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Financing the Community budget: The way ahead

(sent by the Commission to the Council on 23 November 1978)

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CORRIGENDUM to Supplement 8/78 — Bull. EC (English version)

Title page:

For: '(sent by the Commission to the Council on 23 November 1978)'.
Read: '(sent by the Commission to the Council and Parliament on 23 November 1978)'.

Page 21:

Table 8 is replaced by the following:

Table 8 — *Hypothetical taxes on energy*

(1977)

Member State	Tax on petrol %	Tax on total energy consumption %	Estimated GDP key %
Belgium	3.9	4.7	4.9
Denmark	2.1	2.1	2.9
FR of Germany	29.2	27.6	32.8
France	22.1	19.0	24.1
Ireland	1.2	0.8	0.6
Italy	13.7	14.8	12.4
Luxembourg	0.2	0.5	0.2
Netherlands	5.0	8.0	6.7
United Kingdom	22.6	22.5	15.4
	100	100	100

The section entitled 'A tax on energy' (paragraphs 48, 49 and 50) should come under the heading 'Indirect taxes' (page 19).

Commission of the European Communities

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Contents

The way ahead

Guidelines

1. The Commission has been considering what steps should be taken to meet the situation which will arise when the Community budget becomes too big to be financed entirely by funds accruing from customs duties, agricultural levies and application of a VAT rate which may not exceed 1% of a uniform base, as is provided for in the Council Decision of 21 April 1970.[1]

2. The Commission believes that the developments of the Community will in part be measured by the development of the role of its budget, which constitutes the operational means through which individual actions find their expression. This does not mean that the Commission wishes the budget to grow for its own sake. Indeed it considers that both existing and possible future policies should be judged against the need for constraint in public expenditure. They should also satisfy the condition that they can be more effectively conducted at the Community rather than at the national level. In many cases actions by the Community should take the place of action at the national level, with the result that their inclusion in the Community budget should not lead to an increase in the level of overall public expenditure within the Community. This will of course only be the case if Community actions are carefully chosen to satisfy the condition mentioned above, and if, once decided, the Member States are prepared to see these actions largely or even wholly carried out at the Community level. In other cases Community expenditure, for example on the Social and Regional Funds, should be additional to that undertaken by the Member States, or tackle new problems not yet covered by actions at either the national or the Community level.

3. The Commission has already presented detailed estimates of Community expenditure for 1980 and 1981, in the three-year forward forecasts transmitted with the preliminary draft budget for 1979.[2] These estimates examine each policy in turn. The overall conclusion is that there is a real possibility that the 1% VAT ceiling may be exceeded in 1981. It is plain from the Commission's forecasts that this conclusion is the result of an assessment of a range of factors.

There are two elements already foreseeable which have to be taken into account. Most important, enlargement of the Community to include Greece will involve a net addition to the budget as a result of the extension to the new Member State of existing policies.

The Commission made no allowance in its forecasts for new policies to meet the needs of Greece or for preparatory aid for Portugal, though these possibilities should not be ruled out. Secondly, there is the budgetization of the EDF flowing from renewal of the existing Lomé Convention. This is a desirable change in the form of Community financing of this activity, though not likely to involve amounts critical to the issue of additional resources.

4. There is also the future trend of expenditure on existing Community policies. Of these, agriculture is by far the most important. Here the Commission's forecasts bring out the consequences of policy decisions in this field for future spending. If the increase in agriculture guarantee spending is extrapolated from 1973 it would rise very substantially and leave little room for the development of other policies by 1981 within the existing own resources. If, however, it can be contained more effectively than in the past, the scope for development of other policies is greater, though still inadequate for the development of the major new policies required to meet the challenges now facing the Community and to give a better balance in the range of the Community's actions. The Commission hopes that every effort will be made to contain the cost of agricultural guarantee expenditure and its own proposals will be directed towards this objective.

[1] OJ L 94 of 28.4.1970.
[2] Supplement 6/78 — Bull. EC.

5. Turning to the revenue side of the budget, a common characteristic of the existing own resources is that they lack buoyancy. This is likely to be even more true of customs duties in the future than in the past. The unpredictability of the yield from agricultural levies is also such that it is advisable to guard against an unexpected shortfall. So far as VAT is concerned, the 1978 budget is based on a rate of 0.64% compared with the maximum permitted 1%; for 1979 the rate has not yet been decided but the preliminary draft budget proposed by the Commission (including the letter of amendment implied a rate of VAT of 0.77% while the draft budget resulting from the Budget Council of 20 July 1978 implied a rate of 0.67%.[1] There is thus only a limited margin of VAT left, the more so as VAT as a source of revenue based on consumption expands less rapidly than overall wealth. And it is not acceptable that the present 1% rate of VAT should constitute a ceiling on Community expenditure.

6. For all these reasons, there is no doubt that new revenue will be needed. The only question is when. Although the date cannot definitely be determined now, the Commission believes that in the light of the factors described above the new resources will be needed in time for the 1982 budget.

7. The Community's needs for additional resources could be met in different ways. Borrowing is already source of finance for many Community actions which stimulate investment or are otherwise appropriate for on-lending. The Commission considers that there will be a long-term need for investment in the Community which it may be appropriate to stimulate and coordinate through Community actions. The recent development of Community and Euratom loans and the new Community borrowing instrument are already major advances in this direction. This method of finance must be borne in mind in relation to future Community policies. But given the prospects for growth of the existing range of actions financed from the Community budget and the need to develop further actions for which loan finance would not be appropriate, this will not avoid the requirement to find additional sources of Community revenue, the more so as it is not appropriate to envisage the development of deficit financing as a means of meeting current expenditure needs.

8. A separate possibility would be to revert to the use of financial contributions, instead of increasing the resources due to the Community as of right. The development of a series of political keys to finance individual policies would, however, create many political difficulties. Such a step backwards would be opposed to both the letter and spirit of the Treaties.

9. The Commission believes that it is therefore essential to find a new source of Community revenue. To this end its services have prepared a technical analysis which is annexed. This is deliberately intended to be a neutral examination of the factors relevant to the decision which will be required. Apart from a description of the present system of financing the Community budget and the prospects for expenditure the paper first examines the institutional considerations concerning the choice to be made. Drawing on an analysis of the provisions of the Treaty and on the nature of own resources the paper stresses the need to establish additional true own resources to meet the Community's continuing financial needs. The choice of type of additional revenue must thus lie from within a range of taxes which have the full character of own resources.

10. It then notes the technical considerations which are important, including a harmonized tax base, a buoyant yield and administrative simplicity. The economic considerations are next examined. After analysing the economic concept of taxable capacity the paper notes that this could be applied either to avoid the worsening of present economic disparities (non-regressivity) or to narrow these disparities (progressivity). It points out that if one of these objectives is retained and

[1] Bull. EC 7/8-1978, point 2.3.94.

cannot be achieved through the choice of a range of different own resources, there is the possibility of a corrective mechanism which would adjust the overall economic impact of payments to the Community budget (other than customs duties and agricultural levies). Some of the examples given are related to comparisons based on market exchange rates; the Commission recognizes that there is room for argument as to whether market exchange rates are necessarily the best indicator of economic capacity, though in the budget context it is essential to remember that the same methods have to be applied to both expenditure and receipts.

11. Finally the different revenue options are listed. These range from the simple increase of the VAT ceiling to possible new sources such as transfer to the Community of part of certain existing national taxes. Some of these options are clearly more suitable than others. An idea to be borne in mind in making a choice is the possibility of linking expenditure on particular Community policies with finance from a source associated with those policies; for example, revenue from a tax on energy could be hypothecated to expenditure arising from energy policy.

It is clear that the choice now required must be durable. It is therefore important that it should be capable of being applied in the countries now candidates for membership after enlargement as well as in the existing Member States.

12. The Commission presents this paper to the Council and to the Parliament as joint budgetary authorities so that the discussion which is now necessary about future own resources can be based on as clear an analysis as possible. The Commission for the time being does not intend to present a formal proposal. It believes that there should first be discussion of the various options among the Community institutions and beyond, a discussion in which it intends to play a full part. Nevertheless it believes that it should indicate at this stage the direction of its own thinking.

13. For the Commission, customs duties and agricultural levies belong irrevocably to the Community and should not be modified in any way. The Commission also believes that VAT is a good basis for an own resource, for despite the limitations and problems of the existing system it has the character of a tax which bears on the individual Community citizen. To raise the existing ceiling would also have the advantage of simplicity. However, the Commission considers that it would be useful to study whether it would be possible to ensure that the overall impact of Community resources other than customs duties and agricultural levies should be progressive, and what would be the most appropriate yardstick for achieving this. As a matter of principle, the Commission believes that any element of regressivity should be avoided. This essential condition mut be borne in mind when the final decision is made.

In conclusion, the Commission again draws attention to the inevitability of the need for a decision, and to its expectation that additional resources will be required in time for the 1982 budget. In view of this, and of the need to allow time for the necessary ratification procedures at national level to be completed, the Commission thinks that a decision on the new own resources will be needed in 1979. The Commission will make a formal proposal in due time.

Financing the Community budget

Introduction

1. This paper is an analysis of the different factors and options to be borne in mind in considering the choices before the Community for an increase in the resources available to finance the Community budget.

Part One

The present system of financing the Community budget

2. Apart from a small amount of miscellaneous revenue the Community budget is at present financed (in accordance with the Decision of 21 April 1970) by customs duties, agricultural levies and a contribution from the Member States related to their shares in Community GNP. The Decision envisages that the budget, irrespective of other revenue, should be financed by the Communities own resources and, to this end, the GNP contributions are expected to be replaced in 1979 by the proceeds of a Community rate of VAT which cannot exceed 1%. In the view of the Commission the expression 'own resources' signifies revenue of a fiscal nature belonging once and for all to the Communities for financing its budget as of right and without the need for any subsequent decision by national authorities.

(a) Customs duties result from the fact that the Community is a customs union with common duties levied on certain goods entering the union but no duties on internal trade. Since external duties on imports are collected on the periphery of the union without regard to the place of consumption it is natural and logical that the duties should belong to the Community rather than to the Member State which collects them. To this extent they are an ideal own resource for the Communities. Customs duties are, however, levied for commercial or regulatory reasons and have economic and political, rather than financial, objectives. It is also international policy that they should be gradually reduced and even eventually disappear. Although a logical and inevitable own resource, the fact that it is a declining one, in real terms, has consequences for financing the budget in the medium term.

(b) Agricultural levies are also the product of a Community policy and the place where they are collected is not necessarily the same as the place where the products are consumed.

Like customs duties, they are therefore a logical own resource. Also like customs duties, however, they are not levied for the purpose of financing the budget. Their yield depends on trade, price and monetary fluctuations; it is therefore not constant and is difficult to forecast. Thus agricultural levies, although a logical and inevitable own resource, cannot respond to the needs of a growing Community budget.

(c) GNP contributions are provided for in the Decision of 1970 as a temporary method of financing until VAT is introduced. They are calculated in relation to the average share of each Member State's GNP in the GNP of the Community in the first three years of the five-year period preceding the year in question.

(d) Value Added Tax was included as a Community own resource by the Decision of 1970 partly because the tax existed already and it was Community policy to harmonize its structure and partly because it was thought to be a tax which, since it affects every citizen of the Communities, would be seen as a direct contribution to Community financing. In practice it has not yet turned out as envisaged since a number of temporary exceptions from the harmonized common tax base still exist. Also, and partly as a result of this, the Council has given Member States a choice between two methods of assessment of the amount of own resources payable to the Community:

(i) directly on the basis of tax-payers' information on the taxable base as returned to the national tax administrations;

Table 1. — *Trend in customs duties*[1]

(million EUA)

	1971	1972	1973	1974	1975	1976	1977
BLEU	171.8	185.9	218.8	253.3	236.2	284.2	307.5
FR of Germany	738.8	801.1	943.2	1 058.5	1 044.6	1 288.1	1 378.8
France	378.8	434.4	519.6	555.6	547.6	654.8	669.6
Italy	309.8	316.9	345.5	409.4	341.5	407.5	426.1
Netherlands	250.6	251.7	300.3	351.8	338.7	395.6	441.5
Total (the Six)	1 849.8	1 990.0	2 327.4	2 628.6	2 508.4	3 030.2	3 223.5
Percentage variation (±%)		+7.6	+17.0	+12.9	−4.6	+20.8	+6.4
Denmark	—	—	110.5	105.2	106.0	140.5	134.0
Ireland	—	—	—	—	31.7	40.6	42.4
United Kingdom	—	—	—	—	882.7	980.2	1 059.0
Total (the Nine)	—	—	—	—	3 528.8	4 191.5	4 458.9

[1] The breakdown into protective and fiscal duties is not available.

(ii) on the basis of the total actual VAT revenue and an estimated average VAT rate from which is calculated an estimated taxable basis.

This latter procedure must be abolished after the initial five-year period. The Commission will also pursue continued adjustments towards the common, truly harmonized tax base. When this is reached, the consumer will be able to calculate his contribution to the Communities out of each transaction, as the current Community VAT rate multiplied by the price before tax.

3. Tables 1 and 2 show the amounts and rates of growth, in money terms, of customs duties and agricultural levies (including sugar contributions) collected in the Community from 1971 to 1977. Customs duties exclude certain fiscal duties collected by the United Kingdom and Ireland which have now been

Table 2. — *Trend in agricultural levies (including sugar contributions)*

(million EUA)

	1971	1972	1973	1974	1975	1976	1977
BLEU	72.0	67.2	30.3	17.3	61.9	149.8	265.3
FR of Germany	182.3	215.7	145.9	110.0	146.5	254.9	447.6
France	110.3	145.1	88.2	66.5	74.0	116.7	178.2
Italy	213.9	237.6	123.7	58.3	106.6	220.3	479.4
Netherlands	121.1	126.5	94.8	32.9	128.2	317.8	449.8
Total (the Six)	699.8	792.1	482.9	285.0	517.2	1 059.5	1 820.3
Percentage variation (±%)		+13.2	−39.0	−40.9	+81.5	+104.9	+71.8
Denmark	—	—	4.9	5.8	6.9	18.2	31.0
Ireland	—	—	3.7	5.7	4.2	8.4	28.0
United Kingdom	—	—	55.2	68.8	97.9	102.4	284.2
Total (the Nine)	—	—	546.7	365.3	626.2	1 188.3	2 164.3
Percentage variation (±%)				−33.2	+71.4	+89.9	+82.1

Table 3. — *Percentage of own resources compared with gross national product*

	1971	1972	1973	1974	1975	1976	1977
Customs duties '6'	0.36	0.34	0.34	0.34	0.29	0.30	0.29
Customs duties '9'					0.32	0.34	0.32
Agricultural levies and sugar levies '6'	0.13	0.14	0.07	0.04	0.06	0.11	0.16
Agricultural levies and sugar levies '9'			0.06	0.04	0.06	0.10	0.16
Total (the Six)	0.49	0.48	0.41	0.37	0.35	0.41	0.45
Total (the Nine)					0.38	0.43	0.48

converted into internal taxes, as is the practice in the other Member States. The amounts paid to the Community during this period were different because the Decision of 1970 and the Treaty of Accession provided that these should be paid on a progressive basis up to the end of 1977.

4. Table 3 shows the relationship, during the same period, between customs duties and agricultural levies and GNP. It illustrates that customs duties have declined, in real terms, during the period; this decline will be accentuated when the effects of the current GATT negotiations begin to be felt.

5. Tables 4 and 5 show for 1978 and 1979 the forecast geographical origin of the various components of financing the budget. No account has been taken of the extra-budgetary effects of Article 131 of the Treaty of Accession because it does not operate after 1979. As already noted, customs duties and agricultural levies are collected on behalf of the Community. The amounts collected are not necessarily finally paid by the citizens of the State where the collection is made (for example: the Rotterdam and Antwerp situation).

6. While the receipts of the budget are financed by the methods described under 2, the expenditure side of the budget provides for a 'financial mechanism' which could result in payments from the budget to Member States in a special economic situation whose

Table 4 — *1978 (Amending budget)*

Member State	Agricultural levies	Customs duties	GNP contributions	Total
Belgium	14.1	6.7	4.5	7.0
Denmark	2.7	3.5	2.6	3.0
FR of Germany	20.9	30.4	32.1	29.5
France	9.2	15.3	23.9	18.0
Ireland	0.8	1.0	0,6	0.8
Italy	19.2	10.0	13.2	13.0
Luxembourg	—	0.1	0.2	0.1
Netherlands	22.3	10.1	6.0	10.4
United Kingdom	10.8	22.9	16.9	18.2
Total	100.0	100.0	100.0	100.0

Table 5 — *1979 (Preliminary draft budget)*

Member State	Agricultural levies	Customs duties	VAT	Total
Belgium	11.1	6.7	5.2	6.7
Denmark	2.1	2.5	2.6	2.5
FR of Germany	21.5	30.5	32.4	30.0
France	10.8	15.1	24.0	18.8
Ireland	0.7	1.1	0.8	0.9
Italy	19.1	9.5	10.4	11.5
Luxembourg	—	0.1	0.2	0.1
Netherlands	17.2	9.4	6.3	9.1
United Kingdom	17.5	25.1	18.1	20.4
Total	100.0	100.0	100.0	100.0

economies make a disproportionate contribution to budget finance. This system is applicable temporarily and experimentally for a period of seven years from mid-1976 and until now has not been called into play. The 'mechanism' operates in favour of any Member State fulfilling the following conditions.

(i) *per capita* GNP is less than 85% of the Community average;

(ii) *per capita* GNP growth rate, in volume terms, is less than 120% of the Community average rate;

(iii) the payments made for the overall financing of the Community's budget exceed by more than 10% the sum which would have been paid if financing had been on the basis of GNP.

The calculation of the amount to be paid is complex but approximates to an income tax system in that successive slices of the 'excess contribution' attract higher rates of repayment.

7. The total amount payable in any one year is limited to 250 million EUA or 3% of the budget, whichever is the higher. Within this overall limit, however, other limitations apply. The payment may not exceed the smaller of either:

(a) the net transfers from the Member State to the Communities (thus, a Member State benefiting from the mechanism can never be a net recipient from the budget); or

(b) the Member State's VAT payments—or GNP equivalent if VAT is not applied (i.e. no part of a Member State's budget payments by way of customs duties or agricultural levies can be repaid under this mechanism).

8. The system outlined under 7 applies when the Member State in question has a deficit on current balance of payments. If it has a surplus, then the calculation to establish whether the share of budget finance is disproportionate is based on the difference between the relative share of VAT own resources and the relative share of Community GNP.

Part Two

The relationship between existing sources of finance and Community expenditure

9. As will be seen from this description of the present financing system, Community expenditure cannot at present exceed the resources available from customs duties, agricultural levies and as far as 1% of VAT. These resources will tend to grow, in the next decade, significantly slower than the growth of GDP. On the other hand, there are various factors, notably enlargement to a Community of Twelve, which indicate that expenditure should grow faster. It is therefore necessary to consider how soon the present ceiling will be reached.

10. In its three-year forecasts 1979-1981,[1] the Commission explained two possible hypotheses under which Community expenditure might grow in the years in question. The first assumed an extrapolation of EAGGF Guarantee expenditure from 1973 and the lower limits of a desirable bracket of expenditure in the social, regional, energy and development aid sectors. The second represented a more dynamic approach, involving a limitation of EAGGF Guarantee expenditure and the upper limits of the desirable brackets of expenditure in the other sectors.

11. The Commission then compared the expenditure resulting from these two hypotheses with forecasts of own resources based firstly on a GDP growth in real terms of 3.5% a year and secondly on a growth of 4.5% a year. Under the first hypothesis the VAT rate in 1981 would be 1.12% with the lower GDP assumption and 1.08% with the

[1] Point 3.