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Citation

Leen, A. R. (2017). The Austrian Case for a Consumption Tax to Finance the European Union. In N. Delener & C. Schweikert (Eds.), *Annual International Conference Readings Book / Global Business and Technology Association* (pp. 348-355). New York: Global Business and Technology Association. Retrieved from https://hdl.handle.net/1887/57403

Version: Not Applicable (or Unknown)
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Downloaded from: https://hdl.handle.net/1887/57403

Note: To cite this publication please use the final published version (if applicable).

Published: A.R. Leen (2017), 'The Austrian Case for a Consumption Tax to Finance the European Union', in *Changing business environment: gamechangers, opportunities and risks*, ISBN 1-932517-13-6. New York, NY, 2017, pp. 289-296.

THE AUSTRIAN CASE FOR A CONSUMPTION TAX TO FINANCE THE EUROPEAN UNION

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ABSTRACT

We discuss the proposal of the High Level Group on Own Resources to introduce new means, stemming from production, consumption and environmental policies, to finance the budget of the European Union. We assess the taxes from the perspective of the market economy in general and entrepreneurship in particular. To modern Austrians, the market is a spontaneous evolutionary process of discovery. Based on that perspective a consumption tax is, by far, the preferred tax to finance the Union's budget.

Keywords*: entrepreneurship, EU budget, EU VAT, financial transaction tax, modern Austrian economics*

INTRODUCTION

One of the main objectives of taxation is collecting money for the government. In principle it should not influence the market process, except of course if the explicit aim is to stir up the market with a specific tax or Keynesian-based fiscal policy. This paper looks at the tax policy of the European Union (EU) based on the first of these two points of view. At the moment this is the predominant and relevant view. The present budget is too small for anti-cyclical economic stabilization and substantive redistribution (HLGOR, 2016: 6). For ideas on these latter goals of the EU budget, including progressivity in the contributions of the Member States (MS) (HLGOR, 2016, p. 39), see, e.g., the MacDougall Report (1977, pp. 64-65).

Until recently two taxes were discussed for financing at least about half of the budget, based on a proposal of the European Commission (2011a): a financial transaction tax (FTT) and a consumption tax (an EU VAT). More recently, in December 2016, a High Level Group on Own Resources (HLGOR) chaired by Mario Monti that was established in April 2014 broadened the range of candidates for new own resources to nine. Taking the perspective of modern Austrianism, this paper makes the case for one of them: a consumption tax. The results are based on the ideas of Friedrich Hayek and Israel Kirzner in particular.

EU BUDGET REFORMS

When the EU's two predecessors - the European Economic Community and the European Atomic Energy Community - were established in 1958, direct Member States' contributions financed the Union. However, the goal has always been to have independent sources of finance. At the beginning of the 1980s the EU indeed got its own resources: agricultural levies, custom duties and a percentage of a harmonized VAT base.

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At present, because of a growing budget and dwindling custom duties, the EU is financed for only 30 percent by these so-called traditional own resources. Its main source of revenue consists of direct contributions by the Member States, which pay a percentage of their Gross National Income (GNI) that is 1.23 percent at most. For 2017 the total budget, in commitments, is nearly 158 billion euro or 1.04 percent of GNI.

Direct contributions, however, have a great drawback: they stimulate so-called *juste retour* behavior of the Member States: they look at what they get and what they give to the Union. Expenses with a real added value to the EU as a whole are stifled. Added value is defined as "the value resulting from an EU intervention which is additional to the value that would have been otherwise created by Member State action alone" (HLGOR, 2016, p. 27). One can think of the present needs for migration and security policy, as well as e.g., energy security and a European infrastructure. The bulk of the expenses, almost 80 percent, however, concern agricultural subsidies and income redistribution among Member States (MS). In general, MS tend to favor instruments that improve their net position rather than those with the greatest value added for the EU as a whole.

To curtail the Member States' focus on their net contributions, the EU wants new, so-called true own resources. The European Commission (2004) or simply Commission (the EU's executive arm, which proposes and rejects) and the European Parliament (2007) (which exercises legislative and budgetary functions jointly with the European Council) endorse the idea of a European tax. (The Council defines the EU's overall political direction and priorities. Its members are the heads of state or government of the 28 EU Member States, the European Council President, and the President of the European Commission). As announced in the budget for the European Union that was accepted by the Commission on February 8, 2013, and still on the wish list today (European Commission, 2016), the Union wants to introduce new own resources. The Commission (2011b) selected a financial transaction tax (FTT) and a European VAT as the two most likely candidates. Recently, however, a HLGOR composed of members appointed by the Commission, Council and European Parliament broadened the list to nine candidates by including taxes stemming from production, consumption and environmental policies: (1) CO_2 levy/carbon pricing; (2) Inclusion of the EU Emissions Trading System proceeds; (3) Motor fuel levy; (4) Electricity tax; (5) EU corporate income tax; (6) FTT; (7) Bank levy; (8) EU VAT reformed; and (9) Seigniorage (HLGOR, 2016: 87).

It should be noted here that the new EU VAT is not to be compared with the existing VAT contribution. The latter has nothing to do with the direct VAT revenues of MS. In order to compensate for the regressive nature of taxing consumption, the base for calculating the contribution is currently set at 50% of the GNI of the Member States. Furthermore, with all of the later adjustments and rebates the VAT contribution has become a statistical figure based on a Member State's GNI. It is a thorn in the side of the Commission. According to the Court of Auditors (the EU's independent external auditor) "the VAT resource is levied on a 'virtual' basis (a harmonized VAT base which may be subsequently capped and takes into account compensation arrangements for the UK) which is complex to the point of incomprehensibility" (European Commission, 2011a).

Another point of note is that an FTT is a tax that impacts financial transactions between financial institutions. For a VAT, however, the aggregate tax base is the sum of all sales by businesses to non-businesses. The latter is a measure of aggregate consumption, which is the reason why it is called a consumption tax. The base is called an R base (for real, to distinguish it from financial transactions). Under an R based tax, sales for goods and services are taxed, and purchases of goods and services are deductible, but financial transactions, including the payment and receipt of interest and dividends, are ignored. This creates an issue with regard to the taxation of banks and other financial intermediaries: it compromises the neutrality of the tax. Competitive distortion and diversion of tax revenue may be the result. Hence, one of the aims of introducing an FTT is to make the sector pay its fair share since it is under-taxed in comparison to other sectors. It is estimated that the sector, because of VAT exemption on financial services, enjoys a tax advantage of about 18 billion euros each year (European Commission, 2011c). The other reason to introduce an FTT is that, in the eyes of the Commission (*o.c.),* the sector contributed to the financial crisis of 2008 and should pay for it.

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THE MARKET PROCESS

The two central figures of modern Austrianism are Ludwig von Mises and Friedrich Hayek. Both of them focus on market adjustment processes. Building his theory as Mises and Hayek have done, Israel Kirzner believes that one of the central failures of neoclassical (equilibrium) analysis is that it assumes that equilibrium is actually brought about. The real problem, however, is to describe the possible realization of an equilibrium as the result of "the systematic way in which plan revisions are made as a consequence of the disappointment of earlier plans" (Kirzner, 1962, p. 381). In short, the market process is a "dynamic entrepreneurial-competitive discovery process" (Kirzner, 1988, pp. 5-6). What drives the market is entrepreneurship; what characterizes it is competition; and the various steps of the process are discoveries.

What is more, the market is an evolutionary spontaneous process of discovery (Hayek, 1988, p. 146): the market order evolves spontaneously without central direction. No central planner is needed, nor even possible. We do have individual economies, a household or an enterprise, which have their goals and given sets of means. We do not have a market economy in the sense of an order that has a single order of ends. The allocational approach to economics, i.e. economics seen as a theory of choice, is inapt for the market order. The market is a network of many interlaced economies; it is not a singular economy (Hayek, 1982, II, pp. 107-8).

Hayek's insight resembles modern complexity theory. Complexity theory "studies how the interacting elements in a system create overall patterns, and how these overall patterns in turn cause the interacting elements to change or adapt" (Arthur, 2013, p. 2). We are looking at cultural evolution and the adaptive learning that goes on within large organizations. It is a view of the economy as something that is emerging from the interactions of individual agents whose behavior constantly evolves, whose strategies and actions are always adapting.

Since we are living in a complex world we have a fundamental lack of knowledge of all the specific facts that lead to a market order but on whose functioning we depend. The order, a self-maintaining complex structure, is the result of individuals observing certain rules and adjusting them to their specific situation. The market order is "the result of human action but not of human design" (Hayek, 1982, I. p.20). It is a harmony too complicated for individual comprehension. "The curious task of economics is to demonstrate to men how little they really now about what they imagine they can design" (Hayek, 1988, p. 76). The twin concepts of spontaneous order and evolution are the main tools for understanding and coping with complexity.

THE MARKET PROCESS AND TAXATION

How to cope with our fundamental ignorance of the market process? For taxation this means that we have to assess a tax for its ability to promote creative acts of entrepreneurship. In this respect the distinction between risk and uncertainty is of fundamental importance. The first refers to the risk of a known alternative. The main situation the entrepreneur has to cope with, however, has nothing to do with a known uncertainty compared to given alternatives. The entrepreneur first has to come up with those alternatives. He has to come up with a framework of ends and means (Kirzner, 1973, pp. 82-4). Afterwards he can assess the riskiness of the ends and means. The effect of taxation is different for each of these situations: we're talking about a known uncertainty of "given" means and ends versus a fundamental uncertainty as far as what the means and ends are in the first place. Neoclassical economics hints at the influence of taxation with regard to the first form of risk; Austrian economics hints at the second form of risk. Fundamental ignorance, and hence an ultimate error, is pitted against a situation of given alternatives involving risk (where we do know the probability distribution of incomes attached to each alternative). For the Austrian economist, entrepreneurship is defined as the very perception of the ends-means framework within which allocation and economizing is to take place (Kirzner, 1973, p. 33).

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Four reasons why taxing businesses or changing relative prices is wrong

The first reason not to tax an entrepreneur, and hence not to introduce business related taxes such as an EU corporate income tax, an FTT and a bank levy, relates to the entrepreneurial role of spotting a new opportunity that is available (Kirzner, 1985, pp. 93-118). The entrepreneur spots something that we did not even know existed. This is true for the financial as well as the non-financial sector. An error (utter ignorance) in a market economy reveals itself by showing up as an opportunity for monetary profit. This is completely different than speaking of an uninsured idiosyncratic risk. To stimulate the discovery process we have to look at the producer-entrepreneur. We can conclude that any form of taxation that lowers prospective profits hinders the market's entrepreneurial process of discovery. Profit provides the incentive that inspires entrepreneurial discoveries.

A second reason to exclude the entrepreneur from taxation is that demand is not the desire of the consumer, *i.c.* other traders who buy a product, for a hypothetical product that has not yet been produced. "[T]he demand that is expressed in the demand curve for a product means the quantities of it that consumers will be prepared to buy, at given prices, when offered the opportunity of doing so" (Kirzner, 1973, p. 178). Consumer sovereignty means that production patterns are dictated by the pattern of consumer demand. To be specific, it means that "production decisions are determined by entrepreneurial anticipation of the patterns of demand that will be evoked by alternative production plans" (*o.c.*, p. 176). Consequently, if the distortions of taxation—the impact on the discovery process—should be minimized, taxes should not be levied on the entrepreneur. He is the first, the *conditio sine qua non*, to come up with something new in the causal market process.

The third reason is that if it is entrepreneurship that we focus on, profits have to be as visible and promising as possible. Entrepreneurship has to be stimulated. It involves fundamental uncertainty in general but also, and of particular relevance in this respect, uncertainty as far as the complexity and instability of the tax code goes: legislative changes and tax court rulings. Often, because of either the sheer size or instability of the tax code, it is impossible to predict the tax consequences of a particular activity. This fundamental uncertainty loosens the entrepreneurial grip on pure profit. Profits or losses arising from tax changes, by a fortunate or unfortunate change in the tax system, take place after the entrepreneur has taken up his position. A potential and in fact superior vision may be highly stifled. We remove much of the incentive—to "purposeful alertness, the alert purposefulness" (Kirzner, 1999, p. 39)—for paying attention to the unknown.

Fourth, Austrians emphasize the division of knowledge and its growth. To Hayek (1945, pp. 519-520), "the economic problem of society […] is a problem of the utilization of knowledge not given to anyone in its totality." Entrepreneurial opportunities tend to present themselves within the context of a specific time and place. A decentralized economy allows individuals to act on their entrepreneurial insights, and rewards them for doing so. And since entrepreneurial insights also lay the foundation for additional entrepreneurial insights, the growth process of the economy is sustained. The market system encourages the full use of (decentralized) human knowledge. There is no efficient non-market, e.g., governmental, resource allocation. This was the insight that the Austrians tried to bring to the fore in the socialist-calculation debate that raged during the interwar period of the last century (Hayek, 1949). The debate began with the question, "Is an efficient non-market resource allocation possible?" For the Austrians, market based prices are necessary to signal scarcity, to transmit knowledge and to stimulate discovery. The government cannot be trusted to do this job, i.e. guiding the discovery process by changing the relative preferability of means of production, as is done with a carbon pricing, the proceeds of the EU Emissions Trading System, a motor fuel levy and an electricity tax.

Policy conclusion (1): an EU VAT

Of all of the proposed new own resources, seigniorage, i.e. the revenue of the European Central Bank (ECB) from issuing currency, would be an ideal, in fact *the* ideal candidate. This is because it has no influence on the discovery process whatsoever. However, because of the need for a Treaty change—something that is not required for any of the other tax options—the HLGOR does not really consider seigniorage a serious option for a

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new own resource. Additional reasons are the volatility of its proceeds and the fact that not all countries participate in the euro area.

What about the other options for new own resources? Taxing pure profit and/or changing relative prices will hamper the market's discovery process. If profits are lowered (especially since risk is involved), impeding the first one in the discovery process—i.e. the producer-entrepreneur—and relative prices are changed by the central government with unknown consequences, discovery is seriously stifled. We can also conclude that an EU-VAT is the preferred type of tax. Taxing consumers without changing relative prices is the least intrusive way to collect taxes in the market's competitive-entrepreneurial discovery process.

An FTT is not relevant in its present form as a new own resource as it is a tax on business to business. It would become an option in a reformed form, i.e. if it indeed would tax consumers. However, in that case public support for it would probably dwindle. In 2011, 65 percent of European citizens were in favor of its present form, which involves taxing financial institutions (European Commission, 2011c), obviously under the incorrect assumption that consumers would not pay for it (Worstall, 2011).

However, as Milton Friedman said, "[…] the ideal tax system […] ought to be a flat rate tax on consumption […] it has a great virtue which is also the reason it will never exist, [it] limits what Congress can do to mess things up from year to year" (Friedman, 2005). Also, what is the likelihood of an EU VAT to be implemented given the EU decision-making process?

THE (IM)POSSIBILITY OF A CONSUMPTION TAX

What arguments favor the introduction of a consumption tax? First of all, each consumer will be able to see on every sales slip which part of the VAT is going to Brussels. What also stands out is its visibility and simplicity. It could create a better bond between citizens and the Union; the higher visibility of the EU could result in increased political accountability for expenditure decisions. It also brings the size of the EU budget into perspective. A 1% sales tax, as the Commission is thinking of, could furnish about one third of the EU budget. Second, it is easy to introduce. If, as proposed, the total burden for the citizens indeed remains the same (European Parliament, 2007; HLGOR, 2016: 7), it can be introduced simply: all that needs to be done is deducting the EU rate of 1 percent point from the current national VAT rates. Third, the VAT is a stable source of revenue and growth in line with increased spending without any change in its rate (cp. HLGOR, 2016: 53-55).

What arguments exist against the introduction of a consumption tax? First of all, it is most likely that lip service will be paid to earlier statements that the burden for the citizens will stay the same. Citizens will identify the EU VAT as an additional, and most of all, regressive burden. Of course, overall the national contribution of every MS to the EU will stay the same; however, a larger part will be paid through a direct contribution by the citizens. After all, the overall ceiling for the total amount of own resources that may be collected is fixed. The GNI based own resource is always used as a balancing tool; it is a truly residual resource. Second, what can also be an injustice is that because of national differences regarding tax fraud and administrative efficiency the postulate of horizontal equity between EU citizens is violated. In the 1990s the rate of VAT evasion and fraud ranged, e.g., from 2.4 percent in the Netherlands to 34.5 percent in Italy (Heinemann, *et.al.*, 2008). Third, the visibility of the tax could also work against its introduction. Citizens cannot be fooled into thinking that someone else is footing the bill as is the case with, e.g., an FTT or corporate income tax. Fourth, the introduction of an EU VAT is difficult. The decision-making process for the own resource system is amongst the Union's most difficult ones: after consultation of the European Parliament, the proposal of the European Commission must be adopted unanimously by the Council and the national parliaments of the MS.

In order to facilitate a rational discussion that will fulfill the quality demands of both national and international law, the EU must also arrive at a manageable list of criteria to assess the new tax (Heinemann, 2008). In the past, both the Commission and the European Parliament have mentioned visibility, simplicity, financial autonomy, efficiency, sufficiency, cost-effectiveness, stability of revenue, equity, and added value for Europe as potential criteria. The problem is how to tackle this "shopping list" of criteria that the VAT, or any

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other EU tax, would have to meet. What criteria do we include in our measurement and what weights are attached to these criteria? Over the years all has been tried and done to solve this problem (Begg & Grimwade, 1998; Cattoir, 2004; European Parliament, 1997; Federal Ministry of Finance, 2014).

The latest list of criteria and the quantitative assessment thereof (HLGOR, 2016, pp. 87-94) mentions the classical sufficiency and stability criteria, vertical and horizontal aspects of 'fairness' requirements and it also looks if the tax tackles EU policy objectives. However, as was the case with all previous attempts, it doesn't solve the problem either. The EU admits that none of the proposed own resources *per se* fulfill all of the, sometimes even contradictory, requirements. According to the HLGOR (2016, p. 36), however, together they do meet the requirements. That is, if we only look at the fulfilled criteria. Obviously, this is a rather weak argument. Similarly, if we would only look at the criteria that are not fulfilled it could be concluded that together they don't fulfill the criteria.

Moreover, is there a compelling reason at all for introducing a new EU tax? After all, the present GNI based own resource has some strong points. It is a reliable, stable tax that by definition generates sufficient income, and it receives support from the MS. National payments of the GNI resource are easy to calculate, understood by the citizens, and they are seen as a good indicator for the national capability to pay. In short, the system is seen as a simple and fair way of financing, even though some countries do of course underestimate their GNI because of tax fraud. In sum, the GNI contribution is not much different from what the European Parliament wants to achieve with an EU VAT. The only difference is that no direct relation exists with the EU citizens, and the financial autonomy for the European Union would not be changed. Besides that, at the beginning of the 1980s the Union got its true own resources---and still there were budgetary battles.

What's in a name?

It should be noted that the EU avoids the sensitive word EU tax in its documents, albeit inconsistently. The reason for this is that the EU does not have the power, the sovereignty, to tax, which is a fact that the Treaty clearly recalls. So to reform the system of own resources by talking of EU taxes can raise suspicion of the existence of a hidden agenda to compromise the Member States' fiscal competences (HLGOR, 2016: 20).

Member States, however, seem to interpret a new own resource as an EU tax, i.e. as a loss of their fiscal sovereignty. Hence, the European Parliament (2007) emphasizes that "fiscal sovereignty will be maintained, but only temporary the receipts of certain taxes will go directly to the EU". Or as the HLGOR puts it:

> "[T]he Union's own resources can be defined as revenue allocated irrevocably to the Union to finance its budget and accruing to it automatically without the need of any subsequent decision by the national authorities. The initial decision to attribute any particular source of revenue remains a national competence" (2016, p. 20).

Since the initial decision is still made at the level of the MS, as far as the Union is concerned, the tax competences also remain with the national authorities. The attribution of own resources is decided according to the most stringent procedure of decision-making: unanimity in the Council and ratification by all of the MS in accordance with their respective constitutional requirements. After this the revenue is "owned" by the EU.

The EU is anxious to make the characteristic of a "genuine" own resource as clear as possible in the way that MS account for their contributions to the EU. Contributions of MS to other organizations, like the United Nations, are to be clearly distinguished from contributions to the Union. Contributions to, e.g., international organizations are often the instruments of national power games to the detriment of the stability and predictability of the polies of the entire organization (HLGOR, 22016: 20). Therefore one of the Commission's wishes is that national budgets should not present their share of EU own resources as transfers from their national budgets. In other words, they should not count such revenues as government income first, but as resources owned directly by the EU and raised on behalf of the Union (European Parliament, 2014). In sum, the contribution to the Union is an appropriation levied for the EU and a reduction in government income and hence

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not a government expenditure. However, so far only four countries have classified the EU contribution as an attribution of national receipts to the EU and thus as a reduction in income of the central government.

Hence, the EU does not speak of taxes but of own resources. It should be noted that from an economic viewpoint, the eternal socialization of an asset's return is the same as the socialization of the asset itself (Sinn & Feist, 2000). *Mutatis mutandis*, this is also true for the temporary pooling of the revenue of taxation.

Notwithstanding that which was just said, with the new EU VAT the MS will probably still continue to try to balance their net contributions and net benefits. *Juste-retour* behavior is natural and hard to fight (Leen, 2011). Moreover, for the Union the goal of achieving autonomy, previously mentioned as one of the criteria to assess a new own resource, is or ought to be no goal at all. In order to qualify as an own resource financial independence is necessary. The same is true for the traditional own resources: the common custom duties and agricultural and sugar levies are fiscal resources levied on companies and/or individuals, whose proceeds are attributed directly to the EU even if they are collected at the national level. "This 'right of access to the source of taxation', which involves independence from decisions of Member States—also called financial autonomy—is considered essential to qualify as an OR [Own Resource] in the literature" (HLGOR, 2016: 22).

Financial autonomy is obviously something that every bureaucracy wants, though. This is illustrated, in the extreme, by the Commission's reluctance some years ago to have its finances checked by its own chief accountant (Andreasen, 2009). Therefore, autonomy can never be a goal per se. It can only be a goal because of some other goal that otherwise cannot be attained. For the Union this clearly is the goal of securing expenses with an added value for Europe as a whole. For the same reason, however, an EU tax may lead to less budgetary discipline at the European level. As Wolfgang Schäuble, the German Minister of Finance, said to Monti: "Any reform of the EU's financing system must therefore pay adequate attention to taxpayers' interests. In the existing system, it is mainly the net contributions that look after these interests" (Federal Ministry of Finance, 2014: 1).

Policy conclusion (2): a mission impossible or a package deal

Affirming the pros, why do they seem to be outweighed by the cons? Notwithstanding the intentions of the Commission and Parliament, the total VAT rate will probably increase, and regressivity and social justice will be at the forefront of the discussion. The problem of tax fraud, and hence horizontal equity, will not be easy to overcome. This is true in spite of the Union's policy to achieve a better overall VAT by tax harmonization. That policy will probably mostly reduce cross-border VAT fraud. The EU decision-making process, however, looks to be the most insurmountable obstacle. Since contributions change, *juste-retour* behavior will be pervasive.

In sum, from an Austrian perspective a consumption tax, next to seigniorage, is the preferred tax. The chances that such a tax will be introduced are slim, though. However, as indicated, the budget is often just the snake oil to make the really important decisions possible. "So, instead of spending it efficiently, it is best to use it, and if need be waste it, in such a way that Member States can reach much more important political deals" (Figueira, 2008, p. 2). Political horse-trading is also likely to occur. This is not much different from the solution that an expert group installed by the Commission is hinting at in its conclusion regarding the introduction of new EU taxes---reaching an agreement by creating a package deal (Ferrer, *et.al*., 2016, p. 136).

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