THE EUROPEAN COMMUNITY BUDGET: THE FACTS

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"A new budget crisis" - "Communities' own resources almost exhausted" - "Community unable to make ends meet" - "Chaos in Community finances" are the sort of headlines that seem to appear each year in the newspapers.

Now, just three months after a substantial increase in own resources became effective and less than two years after the Fontainebleau summit came up with a solution to the budgetary disputes which had paralysed the Community for almost five years, the Community once again appears to be up against a major financial problem.

But is it true that the Community is not capable of managing its finances ? Is it true that financial planning is impossible at Community level ?

I. MISUNDERSTANDINGS CONCERNING COMMUNITY FINANCE

There are still a number of prejudices, misconceptions or misunderstandings which influence public discussion of European budgetary questions and do a great deal of harm to the Community's image.

1. Is the Community budget too big ?

The Community budget is actually very small, especially in comparison with national expenditure ; its volume in 1985 was 28,400 million ECU (see Table 1) corresponding to :

- less than 3% of national central government budgets, accounting for per capita expenditure of 105 MECU every year, i.e. 0.65 pfennig a day for every German, FF 2 for every Frenchman, Bfrs 13 for every Belgian, Lit 440 for every Italian and 20 p for every Britan. Table 2 shows that the equivalent contributions to national budgets amount to DM 25 in the Federal Rapublic, FF 80 in France and Bfrs 507 in Beligum (see Table 2);

- less than 1% of the GDP of the Member States; Note : public sector spending in the Member States accounts for more than half (50.7%) of GNP over the Community as a whole (see Table 3).

Table 1

Volume of budget

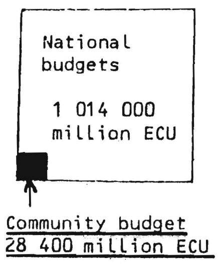


Table 3

Proportion of GDP of the Member States

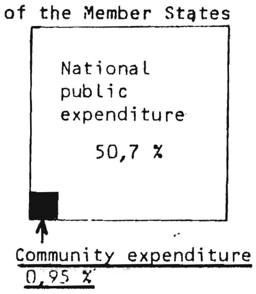
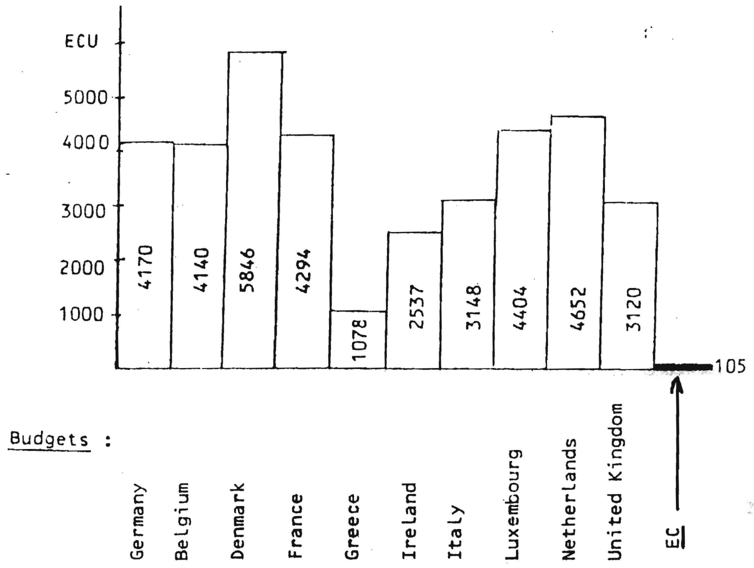


Table 2

Annual per capita contributions to national budgets and the Community budget



2. Is the growth rate of the Community budget too large compared with national budgets ?

A comparison between the growth of the Community budget and that of national budgets shows that they have evolved in parallel. Between 1979 and 1985, the Community budget rose from 14 000m to 28 400m ECU, whereas the national budgets of the Ten rose from 527 000m to 1 014 000m - roughly a doubling in each case.

There have undoubtedly been divergencies in the short term to meet specific Community needs. Thus Community expenditure had to increase more strongly between 1985 and 1986 because of the enlargement of the Community, and there will have to be an expansion in the coming years in the research sector if Europe really wishes to face up seriously to the technological challenge which threatens its competitivity on the global level (1).

Simplistic comparisons between the growth of the Community budget and that of national budgets are pointless since Community policies :

- start from a much smaller base (see 1) ;
- are still developing and must include the financial effects of new policies, enlargement and other exceptional factors ;
- supplement national expenditure and thus lead to savings in national budgets.

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(1)Note : R and D expenditure takes up less than 3 per cent of the community budget at present and represents only about 2 per cent of the Member States' public expenditure in this sector.

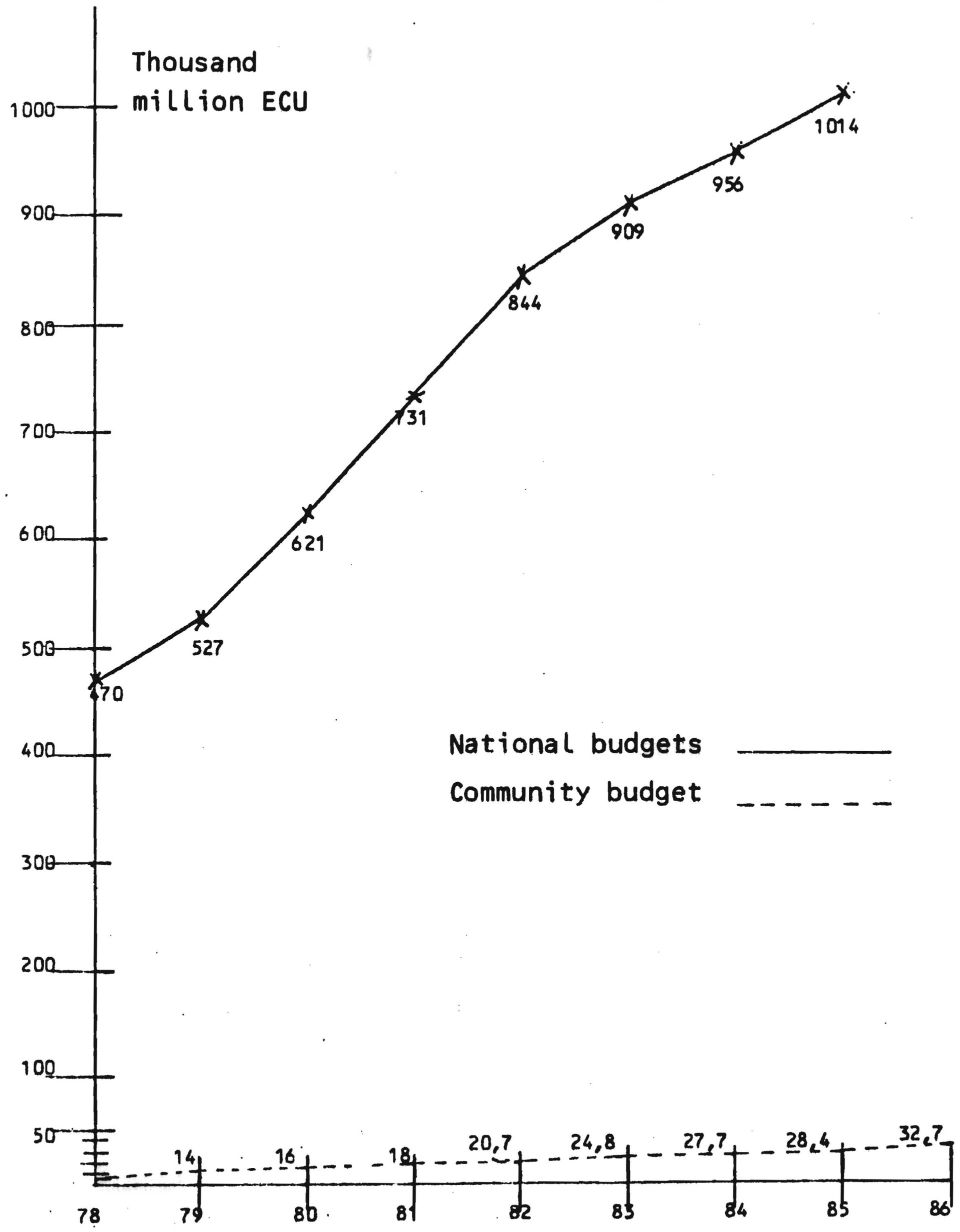
3. Why could the Community not manage within the original own resources limit ?

Considering what the Community has achieved in the past fifteen years it is surprising that all this could be done within the original 1% VAT limit. Indeed when the ceiling was placed more or less arbitrarily at the round figure of 1%, it was hard to imagine that the Community was going to develop in the way it did in the seventies and eighties with the creation and reform of the structural funds (Regional and Social Funds, Integrated Mediterranean Programmes), and the establishment of new policies (industry, research and innovation). Furthermore, these years have seen the accession of six new Member States. For some, this has invovled corrective mechanisms financed from the Community budget which have proved extremely expensive in budgetary terms.

Despite these factors, it is interesting to note that the share of Community expenditure in GDP has hardly changed (rising from 0.8% in 1979 to 0.9% in 1985) and that, in absolute terms, the Community budget has developed at practically the same rate as national budgets. This shows that criticisms of "the excessive growth rate in Community expenditure" simply do not bear examination.

Unlike the Member States, <u>the Community is not allowed to engage in deficit financing</u> : revenue and expenditure must always balance. National budgetary authorities on the other hand can turn to the capital market to cover deficits and it is well known that they have made no small use of this possibility in recent years. Community finances are thus subject to a stricter regime.

GRAPH 1



Between 1979 and 1985 the total volume of the Member States' public debt rose by 925 000 million ECU,i.e. 60 times more than the 14 400 Mio increase in the size of the general budget of the Communities over the same period.

4. Is the accession of Spain and Portugal to be considered an exceptional burden borne solely by the old Member States ?

The answer is no. Although the volume of expenditure in the 1986 budget far outstrips that in the 1985 budget, revenue too has increased since, immediately upon accession, the two new Member States contribute fully towards the financing of the Community budget. But because Community policies will be applied only gradually in the initial years after accession, a degressive system of compensation has been devised for these countries. In budgetary terms, enlargement has thus led to an increase in both revenue and expenditure.

5. It is sometimes argued that net contributions and receipts to and from the Community's budget give an accurate reflection of the "profits" and "losses" which Community membership brings to the different Member States.

This is not the case. The net transfers reflect only a very limited proportion of the financial and economic advantages of European integration ; the advantages do not feature in the budgetary accounting, for example the economic effects of the spectacular expansion of trade - which has increased 25-fold since the beginning of the Community - and the effects of competition policy and of monetary stabilisation.

A simple comparison of net budget transfers comes nowhere near providing an adequate indication of the contributions and benefits from economic integration which are to the advantage of all Member States. The Community budget represents a limited part of the whole picture.

II. DEVELOPMENT OF VAT OWN RESOURCES

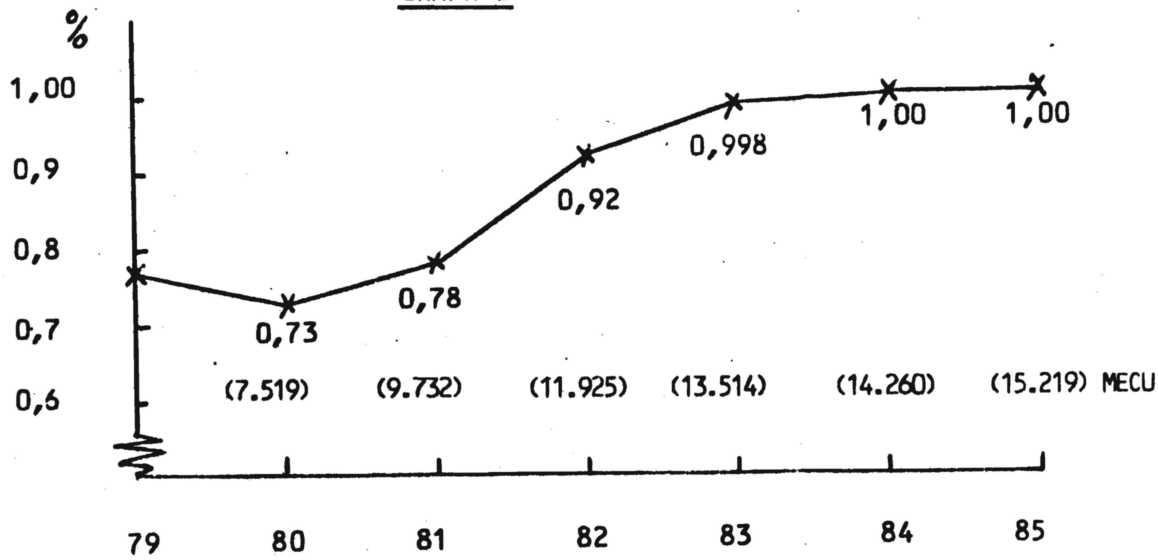
There are three components to the Communities' own resources : customs duties, agricultural levies and a proportion of VAT.

The nature of the first two components limits their volume and development potential.

VAT alone can provide the essential basis for covering future financial requirements. Moreover, VAT gives the best reflection of the capacity of the Member States' economies to contribute to the Community's finances.

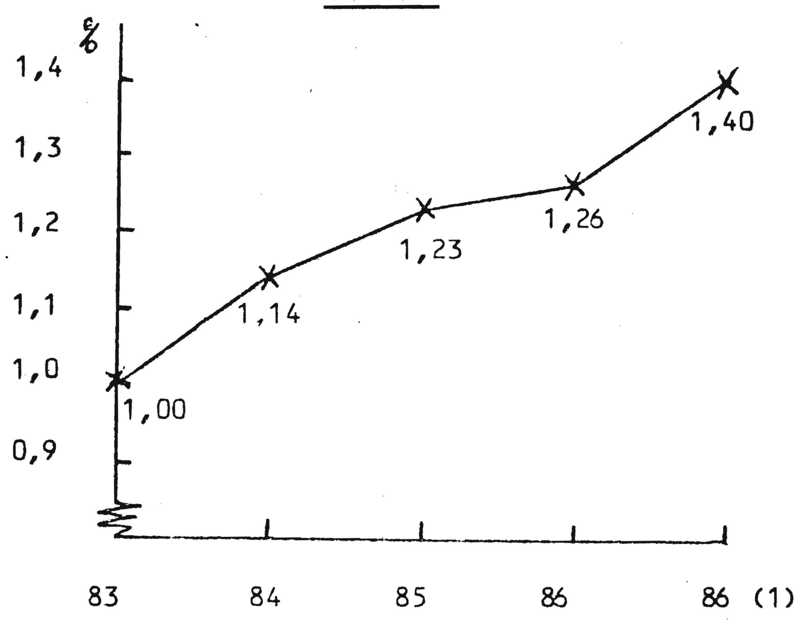
Graph 2 below shows the VAT rates applied since the end of the seventies. Following a period of relative stability up to 1981, the rate jumped considerably in 1982 by 0.14% to 0.92% and practically reached its ceiling in 1983 (0.998%).

GRAPH 2



It can be seen that the VAT component of own resources was already practically exhausted in 1983, i.e. three years before the maximum rate was actually raised. The budgetary deficit which then accumulated over the next two years (1984 and 1985) was finally covered by direct payments from the Member States under an intergovernmental agreement designed allow the Community to meet its legal obligations. If this aspect is taken into acccount, the trend in the highest VAT rate (simulation) follows the curve shown in graph 3 below :

GRAPH 3



(1) Including the supplementary and amending budget to be presented for 1986

This graph clearly shows that the available volume of additional funds within the higher VAT limit of 1.4% was already practically exhausted even before the measure took effect, so much time being needed for the decision to be taken and then to be ratified by the national Parliaments.

What are the reasons for this sudden development?

Three specific factors have emerged to seriously encumber the Community's financial future :

(a) compensations to the United Kingdom to correct budgetary imbalances, as agreed by the European Council of Fontainebleau in 1984 ;

(b) the enormous expansion of agricultural expenditure;

(c) the large volume of appropriations committed under the structural funds but not followed up by payments ("burden of the past").

(a) The budgetary impact of the Council's decision of 30 May 1980, after several years of hard bargaining, to grant compensation to the United Kingdom from the general budget is clearly reflected in the increase in the take-up rate for own resources : the 0.14% jump in the VAT rate between 1981 and 1982 was mainly due to this decision, which involved an additional sum of 1 654 million ECU for 1981. Since similar sums have been paid in subsequent years, this represents a permanent additional burden on the Community budget.

(b) The unchecked rise of agricultural expenditure is clearly the most important and most alarming factor affecting the future of the Community's finances. Expenditure on market intervention operations has almost doubled in the last five years, increasing from some 11 000 million ECU in 1981 to more than 21 000 million ECU in 1986. The reasons for this sharp rise are well known : continuous and rapid increases in agricultural productivity, combined with a distinctly smaller rise in consumption, limited scope for exports to the world markets since agricultural over-production has become an international problem, the consequent drop in world prices and the accumulation of enormous agricultural stocks.

The particularly alarming conclusion for the budget is that this considerable increase in agricultural expenditure in recent years fails to reflect the true costs of the CAP for two reasons :

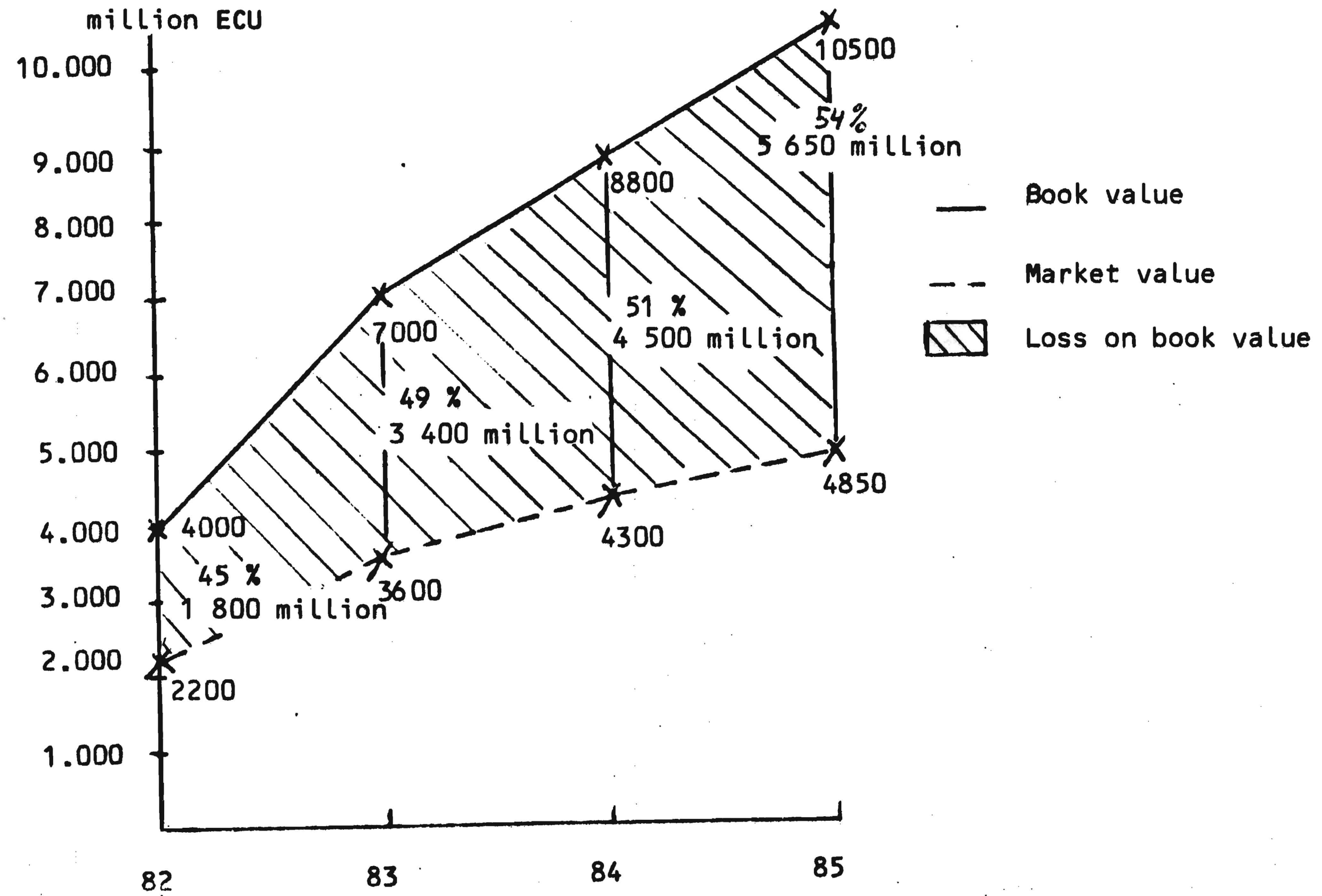
1. The agricultural stocks, which are now at record levels with a book value of more than 10 000 million ECU, generate costs not only for storage but also as a result of the loss in value of the products as storage continues (in particular milk products and beef and veal).

In 1985 the real value of the agricultural stocks was less than half the book value (4 850 million ECU as against 10 500 million ECU) - this discrepancy is hard to reconcile with sound budgetary management.

Graph 4 shows the growth in agricultural stocks in recent years in both book value and market value :

GRAPH 4

Value of agricultural stocks at year's end, 1982-1985

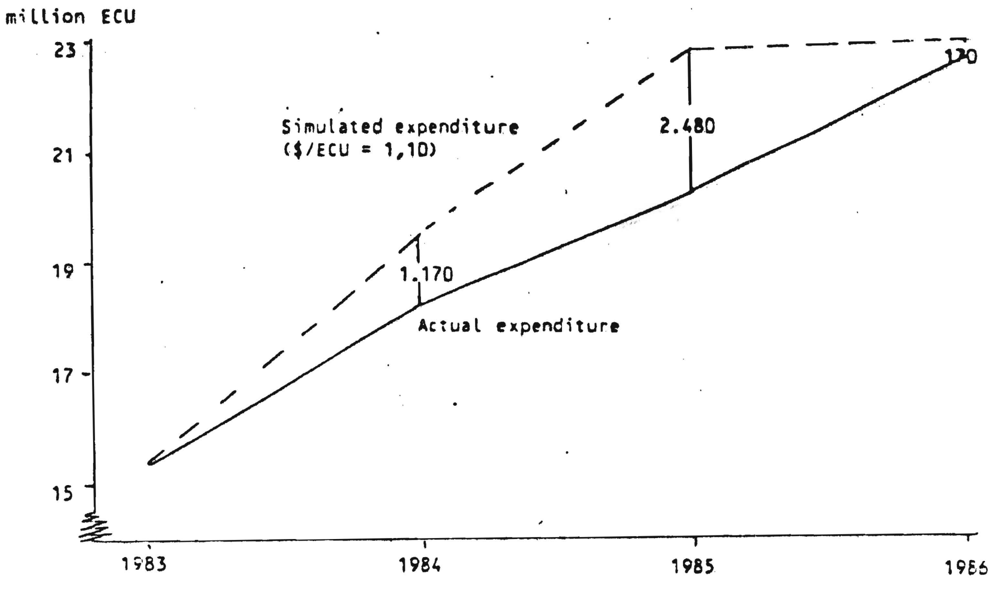


2. The particularly high level of the dollar, especially over the past two years, has had the effect of artificially reducing budgetary expenditure. Mainly through the workings of export refunds, a 10% rise in the rate of the dollar against the ECU normally leads to a budgetary saving of around 1 000 million ECU while a drop in the dollar rate will lead to a similar loss.

Graph 5 shows the effect of the artificial saving resulting from the extremely high dollar rate in 1984 and 1985; the simulated expenditure assumes a stable USD/ECU rate of 1.10 for the period 1983-86. Expenditure on price support would have been significantly higher in 1984 (by 1 170 million ECU) and 1985 by 2 840 million ECU) if the dollar rate had stayed at the average 1983 level. With a dollar-ECU rate which is likely to be even lower in 1986 than in 1983 it would not be surprising if agricultural expenditure in 1986 - and possibly in future years as well - were to rise above expected levels.

Graph 5

Simulated expenditure with a stable dollar-rate 1983-86



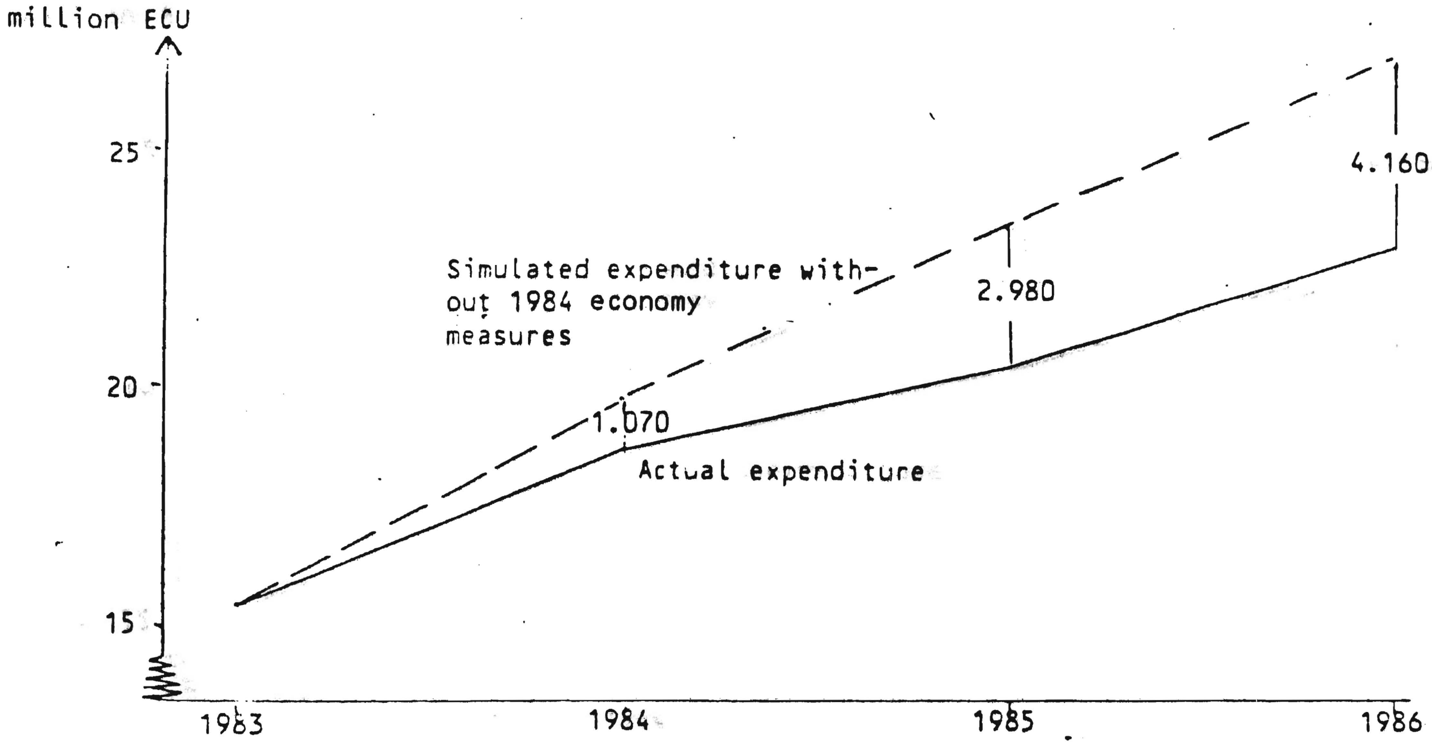
These two factors have evidently produced a considerable though artificial reduction in budgetary expenditure in the past; furthermore, the first factor merely defers actual expenditure and will inevitably give rise to even greater increases in the future when the book values are corrected. The second factor will lead to substantially higher costs as the dollar returns to its real value on the exchange markets, as it very clearly has done in recent months. This, incidentally, is one of the main reasons why the Commission has been forced to present a supplementary budget for 1986.

It should also be pointed out that, on the basis of Commission proposals dating from 1983, the Community has introduced a number of measures which will yield savings totalling more than 4 000 million ECU in 1986. These measures are the quotas for milk and guarantee thresholds for cereals, oilseeds and processed tomatoes.

Graph 6 shows the impact of these savings on the budget by comparing actual expenditure and simulated expenditure without the special measures. The savings total almost 3 000 million ECU for 1985 and more than 4 000 milion ECU for 1986 ! It also shows clearly how much time is required for these measures to be fully effective.

Graph 6

The budgetary effects of economy measures introduced in 1984



Finally, the effect which the CAP has in reducing national expenditure should not be ignored. According to a study recently published by a group of national specialist institutes (1) , national public expenditure on agriculture in the ten-nation Community increased by only some 12% between 1975 and 1980, rising from 8 547 million ECU to 9 520 million ECU while the corresponding expenditure at Community level increased by 153% from 4 764 million ECU to 11 909 million ECU.

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(1) SEMA-Matra, IFO, Price Waterhouse

Since all these attenuating factors have not led to a real stabilization of agricultural expenditure in the past, it is easy to see how much determination and support the Community will require from every side if it is to manage to regain control of this expenditure and, at the same time, make inroads on the accumulated costs carried over from previous years.

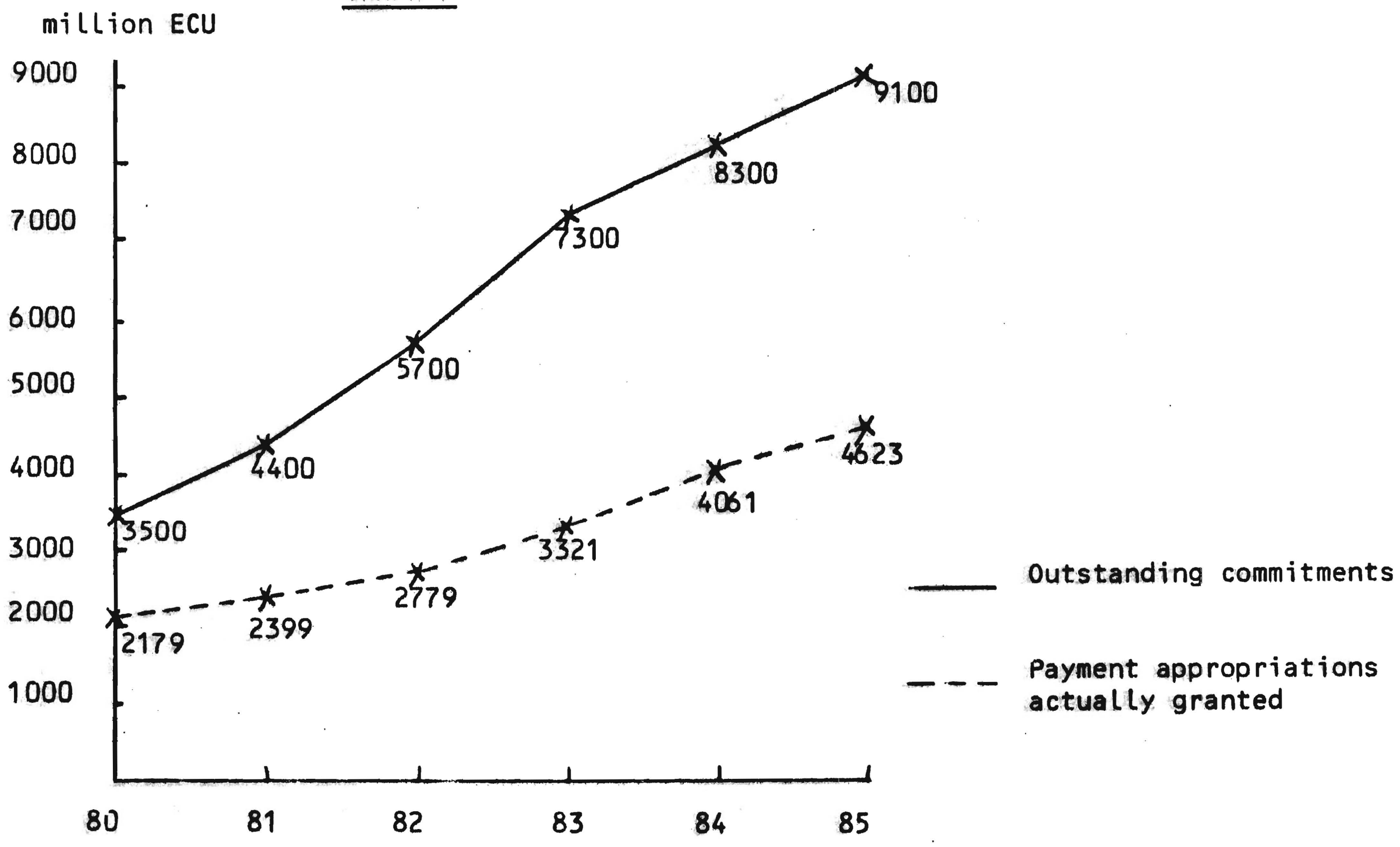
(c) Burden of the past

The third problem casting a shadow over the future of Community finances is the growing discrepancy between the commitment and payment appropriations allocated to the structural funds since 1980.

The accumulated commitments awaiting payments under the three main structural funds (Regional Fund, Social Fund and EAGGF Guidance) have almost tripled since 1980. Like the failure to allow for the depreciation of agricultural stocks, this leads to a grave underestimate of the true budgetary cost of Community policies and merely defers expenditure to a later date. The commitments entered into under the structural funds are legal obligations for the Community comparable to expenditure under the agricultural rules. The Commission must pay the bills for projects in respect of which commitments have been properly entered into if it is to guarantee operation of the structural funds, a basic test of its credibility.

Graph 7 shows the trend in outstanding commitments and payment appropriations granted.

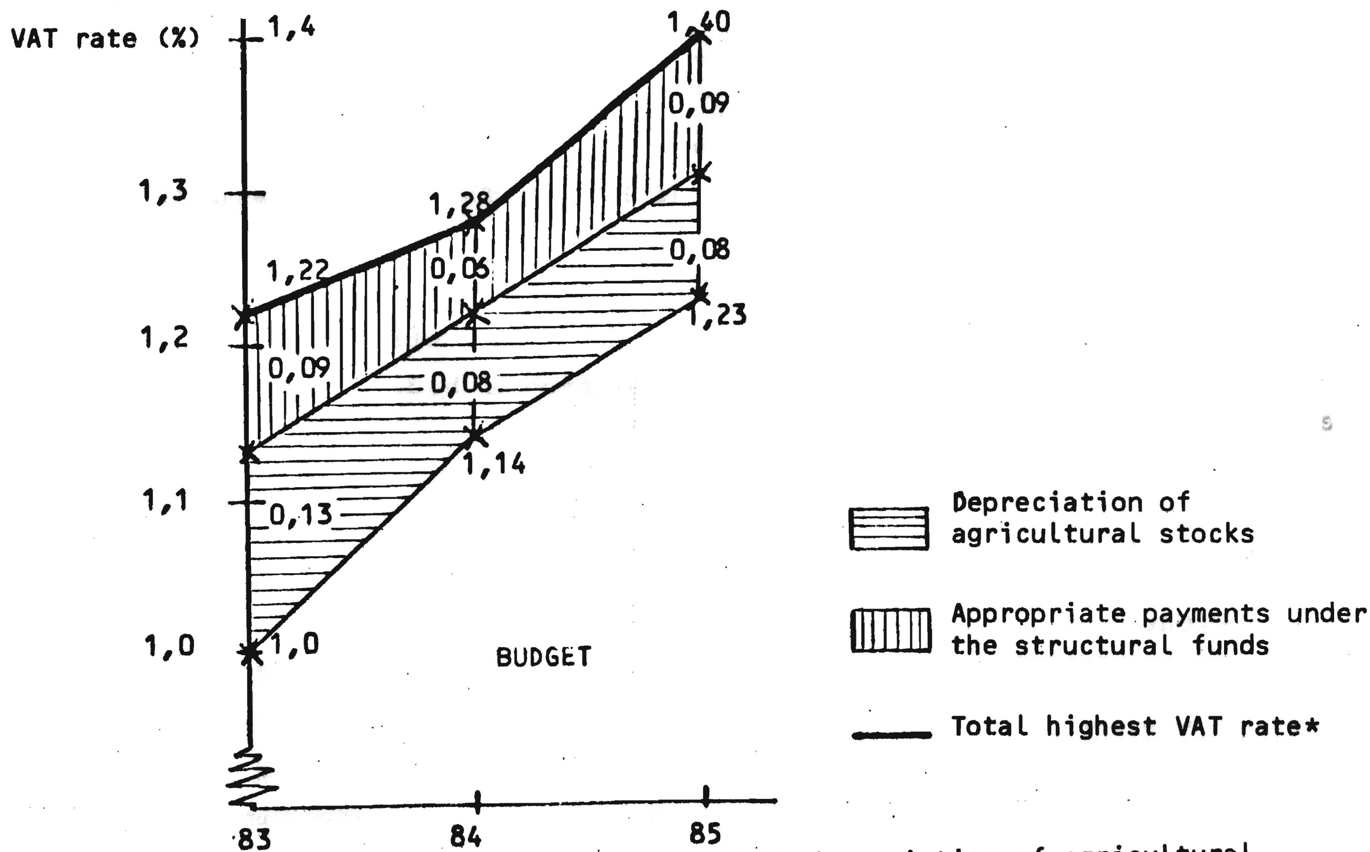
GRAPH 7



If the Community is to regain control of this development, a fairly substantial amount of payment appropriations must be provided.

Graph 8 shows the effect on the VAT rate if sound budgetary management had been applied in these two areas. Maximum VAT rate (%)

GRAPH 8



* Simulated VAT rates assuming full depreciation of agricultural stocks and appropriate payments against structural fund commitments in 1983-1985.

In terms of simulated VAT rates for the years 1983-85, the correction of budgetary imbalances, a yearly depreciation of the increase in agricultural stocks, and an appropriate level of payments against outstanding commitments under the structural funds would have implied a considerably higher VAT rate than the 1.0% limit from 1983, i.e. three years before the 1.4% ceiling took effect. The 1.4% rate would actually have been reached in 1985 if the true costs of the present policy had been fully accounted for.

On the whole one must note that not only own resources have been consumed, during the past few years, earlier than foreseen, but that effective demand for own resources remained conderably below the level which would be realistic or appropriate from a budgetary point of view.

The bill will have to be paid for this in the following exercices.

Furthermore, a new element is emerging which will influence the budget as regards receipts: according to the most recent projections the estimates for own resources from VAT must be reduced by several millions of ECUs. The main reason for this is the considerable reduction of the rate of inflation (estimated for 1987 at 3.4 %, after 5 % in 1986 as the Community average) which automatically reduces the VAT receipts.

Although this may be regrettable from a budgetary point of view, one should not overlook the fact that the Community budget has thus to bear the burden of two new elements which constitute in fact, on a general economic level, indisputable and encouraging successes:

- the rapid decline of the Dollar
- the equally spectacular reduction of the level of inflation in the Community

in other words, two objectives to which the Community and the Member States have committed themselves for some time.

If these have materialized to an unexpected degree, one must not only see the negative consequences for the Community budget, but equally the positive effects on the general economy, particularly as the latter are by far more important.

III. FOUR YEAR FORECASTS - A NEW APPROACH TO MEDIUM-TERM FINANCIAL PLANNING AT COMMUNITY LEVEL

What lessons should be drawn from the development of the budgetary situation and what solutions can be found to escape from it and to restore confidence in European finances ?

First, strict management is necessary, especially in the agricultural domaine. Only by a common effort by everyone concerned can one regain control in this field.

On the other hand, it is essential to ensure that in solving agricultural problems - although these are a priority - we do not paralyse the development of the whole range of other Community policies.

Secondly, specific measures of budgetary policy are necessary in order to restore confidence.

There are three main reasons why the Community's budgetary problems have, in the past, often caused disputes and controversy at both political level and in public opinion :

- a lack of transparency in respect of budgetary problems ;
- a lack of consistency between policy decisions and their budgetary consequences ;
- unforeseen or unforeseeable events and developments beyond the Community's control (e.g. world agricultural prices or the rate of the dollar).

The way in which the first two problems are dealt with at Community level could and should certainly be improved. Budget transparency should be strengthened, as well as the consistency between political decisions and the financial consequences which flow from them.

It is in this context that the Commission sees a need for medium-term financial planning covering at least three or four years and going further than the purely forecasting exercise conducted in the "three-year forecasts" which the Commission has published each year when presenting the preliminary draft budget.

Mere extrapolation of current trends is of limited use in planning public expenditure; in the present situation of severe financial restrictions imposed at all levels, public expenditure planning must be transparent and reliable, especially at Community level. Although, for a number of reasons, the Community's financial problems cannot be equated with national public finances, it is interesting to note that most States operate multiannual budgetary planning systems of varying degrees of sophistication. The Community therefore needs an instrument of this type to enable it to prepare its medium-term financial strategy and ensure that the financial implications of the specific policy decisions are incorporated in these decisions and form part of a longer-term financial strategy.

The main aim of such an instrument is to establish priorities, provide a longer-term perspective for priority measures and thus make Community measures more effective and coherent.

It is with this in mind that the Commission has established a new system of four-year budgetary forecasts which take account of the problems and prospects set out at III and IV above.

IV. THE FINANCIAL PERSPECTIVES 1987 - 1990

The Community's own resources are expected to grow by about 6 per cent per year between 1987 and 1990. On the expenditure side this period will be marked by the steadily growing participation of Spain and Portugal in the policies of the Community and by a restructuring of the budget designed to ensure that at least the priority political commitments are respected.

1. Revenue within the 1.4% VAT limit

Total resources available within the 1.4% VAT are expected to increase from about 39 830 million ECU in 1987 to 47 080 million ECU in 1990, an average annual increase of 5.7%. As average GDP growth is 5.9% per year, the share of own resources in GDP will drop.

In 1987 about 2 400 million ECU, i.e. 6% of resources, will have to be set aside for the correction of budgetary imbalances.

Allowing for this, the resources available will increase from 37 430 million ECU in 1987 to about 43 900 million ECU in 1990, an average annual rate of increase of 5.4%.

2. Expenditure

The main features of expenditure between 1987 and 1990 will be as follows :

- gradual realization of the Commission's plans for the future of agriculture in the Community, provided the proposals made are adopted by the Council from 1986 onwards. The expenditure figures for the EAGGF-Guarantee Section have been calculated according to the EAGGF guideline for budget discipline.

- A substantial increase in appropriations allocated to research;

- structural expenditure showing a cautious increase in terms of commitments subject to the gradual stabilization of the burden of the past in payments.

- A reduction in the automatic repayments to Spain and Portugal, in accordance with the schedule set out in the Act of Accession.

- A provision is entered to cover new policies and actions. This provision is essential for the development of the Community because none of the existing policies have any room for manoeuvre beyond objectives already stated by Community Institutions. Any new and desired initiatives must therefore be contained in this provision.

Expenditure 1987-1990 - Appropriations for payments

(million ECU)

	1986	1987	1988	1989	1990
1. EAGGF-Guarantee	22 012	23 061	24 481	25 850	27 436
2. Structural policies	6 201	6 593	7 625	8 694	8 941
3. Research	437,6	592	997	1 610	1 996
4. Development coperation	1 110,5	1 167	1 214	1 252	1 300
5. Other policies	367,7	435	472	492	521
6. New policies	5	80	400	600	800
7. Repayments to Member States	3 307	2 956	2 879	2 757	2 207
8. Administratives expenditure	1 776,4	1 959	2 095	2 204	2 321
9. TOTAL	35 217,2	36 843	40 163	43 459	45 522
% increase		4,6	9,0	8,2	4,8
10. Highest VAT rate		1,37	1,43	1,49	1,47

3. VAT rate and margin remaining

The estimated increase in expenditure would bring the highest VAT rate to 1.37 in 1987. This would leave a margin of about 590 million ECU for contingencies. Recent developments in the dollar/ECU rate are liable to deplete this margin.

From 1988, resources available within the 1.4% VAT limit will no longer be sufficient. Also it is necessary to leave a margin of 0.1 - 0.2% of VAT to allow for factors of uncertainty in forecasts, notably with regard to EAGGF Guarantee expenditure, the effects of enlargement and the forecasts of resources.

The Heads of State and Government at Fontainebleau recognized that "the maximum rate may be increased to 1.6% on 1 January 1988 ...". The figures given indicate that this judgement was right : an increase to the 1.6% will be needed as from 1 January 1988.

SPOKESMAN'S SERVICE OF THE COMMISSION