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Rui Henrique Alves* and Oscar Afonso**

The Reform of the EU Budget: Finding New Own Resources

The following paper addresses the ongoing debate on the questions of the composition and financing of the European Union's common budget. The authors argue in favour of a significant enlargement of the budget, together with a profound reform of its composition and financing.

Like any state or group of states, the European Union has a budget (the Community budget), with which it finances the functioning of its institutions and organs and the development of common policies. The EU budget describes the set of expenses to be made by the Union, as well as its revenue.

The theme of the need for a reform the EU budget and the way in which this should be done has been discussed several times in recent years, but any tentative attempt at a profound reform has failed. Nowadays there is an ongoing debate on the questions of the composition and financing of the EU budget, with an important impulse from the European Commission.

This paper is focused mainly on the latter issue, i.e. how to finance the EU budget. The question of the (re) composition of the common expenditure is important and probably more likely to be addressed by the common institutions and the national governments in the near future. However, we think (and we will try to argue) that the effectiveness of response by the EU to its present challenges and deficits requires an increase in the size of the common budget, which requires the search for new financial resources.

The paper presents the present situation of the EU budget, analysing its structure in terms of revenue and expenditure. We suggest the need for a major change in the composition and financing of the EU budget, based on the main challenges facing the EU at present / in the near future and on relevant aspects of fiscal federalism theory. Our attention then turns to the reform of EU budget financing, and we present the main proposals that have been made in recent years. We defend the idea of an EU surcharge on national personal income tax and present a simulation of its possible value in the present situation.

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The EU Budget: Current Situation

The EU budget lays out the set of expenses to be made by the Union, as well as its revenue. With regard to the type and structure of the former, it is worth mentioning that:

- they include two types: compulsory expenses, which result from Treaties' commitments, and non-compulsory expenses, arising from the budget's operating areas;
- despite having increased with the reforms implemented under the "Delors Packages" (I and II), the set of expenses covered by the community budget never exceeded 1.3% of the Union's GNP; note that this financial dimension is almost similar to some governmental departments of certain large EU countries; also it largely contrasts with what happens in most geographic areas with a single currency;¹
- as can be seen in Figure 1, a highly significant share of the expenses is due to the Common Agricultural Policy (CAP), one of the most problematical (and possibly unfair) in the Union, still accounting for over 40% of the Community budget, although this has been reduced following successive reforms (not always fruitful); this is followed by expenses related to regional policy and, with a significant increase in the most recent years, expenses related to research and development; in any case, note that in 2008 the joint objective of growth, innovation, employment and cohesion is already the most important.

With regard to the budgetary resources, the initial phase of national contributions was replaced, from 1970 on, by a system of own resources. These are considered the revenue of a fiscal nature attributed once and for all to the Community to finance its budget, with the duty being conceded to it without the need for any further decision from the national authorities.

¹ However, as the majority of these areas are in fact individual nations, the comparison is harder to make.

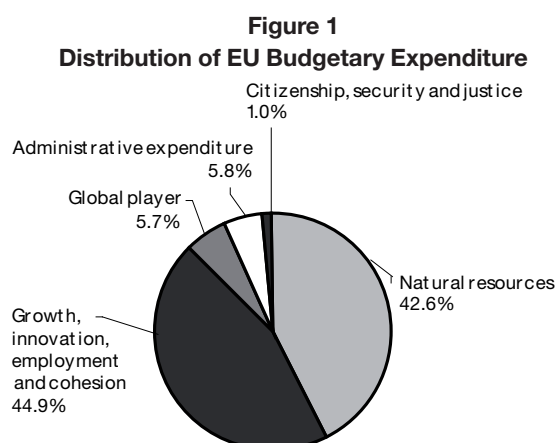
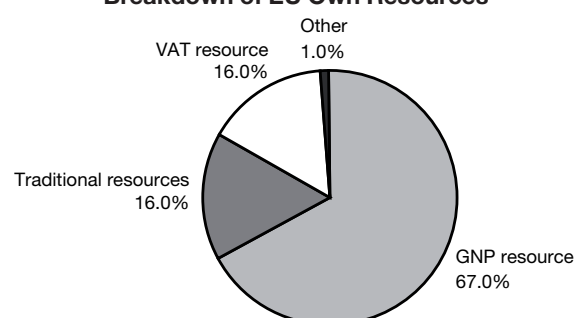


Figure 2
Breakdown of EU Own Resources



Source: PSE: European Union Budget 2008 – a Socialist Perspective, Socialist Group in the European Parliament, Brussels 2008.

Source: PSE: European Union Budget 2008 – a Socialist Perspective, Socialist Group in the European Parliament, Brussels 2008.

As Figure 2 shows, the system of own resources involves mainly:

- the “traditional resources”, considered own resources “by nature”, because they are revenue obtained within the scope of common policies, and not revenue from the member states calculated as national contributions. They thus include customs duties, resulting from the application of the common tariffs and agricultural duties, resulting from the imports of agricultural products from non-members and linked to the CAP.
- the “VAT (value added tax) resource”, created in April 1970, when it was clear that the traditional own resources were not enough to finance the community budget. Due to the difficulties of ensuring its harmonisation, the resource was only applied as of 1980, and it is obtained from the application of a uniform rate to the national VAT revenue. The value of this rate has varied and it has been 0.5% since 2004.
- the “GNP (gross national product) resource”, created in June 1988 as a resource for balancing the budget, corresponding globally to the difference between the expenses and the revenue of the other own resources and “shared” according to the GNP of each member state.

Figure 2 also shows that the “GNP resource” is presently by far the most relevant resource in the EU budgetary framework, in an evolution that has been accentuated as VAT mobilisation rates have dropped and the amounts of “traditional duties” have progressively fallen.

The EU Budget: Why Reform It?

Some factors suggest that there is only a slight possibility of a significant change in the situation described above in the very near future.

In September 2004, the European Commission presented a report on the evolution of own resources.² In this report, it admitted that there were possible advantages in gradually substituting the present model with another one more directly oriented towards citizens. However, it manifested no intention of proposing a new own resource in the scope of the financial perspectives for the subsequent period: this has in fact happened.

The financial framework for the period 2007-2013 did not bring about significant changes either in terms of the composition of expenses or in terms of the origin of resources.

In the first case, it is true that expenses related to the common agricultural policy continue to fall and that there is heavier investment in areas such as cohesion, competitiveness and growth, but fields such as security, justice, defence or citizenship still have highly unsatisfactory figures (little more than 1% of the budget over the entire period). In the same way, the EU foreign action also has very little weight, although it will be increased by one percentage point at the end of the period compared to the beginning.³

² European Commission: Financing the European Union, Commission Report on the Operation of the Own Resources System, COM (2004) 505, 2004.

³ The focus of this article is not the (re)composition of the expenditure but the reform of the financing side of the budget (dimension and resources). Nevertheless, there are some additional resources coming from the fall in the importance of CAP, which, in our view, are being correctly devoted to new areas, such as those mentioned. However, we will argue that these additional resources are still of small importance regarding the kind of challenges that the EU is facing.

In the second case, the maximum ceiling for revenue (and naturally expenses, since the budget must be balanced) remains at 1.24% of the EU's GNP throughout the period, though it is expected that not even this figure will effectively be reached.

The Lisbon Treaty, which is in the process of ratification, brings no change to the existing framework of the own resources system.

As mentioned below, a "taboo-free" debate has been opened on the question of the EU budget reform, led by the European Commission. However, the positions of the main European political blocks that have become known indicate that the debate may be focused more on reformulating the composition of expenses than on the central issue of community budget size.

There are, however, several factors that allow us to argue in favour of a profound reform of the community budget.

- The need to give the EU greater financial autonomy, so that it can deal efficiently with the new challenges it faces. As mentioned, for example, in 2007 by Alves,⁴ it seems essential for the EU to reduce the divergence between the high level of economic integration and the low level of political integration. Strengthening the political component would be relevant for reducing the deficit of political importance on the international scene, as well as for increasing democratic participation and citizenship or the capacity to take decisions and action. It is true that the major forces driving these deficits, described, for instance, by Alves,⁵ are further beyond the dimension of the budget. But certainly it would be very difficult for the EU to efficiently deal with those deficits without a significant enlargement of its budget.
- In the same vein, an analysis of fiscal federalism theory⁶ seems to indicate that it would be beneficial to have greater intervention at the Community level concerning the supply of goods and services that are clearly supranational in nature (defence, security etc.), thus constituting an exception to Oates's theory of decentralisation.⁷ The theory would also point

⁴ R. H. Alves: European Constitution and (Fiscal) Federalism, in: J. McCombie and C. R. Gonzalez (eds.): *European Union: Current Problems and Prospects*, 2007, Palgrave Macmillan, pp. 154-172.

⁵ Ibid.

⁶ R. H. Alves, O. Afonso: Fiscal Federalism in the European Union: How Far Are We?, in: J. Ferreira, G. Fontana, F. Serrano (eds.): *Fiscal Policy in the EU*, 2008, Palgrave Macmillan.

⁷ W. Oates: *Fiscal Federalism*, London 1972, Harcourt Brace.

towards an increase in the relevance in inter-regional distribution, namely via transfers through the EU budget, particularly after the latest enlargements.⁸

- The possibility of a real exercise of the macroeconomic stabilisation function, as the central budgets assume in the main federations, also requires an increase in the size of the community budget along with the demand for new own resources.

The literature on the scope of fiscal federalism traditionally postulates an important role for "insurance" for the central budget, which seems to exercise an important degree of stabilisation, through transfer mechanisms between the states/regions positively affected by asymmetric shocks and the states/regions negatively affected by these shocks. In fact, this is shown by various studies in the wake of the analyses in the first half of the 1990s by Sachs and Sala-i-Martin, Italianer and Pisani-Ferry, and Bayoumi and Masson, who estimated, based on different methodologies, a significant degree of stabilisation in the absorption of shocks by the North American federal budget.⁹

The same kind of role has been mentioned by subscribers to the theory of optimal currency areas. They considered that, once the monetary and exchange-rate instruments were lost, an efficient response to the negative effects of specific and asymmetric shocks, in the context of a monetary union would be obtained by mobilising a broad central budget.¹⁰

- If we admit that an effective response to the new challenges includes a profound change in the EU's political and institutional model (something we have, in fact, defended in previous studies), in the sense

⁸ E.g. G. Deltas, G. Van der Beek: An Empirical Model of Transfers Within a Federation, With an Application to the European Union, in: *Journal of Urban Economics*, Vol. 53, No. 3, May 2003, pp. 339-356; C. Fuest and B. Huber: Can Regional Policy in a Federation Improve Economic Efficiency?, in: *Journal of Public Economics*, Vol. 90, No. 3, February 2006, pp. 499-511.

⁹ J. Sachs, J. Sala-i-Martin: Fiscal Federalism and Optimum Currency Areas: Evidence for Europe from the United States, in: M. B. Canzoneri, V. Grilli, P. R. Masson (eds.): *Establishing a Central Bank: Issues in Europe and Lessons from the US*, Cambridge 1992, Cambridge University Press; A. Italianer, J. Pisani-Ferry: The Regional-Stabilisation Properties of Fiscal Arrangements, in: J. Mortensen (ed.): *Improving Economic and Social Cohesion in the European Community*, New York 1994, St. Martin's Press, pp. 155-194; T. Bayoumi, P. Masson: Fiscal Flows in the United States and Canada: Lessons for Monetary Union in Europe, in: *European Economic Review*, Vol. 39, No. 2, February 1995, pp. 253-274.

¹⁰ E.g. P. De Grauwe: *The Economics of Monetary Integration*, Oxford 2007, Oxford University Press, 7th edition; J. Horvath: Optimum Currency Area Theory: A Selective Review, in: *BOFIT Discussion Paper*, No. 15/2003, November 2003.

of creating a “Federation of Nation States”, such a change will imply an equally profound reform at the level of the Community budget: in fact, political federalism must be accompanied by fiscal federalism.

A major reform of the EU budget therefore seems justified for all these reasons. It would go together with important changes in the political and institutional organisation of the EU, including the creation of a true “European government”. This government would have competences only in supranational matters, which means mainly those that the fiscal federalism theory suggests. A constitutional restriction of its action to a reduced number of areas would be very important in order to make these changes acceptable in the context of growing diversity in Europe.

The budget reform could occur progressively or simply in the medium or long run, for political reasons. Whatever the scenario might be, it will have to involve changes in the composition of expenditure, as well as the reinforcement of financial resources, i.e. of the autonomy of EU action.

- In the first case, the application of the fiscal federalism theory and an analysis of what happens, with significant success, in other political entities with a single currency, may help in putting together a catalogue of exclusive and shared competencies for the EU, which will result in the (re)composition of expenses. Some proposals along these lines have been presented: for instance, in 2008 Alves made a proposal based on the fiscal federalism theory,¹¹ and Figueira made another one based on a multidisciplinary approach, combining public sector economics, fiscal federalism, political science and literature on the concept of subsidiarity.¹²
- In the second case, it seems difficult to solve some of the Union’s more relevant challenges and to achieve the aims of solidarity and economic and social cohesion while maintaining the present size of the community budget, i.e. without assuming the discussion of a new truly own resource. That is our focus in the following.

How to Reform the Budget: Main Proposals

The reform of the present model, replacing it with a more efficient and transparent model from the point of

view both of resources and of the composition of expenditure, is in fact the concern of the debate recently launched by the European Commission mentioned above. This debate, in which European citizens and institutions were invited to take part,¹³ comes in the wake of a joint decision by the three main Community institutions that the Commission should undertake a fundamental review of the EU budget, including both the guidelines for future expenses and the ways of obtaining the resources necessary for financing the EU’s political priorities.

The consultation will end by mid-2009, with the Commission then producing a report. This immediately brings the advantage of generating an assessment on a long time-horizon, to see how the budget can be shaped to serve EU policies and to meet the challenges of the decades ahead. This means an assessment that is not involved in an (always difficult) financial negotiation for a multi-annual framework. In fact, the task of proposing the multi-annual financial framework for the period 2014-2020 will be left to the next Commission, so that in this review the present Commission will not decide on the global volume or on the detailed breakdown of the EU budget.

Taking into account the importance of this present debate and the need to increase the community budget, there is room for a brief analysis of the main reform proposals that have been put forward for the case of common budget revenues.¹⁴

These proposals have been made along two fundamental lines: simplification of the present system of own resources; and enlargement of the fiscal bases, namely with the introduction of new (and real) own resources.

With regard to the former, it seems possible to establish three hypotheses:

- substitution of traditional own resources by the GNP-based resource, with the former going back to the member states in which the final consumption of the respective goods and services takes place;
- simplification of the method of calculating resources based on VAT, eliminating their association with the British rebate and introducing a uniform VAT rate for all member states;

¹¹ R. H. Alves: *O Futuro da União Europeia: Organização Económica e Política no Contexto dos Desafios Pós-Euro*, PhD dissertation, Faculdade de Economia do Porto, 2008, unpublished.

¹² F. Figueira: *How to Reform the EU Budget? A Multidisciplinary Approach*, Tjalling C. Koopmans Research Institute, Utrecht School of Economics, Discussion Paper Series, No. 08-07, 2008.

¹³ See http://ec.europa.eu/budget/reform/issues/issues_en.htm.

¹⁴ For further development of this aspect, see, for instance: European Commission: *Financing the European Union*, 2004, op. cit.; P. Catoire: *Tax-Based EU Own Resources: An Assessment*, Working Paper, No. 1/2004, Taxation Papers, European Commission, 2004.

- full substitution of the present set of own resources by the GNP resource.¹⁵

Any of the above possibilities, particularly the latter, would lead to a relevant simplification of the determination of EU budget resources. In any case, it would not necessarily mean that the budget size would be strengthened, something that would be justified accordingly to what has been said above.

In this context, the relevant debate moves on to the definition of new own resources. In this line of reform, in the aforementioned study by the European Commission, this institution suggested, in the medium-run, the introduction of a new own resource based on taxes. This resource would have to substitute the present resource based on VAT and finance a significant part of the Community budget, enabling the main disadvantages of the present system to be overcome, including the overwhelming dependence on transfers from national budgets. In this context, the Commission also considered that the resource based on GNP should continue to play an important role, though it would come to represent a smaller part of the total own resources than in the present system.

In the same report, the Commission mentioned three kinds of tax more likely to become new own resources in the future:

- a tax based on energy consumption
- modulated VAT (a proposal already made in the Langes Report in 1994)¹⁶
- a tax based on corporate income.

Any of these would be generically in line with the main conclusions of the fiscal federalism theory in the field of taxation, particularly with the criteria introduced by Musgrave in 1983.¹⁷

The tax based on energy consumption could be conceived in two ways: as a tax with a broad base (coal, gas, oil etc.) or as an EU tax on fuel for road transport. The tax would be paid by consumers through the energy suppliers, creating a direct link between the EU budget and European citizens. This would certainly constitute a stable source of financing for the community budget and enough for a level of needs close

¹⁵ For further development of this aspect, cf. M. Cieslukowski, R. H. Alves: *Financial Autonomy of the European Union After Enlargement*, in: FEP Working Papers, No. 217, July 2006.

¹⁶ European Parliament: *Draft Report on a New System of Own Resources for the European Union (Langes Report)*, Committee of Budgets, A3-0000/94, 1994.

¹⁷ R. Musgrave: *Who Should Tax, Where and What?*, in: C. McLure (ed.): *Tax Assignment in Federal Countries*, 1983, Australian National University Press, pp. 2-19.

to that of the present.¹⁸ Either of the two ways, would however, require a definition of tax rates at the European level.

In the case of modulated VAT, the VAT paid by the consumer would result in a combination of national VAT and European VAT, with the rate of the former defined by the national parliament and the latter by the EU – a rate of 2% was initially suggested for the European case, and may be raised as Community responsibilities evolve. This proposal would make EU financing quite visible for EU citizens, also offering as advantages the fact that the harmonisation in the context of VAT is quite advanced and the possibility of constituting a sufficient and stable source of revenue. On the other hand, it would also be evolutive since it would give rise to a reform of the current provisions instead of introducing a completely new resource. From the administrative point of view, its introduction would also not appear to present any unsurmountable difficulties.

The third possibility, resulting from the application of a uniform tax over corporate income taxation would also allow an adequate form of financing for the community budget, though it would probably only cover less than half the present budget expenditure. However, considering the poor community harmonisation in this area, it could only be taken as a long-term option, unlike the previous two, which could be done in the medium run.¹⁹

Other proposals have also been studied and put forward. For example, in 2004 Cattoir analysed, in addition to those mentioned above, the possibilities related to:

- specific taxes on tobacco, alcohol and mineral oil
- the transfer of revenue from seignorage (from the ECB)
- taxation of communications services
- a tax on financial transactions on the European stock markets
- a tax on aviation, making it internalise the negative effects on the climate resulting from its activity
- a tax on personal income.²⁰

¹⁸ European Parliament: *The Own Resources of the European Union: Analysis and Possible Developments*, Working Document, Budget Series, W-4, September 1997.

¹⁹ For further development of the various issues involved in a proposal of this kind, cf., for example, E. Albi, R. Paredes, E. Corona: *Corporate Tax as a Possible Fifth Own Community Resource: How Much Harmonisation Is Necessary?*, Study XIX/B1/9602, prepared for the European Commission, DG XIX, June 1997.

²⁰ P. Cattoir, *op. cit.*

Cattoir assesses these proposals based on the criteria of sufficiency and stability for the European budget in the long run, efficiency (including visibility, administrative costs and the effects on the assignment of resources) and horizontal and vertical equity, and comes to the same conclusion as the European Commission's study cited above. In his opinion, which we share, excluding the case of the personal income tax, any of the proposals mentioned here would be less desirable, for various reasons. Among others, we could mention: insufficiency and lack of stability in the case of taxation on aviation or on financial transactions; lack of visibility in the case of the latter and of the income from seignorage; lack of vertical equity in the case of specific taxes.

A Possible Solution

One possibility that seems particularly interesting is that of creating an own European resource based on the taxation of personal income, because "personal taxes constitute one of the most direct and visible links between taxpayers/citizens and elected authorities".²¹ In this way, the system's transparency mechanisms would be greatly strengthened. On the other hand, this kind of proposal seems to behave well according to the assessment criteria suggested by Cattoir, as it would sufficiently reinforce the European budget.

With regard to its implementation, it would be possible to discern at least three alternatives.

In the first place, a certain amount of tax could be established for each European citizen to pay. For 2008, for instance, considering the forecasts of European Economy for the population size of the EU and for the European GNP and allowing for a community budget size close to that of the present (around 1% of the European GNP), a tax of little more than 255 euros per person would cover the present spectrum of Community expenses.²²

In this case, there would be the advantage of dealing with a highly visible, simple and efficient resource. In terms of visibility and simplicity, in fact, it would seem to be difficult to find a more satisfactory resource. However, it would immediately pose problems of equity²³ and, given similar experiences (the disaster of the poll tax in the United Kingdom, for instance), it

would present great political difficulties in its implementation.

As a second possibility, a European tax could be created on personal income, separate from the national one, also with deductions, progressivity etc. Citizens would have to fill in two declarations, one for the state in which they are resident and another for the EU, in a similar way to what happens in Quebec, for example, with the payment of separate personal income taxes for the province and for the federation.

In this case it would also be easy to ensure sufficient amounts for the present size of the Community budget without excessively burdening citizens. In 2004, Cattoir showed that since the revenue from taxes on personal income from the group of the (then) 15 member states represented around 10% of the EU's GNP (2001), a tax equivalent to around 10% of the equivalent in the member states would produce a total revenue of approximately 1% of the EU's GNP. Equity would also be generically ensured, both horizontal (that is, between taxpayers resident in different member states), and vertical (since the taxation could be progressive).²⁴

The biggest problem aside from, as in other cases, the question of political will, would be the high costs of administration, execution and control of this tax, to a certain extent duplicating the national situation.

As a third alternative, a surcharge could be applied to the amount of national income tax owed by each individual and the revenue would revert directly to the Community budget.

This case would have the advantage of not implying high costs of administration, execution and control and it would enable a volume of resources identical to that of the previous proposal. On the other hand, the surcharge would be clear on each individual declaration (and notice of payment), enabling, as in other cases, taxpayers to know the value of their contribution to the EU budget.

However, the proposal could present some problems from the point of view of horizontal equity: although progressivity would be maintained within each member state, the use of an identical surcharge for all could lead to an unacceptable inequity between countries resulting from differences in their taxation systems.

This situation could be resolved in two ways. On the one hand, the harmonisation of the systems could be significantly improved, which seems a somewhat

²¹ Ibid, p. 30.

²² European Economy: Statistical Annex, Autumn 2007.

²³ Immediately, because the level of income per capita varies significantly from country to country within the EU. On the other hand, the figure mentioned is per person and not per taxpayer, so it would have to be modulated according to certain variables, namely the number of people in the household.

²⁴ P.Cattoir, op. cit.

eration of Nation States”) would require the strengthening of the central budget.

In this context, a significant change in the financing framework of the EU would become necessary. Throughout this paper, we have gone through the possible lines of reform, based fundamentally on proposals that have been put forward in recent years both by independent economists and by the European Commission itself. These proposals have been developed along two main lines: on the one hand, simplification of the present regime of own resources; on the other hand, expansion of the revenue including the introduction of new own resources. Our attention has been focused on this latter aspect.

At this level, the application of the principles of taxation proposed in fiscal federalism theory seem to validate some of the proposals considered by the European Commission as being potentially more successful, particularly resources based on the taxation of energy consumption or the income of corporations and the modulated VAT resource.

However, it seems to us that, from the point of view of visibility and the proximity of citizens to the financing and functioning of the EU, a resource based on the taxation of personal income would be ideal.

Since it would seem that the possibility of determining an identical amount for all EU citizens would have to be disregarded for reasons of equity, and the possibility of the double determination of the tax (with two declarations, one European and one national) seems unviable because of the operating costs involved, a good possibility would be the application of a surcharge on the amounts paid as a national tax, with the revenue from this going directly to the EU budget.

As we have seen, any of these possibilities (and, in particular, the latter) would allow for full financing of the Community budget at its present size without greatly increasing the tax burden.

An increase in its size could, in a first stage, involve adding the new resource to the present ones. This situation, as well as any other meaning a deeper adjustment of the size of the Community budget, should necessarily involve some reduction in the tax burden aimed at national budgets. This would be justified by the fact that part of the national competencies would also be transferred to the domain of the Union in more clearly supranational areas. And this is a very interesting aspect that is open to future research.