CENTRO STUDI SUL FEDERALISMO

research paper

ALBERTO MAJOCCHI

A EUROPEAN FISCAL STRUCTURE FOR EQUITABLE AND SUSTAINABLE DEVELOPMENT

May 2020

ISSN: 2038-0623

ISBN: 9788896871843

ABSTRACT

Europe faces a multiplicity of problems, which require an increasing use of resources. But the size of the European budget is totally inadequate to deal with these, and also to counter the devastating effects of the health emergency. The financing of the economic recovery can only be ensured, by not only the interventions of the ECB, but also by issuing bonds, which must be guaranteed by the European budget, and not by individual Member States. In consequence, there is an urgent need to identify new sources of revenue that can support increased spending by the Union. As well as being the most efficient instrument for combating global warming, setting a carbon price is also the most appropriate fiscal instrument for providing new resources to the budget and launching, through the use of the carbon dividend, a tax reform that shifts the burden of taxation away from labour to the consumption of natural resources, and represents a first step towards promoting the Union's fiscal autonomy.

Keywords: carbon pricing, European budget, fiscal federalism, Multiannual Financial Framework, own resources.

Alberto Majocchi is Emeritus Professor of Public Finance, University of Pavia, and Vice-President of the Centro Studi sul Federalismo, Turin

E-mail: **alberto.majocchi@unipv.it**

This paper is a revised version of the one presented at the Conference "Pago, dunque sono. Il futuro dell'UE tra responsabilità fiscale, solidarietà e nuova cittadinanza europea" (Florence, 28 November 2019), soon to be published (in Italian) in: M. Campus, S. Dorigo, V. Federico, N. Lazzerini (a cura di), *Il futuro dell'UE tra responsabilità fiscale solidarietà e nuova cittadinanza europea*, FUP, Florence, 2020.

1. The dramatic health emergency that has hit Europe has put the issue of a thorough reform of the system of financing the European budget back on the political table: a system able to support the expenditure needed to cope with the new tasks that should increasingly be assigned to the Union. The lockdown, needed to deal with the control of contagion, has caused a sharp fall in production and income, which in the Italian case is estimated by the International Monetary Fund at 9.1% and by the European Commission at 9.5%. But the recession affects all the countries of the Union, albeit in different ways. And the decision to launch a Recovery Plan financed by debt issuance requires this to be guaranteed by a European budget with commensurate own resources. The ensuing debate is therefore over both the nature of these new resources, and the new tasks to be allotted to the European budget. It also concerns the way in which the distribution of resources between the different levels of government has to be defined.

Indeed, the debate on the budget is not just about the health emergency. Today, Europe is confronted with many serious issues: security, following the gradual disengagement of the United States from the protection it guaranteed in the past to the defence of Europe; the many conflicting situations in countries bordering, or in any case falling within an area of interest to the Union – especially in the Mediterranean and the Middle East; the fight against terrorism and the control of migratory flows; and the need for a reduction of CO_2 emissions to limit global warming and launch Europe towards a model of sustainable development. But the debate is also about the need to promote the competitiveness of the European economy in a globalised world, and to guarantee social stability in the face of the very rapid changes in the labour market brought about by the technological revolution.

In the face of the prospect of increased spending commitments, the European institutions and the governments of the Member States are becoming increasingly aware of the excessively tight quantitative limits (around 1% of European GDP) imposed on the size of the budget, but also of the inadequacy of the extant funding structure, no longer able to cope efficiently and fairly with the new requirements and to adapt to the structural changes in the economic system that have emerged in recent years.

The urgent need for an in-depth reform of the size and financing of the European budget also appears to be reinforced by two factors of worldwide change: globalisation, and the technological revolution. Globalisation makes it very difficult to tax highly mobile capital income, while the aggressive tax avoidance of large multinational companies, in particular in the domains of social media and web-based trading, and harmful tax competition between the various national tax systems, are helping to shift the tax base of these companies to areas where taxation is less burdensome. As a result, in order to maintain unchanged levels of public spending, the tax burden on labour income, particularly on employees, must increase significantly, with a growth in inequalities that can lead to disruptive social effects.

At the same time, the technological revolution continues to favour the replacement of manual labour with machines. The employment of labour in the industrial sector is constantly decreasing and only highly skilled workers are able to find employment, either in the industrial sector or, above all, in the new services sector, whose share of GDP is set to increase progressively. Income tax revenue, largely guaranteed by withholding tax on employees' income, tends to fall, and this reduction is very difficult to offset by an increased levy on business income, self-employment and the service sector.

2. The starting point for our analysis is that the framework for budgetary reform in Europe is necessarily linked to a model of fiscal federalism. European competence in tax matters cannot be exclusive; it is a competence shared with lower levels of government – national, regional and local. Today, fiscal autonomy at the European level cannot not be guaranteed. It is the case that Article 311 of the Treaty on the Functioning of the European Union states that "The 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." But, subsequently, the same Article 311 defines a procedure for the creation of own resources which in fact gives the last word to the Member States and excludes a role for the European Parliament. The third paragraph states: "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. In this context it may establish new categories of own resources or abolish an existing category. That decision shall not enter into force until it is approved by the Member States in accordance with their respective constitutional requirements".

The size of the budget is currently established within the Multiannual Financial Framework (MFF) by a procedure which provides for a unanimous decision (which can be amended so that the Council can decide unanimously to take a decision by qualified majority), but gives a power to the European Parliament to decide by majority. Indeed, Article 312 states: "1. The multiannual financial framework shall ensure that Union expenditure develops in an orderly manner and within the limits of its own resources. It shall be established for a period of at least five years. The annual budget of the Union shall comply with the multiannual financial framework. 2. The Council, acting in accordance with a special legislative procedure, shall adopt a regulation laying down the multiannual financial framework. The Council shall act unanimously after obtaining the consent of the European Parliament, which shall be given by a majority of its component members. The European Council may, unanimously, adopt a decision authorising the Council to act by a qualified majority when adopting the regulation referred to in the first subparagraph."

Today the budget is limited in size – at around 1% of Europe's GDP – and the Union's 'own resources' are only traditional ones, derived from customs duties and sugar levies. These are in addition to VAT-based own resources: derived from a uniform rate of 0.3% applied to the value added tax base of each Member State, with the VAT base capped at 50% of each country's GNI; and GNI-based own resources, derived from a uniform rate applied to Member States' gross national income; this rate is adjusted each year in order to achieve a balance between revenue and expenditure. The latter is called an own resource, but in reality it is fully comparable to national contributions, introduced to ensure that each country contributes to the European budget in proportion to its income.

3. In the European context, in order to assess the prospects for fiscal federalism, it should first be noted that in recent years two institutional changes have taken place: on the one hand, a devolution of powers upwards, from the States to Europe and, at the same time, a transfer of powers downwards, from States to regional and local authorities. In the current political debate, this contextuality is not generally considered, and the two problems are studied separately. In particular, while careful consideration is given to the increasing downward decentralisation of public functions, insufficient account is taken of the new constraints and opportunities that membership of the European Union imposes on all lower levels of government.

In fact, the strengthening of the process of decentralisation of functions by central government to regional and local authorities is a widespread phenomenon in almost all EU Member States: new powers are assigned to below the state levels and, at the same time, the necessary resources are transferred to meet expenditure requirements, albeit in different ways according to different national experiences. As for the European experience, it has significant original elements which tend to differentiate it from the traditional model of fiscal federalism.

According to the Musgrave-Oates model,[1] there are solid reasons of an economic nature to justify a federal structure of the state. It is not only optimal for the benefits it offers from a political point of view – guaranteeing greater democracy through the creation of a pluralistic and, therefore, competitive system, with a built-in mechanism of checks and balances – but also from an economic point of view: it fulfils Wheare's condition that "by the federal principle I mean the method of dividing powers so that the general and regional governments are each, within a sphere, coordinated and independent."[2]

An economic model of a federal nature accomplishes Wheare's two-fold institutional vision: in guaranteeing efficient coordination, and therefore unity, on the grounds of the policy of stabilization and redistribution; and in the independence of the different levels of government, and therefore diversity, in allocative policy, since in this sector, in order to maximize the welfare of the community, it is necessary to ensure territorial diversification in the production of goods and public services.

4. This theoretical scheme is contradicted by the current distribution of functions within the European Union in at least two respects:

a) the policy of interpersonal redistribution is, and presumably will be, at least for the foreseeable future, assigned to the decentralised level, and not to the Union. In the literature, starting from Pauly's famous essay on redistribution as a local public good,[3] there are theoretical justifications for this choice, which also appears to be determined in Europe by the strong differences that remain at the national level in the functions of preference relative to the optimum level of redistribution;

---

[1] R.A. Musgrave, *The Theory of Public Finance*, New York, McGraw-Hill, 1959; W. Oates, *Fiscal Federalism*, New York, Harcourt, Brace, Jovanovich, 1972

[2] K.C. Wheare, *Federal Government*, London, Oxford Univ. Press, 1963, p. 10

[3] M. Pauly, "Income Redistribution as a Local Public Good", in *Journal of Public Economics*, 2, 1973, pp. 35-58

b) but stabilisation policy is also predominantly assigned to the national level. It is true that the management of monetary policy has now been transferred to the European level, but the Maastricht Treaty only gave the European Central Bank the task of ensuring price stability, while, as far as stabilisation policy is concerned, it merely provided for it to be pursued through the coordination of national policies.[4]

As far as the allocative function is concerned, the role of the Community budget is extremely limited, since its total is currently around 1% of European GDP. The production of public goods and services remains mainly concentrated at the national level, even though it now appears to be distributed, albeit with significant variation within the Union, between the various lower levels of government.

Ultimately, given that the allocative function is largely attributed to the national level, the model of fiscal federalism that seems to emerge within the European Union appears more decentralised than the theoretical model derived from the analyses of Musgrave and Oates. Europe will necessarily have a federal structure. The problem is that this federal structure – capable of guaranteeing both the efficiency and the maximum possible decentralisation of economic functions in the public sector – does not yet exist, and considerable problems may emerge during the transition phase. This is particularly so with regard to the effectiveness of stabilisation policy, since national governments are less willing to produce public goods stabilisation to the degree that is considered optimal from the European point of view, given that the positive effects of a counter-cyclical policy pursued at the national level also tend to manifest themselves in the territory of the other countries that are part of the Union.

5. On the occasion of the financial crisis, which began in the United States with the bankruptcy of Lehman Brothers on September 15, 2008, European governments understood the impossibility of activating expansionary fiscal policies given the strong openness that characterizes national markets, and the constraints imposed by the Stability and Growth Pact, reinforced by the Fiscal Compact. As such, they entrusted stabilization policy within the Union, and in particular in the euro area, to the European Central Bank, which acted quickly and decisively with the launch of Quantitative Easing.

This shift of emphasis from fiscal policy to monetary policy is also linked to structural factors, and not only cyclical ones, since, in a market that is strongly open to trade like the European one, a considerable part of the expansionary effects of demand growth is manifested externally through an increase in imports, with a consequent lowering of the multiplier value. In today's Europe, this limitation appears particularly relevant after the completion of the internal market and the strengthening of the globalisation process.

Given the difficulty of acting through fiscal policy measures, not least because of the constraints imposed by European rules on the size of deficits, during the crisis generated by the health emergency linked to the Coronavirus support for demand has been entrusted primarily to the European Central Bank. With this in mind, and taking into account the technological changes that

[4] "Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council" (Article 121, TFUE)

have made the link between growth in demand and increased employment more fragile, the role of fiscal policy appears to have changed radically, and must be primarily aimed at supporting investment and the production of public goods that are not guaranteed by the market.

This is why the Green Deal, presented to the European Parliament by the President of the Commission, Ursula von der Leyen,[5] and formulated in more detail in a Commission Communication of 11 December 2019,[6] may well represent a turning point in the management of stabilisation and development policy at the Union level. The Green Deal provides for a policy of investment and production of public goods designed to accompany monetary policy, ensuring not only the growth of the productive system, but also a redistribution of income in favour of the less well-off classes through tax reductions, accompanied by the production of public goods that will make it possible to guarantee a higher quality of life for all, not just for the more affluent classes.

6. As far as interpersonal redistribution of income is concerned, it is very extensive within the Member States, but is still limited at the European level, although some significant innovation in this area seems to be emerging as a result of the Coronavirus pandemic. The Union, on the other hand, has still limited but significant territorial equalisation policies, the basic justification for which, in addition to fairness, lies in the fact that, due to the different levels of per capita income, fiscal capacity varies from country to country. This variation has a deleterious effect: in order to provide the same level of services, governments in less developed areas are forced to impose higher rates, favouring the shifting of production factors due to tax reasons and thus causing inefficient distribution of resources.

These equalising policies between different areas are influenced by the objective of promoting greater solidarity between the Member States of the Union. The aim is to ensure that even the poorest areas can enjoy certain minimum standards of public services, to offer at least equal opportunities to all those living in the Union. At present, therefore, there is an important distinction between territorial redistribution and personal income redistribution in Europe. The European level must intervene in territorial redistribution, to ensure through equalisation transfers that all areas of the Union tend to offer equal opportunities and that basic services are provided as uniformly as possible throughout the territory (although there is still a long way to go to ensure equal minimum standards of health, education and other essential public services). Conversely, EU Member States and territorial communities still retain greater responsibility for managing social policy and personal income redistribution, based on the preferences of each community.

In fact, from a political point of view, there seems to be only limited immediate scope for strengthening interpersonal redistributive processes within the Union. If we go back to its origins, the policy of interpersonal redistribution of income does not start out as a public policy, but is managed by private individuals and is based on the feeling of solidarity, which is stronger at the

---

[5] U. von der Leyen, “A Union that strives for more. My Agenda for Europe. Political Guidelines for the Next European Commission 2019-2024”, European Parliament, 16.7.2019

[6] European Commission, *The European Green Deal*, COM(2019)640, Brussels, 11.12.2019

local level, where face to face relations are manifested, while it tends to decrease as the territorial dimensions increase. It is clearly easier to develop feelings of solidarity where there are personal relationships, because solidarity arises from the fact that there is interdependence in utility functions and positive external effects are manifested if poverty is reduced. If redistribution is entrusted to higher levels of government, the extent of redistributive policy tends to diminish precisely because it becomes more difficult to assert an effective feeling of solidarity.

In the most recent period, and during the difficulties that emerged during the health emergency, there has been a strengthening of manifestations of solidarity at the local level, through the commitment of individuals or voluntary organisations. In this case, we have returned, in a certain sense, to the origins of the equalisation policy, without, however, losing the effectiveness that has been achieved at the national level with the creation of the major social security systems that characterise the European model. Interpersonal redistribution remains largely in the hands of the lower levels of government, which are, among other things, the ones that already predominantly deal with it. However, it nevertheless seems necessary to promote in the future, at the European level, a definition of common standards that limit inequalities in income distribution in the Member States to an extent compatible with the objectives of the European social model, thereby ensuring compliance with the requirements of Article 3 of the Treaty on European Union.[7]

7. Given the diversity of functions that are assigned to different levels of government, the central problem of a system of fiscal federalism is the decision-making mechanism that can be used to define a fair distribution of resources. If the allocation is made through mechanisms that fail to guarantee both the effective financial independence of the lower levels of government, and also their real participation in decisions concerning the distribution of resources, the central government will naturally tend to assume a prevaricating role, as has already happened in federal states, and in particular in the United States. The opposite is the case if the funding of the central level is decided by the lower levels, which have a veto right over the distribution of resources, as is the case in the European Union.

Distribution cannot take place on the basis of the quality of the taxes either – some of which are reserved specifically for each level of government – since it cannot be guaranteed that the development of the revenue from these taxes will be adequate to meet the objectives to be achieved. And, this cannot be achieved on the basis of pre-established quantitative limits, i.e. constraints which would prevent economic policy from matching the needs of the changing economic situation. In order to have an effective system of fiscal federalism, decisions on the distribution of resources between the various levels of government must be the central element of a plan in which the fundamental choices affecting the life of all citizens are made consistent; and these decisions must necessarily involve the representation of both the upper and lower levels of government.

It is true, in fact, that the federal principle is based, according to Wheare's classic definition, on "the method of dividing powers in such a way that general and regional governments are, each in

[7] "[The Union] shall combat social exclusion and discrimination, and shall promote social justice and protection"

its own sphere, coordinated and independent".[8] A system of fiscal federalism can therefore only be considered effective to the extent that there is independence, including in tax matters, on the part of all levels of government. But, if taxation at a lower level is decided unilaterally by the higher level, according to the Wheare model, "this is not federalism, it is decentralisation". However, the problem also arises in genuinely federal states, where the fiscal autonomy of the Member States is recognised. In tax matters, competences are structurally shared, since the levy at any level of government burdens the taxpayer himself, and a higher levy by the central authority or the system of regional or local self-government, given the tax burden considered sustainable in a given social context, leaves less resources available for the other levels of government. It is therefore necessary to identify a procedure that allows for an agreed solution between central government and all local governments. Only in this way can independence and coordination be guaranteed, while meeting the criteria set by Wheare.

In federal systems, regional governments not only have a constitutionally recognised role, but regional realities also have constitutional significance in the mechanisms of representative democracy. The German system is the most effective in this respect. In Germany, the second chamber, the Bundesrat, is made up of representatives of the governments of the Länder and has competence, i.e. the right of initiative and veto, over all matters of relevance to the Länder, and in particular over the tax system. The Federal Government and the Länder are thus closely integrated at the decision-making level, which produces positive results both in terms of the territorial allocation of resources and in terms of economic stabilisation and development.

In reality, a functional system of multi-level finance requires the full participation of all levels in decisions affecting them. While the essential point is to establish who has the power to say the final word, particularly on decisions on the allocation of fiscal resources, the only balanced solution is to identify an effective institutional forum for co-decision. Otherwise, if it is the State that has the last word, the system tends towards centralisation, as is the case in Italy; if it is the decentralised level, the central government is prisoner of decisions taken by the Member States, as is the case in the European Union financing system. In order to properly address the problem of a correct distribution of fiscal resources, an indispensable prerequisite, at both the national and European levels, is an institutional reform that provides for the establishment of a second Chamber representing the lower levels of government, at all levels.

At the European level, this institutional structure would also make it possible to solve, in an optimal way, the problem of the decision-making mechanism to be used to distribute fiscal resources between different levels of government. We need to move away from the humiliating and ineffective practice of permanent bargaining: the definition of new resources at the European level and, consequently, the allocation of resources between the European and national levels, should be approved at the beginning of each legislature by both arms of the legislative authority, the Council and the European Parliament, but by a majority vote, whereas currently Article 311 of the TFEU stipulates a unanimous decision and ratification by all national parliaments. This would create a federal body, by its very nature dialectical, since it would represent the interests of the community and its parties at the same time, while guaranteeing, following Wheare's instructions, independence and coordination. At the same time, the structural

[8] K.C. Wheare, *Federal Government*, London, Oxford Univ. Press, 1963, p. 10

inadequacy of the model of fiscal federalism, based on the premise of tax autonomy of all levels of self-government, would be overcome. "In reality, the application of this model has given rise to a competition between central and lower levels of taxation which, in the face of the insurmountable limit constituted by citizens' ability to pay, can only reach a point of equilibrium with the subordination of the weakest level to the strongest level."[9]

In carrying out this procedure an important role could be played by the European Fiscal Board (EFB). The EFB, an Advisory Board of the Commission, was set up following the Five Presidents' Report,[10] with the aim of strengthening the current economic governance framework in the Union. As it stands, the main responsibilities of EFB are:

- to evaluate the implementation of the Union's fiscal framework and the appropriateness of the actual fiscal stance at euro area and national level;
- to make suggestions for the future evolution of the Union's fiscal framework;
- and to assess whether the prospective fiscal stance is appropriate for the euro area as a whole based on an economic judgment, as well as the appropriate national fiscal stances.

Consistent with the model previously discussed, the role of the Board should be strengthened, following the lines set up for the Indian Finance Commission that, in the words of Shri N.K. Singh, Chairman of 15th Finance Commission of India, is "a Constitutionally mandated body that is at the centre of fiscal federalism. Set up under Article 280 of the Constitution, its core responsibility is to evaluate the state of finances of the Union and State Governments, recommend the sharing of taxes between them, lay down the principles determining the distribution of these taxes among States."[11] If the mandate of the EFB were enlarged correspondingly, it would be able to contribute to defining the optimal distribution of resources between the different levels of government, which would be finally decided according to the democratic procedure that will be introduced once Article 311 TFEU has been amended in a federal sense.

8. Following the outbreak of the pandemic crisis, a debate on a possible increase in own resources to finance the Union budget will inevitably resume.[12] The size of the budget will necessarily have to increase if the Union is to cope with its new and different tasks: ensuring internal and external security, in a world where the American guarantee for European security has lapsed; controlling migration flows through the financing of a Growth Plan with Africa, managed in agreement with the African Union;[13] guaranteeing the resources needed to stabilise the European economy in the face of general or asymmetric shocks that may affect it in the future; promoting research and technological development, including through the creation of European champions in leading sectors; reducing inequalities between people and territories within the

[9] F. Rossolillo, *Città, territorio, istituzioni*, Guida Editori, 1983

[10] The Five Presidents' Report, *Completing Europe's Economic and Monetary Union*, Brussels, 22 June 2015

[11] https://fincomindia.nic.in/

[12] A. Majocchi, "European Resources or National Contributions: a Challenge for Europe", Centro Studi sul Federalismo, Torino, Comment no. 131, 29 August 2018

[13] A. Majocchi, "A Green New Deal for Europe and Africa", in A. Majocchi (ed.), *Europe and Africa: a Shared Future*, Peter Lang Brussels, 2020

Union; and, last but not least, funding a Green Deal, which will ensure the control of climate change by switching from fossil fuels to renewable energies, and launch Europe on a path of environmentally, economically and socially sustainable development.

The growing awareness that the objective of reducing climate-altering emissions must be pursued with determination is accompanied by the recognition of the urgent need to identify the instruments required to achieve it. In the Economists' Statement on Carbon Dividends,[14] signed by 27 American Nobel Prize winners for economics, it was clearly stated that the carbon tax is the most efficient instrument to reduce carbon dioxide emissions. This statement made it clear, however, that it is not a question of imposing a new levy, but of correcting a market failure – linked to the existence of external diseconomies generated by the lack of internalisation of the damage caused by CO_2 emissions – through a price signal to direct the behaviour of producers and consumers towards a carbon free economy.

Today, 43% of emissions in the European Union are managed within a quantity control mechanism under the Emission Trading System (ETS),[15] so that companies, concentrated in the electricity generation and carbon intensive sectors, where the quantity of emissions is easily verifiable, are sold emission permits, which can then be traded on the market. But even in European sectors outside this mechanism – transport, households, SMEs and agriculture – where 57% of total emissions originate, it is essential to introduce a carbon price. This must be accompanied by the imposition of a countervailing duty at the border on imports from countries that do not adopt a carbon pricing system, equal to the price imposed on European production, so as to be compatible with WTO rules.

The point to emphasise here is that the imposition of a carbon price at European level must be used to initiate a profound reform of the structure of public finance, on both the revenue and expenditure sides, in the direction of a carbon free and socially equitable economy. In essence, revenues will have to be recycled into the economic system, through either reductions in the tax levy on low-income households, or reductions in social security contributions, to favour non-energy-intensive businesses with a reduction in labour costs and workers with an increase in net wages (for the same gross income). On the other side, expenditure will have to be directed towards supporting the investments needed to promote the ecological transition.

[14] www.econstatement.org. A similar position has been taken by European economists (EAERE, *Economists' Statement on Carbon Pricing,* www.eaere.org/statement)

[15] The ETS adopts a cap-and-trade method. The total volume of greenhouse gases that can be emitted each year by power plants and other companies included in the scheme is subject to a limit set at Union level which, from 2013 onwards, is reduced annually by 1.74%. Within these limits, companies receive or purchase emission permits which they can trade on the market. The number of permits to be allocated is defined through national allocation plans, as there are differences between the commitments to be made by Member States under the European burden sharing agreement and the Kyoto Protocol. The activities covered by the scheme include all combustion installations with a thermal input exceeding 20 MW: mineral oil refineries, coke ovens, ferrous metal production and processing, mining (cement, glass, ceramic products), pulp and paper production, totalling about 11,000 installations

The scale of this potential tax reform is significant. With a carbon price growing annually by €10 per tonne/CO_2 (tCO_2), from an initial value of €50[16] to €100, revenue at the initial rate would amount to €112.5 billion, with CO_2 emissions in non-ETS sectors reaching 2,252.2 million tonnes in 2017.[17] The price of allowances in ETS sectors, which will increasingly be sold by auction, will also tend to rise as more and more allowances will be issued in smaller numbers, with additional revenues. If the carbon price were to be imposed as a floor price for the purchase of emission permits, there would be an additional revenue of €86 billion, as emissions in the ETS sectors[18] reach 1,718 million tCO_2. Ultimately, this could lead to an additional revenue of around €198 billion. Finally, the revenue from the imposition of a compensatory duty at the border[19] (Border Carbon Adjustment – BCA) should also be taken into account. Eurostat estimates that, in the EU27, CO_2 emissions related to imports (both ETS and non-ETS sectors) are 980 kg per capita in the EU27, resulting in total emissions of 437 million tonnes of CO_2. A €50/tCO_2 BCA on all imports would therefore generate revenues of almost €22 billion,[20] bringing total revenues to €220 billion.

These figures do not necessarily imply additional revenue for public finance, as they would have to be, at least partially, compensated by tax reductions foreseen for social equity purposes. The point to underline is that, in any case, total revenues from the imposition of a carbon price in non-ETS sectors and the auctioning of allowances in ETS sectors would create a price differential between the use of fossil fuels and renewable energies, and will consequently favour fuel switching from the former to the latter, while defining the amount of usable carbon dividend for a socially equitable ecological transition of the European economy.

This carbon dividend will allow for a profound reshaping of the tax system, which will shift the burden of taxation away from labour income towards a levy on the use of fossil fuels. Revenues from the imposition of a carbon price will be partly allocated to the national level, to promote measures to promote employment and combat poverty levels, by lowering taxes on labour, in particular on lower incomes and reducing social security contributions on companies and workers. Part of the revenue, and in particular the revenue from duties collected at the border, will flow directly to the Union budget, as an own resource that does not need a decision on the basis of Article 311 TFEU. But the largest share of the resources allocated to the European budget will have to be used to finance the Recovery Plan which will be put in place to launch the recovery of the European economy, following the Coronavirus emergency, along a path of sustainable and socially equitable development.

---

[16] As one barrel of oil corresponds to 159 litres of petrol and emits 0.366 tCO_2, the emission of one tCO_2 corresponds to the use of 2.7 barrels and therefore 429 litres of petrol. A tax of €50 per tCO_2 would generate an increase in the price of one litre of petrol of €0.116.

[17] ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&language=en&pcode=t2020_35&plugin=1

[18] https://ec.europa.eu/eurostat/tgm/refreshTableAction.do?tab=table&plugin=1&pcode=sdg_13_10&language=en

[19] O. Fontana, A. Majocchi, "*Border Carbon Adjustment*: una nuova risorsa per il bilancio europeo", Centro Studi sul Federalismo, Torino, Commento n. 172, 3 aprile 2020

[20] O. Fontana, "Il *Border Carbon Adjustment*: una nuova via per il bilancio dell'Ue", Centro Studi sul Federalismo, Torino, Commento n. 168, 6 marzo 2020

9. The health emergency has temporarily overshadowed the launch of the Green Deal. In fact, as far as the financing of the health expenses caused by the pandemic is concerned, it is clear that this is a task for the European Central Bank (ECB); it is the only institution able to act immediately to finance these extraordinary expenses, purchasing sufficient assets to meet them, while ensuring the containment of the spread. It was an inevitable choice, because it is necessary to act quickly, and the use of any other instrument seemed inadequate. Public debt will grow, but if interest rates remain low, the debt will be sustainable, as Blanchard[21] pointed out precisely in the case of Italy, even if a strict policy were required later. The pandemic demanded immediate intervention, and the only institution able to intervene quickly was the Central Bank. And the intervention of the ECB was indeed timely and massive, with the new Pandemic Emergency Purchase Programme of €750 billion, in addition to the Quantitative Easing of €240 billion and that of €120 billion decided in March 2020.

Alongside this intervention by the ECB, the Eurogroup meeting of 7-8 April 2020 approved a European Investment Bank intervention with a credit line of €200 billion, and the launch of the SURE programme (Support to mitigate Unemployment Risks in an Emergency), with a total of €100 billion. The European Stability Mechanism has also been authorised to use the existing precautionary credit lines (ECCL – Enhanced Conditions Credit Line), which will be made available to all Member States to the extent of 2% of the GDP of the Member State requesting the loan, with the only condition being that it undertakes to support the financing of health measures linked to the Coronavirus pandemic. Finally, the Stability Pact has been temporarily suspended and greater flexibility has been introduced in the application of state aid rules.

But the decisive point concerns the financing of a Recovery Plan to revive the economy after the Coronavirus tsunami. In referring the definition of the Recovery Plan to the European Council's guidance, the Eurogroup stressed the need to discuss "its relationship to the EU budget, its sources of financing and innovative financial instruments". In fact, the proposal to finance the plan by issuing Union bonds has already been taken up by the European Parliament in its Resolution adopted on 17 April 2020, which, in point 19, "calls on the European Commission to propose a massive recovery and reconstruction package for investment to support the European economy after the crisis, beyond what the European Stability Mechanism, the European Investment Bank and the European Central Bank are already doing, that is part of the new multiannual financial framework (MFF); believes that such a package should be in place while the economic disruption caused by this crisis lasts; the necessary investment would be financed by an increased MFF, the existing EU funds and financial instruments, and recovery bonds guaranteed by the EU budget; this package should not involve the mutualisation of existing debt and should be oriented to future investment"; and in point 20 "stresses that this recovery and reconstruction package should have at its core the European Green Deal and the digital transformation in order to kick-start the economy, improve its resilience and create jobs while at the same time assist in the ecological transition, foster sustainable economic and social development – including the strategic autonomy of our continent – and assist in implementing an industrial strategy that

---

[21] O. Blanchard, *Italian debt is sustainable*, Peterson Institute of International Economics, March 18, 2020

preserves core EU industrial sectors; highlights the need to align our responses with the EU's objective of climate neutrality".

In this Resolution three points appear particularly relevant and highlight the practicable innovations that have emerged following the health emergency. Firstly, an increase in the size of the budget is envisaged, within an enlarged MFF; secondly, the necessary investments can be financed through the issuance of bonds guaranteed by the European budget, without involving any possibility of mutualisation of existing debt; finally, a close link must be ensured between the measures provided for in the Recovery Plan and the Green Deal announced by the Commission. If effectively implemented, these proposals would represent a significant step towards an effective fiscal union, making the Commission capable of managing a recovery plan capable of launching the transition to a fair and carbon-free economy.

At the European Council meeting on 23 April 2020, the 27 Member States mandated the Commission to rapidly finalise the project for a Recovery Fund, aimed at reviving the European economy after the crisis generated by the COVID19 pandemic. President Ursula von der Leyen has foreseen an increase in the size of the Union budget from 1.2% to around 2.0% of European GDP, to allow the Commission to issue bonds on the financial markets – guaranteed by the Union budget – to the extent necessary to support the financing of the Fund.[22] The amount of bonds to be issued on the market remains to be established, and will depend on the size of the budget as defined in the MFF, the increase in own resources that will be achieved, and the use that will be made of the Fund's resources to grant loans or to ensure subsidies to the Member States most affected by the pandemic[23].

On this point, two further comments are appropriate. The issue of bonds should only be used to finance the Recovery Plan. The pandemic generated a symmetric shock, which affected all the countries of the Union. It is therefore not a question of rescuing certain states, and in particular the southern states, which have to bear a huge cost for servicing their past debt, but of financing the investments needed to get the economy back on track, particularly by starting the ecological transition. With the issue of European bonds, therefore, there will be no mutualisation of existing debt, and the bonds issued will have to be guaranteed by the European budget, and not by individual Member States.

But, in order to provide this guarantee, the size of the European budget must be increased to 2% of EU GDP, as proposed by President von der Leyen, with the introduction of new own resources,

---

[22]A funding through bond issues of a sustainable growth programme for the European economy has been supported in literature since the time of the Lisbon Agenda (A. Majocchi, "Issuing Union Bonds to Finance the Lisbon Agenda", in *The International Spectator*, 2005, No 4, pp. 49-58)

[23] "Pour soutenir une reprise durable qui rétablisse et renforce la croissance dans l'UE, l'Allemagne et la France soutiennent la création d'un Fonds de relance ambitieux, temporaire et ciblé, dans le cadre du prochain cadre financier pluriannuel (CFP), et une augmentation du CFP concentrée sur ses premières années. (…) La France et l'Allemagne proposent d'autoriser la Commission européenne à financer ce soutien à la relance en empruntant sur les marchés au nom de l'UE sur une base juridique respectant pleinement le Traité européen, le cadre budgétaire de l'UE et les droits des parlements nationaux. (…) Le Fonds de relance sera doté de 500 milliards d'euros en dépenses budgétaires de l'UE pour les secteurs et régions les plus touchés, sur la base des programmes budgétaires de l'UE et dans le respect des priorités européennes (…) et qui sera lié à un plan de remboursement contraignant au-delà du prochain CFP sur le budget de l'UE". (*Initiative franco-allemand pour la relance européenne face à la crise du Coronavirus,* 18 mai 2020)

and not through contributions from the Member States, so that a link cannot be established between the payment of contributions and loans financed by the issue of securities. The increase in the European budget financed by new own resources will only guarantee issues intended to support the investments provided for in the Recovery Plan.[24] If this does not happen, the Recovery Plan will not have the financial size needed to put the European economy on the path of ecological transition and the digital revolution, accompanied by a reduction in the inequalities affecting our system.

10. As far as the creation of new own resources is concerned, the most reasonable assumption, which also emerges from the Commission's Communication on the Green Deal,[25] is that to promote carbon pricing on all uses of fossil fuels, and in anticipation of a future introduction of a carbon tax, the Emissions Trading System (ETS) should be extended – at least in part – to currently excluded sectors, permits should be auctioned, and part of the revenue should go to the European budget. In addition, a border carbon adjustment should be introduced, the revenue from which would constitute an own resource, and, since it is a customs law, without needing to resort to the procedure laid down in the Treaties (Article 311 TFEU) for the creation of new categories of own resources.

To this end, an agreement between the European Parliament and the Council on the MFF will have to be reached as soon as possible and should enter into force on 1 January 2021, on the basis of the proposal being prepared by the von der Leyen Commission. The new MFF will have to be based on a recurring five-year period (2021-2025) – and not seven years (2021-2027) – to coincide with the legislature, and on own resources: both existing (duties, agricultural levies, VAT share, taxes on salaries of the European civil service) and new (from now on carbon pricing and border carbon adjustment and, later, web tax and financial transaction tax).

Also on the table are the proposals made on 2 May 2018 by the European Commission: 20% of the revenue from the Emissions Trading System; a 3% levy rate applied to the new Common Consolidated Corporate Tax Base (to be phased in following the adoption of the necessary legislation); and, finally, a national contribution calculated on the amount of plastic packaging waste not recycled in each Member State (€0.80 per kg).

These new resources should gradually replace Member States' national contributions, bringing the Union out of its *juste retour* conflicts, and lay the foundations for an ambitious European budget to contribute, including through the issuance of bonds, to the revival of the European economy. But the decisive point is that the issue of bonds by the Union must be not guaranteed by the Member States, but by budgetary resources to be identified in the context of the definition of the next MFF.

There is a strong similarity between this process and what happened with the approval of the European Monetary System (EMS). At the time, the objective was the creation of a European currency, but it became quite clear that the EMS was the decisive juncture for achieving this

[24] A. Iozzo, A. Majocchi, "Oltre l'emergenza: verso gli Eurobonds", Centro Studi sul Federalismo, Torino, Commento n. 171, 23 marzo 2020

[25] European Commission, *The European Green Deal*, COM(2019)640, Brussels, 11.12.2019

result. Equally, it has now become clear that achieving the objective of full fiscal autonomy for the Union requires a reform of Article 311 of the TFEU, involving the creation of new resources by a procedure based on a majority decision in the Council and the European Parliament (no taxation without representation), without having to resort to ratification by all the Member States, whose will has already been expressed in the Council. However, if a breakthrough were made in this MFF for an increase in the size of the budget financed by new resources to at least 2% of GDP, it would then become possible to launch a political process that must lead to this important reform of the Treaties before the next European elections. Ultimately, after the Coronavirus tsunami, a new structure of European economy and finance could emerge, aimed primarily at the implementation of the Green Deal, largely financed by issuing securities guaranteed by own resources from the European budget – and not by the Member States – thus prefiguring the emergence of an autonomous finance at Union level.

11. European taxation has thus far been based on the principle that fiscal power remains a competence of the Member States – a basis that has not been extensively examined or questioned to date. A different understanding was provided for in the Treaty establishing the European Coal and Steel Community, in which Article 49 provided that "The High Authority is empowered to procure the funds necessary to the accomplishment of its mission by placing levies on the production of coal and steel; by borrowing. It may also receive grants." But as far as the European Union is concerned, although Article 311 states that "The 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." In fact the bulk of the financing is done through national contributions proportional to the states' share of EU GDP.

The structure of the European budget differs significantly from the traditional model of fiscal federalism, and in particular in the composition of expenditure, which is largely based on transfers for the purposes of agricultural policy and the cohesion funds. This structure justifies, at least partly, the fact that the budget, which is intended primarily for territorial equalisation purposes, is financed by national contributions, so that the principle of *juste retour* is substantially respected.

The absence of real resources earmarked for financing the European budget has therefore not been an item on the political debate agenda. But things have changed significantly recently, for a number of reasons. First of all, the Union's spending needs are set to grow significantly to meet the new tasks facing Europe. Of these, the objective of controlling climate change is particularly important as the Union has set itself the target of 2050 to promote carbon neutrality, i.e. a carbon-free economic structure. And to achieve this objective, given the prevailing position in the literature in favour of carbon pricing, the idea of flanking the Emission Trading System with a carbon price has become established.

The setting of a carbon price should be accompanied by a series of complementary measures. In particular, the carbon dividend should be used to finance investments needed for the ecological transition, but also to ensure a redistribution of resources in favour of lower income classes. This will thus counteract the increase in inequalities that has emerged in recent decades as a result of the prevalence of neo-liberal theories and the concept – proven to be completely unfounded – of trickle down, according to which a reduction in the levy on the richer classes would have resulted in a positive spillover across the income scale. The consequence was an abnormal growth in inequalities, particularly in Anglo-Saxon countries, but also within the European Union.

Secondly, the introduction of carbon pricing at the European level should be supported by the introduction of a compensatory levy at the border corresponding to the price paid internally, not only to avoid a loss of competitiveness of European production, but also to encourage other countries to internalise, by setting a carbon price, the negative externalities linked to carbon dioxide emissions. The revenue linked to this offsetting duty could flow directly, as an own resource, to the European budget, since it is customs duty and, as such, does not require the implementation of the special procedure provided for in the third paragraph of Article 311 TFEU.

12. In fact, the levying of a compensatory duty at the border is a particularly important case, as it makes it possible to activate a new own resource for financing the European budget without having to go through the process of unanimous approval in the Council and ratification by the 27 Member States. It is therefore possible to achieve a nucleus of European taxation, which, while still limited in amount[26] (the expected revenue is realistically between €9 and €15 billion), is of great political significance. This remains true, even if fiscal autonomy at the Union level can only be achieved by amending the special legislative procedure provided for in the fourth paragraph of Article 311, with the adoption of a rule providing for majority approval in the Council and the European Parliament, and without national ratifications.

Fiscal autonomy, i.e. a recognition of the Union's fiscal power, must underpin a new relationship between citizens and the Union. It is widely held that Europe is an institutional entity far removed from common feeling, and this phenomenon is also at the root of the explosion of sovereign movements in several European countries. An initial response to these claims was the decisions that the Union was able to take during the crisis caused by the Coronavirus. However, an important factor is that the citizen is unable to assess the extent to which he or she contributes to the financing of the European level of government, and to what extent he or she receives a benefit from it.

Fiscal autonomy implies, on the one hand, an increase in the Union's responsibility towards its citizens, who pay directly to support its expenditure. Seen from this perspective, a major reform could be a replacement of national contributions by a European surtax on national income tax, without any change in the structure of each country's tax system. This surtax, as well as highlighting for each citizen the contribution required to finance the European budget, could be formulated at a rate that increases progressively as the per capita income of the various Member States increases.[27]

[26] O. Fontana, A. Majocchi, "*Border Carbon Adjustment*: una nuova risorsa per il bilancio europeo", Centro Studi sul Federalismo, Torino, Commento n. 172, 3 aprile 2020
[27] A. Majocchi, *Progressivity in Financing EU Budget*, Centro Studi sul Federalismo, Torino, Policy Paper no. 22, January 2017

On the other hand, fiscal autonomy also follows a change in the structure of European expenditure, which becomes closer to the citizens, for example with SURE, and which represents the first steps of a European intervention to co-finance unemployment benefits. This intervention is also the result of the emergence of a more widespread feeling of solidarity during the health crisis, and will have to evolve towards a more active European policy to guarantee minimum standards of social benefits throughout the Union, particularly in the areas of health, education, protection of the elderly and the disabled, and guarantees of job security for workers.

The recognition of the Union's fiscal power will therefore give meaning to the evolution of European taxation towards a fairer and more transparent structure. Thanks to the use of the carbon dividend, this will provide a role for the Union in stabilisation and development policy – today with the financing of the Recovery Plan, through the issuance of bonds guaranteed by the European budget. But this will also be the case in the EU's allocative function, with increased production of European public goods – particularly in relation to environmental protection – and in the interpersonal redistribution of income, pending the completion of the federal structure with the launch of a common foreign and security policy.

CENTRO STUDI SUL FEDERALISMO
Piazza Arbarello 8 - 10122 Torino - Italy
Tel. +39 011 670 5024
info@csfederalismo.it
www.csfederalismo.it