Commission report on the operation of the own resources system (7 October 1998)

Caption: In its report of 7 October 1998, the Commission analyses the results of the own resources system of the European Union, seeks new own resources and considers the correction mechanism established on behalf of the United Kingdom.

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Financing the European Union — Commission Report on the Operation of the Own Resources System (7 October 1998)

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Executive summary

The object of the present report is to review the performance of the EU own resources system, including the search for new own resources as well as the possibility of applying a fixed rate of call for the VAT resource; and to examine the correction mechanism in favour of the United Kingdom and the issue of contributions to the EU budget raised by several Member States.

The EU ***own resources system*** has evolved considerably over time and, following modifications introduced by the 1988 and 1994 Own Resources Decisions, the equity among Member States of gross contributions to the EU budget has improved substantially as they have become more aligned with their respective shares in EU GNP. This improvement has been primarily a result of the increasing importance of the GNP resource in total budget contributions. The current system has also provided the resources necessary to finance EU expenditure. However, the present system has shown shortcomings in at least two respects. By relying increasingly on transfers from Member States treasuries, the system has not secured genuine financial autonomy for the EU; and various interventions in the contributions system, including the correction mechanism in favour of the United Kingdom, have inhibited transparency in the financial relationships of the Member States and the EU budget.

Reform of the present EU financing system could take either of two forms. It could be directed towards enlarging the fiscal base and developing new own resources for the Union or it could aim towards a simplification of present contributions arrangements. In the former case, the report notes that several candidates for ***new own resources*** exist but only one would be realistically available in the medium term. This is a modified VAT resource which, however, would not be entirely consistent with the equity criterion. Under the latter possibility, the present system of contributions could be replaced by a system where the VAT resource or even the so called Traditional Own Resources (TOR, i.e. essentially customs and

agricultural duties) are replaced by contributions based on GNP. In this respect, Spain, supported by Greece and Portugal, has proposed the introduction of an element of ***progressivity*** into the system taking into greater account, albeit modified, each Member State's GNP. Although prima facie appealing, progressivity in contributions would not be consistent with the current *acquis communautaire* of practising solidarity through the expenditure side of the budget and promoting real convergence through investment.

Despite conceptual and technical difficulties linked to the relevance and measurement of budgetary (or net) balances, the issue of ***budgetary imbalances*** has re emerged in the budget debate. Germany, the Netherlands, Austria and Sweden, have argued that their budgetary balances ought to be considered as excessive under the terms of the Fontainebleau agreement.

The report, as mandated by the 1994 Own Resources Decision, reviews the functioning of the existing ***correction mechanism in favour of the United Kingdom*** and of the budgetary imbalance of this Member State. The report notes that circumstances at the background of the UK rebate have undergone significant changes since the early and mid 1980s. The UK imbalance is no longer unique since several other Member States record similar imbalances. The relative prosperity of the United Kingdom after enlargement will be well above the average of the Union. While the Fontainebleau mechanism was essentially intended to provide a correction for the low share of the United Kingdom in agricultural expenditure, it currently confers it an advantage for all expenditure. Furthermore, if the mechanism were to remain unchanged, the United Kingdom would pay only one third of what it would otherwise pay for the forthcoming enlargement. Nevertheless, even after the rebate, the United Kingdom remains a larger net contributor than Member States with higher capacity to pay.

The ***budgetary imbalances of Germany, the Netherlands, Austria and Sweden*** have become large in recent years reflecting, predictably, the impact of several factors. For the years to come, these imbalances, when measured in terms of GNP, are expected to change somewhat, under the influence of the forthcoming enlargement and the prospective reforms of expenditure policies and this would be more pronounced in the case of the Netherlands. Regarding enlargement, there will be an average deterioration in the budgetary balance of the present Member States of around 0.15 per cent of GNP, which should not give rise to demands for compensation. With regard to the reforms, it is not possible to estimate precisely their impact prior to the completion of the negotiations. However, it is likely that the reform of the Common Agricultural Policy will not affect significantly the budgetary balance of the Member States in question with the exception of the Netherlands where there is likely to be an accounting rather than a substantive effect. The impact of the reform of Structural policies on budgetary balances is even more difficult to estimate but, in any case, the reduction in Structural expenditure within the present 15 Member States will mean a reduction in contributions and a consequent relative improvement in the budgetary balances of these Member States even if Structural spending is concentrated in less prosperous regions.

If a political consensus on the need to address the issue of these imbalances were to develop, three courses of action would be possible. An option on the ***financing side*** of the budget would be to move towards an own resources system characterised by greater transparency, that is absence of ad hoc features, and equity, that is the removal of the remaining elements of regressivity. This would encompass the reduction or even the phasing out of the present correction mechanism, whose rationale would be weakened if an option on the expenditure side was to be adopted, and/or the partial or complete substitution of the GNP resource for the other resources was to be implemented.

Another approach, consistent with the Fontainebleau conclusions, would be to introduce corrections on the ***expenditure side*** of the budget. The report discusses an option involving the partial (75 per cent) reimbursement of CAP expenditure on direct aids to farmers. Without affecting either the Community nature of the CAP or the overall assistance to farmers   since the conditions attached to direct aids payments will continue to be an integral part of the Common Agricultural Policy and would result from EU decisions   the possibility exists to share between the EU and the national treasuries the amount of assistance in direct aids. This option would benefit those Member States where the share in financing is greater than the share in direct aids, but it would affect adversely those Member States where the opposite holds. Such an option would permit a reduction of the Agricultural Guideline and possibly of the own resources ceiling.

Finally, there is the option of a ***generalised correction mechanism***. A straightforward generalisation of the present mechanism to all Member States recording a negative budgetary balance would involve a huge increase in the redistribution of resources between Member States. However, it would be possible to modify some parameters of the present mechanism, for instance the threshold for compensation or the value of the compensation coefficient. This would generate many outcomes, some involving less, and others involving more, resources than the current UK rebate.

The report concludes by confirming the view put forward in *Agenda 2000*, that neither the need for an increase in the financial resources of the Union, nor the limited shortcomings of the financing system provide grounds to modify the Own Resources Decision at an early stage. The options presented in the report are interchangeable, can be completed and can be spread over time. However, none of the options discussed in the report provides an ideal solution. Technical and conceptual weaknesses can be found in all of them. The shifts in the burden of financing that results from some of these options present regressive elements that might need a redress in the context of an overall solution.

If a consensus were to emerge on the need to address the issue of budgetary imbalances, it would be necessary to choose between the options presented in the report or to agree on a combination of them which would respect their logic. The timing of any change would depend on whether a modification of the Own Resources Decision would be required, and enlargement would appear to present a change of circumstances so significant as to justify such a major structural reform.

Introduction

The current Own Resources Decision foresees that the Commission will submit by the end of 1999 a report on the operation of the own resources system as well as on the correction of the budgetary imbalance granted to the United Kingdom. The Decision also requires that the Commission report on the feasibility of creating a new own resource as well as on the arrangements for the possible introduction of a fixed uniform rate levied on the VAT base[1].

The report has been prepared at a time when the EU is expected to widen its membership with the forthcoming enlargement and is in the process of considering significant policy reforms. Although difficult to quantify, the likely effects of enlargement and of the proposed reforms are also an important part of the report.

The first part of the report reviews and assesses the performance of the financing system of the European Union. A key argument developed in this part of the report is that the current system has performed adequately both in terms of sufficiency and in terms of equity in gross contributions. However, judged against the criteria of financial autonomy, cost effectiveness and transparency, the present system shows some shortcomings. The introduction of a new own resource is often seen as a way of improving the performance of the system. This part of the paper examines the case for and the difficulties in introducing a new own resource and of permanently fixing the rate of call of VAT. In addition, it reviews the recent proposal of Spain, Greece and Portugal to introduce a significant element of progressivity into the own resources system.

The combination of the present financing arrangements and of the expenditure decisions has resulted in budgetary imbalances which some Member States consider as too large. The second part of the report examines issues related to the budgetary positions of the Member States. In the current system, the sole Member State benefiting from a correction of its budgetary imbalance is the United Kingdom (also, Germany’s share in the financing of the UK rebate is reduced by one third). Recently, other Member States have argued that they also meet the conditions mentioned in the Fontainebleau agreement as justifying the granting of budgetary relief. This section of the report comments on the budgetary imbalances of this group of Member States and presents some options for addressing the perceived difficulties.

1. The performance of the own resources system

The present part of the report extends over three sections. The first provides a description of the resource composition of the current system of own resources while its historical development is briefly summarised in Annex 1. The second section provides an assessment of the present system according to the criteria of *adequacy, equity, financial autonomy, transparency/simplicity* and *cost effectiveness*. The third section addresses the issue of possible new own resources for the EU. Several potential new resources are considered while a detailed review of new own resources options is presented in Annex 2. Given the unequal tax base each potential resource represents in each of the Member States, this section also alludes to the possible conflict between increasing the financial autonomy of the EU and improving the equity of the system.

1.1. The resource composition of the present system

The most recent modification of the system of own resources was agreed in the Edinburgh meeting of the European Council in December 1992. This political agreement was then transformed into a formal decision in October 19942 while the ratification by all national parliaments was finally obtained in the spring of 1996. The present system of own resources came into force, retroactively, on January 1, 1995.

[Table 1: The composition of EU own resources]

The changes introduced on this last occasion went in the same direction of those introduced in 1988 and have had significant implications for the composition of own resources. Table 1 presents the share of each category of resources in the budget, and graph 1 shows the absolute value of contributions by resource, over the period 1988 1999.

A notable feature of these data is, first, the trend decline in the relative contribution of the so called "traditional own resources" (TOR, customs and agricultural duties) whose share has fallen from 29.1 per cent of the total in 1988 to 19.1 per cent in 1996 and about 16 per cent in 1998 99. The impact of trade liberalisation on tariff levels has meant that the total yield of this resource has failed to increase in line with the expansion of world trade. In absolute terms, traditional own resources have remained in the range of Ecu 12 to 14 billion thus giving the observed reduction in the share of total resources.

[Graph 1: Composition of EU own resources 1988 1999]

A second important development is represented by the decline in the share of VAT contributions from almost 70 per cent of total resources in 1990 to 51.3 per cent in 1996 and about 35 per cent in 1999. Correspondingly, the share of the GNP resource has risen to 35.7 per cent in 1997 and is projected to be close to 50 per cent in 1999.

The declining share of VAT revenues primarily reflects policy reforms introduced by the 1988 and 1994 Own Resources Decisions. In 1988 it had been agreed that the VAT base of the Member States should be limited to 55 per cent of their GNP. In 1994 it was decided to lower this limit to 50 per cent from 1995 onwards for the Member States whose GNP per head was below 90 per cent of the EU average (i. e. Greece, Ireland, Portugal and Spain) and to reduce progressively the capping of the VAT bases of the other Member States from 54 per cent in 1995 to 50 per cent in 1999. Table 2 records the capping threshold and the Member States whose VAT base has been capped over the period 1988 1999 as well as time series on the maximum and the uniform call rate for VAT.

In addition, in 1994 it was decided to lower, from 1995 onwards, the maximum call rate for VAT from 1.4 per cent to 1 per cent in 1999. However, the rate determining actual VAT contributions is the so called *uniform rate* which is lower than the maximum rate because of the need to leave aside an amount for the notional financing of the UK correction3. This rate has fluctuated between 1.20 and 1.28 per cent until 1994, but has since declined in line with the maximum rate and is projected to drop to 0.84 per cent in 1999 (see table 2).

The role of the GNP resource, introduced by the 1988 Decision, is one of a buffer serving a residual function to equate revenue and aggregate budget expenditure. As a consequence, the uniform call rate for GNP varies according to annual budgetary requirements; in 1995, for example, it was 0.339 per cent ; in 1997, it was 0.403 per cent; in the 1999 budget, it is estimated to be 0.534 per cent[4].

The budgetary balance from the previous year can affect resource availability in the current year and, correspondingly, the need to draw on the GNP resource. For example, the budget surplus of 1989 reduced GNP financing in 1990 to a minimum; in contrast, the slow growth in VAT revenues during the recession years of 1992 1994 made it necessary to increase residual GNP financing. In general, however, with the progressive decline in the share of revenues from traditional own resources as well as from VAT, the GNP resource is taking on an increasingly significant role in the financing of the EU budget.

[Table 2: Capping threshold, Member States whose VAT base is capped, the maximum VAT call rate and the uniform VAT call rate]

In addition to the resources mentioned in the previous paragraphs, the EU budget receives other revenues, which are not considered own resources, resulting from specific Community provisions. These revenues consist of fines, revenues accruing from the administrative operations of the Community institutions, contributions related to activities in the European Economic Area, interest on late payments, taxes on the salaries of employees of the European Institutions, income from borrowing and lending operations and other miscellaneous revenues. In 1997, such revenues amounted to Ecu 612 million or 0.74 per cent of all resources available to the budget.

1.2. An assessment of the present own resources system

The key criteria according to which the performance of the system can be evaluated are:

– *Resource adequacy*, i.e. the resource must have a significant yield relative to the size of the EU budget;

– *equity in gross contributions*, i.e. the burden should be fairly shared among Member States;

– *financial autonomy* i.e. the resource should increase the independence of the EU budget from national treasuries;

– *transparency and simplicity*, i.e. the determination of the tax should be easily understood by citizen; and

– *cost effectiveness*, i.e. the collection and administration costs of the resource should be low relative to its yield.

To anticipate the conclusions of this section, the present own resources system has performed satisfactorily when judged against the first two criteria, but some shortcomings are encountered with regard to the last three.

1.2.1. Adequacy and equity

The present own resources system has performed well against the criteria of adequacy of resources and equity in gross contributions.

Adequacy

The present own resources arrangements have generated sufficient revenue to finance expenditure plans. The decline of the traditional and VAT resources has been made up by the GNP resource. The previous own resources ceiling of 1.20 per cent of GNP proved barely adequate and difficulties were experienced, particularly during the recession of 1993. The recovery of 1994 and the accession of three new Member States in 1995 eased somewhat the constraints. More recently, however, the progressive increase in the own resources ceiling agreed in Edinburgh has gone hand in hand with greater restraint in spending decisions. As a result, a margin has appeared under both the Financial Perspective and the own resources ceiling which is expected to increase further in 1999 (see graph 2).

Equity

The equity of gross contributions of the Member States has improved, largely because of the progressive replacement of the VAT resource with the GNP resource. In this context, equity is interpreted to mean proportionality of gross contributions to income across the Member States[5].

[Graph 3: Share in VAT and GNP contributions and share in EU GNP]

As a result of the 1988 Own Resources Decision, which opted for introducing the GNP resource rather than meeting financial needs through increasing the VAT call rate, and of the confirmation of this choice in 1994, Member States' contributions are now becoming more closely correlated with national GNPs6. As the ability to contribute to the EU budget can best be measured by a nation's national income converted at current exchange rates into a common currency, the increasing importance of the GNP resource translates into improved equity in gross budget contributions.

Graph 3 presents data for shares in VAT and GNP financing, which is the part of the contributions that can be seen as coming directly from the Member States' treasuries, and shares in EU 15 GNP in 1997 for all Member States ranked in descending order, starting with Germany. The data confirm that contributions mirror closely GNP shares with the particular exception of Italy, and of the UK where the rebate has led to contributions that are considerably lower than the GNP share. Each year, however, the relationship between VAT and GNP contributions and GNP shares is influenced by several factors.

[Table 3a: Member States' shares in EU financing and in EU 15 GNP]

First, because all Member States pay an identical percentage of their VAT base and/or GNP, differences in the rates of growth of the VAT harmonised base (influenced largely by the growth of private consumption) and in that of GNP imply changes in relative shares and corresponding changes in relative contributions. Secondly, the corrections of the VAT and GNP contributions made once the outturn is known (i.e. in the year following that in which the contributions are paid) usually tend to amplify movements in contributions resulting from growth in the economy (when good economic growth is sustained for a number of years, the initial forecasts tend to be underestimated and therefore result in large supplementary payments when the correction is made and vice versa in the case of a downturn). As a result, trends in national contributions tend to show a cyclical pattern that is more pronounced than the economic cycle which influences its bases.

The inclusion of traditional own resources modifies somewhat the pattern of total contributions (see table 3a for the percentage shares and table 3b for absolute values). The share of Belgium, Ireland, the Netherlands and the UK in TOR is markedly higher than their shares in GNP, a reflection of substantial port facilities that serve as gateways of entry of foreign goods into the EU; studies suggest that this effect may be substantial. Its existence underscores one of the many difficulties involved in interpreting a simple difference between budget contributions and budget expenditure as a measure of the benefits a Member State enjoys from membership in the EU.

[Table 3b: Difference between actual VAT contributions, TOR collection and theoretical GNP contributions]

Additional advances towards improving equity in contributions will take place over the next years as the share of TOR and VAT in own resources will decline further. However, perfect equity cannot be expected since the VAT resource will continue to yield revenues which will not be correlated with national income and will continue to introduce an element, albeit small, of regressivity into the system. In addition, equity in gross contributions is hindered by the presence of the UK rebate mechanism, which reduces their correlation with the ability to pay.

1.2.2. Financial autonomy, cost effectiveness, transparency and simplicity

In certain respects, the present system shows shortcomings in terms of financial autonomy, cost effectiveness and transparency. To a large extent, this is due to the fact that there are inevitable trade offs between financial autonomy, equity and cost effectiveness. The dominant part of EU resources derives from national contributions from the treasuries of the Member States; this reduces the financial autonomy of the EU, but offers a good degree of equity and of cost effectiveness. Traditional own resources contribute to financial autonomy, but their equity is contested and their collection and control are very cumbersome.

Financial autonomy

Traditional own resources represent currently the only true own resource of the EU. However, the importance of TORs in financing EU expenditure is diminishing markedly. Moreover, although customs duties and related revenues resulting from the EU's commercial policy formally belong to the EU, Member States that collect these duties tend to regard them as national contributions. This is not appropriate and it reduces further the significance of budgetary balances[7].

The lack of financial autonomy resulting from the low share of real own resources in the financing of the budget is considered responsible for various shortcomings of the present system.

– *First*, it has made the EU increasingly dependent on intergovernmental transfers; such dependence has already contributed to conflicts and has encouraged Member States to seek to maximise ill defined concepts of the national benefit from the EU budget;

– *second*, the system whereby all financing needs not covered by TOR or the VAT resource are covered by the GNP resource is very cost effective, but it results in changes in EU expenditure at the margin being reflected in changes in national spending. This entangles EU financing issues with domestic financial and budgetary policies at the expense of revealing to the citizens the EU wide priorities at stake; and

– *third*, democratic accountability is obscured because of lack of a direct relationship between citizens and taxes paid to the EU budget.

Cost effectiveness

The collection of traditional own resources is very cumbersome and the attitude of Member States towards these resources is ambiguous. Customs legislation is very elaborate with over eleven thousand tariff positions and a Community customs code of about 400 articles[8]. However, international trade is a much more complex reality with new products and new trade flows appearing every day. Under these conditions, there is scope for fraud, irregularities and litigation.

In the present institutional system, Member States are responsible for collecting traditional own resources and putting them at the disposal of the Commission. The latter has the responsibility to control the way Member States perform this task. To this end a complicated machinery has been set up which amounts to a form of *multilateral surveillance* of the way in which Member States carry out their duties. Any loss in the collection of TOR in a Member State must be made up by a corresponding increase in the GNP resource called. As a result, the negligence of a Member State has financial consequences for all the others. For this reason, the results of the control activities of the Commission are made available to all Member States9 and all important decisions on the non recovery or remission of customs duties as well as on the write off of amounts impossible to collect are taken with some involvement of all Member States.

These provisions result in a substantial amount of administrative work which, as the reports of the Court of Auditors show year after year, always falls short of what would be desirable for a better protection of the financial interests of the EU. In addition, the complexity of the procedures for the recovery of amounts put at risk by fraud or irregularities appears to discourage most national administrations, which often appear unable or unwilling to recover what is due.

Under these conditions, Member States appear to prefer to finance the EU budget through GNP instead of through a more effective collection of TOR even if this must have implications for the distribution of the financial burden. In effect, they are neither inclined, for understandable reasons, to tighten the regulatory framework of the customs system nor do they appear willing to commit the necessary resources to the collection of customs duties.

Transparency and simplicity

With four Member States having their VAT base capped in 1998 (as, probably, will be the case for all the future new Member States), the VAT resource is becoming in effect a GNP resource. In its 1998 report on the functioning of the VAT and GNP resources, the Court of Auditors points out that the VAT resource, despite being formally a tax on consumption, has taken the character of a financial contribution from Member States to the EU budget with its determination depending to a certain extent on statistical calculations (especially for the estimation of the weighted average rate).

The presence of the UK rebate contributes to obscuring the exact nature of the system and its consequences. Not only, as already indicated previously, does it reduce the correlation between gross contributions and ability to pay, but its calculation and financing arrangements are so complex as to impair the transparency of this mechanism.

1.3. Options for a new system of contributions

Modifications of the present system of contributions could either make it simpler through a reduction in the number of sources of financing or could introduce new own resources in addition to the existing ones or as a replacement of some of them. The arguments in favour of a simplification of the present system of contributions are essentially based on the shortcomings of the present own resources system in terms of financial autonomy, cost effectiveness and transparency discussed earlier. The introduction of new own resources is sought as a way of improving financial autonomy.

New fiscal own resources would clearly reduce the share of the EU budget financed through national contributions and would ease the tensions arising from attempts to measure net contributions. Should the budget be fully financed through own resources, the link between changes in EU expenditure and corresponding changes in national expenditure would also be broken. As well, if the EU budget were to become entirely financed through “real” own resources whose rates of call were to be decided every year, the budgetary authority would have full control of the expenditure and of the revenue side of the budget. Finally, proponents of new own resources expect them to enhance political accountability, transparency and visibility to citizens. However, because the distributions of the tax bases for fiscal resources are not equal across the Member States, introducing a new own resource and, thus, enhancing financial autonomy, could be in conflict with enhancing equity in contributions.

1.3.1. Simplification of the present system of contributions

The yield from TOR is low and will decline further while their administration is very cumbersome. The frustration felt with TOR is such that proposals have been made to return them to the Member States. While admitting that TOR should theoretically be attributed to the central level, it is sometimes considered that their relative share in the total financing of the EU is so low that returning them to the Member States would yield practical advantages compensating for the implicit sub optimality of such attribution. The distributional problems that are likely to appear could be partly reduced through measures aimed at encouraging the use of the transit facility that allows the payment of customs duties where the goods are finally consumed. It is clear that even if customs duties ceased to be own resources of the EU budget, they would continue to represent an important instrument of the Union's trade policy and their effective collection would require some form of control by the Commission on behalf of the Member States.

The present VAT based own resource has drawbacks with respect to equity in contributions, financial autonomy and transparency. As the Court of Auditors has recently underlined again, it is hardly an own resource given the way in which its base is calculated and the existence of rules which, for some Member States, make it effectively a GNP based resource. In addition, its uniform rate of call varies every year according to the size of the UK rebate. This is due to a provision that calls for the UK rebate to be notionally financed through VAT and therefore reduces further, by a variable amount, the maximum rate of call. If on the occasion of a future modification of the Own Resources Decision the VAT based resource were maintained, it would at least appear necessary to call it at a fixed rate. This could be achieved through putting an end to the presumption of financing the UK rebate on the VAT resources accompanied by a corresponding permanent lowering of the maximum rate of call[10].

Own resources almost always entail significant collection and control costs and are therefore less cost effective than straightforward national contributions. In addition, no own resource can be more equitable   in the sense of being linked to the ability to pay   than a contribution based on GNP which constitutes the best available proxy of such ability to pay. Indeed, some proposals for new own resources include parallel corrections in the form of an equalisation mechanism intended to align gross contributions to GNP shares.

A further consideration in this context is that taxes influence the allocation of resources and there is some merit in having a system of national contributions and leaving it to the Member States to decide on the best way to raise the corresponding financial resources. These considerations have prompted proposals for the replacement of the present system of own resources with a system based solely on GNP contributions, which would provide no financial autonomy whatsoever, but that would be equitable, transparent and cost effective.

Whatever the future of such a proposal, it must be underlined that the present GNP based contributions suffer from the unwillingness of Member States to use the best available data for the reference aggregate. Estimating the total value of the national income of a country is a difficult task. In particular, the methods used must evolve in line with the transformations of the economies to take into account the changes in the goods and services produced and delivered. To this end, the national statistical offices of the European Union have recently developed a new common methodology to estimate GNP[11] and new decisions are taken periodically to update and refine it (a recent important one was taken at the end of 1997 and concerned the imputation of financial services indirectly measured). However, Member States have sought to delay the use of these new measures in the EU budget[12] thus leading to the coexistence of two statistical series for GNP: one, of better quality, for general use and another, less reliable, used for the assessment of the GNP contributions. If GNP will continue to play a role in the system of own resources, this situation must be corrected with any GNP contributions based on the most recent and most reliable definitions.

1.3.2. Criteria for new own resources

A set of criteria, some of which derive from economic rules regarding the assignment of policy instruments to different levels of jurisdiction (Member State or EU) while others are more specific to the EU, can be used to select candidates for new own resources[13]. Economic theory predicts that tax instruments belong optimally to a higher level of authority when there are cross border externalities and/or when it is difficult to attribute specific revenues to specific Member States.

In the case of the EU, additional specific criteria are appropriate. A very important one is that contributions ought to respect *horizontal equity* so that among Member States of equal ability to contribute all do indeed contribute an identical amount. However, given that the level of real income is not equal among the Member States, it is sometimes felt desirable that *vertical equity* be satisfied as well, so that contributions to the EU budget are a function of the Member States’ differential ability to pay. Recently Spain, supported by Greece and Portugal, has proposed the introduction of a significant element of progressivity into the contributions to the EU budget.

It is also necessary that new own resources be consistent with other EU policies so as not to offset their effects. Their visibility for the EU citizens is also desirable while, on a more technical level, their base must present a sufficient degree of harmonisation and their collection should be possible without too high administrative costs. Finally, their yield must be high enough to finance a substantial amount of EU spending.

1.3.3. Possible future own resources

The search for new own resources has so far proved elusive. This has been partly due to the generally good performance of the present system, which has blunted incentives for finding new resources, but principally to the difficulties involved in establishing new own resources and also to differing political priorities. Since 1992, however, interest in establishing new own resources has increased, in part reflecting institutional initiatives and in part related to emerging new possibilities[14]. The publication of a report by the European Parliament on new own resources, advocating a modulated VAT based system[15], is important in this context.

A ***modified VAT resource*** offers the potential of becoming an important own resource in the future. Such a tax would be highly visible to taxpayers and would be consistent with the establishment of EU wide minimum tax rules and would also generate sufficient revenues for the budget. However, VAT is levied on a national tax base and it is difficult to see its revenues as belonging to the EU, and also it may entail considerable administration costs.

A European Parliament (1994) report[16] advocated a new own resource based on a common VAT call rate across the Member States, differentiated across commodities according to two rates, a lower one and a higher one, of say 1.5 per cent and 3 per cent. The tax would be levied on a harmonised base through declarations explicitly recording that it is an EU tax. Total VAT revenues would be divided between the national budget and the EU, and national parliaments would determine the part for domestic budgetary purposes while the EU budgetary authority would determine the part to be attributed to the Community budget.

The proposal could be implemented. It would clearly involve a number of technical problems, but these could be overcome if there was the political will to proceed in this direction. It is questionable, however, if such a system should be accompanied, as in the European Parliament proposal, by an equalisation mechanism ensuring that national contributions would be proportional to each Member State's share in the GNP of the Union[17]. If the idea is to tax the consumption of individuals, then the concept of national contributions should not enter into the equation.

Other possible own resources – a form of withholding tax, a CO2/energy tax, excise taxes, seigniorage, corporate and personal income taxes, new communication taxes – are discussed in the Annex "*Review of possible new own resources for the European Union*" (Annex 2). At this stage, it is important to note that, despite proposals made for new own resources, there is little consensus about which one(s) would be the most appropriate. This is a reflection of differences of views regarding the future orientation of European integration.

1.3.4. Progressivity in contributions

A proposal to introduce progressivity in the system of own resources has been made by Spain. The proposal, which is supported by Greece and Portugal, is founded on the Protocol on Economic and Social Cohesion, in particular, on the declaration of intent of the high contracting parties to take *"greater account of the contributive capacity of individual Member States in the system of own resources, and of examining means of correcting, for the less prosperous Member States, regressive elements existing in the present own resources system"*. It should be stressed at this stage that, during the 1992 discussions of the 1993 1999 Financial Perspective, equity was understood to mean proportionality with GNP and, as noted in section 1.2, measures have already been taken to address the regressive elements of the own resources system. The proposal recognises that improvements, related to the increasing importance of the GNP resource, have been made but it also underlines that progressivity in contributions continues to be absent from the own resources system.

Greater progressivity in contributions could be achieved, according to the proposal, by adjusting the base of the GNP resource through the use of coefficients reflecting each Member State's relative prosperity. The adjustment can be complete (applying to the GNP resource) or partial (applying to only part of the GNP resource), and in the latter case progressivity would also be partial. Member States could also be grouped into classes of relative prosperity (for example, Member States with income per capita less than 90 per cent of the EU average, those between 90 per cent and 100 per cent, etc) with specific adjustment coefficients assigned to each class. Contributions to the EU budget would then be determined according to the new bases. The new resource could ultimately, it is argued, replace the VAT resource.

[Table 4: Modifications of total national contributions relative to the present system
Progressivity proposal applied to the GNP resource]

It should be noted at the outset that the proposal does not entail the introduction of a new own resource as such but it provides for a significant modification of an existing resource (GNP). A simulation of the impact of the proposal on the budget contributions in 1996 and 1997 is presented in table 4.

The proposal is prima facie appealing since progressivity is found in virtually all the Member States' national tax systems. However, the proposal has an important drawback in that it does not acknowledge the nature of solidarity and its practice in the Community. There are two main reasons for the current EU choice of implementing solidarity through the expenditure side of the budget[18].

– *First*, solidarity in the EU is mainly expressed in the form of improving real convergence by directing funds mainly to eligible regions in any Member State rather than to a Member State as a whole.

– *Second*, achieving real convergence has a higher probability under expenditure based progressivity than under progressivity in contributions. The reason for this is that progressivity in contributions, by lowering the financing shares of the less prosperous Member States, would leave it up to them to use the funds as they see appropriate. It is plausible to expect that, in this case, investment activity would not be strengthened as much as under expenditure based progressivity.

2. The issue of budgetary imbalances

Budgetary balances (also called net balances), measured by the simple difference between contributions to and receipts from the EU budget, represent only a narrow view of, and fail to fully account for, the benefits accruing to Member States from participating in the EU[19].

Recorded budgetary flows fail to account for positive externalities arising from EU policies. For example, CAP, structural operations and external expenditure benefit not only the immediate recipients but also give rise to spill over effects transcending national borders[20]. It is clear that their consideration would modify the assessment of the accounting imbalances even if it is not possible to quantify the importance of these spill overs.

[Graph 4a: Total allocated expenditure, VAT and GNP contributions (before UK correction) and total payments to the EU budget]

There are also difficulties associated with the identification of the ultimate beneficiaries of EU expenditure policies; for instance, CAP export restitutions do not necessarily benefit the residents of the country where they are paid. In addition, EU budget expenditure is heterogeneous and comparisons of total amounts received have often limited meaning in appreciating the "benefit" resulting from such payments: a given amount spent in purchasing goods and services does not bring the same advantages of the transfer of a grant of an equivalent amount. Similar problems appear on the revenue side: the country where customs duties are collected is not necessarily the one of residence of the economic agents ultimately bearing their burden.

The definition of budgetary balances is also fraught with significant conceptual and accounting problems. To compute budgetary balances it is necessary to make numerous choices on the items to be included in the receipts and expenditure flows as well as on the reference periods (e.g. cash vs. accrual figures, surpluses from previous years, etc.). Depending on the choices made, it is possible to obtain numerous, equally valid, definitions of budgetary balances which sometimes produce significantly different results[21].

[Graph 4b: EU expenditure (excluding administration), VAT and GNP contribution (before UK correction) and total payments to the EU budget]

Nevertheless, the size of some of these imbalances has been at the centre of discussions for many years[22]. In response, a compromise was struck in 1984 at the Fontainebleau meeting of the European Council. According to the conclusions of that meeting,

"Expenditure policy is ultimately the essential means of resolving the question of budgetary imbalances.

However, it has been decided that any Member State sustaining a budgetary burden which is excessive in relation to its relative prosperity may benefit from a correction at the appropriate time." [23]

The reference to expenditure policy as the means of correcting budgetary imbalances reflects the prominent role that expenditure decisions have in their determination (see graphs 4a and 4b). Correcting budgetary imbalances through ad hoc mechanisms essentially amounts to a refusal to act directly on the sources of the imbalances.

[Graph 5: Negative balances of some Member States]

In the present part of the report, the first section reviews the performance of the correction mechanism in favour of the United Kingdom set up following these decisions. In March 1998, four Member States, namely Germany, the Netherlands, Austria and Sweden have stated their belief that their negative balances are to be seen as excessive in relation to their prosperity under the terms of the Fontainebleau agreement. The second section of the report examines the development of the balances of these Member States.

The third section provides some indications of the possible effects of the Agenda 2000 reforms on the budgetary imbalances of the five countries examined in the previous two sections. Finally, the fourth section reviews some of the main options available in relation to the issue of budgetary imbalances: phasing out of the correction mechanism for the United Kingdom, corrections on the expenditure side of the budget and application of a correction mechanism to all Member States experiencing large imbalances.

2.1. The UK budgetary imbalance
[24]

The budgetary imbalance of the United Kingdom was at the centre of the political debate for about a decade (1974 1984) provoking frequently stalemates in the EU decision making process. The question was finally settled at the Fontainebleau European Council of 1984 and the resulting rebate mechanism constitutes an integral part of the Own Resources Decisions taken subsequently. The rebate was reviewed in 1988 and 1992 and on both occasions the European Council decided that it should be continued.

[Graph 6: Share of the United Kingdom in (VAT and GNP) payments and in EU (allocated) expenditure]

The size of the budgetary imbalance of the United Kingdom   and therefore that of its compensation   has fluctuated substantially since 1985 around half a point of GNP for the imbalance and 0.3 per cent of GNP for the rebate25. Graph 6 shows developments in the shares of the United Kingdom in payments to the EU budget and in EU expenditure over the period 1987 1998.

Graph 7 shows that the mechanism has been effective in reducing substantially the negative balance of the

United Kingdom. However, even after the rebate the United Kingdom remains a larger net contributor to the EU budget than Member States with a higher capacity to pay.

[Graph 7: Budgetary balance of the United Kingdom]

Some of the conditions that prevailed at the time the mechanism was decided do not apply any more:

i) Changes in the composition of EU spending have modified the rationale of the compensation. Whereas in 1984, it had essentially the nature of a correction for the specific agricultural problem (CAP represented about 70 per cent of total allocated expenditure), it has now lost to a great extent this characteristic since it corrects equally the agricultural problem as well as the United Kingdom's contribution to the solidarity effort of the EU and to its other policies. If a correction on the expenditure side of the type presented in section 2.4.2 (partial reimbursement of CAP direct aids) were to be introduced, this consideration would become even more relevant.

ii) The budgetary imbalance of the United Kingdom is no longer unique. In 1984, the imbalance of the United Kingdom, before correction, was the largest of the Community. In recent years, four more countries have budgetary imbalances as large as the United Kingdom’s (see graph 8).

iii) The gap in relative prosperity between the United Kingdom and some other large contributors to the EU budget has narrowed. The United Kingdom has a relative prosperity (and a corresponding relative capacity to pay) around the EU average and will certainly be above this mark after the forthcoming enlargement of the EU[26].
The mechanism also has some technical drawbacks and a more fundamental, systemic, characteristic which, although not new or unexpected, ought to be underlined.

With respect to the technical drawbacks,

– the existence of the rebate leads to budget contribution by the United Kingdom representing a lower proportion of its income than those paid by the other Member States and therefore creates a distortion in the system of contributions;

– the definition of the EU expenditure to be used in the calculation of the compensation ("allocated expenditure") includes also administrative expenditure whose nature is substantially different from the rest of EU spending and whose inclusion in any calculation of the budgetary imbalances has often been questioned [27]; and

– allocated expenditure is defined in a way which may provoke a small, but quite unjustified, increase in the rebate at the time of enlargement. With enlargement, some expenditure flows directed to the new Member States (e.g. PHARE), which are currently considered “external expenditure” and therefore do not enter into the calculation of the rebate, will be replaced by payments under internal policies which enter into the calculation.

The systemic characteristic of the rebate mechanism, on the other hand, is its function as a shock absorber for all changes in the imbalance of the United Kingdom; this would place this country in a unique position in respect to common budgetary decisions. This not only risks insulating the United Kingdom from the implications of budgetary decision making but would have significant adverse effects at the time of enlargement. The accession of a large number of new Member States with very low standards of living is expected to have a negative effect on the budgetary positions of the current Member States. But the United Kingdom will see its budgetary position deteriorate by only one third of what would have happened in the absence of the correction mechanism, which would put into question an equitable sharing out of the burden resulting from enlargement.

The provisions for the calculation and for the financing of the rebate are extremely complicated and inhibit budgetary transparency and accountability. In any case, it would be necessary to at least simplify the financing provisions and ensure that the VAT rate of call will not depend any more on the size of the rebate (see paragraph 1.3.1).

2.2. The budgetary imbalances of Germany, the Netherlands, Austria and Sweden

Germany, the Netherlands, Austria, and Sweden have recently indicated that they consider their negative budgetary positions as excessive "relative to their prosperity" and, therefore, as candidates for a correction under the Fontainebleau agreement. In addition, these countries underlined their dissatisfaction with the present situation where other Member States of similar capacity to contribute to the EU budget show much smaller negative balances or even positive ones. Graph 8 confirms that these four countries do indeed record significant budgetary imbalances.

[Graph 8: Budgetary balances of the UK, Germany, the Netherlands, Austria and Sweden]

The Fontainebleau agreement established that to benefit from a correction mechanism a Member State's budgetary burden must be excessive in relation to its relative prosperity[28]. *Relative prosperity* is used to determine how well off are the citizens of a country or of a region compared to the EU average and is expressed in Purchasing Power Standards (PPS) data. Subsequently, the Protocol on Economic and Social Cohesion established that the proper way to take greater account of the Member States' *relative prosperity in the system of own resources* is by considering their *contributive capacity*. A Member State's *contributive capacity* can be used to determine its (citizens') capacity to contribute to a given international expenditure and is measured by converting nominal incomes into a common numeraire using current exchange rates, since the latter constitute the terms in which a country's income purchases international goods and services, including EU budget contributions[29].

Over the last decade, substantial changes in the relative position of the four Member States, measured by either concept, have taken place and these have been particularly pronounced in the cases of Germany and Sweden (see table 5, and tables 8 and 9 of the Statistical Annex 8).

[Table 5: Capacity to pay and relative prosperity]

The origins of the imbalances of these four countries, however, are different. Germany has had a large negative budgetary position for many years. As a wealthy country with a relatively small agricultural sector it attracts low shares of Structural Funds and CAP spending. The German negative balance deteriorated further between 1990 and 1995 for various reasons. In 1990 and 1991, the country experienced a rate of economic growth much higher than those of the other Member States which led to an increase in its relative share in GNP and in the financing of the Community. After unification the country started receiving significant payments in favour of the new Länder under the Structural Funds, but this was more than compensated by the progressive increase in Structural Funds spending decided in Edinburgh in 1992 and by their concentration in the so called "cohesion" countries. Since 1995, the negative budgetary position of Germany has remained essentially stable. These developments have been largely consistent with the projections made at the time the 1988 Own Resources Decision was modified. In fact, had EU expenditure increased by as much as the current Financial Perspective would have allowed the negative budgetary balance of Germany would have been larger[30].

[Table 6: Budgetary balances of some Member States in 1999 and worst and best performance in the 1995 97 period]

The case of the Netherlands is different. The definitions of budgetary balance used in graph 8 and in table 6 do not take into account the effect known as the "reverse gateway effect", i.e. the fact that export restitutions paid where the port facilities are located, often do not go in favour of nationals of that country. The figures for the Netherlands are influenced by this effect. As long as export restitutions played a significant role in the Common Agricultural Policy (together with measures for storing surpluses temporarily withdrawn from the markets) the country was a significant recipient of this type of expenditure to the point of appearing for many years as a large net beneficiary. The reforms of the CAP have gradually altered this situation and the Netherlands has gradually become a net contributor to the EU budget as it receives low returns from both the Structural Funds and on direct aids from agricultural expenditure.

However, the position of this country also depends to a large extent on the definition of budgetary balance used and, in particular, on the treatment of customs duties. If balances are calculated according to the provisions of the correction mechanism decided in Fontainebleau, which would neutralise the impact of traditional own resources in the measure[31], the negative balance of the Netherlands is currently somewhat smaller than that of the other countries.

Both Sweden and Austria were expected to have negative balances. The shares in Agricultural and Structural Funds spending that these countries can expect up to 1999 are low. In 1997 these two countries were contributing 3.1 and 2.8 per cent of the EU financing, respectively. Their shares in CAP spending were 1.8 and 2.1 per cent, while their shares in the Structural Funds were 0.9 and 1.4 per cent. A significant amount of spending foreseen for these two countries in 1995 was paid only in 1996 and this explains the apparent improvement of their position in 1996. In 1997, the two countries received Ecu 76 and Ecu 71 millions, respectively, as the penultimate instalment of the temporary compensations decided in the accession treaties.

It has often been underlined that in 1997 Germany’s budgetary balance amounted to more than 60 per cent of all negative balances. This estimate, however, was influenced by the strong fluctuations of the UK rebate. In 1999, the budgetary balance of Germany should represent slightly less than 50 per cent of all negative balances. In coming years this percentage is expected to come down further as, following enlargement, more Member States are likely to record negative budgetary balances; it is likely that by 2006 Germany’s share in all negative budgetary balances will have decreased to around 40 per cent.

2.3. The impact of Agenda 2000 on the most important budgetary imbalances

To understand the impact of the Agenda 2000 programme on budgetary imbalances it is necessary to consider the effects of both enlargement and the proposed policy reforms.

The countries which will join the Union on the occasion of the next ***enlargement*** have a level of prosperity well below that of all the current members and will therefore become large net beneficiaries. This implies that the budgetary positions of the present 15 Member States will have to undergo a corresponding deterioration which, on the basis of the approach that the Commission outlined in its *Agenda 2000* communication[32], can be estimated at around 0.15 per cent of their GNP by 2006. As the Commission has indicated in *Agenda 2000*, this development "*cannot come as a surprise and should not give rise to claims for compensation*".

The ***reform of the Common Agricultural Policy*** is not expected to affect significantly the budgetary balances of the five countries examined in this section of the report. However, this must be qualified since the proposals presented by the Commission in March of 1998 contain numerous provisions which may affect payments in the individual Member States. As a result, the eventual precise effects on the budgetary positions of the Member States will depend on the outcome of the current negotiations.

In general terms, the proposed reform aims at reducing the level of guaranteed prices while partially compensating the resulting income losses through increases in direct aids. This may have an effect on the budgetary balances of the Member States which is largely of a purely accounting nature and underscores the fragile nature of the budgetary balances calculations. The most notable example of this is in the case of the Netherlands. At present the Union intervenes in the Netherlands to support the price of produce for which a common market organisation exists through exports restitutions. The expenditure carried out in this country will benefit the producers which may well be situated in other countries; say, in neighbouring Belgium or Germany. As CAP spending moves from market support towards direct aids, the producers in these two countries will be receiving in direct aids some of the support which they were previously deriving from the market intervention measures carried out in the Netherlands. As a result of this change, the recorded budgetary balance of the Netherlands will deteriorate correspondingly while those of Belgium and Germany will improve without any fundamental change in the underlying situation. This consideration must be kept in mind when examining the impact of the CAP reform on the budgetary imbalances of the Member States since it explains some of the expected changes.

In global terms, the reform is expected to lead to an initial increase in CAP spending (until 2003/2004) followed by a stabilisation as implementation of the reform is completed. The overall amount of spending plays also an important role considering that for most countries there is a significant difference between their share in the marginal financing of EU expenditure (i.e. their share in EU GNP) and their share in CAP expenditure which is not expected to change dramatically because of the reform.

The main sectors affected by the reform are arable crops, beef and the dairy products. Considering the parameters of the reform and the importance of these sectors in the agricultural sector of the five countries examined in the previous sections, it is possible to predict that, if the Commission's proposals were to be confirmed by the negotiations, the reform of the CAP should not have a significant effect on their budgetary imbalances.

Once the reform of the CAP will have reached its full effect (i.e. towards the end of the period covered by the next Financial Perspective), the budgetary balances of Germany, Sweden and of the United Kingdom, measured as a percentage of their GNP, should hardly change compared to their pre reform levels. The expected increases in CAP spending received by these countries should be offset by the increases in their contributions to the EU budget provoked by the change in total CAP spending. The budgetary imbalance of the Netherlands could record a small deterioration although this may be largely an accounting effect of the type mentioned at the beginning of the section. The budgetary imbalance of Austria could experience an improvement although this essentially would be the result of the proposed transfer of rural development measures from structural spending ("heading 2" of the Financial Perspective) to agricultural expenditure ("heading 1").

More uncertain are the effects of the reform of ***Structural spending***. The Commission has proposed to maintain the overall EU effort in the structural area constant as a percent of GNP at the level of 0.46 per cent of the GNP of the Union. This effort, however, will have to cover also the structural part of the pre accession strategy and the aid to the new Member States. For the current 15 Member States the proposed reform implies some decline of total spending measured as a percentage of GNP between 1999 and 2006.

The precise effects of the reform on the individual budgetary imbalances are still uncertain and will depend on the eligibility decisions to be made on the basis of the latest available data and on the outcome of the current negotiations. The general aim of the proposals presented by the Commission is to focus resources on the areas and sectors in greatest need. This is to be achieved through a stricter geographical concentration and through a rationalisation of the modes of intervention. In particular, it is proposed to reduce the number of regions receiving the highest levels of aid through a strict respect of the conditions for eligibility as "objective 1" regions (i. e. GDP per head in purchasing power parities lower than 75 per cent of the EU average). A greater geographical concentration is also sought for the so called "objective 2" regions.

Additional elements which may affect the distribution of Structural Funds spending amongst Member States are the criteria which should be used to determine the level of per head aid in the eligible regions. These criteria include the gap between GDP in the region and the EU average, the relative prosperity of the country and the relative level of unemployment.

However uncertain these elements may be, it is possible to venture some broad considerations which can contribute to a better assessment of the trend of the budgetary imbalances being discussed here. Austria, Germany, the Netherlands, Sweden and the United Kingdom all contribute to the EU budget with shares which are substantially higher than their shares in structural spending and are therefore likely to see some improvement in their budgetary balances due to the lower overall expenditure resulting from the reform, even if this will be concentrated in the regions characterized by the greatest need. This improvement may be greater in the case of Germany. A strict respect of the 75 per cent benchmark for the choice of the “objective

1” regions will not affect this country (except East Berlin). In addition, the overall effect of the criteria for the determination of the aid per head may also be to the advantage of the new Länder.

As a result of the whole Agenda 2000 package, of the five Member States examined in this section, only the Netherlands is expected to experience between 1999 and 2006 a deterioration of its net balance of the same order of magnitude as that mentioned at the beginning of this section as the average impact of enlargement (about 0.15 per cent of GNP). This result, however, is strongly influenced by the mechanical effect of the shift away from CAP market support measures to direct aids payments and should not correspond to a parallel deterioration in the benefits derived by the Dutch economy. The reform of the Structural Funds, on the other hand, should have a small positive effect on the budgetary balance of this country.

The budgetary balances of Austria, Germany and Sweden are expected to deteriorate somewhat less than the impact of enlargement. In the case of Austria, the transfer of rural development measures from the structural funds to the CAP should provoke a less favourable result of the reform of the structural funds matched by a corresponding better outcome of the CAP reform.

Very different is the position of the United Kingdom whose budgetary position (measured as a percentage of its GNP) could remain broadly stable between 1999 and 2006. The reforms of the CAP and of the Structural Funds would not affect negatively the budgetary balance of this country. Furthermore, unless the UK correction is modified, the negative impact of enlargement on the budgetary position of the United Kingdom would be reduced by the operation of the compensation mechanism.

2.4. Options for reform

If a broad agreement on the need to address the issue of budgetary imbalances were to emerge, some key options could be contemplated. These options, which are discussed below, obey a certain logic. First, on the financing side, it is possible to consider that an orthodox and transparent system should be put in place. This would, imply that the UK rebate is progressively eliminated. Secondly, it is possible to consider, in recognition of the fact that the principal cause of budgetary imbalances is the expenditure side of the EU budget, the possibility of implementing reforms on EU spending with the view to reducing these imbalances. And, third, ad hoc solutions on the revenue side of the budget, aimed at redressing the imbalances, can also be contemplated. The present section considers these possibilities sequentially.

2.4.1. Return to a more straightforward system

It could be envisaged progressively to phase out or to reduce the correction presently granted to the United Kingdom. This could find a justification in the fact that after enlargement, the relative prosperity of the United Kingdom, which is already around the EU average today, would almost certainly be above the EU average, thus weakening one of the conditions for the initial granting of the rebate. In addition, with five countries experiencing negative budgetary positions of a similar order of magnitude, the maintenance of a special treatment for just one of them could appear unjustified. The change in the nature of the mechanism mentioned in section 2.1   from correction of a specific structural agricultural problem to a reduction in the cost of all expenditure decisions   is also a strong argument.

Furthermore, it is conceivable that other changes to the present arrangements might make the maintenance of the rebate superfluous or, at least, less justified. This could, for instance, be the case of the introduction of a correction on the expenditure side along the lines indicated in the next section. But ending the UK rebate by itself would not remove the current imbalances between the contributor Member States.

[Table 7: Cost of the UK correction for Germany, the Netherlands, Austria and Sweden]

It is also important to mention that there exist additional possibilities that could contribute towards the development of a more straightforward financing system for the EU. One possibility would be to substitute the GNP resource for the VAT resource. Clearly, as noted earlier, the equity of the system would improve since the regressive elements associated with VAT would be removed. Table 3b (in section 1.2.2) offers an indication, for the year 1997, of the effects, per Member State, of substituting the VAT resource with a theoretical GNP resource. Another possibility would be to substitute all other own resources (including traditional own resources) with the GNP resource (the results for each Member State are also shown in table 3b).

It is clear that there is a trade off between financial autonomy and simplicity. To replace fiscal resources with direct contribution from Member States may render the system more intelligible and cost effective, but it certainly reduces further financial autonomy and, in the case of TOR, would constitute a significant departure from EU orthodoxy.

2.4.2. Correction on the expenditure side

A correction on the expenditure side, which would not require modification of the Own Resources Decision, would be consistent with the Fontainebleau conclusions and would address the fundamental cause of budgetary imbalances. The current imbalances result essentially from Structural Funds and agricultural spending. It would not appear logical to correct the imbalances resulting from structural interventions as these have an explicit redistributive aim. It is however conceivable to modify agricultural spending. Given the integrated nature of the Common Agricultural Policy, it is not possible to modify spending by Member State, but it is possible to reduce the overall amount of spending which is allocated through the EU budget.

[Table 8: Implications of a partial reimbursement (75%) of CAP direct aids]

In particular, it is possible to imagine that, while market support expenditure will continue to be integrally reimbursed to Member States, that part of expenditure which goes directly to individual beneficiaries could be reimbursed only partially. The scope for this type of action would increase as the proposed reform of the CAP aims at reducing the weight of market support measures, while the relative weight of direct aids would increase correspondingly (from 65 per cent in 2000 to 75 per cent in 2006). The essential idea is to take advantage of the fact that all the Member States that record large budgetary imbalances have a share in the financing of the EU budget much higher than that in EU agricultural spending, and that a reduction in the overall amount of spending would improve their budgetary balances. Moreover, the original rationale for 100% financing of the CAP market support expenditure (i. e., that market support benefits farmers throughout the Community, not just those in the Member States where the expenditure occurs) is no longer valid for the income aid component.

If implemented, this option would be consistent with and would represent a generalisation of the principles currently governing most EU expenditure and especially that under the Structural Funds. At the same time, it should not be seen as a dismantling of the CAP or a move towards its re nationalisation. Neither the degree of integration, nor the level of decision making or the overall amount of financial resources available to pursue its objectives would be modified. Farmers would receive the same support as currently since CAP expenditure by Member State is compulsory once determined by the relevant legal provisions. The level and the conditions attached to the payment of these direct aids would continue to be an integral part of the CAP and would result only from EU decisions. The overall amount of spending available would remain the same, but would be shared between the EU budget and the national exchequers.

The fact that a lower share of financial resources would need to be allocated through the EU budget suggests that the agricultural guideline should be reduced if this constraint is to maintain its effectiveness. A corresponding reduction in the Own Resources ceiling might also be appropriate. This could be done on the occasion of the first modification of the Own Resources Decision[33] and, in the meantime, should be replaced by some form of strong engagement not to use the whole ceiling.

Table 8 presents the impact of a 75 per cent partial reimbursement of CAP direct aids. The overall reduction of EU spending in 2006 amounts in this example to Euro 9 145 million. More details on this simulation are presented in Annex 5. The table also shows the negative effects that the introduction of a measure of this type would have on the budgetary balances of some Member States.

2.4.3. A generalised correction mechanism

Germany, the Netherlands, Austria and Sweden have asked to benefit from a transformation of the present correction mechanism applying to the UK into a capping model. A simple transposition of the present mechanism is not possible. Applying the present mechanism to all countries that have a negative budgetary balance or simply extending to the four countries that have made the request would result in a three to fourfold increase of cost of the mechanism (see table 9 and the report by the European Court of Auditors (1998)[34]). In addition, depending on the assumptions made, this burden would have to be borne by a group of countries representing less than a fifth of the GNP of the European Union.

The four countries that have made the request, aware of this difficulty, have asked for a modified version of the mechanism. They, correctly, point out that the present mechanism contains various implicit parameters that may be modified. In particular, they point out that whereas the current mechanism corrects 66 per cent of the entirety of the negative balance of the United Kingdom, it is conceivable that Member States be asked to accept a negative balance up to a given percentage of GNP – say 0.3 or 0.4 per cent of GNP – and be granted a compensation only for the part exceeding this threshold. In addition, the benchmark of 66 per cent may also be modified. It is also possible to introduce modifications in the items included in the contributions to the EU budget (e.g. traditional own resources could be excluded or re apportioned according to different keys) and in those included in expenditure (e.g. to exclude administrative expenditure or expenditure in the new Member States or Structural Funds and so on).

[Table 9: Overall redistribution induced by the UK correction mechanism for 1996 under different assumptions]

[Table 10: Changes in the budgetary balances induced by compensation mechanisms based on different parameters]

An additional important modification could concern the financing of the rebates. In the present system the United Kingdom does not finance its own rebate. A generalisation could be seen as implying that the Member States benefiting from the system should not finance it. However this solution is not only very costly in a situation where many Member States benefit from the system, but is also fraught with risks. In particular, a "threshold effect" could appear whereby a country with a negative balance just above the threshold would receive a minimal rebate but would be exempted from the burden of financing whereas if it had been just below the threshold it would have had to contribute to the financing of all other rebates for substantial amounts. It seems logical therefore to assume that a Member State should not finance its own rebate, but that it should finance all the others[35] (as assumed in the simulations presented in table 10).

Modifying these parameters provides the system with a substantial degree of flexibility, albeit at the cost of significantly reducing transparency and increasing the complexity of the calculations. However, this flexibility yields mechanisms with different overall costs and different effects for the individual Member States.

Annex 6 discusses some simulations and some key results are reproduced in table 10. The simulations show that any system based on the same parameters for all Member States, and under the assumption that its overall cost is to be maintained within reasonable limits, would lead to substantial reduction in the size of the rebate currently enjoyed by the United Kingdom.

3. Final comments

The proposals presented by the Commission in *Agenda 2000* indicate that it is possible to face the challenges resulting from enlargement and from the reform of the major EU policies within the own resources ceiling set, for an unlimited time, by the current Own Resources Decision. To achieve this it is essential that the budgetary rigour pursued by the Member States in the framework of EMU characterises also the EU budget.

The shortcomings of the system discussed in the first part of the report do not by themselves provide grounds to justify an urgent modification of the Own Resources Decision. If and when this Decision were to be modified so as to allow an in depth reform of the Own Resources system, these shortcomings could be corrected either through a simplification of the system of contributions or through the introduction of new own resources. The proposed introduction of an element of progressivity could also be discussed in this context.

Currently, the most pressing source of dissatisfaction with the present arrangements appears to be linked to the issue of budgetary imbalances of Germany, the Netherlands, Austria and Sweden. It is not possible, at this stage, to determine with precision how these imbalances will evolve over the next few years as some important policy parameters have yet to be fully articulated. However, it is possible to predict that the imbalances of these large net contributors as a percentage of GNP should deteriorate somewhat, more for the Netherlands than for the others, but most likely less than the average deterioration due to enlargement. This outcome would be due to the proposed containment of spending in the present Member States over the period covered by the next Financial Perspective and to some specific provisions of the proposed reforms.

Establishing correction mechanisms to ameliorate budgetary imbalances is a difficult task since, for a given size of the EU budget, an improvement in the budgetary position of some Member States invariably involves a corresponding deterioration in the budgetary position of others. If a consensus were to emerge on the need to address the issue of budgetary imbalances, a decision would have to be taken on how to achieve this result and on the timing of the changes.

The report indicates three, mutually compatible, options:

– ***on the financing side***: a simplification of the financing structure in favour of a system more, or even totally, based on GNP contributions; such a simplification could also include the phasing out of the existing correction mechanism;

– ***on the expenditure side***: the introduction of a system of partial reimbursement of CAP spending aimed at directly supporting incomes;

– ***on the balances***: the application of a generalized correction mechanism to all Member States experiencing large imbalances.

None of the options discussed in the report provides an ideal solution. Technical and conceptual weaknesses can be found in all of them. The shifts in the burden of financing that results from some of these options present regressive elements that might need a redress in the context of an overall solution.

The timing of any changes would depend on whether it will be necessary to modify the Own Resources Decision or not. A modification would entail long ratification delays and would suggest a process allowing the new financing system to become effective at the time of the accession of the first group of new Member States. Enlargement would indeed represent such a significant change of circumstances as to warrant a structural modification of this type.

The significant methodological and conceptual reserves that the Commission has on the issue of budgetary imbalances have prompted it to limit this report to a review of options for their correction. If a broad agreement towards a solution of the problem were to appear within the European Council, the Commission would put forward the appropriate detailed proposals.

[1] Article 10 of the Council Decision of 31 October 1994 on the system of the European Communities' own resources (94/728/EC, Euratom), *Official Journal of the European Communities* No. L 293/9, November 12, 1994.
[2] Council Decision 94/728/EC, Euratom of October 31, 1994, footnote 1.
[3] See Annex 4 for a discussion of these issues.
[4] The 1995 and 1997 data refer to the Supplementary Amending Budget 1/95 and 1/97, respectively; the 1999 estimate is from the

Preliminary Draft Budget 1999; the figures are rounded to three decimals while the actual budgetary calculations are performed using 15 decimals

[5] The issue of progressivity in the EU financing system is discussed in section 1.3.2 and in 1.3.4.

[6] It is generally considered that the contributions on the VAT resource are regressive since they represent a higher proportion of GNP in poor rather than in rich Member States.

[7] For a discussion of the concept and measurement of budgetary balances see Annex 3.

[8] There are, in addition, over 900 articles of the Regulation laying down the provisions for its implementation.

[9] This provision also applies to the controls on the VAT and GNP resources.

[10] On average, over recent years this provision has lowered the rate of call of VAT by 0.12 percentage points see Annex 4.

[11] European System of Accounts (ESA) 1995, Council Regulation 2223/96 of June 25, 1996, *Official Journal of the European Communities* L310, November 30, 1996.

[12] The use of the figures resulting from the new system of national accounts will have to wait until the adoption of a new Own Resources Decision while those taking into account the indirectly measured financial services will need an ad hoc decision by the Council.

[13] For a review of these issues see Commission of the European Communities (1993): “Stable Money Sound Finances Community Public Finance in the Perspective of EMU”, European Economy no. 53, especially ch. 7; see also Annex 2. These criteria obviously do not apply in the case of a tax introduced throughout the EU as instrument for the implementation of a Community policy. In this case, the rationale for the introduction of the tax would derive from the specific policy in question and the attribution of its yield to the EU budget would only have to respect the criterion of cost effectiveness.

[14] Annex 2 reviews in detail eight specific proposals for new own resources.

[15] See European Parliament (1994): “Draft Report on a New System of Own Resources for the European Union”, Rapporteur Horst Langes, Committee of Budgets, A3 0000/94.

[16] See European Parliament (1994): op. cit., footnote 15.

[17] See Annex 2 for a more detailed discussion of this proposal.

[18] The arguments are developed in greater detail in Annex 7.

[19] See Annex 3 for a discussion.

[20] These spill over effects include the spending of income generated in the receiving Member State on goods produced in another Member State, the purchase of financial asset denominated in various Member States currencies etc.

[21] See Annex 3 and Commission of the European Communities (1997): “Budget Contributions, EU Expenditure, Budgetary Balances and Relative Prosperity of the Member States”, paper presented by President Santer to the Ecofin Council, October 13. The two definitions used in this report are the UK *rebate* definition (concept used in the calculation of the UK rebate) and the *operational* definition (difference between all moneys paid to and all moneys received from the budget excluding administrative expenditure and expenditure related to other EU institutions).

[22] The largest imbalances, although substantial in absolute terms, measured as a percentage of the GNP, are much smaller than the regional budgetary positions existing within Member States. A recent study conducted under contract for DG XIX indicates that, using a definition of regional budgetary positions comparable to that commonly used in the relationships between Member States and the EU budget, the average negative budgetary position of a region of northern Italy is equal to almost 4 per cent of its GDP, while the average positive balance of a southern Italian region is equal to around 7 per cent; see G. Pola (1998): "The Regional Incidence of a Central Budget – The Italian Case".

[23] See Fontainebleau European Council, Conclusions of the Presidency, Bulletin of the European Communities 6 1984.

[24] For more details on the functioning of the UK rebate, see Annex 4.

[25] See Annex 4 for a more detailed analysis of the evolution of the UK rebate and an explanation of its variability.

[26] International comparisons of income are made by comparing the levels of GNP per head of different countries. These comparisons need a common numeraire which is usually arrived at through the use of current exchange rates or especially computed conversions rates – the so called "purchasing power parities" (PPP) – which take into account the differences in the price levels. Data based on current exchange rates provide a measure of actual income and are therefore the best proxy for the ability to pay. Data based on PPP estimates measure the real income of the average citizen of a country when he/she spends it in his country. The Fontainebleau agreement does not specify the measure to be used. The EU uses both measures. PPP data are used in identifying “objective 1” regions and the beneficiaries of the Cohesion Fund; current exchange rates are used in the calculations of budgetary contributions and in the identification of the countries benefiting from the lower level of capping of their VAT bases.

[27] For this and other difficulties in defining budgetary imbalances see Annex 3.

[28] See footnote 26 and Annex 4.

[29] See footnote 26.

[30] A study of the Bundesbank published in November 1993 (Die Finanzbeziehungen der Bundesrepublik Deutschland zu den Europäischen Gemeinschaften seit dem Jahr 1988, Monatsbericht, November 1993) had forecast a negative budgetary position for Germany in 1997 30 per cent higher than the one effectively recorded.

[31] See Annex 3 for a discussion of these issues.

[32] Commission of the European Communities (1997): *Agenda 2000 For a Stronger and Wider Union* , COM (97) 2000 and Bulletin of the European Union, Supplement 5/97.

[33] On the occasion of the first modification of the Own Resources Decision the reference will have to change from the GNP based on the 2nd edition of the European System of Accounts to the new ESA 95. If the level of the GNP of the EU according to the new system of accounts were to be different, this would justify a corresponding adaptation of the ceiling so as maintain the stability of the financial resources put at the disposal of the EU budget.

[34] European Court of Auditors (1998): *Special report no 6/98 on the system of own resources based on VAT and GNP* . Official Journal of the European Communities C 241, July 31, 1998.

[35] See Annex 6 for a discussion of this model and in particular for the opportunity to ignore second round effects, i.e. the case where

a country is just below the threshold at the beginning of the exercise, but where it will exceed it once the cost of financing the other rebates is taken into account.

Annex 1 – The evolution of the EU financing system1

During the period 1958 1970 the Community budget was financed exclusively by contributions from the Member States. The *Luxembourg European Council* of 21 22 April 1970 introduced for the first time a system of own resources for the general budget of the Community taking effect in 1971. One objective was to gradually enhance the Community's financial independence from Member States' transfers. The own resources introduced were customs duties and agricultural levies (which were to become known as the Traditional Own Resources, TOR) and one based on a harmonised VAT base. While traditional own resources became effectively own resources over the period 1971 1975, difficulties with establishing a common VAT system across the Member States and with defining the base for VAT assessment delayed the introduction of VAT as an own resource until 1979.

In the period 1975 1987 revenue growth on the own resources account was eroded by a diminishing yield from TORs while revenues from VAT were adversely affected by the generally weak economic growth prevailing during this period. At the same time, the strengthening of existing and the launching of new policies, the inability to contain spending on the Common Agricultural Policy (CAP) and expenditure growth associated with the two enlargements[2] led to pronounced resource inadequacy. Persistent complaints on the part of the UK concerning its financial contribution also became a feature of the budgetary disputes that were prominent during this period.

A temporary resolution of the budget difficulties was secured at the *Fontainebleau European Council*. The Fontainebleau Council of June 25 26, 1984 increased the maximum rate of call for the VAT resource to 1.4 per cent and established a correction mechanism for budgetary imbalances which has since applied only to the UK[3].

The modifications to the financing system introduced by the Fontainebleau Council proved almost immediately insufficient. They failed to generate sufficient revenues owing to the continuing decline in revenues from TORs and to the slow growth in revenues from the VAT resource. In addition, some dissatisfaction started to appear with the VAT based resource which, being based on consumption, was felt to contain a significant regressive element. The problem of revenue inadequacy and inequity was compounded by rising, and incompletely anticipated, expenditure commitments. These were related to difficulties in controlling spending on the Common Agricultural Policy (CAP), especially following the accession of Portugal and Spain, the dollar depreciation after the spring 1985 and the fall in international commodity prices, factors which added considerably to the financing of export restitutions.

Fundamental reforms, which determined the character of the present own resources system, were adopted in June 1988[4]. Among the principal reforms of the Brussels European Council was the introduction of a new own resource based on the Member States' GNP (intended to match contributions closer to the ability to pay), and that of an overall ceiling to the total amount of own resources which could be called to finance Community spending. This payments ceiling was set at 1.15 per cent in 1988 with progressive yearly increases which were to bring it to 1.20 per cent by 1992. The Council also limited the role of the VAT resource by introducing a capping of its base at 55 per cent of GNP, a measure intended to reduce the effects of the regressive character of the resource.

The consolidation of the 1988 reforms and ultimately of the Community finances took place within a context where the Community's ambitions, expressed in the Treaty on European Union, grew significantly. The *Edinburgh agreement* of December 1992, which adopted the financial perspective for the years 1993 1999, increased the overall ceiling of own resources from 1.20 to 1.27 per cent. In addition, it introduced steps to decrease further the importance of VAT in the financing of the budget.

However, the system of own resources decided in Edinburgh could only enter into force on January 1, 1995. In the meantime, significant difficulties were experienced during the recession years of the early 1990s when initial budget estimates turned out to be too optimistic. Successive downward revisions in economic growth during 1992 1994 resulted in corresponding revisions to budget revenues. Nevertheless, despite the adverse climate, it was possible to respect the constraints imposed by the own resources ceiling without undermining financial discipline.

In subsequent years budgetary arrangements have proved generally successful. In addition, from 1997 cautious annual budgetary decisions have lead to spending levels significantly lower to those foreseen in the Financial Perspective. As a result, the European Union approaches the challenges resulting from enlargement to Cyprus and to the countries of central and eastern Europe and from the reform of its main policies with substantial margins under the own resources ceiling.

[1] For a detailed review of the history as well as an assessment of the EU financial arrangements up to the early years of the Edinburgh agreement see Commission of the European Communities (1995): *European Union Public Finance* , Luxembourg; see also the discussion in Commission of the European Communities (1997): "Budget Contributions, EU Expenditure, Budgetary Balances and Relative Prosperity of the Member States", paper prepared by DG XIX and forwarded to the Ecofin Ministers by President Santer for their October 13 meeting.
[2] Greece joined the Community in 1981 followed by Spain and Portugal in 1986.
[3] See Fontainebleau European Council, Conclusions of the Presidency, Bulletin of the European Communities 6 1984.
[4] See Council Decision 88/376/EEC, Euratom of June 24, 1988, On the System of the Communities' Own Resources, *Official Journal of the European Communities* , L 185, July 15, 1988.

[…]

Annex 4 – The budgetary compensation for the United Kingdom

1. Introduction

This annex reviews the performance of the compensation mechanism for the United Kingdom set up with the 1984 Fontainebleau agreement. It starts by recalling the steps which led to this decision and its contents. Subsequently it reviews the past trend of the budgetary imbalance of the United Kingdom and discusses its possible future evolution in the light of the reform proposals presented by the Commission (*Agenda 2000*). The third section assesses the operation of the mechanism and discusses some issues it raises. The final section examines its consequences for the rate of call of the VAT resource and analyses the possibility of permanently fixing this rate.

[Graph 1: Budgetary imbalance of the UK and compensation]

2. Origin of the mechanism

The question of the budgetary imbalance of the United Kingdom appeared immediately after the accession of the country to the European Community. The large imbalance was essentially due to two factors:

i) an agricultural sector relatively smaller and structurally different from those of other Member States, which results in lower CAP spending in the United Kingdom;

ii) a proportionally larger contribution to the financing of the Community budget due to the fact that the United Kingdom has a relatively higher share in the harmonised VAT base than in the total GNP of the Community.

A first mechanism aimed at addressing the issue of the budgetary imbalance of the United Kingdom was agreed in March 1975 in Dublin. This mechanism – known as the *"dynamic brakes"* – aimed at preventing the size of the United Kingdom contribution to the EU budget from becoming too large. The contribution would be capped if three conditions were met simultaneously (GDP per capita lower than 85 per cent of the Community average, rate of economic growth less than 120 per cent of the Community average, share in own resource payment more than 10 per cent higher than the share in GDP). The three conditions never applied for any Member State and the mechanism was never triggered.

[Graph 2: Budgetary balance of the United Kingdom]

A second arrangement was introduced at another Dublin Council in November 1979. It provided for a compensation on the expenditure side in the form of specific measures for the United Kingdom.

The current mechanism was decided in Fontainebleau in June 1984 and given effect by the Decision of May 7, 1985. This decision contained a transitional arrangement – a reduction of one billion Ecu in the VAT contribution of the United Kingdom for 1985 – and the rules governing the calculation of future rebates, i.e.,

– the contribution of the United Kingdom to the Community budget is reduced by an amount equal to 66 per cent of its budgetary imbalance. This imbalance is calculated by multiplying the difference between the UK's percentage share in VAT payments to the Community budget and its share in allocated expenditure times allocated expenditure (see below). Given that some expenditure (e.g. external expenditure) cannot be considered to have been made for the benefit of any particular Member States, in the calculation of the share of the United Kingdom in the payments made by the Community and in that of the overall imbalance, total Community payments are replaced by the total of all payments that can be allocated to an individual country (usually referred to as *"allocated expenditure"* – see footnote 5 of Annex 3).

– the shortfall in financing is made up by all the Member states in accordance with their respective percentage shares of VAT payments (with the exception of Germany, which pays only two thirds of its normal share, the balance being divided up between the other Member States).

The Own Resource Decision of 1988 modified substantially the system of Own Resources through the introduction of a new resource based on GNP and the reduction in the importance of the one based on VAT. These changes, which went in the direction of reducing the causes of the budgetary imbalance of the United Kingdom, necessitated some adjustments in the compensation mechanism. These were:

i) The calculation of the amount of the refund as if the budget were still fully financed by non capped VAT (pre 1988 system);

ii) the reduction of the resulting amount of the rebate by the "savings"1 in its contribution that the United Kingdom derives from the modifications introduced in 1988 (the so called *“UK advantage from the new system”*);

iii) the financing of the UK correction by the other Member States according to their shares in the GNP of the Community. The one third reduction for Germany was maintained.

3. Developments in the UK rebate since its inception

There is no clear trend characterizing either the budgetary imbalance of the United Kingdom or the rebate (see graph 1).

All budgetary balances show a high degree of variability for the reasons indicated in Annex 3 (underlying expenditure trends, different rates of economic growth, exchange rate fluctuations, carry over of unspent surpluses from previous years, adjustments for previous years, etc.). The budgetary balance of the United Kingdom, however, shows an even greater variability because of the operation of the correction mechanism itself which foresees the payment of the compensation with a one year lag (an exceptionally large imbalance in one year leads to a large compensation which is paid in the following year, thus reducing further what may have been a normal imbalance, and so on). Furthermore, budgeting rules require that in the budget of year *t* under the heading “UK correction”, two different corrections are recorded: the provisional correction for year *t 1* and the definitive correction for year *t 4*. Clearly, the sum of the two corrections has no economic meaning. Table 7 of Annex 8 shows in column (5) the UK correction as reported in the budget in year *t* (that is, the sum of the UK correction for year *t 4* plus the provisional correction for year *t 1*) and, in column (2) the definitive UK correction for year *t 4*.

[Graph 3: UK compensation]

Budgetary rules also require that, in order to calculate the definitive UK correction for year *t 4*, to construct a UK imbalance on the basis of the GNP, VAT and allocated expenditure outturns for year t (that is, four years later). These data permit the estimation of the UK imbalance for year *t 4* shown in column (1) of Table 7, Annex 8. Note also that the imbalance of the UK measured in this manner differs from the imbalances reported in Tables 6a and 6b of Annex 8; the latter are estimated on the basis of GNP, VAT and allocated expenditure outturns as they are known one year after the budgetary year. The use of the definition implicit in the rebate mechanism (graph 2) itself provides a more stable picture as this definition is not influenced by the carry over of the unspent surpluses (see Annex 3).

Beyond short term fluctuations, the budgetary imbalance of the United Kingdom since 1985 has been relatively stable with the imbalance before correction averaging about half a point of the country's GNP. Correspondingly, the amount of the rebate has also remained relatively stable.

Various factors have been at work, which appear to have broadly offset each other. As already indicated, the origin of the budgetary imbalance of the United Kingdom is to be found in two factors: its relative high share of the combined VAT and GNP base on the revenue side, and the low agricultural returns on the expenditure side.

[Graph 4: Share of the United Kingdom in (VAT and GNP) payments and in EU (allocated) expenditure]

The reduction in the relative weight of the VAT resource brought about by the decisions of 1988 and 1992 should have contributed to a reduction in the imbalance and in the rebate. However, the effect on the rebate was explicitly excluded by the provision which imposed the continuation of its computation on the basis of the pre 1988 system and of the reduction of the result by an amount corresponding to the so called "advantage" that the United Kingdom was obtaining from the new system. The calculations of this "advantage" done every year show that until now the effect of the changes on the imbalance have been very small. They may have become more significant over the last two or three years in correspondence with the effective reduction of the weight of the VAT resource, but even so their order of magnitude is not large enough to be discernible in the overall trend.

More fundamental changes have taken place on the expenditure side of the EU budget. Agricultural spending, which in 1984 represented about 70 per cent of allocated expenditure, is now down to about 50 per cent. Per se, this change should have contributed to reducing the imbalance of the United Kingdom. However, over the same period, the component of expenditure that grew most rapidly was the Structural Funds. Given the explicit redistributive nature of this type of spending and of its concentration on the so called "cohesion countries", the share of the United Kingdom in total EU spending could not increase. In fact, since 1992 the redistributive component in total EU spending has become stronger.

The factors which have played the greatest role in determining the trend of the rebate – and especially its fluctuations from year to year – have been the difference between the rate of growth of the economy of the United Kingdom and that of the other Member States and the instability of exchange rates. Since the end of the 1980s, the economic cycle of the United Kingdom has been markedly different from that of the rest of the Union. In addition, the pound sterling has fluctuated significantly vis à vis the other European currencies between 1992 and 1997.

Underlying expenditure trends have also played a significant role, although in quantitative terms they have been less important and have been overshadowed by macroeconomic developments just mentioned. For instance, in 1994 the United Kingdom was very successful in drawing on structural funds spending and in 1997 98 the BSE crisis led to increased agricultural spending in the country.

Over the next years the imbalance of the United Kingdom (and its compensation) are expected to increase somewhat. This will be essentially the result of the enlargement of the Union to a number of countries that will certainly be net beneficiaries.

4. Assessment of the performance of the mechanism

The rebate mechanism has been effective in achieving its intended goal: a significant reduction in the United Kingdom's budgetary imbalance. As graph 1 shows, over recent years the negative budgetary balance of this country, after correction, has averaged around 0.2 0.3 per cent of GNP.

However, some of the conditions that prevailed at the time the mechanism was decided do not apply any more:

i) The changes in the composition of EU spending have modified the rationale of the compensation. Whereas in 1984, it had essentially the nature of a correction for the specific agricultural problem (CAP represented about 70 per cent of total allocated expenditure), it has now lost to a great extent this characteristic since it corrects equally the persistent agricultural problem as well as the United Kingdom's contribution to the solidarity effort of the EU and to its other policies.

ii) The budgetary imbalance of the United Kingdom is not unique any longer. In recent years, as graph 5 shows, the imbalance of the United Kingdom, before correction, was the largest of the Community. In 1997, four more countries have budgetary imbalances as large as or even larger than the United Kingdom’s.

iii) The gap in relative prosperity between the United Kingdom and the other largest contributors to the EU budget has narrowed. Depending on the measure used, the United Kingdom has a relative prosperity or a relative capacity to pay around the EU average and will certainly be above this mark after the forthcoming enlargement of the EU.

The mechanism has also some drawbacks, which although not new or unexpected, are worth recalling at this stage.

– The existence of the rebate leads to the contribution paid by the United Kingdom representing a lower proportion of its income than those paid by the other Member States. This situation contrasts with the principle of horizontal equity. At the national level, this would be analogous to granting tax relief to individuals who cannot use some public services or who are not recipients of public assistance.

[Graph 5: Budgetary balances of the Uk, Germany and the Netherlands]

– The compensation mechanism works as a shock absorber for all changes in the imbalance of the United Kingdom and places this country in a unique position with respect to common budgetary decisions. For example, a budgetary decision that would have a net cost of Ecu 100 to a Member State in fact costs the UK Ecu 33. Conversely, a measure that would improve the balance of another country by 100, improves the balance of the United Kingdom again by only one third of this amount. This situation, not only risks decoupling the UK from budgetary decision making, but will also have significant adverse effects at the time of enlargement. The accession of a large number of new Member States with very low standards of living is expected to have a negative effect on the budgetary balances of the current Member States. But the United Kingdom will see its budgetary balance deteriorate by only one third of what would have happened in the absence of the correction mechanism. This puts into question a fair sharing out of the burden resulting from enlargement.

– Also in this context, it will be necessary to adapt the definition of allocated expenditure to prevent the United Kingdom from benefiting from purely statistical factors. In effect, at the time of accession of the new Member States some items of present expenditure in these countries (e.g. PHARE) will be replaced by full participation in EU policies. This would lead to their reclassification from external expenditure (excluded from the calculation of the rebate) to internal expenditure (included in the calculation) leading to a mechanical increase in the size of the UK rebate.

– The Commission indicated that it would take into consideration, on the re examination of the correction system, the opposition of Belgium and Luxembourg to current procedures governing the entry in the accounts and the allocation of administrative expenditure. The position of the Commission was that administrative expenditure could not be treated differently from other expenditure and that it is, therefore, appropriate to include it in the determination of allocated expenditure to any given country. This position was based on the consideration that if it is true that administrative expenditure is, in economic terms, very different from the unrequited transfers typical of the structural funds, there exist various other items of expenditure whose economic nature lays between these two extremes. It would be arbitrary to make a distinction only for administrative expenditure when, for instance, some items of research spending have a very similar nature.

5. The impact of the UK rebate mechanism on the rate of call of vat

The rules determining the calculation of the UK rebate and of its financing contain provisions that affect the rate of call of the VAT resource. In 1984, when the mechanism was established, the VAT resource played the role of the complementary resource to be called up on the occasion needed to finance the budget of the Community. It was therefore logical that the rebate be financed according to the share of each country in this resource (with the exception of Germany that was granted a reduction).

The 1988 Own Resources Decision provided for a reduction in the role of the VAT resource and for the introduction of a new one based on GNP. As a result, the role of complementary resource was assigned to GNP and it was decided that the UK rebate would be financed according to the share of each country in this new, more equitable, resource.

However, the shares of the Member States in the VAT and GNP bases are not equal and the introduction of the GNP resource favoured some countries relative to others. The countries which desired to reduce further the role of the VAT resource, failing to obtain a reduction in its maximum call rate, obtained some reduction indirectly through the UK rebate mechanism. It was, in effect, decided to calculate the amount of VAT theoretically necessary to finance the UK rebate and not to call a corresponding amount of VAT[2].

The provisions of the *Mode de Calcul*[3] determine an amount (called the *"gross equivalent"* and which is actually larger than the UK rebate) that must be left aside for the notional financing of the UK rebate. The percentage of the total EU VAT base necessary to generate this amount (called the *"frozen rate"*) is deducted from the maximum rate foreseen in the Own Resources decision to obtain the yearly rate of call. This rate of call changes every year depending on the size of, and shows the same high variability as, the UK rebate.

This situation generates additional complications every time the amount of the UK rebate is revised[4]. An upward or a downward revision of the UK rebate provokes a change in the opposite direction of the rate of call of VAT and in the amount to be called (or that should have been called). Given that the size of the budget to be financed remains the same, a change in the amount of VAT called must be compensated by a corresponding change of opposite sign in the amount of GNP called. Since Member States have different shares in the bases of the two resources, these changes are not neutral (this effect of the rebate on the VAT and GNP contributions of the Member states is usually called the *"indirect effect"*). If the amount of the UK rebate must be revised, it becomes necessary to compensate Member States for the incorrect amount of the VAT and GNP contributions that have been called. This calls for complicated calculations for each revision of the UK rebate and its budgeting in two different chapters (Chapter 15 and chapter 35) which produces the somewhat surprising result that the United Kingdom appears to participate in the financing (albeit for very small amounts) of its own rebate.

In 1992, the Commission argued forcefully that the same reduction in the role of the VAT resource could be obtained through a straightforward reduction in the maximum call rate equal to the average frozen rate of the last years. The maximum rate of call was indeed reduced from 1.4 in 1994 to 1.00 per cent in 1999, but the notional financing of the rebate through VAT (with its *"gross equivalent"*, *"frozen rate"*, *"indirect* *financing"* and two budgetary chapters) has remained.

The Commission hopes that on the occasion of a revision of the Own Resources Decision it will be possible to suppress these unnecessary complications. Over recent years the amount frozen for the notional financing of the rebate has averaged 0.12 per cent of the total EU VAT base.

[1] These savings are equal to the difference between the amount the United Kingdom pays on the basis of the (capped) VAT and GNP resources under the 1988 system, and what the United Kingdom would have paid under the pre 1988 system (only uncapped VAT).
[2] See Article 5 of the Council Decision 88/376/EEC, Euratom on the system of the Communities' own resources, June 24, 1988; *Official Journal of the European Communities* L 185, July 15, 1988.
[3] See "Method of Calculation, Financing, Payment and Entry in the Budget of the Correction of Budgetary Imbalances in Accordance with Articles 4 and 5 of the Council Decision on the System of the Communities' Own Resources", Council of the European Union, 5455/94, March 9, 1994.
[4] This is done at least twice during the budgetary process, once in the first supplementary amending budget of the year in which the rebate is paid and three years later when the final calculations are made.

[…]