COMMUNITY BUDGET : PRESENT AND FUTURE.

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1. The Community Budget and Economic and Monetary Union

The budget of the European Community is the key measure of European economic integration. It reflects the few joint economic policies that the member-states currently operate-the Common Agricultural Policy, the Social and Regional Funds, and Community Development Aid - and would reflect any advances in economic and monetary union-industrial policies, employment schemes, deficit financing facilities, Community fiscal policies, etc.

As a benchmark, its smallness and lack of any substantial growth measure the current undynamic state of Community economic integration.

Just as monetary union has proved a chimera without economic union, so economic union is stymied without movement toward political union. A directly-elected European Assemby may, but only may, start the ball rolling. If it does, the technicalities of budget expansion, discussed in this paper, will become important.

2. Present Size and Structure of the Community Budget

The magnitude of the budget in 1976 is 7576 mn. units of account or approximately £4500 mn. This represents below 1% of the combined GNP of the Nine, i.e. of the Gross Community Product.

The budget is balanced, this figure represents total expenditure and total current income received. There are no current/capital, «above the line»/ «below the line» distinctions.

Some 98 % of expenditure is on account of the Commission, miniscule amounts for the operation of the European Parliament, Council and Court of Justice.

The percentage distribution of budgetary income and expenditure over principal items is as follows :

Revenue (%)		Expenditure (%)	
Customs Duties	46.9	Administration	7.6
Agricultural levies	9.7	Re-Imbursement to Member-States	5.7
Contributions based on GNP	42.6	Research and Development	1.8
		Social Fund	5.8
		Regional Fund	4.0
		Agriculture : Guarantee	68.1
		: Guidance	4.3
		Development Assistance	2.7
	100.0		100.0

The revenue side of the budget represents a transitional phase between the old system of direct contributions by member-states, and the new system of «own resources» agreed for the Community in 1970 by the Six, and accepted by the acceding Three on entry in 1973.

When realised, the new system will grant the Community its own resources from three sources, customs duties, agricultural levies, and an additional sum to meet the balance of agreed expenditures from the V.A.T. revenues of Member-States, but not to exceed the equivalent of a 1.0 % V.A.T. rate in those Member-States. The first two are said to be logically Community sources of finance since they arise from Community policies, and it is only chance that much of the revenue therefrom accrues to the Benelux countries due to entry of *European* imports at Rotterdam and Antwerp. The third is the chosen embryonic community tax system. At present, the Six are on the «own resources» system as regards tariffs and levies, but the V.A.T. element is held up due to non-agreement on a common base for the tax. The acceding Three will phase into the «own resources» system completely by 1980.

The expenditure side is dominated by the European Agricultural Guidance and Guarantee Fund to the extent of 72.4 %. Industrial, social and regional policies account only for an aggregate of 11.6 % of expenditure. Re-imbursement to Member-States is a provision to repay 10 % of «own resources» as a collection cost.

A potentially important distinction exists on the expenditure side between «obligatory» and «non-obligatory» expenditures. The former consists of items necessarily resulting from implementation of the Treaty of Rome and subsequent treaties, and includes the E.A.G.G.F. and development aid. «Non-obligatory» expenditure, over which the European Assembly has more power, includes the Social Fund, research and development, and administration; the category of the Regional Fund is in dispute.

The Commission has to calculate each year a permissible rate of increase in «non-obligatory» expenditure, as a check on the Assembly's power to expand

expenditure. For 1976, the limit was put at 15.3 % increase over 1975, though the apparent figure was over 16.0 %. The confusion lies in a dispute between Commission, Council and Assembly about the proper definition of «non-obligatory» expenditure.

3. The Distribution of Contributions to and Benefits from the Present Community Budget

Whilst later in time we may be more interested in the distribution of net contributions/receipts by region, income-class or social class, focus inevitably focusses at present on the Member-State distribution. This is the immediate policy issue of distributional questions; for example, the concern of the UK in the recent re-negotiation of membership.

Strong feeling exists in Member-States that contributions should bear a relationship to relative GNP in Gross Community Product. As a concept of equity, this is extremely narrow. It takes no account of benefits from the budget, whereby the net contribution/benefit of each member-state would be keyed to its degree of wealth. Further, it is based on a *nominal* rather than effective concept of the incidence or burden of the cost of the contribution. Again, the gross contributions are made *proportional* to relative wealth, rather than progressive, the latter principle accepted by all Member-States in their own internal tax systems.

Returning for the moment to gross contributions keyed to GNP, the discussion in the re-negotiations centred on the «overpayment» of some Member-States. This arises where the proportional share in financing the budget exceeds the proportional share of the member-states GNP in GCP. The «over payment ratio» (Gross contribution divided by GNP share times 100) was greatest for UK at 142 % and exceeded 100 % also for Netherlands (130 %) and Belgium (118 %).

For such contributions, a clawback is permitted under a complex scheme. Firstly, the GNP per head has to be below 85 % of the Community average, and the rate of growth of this below 120 % of the Community average. Then, a sliding scale comes into operation according to the degree of «overpayment». Finally, the ceiling for the clawback is £125 mn, or 3 % of the budget, or the size of a country's V.A.T. contribution.

Only UK, Italy and Ireland satisfied the first condition, but the latter two countries had little or no «overpayment». The UK was the only member which fell into both the «overpayment» and «under-average income» categories.

The UK's overpayment position is not surprising when one remembers the sources of finance for the budget, under the own resources system. If the V.A.T. were the only source, contributions would be proportional to consumption expenditures in the member-states, and thus varying from G.N.P. only by variations in the consumption/total income ratio in the various States.

It is the relative significance of customs duties and agricultural levies in each

member-state which gives rise to the problem, these reflecting differences in the levels of imports from non-E.E.C. sources. The UK of course, is historically a major importer of food and other products particularly from Commonwealth sources. The other States similarly affected by the own resources system, Netherlands and Belgium, reflect the entrepot role of Rotterdam and Antwerp.

Within the narrow confines of gross contribution equity, the UK could fairly claim to be suffering from the trick of the budget's «own resources» system. However,'the case is much less strong once the wider concepts of incidence and equity are allowed in.

Net equity takes account of both national contributions and benefits. The benefits side is complex, since it may involve simply official financial flows, for example, incoming receipts from the Regional and Social Funds and direct cash payments under the C.A.P. such as export subsidies to farmers. But also the farming community may be receiving benefits in the form of higher selling prices for agricultural produce where the price is kept up by intervention purchasing with E.A.G.G.E. funds.

Taking the simpler concept of direct cash benefits to public agencies or private individuals from the Community budget, each member-state will be in a net credit/debit account with the budget. These credit/debits will not necessarily sum to zero, because of use of funds in ways not directly benefitting member-state agencies or individuals-the loss on the intervention purchasing/disposal abroad programme of F.E.O.G.A; also administrative expenses in general.

However, these net credit/debit positions could be related to G.N.P. per head (now per head as a measure of relative wealth in the Community) on some principle of equity. For example, mean or median rank in wealthiness is made to correspond with a net balance in relation to the Community budget, relative poverty brings a net credit, above-average prosperity a net debit.

It is difficult to assess the U.K.'s standing in equity on such a principle. Having below average income per head, she would be entitled to a net receipt from the budget. This *is* her position in 1976. * Whether she is sufficiently so would depend on the exact nature of the net equity principle adopted; but it cannot be assumed that any inequity could necessarily be claimed if net rather than gross were in use.

Whether the question of equity between member-states in bearing the burden of Community budget operation be looked at from a gross or net point of view, a further sophistication lies in distinguishing nominal cash flows from actual or effective reductions/additions to real income. For example, if a country has to hand over customs duties imposed on foreign suppliers, but those duties have been borne by the foreigner in a reduction in his net receipts for his goods supplied,

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* Due to an unanticipater event, the steep decline of the market ratc of sterling whilst tqe Green Pount remaines at a fixed parity.

he and not anyone in the member-state has borne the contribution to the Community budget.

The assumption has been made in recent work that one-third of the burden of tariffs imposed by a country is borne by the foreigner. Remembering that the «over-payment» problem of the UK arises from the large amount to be paid over from the common external tariff and agricultural levies, not from the V.A.T., the problem would appear to be partly a bogus one if considered an excess charge on the citizens of the U.K However, this is not entirely the case since the charge on the foreigner via tariffs was previously kept by the U.K. government and is now surrendered.

This complicated controversy is removed, of course, if and as the V.A.T. contribution becomes the sole source of «own resources». But this could be surrounded by a further «equity» dispute. The V.A.T. falls on consumption expenditure not on investment, exports or government expenditure. It penalises the «high-spenders» so long as the spending is in the private sector.

The re-negotiation, instigated by the U.K., of budget contributions, was argued and concluded on a rather simplistic level. The U.K. was seemingly put to a disadvantage over the «own resources» system agreed by the Six before British membership. However, some of the «excess» payment was in fact borne by foreign producers, and further, the substitution of a net concept of equity on a rolling basis (so as to account for the development over time of programmes yielding benefits to the U.K.) would have weakened Britain's case. It might be said that the U.K. did well to substantiate «over-payment» and gain a relief.

But one further sophistication in the equity argument would have strengthened the U.K. case on a gross or net basis. The implied principle throughout is one of proportional taxation. If the progressive principle that is accepted in all member countries for internal direct taxation were to be allowed for inter-state taxation, the UK, as third-proorest of the Nine would be entitled to a much reduced contribution on a gross basis or a larger net receipt on a net basis.

4. The Short-Term Future of the Community Budget

A vital distinction exists between short-term and long-term perspectives for the Community budget. The distinction is a double one, involving a quantitative issue of financial resources, but also a qualitative one of the functional role of the Community budget in the European Community economy. We shall deal with the longer-term aspects in a subsequent section. Here we look at the position up to the early 1980's.

Estimates are recently available of foeecast expenditures and «own resource» revenues for 1978 (at 1975 prices) *. By then, the «own resource» system should be fully operational for the Six, whilst the Three will be in transition to it.

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* E. E. C. Document. Com-75-330.

These estimates show a potential «excess» of revenue, being 11,235 mn units of account over expected expenditure of 8,420 mn. units of account. In this situation, the V.A.T. source of revenue need only be taken up to the extent of Member-States paying over to Brussels the yield of a 0.55 % V.A.T.

This projected slack revenue may prove to be over-sanguine. It is predicated on a reduced real rate of expenditure on the C.A.P., and further, may not fully anticipate the steady real erosion of «own resources» from the Common External Tariff and the Agricultural Levies, which diminish respectively as more and more trade pacts are concluded with third countries and as Community agriculture is re-structured.

Further, the appetite for further discretionary expenditure may well grow rapidly on the part of the European Parliament as a directly-elected assembly becomes a reality.

Certainly, soon after 1978, it would seem that the budget will run into a veritable crisis as regards continued expansion, arising from the limitations on the sources of finances in the «own resources» system.

The two sources, the Common External Tariff and Agricultural Levies, are, as stated, more likely to diminish than expand, and can be disregarded as dynamic sources of finance for the 1980's.

The budget can only grow given substantial new tax revenues or deficit financing. The latter seems unlikely in view of lack of progress in monetary union, which would sustain the issue of Community bills of various kinds, and in view of the distaste of some powerful Member-States for budgetary financing of this kind.

All of the heat is therefore turned toward new tax revenues. The preestablished Community tax source is, of course, the V.A.T. The Community has thereby departed from the precedent of the U.S.A. with its federal income tax. From time-to-time, other tax sources have been discussed, principally a federal corporation tax. This remains of long-term interest, but hardly for the 1980's. It predicates a harmonisation of the law and administration of the taxation of companies in the nine Member-States, a mammoth task not yet begun. It also presupposes a relinquishment of the idea of equity between national contributions, since the size of the incorporated business sector relative to G.N.P. varies greatly from state to state. It awaits acceptance of the idea of a European tax levied irrespective of the location of taxable units, a very foreign idea at present.

No, the only prospect for increased tax revenues for the budget lies with the V.A.T., or earmarked taxes or levies or charges associated with newlyagreed programmes. We shall consider each of these in turn.

The advantages of the V.A.T. as a federal Community tax lie in its wide tax base, on the whole of private consumption expenditure, so that a few % rate brings in massive revenues. It is also said to be a «neutral» or non-distorting tax, but this appears rather bogus when government current and capital expenditure

and investment are all exempt (exports are taxed by the country of destination), and multi-rate systems influence expenditure and production between one sector and another. It was also claimed to improve tax administration and enforcement by the complex and detailed accounting it imposed on all traders, but different Member-States appear to have persisted in their pre-existing traditions of high compliance and severe enforcement - or the opposite.

The disadvantages of the V.A.T., a virtually unknown tax form before the emergence of the Community,* consist of defects per se-the aspects just referred to : discriminatory effects and the costly and onerous administration arising from trying to collect a tax from so many tax points. But of more interest here is the disadvantage, at least from the point of view of achieving expanding budget revenues, of the negative fiscal drag or less-than-unity tax elasticity of the V.A.T. V.A.T. is levied on private consumption expenditure, and for a start penalises those member-states with high private consumption/G.N.P. ratios. Perhaps this is no bad thing, but the rate of growth of private consumption seems unlikely to keep up with G.N.P. growth rate, if investment expenditure is to be more encouraged, and particularly if trends continue in the transfer of resource use from private to public sectors.

The negative, or at best neutral, fiscal drag of revenues from a fixed V.A.T. rate schedule contrast with the positive effect on revenue for the U.K. budget from the overall tax system, with a tax elasticity of about 1.2 (a figure of 1.4 for the personal income tax alone).

Irrespective of the fact that this implies a rate of growth of V.A.T. revenues for the Community budget less than proportional to G.C.P., which may or may not be considered a good thing from a political viewpoint, it poses a structural problem for the federal relation between Member-State and Community budgets. Parity between the Community and member-state budgets, in the sense of equal growth rates of each, or each remaining a constant proportion of G.C.P. and G.N.P., can only be achieved by agreement on everincreasing V.A.T. percentage rates for the Community budget, or steadily decreasing rates in member-state tax schedules-both politically difficult operations.

Putting this parity problem aside, we come to the more straightforward issues of the V.A.T. rate and the V.A.T. base for an expanded Community budget.

The present size of the Community budget is less than 1 % of G.C.P., roughly 1 % if the full permissible V.A.T. revenues if a 1 % yield were taken up. It is fairly easy to broadly estimate the V.A.T. revenue requirements of an expanded budget. A doubling of the budget to 2 % G.C.P. would add another $1\frac{1}{2}$ % to make a Community rate of $2\frac{1}{2}$ % (bearing in mind that the first tranche of finance in-

* The V. A. T. was recommendad aj the harmoised form of sales taxation for tbe Community by the Neumark Committee, set np by the E.E,C. and reporting in 1963.

cludes the common external tariff and agricultural levies, the second tranche consists only of V.A.T.). A Community budget of 5 % of G.C.P. would require a Community V.A.T. rate of 8 %, the current U.K. standard rate.

This poses the most critical problem in a stark way : is the Community V.A.T. to be a substitute for or an addition to Member-State V.A.T. rates. They surely have to be substitutes, and hence predicate the *transfer* of revenue and expenditure functions from member-state to Community public authorities. If at all politically credible by the early 80's, such an outcome certainly rests on parallel development of the European Parliament.

In preparation for a Community V.A.T., even the currently agreed 1 % provision, the member-states have to agree on a common tax base for the V.A.T. This is necessary to preserve a sense of equity between member-states, that they cannot diminish their liability by drawing the base narrower than do other states.

The draft Sixth Directive, which aims to finally harmonise the V.A.T. base, has been stymied for 2 to 3 years; by different states' insistence on excluding sensitive sectors.

The UK wishes to exempt food sales from the tax base, the Italian and Belgians seek a much bigger exemption for small business than the extremely low turnover limit proposed by the Commission. Germany is interested in differentiation of the tax treatment of land.

It appears certain that the Sixth Directive will only be able to go forward with these derogations allowed to different member-states.

They will nevertheless have to pay an amount to Brussels «as if» the given sectors were included not derogated from the V.A.T. base.

This is quite a break in the concept of a Community tax raised on a uniform basis on all citizens of the Community, e.g. U.K. consumers of food will be exempt from payment of a tax which other Community consumers have to pay.

That the member-state has to make a compensatory payment is a step back toward direct contributions : the private consumption (including imports) part of G.N.P. is being used as a key to determine the size of contributions. There seems no reason in logic why other national political and social considerations should not adapt the tax supposedly imposed equally on all like citizens of the Community, reducing the original idea of a Community tax to a mere accounting formula.

This a tendency which is only likely to be accentuated if much higher rates of «Community» V.A.T. are eventually used to finance an expanded Community budget.

The blame for this blighting of an ideal may seem to rest with the obstinacy of member-state governments. However, the opposite argument can be made : the Commission should never have chosen such a novel, complex and «bureaucratic» tax as the vehicle of tax harmonisation and Community budget finance. A tax with far fewer tax points, and simple in administration, would have been easier for many member-states to conform to.

In view of the clear difficulties of expanded finance for the Community budget

via the corporation tax and V.A.T., the idea of programmes with an integral tax element has been canvassed.

For example, expanded Social or Regional Fund ventures, aimed at re-training redundant workers in relatively depressed sectors or regions, could be financed from payroll taxes on firms in prosperous sectors or regions-on the argument that their good fortune had been accentuated by the existence of the E.E.C. as others had been disadvantaged.

Such schemes again run into the «augmentation» objection of higher Community V.A.T. rates. At a time when higher business investment is the clarion call in many member-states, higher business taxation over the next few years appears a non-starter. The alternative, Community schemes replacing national regional and unemployment policies, again runs the equally difficult obstacle course of the surrender of member-state sovereignty.

The resources obstacle to any substantial expansion of the Community budget, allowing development of non-agricultural policies, appear to be very great in the years to the early 80's. Already, paths involving corporation tax, increased V.A.T., integral expenditure-tax programmes, are equally stony. A fundamental political shift would appear to be required to allow the necessary transfer of powers. This may begin with the increase in authority of the European Parliament after direct elections, but a shift of power to that body and its executive is a substantial and lengthy political development after that.

5. The Long-Term Role of the Community Budget

The Community budget can be looked at as a book-keeping operation-accounting for the agreed expenditure programmes and their finance-or as an instrument of management of the Community economy. At present, in both size and concept, it can only be seen as the former. It may be premature to consider it in the latter light, except in one important respect. We have seen that the lines of expansion is still an open question-what expenditure role it should play or take over from member-states; what tax or other means of finance it should command. A consideration of the instrumental role of the budget in a more developed fiscal federal structure may illuminate now the incipient lines of extension of Community expenditures and taxes.

The rationale made in public finance literature for public provision rather than private provision of a good or service lies either in the unavoidable spill-over of some types of goods, requiring tax «pricing» rather than voluntary purchase, or that a society ethically demands more or less of a good than people would voluntarily consume. An example of the first, a «social» good, is the provision of nuclear defence; of the second, a so-called «merit» good, compulsory schooling to a given age.

The question arises : is there a Community public good? That is, do the above

concepts imply public provision on a Community scale rather than a member-state scale?

It is quite difficult to perceive Community public goods. The multinational character of defence provision is already met through N.A.T.O. The classic «pup-lic goods» of the U.S., Canadian and Australian federations-transconinental rail-ways, highways and postal services-are already highly developed and co-ordinatrd in Europe.

More scope may eventually be generated by the other type of «public good», merit goods. Common norms regarding education, health, environment may emerge and demand common public provision throughout the Community.

Other possibilities include large-scale, advanced, technological developments, e.g. aerospace or nuclear power, where capital provision and risk-taking is necessary on a scale impossible for private firms acting autonomously. These are not «public goods» in the classic sense, but depend on sheer magnitude for the justification for public provision.

There is a «welfare» and «productive» Community budget perceived dimly ahead. But there is a lack of immediate dynamic developments, such as railways, which helped found the great N. American economic federations.

There are two further functions of a budget, to redistribute real incomes between groups in the Community, and to assist in the achievement of macroeconomic goals for the Community and its constituent parts. These roles depend both on the expenditures and taxes in the budget.

Little idea of a redistributive role can be entertained at present, especially when it is remembered that member-states are insisting on «juste retour»-getting as much back from the budget as they put in. The Regional Fund is a commencement at redistribution between regions, but it is hamstrung by paucity of resources, constraints by national quotas, and a prejudice against failing regions by those who have to pay.

More scope may exist for a management role for the budget. As economic integration develops between member-states, in sense of increased imports and exports, increased capital mobility and the flow of technical ideas often though corporate integration, off-norm behaviour-higher than average inflation, higher than average unemployment-increasingly spreads into other member-state economies. Floating exchange-rates (which will not exist after monetary union anyway) hardly seem to correct the situation, large deficits/surpluses continuing to exist in the balances between member-states. Adjustment through Community policy instruments could become increasingly necessary.

What instruments would there be? After monetary union, there are no national monetary instruments. The Community may mandate changes in member-state fiscal instruments or exercise control through those in the Community budget. A flat-rate V.A.T. is hardly useful for the purpose. Even a variable-by-state rate is to return to a weapon mainly abandoned due to its direct priceincreasing effects.

The longer-run perspective of the Community budget by no means confirms the V.A.T. as the suitable tax means of finance, since it is weak as a redistributive tool, and rather outmoded as a stabilisation instrument. Either a payroll tax/subsidy scheme, perhaps confined to large corporations or expenditure taxes on a limited range of goods, like the old British purchase tax would be preferable.

Each of these has the advantage of being a limited-tax-point tax, and advantage which will be accentuated if and as Greece, Turkey, Portugal and Spain become full members.

In conclusion, we see that the problems of the Community budget are more serious on the resources side. On the expenditure side, the C.A.P. should steadily decline, but social, regional, and industrial programmes will be under pressure, given European parliamentary development, to grow at a faster rate than resources released from agricultural support. At the same time, non-tax revenues are likely to weaken. The pressure for increased tax revenue for the Community budget will be great. And as it grows, the budget will be evaluated for its macroeconomic impact on the economy. The V.A.T. is not a good form for a federal, instrumental tax. To find a more efficient and politically-feasible tax for the taks is a substantial future problem, if there is not to be an increasing retrogressive step back to direct member-state contributions.