COMMISSON OF THE EUROPEAN COMMUNITIES

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THE UNACCEPTABLE SITUATION AND THE

CORRECTING MECHANISM

(Commission communication to the Council)

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In the communique issued following the Summit meeting in Paris on 9/10 December 1974, the Community Institutions (the Council and Commission) were invited "to set up as soon as possible a correcting mechanism of a general application which, in the framework of the system of 'own resources' and in harmony with its normal functioning, based on objective criteria and taking into consideration in particular the suggestions made to this effect by the British Government, could prevent during the period of convergence of the economies of the Member States the possible development of situations unacceptable for a Member State and incompatible with the smooth working of the Community".

The Heads of Government confirmed that "the system of 'own resources' represents one of the fundamental elements of the economic integration of the Community", and recalled the Community declaration during the accession negotiations that "if unacceptable situations were to arise the very life of the Community would make it imperative for the Institutions to find equitable solutions".

The Commission here sets out, in the light of these texts, the approach it feels should be adopted in devising a correcting mechanism to prevent the possible development of "unacceptable situations incompatible with the smooth working of the Community".

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I. WHAT CONSTITUTES AN "UNACCEPTABLE SITUATION INCOMPATIBLE WITH THE SMOOTH WORKING OF THE COMMUNITY"

Paragraph 37 of the Paris Communique refers to objective criteria on which the correcting mechanism must be based and which must define the possible development of unacceptable situations.

The Commission has endeavoured to define criteria straight-forward enough for their fulfilment to be established without unnecessary discussion, and carrying sufficient meaning to enable an assessment to be made of the risk of an unacceptable situation arising. These criteria would be used as the basis for a decision to put the correcting mechanism into operation.

For it to be apparent that an unacceptable situation is about to arise, there have to be two factors present, the existence of which is itself established as a resultant of several criteria. These two factors are a certain economic situation and a disproportionate contribution to Community financing.

The Commission considers that the risk of an unacceptable situation within the meaning of the Paris Communique must depend on an assessment of the simultaneous occurrence for a Member State of a certain economic situation and of a disproportionate contribution to Community financing.

A. Economic situation

The criteria in which may be adopted in this regard are of several kinds.

They may be indicators of national wealth, such as Gross National Product per capita, or of economic growth, such as the rate of increase in GNP per capita. These criteria may be evaluated against a Community average. The former shows the extent of the current gap between national economies and the latter gives a good idea of the convergence or divergence between the Member States' respective economic situations and of the effectiveness of their economic policies.

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Other criteria give a clearer picture of the overall state of the economy concerned, for example the existence of a current-account balance-of-payments deficit, the size of which must be related ------- to the Gross National Product.

These criteria have to be applied in combination to assess the economic situation with regard to the question at issue; the definition of such an economic situation is that the following are all present at the same time:

- Gross National Product per capita below 85% of the Community average;
- rate of growth of GNP per capita below 120% Community average;[1]
- a deficit on the balance of payments on current account.

These criteria would be calculated on the basis of a moving three-year average, in line with the market rates of exchange, pending the introduction of a theoretically more satisfactory system of assessing rates of exchange in terms of purchasing power.

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[1]Where the national wealth of a Member State measured by GNP per capita is below the Community average, for the respective economic situations to converge it is necessary that that State's rate of growth should be above the Community average: this would result in its progressively catching up with the others. Where its rate of growth is below the Community average it would only lag further and further behind them.

4. Disproportionate contribution to Community financing

As concerns Community financing, the Commission feels several aspects of the Member States' payments towards the Community Budget have to be taken into consideration, both as to the criteria defining the circumstances liable to lead to an unacceptable situation and, when these criteria are fulfilled, as to the activation of the correcting mechanism.

The first aspect, until such time as the process of convergence has been completed, could be comparison between a Member State's relative share calculated according to the results of the Decision of 21 April 1970 on the replacement of financial contributions from the Member States by the Communities' own resources[1] and what its share would be if based on the straight relation between its own GNP and the Community's.

Where the Member State's relative share is appreciably higher than it would be if based on relative GNP, and where the other criteria referred to in this communication are operative, corrective action would be called for. Such action would need to take account of the different character of the three classes of Own Resources designated in the Decision of 21 April 1970. Whereas payments from VAT (or based on relative GNP pending agreement on VAT) can be regarded as a burden on the Member State concerned, the same reasoning cannot be applied to the same extent to agricultural levies and customs duties, in consequence of the free movement of goods within the Community. Hence, having regard to the nature and purposes of the Own Resources system, the correcting mechanism should not be set in motion every time that any disparity, no matter how small, develops, and for the same reason even where it is set in motion, the disparity should not be compensated in its entirety.

Accordingly, it would appear best that application of the correcting mechanism should be confined to cases where the relative share is over 110% of the relative GNP of the Member State concerned; also, the correction should not apply to the whole of the disparity but should be limited to two-thirds of it.

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[1] This Decision defines the relative share of a Member State as the share of each Member State in the total amounts paid.

The second aspect to be considered is the existence of a potential net foreign-exchange burden due to the implementation of the Community Budget. So long as the process of convergence has not produced a true monetary union, payments towards the Community Budget represent a potential foreign-exchange burden on the Member States. The Community Budget is implemented through convertible accounts held by the Commission in Each Member State. Under the regulations in force, to avoid unnecessary exchange transactions, the Commission, to whose account are credited Member States' Own Resources payments, gives priority in drawing on this account to payments corresponding to its expenditures in the Member States concerned. In accordance with its requirements, the Community may then make transfers for the purpose of financing operations outside that State. As a result there is a potential net foreign-exchange burden on the Member States concerned, once its national currency has been paid outside its borders and can be the subject of conversion. Unless there is such a potential foreign-exchange burden, Member States should not be able to call in question the consequences of the Own Resources system.

Also, the amount of the potential net foreign-exchange burden would be a second ceiling on the operation of the correcting mechanism.

Thirdly, the correcting mechanism should take account of the different nature of the three classes of Own Resources designated in the Decision of 21 April 1970: whereas payments from VAT (or those based on relative GNP pending agreement on VAT) can be regarded as a burden on the Member States concerned, the same reasoning cannot be applied to the same extent to agricultural levies and customs duties, because of the free movement of goods within the Community. Hence operation of the correcting mechanism could appropriately be limited to the total payments in respect of VAT by the Member State concerned.

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The foregoing comparisons and calculations would need to be effected on the basis of market rates of exchange pending the introduction of a theoretically more satisfactory system of evaluating rates of exchange in terms of purchasing power.

C. Procedure

The Commission considers that where the criteria for the possible development of an unacceptable situation are operative this entitles a Member State to apply for the correcting mechanism to be put into operation. It would be for the Commission to assess the reality of the situation by reference to the pre-established criteria, and if appropriate to enter the necessary amount, determined as below, in the next preliminary draft Budget. The Council would decide on the amount so entered under the Budget procedure.

In practice the Member State concerned would have to act at the end of the first half-year. In doing so, it would indicate to what extent it considered the above criteria applied to its case in the context of the process of convergence of the Community economies. The criteria as to the economic situation would be considered in the light of the figures for the past three years expressed as a moving three-year average, and the criteria as to contribution to Community financing in the light of the forecasts for the current year. The amount required would be entered as "expenditure necessarily resulting" in the Budget for the following year; it might if necessary be adjusted on the basis of the correcting mechanism according to the outturn of the forecasts of the contribution to Community financing.

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II. SUGGESTED CORRECTING MECHANISM

To achieve the desired end, the Commission considers the correcting mechanism to be used should be based on Budget refunding.

For this purpose, any excess payment of Own Resources, on the basis of Own Resources actually transferred and Own Resources which have been transferred had a GNP-based financing scale been used, would give entitlement to a refund from a new Budget line, the amount of the refund being determined by reference to the excess payment.

For this purpose the amount would be calculated as follows:

(i) with respect to the tranche of the relative share between 100% and 105% of the relative GNP, there would be no refund;

(ii) with respect to the tranche of the relative share between 105% and 110% of the relative GNP, the refund would be 50% of the payment corresponding to this tranche.

Similarly, for the tranches beyond, the refund would be:

110%-115%	60%
115%-120%	70%
120%-125%	80%
125%-130%	90%
130% and over	100%

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As noted above, the amount of the refund would be subject to a ceiling of (i) two-thirds of the total excess payment, (ii) the amount of the net potential foreign-exchange burden which the implementation of the Community Budget imposed on the Member State concerned or (iii) the amount of VAT Own Resources paid, whichever was the lowest. Notwithstanding the Budget rules in force, all the foregoing calculations are at market exchange rates; Budget entry would be calculated at the Budget exchange rate. exchange rate.

The fact that a Member State has benefitted from the correcting mechanism for three consecutive years could indicate a chronic divergence between Member States' economic situations. The Community authorities would then make a special examination of the situation of the State in question and take the appropriate measures to give effect to Community solidarity in the light of the assessment made of the convergence of economic situations and policies.

III. CONCLUDING REMARKS

As there is no Treaty provision for specific means of action on which the correcting mechanism thus outlined could be based, the Commission considers it would be necessary to have recourse to Article 235 EEC.

The arrangements suggested by the Commission could be operated for a trial period of seven years. At the end of that time the Community authorities would consider the conditions of application of the mechanism and take steps accordingly.