COMMISSION OF THE EUROPEAN COMMUNITIES

COM(83) 10 final
Brussels, 4 February 1983

THE FUTURE FINANCING OF THE COMMUNITY

(Communication from the Commission to the Council and to the European Parliament)

THE FUTURE FINANCING OF THE COMMUNITY

INTRODUCTION

1. The European Community is financed by resources which accrue to it as of right and as a direct consequence of its own policies. The current own resources system, consisting of agricultural and sugar levies, customs duties and an element of Value Added Tax of up to 1% of a uniform base, has served the Community well for twelve years. But the time has now come to consider its further development. In this present communication the Commission sets out some preliminary ideas on how this development might take place. The character of this communication is that of a discussion document, of a kind which is sometimes referred to as a "green paper". It describes various considerations affecting the development of the Community's financing system and lists a certain number of options which, at this stage of the Commission's reflections, seem prima facie suitable for further study. It does not, deliberately, contain specific proposals. The Commission will make such proposals, in the spring of 1983, in the light of its further internal considerations of the issues involved and of the reactions of the Council and of the Parliament to this communication.

2. This discussion document on the Community's financing system is presented to the Council and the Parliament in parallel with the speech which the President of the Commission will make before the Parliament on 8 February in which the Commission's policy priorities for the remainder of its Mandate will be set out. The Commission's ideas on the Community's financing system need to be appreciated in the light of its policy proposals. The Commission also emphasizes, at it has done on previous occasions, that the Community's budget, with the financing of which this "green paper" is concerned, gives only a very partial picture of the reality of the Community and cannot in any sense constitute the only, or even the principal, touchstone by which the advantages of Community membership can be judged.

3. The Commission's proposals for the future financing of the Community will be designed to:

(a) provide the Community with the necessary resources and with the necessary financial flexibility and autonomy to respond to the increasing budgetary demands of its policies;

(b) develop the Community's financing system in such a way as to stimulate the further development of these, and new, policies;

(c) establish a financial framework which allows enlargement by Spain and Portugal to take place without prejudice to the acquis communautaire as it now exists and as the Commission has proposed it should be developed in the context of enlargement;

(d) reinforce the Community's internal cohesion by contributing to the correction of budgetary imbalances, as demanded in various resolutions of the European Parliament.

4. The Commission has on a number of occasions explained why it believes an extension of the Community's own resources to be necessary and why it cannot accept that the present ceiling should constitute a permanent constraint upon the growth of the Community's budget. In his programme speech of February 1981 to the European Parliament the President of the Commission emphasized that the Community could not remain simply a Community of one percent. In the first place, this is because of the need to safeguard the maintenance of the full range of the Community's existing policies. The Community is already living in the shadow of the exhaustion of its current financial resources; and whatever the actual level of expenditure envisaged for any budget year, the Community needs to have in reserve a certain margin of potentially available resources so as to safeguard, within an overall budgetary framework, the security and continuity of all its policies.

5. In addition, the existing range of Community policies needs to be developed further. The Commission presented ideas for the development of Community policies in its Mandate Report and will amplify and extend these in the Programme Speech which its President will deliver to the European Parliament on 8 February 1983. In brief, the Commission envisages:

(a) the intensification of the Community's energy and industrial strategy and the expansion of Community expenditure on research and development and on innovation projects;

(b) more systematic and extensive use of Community financed structural expenditure through the Regional and Social Funds, as well as the development of other structural expenditure such as FEOGA Guidance and Fisheries and Mediterranean programmes;

(c) the development of a substantial Community financed transport infrastructure programme;

(d) the achievement within the next ten years of a Community development aid programme representing 1/1000 of the Community's Gross Domestic Product;

(e) the maintenance of the Commission's aim, which is that agricultural expenditure should grow more slowly than the Community's own resources assessed over a period of several years.

6. In assessing the contribution which particular forms of new resource can make to the attainment of the objectives set out in paragraph 3 above the Commission starts from the premise that the development of the Community's financing system must be viewed in connection with the development of the Community's policies, particularly its expenditure policies. The Commission has long emphasized the need to expand the Community's policies in the non-agricultural area and the effect of this would be to produce a better balance of expenditure within the Community Budget. In this context, the Commission regrets that, as a result of the current stagnation of Community decisions in many areas, the relationship between the development of national and Community policies is not moving as expected in favour of Community programmes.

7. In making these proposals, the Commission does not proceed from the assumption that an increase in the size of the Community's budget is desirable simply for its own sake. The Commission recognizes the severe economic constraints facing all its member states and has itself emphasized the importance of budgetary discipline in the public sector. All expenditure at Community level should be rigorously scrutinized with a view to showing that it represents a cost-effective alternative to national programmes. Indeed, in the Commission's view the relationship between Community expenditure and that of national governments could in certain appropriate cases be more systematically examined and publicised.

The significance of economies of scale needs to be given greater attention. In particular, in the field of policies designed to promote structural adjustment as well as industrial and technological innovation, purely national programmes entirely financed by national budgets risk in many cases not to be adequate because of budgetary restrictions and limitations of scale. A higher level of Community financing can in some cases not only avoid the waste of scarce public resources but also provide an incentive for greater opening of the market. It should be possible to show the people of Europe that any increase in the Community's resources should not automatically involve an additional burden on the European taxpayer; on the contrary, in many cases the corollary of increased Community expenditure should be a reduction in expenditure at the national level.

8. There are no potential additional new forms of revenue available to the Community which flow as automatically from its policies as do the traditional own resources of customs duties and agricultural levies. The Comission has therefore sought to identify those new resources which best reflect the overall interest of the Community, which enhance the attraction for all Member States of full participation in Community policies and which best ensure a coherent relationship between the Community's revenues and its pattern of expenditure.

9. In order to allow the development of the Community's present policies to be maintained with an adequate margin of security, and in order to promote the growth of those additional policies and expenditures which will be needed in the future, including in the context of enlargement, the Commission believes that a better diversified system of financial resources is required.

10. Such a diversification would also contribute to the mitigation of the budgetary problems to which the Commission referred in the Introduction to its Preliminary Draft Supplementary Budget N° 1 1983, and for which the European Parliament in its Resolution of 16 December 1982 called for a lasting Community solution*. The Commission made clear that it was alive to the concern expressed by Parliament and to its desire to see the ad hoc solutions of recent years replaced by a permanent arrangement for strengthening Community policies and would accordingly be presenting proposals in the near future for developing these policies and for introducing a more diversified system of own resources.

11. A further factor which has intervened in the years since the establishment of the current own resources system, is the emergence of a directly elected European Parliament. The Parliament's role as part of the Budget Authority is clearly defined in the Treaty. In the Commission's view, it is essential that in any further renewal of the system proper provision should be made for the exercise by the directly elected European Parliament of budgetary powers and responsibilities which adequately refect its status.

---

* In its resolution of 16 December 1982, the European Parliament called on the Commission and the Council "to submit as soon as possible new financial and budgetary proposals which provide an effective follow-up to the Mandate of 30 May and lay the basis for a lasting Community solution to the unacceptable situations which have arisen for a number of Member States".

12. The following paragraphs discuss, successively, possible sources of general revenue for financing the Community Budget, under the headings of VAT, progressivity and sources of revenue related to agricultural indicators; possible sources of revenue related to the financing of specific policies; revenues which accrue incidentally as the consequence of the Community's agricultural and commercial policies; the role of borrowing and lending; the feasibility of the introduction of some kind of financial equalisation or transfer system; and the role of Parliament. Annexes to this communication is a brief commentary on certain other financing ideas which the Commission has examined but which do not seem, in present circumstances, to be feasible as Community resources; a fuller analysis of the idea of financial equalisation; and a discussion of the integrity and autonomy of the Community budget.

13. In setting out these ideas for a diversification of the Community's financing system, the Commission starts from the assumption that the existing range of own resources will remain intact; and that any new forms of revenue would constitute an addition to this range.

SOURCES OF GENERAL REVENUE

VALUE ADDED TAX

14. Of all the possible sources of additional general revenue for the Community Budget Value Added Tax has obvious attractions. It is an existing own resource capable of being linked directly to the taxpayer. In principle the tax base is already harmonized. The necessary mechanisms for assessment, payment and control are in place, work relatively well and ensure a large measure of continuity in financing the Community's budget expenditure. Moreover, VAT is levied on consumption and thus offers a very large reliable base, generating high revenue from a low tax rate. These revenues are adequately buoyant. For the Community as a whole, the VAT base can be expected to grow over time more or less in proportion to Community GDP. Finally because of the mechanism whereby VAT taxpayers must deduct tax already paid in order to arrive at their own net VAT bill, VAT enjoys an element of self-checking: it is thus to some degree less subject to evasion than other broadly based tax options. Thus the increase or removal of the 1% ceiling would provide a durable and reliable source of revenue which would be capable of assuring a considerable development of Community policies. It also roughly reflects the relative wealth of the Community's Member States.

15. Further measures are still required to perfect the development of the VAT system so as to enable it better to correspond to the original ideal of a direct relationship between the taxpayer and the Community. For example, although the VAT base is harmonized in principle, Member States currently enjoy a variety of temporary derogations from it which have to be compensated by financial payments based on approximate calculations of the tax which would have been due. Moreover, under transitional arrangements VAT is not perceived directly from individual taxpayers but on the basis of a weighted average involving a considerable degree of statistical estimation applied to the total revenue collected. The Commission will maintain and reinforce its efforts to secure the complete phasing out of those transitional anomalies. It is VAT which should, in the Commission's view, remain for the foreseeable future as the backbone of the Community's financial autonomy. The Commission envisages therefore that, as the Community develops a fuller range of expenditure policies additional VAT revenues beyond the 1% ceiling will be necessary, together with a more diversified system of Community financing.

PROGRESSIVITY

16. The Commission has examined the desirability and feasibility of introducing an element of progressivity into the Community's revenue system. The introduction of such a concept would be consonant with the notion of equity which is basic to all public financing systems. The political purpose of its introduction into the financing of the Community Budget would be to contribute, in a modest way, to the convergence of Member States' economies by ensuring that each Member State's liability for payments into the Community Budget was modulated either upwards or downwards in relation to that Member State's level of prosperity. It would mean that those Member States with an above-average wealth (measured most conveniently by GDP per capita) would have an increased requirement for revenue contributions whereas less prosperous Member States would be relieved. There are two broad ways of introducing progressivity into the Community financing system; either an element of progressivity could be added into the VAT system; or Member States could be progressively taxed on the basis of GDP.

17. The addition of an element of progressivity into the VAT system would mean the application of a corrective mechanism to the calculation of the VAT rate, which follows immediately after the adoption of the budget. Such a mechanism could take two forms:

- a correction of VAT in function of the per capita GDP of each of the Member States as a percentage of the Community average. This would mean that each Member State would be allocated its own VAT rate and that the actual rate applied would differ from one Member State to another;

- a correction of the VAT rate in favour of certain Member States only (e.g. a rate reduction in favour of those whose GDP per capita fell below the Community average). This mechanism would be similar to that which is at present applied, on a transitional basis, to Greece.

18. Both these methods of applying a corrective mechanism to VAT, neither of which has any counterpart in existing national VAT legislation, would require amendment to the existing own resources legislation, and both would further stretch the tenuous link between the VAT taxpayer and the Community. The replacement of a single VAT rate by ten different rates would be a major innovation which would change significantly the character of the own resources system.

19. If it were thought preferable to introduce an element of progressivity without weighting the VAT yield in this way, an alternative method would be to include in the Community's revenues, in addition to the consumption based VAT, another source of income reflecting directly the prosperity of Member States. GDP per capita is widely recognized as a

measure of prosperity and the Community has made explicit use of it for some years. A tax on Member States based on GDP could be modulated in a progressive sense by the application of a coefficient of elasticity to the percentage of contribution which the uncorrected relative GDP shares would represent. Such a progressive GDP tax would fulfil more directly the objective of promoting economic convergence in the Community by relating liability for payment to capacity to pay; and would do so in a way which avoided prejudice to the smooth operation and further development of the VAT element of the Community's present own resources.

20. Although a progressive GDP tax on Member States would thus have a number of attractive characteristics as a source of general revenue it would suffer from one significant drawback: it would be seen as a partial return to the system of financial contributions which applied before the own resources decision of 1970 and thus as a political step backwards.

21. The introduction of the concept of progressivity whether by a modulation of VAT or through a progressive GDP tax, would pose a number of technical and political difficulties. It would be necessary to agree upon how the progressive indicators of taxable capacity should be defined. Moreover, in order to have any significant impact upon the Community's budgetary problems, progressivity would have to be introduced on a scale far in excess of that which has usually been discussed in this context or than which seems realistic in current circumstances.

SOURCES OF REVENUE RELATED TO AGRICULTURAL INDICATORS

22. Agricultural policy, the only policy actually integrated, accounts for a large slice (around 65%) of the Budget. In future increasing provision will need to be made in the Budget for the new policies which the Community will have to introduce and to give effect to the forthcoming enlargement. During this phase of gradual diversification it would be appropriate for a new type of resource, drawn from the whole economy but based on agricultural parameters, to be added to the present own resources system so as to bring it more into line with the pattern of expenditure. The introduction of such a new type of resource would have the further advantage of avoiding situations in which discussions of financial problems impose artificial constraints into the normal operation of the CAP.

23. The purpose of this new resources, to be levied from the Member States, would be to contribute to the financing of the whole of the Community's expenditure, i.e. it would not be linked specifically to any one part of the budget; but it would be based upon indicators of an agricultural nature. The income from this new resource would need to be sufficiently substantial to make a worthwhile contribution to the mitigation of some of the Community's budgetary problems. But it should be conceived as a transitional, rather than a permanent element in the budget and its form should therefore be such as to ensure a

gradual reduction in its relative size, and eventually even its complete disappearance, in parallel with the development of a better reflection in expenditures of the various Community priorities suggested by the President in his 8 February speech. Amongst the hypotheses which might be envisaged, the size of the revenues which the new resources should generate might therefore be calculated in such a way as to correspond to the amount of agricultural expenditure in excess of a certain percentage of either the total budget or the total available own resources.

24. The calculation of this new resource could be made in a number of ways in relation to Member States' shares in the Community's overall agricultural production. The elements to be taken into consideration could include, for illustrative purposes, the final or added value of agricultural production in each Member State, the value of production under regimes benefiting from particular forms of Community support or a set of values modulated in accordance with the nature of such regimes. Account would have to be taken of the situation of certain Member States and their regions whose general level of prosperity is low but whose economies are particularly dependent upon agriculture.

OTHER POSSIBLE SOURCES OF GENERAL REVENUE

25. The Commission has examined a number of ideas for other possible sources of general revenue. For the reasons explained in Annex I none seem prima facie suitable at this stage as a Community resource, either because the necessary tax rate is inadequately harmonized or because the economic consequences of the imposition of a Community tax in the area concerned would be unjustifiably damaging.

REVENUES LINKED TO SPECIFIC POLICIES

26. In addition to its general revenues it might be advantageous for the Community to dispose of certain minor sources of income linked to the development of specific policies. The example of the European Coal and Steel Community Budget has shown that under certain conditions and up to a certain point expenditure in connection with policies in particular sectors can satisfactorily be financed by levies from those same sectors. Energy, research and industry suggest themselves as sectors where arrangements on these lines might be feasible. The Commission is not at this stage thinking in terms of specific practical cases: this is not a mode of financing for general use, and the desirability of employing it to fund certain items of expenditure would have to be appraised case by case according to the particular features presented by the case concerned. In this context, it would be appropriate to decide on the affectation to the Community of the customs duties on ECSC products.

INCIDENTAL REVENUES

27. The Community Budget will continue to benefit from the revenues accruing from customs duties, agricultural levies and sugar levies. The yield of these traditional own resources is substantial (currently around 8.139 MECU per year) but fluctuates from year to year and is gradually declining in accordance with the downward trend in real terms of customs duties. Various policy changes in this field could produce additional revenues in the future for example the introduction of a tax on cereal substitutes or of a tax on oils and fats. The justification of such taxes in terms of agricultural policy is not dicussed here. But neither would be appropriate as a source of regular finance for the Community Budget. A tax on cereal substitutes would have a low yield and would be subject to unpredictable fluctuations. A tax on oils and fats would, if introduced, be geared to covering expenditure necessary to maintain the level of olive oil consumption.

28. Similarly agricultural co-responsibility levies, though they can yield not inconsiderable amounts of revenue in certain years, are designed as tools of agricultural management, not as primary sources of revenue. The basic idea behind the co-responsibility levy as it is now applied in the milk sector, is to contain the surpluses above the production

target by making the producers participate financially in the market regulation mechanisms. So far, this levy is considered as an earmarked resource. In the interests of budget transparency it ought to be entred in the budget as revenue. The resources accruing from the co-responsibility levy depend on the trend in surplus products, and they therefore drop to the extent that the objectives of regulating the agricultural markets are attained.

THE ROLE OF BORROWING AND LENDING

29. In the Commission's view, loans cannot substitute for Community own resources. On the other hand, they have an important role to play for increasing the Community's participation in the financing of projects which correspond to the objectives of Community policies. In fact they already play an important role in the financing of some policies, a role which should be developed further in the future. The development of this role can be facilitated by an increase in the resources of the Community since the budget provides guarantees and in some cases interest rebates for those loans which have reached a substantial level.

FINANCIAL EQUALISATION OR TRANSFER SYSTEM

30. On 15 November 1979, the European Parliament adopted a Resolution (the Lange Resolution) on the communication from the Commission of the European Communities entitled "Convergence and Budgetary Questions". This Resolution was based on a number of considerations which remain relevant today and set out various basic principles of European finance. The Resolution:

- "considers that a new and lasting system of financial equalisation between the Member States within a Community framework - based on the concept of per capita gross domestic product and organised within the framework of the Community Budget - can effectively contribute to the furtherance of the efforts at convergence made through the common policies;"

- "calls on the Commission ... to draw up a formal proposal based on the Community system of equalisation described above and on proposals for convergence between the economies."

This Resolution was followed in 1981 by a Resolution on the Community's own resources (the Spinelli Resolution) which stated that the budget should have a more distributive role and placed the emphasis more on the modulation of resources and the development of stuctural policies.

31. The Commission fully agrees with Parliament as regards the following considerations and principles:

- "that convergence between the economies can result only from the development of genuinely common policies and from the coordination of the policies pursued by the Member States in the economic and monetary spheres, and also in the regional, social, agricultural and other sectors;"

- "that the financial imbalances which characterize the present situation and the burdens which they place on certain Member States are a serious problem which calls for an immediate solution;"

- "that it considers 'inadequate, given its incompatibility with the spirit of the Treaties, any solution based on the concept of a fair return, calling into question the principle of own resources or resorting to non-budgetary financial transfers.'"

32. In considering the possible application of a financial equalisation system to the Community, the Commission has had to bear in mind the diferences which exist between the Community as it is today and those federal states, where such a system operates. Financial equalisation in those states involves arrangements on both the revenue and expenditure side, designed to establish a unitary level of provision of certain public services. As regards the Community's revenues, the introduction of a better diversified financing system would correspond with some of the objectives of financial equalisation particularly insofar as it led to a reduction in

the liability for contributing revenue of the Community's less prosperous Member States.

33. As regards the Community's expenditure, it is clear that a budget accounting for scarcely 1% of the GDP of the Community obviously cannot bring to bear a sufficient volume of resources to impact significantly upon the full range of the Community's problems of regional differences and economic non-convergence. It is clear too that if a new mechanism were to be introduced into the Community Budget, there would have to be adequate guarantees that the transfers paid over would actually promote convergence. This would seem automatically to rule out a system of unconditional transfers, at least within the Community's current institutional framework.

34. A form of equalisation mechanism, involving transfers on the expenditure side additional to those under the Community's structural funds could nonetheless be a useful new element in the Community's budget. Such a mechanism could be geared to two purposes. It could provide additional financing so as to allow certain Member States to participate more fully in economic programmes reflecting agreed Community priorities. The interest rate subsidies disbursed in Ireland and Italy in the context of their participation in the European Monetary System are an illustration of this kind of possible transfer. Or its application could be limited to a certain number of the least prosperous Member States. The resources so transferred would need to be subject to the necessary consistency with Community policies and subject to proper Community control.

35. An equalisation mechanism of this kind would perhaps be more politically attainable in the short term. The sums required for its operation need not be excessively large. A transfer of resources limited in overall size could still have a significant economic effect upon the least prosperous Member States concerned.

THE ROLE OF PARLIAMENT

36. Any new development of the Community's financing system should, in the Commision's view, reflect and enhance the role of the directly elected European Parliament as one branch of the budgetary authority.

37. Article 201 of the EEC Treaty stipulates that the creation of new own resources is decided by Council, acting unanimously after consulting the European Parliament, and subsequently ratified by the Member States. The Commission proposed in 1973 an amendment to this Article, designed to enable the Institutions of the Community to create additional sources of revenues without having to obtain ratification by national Parliaments. This proposal covered three points: the Commission should examine in what manner new revenues could be raised; in every fifth year the Council, after receiving a report from the Commission and consulting the Parliament, should examine whether and in what manner new revenues should be introduced for the Community;

finally, the Parliament acting on a proposal of the Commission and after the Council had given its unanimous assent, might, by a majority of its members and of three-fifths of the votes cast, amend the upper limit for existing resources or make provisions for new resources for the Community.

38. This proposal of the Commission has been on the table of the Council for almost ten years. It clearly raises issues of considerable domestic sensitivity in some Member States. Nonetheless, the Commission maintains its view that if the Community is to develop as a viable political and economic entity, its institutions must have some greater degree of independence in their revenue raising powers. Whatever new sources of revenue are created, they should be of such a kind as to sustain the development of the Community for a secure period of time, without the automatic requirement for national ratification procedures. The Commission would not, for example, wish to see the 1% VAT ceiling replaced simply by a new ceiling so low that it too would soon be reached.

39. It is not in the context of the present green paper that the Commission wants to take a position on ways in which Parliament's powers in the annual budgetary procedure can be brought up to date. However, the Commission is aware of the potential relationship between decisions concerning revenues

and those concerning expenditure. It is taking note of the work which has started within Parliament on the way the budgetary procedure could be improved for expenditure as well as revenues. The manner in which the Commission will put forward its proposals on developing the Community's financing system, i.e. the presentation, first of this consultative document, has been chosen in part so as to enable the Commission to take due account of Parliament's views. The Commission would wish to associate Parliament as closely as possible with the further refinement of its ideas. The Commission envisages that these ideas will in any event be a subject for the conciliation procedure between the institutions.

* * * * *

FORMS OF REVENUE WHICH DO NOT SEEM, IN PRESENT CIRCUMSTANCES, TO BE FEASIBLE AS COMMUNITY RESOURCES

1. Excise Duties

The Commission does not consider that excise duties on cigarettes or alcohol would be a suitable source of revenue for the Community. They would not facilitate the realisation of any Community policy. For alcohol excises, there is the additional problem of the lack of harmonisation of duties on beer, wine and spirits where the Commission's proposals have not yet resulted in a Council decision.

2. Corporation Tax

The Commission has long advocated the harmonisation of corporation taxes. For Community involvement in the taxation of corporations, three hypotheses could be considered:

- the replacement of national corporation tax systems by a Community tax administered directly by the Community;

- allocation to the Community budget of part of the yield of national corporation taxes;

- the introduction of new taxes on companies earmarked for the specific purpose of financing certain expenditure from which companies benefit particularly in the research sector.

At this stage, it appears that corporation tax is not a suitable source of Community finance in the near future. This would be practical only in the long term since it would

require a uniform base on which the tax could be imposed. Such harmonisation will be extremely complex and so take a considerable amount of time. The Commission is engaged on the necessary preparatory work but would find it difficult to present a formal proposal until the Parliament has given an opinion on the Commission's 1975 proposal on Harmonisation of Systems of Company Taxation. The Parliament gave an interim opinion in 1979 but has not returned to the issue.

The third hypothesis is dealt with in paragraph 26 of the main text.

3. Income Tax

The use of personal income tax, the only real progressive tax as an own resource would depend on at least the following conditions being met:

- harmonisation of its scope, that is definition of the natural and legal persons to be taxed;
- harmonisation of the base which requires common rules to determine personal income, not just of individuals, but also of industrial and commercial firms and agricultural enterprises not subject to corporation tax.

The complexity of this harmonisation and its political implications probably mean that action is unlikely to be taken in the foreseeable future in this field.

4. Taxation of hydrocarbons

The benefit of a tax on hydrocarbons must be assessed in a general economic and political context. In the event of a future decline in world market prices of oil, some fiscal intervention might be

appropriate on these grounds. The Commission, in its communication COM(81) 555, has put the main emphasis on the coordination of national tax policies in relation to the Community's economic and energy policies. Although it is possible that, in addition to such national coordination, the imposition of a specific Community tax might merit further study, such a tax, even if introduced, could not be expected to yield significant amounts of revenue.

FINANCIAL EQUALISATION

In the light of the suggestions often made (particularly in the context of the Lange Resolution of November 1979) for the introduction of financial equalisation arrangements in the Community financing system, the Commission has thought it useful to set out briefly:

- what is meant by financial equalisation and what is its purpose;
- how financial equalisation operates in certain existing federal systems, notably Switzerland and the Federal Republic of Germany;
- what conclusions might be drawn for the Community from the operation of these financial equalisation arrangements.

Financial equalisation in the strict sense means a systematic process of financial transfers directed towards the equalisation of the budget capacity or economic performance of different levels of federal governments. A purpose of such equalisation is to enable states to ensure the provision of a comparable range and quality of public services for their citizens while maintaining broadly comparable fiscal burdens in the form of standard rates of taxation and other charges.

Financial equalisation systems exist in practice in all major western federations: Germany, Switzerland, Austria, the United States, Canada and Australia. They are of broadly two types: horizontal systems where the equalisation takes place between the various subsidiary levels of government; and vertical systems where it takes place through the fiscal activities and powers of the central government. Equalisation systems normally have two elements: general purpose equalisation on the revenue side and a specific purpose grant system (e.g. for social services, health, education or transport) on the expenditure side. The

precise mix and scope of the system varies considerably from one federation to another. But problems may arise when general and specific purpose equalisation payments are made in conjunction: the effect of one form of payment may in some circumstances either duplicate or be incompatible with the effect of the other.

In Switzerland, there exists a system of vertical financial equalisation. Subsidiary authorities (in this case the cantons) receive varying payments from the Confederation in accordance with specifically defined needs. The cantons have a direct share in the Confederations's revenue (where revenue equalisation operates) and in its expenditure, in the form of federal grants (where expenditure equalisation applies).

Revenue equalisation covers the number of taxes recorded in the Swiss constitution which the Confederation has to share with the cantons. The shares which the Confederation and the cantons as a whole receive from each source of taxation are laid down by the constitution. Revenue equalisation applies only to the distribution of the cantons' share between the individual cantons. Different scales of apportionment are laid down for each tax. The bulk of tax revenue is divided up in proportion to the canton's population (though its defence tax capacity is also taken into account).

No conditions are imposed on how the cantons may use the funds received from federal taxes (though conditions are attached to the use of the separate Federal expenditure grants to which the cantons are required to make a contribution of their own). Equalisation on the expenditure side applies, in that the cantons are granted varying rates of aid. The Confederation's percentage contribution to the canton's programmes or projects is mainly based on its fiscal capacity index. This index, mainly based on tax burden, taxable capacity, size of population and geographical/

regional factors, gives each canton a rating on the basis of which its requirements for additional funds in relation to those of the other cantons are assessed.

The Swiss system of equalisation avoids direct payments from one canton to another. Financial equalisation operations are always conducted centrally and are based on criteria which take into account the financial requirements and fiscal capacity of the cantons. This gives greater protection for the cantons' fiscal independence than would a horizontal system of financial equalisation. But the corollary of this greater independence is a wider range of discrepancy between the cantons in the provision of public welfare services.

In Germany, in addition to a vertical equalisation arrangement through the VAT sharing system which increases the tax capacity of each 'Land' to a level of 92% of the average, there is a horizontal system of inter-land equalisation. The German 'Länderfinanzausgleich' is unique in the world in that it provides for horizontal payments from fiscally rich to fiscally poor states without affecting the federal budget. It has been created in special post second world war circumstances where a particularly high degree of solidarity between the 'Länder' was required in order to cope with the problem of rebuilding the German economy and absorbing the refugees from the lost territories.

The 'Länderfinanzausgleich' is designed to ensure that a below average 'Land' always reaches 95% of the per capita average tax receipts of all 'Länder' and that a 'Land' required to make equalisation transfers does not, as a result, fall below 100% of the average. The level of equalisation contributions/grants is determined by the relationship between a tax capacity indicator ('Steuerkraftmesszahl') and an expenditure need indicator ('Ausgleichsmesszahl').

The 'Länderfinanzausgleich' is part of a more general financial equalisation between the 'Länder'. On the revenue side, in addition to the VAT sharing system additional payments ('Ergänzungszuweisungen') are made by the 'Bund' to the less prosperous 'Länder'. Finally, on the expenditure side, a system of specific purpose grants exists in the areas of university and hospital construction, regional policy, agricultural structural policy, coastal protection, urban development, etc.

In view of the special circumstances which led to the horizontal German 'Finanzausgleich' and the fact that this is operated outside the federal budget , it can hardly be regarded as an appropriate model for a new Community system.

Some kind of vertical system might seem more promising as a possible model for the Community. Nevertheless a number of preconditions would need to be fulfilled: first, the Community would have to have the necessary budgetary means at its disposal for making any equalisation payments. At the moment, when the Community is not a federal state and because its powers are limited, its budget, in contrast to the budget of federal states, is smaller than the budgets of its constituent members and the scope for financial equalisation is consequently restricted from the outset. Secondly, an agreed overall political aim and objective method for calculating the equalisation payments would have to be set up and it would need to be geared to the objective of convergence. Finally, an effective monitoring in respect of this objective would have to be put into place.

The Lange Resolution calls for a "new and lasting system of financial equalisation between the Member States within a Community framework - based on the concept of per capita GDP and organised within the framework of the Community Budget". This would imply not a full fiscal equalisation system as practised in existing Federal states, but a more limited mechanism geared towards partial economic equalisation or transfers.

The existing Community structural funds (particularly the Regional and Social Funds) already constitute a first step in this respect. But it would of course be possible to develop the idea of resource transfers further and to introduce a more far-reaching transfer mechanism expenditure into the Community Budget.

Such a mechanism, linked to the aim of economic convergence, would however need to be geared to the following considerations:

- the revenue raising capacity;

- identifying the public finance functions for which a need for resource transfers exists at the level of the Community;

- in respect of the selected functions
  - . the measurement of expenditure needs
  - . the degree of transfer appropriate

The political and technical complexities involved in this should not be under-estimated. In existing federations, equalisation systems have evolved over a long period of time and have a well-established tradition. The Community is however more heterogeneous in economic capacities, policies and traditions than existing federations. It is probably unrealistic therefore to envisage at this stage more than a modest step in this direction, perhaps by the introduction in complement to the existing structural funds of a special fund geared either to the provision of additional finance for activities reflecting particular Community priorities or limited in application to the Community's least prosperous Member States.

THE GLOBALITY AND AUTONOMY OF THE COMMUNITY'S BUDGET

In addition to the Community's general budget, two other budgets exist through which expenditure on Community policies is disbursed, namely the European Development Fund and the operational budget of the European Coal and Steel Community. For both of these separate budgets there are different financing arrangements. The EDF is financed by special contributions by Member States calculated according to a political key. The ECSC operational budget is financed mainly by a production levy on coal and steel enterprises (although in recent years special contributions from Member States or from the general budget have also been made).

The existence of sources of finance for Community expenditure outside the general budget is at variance with the principle of the unity of the budget and has been criticised by the European Parliament. As regards the European Development Fund, the Commission is committed to supporting its full budgetisation and is proceeding on the presumption that the successor to the Lomé Convention, which will enter into force in 1985, will be so budgetised. In addition to the issue of principle, there are practical advantages to this. The distinction between associated and non-associated developing countries can no longer be rigidly applied in the budgetary field. Programmes covering both sorts of countries have already been proposed by the Commission under the general budget despite the separate existence of the EDF.

As regards the ECSC, however, the Commission remains sceptical about the advantages of incorporating its budget into the general budget. The reasons lie in the separate juridical existence of the Paris Treaty and the particular characteristics of the ECSC Budget, for example its role in support of borrowing and lending and the direct relationship which it embodies between sources of revenue and areas of expenditure. Nonetheless, it seems likely that the demands of Community expenditure in certain ECSC areas, particularly the steel social field, will be so acute over the next few years that the ECSC Budget will be unable to cope with them. This means either that the ECSC Budget will need to be supplemented significantly by revenue from the General Budget or from Member States; or that certain types of expenditure in the social and other fields, hitherto falling under the aegis of the ECSC Budget, will need in the future to be implemented through the general budget.

There is in any event one further anomaly in the current ECSC and Community Budget arrangements which in the Commission's view ought to be speedily rectified. Customs duties on ECSC products are not paid over like other customs duties to the Community, but are retained by the Member States. They amount currently to around 50 MECU per year. The Commission and the Parliament have for some time urged the transfer of these duties to the Community, but the Council has not so far agreed.

As regards the financial autonomy of the Community, there are a number of areas where the Community's current powers over its own resources are severely restricted and where the removal of such restrictions would constitute a logical strengthening of the Community's

present competence. The first set of restrictions concerns the availability of own resources and other revenue derived from Member States. The Community does not in practice freely dispose of such revenues at the present time. They are not placed unconditionally and definitively at the disposition of the Community but may only be withdrawn from the accounts with the Member States' treasuries to the extent necessary to cover cash resource requirements arising out of the implementation of the Budget. These accounts bear no interest and the Commission is prevented from depositing the funds in them in interest bearing accounts. Moreover, any balance between actual income and expenditure at the end of the year is not retained by the Community but must instead be entered in an amending budget of the following year: the balance is thus in effect returned to the Member States.

Similarly, when Member States send to the Commission the statements of their VAT bases for the preceding year, and pay or are refunded the difference between the actual amounts due and the provisional amounts made over, these payments or refunds are immediately entered in an amending budget.

This situation reflects the system whereby the budget was financed entirely by financial contributions from Member States, not a system of true Community own resources. Removal of the restrictions in question would be relatively easy, as they are contained in regulations and their modification would not therefore require ratification by Member States' Parliaments. The Commission has already submitted proposals of a limited nature to improve the situation. In its suggested modifications to the Financial Regulation it proposed

that the balance of a budget year could be kept for a full further year before being entered in an amending budget. And in its proposals for amending Council regulation number 2891/77 implementing the decision of 21 April 1970, it proposed that the Commission's accounts with Member States' treasuries be interest bearing.

A further budgetary innovation which, in the Commission's view, merits study, relates to unused FEOGA Guarantee appropriations. In the Commission's opinion such unused appropriations, which because of the volatile and unpredictable nature of agricultural expenditure are bound occasionally to occur, could appropriately be placed, either in full or in part, in a reserve which could be used to cover additional FEOGA Guarantee financial needs in a future year.