



Financing the EU's recovery

Increased budget ceiling and (new) EU revenues

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EUR 1.82 trillion financial package – an overhaul of the EU's funding. The EUR 750 bn recovery package agreed upon by EU leaders two weeks ago will be financed through EU borrowing while the EUR 1,074 bn budget for the next seven years mainly depends on payments by EU members.

EU budget mainly financed through members' direct contributions. The EU's EUR 1 trillion Multiannual Financial Framework (MFF) will continue to be primarily financed through the EU's own resources, with the lion's share stemming from members' contributions based on their relative Gross National Income (GNI).

Increased own resource ceiling as a precondition to tap markets. The EUR 750 bn recovery package will be financed through market borrowing by the European Commission. For the Commission to tap markets, the own resources ceiling – i.e. the maximum amount that can be called per year to finance EU expenditure – will be temporarily increased from the current 1.2% to 2% of EU members' GNI.

New own resources to repay EU borrowing. The Council committed itself to reforming the EU's financing system and plans to introduce new own resources for early repayment of EU borrowing. A new levy on non-recycled plastic packaging waste will be introduced by 1 January 2021 (estimated revenues: EUR 7 bn p.a., according to the EC). By the end of 2022, a carbon border adjustment mechanism (EUR 5-14 bn p.a.) and a digital tax (EUR 1.3 bn p.a.) should follow. This should be supplemented by a levy stemming from the European Emissions Trading System including a possible extension to aviation and maritime (EUR 10 bn p.a., no timeline). Later down the road, a long-discussed financial transaction tax (EC estimate: potentially EUR 57 bn) might follow, but only with a view to the next MFF.

Top priority at present is swift adoption of the budget and recovery fund to address the consequences of the pandemic over the coming years. Following agreement in the Council, the MFF 2021-2027 now requires the consent of the European Parliament, in an absolute-majority vote. The decision about own resources – EU borrowing, increased ceiling and new own resources – needs to be approved by all member states in accordance with their constitutional requirements (including approval by national parliaments). While we do not expect an overall blockage of the package by the European Parliament or member states, delays cannot be excluded.

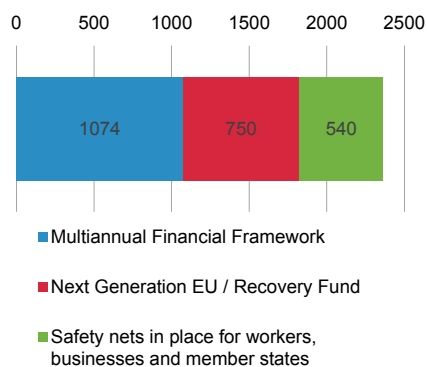


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The EU's 2 trillion recovery package

1

Recovery Plan for Europe, EUR bn

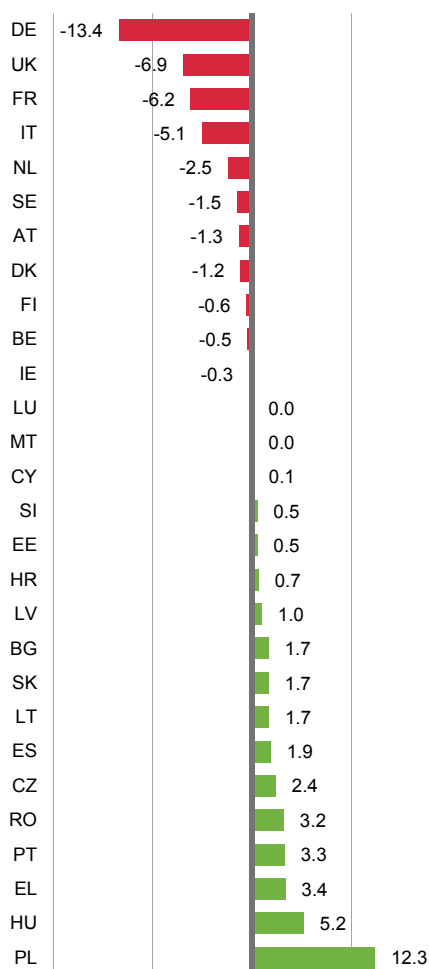


Source: European Council

EU members' operating budgetary balance in the MFF 2014-2020 (2018 contributions)

2

EUR bn (2018)



Source: European Commission

An overdue overhaul of the EU's revenues

In their almost-five-day special meeting from July 17 to 21, EU leaders agreed after cumbersome negotiations on a historical EUR 1.82 trillion financial package for the EU, consisting of a EUR 1,074 bn budget for the next seven years and a EUR 750 bn recovery package.¹ As in the past, the EU's EUR 1 trillion Multiannual Financial Framework (MFF) will be mainly financed through the EU's own resources, with the lion's share stemming from members' contributions based on their relative Gross National Income (GNI).

The EUR 750 bn recovery package will be financed through market borrowing by the European Commission. The bulk of it will go to the newly introduced Recovery and Resilience Facility (EUR 672.5 bn), in the form of grants (EUR 312.5 bn) and loans (EUR 360 bn). The rest of the recovery package (EUR 77.5 bn) will be used to size up and front-load the seven-year budget.

For the Commission to tap markets, the own resources ceiling – i.e. the maximum amount that can be called per year to finance EU expenditure – will be temporarily increased from the current 1.2% to 2% of EU members' GNI. Following the proposal of Council President Michel, new own resources will be introduced, starting in 2021. These will be used for early repayment of the Commission's bonds already within the 2021-2027 budgetary period.

As economic data across the EU start to confirm the severity of the fallout of the pandemic, the EU is in a hurry to get its joint fiscal response in place. But unanimous agreement among the EU's 27 leaders on the recovery package was only the first hurdle towards implementation of the EU budget and recovery fund.

The European Parliament needs to consent to the MFF as well, and it has already expressed its discontent with parts of the Council conclusion in a resolution adopted on July 23. The EP declared its preparedness "to withhold its consent for the MFF until a satisfactory agreement is reached".

The decision to increase the EU's own resources ceiling needs to be approved by all 27 EU member states; the summit agreement was just a political declaration, the legal implementation act will follow and includes votes by national parliaments in member states. Any delays in final approval of the MFF and the own resources decision might translate into delays in the disbursement of spending programs and funds urgently needed to tackle the crisis.

In the negotiations among leaders in the Council, the size and net contributions to the next budget and recovery package took center stage. The introduction of new EU-wide taxes and levies to prop up the union's finances has been discussed for years, with no significant progress until now. Member states had been concerned that granting the Commission any rights to directly raise revenues might limit their own control over these resources as well as their sole power to levy taxes.

The financing of the EU's multi-year budget has always been a controversial issue among members, repeatedly leading to contentious negotiations between net contributors and net recipients. In particular the "frugal four" – the Netherlands, Austria, Denmark and Sweden – feel that they contribute too much to the budget. In the next budget, they – and Germany – will therefore benefit from further rebates on their contributions, a remnant of the British EU membership arrangement that the Commission and EP had hoped to abolish post-Brexit. Together with heavy lobbying for protecting the status quo in cohesion and agricultural funding among members, the continuation of rebates

¹ See EU Monitor, EUR 750 bn EU Recovery Fund: Deal! July 21, 2020.



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contributes to the cuts of urgently needed spending on innovation and digital transformation in the next EU budget.

The need to reform EU budget revenues seems to have gained a new impetus given the urgency to rapidly react to the pandemic. While for some, including the European Parliament, the Council's Conclusion is not ambitious enough, others see the mere fact that European leaders managed – in a relatively short period – to unanimously come up with a recovery plan and its financing as a remarkable success.

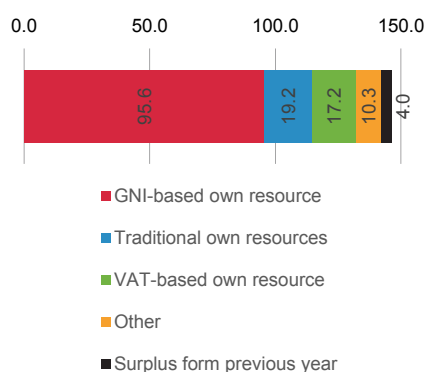
The composition of EU finances and in particular the introduction of new own resources as well as the own resources decision agreed on in the Council have frequently led to misunderstandings and confusion, which we attempt to clear up in the following overview and discussion.

Structure of the EU's revenues

Financing of the current EU budget

3

EU budget revenues (2014-2018 average), EUR bn



Sources: European Commission, Deutsche Bank

The EU is mainly financed by its “own resources”. These are revenues assigned to the Union to finance its budget and that accrue to it automatically, with no necessity for further decision-making by national authorities. They account for more than 90% of the budget, while the remaining revenues come from other sources of income (see Chart 3).

The EU's three own resources:

- **GNI-based own resource** consists of national contributions calculated on the basis of gross national income (GNI), which is considered to reflect each country's financial ability to contribute. It was designed as a complementary resource, needed in addition to the other two own resources to achieve a balanced budget. For this reason, contributions are determined on an annual basis. Today, GNI-based contributions are the EU's largest source of income, covering approximately 67% of the budget in 2014-2018. EU countries' contributions differ sharply, based on their GNI, leading to stark variations in net contributions to or receipts from the budget between the EU's wealthier and poorer members.²
- **VAT-based own resource** is a percentage of the value-added tax collected in the member states paid to the EU. For the next MFF, the contribution rate is 0.3% of the harmonised VAT base (same call rate as in the current period, but the reduced call rate of 0.15% for Germany, the Netherlands and Sweden has been abolished). This revenue source contributed around 12% to the EU budget in 2014-2018.
- **Traditional own resources (TOR)** include customs duties levied at the external border of the single market. They are collected by the member states and forwarded to the EU. For their collection costs, member states can retain 25% under the new MFF (increased from 20%). Traditional own resources contribute around 13% to the current budget.

Correction mechanism. The member states' contributions consist mainly of GNI-based own resource. This has resulted in some wealthy member states feeling that their net contribution to the EU budget is disproportionately high. To address this, reductions of the VAT-based and GNI-based own resources have been granted to these member states. They were able to secure their rebates for the next MFF as well. The Council decided upon lump-sum corrections of the annual GNI-based contributions for Germany (EUR 3.7 bn), the Netherlands

² See Talking Point, EU budget 2021-2027. Europe's future sacrificed to the status quo? February 25, 2020.



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(EUR 1.9 bn), Sweden (EUR 1.1 bn), Austria (EUR 0.6 bn) and Denmark (EUR 0.4bn).

Other sources of income. In addition, the EU generates other income with taxes from EU staff salaries, bank interest, fines and contributions from third countries.

New own resources to repay EU borrowing

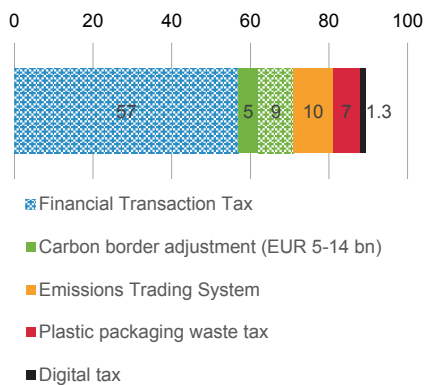
Commitment to reform the own resource system. For years, the Commission and the European Parliament have called upon the Council to introduce new own resources as direct contributions to the EU. But in the past, member states were reluctant to grant the EU new sources of income. Discussion of the introduction of new own resources has been ongoing since 2004 with no material achievement.

The current pandemic and need to repay the planned Commission borrowing seem to have provided the required impetus to substantial reforms of the revenue system. Increased financing needs from Brexit (with the departure of the UK, the EU lost one of its largest contributors; it provided EUR 6.9 bn [net] to the budget in 2018; see Chart 2) and pressure from the European Parliament contributed. At the special meeting on July 17-21, the European Council committed itself to reform the own resources system in the coming years.

Estimated revenues from proposed new own resources

4

Estimated annual revenues from proposed new own resources, EUR bn



Note: FTT Commission's estimation from 2011; could change substantially depending on the design of the FTT; not likely to be introduced before the next MFF.

Source: European Commission (2020, 2018, 2011)

To repay the EU borrowing, several new own resources should be introduced or might be considered over the next years:

- i. A new own resource based on non-recycled plastic packaging waste
- ii. A carbon border adjustment mechanism (carbon border tax)
- iii. An EU-wide digital tax
- iv. An own resource from the Emissions Trading System and extension to aviation and maritime
- v. A Financial Transaction Tax

The introduction of new sources of income might also help to secure a high credit rating for the Commission's bond issuing. Several of these levies – such as the financial transaction tax and the digital tax – have been discussed on and off for years already. The Council Conclusion now provides a roadmap for an introduction of these taxes. According to different estimates by the European Commission over the years, these new taxes could account for additional revenues of up to EUR 90 bn per year; a bulk of revenues could come from the FTT (see Chart 4). But even without the introduction of an FTT, the Commission estimates call for direct contributions to the EU (customs duties plus new own resources) to more than double to above EUR 50 bn if the other proposed levies are introduced.

Levy on non-recycled plastic packaging waste

The Council agreed to introduce this new plastic levy by 1 January 2021. The objective is to reduce the volume of non-recycled plastic packaging waste in the EU, i.e. to create incentives for member states to reduce waste and increase recycling. The levy is therefore a policy instrument derived from the European Strategy for Plastics in a Circular Economy. Member states will pay a levy of EUR 0.8 per kilogram of non-recycled plastic packaging waste. A correction mechanism ensures that poorer member states do not pay disproportionately high levies (which in itself contradicts the environmental reasoning for the tax).

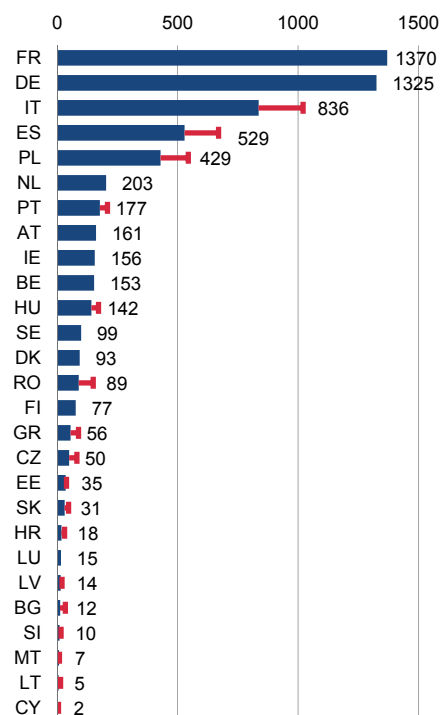


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Estimated national contributions to levy including correction mechanism

5

Annual levy on non-recycled plastic packaging waste, EUR million



Note: Rebates based on the correction mechanism are indicated in red. Calculations based on data from 2017.

Sources: Politico (February 25, 2020), Eurostat, Deutsche Bank Research

In its initial proposal of 2018, the European Commission estimated the revenues from this tax at EUR 7 bn per year. However, the correction mechanism that has now been adopted will reduce revenues by about EUR 700 m per year (Politico, February 25, 2020). The largest contributors will be France and Germany, followed by Italy, Spain and Poland (see Chart 5). One issue with this levy: if the instrument is effective in achieving its policy goal, it will not be a stable source of revenue, as adjustments and measures to reduce waste can be expected to reduce revenues over the years.

Carbon border adjustment mechanism (CBA)

The EU's climate targets laid down in the European Green Deal³ will make CO₂ emission more expensive. To prevent emission-intensive production from moving to regions with no or lower CO₂ taxations, the European Commission plans to introduce a 'carbon border adjustment mechanism'. Under the mechanism, products imported into the EU would be taxed according to the CO₂ emissions generated during their production. This is intended to create incentives for low-emission production as well as to reduce competitive disadvantages for producers within the EU. The CBA could generate considerable revenues at EUR 5-14 bn per year, according to Commission estimates.

The CBA is comparable to custom duties. The Council intends to introduce a CBA by the end of 2022 and mandated the Commission to present a proposal early in 2021. Whether the introduction will succeed within this timeframe is more than uncertain, as there are still complex issues to be resolved. These include, in particular, defining how much CO₂ is contained in a product as well as finding a solution that is compatible with WTO rules and does not further intensify existing trade conflicts. The tightrope walk towards a protectionist instrument is narrow. Different commentators consider the political costs of introducing the CBA disproportionately high.⁴ With regard to the repayment of EU borrowing, it should also be noted that the CBA is an instrument of climate protection and is not primarily intended to generate income.

Digital tax

The Council intends to introduce a digital levy by the end of 2022. The objective of the digital levy is to adapt the tax system to digital business models. The Commission is considering taxing large digital companies with a global annual turnover over EUR 750 m and more than EUR 50 m in the single market. Revenues from this levy are estimated at EUR 1.3 bn per year. The first proposal on taxation of the digital economy was presented by the Commission in 2017 but failed to achieve agreement in the Council. From the Commission's point of view, the current international tax rules do not adequately cover these business models, as many tech giants pay comparatively low taxes in Europe despite the profits they make in the single market. The EU has been working within the OECD and G20 to find an international solution, an endeavour that so far has shown only very slow progress.

The issue of introducing a digital tax is controversial among both academics and EU leaders. The Commission's initial proposal foresaw the taxation of certain revenues of large companies (e.g. digital advertisement). This has caused criticism, as current rules tax profits, not revenues. The levy also raises

³ https://ec.europa.eu/info/strategy/priorities-2019-2024/european-green-deal_en

⁴ Zachmann, Georg and Ben McWilliams (2020). A European carbon border tax: much pain, little gain. In: Bruegel Policy Contribution No. 5.



questions about the avoidance of double taxation and coherence with policies to promote digitalisation.

In addition, there is the risk of further tensions with the United States as the levy primarily affects US companies. However, the Commission also sees itself as compelled to act because some member states – such as Austria, Italy, France and Spain – have already introduced or are preparing to introduce their own digital taxes, which results in different rules within the single market.⁵

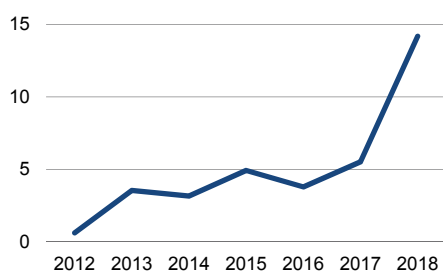
To what extent members are willing to share these revenues with the EU is not entirely clear. But several members – including France, Italy, Spain and Austria as well as Germany, Bulgaria, Romania, Slovenia, Greece and Portugal – have expressed their support for the introduction of a European digital tax for some years already. Ireland, the Netherlands, Denmark, Sweden, Finland, Luxembourg and Malta were rather critical or even opposed to such a levy (Politico, September 21, 2017; International Tax Review, July 12, 2018). Still, the fact that the proposal for a digital levy found its way into the Council Conclusion, including a timeline for its introduction, provides some indication that opposition among members might have diminished.⁶

Own resource from the ETS, extension to aviation and maritime

Revenues from the European ETS

6

Revenues from the ETS, EUR bn



Source: European Commission

The Council has invited the Commission to revise its 2018 proposal for an own resource based on the European Emissions Trading System (ETS) and to explore the possibility of an extension to aviation and maritime. Based on recent estimates, the Commission expects annual revenues of EUR 10 bn, including an extension to aviation and maritime. In the Commission's view, the ETS is a suitable basis for own resources as it provides a EU-wide system. So far, the revenues from the ETS have been allocated to member states only. The Commission has proposed that 20% of the revenues from certain emission allowances should flow into the EU budget.

While the Council has mandated the Commission to work towards the introduction of a revised ETS scheme, it remains uncertain when and how it might be implemented. All members would have to agree. On the one hand, revenues from the ETS are expected to increase further (see Chart 6), which might make member states more willing to allocate a share to the EU budget. On the other hand, countries that would contribute more to the EU budget than under the GNI contributions could be particularly opposed to contributions via the ETS. According to one estimate⁷, this is the case for Poland, whereas France, Germany and Sweden would contribute less to the EU budget through the ETS compared to their share of GNI contributions.

Yet we expect a contribution from the ETS to the EU budget to be politically more feasible than an extension to aviation and maritime. In both sectors, there are efforts at an international level to introduce an emissions trading system. Aviation has been part of the European ETS since 2012. However, the EU had to limit it to aviation within the single market, following strong reactions – particularly from the United States and China – to plans to include international aviation in the European ETS. Without international agreement, it remains difficult to include international aviation and maritime. Instead, the reduction of free allowances for the European aviation sector is currently being considered.

⁵ Tax Foundation, June 2020.

⁶ See EU Monitor, Taxing the digital economy, May 21, 2019, for a more detailed discussion about taxation of the digital economy.

⁷ Darvas, Zsolt (2019). A new look at net balances in the European Union's next multiannual budget. In: Bruegel Working Paper No 10.



Financial Transaction Tax

In their conclusion of the July Council meeting, EU leaders also listed a Financial Transaction Tax (FTT) as a possible other own resource to be introduced in the course of the next MFF. An FTT could generate substantial revenues. According to the Commission's initial estimate in 2011, it could amount to EUR 57 bn per year. But the revenue depends largely on the design of the FTT. It is also likely to vary from year to year due to the volatile volume of financial transactions over time.

An FTT has been under discussion since the 2008 financial crisis, when calls for higher contributions to public finances from the financial sector became louder. The Commission presented a first proposal for a harmonized FTT in 2011, also with the aim of avoiding different rules and regulations within the single market. But no agreement was reached. Since then, ten member states⁸ have joined forces in an enhanced cooperation to introduce a harmonised FTT – still without success. In the meantime, seven member states introduced an FTT on a national level, including three participating states (France, Italy, Belgium) and four states that are not participating in the enhanced cooperation (Ireland, Poland, Finland, Hungary).

Critics of the FTT fear competitive disadvantages and the withdrawal of financial players from their markets and thus advocate for an international solution. Given the long-winded discussion and the different development in member states, it will likely be difficult to reach an agreement on an EU-wide FTT as a new own resource.

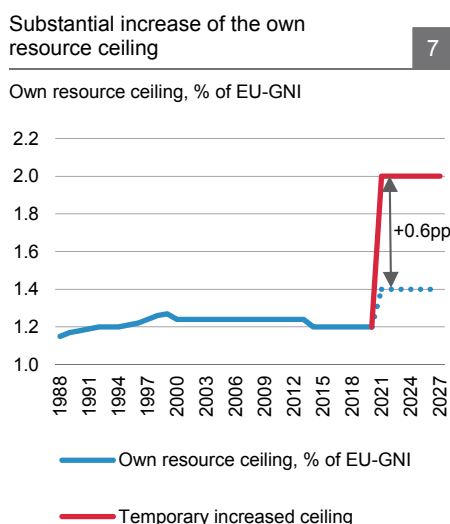
Introducing new own resources – not the same as increasing the EU's own resources ceiling

In the discussion about financing the EU's next budget, two things frequently tend to get confused: the introduction of new own resources – which we discussed above – and an increase of the EU's own resources ceiling.

“New” own resources will add further sources of income to the budget. In the same manner as the traditional own resources, they will constitute direct contributions to the EU's finances. When there is talk about the EU's own resources, all three types are meant, i.e. GNI-based, VAT and traditional and new duties and levies.

With the own resource ceiling, the member states determine the maximum own resources allowed for the EU budget. It is expressed as a percentage of all member states' GNI. It is not limited to the GNI-based contributions. Rather, it is the total amount that the GNI-based contributions, together with the (currently two) other types of own resources, may not exceed. At the same time, the ceiling also sets the limit on expenditure, as the EU budget must be balanced.

At the special meeting in July, the Council agreed to increase the own resource ceiling for payment appropriations from the current 1.20% to 1.40% of the EU GNI. According to the Commission, the increase was necessary to provide the EU with sufficient financial leeway to meet current financial obligations after Brexit. On top of that, the Council decided to temporarily increase the own resource ceiling by additional 0.6pp. These additional resources are intended solely to cover the liabilities in connection with the EU borrowing needed to finance the European recovery fund. The elevated ceiling applies only as long as the liabilities are not repaid, at most until the end of 2058 (but might be reduced much earlier, depending on the repayment schedule). Taken together,



Source: European Commission

⁸ Austria, Belgium, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia, Spain.



this means that a ceiling of 2% of the EU27 GNI applies from next year (see Chart 7).

Next steps

At its July 17-21 meeting, the Council agreed on the next MFF, a recovery package financed with EU borrowing, the increase of the own resources ceiling and the introduction of new own resources over the next years. These decisions now face different further legal requirements.

Adoption of the MFF and the role of the European Parliament. Following the Council's agreement, the MFF needs the consent of the European Parliament, which votes with absolute majority. The EP is strongly in favour of the introduction of new own resources and has called for it for many years. However, the income side of the budget is dealt with in a separate own resource decision, in which the EP is consulted but has no decision-making power. The EP's primary power in this process is its responsibility to vote on the MFF, by which it could express its dissatisfaction with the Council Conclusion. In an EP vote shortly after the Council meeting, the EP already threatened to reject the plan in its current form, criticising it for cuts to (future-oriented) MFF spending, concessions on the rule of law, and rebates. A binding commitment and calendar by member states for new sources of EU revenues is deemed indispensable.

In 2013, the EP first rejected the Council Conclusion on the MFF 2014-2020 with a vast majority and accepted the long-term budget only after months of negotiations and adjustments to the plan.⁹ However, whether the EP in the current situation would substantially delay the urgently needed budget plus recovery fund can be questioned; and a permanent rejection of the budget by the EP after consultations with the Council would be unprecedented.

EU borrowing, elevated ceiling and new own resources require approval by all member states. Regarding the own resources decision, including the increase of the own resources ceiling, Commission borrowing and the introduction of a plastic levy, the Council's unanimous decision was the first step. In a second step, all 27 member states need to approve the decision "in accordance with their respective constitutional requirements". This includes the consent of national parliaments. On the own resources decision, the EP will only be consulted. Again, while our baseline is not a blockage of the decision among members, delays cannot be excluded.

For all other proposed new own resources, the Commission has to prepare individual legislative acts that must in the same way be unanimously approved by the Council and all member states. The only exception could be the carbon border adjustment mechanism. If its design is to be more of a 'custom duty' rather than a 'tax', the Council can decide on it by qualified majority and under the co-decision procedure with the European Parliament.¹⁰

Top priority is agreement on the MFF and the increased ceiling. In the short term, the priority will be to get EP approval on the budget and national approvals on own resources as soon as possible to bring spending programs along and allow the Commission to tap the market and bring the RRF life. When it comes to the design and implementation of new own resources, national preferences and priorities will continue to diverge strongly.

⁹ European Parliament, November 2013.

¹⁰ Lamy et al. (2020). Greening EU trade 3. A European Carbon Border Adjustment proposal. In: Policy Paper, June 2020, Europe Jaques Delors.



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The introduction of new own resources will therefore be a medium- to long-term project. While the first one, the plastic levy, should start already in 2021, lengthy negotiations and discussions can be expected about the introduction of the proposed other new own resources.

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