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An EU Tax? – Not a Good Idea

The idea that the EU should be given the right to raise its own taxes is not new at all. In particular, representatives of the European Parliament and the European Commission have repeatedly brought up such suggestions, and some economists have supported them as well at least for an EU in the final stage of a political union. However, two years ago it was explicitly stated in the Agenda 2000 that for the foreseeable future there was no need for such a tax and that the member states did not seem to be prepared to grant more tax competence to the European level. Taking this into account, it seems rather surprising that the debate on an EU tax has come up again now. The suspicion grows that this might have something to do with the growing concerns about EU eastern enlargement and, in particular, with the fiscal burdens expected in this context.

From public choice theory it is known that politicians, and bureaucrats as well, have an immanent tendency to increase budget revenues in order to finance additional expenditures. However, the present proponents of the EU tax idea have explicitly affirmed that this was not their intention and that the limit of 1.27 per cent of EU GDP should not be questioned until 2006. Instead, other arguments are raised. In particular, it is said that an EU tax would provide a higher transparency of EU financing for the taxpayer as he/she would then know what he/she was paying for the Community. In addition, it is argued that more efficient budget decisions at the EU level could be achieved if the European Parliament and/or the European Council had to vote not only on expenditures but also, and simultaneously, on revenues as well. In this perspective, an EU tax is regarded as a possible contribution to more transparency and rationality in European budget affairs. Furthermore, some proponents – like EU Commissioner Michaele Schreyer – believe that an EU tax might provide a solution for the ongoing debate on "net contributors to" and "net receivers from" the EU budget. Finally, it is argued in a more general sense that a European Community with an expanding scope of responsibilities and functions would need a tax competence independent of the national member states.

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More Transparency via an EU Tax?

Of course, the present system of EU financing is fairly complicated and certainly not transparent for European citizens. At best, the "man in the street" may have a vague idea of how much his country is contributing as a "net payer" to the EU budget. But probably he has neither a correct perception of the real size of the EU budget nor has he ever heard of the four types of "own resources" of the EU. Moreover, he would be unable to understand why the two most important of these alleged "own resources" – i.e. the value added tax component and the GDP component – are in fact only fiscal contributions by the member states' central governments. Hence, there is no doubt that more information could create a better understanding of European fiscal problems and maybe help to reduce the often quoted Euro-scepticism among the public.

However, to achieve this it is not necessary to transfer to the EU the right to raise its own taxes. Firstly, the indisputable deficits of transparency with respect to EU expenditure decisions in general, and EU agricultural and structural policies in particular, could and should be reduced by a reform of the EU policy-making process and by reforms of the respective policy fields; the revenue side has little to do with these problems. Secondly, the confusing and intransparent system of four different revenue sources could be simplified by reducing the number of revenue sources without introducing an EU tax. For example, it is imaginable that the EU should simply receive – apart from import duties – GDP-oriented contributions from the member states; this would render superfluous the complicated calculation of the VAT-based "own resources". Thirdly, it would be easy to make the taxpayer feel the true burden from the EU budget within the present system of contributions. It would only be necessary to convert a country's contribution to a surcharge on a national tax (to be chosen by the national government) and to declare the respective percentage openly to the taxpayer. In principle, any tax could be considered but probably the VAT (or the national income tax) would be the most appropriate one. To sum up, there is certainly a need for more transparency concerning the EU budget, but the question of an EU tax is an entirely different one.

More Efficiency in Budget Decisions?

The introduction of a widened EU competence in the field of taxation is also justified by the efficiency argument quoted above that those institutions which decide on expenditures should simultaneously vote on revenues as well. The theoretical basis of this argument is the principle of "fiscal equivalence" familiar from the theory of fiscal federalism. It demands that those who benefit from a public good and those who decide on the amount and the financing of this good should be identical. The present contribution system of the EU is regarded as being in contradiction to this principle because the decisions of the European Parliament and the European Council on expenditures are separated from the fundamental decisions concerning EU revenue limits. As a consequence, an incentive for an inefficient expansion of the budget is created as politicians calculate the political benefits of expenditure programmes but not the political costs of the tax burden resulting from these programmes. Tax competence for the EU could help to reduce such inefficiencies.[1]

Now it is certainly true that many examples can be found of inefficiencies in the field of EU expenditures. This applies particularly to the CAP and the structural funds. But it is highly doubtful that an EU tax would be a factor enhancing budget discipline. Firstly, when looking at political reality, there is little reason to think that the European Parliament would behave in a more disciplined way if it had the power to tax. Secondly, there is no effective democratic control of the European Parliament in the present political system; in fact, European voters have practically no means of sanctioning EU policy-makers for "bad" budget decisions. It is highly questionable whether the tax decisions by such a parliament could be accepted as being really democratic. Thirdly, according to the supporters of a "competitive federalism", a central tax competence for the EU would suspend the disciplining effects attributed to tax competition and create a "taxation cartel" instead. This argument would apply even more if the public sector in general, and the EU in particular, is regarded from a "Leviathan" point of view.

The "Net Positions" Debate

The hope expressed by Ms. Schreyer that an EU tax could put an end to the debate on the "net positions" of EU member countries does not seem very convincing. In the present EU budget, the redistributing effects between the member states result mainly from the structure of expenditures and not from the composition of revenues. Hence, a restructuring of the revenue side would not change the underlying causes of the positions of "net contributors" or "net receivers". For instance, the contributions of German taxpayers to Brussels could continue to be confronted with the flows from the EU budget to German recipients.

With an EU tax, the transparency of redistribution would probably be reduced. But this should not be seen as an advantage compared to the existing system.[2] Intransparent redistribution tends to increase the risks of moral hazard and possible inefficiencies resulting from this behaviour. In addition, less clearness on the redistributing effects of the budget could be regarded as a contradiction to the declared intention of EU policy-makers to create a transparent and citizen-oriented Community. Instead, the only effective way to finish off the "net positions" debate is a fundamental reorientation of EU budget expenditures. In sum, this would mean reducing the weight of the CAP and the structural policies (or even "renationalising" these policies) and concentrating instead on the provision of EU-wide public goods.

New Responsibilities for the EU?

Leaving aside such public choice arguments for a moment, the justification of an EU tax also seems highly doubtful from a welfare-maximising viewpoint. On the basis of the theory of fiscal federalism, there are mainly three possible arguments for transferring a tax competence to the central level, i.e. in the European case, to the EU.[3]

Firstly, the equivalence argument already mentioned suggests a European tax in order to finance EU-wide public goods. However, the present activities of the Community cannot be characterised as the provision of public goods but rather as (at least in their majority) a system of redistribution between member states; moreover, even if the Community were to provide public goods to a greater extent in the future, the postulate of fiscal equivalence could equally be fulfilled by a system of fiscal contributions.

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[1] Cf. D. Biehl: Die Reform der EG-Finanzverfassung aus der Sicht einer ökonomischen Theorie des Föderalismus, in: M.E. Streit (ed.): Wirtschaftspolitik zwischen ökonomischer und politischer Realität, Wiesbaden 1988, pp. 63-83.

[2] Cf. F. Heinemann: Europäische Finanzverfassung: Zwischen Umverteilung und Effizienz, in: R. Ohr, Th. Theurl (eds.): Kompendium Europäische Wirtschaftspolitik,, Munich 2001, pp. 231-232.

[3] For details, cf. P.B. Spahn: The Community Budget for an Economic and Monetary Union, Houndsmill et al. 1993; and R. Caesar: Zur Reform des Einnahmesystems der Europäischen Union, in: W. Zohlnhöfer (ed.): Europa auf dem Wege zur politischen Union?, Berlin 1996, pp. 145- 173.

A second approach starts from the instrumental character of taxes to achieve economic goals. An EU tax might thus be advocated if the EU were given explicit responsibility either for new allocative purposes, or the task of personal distribution, or for fiscal stabilisation. However, these arguments apply to the EU in its present state at best to a very limited extent. The Community performs considerable interregional redistributing activities, but it has no functions for personal redistribution; whereas a policy of personal redistribution might well suggest the use of taxes (mainly personal income tax), there is no economic reason why transfers between countries, or regions, should be financed by a general tax and not by intergovernmental fiscal contributions. With respect to stabilisation policy, opinions are quite ambiguous as to whether the EU ought to perform an explicit function in this policy field. Finally, the "instrumental approach" might make sense with regard to some allocative functions, such as environmental policy. In fact, the Community is already active in this area; however, if an EU environmental tax were justified for environmental reasons, then it could not at the same time be a solid basis for the financing of the Community.

Finally, a third argument refers to the case of a differing interregional distribution of the tax base, which suggests transferring such a tax to the central government level. This argument is particularly valid for import duties which, according to fiscal federalism theory, should flow to the central budget. However, this already happens in the EU. Thus it cannot provide an additional argument for an EU tax.

Altogether, welfare theory does not provide convincing arguments in favour of an extended tax competence for the European Community. Rather, it suggests that the existing mixed system which combines EU revenue competence for import duties with contributions from member states, is quite appropriate for the EU in its present state of political integration.

The Political Economy Aspect

This position can be supported when taking into account the dimension of political economy. To give the EU its own power to tax would entail a considerable softening of the budget constraint. Contrary to that, the financing of the EU budget by fiscal contributions reduces the financial scope of EU political actors. From the viewpoint of the "Leviathan theory", this means that a contribution system is better suited to restrict the Leviathan and to prevent him from exploiting the taxpayer. In the words of Brennan and Buchanan,[4] the allotment of tax competence to the European level in combination with an extended system of fiscal transfers from the European to the national level would have to be interpreted as some sort of an "institutionalised tax cartel". Keeping the existing tax pluralism within the EU is the best way to constrain the national Leviathan governments via tax competition and to adapt national tax systems to the differing preferences of taxpayers, and thus to realise the principle of "fiscal equivalence".

Altogether, there is no need for an EU tax. From a welfare point of view as well as from a political economy point of view the further financing of the Community by member states' contributions is much preferable to an extended EU tax power. Even the first step in this direction would be risky as it would set the stage for new desires by both the European Parliament and the European Commission. There is no doubt that EU eastern enlargement is a perfect opportunity for such increasing demands because an enlargement will unavoidably involve serious conflicts not only between the old and the new EU members but among the present EU countries as well. In such situations of conflict politicians at both the European and the national level will probably be inclined to follow the politically easier path of increasing taxes instead of cutting expenditures. And it might even be a temptation for national politicians to blame Brussels for the tax increases – in fact a very comfortable excuse.

As a matter of course, the proponents of an EU tax swear that such a tax would not increase the total tax burden. This would require that national taxes be reduced by the amount of the additional EU tax revenues. However, looking at historical experience, this is not particularly realistic. It can, rather, be expected that national politicians would use the tax relief (at least partly) either for a reduction of national fiscal deficits or for additional expenditures. Moreover, in a federal state like Germany it is difficult to imagine that the Federal and Länder governments would agree to resign part of their tax legislation power (e.g. on VAT) in favour of the EU. And at the EU level, the overdue scrutiny and further reform of the CAP and the structural funds would probably be slowed down. Therefore from the taxpayer's standpoint the verdict on the EU tax idea should be: "These things must be nipped in the bud!"

[4] G. Brennan, J. Buchanan: The Power to Tax, London et al. 1980.