses on the elements that can be reformed under the current institutional framework, bearing in mind that fiscal competences remain at national level and within the overall budgetary constraints of the budget so that the reform of own resources proposal does not create an additional tax burden on EU citizens. The Monti Group singles out the need to strive for more "European added value", the budget should be more directed towards shared European interests rather than towards national interests.

Therefore the Monti Report has the merit to introduce genuine EU own resources that would be a return to the spirit of the Treaty (Article 311 TFEU). However it is precisely because the budget is so interconnected with state sovereignty that I believe that the debate about the budget reform must deal with questions regarding the future

EU and of its integration process. Only a major decision on the future of the European Union could settle the debate around the Union finances reform, unfortunately gathering together the necessary political will for a radical reform is hard to achieve. Therefore addressing the issues on own resources in a structured way -following the Monti Group recommendations- should be considered as a huge step forward towards a stronger European Union.

Appendix

Interview with Professor Leonardo Morlino – Rome, 05-09-2017

1. Secondo l'approccio federalista, gli stati membri dell'Unione dovrebbero gradualmente cedere la loro sovranità fiscale. Lei, da studioso empirico della scienza politica, pensa che la sovranità fiscale sia un elemento che possa essere trasferito, anche parzialmente, all'Unione Europea?

La sovranità fiscale è un elemento irrinunciabile per un dato strutturale che riguarda le democrazie. Non lo è in una fase pre-democratica da cui emergono, per esempio, le realtà federali come quella nord americana, brasiliana e canadese. Quando si ha una democrazia con i meccanismi delle *accountabilities* già sviluppati, quindi meccanismi elettorali già consolidati su un certo territorio e con un certo numero di elettori, non si può pensare che questi cedano la propria sovranità ad un' organizzazione internazionale come L'Unione Europea. Nella teoria democratica c'è un dibattito molto ampio e uno dei più autorevoli studiosi è stato Robert Dalh, il quale ha fatto diversi interventi su questo punto, sostenendo l'impossibilità delle organizzazioni internazionali di essere democratiche, in quanto le democrazie non possono formare altre democrazie più ampie.

L'ideale federale è sicuramente ultra nobile, ma si scontra con un dato oggettivo proprio del meccanismo democratico: nel meccanismo democratico l'elettore giudica l'eletto sulla base di quello che fa (durante il mandato), l'eletto certamente cerca di manipolare, di modificare le situazioni ma, nonostante ciò, il un rapporto tra eletto ed elettore rimane circoscritto ad un certo territorio. Un elemento fondamentale di questo rapporto è quello fiscale, basti pensare a quanto risalto si dà all'elemento fiscale durante le campagne elettorali italiane ed all'importanza che si dà al tema tasse.

Quindi io, essendo uno studioso empirico, non vedo possibile condurre l'Unione Europea verso un'unione fiscale, in quanto strutturalmente l'Unione non può andare in questa direzione.

2. Recentemente l'High Level Group diretto da Mario Monti ha pubblicato un Report dal Titolo *Future financing of the EU.* Come si posiziona lei rispetto alla proposte avanzate del Gruppo? Si trova concorde?

È una posizione ragionevole che tenta di fare dei piccoli passi avanti, quindi certamente è un tipo di proposta che mi trova simpatetico. Proprio perché, strutturalmente alla sovranità fiscale nessun governante di una democrazia consolidata all'interno dell'Unione Europea può rinunciare. E questo elemento sembra essere stato capito da Monti e dagli altri membri del Gruppo.

3. In Europa ci sono due nuove crisi d'affrontare: la crisi migratoria e quella della sicurezza che dovrebbero essere affrontate in modo comunitario. A questo riguardo il *Monti Group* ha una posizione molto netta: l'Europa deve intervenire unita per contrastare in modo efficace ed efficiente le due crisi. Secondo Lei rispetto a queste due crisi che coinvolgono tutti i paesi UE, come si dovrebbe intervenire? Il budget non potrebbe avere un ruolo?

Innanzitutto dobbiamo nettamente distinguere le due crisi. Sono due crisi con andamento ed interessi diversi.
La crisi di sicurezza ha dei tratti paradossali: da una parte c'è un potenziale di coinvolgimento di tutti i paesi nella risoluzione della crisi poiché tutti sono ne toccati, specialmente i paesi leader dell'Unione Europea. Da questo punto di vista si potrebbe pensare che possa essere interesse di tutti una maggiore cooperazione. Al tempo stesso i temi della sicurezza sono i temi rispetto a cui una burocrazia è molto sospettosa ed è molto attenta a divulgare informazioni a terzi. C'è quindi un elemento contradditorio in interno: ci sono alcuni aspetti oggettivi che spingono verso un'unione molto forte soprattutto delle grandi democrazie europee (che sono state fortemente colpite) e l'altro aspetto è lo scambio di info delicate e sensibili. Su questo c'è un cauto ottimismo, penso che qualcosa si possa fare e che delle risorse comuni (che potranno venire dal budget o da altri sistemi di finanziamento) possano aiutare la coesione degli stati su questo tema.

Discorso diverso riguarda la crisi di migrazione. L'aspetto fondamentale è la modifica del Trattato di Dublino (in questo senso l'apertura della Merkel è stata molto importante). Se gli stati non decidono di cambiarlo nulla potrà veramente cambiare.
Al momento, la crisi migratoria è una crisi che deve essere affrontata, gestita e contenuta dai paesi che ne sono più colpiti, soprattutto l'Italia, la Grecia e in buona parte Portogallo e Spagna. Questa crisi non ha le caratteristiche della crisi precedente che investe tutti i paesi, ma ne investe solo alcuni, quelli della sponda Sud, i paesi leader dell'Unione non ne sono colpiti direttamente.
Ritornano quindi tutti gli elementi oggettivi dell'assenza di un'unione federale, che coinvolga tutti gli ambiti della vita di uno stato.
In questa crisi i paesi dell'Unione stanno difendendo i propri interessi nazionali, in questo senso è da lodare l'operato del Ministro Minniti, che sta finalmente facendo gli interessi dell'Italia.

4. Nell'attuale assetto dell'Unione Europea vediamo che il Parlamento sostanzialmente è escluso dalle decisioni che riguardano l'ambito economico e fiscale. Lei pensa che in futuro si potrà fare qualche passo in avanti nel ruolo del Parlamento? O la gestione interstatale prevarrà? È da notare che anche il Report Finale del *Monti Group* propone una revisione del ruolo del Parlamento Europeo nel sistema decisionale riguardante il budget

Fondamentalmente rimarrà una questione interstatale per gli argomenti detti prima[49].
Non ci dimentichiamo anche che il Parlamento è uno spazio in cui le lobby sono molto presenti. Per fare il ragionamento che stiamo facendo circa la sovranità fiscale e il ruolo che questa ha nelle democrazie europee non possiamo non prendere in considerazione il ruolo dei gruppi d'interesse. Questo è un altro aspetto rilevante che blocca il processo di trasferimento della sovranità fiscale all'Unione Europea. L'aspetto fiscale è un aspetto verso cui tutte le industrie sono estremamente sensibili. E mi riferisco con questo a legittime azioni di lobbying non certamente all'elusione fiscale perpetrata da gruppi multinazionali.

[49] Il Professore Morlino fa riferimento agli argomenti esposti rispondendo alla prima domanda.

Da un punto di vista empirico sappiamo che le aziende contano e che fanno lobbying a tutti i livelli. Non sappiamo, però, quantificare l'efficacia dell'azione delle lobbying, questo è sicuramente un limite della ricerca empirica. Limite non facilmente superabile. Certamente, è da considerare che Bruxelles è la città, dopo Washington, con più agenzie di lobbying registrate nei registri dell'Unione Europea.

5. La proposta dell' High Level Group di Monti punta molto ad un budget che possa finanziare programmi dove il valore aggiunto dell'azione Europea sia palese. Pensa che questo possa aumentare l'accountabilility del budget ed in generale dell'Europa ?

Sicuramente il gap cittadino/Unione non si colma. Allo stesso tempo le proposte di Monti (che poi sono proposte moderate) devono essere viste positivamente.
Ci sono delle *costraing conditions* che rendono impossibile lo sviluppo di una federazione europea. Quale sia il limite non lo sappiamo, noi non conosciamo il limite finché non lo tocchiamo. Quindi in questo senso quello che ha fatto Monti, cioè fare proposte concrete e ragionevoli che possano spingere questo limite, ha senso e deve essere visto in chiave positiva.
Concludendo, dobbiamo aggiungere alcune riflessioni sul tema della sovranità. In Europa abbiamo alcuni paesi che sono sovrani, altri lo sono debolmente, altri non lo sono proprio. In Europa Germania e la Francia hanno sovranità, non ce l'ha l'Italia e neanche la Grecia. Per questo, qualsiasi riforma riguardante temi economici e fiscali dovrà ottenere lo sta bene delle Germania (la Francia è storicamente più aperta all'Unione fiscale) ed al momento non vedo nessuna disponibilità della Merkel in questo senso. Ricordiamoci che la Merkel sta vivendo un momento politico interno molto delicato e parlare di "più Europa" non le porterebbe alcun beneficio politico.

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Abstract

The debate over the EU revenue system and in particular over the nature of the financing resources of the budget has been harsh and controversial. It involved questions on the nature of the European Union budget, its size and resources that finance it (or could finance it in the future). The debate cannot ignore the condition of the Union integration, its history and its evolution and the actual availability and will of Member States to advance on the road of integration. Member States are the main actors and therefore have the fundamental responsibility of every possible evolution.

In this historical moment the European Union is in turmoil. New challenges have emerged such as the refugee crisis, security and terrorism crisis. At the same time Eurosceptic and nationalist movements have gained or regained strength in many countries while the EU decision-making actors struggle to define a new vision of the European integration process. The present situation does not necessarily have to be a limit for the future of Europe. It can be an opportunity to fathom what future we want for the whole Union.

The aim of this work is to explore and discuss what kind of role the Union budget could have in this evolving scenario. More specifically, the research questions that this work must address are: how can the budget collaborate in the resolution of the EU problems and challenges? Which would be the right path to take in order to achieve this?

In order to give a satisfying answer to these questions, the budget analysis requires a comprehensive evaluation that will focus on its design and both on the political and economic consequences that its reform would trigger. The work is divided into three chapters: in the first one I try to make explicit the fundamental characteristics and evolution of the budget and its "own resources system", outlining the motives that determine its peculiarity and its defects. I also try to emphasize the reasons why it is

crucial for the European Union to initiate a reform. In the second chapter, I investigate if it is feasible for the Union to follow a new path thus modifying the current structure of the Union budget: its size and composition or, in other words, whether a new and different division of competences and governmental functions between Member States and the European Union is acceptable. In this chapter I try to look at the federal proposal combining an economic analysis with a political one, attempting to demonstrate that the optimal economic approach unless supported by political will, will not have a positive outcome. In the third and last chapter I analyze the second viable reforming stream: acting inside the Treaties. Hence I analyze the most recent proposal put forward by the High Level Group on Own Resources, published in December 2016. I try to explain why such a proposal could represent a desirable compromise from the economic and political point of view and I see how this report could contribute to the negotiation process of the Multiannual Financial Framework (MFF) post 2020. The work carried out by the High Level Group on Own Resources chaired by Mario Monti went beyond the ordinary technical analysis of the various sources of revenue since it took into account the procedural and legal implications as well as political and institutional interdependencies. The Report meets the challenge to integrate different needs: the economic one giving a strong budgetary efficiency and the political one giving more accountability to the system without forcing any steps towards federalism.

Chapter 1: The EU Budget Revenue system

The purpose of this chapter is to illustrate the fundamental characteristics of the European budget system and show both, its strengthens and weakness.

The European budget for the most part (98%) is funded by "own resources*",* that are the EU revenue, that allows the Union to *pursue its objectives by appropriate means commensurate with the competences which are conferred upon it in the Treaties* (Article 3(6) of the Treaty on European Union). There are three kinds of own resources, differently distributed: traditional own resources (custom duties and sugar levies), VAT based own resource and GNI based own resource.

The evolution of the EU Budget financing follows a precise historical path, in the first paragraph of chapter 1, I analyze the most significant step of its development. At the very beginning (period that goes from the 1952 to 1969) the European Coal and Steel Community (ECSC) was autonomous from a financial point of view. The High Authority (today the Commission) was able to carry out its activities by imposing levies on coal and steel. Such "levies", established by the High Authority, were nothing more than taxes paid by producers. Initially, Member States' contributions had to finance the European Economic Community Budget (Art 200 ECC). At a later stage, direct Member States contributions will be replaced by the own resources system (Art 201 ECC).

At a later stage (1970-1984) the first Own Resources Decision (ORD) was implemented: Member States decided that Member States agreed that *the budget of the Communities shall, [...] be financed entirely from the Communities' own resources.* As a result: Common Customs Tariff and Tariff on Sugar (Traditional Own Resources- TOR) were collected by Member States and gradually transferred to the common Budget. Later, in 1980, VAT based payments were introduced: 1% of the VAT revenues were transferred to the Community Budget, this new revenue turned out to become the main source of financing for the whole budget. Another significant step towards the current own resources system is undertaken in the period that goes from 1985-1987. The United Kingdom, under the leadership of Prime Minister Margaret Thatcher, was the first country to negotiate a partial repayment of UK-funded funds to the European Community, the so-called "British Rebate". Following the creation of the "UK rebate", other Member States claimed that their EU financial burden was excessive, thus demanding reductions in their contributions, including UK repayment funding. This has led to a complex permanent and temporary *ad hoc* correction system. Correction mechanisms have attracted a series of criticisms, not least that they make EU finances more complex, less transparent, less equitable and difficult to reform. Other two important novelties introduced in 1988 are the Multiannual Financial Framework (MFF) and the GNP based own resources. The

MFF is a seven years framework that regulates the European Union annual budget setting the ceiling for each category of budget spending. The GNP based resource (in 2000 the GNP resource will be replaced by the GNI resource) is essentially linked to the concept of contribution capacity of MSs and the need to cope with the increase of the Community budget expenditures. After these two major changes the EU revenue system did not change much.

After the historical overview I try to investigate why the EU budget cannot be compared with a regular federal or national budgets. First of all, that of the Union is not a classic national budget given its size, characteristics and composition, and most important fiscal public finances remains primary responsibility of Member States.

The small size of the EU budget, equal to about 1% of EU GNP, dramatically affects its effects and potentials. The other national budgets of the main Western countries are typically above 40% of GNP. The EU budget is therefore far from other size-scale budgets, having neither the quantitative relevance nor the economic impact of national or federal budgets. Furthermore the Community budget is characterized by extremely limited maneuverability and strong rigidity caused by: the principle of equilibrium (total expenditure has to be equal to total revenue of the budget, implying that the EU cannot have any kind of deficit), by the fact that the EU spending has to be predictable (the MMF provides a framework for the financial programming and defines the discipline that has to be observed within the seven years) and by the capability of the budget management. Almost 90% of the budget resources are managed at the national level. Basically, national administrations manage both local and European resources. Such a construction, albeit singular, reflects both the complementary nature of the EU budget and the conceptual basis of the principle of subsidiarity.

Many academic analyses agree on the fact that only TOR (representing 13% of "own resources") can be defined, as real own resources since TOR are the only duties that are levied as tax devolved directly to the EU Budget. Traditional own resources (TOR) consist mainly *of customs duties on imports from outside the EU and sugar levies* (Commission, 2017). The major amount of resources (about 87% of own resources) comes from VAT and GNI based resources. These two resources are not collected but are at the disposal of the EU Budget, that is to say that the VAT and GNI based contributions are transfers from MSs, at the opposite TOR goes directly to the budget. The Own resources composition is deeply affected by the correction mechanism. The principle of correction was envisaged in the form of a reduction in budgetary contributions, but the Council pointed out the temporary nature of this exception and the need to act in the future through expenditure, it is evident that the temporary nature of this rebate was not taken into consideration by the UK and by thy other countries that benefit from the rebate. The legitimacy of the correction mechanism legitimized the principle of the *juste return,* that is to say that the budget is seen as sum- zero logic where some states win at the expenses of some other Members. Despite all the weaknesses, this analysis demonstrated that the own resources system works: money flows regularly to the budget, the whole expenditures are financed and the equilibrium between revenues and expenditures is always maintained. If on the one hand Member states are not willing to change the *status quo,* on the other hand many criticisms towards the present system come from the European Parliament, the Commission and the Court of Auditors. The reason for change has been provided by the MFF 2014-2020 that states four main criteria: simplicity, transparency, equity and democratic accountability.

Chapter 2: The EU Budget and the federalist integration

The academic literature finds two main possible paths that could eventually be followed either reforming the system respecting the current legal framework or acting outside the treaty (a treaty reform would be needed) to give a federal budget to the European Union.

It seemed reasonable to investigate if there are any new ways to modify the current structure of the Union budget: its size and composition or, in other words, whether a new and different division of competences and governmental functions between Member States and the European Union is justified, which would see an increase in the role of the latter in a more federal direction.

In this chapter I analyze the federalist proposal and I will see if there is any relations between the European stage of integration and the federal approach.

In the first part of the chapter I analyze the federal proposal from an economic point of view, in the second part I will look at the federal approach from a political science point of view, attempting to demonstrate that the optimal economical approach unless supported by political will, will not have a positive outcome.

The theory of fiscal federalism presents elements of extreme interest. Generally speaking, the starting point is the division of government functions carried out by Musgrave in 1959 and subsequently by Oates in 1972. The theory states that the central government should have the primary responsibility for macroeconomic stabilization and income distribution. In addition to these functions, the central government should provide national public or collective goods serving the entire population of the country.

Regional levels of government have their say in providing public goods and services whose production and consumption are limited to their jurisdictions. The main reason for decentralization and division of responsibilities between different levels of government is essentially linked to the divergence of territorial preferences within a federation. In addition, the decentralization lowers administrative and planning costs and most importantly, more efficient political measures can take place, as citizens are able to influence those who govern. The question arises whether the fiscal federalism theory as it stands is applicable to the European Union and whether it can adapt to the current level of integration. There are a few caveats which need mentioning. It should first be said that the theory of fiscal federalism has always referred to federal contexts with strong, established central governments. The Union has a few of the characteristics of a federation: first of all a common currency in most of the member states, and a sufficiently high level of national economic integration, as well as a few policies administered collectively at EU level. But the following question remains: is the European Union is comparable to a confederation or is it quite simply an economic union? In a way, fiscal federalism has also overlooked political economy, namely the division of competencies between the various levels of government: that is, the functioning of the institutions, the institutional and political mechanisms of the formation of public choices, the electoral systems. In particular, the collective choices are influenced by interest groups, which can sway decisions according to their preferences. Even if centralisation is justified from an economical theory point of view, it does not necessarily mean that this is the path to take. At a national level there may be fears that this centralisation at a federal level (in this case that is the move of decision-making power from a member state government to that of Brussels) could reduce the well-being of the country and its citizens and more important such a shift might go against their interests.

From a mere political point of view the European Union is far from achieving any kind of federal union. Almost 60 years after Shuman's famous speech in which he illustrates the *European federation* as the ultimate step of the Union integration process, we can say that the process of integration is far from reaching this goal, for economic, political and institutional reasons.

Compared with the existing international organizations the European Union has large competences but less if compared with a mature federal state. As we have seen the EU functions are limited to the trade of goods and services, movement of factors of production, production and trade in agriculture, monetary policies, moreover the Union is in charge of those policies concerning environment, competition, consumer and workplace policies. On the one hand it is remarkable the wide range of activities that the union has to carry out but on the other hand significant the lack of policies and powers to mark the EU as a Federation of states. First of all, the European Union is not involved in provisions regarding social welfare. National states provide citizens with medical care, unemployment insurances, and pensions. Concerning this topic, the EU is only allowed to intervene when there are trans-border issues like the right of European citizens to get their pensions and invest them abroad. Most importantly the EU, as a whole, lacks in military defense and foreign policy. These features are the oldest and most fundamental features of modern states and in fact this feature largely remains in Member States' hands. Only in recent years significant steps have been made in this area: the Lisbon Treaty introduced some significant changes, such as the creation of the High Representative of the Union for Foreign Affairs and Security Policy as a permanent figure and the European External Action Service became a diplomatic and administrative apparatus that manages common foreign policy. Despite these changes, however, the CFSP continues to function essentially according to the intergovernmental approach, so the European Commission and the European Parliament have very limited powers in this area.

Another aspect that distances Europe from other federations is the lack of a significant education and cultural policy. The EU has no jurisdiction over Member States education systems. Regarding the school system and its main components: quality of education, financing of the system itself, the status of private schools. This aspect is important to emphasize because it is at school that a population is formed, and having students who feel part of a larger community would help increase support for the European Union.

Another crucial aspect that distances the EU unique system from any other federal system is its democratic deficit. The roots of the democratic deficit lie in a lack of balance between the European institutions and in the methods of integration pursued for over half a century, which entrusts the monopoly of the legislative initiative to an executive body, without democratic legitimacy; this system has produced, a unicum in the history of modern democracies where there is a monetary unity without political union; there is a lack of transparency of decision-making processes.

In the conclusion of this chapter, I include the interview with Professor Leonardo Morlino. Professor Morlino clarifies that he does not see any empirical evidence that could bring the European Union towards becoming a federal union; too many are the *constraining conditions* within the European institutional and political structure. The first obstacle that Morlino finds regards the nature of the EU itself. The EU is an International Organization made up of sovereign states accordingly consolidated democracies cannot form larger democracies, since the movement to build the democracy itself has to come from the bottom and this is not the case of the European Union. Professor Morlino, in order to stress the difference between the European Union and other Federal Unions, pays close attention to two new challenges that the Union is facing: migration and security. In this field it is possible to see the real nature of the EU: that is an international organization governed by the intergovernmental method where stronger nation states prevail over the others. This is evident in the migration crisis where all the objective elements of an absence of unification emerge. There is no unanimous will to modify the Dublin Regulation or to concretely help those Southern countries that suffer more because of the migration crisis. On the other hand the security crisis differs from the previous one for one main reason all Member states are hit so there is a wide interest in addressing the issue, but more importantly the most powerful countries are deeply touched by terrorism (France, Germany, the UK).

Regarding the Fiscal Union Professor Morlino is very clear, he does not see the conditions for a broad fiscal union and neither for a more pervasive role of the European Parliament in this field. For two main reasons: the voter judges the elected politicians work, there is a direct mechanism of check and balance and in issues like Fiscal or Financial sector this bound is even stronger. The EU lacks of this kind of tie.

Morlino beyond the classical constraints towards a fiscal union and towards a stronger budget sees another obstacle: the group of interest action that represents a brake on too much "Europeanization" of fiscal matters, this is true for environmental, energy telecommunication and many others. Professor Morlino closing comments highlighted that the political science empirical research is not able to indicate neither the present limit of the European integration nor the future limit, but any attempt to push it further is seen positively. In this sense the Mario Monti High Level Group final Report, that is going to be analyzed in the following chapter, is seen positively as it can bridge the gap between citizens and the action of Europe to illustrate the benefits that these actions can bring.

Chapter 3: A Feasible proposal to boost the EU financing system

Commencing from the belief that the current system of own resources is far from achieving its goal in the *spirit of the Treaty* (Monti, 2016) and it presents some flaws that must be reviewed such as: its complexity and transparency, the genuineness of own resources (as already said 83% of the revenues come directly from Member

States budget), the logic of the "just return" and the decision-making process of the budget approval. If no reform would take place there is a high risk that the EU budget is destined to become more and more irrelevant.

As we have seen in the previous chapter, for convinced federalists the budget should turn into a real federal budget, with the Union able to levy taxes and the decision making process should follow the community method rather that the intergovernmental one, but such prospective is the very reason why the most part of Member States would fight against autonomous budget. Accordingly the European Union is not ready for such a step, this is why if the system wants to improve we need meaningful measures that can receive broad support from Member States, and this is why a reform of the own resources must respect the current legal framework of the European Union.

In this chapter I analyze the most recent proposal put forward by the High Level Group on Own Resources, published in December 2016, I try to explain why such a proposal could represent a desirable compromise from the economic and political point of view and I see how this report could contribute to the negotiations process of post 2020. Furthermore I analyze the reflection Paper on "The Future of the EU Financing", in order to show that there is a vivid interest in embarking on a new path of reform and that the Monti Group proposals have defined the right route.

The High Level Group chaired by Prime Minister Monti has been set up to analyze how to make the EU budget revenue simple, transparent, fair and democratically responsible. The will to call together a Group of specialists on own resources comes from the European Parliament impulse to review the whole system. During the MFF negotiations of 2014-2020, the Commission and the EP put forward two proposals to review the budget, but they were not successful, the status quo remained unchanged.

The former Italian Prime Minister has highlighted in different occasions that the final report is not an academic one, meaning that the proposals put forward are not original, the Group instead designed a number of ways to make a package of measures, aimed to review the system of Own Resources. Their proposals meet the challenge to integrate different needs: the economic one giving a strong budgetary efficiency and the political one giving more accountability to the system without forcing any steps towards federalism.

Monti's Group launches a comprehensive reform with a focus on both the spending and revenues sides of the budget. The cornerstone of the Report is the continuous attempt to stop thinking in terms of *net balance categories* (Monti, 2017) thus it tries to overcome the "just return logic". The Group clarifies why the budget must be considered as an "investment budget" rather than a zero sum game where some Member States win and others lose. Then States contributions to the budget should be considered as a broad investment in public goods that will create positive externalities all over Europe. The Report emphasizes that the heart of any budget reform must be the principle of the European added value. This principle is key to understanding the High Level Group proposal. The Report defines the European added value as: *the value resulting from an EU intervention which is additional to the value that would have been otherwise created by Member State action alone, can guide future budgetary decisions on the expenditure side* (High Level Group report, 2016). These two statements suggest that the EU spending added value should have three main features: the EU budget is expected to pool national resources at the EU level creating transnational positive externalities. The budget spending should be directed towards those investments that offer the best added- value. The budget should adopt a realistic approach, in order that its spending always meets the goals.

Contritely speaking, the Group, among the nine measures proposed to reform the system, makes four important. In order to base the system on a more "genuine" own resources two criteria must be fulfilled: strong bond between new resources and the European competences (Environment, Single market). New own resources must go directly to the European budget; no Member States filters should be needed. Net budgetary balances can no longer be considered as a reliable metric to measure how much a Member State can contribute to the budget. A new indicator must be put into place in order to measure MSs losses and gains related to EU policies implemented by the budget resources. Abolish the correction mechanisms. This is crucial in order to simplify the revenue system. Create some "differentiated integration projects not directly financed by the EU budget but from a special revenue fund, i.e Euro countries increasing cooperation, enhancing defense cooperation.

In June 2017 the Commission published a Reflection Paper on "The Future of the EU Financing", where it indicates the paths to follow in order to change the financing of the EU. Moreover the Reflection Paper gives a realistic analysis of the financial implications of the five scenarios forecasted by the Commission in the White Paper on the "Future of Europe" (2017).
It is interesting to note that the Commission draws on key principles set up by Monti's Report, principles such as the EU added value that becomes the driver for any further discussion about the EU financing system, efficiency and transparency of the European spending, modernization of spending programs, increased action on transversal problems: migration, defense, physical terrorism and cyber terrorism, border controls and continued steps to halt global warming (Environmental based own resources could be an important step), and as stated by the Report the budget as it is now cannot support a reform path. The EU added value seemed to be the core element for any European action, if this is the direction that the MFF takes for the post 2020, it is mandatory to find specific criteria able to measure the effective added value.

In conclusion the path of reform embodied by Mario Monti High Level Group could efficiently address the weaknesses of the EU revenue system. The Monti Report has the merit to introduce genuine EU own resources that would be a return to the spirit of the Treaty (Article 311 TFEU). However it is precisely because the budget is so interconnected with state sovereignty that I believe that the debate about the budget reform must deal with questions regarding the future EU and of its integration process. Only a major decision on the future of the European Union could settle the debate around the Union finances reform, unfortunately gathering together the necessary political will for a radical reform is hard to achieve. Therefore addressing the issues on own resources in a structured way- following the Monti Group recommendations- should be considered as a huge step forward towards a stronger

European Union.