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About publication

This publication is result of cooperation between independent think tanks in Central and Easter Europe (CEE). The purpose of this cooperation is to increase awareness of upcoming legislative initiatives in CEE countries, and to increase the presence of liberal opinions from CEE countries in the EU decision making.

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Cash Payment Restrictions in the Fight against Criminal Activity and the Shadow Economy

The European Commission has launched a legislative initiative on cash payment restrictions aimed at exploring the rationale for the introduction of upper limits on cash transactions.

Restrictions on payments in cash are not efficient in the fight against criminal activity and the shadow economy

Although cash is used in criminal activity and the shadow economy, restrictions on cash payments have a very limited impact on them primarily because the availability of transactions in cash is not among the causes of criminal activity and the shadow economy. Research[1] shows that people choose to engage into undeclared activity to avoid taxes and/or regulations. Cash only plays an intermediary role in providing a sufficient level of anonymity. Therefore, though restrictions on payments in cash may affect the use of the intermediary to a certain extent, they will have no effect on the primary motivation behind the shadow economy.

Cash restrictions may have an impact on illegal activity or the shadow economy only when one party of a transaction is passive, i.e. the party is not interested in and is unaware of having engaged in an unlawful activity (e.g. when a transaction in cash is not accounted for in accordance with the law and the payer is unaware of this.) However, cases of passive participation are few in number as compared to instances where both parties are willing to and are aware of their involvement in an unlawful transaction. Since active participants are consciously engaged into illegal activity, an additional restriction would not have a deterrent effect.

Nevertheless, in some cases restrictions on transactions in cash may hinder transactions. For example, cash payment restrictions might work in transactions that are legal *per se*, i. e. one counterpart respects the law and the other party is willing to buy a good using illegally obtained cash. Yet, two arguments should be taken into account here. Firstly, since restrictions would only apply to high value transactions, their impact will be very limited. Secondly, money would either be laundered allowing for an electronic transaction or buyers would have to find a counterpart willing to violate the law. In the first case, cash payment restrictions would pose a minor burden on illegal activities and might even broaden their scope as cash transaction that used to be legal (illegal source of money, but a legal purchase) will become illegal. Therefore, restrictions on payments in cash would have a very limited effect on criminal activity and the shadow economy, if any.

Restrictions or a ban on transactions in cash would have long-term negative consequences

[1] Feld, L. P., and Schneider, F. (2011), Survey on the shadow economy and undeclared work in OECD countries. In F. Schneider (Ed.), Handbook on the Shadow Economy (pp. 78-131). Cheltenham, UK; Northampton, MA, USA: Edward Elgar Publishing

The restriction on cash payments is the first step towards a cashless economy. Importantly, the path towards a cashless economy would entail certain risks which must be investigated and evaluated prior to limiting cash transactions.

Cash payment restrictions would limit competition between different means of payment. Competition between different means of payment is crucial for the development of the market for payments. Market participants compete with each other by providing different types of payment and trying to offer more convenient and cheaper services. Therefore, transactions in cash compete with electronic payments thus limiting the possibilities of electronic payment service providers to increase their prices.

The usefulness of cash as opposed to other means of payment should also be considered. Kari Takala and Matt Viren[2] claim that cash transactions are important for at least two reasons. First, payments in cash provide an alternative to credit and debit cards, preventing the banking industry from gaining a monopoly in pricing the use of cards. Second, cash has turned out to be extremely secure in the payment industry as there have been no large-scale payment failures due to misuse or forgery of cash. Electronic transactions, on the other hand, pose a large-scale systemic risk arising from, for example, identity theft; therefore, cash also serves as a back-up system in case of a systemic failure. Consequently, cash payment restrictions of any kind would limit the necessary competition between different types of payment, harming the consumer in the long-term.

Cash payment restrictions would increase the fragility of the financial system. Cash payment restrictions would increase the systemic risk and fragility of the financial system in the long-term. In the current system of fractional reserve banking, central banks are not the only entities that have the power to create money. Commercial banks also create money through advancing new loans in the market on top of the reserves. In fact, commercial banks in Eurozone are responsible for the creation of about 80 per cent of M2 money supply. This process of money creation by the commercial banks creates systemic risk and contributes to the fragility of the banking system. The systemic risk of the banking sector manifests itself when people lose their trust in the banking system and demand for their money in cash (bank run).

The use of cash in transactions restricts the ability of commercial banks to create money and increase the money supply independently, because banks have to provide people with cash instead of electronic money if they so desire. If people are forced to use only electronic payments, this safeguard against the creation of electronic money will become invalid. Therefore, commercial banks would create more money and increase money supply more rapidly, creating inflation and increasing the fragility of the financial system.

Conclusion

Restrictions on payments in cash would have very limited impact on illegal activities, because most of them manifest in situations where both parties are motivated to break the law. However, restrictions would hamper competition between different means of payment and contribute to the fragility of the financial sector. Moreover, while having limited effect on illegal activity and the shadow economy, they will have unintended long-term negative consequences. Therefore, restrictions on payments in cash should not be introduced as a measure against criminal activity or the shadow economy.

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[2] Is Cash Used Only in the Shadow Economy? Kari Takala, Matt Viren. p. 539. http://ideas.repec.org/a/taf/intecj/v24y2010i4p525-540.html

The Reform of VAT Rates in Europe

On 7th of April 2016 the European Commission (EC) adopted an Action Plan on VAT. One of the aims of the Action Plan on VAT is to modernize rates policy. The Commission has put forward two options for giving Member States more freedom on setting the VAT rates. The first option would be to maintain the standard rate with a minimum of 15% and to extent the list of goods and services subject to reduced rate. The list of goods and services subject to reduced rate would be reviewed on a regular basis, taking political priorities into account. The second option would be to remove the standard rate with a minimum of 15% and to abolish the list of goods and services subject to the reduced rate, granting countries more freedom on the number of reduced rates and their level.

More freedom on the number of reduced rates and their level would contribute to the free movement of goods and services

A diversity of tax rates is not a roadblock for free trade. Quite the opposite, differences in tax systems might serve as a stimulus for the cross-border trade. Taxes constitute a significant share of costs and a large share of the price of factors of production, labour in particular. It is tax diversity (which is usually determined by the necessity to accommodate to local conditions and traditions) that frequently provides opportunities to produce cheaper goods and services and to offer them on the international market. Thus, absence of centralised tax harmonisation encourages beneficial trade rather than undermining it.

Countries have always competed using their exogenous factors (e.g. the amount of land, population, proximity to waterways, etc.) as well as endogenous one (e.g. the level of corruption, political stability, the level of bureaucracy and taxation). Competition by endogenous factors (e.g. taxation) should not be perceived as “unfair” or “unnatural.” Tax competition is no different than competing for investment by cutting red tape, lowering bureaucracy and other factors that depend on national governments.

The abolition of minimum VAT rate may open possibilities to reduce the overall tax burden

Under current rules Member States must set a minimum standard VAT rate of 15%. Those Member States that have fewer exemptions and/or reduced rates tend to keep a single tax rate for most of the categories of goods and services in order to avoid market distortions. Therefore, their VAT burden is comparatively high.

On average, approximately 65% of final consumption is subject to the standard rate in the entire European Union; in Portugal, Ireland and Greece, the share of the standard-rated goods and services is less than 50% of total consumption, whereas it is more than 90% in Bulgaria, the Slovak Republic and Romania. The share of reduced-rated goods and services is on average 26% and ranges from a few percentage points (in two Baltic Member States, Romania, Bulgaria and Denmark) to more than 40% of total consumption (in Portugal, Spain, Greece, and Poland). Finally, approximately 9% of final consumption is exempt or outside the scope of VAT. [3]

In Lithuania, where statutory VAT rate is 21% and effective VAT rate is 19.1%, the gap between the effective VAT rate and the statutory standard VAT rate is one of the smallest in the EU (less than 10%). Such rates are relatively high, compared to the EU, where average standard VAT rate is 20.7% and average effective VAT rate is 15.5%. Due to the inflation, VAT revenues are constantly growing. This is a strong basis to reduce the statutory VAT rates. For example, in Lithuania VAT revenues grew from 1.8 bln. Euros in 2006 to 3 bln. Euros in 2016.

Possibility to set statutory VAT rate below 15% for a wider set of different goods and services may lead to lower effective VAT rates in various Member States. Therefore, countries, which have fewer exemptions and/or reduced rates, may maintain the same principles of taxation but lower their standard VAT rate.

Of course, there is a possibility that countries may differentiate VAT rates for different groups of products and services extensively and in order to raise the same budgetary revenues or reduce the consumption of some goods or services for those they may set a disproportionately high VAT rates.

However, there is a little possibility, that the VAT may be used as a tool to reduce the consumption of some products, e.g. alcohol or tobacco, as other taxes aimed at the same purpose already exist. As EU will continue to set the minimum excise rates, Member States will continue to use them as a regulatory tool.

Similarly, due to free movement, citizens of the EU could buy goods in other Member States, thus discouraging governments, that decide to abuse the possibility to set the VAT for different goods at their discretion, from such practice.

Greater autonomy on setting VAT rates would contribute to the greater subsidiarity in the EU

Abolishing the list of goods and services subject to reduced rate and granting countries more freedom on the number of reduced rates and their level would increase the subsidiarity of Member States' tax systems, as decisions would be taken closer to the citizen. It would allow Member States to control the level of revenue at the margin more consistently, *i.e.* they will be able to set the level of taxes to correspond to the desires of voters.[4] It would be a very important change for those countries, which gain a large share of their budget revenues from the VAT, as they are at current disadvantage looking from the perspective, that they have less freedom of manoeuvre. *I.e*., countries relying on other forms of taxation revenues have more discretion in setting the tax rates.

In addition, choosing the second option would allow Member States to set their tax rates in accordance to the existing purchasing power. For example, countries with low purchasing power may set lower VAT rates for a wider set of goods and services. As due to the single market the prices of consumer goods tend to converge in the entire EU, it is an important issue, especially for the new Member States, where consumers pay a larger share of their income as consumption taxes, than the citizens of the old EU Member States.

[3] Borselli, Fabrizio, Salvatore Chiri, Ettore Romagnano, *Patterns of Reduced VAT Rates in the European Union*, http://empcom.gov.in/WriteReadData/UserFiles/file/No_1%20A-5

[4] Cnossen, Sijbren, *Tax Policy in the European Union: A Review of Issues and Options*, https://www.econstor.eu/bitstream/10419/76060/1/cesifo_wp758.pdf

In the light of recent tax harmonization activities regarding the corporate income tax, greater autonomy on setting the VAT rates may be welcomed by the public and appease the Eurosceptic sentiments. The claims that Member States now cannot impose a lower VAT level were extensively used during the vote on the Brexit campaign.[5] As the VAT is paid by personal end-consumers, therefore more people confront the obligation to pay this tax during their daily activities, compared to CIT and other forms of taxes. For this reason, more flexibility on the VAT regime may be widely welcomed by the general audience.

Conclusions

- The abolition of the standard rate with a minimum of 15% together with more freedom on the number of reduced rates and their level would contribute to the free movement of goods and services in the EU.
- Possibility to set statutory VAT rate below 15% for different goods and services may lead to lower effective VAT rates in various Member States.
- Greater autonomy on setting VAT rates would contribute to the greater subsidiarity in the EU and may be welcomed by the public, which, in the current light of the growing Euroscepticism views tax harmonization as a breach of EU subsidiarity principle.

Recommendations

- The European Commission should work to preserve the highest degree of tax competition between Member States.
- High-tax EU Member States advocating tax harmonisation should take practical steps towards harmonisation by aligning their tax systems with those tax regimes that are the most conducive to economic growth.
- The European Commission should further develop the proposal to remove the standard rate with a minimum of 15% and to abolish the list of goods and services subject to reduced rate, granting countries more freedom on the number of reduced rates and their level.

[5] *Reality Check: Does the EU control UK VAT rates?* http://www.bbc.com/news/uk-politics-eu-referendum-36430504

A Joint Open Letter on the Future of EU Finances

The EU budget has been a result of political negotiations and trade-offs between Member States rather than a well-grounded financing of mutually agreed pan-European goals for a long time. The politicized use of EU funds distorts the motivation of market participants, impairs free competition, discourages an effective allocation of limited resources, incentivizes corruption, drives inflation in recipient countries and brings benefits primarily to particular interest groups rather than to all EU citizens.

The process of forming the EU budget faces a phenomenon known in economics as "The Prisoner’s Dilemma" where each Member State would be better-off financing common goals. Failing to cooperate on mutual goals and seeking to maximize their own benefits, Member States end up trapped in a situation of inefficient spending. A mutual agreement that funds can only be allocated for projects that bring pan-European benefit is needed to tackle this, while any other use of funds should be restricted as bringing much less benefit to citizens. For the EU budget reform, there must be a zero baseline in the beginning, with no preconceptions regarding the principles, size, revenue sources, policies and measures of the budget.

The present budgetary revenue system is too complex, and the use of multiple revenue streams is inefficient and unjustified. The VAT and GNI-based revenue streams overlap, causing double taxation of the value added component. The EU budget's revenue sources must be reformed and built on the following maxims: national contributions to ensure democracy; proportionality to secure fairness and neutrality; simplicity and transparency to create accountability; and a low administrative burden to increase the effectiveness of payments. However, the only scenario of the Reflection Paper on the Future of EU Finances which reflects the abovementioned maxims is Scenario 5 “Radical redesign: Simplification of the current system: abolish all rebates, reform or abolish value added tax-based own resource.” Currently, the policies funded from the EU budget are too demanding, too ambitious and thus unrealistic. They are incoherent and contradictory; some of them erode European competitiveness, so the goals attached to every policy and consistency thereof need profound re-examination.

In our view, the way out of this "Prisoner’s Dilemma" lies in the agreement to finance only pan-European projects. Given that the single market and economic freedoms bring real and tangible benefits to all EU citizens and to all Member States, and that this was the major aspiration for founding the EU, its budget should be strictly in line with the goal of implementing and strengthening the common market. No funding should be justified if it hampers the free movement of capital, technology, goods, services and people. Instead, budgetary expenditure must be aligned with the following maxims: EU funds for EU goals, because goals, not interests, ensure efficiency. Applying those principles implies a fundamental reform of the existing policies.

Importantly, cohesion may only be achieved through the removal of regulatory barriers to flexibility and the free movement of the factors of production within the common market, as well as the improvement of the physical conditions to free movement, e.g. the development of infrastructure that links Member States together.

Competitiveness policy should promote free competition. Public “competition” projects or publicly subsidized private for-profit projects should not be acceptable. A number of current competitiveness policies include programmes that improve market conditions, such as pan-European transport projects. Such programmes should be prioritised in the future.

Finally, there is hardly any social and economic justification for the Common Agricultural Policy (CAP) and rural development programmes. The investment into creating a “good” CAP is a waste of time and other limited resources, so all efforts should focus on the creation of a sound exit mechanism and abandoning this destructive use of public resources.

On the expenditure side, there is a need for the following actions:

- to create a sound exit mechanism from CAP and rural development policies with an annual reduction of contributions to the EU budget by the amount previously allocated to these policies;
- to redesign the Cohesion Policy focusing on the removal of barriers to flexibility of the markets and the free movement of the factors of production inside the EU and the improvement of the infrastructure links between Member States;
- to abstain from financing highly uncertain goals, such as climate change control and mitigation, Galileo, etc.;
- to rely on the private financing of innovation, research and development and not to increase the present EU budget funding for those purposes;
- to supplement the Union’s external actions with the promotion of free market reforms in non-EU countries;
- to avoid the financing of for-profit private companies regardless of their region, economic activity or project;
- to avoid unrealistic and potentially harmful large scale investment programs such as the Juncker’s Investment Plan.

To conclude, only a fundamental budgetary reform, not a minor structural change, may advance a prosperous Europe. The EU budget must be reduced if an agreement on common and attainable goals cannot be reached.

Undersigned by the Lithuanian Free Market Institute, Lithuania, the Institute of Economic Affairs, the United Kingdom, Institut économique Molinari, France, Civismo, Spain Timbro, Sweden, all of the aforementioned members of the EPICENTER Network, and the Institute of Economic and Social Studies, Slovakia, the Foundation for the Advancement of Liberty, Spain, and the Spanish Taxpayers Union, Spain.

A Position Paper on the Future of EU Finances

Foreword

This Position Paper (further – the "Paper") is a response to the Reflection Paper on the Future of EU Finances by the European Commission (further – the Reflection Paper). The goal of this Paper is to evaluate the outlook for EU Budget, its trends and ongoing discussions and to present EU budget reform solutions that would change Europe, make it prosperous. This Paper will focus on demonstrating how the EU budget's revenue and expenditure should be modified in order to respond to global challenges, to harmonize interests among member states, to reduce tensions during the budget's formation and to make the budget more effective and less costly. More attention will be paid to the changes needed and their merits rather than the deficiencies of the present system. The budget adoption process, institutional reform and the question of the budget's term will not be addressed here. This Paper will be helpful to the EU institutions in preparing the official proposal for the EU reform and to national governments in forming their positions. It will also help the European citizens to recognize those solutions that would promote an economically sustainable Europe.

The Paper provides a general evaluation of the current budget and then discusses the EU budget revenue, expenditure and size. The Paper is concluded with a summary and a proposed scenario for the future of EU finances.

Executive Summary

The EU budget has been a result of political negotiations and trade-offs between member states rather than a well-grounded financing scheme of generally agreed pan-European goals. The politicized use of EU funds distorts the motivation of market participants, harms free competition, impairs an effective allocation of limited resources, incentivizes corruption, contributes to higher inflation in recipient countries and brings benefits primarily to particular interest groups rather than to all EU citizens. The process of forming the EU budget faces a phenomenon known in economics as "the Prisoner's Dilemma" where each member state would be better-off financing common goals. Failing to cooperate on mutual goals and seeking to maximize their own benefits, member states end up in a situation where funds are used inefficiently. The EU budget's "Prisoner's Dilemma" may be solved by a mutual agreement that funds should be allocated only for projects that bring mutual pan-European benefit. Any other use of funds should be prohibited as it returns much lower payoffs to the people of the EU. For EU budget reform, there must be a zero baseline in the beginning, with no preconceptions regarding the principles, size, revenue sources, policies and measures of the budget.

The present EU budget revenue system is too complex and the use of multiple revenue streams is inefficient and unjustified. The VAT and GNI-based revenue streams overlap, causing double taxation of the value added component. The EU budget's revenue sources must be reformed and built on the following maxims: national contributions to ensure democracy; proportionality to encourage fairness and neutrality; simplicity and transparency to create accountability; and a low administrative burden to increase the effectiveness of payments. The only scenario of the Reflection Paper on the Future of EU Finances which reflects the abovementioned maxims is “Radical redesign: Simplification of current system: abolish all rebates, reform or abolish value added tax-based own resource”.

The employment of these maxims dictates the following changes on the revenue side:

1) to eliminate the VAT-based revenue stream;
2) to rely on member states' contributions based on equal proportions of GNI;
3) to diminish the financial role of the traditional “own” resources, leaving them as a temporary regulatory tool and to move towards deeper liberalisation of trade;
4) to abstain from creating new sources of revenue;
5) to eliminate "corrections of payments" or rebates.

Policies that are funded from the EU budget are too demanding, too ambitious and therefore unrealistic. Policies are incoherent and contradictory; some of them erode European competitiveness, so the aims of every policy and their consistency need profound re-examination.

The way out of this "Prisoner’s Dilemma" lays in the agreement to finance only pan-European projects. Given that the single market and economic freedoms bring real and tangible benefits to all EU citizens and to all member states, and that this was the major aspiration for founding the EU, the EU budget should be strictly in line with the goal of implementing and strengthening the common market. And vice versa, no funding is justified if it hampers the free movement of capital, technology, goods, services and people. The current situation of the budget is a result of a gradual departure away from the original values of the Common Market behind the EU’s foundation.

EU budget spending must go in line with the following maxims: EU funds for EU goals; goals, not interests of particular groups, ensure efficiency; financing may bring desired results, yet redistribution is a result in itself. The application of these principles implies an essential reform (and perhaps the abolition of some) of the current policies.

Cohesion can only be achieved by the removal of regulatory barriers to flexibility and free movement of factors of production within the common market, as well as the improvement of the physical conditions to free movement; thus, EU funds should focus on infrastructure that links member states together.

Competitiveness policy should create market conditions conducive to free competition. Any public “competition” projects or publicly subsidized private (profit-seeking) projects are not acceptable. Competitiveness Policy includes some programs, such as the implementation of pan-European transport projects that improve market conditions; therefore these programs should be included in the future finances.

There is hardly any social and economic justification for the Common Agricultural Policy and rural development programs. The investment into creating a “good” CAP (which makes up 37% of 2014-2020 budget) is a waste of time and other limited resources because it is in all aspects unjustifiable: the member states have different problems, however the common policy applies the same mechanisms of subsidies to all states; the system itself is rigid and cannot respond to changing global conditions; it does not bring mutual benefits, yet leads to mutual problems and costs. Therefore all efforts should focus on the creation of a sound exit mechanism from this destructive use of public resources.

On the EU budget expenditure side there is a crucial need for the following actions:

1) to create a sound exit mechanism from CAP and rural development policies and annually reduce contributions to the EU budget by the amount previously allocated to these policies;
2) to redesign the Cohesion Policy, focusing it on removal of barriers to flexibility of the markets and free movement of factors of production inside the EU market and improvement of infrastructure linking member states;
3) to abstain from financing highly uncertain goals, such as climate change control and mitigation, Galileo, etc.;
4) to rely on the private financing of innovation, research and development and not to increase present EU budget funding for these purposes;
5) to supplement the Union's external actions with the promotion of free market reforms in non-EU countries;
6) to avoid the financing of profit-seeking private companies regardless of their region, economic activity or project;
7) to avoid unrealistic and potentially harmful large scale investment programs such as the Juncker's Investment Plan.

To conclude, only a fundamental budget reform, not a reform of the budget's structure, may change Europe. Accordingly, the EU budget must be reduced if an agreement on common needs or attainable goals is not reached.

To put it in a scenario, a "Radical redesign: version 2" is presented in this paper:

<u>General trend and volume</u>

► Lower budget

► Share of cohesion and common agricultural policy (CAP) reduced or abolished (Cohesion Policy transformed to focus on free markets; CAP abolished)

► Focus on projects that bring mutual pan-European benefit

► No large-scale investment programs

► Focus on trade liberalization and free movement of capital, technology, goods, services or people

<u>Expenditure</u>

► Common agricultural policy

- to create a sound exit mechanism from CAP

► Economic, social and territorial cohesion

• removal of regulatory barriers to flexibility and free movement of factors of production within the common market

• the improvement of the physical conditions to free movement

► New priorities

• Security and defence depending on circumstances

► Existing priorities

• Connecting transport and energy grids to improve international trade and communications

• External policies

Revenue

► Simplification of the current system: abolish all rebates, abolish value added tax-based own resource

A General Evaluation of the EU Budget and the Need for Reform

The EU budget is the result of a history of political negotiations and trade-offs among member states rather than a well-grounded financing of mutually agreed pan-European targets or needs. The "redistribution" portion of EU funding is constantly criticized for failing to attain its goals of cohesion, growth and competitiveness. There is ample evidence of how EU funding for cohesion and agricultural policy distorts the motivation of market participants and harms free competition, undermines the effective allocation of limited resources, creates a background for corruption, preordains a lack of transparency, contributes to higher inflation in recipient countries and new member states, raises prices on agricultural goods, and brings benefits to particular interest groups rather than to all citizens.

The politicization of the budget formation process has created incentives for non-member states to seek membership in the Union[6]. Instead of uniting its members, the EU budget has degenerated into a struggle over who will become a “net-receiver” of budget funds. This has ruined the EU's declared purposes of integrity and solidarity. It is not enough to merely have a budget representing the interests and compromises among member states anymore. In light of severe global competition, it is vitally important that the EU's resources bring collective pan-European benefits, not just a conglomeration of small benefits that leave everyone somewhat unhappy. If Europe goes down this road, it will definitely lose its competitiveness.

The present EU budget formation process is a case of what is known in economics as a "Prisoner’s Dilemma" where each member state would be better-off choosing financing of common EU goals. By failing to cooperate and by seeking to maximize their own benefits, member states end up trapped in a situation where funds are used inefficiently. The Prisoner’s Dilemma situation is neither natural nor unavoidable in the EU budgetary process. The EU budget's Prisoner’s Dilemma may and must be solved

[6] In addition, most economists agree that the most important benefit of the EU membership comes from the participation in the Common Market.

by a mutual agreement by the member states to only allocate funds for projects that bring collective pan-European benefit. Any other use of funds should be prohibited as it forces us back to the outcome with the lowest payoffs.

The EU Budget should not be a goal in itself, but an integral tool for achieving common European goals. It is crucially important to choose among financial and (de)regulatory measures those that are the most effective and bring least market distortions.[7]

It is advisable to have zero preconceptions regarding the principles, size, revenue sources, policies and measures as the baseline for the EU budget reform.

EU Budget Revenue

*The EU budget is currently financed from three main sources: its own "traditional" resources, customs duties, agricultural duties and sugar levies, which comprise about 16% of total revenue), the VAT based revenue stream (~12 %) and a GNI based revenue stream (~70%)***.**[8] *There is a payment correction (rebate) system that favours a few member states and is thus supported by these states.*

The EU budget amounts to over 130 billion Euros per year, or about 1% of the EU's GDP and constitutes around 2% of the member states' total public expenditure. Given these figures, the need to have numerous revenue streams is questionable from various viewpoints, including those of sufficiency and of the diversification of risks. The VAT and GNI-based revenue streams overlap, causing double taxation of the value added component, reducing the transparency of the payments and increasing their complexity. The EU budget's financing methods needs simplification and better justification.

Principles of the Budget Revenue Sources

The EU budget revenue sources should be built on the following fundamental principles:

National contributions to ensure democracy. This principle comes from the historical tradition of the European Community's founding as an association, not a federation, of independent states. This principle means that member states may contribute to the EU budget but the EU has no right to tax. This principle ensures the smoothness, stability, sufficiency and balance of the EU budget.

Proportionality to encourage fairness and neutrality. The fairness principle implies that member states' contributions should be an equal proportion of the member states' national income. The present GNI-based resource meets this principle since the contributions are based on a flat rate. This fairness principle does not allow for any "payment corrections" or "diversified contributions".[9]

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[7] Regulation also brings enormous compliance costs and therefore EU funding in some cases may be the lesser evil, however this Paper will not elaborate on the costs and impacts of the regulatory environment.

[8] 2017 EU budget

[9] The EU budget should eventually be financed by per capita payments. Such payments would be the least distortionary revenue source, ensuring equal rights, duties and fairness while helping to create an authentic union of citizens.

Simplicity and transparency to create accountability. The simplicity and transparency principle requires that the income source (member states' contributions) needs to be clear to public officials and to every EU inhabitant. Every country and individual has to know precisely how much they are contributing to the EU. It is not enough merely to report how much was paid to the EU budget. Every citizen should be able to make a rough estimate of their contribution based on basic information such as their member state's GDP and contribution rate. Applying this simplicity principle would ensure EU accountability and eliminate attempts to conceal whether a member state is a net donor to the EU budget or a recipient. Simplicity leads to fewer mistakes and misinterpretations. A simplicity principle also implies fewer income sources.

A low administrative burden to increase the effectiveness of payments. The principle of a low administrative burden closely correlates with the simplicity and transparency principle. It means that the calculation and the payment of contributions should not require additional regulations or procedures. The principle of low administrative burden does not, however, justify the introduction of new income sources in order to increase the EU's budget revenue.[10] Low compliance costs reduce the likelihood of mistakes while increasing the transparency and the efficiency of the payments system.

By understanding these Budget Revenue principles, the relative advantages of GNI and VAT revenue sources may be compared. The GNI source appears to be better than the VAT based revenue stream because:

1) the calculation of any VAT based resource is more complex; it goes through several intermediate procedures and deviates from the actual size of VAT collected in each member state. To avoid this deviation, an absolute uniformity of VAT bases and rates would be required, which is neither desired nor realistic;
2) a uniform percentage rate applied to the Member States' GNI contributions would be proportional and fair;
3) since reliable, accurate and comparable statistics are required to calculate GNI correctly, the calculation of each contribution should be as simple as possible;
4) the GNI based revenue source is a proven, effective, and sufficient source of revenue.

In summary, the application of these Budget Revenue principles implies the following policies:

1) to eliminate the VAT-based revenue stream;

2) to rely principally on member states' contributions based on equal proportions of GNI;

3) to reduce the relative financial role of traditional "own" resources, leaving them as a temporary regulatory tool and to move towards a deeper liberalization of trade;

[10] An increase may be achieved by increasing present rates without complicating the existing system of contributions.

4) to abstain from creating new sources of revenue; the introduction of new taxes should be banned; and

5) to eliminate the "corrections of payments" and rebates.

EU budgetary expenditure

The financial perspective of 2014-2020 EU budget is intended to pursue the following EU Policies (each policy's percentage of total expenditure is shown in parentheses):

- *Sustainable growth: Natural Resources (Agriculture, Rural Development, Fisheries, Environment and others) – 39%,*
- *Cohesion Policy – 34%*
- *Citizenship, Freedom, Security and Justice – 2%;*
- *External Affairs – 6%;*

Administrative expenditure is covered by the EU budget and comprises approximately 6% of the budget for the years 2014-2020.

Despite the fact that the EU pursues few policies, the programs and tools used to apply these policies are complex. To draw a roadmap of the myriad goals, programs, measures, funding sources and schemes involved would be nearly impossible. A complex array of horizontal and vertical goals are financed from different sources, resulting in waste and high compliance costs. Actual allocations are further reduced by the army of specialized consultants that has emerged in every member state.

Overall, EU funding has failed to achieve the goals of cohesion and competitiveness. According to the OECD, the EU-28 does not compare well with the US; labour productivity per person is 25 per cent lower while the unemployment rate is nearly double. EU-19 data is not optimistic either. Significant economic and social differences remain among member states. Of course, these comparisons are based on highly aggregated data and these statistics do not evaluate the effects of regulation. Yet these comparisons, in general, reflect policy goals. The problem is that policies may not be aligned with their aims, or simply incoherent and contradictory. For example, Cohesion versus Competitiveness, a Common Agricultural Policy versus Competitiveness; thus the aims of every policy and their internal consistency need profound re-examination. Policies and goals need to be sound, consistent and achievable by budgetary means. The financing structure must be in line with priorities. First and foremost, spending principles must be agreed upon.

1. Principles of Budgetary Expenditure

EU budget spending should be in line with the following maxims:

EU funds for EU goals (subsidiarity). The Subsidiarity principle means that the EU should only fund projects that are pan-European, that bring tangible benefits for all Europeans. Projects that can be realized at the national level should be ineligible for EU funding. Given that the single market and economic freedom bring real and tangible benefits to all EU citizens in all member states, EU funding should be directed towards improving the single market. Conversely, no funding is justified if it hampers the free movement of capital, technology, goods, services or people.

Goals, not interests, ensure efficiency. The EU is mature enough to delineate its goals, to finance the attainment of these mutual goals and to stop supporting policies which simply help individual member states become net receivers of funds. Without depoliticization of budget spending it is impossible to form a budget that attains non-political goals. Pan–European goals must replace narrow national interests. The economic benefits of EU funded-projects must be greater than their costs.

Financing may bring results, redistribution should not be an aim in itself. Economic reasoning shows allocating funds based on measurable targets is superior to simply redistributing funds to poorer regions. Allocation creates incentives to become a winning leader, not to be financed solely because you are least well-off; it sends correct signals to market participants; it creates measurable targets. So, EU funds should be allocated to those projects that bring Europe closer to its common goals. Redistribution merely for the sake of giving money to poorer countries or for the sake of compromise is unjustifiable.

Below, each major EU Policy will be evaluated and proposals will be drawn on the basis of the Budget Expenditure Principles outlined above.

2. Cohesion Policy

The Cohesion Policy is aimed at reducing social and economic disparities among the regions. The Cohesion policy is highly redistributive, hardly justifiable and almost impossible to adhere to (see the box below).

The goal of the social and economic cohesion policy is ambitious, but dubious:

- Is complete cohesion desirable if the European market relies on regional differences and the division of labour?
- Can this cohesion be achieved in principle?
- Is the lack of cohesion a result of barriers to the free movement of labour, and other factors of production, inflexibility, historic circumstances, etc., or is it due to the lack of EU funding?
- Can state financial intervention induce cohesion?
- What amount of funding would be sufficient to achieve cohesion?

There are no precise answers to these questions. What we know for sure is that the goals of cohesion are introverted, focusing on the EU's internal differences and unable to react to the external challenge of global competition facing the entire EU. Furthermore, the goal of cohesion contradicts the goal of competitiveness in so far as it harms the efficient allocation of resources, which often require urbanization and a higher degree of economic centralization within a country's economy. In practice, pursuing cohesion causes malinvestment and overinvestment in declining regions.

The fundamental problems in achieving cohesion are as follows::

- funds are distributed through governmental bodies whose methods cannot guarantee the allocation of money to the areas that most contribute to cohesion;
- cohesion policy promotes provincial thinking, where the mere absorption of funds becomes more important than policy goals.

Cohesion policy should be limited to the removal of existing barriers to trade and the movement of people or to the creation of closer infrastructural links between member states. Since barriers to trade are of a regulatory nature, the removal of red-tape would enable member states to buy in the cheapest markets and sell to the dearest.

Cohesion can only be achieved by removing regulatory barriers to flexibility and the free movement of the factors of production within the common market, including physical improvements promoting free movement; thus, the EU budget should focus on improving the infrastructure links between member states.

3. Competitiveness Policy

Competitiveness Policy includes innovation, research and development, transport, energy, the Galileo Project, etc.

Competition is the key to competitiveness. Competition will arise only if market conditions are favourable to free competition. Any engagements in public "competition" projects or publicly subsidized private (profit-seeking) projects are not acceptable (see the box below).

> The Galileo project is an excellent example of misinterpreting the concept of competitiveness and competition. The creation of a duplicate product that already exists in the market free of charge on the basis of "prestige" or "grandeur" adds nothing to the competitiveness of the EU. The argument that it is better to spend money on hi-tech rather than on agriculture enters a dangerous area which is driven not by sound economics, but by arbitrary judgment. Diverting public resources to uncompetitive products is wrong, regardless of the nature of the product.

There is an ongoing discussion in the EU about increasing financing for innovation, research and development. Research and innovation certainly plays a crucial role in economic progress, but that applies first and foremost to private funding of research and development. Increasing the public share of R&D financing will not bring proportionate results. The EU shouldn't engage in a numerical competition of the "share of public expenditure allocated to R&D".

The existing Competitiveness Policy includes some programs that comply with the proposed principles such as the implementation of the pan-European transport and energy projects. These programs should receive funding in the future.

4. The CAP and Rural Development

Despite the diminishing relative significance of the Common Agricultural Policy (CAP), it continues to be the most resource-consuming and destructive of all EU policies (see the box below).

The agricultural sector under the CAP has become a purely social and political phenomenon, influenced by interest groups rather than the market. The price of evading the market is paid twice: once by taxpayers when their contributions directly finance agro-producers and again by consumers when they buy agro-products at a price higher than the market's, a price protected from external competition by EU-wide import duties. Due to the CAP, the EU has the world's most inefficient and expensive agricultural sector. Instead of gaining from the benefits of global competition and the division of labour, EU citizens inadvertently subsidize consumption in non-European countries. The CAP does not create the conditions for prosperity of the EU. The CAP is in all aspects unjustifiable: member states have different problems, however the common policy applies the same mechanisms of subsidies to all states; the system itself is rigid and cannot respond to changing global conditions; it does not bring mutual benefits, yet leads to mutual problems and costs.

The CAP has undergone several reforms but remains far from its primary goals of increasing production, stabilizing the market, creating reasonable prices for agricultural products and ensuring a reasonable income level for producers. Generous funding caused overproduction and forced a modification of the payment system. Global demand for agricultural products and their consequent rise in prices may solve the producers' income problems. Furthermore, the financial support that was supposed to increase the income of agricultural producers as a rule goes to other market participants due to the visible and significant capitalization of that support - an increase in prices for agricultural land, agricultural vehicles, fertilizers and other goods purchased by agro-producers. The CAP also increases the demand for and the cost of unqualified labour, which slows the movement of workers from the less productive agricultural sector to more productive spheres. The natural question arises “what does the EU want to achieve with its CAP?” Are there any reasons for the exclusion of the agricultural sector and its special treatment? What is the mission of the CAP and why should it be carried on at the EU level given the radically different status and problems that member states face? This is hardly justifiable and therefore the CAP is reduced to either a political bargaining chip or a mere tool for a region to receive EU funding.

Some signs indicate that the discussion on CAP reform may take the dangerous form of “what should be financed instead of CAP?” Such a question is faulty in principle as it leaves out one more alternative – to reduce contributions. Even net recipients may be willing to support the abolition of the “first pillar” as a negotiation tactic to trade off for favourable votes in other policies.

The second pillar is rural development, an agricultural policy designed to protect the environment and diversify the rural economy. Rural development is an issue that should be evaluated critically from the point of view of its effectiveness. A switch from CAP to financing rural development policies would mean 1) a greater overlap of agricultural and cohesion policies; 2) a larger market influence and an exhaustion of limited resources; 3) less transparent targets and fund distribution. A lavish financing of rural development would not be a better choice than the current agricultural policy nor be the solution to current problems. Instead, it would simply be yet another bad policy that does not comply with the proposed tasks and principles of reform.

There is hardly any social or economic justification for the CAP and rural development programs. The attempts to create a “good” CAP is a waste of time and other limited resources. Given the deep-rooted tradition of financial support for the agricultural sector there would be a huge resistance to the abolition of all funding; thus all efforts should be focused on the creation of a sound exit mechanism from the CAP. One of the solutions could be an automatic reduction of the size of the budget together with gradually diminishing payments to agro-producers. It is advisable to reduce the contributions to the EU budget by the amount presently allocated to the CAP and rural development programs. This redefinition of budget revenue and expenditure, especially of the CAP and Cohesion Policy, would allow the EU to retain GNI as a revenue source and to reduce contributions.

Given that the competitiveness of the agricultural sector is hampered by the high compliance costs of EU quality and environmental standards, there is an urgent need for deregulation of the agricultural sector.

It should be noted that the abolition of common agricultural policies does not mean agricultural funding should be shifted to the national level. Similarly as for the other sectors, national support to the agricultural sector should be treated as state aid and must not be tolerated.

Some may argue that the abolition of CAP funding would radically reduce or even eliminate the agricultural sector from the EU economy, since foreign agro-producers with more favourable climatic conditions can out-compete EU producers. These forecasts seem overly dire – there will always be a space in the EU's market for efficient and ecological production. Furthermore, the EU's agricultural sector amounts to merely 1.5 percent of its GDP while only 5 percent of the EU's population is engaged in agriculture. The fact that the EU is the second biggest agricultural exporter on Earth means that EU taxpayers subsidize global consumption which is another argument in favour of abolishing the CAP.

5. EU’s External Actions

‘The European Union as a global actor’ programs include development cooperation, humanitarian aid, European neighborhood and partnership, common foreign and security policy and others.

The financing of "external actions" has the fewest economic effects on the economy and market behavior because it is based on allocation, not redistribution, to targeted recipients outside the EU. It is difficult to evaluate whether this expenditure has led to the achievement of EU goals; however, it is a priori apparent that allocating funds for the implementation of market reforms in non-EU countries would bring the highest value to the EU and the global economy. The EU’s external actions must be supplemented with the promotion of market reforms in non-EU countries and the liberalization of trade with less developed countries.

6. On Climate Change Control and Mitigation

Climate change is one of the central EU and global issues. The established viewpoint is that climate change can be mitigated by financial tools and regulations. Although climate change does pose a certain economic threat, there are no sound economic reasons as to why the EU should be at the forefront of combating climate change at the expense of its citizens’ welfare. Climate change is by definition a global challenge.

The argument that it makes economic sense to force EU citizens and business to take up “low carbon” practices is only partially correct at best. While it might make sense to be the first to discover a certain technology, it also must be acknowledged that not every novel technology is feasible from the economic or even environmental point of view. The evolving situation with bio fuels may be an example of this. The "low carbon" technologies must be subjected to the forces of competition, not shielded from it.

It must be acknowledged that any sort of "climate change tax" on imported goods would have disastrous results on international trade. This kind of tax is already recognized as a protectionist measure by the EU's trade partners. Implementing such a tax would disrupt international trade and seriously impede further negotiations on the liberalization of trade.

It is advisable to abstain from financing policies that are aimed at climate change control and mitigation.

7. On large-scale investment programs ("Juncker's plan")

In November the European Fund for Strategic Investments was set up as a measure to achieve the investment target of €315 billion. With the proposed extension it should trigger at least €500 billion in investment. The aim is to leverage EU funds through loans and guarantees that should reduce investment risk and encourage private investment. Since direct contributions from the Commission and the European Investment Bank (EIB) would amount to just €21 billion (the leverage would be 15:1), these assumptions are highly optimistic.

It should be noted that throwing public billions into the market will not alleviate the effects of reduced investment, but will certainly pose a significant burden on taxpayers. Public investment does not work since it is politicized and not effective: private investors make financing decisions based on various factors and risk assessment is not necessarily the main one, meanwhile public investors dispose taxpayers money as not their own so the necessity evaluation is usually not weighed enough. In addition, public investment often pushes out private investment rather than attracting it. Besides, public investment is costly for taxpayers and the target of €315 billion would be a serious burden. After all, due to weak economies of the new member states, the shortage of supply plays an important role. Therefore, only liberalisation and deregulation may solve the problem of investment shortage.[11]

The Size of the Budget

A relatively small size of the EU budget does not imply that the EU has a negligible influence on the European and global political and economic development. Public financing is only one and not the most important tool in achieving public policy goals. The EU exercises significant regulatory impact on markets as well as on social and political behavior; hence EU regulations greatly increase the role of EU institutions. The compliance costs and their respective impact may be much larger in size than the EU budget. The EU's regulatory tools and costs should be considered together with the EU budget if one attempts to evaluate the role of the Union.

The budget itself is a double-edge sword: it may bring funds to receivers and help solve their problems but at the same time it is always a burden to all contributors. If the budget fails to attain its goals then even a relatively small budget may face criticism. That is why it is crucial to ensure the effectiveness of the budget, both on revenue and expenditure sides, regardless of its size.

[11] IEA "The EU needs supply-side reform" https://iea.org.uk/blog/the-eu-needs-supply-side-reform

It is important that during budgetary reform processes the present size of the budget is not considered as given and sacred. The task ahead is to find out whether the present level of redistribution is justified, not to redesign the allocation of billions.

Only a fundamental reform of the budget, not a structural reform, may change Europe. The EU budget must be decreased if an agreement on common needs or attainable goals is not reached.

Conclusions and Recommendations

There are no official estimates as to how EU funds have contributed to the achievement of its objectives. This should come as no surprise as the budgetary priorities have little to do with the goals and challenges of the Union. The budget is manipulated to leverage the contributions and benefits of each member state. The current budget is far from the original goals of the Common Market. Therefore, the budget must be carefully re-examined from its roots in order to reach the benefit-maximizing outcome and the way out of the Prisoner's Dilemma. The preservation of the current budgetary system is too costly even given its relatively small size. Therefore, the future of EU finances should rest on the "Radical Redesign" scenario of the Reflection Paper with necessary free-market adjustments.

Scenario "Radical redesign: version 2"

<u>General trend and volume</u>

► Lower budget

► Share of cohesion and common agricultural policy (CAP) reduced or abolished (Cohesion Policy transformed to focus on free markets; CAP abolished)

► Focus on projects that bring mutual pan-European benefit

► No large-scale investment programs

► Focus on trade liberalization and free movement of capital, technology, goods, services or people

<u>Expenditure</u>

► Common agricultural policy

- to create a sound exit mechanism from CAP

► Economic, social and territorial cohesion

- removal of regulatory barriers to flexibility and free movement of factors of production within the common market
- the improvement of the physical conditions to free movement

► New priorities

- Security and defence depending on circumstances

► Existing priorities

- Connecting transport and energy grids to improve international trade and communications

• External policies

Revenue

► Simplification of the current system: abolish all rebates, abolish value added tax-based own resource

Therefore, the following steps should be taken:

On the reform process:

► The starting point for EU budget reform should be zero preconceptions regarding the principles, size, revenue sources, policies and measures.

► To carry out a budgetary reform, not a structural reform and to align aims with policies as well as policies among themselves, reducing the size of the EU budget if an agreement on common needs or attainable goals is not reached.

► Policies and goals need to be realistic, achievable and consistent. The financing mechanism should be in line with the priorities. First and foremost, there is a need to agree upon the principles of funding and expenditure.

On revenue:

► To follow the principles of national contributions (democracy), fairness, simplicity, transparency and low administrative burden.

► To eliminate VAT-based revenue stream.

► To rely on member state contributions based on equal proportions on GNI;

► To reduce the financial role of traditional own resources, leaving them as a temporary regulatory tool and to move towards the deeper trade liberalization.

► To abstain from adding new sources of revenue.

► To eliminate the corrections of payments or rebates.

On expenditure:

► To follow the principles of subsidiarity and efficiency.

► To direct all efforts to the creation of a sound exit mechanism from the CAP and rural development policies while reducing budgetary contributions.

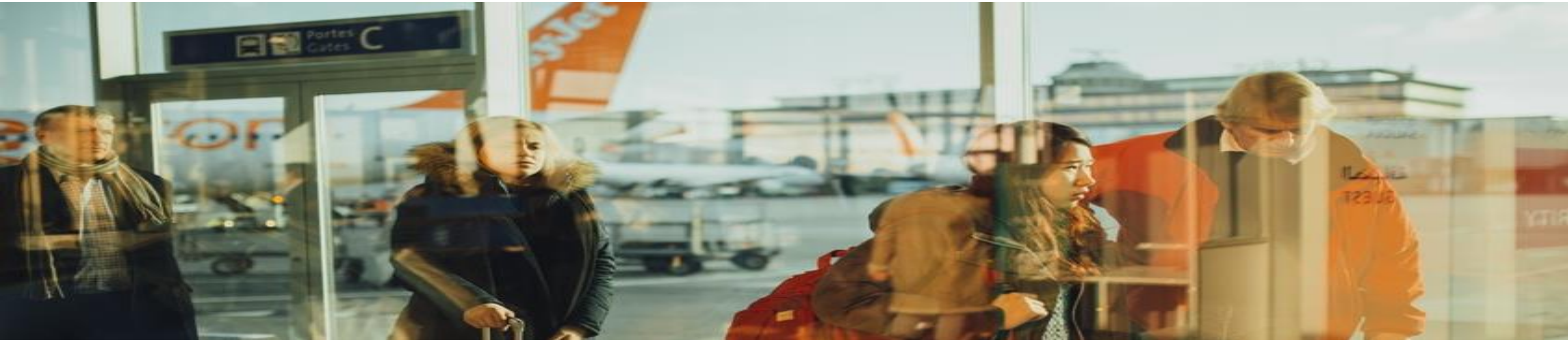
► To redesign the cohesion policy, focusing on the removal of barriers to flexibility of markets and the free movement of factors of production inside the EU.

► To abstain from financing new highly uncertain goals such as climate change control, Galileo, etc.

► To rely on private funding for innovation, research and development.

► To supplement the Union’s external actions with the promotion of market reforms in non-EU countries.

- ► To avoid financing profit-seeking private companies regardless of their region, economic activity or project.
- ► To avoid unrealistic and potentially harmful large-scale investment programs such as the Juncker's Investment Plan.



A Joint Open Letter on the Posting of Workers in the European Union

Posting of workers plays an essential role in the Internal Market and the cross-border provision of services. Simply put, posting of workers allows a worker from a sending country to work in a recipient country while observing regulations of the former[12].

The current system of posting of workers is strongly criticized by some old Member States. They accuse new Member States of social dumping and call for the introduction of the "equal pay for equal work in the same place" principle. This principle disregards the Single Market and ignores the facts that the pay rate differences constitute a legitimate element of competition. Moreover, a discussion on differences in labour market flexibility and minimum wage regulation remain on the periphery of the debates.

A comparison of labour regulation in new Member States and old Member States suffices to challenge the argument of social dumping. As reported by OECD and the World Bank Doing Business Index, new Member States have stricter labour regulation than the old ones. Labour codes in new Member States stipulate less working hours and higher extra pay for overtime, night time and work on rest days, etc. Therefore, allowing posted workers from new Member States to observe regulations of their sending countries while working in old Member States does not exacerbate their situation in any way.

A mere statement of the fact that minimum wages in new Member States are considerably lower than in old Member States disregards a couple of key aspects. Lower minimum wages are neither a consequence of different mentality or social policy nor a deliberate attempt by new Member States to gain an unfair competitive advantage. In fact, the nominal minimum wage across Member States varies due to differences in economic development, and related policy choices should be compared in terms of the ratio between the minimum wage and the average wage. According to Eurostat, in 2014 the ratio was 41.5% in new Member States and 43.1% in old Member States, implying no significant difference between the two. Therefore, punishing new Member States for having lower nominal minimum wages would go against fundamental principles of the Single Market where price competition is explicitly allowed and encouraged.

Finally, applying the principle of "equal pay for equal work in the same place" would be arbitrary and unfair, given that it does not even exist at the level of Member States. In any given Member State, workers with similar jobs or with similar qualifications receive different pay. According to Eurostat, earnings of workers with identical occupation may differ by more than 100 percent, depending on the size of a company. For example, the pay for workers engaged in non-manual labour varies by 100 percent in

[12] Directive 96/71/EC provides three options of posting: a direct provision of services between two companies under a service contract, posting in the context of an establishment or a company belonging to the same group (intra-group posting), and posting by hiring out a worker to a temporary work agency established in another Member State.

Germany and Spain. Similarly, differences in earnings may depend on different conditions of collective bargaining agreements.

To conclude, a selective application of the principle of “equal pay for equal work in the same place” has much more to do with restricting access to labour markets rather than achieving the equality of pay. As such, this type of protectionism goes against the fundamental principle of free movement of labour in the Single Market.

We, the 15 undersigned think tanks in 12 Member States, members of 4Liberty.eu Network and EPICENTER Network, call on the European Parliament, the European Council, the European Commission and national parliaments of the EU Member States to refrain from introducing the “equal pay for equal work in the same place” and to uphold the principle of free movement of workers in defense of the very foundations of the Single Market.

Undersigned by Centre for Economic and Market Analyses, the Czech Republic, Civil Development Forum, Poland, Civismo, Spain, F. A. Hayek Foundation, Slovakia, Istituto Bruno Leoni, Italy, Institut économique Molinari, France, Institute for Market Economics, Bulgaria, Institute of Economic Affairs, United Kingdom, Institute of Economic and Social Studies, Slovakia, Liberální institute, the Czech Republic, Liberté!, Poland, Lithuanian Free Market Institute, Lithuania, New Economic School – Georgia, Georgia, Timbro, Sweden, Visio Institut, Slovenia.