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Volume I/II

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COMMISSION OF THE EUROPEAN COMMUNITIES

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Volume I

Report from the Commission

Financing the European Union

Commission report

on the operation of the own resources system

INTRODUCTION

Article 9 of the current own resources decision¹ calls on the Commission to

"undertake, before 1 January 2006, a general review of the own resources system, accompanied, if necessary, by appropriate proposals, in the light of all relevant factors, including the effects of enlargement on the financing of the budget, the possibility of modifying the structure of the own resources by creating new autonomous own resources and the correction of budgetary imbalances granted to the United Kingdom as well as the granting to Austria, Germany, the Netherlands and Sweden of the reduction pursuant to Article 5(1)".

In response to a request from the European Parliament and in agreement with the Council, the Commission committed itself to present the abovementioned review on the functioning of the financing system before the end of 2004.

On 10 February 2004 the Commission adopted its communication² on the Financial Perspective 2007-2013. The communication identified two main elements of the current own resources system deserving closer attention: first, the insufficient transparency of the system for EU citizens combined with limited financial autonomy from national treasuries; secondly, the need to reform the existing mechanism for correction of negative budgetary imbalances.

In line with those orientations, this report provides an overview of the current system and its main drawbacks, proposes a generalised correction mechanism as a short term adjustment in order to address the main outstanding issue and outlines for the longer term an own resources structure that would be effective, transparent and democratic.

A more detailed assessment of these issues can be found in the Commission working document annexed to this report.

1. THE CURRENT OWN RESOURCES SYSTEM

The current own resources system is the result of successive modifications of the original system introduced in 1970. The system may be divided into the following three categories:

- (1) Traditional own resources (TOR). These are mainly customs duties collected by Member States on behalf of the EU.
- (2) The resource based on value added tax (VAT). The VAT resource is levied on the statistical 'notional' *harmonised* VAT bases of Member States, which is calculated on the basis of national VAT receipts.

Furthermore, the notional VAT base is 'capped', where applicable, at 50 % of each Member State's gross national income (GNI) to reduce the effect of the slightly 'regressive' character of VAT. In practice, this turns the VAT-based own resource into a GNI-based resource for the countries concerned by the capping rule.

The call rate on VAT cannot exceed 0.5 % of the base.

¹ Council decision (2000/597, EC, Euratom) on the system of the European Communities' own resources, OJ L 253, 7.10.2000, p. 42.

² COM(2004) 101 final of 10 February 2004.

- (3) The GNI-based resource. This is the residual resource used to balance the budget. It is levied as a uniform rate in proportion to the GNI of each Member State. There is no particular limit on this rate other than the own resources ceiling that limits the total amount of all own resources to a maximum of 1.24 % of the EU's GNI.

Finally, a specific mechanism for correcting the budgetary imbalance of the United Kingdom is also part of the own resources system (see section 3). It has been modified on several occasions, rendering the mechanism increasingly complex and non-transparent.

The latest changes to the own resources system were decided by the European Council in Berlin in 1999. These changes further reinforced the declining trend of traditional and VAT-based own resources and the corresponding increase in the relative share of the GNP³/GNI-based contributions.

Table 1 – The composition of EU own resources
(in per cent of total own resources; cash basis)

OWN RESOURCES 1996-2005										
	1996	1997	1998	1999	2000	2001	2002¹	2003	2004²	2005³
TOR	19,1%	18,8%	17,2%	16,8%	17,4%	18,1%	11,9%	13,0%	12,0%	11,4%
VAT	51,3%	45,5%	40,3%	37,8%	39,9%	38,7%	28,8%	25,4%	14,6%	14,1%
GNP/GNI	29,6%	35,7%	42,5%	45,4%	42,7%	43,2%	59,3%	61,6%	73,4%	74,5%
Total own resources (€ billion)	71,1	75,3	82,2	82,5	88,0	80,7	77,7	83,6	93,3	108,5

¹ As from 2002 the % of TOR retained by Member States as a compensation for their collection costs was raised from 10 % to 25 %. This difference represented about € 2.2 billion in 2002 as well as in 2003.

² Preliminary draft amending budget 8/2004 (EU-25).

³ Preliminary draft budget 2005.

2. ASSESSING THE PERFORMANCE OF THE CURRENT OWN RESOURCES SYSTEM

2.1. Assessment criteria

The own resources system and individual own resources can be assessed against specific criteria. It is virtually impossible for individual own resources to satisfy all possible assessment criteria. However, a system based on a combination of resources of different nature may reasonably meet the main relevant criteria.

³ Prior to 2002, the GNP (gross national product) resource.

The following seven assessment criteria are considered relevant to this report:

- *Visibility and simplicity;*
- *Financial autonomy;*
- *Adding to the efficient allocation of economic resources;*
- *Sufficiency;*
- *Administrative cost-effectiveness;*
- *Revenue-Stability;*
- *Equity in gross contributions;*

2.2. Assessment

The current system has performed well as regards the criteria of sufficiency and stability, but clearly fails to fulfil the visibility and simplicity criterion and does not contribute significantly to a more efficient allocation of economic resources in the EU. The financing system has grown increasingly complex over time, making it difficult even for the interested citizen to understand how it works. Financial autonomy is, furthermore, becoming more and more limited. Although the financing of the budget is ensured by rules that are binding for all Member States, there is virtually no direct link to citizens or tax-payers. Instead the financing of the budget relies on transfers from national treasuries. As for the remaining criteria the current financing system has shown various shortcomings, as explained more in detail in the Commission working document annexed to this report.

3. PREVENTING EXCESSIVE NEGATIVE BUDGETARY BALANCES

3.1. The issue of budgetary imbalances

The European Union is a community of solidarity with parts of the EU budget serving a clear solidarity goal, while others fund the achievement of specific objectives through EU agreed programmes. That gives rise to budgetary net benefits from, and net contributions to the EU budget, although the policy benefits accrue to the Union as a whole.

Budgetary net balances, measured by the difference between contributions to and receipts from the EU budget, obviously fail to account fully for the benefits resulting from membership in the EU.

Nevertheless, the size of some of these imbalances has been at the centre of political discussions. In 1984 the Fontainebleau European Council introduced the existing correction mechanism with regard to the net contribution of one member state, the UK. This mechanism reimburses the UK by 2/3 of its net contributions according to the concept of allocated expenditure. The introduction was based on the general principle 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.'

Although the correction was only decided for the UK, the principle of a generalised correction was therefore already acknowledged in Fontainebleau ('any Member

State'), with the correction to be based on the size of the budgetary imbalance ('excessive') and the wealth of a Member State compared to the EU as a whole ('relative prosperity').

Over the last 20 years, economic developments, enlargement and changes in the structure of the EU budget have significantly modified the context in which the existing UK correction mechanism operates.

The table below shows the development of gross national income (GNI) per capita, expressed in purchasing power standards (PPS⁴), between the years 1984 and 2003 for all Member States that were net contributors to the EU budget in the year 2002⁵.

GNI per capita of net contributors (in PPS) (EU-15 average. = 100)		
	2003	1984
United Kingdom	111.2	90.6
Denmark	111.1	104.0
Austria	109.8	--
Netherlands	106.6	95.0
Sweden	104.6	--
France	104.2	104.0
Germany	98.6	109.6
Italy	97.3	92.9

In view of the dramatic shift in the UK's position compared to the other net contributors and in application of the Fontainebleau principle the granting of a correction on an exclusive basis to the UK should be re-considered. Therefore, the existing mechanism should be transformed into a generalized correction mechanism, respecting the twin goals of

- preventing excessive negative budgetary balances combined with a reduction of differences between net contributors at comparable levels of prosperity;
- ensuring that the financing costs of the mechanism are kept at a reasonable level.

3.2. Impact of the existing correction mechanism on the net balances of Member States

In the existing mechanism the UK's reimbursement of its net contribution is 66%. The mechanism is financed by all Member States according to their respective shares in GNI with the following exceptions:

- The UK does not participate in the financing of its own rebate
- The share of DE, NL, AT and SE is restricted to 25% of their normal shares

⁴ The PPS is an artificial currency that reflects differences in national price levels that are not taken into account by exchange rates. This unit allows meaningful volume comparisons of economic indicators among countries.

⁵ Net balances presented in this document, like those used for the UK correction, are calculated including administrative expenditure. For this reason, Belgium and Luxembourg do not appear among the net contributors. As the correction is paid one year later, the 2007 correction is to be paid in 2008.

While the UK's net position before correction has changed little since its introduction (-0,48% of GNI in 1985 and -0,47% during the period from 1996 to 2002), its final net position has improved significantly compared to other Member States at similar or even lower levels of prosperity, like NL and DE (-0.47% and -0.44%, respectively).

A very significant factor for assessing the existing correction mechanism is its impact of enlargement. With the accession of new net beneficiaries the net balances of all old Member States will deteriorate as a growing share of expenditure is allocated to the new Member States. However, as a consequence of the current mechanism the volume of the correction will increase very significantly for the UK. The cost for the other Member States, including all new Member States, will increase. Should the current correction mechanism remain in force, the UK correction would, according to Commission estimates on the basis of the Commission's proposal for the 2007-2013 financial perspective, increase by more than 50%.

3.3. The proposed generalised correction mechanism

The Commission proposes a generalization of the correction mechanism, evolving from the existing correction in order to bring the system closer to the original objective of avoiding excessive budgetary burdens. By introducing a sort of 'safety net' for large net contributors whose net contribution exceed a certain level, it may also facilitate a more constructive approach to ensure budgetary means to meet the policy challenges of the enlarged Union.

The future correction is to be calculated on the basis of the net budgetary balance of each Member State in relation to the budget of the EU. The mechanism should be triggered if net contributions exceed a threshold, expressed as a percentage of each Member State's GNI, reflecting the minimum accepted level of unlimited financial solidarity between Member States. Net positions exceeding such a threshold will be eligible for a correction (partial refund), thus giving an insurance against excessive net contributions. Conversely, the total volume of corrections (refund volume) will be limited to a maximum amount, thus insuring those not benefiting from a correction against excessive costs of the mechanism. If the sum of all corrections exceeds the total predetermined volume, the refund rate is reduced accordingly.

Any correction mechanism entails complications to the financing of the budget. Therefore the basic proposal should be relatively simple and sufficiently transparent. In this respect, the current parameters used for the UK correction calculation should be modified only where necessary and simplified whenever feasible.

The new mechanism proposed by the Commission contains the following elements:

- setting a threshold level as a percentage of GNI;
- capping the total volume of corrections;
- simplifying the financing of the corrections by basing them on GNI shares, whereby all Member States participate in the financing of the global amount of the corrections in proportion to their relative prosperity;
- keeping the concept of allocated expenditure and the re-imburement rate up to the maximum volume unchanged.

According to this proposal, the UK would be by far the largest beneficiary from the generalised correction mechanism. According to the Commission's proposal on the next Financial Perspective and the proposal on a generalized correction mechanism, the UK would receive on average a net compensation approximately twice as much as that of D.

Table 6. Estimated net budgetary balances (average 2008-2013)			
	<i>in % of GNI</i>		
	GCM	Current ORD	No correction
United Kingdom	-0.51%	-0.25%	-0.62%
Netherlands	-0.48%	-0.56%	-0.55%
Germany	-0.48%	-0.54%	-0.52%
Sweden	-0.45%	-0.50%	-0.47%
Austria	-0.41%	-0.38%	-0.37%
Italy	-0.35%	-0.41%	-0.29%
France	-0.33%	-0.37%	-0.27%
Cyprus ⁶	-0.33%	-0.37%	-0.28%
Denmark	-0.25%	-0.31%	-0.20%
Finland	-0.19%	-0.25%	-0.14%
Spain	0.26%	0.23%	0.32%
Ireland	0.51%	0.47%	0.56%
Malta	1.10%	1.06%	1.16%
Belgium ⁷	1.27%	1.21%	1.32%
Slovenia	1.34%	1.31%	1.40%
Portugal	1.54%	1.50%	1.60%
Greece	2.20%	2.16%	2.25%
Hungary	3.09%	3.06%	3.15%
Czech Republic	3.21%	3.17%	3.26%
Slovakia	3.31%	3.27%	3.36%
Estonia	3.79%	3.76%	3.85%
Poland	3.80%	3.76%	3.85%
Lithuania	4.44%	4.41%	4.50%
Latvia	4.45%	4.40%	4.51%
Luxembourg ⁷	5.84%	5.80%	5.89%

The table above illustrates Member States' estimated average net budgetary balances resulting from the proposed generalised correction mechanism over the period till 2013 and compares it to the continuation of the current mechanism and to a situation without any correction.

The generalized correction mechanism will decrease the negative net balances, reduce the spread among net contributors, and, on the other hand, lessen the financing burden of those who do not benefit from the mechanism⁸.

The Commission presents separately a specific proposal for modifying the current own resources decision in view of introducing the proposed generalised correction mechanism.

⁶ Estimates based on areas controlled by the Republic of Cyprus.

⁷ When excluding administrative expenditure, Belgium and Luxembourg appear as net contributors.

⁸ See attached technical annex for more detail.

4. THE OWN RESOURCES STRUCTURE

4.1. Finding the optimal own resources structure

Three basic alternatives for the financing of the EU budget are discussed below. In all three cases traditional own resources (TOR) would be maintained, as the collection of import duties constitutes an instrument of the Union's trade policy whose yield 'naturally' accrues to the Union.

(1) *Maintaining the present financing system unchanged*

The present financing system has ensured a smooth financing of the EU budget. However, in its present form the financing system lacks a direct link to citizens. Past adjustments to accommodate specific interests have added to the system's opacity. The budgetary consequences of the Union's policies thus remain palpable to the general public. With the overwhelming weight of the GNI resource, Member States, and in particular net contributors, tend to judge EU policies and initiatives exclusively in terms of their national allocation and with little regard to the substance of policies, with the risk of obscuring the added value of EU policies.

Because of the absence of any link to and visibility for EU citizens, and the increasing incentive to focus on narrow budgetary concept of 'juste retour', the current system should be reformed.

(2) *A purely GNI-based financing system*

Under a financing system exclusively based on the GNI key the Union would entirely depend on 'contributions' from Member States. The advantage of such a system is that it would be simple and easy to understand. The 'contributions' would correspond closely to Member States' relative prosperity. But financing the budget by contributions of the Member States may be adequate for an international organization such as the UN. It does, however, not reflect the status of the European Union. It would imply an idea of the Union in which citizens would be represented purely indirectly by their Member States. The status of the EU as a Union of Member States and the citizens, which is currently reflected in the Treaty, would be abandoned on the financing side of the budget. This, in turn, would imply ditching the concept of 'own' resources which has been a cornerstone of EU finances since the first own resources decision in 1970. The Commission rejects such an alternative.

(3) *A financing system based on fiscal own resources*

A system based to a large degree on tax-based own resources has the potential to increase the financial autonomy of the EU budget by creating a more direct financial relationship between the EU budget and EU citizens. The shift towards individuals and economic operators as contributors, and the corresponding reduction of Member States' contributions to the financing of the EU budget would entail higher visibility towards citizens and thus increased political accountability of the budgetary authority for their expenditure decisions. It would also contribute to shifting the political

discussion away from the narrow focus on national contributions towards the merit of EU policies and the general European interest. Finally, increased visibility would enhance trust in the EU's finances, whose volume of less than 2.5% of total public expenditure in the EU is often over-estimated.

However, also a fully tax-based financing of the EU budget does not appear appropriate. As the balanced budget requirement of Art. 268 of the treaty is not and should not be put into question, a fiscal resource assuming the current role of GNI as 'residual' balancing resource would either involve a variable tax rate according to budgetary requirements or require a higher flexibility on the expenditure side than the current financial perspective framework allows. However, frequent amendments to the tax rate would in practice be unwelcome by taxpayers (legal uncertainty, technically and administratively cumbersome procedures) and could conflict with national tax-setting. A progressive approach, consisting in maintaining a limited GNI resource while increasing the share of tax-based resources, appears preferable.

A reform of the own resources structure should thus focus on the budgetary neutral introduction of a new tax-based own resource representing up to half of the budget.

5. TOWARDS A FINANCING SYSTEM BASED ON CONTRIBUTIONS BY MEMBER STATES AND CITIZENS

5.1. Increasing the share of tax-based own resources

The reform of the financing system should tackle the drawbacks of the current system, i.e. the absence of a direct link to EU citizens, dependence on transfers from national treasuries and unjustified complexity, while contributing as far as possible to an efficient allocation of resources. Other criteria become less relevant for the new resources, as long as the overall system allows them to be met to a reasonable degree.

For reasons of equity between citizens in different Member States, the introduction of new fiscal resources requires a sufficient prior harmonisation of the tax base. The choice of the most appropriate tax-based resource crucially depends on the actual degree of tax base harmonisation.

The existence of regional arbitrariness⁹ or the presence of cross-border externalities are strong arguments for harmonising tax bases and rates, which could also justify assigning all or part of the corresponding tax revenue to the EU level. This could contribute to reducing inefficient allocation of economic resources.

Increasing the share of tax-based own resources for the EU budget does not require any new taxes. It does, however, imply a decision on sharing either revenue or tax rates between the national and the EU level. The EU share could be levied as part of the national rate paid by taxpayers. The total EU budget, anyway limited by the own resources ceiling to a maximum of 1.24% of EU-GNI, would not increase, as

⁹ Regional arbitrariness refers to a situation where it is difficult to determine the exact share of a tax base to be allocated to individual Member States or where there is a high (potential) mismatch between the country collecting the tax and the country of residence of the economic agents bearing the burden of the tax.

revenue from the tax-based resource would be offset by a corresponding decrease of the current GNI-based resource.

The following sections illustrate three main options in order to improve the functioning of the EU financing system. All three retain the current GNI-based resource as a residual balancing resource as well as the traditional own resources, but assume that up to half of the budget is financed by a new fiscal resource that would also replace the current statistical VAT.

5.2. Option 1 – An own resources system with fiscal resources related to energy consumption

Under the new directive on energy taxation¹⁰ most energy products are subject to Community taxation. Although the adopted directive on energy taxation was not prepared for the purpose of introducing new own resources, it nevertheless creates suitable conditions for it by harmonising tax bases and establishing minimum rates.

A fiscal resource on energy products would, however, not need to be based on all products covered by the directive. An EU levy could be limited to the tax base related to motor fuel used for road transport (leaded and unleaded petrol, diesel, LPG and natural gas used for transport). This would be relatively simple from an administrative point of view as the tax base is already harmonized at EU level and as most possibilities of tax differentiation allowed by the directive apply to other energy products. EU rates below half of the minimum rates in the energy taxation directive would be enough to finance half of the EU budget. The main decisions would bear on the rates to apply and possible variations according to the product and use.

¹⁰ Directive 2003/96/EC of 27.10.2003 of the Council restructuring the Community framework for the taxation of energy products and electricity (OJ L 283 of 31.10.2003).

An EU levy on aviation fuel or the related emissions might be a useful complement to a levy on motor fuel for road transport. The European air transport system is highly integrated and aviation emissions transcend national borders. There are therefore good arguments for taxing such emissions at the EU level, as a way of internalising the external socio-economic costs of climate change and other environmental effects caused by aviation into the price of air travel. However, aviation fuel (kerosene) is currently exempted from taxation for cross-border flights.

From a technical point of view, the introduction of a fiscal resource based on road transport fuel would be possible in a relatively short period of time (around 3-6 years).

5.3. Option 2 – An own resources system with a fiscal VAT resource

Due to its direct link with daily consumption, and contrary to the current “statistical” VAT resource, the application of an EU rate to national VAT bases would create a clear direct link between the financing of the EU budget and the citizen and increase awareness of the costs of the Union.

A genuinely fiscal VAT resource would be implemented through an EU rate as part of the national VAT rate paid by taxpayers. The rate would be levied together with the national rate on the same taxable base. Citizens would not have to bear an additional tax burden as the EU rate would be offset by an equivalent decrease of the national VAT rate. For example, if the national VAT rate were at 21 %, and an EU rate at 1 %, the national rate would come down to 20 %. The total VAT rate levied would still be 21 %.

For visibility purposes, the EU VAT and the national VAT should appear as separate taxes on the invoice or receipt that a taxable person provides to his customer.

An EU rate of 1 % would be enough to cover about half of the financing needs of the EU budget.

Potential difficulties with this proposal are related to incomplete harmonisation of Member States’ VAT systems mainly linked to zero-rated goods. Another potential difficulty may stem from a different share of the VAT base in national income across Member States (the so-called regressivity of VAT), which since 1988 has pushed Member States to reduce its share in own resources. On the other hand, seen from a consumer perspective, the EU rate would have the same impact on comparable consumers across the Union¹¹.

Technically, the introduction of an EU VAT rate would be possible in a relatively short period of time (up to 6 years).

¹¹ Assuming the effect of zero-rates are neutralised (see also annex to this report).

5.4. Option 3 – An own resources system with a fiscal resource based on corporate income

As for the other two options, also an EU fiscal resource based on corporate income would require a prior definition of a common (consolidated) tax base, which would be applied to companies. Such harmonisation would contribute to the proper functioning of the internal market and a more efficient allocation of economic resources which are currently distorted by cross-border externalities. Today, the existence of 25 separate national tax systems and the multiplicity of tax laws, conventions and practices represent in itself a barrier to cross-border economic activity. It imposes substantial compliance costs on companies operating across borders in the EU and leads to numerous loopholes in the tax system.

Current work on a comprehensive reform of company taxation is focussed on the concept of a common (consolidated) tax base, in all likelihood for a sub-group of interested Member States, to remove tax obstacles to the internal market. This work does not envisage any action on tax rates, nor is it conceived as a method for raising revenues for the EU budget.

The option of a corporate income tax would imply setting a minimum tax rate to the harmonized tax base.

Revenue from corporate income taxes is significant, with total revenue in the EU currently representing on average 2.6 % of total EU GNI. Thus, for the needs of the EU budget less than a quarter of that revenue would need to be assigned to the EU.

Given the current state of affairs, this alternative would take longest to implement, both from a political as well as from an administrative perspective.

6. SUMMARY AND CONCLUSIONS

The introduction of a new tax-based own resource replacing the current statistical VAT-based resource and financing a significant part of the EU budget would make it possible to overcome the main drawbacks of the current system, i.e. the absence of a direct link to EU citizens, overwhelming dependence on transfers from national treasuries and unjustified complexity. It could also contribute to a better allocation of economic resources in the EU. Even if accounting for a lower share of total own resources than under the current system, the GNI-based resource should continue to play an important role and ensure that the system reasonably fulfils all relevant criteria.

The Commission proposes three main candidates as possible future fiscal own resources: a resource based on 1. energy consumption, 2. national VAT bases and 3. corporate income.

A resource based on energy consumption and conceived as an EU levy on motor fuel for road transport would be a sufficient and stable financing source for the EU budget and would create a direct link to the citizens. The tax base is already harmonised at EU level. It could be complemented by an EU levy on aviation fuel or the related emissions thus ending the current tax exemption for jet fuel and setting a price on the environmental costs of aviation.

Tax base harmonisation in the field of VAT is quite advanced and it is a sufficient and stable source of revenue. A fiscal VAT resource would make the financing of the

EU highly visible to EU citizens. It would also be evolutionary, since it would entail a reform of existing provisions rather than the introduction of a completely new resource. From an administrative point of view, its introduction would not present any insurmountable difficulties.

Due to the link to a common EU policy and the presence of cross-border externalities, revenue from a harmonised company tax base would also be a suitable financing source for the EU budget.

The European Union is a Union of Member States and citizens. Any of the three candidates for fiscal own resources examined above would transpose this concept into the area of financing the EU budget. Strengthening the direct link of citizens to the budget would also help focussing expenditure debates on substance rather than on purely "national" budget "net positions".

Obviously, any new assignment of a resource to the EU budget has not only to be decided unanimously by Council, but also has to be ratified by all Member States' parliaments.

The implementation of an energy- or VAT-based resource would be feasible over the medium-term, whereas a fiscal resource based on corporate income is to be seen as a much longer-term option. What is needed now is a political orientation to prepare the conditions for reforming the structure of the existing own resources. In this regard, the Commission calls on the Council:

- to discuss the options proposed in this report;
- to take note of the Commission's intention to prepare a roadmap in view of replacing, on the basis of a Commission proposal, the current VAT resource by a genuinely tax-based own resource by 2014.

In order to provide a short-term solution to the issue of excessive budgetary imbalances to be operational as from the beginning of the next Financial Perspective, the Commission proposes

- to introduce a generalized correction mechanism to correct excessive budgetary imbalances according to the proposed Council decision on the system of own resources and the accompanying proposed implementing measures.